FOR AGENDA

0451

EBS/90/213

CONFIDENTIAL

December 13, 1990

To: Members of the Executive Board

From: The Secretary

Subject: Papua New Guinea - Staff Report for the 1990 Article IV Consultation and Review Under the Stand-By Arrangement

Attached for consideration by the Executive Directors is the staff report for the 1990 Article IV consultation with Papua New Guinea and review under the stand-by arrangement, which is tentatively scheduled for discussion on Monday, January 7, 1991. A draft decision appears on page 20.

Mr. Browne (ext. 7329) or Mr. Schulz (ext. 7342) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

PAPUA NEW GUINEA

Staff Report for the 1990 Article IV Consultation and Review Under the Stand-by Arrangement

Prepared by the Asian and Exchange and Trade Relations Departments

(In consultation with the Fiscal Affairs, Legal and Treasurer's Departments)

Approved by Bruce Smith and Anupam Basu

December 12, 1990

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I. Introduction

A staff team visited Port Moresby during September 5-18, 1990 to conduct Article IV consultation discussions and review performance under the present stand-by arrangement; most meetings were held jointly with the World Bank structural adjustment loan review mission. 1/ The Papua New Guinea representatives included Finance Secretary Vele, Bank of Papua New Guinea Governor To Robert, and senior government, business, and trade union officials. The team met with Prime Minister Namaliu.

Papua New Guinea has accepted the obligations of Article VIII, Sections 2, 3, and 4 and maintains an exchange system that is free of restrictions for payments and transfers on current international transactions, other than a restriction on payments and transfers to Iraq and Kuwait pursuant to U.N. Security Council Resolution No. 661. The last Article IV consultation was completed in October 1988 and an interim staff report was circulated to Executive Directors in December 1989. Papua New Guinea was moved from the bicyclical procedure to the standard 12-month consultation cycle in April 1990.

The Executive Board approved on April 25, 1990 a 14-month stand-by arrangement for Papua New Guinea in an amount equivalent to SDR 26.36 million or 40 percent of quota and a request for compensatory financing under the compensatory and contingency financing facility in an amount equivalent to SDR 42.835 million or 65 percent of quota. 2/ As of October 31, 1990, Papua New Guinea's outstanding use of Fund credit was 65 percent of quota (Appendix Table 1). While all quantitative performance criteria for June and September have been met (Appendix Table 2), no drawings have been made under the stand-by arrangement and none is foreseen in view of the better than expected external reserve position.

The stand-by arrangement includes completion of a mid-term review as a performance criterion. This will also facilitate the continued disbursement of structural adjustment assistance from the World Bank and several other donors. The subjects of the review are the adequacy of the stabilization measures in light of the crisis in the North Solomons province, the world market prices for Papua New Guinea exports and

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1/ The staff team comprised Messrs. Browne (head), Schulz, Kibria, Ms. Sahay, and Mrs. Ellyn, staff assistant (all ASD). The Bank mission was led by Mr. Qureshi.

2/ The CCFF purchase was made in respect of a shortfall in earnings from merchandise exports calculated for the 12 months ended June 1990. On the basis of actual data now available for the shortfall year, the Executive Board has been notified that Papua New Guinea was not overcompensated and there is no expectation of an early repurchase (EBS/90/200, 11/26/90).

developments in concessional external assistance, and the progress achieved in key areas of structural reforms, including reductions in the size of the civil service.

In the attached letter and accompanying Memorandum on Economic and Financial Policies dated December 11, 1990, the authorities review the implementation of the program to date and describe the policies that are being adopted for 1991. They are requesting modification of the performance criteria under the stand-by arrangement on net credit to the Government for December 1990, because this year's budget deficit is expected to be slightly higher than programmed, and on net credit to the Government and net domestic assets of the banking system for March 1991, because of the need for government bank borrowing in the first quarter in view of the projected seasonal shortfall in budgetary revenue. As the review under the stand-by arrangement will not be completed until January 1991, a waiver of applicability of the December ceilings to the purchases that have become available is being requested to leave open the option of a purchase pending receipt of the necessary data.

II. Background to the Discussions

Papua New Guinea's economic performance improved during 1985-88, following a period of large financial imbalances (Chart 1). Real GDP growth averaged 4 percent, the inflation rate was held below 5 percent, the budget deficit was reduced to 1 percent of GDP, the public enterprise finances were satisfactory, and credit growth was curbed. Investment averaged 22 percent of GDP, of which two-thirds was financed by national savings. The external current account deficit was reduced to 7 percent of GDP, assisted by growth in gold and copper exports. External debt service declined to 15 percent of current receipts and official reserves rose to five months of nonmining imports.

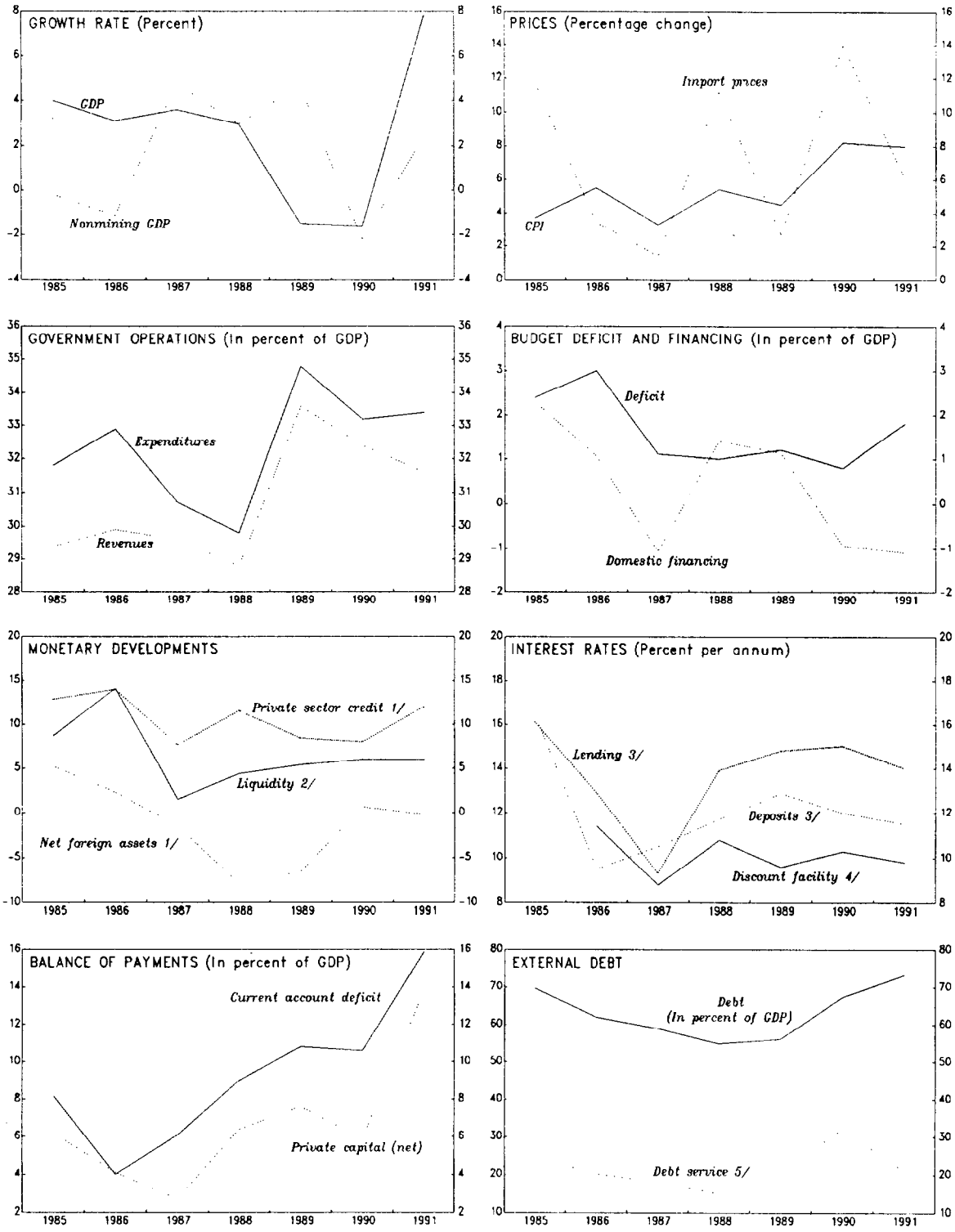
Much of the increased output stemmed from earlier investment in the mining sector. The development of the nonmining sector, which accounts for more than 80 percent of GDP and provides income and employment for the bulk of the population, continued to be hampered by inadequate social and economic infrastructure, high real wages, and shortages of manpower with management and technical skills. Unemployment increased, progress in poverty alleviation was limited, and the economy remained vulnerable to exogenous shocks.

The economic situation deteriorated dramatically in 1989 with the closure of the Bougainville copper and gold mine in the North Solomons province. The mine, which had accounted for 35 percent of exports and 15 percent of government revenue, was closed after attacks by armed groups seeking increased compensation for landowners and independence for the province. The downturn in activity was exacerbated by sharply lower export prices of coffee, cocoa, copra, and palm oil. The authorities reacted by cutting budgetary expenditure and limiting credit to the private sector. Real GDP declined by 1 1/2 percent, the external

CHART 1

PAPUA NEW GUINEA

SELECTED ECONOMIC INDICATORS, 1985-91



Sources: Data provided by the Papua New Guinea authorities; and staff estimates and projections.
1/ Contribution to liquidity growth.
2/ Percentage change.
3/ Weighted average.
4/ Bank of Papua New Guinea.
5/ In percent of external current receipts.

current account deficit increased to 11 percent of GDP, external debt service rose to 21 percent of current receipts, and official reserves fell to 4 1/2 months of nonmining imports.

The owners of the Bougainville mine decided in January 1990 that the mine should remain closed indefinitely. The economic outlook was further depressed by the continued weak agricultural export prices. This environment underscored the need to restore financial stability and develop a more broadly based economy. The Government, while seeking financial support from the Fund, the World Bank, the Asian Development Bank and bilateral donors, undertook adjustment measures, including a 10 percent depreciation of the kina in January 1990. Structural reforms were initiated, consistent with the observations of Executive Directors during the 1988 Article IV consultation, to raise agricultural productivity, reform the tax system, limit public expenditure, reduce the size of the civil service, enhance the role of the private sector, and increase flexibility in wage determination.

III. Report on the Discussions

The discussions focused on developments in 1990, especially in relation to the stand-by program targets; policies for 1991, including the budget and the monetary program; and the medium-term prospects for stimulating growth and employment in the nonmining economy, in light of the favorable outlook for mining and oil developments and the implementation of the structural reforms. The staff team agreed that the adjustment policies had been implemented successfully in 1990 and the original program objectives for 1991 remained appropriate.

1. The economy in 1990

a. Output and prices

Real GDP is estimated to have declined by about 1 1/2 percent, in contrast to the small increase that had been programmed (Appendix Table 3). Real GDP is estimated to have increased in the mining sector by 4 percent, primarily reflecting construction activity at the new Porgera gold mine, while declining by 2 percent in the nonmining sector. A sizable fall in government services has been in line with expectations, although private sector activity has been weaker than projected. The authorities commented that the impact of the cutbacks in public expenditure on private sector output had been underestimated. Mining investment had helped to boost investment to an estimated 25 percent of GDP. National savings had risen to 14 percent of GDP, well above the program target.

The rate of consumer price increase is estimated at 7 1/2 percent, below the range of 8-9 percent specified in the program. The authorities estimated that the 10 percent depreciation of the kina had added

3 percentage points to the index during the year. Increases in retail petroleum prices are estimated to add 0.5 percentage point to the index during the fourth quarter. These prices are subject to administrative control and the authorities have approved cumulative adjustments of 33 percent since August to fully reflect changes in import prices. They state that further changes in petroleum import costs would be passed on to consumers.

b. External developments

The external position has been stronger than programmed, mainly because of lower imports. The external current account deficit is estimated at 11 percent of GDP, well below the program target of 16 percent of GDP (Appendix Table 4). The estimated fall in the value of exports by 20 percent in SDR terms, broadly in line with the program, has reflected the disruption to mining and agricultural activity in the North Solomons province, lower gold prices and weak commodity prices. The estimated fall in the value of imports by 13 percent in SDR terms is more pronounced than programmed because of weak domestic demand and destocking in the private sector. The authorities also believe that the increased availability of domestic goods and services has reduced the imports associated with new mining projects. The oil import bill is estimated at SDR 115 million in 1990, equivalent to 11 percent of total imports compared with 9 percent of the total in 1989. The net deficit on services has been in line with the program. Net transfers have increased because of extra Australian budgetary support.

