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MONETARY POLICY STATEMENT BY THE GOVERNOR OF THE BANK OF PAPUA NEW GUINEA, MR. L. WILSON KAMIT, CBE

PORT MORESBY

30 July 2004

OBJECTIVES OF THE CENTRAL BANK

"For the advantage of the people of Papua New Guinea, the objectives of the Central Bank are:

(a) to formulate and implement monetary policy with a view to achieving and maintaining price stability; and

(b) to formulate financial regulation and prudential standards to ensure stability of the financial system in Papua New Guinea; and

(c) to promote an efficient national and international payments system; and

(d) subject to the above, to promote macro-economic stability and economic growth in Papua New Guinea."

Central Banking Act (CBA) 2000, Section 7

POLICY STATEMENTS

"The Governor[1] shall, within one month of the coming into operation of this Act, and every six months thereafter, issue a policy statement setting out the monetary policy of the Central Bank to achieve and maintain price stability for the following six months."

CBA 2000, Section 11, Sub-section 1

OBJECTIVE OF MONETARY POLICY

In pursuing monetary policy in Papua New Guinea, the Bank of Papua New Guinea targets price stability. Maintaining price stability in a small open economy like Papua New Guinea requires amongst other things, relative stability in the exchange rate which can:

- Improve confidence in the local currency and management of the economy;
- Provide certainty for private sector businesses to plan for long-term investment and development;
- Minimise volatility and price distortions;
- Provide the Government a foundation for stable revenue flows; and
- Potentially lead to a stable macroeconomic environment.

[1] The Board of the Central Bank is responsible for determining the policies of the Bank other than Monetary Policy.

EXECUTIVE SUMMARY

The consolidation of favourable economic performance in the first half of 2004 provided a foundation for further easing of monetary policy by the Central Bank. The major economic indicators that support the above include:

- A stable kina exchange rate;
- A decline in annual headline inflation rate to 2.9 percent in March 2004, consistent with the trend expected by the Bank in January 2004;
- A build up of international reserves to an unprecedented level of US$550.2 (K1,771.9) million at end June 2004;
- A declining trend in interest rates; and
- A sound fiscal management by the Government.

The outcomes to June 2004 are consistent with the Bank's projections for 2004 made in the January 2004 Monetary Policy Statement (MPS). The potential for a turnaround in growth in credit to the private sector to generate economic activity and investment should be encouraged, given the high level of liquidity and declining interest rates.

The Central Bank expects the stability in macroeconomic conditions to continue in the second half of 2004. This should provide an environment conducive for increased private sector activity and enable the achievement of the projected real gross domestic product (GDP) growth of 2.8 percent in 2004. Based on these expectations, the Central Bank has revised its projections for 2004 as follows:

Annual headline inflation rate	7.4 percent
Private sector credit growth	6.7 percent
Net credit to Government	-6.1 percent
Net foreign assets	6.7 percent

The major risk of achieving the above targets remain the fiscal slippages by the Government, and the threat to stability in the exchange rate arising from the high level of liquidity and adverse terms of trade resulting from unfavourable international commodity prices and supply shocks.

Monetary Policy Statement (MPS) July 2004

INTRODUCTION

The MPS is published pursuant to Section 11 of the Central Banking Act 2000. It represents a key requirement of the transparency and accountability of the Bank of PNG. The Policy Statement is presented in two parts. The first covers economic developments in the first half of the year and revised projections for 2004. The second sets out the rationale for the monetary policy stance for the second half of the year and the conduct of monetary policy.

1. DEVELOPMENTS IN THE FIRST HALF AND REVISED PROJECTIONS FOR 2004

In designing monetary policy, the Central Bank considers actual and projected developments in seven main areas:

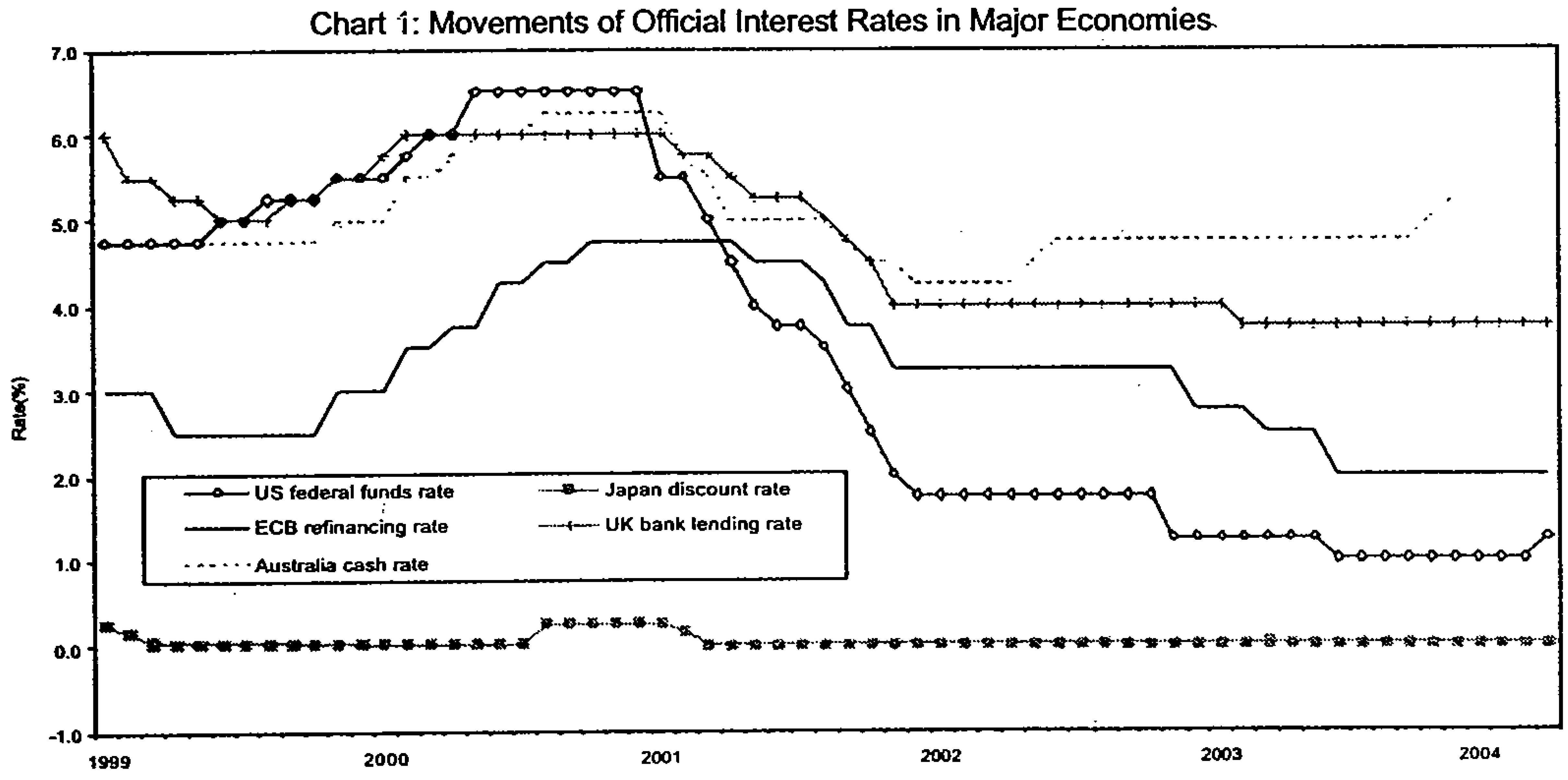
(a) The World Economy;
(b) Domestic Economic Activity;
(c) Balance of Payments;
(d) Fiscal Operations of the Government;
(e) Exchange Rate;
(f) Inflation; and
(g) Monetary and Financial Market Developments.

