ADB

Concept Paper

Project Number: 53425-001
January 2020

Proposed Policy-Based Guarantee
Papua New Guinea: Fiscal and Debt Sustainability Program

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Asian Development Bank

CURRENCY EQUIVALENTS
as of 10 January 2020

Currency unit	–	kina (K)
K1.00	=	$0.294
$1.00	=	K3.407

ABBREVIATIONS

ADB	–	Asian Development Bank
AML	–	anti-money laundering
CFT	–	counter the financing of terrorism
GDP	–	gross domestic product
HSSDP	–	Health Services Sector Development Program
IMF	–	International Monetary Fund
MTFS	–	medium-term fiscal strategy
PCG	–	partial credit guarantee
PNG	–	Papua New Guinea
TA	–	technical assistance

NOTE

In this report, "$" refers to United States dollars.

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CONTENTS

PROGRAM AT A GLANCE

1. Basic Data			**Project Number:** 53425-001
Project Name	Fiscal and Debt Sustainability Program	**Department/Division**	PARD/PASP
Country	Papua New Guinea	**Executing Agency**	Department of Treasury
Borrower	Government of Papua New Guinea		
Country Economic Indicators	https://www.adb.org/Documents/LinkedDocs/?id=53425-001-CEI		
Portfolio at a Glance	https://www.adb.org/Documents/LinkedDocs/?id=53425-001-PortAtaGlance		

2. Sector	**Subsector(s)**	**ADB Financing ($ million)**
✓ **Public sector management**	Public expenditure and fiscal management	300.00
	Total	**300.00**

3. Operational Priorities	**Climate Change Information**	
✓ Strengthening governance and institutional capacity	Climate Change impact on the Project	Low
Sustainable Development Goals	**Gender Equity and Mainstreaming**	
SDG 17.4	No gender elements (NGE)	✓
	Poverty Targeting	
	General Intervention on Poverty	✓

4. Risk Categorization: Complex

5. Safeguard Categorization **Environment:** C **Involuntary Resettlement:** C **Indigenous Peoples:** C

6. Financing

Modality and Sources	**Amount ($ million)**
ADB	**300.00**
Sovereign Partial Credit Guarantee: Ordinary capital resources	300.00
Cofinancing	**0.00**
None	0.00
Counterpart	**0.00**
None	0.00
Total	**300.00**

Currency of ADB Financing: US Dollar

I. THE PROPOSAL

1. The Government of Papua New Guinea (PNG) recognizes that improving fiscal management and debt sustainability, including through deepening the country's finance sector, is critical to its ability to foster more inclusive and sustainable economic growth. Despite substantive regulatory and administrative reform efforts, significant gaps remain. The proposed Fiscal and Debt Sustainability Program will support government efforts to improve fiscal and debt management practices and their implementation, while supporting legal and regulatory reforms to strengthen the financial system. The policy-based guarantee enables finance sector deepening by encouraging new commercial banks into PNG. It complements the Asian Development Bank (ADB) Health Services Sector Development Program (HSSDP) and is aligned with the International Monetary Fund (IMF) Staff-Monitored Program, which is currently being finalized.[1]

2. The program is aligned with the ADB country partnership strategy, 2016–2020 for PNG and ADB's Strategy 2030, with an emphasis on operational priority 7 (strengthening governance and institutional capacity).[2] A programmatic approach and policy-based guarantee (PBG) is proposed to finance two subprograms to be implemented during 2020 and 2021. A programmatic approach reflects the medium-term horizon and flexibility needed to effectively design and implement reforms. Use of a PBG will allow ADB to leverage private sector capital from international markets, which the government intends to mobilize to restructure public debt; and lower debt servicing costs. Ongoing technical assistance (TA) will assist in implementation.[3]

