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BANK OF PAPUA NEW GUINEA



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

PORT MORESBY

31 July 2007

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Objective of Monetary Policy

The objective of monetary policy in Papua New Guinea (PNG) is to achieve and maintain price stability. This entails low inflation supported by stable interest and exchange rates. If achieved, price stability will lead to:

- Confidence in the kina exchange rate and management of the economy;
- A foundation for stable fiscal operations of the Government;
- Certainty for businesses to plan for long-term investment; and
- A stable macroeconomic environment conducive to economic growth.

Executive Summary

The Government maintained fiscal discipline in its fiscal operations for the first five months of 2007. Based on the annual inflation rate to March 2007 of 4.5 percent, projections by the Bank of Papua New Guinea (Bank) indicate that inflation for the year will be 6.0 to 8.0 percent. The increase in inflation was due to the depreciation of the kina against the Australian dollar, combined with the high growth in monetary aggregates. The Bank is concerned that inflationary pressures will arise in the second half of 2007. The Bank will therefore monitor the situation closely, including assessing the June quarter inflation and fiscal outcomes before deciding on its monetary policy stance for the second half of 2007.

The main risks to price stability in the second half of 2007 are further depreciation of the kina against the Australian dollar, imported inflation from PNG's major trading partner countries, declines in prices of PNG's exports, further fast expansion of monetary aggregates and any fiscal slippages. Fiscal discipline by the incoming Government is important, without which, the Bank will have great difficulties in mitigating the inflationary pressures to ensure that macroeconomic stability continues over the medium-term.

Monetary aggregates are expected to continue to grow strongly in the second half of 2007 as a result of increases in net foreign assets and private sector credit. The low official interest rates are a contributing factor to the fast growth in monetary aggregates. The fast growth in monetary aggregates might exert further inflationary pressures, the Bank will therefore see to it that the growth in monetary aggregates is non-inflationary.

The Bank is committed to achieving and maintaining price stability. The neutral monetary policy stance that the Bank maintains will be reassessed subject to the June quarter inflation and fiscal outcomes and, if necessary, changes to it will be made to counter any adverse effects on the achievement of price stability in the second half of 2007.

1.0 Monetary Policy Discussions

1.1 Monetary Policy Assessment and Issues

In the first half of 2007, the Bank continued its neutral monetary policy stance. The Kina Facility Rate (KFR) was maintained at 6.0 percent.

The annual headline inflation of 4.5 percent in March 2007 is within the 2007 forecast stated in the January MPS, as a result of the low prices of seasonal produce. Based on this inflation outcome, expected exchange rate movements, imported inflation from PNG's major trading partners, the lagged effect of past increases in fuel prices and fast expansion of monetary aggregates, inflation is now projected by the Bank to be 6.0 to 8.0 percent for 2007.

The Trade Weighted Index (TWI) and Real Effective Exchange Rate (REER) declined over the same period mainly reflecting the weakening of the kina against the Australian dollar. The depreciation of the REER also indicates a general improvement in the terms of trade of PNG's exports.

The low interest rate environment combined with sustained business confidence led to increased lending to the private sector by other depository corporations (ODCs). The increase in lending enabled the private sector to expand business activity, employment and consumption. Given the projected increase in inflation and low interest rates, real interest rates could turn negative and lead to capital outflow.

Annual growth in broad money supply (M3*) and the monetary base were 35.1 percent and 12.9 percent, respectively, to June 2007. The growth in broad money supply was primarily attributed to an increase in net foreign assets of the Central Bank and net claims on the private sector by ODCs. Whilst, the Bank was able to partly sterilise excess liquidity caused by the build up in net foreign assets of the Central Bank, interest rates remained low. The faster growth in monetary aggregates contributed to the inflationary pressure.

The Government achieved a budget surplus for the first five months of 2007, reflecting tighter controls on its expenditure compared to previous election years. This, combined with the slow drawdown from the trust accounts, has assisted the Bank in mitigating inflationary pressures. In this regard, the incoming Government should maintain fiscal discipline, without which, the Bank will have great difficulties in mitigating the inflationary pressures to ensure that macroeconomic stability continues over the medium-term.

1.2 Monetary Policy Stance

The Bank of Papua New Guinea is concerned about the increase in inflation in the first quarter of 2007, due to the depreciation of the kina against the Australian dollar and the fast growth in monetary aggregates. The Bank will monitor these developments closely and adjust its monetary policy stance to ensure that price stability is achieved.

