

## PAPUA NEW GUINEA

**D**espite substantial external assistance and improvements in macroeconomic stability, the economy contracted in 2000. Its near-term prospects remain weak, and the Government needs to address basic development constraints as well as diversify the production and export base to move to a sustainable growth path.

Economic Indicator (percent)	1998	1999	2000	2001		2002	
				Current	ADO 2001	Current	ADO 2001
GDP growth	-3.8	5.4	-1.8	-2.0	3.1	1.5	5.7
Inflation rate	13.6	14.9	15.6	10.0	11.6	6.0	6.2
Current account/GDP	0.6	1.4	7.8	3.8	-3.5	3.5	-3.4

**Economic Assessment.** Economic activity remained depressed in the first half of 2001 following disappointing growth in 2000. According to revised estimates, GDP contracted by 1.8 percent in 2000, even though stabilization measures and reform efforts generally continued on course. Production of crude oil and most major agricultural commodities declined in the first half of 2001.

The maintenance of a tight monetary policy stance led to a gradual easing of inflation in 2000, which continued to decelerate into 2001. The average second quarter year-on-year rate of 7.9 percent was the lowest quarterly rate since the first quarter of 1998, which reflected weak aggregate demand and lower inflationary expectations.

Total government revenue and grants of K1.1 billion in the first half of 2001 amounted to only 34.6 percent of the Government's annual budget target, reflecting weak economic activity, civil unrest, and weak performance of revenue administration. Total government expenditure of K1.1 billion during this period was also low, pointing to financial constraints and tight expenditure controls. In particular, development expenditure, at about K99 million in the first half of 2001, represented only around one tenth of the budgeted amount for the full year. Delay in bringing the Papua New Guinea Banking Corporation to the point of sale—due to employee resistance—has deferred the release of \$20 million under a structural adjustment loan from the World Bank by about six months. This caused serious cash management difficulties for the Government in the first half of 2001, but despite these, the Government succeeded in meeting its debt service obligations.

The decline in inflation in the last few months of 2000 allowed the central bank to begin a measured easing of monetary policy in 2001. In February, it introduced a new price-based signaling mechanism to announce a “kina facility rate” (KFR) at the start of every month as a benchmark rate for interbank trading. Treasury bill rates moved in line with the gradual reduction in the KFR from 15.5 percent to 13.0 percent from February to July. However, commercial bank rates stayed firm, indicating a hardening

of real interest rates. Bank lending to business also remained low during this period.

In the first half of 2001, merchandise exports in kina terms increased by 4.2 percent compared to the corresponding period of 2000, due to the higher value of major exports except agricultural products. In the agriculture sector, rubber exports increased, reflecting better export prices, while coffee and palm oil exports declined due to weak international prices and a poor harvest. During this period, merchandise imports recorded a year-on-year increase of 2.2 percent, due to higher capital goods imports in the minerals sector. The current account recorded a surplus of K599 million in the first half of 2001, stronger than the corresponding figure in 2000 as a result of the higher trade surplus and transfer receipts. The overall balance of payments improved to a surplus of K183 million in the first half of 2001 despite a deficit on the capital account due to net official capital transfers and higher capital transfers by mineral companies to their offshore accounts. The level of foreign exchange reserves at the end of the first half of 2001 was K1.1 billion, sufficient to cover 4.6 months of imports. External public debt as of end-June 2001, at K4.2 billion, was 23.8 percent higher than one year earlier. The kina recorded wide fluctuations in 2001, and at the end of July 2001 had depreciated by about 10 percent since December 2000 against the dollar.