II. PROGRAM AND RATIONALE

A. Background and Development Constraints

3. PNG has a small, open, export-oriented economy heavily reliant on commodity products; minerals constitute roughly 77% of total exports, agriculture products 16%, and forestry products 7%. This economic structure and low levels of diversification drive a high level of volatility. The year 2015 marked the end of a strong period of growth driven by liquefied natural gas investment and favorable commodity prices. Since then the economy has slowed considerably, with average gross domestic product (GDP) growth falling from 7.1% during 2010–2015 to 2.3% during 2016–2019. In response, the government adopted a strategy of fiscal consolidation, which led to sharply reduced deficits, from an average of 5.6% during 2013–2016 to 2.5% during 2017–2018. However, weak wage bill controls (the public sector wages–GDP ratio remained stagnant at 6.0% in 2016–2019, from 6.1% in 2012–2015) have led to expenditure cuts being largely driven by cuts in operational and capital spending, including through the accumulation of substantial arrears in pension contributions; utility and rental payments; and contractual payments for capital outlays. In particular, capital expenditure fell to the equivalent of only 2.5% of GDP in 2016–2019, from 5.7% in 2012–2015. In June 2019, the government committed to address these outstanding payment obligations and restore funding necessary for improved service delivery. However, with low global commodity prices, recent drought, and low revenue collection in a slow growth environment, fiscal deficits are expected to increase, from 4.1% of GDP in 2019 to 5.0% in 2020.

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[1] ADB. 2018. *Report and Recommendation of the President to the Board of Directors: Proposed Programmatic Approach, Policy-Based Loan for Subprogram 1, and Project Loans for Papua New Guinea: Health Services Sector Development Program.* Manila; Government of PNG. 2019. *2020 National Budget.* Port Moresby. The IMF Staff Monitored Program reform details were shared with ADB prior to being approved by IMF management.

[2] ADB. 2016. *Country Partnership Strategy: Papua New Guinea, 2016–2020.* Manila. The PBG is not included in the country partnership strategy or country operations business plan as the product was only approved in October 2018.

[3] ADB. 2016. *Technical Assistance to Papua New Guinea for Supporting Public Financial Management (Phase 3).* Manila; ADB. 2019. *Technical Assistance for Developing Anti-Money Laundering and Combating the Financing of Terrorism Approaches, Methodologies, and Controls (Subproject B).* Manila.

4. Sustained deficits have contributed to an increase in public debt, which rose from K7.4 billion in 2011 (equivalent to 17.4% of GDP) to K27.0 billion in 2018 (equivalent to 32.8% of GDP). In 2019, following a recalibration exercise which brought substantial contingent liabilities into official debt figures, public debt at the end of 2019 was estimated to be 40.2% of GDP. While this is below regional averages, a shallow domestic finance sector, country risk ratings that are below investment grade, and consequent limited access to international debt markets have contributed to ballooning interest costs.[4] In 2012, the annual cost of interest on PNG's public debt was K452.0 million, equivalent to 4.8% of government revenues (including grants) or 1.1% of GDP. By 2018, the figure had grown to K1.9 billion (13.7% of revenues or 2.3% of GDP) and is expected to reach 14.6% of revenues in 2019.

5. As fiscal consolidation efforts commenced in 2016–2017, the Medium-Term Fiscal Strategy (MTFS), 2018–2022, aligned to the Fiscal Responsibility Act, 2006 (as amended) was developed to support a more strategic approach to budget formulation and debt management.[5] The government updated the MTFS for 2020–2024 as part of the 2020 national budget, including a debt stock valuation and adding coverage of contingent liabilities and arrears (para. 4). The MTFS provides the framework for targeted policy interventions to address three major constraints on more inclusive and sustainable fiscal and debt management.

6. **Unsustainable fiscal management.** The MTFS identifies a need to address poor fiscal management through improvements in revenue mobilization and compliance as well as improved expenditure efficiency. The strategy highlights a need to broaden the tax base; ensure more appropriate resourcing and operational capacities in tax administration to effectively improve compliance and enforcement activities; invest in modernizing the tax collecting agencies to ensure greater efficiency, including through a gradual upgrade of information technology systems; and develop specific strategies for each taxpayer segment, having identified a need to address expenditure-side inefficiencies including weak control of overall public expenditure levels.