Based on the assumptions that inflation will be 6.0 to 8.0 percent, further depreciation of the kina exchange rate against the currencies of PNG's major trading partners and fast expansion of monetary aggregates, will warrant a change in the monetary policy stance. This will be subject to the inflation and fiscal outcomes for the June quarter.

The Bank expects broad money supply to grow by 27.9 percent and the monetary base to grow by 7.7 percent in 2007. These increases are mainly due to the projected growth in net foreign assets of the Central Bank, net claims on the private sector by ODCs and low official interest rates. These factors, combined with sustained business confidence, led to an expansion of business activity and employment on one hand and exerted inflationary pressures on the other hand.

Based on the projected inflation, official interest rates are low, and there is a potential that real interest rates might become negative, which could lead to capital outflow.

The Bank expects the incoming Government to continue to prudently manage its fiscal operations in the second half of 2007 and remain within the parameters of the National Budget and the Medium Term Development Strategy (MTDS). The surplus should be used to retire debt. The Government should also improve efficiency in the implementation of development expenditure in the priority areas of health, education, law and order and physical infrastructure. The continuation of public sector reforms, improving the efficiency of public utilities and the removal of impediments to trade and investment will also contribute to higher economic activity and growth in PNG, and assist in absorbing the increasing domestic demand. At this stage of PNG's development, it should aim for economic growth of 6.0 to 7.0 percent to ensure that the great majority of the population benefits from the mineral boom the country is enjoying.

The risks to price stability over the medium term could come from:

- Further depreciation of the kina against the Australian dollar;

- High inflation imported from PNG's major trading partner countries;
- Further fast growth of the monetary aggregates;
- Decline in export commodity prices;
- Any fiscal slippages by the National Government;
- Lagged effect and further increases in oil prices; and
- Other unforeseen external and domestic shocks.

In this respect, the Bank will closely monitor these risks and their potential effects on the achievement of price stability and, if necessary, make adjustments to the stance of monetary policy in the second half of 2007 and over the medium-term.

1.3 Conduct of Monetary Policy

The Monetary Policy Statement (MPS) provides the overall monetary policy framework, while the monthly KFR remains the instrument for signalling the Bank's monetary policy stance through an announcement by the Governor. Monetary policy will be conducted within the monetary base framework. Following the announcement, Open Market Operations (OMOs) will be conducted to support the Bank's monetary policy stance. The OMOs involves Repurchase Agreement (Repo) transactions with commercial banks and the auction of Central Bank Bills (CBB) to ODCs and Treasury bills to the general public.

The Bank is committed to adopting appropriate monetary policy management strategies that will achieve price stability.

2.0 Developments and Expectations

2.1 International Developments

World economic growth is expected to remain strong this year according to the April 2007 *World Economic Outlook (WEO)*, by the International Monetary Fund (IMF). In 2007, the world economy is expected to expand by 4.9 percent compared with 5.4 percent in 2006. Emerging market economies, especially China and India, are the main forces behind this growth, while the Japanese economy continues to recover.

