

I. ECONOMIC ENVIRONMENT

(1) INTRODUCTION

1. Papua New Guinea (PNG) is an archipelago of some 600 islands located in the south-west Pacific Ocean just north of Australia. It comprises predominantly the eastern half of New Guinea, where it borders on the Indonesian province of Irian Jaya, and many other islands, including especially New Britain, New Ireland and Bougainville. PNG has an area of approximately 463,000 square kilometres, with a mainly Melanesian population of about 4.5 million. The diversity of the population, and thus the country, is reflected in the fact that some 800 different dialects and spoken, although English is the official language. The country became internally self-governing in December 1973, having been administered as an Australian territory under the United Nations since 1945, and fully independent in September 1975.

2. PNG is by far the largest and most heavily inhabited South Pacific island, and is richly endowed in natural resources, including minerals, oil, forests, and fish. However, the economy remains heavily reliant on subsistence agriculture. While GDP per capita in 1998 of approximately US\$900 places PNG in the middle of Pacific island countries, it has not kept pace with lower-middle income Asian countries. Its declining social indicators are among the poorest in the world, well behind other comparable lower-middle income economies, and are characteristic of lower income countries (Table I.1). The United Nations regards PNG as a developing country; it ranks in the lower third of countries on the UN human development index.

3. Annual per capita income grew slowly post-independence until the 1990s when expansion of the mining sector generated substantial economic growth ahead of population growth (Table I.2). Income per head fell substantially in the late 1980s and in 1995 and 1997. Apart from the mining and construction sectors, the formal economy has shown little growth. Incomes remain barely above subsistence for most of the population, with some 85% living in rural areas dependent on simple agriculture. Moreover, despite achieving periods of successful economic growth based on natural resources, Papua New Guinea has been unable to improve its social conditions. These have further deteriorated in recent years in the light of poor delivery of key social services, such as health and education, and low investment in human and rural development. Chronic law and order problems persist and poverty is increasing.

4. Improved governance combined with strengthened institutional arrangements and more effective public administration are fundamental to lifting the economic and social performance of the PNG economy. Without these changes, it will continue to perform well below potential, and benefits from long overdue and urgently needed economic reforms will be muted. Continued political instability and lack of political commitment will seriously undermine such efforts.

5. PNG is a dualistic economy; the relatively prosperous "enclave" mining sector contributes most to economic growth and has few spill over effects on the rest of the economy. The modern, foreign-owned capital-intensive mining sector, which exports its entire output and accounts for most private investment – but a small share of employment – exists within what is essentially a subsistence and non-growing economy. Although traditional agricultural export crops of coffee, copra, cocoa and more recently, oil palm products, as well as logging still account for around 30% of GDP, the most striking structural change in the economy has been the growth of the mining and petroleum sectors and the relative stagnation of agriculture, the mainstay of the economy. Mining, and especially petroleum, accounted for over one fifth of GDP in 1997, and contributed almost two thirds of export receipts and around one fifth of government revenue.

Table I.1
Main economic and social indicators

| | | | |
|---------------------------------------|----------------|---|-------------------------------------|
| Area | 463,000 sq. km | Urban share of population | 16.3% |
| Population (1997) | 4.5 million | Nominal GDP at current prices (1997) | K 6.8 billion or US\$4.8 billion |
| | | Per capita income (1998 current US\$) | US\$890 |
| Annual population growth (1996) | 2.3% | GDP at factor cost 1997 (at 1983 prices) of which: | US\$2,332.4 million |
| | | - Mining (including petroleum) | 20% |
| | | - Agriculture, forestry & fishing | 28% |
| | | - Manufacturing | 9% |
| | | - Services | 43% |
| Life expectancy at birth (1996) | 58 years | Total formal employment (1990) of which: | 157,475 |
| | | - Agriculture, forestry & fishing | 23% |
| | | - Mining | 3% |
| | | - Manufacturing | 12% |
| | | - Services | 62% |
| Crude birth rate per '000 (1996) | 32 | Enrolment ratio in education (1996) | |
| | | - Primary | 80 |
| | | - Secondary | 14 |
| | | - Tertiary | .. |
| Infant mortality rate per '000 (1996) | 62 | Energy consumption per capita | 232 kg. of oil equivalent |
| Adult literacy (1996) | 71% | | |

.. Not available.

Source: Asian Development Bank (1997a), *Country Economic Review of Papua New Guinea*; International Monetary Fund (1999), *Staff Report for the 1999 Article IV Consultations*, April; World Bank (1998), *World Development Indicators*; and Papua New Guinea Government (1998), *1999 Budget Papers*, Vol. 1, "Economic and Development Policies", November.

Table I.2
Economic performance, 1994-98

| | 1994 | 1995 | 1996 | 1997 | 1998 ^a |
|---|-------|-------|-------|--------|-------------------|
| US\$ million | | | | | |
| GDP at current market prices | 4,599 | 4,832 | 5,280 | 4,656 | 3,581 |
| Real GDP (1983 prices) | 2,940 | 2,570 | 2,708 | 2,332. | 1,778 |
| Annual percentage change (in domestic currency) | | | | | |
| Real GDP growth | 5.2 | -2.9 | 4.0 | -4.6 | 2.4 |
| Real GDP growth per capita | 2.2 | -3.4 | 1.4 | -8.6 | 0.4 |

Table I.2 (cont'd)

| | 1994 | 1995 | 1996 | 1997 | 1998 ^a |
|--|--|-------|------|------|-------------------|
| | Per cent | | | | |
| Inflation (CPI) | 2.9 | 17.3 | 11.6 | 3.9 | 13.6 |
| Interest rates | | | | | |
| - Commercial bank loans | 10.0 | 15.4 | 10.2 | 10.6 | 17.9 |
| - Treasury bills (182 days) | 10.8 | 21.5 | 9.2 | 14.5 | 20.5 |
| - Term deposits | 4.5 | 9.4 | 4.0 | 5.1 | 8.1 |
| Broad money growth (M3) | -0.2 | 13.8 | 31.8 | 6.8 | 1.8 |
| | Per cent of GDP | | | | |
| Government deficit | -2.3 | -0.8 | 0.5 | 0.1 | -1.8 |
| - Revenue (including grants) | 26.1 | 26.4 | 27.3 | 32.8 | 30.0 |
| - Expenditure | 28.4 | 27.3 | 26.8 | 32.7 | 31.8 |
| Balance of payments | | | | | |
| - Current account (including grants) | 10.9 | 17.1 | 5.5 | -6.4 | 0.1 |
| - Capital account | -11.2 | -13.4 | 1.6 | 1.9 | -4.1 |
| - Overall balance | -1.8 | 3.2 | 6.5 | -4.8 | -3.9 |
| External public debt | 26.4 | 26.4 | 24.5 | 31.6 | 35.9 |
| | Per cent of external current receipts | | | | |
| Debt service ratio | 32.8 | 25.2 | 17.7 | 17.1 | 24.4 |
| Memorandum items | | | | | |
| International reserves | | | | | |
| - US\$ million | 95 | 268 | 549 | 355 | 194 |
| - Months of non-mineral imports c.i.f. | 0.9 | 2.8 | 5.1 | 3.0 | 2.1 |

a Estimate.

Source: Papua New Guinea authorities; Bank of Papua New Guinea (1998), *Quarterly Economic Bulletin*, September; and International Monetary Fund estimates.

6. Merchandise exports and imports averaged 49% and 27% of GDP respectively over the period 1992-97, with little variation in more recent years (Chart I.1). These shares are somewhat low relative to other comparable economies in the region. However, while dependant on mining exports, PNG's trade is less narrowly based than other neighbouring islands. Its three-product export concentration ratio of 65% – comprising crude oil, gold, and logs – in 1997 is well below the average of other Pacific island economies of 80%.¹ Nevertheless, these products, together with coffee, copper and palm oil, accounted for 90% of exports in 1997. There are few manufactured and fish exports. Despite attempts to diversify its export mix, Papua New Guinea remains vulnerable to external developments affecting primary commodities.

