

THE WORLD BANK GROUP ARCHIVES

PUBLIC DISCLOSURE AUTHORIZED

Folder Title: Contacts with member countries: Papua New Guinea - Correspondence 01

Folder ID: 1771159

ISAD(G) Reference Code: WB IBRD/IDA 03 EXC-10-4549S

Series: Contacts - Member Countries files

Sub-Fonds: Records of President Robert S. McNamara

Fonds: Records of the Office of the President

Digitized: June 28, 2013

To cite materials from this archival folder, please follow the following format:
[Descriptive name of item], [Folder Title], Folder ID [Folder ID], ISAD(G) Reference Code [Reference Code], [Each Level Label as applicable], World Bank Group Archives, Washington, D.C., United States.

The records in this folder were created or received by The World Bank in the course of its business.

The records that were created by the staff of The World Bank are subject to the Bank's copyright.

Please refer to <http://www.worldbank.org/terms-of-use-earchives> for full copyright terms of use and disclaimers.



THE WORLD BANK
Washington, D.C.

© 2012 International Bank for Reconstruction and Development / International Development Association or
The World Bank
1818 H Street NW
Washington DC 20433
Telephone: 202-473-1000
Internet: www.worldbank.org

PUBLIC DISCLOSURE AUTHORIZED

McNamara papers

Contracts
Papua / New Guinea (1973-1975)

The World Bank Group
Archives



1771159

A1993-012 Other #: 15

209351B

Contacts with member countries: Papua New Guinea - Correspondence 01

DECLASSIFIED
WBG Archives

PAPUA/NEW GUINEA

PAPUA - NEW GUINEA

1. 6/12/73 Minister of Finance, Julius Chan Sungmen
Minister of Public Works, Thomas Kavali
2. 2/11-13/74 RMcN Notes On Visit (*Filed in RMcN office*).
3. 2/11/74 Julius Chan, Minister of Finance
(Port Moresby) Merauke Morauta, Secretary, Ministry of Finance
H. P. Ritchie, Senior Advisor, Ministry of Finance
David Beatty, Director, Central Planning Office
William L. Conroy, Secretary, Department of Foreign Relations
and Trade
Henry T. Robert, Governor, Bank of Papua New Guinea
P. Bouraga, Acting Secretary, Department of the Chief Minister
John Natera, Director, Department of Agriculture, Stock and
Fisheries
- " " Michael T. Somare, Chief Minister
Dr. John Guise, Deputy Chief Minister and Minister of the Interior
Julius Chan, Minister of Finance
Albert Maori Kiki, Minister for Defense, Foreign Relations and Trade
Iambakey Okuk, Minister for Agriculture
N. E. Olewale, Minister for Education
Paul Lapun, Minister for Mines and Energy
Donatus Mola, Minister for Business Development
P. Bouraga, Secretary, Department of the Chief Minister
Bunais Sabumei, Foreign Relations Officer
- " 2/13/74 L. G. C. Moyle, Managing Director, Investment Corporation of PNG
(Port Moresby) Mr. Small, Manager, Commonwealth of Australia Banking Group in PNG
E. Cleland, Manager, British New Guinea Development Co., Ltd.,
Member of Copra Marketing Board, President of Planters Assn.
of Papua and of National Farmers Union
Paulius Matane, Secretary, Department of Business Development
Elliot Elijah, Department of Business Development
Mahuru Rarua, Director of Cooperative Wholesale Society, Director
of PNG Printing, Pacific Insurance Company and Pagini Taxi Co.
Mr. Clunies-Ross, Head of Department of Economics, University of PNG
Dr. Ross Garnaut, Research Fellow on Economic Policy, Australia
National University
Elias Vuvu, Private Secretary to Minister of Agriculture, Stock
and Fisheries
John Noel, Office of the Chief Minister
- " " L. G. C. Moyle, Managing Director of the Investment Corp. of PNG
- " " Tei Abal, Leader of the Opposition
W. A. Lussick, Opposition Party Official
- " Others met: M. Lyon, Deputy Head of the Australian Office
T. Unwin, Resident Representative, UNDP
L. W. Johnson, High Commissioner
Dr. K. S. Inglis, Vice Chancellor, University of PNG
Prof. Maddocks, Professor of Clinical Science, Univ. of PNG
Major E. Diro, PNG Defence Force
T. ToBunbun, Foreign Relations Officer, Dept. of
Foreign Relations and Trade
G. B. Feakes, First Asst. Secretary, Australian Dept.
of Foreign Affairs
Mr. Cole, Managing Director, PNG Development Bank

2/13/74
(Kundiawa)

A. Creedy, District Commissioner

(Garoka)

P. J. Walsh, Acting District Commissioner

4. 10/9/75

Prime Minister Michael Thomas Somare
P. Matane, Charge d'Affaires in Washington
Paul Bengo, Assistant to the Prime Minister

OFFICE MEMORANDUM

TO: Memorandum for the Record

DATE: June 15, 1973

FROM: Raymond J. Goodman *RJG*SUBJECT: PAPUA NEW GUINEA: Visit of Messrs. Chan and Kavali

7/15

Messrs. Julius Chan, Minister of Finance, and Thomas Kavali, Minister of Works of the Territory of Papua New Guinea called on Mr. McNamara on June 12. They were accompanied by Mr. Sabumei, who is attached to the Australian delegation to the U.N. Mr. McLeod and I were also present. The visit was essentially a courtesy call, and Minister Chan said he wished to take the opportunity of thanking the Bank group for its very helpful support of the development efforts of the Territory. He referred to Mr. McNamara's speech at the last annual meeting and said that it fitted in well with his government's strategy to bring on the large portion of the population that remained in the traditional sector.

Mr. McNamara inquired about the timing of the Territory's independence and the future of Australia's assistance. Mr. Chan said that full self-government would be achieved by the end of this year but that the timing had not yet been set for independence and that this was still under discussion with the Australian authorities. The new Australian government had given a firm promise of continued support on at least the present scale.

Mr. McNamara then referred to the question of whether Australia would continue to guarantee Bank loans to the Territory after independence. Minister Chan said that he had learned about this problem during his discussions earlier in the day and would discuss it with his cabinet colleagues on his return to Port Moresby. I reported that I had also raised the matter with Mr. Hay, Secretary of the Department of External Territories of Australia who had said that it had not yet come before the Commonwealth Cabinet but that it would be highly unusual, if not unique, for one country to guarantee loans incurred by another. However, he appreciated Australia's interest in enabling the Bank to continue lending to Papua New Guinea and would look into the matter carefully on his return to Canberra.

cc: Mr. McNamara's Office
cc: Mr. Helmers

RJGoodman:rf

President has seen

OFFICE MEMORANDUM

TO: Mr. Robert S. McNamara
DATE: May 31, 1973

FROM: B. Sandberg, Acting Director, East Asia & Pacific Dept., in the absence of
Mr. Goodman

SUBJECT: PAPUA NEW GUINEA - Visit of Ministers Chan and Kavali

Ministers Chan and Kavali will be meeting you on June 12 at 6:10 p.m. They will probably be accompanied by Mr. Visbord, Minister (Financial) attached to the Australian Embassy in Washington, and Mr. Cranswick (Alternate E.D.). We are not aware of any specific issues that they wish to raise with you, but we presume that PNG's forthcoming independence and the Bank's role as a development partner will be discussed.

Attached are a brief background note on PNG and our lending operations (Attachment 1) and biographic data on Ministers Chan and Kavali (Attachment 2).

Attachments

cc: Messrs. Knapp, Cargill
Goodman (o.r.)

LHelmers:vmk
PH

President has seen

BACKGROUNDPolitical

Papua New Guinea will attain internal self-government at the end of this year and is expected to become independent sometime between April and December 1974. The movement towards national independence has, indeed, accelerated considerably under the new Australian Labor Government, which is eager to divest itself from its colonial responsibility as soon as possible. Mr. Whitlam, the Australian Prime Minister, said literally that "no country in the world can force Australia to remain a colonial power." On various occasions, Australia has assured PNG of its intention to provide substantial financial and technical assistance in the future. However, after independence Australia's guarantee for Bank Group lending to PNG will probably cease. This applies also to PNG's borrowing in the European and Australian capital markets, which will probably make it impossible for PNG to raise new funds in the international capital markets after independence. In this light our forthcoming economic mission scheduled for September 1973 will review PNG's creditworthiness and the terms and size of future Bank Group lending. We feel that there is scope to increase Bank Group involvement in PNG and that our help is welcomed by the new Government in its search for new financial sources and development partners.

Internally, recent constitutional changes have progressively increased the political responsibilities of the local population and given wider power to their representatives. After the general election in March 1972 a so-called National Coalition Government^{1/} was formed, headed by Michael Somare, the leader of the progressive Pangu Party who de facto became the country's first Chief Minister. The new Government has asserted its widened constitutional powers vigorously and has for the first time established an effective national leadership. Its task to prepare PNG for self-government and nationhood is formidable. Geographic, cultural and ethnic fragmentation of PNG's population fosters regional jealousies and separatist political movements. Expansion of transportation and communications is a slow and costly process, impeded by the country's rugged topography and its multi-insular character. Although the use of Pidgin English and English is increasing, the majority of the people still speak only one of the 700 local vernaculars. Literacy is very low and the number of skilled workers, technicians and university graduates is insufficient to replace the numerous expatriates who still dominate the modern public and private sectors of PNG's economy. In fact, public administration in PNG relies heavily on expatriates, not only in the professional but also in the sub-professional level. Private foreign businesses have only recently started training programs to replace expatriates by local employees. Hence, in the immediate

^{1/} Four smaller groups joined the Pangu Party in the coalition. They include the moderate People's Progress Party led by Finance Minister Chan, the National Party (of which Mr. Kavali, the Minister of Works, is a member) representing a group of progressive Highlanders, the Tolai Mataungan Association and a group of Independents.

future much will depend on the new Government's success in winning not only the confidence of the various PNG tribes, but in particular in localizing public administration in an orderly and gradual fashion and in safeguarding the interests of the expatriate business community.

Economic

Economically, Papua New Guinea approaches independence with a basically dichotomized structure consisting of (i) a large but sluggish indigenous subsistence sector based on traditional agriculture and (ii) a rapidly expanding modern monetized sector, with emphasis on export oriented plantation agriculture, Government operations, services and, lately, also mining. The economy as a whole has grown satisfactorily during the 1960's. GDP rose by almost 8 percent a year during 1960/61-1965/66, and more recently by almost 11 percent a year, owing partly to the implementation of the large Panguna copper mining project on Bougainville Island. This growth was also sustained by a 15 percent average annual increase in the export-oriented modern agricultural sector, by favorable trends in private non-mining investments, and by sharply rising Government expenditures, especially for economic development. Since growth has been virtually limited to the monetized sector the share of the traditional subsistence sector, from which 70 percent of the local population still derives the main part of its living, fell from about two-thirds to less than 40 percent during the sixties. Per capita GNP in Papua New Guinea in 1971 was around US\$300 including the high-income expatriate sector; the per capita income of the indigenous population was around US\$160, or only 14 percent higher than five years before, reflecting the problems of the country's dichotomized economic structure.

Since mid-1971 the economy has been passing through a recession; real GNP has declined by 4 percent. Main factors have been the readjustment of private investment to previous levels after the completion of the construction of the Bougainville project, and declining world market prices for most of the country's agricultural export commodities (copra, cocoa, rubber and palm oil) and temporary marketing difficulties for coffee. In addition, the present atmosphere of uncertainty and expectation explains to some extent the slowdown in business activities. New investments are deferred, some smaller foreign owned firms are closing and the departure of Australian civil servants has started. This atmosphere of uncertainty among the expatriate community will probably prevail in the near future when the new Government will have to establish itself firmly and to work out in detail its development policies and programs. Through our lending program as well as our economic missions we hope to support the new PNG Government with financial aid as well as advice on its future development policy^{1/}; thus the Bank Group may be able to be a stabilizing factor during the difficult transitional period when PNG moves towards independence.

^{1/} The Bank has acted as Executing Agency for a UNDP-financed study on PNG's future development strategy which was finalized in late 1972.

Bank Lending Program

The Bank Group's assistance to PNG has been designed to supplement, not to substitute for Australian aid. The Bank has made four loans to PNG for a total of US\$44.7 million and the Association four development credits amounting to US\$25.2 million. The largest single loan was US\$23.2 million for a hydroelectric project, which was needed to provide power for one of the most rapidly developing areas of the country. The remainder of Bank Group lending has been for telecommunications, highways, ports and agricultural development. These projects were selected for their high economic priority in helping to open up the country, to provide basic infrastructure facilities and to bring the local population into the cash economy. Implementation of these projects did not encounter major difficulties.

The average annual Bank Group lending to PNG during FY74-78 is tentatively proposed at US\$22 million. We expect three projects in FY74: a small power project, a first education project and a third large oil palm scheme. The Government is giving high priority to rural development aid and we intend, with the help of our forthcoming operational and economic missions, to pay special attention to rural development possibilities.

CURRICULUM VITAE

Julius Chan Sungmen, Minister of Finance

Age 33, born in New Ireland of Chinese extraction, graduated from Secondary School. Official of the Administration of the Cooperatives, 1961-64.

Member of the House of Assembly since 1968 (Namatanai Open Electorate), Deputy Speaker of the House. Re-elected in 1972. Co-founder and currently Chairman of the People's Progress Party (PPP), a moderate political group with relatively strong Chinese and some European influence, representing middle-class business interests but also supported by elements of the newly formed indigenous elite, especially in the coastal and island areas of PNG.

Chan led the PPP into a coalition with the progressive Pangu Party which (together with three smaller groups) gave the new Chief Minister Michael Somare a majority in the House and put the conservative United Party, the largest political group, into opposition. The PPP currently holds 14 seats in the 100 member House of Assembly.

Chan became Minister of Internal Finance in 1972. Since very recent, this function includes the responsibility for external finance and foreign aid, and the title was changed to Minister of Finance.

Thomas Kavali, Minister of Works

Age 28, born in New Guinea's Western Highlands District.

Standard VI Education, Primary School. Former Trainee of the Department of Agriculture in Madang 1963. Official of Bureau of Corrective Institutions 1965-1969.

Member of House of Assembly (Jimi Open Electorate) since 1969. After re-election in 1972 co-founder of National Party, a small group representing progressive Highlanders, especially public servants, which separated from the United Party, the dominating political group in the Highlands.

Kavali became Minister of Works in 1972, with responsibility for public works.

3.

MEMORANDUM FOR THE RECORD

Briefing Session for Mr. McNamara with Minister of Finance, Julius Chan and Senior Government Officials, February 11, 1974 in Port Moresby, PNG.

Present: Minister Julius Chan (Chairman: Mr. Merauke Morauta, Secretary, Ministry of Finance; Mr. H. P. Ritchie, Senior Advisor, Ministry of Finance; Mr. David Beatty, Director, Central Planning Office; Mr. William L. Conroy, Secretary, Department of Foreign Relations and Trade; Mr. Henry To Robert, Governor, Bank of Papua New Guinea; Mr. P. Bouraga, Acting Secretary, Department of the Chief Minister; Mr. John Natera, Director, Department of Agriculture, Stock and Fisheries. Also present: Messrs. William Clark and Anders Ljungh.

Mr. Morauta and Mr. Beatty gave a comprehensive briefing on Papua New Guinea's recent economic and social structure, the Government's basic policies to be reflected in the new plan, and the financial situation and prospects. An outline of the briefing containing a full set of copies of charts which were shown during the briefing is on file in Division D, EA&P Department, Asia Region.

The discussions centered on Papua New Guinea's creditworthiness, possible continuation of the Australian guarantee for Bank loans, Australian aid commitments to PNG after independence, future large-scale projects, and future Bank Group assistance to the Country.

Creditworthiness

The Treasury officials pointed out that PNG's trade balance had considerably improved during the last year as exports increased rapidly because of high copper prices during the first full production year of the Bougainville mine and high primary produce prices for almost all of PNG major agricultural export crops. Imports, on the other hand, increased only slightly because of the declining expatriate population. Thus, PNG's resource gap had dramatically diminished and was currently projected to disappear. Therefore, the projections by the last Bank Economic Mission should be revised and PNG should be considered credit-worthy for Bank loans on its own.

Mr. McNamara cautioned that the improvement of the trade balance alone would not be sufficient to establish PNG's creditworthiness because of the continuing substantial net outflow of services, especially factor services. Due to the large net transfer abroad of dividends and interest payments as well as its import requirements (especially fuel) the Bougainville project's net benefit to the balance of payment is limited. As far as exports are concerned the figures for this year reflected a record price for copper and major tree crops which was not expected to continue. For copper, it was expected that prices might fall noticeably in two to three years, when a number of new copper mining projects would go into operation in several countries. Creditworthiness

had to be seen by the Bank in the long term because of the long-term amortization schedule of Bank loans. He felt as it stood now that an Australian guarantee would be necessary for continued Bank loans to PNG. However, the Bank would continuously review the question of PNG's creditworthiness and would be glad to revise its position when events would justify it. The next review would be done by the economic mission scheduled for May.

Mr. McNamara also pointed out that an Australian guarantee would allow the Bank to finance projects in PNG on a much larger scale than would be possible if loans would have to rely on PNG's own creditworthiness which for some time to come would probably only be marginal. In his judgment, PNG would need very large amounts of assistance in the future for implementing its rural development program. He would therefore raise the issue of the guarantee in Canberra and was optimistic because of Mr. Whitlam's assurances to him on this matter during the Prime Minister's recent visit to Washington. The PNG officials were skeptical and felt that the Australian Treasury's opposition to the continuation of the Australian guarantee was very strong.

Negotiations on Australian Assistance

The PNG officials reported about their negotiations on Australian aid for the next three years. The negotiations had been difficult with the Australian Treasury taking a tough stand on all PNG proposals. Firm Australian aid commitment was now essential for PNG politically as well as economically since the country was currently passing through a recession. Investment climate was sluggish, public development expenditures restricted pending the decision on the new development plan, and the rapid exodus of expatriates had caused the modern economic sector to shrink. The total number of expatriates had declined to 34,000 (1972: 53,000) implying an expatriate workforce of between 16,000 and 17,000. Expatriate public servants were expected to decrease by 1,600 during FY73/74 as against an expected decline of 960. This hinted at serious manpower shortages in the immediate future. There was also a severe shortage of teachers, especially technical teachers. Australia was accused of doing little to curb a precipitous exodus of Australian public servants and teachers.

