

# CHAPTER 1. ECONOMIC AND FISCAL DEVELOPMENTS IN 2005 AND 2006

## 1.1 OVERVIEW

The Papua New Guinea economy is continuing to reap the benefits of the Government's sound and consistent macroeconomic policy framework and historically high prices for major commodities.

Real Gross Domestic (GDP) in 2005 grew by an estimated 3.3 per cent, with non-mining GDP growing at 3.1 per cent. This improvement in the economy has continued in 2006 with economic growth now expected to reach 3.7 per cent, with non-mining GDP expected to grow by 4.1 per cent. This represents the third year in a row that real GDP growth has exceeded estimated population growth, meaning that real GDP per capita is rising.

Importantly, the Government has laid out a platform for sustaining and building on this solid economic performance. Continued fiscal discipline, improved service from Government-owned utility providers and political stability should see economic growth progressively increase over the medium term.

**Table 1: Principal Economic Indicators**

	2003 Actual	2004 Actual	2005 Actual	2006 Projection
Real GDP Growth (Per cent)	2.2*	2.7*	3.3*	3.7
Real Non-Mining GDP Growth (%)	2.1*	3.1*	3.1*	4.1
Employment Growth (%)	6.2	0.6	1.6	7.8
Inflation (year average) (%)	14.7	2.1	1.7	1.7
Treasury Bill rate (%)	18.3	9.0	4.5	5.0
3 year Inscribed Stock yield (%)			7.5	6.0
World Economic Growth (%)	4.1	5.3	4.9	5.1
Oil Price (US\$ per barrel)	27.4	42.1	53.4	65.0
Copper Price (US\$ per pound)	0.81	1.30	1.67	2.99

Sources: National Statistical Office, International Monetary Fund, Department of Treasury, Bank of Papua New Guinea.

\* GDP data for 2003 and 2004 are preliminary estimates from the National Statistical Office. The 2005 GDP figure is a Treasury estimate. Employment growth is the change in formal non-mining employment.

Formal private sector employment continued to grow in 2005, with employment in non-mining sectors up 1.6 per cent and mining sector employment up 6.2 per cent in the year. Employment growth has been very strong in most sectors of the economy in 2006, with employment in the non-mining and mining sectors up by 7.8 and 6.4 per cent respectively in through-the-year terms.

The inflation outcome for 2005 was 1.7 per cent in year-average terms, the lowest annual outcome since Independence. Despite higher fuel prices, inflation has remained low in 2006, with inflation of 1.7 per cent expected to be recorded in the year. These low inflation outcomes are directly linked to the Government's improved fiscal management, including productivity-based public sector wage outcomes.

With inflation remaining low, interest rates have stayed at historically low levels. In 2005 Treasury Bills had an average yield of 4.5 per cent, increasing only slightly to 5.0 per cent in 2006, still below the Bank of Papua New Guinea's target rate (the Kina Facility Rate) of 6.0 per cent. Yields on 3 year Inscribed Stock (Government Bonds) were around 6.0 per cent in 2006, strong evidence of investor confidence inflation will remain under control over the medium term.

The exchange rate was generally stable in 2005 and steadily appreciated through 2006. In the first ten months of 2006, the Kina has appreciated against major trading partner currencies, although not as sharply as the terms of trade. The stability of the currency reflects the Government's sound economic management and increased international prices of our key commodity exports.

Gross international reserves increased sharply in 2006, to stand at around US\$1,200 million at the end of September 2006, the strongest external position the country has been in since Independence. This very high level of reserves is more than sufficient to perform the role of appropriately managing short term exchange rate volatility.

## **1.2 GROSS DOMESTIC PRODUCT**

Assessment of current economic conditions continued to be constrained by a shortage of quality data. In particular, official GDP statistics for 2003 and 2004 are still preliminary and preliminary estimates for 2005 and the first half of 2006 are not yet available. Nevertheless, the data available points to continued improvement in the level of economic activity in 2005 and 2006.

In 2005, economic growth is estimated to have grown by 3.3 per cent in real terms, with the non-mining sector growing by 3.1 per cent in the year.

The oil and gas extraction sector is estimated to have grown by 13.6 per cent in real terms in 2005, reflecting extensive workovers to maximize production from current fields in response to higher world oil prices.

The mining and quarrying sector is estimated to have grown by a more moderate 2.0 per cent in real terms in 2005. Output from the Ok Tedi mine increased in 2005, following weather-related disruptions in production in 2004. Output from the Lihir mine continued to improve in line with the mine plan. On the other hand, production at the Porgera mine was not able to repeat the performance of 2004 of nearly 1 million ounces of gold.

Available data suggest that output in the agriculture, forestry and fisheries sector grew by a moderate 1.7 per cent in real terms in 2005.

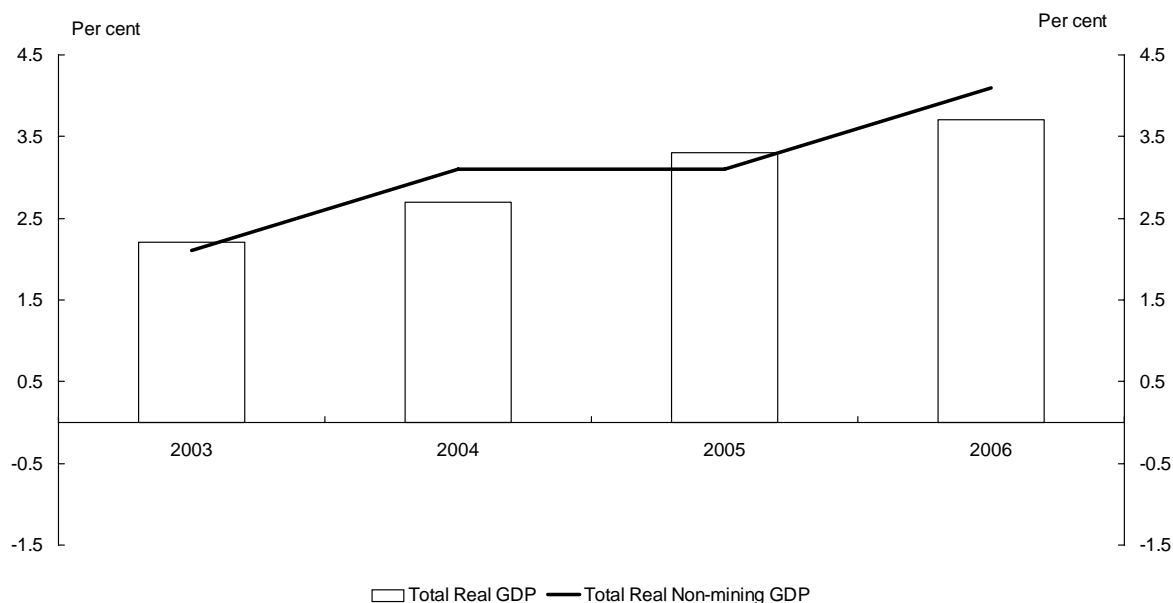
The performance of key agricultural cash crops was mixed, with coffee, copra and cocoa recording strong growth in 2005, while palm oil production was relatively flat, growing by around 2 per cent in real terms. Exports of other agricultural products – including vanilla – were sharply lower in 2005, falling from K409.8 million in 2004 to K242.8 million in 2005, a decline of over 40 per cent, reflecting both lower production and lower prices.

Log exports grew by over 10 per cent in 2005. However, as noted in the recent IMF review of PNG's macroeconomic statistics, it appears that official statistics are not properly capturing the direct contribution of the forestry sector to the economy.

While less data is available for the non-mining sectors of the economy for 2005, the manufacturing sector is estimated to have grown strongly in real terms in 2005, driven by the first full year of production at the InterOil refinery at Napa Napa, and increased domestic demand leading to a general improvement in capacity utilization.

More generally, the Bank of Papua New Guinea's Business Liaison Survey, along with improved company taxation receipts, points to a continued improvement in general economic conditions in 2005.

**Figure 1: Economic Growth: 2003-2006**



Sources: NSO and Department of Treasury

The outlook for 2006 is for continued solid economic conditions, with economic growth increasing to 3.7 per cent. This will be the third successive year of economic growth equal to or above population growth.

The oil and gas extraction sector is expected to again grow strongly in 2006, with the commencement of production at the South-East Mananda and North West Moran fields, and the natural decline of the mature Kutubu and South East Gobe fields being moderated through continued extensive workovers.

