

SM/06/29  
Correction 2

February 28, 2006

To: Members of the Executive Board

From: The Secretary

Subject: **Papua New Guinea—Staff Report for the 2005 Article IV Consultation**

The attached factual corrections to SM/06/29 (1/25/06) have been provided by the staff:

**Page 15, para. 17, lines 5 and 6:** for “Public employment has...will remain large.”  
read “While large cuts were made in payrolls in nonpriority areas in 2004 and 2005, these were offset by hiring in priority areas (including teachers and health workers). As a result, overall public employment has remained broadly unchanged and the wage bill will remain large.”  
**line 12:** for “no wage” read “no new wage”

**Page 26, Table 1, line 1:** for “US\$4.0 billion” read “US\$4.28 billion”  
**line 3:** for “US\$617” read “US\$764”

**Page 29, Table 4, footnote 1:** added to read “Public external debt includes central government, central bank external debt, and statutory authorities.”

**Page 42, Annex VI, last para.:** for “appreciation of the vatu,”  
read “appreciation of the kina,”

Questions may be referred to Ms. Creane (ext. 37294) and Mr. Q. Hussain (ext. 37334) in APD.

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from the tax package and previously scheduled tax cuts (including under the ongoing tariff reform) be offset by additional revenue-enhancing measures to guarantee the integrity of the non-mineral tax base and support the MTDS. In particular, the mission pointed to PFTAC technical assistance recommendations that could achieve this objective, such as through the creation of a large taxpayer unit and the introduction of a presumptive tax regime for small businesses. The authorities agreed with the need to safeguard the non-mineral revenue base through improved tax administration and were receptive to the PFTAC proposals, although they raised concerns that limited capacity could stymie effective implementation of reforms. They also pointed to the possibility of raising goods and service tax (GST) rates if needed in the future.

FY2006-07 Main Tax Policy Measures 1/	
<b>Personal income tax</b>	
Increase in the tax-free threshold from K6,000 to K6,300 in 2006 and to K6,600 in 2007.	
Create a new tax bracket at a 30 percent rate, reducing the existing income bracket at the 35 percent rate.	
Increase the top income bracket from K95,000 to K150,000 in 2006 and to K250,000 in 2007.	
Reduce the top marginal tax rate from 47 percent to 45 percent in 2006 and to 42 percent in 2007.	
Partial elimination of double taxation of dividends with a final withholding tax.	
<b>Tourism industry incentives</b>	
Double deduction for promotion costs.	
Accelerate depreciation for facilities expenses.	
Removal of some import duties.	
<b>Excises</b>	
Cap on inflation adjustment for excise tax rates.	
Introduction of a reduced excise rate for low margin tobacco products.	
1/ Permanent measures introduced in the 2006 budget.	

17. **In line with the MTDS, the authorities view expenditure re-orientation toward development areas as a first priority.** The mission welcomed the shift in 2006 budget expenditure toward infrastructure, the increase in education and health spending, as well as the improvements in the integrated payroll system that will continue to help control salary expenditure. However, overall progress has been slow on expenditure reprioritization. While large cuts were made in payrolls in nonpriority areas in 2004 and 2005, these were offset by hiring in priority areas (including teachers and health workers). As a result, overall pPublic employment has remained broadly unchanged~~not been reduced~~ and the wage bill will remain large. Against this background, the mission argued in favor of more front-loaded retrenchment instead of the current gradual employment reduction plan, and accelerated time-bound execution of the forthcoming recommendations from the “right-sizing” initiative’s to streamline the government’s structure and refocus it on core business. The authorities recognized that little progress had been made to date in reducing the wage bill, although it had been contained as a share of total expenditure and no new wage increase was budgeted for 2006, and that redoubled efforts were needed. These were expected to follow from the “right-sizing” recommendations, including plans for retrenchment in nonpriority areas.

18. **The authorities have made progress in improving expenditure management and plan to further strengthen budget preparation and financial and reporting systems under their Public Expenditure Review and Rationalization (PERR) program.** The current monthly cash budget system and the introduction of financial controllers have helped to keep spending within ceilings and limit the accumulation of new domestic arrears, although unauthorized expenditure reallocations across spending items continue to occur. The government has also made progress on trust accounts, including reducing the number by half since 2004, and tagging another 350 for closure.<sup>2</sup> To capitalize on recent progress, the mission suggested introducing a time-bound plan to close the remaining trust accounts not subject to standard financial management controls. In addition, as statutory authorities do not follow basic accountability procedures, the mission suggested that their budget operations should be subject to standard expenditure reporting obligations.