Capital inflow is estimated to be higher than in preceding years, although less than programmed. Net official capital inflow is estimated at 4 percent of GDP, as projected, with additional concessional aid partially offset by the repayment of commercial borrowing. Net private capital inflow is estimated at 6 percent of GDP, less than expected because of early repayments of private borrowing associated with the Ok Tedi mining project. This had temporarily raised external debt service to 32 percent of current receipts, although public sector debt service has remained at a moderate 9 percent of current receipts. The overall balance of payments deficit has been small and, with lower imports than projected, official reserves have risen slightly to five months of nonmining imports. Ceilings on the contracting or guaranteeing of external commercial debt and floors on the net foreign assets of the Bank of Papua New Guinea, which are specified as performance criteria under the stand-by arrangement, have been observed for June and September and are expected to be met for December.

The authorities explained that from June 1990 they had banned imports of matches and temperate fruits for protective reasons. The staff encouraged the authorities to eliminate these quantitative restrictions as soon as circumstances permit and rely instead on pricing measures, if required, to control imports of these items.

c. Public finance

Fiscal policy has been restrictive, in accordance with the program (Appendix Table 5). The 1990 budget contained new revenue measures to yield K 30 million (1 percent of GDP). The program was strengthened by the implementation of expenditure cuts of K 70 million (2.2 percent of GDP) that were agreed in April, including the initiation of a civil service retrenchment program that will yield substantial savings in future years. However, slight increases in expenditure on security were approved during the year. The overall deficit is estimated at K 33 million (1.1 percent of GDP), compared with the program target of K 7 million (0.2 percent of GDP). The authorities note that, taking account of expected external assistance, the Government would still reduce its net indebtedness to the domestic banking system. The impact on the budget of higher oil prices has been limited; the increased fuel costs were equivalent to about 0.5 percent of Government expenditure.

Revenue and grants are estimated at 32 percent of GDP, slightly above the program. This ratio is only 2 percent of GDP less than in 1989 although mining sector receipts have fallen by 3 percent of GDP because of the Bougainville mine closure. Tax revenue is estimated at 1 percent of GDP less than programmed mainly because of a shortfall in import duty collections. Apart from the lower import volume, the authorities explain that the average duty rate had declined because of reduced spending on motor vehicles and luxury consumer items. They expect that the programmed increases in income taxes and excise duties would be attained. Nontax revenue is estimated to exceed the program target by nearly 1 percent of GDP, mainly because of large receipts of road user fees from a mining company.

External grants are estimated at 7 percent of GDP, exceeding the program target by 1/2 percent of GDP because of additional Australian aid. The budget deficit excluding grants is estimated to increase to over 8 percent of GDP, 1 1/2 percentage point higher than programmed. The authorities recognize that this would not be consistent with the objective of strengthening the medium-term fiscal position, in view of the prospective decline in Australian support. However, the efforts that had been initiated to restructure public expenditure this year, focused on measures to reduce the administrative costs of the civil service, would generate additional savings over the medium term.

Expenditure is estimated at 33 percent of GDP, 1 1/2 percentage point higher than programmed, although less in relation to GDP than in 1989. Program targets have been met in all major areas of spending except defense, police, and correctional services. The authorities calculated that administrative expenditure has been reduced in real terms by 10 percent. The size of the civil service has been reduced by an estimated 3,000 persons (6 percent of the total), well above the program target, as a result of retrenchment, natural attrition, and a freeze on the filling of nonessential vacancies. The wage and salary bill has increased by only 4 percent, including retrenchment costs.

Purchases of goods and services have been severely constrained. Transfers to local governments have been raised in accordance with constitutional provisions, although savings had been achieved through the cutbacks in services for the North Solomons province.

The public investment program is estimated to have been maintained at 5 1/2 percent of GDP. The Government had worked with the World Bank to prioritize projects; key outlays for agriculture, infrastructure, social services and the environment had been safeguarded from budgetary cuts. However, the authorities regretted their failure to raise maintenance works as programmed, owing to implementation constraints as well as the tight overall resource position. Budgetary lending to the public enterprises had been curtailed. The electricity and telephone corporations had benefited from price adjustments in late 1989.

d. Money and credit

Monetary policy has been geared toward inflation and external objectives, while also aiming to allow sufficient credit growth for the nonmining private sector (Appendix Table 6). Total liquidity is estimated to increase by 6 percent; the program had envisaged a decline of 5 1/2 percent but, with the strength of the external position, net external assets increased rather than declining as had been forecast. The authorities noted that, despite the larger than foreseen increase in liquidity, real money balances would decline. Domestic credit is estimated to increase by 3 percent, about in line with the program. Ceilings on the net domestic assets of the banking system and net credit to the Government, which are specified as performance criteria under the stand-by arrangement, have been observed in June and September. The ceiling on net domestic assets is expected to be observed in December, but the ceiling on net credit to the Government is not expected to be met because of the larger fiscal deficit.

Net credit to the Government is estimated to decline during the year by K 13 million or 0.4 percent of GDP, compared with the envisaged decline in the program of K 64 million or 2 percent of GDP (Appendix Table 7). Net external borrowing would be K 25 million less than envisaged, reflecting delays in concessional aid disbursements and early repayment of commercial loans. The program ceiling is automatically adjustable to the extent of any shortfall in external financing. The budget deficit is estimated to be K 26 million higher than programmed. As a result of these developments, net credit to Government is projected at K 65 million at end-December 1990, compared with K 14 million envisaged under the program. The authorities are requesting a corresponding modification of the ceiling, which could be accommodated within the net domestic assets ceiling because of the depressed private credit demand. In these circumstances, they believe that the increase in credit to the Government would not have an inflationary impact.

Private sector credit is estimated to increase by 5 percent, which is below the program target of 11 percent. Lending had been reduced in January-February because of tight bank liquidity, prompting the authorities to reduce the minimum liquid asset requirement by 1 percentage point to 11 percent in March. Credit demand remained weak and the commercial banks appeared cautious in lending because of the losses incurred in the North Solomons province. Bank term deposit rates averaged 13 percent and lending rates averaged 16 percent in January-August. The authorities explained that to facilitate a reduction in interest rates and promote private sector lending, yields on 182-day treasury bills had been reduced by 2 1/2 percentage points to 10.5 percent since September. Consequently, the interest rate differential in favor of Australia, which had been reduced over the preceding year as a result of the increase in rates in Papua New Guinea and the fall in rates in Australia, widened again. However, the authorities noted that key interest rates remain substantially positive in real terms. The staff team supported the efforts to encourage the banks to expand private sector lending, while observing the program ceiling on the net domestic assets of the banking system.

e. Agricultural commodity stabilization funds

The Government has provided credit to the stabilization funds to help maintain rural incomes in the face of falling agricultural export prices. This assistance has been phased down in accordance with the medium-term objective of aligning domestic and international prices and reducing the burden on the budget and the banking system. A reformed system was introduced for the cocoa industry in January 1990 that will eliminate subsidies over a three-year period; payments were reduced by a total of 30 percent in April and October 1990, as scheduled. Studies are being carried out with the assistance of the Asian Development Bank, under the agricultural sector loan, to facilitate the implementation of similar schemes for the coffee, copra, and palm oil industries.

Credit to the stabilization funds is estimated at K 27 million in 1990, well below the limit of K 40 million that is specified as a performance criteria under the stand-by arrangement. Support for the cocoa industry of K 15 million has been less than expected because of lower sales from the North Solomons province and some recovery in world market prices. Support for the copra industry of K 10 million has been higher than expected because of depressed world market prices. The palm oil industry has received modest support. The coffee fund had sufficient reserves to meet the needs of the industry although these have now been almost fully depleted. The authorities reiterated that financial assistance is granted solely through government-guaranteed bank loans and that no budgetary subsidies are being provided.

f. Wages policy

The Minimum Wages Board determination for the three-year period 1989-91 provided that minimum wage earners should receive full compensation for consumer price increases of up to 6 percent, no compensation for increases between 6 and 10 percent and half compensation for increases between 10 and 15 percent. In accordance with this determination, minimum wages have been raised by 6 percent this year. In view of the Government's decision that the award should not flow to all workers, as in the past, agreement was reached with the public sector trade unions to limit nominal wage increases to an average of 4 1/2 percent for civil servants earning above the minimum level. The authorities observed that these arrangements have contained the increase in public sector wages to well below the rate of inflation.

Data on private sector wage developments are incomplete, but the capacity to grant increases has been limited by reduced farm and business incomes and the authorities believe that real wages have declined in rural and urban areas. The staff team stressed the benefits of flexibility in the labor market in terms of the ability to maintain higher levels of employment in the nonmining private sector. The authorities commented that wage restraint, combined with tight financial policies, has enabled the gains in competitiveness achieved from the exchange rate depreciation in early 1990 to be maintained.

2. The outlook for 1991

a. Growth and inflation

Real GDP growth is projected at 8 percent, with real GDP in the mining sector increasing by 55 percent, reflecting the construction of the Kutubu oil project. The Bougainville mine is expected to remain closed, although peace negotiations with the rebel forces are continuing. Real GDP in the nonmining sector would increase by 3 percent, despite a further contraction in government services. Investment is projected to rise to 31 percent of GDP, with most of the increase financed by an inflow of foreign savings. National savings would rise slightly to 15 percent of GDP.

The annual average rate of consumer price increase is forecast at 8 percent, about unchanged from 1990. The authorities expect that the adjustments of retail petroleum prices to reflect import costs would add 1 1/2 percentage points to the index during 1991, based on their assumption of a world crude oil price of $30 per barrel. However, with the impact of the 1990 depreciation and oil price increases having been fully passed through, the rate of inflation is expected to decelerate over the course of the year to 6 percent by December.

b. The balance of payments

The external current account deficit is expected to widen to 16 percent of GDP. The value of exports would increase by 17 percent in SDR terms, with rising gold exports reflecting production from a major new mine. Nonmining exports would increase only modestly in value terms, because of continued low prices and the sustained loss of North Solomons production. The value of imports would increase by 22 percent, with rapid growth in imports for mine construction; other imports would rise in line with the expected rate of growth of nonmining activity. The petroleum import bill is estimated at SDR 160 million, equivalent to 13 percent of total imports, on the basis of an average oil price of $30 per barrel. The increase in the oil import bill is equivalent to 1 1/2 percent of GDP. Service payments would increase because of the improved profitability of the mining sector; external grants are likely to remain about unchanged.

Reflecting the rise in mining investment and imports, capital inflow is projected to be sharply higher. Net private capital inflow is estimated at 14 percent of GDP, the bulk of which is associated with mining developments. Net official capital inflow is forecast at only 1 percent of GDP, taking account of continued sizable repayments of commercial borrowing. Gross inflows of concessional aid are estimated at 4 percent of GDP, including structural adjustment assistance from multilateral and bilateral donors. Strict limits would continue to be observed on new commercial borrowing, in accordance with commitments under the stand-by arrangement. External debt service is projected to decline to 21 percent of current receipts, with public sector debt service remaining at 9 percent of current receipts. Official reserves would decline slightly to 4 1/2 months of nonmining imports. The authorities commented that reserves would be well above the March 1991 floor specified as a performance criterion under the stand-by arrangement and would remain adequate to meet contingencies arising from the volatility of export prices, allow continuation of structural reform, and permit the timely servicing of external debt.

c. Fiscal policy

While the overall budget deficit will be somewhat higher in 1991, the underlying fiscal position is being strengthened. The budget for 1991 contained new revenue measures to yield K 20 million (0.6 percent of GDP), somewhat less than the original program commitment of K 30 million. In view of this, the growth of expenditure has again been constrained, including the further retrenchment of civil servants. The increase in the budget deficit to K 60 million (1.8 percent of GDP) primarily reflects the special intervention program of K 30 million (0.9 percent of GDP), financed by external assistance that is designed to alleviate the social costs of adjustment. In the absence of this program, the overall deficit would have fallen to below 1 percent of GDP, and the overall deficit excluding grants would have been reduced to

8 percent of GDP. A substantial further reduction in Government net indebtedness to the banking system is programmed. The authorities stated that any unforeseen additional budgetary expenditure would be met by compensating revenue measures or further cuts in administrative expenditure.

Revenue and grants are projected at 31 1/2 percent of GDP, unchanged from 1990. Tax revenue is projected to increase by nearly 1 percent of GDP. New measures include a 3 percent excise duty on manufactures, a change in the basis of import duties from an f.o.b. to a c.i.f. basis and tighter income taxation of fringe benefits. Tax administration and collection efforts would be strengthened. The average import duty would decline because of the increased share in imports of mining equipment, which bear low duty rates. Import duty on inputs for the agricultural, industrial and tourism sectors would be reduced from 5 percent to zero to encourage private sector development. Nontax revenue would decline by nearly 1 percent of GDP. External grants are expected to remain unchanged in relation to GDP.