Another politically disconcerting factor was the short supply of kerosene and diesel fuel in the Highlands. Native truck owners find it difficult to repay PNGDB loans. Also tinned fish imported from Japan which had become a major source of protein for natives in the Highland town areas was in short supply when Japanese suppliers recently discontinued deliveries of low-grade tinned fish. These developments heightened to the Highlanders' traditional misgivings about the current national Government and their objections to early independence.

During the negotiations in Canberra the PNG delegation asked for a firm Australian commitment for A\$520 million at constant prices for the next three years. This request was based on the assumption that

current public expenditures would continue to increase by about 15 percent a year, which had been the expansion in the last 5-6 years. While PNG's borrowing capacity was naturally limited, PNG's current internal revenue base was bound to decline with the exodus of the expatriates. Pending a complete overhaul of the revenue system, 88 percent of personal income tax was paid by expatriates; 2 percent of the population paid 80 percent of all tax revenues; 50 percent of the total tax base was "expatriate sensitive". Under these circumstances, the PNG Treasury estimated an annual revenue gap of A\$150 million at constant 1973 prices over the next three years. This would not allow for an increase in capital expenditures.

Australia had so far been willing to promise only a commitment of A\$500 million for the 3-year period at current prices with no allowance for price rises and the exact amount of the annual assistance to be negotiated every year. If special allowances in connection with the transfer of functions from the Australian to the PNG Government were subtracted, genuine budget support would dwindle to A\$350 million, or about A\$115 million a year, which would be less than was provided currently.

Moreover, the Australian Treasury had so far rejected PNG's request to continue the guarantee of PNG borrowing in the Australian capital market after independence. The Treasury apparently wanted to avoid a precedence for other countries in the region, e.g., Fiji or Western Samoa. Mr. McNamara said he could not agree with the Australian position and would raise the matter in Canberra.

The Australian-PNG negotiations were stalled and would be continued at the highest level between Somare and Whitlam in a few days. (In the meantime, it was agreed in these talks that Australia would commit itself to provide PNG with a minimum aid of A\$500 million over the next three years, which would be renegotiated annually between the two countries. The question of constant versus current prices was apparently shelved).

Large-Scale Projects

Total investments cost for the proposed Ok Tedi Copper Project were estimated at about A\$340 million. This would include about A\$80 million for infrastructure, predominantly for transportation. Kennecott was apparently unwilling to pay for the infrastructure and maintained the expected profitability of the copper mine alone would not justify infrastructure expenditures of this size. The company suggested a regional development effort to coordinate the mining project with rural development and forestry projects in the area. With the development of transportation the area's allegedly rich timber resources could be tapped and there was a possibility of growing rubber, oil palms and other export crops in the area. Kennecott felt that part of the infrastructure expenditures could be financed by the Bank Group. In addition, Bank financing of the necessary power generation and distribution facilities (to be built by ELCOM) was also considered.

The PNG officials were extremely skeptical about the agricultural potential of the region in question, which was populated only very thinly. Projects would require massive resettlement efforts of people from the Highlands whose success was doubtful. Also, the forestry potential was uncertain before more thorough studies had been done.

Mr. McNamara assured the officials that the Bank Group would be willing to finance part of the infrastructure investments for the copper project, provided these investments would also make a substantial and meaningful contribution to rural development in the region. He felt that some of the Bank financing could even be guaranteed by Kennecott. However, he warned PNG not to get stuck again with A\$80 million of infrastructure investments for an enclave project which would yield only limited direct benefits to the local economy. He reminded them of the A\$64 million already paid by PNG for infrastructure in connection with the Bougainville mine. If Kennecott would really attach top priority to the opening up of Ok Tedi it would also come up with the finance for infrastructure.

On Purari, Mr. McNamara said the Bank would review the results of the planned feasibility studies. Mr. McNamara refused to make a statement regarding the Government's plans to renegotiate the Bougainville Agreement since he had no detailed knowledge of the background. However, he realized that the present arrangements were very favorable for the foreign investors. If PNG wanted the Bank's advice, the Government should send background material and their plans to Washington and experts in the Bank would review them.

Bank Group Assistance

The PNG officials were particularly interested in Bank Group assistance for the Rural Development Program. They had presented Mr. McNamara in advance with drafts for regional development programs for several districts. They emphasized the new development program would focus on the less advantaged parts of the country. They hoped for financial assistance from the Bank Group but would also welcome technical assistance in preparing their programs and projects. Mr. McNamara referred to his Nairobi speech and promised full support for PNG's rural development program. We would also help formulate such programs but there were serious staff constraints in the Bank. Mr. McNamara cautioned that the Bank itself had only limited experience with the problems of broad rural development programs for the benefit of the rural poor. We were still groping with the complex problems and might not yet have all the answers. He referred to the PNG Development Bank as a channel for Bank Group lending for the Rural Development Program. Asked about PNG's nutritional problems, he said the Bank had also begun to move into this field and would render assistance if requested staff availability permitted. He also pointed to the need to make the remote rural areas more accessible by the expansion of a rural feeder road network.

On education Mr. Beatty mentioned that a task force was set up to resolve the political problems which held up the decision on the Government's new education policy. A decision could be expected soon and the Bank could then go ahead with its first education project.

GHR:rmj
March 28, 1974

MEMORANDUM FOR THE RECORD

Meeting with Cabinet Ministers, Port Moresby, Papua New Guinea,
February 11, 1974

Present: Chief Minister Michael T. Somare, Dr. John Guise, Deputy Chief Minister and Minister of the Interior, Mr. Julius Chan, Minister of Finance, Mr. Albert Maori Kiki, Minister for Defense, Foreign Relations and Trade, Mr. Iambakey Okuk, Minister for Agriculture, Mr. N. E. Olewale, Minister for Education, Mr. Paul Lapun, Minister for Mines and Energy, and Mr. Donatus Mola, Minister for Business Development. Also present were Mr. P. Bouraga, Secretary, Department of the Chief Minister, and Mr. Bunais Sabumei, Foreign Relations Officer, as well as Messrs. William Clark and Anders Ljungh.

Chief Minister Somare welcomed Mr. McNamara and his party on behalf of the Papua New Guinea Government. He explained the Eight-Point Statement of the basic principles of PNG's economic development which was announced by him in December 1972 and endorsed by the House of Assembly in February 1973. PNG's next development plan to be announced later this year would be based on these principles. The plan would concentrate on giving the Papua New Guineans effective control over their economy, would attempt to provide a more equal distribution of economic benefits among the population, and decentralize economic activity, planning and Government spending, with emphasis on rural development in a broad sense. PNG's development strategy would not only focus on the growth of GNP but would following traditional Melanesian ways, be development for the people.

Mr. McNamara said that he agreed with the principles laid down in the Eight-Point Program and he was willing to listen to proposals how the Bank Group could be of assistance. The discussion then centered on agriculture, the Ok Tedi and Purari projects, and on education.

Agriculture:

Several Ministers deplored the fact that agricultural development under the Australian administration focused on certain tree cash crops like coffee, cocoa, copra and, lately, tea but neglected promotion of food crops and vegetables for the local population. This was due to an attitude considering PNG to be only an exclave of the Australian economy and economic development oriented towards serving the expatriate residents. As a result, PNG's food imports in 1972/73 (July 1-June 30) amounted to A\$45 million. The new agricultural policy would therefore focus on food import substitution. A point in case was rice: in 1972/73 PNG imported for A\$12 million. Although large areas of PNG were suitable for rice growing (Sepik Districts, Markham Valley), Australia had never seriously attempted to promote rice growing. PNG had also great potential for sugar but still imported all sugar it needed. Deputy Chief Minister Guise complained that Australia had in the past on purpose sabotaged the growing of products in PNG which were directly competitive to Australian producers (e.g., sugar, rice, fruits, vegetables,). He therefore warned of employing Australian experts to advise on projects in these sectors.

Mr. McNamara endorsed the Government's policy to reduce food imports. He said that the Bank Group would support rice projects if the proposed UNDP study of rice growing in PNG would show possible results and if local production would be competitive. He pointed out that introduction of rice on a large scale would require a considerable number of extension workers. Mr. Somare said he considered hiring extension workers from Taiwan (to which the Australian Government objected), from the Philippines, or even from China.

Minister Okuk pointed to the severe protein deficiency in the nutrition of the majority of the Highland population and welcomed the Bank Group's livestock projects. This would enable PNG to phase out meat imports and broader local meat consumption. He said he understood the Bank Group was also involved in nutrition and he would welcome Bank help in that field. Promotion of livestock and vegetable/fruit farming would, however, essentially depend on the accessibility of rural areas. He welcomed the Bank's involvement in expanding and improving the PNG Highland Road network. Mr. Okuk asked for Bank support of the Madang-Highlands road connection, which was rejected by the Bank some time ago. Mr. McNamara emphasized the importance of rural feeder road construction within the overall rural development program to develop marketing opportunities for agricultural produce. Mr. McNamara warned, however, that as far as the expansion of the trunk road system is concerned, priorities would have to be worked in view of the country's shortage of available financial resources. He recommended the establishment of Government marketing organizations to substitute for expatriate traders until an effective local private trading system had evolved. Mr. Somare stressed the importance of establishing link-up industries for the processing of rural products and asked for Bank help and advice for small-industry or cottage industry projects.

Dr. Guise pointed to the problems involved in the two policy alternatives, i.e., to develop and expand existing village structures with new village centers or to transfer large populations into land resettlement schemes like in Malaysia, as it had been done, on a smaller scale, in the IDA project in Cape Hoskins. Dr. Guise pointed to the danger of uprooting people by moving them to distant areas, although he saw great merits in the Malaysian example. Mr. McNamara assured him that the Bank would never be party to a forced transfer of people to resettlement schemes.

Future Large-Scale Investment Projects

The Ministers discussed briefly with Mr. McNamara the Ok Tedi Copper Mining projects and the Purari Hydro-Scheme; recent developments in the Bougainville Copper project and plans for renegotiating the Agreement between the PNG Government and the Bougainville Mining Company were not raised during this meeting.

Regarding Ok Tedi and Purari, Mr. McNamara emphasized that the Bank would participate in financing such projects only as a lender of last resort and would lend possibly for infrastructure in connection with these projects. He pointed to the fact that in the case of Ok Tedi there

still existed considerable differences of opinion between the U. S. Kennecott Company and the Government about who should pay for the infrastructure. Kennecott apparently felt that the projected US\$80 million costs of infrastructure could not be justified by the Ok Tedi mine alone and that therefore a regional development scheme, involving forestry and agriculture should be combined with it. Some Ministers felt that prospects for a sizeable rural development scheme were dubious. Mr. McNamara pointed out that the Bank Group would only get involved if by financing infrastructure it would contribute to genuine rural development in the region; it would not want to finance infrastructure for the benefit of the foreign mining company.

Regarding Purari Mr. McNamara assured that in principle the Bank would help finance the power project and he is awaiting the outcome of the planned feasibility studies.

Mining Minister Lapun reported on the ongoing oil and gas exploration operations off the coast of Papua and along the Sepik coast. He said that prospects for gas were not bad. Answering a question Mr. McNamara said that the Bank would in general not finance oil refineries because finance from other sources was usually readily available.

Education:

Education Minister Olewale briefly outlined the great problems of creating an education system which is geared to the traditions as well as to the needs of PNG. Only 50% of primary school age children attended schools and only less than a third of them reached secondary level. The Government is groping for ways of providing formal education without uprooting the rural youth from their traditional village society. Present secondary education would produce school leavers unable to take up regular jobs adding to urban problems. Another very serious problem is the pressing shortage of teachers in technical and secondary schools due to the exodus of expatriate teachers. The Minister criticized the Bank Group that it had for a long time neglected education. Mr. McNamara responded by referring to the sharp increase in Bank loans and IDA credits for education in the last five years. He also pointed out that the Bank had an education project mission ready to go out to PNG since last summer. But the mission had been repeatedly postponed because the Government had not yet agreed on the new education program. Olewale and Somare assured that the decision on the new policy would be made soon and Mr. McNamara assured that we would send out a mission as soon as the Government was ready to receive it.

Somare asked about possible Bank support for the introduction of educational TV in PNG to overcome the current teacher shortage. The Government envisaged to establish closed-circuit TV facilities in four to five main urban centers as a first move since introduction of nationwide TV in PNG was very difficult and too costly for topographical reasons. Mr. McNamara mentioned recent Bank financing of educational TV in the Ivory Coast for primary school teachers training but cautioned about the high cost. Minister Mola suggested that educational TV should also be used to train local people in business management.

Bank Group Lending after PNG's Independence

Mr. McNamara explained that IDA lending to PNG would be continued since the country was eligible because of the low per capita income of its local population. However, IDA funds, were limited and largely preempted by big poor countries like India, Pakistan and Bangladesh. He was confident that the recent decision of the US House of Representatives against the U. S. contribution for IDA could be reversed, but funds for PNG in absolute numbers would still be small, even though on a per capita basis PNG was among the three top recipients of IDA assistance. Bank loans, however, had been given to PNG only because Australia guaranteed them. As long as PNG were not creditworthy, it would be crucial that Australia would continue to guarantee Bank loans. He would take up this matter with the Australian Government on his forthcoming visit to Canberra. He was optimistic about the outcome since Prime Minister Whitlam on the occasion of his recent visit to Washington had been sympathetic to the idea of continued Australian guarantee for Bank loans to independent PNG.

GHReif:rmj
March 28, 1974

MEMORANDUM FOR THE RECORD

Informal Discussion with Businessmen, Academics and High Ranking Public Servants, Port Moresby, Papua New Guinea, February 13, 1974.

Present: Mr. L. G. C. Moyle, Managing Director, Investment Corporation of Papua New Guinea (Chairman); Mr. Small, Manager, Commonwealth of Australia Banking Group in PNG; Mr. E. Cleland, Manager, British New Guinea Development Company, Ltd., Member of Copra Marketing Board, President of Planters Association of Papua and of National Farmers Union; Mr. Paulius Matane, Secretary, Department of Business Development; Mr. Elliot Elijah, Department of Business Development; Mr. Mahuru Rarua, Director of Cooperative Wholesale Society, Director of PNG Printing, Pacific Insurance Company, and Pagini Taxi Company; Mr. Clunies-Ross, Head of Department of Economics, University of Papua New Guinea; Dr. Ross Garnaut, Research Fellow on Economic Policy, in PNG, New Guinea Research Unit, Australia National University; Mr. Elias Vuvu, Private Secretary to Minister of Agriculture, Stock and Fisheries; Mr. John Noel, Office of the Chief Minister.

Mr. McNamara reported on his trip to the Chimbu and Eastern Highlands Districts and said that he was much impressed by Papua New Guinea's vast agricultural potential in the New Guinea Highlands, especially for livestock and for vegetable and foodgrain production. He felt more should have been done in the past and he welcomed the Government's plans to focus on rural development. Increased meat production and more varied vegetable growing would also alleviate the Highlands' nutritional problems about which, he understands, the Government was much concerned. Mr. Matane explained that this was part of PNG's colonial heritage. Australia had not promoted growing of sugar, rice and vegetables to avoid competition with Australian products. Since marketing was crucial for the promotion of food crop growing, especially in the Highlands, the Government envisaged the creation of Government marketing corporations. Private marketing organizations were largely controlled by expatriates, and their localization would take a long time. Prof. Clunies-Ross emphasized that accessibility of the villages as well as management and marketing of crops were essential to get an overall rural development program going. So far local vegetable growers had been unable to supply local markets regularly and in adequate volumes. He also pointed to the cultural difficulties to familiarize the Highlanders with cattle breeding. Mr. Vuvu reported on cooperative and private efforts to organize vegetable and fruit marketing on a wholesale and retail level in the Port Moresby area.

All agricultural experts agreed that land ownership was a serious problem and restricted availability of land for development projects. Smallholder vegetable cash cropping had been expanding wherever land had been available. The Government in its land legislation under preparation attempted to combine Melanesian traditional clan land ownership with Western ownership concepts. There was also agreement that introduction of rice and sugar as well as intensification of vegetable growing would require a substantially expanded extension service.

Extreme shortage of qualified local and expatriate extension workers was a severe constraint for the Government's import replacement program.

Mr. McNamara rejected complaints that the PNG Development Bank's interest of 7.5 percent on loans to local farmers was too high. He said the international interest rate level was much higher and considering a 10 percent rate of inflation a 7 $\frac{1}{4}$ rate was actually too cheap, because the very poor farmers would not even have access to these credits and the wealthier farmers could probably pay more. Society would in fact subsidize the wealthier farmer by the lower rates. Mr. Matane explained that most of the farmers were still in the subsistence sector, larger farms were very rare. The concept of interest was difficult to comprehend by most of the subsistence farmers.

According to Mr. Small, Australian commercial banks had been catering largely to the expatriate community and to local groups (e.g. cooperatives, local trucking firms). Credits to local individuals were mostly for hire-purchase. Small productive loans were left to the Development Bank. The local banking system was now being separated from its Australian ties. As the first PNG commercial bank, the PNG Banking Corporation would replace the Commonwealth of Australia Banking Group in PNG. He criticized that little had been done to break the oligopolistic dominance in PNG of the larger Australian trading companies such as Steamship and Burns Philp.

Regarding future mining ventures Mr. McNamara urged that optimal relationships should be negotiated between the foreign company and PNG. He felt that the Government might get better deals in negotiations with Japan which was currently under great pressure to obtain a secured long-term supply of raw materials for its economy and might therefore be more pliable with regard to benefits and control.

Prof. Clunies-Ross and Mr. Garrault explained their ideas of designing a "basic resource tax" for large enclave projects like Bougainville. The tax rate would be related to the rate of return on capital in the project, to be recalculated annually for the determination of the tax rate. The plan would guarantee the foreign investor a 15 percent rate of return below which no tax would be paid. If the rate of return rises the tax rate would increase at a progressive rate. Mr. McNamara considered the idea in principle reasonable, but details regarding the rate structure which had still to be worked out could be crucial.

Asked whether a recent Japanese commercial loan to PNG at 8.25 percent was unfavorable as alleged in Parliament, Mr. McNamara said that with a 10 percent inflation rate the real interest was still negative and the loan was a good deal. He warned that too low a level of interest in PNG would be detrimental to economic development. With capital underpriced and labor, which was ample in PNG, overpriced, this could lead to replacement of labor-intensive by capital-intensive production methods and cause serious distortions and dislocations in the economy.

