CHAPTER 1. ECONOMIC AND FISCAL DEVELOPMENTS IN 2006 AND 2007

1.1 OVERVIEW

The Papua New Guinea economy is growing at the strongest rate in over a decade, reflecting increased business confidence, higher employment growth, stronger investment and higher business profits. This improved economic growth picture stems from a combination of the commodity price boom arising from positive international developments, improved political stability, prudent macroeconomic and fiscal policies, together with low interest rates and inflation.

In 2006, Real Gross Domestic (GDP) growth slowed to an estimated 2.6 per cent, with non-mining GDP growing at 3.7 per cent. Lower than expected growth in 2006 reflected temporary interruptions to oil exports and poor seasonal conditions that reduced agricultural production. In 2007, a rebound in mineral production, better seasonal conditions, high commodity prices and strong growth in the non-mining sector is expected to see the economy grow by 6.2 per cent, with non-mining GDP growth expected to be slightly higher at 6.5 per cent. There are signs of strengthening across most sectors of the economy – growth is broadly based. 2007 represents the fifth successive year of real GDP growth that is now significantly above population growth, assisting to gradually improve the average standard of living.

Importantly, the Government is committed to maintaining and improving the medium-term policy framework which has been built up over recent years. Continued fiscal discipline, lower levels of Government debt, improved service delivery from some Government utilities and ongoing political stability are all contributing to a better outlook over the medium term.

Table 1: Principal Economic Indicators

	2004 Actual	2005 Actual	2006 Actual	2007 Proj
Real GDP Growth (%)	2.7*	3.4*	2.6*	6.2
Real Non-Mining GDP Growth (%)	3.1*	3.1*	3.7*	6.5
Employment Growth (%)	0.7	1.7	7.3	9.5
Inflation (year average) (%)	2.1	1.7	2.3	1.8
Treasury Bill rate (%)	9.0	4.5	5.0	5.0
3 year Inscribed Stock yield (%)			6.0	5.7
World Economic Growth (%)	5.3	4.8	5.4	5.2
Oil Price (US$ per barrel)	42.1	53.4	64.3	67.3
Copper Price (US$ per pound)	1.30	1.67	3.05	3.28

Sources: National Statistical Office, International Monetary Fund, Department of Treasury, Bank of Papua New Guinea.
* GDP data for 2004, 2005 and 2006 are Department of Treasury's estimates. Employment growth is the change in formal non-mining employment through-the-year.

Formal private sector employment is growing strongly, reflecting positive developments in the economy. In 2006, employment grew by 7.3 per cent in the non-mining sectors and by 9.5 per cent in the mining sector. Over the year to June 2007, employment in the non-mining and the mining sectors grew by around 9.5 per cent, with particularly strong growth coming from retail, building and construction, and agriculture, forestry and fisheries sectors.

Consumer prices increased by 2.3 per cent in 2006 in year-average terms, slightly higher than the previous year's inflation outcome – this largely reflected higher fuel, transport and communication and food prices. In 2007, the headline rise in inflation is expected to be 1.8 per cent, largely reflecting lower food prices, continued prudent fiscal management and moderate public sector wage outcomes.

However, higher inflationary pressures have emerged, with underlying inflation increasing by 6.5 per cent over the last year. The Government is very mindful of containing inflationary pressure by closely monitoring the impact of Government expenditure on demand pressures in the economy and with the Central Bank closely monitoring monetary policy to ensure price stability.

Interest rates have remained at historically low levels, reflecting subdued inflation outcomes. In 2006 and 2007, the Treasury Bill interest rate averaged around 5.0 per cent, 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) have been around 6.0 per cent. The historically low interest rates have also been influenced by the high levels of liquidity that are in the system.

The exchange rate was relatively stable throughout most of 2006, but has depreciated significantly on an imported Trade Weighted Index (TWI) basis against major trading partner currencies (especially against the Australian dollar) over the last year. This depreciation of the Kina has seen the price of many imported goods rise. The value of the Kina against the United States dollar has appreciated slightly over the last two years.

Gross international reserves increased markedly in 2006 and have increased further to be over US$1,800 million at the end of September 2007. This reflects the impact of the commodity price boom and is the strongest international reserves position experienced since Independence. This relatively 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

In 2006, real economic growth is estimated to have been 2.6 per cent, with the non-mining sector growing by 3.7 per cent in the year.

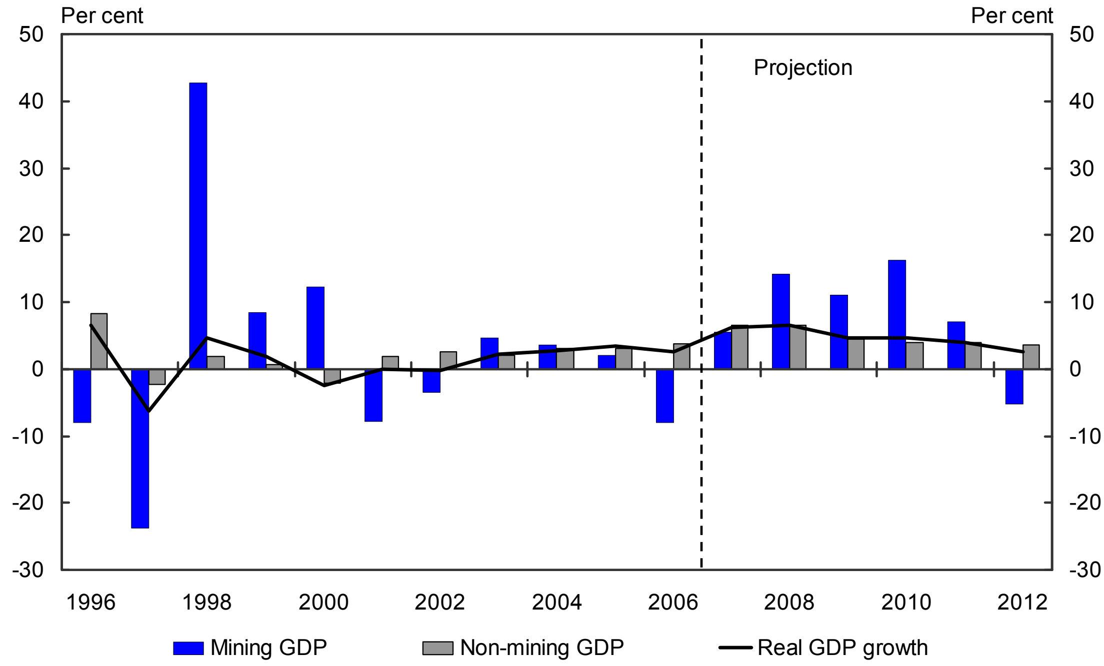
The oil and gas extraction sector is estimated to have declined slightly due to an oil spill that resulted in a one month shut down in operations at the Kumul terminal. In the absence of this shut down the oil and gas sector would have grown by around 5 per cent.

The mining and quarrying sector is estimated to have also declined, by 8.1 per cent in real terms in 2006. Output from Ok Tedi fell due to mining of low ore grades. Lihir mine ramped up production and continued to improve in line with its mine plan. For Porgera, 2006 was a disastrous year, with no output for almost three months as the main power supply from Hides was destroyed by lightning and continuous slips on the pit walls hindered production.

Output in the agriculture, forestry and fisheries sector grew moderately by 0.7 per cent in real terms in 2006. Cocoa recorded strong real growth of 8.5 per cent in 2006, while rubber and palm oil production grew by 3.0 per cent and 2.1 per cent in real terms respectively. Log exports grew strongly by more than 15.6 per cent in real terms in 2006. Most of the key agriculture commodities like copra, copra oil, and coffee experienced a huge decline in their production mainly due to the volcanic eruptions and unfavorable weather conditions in 2006.

