PAPUA NEW GUINEA

The economic environment in Papua New Guinea has improved significantly since the Government initiated macroeconomic stabilization and structural reforms in August 1999. Political stability, government commitment to reforms, and continuity of policies hold the key to the country's economic prospects.

Economic Indicator (percent)	1997	1998	1999	2000	2001
GDP growth	-3.9	-3.8	4.2	3.4	2.7
Inflation rate	3.9	13.6	14.9	12.5	5.0
Current account/GDP	-5.0	0.5	1.4	-0.4	-2.2

Economic Assessment. In the first half of 2000, real GDP growth continued as the agriculture, forestry, and fishing sector expanded after three years of decline. The construction sector is also expected to grow significantly over the whole of 2000 following the initiation of several major road projects. The Government is continuing its macroeconomic stabilization and structural reforms initiated in August 1999. These measures have brought about improvements in the country's fiscal and balance-of-payments positions.

The Government had a budget surplus equivalent to 0.4 percent of GDP through May 2000. This was achieved by a fiscal tightening that sharply reduced development expenditures. The targeted budget deficit of 1.7 percent of GDP in 2000 will require continued efforts at revenue mobilization and strict controls on recurrent expenditure. The Government is continuing to bring down public sector debt, and by March 2000, overall public sector debt had been reduced to K5.6 billion. This consisted of domestic debt of K2.0 billion and external debt of K3.6 billion. Over the first six months of 2000, net domestic credit to the Government declined by 22.0 percent. In addition, the Government also cleared K300 million of accumulated arrears of payments in the 12 months after June 1999.

Inflation remained high in the early months of 2000, in part because of the lagged effects of the kina's depreciation in 1999 and the first quarter of 2000: the year-on-year inflation rate in March 2000 was 19.6 percent. Continued high inflation has made it necessary for the central bank to maintain a tight monetary policy, and over the first five months of 2000 broad money (M3) declined by 5.0 percent. Its target for 2000 is to achieve an annual inflation rate of 12.0 percent. Despite fiscal and monetary constraints, and the kina's appreciation against the dollar during the second quarter of 2000, inflationary expectations remain high. The weighted average yield on 182-day Treasury bills continues to be high, although yields declined from 20.4 percent at the end of December 1999 to 16.3 percent at the end of June 2000. There are indications that interest rates are easing further, as in July 2000 one of the commercial banks announced a reduction of 1.5 percent in its lending rate. Higher world oil prices enabled the country to record a trade surplus of $269.5 million in the first quarter of 2000, though the balance-of-payments account had a deficit of

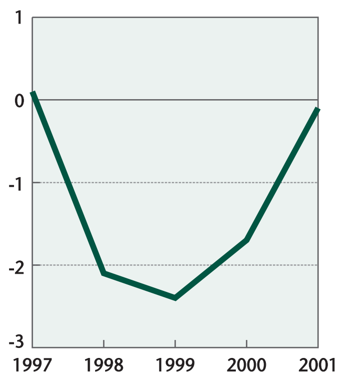
$31.2 million. The country's foreign exchange reserves increased from $204.4 million in December 1999 to $255.1 million in June 2000, or sufficient to cover 2.7 months of nonmineral imports.

The Government's efforts at macroeconomic stabilization and structural reform have received external support: the IMF approved a $115 million line of standby credit in March 2000, and the World Bank approved a $90 million Governance Promotion Adjustment Loan in June 2000. Credibility in fiscal and monetary policies is required to facilitate early adjustments of the economy and improve market expectations. A possible deterioration of the Government's financial position continues to pose a potential risk to ongoing macroeconomic and structural reforms. Delays in the Ramu Nickel and Papua New Guinea-Queensland gas pipeline projects, as well as the Government's failure to meet major conditions of externally assisted programs, also present risks to growth and stabilization of the economy.

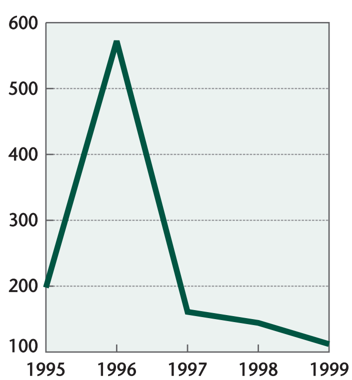
Structural Issues. New legislation and regulations are being promulgated to improve economic governance. A new act on central banking, making wide-ranging changes to bank regulations, came into effect in June 2000. Changes include increasing the independence of the central bank and price stability as a monetary policy objective. Putting a high priority on independent monetary management is crucial because of the economy's reliance on foreign trade, high mobility of capital, and flexible exchange rate regime. The Banks and Financial Institutions Act, which seeks to improve regulation and supervision of the financial system, was passed by Parliament. The ongoing reforms address an array of issues related to fiscal and monetary management, transparency of governance, privatization, and public service delivery. With ADB assistance, the Government is designing a public sector reform program that aims to improve public service delivery and to restructure the civil service.

The economy is extremely vulnerable to external shocks. To foster the macroeconomic stability needed to reduce the number of people who live below the poverty line (estimated at 40 percent of the population), the country needs to diversify its production and exports. Other priority issues are infrastructure development and improvement of law enforcement; the latter is required to improve the business environment and promote development of the private sector.

Fiscal Balance/GDP (percent)



Ratio of Reserves to Short-Term External Debt (percent)



Forecast. For 2000, real GDP is expected to grow by 3.4 percent. Mineral and nonmineral sector growth is expected to be 1.5 percent and 4.0 percent, respectively. Real GDP is projected to grow at 2.7 percent in 2001. The Government expects the budget deficit to decline to 1.7 percent of GDP in 2000, and to shrink further to 0.1 percent of GDP by 2001. Annual inflation is projected to be 12.5 percent in 2000 and 5.0 percent the following year. The balance-of-payments account is forecast to show a surplus of $128 million in 2000 and to be in balance in 2001. Gross official foreign exchange reserves are projected to be $380 million by the end of 2000, or sufficient to cover about 3.6 months of nonmineral imports. The reserves are projected to be $483 million (equivalent to about 4.3 months of nonmineral imports) by the end of 2001. However, political stability and continued commitment to implementing reforms are essential to realizing these projections.