7. **Lack of strategic public debt management**. The MTFS highlights the government's reliance on poorly planned and high-cost borrowing, identifying a need to reduce the overall demand for deficit financing, shifting emphasis from the domestic finance sector to more concessional external sources. Annual budgets require a strong medium-term fiscal framework backed by realistic estimates of available resources and debt sustainability analyses. The medium-term approach should better reflect the development priorities identified in the country's Medium-Term Development Plan.[6]

8. **Shallow and inefficiently regulated financial system.** Weak competition in PNG's banking market stems from the market being concentrated and segmented, with one bank dominating. PNG government bonds are held almost entirely passively, mainly by PNG's banks and superannuation funds. As a result of limited market competition, the government has relied heavily on short-term domestic market funding at high local currency interest rates to fund fiscal deficits, substantially raising refinancing risks and resulting in higher government funding costs. While the finance sector's legal framework is generally comprehensive, effective implementation of financial regulation and supervision remains weak. This has jeopardized PNG's compliance with international banking standards necessary for the domestic banking industry to access

[4] In 2019, PNG was rated *B2 (stable)* by Moody's, *B (stable)* by Standard and Poors, and *B+ (stable)* by Fitch.
[5] Government of Papua New Guinea. 2017. *Medium-Term Fiscal Strategy, 2018–2022.* Port Moresby; Government of Papua New Guinea. 2006. *Fiscal Responsibility Act.* Port Moresby.
[6] Government of Papua New Guinea. 2018. *Papua New Guinea Medium-Term Development Plan 3, 2018–2022*. Port Moresby.

wholesale funding from international capital markets. In 2011, PNG was placed on the Organisation for Economic Co-operation and Development Financial Action Task Force "grey list" for countries judged to have unsatisfactory arrangements in place for countering money laundering and the financing of terrorism (AML/CFT). Following substantive reforms to establish an internationally compliant AML/CFT framework and enact several new laws, PNG was removed from the grey list in mid-2016. However, its regulatory and bank supervision practices remain under close scrutiny to ensure that this framework is effectively implemented. The introduction of an independent commission against corruption bill will make it possible to further receive and consider cases of corruption, and investigate and prosecute.

B. Policy Reform and ADB's Value Addition

9. The proposed approach will focus policy attention and reform capacity on several critical yet challenging actions under each of the reform areas (paras. 10–12). Policy reforms and their effective implementation will be supported by ongoing ADB TA and complemented by other support from other partners (mainly Australia, the European Union, IMF, and the World Bank) (footnote 3).[7]

10. **Reform area 1: Fiscal management strengthened.** Reform efforts will target upgrades in government fiscal management practices by (i) addressing weaknesses in revenue policy and administration, including replacing the outdated income tax legislation with a modern act and supporting tax administration measures to strengthen compliance and enforcement; (ii) strengthening expenditure discipline by expanding the MTFS to include a new expenditure rule calibrated in terms of nonresource GDP and closing gaps in the control of the wage bill; and (iii) increasing expenditure efficiency by reducing wastage.

11. **Reform area 2: Debt management enhanced.** Reform efforts will help the government to manage and contract debt more strategically and transparently by (i) supporting regular, comprehensive recording and public reporting of debt and contingent liabilities; (ii) strengthening strategic planning and management of risks stemming from the rapidly increased debt portfolio; and (iii) strengthening debt and guarantee contracting processes in line with weaknesses identified in the ongoing public expenditure and financial accountability assessment exercise.

12. **Reform area 3: A diversified and resilient finance sector fostered.** Reform efforts will help the government to strengthen the country's finance sector and broaden access to government financing sources through (i) improving the functioning and management of the domestic debt market by completing a number of reforms that are preconditions for the development of a domestic bond market; and (ii) strengthening effective implementation of financial regulation and supervision by continued efforts in the areas of ing AML/CFT efforts and expanded on-site inspections and data verification of high-risk institutions, with the aim of improving compliance with global banking standards to expand access to international credit.

13. **Value addition.** The program is consistent with the government's strategic planning framework and complementary to the ongoing HSSDP that supports national budget and procurement reforms as well as health sector financing and public financial management reforms to improve service delivery.[8] The proposed program reinforces HSSDP's fiscal management

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[7] In addition to TA, in 2019 the Government of Australia provided a loan of $300 million for budget support and is in consultation for additional support in 2020. The program is working closely with the Government of Australia.

[8] Government of PNG. 2009. *Papua New Guinea Vision 2050.* Port Moresby; Government of PNG. 2010. *Papua New Guinea Development Strategic Plan, 2010–2030.* Port Moresby; Government of PNG. 2017*. Medium-Term Fiscal Strategy, 2018–2022.* Port Moresby; Government of PNG. 2006. *Fiscal Responsibility Act*. Port Moresby.

support with complementary areas of debt management and financial market deepening. Together, the two programs support comprehensive fiscal, debt, and finance sector reforms in PNG. The program will be assisted by TA support from ADB (footnote 3).

