

The Australian loan to PNG

- 3.1 The Australian Government loan to PNG that is the subject of this inquiry was made under the provisions of the *International Monetary Agreements Act 1947* (IMAA), as amended in by the *International Monetary Agreements Amendment Act 1998*.¹
- 3.2 As required by sections 8E(a) and (b) of IMAA, this Chapter sets out the nature and terms of the June 2000 loan agreement with PNG, and also addresses Australia's national interest in making that loan.
- 3.3 Before addressing these matters, it will be necessary to discuss a number of other issues, such as the means by which the International Monetary Fund (IMF) assists its members and PNG's reform program.

Principal sources of information

- 3.4 Evidence on details of the loan to the PNG Government, PNG's general economic position and the roles of the IMF and the World Bank was given to this inquiry by the Treasury. The Department of Foreign Affairs and Trade (DFAT) gave evidence on foreign policy, trade and national interest issues.
- 3.5 Evidence from these Departments clarifies and supplements information in the National Interest Statement (NIS) tabled in the Parliament on 28 August 2000. This was the basic document in this inquiry.²

Chronology

- 3.6 Put together from the material provided in the NIS and at the public hearing on 12 September 2000, the chronology of the process by which this loan was granted is:

1 NIS, p. 1.

2 See Appendix A for the NIS.

- December 1999: \$US80 million swap between the Reserve Bank of Australia (RBA) and the Bank of PNG.
- December 1999: Draft Letter of Intent signed between the IMF and PNG.
- 20 March 2000: PNG's Letter of Intent to the IMF, requesting a 14 month Stand-By Arrangement of \$US115 million.³
- 29 March 2000: IMF Board approval for the Stand-By Arrangement with PNG.
- 14 April 2000: IMF request for Australian participation in support of that Stand-By Arrangement.
- 13 June 2000: World Bank approval of a \$US90 million Structural Adjustment Loan for PNG.
- 21 June 2000: Execution of the Agreement for the \$A133.2 million loan between the Commonwealth of Australia, the RBA, the State of PNG and the Bank of PNG.⁴
- 28 August 2000: NIS for the Australian Government Loan to Papua New Guinea tabled in both Houses of the Parliament.

The Reserve Bank currency swap

- 3.7 In December 1999, the RBA provided a swap of \$US80 million to the Government of PNG, pending agreement on the IMF's Stand-By Agreement. This short-term bridging finance was replaced by the loan of \$A133.2 million from the Australian Government, the subject of this inquiry.⁵
- 3.8 Treasury noted that the cost of the RBA's swap was at a cheaper rate than PNG would have obtained by itself.⁶

3 See Exhibit No 1.

4 The chronology can be found in the NIS, p. 3, and in Transcript, Mr Mark Sewell, Treasury, 12 September 2000, pp. 3, 4, 9.

5 NIS, p. 3, Transcript, Mr Mark Sewell, Treasury, 12 September 2000, p. 4. At p. 2, the NIS states that the December 1999 swap 'was put in place following PNG's initial agreement with the IMF on the basic direction of the reform program.' In June 2000, \$US80 million and \$A133.2 million were equivalent amounts. Loans are linked to governments and there is a repayment schedule, whereas the swap referred to was an arrangement whereby Australian dollars were given to PNG and in return PNG kina was lodged with the RBA. See Transcript, Mr Mark Sewell, Treasury, 12 September 2000, p. 6.

6 Transcript, Mr Mark Sewell, Treasury, 12 September 2000, p. 17.

The IMAA Act

- 3.9 As amended in 1998, 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 IMF. It also requires the Treasurer to table a statement including the reasons why the loan is in Australia's national interest, as well as a description of its nature and terms.⁷
- 3.10 Prior to that amendment of the 1947 Act, there was no legislative basis for dealing with requests for assistance in support of IMF programs. Such requests were dealt with in an *ad hoc* manner.
- 3.11 Thus, the 1995 Government-to-Government loan to PNG used funds obtained initially from the Advance to the Minister for Finance. Support for Thailand in 1997 was arranged through a currency swap between the RBA and the Bank of Thailand.
- 3.12 A transaction under IMAA now provides temporary assistance to the recipient country, offering support to its balance of payments (BOP) to boost market confidence, help stabilise financial flows across exchange markets and reduce volatility in exchange rates.
- 3.13 Section 8C of IMAA sets out conditions under which Australian assistance may be provided in support of an IMF program in a recipient country. On behalf of Australia, the Treasurer may enter into a loan agreement if the IMF requests this assistance, and if he/she is satisfied that at least one other government or organisation has provided, or intends to provide, financial assistance to that country in response to 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 a loan in the event of suspension, or premature termination, of the IMF program.
- 3.14 The NIS noted that the Loan Agreement with PNG complies with these three provisions.⁸