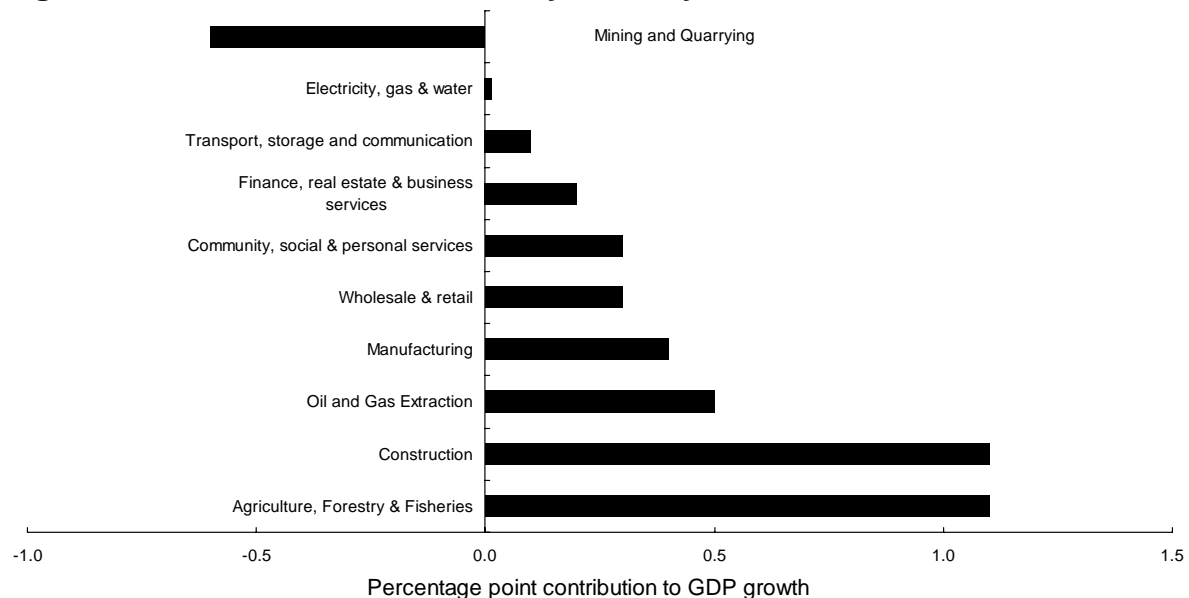
Output in the mining and quarrying sector is expected to decline by 4.9 per cent in 2006. This largely reflects lower production from the Porgera mine due to a major land slippage on the mining wall. This is only partially offset by the commencement of production at the Kainantu mine, with the smaller Sinivit mine expected to commence production in the last quarter of 2006.

Output from the agriculture, forestry and fisheries sector is expected to grow at 2.9 per cent in 2006, reflecting, among other things, the impact of increased funding for the maintenance and rehabilitation of feeder roads and other transport infrastructure increasing producers' ability to access markets.

The Bank of Papua New Guinea's Business Liaison Survey for the first half of 2006 points to further improvement in the non-commodity sectors of the economy, with domestic demand strong and business investment in the minerals sector boosting activity in related services

sectors. In addition, the increased focus of public expenditure on infrastructure maintenance and rehabilitation is supporting strong growth in the construction sector.

**Figure 2: Contributions to Growth by Industry in 2006**

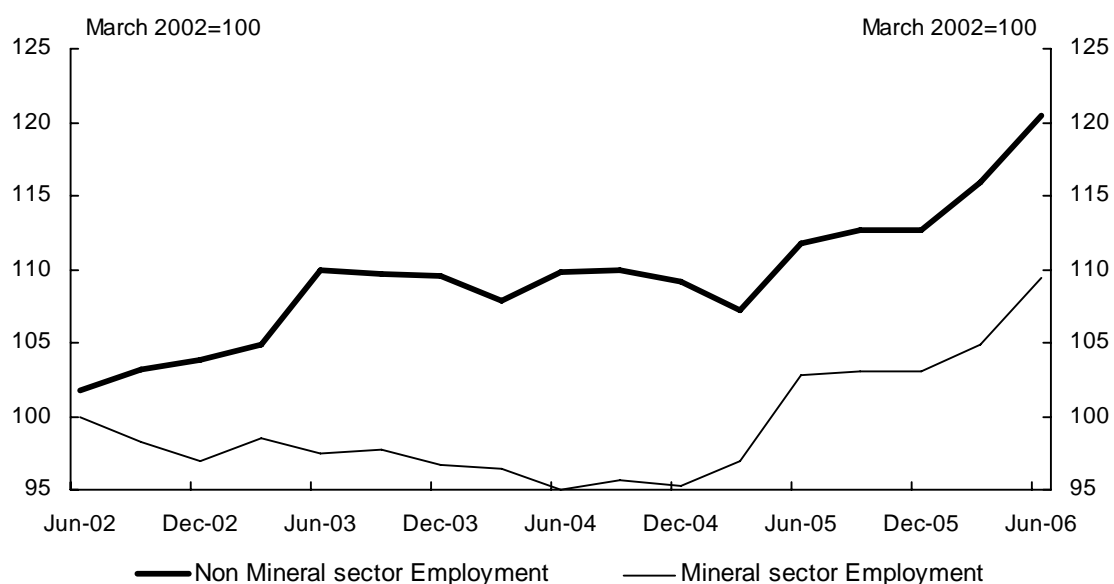


Sources: NSO and Department of Treasury

### 1.3 LABOUR MARKET

Total non-mineral sector employment increased by 1.6 per cent in 2005 with increased employment in the wholesale and manufacturing sectors more than offsetting lower employment in other non-mineral sectors. Employment in the mineral sector increased by 6.2 per cent in 2005.

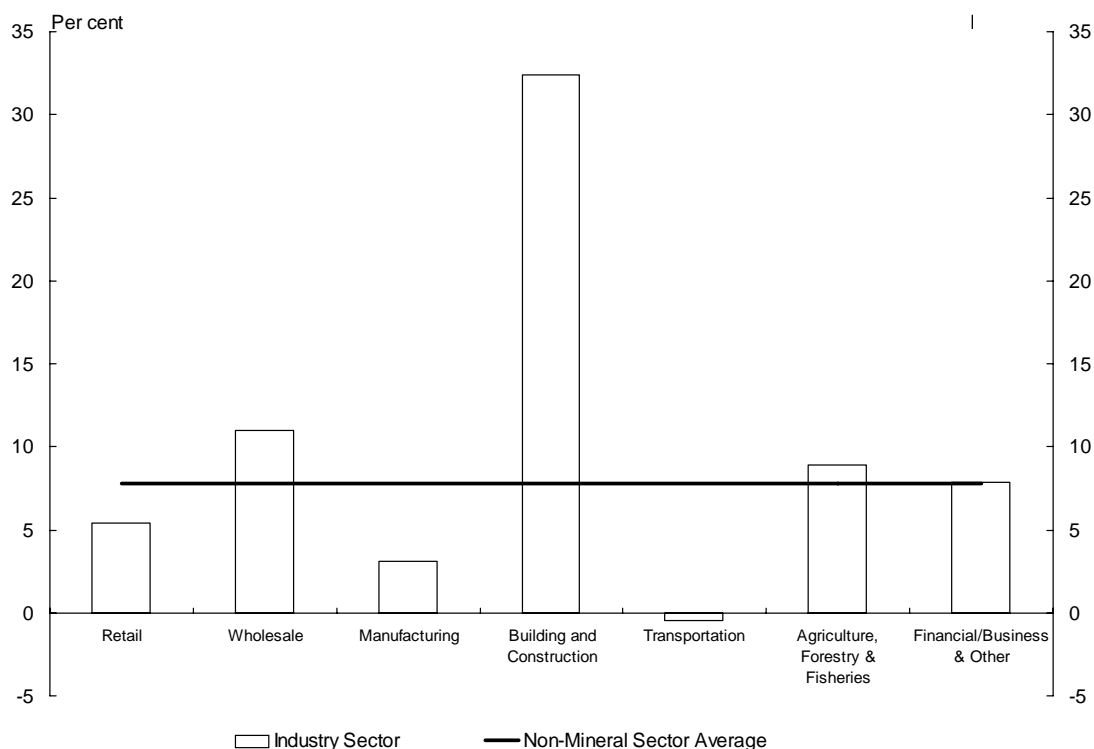
**Figure 3: Index of Non-Mineral and Mineral Sector Employment**



Source: BPNG

In the year to the June quarter 2006, total private non-mineral sector employment rose by 7.8 per cent driven by employment growth in building and construction, wholesale and agriculture/forestry/fisheries sectors. Employment in the mineral sector has continued to increase in the June quarter 2006, up by 6.4 per cent over the June quarter 2005.

