

WESTPAC PNG

IMF Facility

9th June 2023

Executive Summary

- Papua New Guinea requested IMF budgetary support to assist the Government with its objectives to implement medium term fiscal consolidation and undertake critical reforms to help improve the performance of the economy.
- In March the IMF approved a US\$918 million Extended Credit Facility (ECF) and the Extended Fund Facility (EFF) which will run from March 2023 to March 2026.
- The funding is tied to several conditions and reforms that Papua New Guinea is required to meet. To trigger drawdowns of the facilities PNG will have to meet those structural benchmarks and quantitative targets.
- The reforms are aimed at strengthening debt sustainability, monetary policy operations, alleviating FX shortages via reforming exchange rate management to introduce greater market price discovery, enhancing governance and strengthening anti-corruption frameworks.
- The IMF noted that they estimate the Kina is overvalued by more than 13 percent in 2022 compared to just 2.1 percent in 2021.
- This is a solid package that not only helps to alleviate medium-term budgetary stress and improve the operation of the FX market but being tied to key economic reforms if those reforms can be effectively implemented this will help put PNG on the path to generate stable, sustainable growth to the benefit of all Papuans.



Key Highlights

- Papua New Guinea is an emerging economy highly exposed to natural disasters and terms of trade shocks. Low commodity prices from 2014 to 2022, a severe drought in 2015-16, and a major earthquake in 2018 were a shock to growth resulting in a shortage of foreign exchange and a pre-pandemic build-up of public debt. As in many countries the pandemic further increased public debt while development needs remain considerable.
- In March the IMF approved a US\$918 million Extended Credit Facility (ECF) and the Extended Fund Facility (EFF).
- The funding is a 38-month arrangement to support the current reform agenda with an objective to protect the vulnerable and foster inclusive growth. The reforms are aimed at strengthening debt sustainability, alleviating FX shortages, enhancing governance and strengthening anti-corruption frameworks.
- The IMF notes that they estimate the Kina is overvalued by more than 13 percent in 2022 compared to just 2.1 percent in 2021.
- The PNG economy stabilized from the pandemic in 2021 and is on course to register strong growth in 2022, estimated at 4.5 percent. Growth will be driven by a strong recovery in the non-resource sector. Growth is expected to moderate to 3.7 percent in 2023, supported by non-resource sector.

Background of Recent IMF Facility

Successful Completion of the Staff Monitored Programs (SMPs).

The first SMP was completed in 2019, the second in 2022, with the programme guidance opening the door for the requested financial assistance under the Extended Credit Facility (ECF) and the Extended Fund Facility arrangement (EFF). Approved on 22nd March 2023 the assistance is SDR684.3 million¹ (equivalent to US\$918 million) reflecting current and prospective balance of payment needs, need to address long term structural issues and foster reforms that would lead to inclusive and more sustainable growth. The reforms aim to encourage sustained fiscal consolidation to strengthen debt sustainability; strengthen the mandate and autonomy of the Bank PNG (BPNG) by enhancing its legal and operational framework; to alleviate FX shortages and transition the Kina to a market clearing exchange rate; and, enhance governance and operation of the anti-corruption framework.

The IMF found that BOP requirements have manifested as persistent and widespread shortages of foreign exchange due to an overvalued exchange rate (the IMF estimated that the real effective exchange rate, or REER, is overvalued by 13.4 percent in 2022 and 2.4 percent in 2021)² and to FX rationing. Overall Assessment: Staff's judgement is that PNG's external position in 2022 is substantially weaker than the level implied by medium-term fundamentals and desirable policies (current account gap of -4.4 percent

¹ Statement by Robert Nicholl, Executive Director for Papua New Guinea and Rhoda Karl, Advisor to Executive Director March 22, 2023.

² REER is a measure of the weighted average of a country's currency against an inflation adjusted and trade-weighted index of other countries. Potential Policy Responses: The assessment of Kina valuation is consistent with limited exchange rate adjustment to international inflation differentials or terms of trade movements. Future real exchange rate depreciation would help support competitiveness of non-resource exports and address foreign exchange shortages. Improved FX operations and liquidity management would also strengthen the BPNG's ability to manage inflation and the real exchange rate.

of GDP based on the REER model). Estimates for 2022 suggest the real effective exchange rate was overvalued by 13.4 percent.