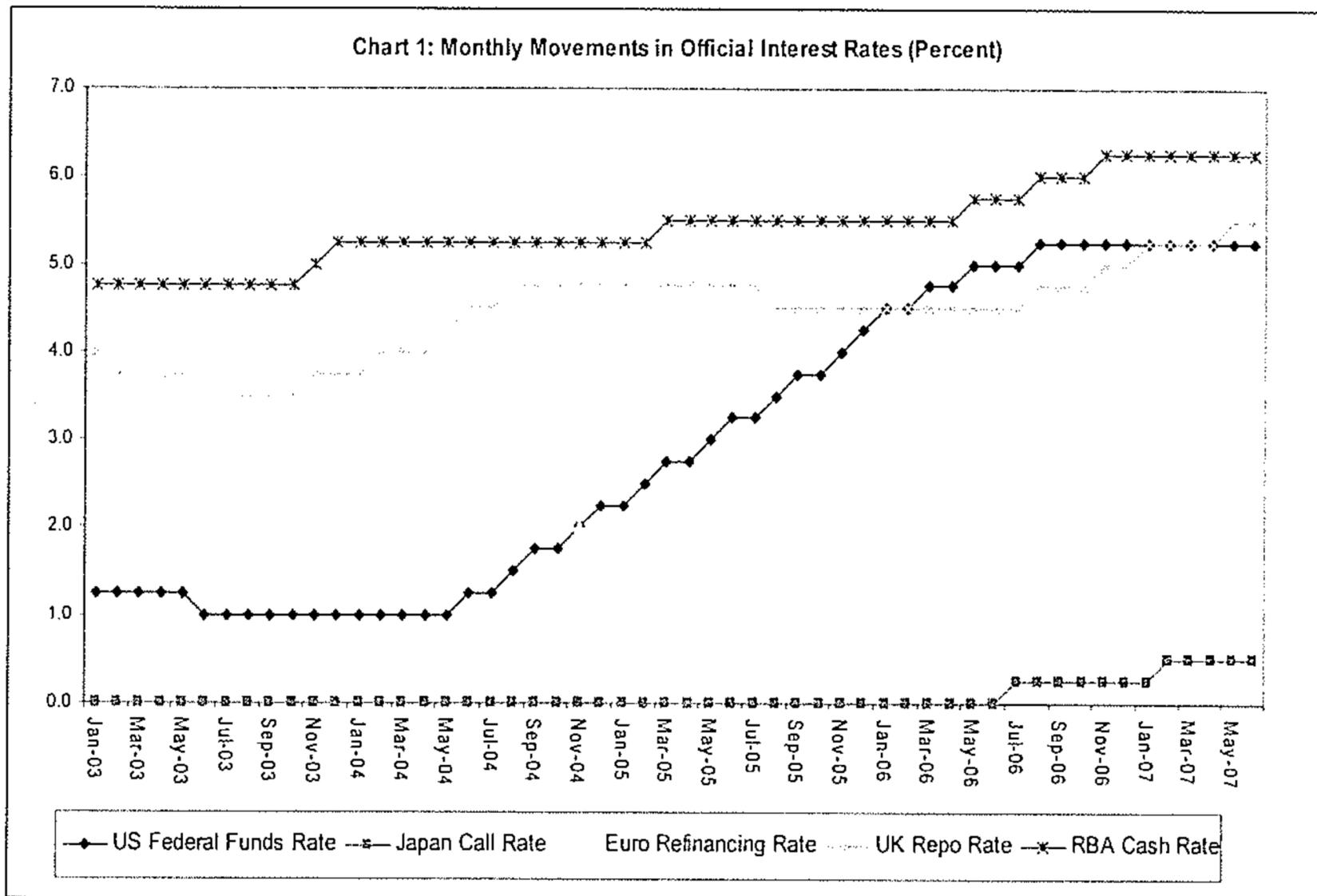
In the US, economic growth, which continued to slow during the first quarter of 2007, was influenced by the ongoing weakness in the housing sector. In 2007, growth is expected to slow to 2.2 percent from 3.3 percent in 2006. In 2007, the Eurozone economy is expected to grow by 2.3 percent compared to 2.6 percent in 2006. The growth in 2006 was supported by strong domestic demand. The Japanese economy is projected to grow by 2.7 percent in 2007 from 2.6 percent in 2006. Rapid growth amongst the emerging economies have been led by China and India, which recorded annual growth rates of 10.7 and 9.2 percent in 2006, and are expected to grow by 10.0 and 8.4 percent, respectively in 2007.

The risks to this global outlook include the potential for a further slow down in the US economy reducing global demand increased volatility in the financial markets, inflationary pressures and global trade imbalances.

Strong economic growth and high commodity and energy prices continue to underpin global inflationary pressures. Oil prices continued to consolidate between US\$60 to US\$70 per barrel during the second half of 2006. Although global headline inflation declined from its peak in 2006, major economies continue to experience high inflation rates close to the upper end of their central banks' inflation targets. As a result, the European Central Bank, Bank of England and Bank of Japan increased their official interest rates during the first half of 2007. In the US, despite the slow down in the economy, the Federal Reserve Board left the Federal Funds Rate unchanged (*see Chart 1*).

Global financial markets continue to experience volatile trading conditions. In the foreign exchange market, the US dollar and the Japanese Yen continued to weaken against the other major currencies. The US dollar weakened on the back of the slow down in the US economy. This led to expectations that the Federal Reserve Board would lower interest rates in future. The weakness of the Yen was due to low interest rates and expectations that the Bank of Japan would delay any rise in interest rates this year. Commodity-based currencies like the Australian and New Zealand dollars appreciated to record highs supported by carry-trade¹ activities. Global equity markets continued to perform strongly, supported by strong corporate profits while bond yields were higher reflecting greater risk premiums relating to global inflation and on the back of monetary policy tightening by major central banks.