Expenditure is projected at 33 percent of GDP, almost unchanged from 1990. Administrative expenditure is estimated to decline by 4 percent in real terms. The size of the civil service would fall by 3 percent because of the continued hiring freeze, the encouragement of early retirement, and further retrenchment under the civil service reform program. The increase in the wage and salary bill is expected to be limited to 3 percent. Purchases of goods and services would continue to be restrained, including measures to curb government fuel consumption. Transfers to local governments would rise in accordance with constitutional provisions, as well as the payment of support grants under new mining agreements. Spending on maintenance works is budgeted to rise by one third. The public investment program, including special intervention projects, will rise to nearly 7 percent of GDP, with increased spending on infrastructure, agriculture, health and education services. These changes in the structure of expenditure are consistent with the program agreed with the World Bank.

Prices of public enterprises are being kept under review, but the authorities state that, in view of present inflationary trends, emphasis is placed on cost containment, including wide-ranging structural reforms. However, the finances of the airline and the electricity corporation would be adversely affected by the recent oil price increases. The staff team urged that price adjustments commensurate with cost increases be implemented in order to maintain the profitability of these corporations in particular.

d. Monetary policy and commodity funds

The monetary program is consistent with the price and balance of payments targets while seeking to accommodate expected faster growth in private sector credit demand. Total liquidity is estimated to increase

by 6 percent, about the same as in 1990, although less than the expected growth in nonmining sector income. Consequently, monetary conditions will remain tight and, despite the effect of the oil price shock, the increase in the consumer price index will be limited to only 1 additional percentage point beyond the original target. Consistent with this stance, domestic credit is projected to increase by 7 1/2 percent. Net credit to the Government is programmed to decline by K 38 million (1.2 percent of GDP), substantially more than in 1990, reflecting the continued fiscal restraint. Private sector credit is projected to increase by 12 percent, faster than in 1990 because of the expected recovery in activity.

An increase in net credit to the Government of K 25 million in the first quarter has been programmed (from the higher ceiling that is proposed for end-December 1990 to allow for the shortfall in external financing and the larger budget deficit) because of the large seasonal shortfall in revenue. The authorities note that this allowance is substantially less than the actual seasonality exhibited in 1990, which demonstrates the prudence of the program. However, since no recourse by the Government to the domestic banking system had been envisaged in this period under the original program, the authorities are requesting a modification of the ceiling under the stand-by arrangement on net credit to the Government for March 1991 and a commensurate change in the ceiling on net domestic assets of the banking system. The staff believes that this adjustment would be appropriate and in line with the proposed fiscal policy stance. As in the original program, the ceiling would be adjusted to the extent that net external financing in the first quarter exceeds or falls short of the projected net inflow of K 45 million. Indicative targets on net credit to the Government have been agreed with the authorities for the subsequent quarters of 1991.

The authorities would continue to support the commodity stabilization funds through commercial bank loans using the proceeds from the European Community STABEX grants. While efforts would be made to reduce the extension of credit, the authorities have not yet decided on targets for next year. The coffee and copra funds would need to be replenished, but assistance to the cocoa scheme was expected to be reduced in view of the prospective upward trend in world prices and the implementation of the reform program. The staff team urged the avoidance of delays in the restructuring of the coffee, copra, and palm oil funds and, in the meantime, close monitoring of their bank borrowing.

e. Wages policy

The policy of wage restraint is being maintained to consolidate the recent improvements in competitiveness. Under existing agreements, minimum wages are expected to be increased by 6 percent during the year, with most civil servants receiving smaller percentage increases. Influenced by developments in the public sector, wage increases in the private sector are expected to remain moderate. The overall decline in

real wages is projected at 2-3 percent. The authorities expect that the weakening of the link between wage and price increases, in combination with restrained financial policies and structural reforms, would lower production costs, raise productivity and contribute to the strengthening of the traded goods sector. They stressed that pressures to renegotiate the minimum wage agreement would be resisted. The trade unions are expected to cooperate in holding down wage demands in the context of the Government's plan to alleviate the social costs of adjustment.

f. Exchange rate policy

The exchange value of the kina is pegged to a weighted basket of currencies representing Papua New Guinea's main trading partners, with the Australian dollar, Japanese yen, and the United States dollar comprising about two thirds of the total weights. During 1985-87, this policy combined with tight financial policies yielded some improvement in the competitiveness of the economy, as measured by the real effective exchange rate index (Chart 2). During 1988-89, the kina remained relatively stable against the major currencies in the basket (Appendix Table 8). However, the nominal effective exchange rate appreciated mainly because of depreciations in partner and competitor countries. 1/ Consequently, there was some weakening of competitiveness of the economy, despite the continuation of prudent financial policies which held the rate of inflation to less than 5 percent in Papua New Guinea.

The authorities depreciated the value of the kina by 10 percent against the basket of currencies in January 1990, because in addition to the appreciation of the real effective exchange rate, the terms of trade deteriorated due to a sharp decline in agricultural export prices in 1988-89. The real effective exchange rate index has subsequently remained at close to its post-devaluation level, about 8 percent less than the average level recorded in 1989. The exchange rate action was combined with a package of demand management measures, including fiscal, monetary, and wage restraint that had already been implemented to strengthen competitiveness. Despite the openness of the economy, with imported goods having a weight of 50 percent in the consumer price index, the tight policies helped to limit the impact of the depreciation on domestic prices to an estimated 3 percent during 1990.

The authorities stated their intention to maintain the value of the kina stable in relation to the basket peg during 1991. They would rely on wage restraint, structural reforms, and tight financial policies to safeguard competitiveness. Papua New Guinea's inflation rate had risen to 8 percent in 1990-91, well above the average recorded during the second half of the 1980s, because of the higher component of imported inflation from the recent depreciation and the oil price increase, as

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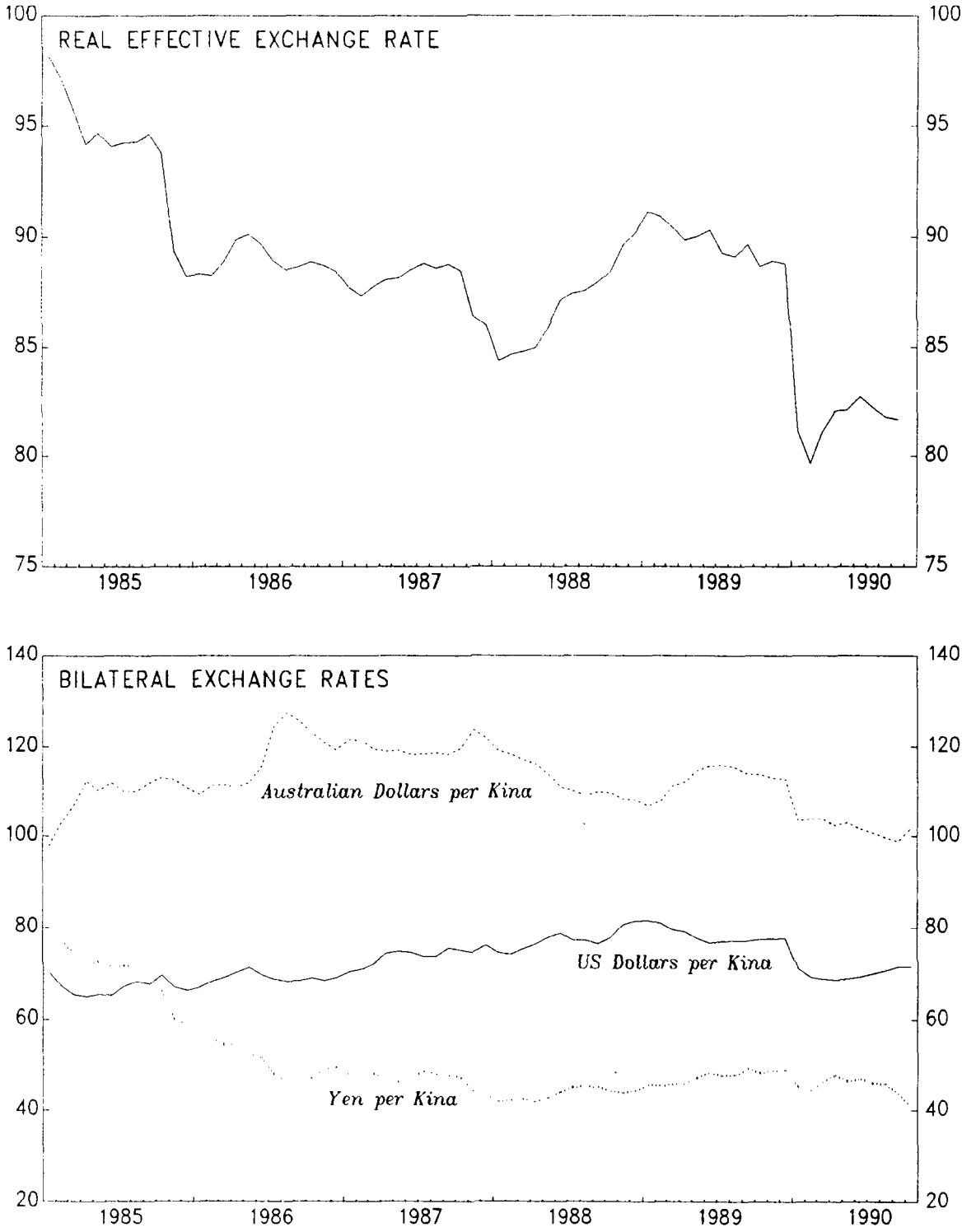
1/ This index includes a broader group of partner trading countries than the countries in the basket peg.

CHART 2

PAPUA NEW GUINEA

EXCHANGE RATE INDICES, 1985-90

(1980=100)



Sources: IMF, Information Notice System and International Financial Statistics; and staff estimates and projections.

compared with inflation from domestic sources. However, the present policy stance was expected to secure an inflation rate that was in line or below the weighted average of the countries in the basket in the course of 1991. The present level of international reserves was adequate to support this strategy and official external commercial borrowing was not envisaged. While competitiveness should be kept under review, particularly in relation to the objective of diversifying the economy over the medium term, the staff agreed with the authorities that a further depreciation of the kina did not seem warranted at this time.

3. Medium-term prospects and structural policies

a. External outlook and capacity to repay the Fund

The medium-term balance of payments outlook remains favorable, even were the Bougainville mine to remain permanently closed as assumed in the projections. The development of other oil and mining projects has not been adversely affected by the North Solomons situation. As a result, strong growth in mining exports is expected for the next several years. However, the authorities confirm this has not diminished the need to strengthen and diversify the nonmining sector and thereby generate employment and achieve faster progress in poverty alleviation. If the structural reform program is carried forward as envisaged, they consider that real GDP growth of 4-5 percent appears sustainable, including nonmining real GDP growth of 3-4 percent. Staff projections indicate that investment would decline from 31 percent of GDP in 1991 to 22 percent of GDP in 1995. National savings would rise to 19 percent of GDP during this period, reflecting the strengthening of the underlying fiscal position and the increase in private sector incomes.

The external current account deficit is projected to fall to 3 percent of GDP in 1995, on the basis of existing proposals for the development of mining and oil resources (Appendix Table 9). The projected deficit for 1992-93 is smaller than previously expected, reflecting a 50 percent increase in the volume of mining exports, including oil exports from the Kutubu field. Net oil exports would be equivalent to 80 percent of domestic production and 15 percent of total exports in 1995. The volume of nonmining exports are assumed to increase by 3 percent annually, assisted by reforms to raise productivity and reduce costs in the agricultural sector.

Mining imports are expected to rise to 44 percent of total imports in 1992, as oil field construction reaches a peak, before declining to 24 percent of the total in 1995. The authorities expected that foreign exchange resources would support volume growth in nonmining imports of 3-4 percent annually, in line with the growth in nonmining activity. The improvement in the trade balance would be partially offset by higher service payments by the mining sector and declining Australian budgetary grants. These projections assume that no major new mining projects are initiated before 1995, although with the present level of exploration activity, further mineral resources may be discovered.

The overall balance of payments is expected to record surpluses from 1992 onwards, despite substantially smaller capital inflow than in recent years. Net official capital inflow is projected at 1 percent of GDP, with concessional aid for the public investment program partly offset by continued repayments of commercial loans. Net private capital inflow is projected to decline to 4 percent of GDP in 1995, as net repayments are made by the mining sector, with the completion of major mining projects. Net inflow to the nonmining sector is expected to rise from 3 percent of GDP in 1992 to 5 percent of GDP assisted by the structural reforms that are envisaged to stimulate foreign investment. With these assumptions, the authorities should be able to meet their objective of maintaining official reserves at about five months of nonmining imports.