The non-mining sector in 2006 grew strongly, driven by a buoyant construction sector which grew strongly by 12.0 per cent and supported by strong growth in the finance, real estate and the business sector with an 8.5 per cent growth in real terms. This was mainly driven by increased private sector investment in the mineral sector, in particular the new projects of Ramu nickel, Sinivit and Simberi mines.

Figure 1: Economic Growth: 1995 – 2012



Source: Department of Treasury

Real economic growth in 2007 is forecast to be the strongest in over a decade at 6.2 per cent, up from 2.6 per cent in 2006. Forecast GDP growth in 2007 has been revised up by one percentage point from the 5.2 per cent growth expected at the time the 2007 Mid Year Economic and Fiscal Outlook (MYEFO) report was prepared. This growth is broad based with strong growth in most sectors, including 35 per cent in communication, 14 per cent in building and construction and 3.7 per cent in agriculture. The major revision has been to the communication sector, due to the exceptionally large expansion in the mobile phone segment of the sector. This alone has added 0.9 percentage points to real GDP growth.

The commodity price boom has continued and strong global demand for PNG's major commodities has resulted in a significant increase in PNG's export prices from previously high levels, further strengthening PNG's favourable terms of trade. This is particularly the case for minerals such as copper, gold and oil where large increases in prices over the last few years have in some cases increased even further to reach record highs in 2007. At the same time, there are signs of an improvement in most sectors of the economy, especially in agriculture where commodity prices have also grown strongly. The fishery and forestry sectors have also boosted output, but the construction sector has experienced the strongest growth.

The strong terms of trade over recent years has influenced the economy largely through increased revenue collections by the Government. While part of that higher revenue is being used on debt repayment, there has been a significant increase in Government spending allocations to trust funds for future spending and some allocations have been actually spent. Despite the commodity price boom, monetary policy remains largely unchanged, with interest rates remaining at low levels, the money supply and credit growing strongly, and the exchange rate depreciating against most major trading partner currencies.

Several years of macroeconomic, fiscal and political stability has led to an increase in confidence in the domestic sector. More favourable economic conditions have encouraged substantial investments in both the mining and non-mining sectors, creating more employment, increasing business opportunities – this has all strengthened the economy.

The communication sector in particular has grown exceptionally strongly in response to microeconomic reform. This has allowed competition in the mobile phone sector, where the incumbent operator and new entrant have expanded operations. This has increased subscriber numbers substantially and has vastly contributed to the increased domestic activity in the economy.

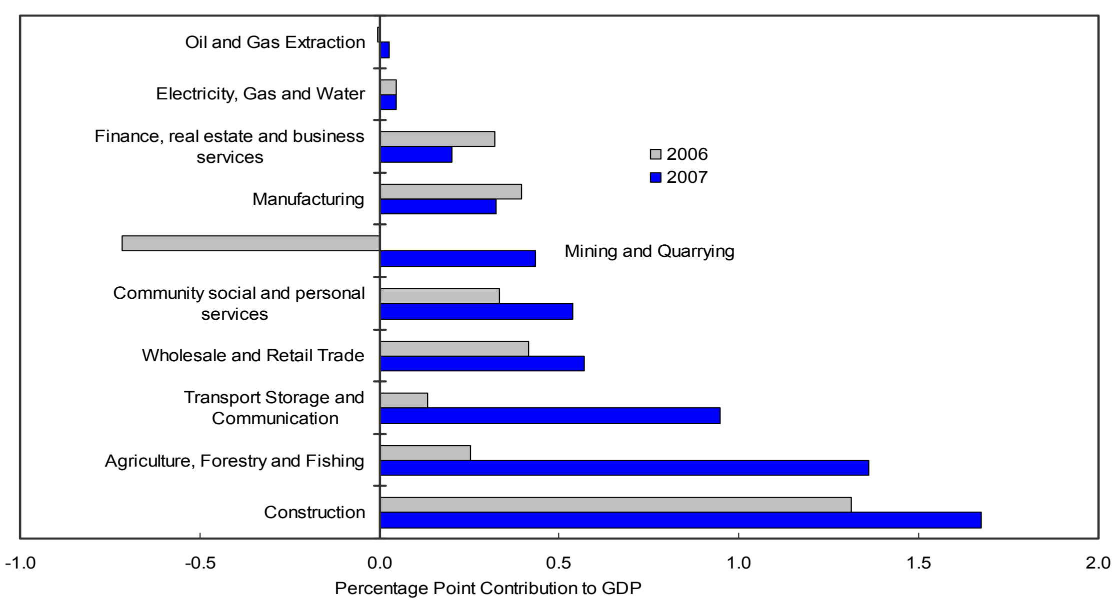
The oil and gas extraction sector is estimated to grow moderately by 0.9 per cent in real terms in 2007, which also reflects a natural decline from all the existing fields. The mining and quarrying sector is estimated to have increased by a robust 5.5 per cent in real terms in 2007, reflecting normal production from the existing mines and the inclusion of Simberi mine in the later part of the year. The Lihir and Porgera mines have ramped up production and continued to improve in line with their expansion plans, more than offsetting lower production from Ok Tedi and other smaller mines.

The agriculture, forestry and fisheries sector is expected to grow solidly by 3.7 per cent in real terms in 2007. The very strong performance of some key agriculture commodities in 2007 partly reflects recovery from large downturns in 2006. For example, copra is expected to record historically high growth of 82.8 per cent in 2007 following negative growth of 43.6 percent in 2006. Copra oil production is expected to rise by 32.5 per cent in 2007. Cocoa and coffee production are expected to grow well by 8.3 per cent and 6.2 per cent respectively in real terms, more than offsetting lower growth in the other sectors.

Log exports are expected to grow by a strong 7.1 per cent in real terms in 2007, reflecting higher production and export due to the inclusion of three new additional projects in the forestry sector that has come into operation; offsetting declining production from existing projects.

The non-mining sector of the economy is displaying robust real growth in 2007, driven by very high growth in construction, agriculture/forestry/fishery and the communication (especially mobile phone segment of the market) combined with solid growth in other sectors. Economic growth also reflects higher Government expenditure to improve and maintain public infrastructure, combined with increased private sector investment in the mineral sector, in particular, the new Ramu nickel project.

Figure 2: Contribution to Growth by Industry in 2006 and 2007

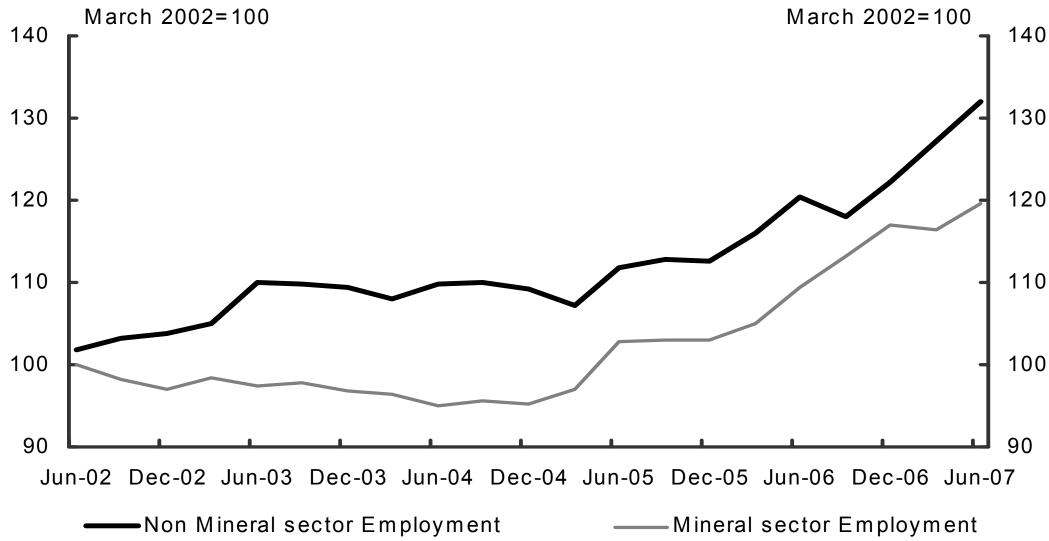


Source: Department of Treasury

1.3 LABOUR MARKET

Total non-mineral sector employment increased by 7.3 per cent in 2006 with strong growth in building and construction, wholesale and agriculture, forestry and fisheries sectors which more than offset lower employment in other non-mineral sectors. Employment in the mineral sector grew by 9.5 per cent in 2006.