**Figure 4: Employment Growth by Sector: June Quarter 2006**



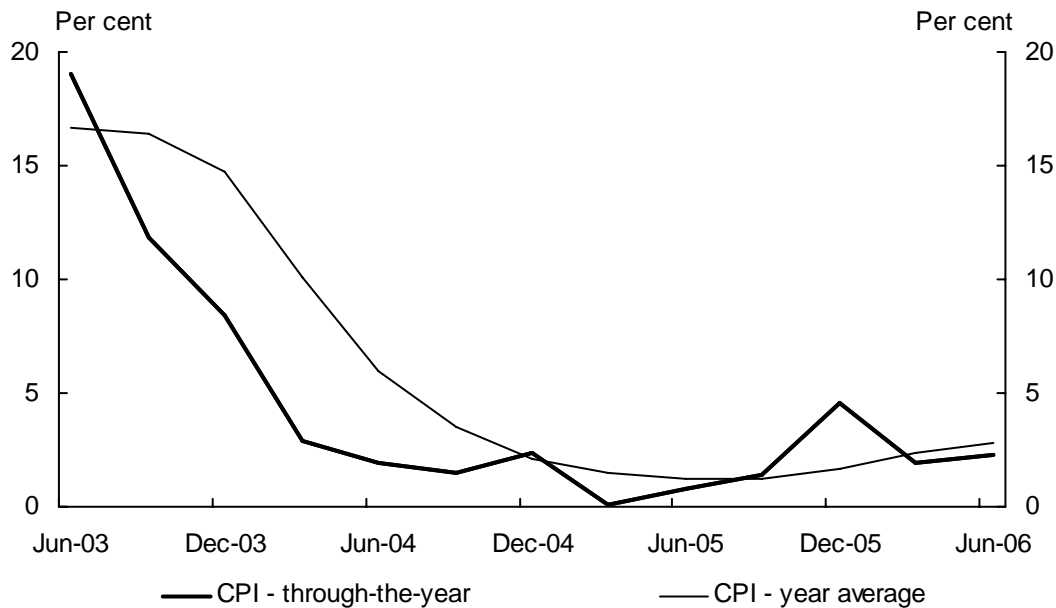
Source: BPNG

The continued solid employment performance in the June quarter 2006 has brought the total increase in employment in the non-mineral private sector since the March quarter 2002 to 20.4 per cent, with mineral sector employment up 9.4 per cent over the same period. While the pace of employment growth has varied by region, importantly all regions have shown significant growth in employment over this period.

Nevertheless, it remains the case that only a relatively small proportion of the working age population is engaged in formal employment.

## 1.4 PRICES

The inflation outcome for 2005 was 1.7 per cent in year average terms, the lowest annual outcome since independence. This is a significant improvement on the very high rates of previous years, and is attributable to prudent fiscal and monetary management and a stable exchange rate.

**Figure 5: Inflation 2003-2006**

Source: NSO

Headline inflation in the year to the June quarter of 2006 was 2.3 per cent compared with 0.8 per cent for the year to the June quarter of 2005. The year-on-year average inflation to the June quarter 2006 was 2.8 per cent compared with 1.2 per cent in the June quarter 2005.

**Figure 6: Expenditure Components of Consumer Price Index**

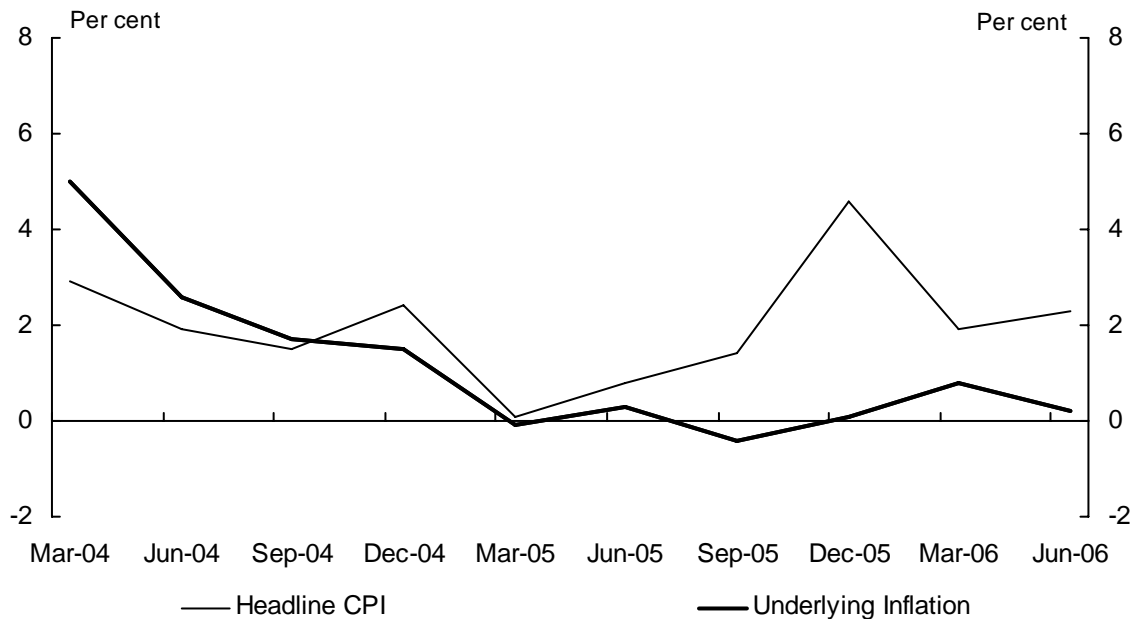
Source: NSO

This outcome reflects a 4.7 per cent increase in the food, rent, council charges, fuel and power expenditure categories. The latter reflects, in part, the pass through of higher world oil

prices to consumers. Price increases in other expenditure categories remained moderate, with household equipment and operations falling sharply in the period reflecting the implementation of the final phase of the tariff reduction program in January 2006.

In underlying terms, inflation remains very low, with average underlying inflation rate (CPI less betelnut, excise taxes and price control items) in the year to the June quarter 2006 at 0.2 per cent, compared with 0.3 per cent in the year to the June quarter in 2005.

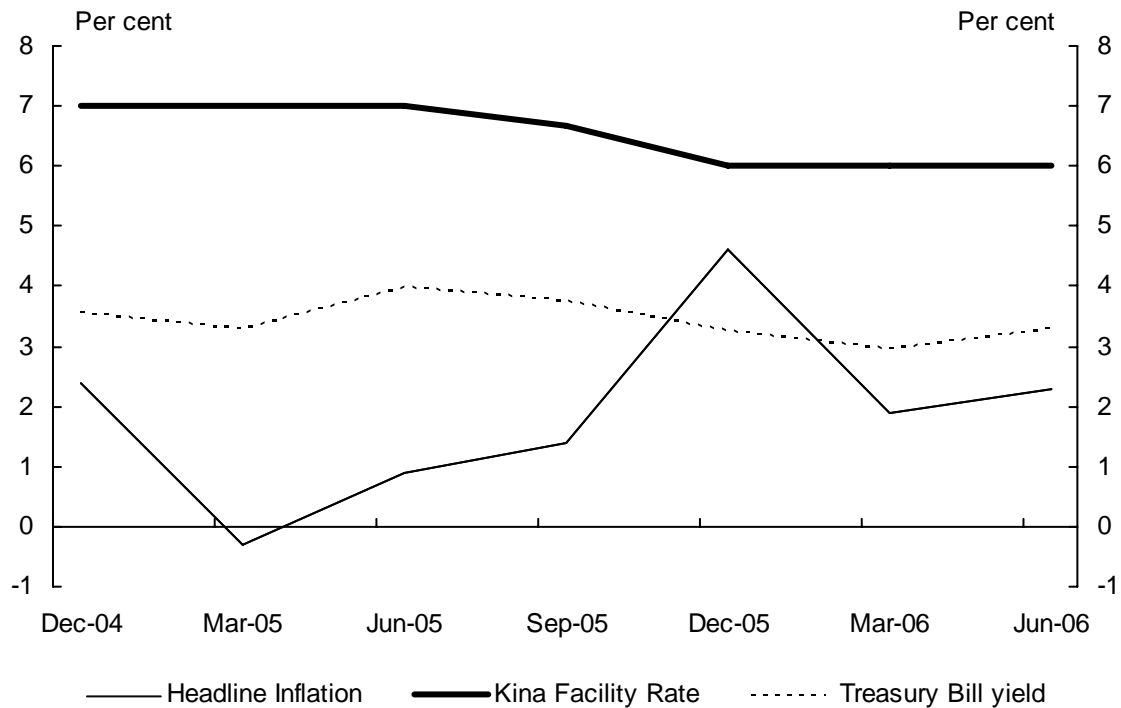
**Figure 7: Headline and Underlying Inflation 2004-2006**