External debt would fall from 70 percent of GDP in 1992 to 48 percent of GDP in 1995, reflecting the large repayment of mining sector debt. External debt service would fall to 16 percent of current receipts in 1995, with public sector debt service stabilizing at 5 percent of current receipts. In the absence of further drawings, debt service to the Fund would reach a peak of only 1 percent of current receipts and 6 percent of total debt service. With the favorable medium-term external prospects and the authorities' firm commitment to strengthening the adjustment effort if circumstances require, Papua New Guinea is expected to continue to discharge its financial obligations to the Fund in a timely manner.

The projections are sensitive to assumptions regarding mining sector developments. If the Bougainville mine were to reopen, mining exports would increase more rapidly and, despite higher imports and service payments, the external current account deficit would be eliminated earlier and the overall balance of payments would be strengthened. On the other hand, the authorities recognized that unfavorable mining developments would reduce the availability of financing for the nonmining sector, and necessitate a more cautious and restrained financial program to preserve external viability. Total exports would be reduced by 1 percent of GDP if either copper prices were $0.10 per pound lower or the gold price was $20 per ounce lower than forecast. Oil export volume projections are based on detailed feasibility studies that have been completed by the operating companies and price projections correspond to those being adopted in the latest Fund World Economic Outlook exercise. It seems unlikely that unforeseen developments in the oil sector would deviate from the baseline projections to such an extent that trends in the external outlook would be fundamentally altered.

b. Structural reforms in the fiscal area

The medium-term fiscal objective is to maintain budgetary balance, while implementing policies that are conducive to private sector growth and poverty alleviation. A Structural Adjustment Committee, with

high-level representatives of policy-making departments, was established in August 1990 to monitor progress in these areas. Tax reform measures initiated in the 1991 budget aim at broadening the tax base and reorienting indirect taxation toward consumption. Further steps are envisaged to generate additional revenue from the mining sector, shift the burden of taxation from direct to indirect taxes, and collect income tax arrears.

The authorities are placing strict controls on administrative costs to improve the management of public outlays. Following the reduction in civil service employment, departments and agencies are being reorganized to ensure that manpower allocations accord with development priorities, in conjunction with the extension of program budgeting to all departments, for which Fund technical assistance has been provided. The finances of the public enterprises are being monitored closely and administered prices would be adjusted regularly in light of reviews of the cost-price situation. Commercialization of public services, including the Government Printing Office and the National Statistical Office, is being carried out in accordance with a timetable established in April 1990. A list of public enterprises to be privatized is being finalized; the Government's inter-island shipping fleet has been sold and sales of the Government shareholdings in forest product and marine enterprises are well advanced.

The authorities state that spending is to be increased in real terms over the medium term on the public investment program, operations and maintenance and the social sectors, in accordance with commitments to the World Bank. Development of infrastructure is expected to help reduce private sector transportation and other industrial costs. Efforts are being made to strengthen project preparation and implementation capacity. A special intervention program to alleviate the social costs of adjustment is being initiated, with donor support, which comprises fast disbursing projects that are ready for implementation and able to generate employment selected from the public investment program in the social sectors.

c. Structural reforms in the private sector

Measures to promote private investment through liberalizing the regulatory framework were announced in June 1990. A Government Regulations Advisory Committee, chaired by the Governor of the Bank of Papua New Guinea with high-level Government and private sector representatives, is advising on possible means to promote new industrial enterprises, reduce obstacles to foreign private investment, clarify procedures for the entry and employment of foreign nationals in Papua New Guinea and encourage training and localization. Legislation is being introduced to replace the National Investment and Development Agency with an Investment Promotion Authority, which will shift the focus from regulatory to promotional activities.

The authorities are conscious that an efficient financial system is needed to support reforms in other parts of the economy. Fund technical assistance is envisaged in early 1991 to assess the scope for more market-oriented monetary management, including the greater use of open market operations. Improvements in rural credit facilities are planned, following an assessment of the performance and role of the Agricultural Bank. In the meantime, in view of the difficulty of controlling the monetary aggregates because of the open and volatile nature of the economy, the authorities plan to continue setting indicative annual targets for the growth of nonmining private sector credit that are consistent with a sustainable rate of real growth.

Wage policy will continue to aim at reducing real wages, easing rigidities in the labor market and broadening the scope for productivity-based wage agreements. Efforts will be strengthened to improve the skills of the labor force. The authorities explain that a major objective was to reduce the cost structure and improve relative profitability in a manner that would promote a shift of resources toward the processing of agricultural and forestry resources for export, production for the domestic market in sectors that could compete efficiently with imports and the development of tourism.

d. Environmental issues

Commercial mining and logging operations are major environmental concerns. Copper and gold mining has caused environmental damage through mining waste and chemical discharge that threaten forest lands and river systems. The Government has incorporated stricter and more comprehensive controls in new mining agreements and improved procedures have also been agreed with respect to certain existing mining operations. Liaison offices are being established at major mining sites in order to strengthen the monitoring of the environmental impact of mining operations. Uncontrolled logging and the absence of reforestation has been threatening the sustainability of forestry resources. Export taxes on timber were raised to 15 percent and a two-year moratorium was placed on the issuance of new logging licenses in 1990, which have reduced recent and projected exports of logs. Under the Tropical Forestry Action Plan, which is supported by the World Bank, a task force has been established to deal with the immediate problems of environmental degradation from logging. Budgetary allocations for environmental policies were largely protected from recent expenditure cuts and increases have been budgeted for 1991.

e. Social impact of adjustment

The adjustment program has been felt particularly by wage and salary earners whose incomes have declined in real terms and public employees who have lost their jobs. However, the Government has offered generous settlement packages and retraining programs to displaced employees. In the rural sector, where most of the poorest segment of

the population reside, there are benefits from the improved competitiveness of agricultural exports as a result of the depreciation of the kina. Programs aimed at disadvantaged groups have been largely protected from budgetary cuts and further assistance to the poor will be provided under the Special Intervention Program. This program includes projects in housing, the improvement of health facilities, small industrial development and the rehabilitation of roads and water supplies. Concessional assistance for these activities has been arranged with the World Bank and other donors. Over the medium term, the adjustment effort should contribute to a more even income distribution, primarily by means of lower real wages and increased employment, and the redirection of public spending toward human resource development.

IV. Staff Appraisal

The Government has been implementing successfully a program of financial stabilization and structural reforms in response to the severe shocks stemming from the closure of the Bougainville mining operations and low world market prices for major agricultural exports. The authorities intend to maintain the present policy stance in 1991 and beyond. Their commitment to the adjustment effort should ensure that foreign investors retain confidence in the mining sector and should promote more rapid development in the nonmining sector.

In 1990, while real GDP has declined and the rate of inflation has increased, the external position has been stronger than initially envisaged. With lower imports, the current account deficit has been well below the program target, private capital inflow and concessional aid have been substantial and gross reserves have risen to five months of nonmining imports. Tight financial policies and wage restraint have preserved the gains in competitiveness from the depreciation of the kina earlier this year. The Government has adjusted retail petroleum prices to fully reflect changes in world oil prices.

In 1991, real GDP growth is expected to resume. Higher oil import costs will raise consumer prices, but the rate of inflation is expected to moderate over the coming year. While the external current account deficit is projected to widen partly because of the higher oil import bill, substantial capital inflow is expected, especially for the mining sector. Present fiscal, monetary, wage and exchange rate policies are consistent with the maintenance of external viability.

Although the budget deficit will be higher in 1991, the underlying fiscal position will be strengthened by cuts in administrative costs, including a notable reduction in the size of the civil service. This restraint in the growth of low priority budgetary expenditure is appropriate from the point of view of short-term stabilization and the longer-term restructuring of the economy. It is also facilitating a change in the composition of expenditure toward public investment,

maintenance spending and social programs, which accords with development objectives. Further efforts should be pursued to redirect public spending toward the promotion of private sector growth and human resource development and thereby help strengthen the nonmining economy.

Fiscal policy also needs to aim at strengthening the tax system, public enterprise finances and the agricultural commodity funds. Building on the reforms that have been initiated in the 1991 budget, further measures to broaden the tax base and enhance tax collection are desirable to improve the equity and efficiency of the tax system. Price adjustments are required to sustain public enterprise profitability, particularly in view of higher fuel costs, in addition to efforts that are being made to contain costs. The rationalization scheme that is being applied to the cocoa stabilization fund should be extended to the coffee, copra and palm oil funds so that they do not impose an unsustainable burden on the public finances. These actions would limit the use of bank credit by the public sector and permit the availability of sufficient credit to promote private sector growth.

Although Government repayments to the banking system would be somewhat less than originally programmed in 1990 and 1991, overall financial policies are sufficiently restrained to contain the rate of inflation within the program target, despite higher oil prices and meet the external objectives by a wide margin. The monetary program envisages that real money balances would decline again, implying that monetary conditions will remain tight. The staff, therefore, proposes modification of the December 1990 and March 1991 ceilings on net credit to the Government and of the March 1991 ceiling on the net domestic assets of the banking system. These modifications will not impede the achievement of the objective of the original program of encouraging faster nonmining private sector growth. Interest rates will have to remain substantially positive in real terms to mobilize deposits and encourage the efficient allocation of financial resources.

More flexible arrangements for wage determination that have been adopted in 1990-91, including the reduced reliance on the indexation of wages for price changes, are helping to lower real wages, which is essential for raising profitability in the traded goods sector. These actions need to be accompanied by structural reforms to raise productivity and stimulate employment in the nonmining sector, including the liberalization of the regulations for domestic and foreign investors and measures to improve the efficiency of the financial system. With these policies, the authorities' intention to maintain the nominal exchange value of the kina in relation to a currency basket peg is appropriate to help moderate price pressures and safeguard competitiveness. In the absence of unusually severe exogenous shocks, official reserves are adequate to meet contingencies arising from the volatility of export earnings and the servicing of external debt in a timely manner, including financial obligations to the Fund. However, if the desired

cuts in real wages are not forthcoming, the authorities will need to strengthen the adjustment effort to protect the external position.

Import bans have been imposed from June 1990 on matches and temperate fruits. While these restrictions are being justified on grounds of domestic protection, the staff encourages the authorities to rely on tariffs rather than quantitative restrictions.

The policies and measures described in the Government's Memorandum of Economic and Financial Policies for 1990-91 constitute an appropriate response to the prevailing macroeconomic imbalances. Accordingly, the staff recommends completion of the mid-term review under the present stand-by arrangement. While no drawings have been made and none are planned, satisfactory performance facilitates the disbursement of concessional assistance. Such aid will continue to be required for the next several years to help finance the infrastructural and structural programs, including measures to alleviate the social costs of adjustment that are essential to develop a more broadly based economy and improve living standards. If the comprehensive reform effort outlined above is pursued vigorously, possibly within the context of another Fund-supported program, further strong donor support would be warranted.

It is recommended that Papua New Guinea should remain on the standard 12-month consultation cycle.

V. Proposed Decision

The following draft decision is proposed for adoption by the Executive Board:

Review Under Stand-By Arrangement

1. Papua New Guinea has consulted with the Fund in accordance with paragraph 4(b) of the stand-by arrangement for Papua New Guinea (EBS/90/61).

2. The letter and attached memorandum from the Minister of Finance and Planning and the Governor of the Bank of Papua New Guinea dated December 11, 1990 shall be attached to the stand-by arrangement for Papua New Guinea and the letter and attached memorandum dated March 23, 1990 from the Minister of Finance and Planning and the Governor of the Bank of Papua New Guinea shall be read as supplemented and modified by the letter dated December 10, 1990.

3. Accordingly, the limits referred to in paragraph 4(a)(i) and (ii) on net credit to the Government of the banking system for the end of 1990 and the end of March 1991 and net domestic assets of the domestic banking system for the end of March 1991 shall be as specified in the table attached to Annex I of EBS/90/213.

4. The Fund decides that the review contemplated in paragraph 4(b) of the arrangement is completed and that, notwithstanding Paragraph 4(a) of the arrangement, Papua New Guinea may proceed to purchase up to the equivalent of SDR 20.5 million.

Table 1. Papua New Guinea: Fund Position, 1990-91

	Outstanding	Amounts drawn or available				
	April 25 1990	April-June 1990	July-Sept. 1990	Oct.-Dec. 1990	Jan.-March 1991	April-June 1991
		(In millions of SDRs)				
Available under tranche policies (net)						
Purchases 1/		17.00	1.00	2.50	2.75	3.11
Repurchases		--	--	--	--	--
Transactions under special facilities (net) 2/						
Purchases		42.84	--	--	--	--
Repurchases		--	--	--	--	--
		(In millions of SDRs; end of period)				
Available Fund credit under tranche policies	--	17.00	18.00	20.50	23.25	26.36
Outstanding Fund credit under special facilities	--	42.84	42.84	42.84	42.84	42.84
		(In percent of quota; end of period)				
Available Fund credit under tranche policies	--	25.8	27.3	31.1	35.3	40.0
Outstanding Fund credit under special facilities	--	65.0	65.0	65.0	65.0	65.0
Memorandum item:						
Trust Fund loans outstanding						
In millions of SDRs	1.2	1.2	1.2	0.1	--	--
As percent of quota	1.8	1.8	1.8	0.1	--	--

Source: International Monetary Fund.