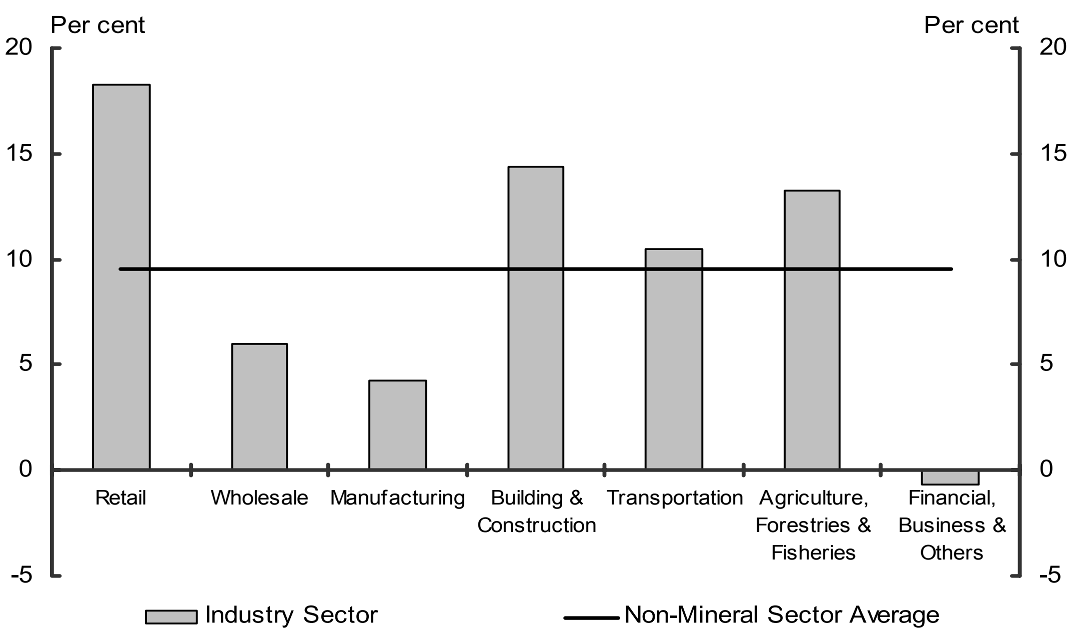
Figure 3: Index of Non-Mineral and Mineral Sector Employment



Source: BPNG

In the year to the June quarter 2007, total private non-mineral sector employment rose by 9.5 per cent, driven mainly by employment growth in retail, building and construction, agriculture, forestry and fisheries sectors. Employment in the mineral sector was also up in the June quarter of 2007, rising by a strong 9.4 per cent from a year earlier.

Figure 4: Employment Growth by Sector: June Quarter 2007



Source: BPNG

While the pace of regional employment growth has varied in 2007, all regions have showed good signs of employment growth with the Morobe and Momase regions recording the highest growth of 17.9 per cent and 13.3 per cent. This notable improvement in employment growth is due to stronger economic growth, which reflects a more conducive investment climate, sound macroeconomic policy and increased expenditure on improving and maintaining public infrastructure.

1.4 PRICES

Official inflation figures released in the June quarter 2007 Consumer Price Index (CPI) report shows that underlying inflation rose by 1.4 per cent in the quarter to be 6.5 per cent higher through the year. This was driven by increases in the price of miscellaneous items (largely medical and health care), food, clothing and footwear. The June quarter 2007 is the third consecutive quarter of large increases in the underlying CPI which increased by 3.8 per cent in the December quarter 2006 and 1.1 per cent in the March quarter 2007. This represents a significant rise in the underlying rate of inflation, being the highest annual rate since December 2003.

However, headline inflation which is typically more volatile than the underlying inflation measure increased by 0.7 per cent in the June quarter 2007 to be only 1.0 per cent higher through the year. The low increase in headline compared to underlying inflation is mainly due to a sharp decline in the prices of some food due to better seasonal conditions

Figure 5: Underlying Inflation

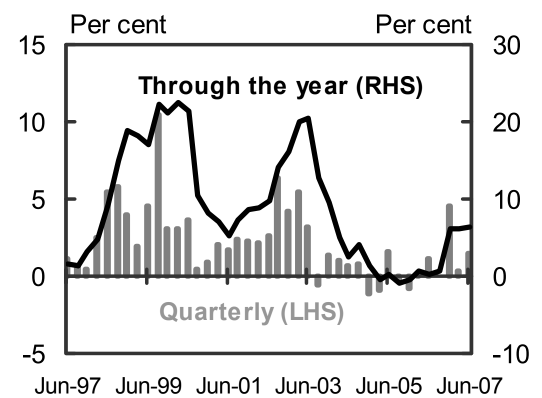
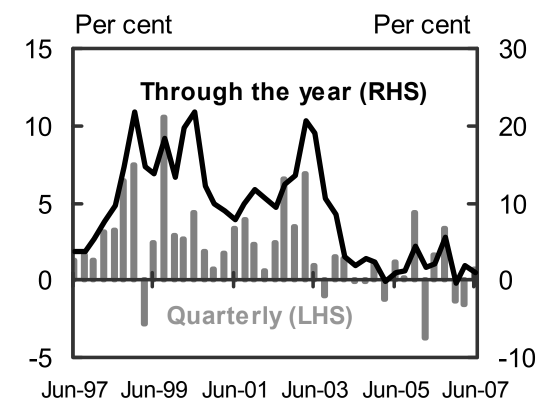


Figure 6: Headline CPI



Source: NSO, Department of Treasury

Annual inflation is expected to be 1.8 per cent in 2007 compared to 4.8 per cent forecast at the 2007 MYEFO. This is due to the significant downward revisions to recent historical figures that were contained in the June Quarter 2007 CPI release.

The Government is closely monitoring rising underlying inflationary pressures (see Box 1) that have emerged over the last year.

Box 1: Inflationary Pressures

The economy has experienced a major terms of trade shock arising from the international commodity price boom, with export prices increasing by 83 per cent since 2005. This is providing a great deal of stimulus to the economy, particularly through the budget. Since 2005, the growth in mineral receipts has increased substantially. This has led to two supplementary budgets in 2006 and one in 2007, with a total of K3.8 billion being allocated for eventual spending in the economy.

While most of this is in trust funds and is yet to be actually spent, it has and will represent a substantial injection of funds into the economy. While some of this spending will be on domestic goods and services, a large portion of it will also be on imported goods and services required for improving infrastructure. Spending on imports will help to alleviate upward pressure on domestic prices, but the impact of Government expenditure on domestic prices will need to be carefully monitored.

Despite the commodity price boom, monetary policy has remained essentially unchanged. Interest rates have remained very low since 2005 and liquidity continues to build up in the economy. Currency in circulation grew by a worrying 35 per cent in the year to August 2007, with wider money supply measures growing by 23 per cent over the same period. Lending across all sectors of the economy also grew strongly by 35 per cent in the year to June 2007. Sustained growth of monetary aggregates of this magnitude is likely to result in further inflation – the Central Bank needs to be ready to respond to these risks.