Source: NSO

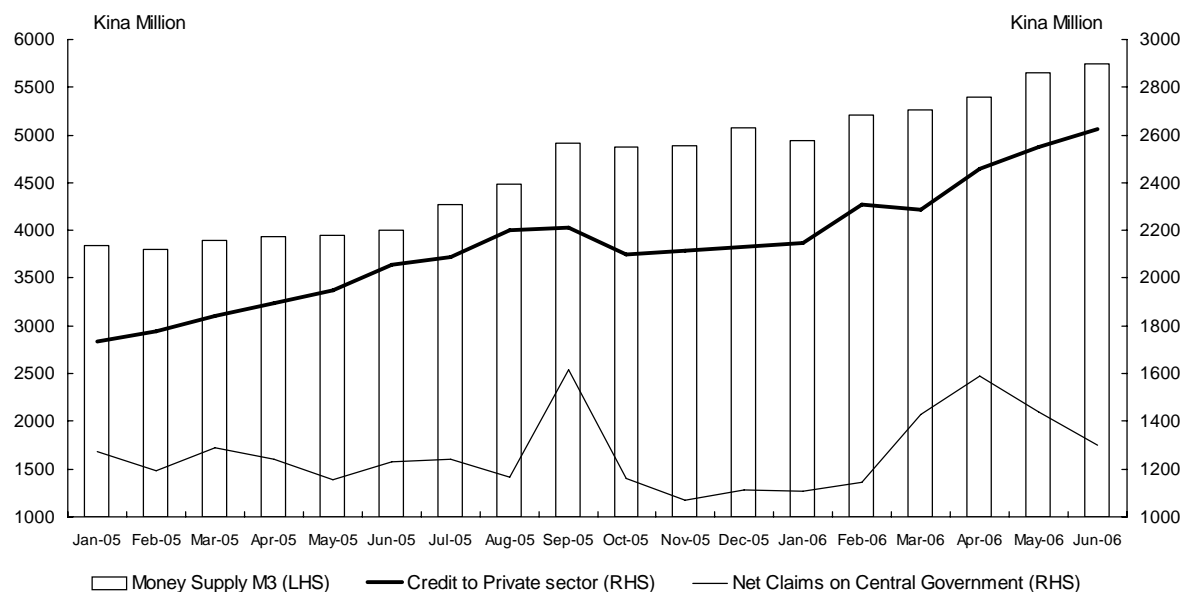
## 1.5 MONETARY DEVELOPMENTS

With inflation remaining low, interest rates have remained at historically low levels. The Kina Facility Rate (KFR) – which is the benchmark interest rate targeted by the BPNG – remained unchanged at 6 per cent in the first half of 2006. Market interest rates have continued to be well below the indicator rate in 2006 with Treasury Bills yields averaging around 3 per cent in the first half of the year.

**Figure 8: Interest Rates and Inflation**

Source: NSO and BPNG

The extended period where interest rates have been below the KFR reflects the excess liquidity that has been allowed to build up in the market. As illustrated in Figure 9, the total money supply increased by 29.5 per cent in 2005 to over K5 billion, and has increased further to stand at nearly K5.8 billion in the June quarter of 2006.

**Figure 9: Money Supply, Private Sector Credit and Net Claims on Central Government**

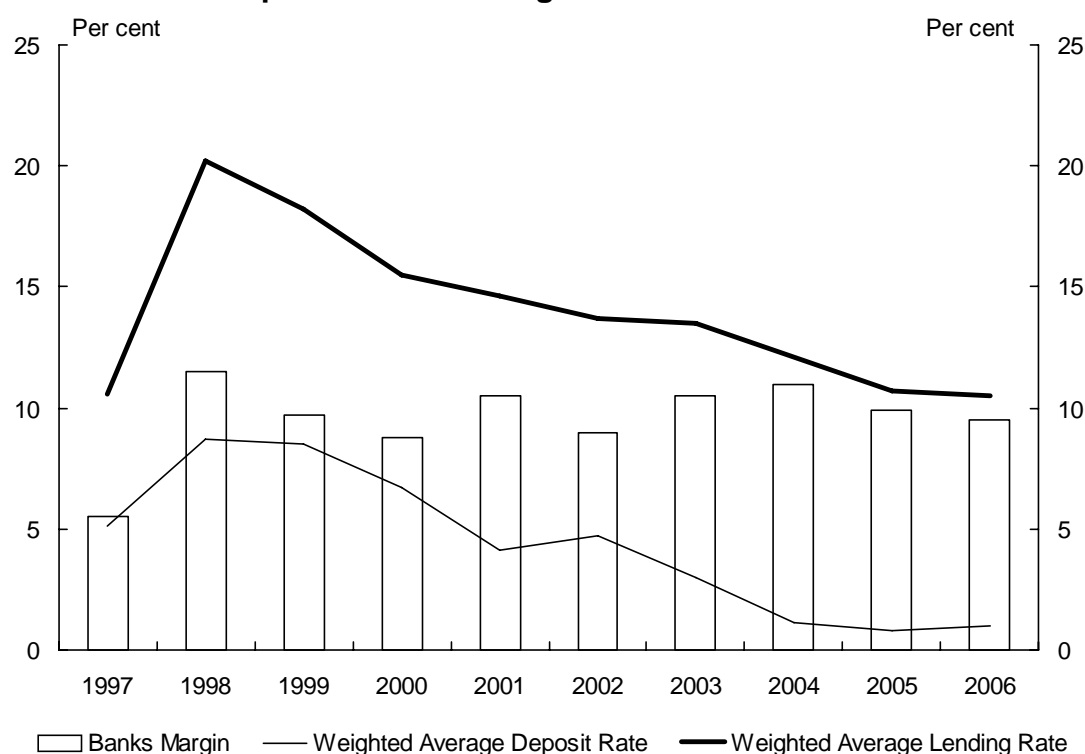
Source: BPNG



Credit growth to the private sector has grown strongly in 2005 and 2006, increasing by 23.7 per cent in 2005 and by a further 23 per cent to K2,623.9 million in the first six months of 2006. On the other hand, net credit to the Central Government decreased by 13.9 per cent to be K114.1 million but has subsequently risen to be at K1,302.3 million at June 2006.

Total advances from commercial banks to business increased by K369.7 million or 23.9 per cent from December 2005 to be K1,918 million or 11 per cent of GDP at June 2006. At the same time business deposits with commercial banks have also been growing from K2,601.9 million in December 2005 to K2,994.6 million in June 2006, an increase of K392.7 million.

**Figure 10: Annual Deposits and Lending Rates**



Source: BPNG

Margins between deposits and total advances have increased since 1997. While margins have declined slightly in the past two years, overall bank margins remain high, pointing to the need for increased competition in this sector.

## 1.6 BALANCE OF PAYMENTS AND INTERNATIONAL PRICES

The current account recorded a surplus of K1,277 million in the first half of 2006 compared with a surplus of K481 million in the corresponding period of 2005. This reflected a larger surplus in the Balance of Trade in Goods and Services which more than offset a larger deficit in the Balance of Income and Transfers.

The surplus in the Balance of Trade in Goods and Services was K2,242 million in the first half of 2006, K1,406 million higher than in the corresponding period of 2005. This increase primarily reflects an increase in the surplus in merchandise trade from K2,234 million in the first half of 2005 to a surplus of K3,786 million in the first half of 2006, as record world prices for PNG's major mineral commodities boosted export values.