1/ All purchases would be made from the Fund's ordinary resources. No drawings have been made so far under the stand-by arrangement approved on April 25, 1990. Undrawn amounts remain available until the expiration of the arrangement on June 25, 1991.

2/ Compensatory and contingency financing facility.

Table 2. Papua New Guinea: Performance Criteria Under the Stand-By Arrangement, 1990-91

	1990									1991	
	June			September			December			March	
	Program	Adjusted program	Actual	Program	Adjusted program	Actual	Program	Adjusted program	Revised program	Program	Revised program
	(In millions of kina; end of period)										
Net domestic assets of the banking system 1/	822	816	797	808	862	814	806	831	831	806	831
Net credit to the Government 1/	83	77	75	49	103	80	14	39	65	14	90
Credit to the agricultural commodity stabilization funds	40	40	15	40	40	21	40	40	40	40	40
	(In millions of SDRs)										
Net foreign assets of the Bank of Papua New Guinea 2/	210	210	274	210	210	269	180	180	180	175	175
Contracting or guaranteeing of new short-term external public borrowing of 0-1 year maturity	--	--	--	--	--	--	--	--	--	--	--
Contracting or guaranteeing of new nonconcessional external public borrowing 3/											
Maturity of over 1 year and not more than 12 years	60	60	8	60	60	23	60	60	60	60	60
Of which: Maturity of over 1 year and not more than 5 years	20	20	--	20	20	--	20	20	20	20	20

1/ The original program provided that the ceiling would be lowered or raised to the extent that net external financing of the central government was higher or lower than assumed in the program (K 79 million for the year 1990 and K 45 million for the first quarter of 1991). The adjusted program ceilings for June and September 1990 reflect the extent to which actual net external financing deviated from the program targets. The adjusted program ceiling for December 1990 assumes net external financing of K 54 million for the year 1990. Net credit to the Government excludes the Treasury IMF Account.

2/ Minimum level below which understandings would be required on further fiscal and monetary actions to meet subsequent targets for net foreign assets of the Bank of Papua New Guinea.

3/ Excluding borrowings by the Mineral Resource Development Corporation that are required to meet the obligations arising from the Government's shareholdings in mineral resource projects.

Table 3. Papua New Guinea: Selected Economic Indicators, 1987-91

	1987	1988	1989	1990 Prog.	1990 Est.	1991 Prog.
Growth and inflation (percent change)						
Real GDP	3.6	3.0	-1.5	0.5	-1.6	8.0
Real GDP adjusted by the terms of trade	5.1	3.3	-6.5	-3.0	-5.3	1.4
Consumer prices (annual average)	3.3	5.4	4.5	8.5	7.5	8.0
Terms of trade 1/	14.8	5.5	-16.4	-10.4	-11.6	-11.2
Gross investment (percent of GDP)	20.5	27.3	23.3	28.1	24.9	31.1
Gross national savings (percent of GDP)	14.4	18.4	12.5	12.0	14.3	15.2
Central government budget (percent of GDP)						
Revenue and grants	29.6	28.8	33.6	31.1	31.7	31.6
Domestic revenue	23.1	22.8	27.3	24.5	24.4	24.5
Foreign grants	6.5	6.0	6.3	6.6	7.3	7.1
Expenditure	30.7	29.8	34.8	31.3	32.8	33.4
Current	27.3	26.3	29.1	27.0	28.2	28.6
Capital	3.4	3.5	4.5	4.3	4.6	4.8
Overall deficit	-1.1	-1.0	-1.2	-0.2	-1.1	-1.8
Domestic borrowing	-1.1	1.4	1.2	-2.2	-0.6	-1.1
Of which: Banking system	(-1.4)	(1.4)	(0.8)	(-2.0)	(-0.4)	(-1.1)
Foreign borrowing (net)	2.2	-0.4	—	2.4	1.7	2.9
Concessional	(3.7)	(2.2)	(2.3)	(5.1)	(4.2)	(5.1)
Commercial	(-1.5)	(-2.6)	(-2.3)	(-2.7)	(-2.5)	(-2.2)
Money and credit (end of year, percent change)						
Domestic credit	4.6	19.0	11.6	4.2	3.1	6.0
Private credit	10.4	14.4	9.6	11.3	4.8	11.0
Total liquidity	1.5	4.4	5.4	-5.5	6.0	4.5
Interest rates						
Term deposits (average rate)	10.5	11.7	12.9	14.4	12.0	11.5
Loans (average rate)	14.3	13.9	14.8	16.3	15.0	14.0
Balance of payments (SDR mn.)						
Exports, f.o.b.	1,039	1,246	1,145	943	925	1,081
Of which: Mineral sector	(675)	(889)	(744)	(602)	(628)	(762)
Imports, c.i.f.	-991	-1,182	-1,198	-1,178	-1,043	-1,272
Of which: Mineral sector	(-260)	(-411)	(-387)	(-346)	(-283)	(-503)
Services and transfers (net)	-196	-306	-244	-180	-142	-230
Current account	-148	-242	-297	-415	-261	-421
Current account (percent of GDP)	(-6.1)	(-9.0)	(-10.8)	(-16.1)	(-10.6)	(-15.9)
Overall balance	-25	2	-53	-99	-32	-31
Reserves (end of year)						
Gross official reserves (SDR mn.)	358	358	303	266	311	280
(In months of nonmineral sector imports, c.i.f.)	(5.8)	(5.3)	(4.5)	(3.8)	(5.2)	(4.4)
External debt (SDR mn.)						
Medium- and long-term debt (end of year)	1,416	1,477	1,545	1,607	1,655	1,947
(As percent of GDP)	(59)	(55)	(56)	(63)	(67)	(73)
Debt service	230	238	333	363	434	313
(As percent of current receipts)	(17)	(15)	(21)	(28)	(32)	(21)
Central government debt service	96	120	149	143	125	134
(As percent of current receipts)	(7)	(8)	(10)	(11)	(9)	(9)
Outstanding Fund credit (end of year; as percent of GDP)	0.3	0.2	0.1	2.6	1.7	1.6
Financial obligation to the Fund (as percent of current account receipts)	0.3	0.3	0.2	0.6	0.5	0.3
Real effective exchange rate 2/	-2.7	4.9	-1.6	-8.0	-8.0	—

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

1/ Based on deflators for exports and imports of goods and nonfactor services.
2/ IMF Information Notice System; percentage changes between end-years. Staff estimates for 1990.

Table 4. Papua New Guinea: Balance of Payments, 1987-91

	1987	1988	1989	1990 Prog.	1990 Est.	1991 Prog.
			(In millions of SDRs)			
Trade balance	48	64	-53	-235	-119	-191
Exports, f.o.b.	1,039	1,246	1,145	943	925	1,081
Minerals	675	889	744	602	628	762
Other	364	357	401	341	297	319
Imports, c.i.f.	-991	-1,182	-1,198	-1,178	-1,043	-1,272
Mining sector	-260	-411	-386	-346	-283	-503
Other	-731	-772	-813	-832	-760 1/	-769
Services and transfers	-196	-306	-244	-180	-142	-230
Services (net)	-273	-375	-312	-243	-230	-320
Of which: Mining sector	-122	-234	-205	-98	-106	-215
Transfers (net)	77	69	68	63	88	90
Of which: Budgetary grants	158	162	170	170	176	187
Current account	-148	-242	-297	-415	-261	-421
Capital account	117	175	192	322	242	391
Official	53	-22	-17	99	91	24
Concessional	89	33	29	167	151	91
Commercial	-36	-55	-46	-68	-61	-67
Private	64	197	209	223	151	367
Mining sector	27	85	137	143	71	284
Other	37	112	72	80	80	83
Errors and omissions 2/	5	69	51	-6	-13	--
Overall balance	-25	2	-53	-99	-32	-31
Monetary movements (increase -)	25	-2	53	99	32	31
Gross official international reserves (increase-)	29	--	53	37	-8	31
Liabilities	-4	-2	--	62	40	--
Of which: Fund credit	--	--	--	63	43	--
Memorandum items:						
Current account/GDP	-6.1	-9.0	-10.8	-16.1	-10.6	-15.9
Gross reserves (end of year)	358	358	303	266	311	280
In months of nonmining sector imports, c.i.f.	5.9	5.6	4.5	3.8	4.9	4.4
			(Percentage change)			
Volume of exports	-3.6	0.9	1.4	-7.3	-9.7	25.8
Volume of imports	8.9	6.0	-6.9	-3.3	-11.6	16.4

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

1/ Including an aircraft valued at SDR 41 million.

2/ Including valuation adjustment.

Table 5. Papua New Guinea: Summary of Central Government Operations, 1987-91 1/

(In millions of kina)

	1987	1988	1989	1990 Program	1990 Estimate	1991 Program
Total revenue and grants	838	905	1,014	1,005	990	1,080
Tax revenue	501	571	696	645	597	675
Of which:						
Corporate tax	(97)	(130)	(180)	(92)	(87)	(97)
Personal income tax	(147)	(157)	(173)	(179)	(182)	(199)
Import duties	(144)	(157)	(204)	(223)	(182)	(215)
Nontax revenue	152	145	128	147	167	161
Foreign grants	184	190	190	213	226	244
Total expenditure	869	935	1,049	1,012	1,023	1,140
Departmental	507	532	606	565	580	610
Construction and maintenance	97	100	106	115	114	137
Transfers to provincial and local governments	101	116	135	134	134	152
Transfers to statutory institutions	57	66	71	62	64	74
Interest payments	78	85	91	107	102	99
Net lending and investment	15	19	23	10	10	23
Other	14	17	17	19	19	45
Overall balance	-31	-30	-35	-7	-33	-60
External financing (net)	61	-14	1	79	54	98
Concessional loans	105 2/	68	70	164	131	174
Commercial loans	-44	-82	-69	-86	-77	-76
Domestic financing (net)	-30	44	34	-71	-21	-38
Banking system	-41	44	23	-64	-13	-38
Of which: MRSF 3/	(10)	(-35)	(-35)	(37)	(45)	(-15)
Nonbank	11	—	11	-7	-7	—
			(Percentage changes)			
Total revenue and grants	6.4	8.0	12.0	-0.9	-2.4	6.9
Tax revenue	13.5	13.8	22.0	-7.3	-14.2	11.6
Nontax revenue	7.7	-4.9	-11.5	14.8	30.5	-10.1
Foreign grants	-10.0	3.0	-0.1	12.3	19.1	8.1
Total expenditure	1.3	7.7	12.2	-3.5	-2.5	11.0
Current	3.2	7.0	10.6	-4.3	-3.5	9.0
Capital	-11.7	13.2	24.0	1.5	5.1	14.0
			(In percent of GDP)			
Total revenue and grants	29.6	28.8	33.6	31.1	31.7	31.6
Tax revenue	17.7	18.2	23.1	19.9	19.0	19.8
Nontax revenue	5.4	4.6	4.2	4.6	5.4	4.7
Foreign grants	6.5	6.0	6.3	6.6	7.3	7.1
Total expenditure	30.7	29.8	34.8	31.3	32.8	33.4
Current	27.3	26.3	30.3	27.0	28.2	28.6
Capital	3.4	3.5	4.5	4.3	4.6	4.8
Overall balance	-1.1	-1.0	-1.2	-0.2	-1.1	-1.8
Overall balance excluding grants	-7.6	-7.0	-7.5	-6.8	-8.4	-8.9
Domestic revenue minus current expenditure	-4.2	-3.5	-3.0	-2.5	-3.8	-4.1
Memorandum item:						
Revenue from mining sector 4/	50	92	120	14	5	15

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

1/ Fiscal year coincides with calendar year. Components may not add to totals because of rounding.

2/ Includes the receipt of K 47 million from STABEX in 1987.

3/ Changes in deposits of the Mineral Resources Stabilization Fund (increase -) into which receipts from the mining sector are paid.

4/ Including interst on MRSF deposits, and excluding import duties.