(2) RECENT ECONOMIC PERFORMANCE

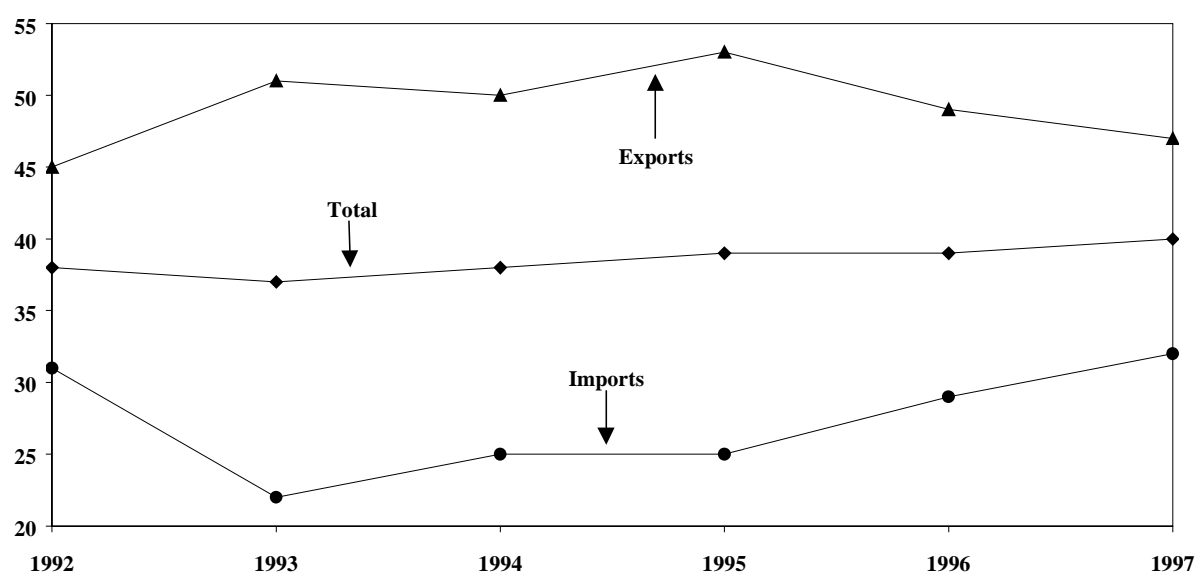
7. Papua New Guinea has faced a number of complex developmental challenges since independence. Despite relatively abundant mining, forestry, and fishing resources, PNG has not fulfilled anywhere near its economic potential. The economy's performance has been mixed at best, partly due to a number of domestic and international shocks, but primarily because of government economic mismanagement, especially during the 1990s. The relatively steady macroeconomic management that was characteristic of the country after independence has since given way to major periods of destabilizing policies that have undone earlier accomplishments, thereby undermining

¹ World Bank (1995).

economic growth. Moreover, structural weaknesses across major areas of the economy, such as in trade and foreign investment, continue to seriously retard economic performance, despite repeated intentions by governments to embark on major microeconomic reform. The economy currently suffers from chronic macroeconomic instability and serious structural flaws and is in urgent need of reform. Unless decisive action is taken, another financial and economic crisis would appear to be looming.

Chart I.1
Merchandise trade as a share of GDP, 1992-97

(Per cent)



Source: Data provided by the authorities of Papua New Guinea.

8. Government policies after independence centred on import substitution and other interventionist measures designed to promote industrialization. High and disparate tariffs along with quantitative import restrictions were introduced. The Government also played an active role in developing industries by adopting restrictive investment and other "domestication" policies aimed at promoting home industries, including, in particular, greater processing of natural resources, such as logs and fish. Many of the structural problems that currently confront the PNG economy and, undermine its performance are due to these policies.

9. The economy's macroeconomic position deteriorated badly after 1989 following the twin shocks from the Bougainville crisis, which resulted in the "long-term" closure of the Panguna mine, and sharp falls in world prices for key commodities.² Although the Government's reform programme helped turn the economy around in the early 1990s, economic growth was mainly due to a resource boom, led principally by the Porgera gold mine and the commencement of oil production from the Kutubu oilfield. Real growth rates rose to 12% and 17% in 1992 and 1993, respectively. However, these years also saw unsustainable fiscal expansion as the then Government actively pursued

² The closure of the Panguna copper and gold mine had serious repercussions on the economy. At the time, it was contributing one third of total exports and 15% of government revenue.

budgetary deficits as a means of stimulating broad-based growth. Fiscal deficits rose to almost 6% of GDP in 1992 and 1993, and the Government's commitment to fundamental institutional and economic reforms waned.

10. These destabilizing macroeconomic policies precipitated an economic and financial crisis in 1994. Public debt escalated from 43% of GDP in 1991 to 55% in 1994, and the Government's financial position became increasingly untenable in the light of unsustainable Central Bank borrowings and accumulated arrears. Major fiscal corrections followed, but were too late to avert a crisis on the external account. Faced with a loss of investor confidence, capital flight and rapidly dwindling foreign reserves, which at one stage fell to well under two weeks of imports, the exchange rate was floated. Negative 3% growth occurred in 1995.

11. The need for fundamental reform was acknowledged in 1995 when the Government agreed with the World Bank and the IMF to undertake a Structural Adjustment Programme in the wake of a self-induced financial and economic crisis.³ As well as prudent macroeconomic reforms, the programme called for widespread measures aimed at improving the structural performance and competitiveness of the economy, such as trade and investment liberalization, public sector reform, and sustainable development of the important forestry sector. Some of these policy reforms were introduced in the midst of the crisis, such as the floating exchange rate system, while some others were contained in the 1995 Budget. However, while macroeconomic stability was largely restored in 1995-96, implementation of the key structural reforms was short-lived. Implementation of the programme stalled during 1996. As had become PNG practice, many of the programme's structural reforms were either excessively delayed, "watered down", or not implemented as the crisis situation passed.

12. Although macroeconomic stability was temporarily restored in 1995-96, the country's current economic situation remains critical due mainly to a prolonged relapse of serious macroeconomic mismanagement. This has coincided with severe economic shocks that have also weakened the economy, still vulnerable from the adverse effects overhanging from previous expansionary fiscal policies and deep-seated structural rigidities. These shocks included the cyclone damage to the copra and cocoa crop in early 1997, followed by the harsh drought that gravely affected agricultural and mineral production. International copper, gold and, until recently, oil prices have also declined significantly, and world timber prices slumped in the wake of the Asian economic crisis. The PNG economy contracted in real terms during 1997 by almost 5%. Only modest real growth, of around 2%, is expected in 1998.

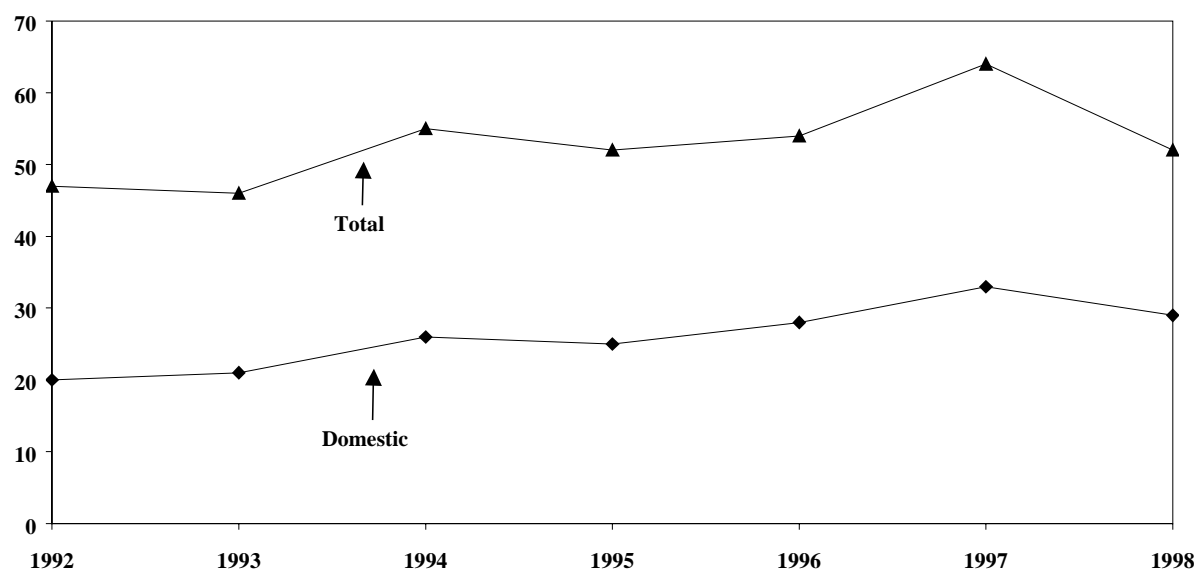
13. The pace and extent to which the economy rebounds will depend crucially on the incoming Government of July 1999 taking the necessary corrective policy actions to restore market confidence and avert a possible financial crisis. The adverse economic effects of recent shocks, which were beyond the government's control, have been compounded by the inept macroeconomic policies of past governments. More prudent monetary and fiscal policies are needed to address concerns of rising inflation, which is currently over 20% annually, and dwindling external reserves, as well as increasingly unsustainable fiscal deficits financed by inflationary Central Bank borrowings. Faced with serious cash-flow problems due to large shortfalls in official external financing, government debt escalated during the 1990s, peaking at 64% of GDP in 1997, before falling to an estimated 52% in 1998 (Chart I.2). Central Bank credit rose above statutory limits in late 1998 and government arrears, including to provincial governments and commercial statutory authorities, accumulated to an

