

CHAPTER 1. ECONOMIC AND FISCAL DEVELOPMENTS

1.1 OVERVIEW

The PNG economy has continued to grow at strong rates over recent years, benefiting from half a decade of extremely favorable global economic conditions, with strong and sustained world growth, benign inflation and surging commodity prices. However, the global financial crisis has led to a severe deterioration in the global economy, with a recession expected in the advanced economies, and a significant slowdown in developing countries. This has translated into sharply lower commodity prices, which will have a major impact on the PNG's economic and fiscal outlook going forward.

The PNG economy is expected to record its strongest sustained rates of growth over 2007 and 2008. Real GDP growth in 2007 was 6.5 per cent, and is expected to increase to 7.2 per cent in 2008. This growth has been underpinned by record high commodity prices, macroeconomic stability, prudent fiscal and monetary policies, increased business confidence, high rates of private sector borrowing, microeconomic reforms and political stability.

Growth has been broad based, driven primarily by the non-mining sectors, in particular the communication, construction and retail sectors. Non-mining GDP growth is estimated at 7.3 per cent in 2007, and expected to be 7.9 per cent in 2008, the highest sustained rates ever recorded.

This has resulted in an unprecedented surge in formal sector employment, which has grown at near double digit rates since 2006. This has been broad based, with above trend increases in most sectors, in particular the building and construction and retail and wholesale sectors, which have grown at consistently strong rates over the past 3 years.

Table 1: Principal Economic Indicators

	2005	2006	2007	2008
	Actual	Actual	Actual	Proj
Real GDP Growth (%)*	3.6	2.6	6.5	7.2
Real Non-Mining GDP Growth (%)	3.4	3.8	7.3	7.9
Employment Growth (%)	1.1	8.2	9.4	7.6*
Inflation (year average) (%)	1.8	2.4	0.9	10.6
Treasury Bill Rate (%)	4.5	5.0	5.0	6.5
3 year Incrbed Stock yield (%)		6.0	5.7	6.0
Gold (US\$/oz)	444.9	604.3	697.0	863.0
Copper (US\$/lb)	1.7	3.1	3.23	3.21
Oil (US\$/barrel)	53.4	64.3	72.3	102.0

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

* GDP data for 2005, 2006, 2007 and 2008 are Department of Treasury's estimates. Employment growth is the change in formal non-mining employment through-the-year.

* Employment growth for 2008 is at June qtr 2008. (QEB)

As a result of surging commodity prices, which have been at record levels over recent years, Government revenues increased substantially, allowing the Government to increase expenditures. By using most of the windfall revenues prudently, paying off public debt, repaying outstanding commitments, and placing the funds in trust to be spent gradually over the medium term, rather than in an inflation inducing burst that could lead to macroeconomic

instability, the Government has maintained a relatively prudent fiscal stance. This has been guided by the adoption of the Medium Term Fiscal Strategy, and the continued use of the Medium Term Development and Debt Management Strategies.

Inflationary pressures have increased significantly, with year average inflation of 10.6 per cent expected in 2008. This increase has been due to strong money supply and credit growth, the positive terms of trade shock, rapid private sector expansion into an economy facing capacity constraints and increased government expenditure. This has been exacerbated by rising global food and energy prices, which have increased the cost of a number of consumer staples, such as rice, fuel and flour.

Monetary policy has reacted to increased inflation but monetary conditions remain too loose for the circumstances. Official interest rates have increased by 100 basis points in 2008, although this has had no noticeable impact on money or credit growth. The exchange rate has appreciated significantly in 2008, particularly against the Australian dollar, reflecting the sharp depreciation of the A\$ against most other currencies, and more steadily against the US\$. The appreciation will help ease inflationary pressures, although it will also reduce the competitiveness of domestic producers.

In the second half of 2008, global conditions took a sharp turn for the worse, unfolding into a full blown global financial crisis in September 2008, with the failure of a number of major international financial institutions. These events have caused a severe deterioration in the global economic outlook (see Box 1).

The freezing of global credit markets, loss of confidence in the international financial system, massive declines in asset prices, and sharp falls in business and consumer confidence around the world are resulting in a major recession in the developed economies, including the US, Europe and Japan, and a marked slowdown in developing economies such as China, India and South East Asia.

The global slowdown has resulted in sharp declines in the prices of PNG's export commodities, with oil and copper falling by more than 50 per cent from the record high prices recorded in July 2008. This has had a major impact on the export values of PNG's commodities, and has resulted in a substantial fall in mineral revenue collections by the Government. It will also have major implication to the balance of payments, with the current account expected to swing from a large surplus in 2008 to a deficit position in 2009.

The global downturn has radically changed the conditions in which the PNG economy operates, with the boom conditions of the previous three years appearing to be at an end.

This will require a significant adjustment in expectations regarding new Government expenditure, which will have to adjust to match the substantial decline in revenues. By following the Medium Term Fiscal Strategy during the boom years, ongoing spending was kept in line with normal revenue, which could be expected in the absence of a commodity boom. Now that the boom appears to be over, there are unlikely to be additional funds allocated. Nevertheless, the funds that are currently in trusts accounts will bolster actual Government spending over the next few years, smoothing the impact of the commodity price boom.

Box 1: GLOBAL FINANCIAL CRISIS

The turmoil and weakness experienced by world financial markets has been some of the most significant since the 1930's Great Depression. This instability and uncertainty is now posing a major threat to global growth.

These developments began with the emergence of the sub-prime mortgage crisis in the United States in mid-2007, which caused losses around the globe on these instruments and financial institutions to lose confidence in lending to each other.

The US sub-prime crisis was caused by two major factors:

- A downturn in US housing markets, where prices have fallen by more than 20 per cent since mid-2006. This resulted in increased defaults, and the failure of many mortgages to be paid. These mortgages are now bad loans, and have to be written down by the lenders. Unfortunately, these loans make up a major portion of many of the assets of the world's banks, finance companies, governments and insurance companies.
- Large numbers of mortgages have been bundled up and sold off as complex financial instruments called Mortgage Backed Securities. Many of these were given AAA credit ratings, and were purchased by companies on the assumption that they were safe assets. With the increased rate of default on mortgages, these assets have lost value. However, because they are so complex and opaque, the true value of these assets is unknown, so no-one is willing to buy them, making them worthless in the current market.

Significantly higher borrowing costs, risk premiums and higher interest rates are a major risk for households, firms and Governments who hold high levels of debt, particularly if that debt is short term, which needs to be rolled over quickly.

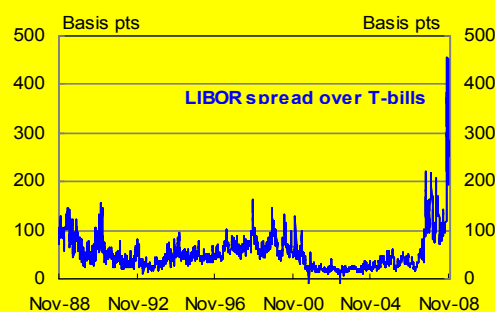
The situation dramatically worsened in mid-September 2008 with a number of the world's largest banks and financial institutions, including Lehman Brothers, Bear Stearns, American International Group, Fannie Mae and Freddie Mac either failing or teetering on the edge of bankruptcy.

The financial crisis has not been restricted to the United States, with financial institutions also collapsing in the United Kingdom, Germany, France, Ireland, Belgium, the Netherlands and Iceland.

The collapse of these financial institutions, created great uncertainty and fear across financial markets. Confidence plunged and banks were unwilling to lend to each other or other businesses, out of fear that the borrowers will fail and be unable to repay the debts. This caused a credit crunch, resulting in a significant increase in risk premiums, increasing the cost of borrowing significantly.

The immediate effect of the credit crunch is illustrated in the chart below, where the spread between the rate at which banks lend to each other and the risk free 3 month US Treasury Bill rate reached nearly 400 basis points in October 2008.