Table 6. Papua New Guinea: Monetary Survey, 1987-91 1/

(In millions of kina at end-period)

	1987	1988	1989	1990 Prog.	1990 Est.	1991 Prog.
			(In millions of kina)			
Net foreign assets	397	323	259	179	294	263
Monetary authorities	435	391	338	251	364	333
Gross reserves	446	396	343	334	422	391
Foreign liabilities	-11	6	4	83	58	58
Commercial banks	-37	-68	-79	-72	-70	-70
Net domestic assets	546	662	779	806	806	902
Domestic credit	772	919	1,025	1,045	1,057	1,137
Net credit to Government 2/	17	55	78	14	65	27
Private sector	755	864	947	1,038	992	1,110
Less: Other items (net)	-226	-257	-246	-239	-250	-235
Broad money (M3*)	817	942	1,017	985	1,085	1,165
Deposits of commodity stabilization funds	102	24	14	--	10	--
Bank of Papua New Guinea	65	13	3	--	--	--
Commercial banks	37	11	12	--	10	--
Deposits of Bougainville Copper Ltd.	24	19	6	--	5	--
Total liquidity	943	985	1,038	985	1,100	1,165
			(Annual percentage change)			
Net domestic assets	5.3	21.3	17.6	4.8	3.5	12.0
Domestic credit	4.6	19.0	11.6	4.2	3.1	7.5
Private credit	10.4	14.4	9.6	11.3	4.8	12.0
Broad money (M3*)	9.5	15.3	7.9	-3.6	6.7	7.4
Total liquidity	1.5	4.4	5.4	-5.5	6.0	6.0

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

1/ Components may not add to totals because of rounding.

2/ Excludes Treasury IMF account.

Table 7. Papua New Guinea: Ceilings on Net Credit to Government Under the Stand-By Arrangement, 1990-91

(In millions of kina)

	1989	1990			1991
	Dec.	June	Sept.	Dec.	March
Program ceiling	78	83	49	14	14
Cumulative excess (-) or shortfall in net external borrowing	--	-6	54	25	25
Concessional	(--)	(-8)	(38)	(33)	(33)
Commercial	(--)	(2)	(16)	(-8)	(-8)
Adjusted program ceiling	78	77	103	39	39
Projected increase in budgetary deficit	--	--	--	26	26
Seasonal shortfall in budgetary revenue	--	--	--	--	25
Revised program ceiling	78	77	103	65	90

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

Table 8. Papua New Guinea: Selected Exchange Rate Developments, 1985-90

(In units of foreign currency per kina; period average)

		Australian dollar	Japanese yen	U.S. dollar	SDR
1985	I	1.35	260	1.01	1.04
	II	1.46	244	0.97	0.98
	III	1.45	241	1.01	0.98
	IV	1.47	209	1.01	0.94
1986	I	1.45	191	1.02	0.90
	II	1.48	179	1.05	0.91
	III	1.65	159	1.02	0.85
	IV	1.59	165	1.03	0.85
1987	I	1.58	163	1.06	0.84
	II	1.56	159	1.11	0.86
	III	1.55	163	1.11	0.87
	IV	1.59	152	1.12	0.84
1988	I	1.55	143	1.11	0.81
	II	1.49	145	1.16	0.85
	III	1.44	154	1.15	0.89
	IV	1.42	150	1.19	0.89
1989	I	1.42	155	1.20	0.92
	II	1.49	160	1.16	0.92
	III	1.51	164	1.15	0.91
	IV	1.48	166	1.16	0.90
1990	I	1.36	154	1.04	0.79
	II	1.34	160	1.03	0.78
	III	1.31	154	1.06	0.77
Trade shares 1/					
Exports		9.8	31.2	2.7	...
Imports		42.9	18.1	8.9	...

Source: IMF, International Financial Statistics.

1/ Average of 1986-88 data.

Table 9. Papua New Guinea: Medium-Term Adjustment Framework, 1991-95

	1991	1992	1993	1994	1995
			(In percent)		
Real GDP	7.8	6.4	10.1	6.6	5.5
Consumer prices	8.0	5.0	5.0	5.0	5.0
Gross investment	31.1	26.0	24.3	23.1	22.2
National savings	15.2	17.3	17.8	19.0	19.3
Foreign savings	15.9	8.7	6.5	4.1	2.9
			(In millions of SDRs)		
Exports, f.o.b.	1,081	1,475	1,850	1,890	1,903
Mining sector 1/	762	1,113	1,446	1,433	1,381
Other	319	362	404	456	522
Imports, c.i.f.	-1,272	-1,501	-1,602	-1,564	-1,501
Mining sector	-503	-653	-661	-515	-338
Other	-769	-848	-941	-1,049	-1,163
Services (net)	-320	-318	-543	-490	-528
Of which: Mining sector	-215	-211	-433	-381	-422
Transfers (net)	90	86	70	37	4
Of which: Budgetary grants	187	194	192	173	156
Current account	-421	-258	-224	-128	-112
Capital account	391	297	281	192	192
Official	24	51	43	11	22
Concessional	91	66	70	45	52
Commercial	-67	-15	-27	-34	-30
Private 2/	367	247	238	181	169
Of which: Mining sector	284	152	118	21	-31
Overall balance	-31	40	57	64	69
Memorandum items:					
Current account/GDP	-15.9	-8.7	-6.5	-4.1	-2.9
Gross reserves	280	320	366	416	471
(Months of nonmining imports, c.i.f.)	4.4	4.6	4.8	5.1	5.3
			(In percent)		
Total debt/GDP	73	70	62	54	48
Debt service ratio 3/	21	20	23	24	16
Of which: Government	9	4	5	6	5
IMF debt/quota	65	65	49	16	--
IMF debt/GDP	2	1	1	--	--
IMF debt/total debt	2	2	2	1	--
IMF debt service/external current receipts	--	--	1	1	1

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

1/ Including oil exports from 1992 onward.

2/ Including direct investment and errors and omissions.

3/ As percent of external current receipts.

Port Moresby, Papua New Guinea
December 11, 1990

Dear Mr. Camdessus,

The attached Memorandum of Economic and Financial Policies of the Government of Papua New Guinea for 1990-91 reviews the considerable progress that has been made to implement the adjustment program in 1990 and the policies that are being adopted for 1991 to maintain the adjustment effort under the 14-month stand-by arrangement of SDR 26.36 million (40 percent of quota) that was approved on April 25, 1990. We are requesting the modification of performance criteria under the stand-by arrangement on net credit to the Government for end-December 1990 because this year's deficit is expected to be slightly higher than programmed, and on net credit to the Government and net domestic assets of the banking system for end-March 1991 because of the need for Government bank borrowing in the first quarter in view of the projected seasonal shortfall in budgetary revenue, as indicated in the memorandum.

The Government of Papua New Guinea believes that the policies being pursued are adequate to achieve the objectives of the program, but will take any further measures that may become appropriate for this purpose. The Government will provide the Fund with such information as the Fund requests in connection with assessing the implementation of policies and the progress made toward achieving the objectives of the program.

Sincerely yours,

Sir Henry To Robert
Governor
Bank of Papua New Guinea

Paul Pora
Minister for Finance and Planning

Attachment

Mr. Michel Camdessus
Managing Director
International Monetary Fund
Washington, D.C. 20431
U.S.A.

Memorandum on Economic and Financial Policies of the Government of Papua New Guinea for 1990-91

1. The Government of Papua New Guinea has been implementing vigorously since the latter part of 1989 an economic adjustment program in response to the severe shocks stemming from the closure of the Bougainville mining operation and the depressed world market prices for major agricultural exports. The program has been formulated in the context of a medium-term framework; the financial stabilization measures are being accompanied by structural reforms to accelerate the rate of growth of the nonmining private sector. The objectives and policies for 1990 were presented in the Memorandum of Economic and Financial Policies attached to the letter of March 23, 1990 to the Managing Director requesting a 14-month stand-by arrangement of SDR 26.36 million (40 percent of quota). This memorandum reviews the considerable progress that has been made to implement the program under the stand-by arrangement and describes the policies that are being adopted for 1991 to continue the adjustment effort.

I. The Economy in 1990

2. Economic activity remained depressed in 1990. It is now projected that real GDP will decline by 1 1/2 percent for the second successive year, rather than stabilizing as initially projected. The sizable fall in mining production and government services has been broadly in line with expectations. Private sector output in the agricultural, industrial and service sectors continued to decline, in contrast to the modest recovery that had been envisaged. The average annual rate of increase in consumer prices is estimated at 7.5 percent, below the range of 8-9 percent specified in the program. Price increases have reflected changes in indirect taxes introduced in the 1990 budget, the 10 percent depreciation in the value of the kina in January 1990, and the higher cost of imported petroleum products.

3. The external position has been stronger than initially expected. The external current account deficit is projected at 11 percent of GDP, compared with the program target of 16 percent of GDP. This reflects lower mining and nonmining imports, higher service receipts from the mining sector and additional Australian grant assistance. Private capital inflow for the mining sector has been substantial. Official concessional aid includes the World Bank structural adjustment loan, the Asian Development Bank agricultural sector loan and cofinancing loans from Australia, Japan and the European Community. All performance criteria on the contracting or guaranteeing of external public borrowing have been met for June and September 1990 and are expected to be observed for December 1990 (Table 1). The Government has continued to make substantial repayments of commercial loans. Gross official

reserves are estimated at SDR 311 million at the end of 1990, equivalent to nearly five months of nonmining imports, SDR 45 million above the indicative target. In these circumstances, no drawings have been made under the stand-by arrangement.

4. Fiscal policy has been restrictive in 1990. The original 1990 budget contained new revenue measures to yield K 30 million (1 percent of GDP). Further expenditure cuts of K 70 million (2 percent of GDP) from the initial budgetary allocations were initiated in April 1990 on the basis of recommendations by a committee headed by the Prime Minister. A retrenchment program was undertaken that will yield substantial savings in future years. These measures were incorporated in the programmed budget deficit of 0.2 percent of GDP. However, the overall deficit of K 33 million (1.1 percent of GDP) is expected to be slightly above the program.

5. Budgetary receipts are expected to reach the program target. Import duties are estimated to be K 41 million less than targeted because of lower import volume and a decline in the average duty rate, reflecting reduced spending on motor vehicles and other luxury consumer items. Export duties are estimated to be K 15 million below target, in view of lower receipts from logging. These shortfalls have been offset by K 26 million in road user fees from the mining sector and K 11 million in additional grants from Australia. Collections of personal and corporate income tax and excise duties have been in line with the targets.

6. Current expenditure has declined in real terms by about 8 percent. Strong efforts have been made as programmed to contain administrative expenditure, transfers to state institutions and lending to public enterprises. Allocations have been raised since the program was formulated by K 18 million for defense, K 6 million for police and K 1 million for correctional services, reflecting the costs of operations in the North Solomons province and the priority attached to law and order. These changes have been partly offset by additional cuts in administrative expenses and lower transfers to the North Solomons province. Capital expenditure is expected to be unchanged in real terms, as targeted.

7. Wages policy has been restrained in 1990. In accordance with the Minimum Wages Board (MWB) determination for the three-year period 1989-91, minimum wages were raised by 6 percent. In view of the Government's determination that the MWB decision should not, as in the past, flow fully onto workers earning more than the minimum wage, agreement was reached with the trade unions in the public sector to limit nominal wage increases for civil servants earning above the minimum level to an average of 4 1/2 percent. These arrangements have contained the increase in public sector wages to well below the rate of inflation. While data on private sector wage developments is

incomplete, the capacity to grant wage increases has been limited by reduced farm and business incomes.

8. The Government has contained the fall in rural incomes in the face of low agricultural export prices by providing credit to the commodity stabilization funds. However, this credit is expected to be limited to K 27 million in 1990, well below the program target of K 40 million. Assistance was less than programmed for coffee because world prices were somewhat higher than expected and for copra and palm oil because of lower production. Support for the cocoa industry was phased down in accordance with the reforms introduced at the beginning of the year that are designed to reduce producer prices in stages to the world market level by the end of 1992.

9. Monetary and credit policy in 1990 has aimed primarily at attaining the inflation and external objectives, while ensuring the availability of sufficient credit to promote recovery in the nonmining private sector. All performance criteria in the monetary area specified under the program were observed in June and September. The ceiling on net domestic assets is expected to be observed in December, but the ceiling on net credit to the Government is not expected to be met because of the larger fiscal deficit (Table 1). Net domestic assets of the banking system are expected to increase by 3 1/2 percent during the year, compared with the increase of 5 percent allowed in the program. The reduction in the banking system's net claims on the Government is estimated at K 13 million, compared with K 64 million in the original program. We are proposing a revised ceiling on net credit to the Government of K 65 million at end-December, compared with K 39 million under the original program. Net external financing in 1990 is estimated at K 54 million, compared with the program target of K 79 million, because of temporary delays in disbursements under structural adjustment loans from several donors. The budget deficit is estimated to be K 26 million higher than programmed and this has to be financed by the domestic banking system.

10. Private sector credit is estimated to increase by 5 percent, compared with the target of 11 percent. Bank liquidity was tight in January-February 1990, which prompted a reduction in the minimum liquid asset requirement by 1 percentage point to 11 percent in March. However, private sector credit demand remained weak and the commercial banks were cautious in lending because of the losses incurred in the North Solomons province. In order to facilitate a reduction in interest rates and encourage lending, the authorities have reduced the yield on 182-day treasury bills by 2.5 percentage points to 10.5 percent since September. Most bank deposit rates and lending rates remain substantially positive in real terms.