14. By providing an ADB-financed partial credit guarantee, the PBG modality will support PNG in accessing international capital markets at more cost-effective borrowing terms than are currently available with its below-investment-grade credit ratings. ADB will also support PNG to develop government capacity for international commercial borrowing and help build relations with commercial lenders as part of the program.[9] ADB will support the government to conduct a rigorous prequalification and bidding process for commercial banks proposing to participate in the purchase of government debt, partially guaranteed by ADB. This will help to encourage more participation in bidding processes and generating better value for money for the PNG government.

15. **Development partner coordination.** The program is aligned with the IMF Staff-Monitored Program requested by the government and currently being finalized with the IMF, providing financial incentives to achieve mutually agreed reform milestones. The IMF program further supports monetary policy reforms to reduce exchange rate imbalances and foreign exchange restrictions and promote the development of the interbank money market. The program is also closely coordinated with the World Bank's ongoing development policy operation.[10]

C. Impacts of the Reform

16. The effect of the reform will be fiscal and debt sustainability improved. Reform areas will support strengthened fiscal management enhanced medium-term debt management, and foster a more diversified and resilient finance sector. These reforms will support higher and more reliable financing for public goods and services to lift economic growth and improve development outcomes. A strengthened finance sector will reduce the borrowing costs for the government and improve availability of financing for the private sector.

D. Development Financing Needs and Budget Support

17. In 2020, the government's net financing needs are estimated at $1.4 billion, with 80% expected from concessional sources, including ADB, Australia, and the World Bank. Net financing needs in 2021 are expected to be $1.1 billion. The government's remaining financing gap will be met by commercial borrowing supported by the proposed PBG programmatic approach. The government has requested that ADB provide a partial credit guarantee (PCG) covering a commercial loan to PNG of $300 million to help finance subprogram 1, and a second commercial loan with an indicative amount of $200 million for subprogram 2. The amount of regular ordinary capital resources utilized for each guarantee will depend on commercial loan amounts and coverage provided by ADB's PCG, and will be determined during program preparation. Indicative regular ordinary capital resources utilization for subprogram 1 is $180 million and for subprogram 2 $120 million. Both partial credit guarantees will be backed with a sovereign counterindemnity.[11]

[9] The Proposal for ADB's New Products and Modalities was approved in July 2018.
[10] World Bank. 2018. *First Economic and Fiscal Resilience Development Policy Operation.* Washington, DC.
[11] The basic terms of the guarantee will be disclosed in the report and recommendation of the President. More detailed conditions will be determined during loan processing and a summary thereof will be approved by the Investment Committee members. A portion of the loan that is not covered by ADB is expected to be covered by other risk participants such as private insurers.

E. Implementation Arrangements

18. The Department of Treasury will be the executing agency. The Department of Treasury and the Bank of PNG will be the primary implementing agencies. Implementation will be overseen by a steering committee chaired by the Department of Treasury with the implementing agencies as members. The implementation periods are January 2019–April 2020 for subprogram 1 and May 2020–April 2021 for subprogram 2.

III. DUE DILIGENCE REQUIRED

19. Public financial management, debt sustainability, and program impact assessments will support the sector assessment. Subprogram 1 is expected to be classified category C for all safeguard aspects.[12] The program design will benefit from strong government commitment and incorporates knowledge from sustained ADB policy dialogue and ongoing TA implementation. Policy dialogue will seek to identify additional gender benefits from the proposed reforms.

IV. PROCESSING PLAN

A. Risk Categorization

20. The program is considered *complex* because of its guarantee size.

B. Resource Requirements

21. The program team will include ADB staff from the Pacific Regional Department (both from headquarters and the PNG Resident Mission); Strategy, Policy and Partnerships Department; Private Sector Operations Department; and the Office of the General Counsel as part of a One ADB program team. Ongoing TA will support program implementation (footnote 3).

C. Processing Schedule

Proposed Processing Schedule

Milestones	Expected Completion Date
Concept approval	January 2020
Informal board seminar	March 2020
Fact-finding mission	March 2020
Management review meeting	April 2020
Negotiations	April 2020
Board approval	June 2020

V. KEY ISSUES

22. The proposed program will be the first use of ADB's policy-based guarantee instrument, introduced in 2018. This will require close coordination between national government agencies to ensure they fully understand and meet all requirements, and with a wide range of private sector representatives from international banking institutions. A One ADB program team comprising representatives from the Pacific Regional Department; Strategy, Policy and Partnerships Department; and Private Sector Operations Department has been established to ensure strong coordination and support within ADB during processing and implementation.