Turning to the exchange rate, while the Kina has appreciated slightly against the US$ over the past year, it has depreciated significantly against a number of other major currencies, such as the Australian dollar, Euro and Singapore dollar. These currencies represent PNG's major sources of imports, resulting in a 8 per cent depreciation of the import weighted Trade Weighted Index (TWI) over the year to October 2007. This depreciation of the Kina is increasing the price of imported goods.

However there are some other deflationary factors that are assisting to reduce prices in some areas. The expansion and competition in the domestic mobile phone market and the falling prices of durable goods imported from East Asia are reducing prices in some areas of the economy.

With the entry of a new foreign firm, Digicel, in the mobile phone market, competition in the mobile phone market has greatly intensified reducing the price of mobile phone services to consumers. Furthermore, with the current expansion in the sector from both the incumbent and its competitor, low prices are expected to spread across the country including the rural areas.

While recent measures of the headline inflation rate are low, this is reflecting seasonal influences on food prices. The rise in underlying inflation rate is more indicative of the growing inflationary pressures in the economy.

Overall, there are significant risks to inflation on the upside. The economy is currently in the midst of a terms of trade boom which has increased money supply and allowed the Government to increase spending. At the same time, the private sector is also expanding strongly into an economy that is facing significant capacity constraints. In addition, the Kina has depreciated against most other major trading partners, notably against the Australian dollar our major Trading Partner – this is placing upward pressure on the prices of imported goods.

In this environment, the monetary policy stance and Government spending needs to be closely monitored to ensure it remains appropriate for the circumstances faced.

1.5 MONETARY DEVELOPMENTS

The Kina Facility Rate has remained unchanged at 6 per cent since 2005. Market interest rates have remained lower over the same period, with the 182 day Treasury bill down by 0.47 percentage points to 4.0 per cent at June 2007. This is below the Central Bank's benchmark rate of 6 per cent which reflects the high levels of liquidity in the system.

Figure 7: Kina Facility Rate (KFR)

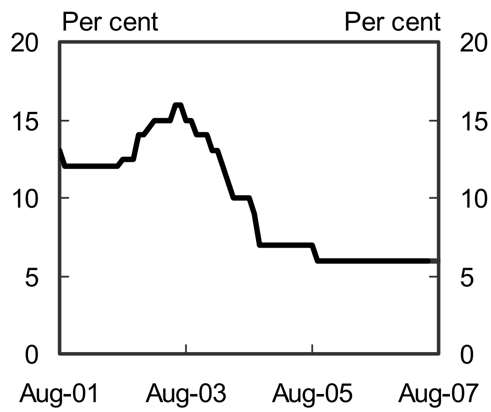
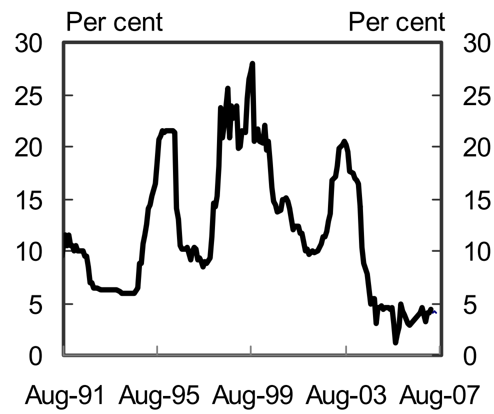


Figure 8: 182 Day Interest Rate



Source: BPNG

Total money supply has continued to increase strongly in 2006 and 2007, increasing by 36 per cent in 2006 and by a further 23 per cent in the year to August 2007, although growth rates appear to be easing. On the other hand, currency in circulation has grown by a worrying 35 per cent over the year to August 2007 and appears to be on an upward trend.

Figure 9: Money Supply (M3)

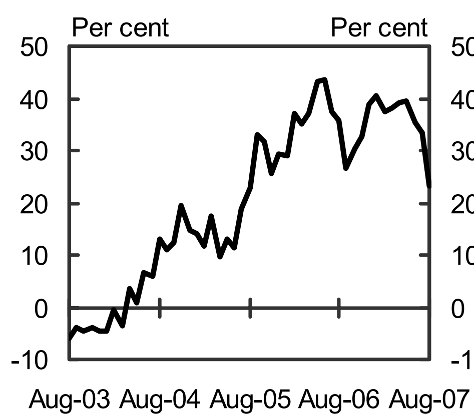
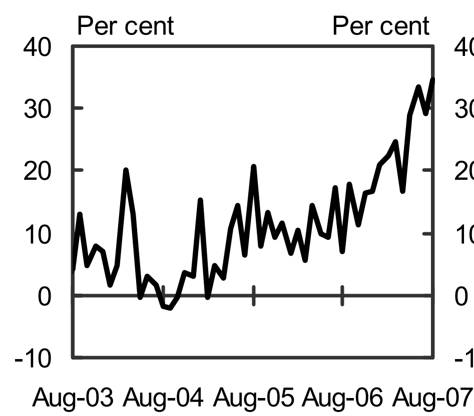


Figure 10: Currency in circulation



Source: BPNG

Lending from the commercial banks to business has also increased strongly, growing by 35.1 per cent through the year to June 2007. At the same time, business deposits with commercial banks have also increased, growing from K2994.6 million in June 2006 to K3900.2 million in June 2007, an increase of K905.6 million. This strong growth in lending and deposits reflects higher domestic activity across all sectors of the economy, particularly in business like hotels and real estate. Bank margins between average interest rates on deposits and loans remain high.

1.6 BALANCE OF PAYMENTS AND INTERNATIONAL RESERVES

In 2007, the current account balance is expected to be a surplus of K802 (4.3 per cent of GDP), which is K453 million lower than the 2006 surplus of K1,255 million. The lower surplus reflects higher imports, which increased by more than exports.

In the first half of 2007, the current account balance recorded a surplus of K304 million, which is lower than the surplus of K1,059 million recorded in the corresponding period of 2006.

The value of exports in 2007 is expected to increase by 14.4 per cent from 2006, reflecting increased volumes of exports of both agriculture and mineral exports due to a pick up in production and higher world prices of the bulk of PNG's exports.

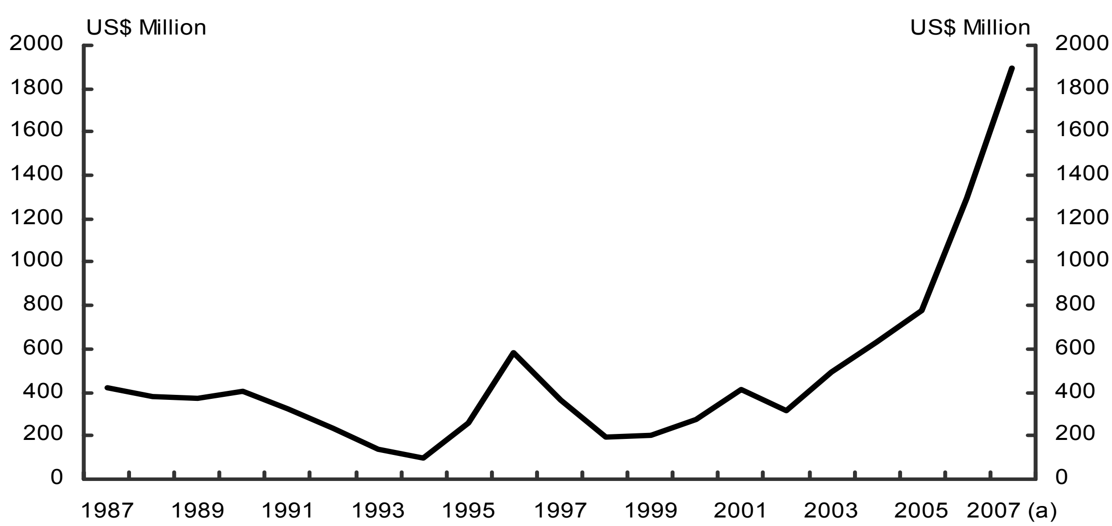
The value of imports is expected to increase by 26.7 per cent in 2007, mainly reflecting stronger investment and economic growth. There are also large amounts of capital goods imports for the Ramu Nickel mine and other new projects. Also, there are expected to be increases in services imports, as well as higher transfer payments abroad.