MEMORANDUM FOR THE RECORD

Meeting with Mr. L. G. C. Moyle, Managing Director of the Investment Corporation of Papua New Guinea, February 13, 1974, Port Moresby, Papua New Guinea

Present: Mr. Moyle, Mr. McNamara, Mr. William Clark, Mr. Anders Ljungh.

Mr. Moyle briefed Mr. McNamara on the objectives and policies of the Investment Corporation (IC): its main objective was to provide for equity interests by Papua New Guineans in major overseas enterprises operating in PNG; its main activities were investment, the raising of investible funds and the retailing of equities. The IC had so far made 15 investments totalling A\$11.5 million building up a well-diversified portfolio of income-producing equity investments. 75% was in existing overseas controlled companies, 25% in enterprises that were newly established. Major investments include a 20% share (held by IC and PNG Government combined) in the Bougainville Copper Pty. Ltd., a 26% share in Burns Philp (New Guinea) Ltd., (retailing, hotels and shipping), and 35% share in Commonwealth - New Guinea Timbers, Ltd. (previously an Australian Commonwealth Government enterprise). IC would use its influence on the boards of the companies to promote more employment, active training, and career opportunities for local people, and the development of local customers and sources of supplies. IC has currently a staff of 22, still mostly expatriates.

So far PNG Government capital grants accounted for a substantial portion of IC's financing (1972/73: 42%) in addition to loans from the Australian and PNG Governments (34%), and loans from private sources (21%). Retained profits accounted for A\$300,000 or 31% of sources of funds in FY72/73. Borrowed money is used for acquiring shares in existing enterprises while grants are being increasingly used to establish new enterprises in field which are also emphasized by the Government's new development strategy.

As a first step to retail equities to Papua New Guineans a \$750,000 Unit Trust Fund was established in September 1973 which had so far 500 Papua New Guinean participants. Most of the participants are local groups, e.g., local Government Councils, Cooperatives, sport organizations, but still few individuals invested in the Fund. The Fund invested in best portfolios (currently eight "blue chip" enterprises). The stocks are valued on the basis of three-year moving averages. I.C. ensured that investors and potential investors would understand the risks, benefits and responsibilities of equity investment. Most local people had still unreasonably high expectations regarding profits.

GHReif:rmj
March 28, 1974

MEMORANDUM FOR THE RECORD

Meeting with Opposition Leader, Papua New Guinea, February 13, 1974

Present: Mr. Tei Abal, Leader of the Opposition, and Mr. W.A. Lussick, Opposition Party Official, and Mr. McNamara

Mr. McNamara asked about the prospects for independence. Mr. Abal was skeptical of political independence before more economic development had taken place. PNG would not be able to repay large loans. Self-government and independence mean requirement for a larger budget. Militant attitude towards foreign investors may destroy PNG confidence abroad. He asked the Bank's policy on major projects.

Mr. McNamara said the Bank wants to be of continuous help to PNG. Since the level of income in PNG is low, concessionary aid is needed and IBRD money will have to be guaranteed by Australia.

Mr. McNamara asked about the prospects for development in the highlands. Mr. Abal said that the problems are among other things to find markets for vegetables grown in the highlands. Australian imports would have to be stopped and air freight subsidized. Coffee could be more widely produced. For both coffee and livestock constraints are lack of financing and roads. Mr. Abal said that feeder roads have been and should be constructed and financed locally. He did not think that land tenure was a major obstacle to livestock production.

Mr. Abal expressed concern over the form of government proposed and said that the Westminster system may have to be modified considerably. He said that the present government may be influenced by socialists or communist ideas and he was worried about the rapid outflow of Australians, since expatriates would be needed for some time to come both for technical competence and as a counterweight to leftist tendencies.

AL
March 1, 1974

President has seen

4

October 17, 1975

MEMORANDUM FOR THE RECORD

From: S.S. Kirmani, Acting Regional Vice President,
East Asia and Pacific

Subject: PAPUA NEW GUINEA: Meeting of Mr. Somare with
Mr. McNamara

1. Mr. Somare, Prime Minister of Papua New Guinea, accompanied by Mr. P. Matane (Charge d'Affaires of Papua New Guinea in Washington) and Mr. Paul Bengo (Assistant to Mr. Somare) met with Mr. McNamara on Thursday, October 9 at 6.30 pm. Also present were Mr. W.A. Green (Executive Director for Australia, New Zealand and Papua New Guinea) and Messrs. Kirmani, Votaw and Helmers.

10/20
2. Noting that Mr. Somare had deposited the Instruments of Acceptance and signed the Articles of Agreement of the Bank, IDA and IFC during the afternoon, Mr. McNamara bid Papua New Guinea a warm welcome to the Bank Group. Mr. Somare responded that Papua New Guinea was very grateful for the assistance it had so far received from the Bank and IDA, and that it counted on continued assistance. PNG has good natural resources (hydro-electric energy, copper, timber, coffee), and it believes it can become self-reliant in the not too distant future. Mr. Somare assured Mr. McNamara that whatever PNG borrowed from the Bank it would pay back.

3. Mr. McNamara responded that the Bank Group will do everything it can to help PNG within the limits of the Group's resources, which were far less than needed by the developing member countries. As regards IDA credits, Mr. McNamara had allocated to PNG three to four times as much as would be its share on a straight per capita allocation basis. This was justified because PNG is a small country and newly independent. Creditworthiness criteria must be fulfilled before the Bank can extend Bank loans to a country. Mr. McNamara wanted to make clear to Mr. Somare that, because of the many uncertainties, the Bank has not yet been able to say that PNG is creditworthy. A mission would visit PNG shortly to update the Bank's knowledge about the economic situation. Moreover, the PNG Government should understand that, even if PNG were considered creditworthy, the amount of money the Bank could make available would be limited.

4. Mr. Somare replied that PNG has demonstrated its ability to face the facts of life; for example, since Australian aid for this year is much less than expected, he and his Ministers had decided to cut this year's

October 17, 1975

budget expenditures by 50 percent. Long-term aid discussions with Australia had started at the official level last week and are to continue in November between the Ministers of Finance. A large part of the Australian aid is presently earmarked for the compensation of Australian civil servants who are leaving the country (down from about 7,000 a few years ago), and he expected that eventually only about 2,000 would be retained. The PNG people are aware of the financial constraints the Government faces, and support the budget cuts. As Mr. Green remarked, the labor unions have also shown a very responsible attitude and have deferred their requests for salary and wage increases.

5. Mr. McNamara was very pleased that the agreement with the Bougainville Copper Company had been renegotiated. He had heard, however, about the recent secessionist movement of Bougainville and asked whether this had to be taken seriously. Mr. Somare replied that only a small group wanted to secede and that the majority of the Bougainville population stood behind his Government. In fact, two of his Ministers were from the Bougainville area. He had discussed the matter with the Council of Ministers of the Solomon Islands - the Bougainvilleans are ethnically related to the Solomons - and had been assured that the Solomon Islands would not support the secessionists.

6. As the last topic, the lending program was discussed briefly. The only project scheduled for this year is the Popondetta Oil Palm Project, for which an IDA credit is planned to finance smallholder development. For next year the Bank Group plans to lend for a revised Highlands road project (which needs reappraisal once the changed scope is defined clearly) and an education project. A preappraisal education mission is presently in the field. Mr. Somare said that for the future he hoped that the Bank Group could also provide assistance to make the country self-sufficient in sugar and rice. As regards the proposed Bialla oil palm project, the PNG Government is seeking formal arbitration as a means of renegotiating its agreement with the Japanese investors.

Cleared with and cc: Mr. Votaw
cc: Mr. McNamara
Mr. Knapp
Mr. Bell (o/r)
Mr. Kirmani

LHelmers :vh

R. Mc N File

OFFICE MEMORANDUM

TO: Mr. Robert S. McNamara

DATE: October 7, 1975

FROM: S.S. Kirmani, Acting Regional Vice President, East Asia and Pacific

SUBJECT: PAPUA NEW GUINEA: Visit of Prime Minister Somare

64-68 7.
67-73 63.
74-78 48.
79 11
76 0
76 12

*1. Will apply same effect then
2. IDA allow more than twice
the value.
3. Even if creditworthiness shall be
not over
and sample
4. ...
your
Rajiv
A. ...*

1. I am attaching a Briefing Paper for your meeting with Prime Minister Somare on October 9 at 6:30 p.m., based mainly on information collected for our discussions during the Annual Meeting.

2. Although we were informed that the Prime Minister's visit would be mainly a courtesy call, the following matters may be relevant for the discussions.

3. As you will remember, the creditworthiness issue was discussed extensively during the Annual Meeting, by you in your meeting with the Australian Delegation, by Burke and Bernie in their discussions with the PNG Delegation, and again by Bernie when he visited PNG in September for the Independence celebrations and Canberra thereafter. Minutes of these meetings are included in the Briefing Paper as Items 5 and 6.

4. We explained that, on the creditworthiness of Papua New Guinea for Bank loans, we would like to defer our judgment until we had reexamined all the relevant factors, based on the findings of an economic mission scheduled to visit PNG later in 1975. The mission is scheduled for November/December and will be headed by Mr. Hawkins, Senior Economist, East Asia and Pacific Country Programs Department. The mission should be able to review export prospects--particularly of agricultural commodities--in the light of the recent decline in prices, make short-term projections of balance of payments including changes in the reserve position, examine the new links with the Australian currency and banking systems--all matters which are important for judging debt service capacity. The mission should also be able to make some judgment on administrative viability based on the brief post-Independence experience. Incidentally, an IMF Acquaintance Mission will be in PNG in November and our mission will try to overlap with them.

5. The Lending Program FY76-80 is included in the Briefing Paper as Item 8. As a result of recent Government decisions discussed with Bank staff during the Annual Meeting and in the field, the following developments have occurred: The Highlands Highway Project, for which bids were received in July 1975 and for which a Bank loan had been scheduled for Board action prior to Independence in FY76, has been abandoned by the Government. Instead, the Government is considering proposing to the Bank a substantially reduced project for improving only certain sections of the Highlands Highway, which would provide the basis for a Bank loan or IDA credit of the order of US\$10 million, which could be ready for Board consideration in FY77. The only other project scheduled for FY76 is the Popondetta Oil Palm Project, on which a note is attached as Item 9. The nucleus estate and factory development components of this project will be financed by joint venture arrangements between Government and the Commonwealth Development Corporation (CDC). The IDA credit

10/8

./...

October 7, 1975

will contribute to the financing of the smallholder development. Negotiations between CDC and the PNG Government are progressing well. Subject to their completion, we are planning for a follow-up appraisal mission in November 1975. We expect the project to be on schedule and to use the entire IDA allocation of US\$12 million for it. The original scheme included a companion project, the Balla Oil Palm Project, which has been dropped from the Lending Program in view of the dispute between the Government and the Japanese joint venture partner on the design of the mill equipment.

6. A Bank mission which just returned from the field has tentatively identified two further agricultural projects for possible Bank Group financing in FY77 and 78; one a rural development project in the Southern Highlands District, the other a project focusing on the development of foodgrain, sugar and tobacco industries, and management training for community-owned plantations. Details are given in the Briefing Paper under Item 10. We are also sending a mission in October to identify an education project which may include primary teacher training, community-oriented education, and agricultural vocational training.

7. Concerning membership in the Bank Group institutions (and the IMF), we understand that the Prime Minister would like to sign during his visit the Articles of Agreement and deposit the respective Instruments of Acceptance. This can be done provided the required payments of subscriptions are completed. Tentative arrangements have been made for the signing of the Bank and Fund Articles of Agreement at the State Department at about 2:30 p.m. and for the signing of the IDA and IFC Articles in the Board Room at about 6:00 p.m. on October 9 prior to the meeting with you.

cc: Messrs. Knapp (with the Briefing Paper)
Votaw

Hasan
Hawkins
Helmerts

SSKirmani/JMJentgen:mh

BRIEFING PAPER
PAPUA NEW GUINEA

Contents

1. Creditworthiness
2. Current Economic Situation
3. Note on the Bank's Decision not to Consider PNG Creditworthy
4. Extracts from Draft Economic Report Relating to Creditworthiness
5. Minutes of Meetings: Mr. McNamara - Australian Delegation,
September 1, 1975
Mr. Knapp - PNG Delegation, September 2, 1975
Mr. Bell - PNG Delegation, September 2, 1975
6. Telex by Mr. Bell, September 30, 1975
Minutes of Meetings: Mr. Bell - Visit to PNG, September 14-17, 1975
Mr. Bell - Visit to Canberra, September 19, 1975
7. Biographical Data
8. Lending Program FY76-80
9. Note on Popondetta Project (FY76)
10. Note on Agricultural Development Projects V and VI
11. Note on Application for Membership

PAPUA NEW GUINEA

Creditworthiness

1. The 1974 economic mission to PNG reached the tentative conclusion that PNG should be considered creditworthy for a limited amount of Bank lending some time after Independence; this determination was heavily qualified by a number of uncertainties regarding PNG's political and economic future. (A preliminary draft of the mission's report was given on an informal basis to Australian and PNG officials for review and comment; extracts from the economic report (in a somewhat edited form) are attached as Item 4.

2. The following few paragraphs present updated information on major issues relating to creditworthiness.

3. Administrative Viability: We agree with both Governments that manpower will be the most serious constraint facing PNG for the next decade or so. It is severely restricting development planning and project implementation capacity, and forces the public service to rely very heavily on expatriate expertise, at considerable cost. Moreover, the presence of large numbers of expatriates keeps the salary scale for all government employees higher than would otherwise be justified. The problem is made even more acute by the complexity of the task facing PNG's public service immediately after Independence. Not only will normal Government functions have to be carried on but, in addition, the structure and functions of the public service will have to be reshaped into a form more suitable for an independent nation state. The Government is, of course, aware of the problem and has initiated a vigorous recruitment drive. Thus far, more than 900 expatriate professionals have been hired (mainly from New Zealand, Australia, the Philippines, Sri Lanka and the United Kingdom) to replace departing expatriate civil servants. These efforts will have to continue, and in fact accelerate, since it is likely that many of the present contingent of some 3,000 Australian expatriates will eventually leave PNG. Unlike the past, counterpart training is a major emphasis in the job descriptions for most expatriates presently being recruited.

4. Political Situation: There has been no test of PNG's spirit of national cohesion. Secessionist threats have been heard several times in the last few years, most of which need not be taken seriously. The most recent, and the most serious, comes from Bougainville District which, for the past year or so has been voicing its dissatisfaction with its share of benefits from the huge copper mine, and its share of Government investment funds. Following several threats to do so, in June the Provincial Assembly

formally voted to secede. Various Central Government emissaries, including the Chief Minister, have visited Bougainville to publicize to the people the benefits of a unified PNG, and the Central Government has remained adamant that national unity is not a negotiable issue. The Provincial Assembly has set Bougainville's Independence date for September 1, preceding PNG's on September 16. However, the Bougainvillians have thus far made no "implementable" plans to carry out their threats. After Independence, when the Chief Minister has full control of the armed forces and ultimate authority within PNG, the secessionists will most likely be squelched.

5. Australian Aid: Australia has made a commitment to PNG of A\$500 million in financial support for the three fiscal years 1975/76-1977/78. Without such aid and more, PNG would not be financially viable. The composition of Australian aid during FY75 and 76 is approximately as follows (A\$ million):

	<u>FY1975</u>	<u>FY1976</u>
Total Aid	170	210
Compensation Payments for officers who left service of PNG	30	49
Payment of salaries of Australian civil servants	56	51
Direct grant to PNG budget	90	110

6. Ok Tedi and Purari: The draft Economic Report projected revenues from Ok Tedi (copper mine) and Purari (hydro-electric energy) beginning in the mid-1980's, which would contribute significantly to strengthening Government revenue and domestic resource mobilization. Recent developments, however, suggest that this is unrealistic. Earlier this year, negotiations with the Kennecott Copper Company (which had been exploring the Ok Tedi deposit) broke down completely. The Government is continuing the drilling phase and is looking for a new partner, but has yet to find any likely candidates. Massive infrastructure which will be required to exploit the deposit make the Ok Tedi project, on its own, a marginal one at this point. Thus, to ensure its viability, the Government wishes to verify the size of the Ok Tedi deposit itself as well as other nearby deposits which could share the cost of the infrastructure. Two such deposits have recently been discovered, and the Government is hopeful of finding others. Thus, while the project may go ahead, construction is unlikely to commence until after 1980, about three years later than previously estimated. At the earliest, then, the project would not begin to generate any revenues until the late 1980's. Investigations into the Purari hydro scheme have recently uncovered technical problems which could scotch the entire project and will certainly delay it by several years. Furthermore, there is clearly no financial or economic basis for the project unless and

until arrangements have been concluded with foreign firms for the establishment of large electric power consuming operations, e.g., aluminum smelters. All experience elsewhere indicates that the consummation of such arrangements would require protracted negotiation, especially if more than marginal benefits to PNG were expected. Hence, the likelihood of realizing substantial revenues from this project within the next decade has also been markedly diminished.

7. Bougainville Copper Exports: The renegotiation of the agreement with Bougainville Copper Company significantly increased PNG's revenues to a level of about US\$60 million in fiscal year 1973/74. However, future revenue generated from Bougainville will vary with the level of international copper prices. The volatility of this price is well demonstrated; since the staff analysis a year ago, the copper price has fallen substantially. It has not yet been possible to revise balance of payments projections, but it seems likely that the payments and reserve position of PNG has deteriorated from the level forecast a year ago.

8. It is not possible on the basis of present information to recommend Bank lending for PNG. Normally, we would consider that such a poor country just reaching independence should not be burdened with service of relatively hard-term Bank debt and should receive IDA assistance. However, because of an apparently rich endowment of mineral and other natural resources, the promise of continued large-scale grants from Australia and the persuasive insistence of PNG authorities, the staff is prepared, during the next six months, to analyze information normally required in connection with a creditworthiness judgment. It would be an error to raise optimistic expectations; equally, it would be wrong to suggest that Bank Management has a closed mind on the creditworthiness issue or to take steps which Somare's Government would interpret as undermining PNG's other efforts to raise resources internationally.