(a) The World Economy

In the April 2004 World Economic Outlook (WEO), the International Monetary Fund (IMF) forecasts real GDP growth in the world economy to be 4.6 percent in 2004, compared to 3.9 percent in 2003, with growths of 3.5 percent in the United States (US) and 3.4 percent in Japan. The other industrialised economies and the Euro area are expected to grow by 3.6 and 1.7 percent, respectively. The emerging markets in Asia are expected to grow by 7.4 percent, while developing countries as a whole are expected to grow by 6.0 percent.

Global inflation is expected to remain low, with increases of around 1.7 percent in the industrialised countries and 5.7 percent in other emerging markets and the developing countries, respectively. All major central banks maintained accommodative monetary policy stance during the first half of 2004, in order to support recovery in production following subdued levels of inflation The US dollar (USD) initially weakened against all the major currencies during the first quarter of 2004, following sharp increases in the trade and fiscal deficits. This led to capital outflows from the US, particularly to Europe, resulting in the euro appreciating above 1.25 percent against the USD. Thereafter, the dollar rebounded strongly against all the major currencies supported by strong growth and expectations that the Federal Reserve Board

Chart 1: Movements of Official Interest Rates in Major Economies



Source: RBA Website http://www.rba.gov.au would soon increase interest rates (Federal Fund rate was increased by 25 basis points to 1.25 percent at the end of June 2004).

In contrast, the Euro zone economy expanded modestly and the European Central Bank (ECB) was expected to leave interest rates unchanged. Japan also recorded strong growth but maintained low interest rates to encourage further growth in aggregate demand. Since the beginning of the year, the USD has appreciated by around 3.5 percent against the euro and yen. The Australian dollar (AUD) depreciated against the USD by 9.0 percent on the back of the slow down in the Australian economy. The decision by the Reserve Bank of Australia (RBA) to maintain its monetary policy stance in May, which was in contrast to earlier market expectations that it would raise interest rates, also contributed to the fall in the AUD (see Chart 1).

Trading in the global financial market during the first half of 2004 was influenced by a combination of factors, which included the uneven pace of expansion in the global economy, ongoing tension in the Middle East and expectations for higher short-term interest rates in the major financial markets. Ongoing tensions in the Middle East coupled with threats of further destruction to oil producing facilities in the region, prompted a sharp increase in oil prices to around US$42 per barrel.

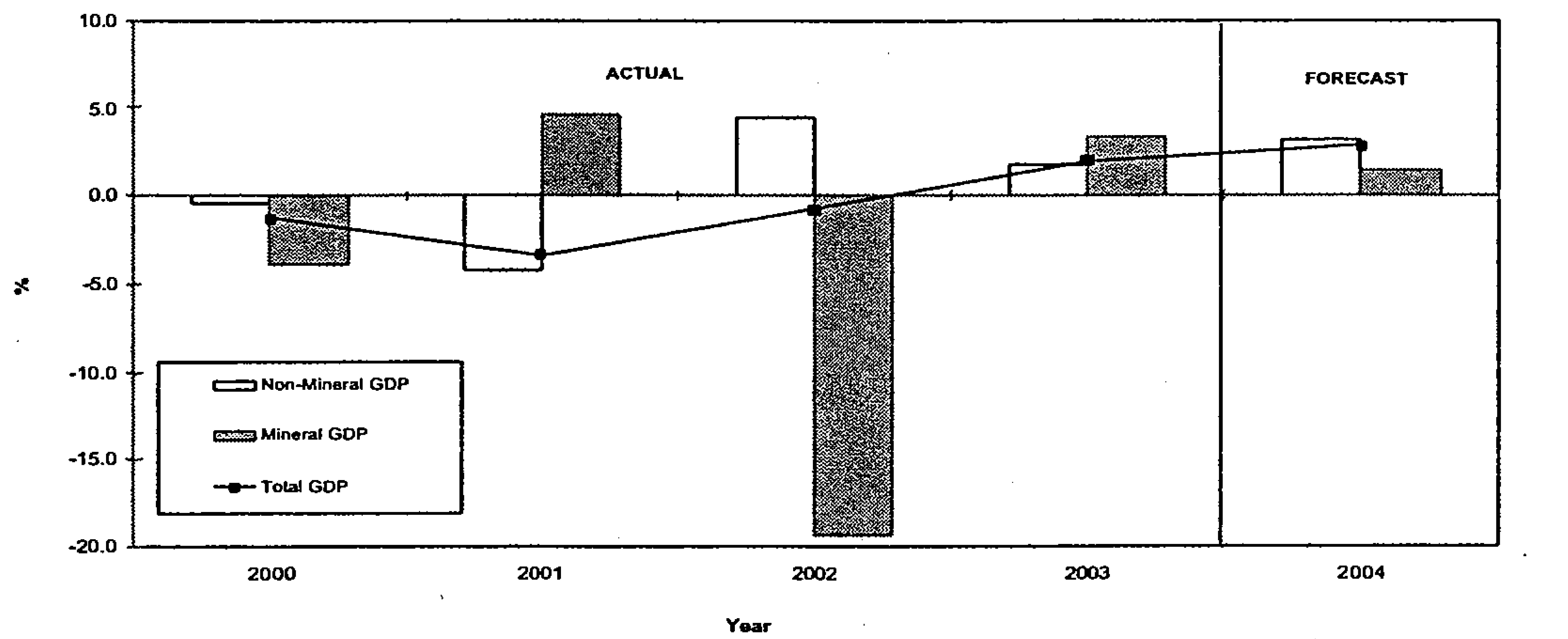
Stock market prices have rebounded strongly during the first half of 2004, aided by the recovery in the global economy and the prospects for improved earning performance for major corporations. In contrast, major bond markets have weaken in response to expectations for higher short-term interest rates and the surge in oil prices, which could exert further pressure on global inflation.