[12] Initial Poverty and Social Analysis (accessible from the list of linked documents in Appendix 3).

DESIGN AND MONITORING FRAMEWORK
(Initial Draft)

Country's Overarching Development Objective
Good governance and broad-based growth to build a prosperous nation[a]

Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting Mechanisms	Risks
Effect of the Reform Fiscal and debt sustainability improved	**By 2022** a. Public debt to GDP is reduced to 39% or lower (2019 baseline: 41%) b. Nonresource primary fiscal balance as a percentage of nonresource GDP improved to 0.5% (2019 baseline: –2.4%) c. Annual public sector debt interest payments are reduced to 2.05% of GDP or lower (2019 baseline: 2.32%) d. Compensation of employees falls to less than 37.0% of total expenditure by 2022 (2019 baseline: 40.5%)	a–d. National budget	Deterioration in external environment, including in global commodity prices External shocks, including natural disasters, disrupt fiscal consolidation.
Reform Areas under Subprogram 1 and Subprogram 2	**Indicative Policy Actions**		
1. Fiscal management	1a. Parliament passed amendments to tax legislation to support domestic resource mobilization efforts 1b. NEC approved a comprehensive reform program of employment and payroll practices 1c. Government amalgamated public agencies to support rightsizing of public sector[b] 1d. NEC approved Independent Commission Against Corruption Bill for submission to Parliament	1a. Official government gazette 1b. Copy of NEC decision and reform plan 1c. Approved organizational structures and national budget 1d. Copy of NEC decision and bill	Political instability results in delays in implementing critical reforms. Poor coordination between government departments limits reform momentum and impact. High staff turnover in key government agencies delays the implementation of reforms.
2. Debt management	2a. Treasury completed a treasury debt issuance and	2a. Copy of plan	

Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting Mechanisms	Risks
	external debt disbursement plan based on cash forecasts for 2019 (2019 baseline: Not Applicable) 2b. Treasury published regular comprehensive debt reports of government and state-owned enterprises, as well as contingent liabilities (2019 baseline: Not Applicable)	2b. Copies of debt reports from official website	
3. Diversified and resilient finance sector	3a. The Bank of PNG established a bond market code of conduct (2019 baseline: Not Applicable) 3b. The government met membership requirements of the Egmont Group [c] (2019 baseline: Not Applicable) 3c. The Bank of PNG completed at least 11 on-site inspections and data verification of high-risk institutions in 2019 and 2020 (2019 baseline: Not Applicable)	3a. Copy of code of conduct 3b. Membership confirmation from Egmont Group 3c. Bank of PNG annual report and evidence of completed inspections	

Policy-Based Guarantee Amount
Subprogram 1 - ADB: $180 million (regular OCR)
Subprogram 2 - ADB: $120 million (regular OCR)

ADB = Asian Development Bank, GDP = gross domestic product, OCR = ordinary capital resources, PNG = Papua New Guinea, NEC = National Executive Committee.