2. CURRENT ECONOMIC SITUATION

1. An economic mission visited PNG in May/June 1974, and an updating mission is proposed for October/November, 1975. No report has yet been circulated. A brief discussion of PNG's economy is presented in the following paragraphs.

2. PNG's aggregate economic growth in recent years has been relatively rapid. GDP has averaged some 9 percent in real terms since the fiscal year beginning in mid-1967 (1967/68). However, this aggregate is not very meaningful in the context of PNG's economy, which is comprised of three parts: the subsistence economy, the monetized sector and the large Bougainville copper mining complex (which by itself constitutes a separate enclave).

3. The subsistence economy accounts for about one-sixth of GDP (pre-Bougainville it was almost 30 percent). It encompasses 70-80 percent of the indigenous population who live in primitive conditions and are engaged in traditional agriculture. In recent years, there has been little apparent growth in the subsistence sector, and the proportion of people entirely or partly dependent on it has remained nearly constant. It appears that subsistence output has, in general, been sufficient to feed the population, although certain nutritional deficiencies have been documented. The improvement of living standards in the subsistence sector will be an important task for PNG in the next several years.

4. The monetized sector (exclusive of Bougainville) contributes about 60 percent of GDP (70 percent before construction for Bougainville began), and consists mainly of the service sector and export-oriented plantation agriculture. Services account for 35 percent of total GDP; within this sector, the importance of Government has increased significantly in recent years. Moreover, employment in services has grown rapidly in recent years, rendering the economy very susceptible to wage inflation. Expatriate-owned plantations have traditionally accounted for some 60-65 percent of monetized agricultural production, mainly coffee, coconut products, cocoa and rubber, which are exported with little or no local processing. Since 1970/71 significant price increases, by as much as 50-75 percent for some commodities, have brought about a marked increase in export commodity earnings. In 1973/74 the total value of output more than doubled, thus raising the share of monetized agriculture in total GDP to an estimated 17 percent.

TABLE 1
SECTORAL COMPOSITION OF GDP
(at current market prices)

	1967/68 ^{/a}		1970/71		1973/74 ^{/b}	
	US\$ Mln	%	US\$ Mln	%	US\$ Mln	%
<u>Subsistence Sector</u>	<u>180</u>	<u>29</u>	<u>197</u>	<u>22</u>	<u>230</u>	<u>16</u>
<u>Monetized Sector</u>	<u>439</u>	<u>71</u>	<u>685</u>	<u>78</u>	<u>1,194</u>	<u>84</u>
Agriculture, Forestry	92	15	116	13	245	17
Fisheries						
Mining ^{/c}	4	1	3	1	334	24
Services	232	37	370	42	495	^{/d} 35
of which Government	(53)	(9)	(110)	(13)	(210)	(15)
Other ^{/e}	111	18	196	22	120	8
<u>TOTAL GDP</u>	<u>619</u>	<u>100</u>	<u>882</u>	<u>100</u>	<u>1,425</u>	<u>100</u>

^{/a} PNG's fiscal year runs from July 1 to June 30.

^{/b} Estimated, data on origin of GDP do not exist after 1971/72.

^{/c} As these figures demonstrate, a small amount of mining took place before the Bougainville Project, but in 1973/74 this project accounts for the great bulk of value added in the mining sector.

^{/d} Includes the transfer of certain functions previously under the jurisdiction of Australia.

^{/e} The high level in 1970/71 was due to the construction of the Bougainville project.

5. By far the most dramatic development in PNG's economy has been the copper mine at Bougainville. However, only about 3,500 new jobs resulted, and the indirect benefits to the economy have been almost nil. Revenue from the project has been limited by a tax holiday through mid-1974; a tax on repatriated dividends and a small royalty payment together amounted to some US\$20 million in 1973/74, or only about 8 percent of the company's US\$225 million profits in that year. PNG renegotiated its agreement with the Company in mid-1974, making the Company subject to income tax payments; and it is expected that Government revenues will amount to some 50 percent of total Company profits in future. This is a particularly important consideration given the limited scope for taxing the indigenous population. The economic mission projected the

Company's profits at about US\$225 million per annum, and the Government's profits at some US\$110 million. Copper prices have, however, fallen since then and new copper price projections have been made. We have not been able to incorporate these into the profitability analysis, but it is certain that Government revenues will be substantially less than originally forecast, perhaps by as much as 50 percent.

6. The balance of payments picture, traditionally one of chronic deficit, has been considerably improved since copper began to be exported in 1970/71. In 1973/74, for the first time, there was a modest surplus on the goods and services account, resulting from copper exports from Bougainville and high prices for agricultural exports. Copper, representing some 70 percent of total merchandise exports, should continue to dominate the export mix for at least the next decade. However, the wide margins within which copper prices have fluctuated historically imply a high degree of vulnerability for future export earnings. Imports continue to be the major source for satisfying the demand for consumer goods and, of course, for capital goods. This latter category has fallen off considerably since the end of the Bougainville construction period but may be expected to pick up again if other enclave projects currently under consideration go forward. This will put the overall balance of payments again into a deficit position. But such deficits would have to be financed largely through commensurate private capital inflows, as in the past.

TABLE 2

Summary Balance of Payments
(US\$ million, in current terms)

	<u>1967/68</u>	<u>1970/71</u>	<u>1973/74</u>
Exports, incl. NFS	106	154	662
(of which copper)	(-)	(-)	(362)
Imports, incl. NFS	196	494	433
(of which capital goods for Bougainville) /a	(-)	(219)	(-)
Factor services (net)	-15	-48	-167
Balance of goods and services	-105	-388	+62
Official transfers (net) /b	162	197	300
Public M< Loans (net)	7	43	30
Private capital (net)	-3	258	38

a/ Estimated.

/b These figures do not strictly correspond with budget transfers as shown on Table 3. This is due to the inclusion in the above figures of some non-budgetary transfers such as direct salary payments to Australian civil servants, as well as direct expenditures by Australian authorities in PNG. In 1973/74, the above transfer item is smaller than that in Table 3, since the latter includes the transfer of ownership of certain military hardware already in PNG, which is not shown in the balance of payments.

7. A serious problem facing PNG is the level of Government expenditure which far exceeds Government revenues. In 1973/74, current public sector outlays totaled some US\$408 million, while revenues were some US\$194 million, resulting in a deficit of some US\$214 million. Since the revenue generating capacity of the economy is limited, it is expected that these deficits will continue into the foreseeable future. Australia, which has financed the deficits in the past, has committed itself to make available a total of some US\$750 million from 1975 through 1977; a significant part of this, however, appears to be ear-marked to pay for pensions of Australian nationals who formerly worked in PNG and for government installations being handed over to PNG.

TABLE 3

Central Government Revenues and Expenditures

(US\$ million - current terms)

	<u>1967/68</u>	<u>1970/71</u>	<u>1973/74</u>
<u>Domestic Revenues</u>	61.2	105.1	194.7
(Tax)	(43.4)	(86.3)	(133.7)
(Non-tax)	(17.8)	(18.8)	(61.0)
<u>Current Expenditures</u>	151.0	238.8	408.2
<u>Current Deficit</u>	89.8	133.7	214.5
<u>Capital Expenditures</u>	31.9	59.9	92.4
<u>Overall Deficit</u>	121.7	193.6	306.9
<u>Financing</u>			
Australia	113.6	186.0	315.3
Domestic	8.1	7.6	-8.4

8. For at least another decade, PNG will face a serious shortage of skilled manpower. Many expatriates, who have been in PNG for a number of years and are familiar with the country's problems, are departing. In the public sector the level of localization is unusually low, particularly at the upper levels, for a country reaching independence, reflecting inadequate training of counterparts in the past. The problem is being dealt with by an energetic recruitment program, and a substantial number of experts from abroad have been hired to replace those who departed recently. Development planning and project implementation capacities are nevertheless extremely limited, and the public service will need considerable expatriate assistance for some time to come to function effectively. Any development strategy will have to give top priority to training and manpower problems. During the last 9 months, the Government has hired some 900 expatriate professionals (mainly from New Zealand, Australia and the Philippines) to replace departing expatriate civil servants. These efforts will need to continue since it is expected that a large proportion of the remaining contingent of about 3,000 Australian Government employees will leave PNG, many in the next year or so, even though the Australian Government has recently introduced financial incentives to encourage experienced Australian public servants to remain in PNG following independence.

3. PNG - CREDITWORTHINESS FOR BANK LENDING

1. A staff assessment of the creditworthiness of PNG for Bank lending must be based on criteria developed and applied to all member countries. The principles involved are well known and were last set out, as far as PNG is concerned, in a communication from the Bank to the Minister (Financial) of the Embassy of Australia in September, 1973. It is worthwhile repeating the key sentences of that statement, since they still apply:

"Since service payments on a Bank or other external loan have to be made in foreign exchange, the ability of a country to meet its obligations will depend not only on the country's domestic economic management and performance, including the expected growth of domestic output, savings and government revenues, but also on the prospective evolution of the country's balance of payments and reserve position. These, in turn, will depend on the long term export prospects, the need for imports to sustain the growth of the economy, and of course the net flow of capital. The amount of foreign exchange that will be preempted to service existing and future debts will influence the balance of payments and reserve position and the growth prospects of the country and must, therefore, be taken into account. A rough guide in assessing all these factors is the so-called debt service ratio which expresses future payments of interest and amortization as a percentage of future foreign exchange earnings. However,, debt service projections are supplemented with an overall assessment of the country's economic performance to determine its eligibility for Bank loans."

2. The main emphasis is placed on the external position of the country, focusing on the prospective balance of payment's position and its debt servicing obligations. In the case of PNG an unusual degree of uncertainty attaches to such forecasts and projections at this time.

3. An assessment of creditworthiness begins with estimates of the foreign exchange earning ability of the economy. This means a careful analysis of the prospects for exports. Since the value of exports is now dominated by copper, such an analysis for PNG is largely concerned with the prospects for the world price of copper ore and concentrate, the volume of production likely to be achieved in PNG, and PNG's expected net share of the export earnings. The volatility of world prices is well known. The fall in prices in recent months and the lower future prices now being forecast are bound to make the prospects for export earnings look less bright than they were a year ago; these changes also have serious implications for the fiscal situation.

4. The volume of future production will also depend partly on price trends and the development of new deposits such as Ok Tedi. Also, most important may be the evolving relationship between the present producer (the Bougainville Copper Company) and the Government. It is obvious that the size and timing of the exploitation of new deposits depends on the negotiations between an independent

PNG and appropriate foreign concerns. These negotiations must include a solution to the problem of financing the required infrastructure, which is certain to be costly compared with other demands on PNG's limited financial resources.

5. The degree of uncertainty attached to all the above issues has increased during the last year. Nevertheless, the natural resource base of the economy appears to be such that the longer term prospects for additional export earnings from minerals are good.

6. The other part of PNG export receipts comes from agricultural commodities, which in the past have been produced largely on plantations. Within agriculture structural changes are expected after independence, and indeed such changes are to be welcomed as a means of drawing a higher proportion of the population into the monetary economy. It is uncertain, however, how such structural changes will affect output and exports. The Bank staff's analysis in 1974 reflected this uncertainty by discounting official projections of export earnings, particularly for plantation production. Nevertheless, even those discounted export projections showed substantial rates of growth both in volume and total value over the next decade. Achieving these rates will depend on the maintenance of a level of government services equivalent to those of the recent past and also imply full implementation of priority government programs in agriculture and rural development. This, in turn, underlines the importance of maintaining an adequate local and district administration and developing skilled manpower to staff basic institutions at the local level.

7. Other items in the balance of payments are also important to the assessment of creditworthiness. In its analysis last year the Bank staff concluded that, even excluding major projects (which could be financed largely from large inflows on capital account tied to such projects), "PNG would still show large deficits in its balance of goods and services which, in the absence of Australian grants, would result in a large negative current account." This analysis now requires revision to relate recent changes in world commodity markets to the development prospects of PNG. Needless to say, deficit in goods and services is characteristic of a developing country undergoing structural change; the creditworthiness analysis must address both the probable size of that gap and the likely external sources of financing it.

8. Both short and long term capital flows are likely to be affected by exceptional uncertainties in the early stages of independence. There is particular difficulty in projecting short term items, including likely changes in the reserve position of the country. The nature of the new links with the Australian currency and banking systems will be crucial to the resolution of this uncertainty. For example, if the Kina and the Australian dollar are linked in a way which will make one currency automatically convertible into the other, this would imply a quite different pattern of reserve holdings and short term monetary movements from a regime in which the Kina would be free to change its value vis-a-vis the Australian dollar. Short term capital flows, and hence the short term element in the debt structure, will be particularly sensitive to such new monetary arrangements as well as to political uncertainties.

9. Although primacy is given to the balance of payments and debt situation in assessing creditworthiness, the Bank has also been very much concerned with the public finance situation. Insofar as there are close links between export receipts and tax revenues in PNG, the estimates and forecasts prepared a year ago now require revision. These revisions may well produce a more gloomy assessment and will certainly not change the conclusion that the fiscal situation is still heavily dependent upon external aid and is likely to remain so over the next decade.
10. Concern over the weak fiscal situation is linked to the concern expressed about the administrative capability of PNG. The Bank staff agrees with the Government's own assessment that the shortage of skilled manpower is likely to be the most serious constraint to economic development in the foreseeable future. Of course, one way to alleviate the shortage of skilled personnel in the short run is to employ expatriates; but while their contribution to maintaining an adequate administration, training local staff and expanding development capacity will be considerable, the cost of such expatriate staff will be a significant burden on the Government's budget. The extent to which expatriates can be employed will be linked directly to the amount of grant aid available in the short run and to the growth of money incomes and domestic revenues in the longer run.
11. A creditworthiness judgment, therefore, involves an interlocking set of considerations including export prospects, import requirements, the subsequent balance of payments situation, public finances, external capital flows and the overall administrative capability of the Government. Uncertainties in making these judgments for PNG are unusually large. Clearly, the crucial requirement is a peaceful transition through the first months of independence such that law and order is maintained, ongoing enterprises continue to operate at their present levels and the flow of private investment is at least continued at present levels and hopefully expanded. Second, there has to be sufficient confidence to permit the investment and structural changes necessary for future economic development. Here the effective use of scarce skilled manpower is basic to the economic management of the economy.
12. In view of the Bank's obligation under the Articles of Agreement to act prudently in making its loans, there is bound to be a conservative bias in creditworthiness judgments. This bias, added to the unusually heavy element of uncertainty in PNG, makes it impossible to recommend lending on Bank terms at the present time. The case for lending can only be established after the country has passed through the first stages of independence, established its own monetary regime and been given a chance to demonstrate a style of economic management appropriate to the constraints that it faces.
13. We are, of course, very much aware of the acute need for external assistance and would like to do what we can to fill the gap and encourage other donors to provide assistance. Other member countries have reached independence in the past under similarly difficult circumstances, and were denied aid on Bank terms until the uncertainties were resolved. It is not possible to make

an exception in the case of PNG; it is possible to make IDA assistance available, to keep PNG's situation under close review and to encourage similar sources of concessional aid to join with IDA in supporting PNG's development program.

4.

EXTRACTS FROM DRAFT ECONOMIC REPORT
RELATING TO CREDITWORTHINESS

I.

RECENT AND PROJECTED ECONOMIC PERFORMANCE

AGGREGATE GROWTH

1. Papua New Guinea's overall economic growth during the period of the First Development Plan has been high. GDP increased by almost 10 percent per annum in real terms between 1967/68 - 1972/73. The monetized sector's rapid economic growth of the early sixties continued and culminated in the boom years of 1969/70 and 1970/71, largely as a result of the construction of the huge Bougainville copper mining complex. On the other hand, according to the official statistics, growth of the subsistence sector lagged considerably at an average annual real growth of 1.7 percent, well below the estimated population growth of about 2.6 percent. The subsistence sector's contribution to GDP fell from 28 percent in 1967/68 to 19 percent in 1972/73.

2. Monetized sector GDP at real terms grew at an annual rate of 12.5 percent during 1967/68 - 1972/73. This is above the 10-11 percent target in the Plan. However, in reality the growth performance fell considerably short of the Plan objectives as the Plan did not take account of the Bougainville copper project. When the direct and indirect effects of the Bougainville project are excluded, the real GDP growth rate of the monetized sector was only slightly above 5 percent per annum, about half the Plan objectives. Assuming a 2.6 percent population growth during the period, per capita monetized sector GDP, excluding Bougainville (justified by the project's enclave nature) has risen by no more than about 2.5 percent a year. The low growth of the non-Bougainville sector of the economy was mainly the result of a disappointing performance by agriculture, especially the plantation sector.

Growth Projections

3. In an attempt to provide some guidance on PNG's future development, the PNG Government published in December 1974 macro-economic projections for the period 1974/75 through 1978/79. In the absence of a development program, they are merely "an indication of the direction and magnitude of macro-economic development on the basis of existing knowledge of trends and policies". They are defined as estimates rather than targets and would be revised when PNG development aims are more clearly defined.

4. The forecasts assume a real GDP growth by 5.2 percent per annum during the five-year period. Monetized GDP is to increase by 6.2 percent a year while the subsistence sector would grow less than one percent. Important other assumptions are that PNG's terms of trade would not worsen substantially and Government revenues would be sufficient to finance a 6.8 percent real growth of Government consumption. The latter assumption seems more realistic now as the projections have not yet taken into account the renegotiated Bougainville agreement. The forecasts also assume a recovery of fixed capital formation, moderately in the immediate future and sharply later on when major projects

like the Ok Tedi Copper Mine and the Purari Scheme are scheduled to go ahead. Private consumption in real terms is expected to increase by about 50 percent over the five-year period to 1978/79 stimulated by increased cash earnings of lower income earning Papua New Guineans who will spend a high proportion of their incomes on consumption goods. This would mean more consumption of non-essential consumer imports, unless restricted, and could have a significantly negative effect on the balance of payments in 1978/79.

Saving Trends

5. PNG's national accounts statistics on savings are incomplete. In Table 1 an attempt is made to correlate capital formation and savings on the basis of the available official national accounts, balance of payments and public finance data. According to this calculation, total domestic savings were apparently very small before the construction of the Bougainville Mine commenced. Subsequently, during the height of the construction, they rose to about 10 percent of GDP and after a temporary lapse between the end of construction and the beginning of the mining operations, they reached a record third of GDP in 1973/74 when the mine was on full stream and the entire export sector benefited from very high international market prices.

