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THE TREASURY

5 March, 2001

Mr Cliff Lawson
Secretary
Foreign Affairs Sub-Committee
Suite R1.120, House of Representatives
Parliament House
CANBERRA ACT 2600

Dear Mr Lawson

INQUIRY INTO THE SECOND AUSTRALIAN LOAN TO PAPUA NEW GUINEA

I refer to your letter of 7 February seeking a written submission from Treasury on the National Interest Statement for the second Australian loan to Papua New Guinea, which was tabled on 7 February 2001.

Responses to your questions are provided in the attachment.

Ministers are considering the draft Government response to the Committee's report on the first loan to Papua New Guinea and I expect it will be provided to you shortly.

As requested in your letter of 16 February, Treasury will be represented at the Foreign Affairs Sub-Committee hearings on the second National Interest Statement on the afternoon of Friday 9 March.

Yours sincerely

Chris Legg
General Manager
Asia-Pacific Division

INQUIRY INTO THE SECOND AUSTRALIAN GOVERNMENT LOAN TO PNG

Q.1 The conclusions and recommendations in the Committee's recent report (Australian Government Loan to Papua New Guinea, October 2000). Once again, the NIS was released at the time the loan was executed (14 December 2000). Why has it not been possible to enable Parliamentary scrutiny to occur <u>before</u> the loan agreement was made?

The Committee's recommendation on the prior scrutiny of loans will be fully addressed in the Government's response to the Committee's report on the first loan to PNG.

The provision of prior Parliamentary scrutiny of loans made under the *International Monetary Agreements Act 1947 (IMAA)* would require amendments to the Act. However, we consider that such amendments could considerably weaken Australia's capacity to provide rapid and effective assistance to countries facing financial crises. The 1998 amendments to *IMAA* were conceived in the context of the Asian financial crisis, which called for speedy assistance by the international community to countries facing the effects of financial contagion. The second reading speech for the amendments to *IMAA* noted the importance of Australian Governments having the capacity to act swiftly 'to help mobilise international support … [and] to provide commitments on our own participation' in economic rescue efforts. The longer lead times for the two Australian Government loans to PNG in 2000 rendered them something of an exception to the type of loan typically expected under *IMAA*.

The introduction of a period of Parliamentary scrutiny of the accompanying National Interest Statement before a loan is executed and disbursed, even for the relatively short period of 5-6 weeks suggested in the Joint Committee report on the first Australian Government loan to PNG, could critically circumscribe Australia's capacity to contribute to financial rescue packages and could weaken the effectiveness of international support efforts for countries in crisis.

We consider that the requirements of accountability and transparency are fully met by the current arrangements under *IMAA*. In keeping with the spirit of *IMAA*, we accept the principle that the National Interest Statement should be tabled as early as possible following the execution of a loan.

Q.2 The criticism in the report of the 'barest minimum of detail' provided in the first NIS in relation to the nature and terms of the loan:

(a) The second NIS appears to cover much the same information as the previous one. In what respects do the two statements differ, and do you consider that the content has been made more informative?

Following the comments made in the Committee's report on the June 2000 Australian Government loan to PNG, the National Interest Statement for the December 2000 loan contains additional information on its nature and terms. This additional information (see pp.3-4 of the National Interest Statement) describes the key terms and conditions of the loan in significantly greater detail and draws attention to important conditions precedent applying to the loan. The National Interest Statement also provides full details of the arrangements agreed with PNG for disbursement of the loan in three tranches linked to the completion of the first three reviews of the IMF's Stand-By Arrangement.

(b) Could you explain how the terms of the loan "do not impose any direct costs on the Australian taxpayer and provide scope to earn income to offset risk"? (p.4 of the NIS).

If a concessional loan were provided to PNG at an interest rate below the cost at which the Commonwealth borrowed its funds, it would impose a direct cost on the Australian taxpayer - the interest earned by the Commonwealth on the former would not match the interest cost to the Commonwealth of the latter. However, the interest rate on the two loans to PNG has been set at a margin above the cost at which the Commonwealth borrows, thereby providing a source of income to the Commonwealth.

(c) Similarly, the Committee would appreciate an explanation of the technicalities of classifying the loan as an advance, with the effect of having "no direct impact on the Commonwealth's fiscal and underlying cash balances, or net debt"?

The principal transactions of Australia's loan to PNG are classified as financing transactions.

Financing transactions have no net impact on the balance sheet: provision of the loan principal reduces the Commonwealth's cash balances but increases loan assets (ie receivables). As the transaction has simply rearranged two financial assets, there is no impact on net debt or net worth. The provision of loan principal does not involve revenues, expenses or effects on net capital investment so therefore has no impact on the fiscal balance.

In the Government Finance Statistics (GFS) cash flow statement, the cash flow associated with providing the loan principal is classified as under 'net cash flows from investments in financial assets for policy purposes' (under cash budgeting these cash flows were referred to as 'net advances'). These cash flows do not impact on the underlying cash balance.

(Of course, interest flows associated with the loan do impact on the fiscal and underlying cash balances and net debt.)

Q.3 From your perspective, in what respects have political, economic and social conditions in PNG changed since the loan matter was last considered by the Committee (September/October).

Changes in the political and social conditions in Papua New Guinea since the Committee considered the first loan are set out in the answers provided separately by the Department of Foreign Affairs and Trade.

In relation to economic conditions, we note that the PNG economy has not performed as strongly as had been anticipated earlier in 2000. In the 2001 budget, approved by the PNG Parliament in early December 2000, growth for 2000 was estimated at 0.8 per cent, against an estimate of 4.7 per cent at the time the 2000 budget was passed by the PNG Parliament a year earlier. The economic performance in 2000 followed negative growth in two of the previous three years. The agriculture, mining and construction industries fell short of expectations in 2000 - the year was marked by a bad coffee crop, poor commodity prices (especially copra) and lower than expected oil production. These constrained exports and weakened the exchange rate.