Credit spreads – US LIBOR vs 3 month T-Bills



The major impact to date on PNG arising from the global financial crisis has been a sharp fall in commodity prices of PNG's exports and a large fall in Government revenue. In addition, equity markets have

<p>also fallen broadly in line with international developments. On a more positive note, the international factors that were driving inflation in PNG in early 2008 have now reversed. Banks in PNG have also been relatively unaffected to date by the global fallout, largely because of their heavy reliance on domestic deposits as a source of funds.</p> <p>In response to this crisis, several countries have implemented emergency measures to support financial institutions. The United States Congress has recently approved the US\$700 billion <i>Emergency Economic Stabilization Act of 2008</i> in the hope that this will help restore financial institutions' balance sheets, and also create a functioning market for the securities.</p> <p>In the past, it would have been expected that a financial crisis of this magnitude would have already affected the PNG economy significantly.</p>	<p>One factor that has helped the economy to date has been the halving of public debt over the past five years (when measured as a percentage of GDP), as well as the rebalancing of the debt portfolio towards domestic and longer maturity debt – which has resulted in improvements to PNG's credit rating.</p> <p>Going forward, the International Monetary Fund in its 2009 World Economic Outlook has indicated that the world economy is decelerating quickly and <i>"is entering a major downturn in the face of the most dangerous financial shock in mature financial markets since the 1930s"</i>.</p> <p>In light of this bleak outlook, it has become clear that the flow-through of the financial crisis to the global economy is going to be much more severe than first anticipated.</p>
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The large commodity price falls have been accompanied by a significant increase in volatility, making it exceptionally difficult to forecast commodity prices in 2009, and increasing the uncertainty and downside risks surrounding the revenue projections for 2009. The 2009 Budget commodity price assumptions will need to be monitored carefully going forward. Similarly, the sharp appreciation of the exchange rate (on a trade weighted index basis) over recent months is likely to result in a loss of competitiveness. This is at a time when the current account position is likely to swing from a large surplus to a large deficit position. These developments will also need close monitoring.

Despite the global downturn, domestic growth prospects for the PNG economy remain relatively favorable, with above trend economic growth expected to continue in 2009, albeit at a more moderate pace. The banking sector, which is reasonably well capitalized, and sources most of its funding through domestic deposits, is expected to remain relatively protected from the financial turbulence elsewhere in the world, allowing for continued private sector expansion.

At the same time, public sector capital expenditure is anticipated to continue to increase, primarily through increased utilization of funds that have been placed in trust over previous years. This illustrates the benefits of spreading the use of the windfall revenues from the commodity price boom over the medium term, rather than spending them as they are received, which would have required deep expenditure cuts as commodity prices and mineral revenues fell. Nonetheless, the rate at which these funds are drawn will need to be carefully monitored and controlled, in order to prevent adding to inflationary pressures in a high inflation environment.

The risks to both the economic and fiscal outlook are very much on the downside. Further falls in commodity prices below the Budget assumptions would have a major impact on mineral exports and the Government's budget position.

The falls in commodity prices have not been limited to minerals, and include agricultural prices. For example, the prices of palm oil and copra oil have fallen by around 50 per cent and 40 per cent respectively since July 2008. Combined with the appreciation of the Kina, this could potentially affect production, as marginal producers reduce output in response to lower prices.

While it appears that the availability of funding for private sector expansion will not be a major impediment to growth, if confidence effects from the global financial crisis take hold in PNG, there could be a slowing of the very strong private sector expansion experienced over recent years.

In addition, the PNG economy is heavily reliant on a small number of producers, meaning that unexpected shutdowns – due to events such as landowner problems, weather or technical issues – can have a major impact on the economy and revenue flows.

One factor that will assist to reduce the risks to public finances during these turbulent times is the reduction in public debt that has occurred over the past 5 years. Total Public debt has been reduced from 72 per cent of GDP in 2002 to 33.8 per cent of GDP as at the end 2007. By end 2008, public debt is expected to decline further to 28.8 per cent of GDP. This has freed up resources within the Budget, and has helped shield public finances from some of the upheavals in global financial markets. It will also provide some room to maneuver in the event of a shortfall in revenue if commodity prices continue to fall.

1.2 GROSS DOMESTIC PRODUCT

2007 Updates

The PNG economy grew by an estimated 6.5 per cent in 2007, up substantially from the estimated growth of 2.6 per cent in 2006 and was the sixth successive year of economic growth. The economy continued to grow very strongly in 2007 due to stable macroeconomic policies, improved business confidence, microeconomic reforms and high commodity prices.

Total estimated non-mining GDP grew by 7.3 per cent in 2007, up substantially from 3.8 per cent in 2006. This reflected exceptionally strong growth in the communication and construction sectors as well as robust growth in the wholesale and retail, manufacturing and agriculture, forestry and fisheries sectors.

The communication and transport sector grew exceptionally strongly by around 40 per cent in 2007 in response to microeconomic reforms that allowed competition in the mobile phone industry. Both the existing operator and the new entrant expanded operations. This increased subscriber numbers substantially and saw a major contribution from this sector to overall economic activity.

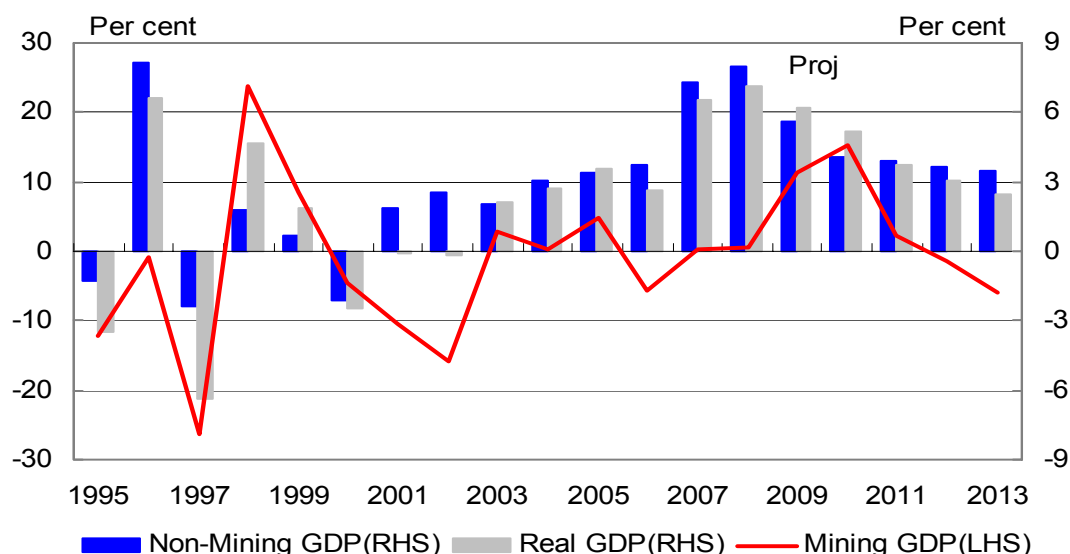
The construction sector grew very strongly by 16 per cent in 2007, reflecting the construction of the Ramu Nickel project, the new mines of Simberi, Sinivit and Hidden Valley, increased private sector building activity and increased government expenditure on infrastructure maintenance. The wholesale and retail sector grew by a strong 10 per cent in 2007 and the manufacturing sector grew by 6 per cent.

The agriculture, forestry and fishing sector also experienced robust growth of around 4 per cent in real terms in 2007. In agriculture, increased production of coffee, palm oil, copra oil and tea were the major drivers of growth.

The mining and quarrying sector is estimated to have increased slightly by 2 per cent in real terms in 2007, reflecting normal production from the existing mines supported by the commencement of the Sinivit gold mine. The Lihir and Porgera mines have ramped up gold production through their expansion plans, more than offsetting lower gold and copper production from the Ok Tedi mine.

The oil and gas extraction sector declined by 5 per cent in real terms in 2007, due to production declines for Kutubu and Gobe, partially offset by increased production from the Moran and SE Manada fields. This shows the extent of the natural decline from the existing fields, even though the world prices of crude oil continued to be very high.

Figure 1: Economic Growth: 1995 – 2013



Source: 2008 Updates - Department of Treasury

2008 Outlook

In 2008, real economic growth is expected to be 7.2 per cent – the highest growth since 1993. This is broadly in line with forecast GDP growth of 7.3 per cent expected in the 2008 Mid Year Economic and Fiscal Outlook (MYEFO), although, the composition of growth has altered, with a large downward revision to expected oil production, partially offset by a broad upward revision across many of the non-mineral sectors.

The strong Gross Domestic Product (GDP) growth in 2008 is broad based and mainly driven by the non-mining sectors. The mining and quarrying sector is also expected to expand, largely due to increased production from Porgera and Ok Tedi. Oil production is expected to decline in 2008, as existing fields continue to mature, resulting in lower extraction rates. Total non-mining GDP is expected to expand by 7.9 per cent in 2008, the strongest growth in over a decade, driven by continued robust growth in transport, storage and communication, construction, wholesale and retail trade, finance, real estate and business and the agriculture, forestry and fisheries sectors.

The transport storage and communication sector is expected to expand by a further 40 per cent in 2008, driven by the communication sector through the continued expansion of mobile phone services. The interconnectivity of the two networks in the year has further expanded

operations and increased the number of subscribers substantially, and has vastly contributed to increased domestic activity in the economy. Subscribers to mobile networks are now estimated to be around one million, and activity related to the sector is now estimated to have contributed around 2 per cent to GDP.