19. **The mission noted that should mineral revenue remain strong, maintaining the 2006 budget deficit target would imply an increase in expenditure and a deterioration in the non-mineral balance.** The mission advocated using any savings in 2006 to finance some increase in priority infrastructure or social spending, as long as the capacity to implement the spending effectively is not overtaxed. The bulk of any additional revenue should be used to reduce government debt, which would provide a continuing flow of resources in the form of lower interest payments and a hedge against the risks discussed above. Over the longer term, as budget dependence on mineral revenue could increase as the large gas and mineral projects underway come on line, the government should strengthen the current fiscal framework to address the impact of mineral revenue volatility on expenditure policy.

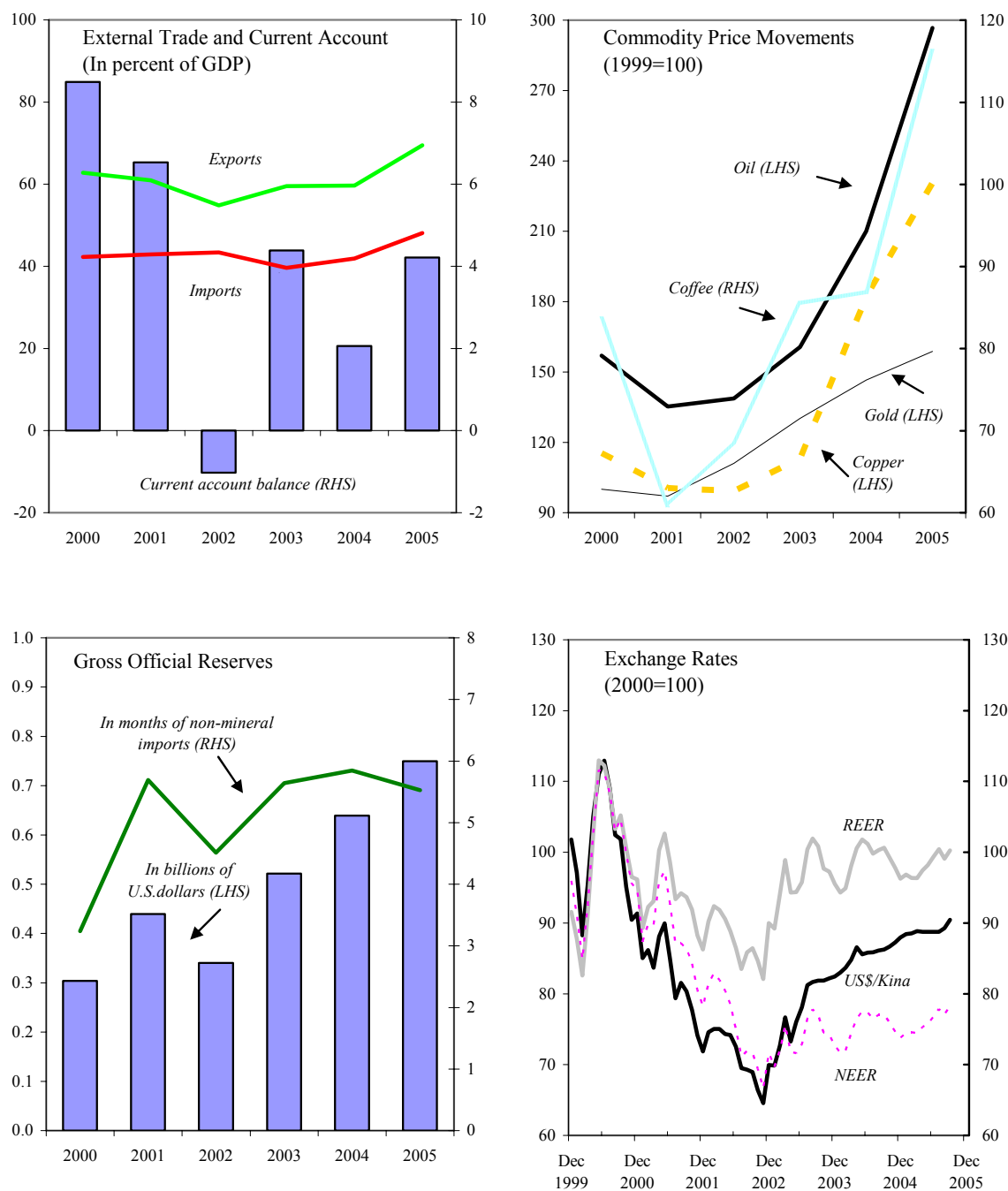
20. **The government has developed new guidelines for debt management that aim to reduce costs and risks.** The strategy is based on limiting acquisition of new debt to either domestic or concessional sources and lengthening the maturity. The mission cautioned on lengthening the maturity of government debt at high cost at a time when domestic interest rates were coming down. It noted in particular that the recent oversubscriptions of longer-term maturity (and more costly) Inscribed Stocks auctions had resulted in yields well below coupon rates. The authorities viewed these developments as reflecting the limited options for longer-term investment in a liquid market. Nonetheless, they indicated that they planned to proceed cautiously in order to avoid an inordinate rise in interest costs. The mission also emphasized the importance of avoiding the contracting of new external debt on commercial terms, and expressed concern about possible growing implicit contingent liabilities given state-owned enterprises' borrowing plans.