The authorities intend on using the ECF/EFF disbursements to finance the budget. PNG's public and publicly guaranteed debt remains at high risk of debt distress (Debt Sustainability Analysis, DSA). Upon completion of the SMP in June 2022, all the quantitative targets were met and all but one of the structural benchmarks were achieved per 2022 review³.

Economics Conditions.

The PNG economy stabilized from the pandemic in 2021 and is on course to register strong growth in 2022, estimated at 4.5 percent. Growth will be driven by a strong recovery in the non-resource sector. Growth is expected to moderate to 3.7 percent in 2023, supported by non-resource sector while continuing delays in reopening the Porgera mine, will weigh on resource sector growth. Over the medium-term growth is projected to converge to potential (around 3.1 percent)⁴. Average inflation is estimated to have increased by 4.5 percent in 2021 to 6.6 percent in 2022, despite fiscal measures introduced to address the rising cost of living⁵. It is expected to moderate to 5.4 percent from projected lower commodity prices and easing supply chain constraints. Monetary policy was also tightened but excess liquidity in the system has weighed on the effectiveness of its transmission. The risks to the outlook for PNG are tilted to the downside. The downside risks include weaker external demand for PNG's exports, the impact of tighter global financial conditions, a delay in the resumption of Porgera mine operations, and climate-related natural disasters.

Aims of the Current IMF Program.

The PNG authorities requested that this program address long standing structural issues. As noted earlier the IMF programme is targeting reforms that focus on (i) strengthening debt sustainability through sustained fiscal consolidation, (ii) enhancing the legal and operational framework of the Bank of PNG (BPNG) to strengthen its mandate and autonomy, alleviate FX shortages and transition to a market-clearing exchange rate, and (iii) enhancing governance and operationalizing the anti-corruption framework. Emphasis will be placed on the first and second set of reforms. The authorities intend to use the entire amounts to finance the budget. The program is expected to be fully financed.

Operationalising Reform Objectives.

The financing program builds on the policy objectives of the last SMP, that is to: progress further reforms to budget repair and fiscal consolidation; improve governance; and strengthen the monetary policy and exchange rate policy frameworks, while addressing prospective balance of payments needs. The PNG authorities have committed to achieving the 9 Structural Benchmarks (SBs) and several Quantitative Performance Criteria (QPC) and indicative targets.

³ The 2021 budget deficit stood at K6.3 billion, significantly below program target of K6.9 billion.

⁴ Driven by higher private investment and the government's public investment program. Other areas of strength include: empowering and investing in Small-Medium Enterprises; improving connectivity/access to markets; reducing public sector arrears; and undertaking structural reforms to improve efficiency in State Owned Enterprises.

⁵ Fixed term budget measures in the form of general subsidies on fuel, staple foods, and hygiene, together with personal income tax relief and expanded school tuition fee subsidies to reach rural areas formed the mainstay of the fiscal response. They were funded by windfall revenue from high commodity prices.

Fiscal Policy.

The 2023 budget passed in December 2022, targets a deficit of 4.3 percent of GDP from K5,985 million in 2022 to K4,895 in 2023 (K1 Billion reduction or a 1.1 percentage points of GDP decline) in line with QPC (Floor on the Cumulative Fiscal Deficit of the Central Government). PNG authorities aim to reduce the deficit to below 2 percent of GDP and achieve a balanced budget by 2027. They can realize this objective if revenue is increased while maintaining strict discipline on expenditures including strengthening debt management.

Domestic revenues are projected to increase relative to estimate outturn for 2022 by around 1.2 percentage points of GDP. Efforts by the government to address nontax revenue has resulted in the passing and implementation of the Non-Tax Revenue Act (NTRA)⁶. This will support the budget by appropriating fees and charges that are currently collected and retained by the statutory authorities and is expected to contribute around 0.3 pp increase in the revenue ratio offsetting decline in commodity prices. Tax revenues are expected to benefit from higher collection of corporate tax and GST⁷. The update for the dividend policy for the SOEs, which calls for a larger revenue contribution from SOEs involved in resource projects. OTML and KPH expected to increase non-tax revenue by K293 million (0.2pp of GDP) and K1 billion (0.6 pp of GDP) respectively, relative to the estimated outturn for 2022 (does not include foreign grants). Budgeted expenditure remains largely unchanged at 21.4 percent of GDP.