Services trade recorded a deficit of K1,543 million in the first half of 2006 compared with K1,398 million in the corresponding period in 2005.

**Table 2: Balance of Payments 2005 – 2006 (Kina Millions)**

	2005 First half	2006 First half	Change
Current Account Balance	481	1277	+796
Balance of Trade in Goods & Services	836	2242	+1406
Balance of Income and Transfers	-355	-965	-610
Capital and Financial Account*	-537	-1180	-643
Net Errors and Omissions	57	-97	-154

Source: BPNG

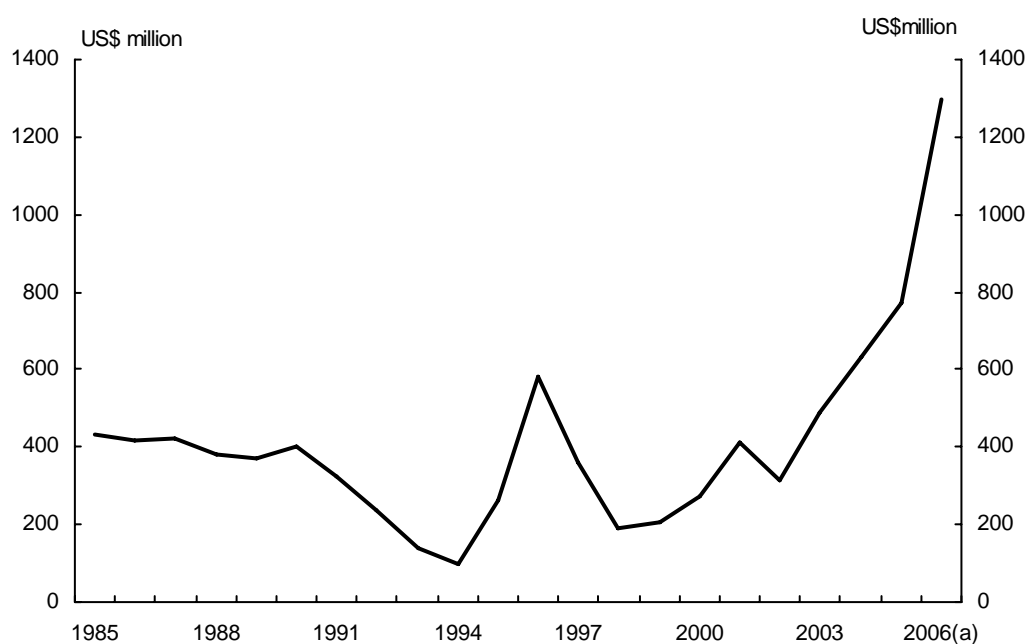
\*Includes changes in official reserves

The Balance of Income and Transfers was a deficit of K965 million in the first half of 2006 compared with a deficit of K355 million in the corresponding period of 2005. The higher deficit was due to a higher income balance deficit, reflecting increased profits of foreign investors in PNG's minerals sector due to higher world prices for copper, oil and gold.

The Capital and Financial Accounts recorded a deficit of K1,180 million in the first half of 2006, compared with a deficit of K537 million in the same period in 2005.

Holdings of gold and foreign exchange reserves by the BPNG at the end of September 2006 were around US\$1,200 million. This very high level of reserves is more than sufficient to perform the role of appropriately managing short term exchange rate volatility.

**Figure 11: Foreign Reserves**



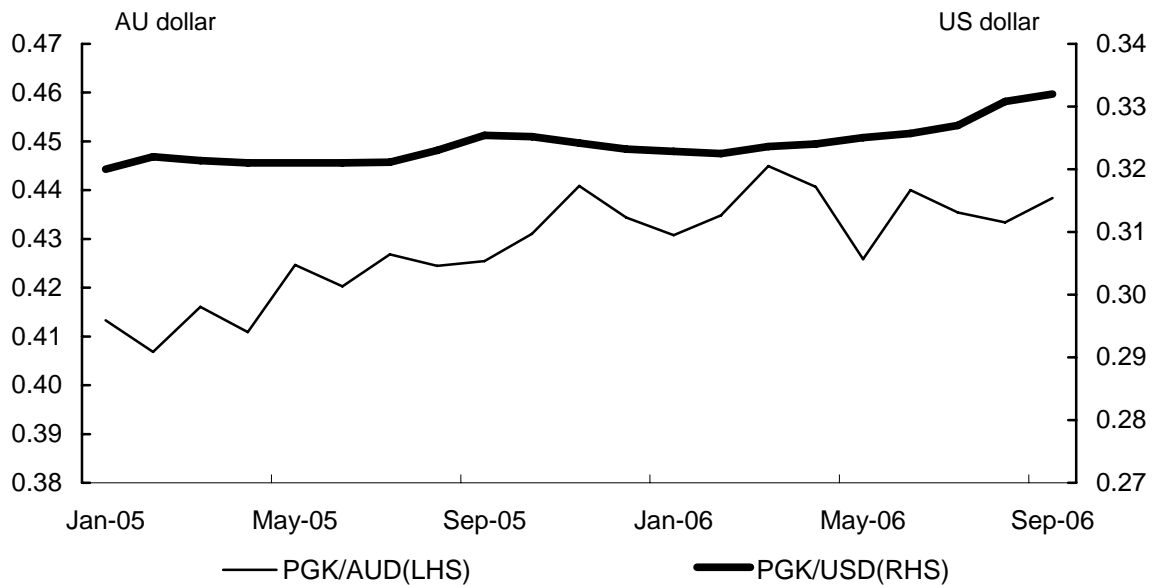
Source: BPNG

(a) Includes levels up to September 2006

## 1.7 EXCHANGE RATE DEVELOPMENTS

The exchange rate has remained relatively stable in 2006, appreciating by 2.6 per cent and 0.2 per cent against the US dollar and Australian dollar respectively in the first nine months of 2006. The Kina's performance against other major trading partner currencies over this period was mixed, appreciating by 5.2 per cent against the Japanese Yen but depreciating by 4.4 per cent and 2.4 per cent against the Pound Sterling and euro respectively.

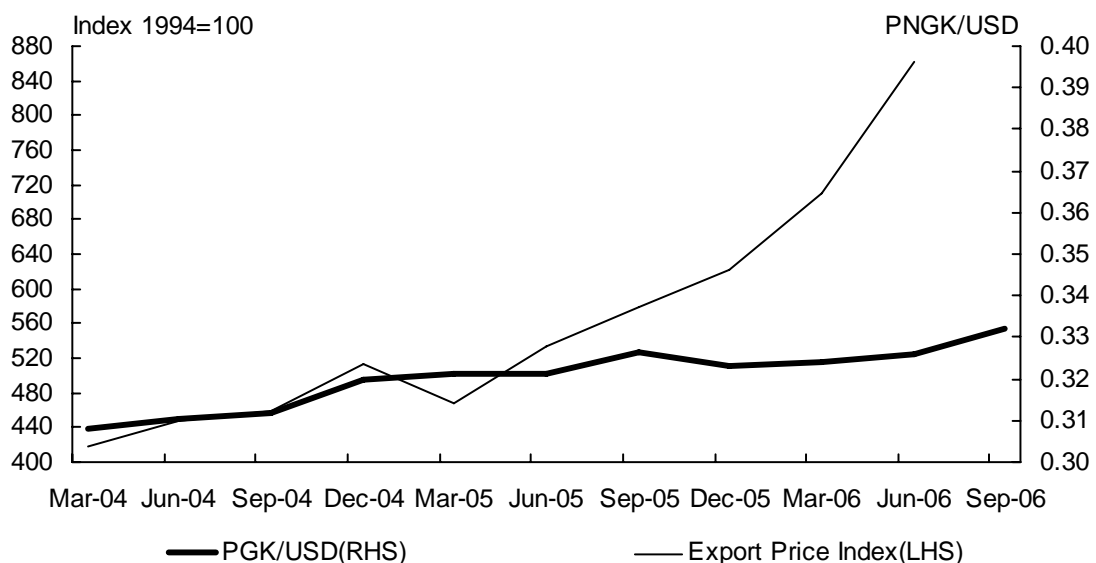
**Figure 12: Exchange Rate Movements (Monthly)**



Source: BPNG

The performance of the exchange rate reflects both an increase in the terms of trade from higher international prices of our major commodity exports and lower inflation due to improved fiscal management.