21. **The government is attentive to the need to strengthen financing and monitoring of sub-national governments' activities.** Sub-national governments manage resources

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<sup>2</sup> Trust accounts are used to hold third party funds (e.g., donor counterpart funds or court orders). Use of the funds does not require treasury authorization and they do not need to be cleared at year end.

Figure 4. Papua New Guinea: External Economic Indicators, 2000-2005



Sources: Data provided by the Papua New Guinea authorities; IMF, *Information Notice System* and *World Economic Outlook*; and Fund staff estimates.

Table 1. Papua New Guinea: Selected Economic Indicators, 2001–06

Nominal GDP (2004): [US\\$4.28 billion](#)  
 Population (2004): 5.6 million  
 GDP per capita (2004): [US\\$764](#)  
 Quota: SDR 131.6 million

	2001	2002	2003	2004	2005 Est.	2006 Proj.
Real sector (percent change)						
Real GDP growth 1/	-0.1	-0.2	2.9	2.9	3.0	3.5
Mineral	-10.4	-15.9	10.2	-0.9	-0.7	6.2
Nonmineral	1.9	2.5	1.9	3.5	3.5	3.2
CPI (annual average)	9.3	11.8	14.7	2.1	1.0	2.4
Central government budget (percent of GDP)						
Revenue and grants	29.7	27.8	28.4	31.3	28.0	27.7
Expenditure and net lending	33.2	31.8	29.6	29.8	25.2	27.3
Overall balance, cash basis (including grants) 2/	-3.9	-5.3	-1.6	1.1	2.7	0.4
Domestic financing (net) 3/	0.9	6.1	3.7	0.5	-1.0	0.4
External financing (net)	3.0	-0.9	-2.1	-1.6	-1.7	-0.8
Money and credit (end-period percentage change)						
Domestic credit	-12.3	20.4	-8.1	1.3	-1.0	24.0
Net credit to government	-26.1	80.3	-10.6	7.2	-24.7	42.8
Credit to the private sector	-1.2	-6.3	-4.3	-2.2	19.9	15.0
Broad money	1.9	4.2	-3.3	15.4	14.9	10.0
Interest rate (182-day T-bills; end-period) 4/	12.4	10.9	18.7	3.1	4.0	6.0
Balance of payments (millions of U.S. dollars)						
Exports, f.o.b.	1,878	1,646	2,153	2,554	3,352	3,714
Imports, c.i.f.	-1,321	-1,301	-1,435	-1,794	-2,321	-2,600
Current account (including grants)	201	-31	159	88	203	239
(In percent of GDP)	6.5	-1.0	4.4	2.1	4.2	4.6
Overall balance	66	-100	184	184	171	51
Reserves and external debt (end-period; millions of U.S. dollars)						
Net international reserves	331	224	398	575	749	800
(In months of nonmining imports, c.i.f.)	4.3	3.0	4.3	5.3	5.5	5.5
Gross international reserves	440	340	521	639	750	801
(In months of nonmining imports, c.i.f.)	5.7	4.5	5.6	5.8	5.5	5.5
Public external debt-service-ratio (percent of G&S exports) 5/	7.9	7.9	7.5	8.7	6.0	3.1
Public external debt-to-GDP ratio (in percent) 5/	48.7	51.5	44.1	34.5	27.3	24.9
Exchange rates						
US\$/kina (period-average) 4/	0.2964	0.2573	0.2814	0.3104	0.3217	...
US\$/kina (end-period) 4/	0.2658	0.2488	0.3000	0.3200	0.3230	...
Nominal GDP (millions of kina)	10,396	11,657	12,858	13,790	15,143	16,117

