

PAPUA NEW GUINEA
ECONOMIC
AND
ASIAN DEVELOPMENT BANK OPERATIONS
UPDATE

October 2001

CURRENCY EQUIVALENTS

(as of 1 October 2001)

Currency Unit	–	Kina (K)
K1.00	=	\$0.2880
\$1.00	=	K3.4722

ABBREVIATIONS

ADB	–	Asian Development Bank
ADF	–	Asian Development Fund
CER	–	country economic review
PNG	–	Papua New Guinea
PNGBC	–	Papua New Guinea Banking Corporation
TA	–	technical assistance

NOTES

- (i) The fiscal year (FY) of the Government ends on 31 December.
- (ii) In this report, "\$" refers to US dollars.

I. THE ECONOMY

A. Introduction

1. A country economic review of Papua New Guinea (PNG) was published by the Asian Development Bank (ADB) in June 2000. This paper presents a further update on recent economic developments and ADB operations in PNG, and should be read in conjunction with that review.

B. Recent Economic Developments

2. Despite significant achievements in macroeconomic stabilization and structural reforms, economic growth in PNG did not show the expected outcome in 2000.¹ According to revised estimates, real gross domestic product (GDP) contracted by 1.8 percent in 2000. Tight monetary and fiscal policies contributed to the poor growth performance, although they helped improve macroeconomic stability. Inflation showed some signs of easing in 2000, which was reflected in decline in the end period inflation rate in 2000 to 10.0 percent from 13.2 percent at the end of previous year.

3. In the first half of 2001, economic activities continued to be depressed. Production of crude oil and most major agricultural commodities declined during this period. Inflation remained high, at 7.9 percent, for the June quarter 2001 compared with the corresponding period last year, which reflected a weak aggregate demand and lower inflationary expectations. However, this was the lowest year-on-year quarterly inflation reported since first quarter of 1998. Based on the decline in inflation since the last few months of 2000, the central bank initiated a gradual easing of monetary policy in 2001. However, commercial bank interest rates remained firm, indicating a hardening of the real interest rate. Bank lending to business also remained low during this period.

4. Government finances were broadly in balance in the first half of 2001, although both total revenue and total expenditure fell short of target. Total government revenue collection of K1,116 million in the first half of 2001 fell short of the pro-rata target, reflecting weak economic activity, civil unrest, and the constraints of the revenue administration machinery. Total government expenditure of K1,103 million during this period was also low, reflecting cash constraints and tight expenditure controls. In particular, development expenditure, at about K99 million in the first half of 2001, was only about one-tenth of the budgeted amount for the full year. Despite cash flow problems, the Government managed to meet debt service obligations.

5. The current account recorded a surplus of K599 million in the first half of 2001, this was higher than the corresponding figure last year due to a higher trade surplus and transfer receipts. As a result, the overall balance of payments was a surplus of K183 million in the first half of 2001, despite deficit in the capital account. The latter reflected net official capital outflows and higher transfers by mineral companies to their offshore accounts. The level of foreign exchange reserves at the end of the first half of 2001 was K1092 million, sufficient to cover 4.6 months of imports. External public debt at the end of the first half was about K4,170 million, 23.8 percent higher than in the same period

¹ Bank of Papua New Guinea (BPNG). 2001. *Quarterly Economic Bulletin*. Port Moresby, 26 September 2001; Department of Finance and Treasury. 2001. *June Treasury Economic Monitor*. Port Moresby; and International Monetary Fund's fourth review under the stand-by arrangement, September 2001.

last year. The kina recorded wide fluctuations in 2001 and had depreciated about 10 percent by July 2001.

6. The economy is projected to contract by 2.0 percent in 2001, as a result of continued decline in wholesale and retail trade, transport, storage and communication, and construction. The mining and quarrying sectors is also projected to decline sharply in 2001, largely reflecting a decline in petroleum sector. In 2002, a modest recovery — 1.5 percent—is expected, associated with a broad-based recovery, except in mining and quarrying. Almost all other sectors are projected to contract in this period. The annual average inflation rate for 2001 is forecast to be 10 percent. On the assumption of the kina's increasing stabilization, inflation in 2002 is expected to fall to about 6 percent. The current account is projected to be in surplus by 3.8 and 3.5 percent of GDP in 2001 and 2002, respectively, because of an increase in export prices of agricultural commodities and less-than-expected imports in the mineral sector. The Government is targeting to limit the fiscal deficit to 2.6 percent of GDP in 2001. To achieve this, some expenditure will be deferred to 2002 that was supposed to take place in the second quarter of this year.