In the Income and Transfers balance, it is expected that there will be increased inflows reflecting increased donor funds and grants. However, it is also expected that there will be higher income outflow in 2007 outweighing inflows, due to higher revenues and very strong profits of mineral producers.

The Capital and Financial Accounts recorded a deficit of K304 million in the first half of 2007. This implies a net outflow of capital from the PNG economy, which has largely taken the form of a build up in foreign reserves which has increased by K394.7 million in the first half of 2007. In the full year of 2007, the capital and financial accounts is expected to record a deficit of K802 million, lower than the deficit of K1,239 million in 2006.

The holdings of gold and foreign exchange reserves by BPNG at the end of September 2007 were K5,500 million (US$1,897.8 million). This very high level of reserves is more than sufficient to perform the role of managing short term exchange rate volatility.

Figure 11: Foreign Reserves (US Dollar Millions)



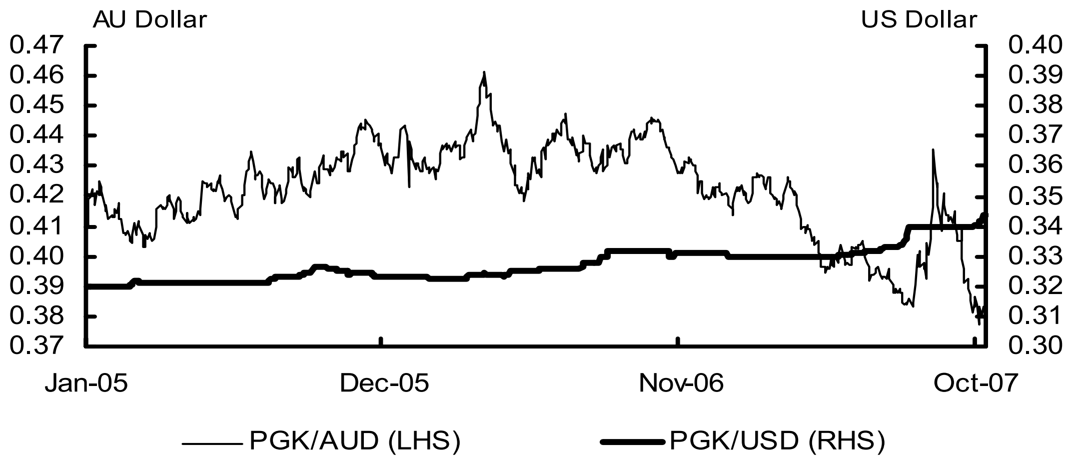
Source: BPNG

(a) Includes reserve levels to end of September, 2007.

1.7 EXCHANGE RATE DEVELOPMENTS

The exchange rate was relatively stable throughout most of 2006, but has depreciated significantly on an imported Trade Weighted Index (TWI) basis against major trading partner currencies over the last year. This is especially the case against the Australian dollar, with the Kina losing 13 per cent of its value against the Australian dollar over the last year. This depreciation of the Kina has seen the price of many imported goods rise, especially as over 50 per cent of imports come from Australia. The value of the Kina against the United States dollar has appreciated slightly by 7 per cent over the last two years. However, given the substantial weakening of United States dollar against most other currencies over this period, the Kina's gain has been very modest.

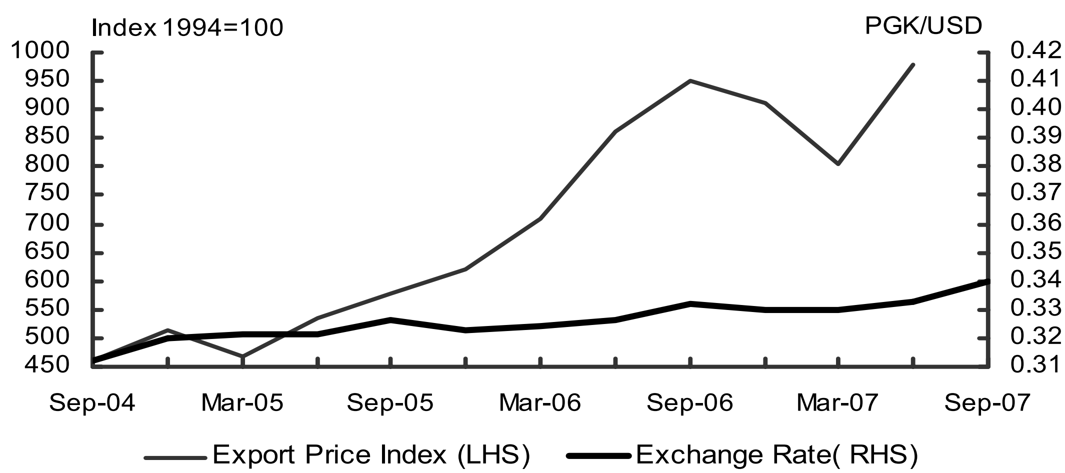
Figure 12: Exchange Rate Developments



Source: BPNG

Exchange rate movements over the last two years do not reflect the massive increase of 83 per cent in the terms of trade that have occurred over this period, or the strong increase in international reserves. Over the last year the Kina has depreciated against the Pound Sterling and the euro by 4 and 7 per cent respectively, however, the Kina appreciated by 1.1 per cent against the Japanese Yen.

Figure 13: Export Price Index and Exchange Rate Movements



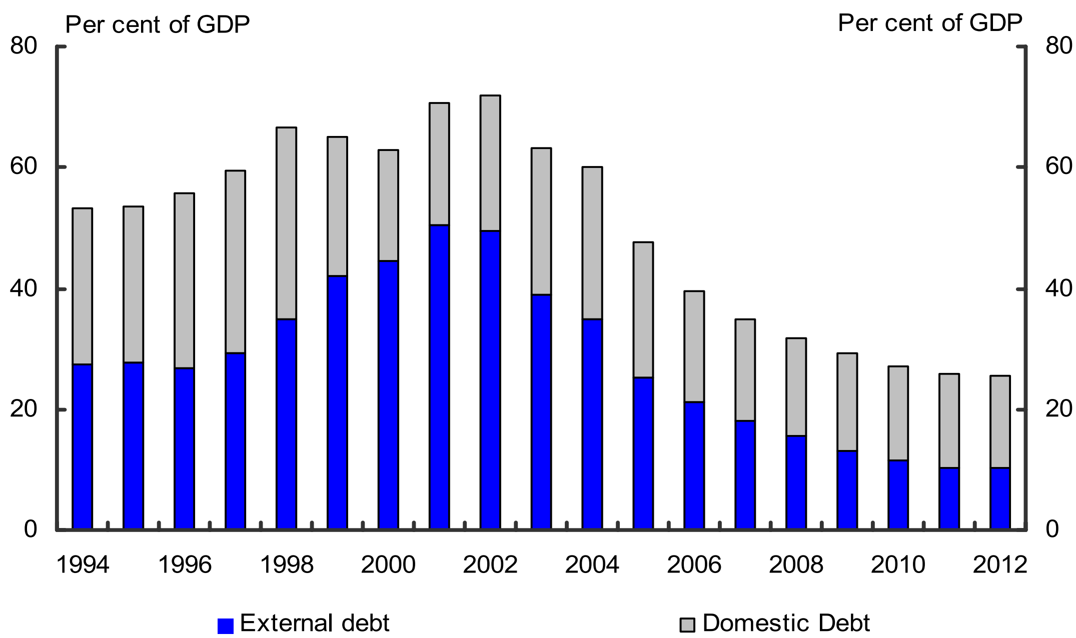
Source: BPNG

1.8 PUBLIC DEBT

Total Public debt has fallen from 72. per cent of GDP or K8,365.3 million in 2002 to 39.5 per cent of GDP or K6,732.1 million at the end of 2006. By the end of 2007, total public debt is expected to fall to 34.9 per cent of GDP or K6,472.5 million. This reflects a combination of robust GDP growth and continued repayment of Government debt.