**Figure 13: Export Price Index and Exchange Rate Movements**



Source: BPNG.

Using the export price index as a proxy for the terms of trade, Figure 13 above suggests that since late 2004 the terms of trade have increased by more than the exchange rate. In 2005 the exchange rate appreciated by 3.9 per cent against the US dollar, while the prices of our exports rose by 19.7 per cent.

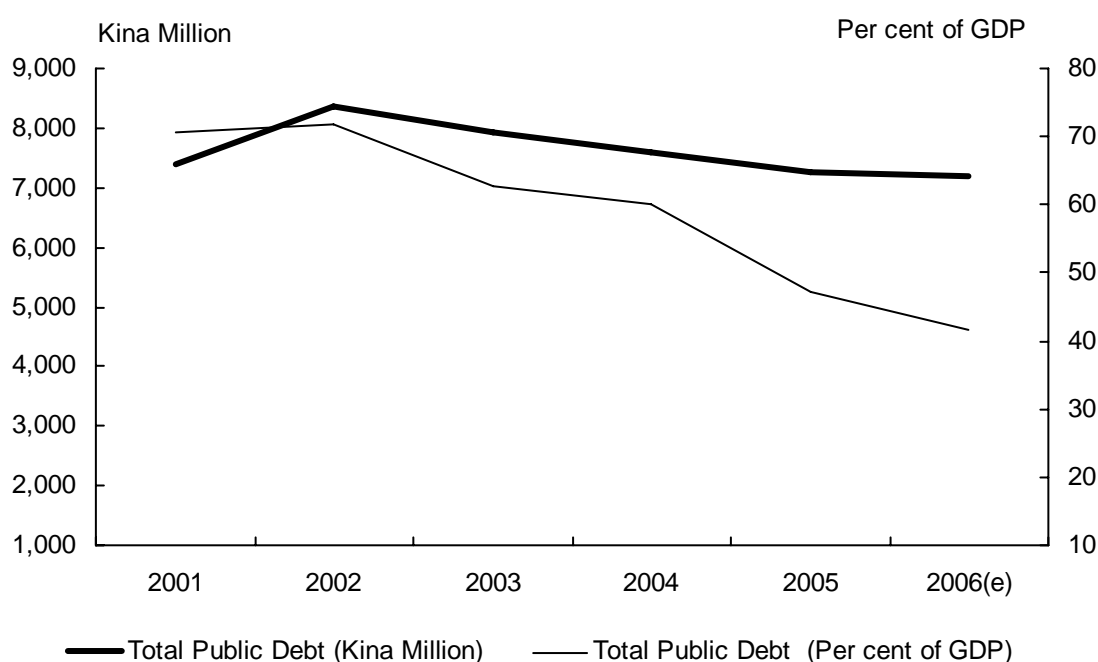
In the six months to June 2006, the export price index rose by a further 38.8 per cent compared to the same period in 2005, while the US dollar exchange rate only appreciated by 0.9 per cent.

## 1.8 PUBLIC DEBT

Total Public Debt as at end of 2005 was K7,402.8 million or 48.3 per cent of GDP. By the end of 2006, total public debt is expected to fall to K7,341.0 million, or 42.5 per cent of GDP, reflecting prudent fiscal management, economic growth and exchange rate appreciation.

This situation represents a significant turnaround from the end of 2002, when total public debt was K8,365.3 million or 71.8 per cent of GDP. As illustrated in Figure 14, total public debt outstanding has been declining as a share of GDP in the last four years.

**Figure 14: Public Debt 2002-2006**



Source: BPNG and Department of Treasury

### 1.8.1 Domestic Debt

As at the end of 2005 the stock of domestic debt was K3,546.8 million, an increase of K365.6 million or 11.5 per cent over the previous year-end level. The stock of total domestic debt at the year-end 2006 is expected to be K3,670.4 million, an increase of K123.6 million or 3.5 per cent over the end of 2005.

This reflects the Government's strategy of increasing the percentage of debt issued domestically (and reducing the percentage share of external or foreign currency debt).

At the end of 2005, the composition of domestic debt was 54.6 per cent Treasury Bills, 44.3 per cent Inscribed Stock, and 1.1 per cent in Other Standard Domestic Loans.

In 2006, the Government continued its Inscribed Stock Issuance Program with the objective of lengthening the maturity of domestic debt, thereby reducing the refinancing risks.

The success of this program is reflected in the changed composition of the domestic debt stock projected at the end of 2006, with 48.2 per cent in Treasury Bills, 51.2 per cent in Inscribed Stock and 0.7 per cent in Other Standard Domestic Loans.

### 1.8.2 External Debt

Total external debt at the end of 2005 was K3,856.0 million. This represented a decline of K553.5 million or 12.6 per cent from the level at the end of 2004. This decline in external debt has continued in 2006, falling K185.4 million to a projected K3,670.6 million by year end.

The decline in external debt reflected scheduled repayment (amortization) of existing loans, lower-than-budgeted drawdowns on project loans in both years and exchange rate appreciation.

Project loan drawdowns are expected to be K163.0 million in 2006, while principal repayment on external debt is estimated to be K386.6 million.

The total external debt stock is comprised predominately of debts to international agencies (multilateral and bilateral creditors), which accounted for 96.6 per cent of external debts as at year-end 2005, with commercial and other loans accounting for the remaining 3.4 per cent.

The major external debts held are in US Dollar (USD) and Japanese Yen. About 46.6 per cent (K1,716 million) of total external debt is denominated in USD, 35.7 per cent (K1,317 million) in Japanese Yen, 14.2 per cent (K524 million) in euro, with the remainder in other currencies.

## 1.9 CENTRAL GOVERNMENT FISCAL OPERATIONS

The fiscal outcome for 2006 is now projected to be a balanced budget, compared with the original deficit target of K90.0 million or 0.6 per cent of GDP.

**Table 3: Budget Balance 2005 – 2006 (Kina Millions)**

	2005 Actual	2006 Budget	2006 Revised	Change
Total Revenue and Grants	5326.8	4739.3	6161.8	+1422.5
Total Expenditure and Net Lending	5319.1	4829.3	6161.8	+1332.5
Deficit (-)/Surplus(+)	+7.6	-90.0	0.0	+90.0
Per cent of GDP	0.1%	-0.6%	0.0%	+0.6%

Source: Department of Treasury

### 1.9.1 Total Revenue and Grants

Total Revenue and Grants for 2006 are estimated to be K6,161.8 million, an increase of K1,422.5 million or 30 per cent from the 2006 Budget projection of K4,739.3 million.

**Table 4: Tax Revenue 2005 – 2006 (Kina Millions)**

	<b>2005 Actual</b>	<b>2006 Budget</b>	<b>2006 Revised</b>	<b>Change</b>
Taxes on Income and Profits	2770.8	2468.3	3644.1	+1175.8
Dom. Taxes on Goods & Services	657.3	700.4	760.1	+59.7
Taxes on International Trade	315.9	278.9	320.7	+41.8
<b>Tax Revenue</b>	<b>3744.0</b>	<b>3447.6</b>	<b>4725.0</b>	<b>+1277.4</b>

Source: Department of Treasury

Tax revenue is now expected to be K4,725.0 million in 2006, K1,277.4 million or 37 per cent higher in 2006 than the Budget projection of K3,447.6 million. The increase in tax revenue largely reflects substantially higher than expected taxes on income and profits.

**Table 5: Taxes on Income and Profits 2005 – 2006 (Kina Millions)**

	<b>2005 Actual</b>	<b>2006 Budget</b>	<b>2006 Revised</b>	<b>Change</b>
Personal Income Tax	841.0	846.9	878.6	+31.7
Company Tax	516.5	457.7	477.1	+19.4
Dividend Withholding Tax	154.7	145.2	176.3	+31.1
Mining and Petroleum Taxes	1076.8	820.1	1900.6	+1080.5
Interest Withholding Taxes	17.9	25.9	18.2	-7.7
Other Direct Tax	72.1	74.3	91.8	+17.5
Gaming Tax	91.9	98.2	101.0	+2.8
<b>Taxes on Income and Profits</b>	<b>2770.9</b>	<b>2468.3</b>	<b>3644.1</b>	<b>+1175.8</b>

Source: Department of Treasury

Tax on income and profits is now expected to be K3,644.1 million, K1,175.8 million or 48 per cent higher than expected in the 2006 Budget. This increase largely reflects higher mining and petroleum taxes due to higher-than-expected world prices for PNG's major mineral commodity exports and an increase in share of oil production subject to income tax. The resultant increased profitability in the mining and petroleum sector has also been reflected in dividend withholding tax collections, which is now expected to be K176.3 million in 2006, up by K31.1 million from the estimate in the 2006 Budget.