³ Financial support for the programme was provided by loans from the World Bank, the Asian Development Bank and a stand-by credit facility from the IMF. Papua New Guinea's bilateral aid donors also endorsed the programme and some, such as Japan and Australia, provided financial support.

estimated K 160 million in April 1999, equivalent to 2% of GDP.⁴ Without urgent corrective action, the nation's precarious fiscal position risks being worsened by the previous Government's unrealistic 1999 Budget, released in November 1998, which relies heavily on access to significant external borrowings.

Chart I.2
Public debt as a share of GDP, 1992-98

(Per cent)



Source : Data provided by the authorities of Papua New Guinea.

14. In June 1999, prior to being removed from office in July, the previous Government had belatedly taken steps to implement an Economic Recovery Package aimed at reinforcing macroeconomic stability by tightening budgetary disciplines. However, in view of the difficult political situation and its impending exit from office, the package was essentially stillborn. Recognizing the untenable fiscal position, the new Government acted swiftly to introduce a supplementary budget, in August 1999, to redress the mounting budget deficit as part of its comprehensive stabilization package (Chapter II). While the new Government's budgetary position also relies upon access to external funding, the Government has moved expeditiously to engage in discussions with the IMF and the World Bank to secure concessional finance for the budget and to implement structural economic reforms.

(3) MACROECONOMIC POLICIES

15. PNG's dependence on primary commodities poses particular policy challenges for the Government. Without appropriate macroeconomic and structural policies, the economy's vulnerability to international conditions will accentuate. Such policy reforms are needed if the

⁴ This includes arrears on pension-related payments, estimated at end 1998 to be K 75 million. The capacity of clearing all arrears by end 1999, as officially intended, will depend on the Government gaining access to external funds.

economy in general is to take full advantage of the potential provided by its rich resource base. This requires fiscal discipline to ensure that additional tax revenues generated from resource booms are used appropriately. Better managing the effects of the so-called "Dutch-disease" from resource booms will be important to the longer term development of the PNG economy (Box I.1).

Box I.1: Managing the sectoral effects of the "Dutch disease"

Small resource-rich economies like PNG are prone to the so-called "Dutch disease" which has important implications for the macro-management of the economy. Dutch Disease is a term coined by economists to describe a situation encountered by the Netherlands following development of new natural gas reserves in the North Sea.

What happened in the Netherlands was that the development of natural gas production was associated with depressed performance of the manufacturing sector. This situation was not unique to the Netherlands, but has been found to have occurred in many other countries, such as Britain, Norway, Australia, and Mexico, that have benefited from rich mineral developments. PNG is also thought to be affected.

The Dutch disease stems from the exchange rate effects on the rest of the economy of large mineral exports and inflows of foreign direct investment needed to develop substantial resource projects. These inflows appreciate the country's exchange rate thereby reducing the international competitiveness of manufactured goods, both in export markets and domestically against imports. Resources flow out of the manufacturing sector into the mineral sector, and manufacturing contracts. The mineral sector attracts labour and capital away from manufacturing by bidding up wages and interest rates.

Catching the Dutch disease is not necessarily a problem. However a relatively small industrial sector is likely to be a natural outcome of having a rich resource base. Thus, efforts to control the exchange rate or to promote industrialization through import protection are likely to be counterproductive. Resources must come from somewhere else in the economy if the mining sector is to expand. There is nothing inherently right or wrong about shifting resources from manufacturing into mining. A contracting manufacturing sector can be associated with strong growth in other sectors and should not therefore be seen as an undesirable outcome.

The Dutch disease effects are accentuated in PNG by the large amount of aid inflow it receives. Such windfall gains are likely to further undermine the competitiveness of the manufacturing sector.

Source: WTO Secretariat.

(i) Fiscal policies

16. At the heart of Papua New Guinea's economic crisis has been expansionary fiscal policies, leading to unsustainable budget deficits financed mainly by heavy Central Bank borrowings. Large fiscal deficits of almost 6% of GDP precipitated the 1994 economic crisis, for example, and the fiscal disciplines restored in 1996 and 1997, culminating in small surpluses in each of those years, have since slackened. The larger than expected budget deficit rose to well over 2% of GDP in July 1999, and would have escalated to above 3% for the year in the absence of any new fiscal measures; these budget deficits are well above the 1% limits agreed with international institutions under the Structural Adjustment Programme. These deficits, which adversely affect the economy, were being financed mainly through the banking system, especially the Central Bank.

17. The previous Government's 1999 Budget strategy crucially depended on securing external finance of some US\$100 million. Funding from multilateral institutions was not forthcoming due to policy disagreements, and the incoming Government inherited a precarious budgetary position. The previous Government attempted to meet the shortfall by means of commercial overseas borrowings of

US\$60-120 million and by raising funds through an international bond issue. None of these contingencies eventuated, and the new Government appears to have put these plans on hold, instead looking for institutional as well as donor support. Commercial borrowings would have entailed onerous terms that could have accentuated the Government's already critical debt situation.⁵ Public debt remains high, amounting to almost K 4 billion or some 52% of GDP in 1998, down from 64% in 1997 (Chart I.2). Over half is domestic debt, held mainly with the banking system. This liquidity overhang and large domestic financing requirement threatens future economic stability and performance.

18. The new Government sees reducing public debt as a high priority in helping to stabilize the currency, restore budgetary stability, and remove obstacles to investment and growth. It intends to reduce domestic debt substantially using the expected proceeds of a revised privatization programme of major state enterprises for completion by 2002, expected to raise K 3 to 5 billion. In addition, the August supplementary budget restructured government finances aimed at controlling the burgeoning government deficit to 1.7% of GDP in 1999 (Chapter II). To avoid accentuating domestic pressures on the banking system, the Government intends to finance the 1999 deficit of K 265.7 million, projected in the supplementary budget, entirely from external sources.

19. Fiscal discipline has also suffered from a lack of budgetary checks and controls. Budgets are often premised on overly optimistic expenditure and revenue projections that cannot be met in practice. There is a lack of transparency and accountability in budgetary management, and large payments, such as the Rural Development Fund introduced in the 1999 Budget and retained in the supplementary budget, are frequently left to the discretion of politicians, without adequate fiscal scrutiny. Funding of losses of public enterprises has also become obscured and subject to non-transparent quasi-fiscal arrangements. The budget preparation cycle and financial management processes are not working, such that budget overruns and malpractices are common. Governance and public confidence was further eroded by the political uncertainty and budgetary implementation problems that followed the previous Government's decision in December 1998, shortly after passing the 1999 Budget, to adjourn Parliament for political reasons until July 1999, when a new government was elected by Parliament.