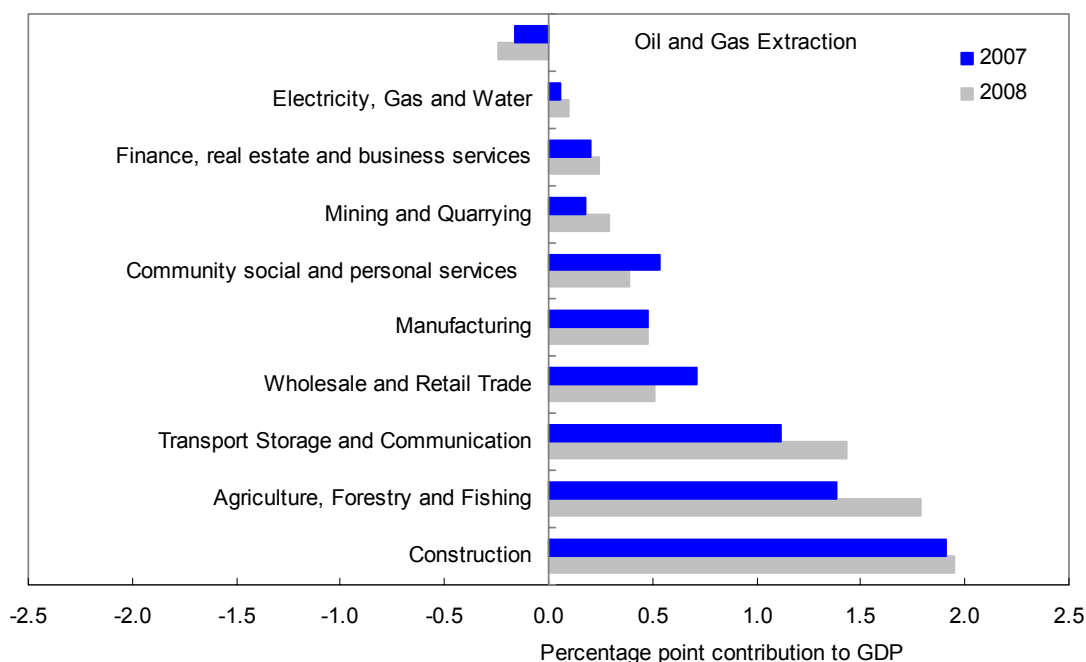
The construction sector is expected to grow strongly by 15 per cent in 2008, with continued demand from both the private and public sectors. However, growth is expected to return to more moderate levels in the future. This is due to the construction sector operating at full capacity, which means that further growth requires increased capacity, rather than increased utilization of spare resources as observed over recent years.

Growth in the agriculture, forestry and fishing sector is expected to accelerate in 2008 to around 5 per cent. The robust growth in agriculture reflects increased production of copra, copra oil, coffee, cocoa and palm oil. This was supported by higher prices in the first half of 2008.

However, in the second half of 2008, prices of most agriculture commodities fell dramatically, in line with the drop in demand for commodities due to the global economic downturn. Since June 2008, agricultural commodity prices have fallen as follows: oil palm by 52 per cent; copra oil 40 per cent; cocoa 22 per cent; and coffee 11 per cent.

Other non-mineral sectors, such as wholesale and retail, finance, real estate and business, manufacturing, and community, social and personal services sectors are expected to have grown strongly in 2008, supported by low interest rates and increased business confidence in line with macroeconomic stability. Growth in these sectors is strongly supported by high employment and lending growth.

Figure 2: Contribution to Growth by Industry in 2007 and 2008.



Source: 2008 Update - Department of Treasury

The mining and quarrying sector is expected to grow by 4 per cent in 2008, reflecting slightly higher production from the existing mines and the commencement and initial ramp up of the

Simberi and Sinivit gold mines. Porgera and Ok Tedi are expected to increase production in 2008, while production from Lihir and a number of other small mines is anticipated to decline in 2008.

The oil and gas extraction sector is expected to decline by 8 per cent in 2008, reflecting a fall in annual total oil production of around 1.3 million barrels. This represents a continuation of the natural decline from all existing fields, despite increased workover due to high oil prices.

Commodity prices have fallen dramatically in the second half of 2008, after increasing to record levels during the first half of the year. Since July 2008, the prices of oil and copper have fallen by more than 50 per cent, and the price of gold has declined by around 30 per cent (see Box 2). This has reduced the value of PNG's exports significantly, and introduced great uncertainty as to where prices will settle. However, as most of PNG's mineral operations appear to be, in general, low marginal cost producers, the prices falls to date are not expected to reduce production volumes.

Box 2: Commodity Price Collapse

Commodity prices have collapsed after being abnormally high for the last five years. Prices peaked in July 2008 and have since plunged.

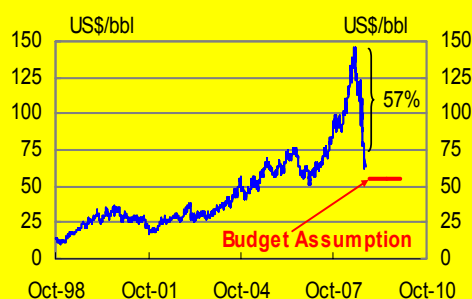
Two opposing trends were evident in 2008. Commodity price began to skyrocket towards the end of 2007 and in the first six months of 2008 reached uncharted territory. This massive run up in prices came during a time when world demand was growing beyond the capacity of supply to respond, and risk premiums were building due to intensifying geopolitical concerns.

By July 2008, oil surged past US\$145 per barrel, copper reached US\$8900 per tonne and gold reached US\$950 per ounce. Since the emergence of the global financial crisis, the situation has changed dramatically, with commodity prices falling sharply in the second half of 2008 as the outlook for world growth deteriorated.

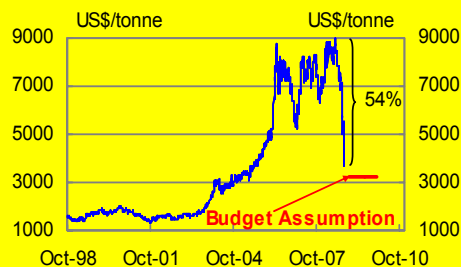
The financial crisis has resulted in into a major slowdown in growth. The IMF has revised down global growth prospects in their latest revised WEO. Global economic growth is expected to slow from 5 per cent in 2007 to 3 ¼ per cent in 2008 and to just over 2 per cent in 2009.

This slowdown in growth has triggered a fall in demand across the advanced economies, especially in the US, European Union and Japan. The US economy has been the worst

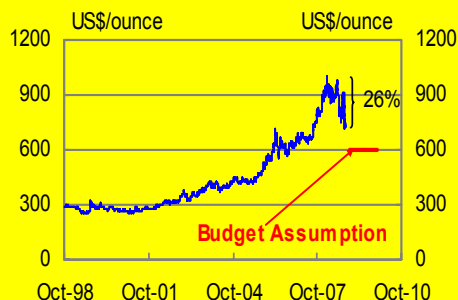
Oil Price



Copper price



Gold Price



<p>hit by the global financial crisis. Activity has slowed down significantly and the US economy is now teetering on the verge of a recession. Since the US economy is the largest consumer of energy, its decline has reduced demand for commodities, with prices falling sharply and by large amounts.</p> <p>Oil and copper prices have fallen dramatically in light of these developments.</p> <p>Since July 2008 oil prices have fallen by a substantial 57 per cent, copper prices have fallen by 54 per cent and gold prices are down 26 per cent.</p> <p>The prices of agricultural commodities have also fallen sharply. Since peaking earlier in the year, the price of PNG's key agricultural exports have fallen as follows: copra is down 52 per cent, palm oil is down 36 per cent, cocoa is down 33 per cent, and coffee has fallen by 15 per cent.</p> <p>The impact of recent price commodity price falls has adversely affected PNG's export values and government revenues.</p> <p>The recent commodity prices falls will have a significant impact on the third and final</p>	<p>tranches of mining and petroleum taxes paid in late 2008.</p> <p>The revenue projections for 2008 have also been affected by the recent appreciation of the Kina which has reduced the Kina value of Mining and Petroleum Taxes. In addition, unexpected hedging losses from owners of several major oil fields are also expected to reduce revenues, including previously expected arrears payments from 2007.</p> <p>The price assumptions for 2009 are US\$55 per barrel for oil, US\$3250 per tonne for copper and US\$600 per ounce for gold.</p> <p>Given the major falls in commodity prices over recent months, these assumptions could be breached in 2009. If this occurs the Government will review the Budget.</p> <p>Over the medium term, commodity prices are assumed to return to 10 year averages. The price of oil is assumed to be US\$46 per barrel, the price of copper is assumed to be US\$3540 per tonne and the price of gold is assumed to be US\$445 per ounce.</p>
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2009 Outlook

Real GDP is forecast to increase by 6.2 per cent in 2009. This represents some moderation from the exceptionally high growth rates in 2007 and 2008 and reflects the impact of further expansion in the mobile phone sector, but at a slower pace; as well as a slow down – albeit from very high levels – of growth in construction activity, which is running up against capacity constraints, reducing the scope for further expansion in the industry.