(b) Domestic Economic Activity

The Bank of PNG's preliminary assessment of available economic indicators supports the forecasted GDP growth of 2.8 percent for 2004 (see Chart 2). As projected in January 2004, production and export of major mineral and non-mineral commodities continue to increase in the five months to May 2004, due to higher international prices and favourable weather conditions. The Bank's survey of the private sector showed that nominal sales and employment levels were high in the first quarter of 2004, following a recovery in 2003.

The continued growth in the agriculture/forestry/fisheries sector is expected to be influenced by higher international prices and production of most agricultural commodities. The commencement of operation at the Wewak Tuna Loining Facility and export of refined oil from the Napa Napa refinery are expected to boost production and export in the manufacturing sector. The continued financing by the international financial institutions and aid agencies of on-going major infrastructure projects, including the sealing of the Kokopo-Rabaul road and maintenance of the Highlands Highway, are expected to increase construction activity. The developments in these sectors are expected to spillover into the other sectors, such as transportation and commerce.

Chart 2: Real Growth in GDP



Source: 2004 National Budget

During the year and over the medium term, the growth prospects will depend on some of these factors:

- Ongoing strong commitment by the Government to implement major structural reforms;
- Redirect and increase expenditure on infrastructure maintenance;
- The development of new mineral and non-mineral projects, including the commencement of the Front End Engineering Design (FEED) of the PNG-Queensland Gas Pipeline Project;
- Development and diversification of export products and markets; and
- The ability to sustain the macroeconomic stability achieved.

(c) Balance of Payments

Five months to May 2004

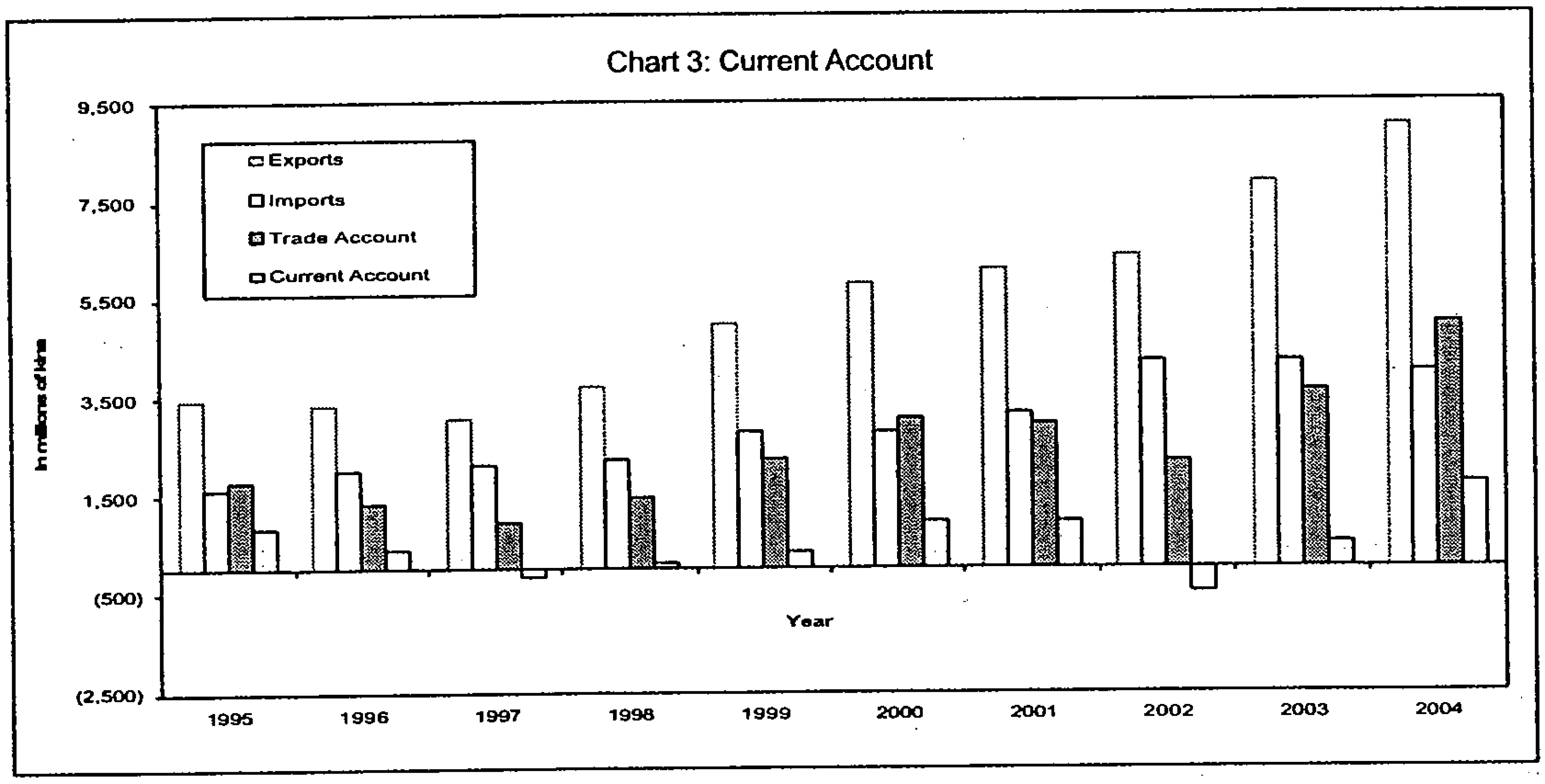
Preliminary balance of payments data for the five months to May 2004 showed an overall surplus of K6 million, compared to a deficit of K67 million in the corresponding period of 2003. This outcome was due to a higher surplus in the current account, reflecting lower net outflows in the services and income accounts, as a result of lower dividend payments by the mineral companies. This more than offset a deterioration in the trade account. The capital and financial accounts balance worsened as a result of higher external loan repayments by the Government combined with lower loan drawdowns this year.

The level of gross foreign exchange reserves at the end of May 2004 was US$543.8 (K1,737.1) million, sufficient for around 5.3 months of total and 7.7 months of non-mineral import covers. As at 28 July 2004, the reserve level was US$539.6 (K1,730.7) million. The accumulation of foreign exchange reserves reflected the high inflows of export receipts and mineral taxes paid to the Government.

Revised 2004 Projections

The latest IMF price projections indicate that the international prices of all of PNG's exports will be higher in 2004, compared to 2003, with the exception of cocoa exports. Coffee export price is projected to increase by 12.5 percent, palm oil by 12.9 percent, copra by 28.7 percent, copra oil by 28.7 percent, rubber by 12.0 percent, logs by 15.0 percent, gold by 7.1 percent, silver by 37.2 percent and copper by 8.9 percent. In 2004, the average price of crude oil is projected to be higher than the level in 2003.