There have been encouraging improvements in some macro-economic aggregates since the Morauta Government came to office, including substantial reductions in interest and inflation rates and, at the time of the 2001 budget, a trebling of official foreign reserves. However, further significant improvements in levels of inflation and interest rates are not predicted for 2001. Although this is impacting negatively on business confidence, the 2001 budget estimated GDP growth at 3.1 per cent in 2001 and at even higher levels in the following years.

Fiscal outcomes have substantially improved under the Morauta Government – the projected fiscal deficit (including one-off structural costs and payments of arrears) for 2001 is 1.3 per cent of GDP, down from 2.2 per cent in 1999 and an expected outcome of 1.8 per cent in 2000. Excluding the one-off factors, the budget will be virtually in balance in 2001.

Although trading in excess of US40c in the middle of 2000, the kina has depreciated to trade at around the US30c level in recent weeks. While seasonal factors are important in setting the level of the kina early in the calendar year, market commentators have also pointed to other factors of significance in causing the depreciation, including the weak performance of key export commodities such as coffee and oil, and the absence of positive announcements from the IMF and World Bank on their next loan disbursements (for further details see Question 4).

Q.4 Could you provide updated information on progress with, or setbacks to, the Morauta Government's reform program? For example:

(a) Key elements of the IMF economic reform program for PNG, including privatisation of public entities?

On 13 October 2000, the IMF's Executive Board concluded the first review under its 14-month US$115 million Stand-By Arrangement with Papua New Guinea, agreed in March 2000. The Board noted that the Fund-supported program was on track and commended PNG for its strong implementation of its ambitious macro-economic and structural reform agenda.

On macro-economic reform, IMF Directors welcomed PNG's improved fiscal performance, including through better expenditure control, and its success in mopping up the large overhang of liquidity that had threatened to increase inflation. In the area of structural reform, Fund Directors welcomed the passage of the revised *Central Bank Act* and the *Banks and Financial Institutions Act*, aimed at improving the framework for monetary policy and the supervision of financial institutions. Directors noted that the introduction of new procedures and institutional structures for rural development spending signalled the PNG authorities' determination to tackle difficult issues. They also noted the importance of proceeding as rapidly as possible in implementing public sector reforms aimed at rationalising the civil service.

The IMF Board welcomed the preparations underway in bringing PNG Banking Corporation to the point of sale by the end of 2000, as set out in the PNG Government's Letter of Intent of March 2000, and urged the authorities to proceed with their privatisation program without delay, but on the basis of careful consideration of the options. On 19 February, the PNG Government announced the regime of community service obligations to apply to the banking sector after the 'forthcoming' privatisation of PNGBC. The Government indicated that the contract of sale for the PNGBC would require it substantially to maintain its existing network outside the main towns for several years.

There has been rapid progress in recent months in preparations for the sale of Air Niugini. The sale terms have been agreed and the Privatisation Commission has called for bids. The PNG Government has indicated that up to 49 per cent of the equity will be sold in a partial trade sale, and it expects to be able to name the successful bidder by the end of the month. The PNG Government has noted that the Air Niugini sale will mark the first privatisation of a significant Government business enterprise after many years of failed attempts by many political leaders.

Significant progress has also been achieved in other areas of the privatisation program. Project managers have been appointed for the other major privatisations (Elkom, Telikom, and Harbours Board) and an independent probity manager, with a mandate to cover all privatisations, has been appointed.

The IMF's second review team visited Port Moresby in early November 2000. However, its report has not been taken to the IMF Board as yet and we understand that both the second and third reviews will be considered by the Board following the third review mission, which commenced in Port Moresby on 21 February.

PNG's withdrawal of recognition of World Bank Resident Co-ordinator Mr Dan Weise on 7 February marked the low point in its relations with the Bank since the Morauta Government came to office 18 months ago. However, we are encouraged that, subsequent to Mr Weise's removal, both parties appear to have understood the imperative to move forward together and have established a practical basis for their continuing commitment to reform in PNG.

The World Bank Board does not undertake formal reviews of progress in its Structural Adjustment Loan. However, its press release of 18 February, issued jointly with the PNG Government, publicly acknowledged the substantial progress to date of the Morauta Government's reform program, including on measures to establish fiscal prudence and financial stability, delivery of services to rural areas, institutional and public sector reform, privatisation and forestry sector management. The Bank has noted, however, that the unfinished agenda remains great and that progress on privatisation would be an important contributing factor for the disbursement of the remaining tranches of its loan to PNG (the 'floating' tranche of US$20 million and the 2nd tranche of US$35 million).

(b) Political integrity, accountability and transparency initiatives? and (c) The Morauta Government's on-going legislative program, and adjournment of Parliament until July 2001.

See submission of the Department of Foreign Affairs and Trade.

Q.5 Your response to the Committee's criticism of the quality (breadth and depth) of the information provided in the NIS in relation to 'Australia's national interest'.

The Committee's comments in relation to the information provided on the national interest for the first loan were addressed in the National Interest Statement for the second loan. Discussion of the national interest was significantly expanded to provide greater detail on the nature of Australia's relationship with Papua New Guinea, including in the context of the wider region.

Q.6 Press reports today (Australian Financial Review) that pressure is increasing on the Australian Government to respond to PNG's request for financial assistance with the Australia-PNG pipeline project.

This issue is to be considered by Ministers shortly. Australian officials have discussed the financial arrangements for the PNG-Queensland gas pipeline extensively with PNG officials over the past six months and have indicated that the project should proceed on its commercial merits. We note that the financing arrangements for the pipeline are just one of many issues requiring resolution before the project can proceed.