

Structural Adjustment Programs in Papua New Guinea

Implementation and experiences

Daniel Weise

In 1999 following the formation of the Morauta Government, the World Bank was asked to assist Papua New Guinea with a structural adjustment loan. By mid 1999, the economy was in an economic and financial crisis.

- The kina had fallen to record lows (around US\$0.34 compared to US\$0.70 at the end of 1997)
- Foreign exchange reserves had fallen to less than US\$100 million from over US\$400 million at the end of 1997
- Inflation was high at over 20 per cent due mainly to the currency depreciation
- Interest rates were high (T-bill rates of over 27 per cent)
- The fiscal deficit was growing to 2–3 per cent of GDP and, as a result, public debt was rising both due to the currency depreciation and to the additional domestic borrowing that was required
- Domestic arrears were mounting, which, if recorded, would have resulted in a higher fiscal deficit.
- Social indicators of poverty were rising
- Real economic growth rates in 1997 and 1998 were markedly negative, although real growth recovered somewhat by the end of 1999.

Further, Papua New Guinea had more than a financial cash flow problem, it had a major economic problem. Successive governments had run down Papua New Guinea's public assets—its state-owned enterprises and superannuation funds—to generate cash for the budget and for other inappropriate objectives. In an accrual sense, Papua New Guinea's solvency

was increasingly under threat. Therefore there was not going to be any quick solution, especially given that the usual economic saviours—large mineral projects and commodity price booms—were not likely. While governments cannot really be classified as insolvent, Papua New Guinea was clearly confronted with falling net worth.

Papua New Guinea had tried to obtain foreign debt financing firstly through a secured UBS-type loan that required the pledging of mineral revenues, then from the international commercial market (with a Eurobond issuance) and finally from the Taiwanese—all without success.

Papua New Guinea had rejected traditional sources of financing from the international donor organisations like the International Monetary Fund (IMF) and the World Bank.

1999–2001 SAP design

Both the World Bank and the IMF sought to design a Structural Adjustment Program (SAP) against this background, and were cognisant of the government's or specifically the prime minister's broad reform agenda.

However, both the IMF and World Bank had struggled with previous SAPs, particularly in terms of the sustainability of structural reforms, so a track record was required before funds were to be disbursed. This is why it took 6–9 months for the IMF program to release funds and 9–12 months for the World Bank to release funds. It was also difficult to design a program that could be monitored rigorously when the state of the available data was so poor.

IMF program design

The program was designed with close consultation between the IMF and the World Bank. As is normally the case, the IMF program sought to achieve macroeconomic stability through rectification of the cash flow problem—through restraint of government expenditure, increases in revenue and maintenance of monetary policy firmness. The IMF determined

- a financing gap, taking into account the projected balance of payments outcome and foreign exchange reserve targets
- a fiscal deficit level that it believed was sustainable (in this case 1–1.5 per cent of GDP)
- government foreign financing needs for debt repayments
- a monetary policy setting that aimed to contain private sector credit growth and capital inflow support.

It was estimated that Papua New Guinea required substantial foreign financing, US\$400 million, to meet the large financing gap. To obtain this level of funding, the government, the IMF and the World Bank sought additional assistance from bilateral donors, including Japan, Australia and the European Union.

The IMF program design, if implemented, was expected to limit the demand for foreign currency, thereby stabilising the kina and reducing inflation rates, and eventually lowering interest rates. This would reduce uncertainty (and risk) in the private sector, and stimulate economic activity.

World Bank program design

In contrast, the World Bank usually seeks to restructure spending allocations and implement policies to target poverty alleviation, improve service delivery and stimulate economic growth over the longer term. While these aspects were seen to be important, the over-riding issue for the World Bank was to design a program to offset what was seen to be the main cause of the economic crisis—namely, a crisis in governance manifested in its most visible form of corruption. In a poor governance environment, fixing policies and providing technical assistance would not fix the problem on a sustained basis.

In the past, a significant lack of accountability and transparency were seen to be deliberate strategies that underpinned the growing corrupt network and not seen as a lack of resource capacity that could be met with donor assistance. Corruption was seen to

- divert scarce financial and human resources to inappropriate and inefficient areas, thus destroying resource and budget management, encouraging inefficient rent seeking and reducing capital and maintenance expenditures
- involve substantial political intervention with respect to appointments and sackings, causing the public sector agencies and enterprises to be highly inefficient, which adversely impacted on resource management, morale and eventually service delivery.