It also reflects opposing trends in the mining and petroleum sectors, where a large fall in oil production due to the decline of existing oil fields is expected to be offset by strong growth in the mining sector, where a number of new mines are scheduled to commence (although the fall in commodity prices could dampen new expansion).

While the domestic economy is not expected to be significantly affected by the global downturn, there is a distinct risk that business and consumer confidence could weaken, which would reduce private sector activity. Combined with the effect of falls in commodity (both mineral and agricultural) and asset prices, this presents a significant downside risk to the economic outlook.

The Agriculture, Forestry and Fisheries sector is expected to grow by a solid 4 per cent in 2009. The major driver of this growth is copra and copra oil, where increased production in Bougainville, an expansion in the number of export licenses and the revitalisation of

plantations is expected to provide a significant boost. Coffee, cocoa and palm oil are also expected to grow strongly. There are some downside risks to these forecasts, due to the large declines in agricultural prices over recent months, which will reduce export revenues, and could lead to lower expansion and output, as producers respond to falling prices.

The Petroleum sector is expected to decline by 7 per cent in 2009, as production from existing fields continues to mature and decline. The Mining and Quarrying sector is expected to grow substantially by 17.5 per cent in 2009. The expected increase is due to increased production in the major mines of Ok Tedi, Porgera and Lihir, as well as the progression of newer mines, such as Hidden Valley, Simberi and Sinivit into the production and ramp up phase of operations.

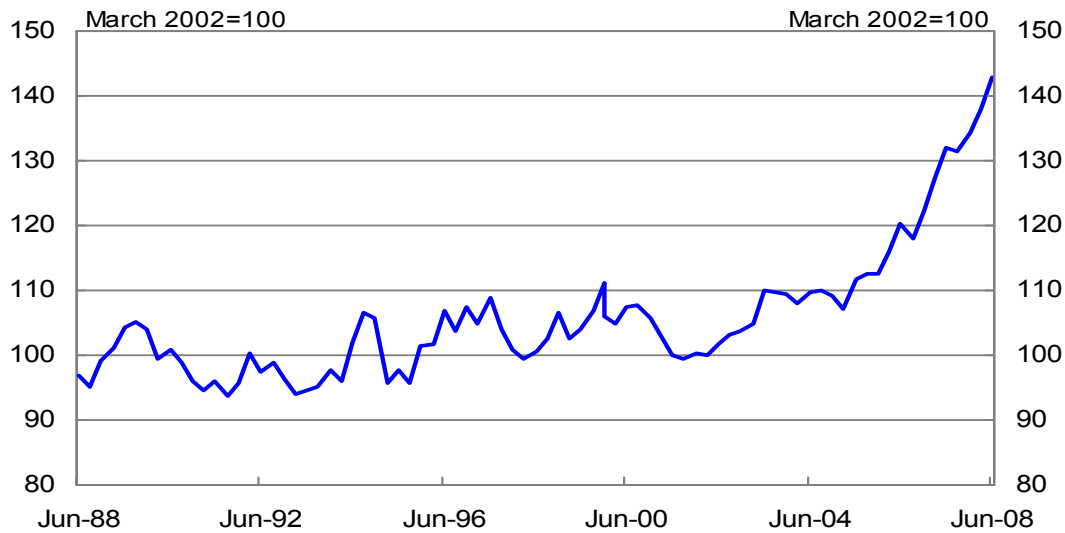
In the non-mineral sector, the communication and construction sectors are again expected to be the major drivers of growth. While the expansion in the mobile phone sector is expected to slow somewhat from the exceptional rates of 2007 and 2008, the subscriber base is still expected to increase, as the two operators continue to expand operations throughout the country.

The construction sector is expected to continue to grow solidly due to increased donor funds and government spending for rehabilitation and maintenance, as well as a build up in capacity. Construction is also being supported by increased private sector investment including new projects in the construction phase like the Ramu Nickel mine, as well as some preparatory work for the LNG project (although this is anticipated to be fairly small). The combination of low interest rates and strong domestic demand is also being translated into several new residential and commercial building projects.

Underlying the strong but more moderate growth for 2009 is the assumption of continued fiscal discipline, political stability and prudent macroeconomic policies. However, there are a number of risks, including unforeseen shutdowns in the mineral sector, further volatility and/or declines in commodity prices associated with deteriorating world economic growth prospects, the spread of the financial crisis into the PNG financial system, and the impact of large exchange rate fluctuations.

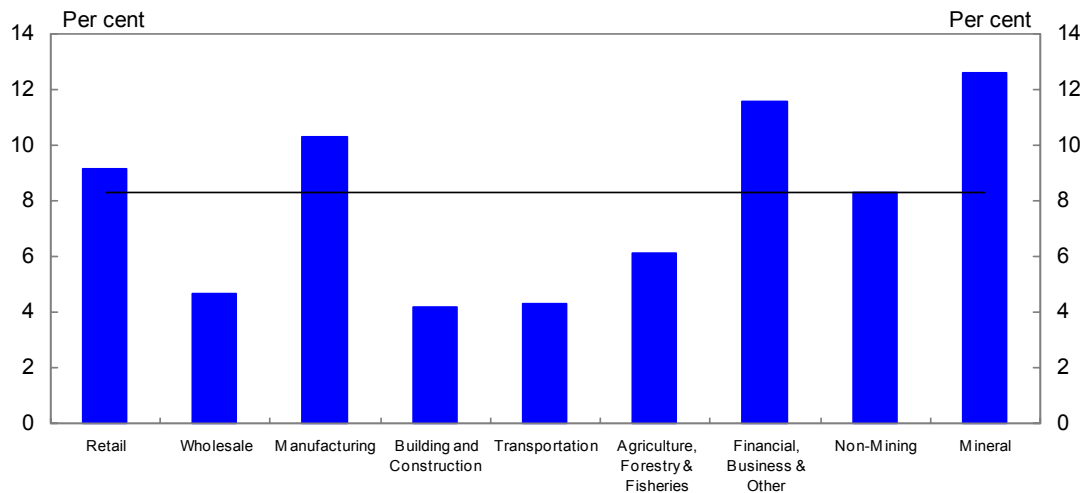
1.3 LABOUR MARKET

Total non-mineral sector employment grew strongly by 10.2 per cent in 2007 with strong employment growth in retail, agriculture, forestry and fisheries, manufacturing and construction sectors. The increased economic activity in the non-mineral sector, in particular, the boom in the construction sector and increase in small holders' production of key agriculture commodities has heightened employment growth in these sectors. One of the major capacity constraints faced by construction companies is skilled labour. Employment in the mineral sector recorded substantial growth of 15.7 per cent in 2007.

Figure 3: Employment Index

Source: 2008 Updates – BPNG

In the year to June quarter 2008, total private non-mining sector employment rose by 8.3 per cent, driven mainly by strong employment growth in finance, real estate and business services, manufacturing and retail sectors. Employment in the mineral sector was also high in the year to June quarter 2008, rising by 12.6 per cent.

Figure 4: Employment Growth by Sector – June 2008 (through the year)

Source: 2008 Updates - BPNG and Department of Treasury

The increase in employment growth is attributed to the impact of strong sustained economic growth over recent years, which followed a prolonged period of relatively stagnant employment growth in the formal sector. Stable macroeconomic conditions, improved business confidence and microeconomic reforms have had a considerable impact on employment growth in both the mineral and non-mineral sectors.

1.4 PRICES

After a number of years of low and stable inflation, inflationary pressures began to emerge in 2007, when underlying inflation picked up considerably. This flowed through to the headline measure of consumer prices, which increased by 13.5 per cent through the year to the September quarter 2008. This is a significant increase in inflation, and represents the highest rate since 2003, when the PNG economy was in considerable difficulty.

In 2008, inflation is projected to be 10.6 per cent in year average terms. This is due to price increases in almost all categories of consumer goods and services, and all regions of PNG. The major contributors to inflation over the past year have been higher food prices – due to increases in prices of imported items, such as rice, and local products such as sweet potato and market goods which do not appear to be affected by supply shocks like drought. The other major driver for most of 2008 has been increased fuel prices, which increased in line with higher world oil prices.

Over the past two years, the build up in inflationary pressures has come from a combination of external and domestic factors. On the external side, rising prices and a slight trend depreciation of the Kina have added to inflationary pressures, with tradeable inflation up 12.1 per cent over the year to September 2008. On the domestic side, excess liquidity in the system, strong economic growth, and increased pricing power combined with capacity constraints are resulting in higher prices, with non-tradeable inflation up 15.1 per cent through the year to the September quarter 2008.