Personal income tax is expected to increase by K31.7 million over the 2006 Budget estimate to K878.6 million mainly due to the late payment of an instalment due in December 2005. Company tax collections were stronger than expected at the time of the 2006 Budget, reflecting a stronger than expected outcome in 2005.

Other direct taxes are now expected to be K17.5 million more than originally forecast, primarily reflecting stamp duty on a significant asset transfer earlier in the year. On the other hand, interest withholding tax will be lower than originally forecast in 2006 as interest rates have remained lower than expected.

**Table 6: Domestic Taxes on Goods and Services 2005 – 2006 (Kina Millions)**

	2005 Actual	2006 Budget	2006 Revised	Change
Excise	255.9	269.4	304.2	+34.8
GST	326.2	359.6	390.2	+30.6
Mining Levy	73.1	70.3	62.8	-7.5
Other Indirect	2.1	1.0	2.9	+1.9
<b>Domestic Taxes on Goods &amp; Services</b>	<b>657.3</b>	<b>700.3</b>	<b>760.1</b>	<b>+59.8</b>

Source: Department of Treasury

Domestic taxes on goods and services are now expected to be K760.1 million, K59.8 million higher than forecast in the 2006 Budget. Domestic excise revenue collections are expected to be better than forecast reflecting increased domestic production of refined petroleum products at the Napa Napa Oil Refinery. GST is also expected to be significantly stronger than forecast in line with the stronger-than-expected growth in domestic demand.

**Table 7: Taxes on International Trade 2005 – 2006 (Kina Millions)**

	2005 Actual	2006 Budget	2006 Revised	Change
Import Duty	101.1	67.2	89.5	+22.3
Export Duty	136.3	122.4	150.0	+27.6
Excise Duty on Imports	78.5	89.3	81.2	-8.1
<b>Taxes on International Trade</b>	<b>315.9</b>	<b>278.9</b>	<b>320.7</b>	<b>+41.8</b>

Source: Department of Treasury

Taxes on international trade are now projected to be K320.7 million in 2006, which is K41.8 million or 15 per cent more than originally expected. Import duty will raise K22.3 million more than expected. This is due the 2005 outcome being stronger than expected and stronger than expected domestic demand resulting in higher imports.

Export duty on logs is expected to be K150.0 million, up K27.6 million from the 2006 Budget estimate. The main driver is the higher production of logs in early 2006 as a result of better seasonal conditions compared to the expectations at the time of the 2006 Budget.

On the other hand, excise duty on imports are now expected to be K81.2 million in 2006, which is K8.1 million lower than originally expected. This reflects the greater than expected rise in domestic production of refined petroleum products at the Napa Napa Oil Refinery.

**Table 8: Non-Tax Revenue 2005 – 2006 (Kina Millions)**

	2005 Actual	2006 Budget	2006 Revised	Change
Property Income	188.2	145.0	290.1	+145.1
<i>Non-Mining Dividends</i>	50.0	48.5	81.0	+32.5
<i>Mining &amp; Petroleum Dividends</i>	138.2	96.5	209.1	+112.6
Interest and Fees from Lending	0.5	3.8	3.8	0.0
Other Non Tax Revenue	90.7	77.8	77.8	+0.0
<b>Non Tax Revenue</b>	<b>279.4</b>	<b>226.6</b>	<b>371.1</b>	<b>+144.5</b>

Source: Department of Treasury

Non-tax revenue is estimated to be K144.5 million, or 64 per cent, higher in 2006 than expected at the time of the 2006 Budget.

The increase is primarily attributable to higher than anticipated mining and petroleum dividend receipts. In particular, the sharp increase in the world price for copper in 2006 has resulted in much higher than expected dividends from the State's share in the Ok Tedi mine. In addition, the State's interest in the Moran oil field – held through the Mineral Resources Development Corporation – has now been fully paid, with dividends in respect of this interest commencing in 2006.

The Bank of Papua New Guinea paid the State two dividends in 2006: K17 million in relation to its 2004 operating profit and K15 million out of its K25 million operating profit in 2005. While dividends should also be received in 2006 from the Independent Public Business Corporation (IPBC) and National Fisheries Authority, these amounts tend to be received relatively late in the year and are among the most difficult of revenue items to predict.

Interest and fees from lending, departmental revenue, and infrastructure tax credits, and project support grants are expected to be the same as forecast in the 2006 Budget.

### 1.9.2 Total Expenditure and Net Lending

Total Expenditure and Net Lending in 2006 is now projected to be K6,161.8 million, an increase of K1,332.5 million or 28 per cent on the 2006 Budget estimate of K4,829.3 million.

**Table 9: Total Expenditure and Net Lending 2005 – 2006 (Kina Millions)**

	2005 Actual	2006 Budget	2006 Revised	Change
Recurrent Expenditure	3447.6	3142.1	3824.6	+682.5
Development Expenditure	1871.5	1687.2	1687.2	+0.0
Additional Priority Expenditure	0.0	0.0	650.0	+650.0
<b>Total Expenditure and Net Lending</b>	<b>5319.1</b>	<b>4829.3</b>	<b>6161.8</b>	<b>+1332.5</b>

Source: Department of Treasury

In 2006, the Government continued to deliver on its track record of restraining spending to limits in Budget Appropriation Acts. While expenditure in 2006 is substantially over the original budget appropriation, this reflected the Government's decision to apply stronger than expected revenue to priority expenditure areas through Supplementary Appropriation Act, rather than a loss of expenditure control or fiscal discipline.

#### 1.9.2.1 Recurrent Expenditure

The overall recurrent expenditure in 2006 is now estimated to be K3,824.6 million or K682.5 million more than expected in the 2006 Budget, reflecting the Supplementary Appropriation approved in August 2006.



**Table 10: Recurrent Expenditure 2005 – 2006 (Kina Millions)**

	2005 Actual	2006 Budget	2006 Revised	Change
Personal Emoluments	1233.9	1350.3	1375.3	+25.0
Goods and Services	1231.7	1046.8	1046.8	+39.8
Interest Payments and Fees	332.8	497.0	432.2	-64.8
Gas Project Acquisition	400.0	0.0	0.0	0.0
Transfers to Bougainville	45.3	40.8	40.8	0.0
Transfers to Statutory Institutions	206.7	211.2	211.2	0.0
Net Lending to CSAs	-2.7	-4.0	-4.0	0.0
Supplementary Budget	0.0	0.0	682.5	+682.5
<b>Total Recurrent Expenditure</b>	<b>3447.7</b>	<b>3142.1</b>	<b>3824.6</b>	<b>+682.5</b>

Source: Department of Treasury

The 2006 Budget provided K20.0 million for urgent unanticipated expenditure in 2006. As this amount had been fully utilized in the first half of 2006, an additional K20 million was provided in the 2006 Supplementary Budget. In addition, the K15 million provision set aside in 2006 for managing excess liquidity in the economy was not required, and was also re-allocated to meeting priority needs. Table 11 outlines the re-allocation of these funds.