Table 1: CAPITAL FORMATION AND SAVINGS - MONETIZED SECTOR
(at current prices)
(in A\$ million)

	<u>1967/68</u>	<u>1968/69</u>	<u>1969/70</u>	<u>1970/71</u>	<u>1971/72</u>	<u>1972/73</u>	<u>1973/74</u>
Gross Investment	91.1	98.1	187.8	291.6	250.2	147.7	105.1
Current Account in							
Balance of							
Payments	+16.3	+15.7	-50.4	-124.8	-104.5	+38.0	+256.0
National Savings							
(Including							
Transfers)	107.4	113.8	137.4	166.8	145.7	185.7	361.1
Transfers (net)	114.3	123.6	134.8	149.5	147.9	166.5	211.5
National Savings							
(Excluding							
Transfers)	-6.9	-9.8	2.6	17.3	-2.2	19.8	149.8
Factor Income Pay-							
ments (net)	11.4	10.5	16.9	33.6	36.4	99.8	138.5
Domestic Savings	4.5	0.7	19.5	50.9	34.2	119.6	288.3
Central Government							
Current De-							
ficit	-63.3	-72.9	-90.5	-94.2	-122.5	-125.3	-151.1
Other	67.8	73.6	110.0	145.1	146.7	244.9	439.4
Domestic Savings as							
% of Monetized							
Sector GDP	1.5	0.0	4.9	10.5	6.9	16.1	34.2

Source: Statistical Appendix, Tables on National Accounts and Balance of Payments.

6. As official national accounts data do not differentiate between public and private savings, the Central Government's current budget deficits are introduced in Table 1 as an indicator of the savings performance of the public sector. The Central Government deficits are very large and have increased significantly in recent years. When correlated to domestic savings as a whole, this would indicate very large private savings (in addition to some savings of statutory authorities) which would have been rising rapidly and would have reached an exorbitant 52 percent of monetized sector GDP in 1973/74. It would also confirm a substantial outflow of private savings from the economy. Normally most of these outflows would probably be recorded as remittances of earnings. Up to now, the net outflow of earnings by the expatriate community from PNG to Australia has apparently not been reflected properly in the national accounts and has shown up in the balance of payments either in the private capital account or in the non-specified "residual" item, which is largely composed of the monetary movements of the banking system between PNG and Australia.

7. This fact has important implications for PNG's future macroeconomic management and especially for the separation of PNG from the Australian monetary area. The magnitude of these net outflows could provide a basis for determining the amount of the official exchange reserves which Australia will allocate for independent PNG.

PUBLIC SECTOR FINANCE

8. Papua New Guinea's monetized sector activity revolves to a considerable extent around public sector spending. Public sector consumption and fixed capital investment were equivalent to about 55 percent of monetized GDP, or almost two-thirds of the estimated GNP before the construction of Bougainville in 1967/68. In 1973/74 total public sector expenditures were 35 percent of monetized sector GDP and 50 percent of monetized sectors GNP. The Central Government (until 1971/72 the "Administration") accounted for the major portion of this, but direct outlays by Australian Commonwealth departments in PNG and statutory bodies have also been significant.

Central Government Finances

9. The PNG Government's financial situation in recent years has been characterized by a growing dependence on the inflow of resources from abroad as expenditures have increased more than domestic revenues due to the country's limited revenue base. During 1967/68 - 1972/73 the PNG Government's current expenditures increased at an average annual growth rate of 14 percent; in real terms the growth rate was approximately 11 percent. During the same period, domestic revenue also grew rapidly from A\$43 million to A\$94 million. But, since revenues covered only 42 percent of current expenditures for the period as a whole, the current account deficit increased from A\$63 million in 1967/68 to A\$125 million in 1972/73 and remained the equivalent of about one-fifth of the monetized sector GDP, or one-fourth of GNP, during the entire period.

(a) Expenditure

10. In recent years there has been a distinct shift in emphasis in the direction of Central Government expenditures in favor of education and economic infrastructure, whereas the share of expenditures for health, and other social services declined as percent of total outlays. General administration accounts now for one quarter of total expenditures and its share has been rising with approaching independence. Expenditures for commodity producing sectors (especially for agriculture) had risen during the sixties but have recently declined relatively as expatriate staff departed without immediate replacement reducing the increase in salary expenditures. Also, long-range policies for these sectors have not yet been determined, thus delaying current development programs.

Table 2: FUNCTIONAL BREAKDOWN OF TOTAL CENTRAL GOVERNMENT EXPENDITURES ^{/a}
(in percent)

	<u>1960/61</u>	<u>1970/71</u>	(Budget) <u>1974/75</u>
Commodity Producing Sectors	9.7	18.4	13.3
Economic Overheads	15.7	22.3	22.9
Education	11.5	14.9	16.7
Health and Other Social Services	26.1	15.7	13.0
General Administration and Law and Order	32.3	21.3	25.0
Other	<u>4.7</u>	<u>7.3</u>	<u>9.1</u>
Total Expenditures in A\$ million	100.0 45.8	100.0 181.4	100.0 321.0

^{/a} Excludes Australian Government department outlays in PNG and Local Government expenditures.

11. Debt service has so far not been a serious problem since it was only a few years ago that the Government began to borrow significant amounts. Debt service (including amortization) accounted for only 8 percent of current expenditure in 1973/74.

12. Central Government direct capital expenditure (excluding loans to statutory bodies and transfers of capital assets from Australian to PNG Government ownership) increased from A\$23 million in 1967/68 to A\$36 million in 1972/73. As a result of stepped-up development efforts they increased sharply in 1969/70 and remained at that level through 1972/73 as the Government purchased 20 percent equity in Bougainville Copper Pty. Ltd., and undertook the construction of the Arawa Township Development Project on Bougainville. However, since the completion of Arawa in 1971/72 capital formation by the Central Government has fallen substantially. Although the Government was able to appropriate adequate funds for capital expenditures, actual project implementation has been slow as a result of supply constraints and the declining project preparation and implementation capacity of the public sector. Another contributing factor was the absence of a comprehensive development program. In 1973/74, capital expenditures fell sharply to A\$30 million at current prices; in constant prices this has amounted to a decline by about 30 percent below the 1972/73 level.

13. In 1972/73 and especially 1973/74 the PNG Government acquired substantial physical assets of Australian Government departments in the course of taking over functions transferred from the Australian Government. Although listed in the budget as capital expenditures these transfers are merely book-keeping transactions and do not represent investments. The PNG "purchases" of these assets are counter-balanced by a corresponding special budget grant to PNG by the Australian Government.

(b) Revenue

14. Between 70 to 80 percent of Central Government internal revenue has been derived from taxation. Lately, non-tax revenue has risen sharply, as the PNG Government began to receive dividend payments and royalties from the Bougainville copper mine. PNG's revenue performance appears favorable by international comparison; the ratio of tax receipts to monetized sector GDP is about 10 to 11 percent, although that ratio hardly increased since 1967/68. However, since about 80 percent of tax revenue was collected from the very high income expatriate sector, the tax burden on the indigenous economy has so far been light. The favorable tax climate has been considered necessary as an incentive to the expatriate community and to attract foreign investments.

Table 3: GOVERNMENT REVENUE AS PERCENT OF GDP AND GNP

	% of GDP		% of GNP ^{/a}	
	1967/68	1973/74	1967/68	1973/74
Tax Revenue	10.2	11.1	12.0	15.0
Income Taxes	(4.7)	(6.3)	(5.5)	(8.5)
Import Duties and Taxes	(3.8)	(2.7)	(4.5)	(3.7)
Excise Duties and Other				
Domestic Taxes	(1.7)	(2.1)	(2.0)	(2.8)
Non-Tax Revenue	<u>4.2</u>	<u>5.1</u>	<u>4.9</u>	<u>6.9</u>
Total Revenue	14.4	16.2	16.9	21.9

^{/a} As estimated by Mission.

The 1974/75 Budget Expenditures and Revenues

15. The 1974/75 budget has not incorporated the results of the Bougainville renegotiation. Since company tax on income is payable the year after it was earned, the full financial benefits will begin to accrue only in 1975/76. The budget provides for a 20 percent rise in current expenditures as a result of a 17 percent across-the-board increase in salaries and wages granted to the public service and a 36 percent increase in purchases of goods and services. This reflects, after the stagnation of recent years, a significant increase in Government operations with the

increase in Government functions, and more transfers to local governments and statutory bodies, plus an allowance of a 20 percent rate of inflation. Capital investment expenditures will rise by 16 percent at current prices, which means that at constant prices they may be at about the 1973/74 actual level.

16. On the revenue side, the Government broadened somewhat the domestic revenue base by several tax measures which, excluding Bougainville, may add A\$10 million in revenue. In particular, the increase in the company tax rate from 25 to 33-1/3 percent brings PNG's rates more into line with the rates of other developing countries, although it still remains substantially below the prevailing rate in Australia (45-47 percent).

Financing the Budget Deficit

17. The PNG Government's overall deficit rose to A\$126 million in 1973/74, and is expected to reach A\$223 million in the 1974/75 budget as more financial demands were made upon the budget including expenditures for functions transferred from the Australian to the PNG Government. Past deficits have been financed mainly from external sources (primarily Australian Government grants) while borrowing from domestic sources has been relatively small.

(a) Australian Financial Assistance

18. Australia's financial assistance to PNG has been generous. During the past five years it was about the equivalent of 0.7 percent of Australia's GNP. Since most of this assistance has been grant aid, PNG approaches independence with a low debt burden.

19. The Australian grant to the PNG budget rose from A\$77.6 million in 1967/68 to A\$126.2 million in 1972/73. Through 1969/70 the grant was in the form of a lump-sum payment negotiated annually with Australia to balance the PNG budget. Beginning 1970/71, the grant was divided into a grant-in-aid, a development grant, and a grant allowance to complement the salaries of Australian public servants in PNG. The salary allowance which was removed from the PNG budget to permit a more rational assessment of PNG's budget needs, was paid directly out of the Australian budget. The grant-in-aid portion was to supplement local revenue in the PNG budget and was to finance "certain well-defined purposes of a development nature." It was eventually to become the major part of Australian assistance to PNG. The grant-in-aid portion in fact decreased from A\$33 million in 1970/71 to A\$25 million in 1973/74 while the development grant rose from A\$37 million to A\$52.1 million. In the 1974/75 budget the trend was reversed in response to PNG's urgent need for completely untied budget financing and the grant-in-aid was raised by 50 percent while the development grant fell by 25 percent. Australian payments for salaries of Australian public servants in

PNG rose to a record A\$53.9 million in 1973/74, equivalent to about 45 percent of the PNG's Government total wage bill. Due to inflation this amount was raised to A\$60 million for this purpose in the 1974/75 Australian budget despite a significant decline in the number of public servants. These payments do not include termination payments and retirement benefits to Australian public servants leaving the PNG public service for which Australia spent A\$14 million in 1973/74 and has budgeted A\$40 million for 1974/75.

(b) Public Borrowing

20. Public borrowing has become an important source of Government finance in recent years. By 1973/74 gross borrowing had increased to almost A\$1.8 million or 18 percent of the deficit. Domestic gross borrowing had been limited to around A\$5 million a year during 1967/68 - 1971/72 but rose to A\$7 million in 1973/74 and will be playing an increasingly important part in 1974/75 (budgeted amount A\$10-15 million). Outstanding domestic debt totaled A\$1.2 million by June 1973, of which A\$1.0 million were private treaty loans directly negotiated with local borrowers. The rest were premium securities and saving securities. About 60 percent of the outstanding debt was held by the Australian banks operating in PNG, about 20 percent by PNG statutory authorities, another 10 percent by marketing boards in PNG (especially the PNG Copra Trust), and the rest by various other PNG institutions.

II. SOCIAL AND POLITICAL ISSUES

21. Papua New Guinea on the eve of its independence is passing through a most difficult period of social and political evolution. The impact of monetized economic activities, Western-type education, modern health services, roads, communication and transport services have accelerated and intensified the penetration of Western concepts and values into the traditional societies. Bridging a gap of centuries in a few years is proving to be a painful experience since conflicts of traditional and Western ways of life create almost insurmountable generation gaps within clans and families. Exaggerated expectations are being created by educational systems for a life style which is largely alien to traditional life.

22. The overriding political problem facing PNG on the eve of independence is national identity and cohesion. Both Australia and the United Nations consider the national unity within the present borders a prerequisite for the recognition of an independent PNG. The Australian Government in fact indicated that it would continue its financial assistance only to a unified PNG. On the other hand, the strong regional sentiments created by cultural diversity and geographical separation cannot be ignored. The period of active preparation for independence was obviously too short to instill a national spirit throughout the country. At the same time, the withdrawal of the colonial administration, which had suppressed or neutralized latent traditional tribal and regional conflicts, aggravates the situation. This leads to the question who should control PNG's political and economic life. And here the striking, almost unreal, contrast between the Papua New Guineans' nearly complete political responsibility on the one hand and their very small involvement in modern sector economy and in the middle and higher echelons of the administration on the other hand becomes politically highly sensitive.

23. The following major issues have surfaced during the deliberations on the new Constitution which is currently before the House of Assembly:

1. the question of citizenship; (since resolved)
2. the choice between a strong Presidential system versus Cabinet system with a powerless Head of State and the role of Parliament and the question of its representation; (since resolved)
3. the role, structure, responsibility and financial power of the future district governments and the reorganization of the local government structure.

24. The other important issue is the political and administrative reorganization of the country, requiring compromises between the strong regional trends and the need for a strong national government. Any solution will necessitate fundamental changes in the present administrative set-up. At present, PNG consists of 19 districts and the national capital district of Port Moresby. The district structure reflects the requirements of the colonial administration. District boundaries have been drawn fairly artificially and the districts do not necessarily reflect regional geographic or ethnic groupings. Some members of the House suggested that the districts be merged into fewer, larger and economically more viable provinces (e.g., Highlands, Sepik, Papua and New Britain - New Ireland). However, opponents feared that this might encourage separatism. Given the very different levels of development in the various districts, it will be difficult to design a uniform and generally acceptable district government structure.

III. ADMINISTRATIVE VIABILITY

25. The most serious challenge confronting PNG on the even of independence is the severe shortage of skilled manpower in the public service. The level of localization of the public service is unusually low by most standards for a developing country reaching independence. Thus, the public service has not yet the capacity to function adequately without heavy reliance on expatriates. Although high-level Papua New Guinean manpower will be increasingly available with stepped-up training efforts, a shortage will remain for some years to come. Localization efforts have so far been confined to the highest and lowest levels of the public service. Middle management remains solidly in the hands of expatriates. It is therefore essential that the present outflow of experienced expatriate public servants from PNG be arrested and the existing shortfall made up through overseas recruitment as well as stepped-up internal manpower development. Otherwise, PNG may, in the short run, be unable to undertake an effective development program, or even to maintain an adequate level of regular administrative services.

26. There are other serious concerns, felt not only by permanent officers, but by all expatriates. Chief among these is uneasiness regarding the country's financial situation. Inflation is high; income tax is being increased and there are fears that after the introduction of a PNG currency it may become difficult to transfer funds out of Papua New Guinea to Australia. Also, schools for Australian children, which exist in more major administrative centers, may be phased out. Overriding all of these is a concern for the preservation of law and order and the general social situation.

27. It is encouraging that both the PNG and Australian Governments have realized the severity of the immediate problem. Departing from previous practice, the PNG Government has begun to recruit on a larger scale public service personnel from countries other than Australia. Recruitment has been extended to Asian countries, especially the Philippines and Sri Lanka, but also to New Zealand and the United Kingdom. However, increasing diversity in sources of recruitment causes training and adjustment problems. Also, the employment of officers, without previous exposure to PNG on a single tour contract (usually two years) will probably have minimal utility. Under the remuneration system which is emerging the same position may command different salaries depending on the applicant's country of origin. This is already beginning to cause serious frictions, especially between personnel recruited from the Philippines and PNG national public servants.

28. Australia through its Australian Staff Assistance Group (ASAG) is encouraging expatriate officers, whom PNG wants to retain, to stay on by changing the remuneration terms. In addition, ASAG hires from within the Australian public service contract officers to serve in PNG over a fixed period of time to replace departing expatriate personnel. Several Australian departments are seconding personnel for shorter periods of time to PNG departments to tackle emergency situations. The Australian International Development Agency assists the PNG Government in hiring personnel from the Australian private sector. Recruiting Australians to work in PNG was difficult as long as there was near-full employment in Australia and job opportunities increased under the new Labor Government. This may have changed lately as unemployment in Australia began to rise sharply. Recruitment in countries other than Australia has been handicapped by the lack of knowledge about the respective labor markets.

29. PNG's present manpower crisis has revealed a weakness in manpower planning within the PNG Government. The Department of Labor, the Public Service Board, and the Central Planning Office each have a role in the collection and dissemination of manpower data, with none having primary responsibility. As a result, there is no comprehensive manpower plan. Neither has there been any attempt to relate the country's education system to the present and future manpower needs of both the private and the public sectors. Faced with a threat to its administrative viability, the PNG Government has at present no overall knowledge of the immediate manpower needs and existing vacancies in the public sector. Nor does the Government know for sure which expatriate personnel will remain in PNG after independence. Stop-gap measures remedy the most serious understaffing problems, by shifting scarce manpower to crisis areas. The present acute manpower shortage preoccupies the Government with emergencies and prevents it from initiating a thorough reorganization of the public service to adjust it to the fundamentally different needs of an independent developing country.

IV. RESOURCE AVAILABILITY AND MOBILIZATION

PUBLIC FINANCE

30. The performance of the public sector in PNG is crucial for overall growth. In 1973/74, public consumption and investment accounted for almost half of the monetized sector GDP outside the Bougainville project. The PNG Government's target of 6 percent annual growth of GDP from 1974/75 through 1978/79 depends on a 7 percent real growth of Government consumption and on significant improvements in public capital formation, although the Government does not specify how much of the targeted gross fixed investment of 11 percent per annum (outside large projects like Purari and Ok Tedi) would have to come from the public sector.

31. Against the background of the official PNG macro-economic medium-term projections, but without the benefit of an overall public development investment program, the mission has prepared long-term public finance projections (at current prices). They take account of the Eight-Point Improvement Plan and are within the mission's estimates of reasonable financial limitations. The projections assume declining inflation from the present 20-25 percent to about 15 percent and 10 percent for 1975/76 and 1976/77 respectively and, subsequently, to 7 percent.