C. Current Issues

7. The economy faces a high-risk period in the immediate future, due to the expected deterioration in the international political and economic environment and the sudden escalation in tension following the events of 11 September 2001 in the United States of America. 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 reasonable success in meeting most of these objectives in the recent past, economic growth continues to be elusive. A weak outlook for world output and trade is added to the woes of the country. This is testing the national resolve regarding its continued commitment to reforms. The situation has been compounded by increased political activity leading up to the forthcoming elections in July 2002. The first half of 2001 witnessed major civil disorder and unrest, including military unrest, antireform protests, and employee strikes. The 2001 agenda of reforms included finalization of a new regulatory framework and competition policy, continuation of the privatization program, and completion of functional and expenditure reviews of government departments.

8. PNG has a high population growth rate of about 3.0 percent, with the population at 5.1 million in 2000. Since the mid-1990s, poverty has been increasing while per capita real GDP has decreased. Real GDP declined at an average annual rate of about 0.1 percent during 1995–2000. The recent experience of reforms associated with declines in output emphasizes the fundamental development constraints of the country, such as rugged terrain, linguistic diversity, and isolated pockets of population. These constrain growth of the domestic market and the extension of public services.

9. The Government is successfully pursuing a macroeconomic stabilization and structural adjustment program with the assistance of donors including the International Monetary Fund and the World Bank. However, current efforts at sound macroeconomic management and structural adjustment have little meaning unless they enhance public services and result in higher standards of living for the population. Poor human resource development in PNG largely reflects the poor public service delivery mechanism.

Demonstrated improvements in the front line services are also required to maintain the commitment for reforms.

10. The country's oil production is experiencing a secular decline as a result of declining oil reserves. The economy is vulnerable to international price fluctuations, which are also associated with fluctuations in government revenue collection from the extractive industry. The country needs to diversify its production and export base and develop an integrated domestic market. These require major investments, which the economy is not able to generate given the low output and high population growth rates. Foreign investments have largely confined themselves to the mineral sector, while the nonmineral sector has been suffering from underinvestment. Continuous underinvestment in rural areas, infrastructure, and human development has resulted in a society manifesting socioeconomic disparity, poverty, and significant gaps in skilled human resources. Most of the people of PNG are poor by regional and international standards. Poverty also has a gender dimension. Across nearly all indicators, women fare worse than men. Investments in infrastructure, health care and education, and improvement in law and order, will go a long way in addressing these constraints and putting the country on a long-term sustainable growth path. Another area deserving priority development is information and communications technology.

II. ASIAN DEVELOPMENT BANK OPERATIONS

A. Operational Strategy

11. The current ADB strategy for PNG focuses on reducing poverty by improving governance, developing the private sector, and improving social indicators. The strategy supports a mix of long-term systemic development and more direct poverty interventions.

12. Poor governance and inadequate public sector management are the country's main development problems. All ADB loans will support improvement of governance. In the direct governance area, ADB is focusing on helping the Government strengthen (i) public sector financial management, by improving the machinery of financial management; (ii) public sector general management, at both national and provincial level, by concentrating management on output and performance; and (iii) strengthening good-governance institutions, by improving systems and procedures and through capacity building.

13. Private sector development is critical to reduce poverty. In addition to helping improve the functioning of government agencies and their ability to support the private sector and establish an appropriate enabling environment, ADB will (i) strengthen sector policy and institutional frameworks, e.g., agriculture support, microfinance; (ii) improve factor productivity, especially through skills development; and (iii) enhance market access, especially by rehabilitating and maintaining road and water transport infrastructure.

14. PNG's social indicators remain far too low, especially for women. Through public sector reforms, ADB will help improve the management and governance of the social service delivery agencies, focusing in particular on the basic services, health, education, public works. In the social sectors, ADB will continue to be involved in (i) policy development, especially in health and in water supply and sanitation; (ii) promotion of

infrastructure investments; and, (iii) improvement of social service delivery. ADB will (i) address gender and population concerns, (ii) focus on measurable service improvements, and (iii) emphasize women's participation in decision making in all sectors. Starting in the health sector, ADB will support the Government's innovative effort to improve the effectiveness of external assistance in the sector by adopting a sector wide approach, helping the Government to develop appropriate mechanisms.

Table 1: Asian Development Bank Ongoing Loans to Papua New Guinea
(as of 17 September 2001, \$ million)

Loan No.	Project Name	Loan Approval Amount
1211-PNG	Third Urban Water Supply	11.300
1224-PNG(SF)	Higher Education	16.512
1518-PNG(SF)	Health Sector Investment	9.127
1652-PNG	Smallholder Support Service Pilot	7.600
1656-PNG	Fisheries Development	6.500
1703-PNG	Financial Management	25.800
1706-PNG(SF)	Employment-Oriented Skills	18.796
1709-PNG	Road Maintenance and Upgrading	63.000
1754-PNG	Rehabilitation of Maritime Navigation Aids	19.800
1768-PNG(SF)	Microfinance	9.477
1812-PNG(SF)	Provincial Towns Water Supply and Sanitation	15.439
Total		203.351

B. Lending and Technical Assistance Operations

15. Since joining ADB in 1975 [through 30 September 2001], PNG has received 53 loans totaling \$774.2 million, of which 23 loans (for \$393.5 million) were from ordinary capital resources and 30 loans (for \$381.7 million), from the Asian Development Fund (ADF). The current loan portfolio consists of 11 loans (Table 1). The net transfer of resources has been negative in each of the five years 1996–2000, apart from 1999, when policy-based lending disbursements resulted in a positive balance. PNG has also received 113 technical assistance (TA) grants valued at \$37.0 million (Table 2).