Given these issues and the large financing required, the program was therefore much larger than any contemplated or implemented previously. It is important to note that these hard currency loans were to be repaid with interest. This meant that the reform program had to be implemented and economic growth lifted such that the loans could be repaid from additional tax revenues. Otherwise, it would only increase the country's debt service

burden and add to the difficulties of the next generation, who would have to service the debt, thus creating an increasing debt dependency.

Because of the size of the funding requested and the poor track record of previous governments in sustaining reforms, a substantial track record was required to be established before disbursement, which consisted of the following

Required prior actions

On macroeconomic policy

- arrears had to be disclosed and a repayment schedule implemented
- the deficit had to be restricted to 1.5 per cent of GDP in 1999 and budgeted at 1.9 per cent of GDP in 2000 (surplus of 0.4 per cent of GDP excluding repayment of arrears and including K101 million for SAP reform expenditures)
- monetary policy was to be kept tight with no early reduction in interest rates.

On governance and structural reform, actions included

- disclosing improved fiscal accounting data, a hiring freeze in the public sector, improving the control of expenditure warrants and abolishing some inappropriate trust accounts
- commencing a review of taxation
- proscribing government borrowing from the Bank of Papua New Guinea (BPNG) through a new Central Banking Act and improving financial sector supervision through a new Banks and Financial Institutions Act, new superannuation arrangements, the instigation of audits of the National Provident Fund (NPF) and the Public Officers' Superannuation Fund (POSF), and establishing a Commission of Inquiry into the NPF
- committing to repayment of debt from any privatisation proceeds, establishing an accountable Privatisation Commission and making a commitment to the early privatisation of the Papua New Guinea Banking Corporation (PNGBC) group
- re-establishing proper Cabinet procedures, establishing the Central Agencies Coordinating Committee (CACC) and placing outstanding corruption reports by the Attorney-General on the agenda
- agreeing to a moratorium on spending under the Rural Development Program (RDP) until the Central Bank had designed

and implemented strict procedures and these had been approved by Cabinet

- drafting legislation on an Independent Commission Against Corruption (ICAC) and instigating legal action on high profile corruption cases such as the Cairns property case
- commencing a review of the government's procurement policy through the Central Supply and Tenders Board (CSTB)
- commencing a number of departmental reviews with a view to rationalising expenditure and adequately resourcing priorities
- improving health and education spending priorities
- re-instating the forestry export tax regime, resourcing the independent log inspection service, and declaring a moratorium on new forest management agreements (FMA).

An added safeguard was built into the program. The Treasury Bill Act prevented excessive borrowing from the domestic market and the new Central Banking Act prevented BPNG deficit financing, both of which would limit access to the foreign exchange reserves that would be adversely affected by excessive government spending. This meant that, if the government conformed to its legislative responsibilities but failed to sustain the reforms, much of the loan funding would be held as BPNG reserves and at least not wasted.

In addition, the World Bank helped the government improve its implementation capacity by providing a large number of consultants who were funded through a consultants' trust fund financed by AusAID.

While there were many discussions and negotiations—some heated—over these track record conditions, for the most part they were all met and the boards of the IMF and the World Bank approved the loans in the first half of 2000.

The IMF program comprised four releases of quota scheduled on a 3-monthly basis. Various targets were set for each quarter covering government spending and financing and foreign exchange reserve levels, and some structural benchmarks associated with the World Bank program.

The World Bank program was designed such that the prior conditions (or track record conditions) were framework conditions—that is, they sought all the required formal government Cabinet approvals, enactment of required legislation, adoption of processes and pursuit of corruption cases and reviews. The subsequent tranche releases were tied to implementation of the framework. This was done to ensure maximum sustainability.

The World Bank's program was built on these prior actions and included

- a US\$35 million tranche release (plus US\$25 million Japanese financing) which was disbursed on Board approval
- a tranche release (US\$20 million) to bring the PNGBC group to the point of sale and facilitate disposal of the remaining assets in the group (defined clearly in the Minutes of Negotiation). The main reason for this was to attack corruption directly in the government-owned and influenced financial sector—PNGBC, Motor Vehicle Insurance Limited (MVIL), Nuigini Insurance and the Rural Development Bank (RDB)—and give the privatisation program some momentum by privatising an entity that was considered solvent, not a monopoly and operating in a sector that was doing well financially, and with a reasonable regulatory regime in place (BPNG). So it should have been relatively easy to achieve the desired outcome, which would have lent encouragement to the whole program.