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

1/ Based on new official national account estimates (1998 prices).

2/ Measured from below-the-line in the fiscal accounts. Staff projections for 2005-06.

3/ Includes changes in check float.

4/ Figures for 2005 are as of end-October.

5/ Includes central government, Bank of Papua New Guinea, and statutory authorities.

Table 4. Papua New Guinea: Balance of Payments, 2001-06

(In millions of U. S. dollars)

	2001	2002	2003	2004	2005 Est.	2006 Proj.
<b>Current account balance</b>	<b>201</b>	<b>-31</b>	<b>159</b>	<b>88</b>	<b>203</b>	<b>239</b>
Mineral	802	473	728	793	1,100	1,105
Nonmineral	-601	-503	-569	-705	-897	-866
Trade balance	556	344	718	760	1,031	1,115
Exports (f.o.b.)	1,878	1,646	2,153	2,554	3,352	3,714
Mineral	1,598	1,228	1,635	1,863	2,494	2,756
Nonmineral	280	417	518	690	858	959
Imports (c.i.f.)	-1,321	-1,301	-1,435	-1,794	-2,321	-2,600
Mineral	-394	-397	-325	-482	-693	-840
Nonmineral	-927	-904	-1,109	-1,312	-1,628	-1,759
Services balance	-497	-571	-795	-853	-1,025	-1,122
Mineral (net)	-401	-358	-582	-588	-701	-811
Nonmineral (net)	-96	-213	-213	-265	-324	-312
Unrequited transfers (net)	142	196	235	182	198	246
Official	184	174	199	142	157	219
Private	-42	22	36	40	41	27
<b>Capital account balance</b>	<b>-252</b>	<b>-104</b>	<b>-23</b>	<b>35</b>	<b>-33</b>	<b>-188</b>
Medium- and long-term loan disbursements	-218	-154	-151	-213	-190	-110
Official (net)	-60	-26	-100	-101	-84	-40
Private capital flows (net)	-158	-128	-51	-113	-107	-70
Foreign direct investment (net)	74	19	97	26	68	88
Change in net foreign assets of commercial banks	2	-33	-60	-1	88	4
Other (net)	-110	63	90	224	2	-170
<b>Exceptional financing</b>	<b>135</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>
<b>Overall balance</b>	<b>66</b>	<b>-100</b>	<b>184</b>	<b>184</b>	<b>171</b>	<b>51</b>
<b>Change in net international reserves (- increase)</b>	<b>-66</b>	<b>100</b>	<b>-184</b>	<b>-184</b>	<b>-171</b>	<b>-51</b>
Gross official reserves	-136	100	-181	-118	-111	-51
IMF (net)	70	0	-6	-62	-60	0
Purchases	72	0	0	0	0	0
Repurchases	-1	0	-6	-62	-60	0
Other foreign liabilities	-1	0	3	-4	1	0
<b>Memoranda items:</b>						
Current account (in percent of GDP)	6.5	-1.0	4.4	2.1	4.2	4.6
Mineral	26.0	15.8	20.1	18.5	22.6	21.3
Nonmineral	-19.5	-16.8	-15.7	-16.5	-18.4	-16.7
Net international reserves						
In millions of U.S. dollars	331	224	398	575	749	800
Gross official reserves (end-year)						
In millions of U.S. dollars	440	340	521	639	750	801
In months of nonmineral imports	5.7	4.5	5.6	5.8	5.5	5.5
Public external debt-service-exports ratio (in percent) 1/	7.9	7.9	7.5	8.7	6.0	3.1
Public external debt-GDP ratio (in percent) 1/	48.7	51.5	44.1	34.5	27.3	24.9

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

1/ Public external debt includes central government, central bank external debt, and statutory authorities.