(ii) Monetary policies

20. Monetary policy has accommodated expansionary fiscal deficits through Central Bank credit. The entire 1998 Budget deficit of 2%, for example, was financed by the Central Bank, despite such borrowing exceeding statutory limits.⁶ High public debt levels strain not only government finances, but also the banking system. Central and commercial banks are heavily exposed to government securities, and business loans have been crowded out. Over 85% of domestic public debt, equivalent to almost K 2 billion in 1998, was held with the banking system in Treasury Bills, with about half being held by the Central Bank (Table I.3).

21. Monetary expansion has continued, despite the Central Bank's 1999 statement that monetary policy would remain tight to curb rising inflation. Monetary policy was loosened in the first half of 1999 by efforts to cover the Government's financing requirements without significantly raising the

⁵ The European loan was expected to be available in 1998. However, negotiations were held up due to the onerous terms being set by the foreign bank, including a short repayment period and what amounted to an effective mortgaging of Papua New Guinea's future mineral tax receipts.

⁶ Statutory limits in the Central Banking Act apply both to the yearly flow of central bank credit to the government and to the stock of such debt outstanding at the end of the year. The annual limit on new credit is 10% of estimated ordinary budgetary revenues and 20% on the stock of year-end debt. These limits may, with ministerial directive, be raised to 12.5% and 25%, respectively, for up to six months.

already high level of bank credit. The minimum cash reserve requirement on commercial bank deposits was cut from 10% to 5% and the minimum liquid asset requirement raised from zero to 15%. Although the banks' initially raised their holdings of Treasury bills, these changes raised the capacity of the banking system to expand credit.

Table I.3
Public debt liability, 1992-98
(K million)

| | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 |
|-------------------------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|
| Domestic debt | 824 | 1,037 | 1,425 | 1,606 | 1,970 | 2,252 | 2,218 |
| Bank of Papua New Guinea | 376 | 308 | 612 | 634 | 622 | 951 | 1,068 |
| Commercial banks | 363 | 498 | 433 | 756 | 1,132 | 1,062 | 907 |
| Superannuation funds | 69 | 73 | 121 | 102 | 81 | 87 | 87 |
| Commodity stabilization funds | 0 | 120 | 194 | 0 | 0 | 0 | 0 |
| Other | 15 | 39 | 65 | 113 | 129 | 130 | 156 |
| External debt | 1,121 | 1,283 | 1,537 | 1,718 | 1,811 | 2,093 | 1,764 |
| International agencies | 918 | 1,011 | 1,279 | 1,476 | 1,579 | 1,938 | 1,698 |
| Other | 203 | 271 | 259 | 243 | 213 | 155 | 66 |
| Total public debt | 1,945 | 2,319 | 2,961 | 3,324 | 3,781 | 4,344 | 3,982 |

Source: Papua New Guinea authorities.

22. Illegal levels of Central Bank credit to fund the budget, involving also financing of losses by public enterprises and quasi-fiscal activities, have undermined fiscal and monetary management and weakened the perceived independence of the Central Bank. Prior to the latest appointment by the incoming Government, there had been three Central Bank Governors in the past two years. There appears to be an increasing haziness of the boundaries between monetary and fiscal operations, including the funding of public enterprises. This is undermining the credibility of the monetary system and its capacity to assist in economic stabilization.

23. Private investment is also being stifled by the high interests rates of around 18% to 20%, which have also been high in real terms during recent years. Upward pressure on interest rates is being perpetuated by the high public borrowings from the Central Bank, along with efforts to support the kina by stemming capital outflows and directly intervening in the foreign exchange market. Inflationary pressures, which are expected to intensify as the price effects of the currency devaluation flow through the economy, are also contributing to high nominal interest rates.

(iii) Exchange rate policies

24. PNG has had a floating exchange rate since abandoning the fixed rate regime (the so-called "hard kina" policy that pegged the kina to a trade-weighted basket of currencies) in October 1994 when kina trading was suspended due to the economic and balance-of-payments crisis.⁷ The Government is committed to a market determined exchange rate, but has followed a policy of regular intervention in the foreign exchange market to support the kina in the face of severe downward

⁷ While the "hard kina" policy may have promoted macroeconomic stability and generally maintained external balance, it contributed significantly to domestic stagnation and growing official unemployment. It effectively locked-in a highly non-competitive exchange rate and perpetuated the high cost structure inherited by PNG at independence, which was unsustainable given PNG's labour productivity levels (Duncan et al, 1998).

pressure.⁸ While the exchange rate used in the 1999 Budget of US\$0.40 is not a target, substantial intervention occurred by the Central Bank in the first half of 1999 when the kina fell to a record low level of US\$0.29. The Central Bank spent some K 60 million supporting the currency, and official external reserves, excluding balances held in the Mineral Resources Stabilization Fund, fell to one month of non-mineral export cover in June 1999.

25. By 1998, the kina had devalued in nominal terms across major currencies by around 40%. However, due to PNG having higher inflation rates than its main trading partners, the kina's real devaluation was less pronounced, at around 22%. Since then, the kina has continued to depreciate substantially. For example, its value had fallen in nominal terms against the US\$ by another 40% as of mid 1999. The real devaluation of the kina has substantially improved Papua New Guinea's international competitiveness, making its products cheaper both on world and domestic markets. Provided domestic wage and price pressures can be contained, the benefits to the economy of having a lower market-determined exchange rate can be significant.⁹

26. Many transactions, including debt servicing, foreign aid, and mineral and oil tax receipts are excluded from the currency market, and are directed in foreign currency through the Central Bank. After recording substantial balance-of-payment surpluses in 1995 and 1996, of around 3% and 7%, deficits occurred in 1997 and 1998, of around 5% and an estimated 4%, respectively (Tables I.2 and I.4).

27. Papua New Guinea does not maintain restrictions on payments and transfers for current international transactions, having accepted the obligations of Article VIII, Sections 2, 3 and 4 of the International Monetary Fund when it joined in November 1975.¹⁰ Only the six commercial banks are licensed as foreign exchange dealers. Delays of up to several days can be experienced in executing large orders. The Central Bank has delegated substantial foreign currency powers to authorized dealers who publish rates for all current transactions within a maximum spread between the buying and selling rates of 2%. Traders may take out forward exchange cover with dealers at market-determined rates, subject to prudential limits set for dealers on their uncovered forward position.

28. Foreign exchange control is administered by the Central Bank (Table I.5). Overall policy is determined by the Government with advice from the Central Bank. Under the previous Government's Economic Recovery Package of June 1999, exporters not surrendering export proceeds to the Central Bank within the required time period would be liable to a fine of K 100,000 or forfeit of 25% of the funds involved. In addition, the surrender period allowed for agricultural and forestry exports would be reduced from six months to three, and for mining exports from three months to two.

⁸ The Bank of Papua New Guinea interprets its statutory responsibility of promoting monetary stability to include a stable exchange rate. No exchange rate targets are used. Exchange rate movements in PNG are set by the Central Bank in consultation with the Minister of Finance. Intervention in the foreign exchange market, based on the U.S. dollar, occurs regularly to support the kina at the discretion of the Bank's Governor. In the 1999 Budget, the Government stated that it was the policy of the Bank of PNG to intervene in support of the currency. The auction system initially introduced when the kina was floated was replaced with a screen-based interbank trading system in August 1995.

⁹ Empirical evidence suggests that the competitiveness effects of a devaluation can be significant in Papua New Guinea, with only about half of the price advantages being reflected in higher inflation, and that supply responses by copra and cocoa growers to the higher post-devaluation prices had been significant (Duncan et al., 1998). There were also signs that some timber processing activities, were benefiting from the devaluation (Duncan and Lawson, 1997). Other modelling work has also suggested that a real devaluation of some 6% is likely to raise the economy's GDP by 1.5% (Fallon et al., 1995).

¹⁰ Papua New Guinea has maintained exchange restrictions against Iraq since August 1990 pursuant to United Nations resolutions.