32. Total Central Government outlays are estimated at about A\$350 million in 1973/74, rising to about A\$1,160 million in 1984/85. Although the 1974/75 budget appropriates only A\$381 million for these expenditures, the mission estimates actual outlays in 1974/75 to be higher, around A\$410 million, because of increases in the costs of supplies, recent public sector wage and salary hikes, and additional financial outlays as more Government responsibilities are transferred from Australia to PNG. After 1976/77, the growth of overall expenditures is expected to slow down to an average annual rate of about 12 percent, at current prices, for the rest of the decade.

Revenues

33. The composition of the country's future tax base will be significantly different from the past. As far as individual incomes are concerned the tax base will be narrower. Direct revenue contributions to the Government from the Bougainville Copper project will until the early 1980s be the single most important revenue source. Under the provisions of the renegotiated Bougainville agreement (as of October 1974), the mission estimates that the project's total revenue contributions will increase from A\$74 million in 1975/76 to about A\$145 million in 1980/81 and A\$250 million in 1984/85. Total domestic revenue is estimated to grow at an average annual rate of 15 percent. In the aggregate, PNG will obtain revenues of almost A\$1.7 billion from now until 1984/85.

Financing the Budget Deficit

34. The Central Government's current deficit would--on the basis of the aforementioned current expenditure estimates--remain in the order of A\$130-A\$150 million until 1981/82, and with beginning revenues from new large-scale projects fall to around A\$50 million by 1984/85. The overall budget deficit is expected to rise from an A\$200 million level now to about A\$300 million in the early eighties and then stay at this level. The future size and the salary structure of PNG's public service will be critical if current expenditures are to be kept within manageable limits.

35. The Australian budget grant will be an important source for financing PNG's budget deficit. In fact, continuation of this grant in a significant amount is a prerequisite for the financial viability of the mission's budget forecasts. So far Australia has committed itself to a grant totaling A\$500 million (at current prices) for the 1975/76 - 1977/78 period. The grant includes both the general and development grants, and Australian contributions to the salaries of expatriate public servants in PNG. After 1977/78 this grant is expected to decline to about A\$120 million. This would mean a reduction from about 80 percent of the budget gap in 1975/76 to less than 40 percent of the gap in 1984/85.

36. Net external borrowing is expected to finance about A\$400 million of the deficit through 1981/85--an average annual inflow of A\$36 million. About A\$300 million of this borrowing would have to be from multilateral and bilateral sources. The other A\$100 million would have to come from private sources.

37. Under these assumptions, the PNG Central Government budget would, after 1977/78, show an increasing finance gap which would have to be financed from sources other than the Australian grant and external borrowing. So far domestic borrowing has not been an important source of finance and the domestic capital market has been fairly limited. However, recent balance of payments data would indicate that PNG has had at least since 1972/73 a significant net inflow of funds from export earnings which increased the liquidity of the banking system. The mission's projections (see the following section on external trade and finance) expect overall balance of payments surpluses throughout 1978/79 and again from 1982/83 onward. Such surpluses would provide greater opportunities for domestic borrowing from non-inflationary sources. A prerequisite to such borrowings would be an appropriate institutionalization of PNG's capital and money markets.

38. Increased borrowing will, of course, raise the level of debt service payments considerably, and the Government's indebtedness will have to be watched carefully. At present, debt service (both internal and external) amounts to less than 5 percent of total Government expenditures. The debt service is bound to increase significantly as the proportion of the budget gap to be financed by borrowing rises. This will be, according to the projections, more difficult after 1980/81 when a net borrowing of around A\$100 - 150 million annually would be required. It is conceivable, however, that to help close the financing gap an additional amount could be raised in international capital markets and/or Australian grant aid could be increased.

V. CREDITWORTHINESS AND ROLE OF BANK GROUP

39. Bank Group assistance to PNG began in 1968 and now totals US\$55.5 million of Bank loans and US\$25.2 million in IDA credits outstanding. Lending has been for agriculture (livestock and oilpalm), road construction, ports, and telecommunications. The largest operation was US\$23.2 million loan for the Upper Ramu Hydro-Scheme. Bank Group involvement in PNG as an Australian dependency was designed to assist Australia in leading the country towards political independence; Bank Group aid was to supplement not to substitute for Australian assistance. PNG was eligible for IDA assistance due to its low per capita income and because of its very large external gap. Bank loans were extended to PNG with an Australian guarantee. IFC has made no investments in PNG so far. The Australian Government has stated that it would not continue to guarantee any borrowing by PNG after the country's independence. This would apply to both PNG borrowing in the Australian capital market and loans from international organizations.

40. This mission's evaluation of PNG's medium and long-term economic and financial prospects is favorable. The country has significant mineral resources, a vast hydroelectric potential, important timber resources, and vast areas of land suitable for agricultural use. Important efforts have been made to make use of these resources. The exploitation of the Bougainville copper deposits, under the renegotiated agreement with the mining company, has increased Government revenue substantially and will help to close the projected large budget deficits in future. The beginning of the copper exports has transformed PNG's chronic trade deficit into a comfortable trade surplus and long-term balance of payments prospects, though not free of considerable uncertainties, are much more favorable than could be anticipated a few years ago. After Independence the country will continue to depend on the inflow of sizeable external financial resources but this dependence will decline as net benefits accruing from schedule large scale ventures become available. While the medium-term will be a difficult period, the completion of the Ok Tedi Copper Project and of the first stages of the Purari Scheme would make PNG financially afloat by the middle of the 1980s. However, this favorable assessment is based on several assumptions and caveats which have been explained in some detail in the previous chapters.

Administrative Capacity

41. The improvement of the country's administrative capacity will be crucial for the period immediately after Independence. This depends on national cohesion as well as the Government's ability to retain and hire sufficient expatriate expertise to keep the public sector running. In the short-run, PNG's severe shortage of skilled manpower at all levels is the most serious constraint on the country's economic development. All efforts should be made to retain existing expatriate personnel and to obtain technical assistance from abroad to fill current vacancies in the public service. Technical

assistance should be obtained through multi-lateral and bilateral channels as well as by direct hiring abroad.

Investment

42. The mission's assessment of production and investment potential assumes the maintenance of a reasonable level of law and order as a pre-requisite to keep expatriate businesses within the country and to encourage new foreign investments. In particular, it is expected that the Government will be successful in keeping the plantation sector operative in the immediate future and in expanding it later, together with stepped-up efforts to promote local smallholder cash crops. The budget and balance of payments forecasts are, of course, based on the assumption that the planned major projects (Ok Tedi and Purari) will be implemented on schedule.

Public Sector

43. On the fiscal side, the Government will have to restrain wage hikes of public servants and restrict the medium-term expansion of the public service. Despite conservative estimates of future current expenditures, the mission's forecasts show large budget deficits in the eighties. Domestic resource mobilization will remain a problem until the eighties when the planned new large projects will yield revenue. In the meantime, the increased revenue from the Bougainville mine will finance only part of the growing budget gap.

Balance of Payments

44. Prospects for Government revenue and the balance of payments depend heavily on the trends in world copper prices. The problem of how to cushion PNG's economy from the detrimental effects of terms of trade fluctuations will be an important influence on PNG's development policy. The mission supports the Government's efforts to establish a special fund into which part of excess revenue obtained from the Bougainville Mine would be channeled. The Fund would be used to finance the Budget in years when revenues from Bougainville are low.

45. The mission feels strongly that during the forthcoming negotiations with Australia on the separation of currencies, PNG should be allocated sufficient exchange reserves, both official and from the Australian banking system, which would reimburse PNG for some of its losses of foreign exchange to Australia in the last few years. A sufficient exchange reserve cushion would bolster the balance of payments against the deterioration of the terms of trade. In line with the mission's projections, it appears that reserves in the magnitude of A\$250 million will be needed beyond 1975/76.

Australian Assistance

46. PNG has with the approach of Independence successfully attempted to diversify its sources of foreign finance and reduce its dependence on Australian aid. It joined ADB and borrowed successfully (with an Australian guarantee) on the German, Swiss and U.S. capital markets and from a Japanese bank. Nevertheless, the country will continue to rely on substantial assistance from Australia in the form of grants. In the mission's forecasts, Australian grant assistance is assumed at A\$190 million a year through 1976/77 and declining thereafter to a level of A\$120 million by 1984/85. Without this assistance the Budget would have deficits in the order of A\$200-230 million a year. The balance of payments would show considerable current account deficits throughout the projection period.

Creditworthiness

47. PNG's immediate future is clouded by many uncertainties which will have to be continuously reviewed. Nevertheless, PNG's medium- and long-term financial prospects have improved to such an extent that a moderate Bank lending program for PNG after Independence appears justified. The country should also remain eligible for IDA credits. Although PNG's per capita income has reached US\$290 equivalent in 1974 (World Bank Atlas), this figure includes the value of the large expatriate economic activities like the Bougainville Copper Mine and is not a valid indicator of the income of the PNG population. The per capita income of the local population may be around US\$150 equivalent as mentioned earlier.

September 9, 1975

MEMORANDUM FOR THE RECORD

From: Bernard R. Bell (by G.B. Votaw)

Subject: Annual Meeting, Washington, D.C., 1975 - Meeting with Australian Delegation

1. The following members of the Australian Delegation called on Mr. McNamara at 6.00 pm on Monday, September 1, 1975:

Mr. W.G. Hayden	Treasurer
Mr. L.W. Johnson	Director-General, Australian Development Assistance Agency
Sir Frederick Wheeler	Secretary to The Treasury
Mr. J.D.C.C. Moore	First Assistant Secretary, The Treasury

Present from the Bank were:

Mr. R.S. McNamara	President
Mr. J.B. Knapp	Senior Vice-President, Operations
Mr. B.R. Bell	Regional Vice-President, East Asia and Pacific
Mr. G.B. Votaw	Director, East Asia and Pacific Programs Department
Mr. L. Helmers	Division Chief, East Asia and Pacific Programs Department
Mr. S. Burmester	Office of the President

2. Mr. Hayden explained that he had requested the meeting to discuss the issue of Papua New Guinea's creditworthiness. In the Australian view, PNG is creditworthy. The country has a debt service ratio of only 6 percent; the country has good sources of income from mineral exports, and can count on substantial Australian aid flows; the Government, elected in 1972, has a commendable record of sound management; although there are some political problems at present these are not to be taken seriously, and new copper deposits have been discovered which would boost the balance of payments even further. All in all, therefore, Australia believes that the country is certainly eligible for World Bank loans. Mr. Hayden furthermore stated that PNG is committed to the development of its rich natural resources with the help of private investments, and he expressed the fear that if the country were not considered creditworthy by the Bank, it would not be able to attract the private capital it required.

September 9, 1975

3. Mr. McNamara informed Mr. Hayden that an economic mission was scheduled to visit PNG later in 1975 to re-examine the creditworthiness question and that he would defer any decision in the meantime. As regards Australia's concern that private investment would not be forthcoming if the Bank found PNG eligible only for IDA credits, he wanted to point out that Sudan, Zaire and Indonesia - countries that had not been eligible for Bank loans in the past - had not encountered any difficulty in attracting very large sums of private capital from all over the world. Mr. McNamara assured Mr. Hayden that the Bank would apply the same standard criteria for the determination of PNG's creditworthiness that it does for any other country. Mr. McNamara did not want to hide that he felt that at present there are many uncertainties regarding the country's future economic development. PNG is totally dependent on Australia for its financial viability. It is also totally dependent on Australian and other expatriates for administering the country. Furthermore, there are political problems, and although he did not want to attach too much weight to Bougainville's declaration of independence, it underlined the uncertainty of the situation.

4. Mr. McNamara further informed Mr. Hayden that he had allocated US\$12 million of IDA credits per annum for FY76 and FY77 (i.e., until the end of the Fourth Replenishment period), which is very large in per capita terms compared to the allocations other countries receive. He wanted to point out that, if the country were found eligible for Bank loans, the maximum he could make available would be about US\$8 million per annum. Mr. Hayden replied that Australia was not so much concerned about the level of Bank lending as about the creditworthiness rating Australia felt PNG deserves. Mr. McNamara reiterated that he would personally study the situation very seriously as soon as the mission's report became available next January or February.

5. Finally, Mr. McNamara raised the issues of: (a) the Fifth Replenishment of IDA; (b) the proposed increase in capital subscriptions to the Bank; and (c) the Third Window. Mr. Hayden answered that Australia fully supports Mr. McNamara's proposals. Australia will play a positive role in the IDA Replenishment. As regards the capital subscription, it feels it has an obligation to help increase capital transfers to the developing world, and it will support Mr. McNamara in increasing the Bank's capital. As regards the Third Window, Mr. Hayden was pleased to inform Mr. McNamara that Australia will commit itself to provide US\$5.2 million. Mr. Hayden was going to announce this during his speech at the Annual Meeting. Mr. McNamara expressed his sincere appreciation for Australia's support.

September 9, 1975

7. The meeting ended at 6.45 pm.

Cleared with and cc: Mr. Votaw

cc: Messrs. McNamara, Knapp, Bell, Kirmani, Hasan

LHelmers:vh

OFFICE MEMORANDUM

5.

TO: Files
FROM: Leslie Helmers
SUBJECT: Annual Meeting: Meeting of PNG Delegation with Mr. Knapp

DATE: September 9, 1975

1. At the request of the PNG Delegation a meeting was held with Mr. Knapp in the Sheraton Park Hotel on Tuesday, September 2, at 12:00 noon. The following persons were present:

PNG

Mr. Ebia Olewale

Mr. Henry To Robert

Paulias Matane

Rabbi Namaliu

Mr. Ross Garnaut

Mr. Ken Woodward

Minister for Justice and Provincial
Affairs

Governor, Bank of Papua New Guinea

Minister for Papua New Guinean Affairs

Chief Minister's Private Secretary

First Assistant Secretary,

Department of Finance

First Assistant Secretary,

Department of Finance

Bank

Mr. J. Burke Knapp

Mr. B. R. Bell

Mr. G. B. Votaw

Mr. L. Helmers

Senior Vice President, Operations

Regional Vice President, East Asia and
PacificDirector, East Asia and Pacific Programs
DepartmentDivision Chief, East Asia and Pacific
Programs Department

2. After the usual courtesies, Mr. Olewale stated that his Government attaches the utmost importance to a Bank loan creditworthiness rating. He wanted to emphasize that his Government had been in power since 1972 and had managed the country soundly. PNG was now accepted internationally as a country with a healthy economy, and it would be extremely harmful to PNG's image if the Bank were to consider PNG eligible only for IDA credits. He knew that the Bank had some reservations about the separatist movement in PNG, but he wanted to make clear that this movement should not be taken seriously. Two-thirds of Bougainville is solidly behind the Government of PNG, and only a minority of one-third wishes to secede. PNG has abundant natural resources and a good economy. It needs the Bank's assistance to help develop the country.

3. Mr. Knapp explained that according to the Bank's Articles of Agreement, the Bank in making a loan has to pay due regard to the prospects that the borrowers will repay the loan. The Articles stipulate that the Bank shall act prudently in the interests both of the borrower and of the members of the Bank as a whole. Since Papua New Guinea is a new country, the feeling in the Bank is that there should be a testing time before Bank loans can be made available. During this period IDA credits would be extended. The allocation

Files

September 9, 1975

of IDA credits to PNG would be US\$12 million per annum in FY76 and FY77, representing more than US\$4 per capita per annum. The total amount of IDA money which the Bank Group has at present is about US\$1.5 billion per annum and this has to serve countries with a population of about 1.2 billion or, in other words, a normal IDA allocation is about US\$1.25 per capita. It should be recognized that the Bank Group was making a very special effort in the case of PNG.

4. Mr. Knapp furthermore explained that there is nothing unique about a country receiving IDA credits only. Mauritius, for instance, received Bank loans in addition to IDA credits only after the Bank had had some experience with the country. Botswana was in the same category; like PNG, it relied heavily on British budgetary support, and the Bank Group at first could only make IDA credits available.

5. As regards the creditworthiness issue, Mr. Knapp wished to emphasize, however, that no decision had yet been taken. An economic mission would visit PNG in November to review the situation and the management of the Bank would make a decision after it had been able to consider all the relevant facts. In making its decision it would apply the same criteria to PNG as it applies to any other country.

6. Mr. Olewale thanked Mr. Knapp for his explanation, but stated that his Government is very much concerned about its international credit standing. If the Bank does not consider PNG creditworthy, the country will not be able to borrow the funds it requires on the international capital markets. Mr. Knapp answered that the Bank's experience was otherwise. For instance, countries like Sudan, Zaire and Indonesia were in the past not eligible for Bank loans; nevertheless they have been able to borrow substantial sums of money in the private capital markets.

7. The meeting ended at 12:45 p.m.

Cleared with and cc: Mr. Votaw
cc: Messrs. Knapp, Bell, Votaw, Kirmani, Hasan

LH:swg

OFFICE MEMORANDUM

TO: See Distribution

DATE: September 4, 1975

FROM: J. M. Jentgen 7,

SUBJECT: PAPUA NEW GUINEA: Meeting with Delegation

1. Messrs. Bell, Votaw and Kirmani met with Messrs. Namaliu, Prime Minister's Office, Woodward and Garnaut, Department of Finance, on September 2. Mr. Parvez Hasan, Hawkins, Helmers, Applegarth and Jentgen were also present.
2. Mr. Woodward expressed the Government's disappointment on the negative assessment by the Bank of PNG's creditworthiness. Mr. Bell stated that a judgment had not yet been made and that we intended to send a mission in October to bring our knowledge up-to-date. The mission would be headed by Mr. Hawkins.
3. Mr. Garnaut indicated that by that time further negotiations with the Australians on the future of their assistance should be completed, or in progress, and that the mission should be in a position to get substantially firmer assurances on the future of Australian aid which he assumed was an important factor in our assessment of creditworthiness. Mr. Bell confirmed that.
4. Mr. Garnaut in reply to questions by Messrs. Votaw, Hawkins and Hasan explained the structure of the agreement with the Bougainville Copper Mine, particularly regarding revenues accruing to PNG in the form of income tax, tariffs, dividend payments, taxes on dividend payments, as well as the arrangement on depreciation allowances and balance of payments effects. He stated that the company is allowed to maintain balances abroad amounting to three months of sales proceeds which should be sufficient to meet all obligations in foreign exchange i.e. for debt service. Sales are based on long-term contracts with Japan, Germany and Spain.
5. Operational questions regarding the Bialla-Popondetta, the Southern Highland Development, the Highland Highway, and the Education projects were discussed at a separate meeting on the same day (see separate minutes).