In addition, the export volumes of all of PNG's major agricultural and mineral export commodities are projected to increase, compared to 2003, with the exception of copper and silver. The projected increases are mainly due to improved supply response from higher international prices, combined with some improvement in road infrastructure and access to markets. The projected increase in gold production is due to the mining of higher ore grades, while the increase in crude oil production is due to full production from the Moran Petroleum Development Licence



Source: Bank of PNG

(PDL5), which more than offset the natural decline in the Kutubu oil fields.

Other main assumptions underlying the revised balance of payments projections for 2004 are:

- A stable kina exchange rate;
- Additional project grants under the Enhanced Cooperation Package (ECP) from Australia are not included;
- The budgeted concessional project loans will be partially drawn down due to capacity constraints by the implementing agencies; and
- The budgeted commercial loan of around US$50 million is not included.

Accordingly, the balance of payments for 2004 is projected to show an overall deficit of K98.3 million, compared to a revised surplus of K353.2 million in 2003. The deterioration reflects a projected deficit of K1,832.0 million in the capital and financial accounts, mainly attributed to an increase in Government loan repayments and higher balances in offshore accounts by mineral companies. This is expected to more than offset the projected surplus of K1,733.7 million in the current account (see Chart 3).

The level of gross foreign exchange reserves by end of 2004 is projected to reach US$491.9 (K1,639.7) million, sufficient for around 4.9 months of total and 6.5 months of non-mineral import covers.

(d) Fiscal Operations of the Government

Actual to May 2004

Preliminary estimates of the fiscal operations of the National Government to May 2004 showed an overall surplus of K258.5 million, compared to a surplus of K16.2 million in the corresponding period of 2003, and represents 2.0 percent of nominal GDP. The surplus was due to higher revenue combined with lower expenditure (see Table 1).

Total revenue, including grants during the five months to May 2004 was K1,435.4 million, 17.6 percent higher than the receipts collected in the corresponding period of 2003, and represents 37.4 percent of the budgeted revenue. The increase was attributed to higher collections from personal, corporate and mineral taxes.

Total expenditure over the five months to May 2004 was K1,176.0 million, 2.3 percent lower than in the corresponding period in 2003, and represents 29.2 percent of the budgeted expenditure for 2004. The decrease was due to lower interest payments, continued tight expenditure control by the Government and slow implementation of the development budget.

The budget surplus resulted in net overseas and domestic loan repayments of K161.8 million and K61.6 million, respectively. The domestic loan repayment mainly reflected lower Treasury bills holding by the Central Bank, which were sold to non-banks.

Table 1: Fiscal Operations of the National Government

	2003	2004 Budget	2004 Adjusted Budget[2]	2003 Jan-May	2004 Jan-May
Total Revenue & Grants	3,610.2	3,837.1	3,837.0	1,220.2	1,435.4
Total Expenditure	3,734.3	4,032.6	4,032.6	1,204.0	1,176.0
Surplus/Deficit	-124.1	-195.5	-195.6	16.2	258.5
% of GDP	-1.1	-1.5	-1.5	0.1	2.0
FINANCING					
Net External	-307.0	-70.3	-411.4	-120.8	-196.9
Concessional	-136.5	-60.9	-202.4	-143.6	-96.9
Commercial	11.3	176.3	-37.5	22.8	-19.8
Exraordinary	-181.8	-185.7	-171.5	0.0	-80.2
Net Domestic	431.1	265.8	607.1	104.6	-61.6
Bank of PNG	-378.6	0.0	-205.7	-32.0	-207.9
Commercial Banks	295.9	0.0	133.6	43.6	5.6
Non-Bank System	565.5	0.0	447.1	310.5	215.2
Other Domestic Sources	-51.7	265.8	232.1	0.0	0.0
Asset sales	40.0	0.0	0.0	0.0	
Other	-91.7	265.8	232.1		
Total	124.1	195.5	195.6	-16.2	-258.5

Source: 2004 National Budget and Bank of PNG

[2] The Adjusted 2004 Budget reflects Bank of PNG's adjustment on financing.

Consistent with the Government's debt management policy, the favourable cashflow enabled it to retire some Treasury bills and successfully issued K100.0 million in long-term Inscribed stocks. It is anticipated that an additional K100.0 million will be issued in the second half of 2004. The declining interest rates and debt restructure should have a positive impact on the Government's cashflow for 2004.

In the Adjusted 2004 Budget scenario, it is assumed:

- No commercial loan of around US$50.0 (K166.7) million and only US$16.0 (K53.3) million in concessional loan would materialise. As a result, there will be a corresponding increase in domestic financing to K607.1 million;
- There will be a depletion of the Bank of PNG's stock of Treasury bills resulting in a net repayment of K205.7 million, while commercial banks will have positive financing of K133.6 million; and
- The Government will issue Inscribed stocks to fund the shortfall in drawdown of external loans and maintain the budget deficit at 1.5 percent of GDP. New issues are expected to be taken up mainly by non-bank entities.