Table I.4

Balance of payments, 1994-98

(US\$ million and percentage change)

| | 1994 | 1995 | 1996 | 1997 | 1998 ^a |
|--|--------------------------|-------|-------|-------|-------------------|
| Current account | 593 | 845 | 289 | -258 | 16 |
| Merchandise trade balance | 1,192 | 1,293 | 813 | 218 | 451 |
| Exports (f.o.b.) | 2,756 | 2,825 | 2,603 | 2,191 | 1,842 |
| Imports (c.i.f.) | 1,564 | 1,532 | 1,791 | 1,972 | 1,391 |
| Services (net balance) | -685 | -609 | -690 | -673 | -642 |
| Private unrequited transfers (net balance) | -115 | -108 | -53 | -32 | -6 |
| Official unrequited transfers | 201 | 238 | 219 | 229 | 213 |
| Capital account | -604 | -661 | 84 | 76 | -163 |
| Investment (net) | 74 | 475 | 226 | 23 | 130 |
| Overall balance | -98 | 159 | 344 | -194 | -157 |
| Memorandum items | Percentage change | | | | |
| External reserves (changes) | -33 | 182 | 105 | -35 | 19 |
| Terms of trade | | | | | |
| Export price index | 16.6 | 40.3 | -1.4 | 10.8 | .. |
| Import price index | | | | | |
| Nominal effective exchange rate | -16.9 | -12.5 | -0.1 | -10.5 | .. |
| Real effective exchange rate | -18.1 | 0.4 | 1.8 | -6.3 | .. |

.. Not available.

a Estimate.

Source: Bank of Papua New Guinea (1998), *Quarterly Economic Bulletin*, September; and IMF (1999).

Table I.5

Exchange controls

| Item | Arrangements |
|---------------------------------------|--|
| A. Payments and receipts | |
| Prescription of currency requirements | Contractual commitments to non-residents expressed in foreign currency must be paid in the currency specified. Export proceeds may be received in any foreign currency. |
| Gold trade | Gold exports must be licensed. For large mines, the licences are contained in the mining agreements. Specific export licences are required from the Central Bank (BPNG) for alluvial gold. |
| B. Resident accounts | |
| Foreign exchange accounts | Resident business entities require BPNG approval to hold such accounts domestically, except for term deposits under 90 days. Accounts held abroad require approval. |
| Domestic currency accounts | Convertible into foreign currency. |
| C. Non-resident accounts | |
| Foreign exchange accounts | Permitted. |
| Domestic currency accounts | Permitted, subject to approval, and may be converted into foreign currency. |
| D. Imports and import payments | |
| Documentation requirements | Authorized dealers can approve applications for import transactions not subject to quotas or licensing. Payments up to K 5,000 can be made on presentation of invoice. Higher amounts also require shipping documents and customs documentation. |

Table I.5 (cont'd)

| Item | Arrangements |
|--|--|
| E. Exports and export proceeds | |
| Repatriation requirements | Proceeds must be received within six months from export date for agricultural and forestry products, and within three months for minerals and oil. |
| Surrender requirements | Export proceeds must be sold to an authorized dealer. |
| Export licences | Required for logs, pearls, fishery and marine products, woodchips, sandalwood, rattan, coffee, cocoa, and copra. Minimum export price guidelines apply to log exports. |
| F. Payments for invisible transactions and current transfers | |
| Controls on payments | Controls apply, but approval is usually granted, provided supporting documentation is given. Dealers can approve up to K 500,000 per year for individuals and companies. Higher amounts, except for trade-related and debt-services payments, must be referred to BPNG. For payments exceeding K 50,000 per year, a certificate of tax payment is required. |
| G. Proceeds from invisible transactions and current transfers | |
| Repatriation requirements | Yes. |
| Surrender requirements | Residents cannot dispose of foreign exchange earnings from any source without BPNG approval. |
| Restrictions on use of funds | BPNG approval needed to dispose of foreign currency proceeds, other than sale by authorized dealer in PNG, or for its retention. |
| H. Capital transactions | |
| Controls on capital and money market instruments | No restrictions on inward portfolio investment. Dealers can approve outward investments by residents of up to K 500,000 per annum. Higher amounts require BPNG approval. Investment income must be returned to PNG as received. Amounts above K 50,000 a year require prior tax clearance. |
| On capital market securities | Residents can buy abroad shares or other securities, bonds, money market instruments. |
| On collective investment securities | BPNG approval required on purchase abroad by residents, and sale or issue abroad by residents. |
| Controls on credit operation | No controls on commercial credit by residents to non-residents. Permission needed on commercial credit to residents from non-residents. Dealers may approve unlimited offshore foreign currency borrowings by residents, other than businesses involved in the forestry sector or mineral resources, provided the term is greater than one year and the interest rates and fees do not exceed those specified by the BPNG. Repayment of principal is subject to six-month moratorium from date of disbursement. A maximum debt-to-equity ratio of 5:1 applies to net outstanding borrowing |
| Controls on liquidation of direct investment | Proceeds can be transferred subject to tax clearance certificates. |
| Lending locally in foreign currency | Subject to presentation of commercial invoices for bona fide transactions. |

Source: IMF (1998), *Annual Report on Exchange Arrangements and Exchange Restrictions*, Washington, D.C.

(4) MAIN DOMESTIC STRUCTURAL POLICY ISSUES

(i) Trade and taxation policies

29. The government revenue base has been heavily skewed towards direct income taxes and indirect trade taxes, which together account for some 90% of tax collections. Most, 60%, comes from income tax, mainly standard company tax payments and higher company taxes levied on mining and oil companies. Trade taxes, especially tariffs, account for around one third of tax revenue.

30. The tax and tariff reform package implemented on 1 July 1999 enabled substantial across-the-board tariff reductions to be funded by the introduction of a 10% VAT and by extending the coverage of excise taxes to a range of "luxury" goods, such as motor vehicles. Shifting the tax burden from discriminatory trade taxes to a broadly based consumption tax is a significant policy

reform that should enhance economic welfare through improved resource-use efficiency.¹¹ While such taxes can have the disadvantage of being regressive, falling heaviest on lowest income groups, so too were the tariffs they partially replaced, with many of the highest tariffs, of over 75%, applied to food and other staple items. Consequently, the adverse effects on lower income groups of the tariff and tax reform package are likely to be minimal overall, and may even benefit them as prices of many staple items fall. This outcome is likely to be reinforced by the extension of excise taxes to "luxury goods", and the inclusion in the VAT of most services that were previously untaxed, many of which are consumed mainly by higher income groups. In this regard, however, exclusion from the VAT of educational, medical and public road transport from the VAT justified for equity reasons may, based on PNG consumption expenditure patterns, add to the regressivity of the new tax system.¹²

(ii) Foreign investment policies

31. Outside the mining and petroleum sectors, PNG has attracted little foreign investment. Although the stock of foreign equity holdings increased in 1997 and represented an estimated 40% of GDP, mining and petroleum accounted for around 80% of foreign ownership (Chart I.3). The proportion of foreign equity to GDP falls to well below 10% if these sectors are excluded. Australian investors held an estimated two thirds of this foreign equity stock in 1997, along with investors from the Bahamas (7%), United Kingdom (6%), Malaysia (4%) and the United States (4%).

32. If PNG's economic performance is to be improved, it is important that its trade and other economic reforms be complemented with investment-friendly policies that facilitate, rather than obstruct, foreign investment. The Government is committed to reviewing existing policies with the aim of facilitating and encouraging foreign investment through a revised national investment policy. Foreign investment is also seen as an important means of developing domestic industries to replace imports and to facilitate the transfer of skills. At the same time, however, the Government is keen to encourage more local participation in projects through either joint or locally owned ventures.

33. Access to foreign direct investment is especially important for PNG to successfully develop its service industries, such as tourism. The high cost and inefficient provision by state monopolies of utility services, such as electricity, telecommunications, and transport, is of major concern and itself a disincentive for foreign investment. Since most of these services are traded internationally through commercial presence by foreign providers, investment restrictions amount to barriers on services trade. The current Government has announced that major utility services are to be privatized and opened to competition, including from abroad. PNG is committed to removing the state monopoly on telecommunications in 2002.