More specifically, the major factors contributing to the high inflation outcome in 2008 includes:

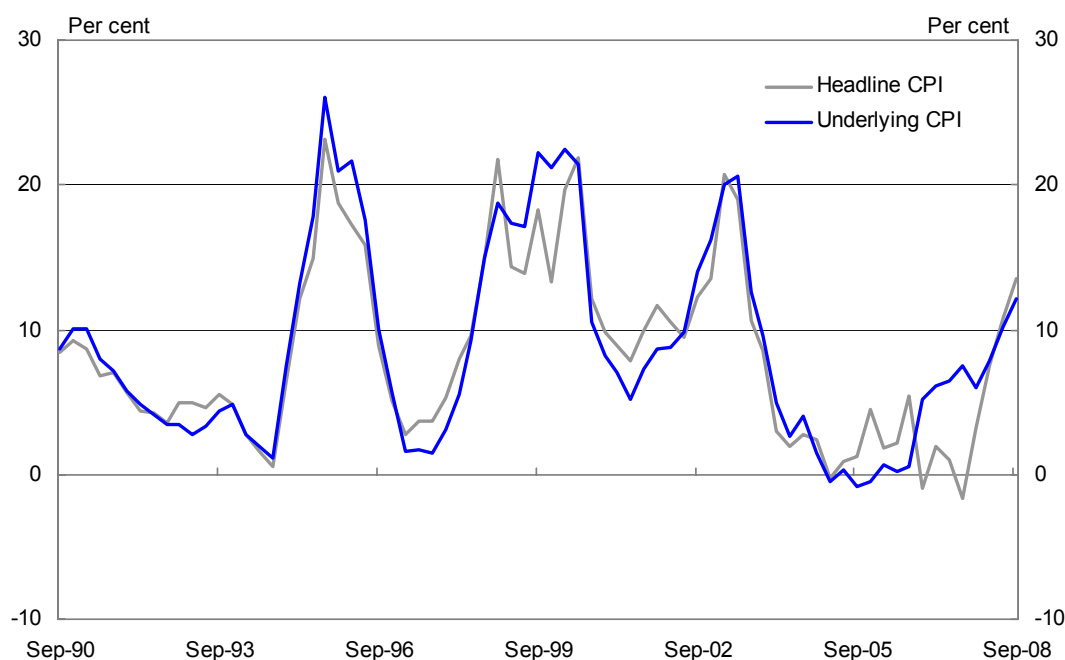
- The fast growth in monetary aggregates – while monetary policy has reacted to rising inflation by increasing the benchmark Kina Facility rate to 7 per cent in 2008, the worrying rates at which money supply and credit to the private sector are growing indicates that there is a substantial amount of liquidity in the system which is imparting significant inflationary pressure;
- The terms of trade boom – This has substantially increased Government revenues since 2005 through the commodity price boom. While the Government has taken the opportunity to increase spending in the budget and through supplementary budgets – adding significant stimulus into the economy, great potential for further spending remains from trust accounts which needs to be carefully monitored to avoid adding fuel to the fire; and
- The rapid expansion in the private sector, which continues to be assisted by increased business confidence, relatively low interest rates and higher profitability which is now running up against significant capacity constraints. This is resulting in skill shortages, higher wage demands and increasing willingness of businesses to pass on higher cost to consumers.

Looking forward, inflation is expected to slow from the worryingly high rate of 10.6 per cent forecast for 2008 to 6.1 per cent in 2009. Underlying this forecast are two opposing trends from domestic and international sources. Continued inflationary pressures are expected to come from the domestic economy, where strong growth is anticipated to continue running up against capacity constraints, leading to increased pricing power on the part of suppliers. This will be exacerbated by the increase in Government expenditure – both from the ongoing Budget as well as from increased utilization of funds from trust.

On the other hand, the international drivers of inflation, which until recently had been adding to inflationary pressures, have reversed sharply. The appreciation of the Kina, particularly against the Australian dollar, combined with recent sharp falls in most commodities, such as oil, rice and flour can be expected to reduce inflationary pressures in the economy.

The extent to which this dampens inflation will be determined by the degree in which lower import prices are passed onto end users. While in some cases, such as fuel, these prices are being passed on relatively quickly, the strength of the domestic economy and lack of competitive pressure in many sectors may lead to higher margins rather than lower prices. Nonetheless, the international factors do mean that there is likely to be reduced pressure on prices.

Figure 5: Headline and Underlying 1990-2008



Source: National Statistical Office

In reaction to the higher inflationary environment, monetary policy has tightened slightly, with the Bank of PNG increasing the Kina Facility Rate (KFR) by 50 basis points in September 2008 from 6.5 per cent to 7 per cent. The Kina has also appreciated significantly, with the Trade Weighted Index up 41 per cent over the past year. Nonetheless, there is room for further monetary tightening, given the very high rates of inflation, the high rates of money and credit growth, negative real interest rates and the strong growth in the economy.

Given the current economic situation, both monetary and fiscal policy must operate in a coherent manner in order to prevent higher inflation being built into peoples' expectations, which could result in a wage price spiral and threaten the macroeconomic stability that has been the foundation of the strong economic growth experienced over recent years.

1.5 MONETARY DEVELOPMENTS

Monetary conditions remained relatively loose in 2008. Liquidity in the economy has been building over the last three years, reflected by a trend of increasing money supply and credit growth – both have increased at higher rates of 30 and 40 per cent respectively through the year to September 2008 (Figure 6).

Figure 6: Money Supply & Credit Growth

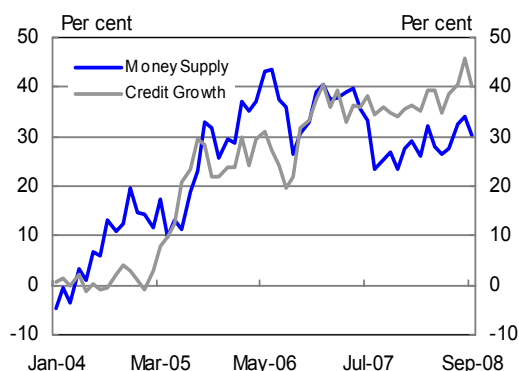
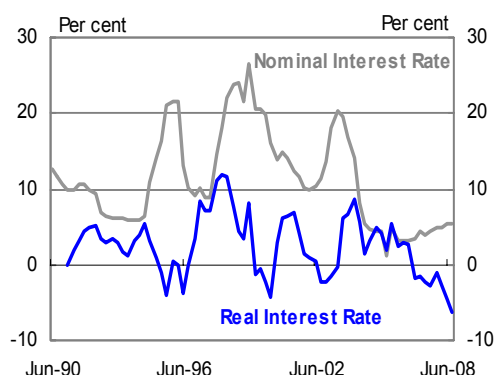


Figure 7: Nominal Vs Real interest Rates



Source: Bank of PNG

While increasing the money supply growth can support an economy with large amounts of spare capacity, it tends to add to inflationary pressures when the economy is growing strongly and facing capacity constraints.

The Bank of PNG has moved to tighten monetary conditions marginally with two 25 basis points increases in June and August and one 50 basis point increase in the Kina Facility Rate in September – a cumulative 100 basis points adjustment, increasing the KFR from 6 per cent to 7 per cent in 2008. This is aimed at slowing the economy in order to reduce inflationary pressures.

Despite this, the increased rate of inflation means that the real interest rate – the cost of borrowing once inflation is taken into account – is significantly negative (Figure 7) hence proving very accommodative to further private sector investment.

Monetary Policy is the key tool in maintaining price stability and it is appropriate that it be monitored closely and adjusted to reflect current and expected circumstances.

1.6 BALANCE OF PAYMENTS AND INTERNATIONAL PRICES

In 2008, the current account balance is expected to be a surplus of K1,880 million (8.7 per cent of GDP), which is substantially higher than the 2007 surplus of K366 million. The higher surplus is due to a large increase in export values, which are expected to increase by more than import values.

In the first half of 2008, the current account balance recorded a surplus of K1,149 million, which is higher than the surplus of K570 million recorded in the corresponding period of 2007.

The value of exports in 2008 is expected to increase by 12 per cent from 2007, reflecting increased volumes of agriculture and mineral exports due to increased production, and significantly higher world prices for most exports. While prices have fallen dramatically in the second half of the year, prices are still expected to be higher on average in 2008 than in 2007.