The governments continued commitment to strengthening transparency in debt recording and management, and through pursuing a prudent financing strategy aimed at reducing debt distress risks and vulnerabilities. Debt risk reduction measures include continued efforts to refinance debt where possible to lower the cost of financing and maintaining a limit on new public external debt contracted under the Fund program, to be measured in present value terms (continuous QPC)⁸. They are also committing to the non-accumulation of new external arrears during the program period (continuous QPC).

Monetary and Fiscal Sector Policies.

The Bank of PNG (BPNG) will strengthen its monetary policy operational framework by intensifying efforts to drain excess liquidity and adopt more effective short-term liquidity management instruments. This will be done by modifying open market operations through the introduction of a fixed rate tender with full allotment⁹. They will also review the terms of the CBBs with a view to making them better suited for short-term liquidity management. Key steps would be to explicitly link the rate of the main short-term liquidity management instrument to the KFR, to ensure that changes in the KFR can effectively transmit to lending rates; and to reduce its tenor from 28 days currently to no more than 2 weeks¹⁰. BPNG will continue to avoid monetary financing and monitor it through a **QPC on the BPNG's gross credit to government**.

⁶ Which requires revenue collecting government units to directly remit revenues collected under the Budget to the Consolidated Revenue Fund rather than the past practice of transferring the funds after netting out costs.

⁷ The higher collection corporate tax collection reflects both the rebound in profits and the imposition of a higher Company Tax Rate on commercial banks.

⁸ The present value (PV) of any external borrowing by the government is defined as the annual discounted future debt service payments for that loan, using a discount rate of 5 percent.

⁹ Accompanied with an interest rate corridor to limit interest rate volatility, would be a clear signal of the BPNG's commitment to mop up all excess liquidity from the market.

¹⁰ These modifications will be complemented by a review of the main parameters of the CRR system, including the length of the maintenance period and its averaging features, to align it with best practices.

BPNG has also committed to continue supplying FX to the market in 2023 to help reduce FX shortages and to return to Kina convertibility. BPNG will make enough FX available for the timely payment of current account (or authorized) transactions. The BPNG will increase the amount of its provision of foreign exchange to authorized FX dealers to help reduce pent-up demand for FX; a **cumulative floor of US\$ 1,200 million will be set as an indicative target**. Given PNG's exchange rate is legally defined as a floating regime, the BPNG along with IMF assistance, will prepare and implement a sequenced roadmap for reforming foreign exchange market operations and regulations, to ensure greater flexibility in the exchange rate within the medium-term¹¹.

As noted, Papua New Guinea's de jure exchange rate arrangement is "floating". However, on June 4th 2014, the BPNG introduced an exchange rate trading margin with a kina buying rate within 75 basis points (bps) above the interbank midrate and a kina selling rate within 75 bps below the midrate. Since November 2020, the exchange rate has stabilized within a two percent band against the US dollar. Accordingly, the de facto exchange rate arrangement was reclassified to "stabilized" from crawl-like, effective November 3, 2020. The BPNG publishes the intervention data in its annual report and semi-annual monetary policy statement¹².

PNG authorities launched a review of the Central Banking Act (CBA) in 2020, through the Independent Advisory Group (IAG) and they will collaborate with the Fund to strengthen the financial independence and governance of BPNG. Actions taken to achieve this includes; appointing permanent BPNG's governor and deputy governors; fill remaining Board vacancies; and, move away from specifying BPNG dividends ex ante. Future dividend payments will be based on BPNG's realized profits, after the need to ensure the BPNG has the financial resources needed to effectively implement monetary policy. The CBA will be further amended to address remaining issues related to mandate, governance, autonomy, transparency, and accountability of the BPNG; in particular, the authorities will limit the provision of advances to the government; rank the mandates of the BPNG with price stability as the BPNG's primary objective; and clarify the role of the Board in monetary policy formulation. BPNG will also ensure returning to the timely publication of audited financial statements.

Papua New Guinea also maintains the following multiple currency practices (MCPs) subject to Fund approval under Article VIII, Section 3: (i) a MCP arising from the spread of more than 2 percent between the rates set by BPNG for its FX allocations to authorized FX dealers (AFEDs), and the rates used by AFEDs in transactions with their clients; and (ii) a MCP arising from the potential spread deviation of more than 2 percent between the rates set by BPNG for its FX transactions with the government and embassies, and the rates used by AFEDs in transactions with their clients.