IMF programs

- 3.15 The IMF is a cooperative international financial institution (IFI) in which member governments provide temporary financial assistance to other

7 NIS, p. 1. Material in this section was drawn from Transcript, Mr Mark Sewell, Treasury, 12 September 2000, p. 2.

8 NIS, p. 3.

member countries experiencing difficulties in paying for imports of goods and services and/or servicing their foreign debts.⁹

- 3.16 As a condition for such support, the borrower country agrees to undertake policy reforms to correct problems underlying its BOP difficulties. Temporary assistance provides members with the opportunity to take corrective actions without resorting to measures that may be destructive of national or international prosperity.
- 3.17 Before the IMF releases any funds, the borrower nation must demonstrate how it intends to solve its payments problem within the normal repayment period of three to five years. Because of its obligation to the membership to preserve financial integrity, the IMF only lends on condition that the borrowed funds are used effectively. The borrowing nation therefore undertakes to initiate a series of reforms that will eradicate the source of the BOP difficulty, and prepare for high quality economic growth.
- 3.18 Potential borrowers therefore negotiate with the IMF plans of reform, based on their particular economic circumstances. In developing such plans, it is important that countries have good quality government spending, including attention to spending on health and education, and good governance, with a proper focus on avoiding corruption, and with openness in fiscal policy and policy making.
- 3.19 The specifics of each adjustment program are selected by the member country, so that it rather than the IMF owns the reform program. The IMF's main concern is that any policy changes are sufficient for the member to overcome its problem, and that they do not cause harm to other members. Depending on the seriousness of the BOP problem, and the amount the member wishes to borrow, the IMF judges whether the reforms proposed will be sufficient and whether repayment can be expected.
- 3.20 If the IMF is satisfied that the proposed reforms will solve the problem(s) and strengthen the member's economy, the loan is disbursed in instalments that are tied to progress in putting those reforms into effect.

9 Material in this section was drawn from Transcript, Mr Mark Sewell, Treasury, 12 September 2000, pp. 2-3. See also the NIS, p. 2.

PNG's reform program

- 3.21 Details of PNG's economic reform program are set out in the Letter of Intent dated 20 March 2000, published on the IMF web site. This program aims to establish sustainable growth by:
- reducing inflation in the budget deficit, underpinned by far-reaching structural reforms;
 - improving public sector governance;
 - promoting private sector development, and
 - strengthening the financial system.¹⁰
- 3.22 A key feature of the reform program is that it envisages a return to fiscal stability through an overall deficit of 1.5 per cent of Gross Domestic Product (GDP) in Financial Year 2000, with a balanced budget in the coming Financial Year and beyond. A key fiscal reform is the enhancement of control over Government expenditure. Other macro-economic targets include:
- growth in Financial Year 2000 increasing to about 4.5 per cent;
 - a reduction in inflation to 5 per cent by the end of that Financial Year, and
 - an increase in gross official reserves.¹¹
- 3.23 On the monetary side, the large amount of excess liquidity that emerged in PNG in 1999 has been mopped up. A new Central Banking Act has been introduced, and the Banks and Financial Institutions Act has strengthened financial sector supervision and regulation. Key structural reforms have included proposals for the privatisation of large-scale public enterprises and the replacement of the Rural Development Program with District Development Program grants. The latter will be allocated to district and local development projects in ways that will, according to the Treasury, enhance transparency, fairness and cost effectiveness.
- 3.24 Over the 14-month period of the Stand-By Arrangement, the IMF will assess progress against the broad targets in the Letter of Intent signed by the PNG Government in March 2000. Australia has committed itself to a

10 See Exhibit No 1 for the Letter of Intent. Material in this section was drawn from Transcript, Mr Mark Sewell, Treasury, 12 September 2000, pp. 3-4. Additional information on the Morauta Government's reform program can be found in Chapter 2.