**Table 11: Allocation of funds from the Secretary's Advance in 2006**

<b>Total Available for Allocation</b>	<b>55.0</b>
Original Balance (2006 Budget) & Supplementary Appropriation	40.0
Savings (BPNG Liquidity Management)	15.0
<b>Additional Expenditure</b>	<b>50.5</b>
<i>Urgent Unanticipated Items</i>	<i>14.0</i>
Security for by-elections (Police allowances)	5.00
Avian Flu Response	3.12
Cocoa Pod Borer Infestation	3.00
Development of ICT policy and strategy	1.50
Maintenance and Repair of Sogeri NHS	0.30
Ad hoc committee on Hela	0.30
Deputy Prime Minister's office	0.20
Customs Modernisation	0.19
Other	0.38
<i>Items overlooked in 2006 Budget</i>	<i>11.95</i>
District Finance Office Roll-out	5.00
Assistance to Solomon Islands Government	3.00
Funding for ICCC Inquiries	1.55
Renovation of Government House	0.80
Printing of Financial Management Manual & 2003 Accounts	0.75
Other	0.85
<i>Outstanding Obligations (including Compensation Payments)</i>	<i>8.8</i>
Outstanding MOA commitments	3.90
Pre March 2003 Arrears	3.00
Land compensation payment: Sirinumu Dam Landowners	1.17
Land compensation payment: Jackson's Airport	0.50

Defence underpayment of 60 per cent State share	0.22	
<i>National Department Budget Over-runs</i>		<i>5.9</i>
National Parliament: shortfall in operations	3.0	
Land Acquisition Claims Administration	1.6	
Other	1.3	
<i>Investigations</i>		<i>3.6</i>
Sambra Haus Inquiry	1.60	
Porgera Investigation	0.60	
Pacific Balanced Fund Investigation	0.50	
SHP Investigation	0.50	
Investigation into the WODP	0.40	
<i>International Travel</i>		<i>1.4</i>
Governor General's overseas travel	0.60	
Agriculture Minister's Travel to China	0.36	
CIS Minister's travel to Melanesian Arts Festival	0.10	
Other	0.38	
<i>Conferences/Festivals etc</i>		<i>3.6</i>
PNG participation at Melanesian Arts Festival	1.15	
Hosting of 37th Pacific Islands Forum	1.00	
Budget overrun: ACP-EU meeting	0.94	
APCC meeting in Madang	0.27	
PNG Participation at Pacific Youth Festival	0.15	
Public Service Conference	0.05	
PNG contribution to Emerging Pacific Leaders Dialogue	0.05	
Hosting Chinese delegation to PNG	0.03	
<i>Additional Vehicles</i>		<i>0.8</i>
Replacement vehicle for Prime Minister	0.6	
Other	0.2	
<i>Donations</i>		<i>0.5</i>
PNG Medical Symposium	0.20	
Anglicare	0.10	
Zifasing	0.10	
PNG Under 20 basketball team	0.07	
<b>Closing Balance (31 October)</b>		<b>4.5</b>

Source: Department of Treasury

### 1.9.2.2 Development Expenditure

Development expenditure in 2006 is expected to remain within the original 2006 Appropriation, except for development items in the additional appropriations in 2006.

**Table 12: Development Expenditure 2005 – 2006 (Kina Millions)**

	2005 Actual	2006 Budget	2006 Revised	Change
Domestic Financing	431.8	459.1	459.1	0.0
Grants	1283.1	994.0	994.0	0.0
Infrastructure Tax Credits	20.3	71.1	71.1	0.0
Concessional Loans	134.3	163.0	163.0	0.0
Commercial Loans	2.0	0.0	0.0	0.0
<b>Total Development</b>	<b>1871.6</b>	<b>1687.2</b>	<b>1687.2</b>	<b>0.0</b>

Source: Department of Treasury

### 1.9.2.3 2006 Supplementary Budget: Repairing the Neglect of the Past

In August 2006 the Government announced its decision to allocate K682.5 million in stronger-than-expected revenue to priority expenditure areas through a Supplementary Budget. The expenditure in the Supplementary Budget was focused on those areas where many years of neglect have seen essential economic and social infrastructure become run down and no longer operate.

The items in the 2006 Supplementary Budget fall into three broad categories: MTDS priority projects, meeting outstanding obligations and non-MTDS spending. In keeping with the Government's commitment to fiscal responsibility, as outlined in the *Fiscal Responsibility Act* 2006, the Government took care in the Supplementary Budget not to spend temporary windfall revenues on items that would place unsustainable pressures on future budgets.

**Table 13: 2006 Supplementary Budget**

Item	Kina Million
MTDS Priority Area Spending	445.8
Meeting Outstanding Obligations	172.8
Non-MTDS Priority Spending Proposals	63.9
<b>Total Supplementary Appropriation</b>	<b>682.5</b>

Source: Department of Treasury

The Supplementary Budget puts the Medium Term Development Strategy into action, with approximately 80 per cent of spending to the priority areas. It reflects the Government's commitment to provide funding directly to the district level, to ensure that service delivery reaches the majority of the people in the rural areas.

### 1.9.2.4 Additional Priority Expenditure

With sustained high prices on world markets for our main mineral commodities (oil, copper and gold), a further windfall of K1,100 million is expected to be available over the remainder of 2006 and 2007 on top of the normal Recurrent and Development Budgets.

This windfall is being used to help repair the neglect of the past and *invest in the future of our nation* through the:

- Rehabilitation of essential public infrastructure;
- Direct Investment in Economic Projects; and
- Repayment of Debt & other one-off obligations.

This approach is consistent with the International Monetary Fund's advice in its *World Economic Outlook* released last month that:

"The key policy message for countries that export commodities — particularly metals — is that they should not assume that high prices will be sustained. Current revenue windfalls should be saved or invested to support future growth in non-commodity sectors, rather than [be] used to increase spending in areas that will be difficult to reverse later."

**Table 14: Use of 2006 & 2007 Windfall Gains (Kina Millions)**

		<b>Total</b>
<b>Rehabilitation of Essential Public Infrastructure</b>		<b>615</b>
<i>Rehabilitation of Education Infrastructure</i>	200	
<i>Rehabilitation of Health Sector Infrastructure</i>	120	
<i>Rehabilitation of Transport Sector Infrastructure</i>	110	
<i>Rehabilitation of Law &amp; Justice Sector Infrastructure</i>	75	
<i>District Finance Office Roll-out (10 new offices)</i>	30	
<i>Rehabilitation of NBC Infrastructure</i>	21	
<i>Rehabilitation of Bougainville Infrastructure</i>	20	
<i>Rehabilitation of Strategic District Markets</i>	20	
<i>Major Maintenance for National Parliament</i>	10	
<i>Feasibility Studies for EU Water Projects</i>	9	
<b>Direct Investment in Economic Projects</b>		<b>270</b>
<i>Equity Injection into State-owned enterprises</i>	130	
<i>Gas Project Equity</i>	100	
<i>Government Contribution to Major Agriculture Projects</i>	40	
<b>Repayment of Debt &amp; Other one-off obligations</b>		<b>215</b>
<i>Repayment of expensive debt</i>	100	
<i>Phasing of Elections</i>	30	
<i>Public Service Sign-on bonus</i>	25	
<i>Resettlement of Volcano Victims</i>	20	
<i>Outstanding PBSS payments (teachers)</i>	20	
<i>Parliament: Election-related one-off items</i>	20	
<b>Total</b>		<b>1100</b>

Source: Department of Treasury

Although for analytical purposes it is preferable to think of it as a single windfall, this amount will be received (and therefore will be available for expenditure) over two years, with K650 million of additional priority expenditure in 2006 and the remainder (K450 million) in 2007.

Given the limited time remaining in the year to implement the additional priority expenditure, items that could be implemented quickly (eg, involving the transfer of funds) were chosen for the 2006 Appropriation Bill.

**Table 15: Additional Priority Expenditure in 2006 (Kina Millions)**

	<b>Total</b>
<b>Rehabilitation of Essential Public Infrastructure</b>	<b>240</b>
<i>Rehabilitation of Health Sector Infrastructure</i>	110
<i>Rehabilitation of Transport Sector Infrastructure</i>	76
<i>Rehabilitation of Law &amp; Justice Sector Infrastructure</i>	25
<i>Feasibility Studies for EU Water Projects</i>	9
<b>Direct Investment in Economic Projects</b>	<b>265</b>
<i>Equity Injection into State-owned enterprises</i>	130
<i>Gas Project Equity</i>	100
<i>Government Contribution to Major Agriculture Projects</i>	35
<b>Repayment of Debt &amp; Other one-off obligations</b>	<b>145</b>
<i>Repayment of expensive debt</i>	100
<i>Public Service Sign-on bonus</i>	25
<i>Outstanding PBSS payments (teachers)</i>	20
<i>Resettlement of Volcano Victims</i>	20
<b>Total</b>	<b>650</b>

Source: Department of Treasury

### 1.9.3 Financing

A balanced budget is now expected in 2006, compared with the original budget deficit target of K90.0 million or 0.6 per cent of GDP.

Net external financing for 2006 is estimated to be an outflow of K223.6 million compared with the outflow of K123.9 million projected in the 2006 Budget, reflecting increased external loan amortization.

Net domestic financing is now estimated to be an inflow of K123.6 million compared with the projected inflow of K213.9 million estimated in the 2006 Budget, reflecting the lower than expected total financing requirement.