(e) Exchange Rate

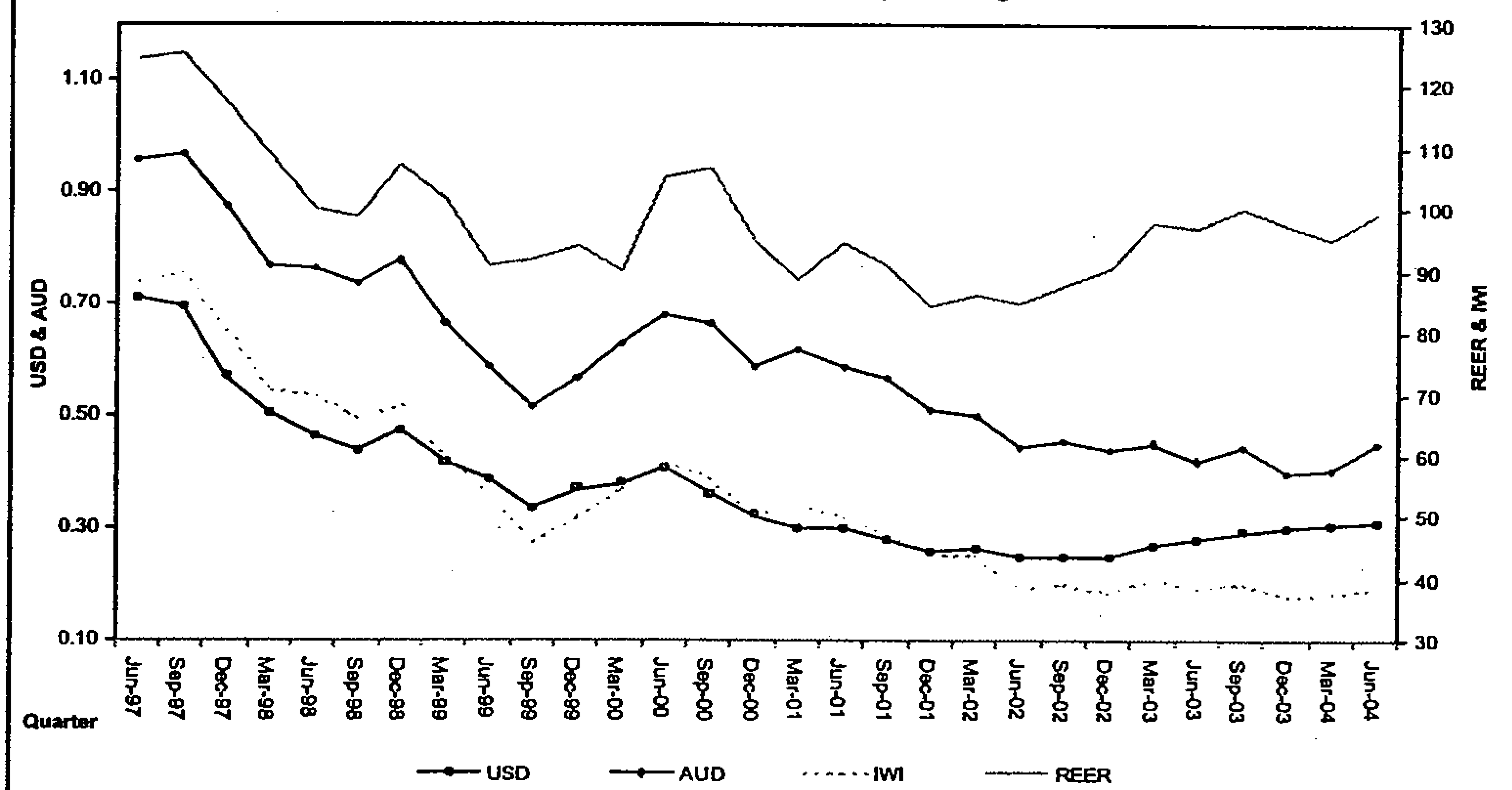
The kina appreciated by 3.5 percent between December 2003 and May 2004. Against the Australian dollar, the kina appreciated by 9.2 percent to A$0.4433 during the same period (see Chart 4). The appreciation mainly reflected the weakening Australian dollar against the US dollar. As at 28 July 2004, the exchange rate was US$0.3110.

The appreciation of the kina exchange rate was due to the following factors:

- Positive supply response to the higher international prices of non-mineral exports, which resulted in sustained inflow of foreign exchange;
- Continued low domestic demand;
- The maintenance of positive real interest rates on Treasury bills, which encouraged investors to hold kina denominated assets on-shore; and
- Sound fiscal management by the Government.

The real effective exchange rate (REER) appreciated in the first half of the year, mainly attributed to the fall in domestic inflation and the appreciation of the kina exchange rate against the currencies of PNG's major trading partners.

Chart 4: Kina exchange rate against USD, AUD, Import Weighted Index and REER



Source: Bank of PNG

(f) Inflation

Actual to March 2004

Inflation continued its downward trend in the first quarter of 2004. The annual headline inflation rate to March 2004 was 2.9 percent, compared to a peak of 20.7 percent in March 2003. The exclusion-based and trimmed-mean inflation rates were 5.3 and 1.6 percent respectively, to March 2004. The annual headline inflation rate to March 2004 is the lowest increase since March 1997. The declining inflation trend is clearly evident in Chart 5, which shows all measures of inflation falling since June 2003.

The lower headline inflation outcome for the March quarter of 2004 was the result of a stable exchange rate, which more than offset the effect of the 2.0 percent import levy introduced in the 2004 National Budget and price increases for fuel products and electricity charges in the first quarter of 2004.

Revised 2004 Projections

The annual headline inflation forecast for 2004 has been revised downwards to 7.4 percent from the projection made in the January 2004 MPS of 8.2 percent. The exclusion-based and trimmed-mean inflation rates have also been revised downwards for 2004 (see Table 2).

The revisions for 2004 are based on the following assumptions:

Table 2: Consumer Price Indices (annual % changes)

	ACTUAL				FORECAST	
Inflation Measures	2001	2002	2003	12 months to Mar 04	2004 Jan MPS	2004 Jul MPS
Headline	10.3	14.8	8.4	2.9	8.2	7.4
Underlying						
CPI Exclusion-based	8.2	17.3	10.0	5.3	4.0	3.7
CPI Trimmed-mean	8.0	15.6	6.7	1.6	3.3	2.5

