



**WMRC Article**

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Prime Minister of Papua New  
Guinea Threatens to Default  
on Foreign Loans

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## Papua New Guinea: Prime Minister of Papua New Guinea Threatens to Default on Foreign Loans

Prime Minister Sir Michael Somare stated that Papua New Guinea would terminate a number of loan agreements with multilateral donor agencies and donor countries if promised aid for its FY2004 budget is not received. Such a move would jeopardise the country's credit rating and relations with those donors.

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| <b>WMRC Perspective</b> |   |
| <b>Significance</b>     | The Prime Minister issued a threat that loan agreements it has signed with donor countries and agencies will be cancelled, unless it receives aid that it has been promised, to help fund the fiscal year (FY) 2004 budget.   |
| <b>Implications</b>     | Cancelling loan agreements will jeopardise the country's credit rating and relations with multilateral agencies and donor countries, as well as its fiscal stability.   |
| <b>Outlook</b>          | Donor agencies and countries have been tying aid commitments to calls for government reform, but if the government cancels these agreements, it will find it nearly impossible to make any further arrangements in the future, putting particular pressure on the much-needed yet capital-intensive infrastructure improvement programme. |

### It Just Doesn't Add Up

Papua New Guinea's FY2004 budget, as passed by Parliament last week, is heavily dependent on the receipt of foreign aid to cover its US\$50m financing gap, despite the ongoing concerns that have been raised by donor countries and agencies about corruption and mismanagement in the government. The US\$1.24bn FY2004 budget assumes a 2.8% increase in gross domestic product (GDP) - an increase in growth rate of 0.8% from 2003 - and focuses spending on economic recovery and development projects. However, real GDP has declined for three consecutive years, and high population growth has resulted in a considerable drop in per capita income and a worsening of social and poverty indicators. The fiscal deficit is widening, inflation pressures are increasing, official international reserves are declining, and there has been a depreciation in the exchange rate.

### Fiscal Promises...

Under pressure from the International Monetary Fund (IMF), the government developed a Medium-Term Fiscal Strategy to be implemented between 2004 and 2008. Minister of Finance and Treasury Bart Philemon recently unveiled the strategy, the provisions of which included:

- Continued reduction of public debt, down to 60% of GDP by 2007;
- Reduction of budget deficits between 2004 and 2007, plus commitment to a balanced-budget strategy thereafter;
- Improved governance initiatives and new, tighter controls on expenditure;
- Reallocation and increase in expenditure on priority goods and services to improve government services; and
- Continued policies to promote production growth in key and export-oriented sectors, such as agriculture, fisheries, forestry, mining and petroleum.

However, the government has only appropriated US\$402m for development in 2004; this represents a 7.6% increase over 2003, but most of the increase is intended to be funded by foreign grants. The budget depends on a 13.7% increase in these grants in 2004.

The government is budgeting for a lower deficit of 1.5% of GDP in 2004, followed by a deficit of 1.1% of GDP in 2005. To achieve this, one-third of the budget goes to repaying debt, supported by a 2% levy on imports.

### ... and Broken Promises

Amid well-founded concerns over government corruption and fiscal mismanagement in Papua New Guinea, donor

countries and agencies have stated that they will withhold aid unless reforms are made. The World Bank has called for reforms to forestry management practices, the Asian Development Bank (ADB) has demanded changes to fiscal policies, and Australia - Papua New Guinea's largest source of aid, at US\$253m - has put increasing pressure on the government to institute widespread reforms and restore law and order to the country (see **Papua New Guinea: 1 September 2003: Australia Outlines New Approach to Relationship with Papua New Guinea**). After initially bucking the suggestions of donors and lenders, the government began to make overtures that it would - albeit reluctantly - attempt to comply with their demands, including allowing Australia to deploy hundreds of police officers in key locations around the country to restore stability. However, now Prime Minister Sir Michael Somare has thrown down the gauntlet, by issuing threats to agencies that have not yet released funds until further progress is made on the reforms they have pledged to make. In an address to Parliament, Sir Michael stated that 'by the first quarter of 2004, if these partners do not deliver, we will have to terminate the arrangements'. He also said that if the aid is not received, he is 'confident' that the US\$50m gap in the current budget will be made up somehow, through other means.

The budget gap has raised concerns that the government will move to increase either personal income taxes or the 10% Goods and Services Tax (GST), which would be extremely unpopular with citizens, many of whom are already struggling to pay for basic food items and services. The leader of the opposition, Sir Mekere Morauta, an economist and former Prime Minister, said that annual inflation is unsustainable at 21%, and that as the value of the kina continues to fall against the Australian dollar, prices of consumer goods will continue to increase.

### **Outlook and Implications**

Prime Minister Somare is hoping to turn to the international market to borrow more funds for much-needed infrastructural projects, particularly roads to rural areas, where farmers have increasing difficulty in gaining access to markets from their fields. However, threats and pledges to break promises with donor agencies and countries will only perpetuate existing concerns over the country's fiscal discipline and the efficacy of the government's decision-making. Donors have already greatly reduced general budget assistance in favour of funding specific projects that can be more easily monitored, but even that will now be in jeopardy.

Domestic pressure is increasing on the Prime Minister, and he may face a vote of no-confidence as early as February, after he attempted to pass a law that would grant a prime minister greater immunity from such votes. The government offered MPs more than US\$5m in inducements to prevent such a motion against Somare, by offering each of the 109 MPs US\$50,000 in 'district support grants' in return for supporting the new laws that would protect Sir Michael from being toppled. Finance Minister Philemon described the payments as a 'sweetener', to obtain support in the legislature for the constitutional change and his budget. No PNG prime minister has served a full term since the country's independence, and it seems likely that Somare will suffer the same fate, as a result of his unpopularity at home and the antagonism he is developing abroad.

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