This first tranche was to be supplemented by a second tranche release (US\$35 million and US\$25 million Japanese) for

- release of full warrant authorities for the development budget
- implementing an integrated payroll and Human Resource Management (HRM) system
- establishing a fully functioning professional debt management office
- ensuring solid progress on privatisation—completion of audits on state-owned enterprises (SOEs), NEC approval of industry structural and civil society organisations (CSO) arrangements and form of privatisation, and commencement of the due diligence exercises
- implementation of tax reforms and review of competition policy recommendations
- implementation of fiscal transparency reforms—publication of budget reconciliations, mid-term review, publication of the audited public accounts as prescribed, departmental annual reports issued, implementation of the RDP reports, enactment of supplementary budgets if overspending occurs, program budgeting format for health, and so forth
- implementation of World Bank designed RDP arrangements and allocation of resources for the managing agent
- implementation of strengthening arrangements for the oversight entities—Ombudsman Commission, Auditor-General's Office,

Public Accounts Committee and the Central Supply and Tenders Board

- public sector restructuring—implementation of the functional review recommendations for key departments—Health, Education, Defence, Foreign Affairs, Police and Works
- implementation of National Health Plan targets in the 2001 budget
- implementation of forestry reforms—forestry revenue regime review recommendations, independent review of FMAs, amendments to Forestry Act and legislation to prevent false land clearing under the guise of road and agricultural projects, and improvements to Forestry Board governance arrangements
- implementation of the recommendations of the NPF inquiry
- implementation of the superannuation legislation

In assessing compliance with conditionality, the World Bank has to ensure first that the macroeconomic framework is satisfactory (analysis is usually provided by the IMF if engaged at the time) and that the overall program is on track (by looking at achievement under the stated performance indicators and any policy reversals, among other things). The specific conditions are assessed utilising the Letter of Development Policy to show the government's overall objectives and the Minutes of Negotiation which detail compliance requirements.

Performance indicators

Performance indicators are stated in the Loan Agreement. Their aim is to assess policy outcomes that would show an improvement in Papua New Guinea's net worth and poverty and governance indicators. These comprised

- real GDP growth in the non-mineral economy to average 5 per cent
- year-end inflation in single digits
- an increase in the number of departments and agencies covered by the integrated payroll and personnel management system
- departmental restructuring
- a substantially improved RDP delivering projects at the district level
- health priority expenditures with 90 per cent of aid posts staffed, stocked and operational
- increases in primary and secondary school enrolment rates, with the number of bogus teachers reduced

- governance components—at least 50 RDP onsite inspections and reports, applications of sanctions; openness of CSTB processes and 100 per cent coverage; early wins against corruption in cases being pursued by the Attorney-General’s Office
- financial recovery of the lost NPF funds
- successful integration of the privatised PNGBC in the financial sector.

Outcomes: evaluation of the compliance with conditionality

In the first tranche, prior actions were assessed to have been met, leading to Board approval and release of the first tranche.

Under the floating tranche, the following issues were raised

- adequate documentation (Information Memorandum) for the sale of PNGBC had been achieved
- the RDB was excluded from the process for political reasons, but a review had been promised. MVIL disposal had been delayed. CSO arrangements were inadequate
- probity issues remain relating to process—release of due diligence information, the exclusion of Westpac, sale proceeds included assets of dubious value among other things
- minutes of Negotiation stated that a reputable foreign bank purchaser for PNGBC should be sought. The winning bid, however, was a local consortium, which resulted in government control/influence remaining—contrary to the governance aim of removing government from this institution.

The World Bank should have looked more closely at this outcome before release of funds, but was generally excluded from the process from mid 2000 onwards (that is after Board approval and release of the first tranche).

Second Tranche

The second tranche was released in December 2001, yet no adequate macroeconomic assessment was undertaken. Such an assessment would have found that fiscal expenditure far exceeded budgeted levels by the end of 2001 and that revenues were clearly falling short of expected levels, leaving a substantial budget deficit for 2001 (nearly K400 million compared with the K140 million budgeted). Foreign exchange reserve levels were below IMF program targets, the value of the kina was reaching record lows, and inflation was rising. With the budget off track, fiscal discipline languishing,

and an election campaign period commencing, any World Bank funds released were at risk of being misused. Despite this, no assessment was made.