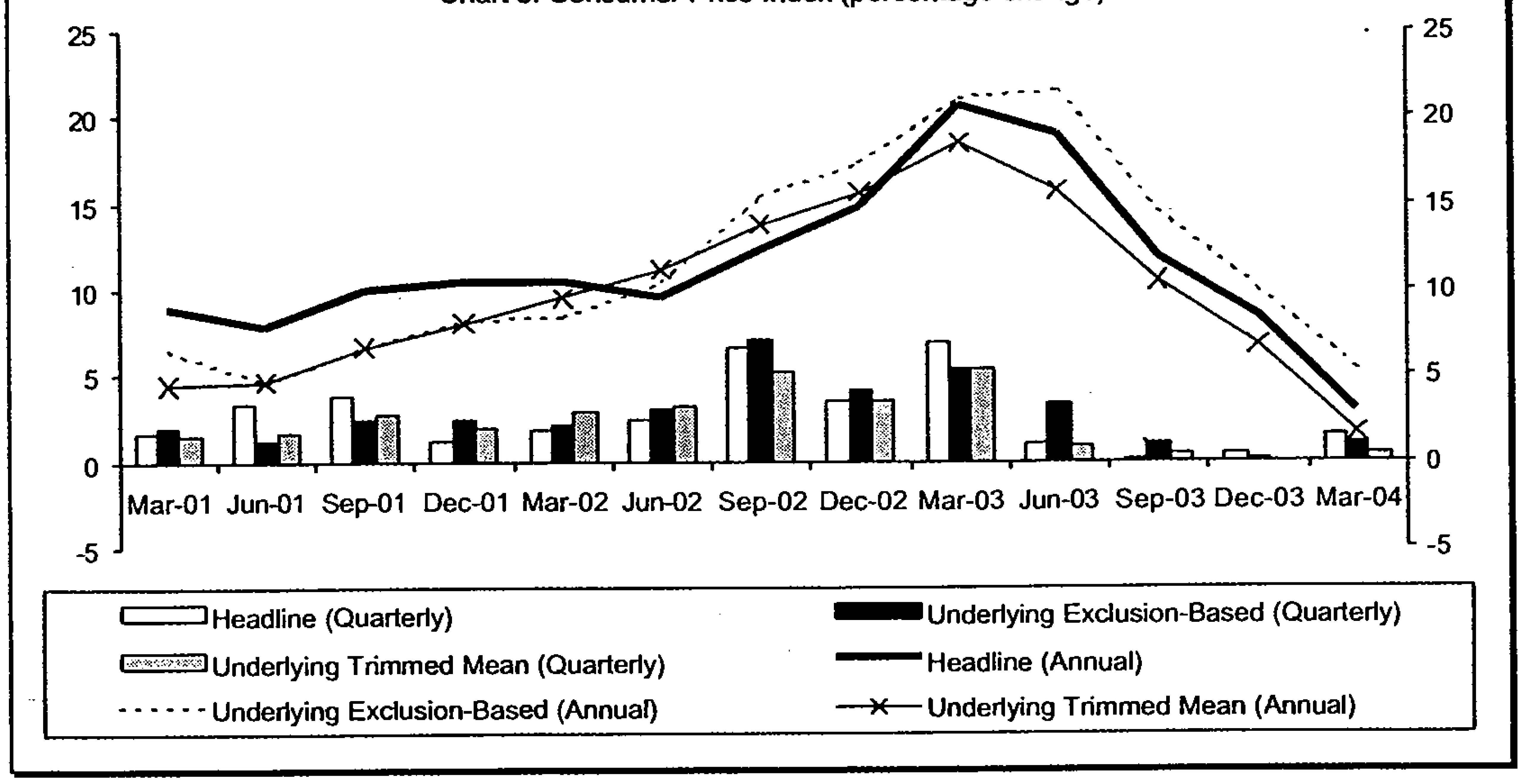
Source: NSO and Bank of PNG

- Continued stability of the kina against the US and Australian dollars;
- Any impact of price pressure on inflation arising from high crude oil prices will be offset by the stability in the exchange rate;
- Favourable balance of payments outcome due to sustained high prices and production of PNG's major export commodities, which is expected to offset any pickup in import demand; and
- Continued sound fiscal management by the Government consistent with the parameters of the 2004 Budget.

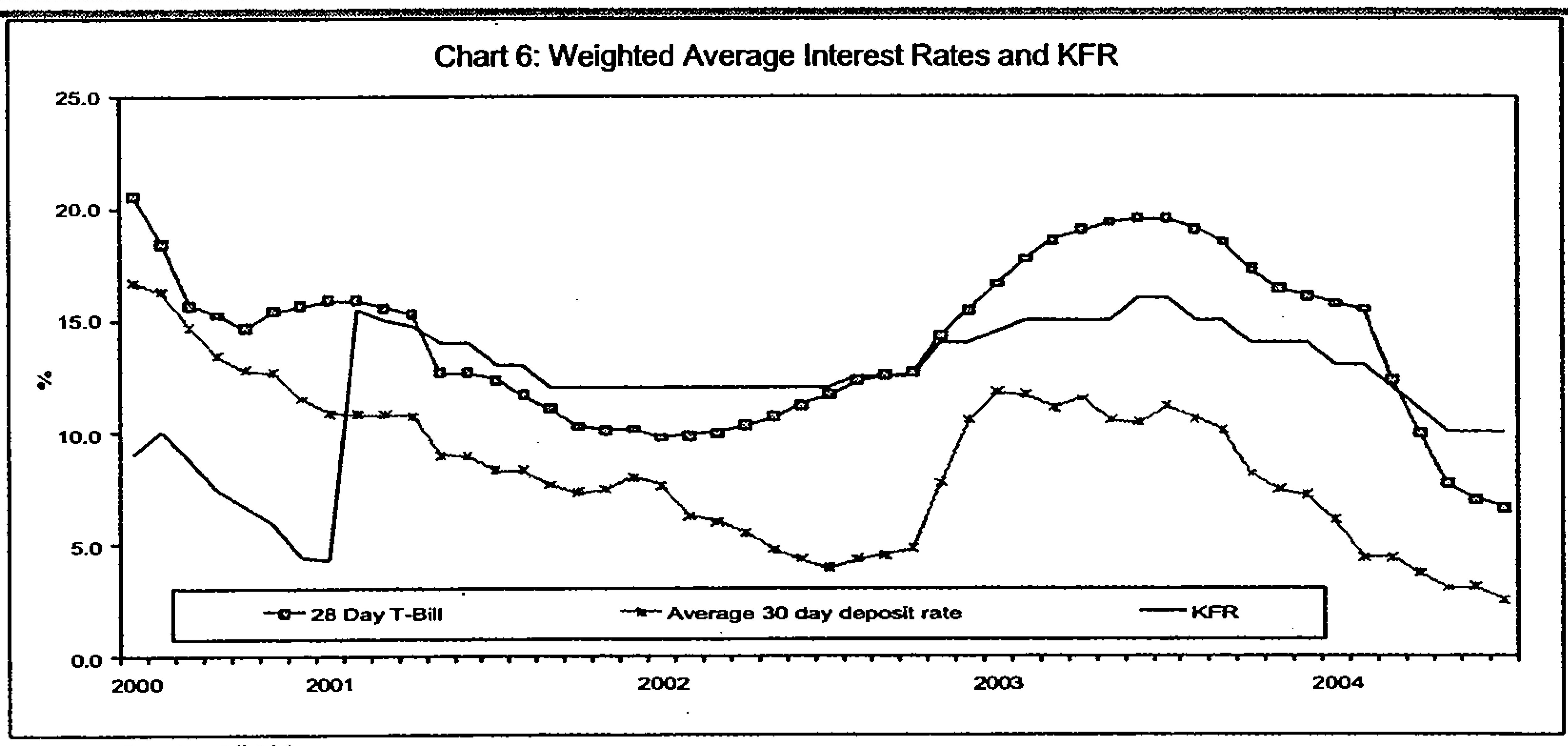
(g) Monetary and Financial Market Developments

The Central Bank gradually eased monetary policy during the first half of 2004, reducing the Kina Facility Rate (KFR) by 4.0 percentage points from 14.0 percent in December 2003 to

Chart 5: Consumer Price Index (percentage change)