Table 5. Papua New Guinea: Medium-Term Scenario, 2001–10

	2001	2002	2003	2004	2005 Est.	Projections				
						2006	2007	2008	2009	2010
Growth and prices (change in percent)										
Real GDP	-0.1	-0.2	2.9	2.9	3.0	3.5	3.5	3.5	4.1	4.5
Mineral	-10.4	-15.9	10.2	-0.9	-0.7	6.2	4.3	2.5	9.4	11.4
Nonmineral	1.9	2.5	1.9	3.5	3.5	3.2	3.4	3.7	3.3	3.4
CPI (period average)	9.3	11.8	14.7	2.1	1.0	2.4	3.5	3.8	3.9	3.9
Savings and investment (in percent of GDP)										
Foreign savings	6.5	-1.0	4.4	2.1	4.2	4.6	-2.0	-2.6	-1.3	3.9
Public saving-investment balance 1/	-3.9	-5.3	-1.6	1.1	2.7	0.4	0.1	-0.1	0.3	0.0
Private saving-investment balance	-2.6	6.3	-2.8	-3.1	-6.9	-5.0	2.0	2.7	1.1	-3.9
Central government operations (in percent of GDP)										
Total revenue and grants	29.7	27.8	28.4	31.3	28.0	27.7	28.4	27.9	26.8	26.3
Of which: Mineral tax revenue	5.3	3.1	3.9	5.3	6.6	6.5	6.2	5.6	5.1	5.1
Of which: Grants	6.0	6.0	5.8	6.2	3.2	4.2	4.9	4.8	4.5	4.2
Total expenditure	33.2	31.8	29.6	29.8	25.2	27.3	28.3	28.0	26.8	26.0
Primary balance 2/	0.1	-1.5	3.8	3.8	4.8	2.9	2.7	2.5	2.4	2.6
Overall balance 2/	-3.9	-5.3	-1.6	1.1	2.7	0.4	0.1	-0.1	-0.1	0.3
Domestic financing (net) 3/	0.9	6.1	3.7	0.5	-1.0	0.4	0.2	0.5	0.5	-0.1
Foreign financing (net)	3.0	-0.9	-2.1	-1.6	-1.3	-0.8	-0.3	-0.3	-0.4	-0.1
Central government debt (in percent of GDP)										
Domestic	23.2	20.7	17.6	19.1	21.3	21.4	21.5	21.3	20.2	19.2
External	48.7	51.5	44.1	34.5	27.3	24.9	28.9	27.8	25.5	23.7
Balance of payments (in millions of U.S. dollars)										
Exports, f.o.b.	1,878	1,646	2,153	2,554	3,352	3,714	3,747	3,693	3,695	4,003
Of which: Mineral	1,598	1,228	1,635	1,863	2,494	2,756	2,738	2,669	2,639	2,912
Imports, c.i.f.	-1,321	-1,301	-1,435	-1,794	-2,321	-2,600	-3,057	-3,038	-2,975	-2,971
Current account	201	-31	159	88	203	239	-109	-144	-79	242
(In percent of GDP)	6.5	-1.0	4.4	2.1	4.2	4.6	-2.0	-2.6	-1.3	3.9
Overall balance (including exceptional financing)	66	-100	184	184	171	51	165	9	20	150
Net official reserves (in millions of U.S. dollars)	331	224	398	575	749	800	965	975	995	1,145
(In months of nonmining imports, c.i.f.)	4.3	3.0	4.3	5.3	5.6	5.5	6.2	6.1	6.0	6.5
Gross official reserves (in millions of U.S. dollars)	440	340	521	639	750	801	966	975	996	1,146
(In months of nonmining imports, c.i.f.)	5.7	4.5	5.6	5.8	5.5	5.5	6.2	6.1	6.0	6.5
Public external debt service-export ratio (in percent)	7.9	7.9	7.5	8.7	6.0	3.1	3.1	3.2	3.3	3.1
Memoranda items:										
Nominal GDP (in millions of kina)	10,396	11,657	12,858	13,790	15,143	16,117	16,757	17,473	19,104	20,754
Nominal GDP (in millions of U.S. dollars)	3,081	2,999	3,618	4,280	4,872	5,188	5,328	5,466	5,874	6,275

Sources: Department of Treasury; Bank of Papua New Guinea; and Fund staff estimates and projections.