11 The PNG Budget is brought down late in a year for the following 1 January to 31 December Financial Year

further \$A30 million of support, in three tranches, linked to IMF reviews. Progress will be assessed against:

- the various monetary targets that are embedded in the IMF's program, and against which the IMF has sought support from Australia and other bilateral donors, and
- the various economic and governance reforms related to improving fiscal performance: in the monetary system, structural reforms including the privatisation program, and changes to the Rural Development Fund.¹²

World Bank loan

- 3.25 On 13 June 2000, the World Bank approved a \$US90 million loan in support of PNG's program of structural reforms, to strengthen economic management and governance in public financial institutions. This loan supports PNG's ongoing efforts to redress past shortcomings in governance policy.
- 3.26 This World Bank loan includes components to improve:
- fiscal and debt management;
 - governance in civil service effectiveness;
 - delivery of health and education services;
 - forestry management;
 - the quality and effectiveness of financial services, and
 - the operating environment for business.
- 3.27 The World Bank loan supports measures to strengthen public sector institutions and the integrity of the civil service. It aims to enhance governance through greater transparency, and to improve public sector management capacity in the provision of government services to priority areas, such as rural development, health, education and fighting crime.

Previous loans to PNG

- 3.28 Treasury noted that the previous Australian Government loan to PNG in 1995 was repaid on time and in full, while an IMF program was in place. It also pointed out that AusAID's support for PNG, via the development cooperation program, is not provided for balance of payment purposes, but to achieve development assistance objectives.¹³
- 3.29 With reference to bilateral loans to PNG, Treasury also noted that reports of the Sovereign Ratings Service of the leading international ratings agency, Standard & Poors, indicated that PNG has 'no history of default on borrowings' since its independence in 1975.¹⁴

Purposes of the Australian loan

- 3.30 The June 2000 loan agreement between Australia and PNG provided that the funds shall be used:
- to repay the outstanding December 1999 swap with the RBA, and
 - to supplement PNG's international reserves.
- 3.31 This agreement further provided that PNG is to maintain net international reserves at a level in conformity with the target specified in its IMF program.¹⁵

Terms of the loan

- 3.32 The NIS noted that the Australian loan agreement contained standard commercial terms and conditions, including an indemnity clause designed to protect the Commonwealth's interests.¹⁶
- 3.33 Repayments are to commence two and a quarter years from the date of disbursement, with the repayment schedule spread equally over the following 12 quarters. Interest is payable yearly from the date of the disbursement, on 21 June 2000.
- 3.34 Consistent with the Australian Government's previously stated policy on loans under IMAA, the terms of this loan more than cover the cost of the

13 Transcript, Mr Mark Sewell, Treasury, 12 September 2000, p. 4, Submission No 5 from Treasury, p. 3.

14 Submission No 5 from Treasury, p. 3.

15 Transcript, Mr Mark Sewell, Treasury, 12 September 2000, p. 4.

16 Details of the terms of the loan in this section are drawn from the NIS, p. 3, and from Transcript, Mr Mark Sewell, Treasury, 12 September 2000, pp. 4, 6.

funds. It does not, therefore, impose direct costs on the Australian taxpayer and provides scope to earn income, offsetting any risk in the loan. As it is classified as an advance, it will have no direct impact on Australia's fiscal and underlying cash balances, nor on net debt. Income on the loan via the interest to be charged will also be largely offset by increased debt servicing costs, leaving both balances 'broadly unchanged'.

- 3.35 Treasury noted that the Australian loan in June 2000 was 'effectively' for the same amount as the RBA's December 1999 swap. When this swap matured on 21 June after one rollover, that loan replaced it.¹⁷

Australia's interests

Investment and trade

- 3.36 Section 8E(b) of IMAA, as amended in 1998, requires the NIS to include the reasons why the agreement is 'in Australia's national interest, having regard, in particular, to foreign policy, trade and economic interests.'
- 3.37 The NIS states that Australia's economic interests in PNG, through trade and investment, are significant for Australia's own continuing economic development. PNG is this country's 11th largest investment destination, and its 18th largest trading partner. In June 1998, Australian investment in PNG was estimated at \$A2.3 billion, dominated by mining and petroleum, followed by services. There was also about \$A405 million of PNG investment in Australia.¹⁸
- 3.38 Mr Chris Mackay of the Australia Papua New Guinea Business Council (APNGBC) estimated that there was \$A5 billion of Australian investment in PNG, with significant opportunities for further investment there. He drew attention to investment of \$A800 million in the Ramu Nickel project, with a further amount still to be committed to the Frieda River project.¹⁹
- 3.39 In 1999, total bilateral trade was worth about \$A2.1 billion: about 1 per cent of Australia's total trade. PNG is Australia's 20th largest export market, with about \$A970 million worth of goods exported to PNG in 1999. Australia's principal exports to PNG were refined petroleum, specific machinery, manufactures and general industrial machinery. Principal imports from PNG were crude petroleum, non-monetary gold