Data releases set for prescribed times in agreement with the World Bank were mostly well behind schedule and inadequate, making assessment very subjective.

Progress against performance criteria is judged to be poor because

- real GDP growth was negative in 2000 and 2001 and inflation was still in double digits and rising
- no significant department was operating the integrated payroll and human resources management system
- no significant implementation of the functional reviews had taken place, although some implementation of the Foreign Affairs and Defence reviews had occurred
- the RDP had been abolished and was well behind the performance measurement at the time of abolition
- priority expenditures were not in full compliance with the National Health Plan
- Aid Posts were considerably understaffed and understocked—possibly even worse so than previously
- school enrolment rates were down not up
- ghost teachers have not been removed from the payroll
- RDP were not at the level set, and application of sanctions had not been undertaken
- CSTB processes had not improved, with some major concerns remaining
- no early wins had been made against corruption in the cases recommended by the Attorney-General's Office
- no funds had been recovered by the NPF.

The program was clearly not on track and a number of policy reversals had taken place

- high level corruption cases had been suspended—for example, the Cairns Conservatory case and the NPF Inquiry follow up prosecutions—and no further work had been done on all the other corruption reports with the Attorney-General
- fiscal transparency reports had not been published—there was no mid-term review in 2001 and public accounts were not closed in 2001 and 2002 for long periods after the end of the financial year

- ICAC legislation had not been submitted
- full warrant authorities had not been issued for the Development Budget
- clear breaches of the new Central Banking Act had occurred with respect to lending to finance the fiscal deficit in the first half of 2001 and breaches of the overdraft section of the Act continued to take place
- the tariff reduction program had not been implemented
- the RDP had been abolished in the 2002 budget with no offsetting policy for these public investment funds and reduced accountabilities for the remaining funds in the trust accounts
- breaches of the conditions regarding coverage by the CSTB with the NEC's announcement of large contracts for roads and bridges
- the superannuation law was not promulgated until mid 2001, stalling implementation of the reforms (which was an indirect second tranche condition).

Assessment of second tranche conditions

- Full warrants for the Development Budget were not released in 2001.
- Key departments have not managed to put an integrated payroll HRM system into operation, although a contract has been let to achieve this end over a number of years.
- A fully functioning professional debt management office has not been established and is not even close to being established.
- The MRSF Act was repealed.
- Solid progress had been made on the privatisation agenda with audits, industry structural arrangements and due diligences being done by the project teams, but there has been little consultation with the World Bank.
- The tariff reduction program has stalled, but other tax measures have been undertaken.
- Competition policy reforms have been undertaken with enactment of a new Act.
- Fiscal transparency measures have generally not been undertaken.
- The RDP has been abolished but no provision has been made for reallocation of funds to investment or the accountability of remaining funds.
- The Auditor-General's Office has been strengthened under AusAID

programs, but government support is still inadequate. The PAC has not been strengthened.

- The CSTB has been strengthened somewhat, but glaring inadequacies remain.
- Hardly any of the recommendations of the functional reviews have been implemented (the ministries of Foreign Affairs and Defence have made some progress).
- National Health Plan targets are not being met in full.
- Significant reforms have been initiated in forestry but these are inadequate—implementation of the reviews inadequate, forest revenue review recommendations inadequate and governance concerns remain.
- NPF inquiry recommendations have been delayed and little implementation has occurred to secure prosecutions and recoveries.
- Legislation on superannuation has been enacted but delayed, adversely affecting second tranche conditions.

The government achieved solid progress on reforms up until November 2000 and good progress on the privatisation program up until November 2001. But reforms slowed significantly after the 2001 budget as the government appeared to switch into election mode and the prime minister lost ministerial control

The floating tranche release should have been delayed until probity matters had been assessed, the RDB reform plan agreed, and the improved CSO framework discussed and agreed.

The second tranche release should have been delayed without question. Fiscal discipline was lacking in late 2001, leading to substantial budget problems, unfunded and inappropriate election commitments in the 2002 budget, deterioration of other macroeconomic indicators. A number of policy reversals emerged, there was a failure to make progress against most of the performance criteria and a failure to meet a large number of specific conditions.

Political pressure on senior World Bank management to support the government in an election period persuaded the World Bank to issue a favourable report leading to release of the funds.