Table 2: Sector Distribution of Technical Assistance
(as of 17 September 2001)

Sector	No. of TAs	ADB	JSF	Others	Total	Percent
Agriculture and Agro-business	29	4.566	3.598	0.350	8.514	23.0%
Energy	8	2.018	0.000	0.000	2.018	5.5%
Finance	4	0.946	0.000	0.000	0.946	2.6%
Industry and Minerals	5	1.230	0.800	0.000	2.030	5.5%
Social Infrastructure	24	6.198	1.788	0.170	8.156	22.1%
Transport and Communications	24	4.306	4.141	0.800	9.247	25.0%
Others	19	3.929	1.752	0.381	6.062	16.4%
Total	113	23.193	12.079	1.701	36.973	100.0%

ADB = Asian Development Bank, JSF - Japan Special Fund, TA = technical assistance.

16. During 2001, it is envisaged that one program loan of \$70 million and a TA loan of \$5 million will be provided, together with \$3.8 million in TA grants. After a review in 2000, PNG's graduation from access to ADF resources was deferred and PNG continues to have access to some ADF funds. Based on the current evaluation of PNG's performance (and assuming the base case for continuing performance), it is envisaged that PNG will have access to about \$50 million of ADF resources over the period 2002–2004, when the program envisages about 3–4 loans totaling \$60 million each year (ADF and ordinary capital resources). In addition, the program envisages about \$3 million worth of TA grants per year.

C. Project Implementation and Postevaluation Findings

17. The current loan portfolio consists of 11 loans. The Health Sector Development Program is still being implemented, although the corresponding loans have been disbursed and therefore closed. Loan portfolio performance, which has been relatively poor in the past, has recently improved as a result of Government and ADB efforts. In terms of development objectives, 10 of the ongoing loans are rated as satisfactory and 1 as unsatisfactory. In terms of implementation progress, 7 are rated as satisfactory, 2 as partly satisfactory, and 2 as unsatisfactory.

18. The satisfactory rating of development objectives is a direct result of efforts made by both the Government and ADB. However, all the loan projects suffer from delays in implementation. Many of the implementation problems are of a recurrent nature. Efforts made to institute improvements on implementation performance have however, been slow. A clear lesson is that closer coordination between government agencies is essential. Frequent changes in personnel (both project and supervisory) have also been the cause of less than satisfactory implementation performance. The underlying cause for staff movements appears to be the inherent shortfall in qualified personnel and to some extent ability of the government agencies to independently recruit staff. An advance approval of the Department of Personnel Management is required for all recruitment.

19. Portfolio review missions have recently prepared an action plan, which has been overwhelmingly endorsed by the government. These must be supported further by the reforms in the public sector. The recent improvement in the operations of the public procurement oversight agency is a clear indicator of the Government's commitment in this area. These have reduced a previously significant impediment to project implementation. Project readiness is another area for potential improvement. It is important that design of all future projects must focus on identifiable and quantifiable benefits to be achieved from timely implementation of these projects. The project design must also include an awareness program that would make not only the Executing Agencies but also all the coordinating agencies and the various stakeholders aware of the beneficial impacts of the loans.

20. A total of 20 projects have been postevaluated since PNG joined ADB in 1975: 7 were generally successful, 12 were partly successful, and 1 was unsuccessful (in agriculture). Focusing on the more recent results, five projects have been postevaluated since 1996: three (one ports, two agriculture) were generally successful, two were partly successful. The first program performance audit report for PNG, completed this year, rates the agriculture sector program as partly successful. These results indicate improvements, albeit modest ones. The lessons from the evaluations, which are

reflected in newer projects, include the importance of project design, the need for careful evaluation of the capacities of executing agencies (with remedial measures provided as required), and careful study of likely beneficiary response. Older projects in particular suffered from inadequate financial and market analysis, and inadequate attention to sustainability issues. The key lesson from the program loan was that inadequate sector analysis and lack of program preparatory TA can lead to programs that are inadequately tailored to the needs of the concerned sectors. Many projects have been affected by personal security and crime problems; project design can mitigate the potential risks.