17 Transcript, Mr Mark Sewell, Treasury, 12 September 2000, p. 9.

18 NIS, p. 1, Transcript, Mr John Oliver, DFAT, 12 September 2000, p. 5.

19 Transcript, Mr Chris Mackay, APNGBC, 12 September 2000, p. 28.

silver and platinum, and agricultural products such as coffee and coffee substitutes.²⁰

Australia's national interest

- 3.40 The NIS stated that Australia's bilateral relationship with its nearest neighbour PNG 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, development cooperation and defence, Australia has 'an over-riding foreign policy interest' in PNG's sustainable economic development and stability.²¹
- 3.41 DFAT interpreted Australia's national interest in a broad way. It believed that it is in Australia's national interest to have a stable prosperous and democratic PNG. It is an important trading partner, and its stability and long-term prosperity 'is very much in Australia's interests.' Thus, this loan served the Australian national interest in trying to underpin PNG's financial stability when it was in 'particular difficulty'.²²
- 3.42 DFAT also suggested that, if this loan had not been granted, PNG could have faced very serious difficulties in meeting a range of financial commitments and in stabilising its economy. Australia was seen as having a particular responsibility to do what it could to ensure that this important near neighbour was given every assistance to make necessary and welcome reforms. If Australia could contribute to this process, both countries would benefit.
- 3.43 The Department stated that this loan would underpin the PNG Government's economic and social reform program. It would allow PNG to pursue further macro- and micro-economic reforms, satisfies its urgent requirements to meet its exceptional financing needs in 2000/2001 and complements the support programs of the IFIs. It also has the advantage of serving as a clear signal to the international financial community, and particularly the regional community, that Australia supports PNG's plans for economic reform.²³
- 3.44 Given Australia's status in the region, and its perceived closeness to PNG, DFAT saw this as an important message, and one that PNG could draw on in its own regional negotiations.

20 Transcript, Mr John Oliver, DFAT, 12 September 2000, p. 5.

21 NIS, p. 1.

22 Transcript, Mr John Oliver, DFAT, 12 September 2000, p. 18, Submission No 4 from DFAT, p. 2.

23 Unless otherwise specified, material set out below is drawn from Submission No 4 from DFAT, pp.1-2.

- 3.45 DFAT believed that failure to grant the loan could also have been seen by the international financial community, with which PNG was negotiating, as a lack of confidence in that country by one of its largest partners, and hence a disincentive for it to contribute to efforts to improve PNG's economic stability. These factors would have had a negative impact on the international investor and business community, which is important for PNG's long-term economic prosperity and growth.
- 3.46 It noted that Australia has a strong national interest in encouraging PNG to provide a favourable security environment for the 6500 Australian residents there. Australia also has an interest in encouraging the PNG Government to maintain investment and trade regimes that encourage and protect Australian investments and two-way trade.
- 3.47 In wider terms, DFAT stated that Australia has a close interest in promoting a nation which, through prudent management of its human and physical resources, is increasingly self-reliant and a practitioner of good governance.
- 3.48 DFAT also noted Australia's core defence and broader security interests which flow from the close geographic proximity of both countries, and their place in the broader South East Asian and South Pacific regions. Australia has an interest in ensuring maintenance of the integrity of the international border in the Torres Strait. As a corollary, Australia has an interest in building a cooperative regime with PNG, to secure the border from threats such as illegal movement of people, smuggling or quarantine-related dangers.
- 3.49 Key aspects of the relationship are encompassed in a number of formal, bilateral agreements, reflecting the strong ties between these nations, and the importance Australia places on the relationship. Significant among these bilateral agreements is the 1999 Treaty on Development Cooperation, which has already been briefly discussed in Chapter 2.²⁴

24 See paragraphs 2.48-2.50.