Attachment

cc: Messrs. Bell
Votaw
Kirmani
Hasan
Hawkins
Applegarth

OFFICE MEMORANDUM

TO: FILES

DATE: September 4, 1975

FROM: Leslie Helmers, Division Chief, AEADD *llh*SUBJECT: PAPUA NEW GUINEA: Projects in Pipeline

1. A meeting was held on September 2, 1975, with Mr. Ken Woodward, Assistant Secretary, Department of Finance. Present from the Bank were: Messrs. Milford, Prins and Blackwood (Agriculture Projects Division); Messrs. Young, Park and Morris (Transportation Projects Division), Mr. Naimie (Education Projects Division) and Messrs. Helmers and Jentgen.

Popondetta Project (FY76)

2. Mr. Helmers informed the meeting that \$12 million IDA money would be available for this project. Mr. Milford said that an appraisal mission would be sent out at the end of November 1975, provided the information he had asked for has been submitted to the Bank. Mr. Woodward promised to follow up this matter.

Bialla Project (no longer in Bank's program)

3. Mr. Woodward informed the meeting that the Government had invoked the arbitration clause but that the Japanese company had not appointed an arbitrator within the stipulated time limit. The Government's position is that no further negotiations will be undertaken with the Company unless they agree to the stipulated Government conditions.

Southern Highlands Development Project (FY77 or 78)

4. Mr. Woodward informed the meeting that the Government had in mind a project of about US\$11 million total cost for the agricultural development of the Southern Highlands, including a rural road from Mende to Tari. Mr. Milford said that he would discuss the project with Mr. Fox after the latter returns from PNG. If there were project possibilities, Mr. Milford said that he was thinking of asking the FAO Cooperative Program to prepare the project. If necessary, any additional consultants work could be financed out of Credit 348 (Livestock) where an undisbursed balance is expected to remain. A request for reallocation of funds could be made by PNG. At the earliest, preparation could take place in March 1976, followed by appraisal in August 1976.

5. The Bank's transportation staff commented that the project cost figure suggested by the Government may not be sufficient to include the Mende-Tari road in the project. The proposed road is about 140 km long and much of the route traverses extremely difficult terrain, including extensive swamps and rocky mountainous areas. The appraisal mission for the Second Highway Project in August 1974 had discussed the possible construction of this road with the district works and administrative officials in Mende and had carried out an aerial reconnaissance of the route with them. The staff believes that even a minimum standard access road would cost several millions of dollars and that a feasibility study is necessary to determine the best location for the road and to prepare realistic cost estimates. In the course of the

September 4, 1975

study the standards of the road should be determined based on traffic forecasts which in turn should be derived from projections of agricultural production.

Highlands Highway Project (FY77 or 78)

6. Mr. Woodward said that at the Cabinet meeting of August 28, it had been definitely decided to drop the project as originally conceived, and that at the moment the Government had in mind a three to four year investment of about US\$15-20 million, consisting of improving some of the most unreliable sections of the highway. Mr. Young promised to draft, before Mr. Woodward left Washington, a note suggesting the approaches the consultants should consider in preparing such a project. Mr. Woodward undertook to discuss the suggested approaches with the consultants and consult with the Bank before the consultants proceed too far with their review.

Education (FY77)

7. Mr. Woodward informed the meeting that the proposed identification mission for October was welcome. However, he added that it should not be expected that a project had been identified by Government. In other words, he hoped that the mission would make proposals to Government for a feasible project, and it seemed to him that it should be mainly in the technical education field. He believed that a project with a total cost of about US\$6-7 million would be acceptable to Government.

Cleared with and cc: Messrs. Young, Naimie, Milford

cc: Messrs. Prins, Blackwood, Park, Morris, Jentgen, Bell, Votaw, Kirmani

LHelmerts:vh

10-9

INCOMING CABLE

DATE AND TIME
OF CABLE: SEPTEMBER 30, 1975

LOG NO.: TELEX /30

TO: INTBAFRAD

FROM: DJAKARTA

DECLASSIFIED
MAY 09 2013
WBG ARCHIVES

ROUTING

ACTION COPY: MR. MCNAMARA ✓

INFORMATION MR. BELL'S OFFICE
COPY: MR. VOTAW

DECODED BY: mf

TEXT: 1320 CONFIDENTIAL FOR MCNAMARA

DURING BRIEF CONVERSATION IN PAPUA NEW GUINEA, PRIME MINISTER
TOLD ME HE WAS PLANNING TRIP TO NEW YORK U.N. ASSEMBLY MEETING
AND ALSO VISIT TO WASHINGTON ABOUT MID-OCTOBER DURING WHICH HE
WISHES TO SEE YOU. I ASSURED HIM YOU WOULD WISH TO SEE HIM PRO-
VIDED YOU WERE IN WASHINGTON AT THE TIME. HE DID NOT INDICATE
ANY PARTICULAR SUBJECT. DURING MY VISIT I DISCUSSED NOT WITH
HIM BUT AT LENGTH WITH MINISTER OF FINANCE AND OTHER OFFICIALS
THE CREDITWORTHINESS ISSUE AND OUR ASSISTANCE PLANS. THEY
UNDERSTAND

ALPHA THAT ISSUE IS NOT YET SETTLED,

BETA THAT OUR PROJECTED SMALL OCTOBER OR NOVEMBER

ECONOMIC MISSION IS INTENDED TO PROVIDE ADDITIONAL FACTS
AND UNDERSTANDING WE NEED AS BASIS FOR JUDGEMENT,

GAMMA THAT JUDGMENT WILL IN ANY CASE NOT BE OPERATIONAL
FOR MINIMUM OF SIX MONTHS SINCE COMING AGRICULTURAL PRO-
JECT TO BE FINANCED BY IDA CREDIT AND CONTEMPLATED HIGH-
WAY PROJECT IS IN PROCESS OF BEING REVAMPED AND RE-
APPRAISAL WILL BE REQUIRED.

I BELIEVE THESE OFFICIALS UNDERSTOOD BASIS OUR CONCERN AND ALSO

INCOMING CABLE

DATE AND TIME
OF CABLE: SEPTEMBER 30, 1975

LOG NO.: TELEX /30

TO: INTBAFRAD

FROM: DJAKARTA

ROUTING

ACTION COPY:

INFORMATION
COPY:

DECODED BY:

PAGE 2

TEXT: FACT THAT ANY BANK LOAN WOULD IN ANY CASE BE UNLIKELY EXCEED 8 TO 12 MILLION. I ALSO EXPLORED POSSIBILITY, OFFERED STRICTLY AS A PERSONAL OFFHAND IDEA THAT SOME PART OF AUSTRALIA GRANT COULD BE EARMARKED IN FORMAL OR SEMI-FORMAL FASHION FOR SERVING ANY BANK LOAN. THERE APPEAR TO BE POSSIBILITIES ALONG THIS LINE AND EVEN SOME EXISTING LEGISLATIVE SANCTION. IN CANBERRA SAME DISCUSSION OCCURED WITH OFFICIALS MINISTRY OF FINANCE AND AID AGENCY. LATTER ALSO RESPONDED POSITIVELY TO SUGGESTION THEY PROVIDE CO-FINANCING WITH US OF SPECIFIC PROJECTS WITH SUCH CO-FINANCING TO BE ADDITIONAL TO AGREED AUSTRALIA GRANT. THEY WILL OBVIOUSLY HAVE SOME DIFFICULTIES IN GETTING THEIR MINISTRY OF FINANCE ACCEPT SUCH PROPOSAL AND WILL IN ANY CASE NOT MAKE IT UNTIL GRANT NEGOTIATIONS CONCLUDED. AUSTRALIA PRIME MINISTER URGED ME INCIDENTALLY TO ENCOURAGE AND TRY TO PERSUADE HIS FINANCE OFFICIALS TAKE FAR MORE POSITIVE ATTITUDE TOWARD AID SPECIFICALLY AND IN GENERAL. HIS OWN ATTITUDE CLEARLY MOST POSITIVE. REGARDS

BELL

UNDERLINED WORDS RECEIVED IN CODE.

MC

FOR INFORMATION REGARDING INCOMING CABLES, PLEASE CALL THE COMMUNICATIONS SECTION, EXT. 2021

ORIGINAL

DD: [unclear]
G. Votaw/clr
File PNC

INCOMING CABLE

6.

DATE AND TIME OF CABLE: SEPTEMBER 30, 1975

LOG NO.: TELEX /30
TO: INTBAFRAD
FROM: DJAKARTA

DECLASSIFIED
MAY 09 2013
WBG ARCHIVES

ROUTING	
ACTION COPY:	MR. MCNAMARA
INFORMATION COPY:	MR. BELL'S OFFICE MR. VOTAW ✓
DECODED BY:	mf

TEXT: 1320 CONFIDENTIAL FOR MCNAMARA

DURING BRIEF CONVERSATION IN PAPUA NEW GUINEA, PRIME MINISTER TOLD ME HE WAS PLANNING TRIP TO NEW YORK U.N. ASSEMBLY MEETING AND ALSO VISIT TO WASHINGTON ABOUT MID-OCTOBER DURING WHICH HE WISHES TO SEE YOU. I ASSURED HIM YOU WOULD WISH TO SEE HIM PROVIDED YOU WERE IN WASHINGTON AT THE TIME. HE DID NOT INDICATE ANY PARTICULAR SUBJECT. DURING MY VISIT I DISCUSSED NOT WITH HIM BUT AT LENGTH WITH MINISTER OF FINANCE AND OTHER OFFICIALS THE CREDITWORTHINESS ISSUE AND OUR ASSISTANCE PLANS. THEY UNDERSTAND

- ALPHA THAT ISSUE IS NOT YET SETTLED,
- BETA THAT OUR PROJECTED SMALL OCTOBER OR NOVEMBER ECONOMIC MISSION IS INTENDED TO PROVIDE ADDITIONAL FACTS AND UNDERSTANDING WE NEED AS BASIS FOR JUDGMENT,
- GAMMA THAT JUDGMENT WILL IN ANY CASE NOT BE OPERATIONAL FOR MINIMUM OF SIX MONTHS SINCE COMING AGRICULTURAL PROJECT TO BE FINANCED BY IDA CREDIT AND CONTEMPLATED HIGHWAY PROJECT IS IN PROCESS OF BEING REVAMPED AND REAPPRAISAL WILL BE REQUIRED.

I BELIEVE THESE OFFICIALS UNDERSTOOD BASIS OUR CONCERN AND ALSO

INCOMING CABLE

ND TIME
F CABLE: SEPTEMBER 30, 1975

LOG NO.: TELEX /30

TO: INTBAFRAD

FROM: DJAKARTA

ROUTING

ACTION COPY:

INFORMATION
COPY:

DECODED BY:

PAGE 2

TEXT: FACT THAT ANY BANK LOAN WOULD IN ANY CASE BE UNLIKELY EXCEED 8 TO 12 MILLION. I ALSO EXPLORED POSSIBILITY, OFFERED STRICTLY AS A PERSONAL OFFHAND IDEA THAT SOME PART OF AUSTRALIA GRANT COULD BE EARMARKED IN FORMAL OR SEMI-FORMAL FASHION FOR SERVICING ANY BANK LOAN. THERE APPEAR TO BE POSSIBILITIES ALONG THIS LINE AND EVEN SOME EXISTING LEGISLATIVE SANCTION. IN CANBERRA SAME DISCUSSION OCCURED WITH OFFICIALS MINISTRY OF FINANCE AND AID AGENCY. LATTER ALSO RESPONDED POSITIVELY TO SUGGESTION THEY PROVIDE CO-FINANCING WITH US OF SPECIFIC PROJECTS WITH SUCH CO-FINANCING TO BE ADDITIONAL TO AGREED AUSTRALIA GRANT. THEY WILL OBVIOUSLY HAVE SOME DIFFICULTIES IN GETTING THEIR MINISTRY OF FINANCE ACCEPT SUCH PROPOSAL AND WILL IN ANY CASE NOT MAKE IT UNTIL GRANT NEGOTIATIONS CONCLUDED. AUSTRALIA PRIME MINISTER URGED ME INCIDENTALLY TO ENCOURAGE AND TRY TO PERSUADE HIS FINANCE OFFICIALS TAKE FAR MORE POSITIVE ATTITUDE TOWARD AID SPECIFICALLY AND IN GENERAL. HIS OWN ATTITUDE CLEARLY MOST POSITIVE. REGARDS

BELL

UNDERLINED WORDS RECEIVED IN CODE.

MC

FOR INFORMATION REGARDING INCOMING CABLES, PLEASE CALL THE COMMUNICATIONS SECTION, EXT. 2021

DUPLICATE

OFFICE MEMORANDUM

TO: FILES

DATE: October 6, 1975

FROM: Leslie Helmers *LH*SUBJECT: PNG: Visit of Mr. and Mrs. Bell from September 14 - September 18, 1975

1. Mr. and Mrs. Bell, accompanied by Mr. Helmers, visited Papua New Guinea from September 14 to 18 to attend the Independence celebrations as guests of the Government. The ceremonies (lowering of the Australian flag; raising of the PNG flag; opening of the House of Parliament; swearing-in of the Governor-General, Sir John Guise, Chief Minister Somare, Ministers, Chief Judges, etc; and a State dinner) were impressive and well-organized. They need not be further described as they were well covered by the international press.

2. A field trip was made to the Popondetta area on September 14, and meetings were held with Mr. Julius Chan (Minister of Finance) on September 17 and with Mr. Natera (Director, Department of Agriculture) on September 18.

3. The main topic of the meeting with Mr. Chan^{1/} was PNG's credit-worthiness. Mr. Bell explained that the Bank had not yet made a decision on this issue and that a small economic mission would visit PNG in November to bring the Bank's knowledge up to date. The Bank would try to let the mission coincide with the IMF mission (also scheduled for November) so that no duplication of effort on the part of the PNG Government would be necessary. A decision on whether the Bank would be able to extend loans to PNG could be expected after Mr. Bell and the other members of the top management of the Bank had studied the data, probably in January/February, 1976. Since no projects were to be presented to the Board of Directors of the Bank before April/May 1976, the issue was not operationally immediate. Mr. Bell further stated that US\$12 million of IDA credits per annum for FY76 and FY77 had been allocated to PNG. This represented a special effort on the part of the Bank Group: the IDA allocation to PNG represents more than US\$4.00 per capita per annum, whereas the average IDA allocation to other countries is only about US\$1.25 per capita per annum. Mr. Bell further explained that if the country were found eligible for Bank loans, the minimum the Bank Group could make available in addition to the IDA credits was unlikely to be more than about US\$8 million to US\$10 million per annum.

4. Another topic discussed concerned the Government's development strategy. Mr. Chan - speaking personally - felt that the outer islands had been neglected. All the projects undertaken by the Bank so far had benefited principally the mainland, and he felt that, politically, it was high time

^{1/} The meeting was attended by Messrs. Garnaut, Temple and Woodward, and Miss Curley (all Assistant Secretaries of the Treasury).

that something was done for the outer islands. Agriculture there is well developed, and he saw no possibility for agricultural projects. However, much remained to be done in the public utility and transportation sectors. He suggested that a possible project would be the Upper Warangoi hydro-electric scheme (total cost Kina 10.0 million) ^{1/} which would supply electricity to Rabaul and rural villages. ^{2/} Mr. Bell promised that Bank staff would review the project. He also suggested that the Bank would be most interested in rural development projects which would affect large numbers of the rural population and would have lower family income targets than those involved in, for example, the Popondetta project.

5. At the end of the discussion Mr. Bell asked Mr. Chan whether it would be possible for PNG in some manner to earmark part of the Australian aid for servicing the country's debt to the World Bank. Mr. Chan replied that, in practice, this happened already. A general Act governing borrowing from the World Bank had recently been passed by Parliament which in effect gave such priority, and he promised to send copies of the Act and a memo outlining the procedures and legal implications of the Act to Mr. Bell.

6. The meeting with Mr. Natera^{3/} concentrated also on the credit-worthiness issue. Mr. Natera had requested the meeting since he was not clear whether the Bank was still willing to lend for the Popondetta project. Mr. Bell explained that US\$12.0 million of IDA credits would be available for this project and assured Mr. Natera that a mission would be sent to PNG as soon as the updating information had been received (this mission is tentatively scheduled for November). Mr. Natera also discussed some of the problems that had arisen under Project 175 (Agricultural Credit II) as regards the sale of beef cattle to smallholder farmers. To streamline the flow of cattle from the private breeder ranches to the smallholders, the Government intends to set up a number of Government holding ranches. Mr. Natera had recently written to the Bank asking for approval of this change in project. Mr. Bell promised that the issue would be speedily reviewed in Washington.

7. Mr. Natera also mentioned that he had had several discussions with Mr. Fox on a possible Southern Highlands Project. This would be an integrated rural development project (expansion of coffee, tea and cattle production; provision of health and education facilities, and construction of rural roads). Mr. Bell said that the project would be reviewed with Mr. Fox. If there were project possibilities and further preparation were necessary, the Bank might ask the FAO/Bank Cooperative Program to prepare the project. Mr. Helmers added that there were still some undisbursed funds in Credit 348 and that, if necessary, any specialist work could be financed out of this Credit.

^{1/} Kina 1.00 = A\$1.00 = US\$1.30

^{2/} A copy of the feasibility study of this scheme was subsequently received by Mr. Helmers from ELCOM.

^{3/} Also present were Messrs. S. Saville (Deputy Director, Department of Agriculture) and Christensen (Agricultural Officer).

October 6, 1975

8. Finally, Mr. Natera mentioned that he also saw project possibilities in sugar and rice. As regards sugar, the Government's intention is to set up a nucleus estate with outgrowers; as regards rice, Mr. Natera believed that the best way to start would be with smallholders. He promised to send the feasibility studies of both projects to the Bank as soon as they had been prepared, probably some time in mid-1976.