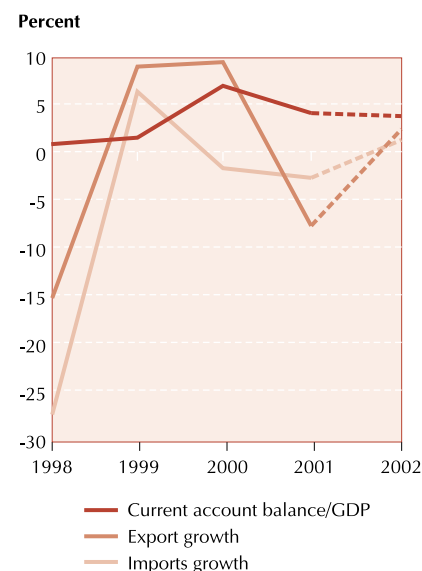
**Economic Management Issues.** The main economic management issues facing the country are (i) tight management of government finances, (ii) stabilization of the kina, (iii) reduction in inflation and interest rates, and (iv) generation of economic growth. Despite the Government's reasonable success in meeting most of these objectives in the recent past, economic growth remains elusive. The sharp slowdown in global growth and weaker trade flows are adding to the country's woes, and is testing national commitment to reforms. The situation has been exacerbated by increased political agitation in the early days of the run-up to elections in July 2002. The first half of 2001 witnessed major civil disorder and unrest.

While the 2001 budget anticipated and relied on a pickup in revenues from nonmineral activities, this has not materialized. The Government has proposed revising downward its revenue estimates for the year, reducing expenditure outlays, and increasing its reliance on nontax revenues. The 2001 agenda of reforms includes finalization of a new regulatory framework and competition policy, continuation of the privatization program, and completion of the functional and expenditure review of government departments.

The prime monetary policy target will be to keep inflation under control so as to weaken inflationary expectations and achieve a reduction in interest rates. The flexible exchange rate regime will be continued and central bank interventions will be restricted to smoothing short-term foreign exchange market volatility, which is a continuing problem and poses a serious threat to macroeconomic stability.

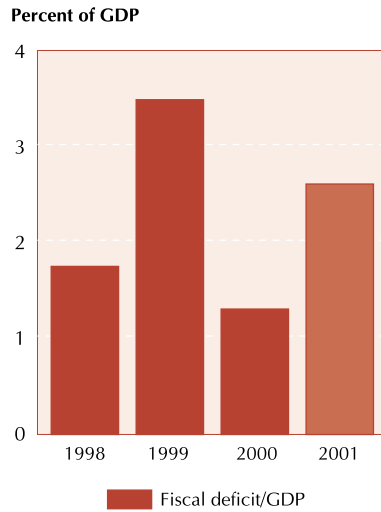
The country has a high population growth rate of about 3.0 percent, with a population of about 5.1 million in 2000. The fundamental development constraints of the country include rugged terrain, linguistic diversity, and

*The current account is likely to continue posting surpluses*



Source: Staff estimates

**The Government aims to limit the fiscal deficit to 2.6 percent of GDP in 2001**



Source: Staff estimates

isolated pockets of population. These hinder growth of the domestic market and extension of public services. The economy needs to diversify its production and export base and develop an integrated domestic market. Continuous underinvestment in rural areas, infrastructure, and human development is resulting in a society manifesting disparities in socioeconomic conditions and poverty, and significant gaps in skilled human resources. Investments in infrastructure, health, and education, and improvements in law and order will significantly help address these constraints and put the country on a long-term sustainable growth path.

**Forecast.** The growth estimate for 2001 and forecast for 2002 have been substantially revised downward since *ADO 2001*, largely reflecting a worsening outlook for the secondary and tertiary sectors, continuing difficulties in the coffee industry, and a secular decline in crude oil production. The economy is forecast to contract by 2.0 percent in 2001 due to a sharp fall in mineral extraction, construction, wholesale and retail trade, and activities related to transport, storage, and communications. A modest recovery of 1.5 percent is expected in 2002, on the back of more broad-based growth (excluding the minerals sector). The annual average inflation rate for 2001 is forecast to be 10.0 percent. On the expectation of greater exchange rate stability, inflation is expected to fall to 6.0 percent by 2002. The current account is projected to post a surplus of 3.8 percent and 3.5 percent of GDP in 2001 and 2002, respectively, due to an anticipated increase in the prices of agricultural commodities and slower imports associated with the minerals sector. The Government is aiming to limit the fiscal deficit to 2.6 percent of GDP in 2001. To achieve this, some expenditures that were supposed to have been made by the second quarter of this year will be deferred to 2002.