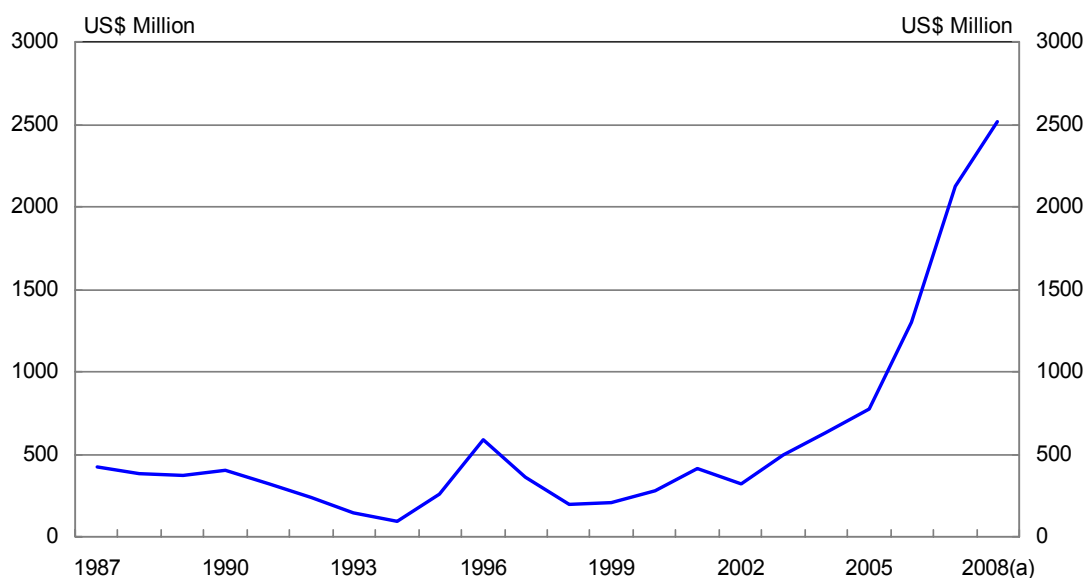
The value of imports is expected to increase in 2008, reflecting imports for the construction work on the Ramu Nickel project, offset by lower import volumes from a number of other projects, such as Lihir, which completed the construction and commissioning of its process plant and geothermal expansion in 2007. Other goods and services imports are expected to have remained at high levels in 2008, in line with continued strong domestic demand.

The Income deficit is expected to have widened in 2008, due to increasing dividend outflows, reflecting the increased profitability of mineral projects caused by higher commodity prices, as well as strong non-mineral profits. This is partly offset by increased inflows of project grants, which increased the Transfers surplus.

The Capital and Financial Accounts recorded a deficit of K1,205 million in the first half of 2008. This implies a net outflow of capital from the PNG economy, which largely reflects a build up in foreign reserves by the Bank of PNG which increased by K400 million in the first half of 2008. In the full year of 2008, the capital and financial accounts is expected to record a deficit of K1,880 million, higher than the deficit of K411 million in 2007.

The holdings of gold and foreign exchange reserves by Bank of PNG at the end of July 2008 were K6,290.9 million (US\$2,428.3 million). This very high level of reserves is more than sufficient to perform the role of managing short term exchange rate volatility.

Figure 8: Foreign Reserves US Dollar Millions



(a) Includes reserve levels to end of July, 2008.

1.7 EXCHANGE RATE DEVELOPMENTS

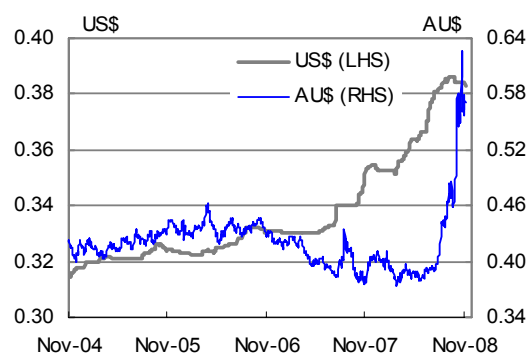
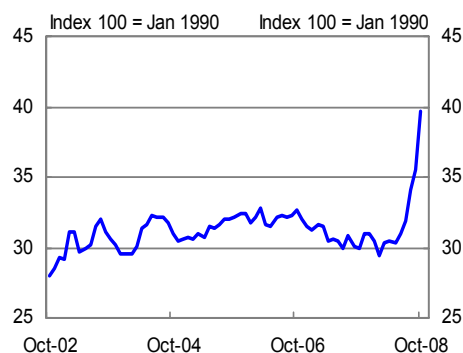
The exchange rate has appreciated significantly against most currencies in 2008, reversing a slight trend depreciation over the previous three years (Figure 9). The import Trade Weighted Index appreciated 33 per cent over the year to October 2008, and has appreciated by 10 per cent against the US dollar, 51 per cent against the Australian dollar, 24 per cent against the Euro. The Kina has depreciated by 6 per cent against the Japanese Yen.

The appreciation against the US dollar is a reflection of the very high rates of mineral revenues received by the Government in the form of tax revenues and dividend payments. The second major factor driving the appreciation of the Kina on a trade weighted index basis has been the large and rapid depreciation of the Australian dollar, which has depreciated sharply against most currencies as a direct result of the global financial crisis. The Kina has now appreciated by an unprecedented 42 per cent against the Australian dollar since July 2008.

Overall, the sharp appreciation of the Kina (to the extent that it is maintained) is likely to have some major impacts on the PNG economy. It is likely to introduce some reduced inflationary pressures, which will be useful in the current high inflation environment. At the same time, it will reduce the competitiveness of PNG export and import competing sectors, and/or reduce the Kina value of export earnings, at a time when export prices, of both mineral and agricultural prices, are falling sharply. This will dampen domestic demand, through a reduction of producers' incomes, as well as through reduced Government tax revenues.

The appreciation will also encourage increased imports, particularly from Australia, which have become 51 per cent cheaper over the past year in Kina terms, at a time when the current account seems likely to switch from a large surplus to a large deficit, on the back of falling export values.

Overall, it seems that some limited appreciation of the Kina was warranted in order to assist in restraining inflationary pressures when the terms of trade was increasing to record levels. However, now that the situation has reversed dramatically, with the terms of trade dropping substantially, the exchange rate should gradually adjust to the new circumstances, and act as a buffer against external shocks, rather than as an amplifier. If the exchange rate moves in the opposite direction to that expected with a terms of trade shock, it could increase the risk of imbalances building in the economy and the risk of a sharp rather than gradual correction.

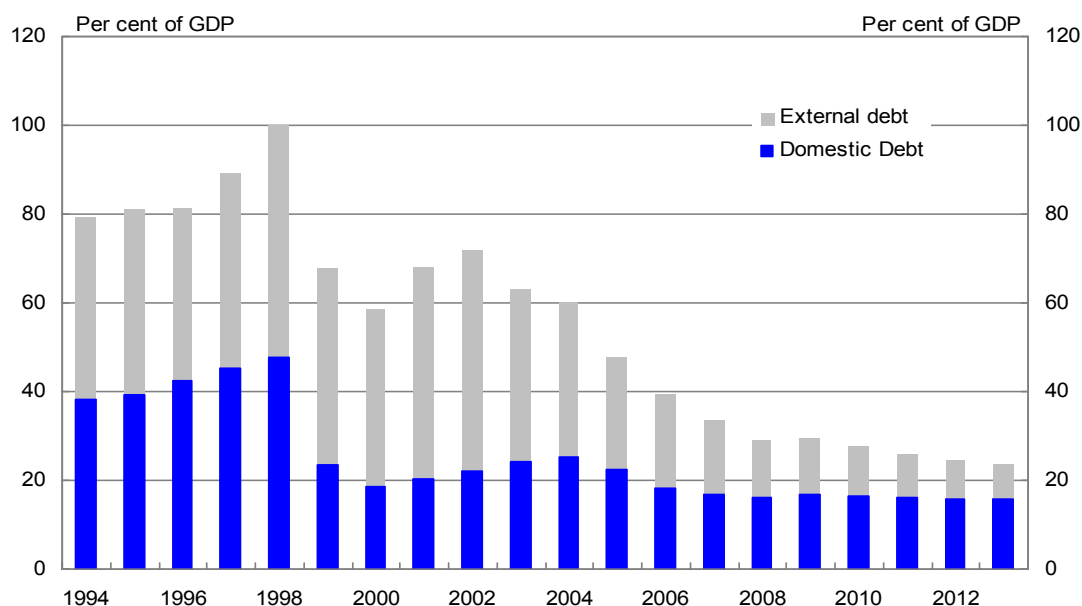
Figure 9: Exchange Rate Developments**Figure 10: Import Weighted Trade Weighted Index**

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 33.8 per cent of GDP or K6,319.0 million at the end of 2007. By the end of 2008, total public debt is expected to fall to 28.8 per cent of GDP or K6,217.2 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 the recent adverse economic and financial developments, as demonstrated recently.