11. The tight stance of financial policies has enabled the gains in competitiveness achieved from the depreciation of the kina to be maintained. An encouraging sign of the strengthened competitiveness has

been the increased share of domestic supplies of goods and services for the construction of new mining projects. Under present circumstances, the Government believes that the growth and diversification of the traded goods sector is best achieved through maintaining stability in the nominal effective exchange rate of the kina against a trade-weighted basket of currencies and relying on wage restraint, structural reforms, and tight financial policies to safeguard competitiveness.

II. Economic Prospects and Policies for 1991

12. Economic activity is expected to recover in 1991, with real GDP projected to increase by 8 percent, although much of this increase will originate in the mining sector, where value added will increase by 55 percent, because of gold production from the new Porgera mine and construction activity at the Kutubu oilfield. Growth in the nonmining sector is projected at 3 percent, with a slight contraction in government services. The average annual rate of inflation is projected at 8 percent, with the pass-through of higher oil prices expected to contribute 1 1/2 percentage points. Retail petroleum prices have been adjusted by an average of 33 percent since August 1990 and retail prices will continue to be adjusted to fully reflect changes in import prices. The rate of inflation is expected to decelerate over the year to the December quarter of 1991 to 6 percent.

13. The external position is expected to remain satisfactory, although further concessional assistance will be needed to limit the overall balance of payments deficit. The external current account is projected to widen to 16 percent of GDP, despite strong growth in mining exports and some recovery in nonmining exports. The Bougainville mine is assumed to remain closed in 1991, although negotiations are continuing on its possible reopening at a later date. Mining imports are expected to rise sharply, reflecting the development of the Kutubu oil resources. Nonmining imports are projected to increase by 8 percent. The increase in the petroleum bill in 1991, as a result of developments in the Middle East since August 1990, is estimated at SDR 35-40 million. Part of this increase may be offset by higher earnings from gold. The net deficit on services is expected to increase on account of mining transactions, and little increase is projected in grant assistance. Private capital inflow for the mining sector is expected to rise sharply, assuming that existing timetables for new projects can be observed. Official capital inflow includes continued structural adjustment assistance from the World Bank, Asian Development Bank, the European Community, Japan and other donors. Strict limits will continue to be maintained on official commercial borrowing. Gross official reserves are projected at SDR 280 million at the end of 1991, equivalent to 4 1/2 months of nonmining imports. If these baseline projections hold, the authorities do not plan to make drawings under the stand-by arrangement.

14. Fiscal policy will remain tight in 1991 in order to continue supporting the adjustment process. Substantial new revenue measures and strict expenditure controls are incorporated in the 1991 budget. While the budget deficit is projected to increase to K 60 million (1.8 percent of GDP), the increase in the deficit primarily reflects the special intervention program of K 30 million financed by external concessional assistance that is designed to alleviate the social costs of adjustment. The overall budget deficit, excluding the special intervention program, is estimated at K 30 million (0.9 percent of GDP). With the projected availability of external finance, the Government will reduce further its outstanding borrowings from the domestic banking system.

15. The revenue measures in the 1991 budget are projected to yield K 20 million (0.6 percent of GDP). They include the imposition of a 3 percent manufactures excise duty, the effects of a change in the basis of import duties from an f.o.b. to a c.i.f. basis, and revised fees and charges for departmental services. However, the overall growth in budgetary receipts will be limited by the expected modest growth in personal and corporate income taxes and grant assistance, and a projected decline in nontax revenue. Import duties on machinery and other imports for the agricultural and industrial sectors will be reduced from 5 percent to zero to encourage private sector development.

16. Current expenditure will increase by 9 percent. Attention is focused on further reducing administrative expenses by maintaining the hiring freeze except for a limited range of essential services, encouraging early retirement and restraining purchases of goods and services. The retrenchments that were carried out in 1990 will reduce wage and salary payments in 1991. This provides scope for increasing outlays, in real terms, on operations and maintenance, social sectors and the public investment program, especially on infrastructure, agriculture, health and education, in accordance with commitments made to the World Bank. Any unforeseen additional budgetary expenditure in 1991 would be met by compensatory revenue measures or cuts in existing expenditure programs.

17. The policy of wage restraint will be maintained in 1991, in order to consolidate the gains in competitiveness that have been achieved recently. The Government will resist pressures that might emerge for a renegotiation of the existing three-year minimum wage agreement. It is expected that wage increases in the private sector, based primarily on capacity to pay, will remain moderate. In these circumstances, real wages are projected to decline by 2-3 percent next year.

18. The Government is not prepared to provide outright subsidies to the stabilization funds. The current approach is to provide support through commercial bank loans using the proceeds from the European Community STABEX grants and loans. The support for each industry through the funds will be gradually phased out over a specified period of time, which is expected to be three years in the case of cocoa and

coffee and somewhat longer in the case of copra and palm oil. While the coffee and copra funds will need to be replenished in 1991, assistance to the cocoa fund is expected to be reduced in view of prospective trends in world market prices and the implementation of the cocoa adjustment scheme. Bank borrowing by the funds will be closely monitored to ensure that the adjustment measures are being implemented.

19. The 1991 monetary program, while consistent with the price and balance of payments targets, is designed to accommodate the expected faster growth in private sector credit demand. The growth in the net domestic assets of the banking system is projected at 12 percent. As implied by the fiscal objectives, the banking system's net claims on the Government are targeted to be reduced by a further K 38 million. This should provide scope for an increase in bank credit to the nonmining private sector of 12 percent. Consistent with these targets, net credit to Government is projected to increase by K 25 million in the first quarter of 1991, because of the large seasonal shortfall in revenue. We are therefore proposing a modification of the performance criteria for end-March 1991 (Table 1). Net domestic assets of the banking system will not exceed K 831 million (compared with K 806 million in the original program) at end-March 1991. Taking into account the proposed increase in outstanding net credit to the Government to K 65 million at end-December 1991, we are proposing that the ceiling on net credit to the Government should be K 90 million at end-March 1991. This assumes that net external financing of the Government will amount to K 45 million in the first quarter of 1991, including financing inflows of K 25 million delayed from the past year and K 20 million of new inflows. As in the original program, to the extent that the new inflows of net external financing of the Government in the first quarter of 1991 exceeds (falls short of) the projection of K 20 million, the ceilings for end-March 1991 will be adjusted downward (upward) by a corresponding amount. Fund technical assistance has been planned to assess the scope for more market-oriented instruments of monetary control and improve the operations of the money and securities markets.

III. Structural Adjustment Policies

20. The Government is pursuing comprehensive structural reforms, supported by a structural adjustment loan from the World Bank, in conjunction with the financial stabilization measures. While the upsurge in mineral exploration and development will contribute to a sharp growth in exports and a more viable balance of payments position in the mid-1990s, a more broadly based economy is needed to generate employment opportunities for the rapidly growing labor force and strengthen the medium-term fiscal position. During 1990, reform efforts were initiated to raise agricultural productivity, encourage domestic and foreign private investment and improve public sector resource management, while minimizing the social costs of adjustment. Further important measures will be implemented during 1991. The Government

attaches high priority to ensuring that the policies are implemented expeditiously, and established a high level Structural Adjustment Committee in August 1990 to monitor progress in this area.

21. Agricultural reforms are being implemented partly in the context of the Asian Development Bank's agricultural sector loan to contain costs and raise productivity, with a view to stimulating output, employment and exports. The Government is focusing attention on research and extension services, smallholder credit facilities, institutional strengthening and human resource development in order to lay the foundation for accelerated and broad-based growth. The revised policy for the stabilization funds that is already being applied to the cocoa industry will be extended to the coffee, copra and palm oil funds. The performance and role of the Agricultural Bank is to be reassessed and alternative schemes to improve rural credit facilities will be examined in 1991.

22. Measures to promote private investment through liberalizing the regulatory framework were announced in June 1990. The Government Regulations Advisory Committee (GRAC) was established under the Chairmanship of the Governor of the Bank of Papua New Guinea to present proposals for this purpose. Legislation will be introduced to replace the National Investment and Development Agency (NIDA) with an Investment Promotion Authority to promote and facilitate private investment. The Committee is examining possible measures to promote new industrial enterprises, reduce obstacles to foreign direct investment, and clarify procedures for the entry and employment of foreign nationals in Papua New Guinea, and encourage training and localization.

23. The Government is implementing a medium-term reform of the tax system. Measures contained in the 1991 budget aim at broadening the tax base and improving the tax structure through realigning taxes on domestic production and external trade and rationalizing import tariffs. The Government also intends to progressively remove the remaining quantitative restrictions on imports.

24. The Government is expediting plans to reduce the size of the public sector and improve the structure of public expenditure. Civil service retrenchment is estimated at about 2,000 persons in 1990, equivalent to 4 1/2 percent of public employees, and a number of agencies have been abolished. Personnel management is now being rationalized in conjunction with the progressive introduction of program budgeting in all departments. Commercialization of public services, including the Government Printing Office, the National Statistical Office and the National Computer Centre, is being carried out in accordance with a timetable established in April 1990. A substantial list of public enterprises to be privatized is being finalized. The Government's inter-island shipping fleet has been largely sold and sales

of the government shareholdings in forest products and marine corporations are at an advanced stage.

25. The Government is undertaking a special intervention program aimed specifically at offsetting the social costs of adjustment. Projects in housing, improvement of health facilities, small industrial development and rehabilitation and maintenance projects for roads and water supplies have been incorporated in the 1991 budget. Concessional assistance for these activities has been arranged with the World Bank and other donors. These programs complement the steps being taken to facilitate the redeployment in the private sector of those affected by civil service reform through retraining and improved placement mechanisms. Services aimed at disadvantaged groups have as far as possible been protected in allocating expenditure cuts.

26. The Government is intensifying its efforts to secure an appropriate balance between the exploitation of nonrenewable resources in the mining sector and the creation of adequate renewable substitutes in the nonmining sector. To address the problem of uncontrolled logging, export taxes on timber were raised to 15 percent and a two-year moratorium was placed on the issuance of new logging licenses in 1990. Under the Tropical Forestry Action Plan, which is supported by the World Bank, a task force has been established to deal with the immediate problems of environmental degradation from logging. In order to strengthen the monitoring of the environmental impact of mining operations, liaison offices are being established at major mining sites. Budgetary allocations for environmental policies were largely protected from recent expenditure cuts and increases have been budgeted for 1991.

Table 1. Papua New Guinea: Performance Criteria Under the Stand-By Arrangement, 1990-91

	1990									1991	
	June			September			December			March	
	Program	Adjusted program	Actual	Program	Adjusted program	Actual	Program	Adjusted program	Revised program	Program	Revised program
	(In millions of kina; end of period)										
Net domestic assets of the banking system 1/	822	816	797	808	862	814	806	831	831	806	831
Net credit to the Government 1/	83	77	75	49	103	80	14	39	65	14	90
Credit to the agricultural commodity stabilization funds	40	40	15	40	40	21	40	40	40	40	40
	(In millions of SDRs)										
Net foreign assets of the Bank of Papua New Guinea 2/	210	210	274	210	210	269	180	180	180	175	175
Contracting or guaranteeing of new short-term external public borrowing of 0-1 year maturity	--	--	--	--	--	--	--	--	--	--	--
Contracting or guaranteeing of new nonconcessional external public borrowing 3/											
Maturity of over 1 year and not more than 12 years	60	60	8	60	60	23	60	60	60	60	60
Of which: Maturity of over 1 year and not more than 5 years	20	20	--	20	20	--	20	20	20	20	20

1/ The original program provided that the ceiling would be lowered or raised to the extent that net external financing of the central government was higher or lower than assumed in the program (K 79 million for the year 1990 and K 45 million for the first quarter of 1991). The adjusted program ceilings for June and September 1990 reflect the extent to which actual net external financing deviated from the program targets. The adjusted program ceiling for December 1990 assumes net external financing of K 54 million for the year 1990. Net credit to the Government excludes the Treasury IMF Account.

2/ Minimum level below which understandings would be required on further fiscal and monetary actions to meet subsequent targets for net foreign assets of the Bank of Papua New Guinea.

3/ Excluding borrowings by the Mineral Resource Development Corporation that are required to meet the obligations arising from the Government's shareholdings in mineral resource projects.