Source: National Statistical Office (NSO) and Bank of PNG



Source: Bank of PNG

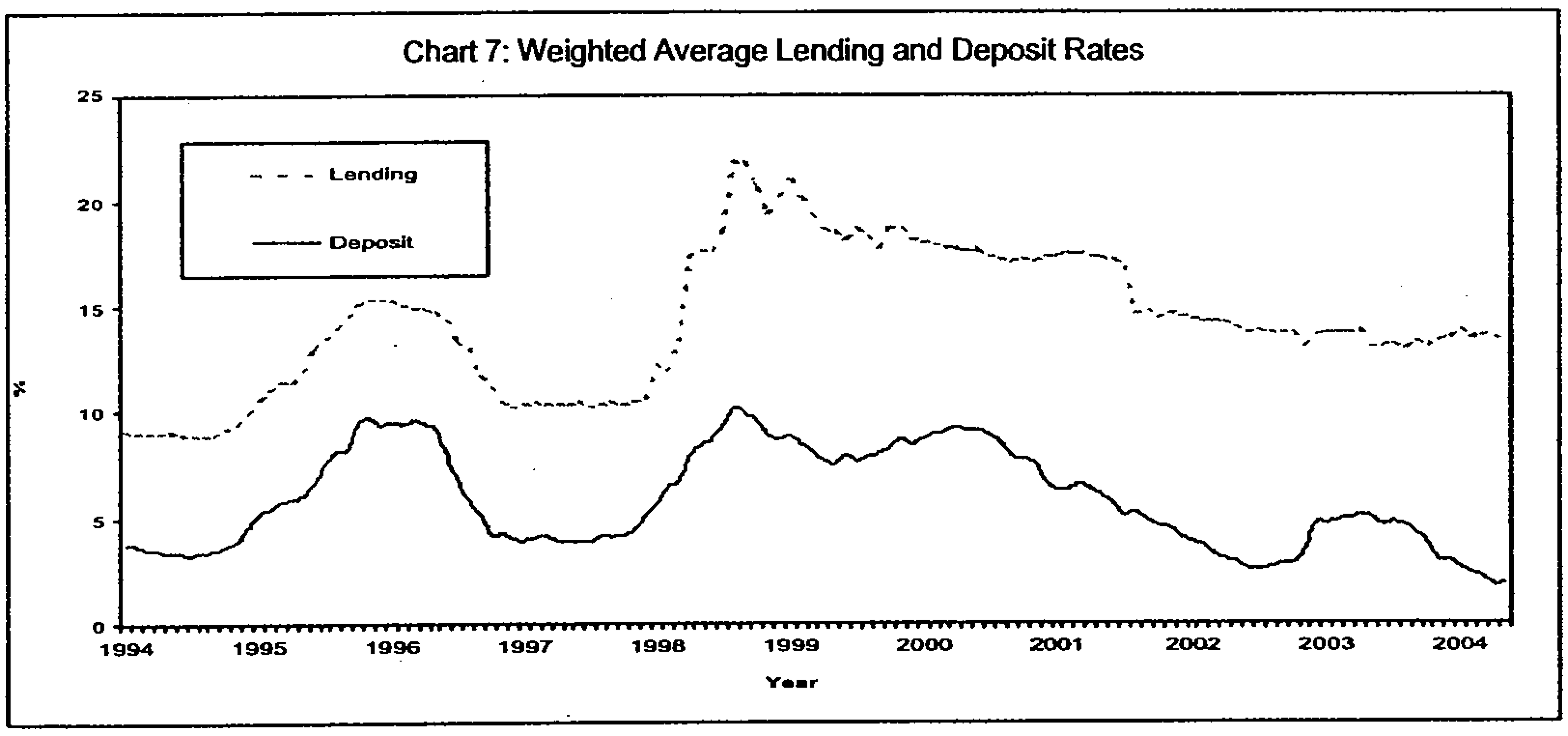
10.0 percent in May 2004, and remained unchanged in June and July (see Chart 6). The easing stance was considered necessary in complementing the macroeconomic stability achieved in 2003, as indicated by:

- The progressive decline in the annual headline inflation in the March quarter of 2004;
- A stable kina exchange rate;
- Sound fiscal management by the Government resulting in a surplus for the first five (5) months of 2004;
- The accumulation of foreign exchange reserves by the Bank of PNG; and
- The continued decline in lending to the private sector by the commercial banks.

Consistent with the easing stance of monetary policy by the Central Bank, interest rates on Treasury bills declined across all maturities, with the 28-day rate falling from 16.13 percent in December 2003 to 6.55 percent as at 29 July 2004. All the commercial banks reduced their Indicator Lending Rates (ILR) to a spread of 12.25 to 13.25 percent by end June 2004. The weighted average lending rate on total loans declined from 13.52 percent in December 2003 to 13.28 percent in June 2004, while the weighted average rate on total deposits declined from 2.95 to 1.51 percent in the same period. In spite of the decline in interest rates, the spread between the weighted average lending and deposit rates remained wide (see Chart 7).

In order to encourage investors in holding kina denominated assets, the Central Bank maintained real interest rates at positive levels.

Total liquidity of the banking system increased by 4.4 percent in the first six months of 2004, as a result of sustained foreign exchange inflows and Central Bank intervention in the foreign exchange market. The Bank sterilised the excess liquidity by utilising its open market



Source: Bank of PNG

BOX 1: HIGH LIQUIDITY LEVELS AND ITS IMPACT ON PRICE STABILITY

In addition to the easing stance of monetary policy since June 2003, the favourable inflow of foreign exchange and the continued decline in lending, the level of total liquidity in the banking system has increased significantly. While this has translated into declines in lending rates, demand for loans continued to be depressed. A significant amount of these liquid assets totaling 44.0 percent is held by commercial banks in Treasury bills, while the non-banks account for 56.0 percent of the total Treasury bills issued by the Government.

The high level of liquidity in the banking system has the potential to give rise to price instability:

- Exert downward pressure on the exchange rate;
- Low real interest rates may give rise to capital outflow from PNG as there exists other competing foreign currency denominated assets, such as in equity markets, and threaten macroeconomic stability; and
- The Central Bank is concerned that the non-bank public, which holds over 56 per cent of Treasury bills, may increase consumption as the interest rates decline to negative levels.

The Central Bank is fully aware of these risks to macroeconomic stability and will closely monitor and counteract any adverse developments that may threaten the objective of maintaining price stability.

instruments, mainly Treasury bills and Repurchase Agreement Facility (RAF). The Tap Facility was closed on 14 May 2004, with the maturing volumes shifted to the auction to increase the amount on offer and smoothen the decline in interest rates.

There were no changes made to both the Cash Reserve Requirement (CRR) and the Minimum Liquid Asset Ratio (MLAR), which were maintained at 3.0 and 25.0 percent, respectively.

The level of broad money supply (M3*) grew by 5.4 percent between December 2003 and June 2004, mainly reflecting an increase in net foreign assets, which more than offset a decline in net credit to the Government (see Chart 8). Reserve money declined by 5.4 percent over the six months to June 2004, as a result of contraction in commercial bank deposits at the Central Bank and currency in circulation.

Despite the high liquidity levels, lending to the private sector continued to remain depressed over the first half of 2004 due to:

- Crowding out of the private sector by the Government;
- Lack of demand for credit by the private sector; and
- Lack of major development projects.