¹¹ The Road Map will be prepared in consultation with the IMF by end-August 2023 (SB). For preparing the roadmap, we seek Fund advice on the trade-offs of our reform options, experiences of other countries that have undertaken similar reforms, and a communication strategy that helps ensure that the roadmap is well understood.

¹² Papua New Guinea maintains the following exchange restrictions subject to IMF approval under Article VIII, Section 2(a) of the IMF's Articles of Agreement arising from: (i) the requirement to obtain a tax clearance certificate (TCC) evidencing the payment of all taxes prior to making payments or transfers for certain current international transactions; and (ii) the rationing of FX, which results in undue delays and arrears in current international payments.

PNG's Capacity to Repay.

PNG's capacity to repay the Fund is adequate, but subject to elevated risks. Based on an ECF/EFF disbursement of 260 percent of quota, principal obligations to the Fund would peak in 2032 at around SDR 121.7 million (46.2 percent IMF quota). This represents 2.0 percent of government revenue and 0.9 percent of exports of goods and services. Outstanding IMF credit is expected to peak at around 38.5% of gross international reserves in 2028. Risks to capacity to repay include weaker external demand for PNG exports, large volatility in commodity prices and natural disasters.

Table 1 and Table 2 following are source from The IMF *"Papua New Guinea: Requests for an Arrangement under the Extended Credit Facility and an Extended Arrangement under the Extended Fund Facility-Press Release; Staff Report; and Statement by the Executive Director for the Papua New Guinea"* March 29,2023.

Table 1. Papua New Guinea: Proposed Quantitative Performance Criteria and Indicative Targets (March 2023—March 2024)
(In millions of Kina unless otherwise specified)

	2022 December Est.	March Indicative target Proposed	June Test date Proposed	2023 September Indicative target Proposed	December Test date Proposed	2024 March Indicative target Proposed
A. Quantitative performance criteria¹						
Fiscal deficit of the government (ceiling, cumulative from the beginning of the year)	5,985	1,646	3,092	4,239	4,985	1,586
Stock of net international reserves of the BPNG (floor, US\$ millions)	3,226	2,845	2,463	2,082	1,700	1,525
BPNG's gross credit to government (ceiling)	2,051	2,400	2,400	2,400	2,400	2,400
B. Continuous quantitative performance criteria (ceilings)²						
New external payment arrears of the government (ceiling, US\$ millions)	0.0	0.0	0.0	0.0	0.0	0.0
Present value of new external debt contracted or guaranteed by the government ³ (ceiling, US\$ millions)		1,405	1,405	1,405	1,405	
C. Indicative Targets						
Non-resource tax revenue of the government (floor, cumulative from the beginning of the year)	10,831	2,512	5,023	9,167	12,558	2,807
New domestic payments arrears of the government (ceiling)	0.0	0.0	0.0	0.0	0.0	0.0
Social and other priority spending (floor, cumulative from the beginning of the year) ⁴	3,678	500	1,500	2,817	3,866	500
BPNG provision of foreign exchange to authorized FX dealers (floor, cumulative from the beginning of the year, US\$ millions)	878	300	600	900	1,200	300

Sources: Papua New Guinea authorities and Fund staff estimates.

¹ Quantitative performance criteria listed under A. and indicative targets listed under C. are assessed as at the end of each reference month above.

² Quantitative performance criteria listed under B. are effective continuously from program approval.

³ Annual for 2023. The debt limit for 2024 will be revised in line with the authorities' borrowing plan and updated DSA.

⁴ Comprises government spending on health, education and law and order (both capital and operating expenses).

