



Appendix A - National Interest Statement

AUSTRALIAN GOVERNMENT LOAN TO PAPUA NEW GUINEA

Introduction

This National Interest Statement relating to the *Loan Agreement Between Australia and the Independent State Of Papua New Guinea* is tabled pursuant to the requirements of Sections 8C - 8F of the *International Monetary Agreements Act 1947 (IMAA)*, as amended by the *International Monetary Agreements Amendment Act 1998*.

As amended, *IMAA* specifies the conditions under which Australia may provide a loan (or currency swap) to a country undertaking an economic adjustment program supported by the International Monetary Fund (IMF). It also requires the Treasurer to table a statement indicating the reasons why the loan agreement is in Australia's national interest, along with a description of its nature and terms.

A transaction under *IMAA* provides temporary assistance to the recipient country. It offers balance of payments support to boost market confidence, helps stabilise financial flows across the country's exchange markets and reduces volatility in its exchange rate.

Australia's National Interest and the Loan Agreement with Papua New Guinea

Australia's bilateral relationship with Papua New Guinea, our nearest neighbour, is based on important and abiding historical, political, economic, strategic and social connections. As a friendly and sympathetic neighbour, and as PNG's closest partner in trade and investment, aid support, and defence, Australia has an overriding foreign policy interest in Papua New Guinea's sustainable economic development and stability. The presence of around 7,000 Australians in the country is also of significant interest to Australia.

Australia's economic interests in PNG, through trade and investment links, are significant to our own continuing economic development. PNG is our 11th largest investment destination and 18th largest trading partner. Australian investment in Papua New Guinea was estimated at \$2.3 billion at end June 1998, dominated by mining and petroleum, followed by services. Total bilateral trade was worth around \$2.1 billion in 1999.

Key aspects of the relationship between Australia and Papua New Guinea are encompassed in a number of formal bilateral arrangements, reflecting the strong ties between Australia and Papua New Guinea and the importance Australia places on this relationship. Amongst these formal arrangements, the Treaty on Development Co-operation covers what is by far the largest of any of Australia's bilateral aid programs. Australia currently provides about \$300 million in aid to Papua New Guinea each year, equivalent to almost half the bilateral aid effort and to a fifth of the total aid program.

By mid-1999, Papua New Guinea was experiencing considerable economic, financial, social and political difficulties. These included significant and worsening macro-economic imbalances, poor governance, and strained relations with Australia and the international donor and investment community. Foreign exchange reserves had dropped to critical levels, the exchange rate had collapsed, inflation was rising, and fiscal excess posed a continuing threat to macro-economic stability.

The Morauta Government came to office in July 1999 dedicated to restoring Papua New Guinea's fortunes. It introduced a broad-ranging program of economic and political reform, including measures to restore accountability, confidence and economic stability. The new Government gave priority to re-establishing the integrity of public institutions and to achieving key macro-economic objectives. These included stabilising the currency, lowering interest rates and inflation, and aligning fiscal policy with the availability of resources.

The PNG Government moved quickly to restore sound relations with Australia and, following a previous period of estrangement, to re-engage with the international financial institutions - the IMF and the World Bank. Engagement with the international financial institutions provides access to substantial financial resources, either directly or indirectly through triggering additional associated bilateral support, has positive effects on business confidence and private sector capital flows, and makes available to the recipient country a body of experience and expertise in the implementation of economic adjustment programs. We note that since the re-engagement of the IMF and World Bank, bilateral assistance has also been provided to PNG by Japan and the European Union.

The Government places a high priority on supporting the implementation of the Morauta Government's economic and political reform agenda. We have provided considerable financial support and, under the aid program, extensive technical

assistance to key PNG central economic agencies in support of the adjustment effort. We have encouraged the PNG Government to re-engage constructively with the IMF and the World Bank in the promotion of responsibly managed economic reform.

Australia's financial support for PNG has been carefully calibrated in line with its progress in re-establishing relations with the international financial institutions. The US\$80 million Reserve Bank of Australia (RBA) swap of December 1999 was put in place following PNG's initial agreement with the IMF on the basic direction of the reform program. This short-term bridging finance was replaced by the A\$133.2 million (equivalent to US\$80 million) Australian Government loan of 21 June 2000 (*Loan Agreement Between Australia and the Independent State Of Papua New Guinea*), which was executed following PNG's agreement with the IMF and World Bank on the details of the reform agenda.