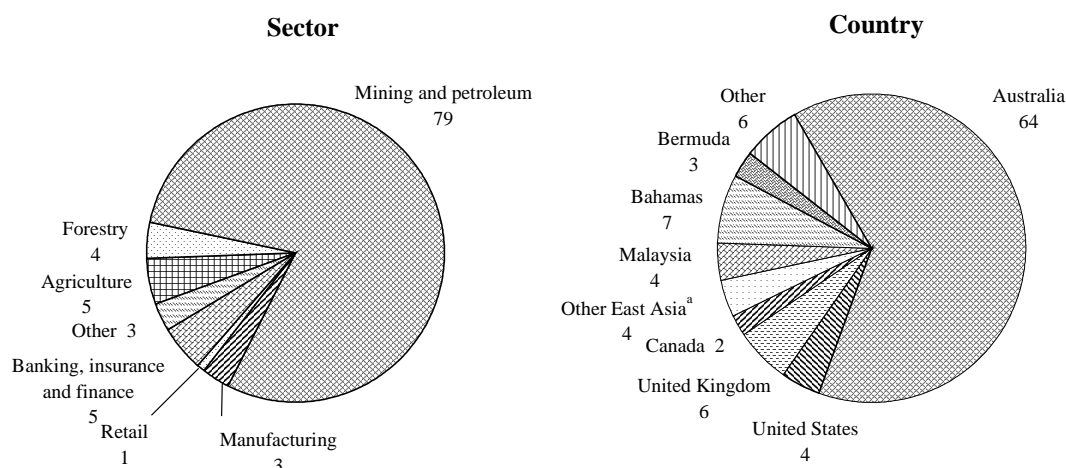
¹¹ While trade taxes can be a substantial source of revenue to governments, they tend to be economically costly. They are likely to impede the efficient allocation of resources. In a small, poor country like PNG, however, where tax administration and enforcement are serious problems, trade taxes may be seen as having some advantages. Nevertheless, tariff rates should still be as uniform as possible to avoid distortions in consumption patterns. A broadly based consumption tax on goods and services, such as the value-added tax implemented in PNG, has the advantage of taxing consumption of domestic and imported products equally, thereby removing protection and improving resource allocation. It would also reduce the burden imposed on exports of having to pay tariff-inflated prices on imported and domestic inputs. The VAT, by zero-rating exports and providing a tax credit for any VAT paid on inputs, effectively exempts exports from the tax.

¹² Gibson (1998).

Chart I.3

Foreign equity holdings by sector and country of ownership, 1997

(Per cent)



^a Other East Asia consists of Hong Kong, China; Japan; Singapore; and South Korea.

Source : Data provided by the authorities of Papua New Guinea.

34. Trade and investment liberalization provide the most effective means of ensuring competitive domestic markets that deliver goods and services efficiently at world prices to consumers and downstream processors. This will improve the nation's productivity, on which all economic growth ultimately depends. However, making PNG an attractive destination for foreign direct investment will require much more than making its investment policies transparent and investor friendly or providing elaborate investment incentives, which are unlikely to be effective. A new approach to economic policies is needed to provide the macroeconomic and political stability that helps promote an efficient business environment conducive to private sector development.

(iii) Labour market policies

35. PNG considerably deregulated the labour market in 1992 when the Minimum Wages Board unified rural and urban wages through a significant reduction in the urban minimum wage, but only for new employees. This ended indexation of urban minimum wages to price increases, which had created wide gaps between the two minimum wages. The decision also emphasized the need for wage levels to be determined by productivity gains. This was an important change as real labour costs in PNG had escalated to non-competitive levels. For example, unit labour costs in PNG, which from 1970 to 1989 ranged between 80-100% of the U.S. level, rose above those levels during 1990 to 1994, despite major differences in productivity between the two countries.¹³ Since 1994, price increases following the currency devaluation have lowered real wages.

36. The Minimum Wages Board is currently sitting to review minimum wage levels and wages policy generally. Since PNG's future development is based on labour-intensive activities, the real cost of labour will have an important bearing on the capacity of its products to compete on overseas markets, and for PNG to attract foreign investment. In particular, its labour costs must remain

¹³ Duncan and Lawson (1997).

competitive with neighbouring labour-rich Asian economies. It is therefore important that wage increases continue to reflect labour productivity improvements, including in the public sector, which has considerable spill-over effects on the private sector. The economic costs of excessive real wage increases relative to productivity growth will be larger official unemployment.

(iv) Policy challenges

37. Papua New Guinea currently faces formidable development constraints as well as a difficult and uncertain economic future, partly as a result of external factors beyond its control, including the recent collapse in world prices for key exports following the Asian crisis and the legacy of the 1997 drought. However, the effects of these external shocks have been accentuated by inappropriate economic policies. Prolonged periods of economic mismanagement and macroeconomic as well as political instability have taken a heavy toll on the economy, culminating in large swings in PNG's economic performance during the 1990s. An urgent priority for the new Government is to take corrective action to restore macroeconomic stability and to reduce public debt. This, together with improved transparency and public accountability, is essential to economic development and to restoring investor confidence.

38. Sound stabilization policies must be accompanied by major microeconomic reforms designed to remove structural rigidities that are impeding the efficient functioning of markets and business activities in general. These include removing inefficient and anti-competitive trade and investment restrictions, as well as making fundamental changes to improve governance and to strengthen basic institutional arrangements needed for the private sector to operate efficiently. This includes establishing clear ownership rights over land and other property as well as transparent and well defined rules on doing business, together with adequate enforcement. Improved law and order is imperative as security concerns and costs, estimated at 1.5% of GDP, are a major constraint to PNG's development.¹⁴ A recent survey found that the four main concerns of the private sector that retarded investment were crime and theft, corruption, poor infrastructure, and policy instability.¹⁵

39. While Papua New Guinea has repeatedly embraced the need for trade liberalization and other structural reforms, progress has been slow. Such reforms have tended to be short-lived and jettisoned when the crisis is over. A large unfinished agenda exists under the Structural Adjustment Programme adopted by the Government in 1995 (Chapter II). Many of these market-opening measures were reiterated in the Medium Term Development Strategy 1997-2002, as well as in the previous Government's 1999 Budget and subsequent Economic Recovery Package. A concerted effort is needed to ensure that these long overdue reforms are implemented with renewed vigour. In this regard, the tax and phased tariff reform programme, introduced from July 1999, are integral elements that the new Government could complete and build upon. The reform agenda is in place. Its implementation, in a sustained and committed manner, is now urgently needed.

40. Papua New Guinea relies heavily on foreign aid, equivalent to some 9% of GDP or US\$80 per head, making it one of the largest recipients of aid in the region. These relatively large inflows must be controlled to avoid contributing to macroeconomic instability. About two thirds of

¹⁴ A recent study of business costs concluded that PNG's law and order problem and resulting security concerns were having the most adverse impact on the business environment and in need of the most urgent attention (Duncan and Lawson, 1997). This was because business costs increased substantially when the indirect costs were taken into account. These were found to be several times higher than the estimated 3% direct increase in business costs from security expenses. Indirect costs of the law and order problem identified included constraining marketing areas, raising employment costs, reducing the intensity of use of capital equipment and generally occupying a large proportion of management's time.

¹⁵ Institute of National Affairs (1999).

foreign aid is supplied by Australia, originally as untied budgetary support but progressively being replaced with programme aid from 1992 to 2000. A new aid treaty, completed with Australia in May 1999, set a maximum annual indicative planning figure for Australian aid of \$A300 million from 2000 to 2003. Other important bilateral aid donors include the EU (under the Lomé Convention), Japan, New Zealand, and China. Aid funds are also provided multilaterally by the World Bank, the IMF, ADB, and UNDP.

41. While foreign aid is essential to the future well-being of PNG, it should not undermine the need for fundamental economic restructuring and policy reform. Foreign aid and technical assistance programmes can facilitate these reforms, provided external financial assistance is at a level and in a coordinated manner that minimizes its potentially adverse economic effects. Foreign aid can compound the "Dutch disease" effects for PNG from resource booms, thereby making economic management more difficult, and obstructing economic restructuring as well as contributing to unproductive rent-seeking activities by private and public sector interests. Long-term aid dependency can itself be a major constraint to PNG's economic development.