¹ Arbitrage by borrowing in low yielding currencies and investing in high yielding currencies.



Source: Respective Central Banks' websites

2.2 Domestic Economic Conditions

The growth in employment in 2006 continued during the March quarter of 2007. Data from the Bank's Employment Survey shows that employment grew by 4.1 percent in the March quarter of 2007, compared to 3.7 percent in the December quarter of 2006. This was due to higher employment in all sectors except the 'financial/business and other services' sector. Annual employment growth was 9.9 percent to March 2007, compared to 8.8 percent to December 2006. Growth in private sector activity, combined with Government spending and higher consumer demand, indicates that real GDP growth could be higher than the Government's forecast of 4.5 percent in 2007.

Over the medium term, addressing key policy issues regarding impediments to business and investment, promoting export-led growth, improving public infrastructures and institutional reforms should promote further economic growth.

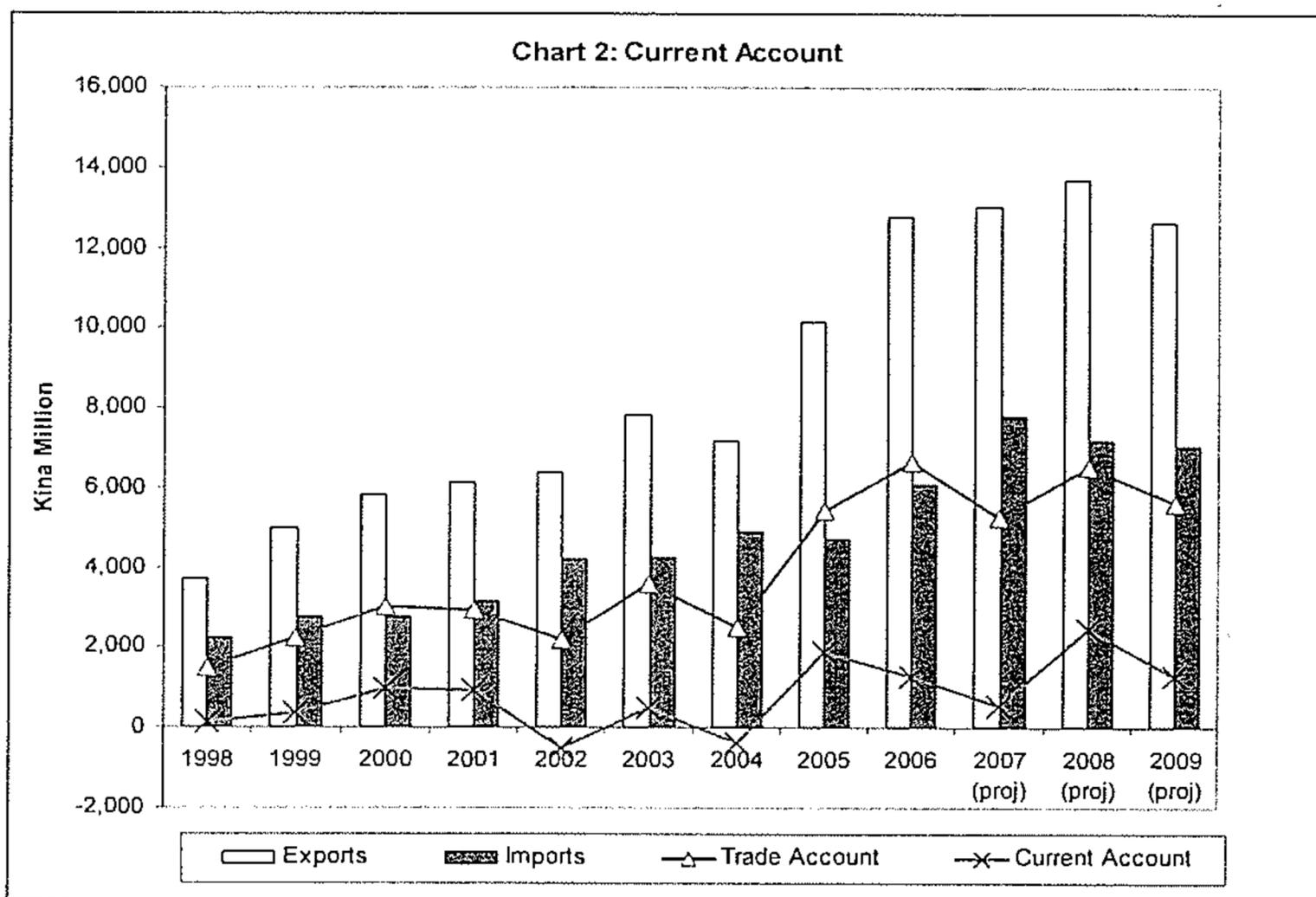
2.3 Balance of Payments

Preliminary balance of payments data for the five months to May 2007 showed an overall surplus of K342.4 million, compared to a surplus of K499.1 million in the corresponding period of 2006. This outcome was due to a deficit in the current account balance, which was more than offset by a surplus in the capital and financial accounts. The deficit in the current account was due to a lower trade surplus

and higher net service payments. The surplus in the capital and financial accounts was the result of net inflows in both the capital and financial accounts, reflecting direct project financing by donor agencies, net equity inflows of direct and portfolio investments and the sale of financial derivative instruments.

The level of gross foreign exchange reserves at the end of May 2007 was US\$1,547.7 (K4,687.1) million, sufficient for 8.5 months of total and 16.1 months of non-mineral import covers. As at 27th July 2007, the level of gross foreign exchange reserves was US\$1,614.0 (K4,678.2) million.