Key elements of the IMF program, as set out in its Stand-By Arrangement, include an underlying balanced budget for 2000, maintenance of a tight monetary policy stance, and the introduction of a number of structural reform initiatives. Major reforms under the World Bank's Structural Adjustment Loan focus on privatisation, forestry, the civil service (including measures to build integrity and independence), the financial sector, governance, and health and education service delivery.

The provision of the Australian Government loan to PNG is recognition of the considerable gains made to date by PNG under the leadership of Prime Minister Morauta. To assist in meeting PNG's exceptional external financing needs over 2000-01, the Government announced in June that it would provide additional financial assistance of up to US\$30 million. This assistance will be provided in three tranches and will be linked to satisfactory IMF program reviews of the Stand-By Arrangement during 2000-2001. Consistent with the requirements of *IMAA*, the additional support will be separately reported to Parliament. This financing will contribute further to our key national interest objective of supporting the stability and sustainable economic development of Papua New Guinea.

The Nature and Terms of the Loan Agreement with Papua New Guinea

The parties to the 21 June 2000 A\$133.2 million *Loan Agreement Between Australia and the Independent State Of Papua New Guinea* are the Commonwealth of Australia, the RBA, the Independent State of Papua New Guinea and the Bank of Papua New Guinea.

The loan, which was publicly announced by the Australian and PNG governments at the time of agreement, has been provided to supplement the IMF's assistance to

PNG's program of economic adjustment, involving a US\$115 million Stand-By Arrangement agreed by the IMF Board in March 2000. The Australian loan provides support to PNG's foreign reserves, allows for lower PNG Government debt to the Bank of PNG, and underpins PNG's economic and governance reform efforts. In so doing, the loan also contributes to a further strengthening of investor and donor confidence in the PNG economy by providing additional assurance to financial markets that PNG's adjustment program has broad international support.

The Australian loan replaces a short-term bridging financial support facility, also equivalent to US\$80 million, which was established through a swap between the RBA and the Bank of PNG in December 1999, pending agreement on the IMF's Stand-By Arrangement. The Loan Agreement contains standard commercial terms and conditions, including an indemnity clause, designed to protect the Commonwealth's interests. Under the terms of the loan, repayments are to commence 2¼ years from the date of disbursement, with the repayment schedule spread equally over the ensuing 12 quarters, and interest is payable yearly from the date of disbursement. Consistent with the Government's previously stated intention in regard to loans under *IMAA*, the terms of the loan more than cover the Commonwealth's cost of funds, thereby not imposing direct costs on the Australian taxpayer and providing scope to earn income to offset risk.

As the loan is classified as an advance, it will have no direct impact on the Commonwealth's fiscal and underlying cash balances, or net debt. Interest income from the loan is also broadly offset by increased debt servicing costs, leaving both balance measures broadly unchanged.

Section 8C of *IMAA* sets out the conditions under which Australian assistance may be provided in support of an IMF program in a recipient country. The Treasurer, on behalf of Australia, may enter into a loan agreement if the IMF requests this assistance and if he is satisfied that at least one other government or organisation has provided, or intends to provide, financial assistance to the recipient country in response a similar request from the IMF. A further condition of Section 8C is that the agreement must provide for Australia to be able to require early repayment of the loan in the event of suspension, or premature termination, of the IMF program.

The Loan Agreement entered into with Papua New Guinea complies with these three provisions.

- On 14 April 2000, the Acting Managing Director of the IMF, Mr Stanley Fischer, requested Australia's participation in the financing package for Papua New Guinea in support of the IMF's US\$115 million Stand-By Arrangement (approved by the IMF Board on 29 March).
- On 13 June 2000, the World Bank Board approved a US\$90 million Structural Adjustment Loan for Papua New Guinea, fulfilling earlier advice from the

IMF of the World Bank's intention to contribute to meeting PNG's 2000 financing gap.

- Clause 9.1 (a) of the Loan Agreement provides for the Commonwealth to be able to require early repayment of the loan if the IMF suspends, or prematurely terminates, its Stand-By Arrangement.