Cleared with and cc: Mr. Bell (o/r)

cc: Mr. McNamara
Mr. Knapp
Mr. Kirmani
Mr. Votaw
Division File

LHelmert:vh

OFFICE MEMORANDUM

TO: Files

DATE: October 6, 1975

FROM: L. Helmers, Chief, Division D

SUBJECT: Meetings of Mr. Bell in Canberra

1. Following the visit to Papua New Guinea as guests of the Government for the independence ceremonies, Mr. and Mrs. Bell and Mr. Helmers paid a short visit to Canberra on September 19. Discussions took place with the Treasury and the Australian Aid Agency.
2. The morning meeting at the Treasury was presided by Mr. Stone (Deputy-Secretary) and attended by Messrs. Potts, Stuparich, Shields and Stevens (Treasury officials familiar with PNG). Mr. Stone was well informed of the discussions which had taken place at the Bank's Annual Meeting, and the only new question he asked was whether the Bank would make any Third Window money available to PNG. Mr. Bell answered that, at this moment, no Third Window allocation decisions had yet been made, but that the possibility of an allocation to PNG depended, in fact, on the outcome of the Bank's review during the next few months of PNG's creditworthiness.
3. With respect to this matter, Mr. Bell asked whether Australia would object if any part of the Australian aid to PNG were to be set aside by the PNG Government for servicing the country's debt to the World Bank. Mr. Stone replied that this was a matter solely to be determined by PNG, which is free to use the Australian aid as it sees fit.
4. Mr. Bell also asked what the specific reasons were that Australia objects to guaranteeing Bank loans after PNG's independence. In his mind, the distinction between grants and guarantees was not that large. Mr. Stone answered that the policy of the Australian Government was that its aid should not create any relationship of dependency. With very minor exceptions, its aid is therefore in the form of grants. To guarantee loans to a sovereign PNG is against this principle of independence. PNG can count on Australia for long-term assistance, but it should stand on its own feet and establish its own creditworthiness.
5. In the absence of Mr. Johnson (Director General of the Australian Aid Agency), the afternoon meetings were presided by Mr. Mentz (Director of the Australian Aid Agency). Also present were Messrs. Kelloway, Jolliffe, Manning and Ingevics (Assistant Secretaries) and Messrs. Voutas, Granger, Detto and Early. At Mr. Mentz' request, Mr. Bell summarized briefly the discussions which had taken place in Washington regarding PNG's creditworthiness and explained that an economic mission would be sent to PNG in November. A decision by the Bank could be expected after Mr. Bell and the other members of the top management of the Bank had studied the mission's report, probably next January or February.
6. The other topic discussed in some detail concerned possible co-financing arrangements. The Aid Agency is very interested in co-financing projects in the East Asia and Pacific Region with the Bank. After some discussions, it appeared

./...

October 6, 1975

that the Agency referred to parallel financing. A problem is that Australia is at present only prepared to finance foreign exchange costs, but the Agency is trying to change this policy so that local costs can be financed. Since the Agency's preference is for aid to rural development type projects, which have a typically low foreign exchange component, it sees this change in policy as essential. Mr. Mentz had copies of the Bank's monthly operational summaries and other project data sheets and would write to Mr. Bell as soon as the Agency had identified suitable projects.

7. As regards PNG, the Aid Agency also wants to move towards parallel financing, but the long-term aid relationship discussions with PNG, which are to start in October, should first be completed. Otherwise PNG could get the impression that Australia's general aid would be reduced by the amount of parallel financing. Mr. Mentz hoped that Australia's parallel financing of projects would be in addition to Australia's general aid once the long-term aid, which Australia would provide to PNG, had been determined.

8. At the end of the discussion, a cocktail party was hosted by Mr. Mentz to introduce the senior staff of the Agency to Mr. Bell.

Cleared with and cc: Mr. Bell (o/r)

cc: Messrs. McNamara
Knapp
Kirmani
Votaw
Division Files

YKimura/mh

BIOGRAPHICAL DATAMichael Thomas Somare - Prime Minister

Age 38, born in East Sepik District. Matriculation (Victorian Leaving Certificate).

Trained teacher and journalist. Member of House of Assembly since 1968 for East Sepik Regional. Founder of Pangu Party (Papua Niugini Pati), the first party in a modern sense with a grass root organization. As Leader of the Opposition in the House during 1968-1972 he had been a supporter of early self-government, but was more reluctant on early independence. Re-elected in 1972, he managed to form a national coalition government with four other groups, thereby unseating from government the conservative United Party, which is still the largest party in the House.

He quickly established himself as a national leader, and by modifying his previously more radical views, has so far been able to hold the coalition together and to defuse regional discontent. Travelling widely throughout the country, he attempts to gain the confidence of the various tribes, especially in the less developed Highlands, who have been particularly suspicious of his Government.

He has travelled abroad quite frequently and has already, as Opposition Leader, established personal contacts with foreign Governments (e.g., Japan, and African countries like Tanzania and Zambia). A forceful and dynamic personality, he has currently little political competition for his role as national leader.

Population: 2.59 million
 Per capita income: \$290 (indigenous \$150)
 Area: 183,500 sq. miles
 Literacy:

PAPUA NEW GUINEA

ACTUAL AND PROPOSED LENDING THROUGH FY80

ANNEX IV

	Through FY69	Actual					Current FY75	Proposed					Total FY69-73	Total FY74-78	Total FY76-80	
		FY70	FY71	FY72	FY73	FY74		FY76	FY77	FY78	FY79	FY80				
Agric. Development I IDA	1.5															
Agric. Development II IDA		5.0														
Agric. Development III IDA					5.0											
Agric. Development IV IDA								12.0								
Agric. Development V IDA									9.0							
Agric. Development VI IDA										12.5						
Agric. Development VII IDA											12.5					
Agric. Development VIII IDA												12.5				
Telecommunications I IERD	7.0															
Telecommunications II IBRD				10.0												
Education I IDA									3.0							
Education II IDA											3.5					
Power I IBRD			23.2													
Power II IBRD						10.0										
Power III IDA									9.0							
Highways I IBRD/IDA		4.3/4.3														
Highways II IBRD									30.0 ³							
Ports I IDA				9.2							9.0					
Ports II IDA																
Operations Program:																
IBRD								30.0								30.0
IDA								12.0		21.0	21.5	16.0	12.5			83.0
Total								42.0		42.0	43.0	32.0	25.0			113.0
No.								2		3	2	2	1			10
Lending Program:																
IBRD	7.0	4.5	23.2	10.0		10.0		30.0								64.7
IDA	1.5	9.5		9.2	5.0			12.0	12.0	12.5	12.5	12.5				60.8
Total	8.5	14.0	23.2	19.2	5.0	10.0		42.0	12.0	25.0	25.0	25.0				125.5
No.	2	1	1	2	1	1		2	2	1	1	1				8
Lending Program (constant 1974 dollars) Deflator	15.1 70.2	15.5 71.5	21.1 74.6	23.7 81.1	5.7 87.7	10.8 100.0	113.2	33.9 124.0	8.9 134.5	8.7 143.9	6.1 153.3	7.6 163.3	92.2 75.0	122.3 120.1	67.2 235.9	
Asian Development Bank				5.0	10.0			5.0	10.0	10.0	15.0	15.0				
<u>Bilateral</u>																
Australia																
Grants		137.0	100.0	155.0	235.0	300.0	256.0	259.0	262.0	221.0	221.0	221.0				
Loans		24.8	27.1	17.0	5.7	3.1	25.0	13.0	10.0	10.0	10.0	10.0				
Other Bilateral							5.0	5.0	5.0	5.0	5.0	5.0				
1/ IERD o/s including undisp. excluding undisp.	7.0	11.5 0.6	34.7 1.7	34.9 6.7	46.6 ² 17.1	56.7 ³ 26.2	36.3 35.2	85.0 85.1	84.3 55.2	82.8 63.7	80.9 69.4	78.4 71.9	134.7 26.1	365.9 225.4	412.2 305.3	
IERD Gross Disbursements		0.6	1.0	4.9	8.7	9.8	9.4	10.4	11.6	10.0	7.5	5.1	15.2	51.2	44.6	
Less: Amortization						0.3	0.4	0.5	1.5	1.5	1.9	2.6		4.2	8.0	
Equals: Net Disb.		0.6	1.0	4.9	8.7	9.5	9.0	9.9	10.1	8.5	5.6	2.5	15.2	47.0	36.6	
Less: Interest & Charges		0.1	0.1	0.3	1.0	1.5	2.2	3.0	3.8	4.5	5.1	5.4	1.5	15.0	21.5	
Equals: Net Transfer		0.5	0.9	4.6	7.7	8.0	6.8	6.9	6.3	4.0	0.5	-2.9	13.7	32.0	15.1	
IBRD/IDA Gross Disbursements		1.6	3.0	9.6	10.2	12.4	13.6	13.6	14.9	15.1	14.5	14.6	24.4	69.6	72.7	
Less: Amortization						0.3	0.4	0.5	1.5	1.5	1.9	2.7		4.2	8.1	
Equals: Net Disb.		1.6	3.0	9.6	10.2	12.1	13.2	13.1	13.4	13.6	12.6	11.9	24.4	65.4	64.6	
Less: Interest & Charges		0.1	0.1	0.3	1.1	1.6	2.3	3.1	4.0	4.7	5.3	5.7	1.6	15.7	22.8	
Equals: Net Transfer		1.5	2.9	9.3	9.1	10.5	10.9	10.0	9.4	8.9	7.3	6.2	22.8	49.7	41.8	

1/ As of end of fiscal year.
 2/ The exchange adjustment of \$0.2 million, as of June 1972, has been included in these figures.
 3/ The exchange adjustment of \$1.9 million, as of June 1974, has been included in these figures, with an increase of \$1.7 million since FY1972.
 4/ The exchange adjustment of \$1.5 million, as of June 1974, has been included in these figures, with a decrease of \$0.4 million since FY1973.
 5/ On the assumption that the project can be completed before the date of 1975 independence, now expected in mid-September, and that the loan would be guaranteed by the Australian Government.
 Note: All data in this table reflect o/s amounts and transactions of loans sold to third parties.

9.

Popondetta Oil Palm Project

1. The Popondetta oil palm project consists in total of three components: (a) an oil palm nucleus estate of 4,000 ha; (b) an oil palm mill with an ultimate capacity of 60 tons FFB per hour, and (c) smallholder oil palm development of 5,180 ha, comprising 595 new settlers, 200 existing settlers, and 500 local villagers.
2. The total cost of the project is estimated to be US\$51.5 million over an eight-year development period, of which about US\$23 million would be for smallholder development. The nucleus estate and factory development will be financed by joint venture arrangements between Government and CDC. The smallholder development component would absorb all of the available US\$12 million of IDA funds.
3. The smallholder development would include land clearing; oil palm planting; resettlement; smallholder housing; feeder roads, initial working capital; research, extension and technical assistance services; and social infrastructure at the village level. Smallholder long-term credit facilities would be provided through the PNG Development Bank. The smallholder development would be managed by the reestablished project coordinator's office in the Department of Finance.
4. We understand that negotiations between CDC and PNG authorities are progressing well and that no insurmountable outstanding issues are left. However, it is considered prudent that we postpone our reappraisal of the smallholder component of the Popondetta Oil Palm Project until CDC Board approval (scheduled for November 13, 1975) of their investment has been obtained.
5. In order to be able to establish their first oil palms in the planting season October 1976 - February 1977, CDC plans to start their nursery operations in PNG in February/March 1976.

10.

Agricultural Development V - Southern Highlands

The Government of Papua New Guinea has requested financing for an area development project for the Southern Highlands District.

1. Proposed Project Components are:

		<u>US\$ million</u>
<u>Productive Component -</u>	<u>Total</u>	<u>4.8</u>
	Coffee :	0.4
	Tea :	4.1
	Cattle :	0.3
<u>Non Productive Component</u>	<u>Total</u>	<u>8.7</u>
	Swamp Drainage :	0.3
	Road Construction :	5.2
	Health and Community Services :	3.2
<u>Total Project Cost</u>	:	<u>13.6</u> /1
<u>IDA or IBRD Contribution</u>		<u>6.8</u> /1

2. Beneficiaries

The Southern Highlands District is considered by Government to be a priority area for development. The project target group would be the District rural population engaged in subsistence agriculture, i.e. about 40,000 families. Their average per capita annual income is US\$ 100 to 150, but in most areas it is well under 100. Adult literacy rate is extremely low (8% of the population above 10 years old) and child mortality extremely high (230 per thousand children under 5). Malnutrition is widespread. Protein and caloric intakes are estimated at

1/ Without price contingencies.

50 to 60% and 60 to 80% of requirements respectively. For all socio-economic indicators, the Southern Highlands ranges last or in the last three of all 20 PNG districts. The project would benefit the whole rural population and provide wage employment for 2,000 to 3,000 persons. It would raise the average per capita income substantially, by some 50%.

3. Organization

The executing agency for all project components would be the Southern Highlands Development Authority, which enters into business on behalf of the Area Authority, the District political body. The D.A. is composed of 6 members elected by the Area Authority and 3 appointees of the Chief Minister. Day to day management and supervision is provided by the Development Authority. The D.A. is currently managing 10 coffee plantations and a few other businesses and seems to be working well.

4. Project Description and Justification

Tea, coffee and cattle development would provide the area with several district-wide base crops where none now exists. Development would center upon community plantations and would have an important self-help component. This type of development is viewed as an essential forerunner to the stimulation of confidence in smallholder development (as it has been the experience in the other Highland districts). The project would result in significantly increased rural employment and provide the District authorities and the Local Councils with appreciable sources of revenues for their own economic and social development programs. The cattle component would consist of small loans to clans for steer fattening, the next logical step in beef development initiated under credits 175 and 348. The project would also provide the District with minimum standard access roads to all its main centers (involving completion of the road to the Tari Basin) and with improved health and nutrition services.

This project appears highly desirable in the present social and political context of both the District and Papua New Guinea. There appears to be no known alternatives to coffee, tea and cattle for which financial returns are good. All out coffee expansion, however, is limited by the possibility of a new International Coffee Agreement and cattle development by relatively limited availability of undisputed clan land. The large tea development component may run counter to the directives in the August 17, 1973 President's Memorandum ("Bank Group Financing of Tea"). However, incremental tea production under the project would have a negligible impact on the world market as it would most probably amount to less than 1% of world production and exports as projected in 1985.

If the tea component is dropped, it is unlikely that the project would be further processed by IDA/IBRD.

Proposed Components

	<u>Approximate Total Cost</u>	<u>IDA/IBRD Credit/Loan</u>
Sugar Production	2.6	1.3
Tobacco Production	2.8	1.4
Coarse Grain/Soya Bean Production	1.8	0.9
Plantation Management Training	2.0	1.0
	—	—
<u>Grand Total</u>	9.2	4.6

1. The project would assist the development of lowland and highland areas throughout Papua New Guinea. The rationale for the project is import substitution and strengthening of the cash economy.

Sugar Production

2. The long range objectives are to establish a viable sugar industry in PNG to satisfy internal consumption needs within the framework of the Government's development objectives which emphasizes decentralization of economic activity, self-reliance, rural development and import replacement. The project would provide for two pilot cane sugar projects; one in the Markham Valley near Lae and the other in the Kemp Welch River area, southeast of Port Moresby. The project would be organized around community nucleus estates with smallholder and village production on the periphery. Approximately 600 ha of cane would be grown to meet an expected 1975 level of internal consumption of 30,000 tons. The internal rate of return for the component is about 18%

Tobacco Production

3. The aim of the component is to stimulate development which would produce 100% of the fire-cured and 60% flu-cured consumption within a ten year period. A tobacco authority would be established which would provide a variety of services required by the smallholder tobacco growers. Most development would occur in the Eastern Highland District, centered around Goroka where the crop is successfully grown. There are indications that fire-cured tobacco can be grown very successfully in the lower lying districts of Madang and Moroby. About 1,500 smallholder growers would be financed to manage about 720 ha of tobacco per year. The internal rate of return is approximately 20%

Coarse Grain/Soyabean Production

4. Opportunities for expansion of grain and soyabean exist in the Markham Valley Central District and in the Highlands. There is an area of 23,000 ha in the Markham Valley and a similar area in the Central District with immediate potential for cropping without expenditure on reclamation. Government requests financing for a minimum 2,400 ha of mechanized grain and soyabean production. The component would be organized again around community nucleus estates with smallholder production on the periphery. About 12,000 ha would be developed in the Markham Valley and a similar area in the Central District. Development would be integrated with the establishment of a large private wheat and coarse grain mill at Lae at the head of the Markham Valley over the next 18 months. Preliminary estimates show an internal rate of return of 15%.

Plantation Management Training

5. Following introduction in January 1975 of the Lands Acquisition Act under which alienated lands may be purchased by the Government for subsequent sale or lease to the original owners. Government anticipates that in the

next 4 or 5 years, most of the 800 plantations in PNG will be locally managed. The on-going exodus of expatriate managers of plantations will leave PNG devoid of personnel with plantation management skills. The component would provide training for plantation managers operating sugar, tea, coffee, coconut and cocoa plantations. Training programs for groups of 20 trainee managers would be held for 18 months each group. The first 6 months training would be formal instruction in technology, accounting and management. The second 6 months would be spent in the field gaining practical experience and the last 6 months in a combination of formal and practical training services. Training centers have been identified with adequate facilities in principal production areas. About 120 trainees would graduate each year and the program would last for 4 years.

11.

APPLICATION FOR MEMBERSHIP

1. By letters dated February 12 and cable dated September 1974, the Government of Papua New Guinea applied for membership in the Bank, IDA and IFC. It has also applied for membership in the International Monetary Fund. The subscriptions in the Bank, IFC and IDA are as follows:

Bank - \$17.1 million, expressed in terms of the 1944 US Dollar.
IFC - \$114,000, expressed in terms of the 1973 US Dollar.
IDA - Initial (obligatory) - \$860,000, expressed in terms of
the 1960 US Dollar.

First Tranche Additional (optional) - \$33,760, expressed
in terms of the 1960 US Dollar.

Second Tranche Additional (optional) - \$32,050, expressed
in terms of the 1973 US Dollar.

2. Membership resolutions were adopted by Bank, IFC and IDA in September 1974. Documents (Instruments of Acceptance, etc.) have been cleared by the Bank, IFC and IDA. Payment of subscriptions--without which the Articles cannot be signed--is awaited.