Over the 5 years to 2007, the debt to GDP ratio has more than halved and is approaching what is considered to be a more sustainable level. This represents an impressive improvement for PNG that is freeing up resources within the Budget and reducing vulnerabilities to any adverse economic/financial developments.

Figure 14: Public Debt 1994-2012



Source: BPNG and Department of Treasury

1.8.1 Domestic Debt

At the end of 2006 the stock of domestic debt was K3,101.0 million, a decrease of K302.8 million or 9 per cent over a year earlier. The stock of total domestic debt at the end of 2007 is expected to be K3,135.1 million, an increase of K34.1 million or 1.1 per cent from the previous year.

The Inscribed stock issuance program which the Government has undertaken since 2006 has been successful in meeting the objective of lengthening the maturity of domestic debt, thereby reducing the refinancing risks.

The composition of domestic debt since 2005 has continued to change, with domestic debt in 2007 expected to be comprised of 29.8 per cent Treasury Bills, 69.6 per cent Inscribe Stock and 0.6 per cent Other Domestic Loans.

1.8.2 External Debt

Total external debt at the end of 2006 was K3, 631.1 million. This represented a decline of K224.9 million or 5.8 per cent from the level at the end of 2005. This decline in external debt has continued in 2007 falling by 8.1 percent or K293.8 million to a projected K3,337.3 million by year end.

The decline in external loans reflects the Government's strategy of increasing the percentage of debt issued domestically, thereby reducing the percentage share of external or foreign currency debt.

Project loan draw downs are expected to be K163 million in 2007 while principal repayments of external debt is estimated to be K518 million.

External debt continues to be dominated by debts to international agencies (multilateral and bilateral creditors) accounting for 96.6 per cent of external debts as at year- end 2006, with commercial loans accounting for the remaining 3.4 per cent.

1.9 CENTRAL GOVERNMENT FISCAL OPERATIONS

The fiscal outcome for 2007 is now projected to be a budget surplus of K321.1 million, or 1.7 per cent of GDP, compared with the original deficit estimate of K35 million or 0.2 per cent of GDP.

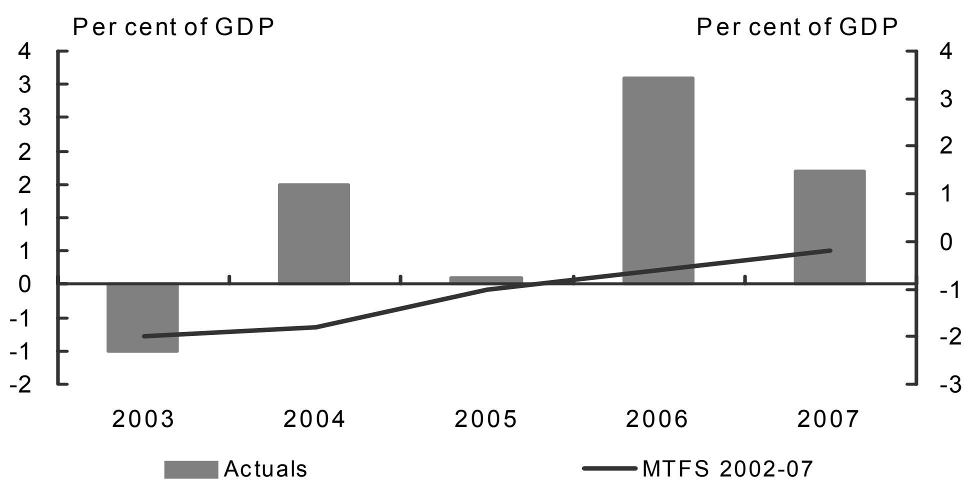
Table 2: Budget Balance 2006 – 2007 (Kina Millions)

	2006 Actual	2007 Budget	2007 Revised	Change
Total Revenue and Grants	6311.6	5421.6	7199.6	+1778.0
Total Expenditure and Net Lending	5775.8	5456.6	6878.6	+1422.0
Deficit (-)/Surplus(+)	535.8	-35.0	321.0	+356.0
Per cent of GDP	3.1%	-0.2%	1.7%	+1.9

Source: Department of Treasury

Over the term of the Medium Term Fiscal Strategy (MTFS) 2002-2007, the fiscal performance has been better than that targeted under the Strategy. See Figure 15 below.

Figure 15: Actual Budget Balance and the MTFS Target



Source: Department of Treasury

1.9.1 Total Revenue and Grants

Total Revenue and Grants for 2007 are estimated to be K7,199.6 million, an increase of K1,778 million or 32.8 per cent from the 2007 Budget projection of K5,421.6 million.

Table 3: Tax Revenue 2006 – 2007 (Kina Millions)

	2006 Actual	2007 Budget	2007 Revised	Change
Taxes on Income and Profits	3823.5	3071.6	4386.9	+1315.3
Dom. Taxes on Goods & Services	784.3	758.0	940.3	+182.3
Taxes on International Trade	337.0	300.3	366.3	+66.0
Tax Revenue	**4944.8**	**4129.9**	**5693.4**	**1563.5**

Source: Department of Treasury

Tax revenue is now expected to be K5,693.4 million in 2007, K1,563.5 million or 37.9 per cent higher in 2007 than the Budget projection of K4,129.9 million. The increase in tax revenue largely reflects substantially higher than expected taxes on income and profits.

Table 4: Taxes on Income and Profits 2006 – 2007 (Kina Millions)

	2006 Actual	2007 Budget	2007 Revised	Change
Personal Income Tax	907.0	890.3	994.1	+103.8
Company Tax	550.6	511.7	633.2	+121.5
Dividend Withholding Tax	200.9	168.1	183.3	+15.2
Mining and Petroleum Taxes	1946.5	1292.8	2362.0	+1069.2
Interest Withholding Taxes	22.1	21.9	19.4	-2.5
Other Direct Tax	92.4	80.8	95.2	+14.4
Gaming Tax	104.0	106.0	99.6	-6.4
Taxes on Income and Profits	**3823.5**	**3071.6**	**4386.9**	**+1315.3**

Source: Department of Treasury

Tax on income and profits is now expected to be K4,386.9 million in 2007, K1,315.3 million or 42.8 per cent higher than expected in the 2007 Budget. This increase largely reflects higher mining and petroleum taxes due to higher-than-expected world prices for PNG's major mineral commodity exports (see Box 2) 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 K183.3 million in 2007, up by K15.2 million from the estimate in the 2007 Budget.

Personal income tax is expected to increase by K103.8 million over the 2007 Budget estimate to K994.1 million in 2007, mainly due to the late payment of an installment due in December 2006. Company tax collections were stronger than expected at the time of the 2007 Budget, reflecting an increase in economic activity and profitability for businesses.

Other direct taxes in 2007 are now expected to be K14.4 million more than originally forecast, primarily reflecting stamp duty on a share transfer in the middle of 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 and gaming tax is expected to come in lower due to the National Government's share of tax rates reduced from 79 per cent to 49 per cent.

Box 2: Commodity Prices

Movements in commodity prices - particularly of oil, copper and gold – and in the exchange rate can have large effects on the Government's revenue through mining and petroleum taxes, dividend withholding tax and mining dividend payments.