(5) MERCHANDISE TRADE PERFORMANCE

(i) Commodity pattern of trade

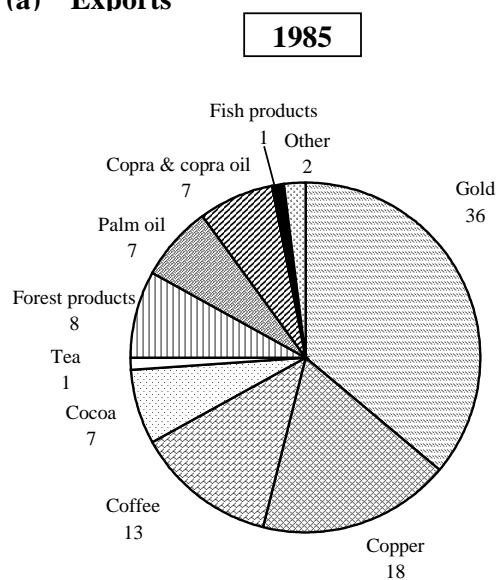
42. Papua New Guinea's commodity trading patterns are heavily concentrated both for exports and imports. Over 95% of exports continue to be primary commodities of minerals, especially crude oil, gold and copper, as well as logs and palm oil. Other important exports include coffee, cocoa and copra. The main change in export composition from 1985 to 1997 was the growing share of minerals – from 54% to 59% of total merchandise exports – relative to traditional agricultural commodities, which declined from 36% to 23% (Chart I.4). Within minerals, the predominant change has been the commencement and growth of crude oil exports since 1991, to 28% in 1997, and the fall in the export shares of gold and copper from 36% and 18% in 1985 to 23% and 8% in 1997.

43. In 1994, the last year for which data are available, imports continued to be dominated by manufactured products, both for consumption and as inputs for exports (Chart I.4). Imports comprised mainly machinery and transport equipment (29%) as well as other manufactured goods, such as textiles and clothing (22%). Other major import groups in that year were food and live animals (13%), chemicals (6%) as well as fuels and lubricants (3%). Major imports included heavy equipment and machinery, basic foods and raw materials, textiles and clothing, and motor vehicles. The share of machinery and motor vehicles fell substantially, from 42% in 1989.

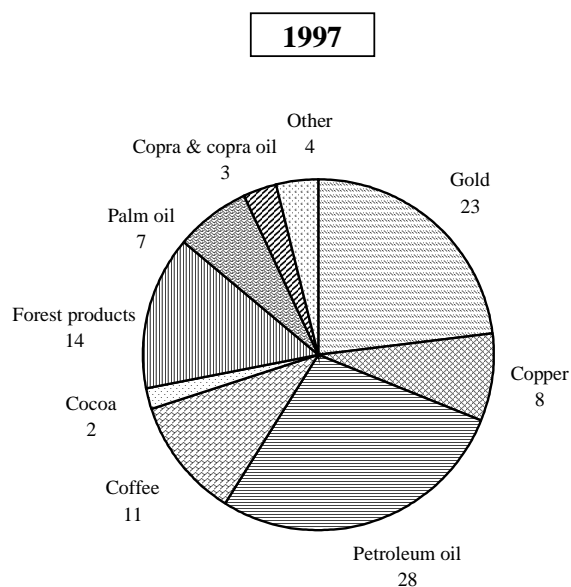
Chart I.4
Composition of merchandise trade

Per cent

(a) Exports

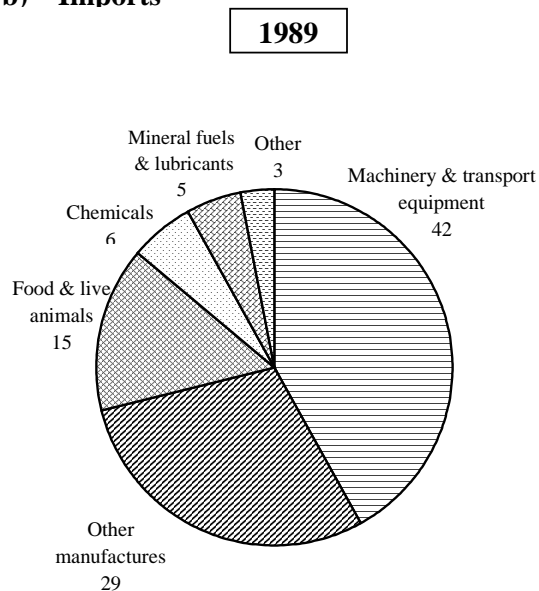


Total: US\$0.96 billion

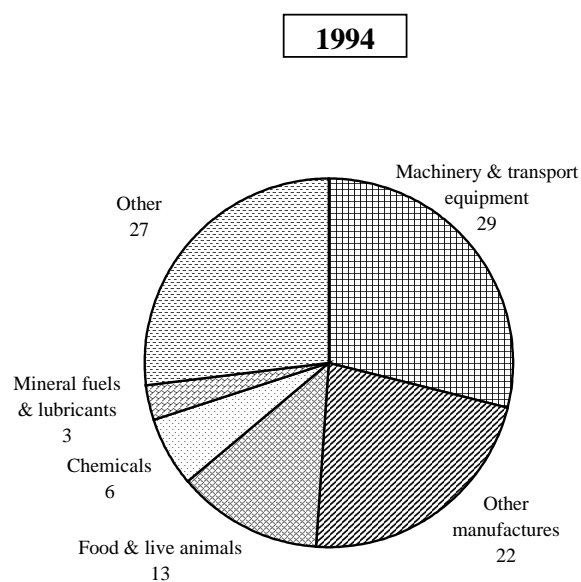


Total: US\$2.19 billion

(b) Imports



Total: US\$1.34 billion



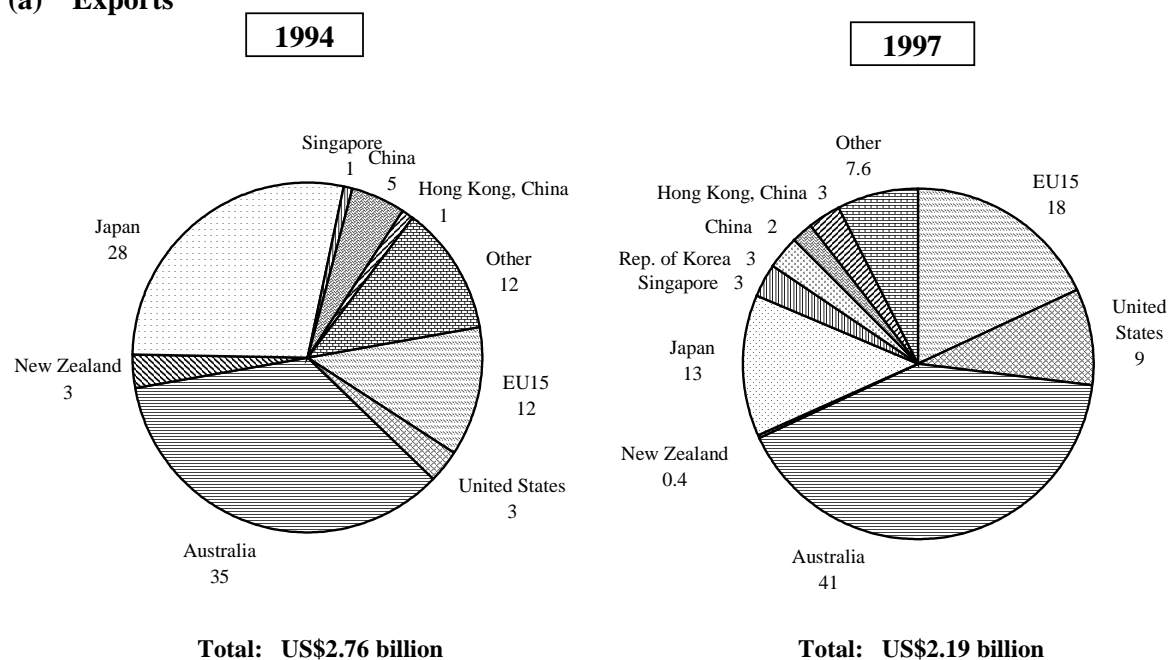
Total: US\$1.56 billion

Source : Data provided by the authorities of Papua New Guinea.