Table 2. Papua New Guinea: Proposed Structural Benchmarks (March 2023—January 2024)			
No.	Measure	Purpose/Macro-criticality	Implementation date
Budget repair			
1.	Introduce amendments to the Income Tax Act to the Parliament aimed at strengthening revenue mobilization, streamlining its operation and ensuring consistency with the Tax Administration Act.	To strengthen domestic revenue mobilization.	End-December 2023
2.	Adopt a new Medium-term Revenue Strategy (MTRS), in consultation with Fund staff, based on technical assistance requested. The MTRS will be adopted once it has been endorsed by the National Executive Council.	To guide revenue administration reforms.	End-August 2023
3.	Complete HR Business Process workshops on staffing and remuneration guidelines with government departments accounting for the majority of government staff.	To ensure government departments are aware of HR rules on staffing and remuneration to strengthen compliance, avoid overspending and prevent payment arrears.	End-June 2023
Governance and operations of the BPNG			
4.	Modify the open market operations framework by introducing a fixed rate tender with full allotment to sterilize excess liquidity more effectively.	To address excess liquidity in the banking system, improve monetary policy effectiveness and strengthen the monetary policy transmission.	End-August 2023
5.	Produce a sequenced roadmap with a concrete action plan and a timeline for (i) reforming monetary policy operations frameworks, and (ii) reforming exchange rate operations and regulations, in consultation with Fund staff.	To improve monetary policy effectiveness, reduce FX shortages and move towards a more flexible exchange rate.	End-August 2023
6.	Submit to the Parliament amendments to the CBA, in consultation with Fund staff, to address the remaining issues related to mandate, governance, autonomy, transparency, and accountability of BPNG and improvements in financial regulation and supervision.	To strengthen BPNG's financial independence and governance and improve the operation of the financial system.	End-December 2023

Economic & Financial Statistics/Forecasts

Economic Statistics

PNG	2019	2020	2021	2022f	2023f	2024f	2025f
Money Supply (%)	4.4	7.0	11.8	14.8	10.1	8.0	8.8
Private Sector Credit (%)	4.0	4.3	0.4	6.9	5.7	6.5	6.3
Current Account (K millions)	18,522.2	17,281.4	20,151.0	31,746.6	28,921.4	26,633.8	29,275.4
Gross International Reserves (K millions)	7,880.0	9,437.9	11,544.9	14,298.4	13,406.2	13,666.1	14,005.5
<i>Total Import Cover (months)</i>	<i>5.0</i>	<i>7.4</i>	<i>9.8</i>	<i>11.2</i>	<i>10.5</i>	<i>10.6</i>	<i>10.8</i>
<i>Non-mineral Import Cover (months)</i>	<i>8.2</i>	<i>11.8</i>	<i>18.7</i>	<i>22.1</i>	<i>19.1</i>	<i>19.0</i>	<i>18.9</i>
Headline Inflation	2.7	5.1	5.7	6.3	5.5	5.0	4.5
Fiscal Surplus/Deficit (K Million)	-4,172.1	-6,501.50	-7,955.50	-5,984.70	-4,984.90	-3,968.70	-3,462.40
Deficit % of GDP	-5.0	-8	-8.5	-5.6	-4.4	-3.3	-2.7

Source: Bank of PNG, International Monetary Fund and National Statistics Office

Interest Rate Forecast

Australia	Latest	Jun-23	Sept-23	Dec-23	Mar-24	Jun-24	Sept-24	Dec-24
Cash	4.10	3.85	3.85	3.85	3.60	3.35	3.10	2.85
10 Year Bond	3.64	3.40	3.30	3.20	3.00	2.80	2.70	2.50
US								
Fed Funds	5.125	4.875	4.875	4.875	4.375	3.875	3.375	2.875
US 10 Year Bond	3.61	3.50	3.40	3.30	3.10	2.90	2.80	2.60
New Zealand								
Cash	5.50	5.50	5.50	5.50	5.50	5.25	4.75	4.25
10 Year Bond	4.30	4.20	4.10	4.00	3.85	3.70	3.60	3.50

Source: Westpac Economics

Global & Trading Partner Growth Forecast

	2019	2020e	2021f	2022f	2023f	2024f
World Economy	2.8	-3.1	6.0	3.4	2.8	3.0
US	2.2	-3.4	5.7	2.1	1.6	1.1
Eurozone	1.3	-6.4	5.2	3.5	0.8	1.4
Australia	2.0	-2.1	4.9	3.7	1.6	1.7
New Zealand	2.9	-2.1	5.6	2.4	1.1	0.8
Japan	0.3	-4.5	1.7	1.1	1.3	1.0
China	6.0	2.2	8.1	3.0	5.2	4.5
India	4.2	-6.6	8.7	6.8	5.9	6.3

Source: International Monetary Fund, World Economic Outlook



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