Funds have now been spent on inappropriate programs, the country is headed for financial crisis with a fiscal deficit running at 6 per cent of GDP, revenues are falling because the economy remains in deep depression, the

kina continues to decline to record lows, inflation and interest rates are on their way back up, reserve levels (excluding the SAP loan funds) are near the levels left by the previous government, and debt to GDP ratios are skyrocketing. Poverty levels are increasing. Another financial rescue package is required and the IMF seems likely to provide it—which will probably lead to more debt as Papua New Guinea plunges into an African-style debt trap.

On specific conditions, only a compliance rate of about 50 per cent has been achieved.

Lessons

The IMF and World Bank programs should have been implemented jointly over a much longer period, such as the expected term of the government—three years in this case. A greater number of tranches should have been used. That is, there should have only been one program. It is not reasonable to release all SAP funds in an IMF program in one year. Structural reforms take time, so, if the IMF framework is to be overarching, it must be lengthened in time. It is unhelpful when the IMF pressures the World Bank into disbursing funds just so that the IMF's program targets for foreign financing can be met.

The program should have included representatives of the bilaterals who were contributing to the program—Japan and Australia—such that their technical assistance could be designed into the reform outcomes rather than used by the government in some cases to undermine the reforms.

The government must be committed to the reforms and not just pay lip service in order to get the loan funds. In this respect, the government should control the reform agenda from design through to implementation. The IMF/World Bank cannot force conditionality onto governments—there are many avenues to circumvent conditions; data manipulation, manipulation of cash flows through balance sheet manipulation, policy reversals, policy erosion, political representations and engineering the removal of officials from these institutions. The political tactics to secure second tranche release in time for the election is a case in point. If the government is not committed to the reforms, then SAP lending should not be pursued by the World Bank in the first place because it is destined to fail. The level of government commitment should be reported independently to the World Bank as part of the design assessment.

If the government pursues political tactics to secure the tranche releases, the World Bank must be prepared to stand firm and coordinate its stand

with other donors. Some form of independent arbiter needs to be established to handle these conflicts.

The program needs to be more inclusive of those interests that stand to lose/gain from the reforms. Strategies need to be developed to meet the legitimate concerns of those interests that will be adversely affected by the reforms and to offset the illegitimate interests of those affected. In other words, how do we manage conflict and criticism?

Program design needs to be improved. IMF program structures (tighter fiscal and monetary policies) tend to have the best chance of success if applied to a situation involving an exogenous shock to the economy of a short-term nature (like the East Asian crisis or a commodity price slump) or fiscal expansion excesses. If an economy is suffering a crisis of confidence or governance and is in economic depression, these policies will not tend to be effective. In such cases the aim must be to stimulate private sector activities and investment and reduce country risk. Raising interest rates for prolonged periods, cutting public expenditure on maintenance and capital, and encouraging governments to manipulate the cash accounting system at the cost of its balance sheet and accountability will not work. The IMF must move to an accrual framework and work with the World Bank to achieve development outcomes. If governments cannot provide adequate and reliable data on key balance sheet aspects, there should be no program. The IMF should involve data expert teams in building capacity and assessing the accounts before the design team comes in.

The World Bank's program design needs to be improved greatly and its implementation strengthened. The World Bank needs to focus on key areas, do a much better job on providing implementation support, insist on an inclusive process with government and interest groups, and establish conflict resolution rules and processes. The World Bank should not be expected to increase economic growth and alleviate poverty—all within one SAP. The design outcomes need to be commensurate with the size of the program package. Preconditions need to be carefully monitored, and some greater independence needs to be brought to bear on sign off of conditionalities. If preconditions are not met, the loan should be suspended or the program redesigned regardless of political and bilateral pressure. Conditions change and there should be a preparedness to redesign aspects, but this should not be an exercise in watering down program conditions or be seen by government as shifting the goal posts.

The government needs a dedicated SAP secretariat that reports directly to the Finance Minister or an NEC subcommittee with responsibility for implementing the SAP. A very senior Papua New Guinea official should be in charge of the committee. This was done with some success in the previous SAP. The committee's performance should be judged on its implementation of the reforms, not on getting the money, and its performance disclosed to the public.

Adequate funding needs to be appropriated to cover the costs of the reforms. These costs should be evaluated with some detail in the design phase and managed by the committee with oversight by the World Bank. The cost of reforms should be associated with the size of the SAP.