Papua New Guinea--Relations with the Fund
(As of October 31, 1990)

(Amounts in millions of SDRs, unless otherwise specified)

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	108.8	165.0
(c)	Fund credit	42.8	65.0
	Of which: CFF	42.8	65.0
(d)	Reserve tranche position	--	--
(e)	Lending to the Fund	None	

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

(a)	Current stand-by or extended arrangement		
	)	26.36	Agreed
	April 25, 1990-June 24, 1991)	--	Drawn
	)	26.36	Undrawn balance
(b)	Previous stand-by and extended arrangements during the last ten years	None	
(c)	Special facilities in the past two years		
	CCFF purchase (May 1, 1990)	42.84	

IV. SDR Department

		Amount	Percent of Allocation
(a)	Net cumulative allocation	9.3	100.0
(b)	Holdings	1.0	10.5
(c)	Current designation plan	Not included	

V. Administered Accounts

	SDR million
(a) Trust Fund Loans	
(i) Disbursed	19.6
(ii) Outstanding	0.1
(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 Papua New Guinea's major trading partners. Since April 1980, the U.S. dollar has been used as the intervention currency. The representative rate of the kina against the U.S. dollar is the midpoint between buying and selling rates for spot transactions in U.S. dollars as determined daily by the Bank of Papua New Guinea. On October 31, 1990, the rate was K 1 = $1.0629.

VIII. Last Article IV Consultation

The last Article IV consultation took place during August 1-12, 1988, and was concluded on October 14, 1988 (SM/88/219 and SM/88/235). The 1989 interim consultation report (SM/89/269) was circulated to Executive Directors on December 18, 1989.

IX. Technical Assistance

A CBD expert is presently assigned to the Bank of Papua New Guinea, as Chief Manager, Economics Department.

The Institute conducted a seminar in Port Moresby on financial programming in September 1990, for which UNDP financial assistance was provided.

A short-term CBD advisory mission is planned for March 1991 to review monetary instruments, improve the operations of the money and securities market and savings mobilization generally, and develop a framework for open-market operations.

X. Resident Representative/Advisor: None

Table 1. Papua New Guinea: Projected Payments to the Fund

(In millions of SDRs)

	1990 Nov.-Dec.	1991	1992	1993	1994	1995	1996	1997	1998	1999	Remaining Period	Total
Obligations from outstanding use of resources												
Principal												
Repurchases	--	--	--	10.7	21.4	10.7	--	--	--	--	--	42.8
Trust Fund repayments	--	0.1	--	--	--	--	--	--	--	--	--	0.1
Charges and interest 1/	1.2	4.8	4.9	4.7	3.0	1.1	0.7	0.7	0.7	0.7		22.5
Total	1.2	4.9	4.9	15.4	24.4	11.8	0.7	0.7	0.7	0.7	--	65.4
(Percent of quota)	1.8	7.4	7.4	23.4	37.0	17.9	1.1	1.1	1.1	1.1	1.1	99.2
Obligations from prospective use of Fund resources 2/												
Principal												
Repurchases	--	--	--	--	9.5	13.2	3.7	--	--	--	--	26.4
Charges and interest 1/	--	1.7	2.5	2.5	2.4	1.2	0.2	--	--	--	--	10.5
Total		1.7	2.5	2.5	11.9	14.4	3.9	--	--	--	--	36.9
(Percent of quota)		2.6	3.8	3.8	18.1	21.9	5.9	--	--	--	--	56.0
Cumulative (outstanding and prospective)												
Principal												
Repurchases	--	--	--	10.7	30.9	23.9	3.7	--	--	--	--	69.2
Trust Fund repayments	--	0.1	--	--	--	--	--	--	--	--	--	0.1
Charges and interest 1/	1.2	6.5	7.4	7.2	5.4	2.3	0.9	0.7	0.7	0.7	--	33.0
Total	1.2	6.6	7.4	17.9	36.3	26.2	4.6	0.7	0.7	0.7	--	102.3
(Percent of quota)	1.8	10.0	11.2	27.2	55.1	39.8	7.0	1.1	1.1	1.1	--	155.2

Source: IMF Treasurer's Department.

1/ Projections are based on current rates of charge, including burden-sharing adjustments where applicable, for purchases in the GRA; the current interest rates for ESAF/SAF and Trust Fund; and current SDR interest rate for net use of SDRs.

2/ Projections are based on the assumption that the stand-by arrangement is fully drawn during the first half of 1991.

Papua New Guinea: Relations with the World Bank Group

Papua New Guinea has received 21 loans and 13 development credits, totalling $513 million (net of cancellations), including a Structural Adjustment loan of $50 million which was approved in June 1990.

The Bank's assistance strategy is to support the Government in: (i) the stabilization and structural adjustment program to overcome the disruptions caused by the closure of the Bougainville mine, the concomitant fall in export crop production on Bougainville island and the sharp drop in export commodity prices; (ii) promoting growth in the nonmining economy, especially private sector development; (iii) strengthening human resource development through improved access to and better quality of basic services; (iv) ensuring sustainable use of natural resources, particularly forests; and (v) building up institutional capacities and implementing administrative reforms to facilitate and sustain efforts to achieve the preceding objectives.

The main instrument for supporting the Government's stabilization and structural adjustment program is the Structural Adjustment Loan (SAL) and much of the Bank's operations over the next two years will be directed toward that end. An important complementary operation will be a program of special interventions designed to alleviate the social costs of adjustment, which has been drawn up by the Government with assistance from a Bank-led multidonor mission. This program provides for early implementation of projects with a high employment and income impact. The lending program furthermore includes: a public service training project to upgrade skills in public service and the private sector; a nucleus estate project to develop oil palm and cocoa production in Oro Province; a forestry project to strengthen institutional capacity in the sector to exploit forest resources on a sustainable yield basis; and an education project. The volume of project lending will continue to be determined largely by Papua New Guinea's access to other sources of financing on terms which are more concessional than those the Bank can offer. It is foreseen therefore that project lending will be limited to at most two projects per year.

The Bank's Economic and Sector Work Program includes a yearly economic report as the main vehicle for policy dialogue and as background for the Consultative Group meetings. The proposed economic work gives emphasis to improvement of public resource management and the policy agenda for promoting private investment in the nonmining economy. Sector studies are currently under preparation or planned in the following areas: education strategy; health and population; transport and rural infrastructure; environment; and private sector development and financial institutions.

Aid coordination will remain a central aspect of the Bank's role. The Consultative Group was established in May 1987 and has evolved into an effective mechanism for achieving a clearer understanding of the Government's development strategy and specific investment priorities, and for securing financial and technical support from the donor community. The next meeting is scheduled for May 1991.

There have been no IFC investments in Papua New Guinea so far. IFC maintains an active interest in the development of investment opportunities and there have been preliminary discussions regarding possible IFC participation in oil and mining ventures. Recently Papua New Guinea signed the MIGA convention. In view of the large prospective mining investments, MIGA membership can be expected to be of particular value.

Papua New Guinea: IBRD/IDA Lending Operations

(In million of U.S. dollars as of May 31, 1990)

	Disbursed	Undisbursed
Completed projects		
IBRD	125.7	--
IDA	109.1	--
Projects in execution (all Bank)		
Agriculture and rural development	21.5	35.4
Education	43.6	5.7
Transportation	32.8	43.8
Power and gas	18.2	10.3
Telecommunications	--	17.2
Structural Adjustment	--	50.0
Total	350.9	162.4
Repayments	66.6	
Total debt outstanding on amounts disbursed	276.1	

Source: Data provided by the World Bank.

Papua New Guinea: Relations with the Asian Development Bank

As of September 30, 1990, the Asian Development Bank (AsDB) had provided 33 loans amounting to $384.4 million for 25 projects. Of this, $174.7 million for 15 loans was from ordinary capital resources and $209.7 million for 18 loans was from Special Funds resources. Furthermore, technical assistance amounting to $11.5 million for 54 technical assistance projects had been provided. Three projects were approved in 1989: Agricultural Sector Program Loan ($80.0 million), Divune Hydropower Project ($8.4 million), and Multisectoral Technical Assistance Program Loan ($5.0 million). A concessional loan of $8.4 million from the Asian Development Fund for the Industrial Center Development Project, aimed at promoting the manufacturing subsector, was approved in August 1990. Further assistance is expected to include assistance to the Government's Special Intervention Program to meet the social cost of structural adjustment, including funding for projects in the water supply and health sectors.

The AsDB's "Operational Strategy Study", which was finalized in 1988, places highest priority on programs and projects in the domestic resource-based smallholder sector for tree crops, food crops, and livestock. The AsDB has played an important role in the road, port, and power sectors through sector studies, investment projects, and related institutional strengthening. In the energy sector, assistance is directed at reducing the country's dependence on oil imports by developing indigenous energy resources, particularly renewable resources such as hydroelectric power.

Papua New Guinea: Loan Approvals and Disbursements, 1986-90

(In millions of U.S. dollars)

	1986	1987	1988	1989	1990 Est.
Loan approvals	49.6	10.0	--	93.4	20.8
Loan disbursements	10.2	16.1	25.5	23.9	68.2
Undisbursed balance of net loan amount at the beginning of the year	130.3	174.8	170.7	138.2	201.5

Source: Data provided by the Asian Development Bank.

Papua New Guinea: Outstanding Loans by Sector

	Number of projects	Loan amount (US$ mn.)	Share of total lending (in percent)
Agriculture and agro-industry	4	134.9	62.7
Energy	2	28.1	13.0
Transport and communications	1	33.3	15.5
Social infrastructure	1	13.9	6.5
Multisectoral technical assistance program	1	5.0	2.3
Grand total	9	215.1	100.0

Source: Data provided by the Asian Development Bank.

Table 1. Papua New Guinea: Social and Demographic Indicators 1/

Area:	461,693 square kilometers
Population (1989):	3.8 million
Rate of growth:	2.6 percent per annum
Density:	8 persons per square kilometer
Population characteristics:	
Age structure	
0-14 years	42 percent
15-64 years	54 percent
65 and above	4 percent
Life expectancy	54 years
Infant mortality	62 per thousand
Crude birth rate	39 per thousand
Crude death rate	12 per thousand
Total fertility rate	6 children per woman
School enrollment ratios:	
Primary - total	64 percent
- female	53 percent
Secondary - total	11 percent
- female	8 percent
Health:	
Population per physician	6,160
Access to safe water:	
Total population	25 percent
Urban population	95 percent
Rural population	15 percent
Nutrition:	
Per capita caloric intake	2,205 per day
Per capita protein intake	46 grams per day
Poverty: 2/	
Urban	10 percent
Rural	75 percent

Source: Data provided by the World Bank.

1/ Most recent estimates.
2/ Estimated population below absolute poverty income level.

Papua New Guinea--Statistical Issues

1. Outstanding statistical issues

a. Real sector

National accounts data have a number of shortcomings, particularly with respect to the estimation of investment and savings and calculation of deflators. The National Statistics Office, in conjunction with the Bank of Papua New Guinea, produced a revised set of national accounts in 1990, including a set of production accounts. The authorities have also approached the Asian Development Bank to provide long-term technical assistance in the area of national accounts and prices.

b. Monetary accounts

It would be desirable to expand the coverage of monetary data in International Financial Statistics (IFS) to include the Agricultural Bank, the savings and loans societies, finance companies, and merchant banks.

c. Government finance

Reported data for Government Finance Statistics Yearbook (GFS) through 1988 show differences with respect to data provided to area department missions, particularly for central government budget figures on external and domestic financing. The National Statistical Office has been requested to clarify the reasons for the discrepancies in financing data.

d. External sector

Trade data on a customs basis, which are processed by the National Statistical Office, are not available on a current basis: in particular, a breakdown of imports by major categories is available only with a two-year lag. External debt data provided to Fund missions differ substantially to data from the World Bank's Debt Reporting System. The World Bank is reviewing these differences with the authorities.

2. Coverage, currentness, and reporting of data in IFS

The table below shows the currentness and coverage of data published in the country page for Papua New Guinea in the December 1990 issue of IFS. The data are based on reports sent to the Fund's Bureau of Statistics by the Bank of Papua New Guinea which, during the past year, have been provided on a timely basis.

Status of IFS Data

		Latest data in December 1990 IFS
Real Sector	- National Accounts	1989
	- Prices	QII 1990
	- Production	n.a.
	- Employment	n.a.
	- Earnings	n.a.
Government Finance	- Deficit/Surplus	1987
	- Financing	1987
	- Debt	1987
Monetary Accounts	- Monetary Authorities	July 1990
	- Deposit Money Banks	July 1990
	- Other Banking Institutions	n.a.
Interest Rates	- Discount Rate	Sept. 1990
	- Bank Lending/Deposit Rates	July 1990
	- Bond Yields	n.a.
External Sector	- Merchandise Trade:	
	Values:	June 1990
	Prices:	
	Exports (aggregates)	June 1990
	Exports (components)	June 1990
	Imports	n.a.
	- Balance of Payments	QIV 1989
	- International Reserves	October 1990
	- Exchange Rates	October 1990

3. Technical assistance missions in statistics (1986-present)

None