The latest IMF and World Bank price projections indicated that most international prices of PNG’s non-mineral exports will be higher in 2007, compared to 2006. According to the mineral companies, prices of all mineral exports are expected to increase, with the exception of crude oil.



Source: Bank of PNG

The export volumes of PNG’s major commodities are projected to increase in 2007, compared to 2006. The projected increases are mainly due to lagged supply responses of improved prices for some non-mineral commodities and higher production associated with favourable weather conditions, harvesting of new plantings coming to maturity from new plantations and from the Autonomous Region of Bougainville. These developments in non-mineral export volumes are expected to continue into the medium-term. The projected increase in gold production is due to the mining of higher ore grades from existing mines combined with commencement of production from the Simberi and Sinivit gold mines. The projected increase in crude oil production is due to higher production from the South East (SE) Mananda oil project.

Other main assumptions underlying the balance of payments projections for 2007 and the medium term include:

- A stable kina exchange rate;
- The commencement of production from the Simberi and Sinivit gold mines in 2007; and
- The continued construction of the Ramu Nickel mine to 2008 and the commencement of production in 2009.

The surplus in the balance of payments is projected to be lower at K1,090.2 million in 2007, compared to a surplus of K1,976.8 million in 2006. At the end of 2007, it is projected that gross foreign exchange reserves will be around US\$1,800.0 (K5,400.0) million, sufficient for 8.4 months of total and 14.9 months of non-mineral import covers. The gross foreign exchange reserves are projected to increase further over the medium term (*see Appendix*).