Figure 11: Public Debt 1994-2013 (Per cent of GDP)

Source: Department of Treasury

1.8.1 Domestic Debt

At the end of 2007 the stock of domestic debt was K3,173.3 million, an increase of K72.3 million or 2.3 per cent over a year earlier. The stock of domestic debt at the end of 2008 is expected to be K3,474.0 million, an increase of K300.7 million or 9.5 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 2008 expected to be comprised of 30.3 per cent Treasury Bills, 69.3 per cent Inscribe Stock and 0.4 per cent Other Domestic Loans.

1.8.2 External Debt

Total external debt at the end of 2007 was K3,146.0 million. This represented a decline of K485.1 million or 13.4 per cent from the level at the end of 2006. This decline in external debt has continued in 2008, falling by 11.7 percent or K369 million to a projected K2,777 million by year end.

The decline in external loans reflects the Government's strategy of increasing the percentage of debt issued domestically, to reducing the share of external or foreign currency debt. This has helped to shield the PNG economy from some of the worst of the financial crises in 2008.

Project loan draw downs are expected to be K163 million in 2008 while principal repayments of external debt is estimated to be K456 million.

External debt continues to be dominated by debts to international agencies (multilateral and bilateral creditors) who account for 96.6 per cent of external debts as at year- end 2007, with commercial loans accounting for the remaining 3.4 per cent.

1.9 CENTRAL GOVERNMENT FISCAL OPERATIONS

The fiscal outcome for 2008 is now projected to be a budget deficit of K9.5 million, effectively a balanced budget when measured as a percentage of GDP, compared with the original surplus estimate of K202.4 million or 1.0 per cent of GDP.

Table 2: Budget Balance 2007 – 2008 (Kina Millions)

	2007 Actual	2008 Budget	2008 Revised	Change
Total Revenue and Grants	7028.6	7201.6	7780.4	+578.8
Total Expenditure and Net Lending	6552.4	6999.2	7789.9	+790.7
Deficit (-)/Surplus(+)	476.2	202.4	-9.5	-211.9
Per cent of GDP	2.5%	1.0%	-0.0%	

Source: Department of Treasury

Since the 2008 Budget, there has been upward to upward revisions to both the revenue and expenditure side in 2008, as a result of the higher than anticipated commodity prices and the 2008 Supplementary Budget passed in September of 2008.

However, there has been a significant downward revision from the revenue estimates in the Mid Year Economic and Fiscal Outlook (MYEFO), which was released in July 2008. This was caused by the collapse in commodity prices in the latter half of 2008. There are also early indications that revenue may potentially be lower than the current estimate, due to continued declines in commodity prices below the current projections, which are likely to impact on the third and final installment of Mining and Petroleum Tax payments.

1.9.1 Total Revenue and Grants

Total Revenue and Grants for 2008 are estimated to be K7,780.4 million, an increase of K578.8 million or 8.0 per cent from the 2008 Budget projection of K7,201.6 million.

Table 3: Tax Revenue 2007 – 2008 (Kina Millions)

	2007 Actual	2008 Budget	2008 Revised	Change
Taxes on Income and Profits	4491.3	4142.0	4659.1	+517.1
Dom. Taxes on Goods & Services	958.5	987.3	1031.7	+44.1
Taxes on International Trade	404.2	387.4	425.4	+38.0
Tax Revenue	5854.0	5516.7	6116.2	+599.5

Source: Department of Treasury

Tax revenue is now expected to be K6,116.2 million, K599.5 million or 10.9 per cent higher in 2008 than the Budget projection of K5,516.7 million. The increase in tax revenue largely reflects substantially higher than expected taxes on income and profits.

Table 4: Taxes on Income and Profits 2007 – 2008 (Kina Millions)

	2007 Actual	2008 Budget	2008 Revised	Change
Personal Income Tax	1006.9	1053.7	1086.2	+32.5
Company Tax	723.7	699.7	778.2	+78.8
Dividend Withholding Tax	199.3	195.5	196.8	+1.3
Mining and Petroleum Taxes	2333.9	2011.8	2392.2	+380.4
Interest Withholding Taxes	19.3	21.4	21.1	-0.3
Other Direct Tax	111.2	86.5	93.1	+6.6
Gaming Tax	97.0	73.4	91.6	+18.2
Taxes on Income and Profits	4491.3	4142.0	4659.1	+517.1

Source: Department of Treasury

Tax on income and profits is now expected to be K4,659.1 million in 2008, K517.1 million or 12.5 per cent higher than the level expected in the 2008 Budget. Personal income tax is expected to increase by K32.5 million over the 2008 Budget estimate to K1,086.2 million in 2008, mainly due to higher than normal arrears collections. Company tax collections are expected to be stronger than expected at the time of the 2008 Budget, reflecting an increase in economic activity and profitability for businesses. Dividend Withholding Taxes remained at elevated levels relative to historical levels and mainly reflects payments for major commodity exports.

Mining and Petroleum Taxes are expected to be K380.4 million or 18.9 per cent higher than the 2008 Budget projection. However, this is a significant downward revision from the MYEFO estimate of K3,049 million, which was made as commodity prices reached record levels. Since the MYEFO was released, commodity prices have fallen sharply and the Kina has appreciated significantly. There has also been significant hedging losses from one of

the joint owners of several major oil fields, which is affecting revenue accrued in 2008, as well as previously expected arrears payments from 2007.

Given these factors, and early indications of weak collections during the third and final installment of Mining and Petroleum Taxes, the potential exists for a further downward revision to Mining and Petroleum Taxes in 2008.

Interest Withholding Tax remains close to the level expected in the 2008 Budget. Other direct taxes in 2008 are now expected to be K6.6 million (7.6 per cent) more than the 2008 Budget forecast, reflecting stamp duty on a share transfer in the middle of the year, while gaming tax is expected to come in higher, in line with increased economic activity.

Table 5: Domestic Taxes on Goods and Services 2007 – 2008 (Kina Millions)

	2007 Actual	2008 Budget	2008 Revised	Change
Excise	342.0	368.3	370.2	+1.9
GST	557.5	600.8	646.1	+45.3
Mining Levy	56.6	15.0	12.0	-3.0
Other Indirect	2.4	3.2	3.3	+0.1
Domestic Taxes on Goods & Services	958.5	987.3	1031.7	+44.4

Source: Department of Treasury

Domestic taxes on goods and services are now expected to be K1,031.7 million in 2008, K44.4 million higher than forecast in the 2008 Budget. 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 2007 – 2008 (Kina Millions)

	2007 Actual	2008 Budget	2008 Revised	Change
Import Duty	135.9	132.7	149.9	+17.2
Export Duty	155.2	155.2	152.0	-3.2
Excise Duty on Imports	113.1	99.5	123.5	+24.0
Taxes on International Trade	404.2	387.4	425.4	+38.0

Source: Department of Treasury

Taxes on international trade are now projected to be K425.4 million in 2008, which is K38.0 million or 9.8 per cent more than originally expected. Import duty will raise K17.2 million more than expected in 2008. This is due to the 2007 base being stronger than expected and stronger than expected domestic demand resulting in higher imports.

Export duty on logs is expected to be K152.0 million in 2008, down K3.2 million from the 2008 Budget estimate. The main driver is the lower production of logs in the first half of the year as a result of seasonal conditions.

Excise duty on imports are now expected to be K123.5 million in 2008, K24.0 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 2007 – 2008 (Kina Millions)

	2007 Actual	2008 Budget	2008 Revised	Change
Property Income	312.7	388.3	376.5	-11.8
<i>Non-Mining Dividends</i>	87.0	128.5	140.0	+11.5
<i>Mining & Petroleum Dividends</i>	225.7	259.8	236.5	-23.3
Interest and Fees from Lending	0.5	5.0	9.0	+4.0
Other Non Tax Revenue	119.8	94.2	93.7	-0.5
Total Non Tax Revenue	433.0	487.5	479.3	-8.2

Source: Department of Treasury

Non-tax revenue is estimated to be K479.3 million in 2008, K8.2 million or 1.7 per cent lower than expected at the time of the 2008 Budget. The decrease is attributable to lower mining and petroleum dividends and property income, partially offset by higher non-mining dividends.

Non-Mining Dividends are expected to be K11.5 million or 8.9 per cent higher than anticipated, whilst Mining Dividends are expected to be K236.5 million, which is K23.3 million or 8.9 per cent lower than expected in the 2008 Budget. This is due to increased amounts of reinvested earnings from Ok Tedi, which will be used to fund cost overruns on the Mine Waste Tailings project and to provide a self financing funding facility to the mine.

In 2008, expected Dividend payments from non-mining State assets are: K50 million from the Independent Public Business Corporation, compared to the K25 million expected in the 2008 Budget; K10 million from the National Fisheries Authority, compared to the expected K23.5 million; and K80 million from the Bank of PNG, unchanged from the 2008 Budget estimate.