2. MONETARY POLICY

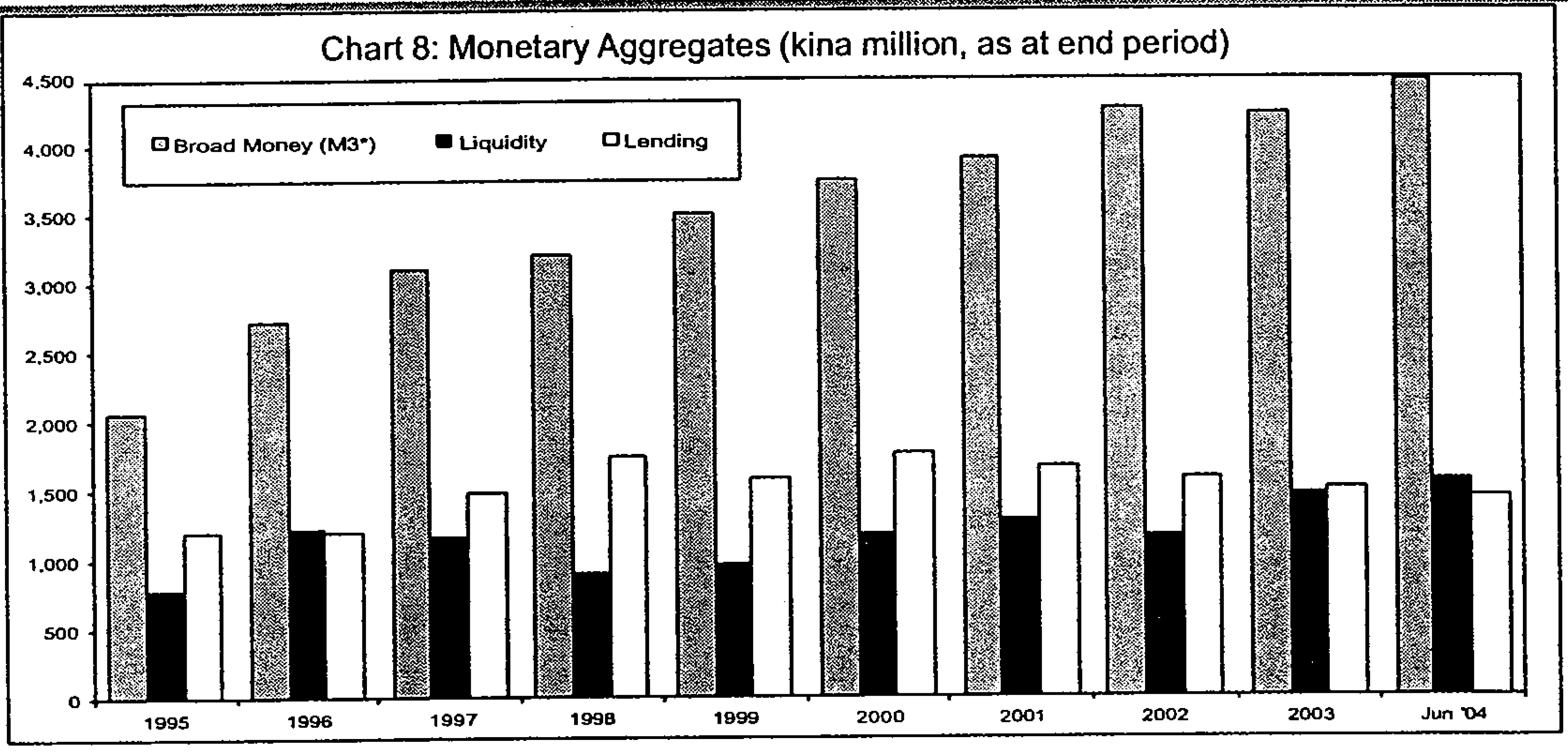
Monetary Policy Stance

The improvement in price stability achieved during 2003 consolidated over the first half of 2004 and enabled the Central Bank to ease monetary policy. Whilst the Central Bank adopted a generally easing stance of monetary policy, several factors prompted the Bank to take a cautious approach in the latter part of the first half of 2004. These factors include:

- The appreciation of the kina exchange rate;
- The higher prices of crude oil;
- The decline in real interest rates on Treasury bills; and
- The high liquidity overhang from 2003.

Over the second half of the year, the Central Bank will continue to pursue a cautious stance by closely monitoring these risks and take appropriate measures to mitigate their impact on price stability (see Box 1). Any major change to the monetary policy stance in the second half of 2004 will depend on the following factors:

- The inflation outcomes for the June and September quarters of 2004;
- The stability in the exchange rate in view of the high level of liquidity in the banking system, sustained favourable terms of trade, the continued sound fiscal management by the Government, demand for imports and the maintenance of sufficient positive real interest rates



Source: Bank of PNG

above those in PNG's major trading partners; and

Timely drawdown of external loans by the Government.

Under these conditions, monetary and credit aggregates are expected to grow at moderate rates (see Table 3). The Central Bank expects to constrain growth in reserve and broad money to 0.2 percent and 7.9 percent, respectively, which are sufficient to support private sector activity. The Bank considers that there is excess reserve money available in the banking system and therefore will constrain any further growth in 2004. Given the decline in net credit to the Government and high free liquidity reserves in the banking system, private sector credit is projected to grow by 6.7 percent. However, this growth rate may not be attained if the Government continues to crowd out private sector investment, combined with the lack of new major projects. The level of net foreign assets is expected to increase by 6.7 percent, due to a decrease in foreign liabilities of the Central Bank and net purchase of foreign exchange by the Bank.

Table 3: Annual percentage changes in Monetary and Credit Aggregates

	2002	2003	Jun-04 Prelim Outcome	Jan MPS 2004	Jul MPS 2004
Broad Money Supply	9.7	1.0	11.3	9.1	7.9
Reserve Money	17.3	13.7	12.4	8.9	0.2
Private Sector Credit	-4.6	-2.8	2.9	9.0	6.7
Net Credit to Government	82.0	-10.4	-5.0	-6.5	-6.1
Net Foreign Assets	-0.9	5.8	60.8	27.7	6.7

Source: Bank of PNG

It is imperative that the Government continues with the positive contributions it made towards the achievement of price stability, by adhering to the parameters of the 2004 Budget. The macroeconomic stability achieved to date rests in part with the Government's commitment towards achieving the Budget objectives and its medium-term development strategy (MTDS). If recurrent expenditure continues to be constrained, the savings need to be diverted to development expenditure because of its potential to facilitate private sector activity and sustain macroeconomic growth over the medium-term.

Conduct of Monetary Policy

The KFR will remain as the instrument for signaling the Central Bank's stance for monetary policy, with an announcement of the KFR each month by the Governor. The transmission of monetary policy will continue to be reinforced within the reserve money framework. The excess level of liquid assets in relation to statutory requirements, which has averaged 23 percent over the first half of the year, is an indicator of the banking system's capacity to finance new lending.

To enhance the transmission mechanism of monetary policy, the RAF will be retained for daily and weekly liquidity management. Transactions under the RAF will continue to be unsecured. Treasury bills remain the main instrument for liquidity management.

Queries on the contents of the Monetary Policy Statement should be directed to the Manager, Economics Department on telephone number (675) 3227311 or Manager, Monetary Policy Unit on telephone number (675) 3227312, or both on fax number (675) 3200757. Copies of the Statement can be obtained from the Economics Department and is also available on the Bank's website: http//www.bankpng.gov.pg

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