2.4 Fiscal Operations of the Central Government

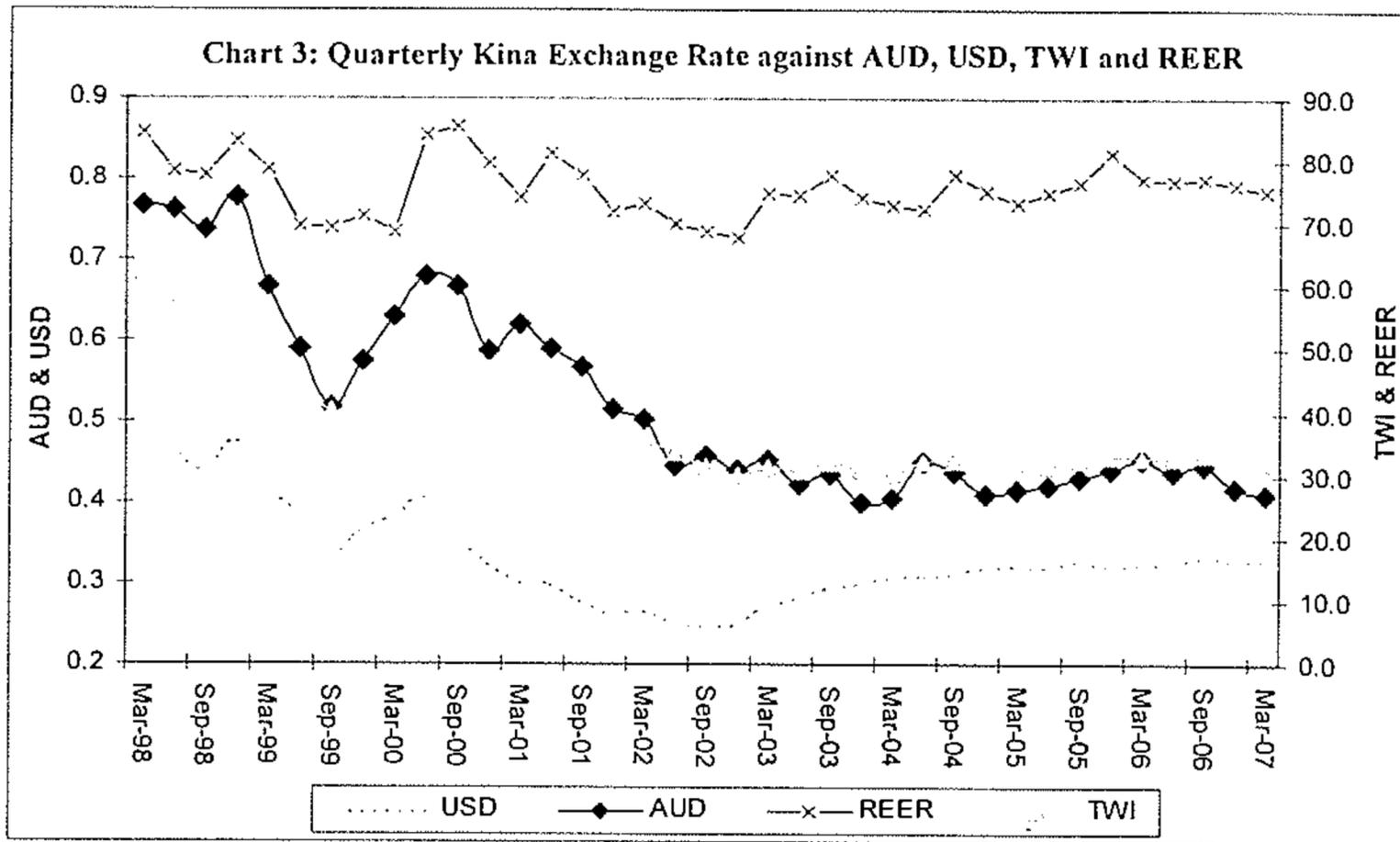
Preliminary estimates of the fiscal operations of the National Government over the five months to May 2007 showed an overall budget surplus of K514.0 million, compared to a deficit of K225.9 million in the corresponding period of 2006. This represents 2.9 percent of nominal GDP. The surplus reflected higher tax receipts, combined with lower expenditure. The budget surplus was used to repay net overseas and domestic loans of K71.4 million and K442.5 million, respectively.

The Government continued to redeem Treasury bills and issue Inscribed stocks. During the first half of 2007, the net retirement of Treasury bills was K337.5 million, while net issuance of Inscribed stocks totalled K203.5 million.

2.5 Exchange Rate

The kina appreciated against the US dollar, while depreciating against the Australian dollar during the seven months to July 2007. It appreciated against the US dollar from US\$0.3300 at the end of December 2006 to US\$0.3400 on 26th July 2007. The kina depreciated against the Australian dollar from A\$0.4171 to A\$0.3844 during the same period. The TWI depreciated by 3.1 percent over the same period, whilst the REER depreciated by 1.5 percent to March 2007, indicating an improvement in the terms of trade of PNG's exports (*see Chart 3*).

The appreciation of the kina against the US dollar was due to Central Bank intervention to stabilise the kina in view of the depreciation against the Australian dollar combined with foreign exchange inflows from the mineral and agriculture sectors. The depreciation against the Australian dollar was due to cross currency movements attributed to interest rate differentials and the slow down in the US economy. In the second half of 2007, the kina is expected to remain stable particularly against the US dollar on the back of continued favourable performance in the external sector and stable domestic economic conditions.