Variations in commodity prices and exchange rates have separate effects on revenue. Higher commodity prices will result in more revenue, while a higher exchange rate will result in less revenue.

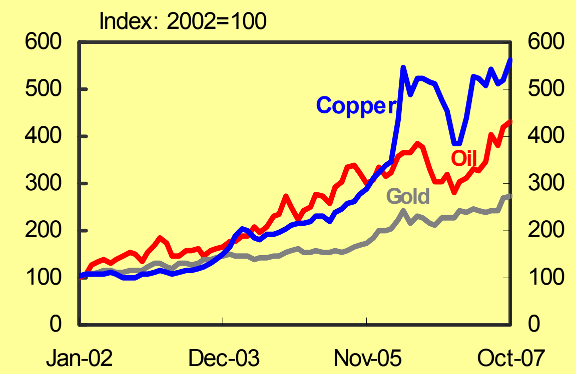
PNG's exchange rate may move in line with commodity-price changes, which would cause an offset to the effects on revenue of the commodity price changes. But this cannot be relied upon. In the last few years, while commodity prices have strengthened, the Bank of Papua New Guinea has built up its foreign currency reserves and the appreciation of the Kina against the US$ has been only slight.

In 2008, the Government expects to collect almost K2.5 billion in mineral and oil revenues – more than 40 per cent of total revenue. This is based on year average price assumptions of US$61.9 per barrel for oil, US$5,400 per tonne for copper, US$662 per troy ounce for gold, and an exchange rate of US$0.34.

These price assumptions are broadly in line with IMF projections. They are well below the current record high market prices, but for good reasons. High commodity prices have been accompanied by increased volatility. Since the beginning of 2006, oil and copper prices have shifted by more than 20 per cent on at least six occasions, with some of these movements taking place over less than a week – as the accompanying chart shows.

Because of this volatility, and the way mineral and oil taxes are assessed, the outlook for revenue can change quickly and by large amounts during a year. The sharp falls recorded in early 2007 illustrate this– oil and copper, prices fell to US$52 per barrel and US$5,100 per tonne well below the prices assumed in the 2007 Budget. If these prices had continued for the rest of 2007, the fiscal scenario would have looked markedly different.

Commodity prices, 2002-2007



Given the great difficulty of predicting commodity prices or exchange rate movements, the Government has been careful to use prudent price assumptions. Doing this is in line with IMF advice and the budgeting practice of most other mineral producing countries. However, the Government has also been careful not to use artificially low price assumptions, unlike a number of other countries, where oil price assumptions used for budgetary purposes have been as low as US$20 per barrel.

Given the prudent assumptions, there is a reasonable chance that commodity prices may come in above the Budget assumptions in 2008. However the consequences of this happening are far less than if prices were to fall below, which would result in a revenue shortfall. It is easier to allocate additional revenue than it is to cut planned expenditure.

The possibility of mineral revenue coming in above the Budget forecast creates challenges for the annual Budgetary process. An expectation that there will always be more money available than contained in the Budget encourages over-spending and the making of spending commitments outside the Budget process.

These practices should be avoided because they weaken the discipline on Government agencies to stay within their Budget allocations, and allow second-best uses of Budget resources.

Part of the answer is to develop a prioritized program of investment projects over the medium term, which can be funded if and when additional revenue is

received and as implementation capacity develops in the public and private sectors. Such a program would be a key input in the event of future Supplementary Budgets.

Given the volatility and uncertainty of commodity prices, some information is provided in the table below about how variations in commodity prices or the exchange rate may affect Government revenue.

The table shows estimates of the changes in revenue which would result if there were different year average commodity prices or exchange rates.

It should be remembered that there is a range of other factors that can also affect mineral and oil revenues, including unforeseen shutdowns, the mining of lower ore grades, project costs, capital expenditures, landowner disputes, changes to dividend policy and timing of MPT payments by producers. Therefore these estimates should be used only as a guide.

Sensitivity of revenues to commodity price and exchange rate assumptions

Variation Per cent	Price	Total Revenue Kina Million	Variation from Budget Kina Million
Oil			
30	$80 per barrel	6402.5	398.3
15	$71 per barrel	6203.4	199.1
Budget	$62 per barrel	6004.3	0.0
-15	$53 per barrel	5805.1	-199.1
-30	$43 per barrel	5623.0	-381.3
Copper			
30	$7020/tonnes	6368.1	363.9
15	$6210/tonnes	6186.2	181.9
Budget	$5400/tonnes	6004.3	0.0
-15	$4590/tonnes	5822.3	-181.9
-30	$3780/tonnes	5640.4	-363.9
Gold			
30	US$861/troy ounce	6271.0	266.7
15	US$762/troy ounce	6138.0	133.7
Budget	US$662/troy ounce	6004.3	0.0
-15	US$563/troy ounce	5871.0	-133.3
-30	US$464/troy ounce	5737.0	-267.3
Combined effects of oil, gold and copper price variations			
30		7033.0	1028.7
15		6518.0	513.7
Budget		6004.3	0.0
-15		5490.0	-514.3
-30		4992.0	-1012.3
Exchange rate (Kina/US$)			
30	0.442	5340.0	-664.3
15	0.391	5629.0	-375.3
Budget	0.340	6004.3	0.0
-15	0.289	6512.0	507.7
-30	0.238	7238.0	1233.7

Table 5: Domestic Taxes on Goods and Services 2006 – 2007 (Kina Millions)

	2006 Actual	2007 Budget	2007 Revised	Change
Excise	324.1	309.8	335.8	+26.0
GST	401.1	420.0	554.3	+134.3
Mining Levy	56.1	25.6	48.0	+22.4
Other Indirect	3.0	2.6	2.2	-0.4
Domestic Taxes on Goods & Services	**784.3**	**758.0**	**940.3**	**+182.3**

Source: Department of Treasury

Domestic taxes on goods and services are now expected to be K940.3 million in 2007, K182.3 million higher than forecast in the 2007 Budget. Domestic excise revenue collections are expected to be better than previously 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 6: Taxes on International Trade 2006 – 2007 (Kina Millions)

	2006 Actual	2007 Budget	2007 Revised	Change
Import Duty	90.4	96.9	124.2	+27.3
Export Duty	162.6	118.0	152.6	+34.6
Excise Duty on Imports	84.0	85.4	89.4	+4.0
Taxes on International Trade	**337.0**	**300.3**	**366.3**	**+66.0**

Source: Department of Treasury

Taxes on international trade are now projected to be K366.3 million in 2007, which is K66.0 million or 22 per cent more than originally expected. Import duty will raise K27.3 million more than expected. This is due to the 2006 outcome being stronger than expected and stronger than expected domestic demand resulting in higher imports.

Export duty on logs is expected to be K152.6 million in 2007, up K34.6 million from the 2007 Budget estimate. The main driver is the higher production of logs in early 2007 as a result of better seasonal conditions and high international prices compared to the expectations at the time of the 2007 Budget.

Excise duty on imports are now expected to be K89.4 million in 2007, which is K4.0 million higher than originally expected. This reflects the greater than expected rise in domestic production of refined petroleum products at the Napa Napa Oil Refinery.

Table 7: Non-Tax Revenue 2006 – 2007 (Kina Millions)

	2006 Actual	2007 Budget	2007 Revised	Change
Property Income	339.3	242.8	375.2	+132.4
Non-Mining Dividends	*68.1*	*73.5*	*73.5*	*+0.0*
Mining & Petroleum Dividends	*271.2*	*169.3*	*301.7*	*+132.4*
Interest and Fees from Lending	0.6	2.6	2.6	+0.0
Other Non Tax Revenue	88.9	81.8	82.0	+0.2
Non Tax Revenue	**428.8**	**327.2**	**459.8**	**+132.6**

Source: Department of Treasury

Non-tax revenue is estimated to be K132.6 million, or 40.5 per cent, higher in 2007 than expected at the time of the 2007 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 2007 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 its dividend in 2007 which was K33 million in relation to its 2006 operating profit. National Fisheries also paid K10 million in dividends.