Interest and fees from lending is expected to be K9.0 million, K4 million higher than the 2008 Budget. Departmental revenue is estimated at K93.7 million which is K0.5 million lower than anticipated.

Both Infrastructure tax credits (ITC) and Project Grants have been revised downwards. ITC has been revised downwards by K3.7 million to K70.0 million due to lower utilization, and project support grants are expected to be K1,095.8 million, down by K15.4 million as a result of the appreciation of the Kina against the currencies of most major donors.

Total revenue and grants are now anticipated to be K7,780.4 million in 2008.

1.9.2 Total Expenditure and Net Lending

Total Expenditure and Net Lending in 2008 is now projected to be K7,789.9 million, an increase of K790.7 million or 11.3 per cent on the 2008 Budget estimate of K6,999.2 million.

Expenditure in 2008 is substantially higher than the original 2008 Budget appropriation due to the Government's decision to apply stronger than expected revenue to priority expenditure areas through the 2008 *Supplementary Budget*.

Table 8: Total Expenditure and Net Lending 2007 – 2008 (Kina Millions)

	2007 Actual	2008 Budget	2008 Revised	Change
Recurrent Expenditure	3498.0	3636.1	3639.3	+3.2
Development Expenditure	1327.6	1887.1	1874.6	-12.5
Additional Priority Expenditure	1726.8	1476.0	2276.0	+800
Total Expenditure and Net Lending	6552.4	6999.2	7789.9	+790.7

Source: Department of Treasury

1.9.2.1 Recurrent Expenditure

The overall recurrent expenditure in 2008 is estimated to be K3,639.3 million, slightly higher than expected in the 2008 Budget, reflecting slightly higher than anticipated expenditure on personal Emoluments, due to a number of pay increases awarded during 2008, which is expected to be partially offset by lower interest expenditure, due to lower than anticipated debt levels over the course of 2008.

Table 9: Recurrent Expenditure 2007 – 2008 (Kina Millions)

	2007 Actual	2008 Budget	2008 Revised	Change
Personal Emoluments	1456.3	1528.9	1546.9	+18.0
Goods and Services	1387.1	1456.9	1457.2	+0.3
Interest Payments and Fees	370.1	373.5	358.2	-15.3
Gas Project Acquisition				
Transfers to Bougainville	50.0	54.0	54.2	0.2
Transfers to Statutory Institutions	238.6	226.8	226.8	0.0
Net Lending to CSAs	-4.1	-4.0	-4.0	0.0
Supplementary Budget				
Total Recurrent Expenditure	3498.0	3636.1	3639.3	+3.2

Source: Department of Treasury

An amount of K20.0 million was appropriated to Secretary's Advance in the 2008 Budget. The following table sets out the allocations made from the Secretary's Advance from 1 January 2008 up to 15 November 2008.

Table 10: Allocation of funds from the Secretary's Advance in 2008 (Kina Thousand)

Allocations: 2008 Secretary's Advance (Kina,000)		(K'000)	(K'000)
2008 Appropriation	Credit 20,000.0	Debit	Balance 20,000.0
Reform Task Group-DPM		1,000.0	19,000.0
Australian Prime Ministers visit		3,200.0	15,800.0
Add.Funds to settle Land Lease Payment		534.0	15,266.0
COI-2006 Riot in Honiara-SI		1,000.0	14,266.0
Foreign Policy Review Exercise		91.7	14,174.3
Withdrawal of funds SA 39/08	534.0		14,708.3
Purchase Replacement Bus		79.0	14,629.3
PNG/China Symposium in June 08		155.0	14,474.3

DSIP Funding (ORD) of NEC Decision	1,656.2	12,818.1
Purchase of GG Support Vehicle	330.0	12,488.1
To cater for 3 add. NEC meetings (PM&NEC)	831.0	11,657.1
ECP Review Team	200.0	11,457.1
National Planning Committee (NEC Dec)	1,470.0	9,987.1
Add. Funds for Secreary's Vehicle(PLGA)	144.0	9,843.1
Kokoda Track Land Owners	200.0	9,643.1
ADB Vice President & IMF E/Director's visit	76.0	9,567.1
6 Regional Workshops to assist the DSIP	192.2	9,374.9
Late President Kabui's funeral costs	700.0	8,674.9
PNG Chancellery - Tokyo	2,900.0	5,774.9
To assist Min. Oil Resources Ltd	200.0	5,574.9
Air Charter costs 10th festival of Arts - Somoa	768.0	4,806.9
GG's Travel Solomon Islands	175.0	4,631.9
Monitoring looming recurrence - Bougainville	100.0	4,531.9
Creation of new act. "Min. Sectoral Committee"	150.0	4,381.9
Assistance to IMR 40th Anniversary	65.0	4,316.9
PNG SINO Trade Sysmposium	145.0	4,171.9
Melanesian-Spear Head Group Sec. - Vanuatu	1,000.0	3,171.9
Reform Task Group-DPM (NEC Dec.36)	500.0	2,671.9
NEC Dec: 102/08 - Tactical Response Unit (Police)	1,000.0	1,671.9
MMI Insurance cover for the Divisional Heads	34.4	1,637.5
To cater for GG's trip to Tonga	342.1	1,295.4
NCC to pay Eastern Highlands Cultural Centre	160.0	1,135.4
Cater for o/s bills and other costs for remain. Mnths.	397.0	738.4
Cater for Public Servants Master's Game	10.0	728.4
Cater for SMC Meeting in Peru	80.0	648.4
Cover short fall in Printing Cost of 2009 Budget Docs	110.0	538.4
To cater for Min's Delegation to China Expo	200.0	338.4
Add. Funding for Min's Del. To China Expo	100.0	238.4
Settle outstanding for MV Buka Princes	71.5	166.9
Cater for Hon. Kapris & delegaton to Melbourne	150.0	16.9
2008 Supplementary budget Replenishment	12,630.0	12,646.9
To cater for Natonal Museum & Art Gallery's	568.9	12,078.0
Bumbu & Markham Rivers in Morobe (Mitigation Proj)	800.0	11,278.0
Implementation of the NY Policy (NEC Dec 9&15/08)	2,670.0	8,608.0
Reimbursement of Village Court All. To Enga	2,000.0	6,608.0
To meet shortfall in 2008 Budget to MBPG	2,000.0	4,608.0
Cover NHC Audit as per PAC Recommendations	70.0	4,538.0
To cater for D/Prime Minister's trip to Bali	45.5	4,492.5
Additonal funding to NIO	325.0	4,167.5
Replenish NNB funds to settle o/s liabilities	332.5	3,835.0
To cater for Vice Minister's rental bills	140.3	3,694.7
To cater for Panguna Restoration Progam	118.0	3,576.7
To cover emergency fudns for Police operations	2,300.0	1,276.7
Cover Passport Booklets (Immigrations)	521.9	754.8
Assistance for Pipes and Drums (CIS)	100.0	654.8
Outstanding Utility Bills for Dept. of Provincial Affairs	360.0	294.8
PM's commitment for Silver - paralympic	250.0	44.8
Closing Balance as at 15 November 2008		44.8

Source: Department of Treasury

1.9.2.2 Development Expenditure

Development expenditure in 2008 is expected to be slightly lower than the 2008 Budget by K12.5 million, due mainly to the appreciation of the Kina which has reduced the Kina value of Grants.

The domestic component which includes GoPNG and the Infrastructure Tax Credits, along with the Loans remain at the original budget levels.

Table 11: Development Expenditure 2007 – 2008 (Kina Millions)

	2007 Actual	2008 Budget	2008 Revised	Change
Domestic Financing	483.2	526.7	526.7	0.0
Grants	721.0	1123.7	1111.2	-12.5
Infrastructure Tax Credits	20.6	73.7	73.7	0.0
Concessional Loans	101.8	163.0	163.0	0.0
Commercial Loans	1.0	0.0	0.0	0.0
Total Development	1327.6	1887.1	1874.6	-12.5

Source: Department of Treasury

1.9.2.3 Additional Priority Appropriation: 2008 Supplementary Budget

Additional Investment/Priority Expenditure in 2008 is expected to be K2,276 million, higher than the K1,476 million estimate in the 2008 Budget. This is due to the 2008 Supplementary Budget in September 2008, which allocated an additional K800 million of expenditure. Further details on the 2008 Supplementary appropriation can be found in Chapter 3 of this document.

Recurrent, Development, Additional Priority Appropriation and the 2008 Supplementary Budget totaled K7,789.9 million estimated in expenditure for the fiscal year 2008.

1.9.3 Financing

A fiscal deficit of K9.5 million is expected in 2008, effectively a balanced Budget when measured as a percentage of GDP. This compares to the original budget surplus estimate of K202.4 million, or 1 per cent of GDP. This will be financed through Domestic Market Borrowing of K302.7 million and external financing of minus K293.2 million.