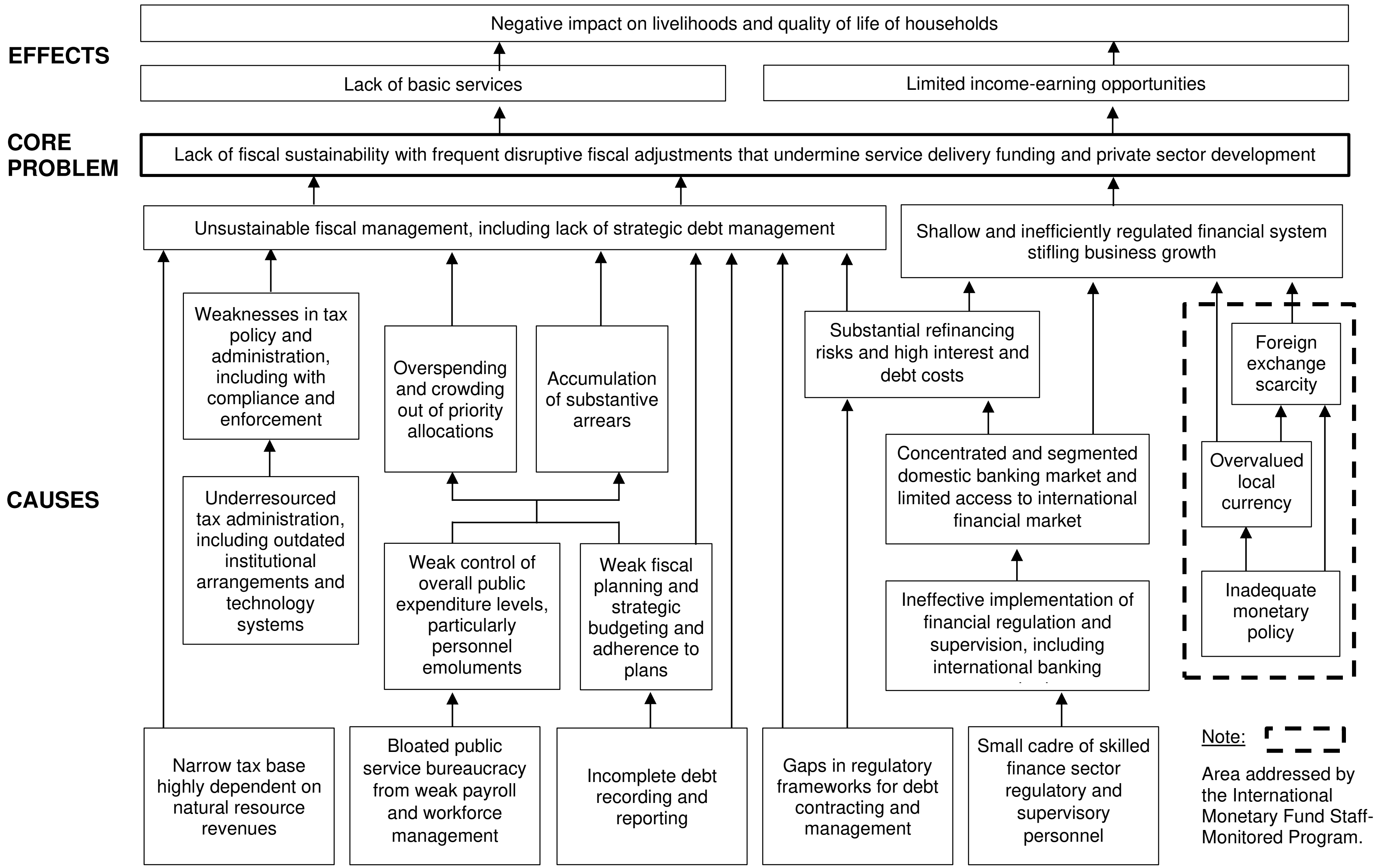
[a] Government of Papua New Guinea. 2010. *Papua New Guinea Development Strategic Plan, 2010–2030*. Port Moresby.

[b] Agencies involved include the Department of Implementation and Rural Development, Coastal Fisheries Development Agency, National Economic Fiscal Commission, National Narcotics Bureau, and PNG Research Science and Technology Secretariat.

[c] The Egmont Group is an international body of 164 financial intelligence units (FIUs) that provides the world's most comprehensive platform for the secure exchange of expertise and financial intelligence to combat money laundering and terrorist financing. The Egmont Group supports international agencies to give effect to the resolutions and statements of the United Nations Security Council, the G20 finance ministers, and the Financial Action Task Force. The Egmont Group adds value to the work of member FIUs by improving the understanding of risks related to money laundering and terrorist financing among its stakeholders. The organization is able to draw on operational experience to inform policy considerations, including anti-money-laundering and countering the financing of terrorism reforms, and their implementation. The Egmont Group is the operational arm of the international anti-money-laundering and countering the financing of terrorism apparatus. Full membership of the Egmont Group is an eight-step process that requires the nominee to initially submit anti-money-laundering and countering the financing of terrorism legislation.

Source: Asian Development Bank.

PROBLEM TREE



LIST OF LINKED DOCUMENTS

http://www.adb.org/Documents/LinkedDocs/?id=53425-001-ConceptPaper

1. Initial Poverty and Social Analysis