1/ Central government operations only.

2/ Measured on a below-the-line basis.

3/ Includes changes in check float.



	Date of Latest Observation	Date Received	Frequency of Data <sup>6</sup>	Frequency of Reporting <sup>6</sup>	Frequency of Publication <sup>6</sup>
Exchange rates	11/30/05	12/19/05	D	W	W
International reserve assets and reserve liabilities of the monetary authorities <sup>1</sup>	8/31/05	10/05	W	W	Q
Reserve/base money	10/05	12/23/05	M	M	Q
Broad money	1 0/05	12/23//05	M	M	Q
Central bank balance sheet	10/05	12/23/05	M	M	Q
Consolidated balance sheet of the banking system	10/05	12/23/05	M	Q	Q
Interest rates <sup>2</sup>	10/31/05	12/20/05	W	W	Q
Consumer price index	06/05	11/05	Q	Q	Q
Revenue, expenditure, balance and composition of financing <sup>3</sup> —general government <sup>4</sup>	09/05	11/05	M	Q	Q
Revenue, expenditure, balance and composition of financing <sup>3</sup> —central government	2004	10/05	M	Q	Q
Stocks of central government and central government-guaranteed debt <sup>5</sup>	2004	11/05	Q	A	A
External current account balance	03/05	11/05	Q	Q	Q
Exports and imports of goods and services	03/05	11/05	Q	Q	Q
GDP/GNI	2004	7/05	A	A	A
Gross external debt	2004	10/05	Q	A	A

<sup>1</sup>Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

<sup>2</sup>Both market-based and officially determined, including discount rates, money market rates, rates on treasury bills, notes, and bonds.

<sup>3</sup>Foreign, domestic bank, and domestic nonbank financing.

<sup>4</sup>The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

<sup>5</sup>Including currency and maturity composition.

<sup>6</sup>Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Irregular (I); and Not Available (NA).

## PAPUA NEW GUINEA: PUBLIC AND EXTERNAL DEBT SUSTAINABILITY

*This annex summarizes the debt sustainability analysis (DSA) for Papua New Guinea using the new framework for low-income countries.<sup>1</sup> The baseline macroeconomic scenario underlying this DSA is the medium-term outlook discussed in the staff report, including the sustained implementation of the ongoing medium-term fiscal strategy. This annex also assesses the impact of various exogenous shocks on the sustainability of public sector debt and external debt under the baseline scenario.*

### A. Main Assumptions

- Real GDP growth is anticipated to rise gradually from about 3 percent in 2005 to about 4.5 percent by 2010, as agricultural productivity improves, the gas pipeline project and the Ramu nickel mine come on line toward the end of the decade, and structural reform is implemented.
- Monetary policy remains geared toward achieving the objective of keeping inflation at subdued levels and maintaining a sound external position.
- Near balance of the fiscal accounts are expected from 2007 forward, along with gradual improvements in the nonmineral overall and primary balances between 2006 and 2010.
- Papua New Guinea would have access to external concessional finance.
- Prices of key commodities are in line with WEO projections.
- Structural reforms, including those under the Medium-term Development Strategy, would continue to gradually improve governance, law and order, transportation infrastructure, and public sector enterprises' finances. Overall, the investment climate would continue to slowly be enhanced.

### B. Total Public Sector Debt Sustainability

**The public sector debt ratio has steadily declined from 76 percent of GDP at end-2002 to an estimated 49 percent of GDP at end-2005.** The improvement reflects the government's prudent fiscal policy, favorable mineral sector developments, the appreciation of the [vatu](#), declining interest rates, and a sustained economic recovery since the current government took office in mid-2002. Multilateral debt accounts for about 58 percent of total external public debt.

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<sup>1</sup> See *Operational Framework for Debt Sustainability Assessments in Low-Income Countries—Further Considerations* (SM/05/109).