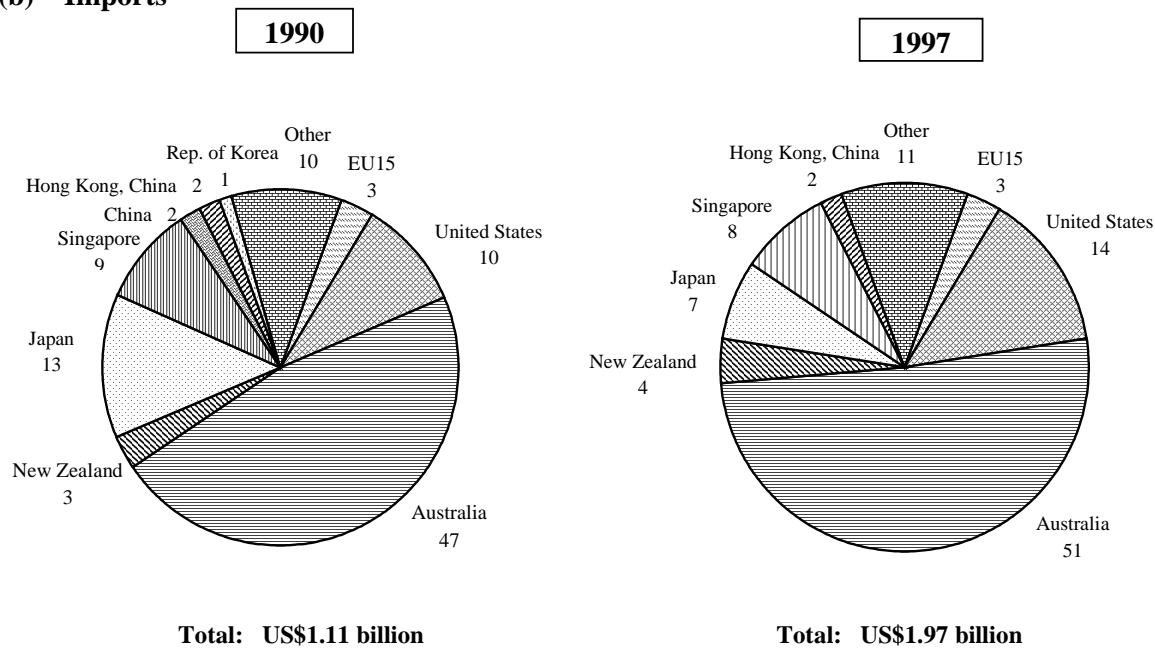
Chart I.5 Merchandise trade by destination and origin

Per cent

(a) Exports



(b) Imports



Source : Data provided by the authorities of Papua New Guinea.

(ii) Regional pattern of trade

44. Merchandise trade of Papua New Guinea remains heavily concentrated in Oceania and Asia, but to a slightly lesser extent than previously. The share of export to Australia, the main single market, rose from 35% to 41% during the period 1994 to 1997, while the share to Japan, the next most important market, fell from 28% to 13% (Chart I.5). Export shares to Singapore, Hong Kong, China, the Republic of Korea, the United States and the United Kingdom increased. An increasing share of exports, from 12% to 18%, has gone to EU markets, principally Germany and the UK, presumably reflecting Lomé preferences. Almost three quarters of PNG exports in 1997 went to the top three markets of Australia, Japan and the EU (Chart I.5).

45. Imports are increasingly being sourced predominantly from Australia, which accounted for 51% of imports in 1997 compared with 47% in 1990, followed by the United States (up from 10% to 14%); Singapore (down from 9% to 8%); Japan (down from 13% to 7%); and New Zealand (up from 3% to 4%). Together, these countries accounted for well over three quarters of imports in 1997 (Chart I.5).

(6) OUTLOOK

46. With its precarious external position and its currency under downward pressure, Papua New Guinea is facing a difficult economic outlook. This situation is the consequence of external factors, involving the Asian crisis, the drought, and depressed international commodity prices, which are estimated to have cost the PNG economy around US\$650 million, equivalent to 15.5% of GDP, in lost export earnings since 1997.¹⁶ The present economic situation is not due solely to external factors, however, it is also the result of internal factors, notably poor economic management culminating in bouts of macroeconomic instability.

47. Crucial, in the short term, will be the Government's ability to secure the necessary external finance to underpin its budget strategy and to implement the reform programme. Re-engaged discussions with the World Bank, the IMF, and major aid donors, following the change in government and the new Government's stated commitment to economic reform, are encouraging.

48. The economy's performance in the immediate future will also depend on how quickly it recovers from the effects of the Asian crisis, which reduced the purchasing power of GDP in PNG by an estimated 12.4%.¹⁷ World log prices collapsed in its aftermath, and international prices for key minerals, especially copper, gold and, until recently, oil also softened substantially. These induced sharp falls in tax revenue from minerals and logs, and inward foreign direct investment fell. PNG was one of the Pacific island economies most badly affected by the Asian crisis because of the importance of mineral and log exports (Table 1.6). Although these Asian economies are recovering, the adverse effects will be felt for some time by PNG.

49. In the medium to longer term, the performance of the PNG economy will be determined mainly by the growth of the resource sectors, especially the mining and petroleum sector. Although recent substantial increases in the world price of crude oil, to around US\$19 per barrel, are promising, prospects for other commodity prices are less bright. Gold and copper prices are likely to remain depressed for some time, and the outlook for forestry exports remains bleak. Moreover, although domestic prices of traditional agricultural commodities, such as coffee, copra and oil palm, have been helped by the substantial currency depreciation, world prices are expected to recover slowly. Thus, the short to medium term economic prospects for PNG are modest at best and subject to significant

¹⁶ World Bank (1998).

¹⁷ Asian Development Bank (1999a).

risk related both to external and internal factors. Foreign direct investment, which is heavily geared to the mining and petroleum sector, declined substantially in 1998, and is expected to fall further in 1999.

50. Turning the present economic situation around is linked not only to improved external factors but also to restoration of macroeconomic stability, investor confidence, and a more conducive business environment generally. This implies implementing key structural reforms and strengthening institutional and governance processes, as well as redressing the serious law and order problem and improving national and provincial governmental fiscal arrangements.

Table I.6
Key effects of the Asian crisis on PNG economy

| Type of effect | Assessment |
|--|--|
| Commodity export exposure | Major adverse impact on commodity prices (particularly oil and copper) and log volumes and prices. The total shock (after allowing for import leakages) is around 7% of GDP. |
| Tourism effects | Negligible. |
| Other net external income effects | Foreign grants will increase in kina terms. |
| Import effects | Depreciation raises the costs of most imports. The reduction in world price of oil provides a small boost to purchasing power. |
| Investment effects | Mining and forestry investments are weaker, but mining investment will recover. |
| Overall impact on GDP or external income | Net shock after allowing for cheaper fuel imports and import leakages of a decline in GDP of about 7% (from what it otherwise would be). A devaluation of 30% has alleviated pressures but the economy is still under serious pressure in the aftermath of a major drought and the impact of the Asian crisis and other factors that have weakened commodity prices. |
| Price effects | Inflation rose from 5.3% in 1997 to 21.8% in 1998, partly reflecting the impact of the devaluation of some 30% but also the impact of the drought. |
| Employment effects | The most visible impact has been an initial loss of jobs in logging of 5,000 but this has been subsequently reduced somewhat as logging activity has picked up. The impact on mining employment will be negligible. |
| Government budget | The budget deficit rose from a budgeted 1.2% of GDP to an outcome of 1.6% of GDP in 1998. The most important factor was lower log export taxes. Low oil prices are continuing to create significant budgetary pressures. |

Source: Asian Development Bank (1999a), *An Update on the Impact of the Asian Financial Crisis on PDMC Economies*, Office of Pacific Operations, April.