While dividends should also be received in 2007 from the Independent Public Business Corporation (IPBC), 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 2007 Budget.

Grants are anticipated to be K1,013.4 million in 2007 and Infrastructure Tax Credits is anticipated at K33 million.

1.9.2 Total Expenditure and Net Lending

Total Expenditure and Net Lending in 2007 is now projected to be K6,878.6 million, an increase of K1,422.0 million or 26 per cent on the 2007 Budget estimate of K5,456.6 million.

In 2007, the Government continued to deliver on its track record of restraining spending to limits in Budget Appropriation Acts. While expenditure in 2007 is substantially over the original budget appropriation, this reflected the Government's decision to apply stronger than expected revenue to priority expenditure areas through the 2007 Supplementary Appropriation Act, rather than a loss of expenditure control or fiscal discipline

Table 8: Total Expenditure and Net Lending 2006 – 2007 (Kina Millions)

	2006 Actual	2007 Budget	2007 Revised	Change
Recurrent Expenditure	3014.7	3370.0	3370.2	0.2
Development Expenditure	1554.1	1636.6	1718.4	+81.8
Additional Priority Expenditure	1207.0	450.0	1790.0	+1340
Total Expenditure and Net Lending	**5775.8**	**5456.6**	**6878.6**	**+1422.0**

Source: Department of Treasury

1.9.2.1 Recurrent Expenditure

The overall recurrent expenditure in 2007 is estimated to be K3,370.2 million, reflecting estimated low interest payments due to low interest rates.

Table 9: Recurrent Expenditure 2006 – 2007 (Kina Millions)

	2006 Actual	2007 Budget	2007 Revised	Change
Personal Emoluments	1360.5	1392.2	1424.2	+32.0
Goods and Services	1070.5	1233.5	1304.5	+71.0
Interest Payments and Fees	307.0	475.9	372.9	-103.0
Transfers to Bougainville	46.5	50.7	50.9	+0.2
Transfers to Statutory Institutions	234.3	221.6	221.6	0.0
Net Lending to CSAs	-4.2	-4.0	-4.0	0.0
Total Recurrent Expenditure	**3014.6**	**3370.0**	**3370.2**	**+0.2**

Source: Department of Treasury

The 2007 Budget provided K20.0 million for urgent unanticipated expenditure in 2007. In addition, K115.4 million was reallocated through Secretary's Advance, sourced from anticipated under spends in certain appropriations. Table 10 outlines the re-allocation of these funds.

Table 10: Allocation of funds from the Secretary's Advance in 2007 (Kina Millions)

Total Available for Allocation		**135.4**
Original Balance 2007 Budget		*20.0*
Savings		*115.4*
Natural Disaster	3.5	
National Road Authority Maintenance	10.0	
Retrenchment	36.9	
Interest Savings – Treasury Bills	25.0	
Interest Savings – Inscribed Stocks	40.0	
Additional Expenditure		**135.0**
Urgent Unanticipated Items		*123.5*
Security for National Election (Defence & CS allowances)	7.8	
Newcastle Disease	2.8	
Deputy Prime Minister's Office	0.3	
Consultancy payments	0.8	
Manam Resettlement Authority	2.0	
National Housing Policy Task Force	0.5	
Lawsuit in New York	1.0	
Education Subsidies	100.0	
Retrenchment payments	4.1	
Fire Emergency Services	0.6	
FIFA Presidential visit	0.3	
Others	0.3	
Items Overlooked in the 2006 Budget		*2.5*
Financial Management Implementation Program	2.5	
Outstanding Obligations (including Compensation Payments)		*2.5*
Peace Negotiation	0.2	
Land Rental Payment (Jackson)	0.5	
Customary Land purchase (Governor General House)	0.7	
Power Bill payments	0.3	
ICT Policy Task Force	0.5	
Social Economic Implementation	0.3	
Investigations		*5.9*
Finance Investigation	4.3	
Pacific Balance Fund Investigation	1.0	
Defence Force Investigation	0.6	
Additional Vehicles		*0.2*
Replacement of Trade & Commerce Secretary's official	0.2	
Donations		*0.5*
Disaster Relief for Solomon Islands	0.5	
Closing Balance as at MYEFO 31 July 2007		**0.4**

Source: Department of Treasury

1.9.2.2 Development Expenditure

Development expenditure in 2007 is expected to remain within the original 2007 Appropriation, except for development items in the additional appropriations in 2007 and increase in donor grants mainly from Australia.

Table 11: Development Expenditure 2006 – 2007 (Kina Millions)

	2006 Actual	2007 Budget	2007 Revised	Change
Domestic Financing	471.2	509.1	509.1	0.0
Grants	914.6	879.1	1013.4	+134.3
Infrastructure Tax Credits	23.3	85.4	33.0	-52.4
Concessional Loans	145.0	163.0	163.0	0.0
Total Development	**1554.1**	**1636.6**	**1718.4**	**+81.8**

Source: Department of Treasury

1.9.2.3 2007 Supplementary Budget

With the continuous sustained high prices on world markets for our main mineral commodities (oil, copper and gold), an additional K1,637.0 million has been allocated to priority areas. This is in addition to the K450 million Additional Priority Expenditure.

Table 12: Additional Priority Appropriation: 2007 Supplementary Budget (Kina Millions)

Items		Total
Recurrent Expenditure		**197.0**
NADP	40.0	
CAA Restructuring	21.0	
Secretary's Advance	20.0	
Election cost overruns	15.0	
SSG	15.0	
Doctors Back Payment of S&W	10.0	
Cocoa Pod and Coffee Borer Measures	12.0	
Defence Uniforms and re-instated staff	8.0	
Outstanding Legal Fees	8.0	
Court Orders	8.5	
Natural Disaster Fund	7.0	
Maritime Boundary Project	5.0	
Others	27.5	
Public Infrastructure		**537.0**
Major Infrastructure Maintenance	257.0	
Infrastructure Maintenance in Health	80.0	
Infrastructure Maintenance in Education	80.0	
Infrastructure Maintenance in Justice	80.0	
Housing and Urbanisation	40.0	
District Service Improvement Project		**356.0**
K4.0 million each District	356.0	
Retiring Public Debt		**297.0**
Nambawan Super		**250.0**
GRAND TOTAL		**1637.0**

Source: Department of Treasury

In line with the Medium Term Fiscal Strategy 2002-2007 and the MTDS 2005-10, the items in the 2007 Supplementary Budget fall into three broad categories: investments in economic impact programs under the recurrent budget, public infrastructure maintenance and improvement, and to paying down Government debt and other one-off outstanding obligations.

As in 2006, in keeping with the Government's commitment to fiscal responsibility, as outlined in the *Fiscal Responsibility Act* 2006, the Government will not spend temporary windfall revenues on items that would place unsustainable pressure on future budgets.

The 2007 Supplementary Budget puts the Medium Term Development Strategy into action and 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.

In line with the guidelines established for the implementation of the Additional Priority Appropriation, funds will be disbursed, monitored, accounted for and reported on accordingly; to ensure that maximum benefits is gained on the intended purpose of appropriation.

1.9.3 Financing

A fiscal surplus of K321.0 million or 1.7 per cent of GDP is now expected in 2007, compared with the original budget deficit estimate of K35.0 million or 0.2 per cent of GDP.

The fiscal surplus will be used to retire debt, resulting in an expected net external outflow of K355.0 million and a net increase in domestic financing of K34.0 million. This compares with the net domestic financing requirement of K34 million for 2007.