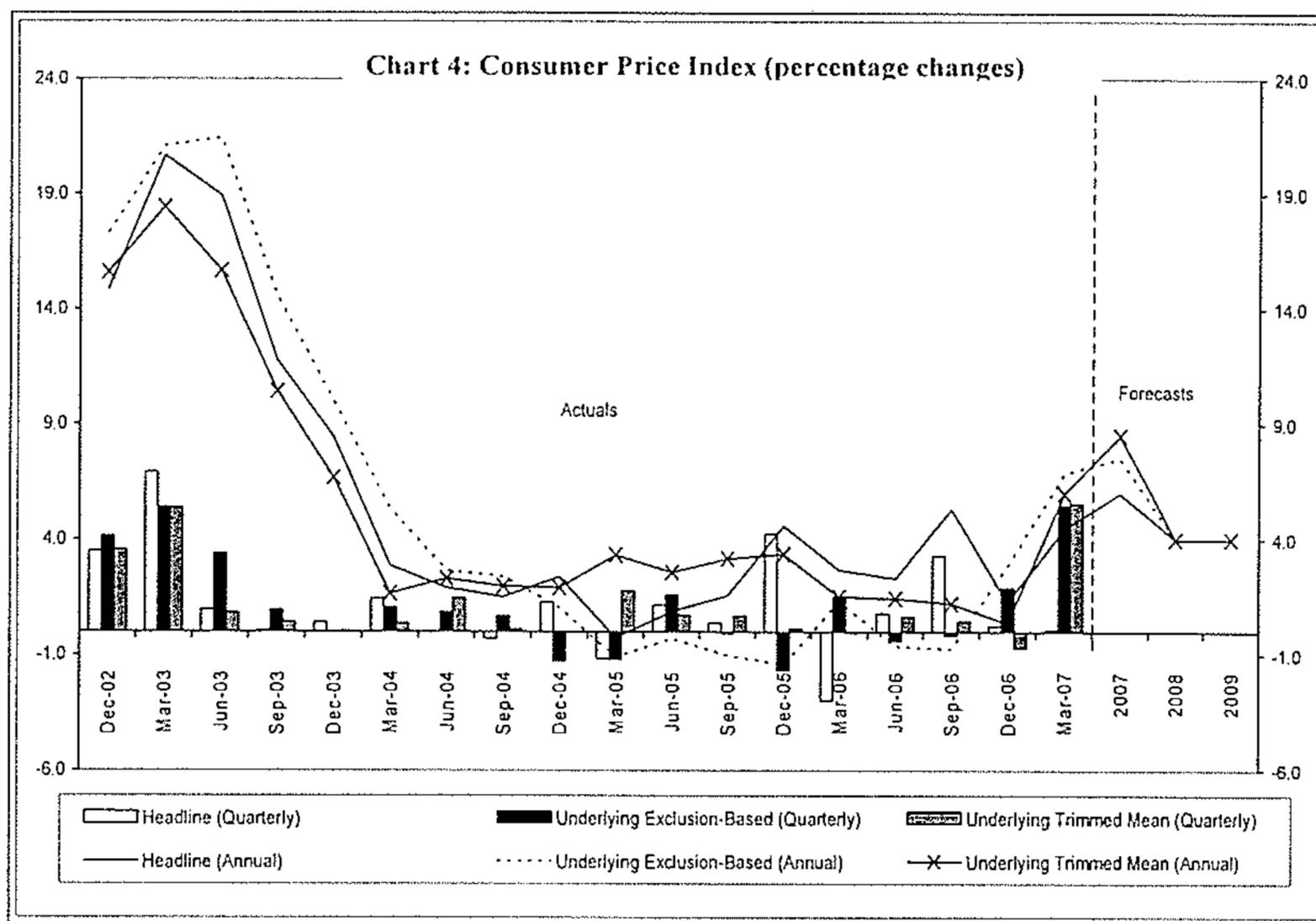


Source Bank of PNG

2.6 Inflation

Annual headline inflation was 4.5 percent in March 2007, compared to 1.3 percent in December 2006. The higher outcome was due to price increases in the ‘Food’, ‘Clothing and footwear’, ‘Rents, council charges, fuel and power’, and ‘Transport and communications’ expenditure groups. Annual trimmed mean inflation was 6.0 percent in March 2007, compared to 0.4 percent in December 2006 while annual exclusion based inflation was 6.9 percent in March 2007 compared to 1.9 percent in December 2006. The higher than projected inflation outcomes were mainly due to the depreciation in the TWI, imported inflation from PNG’s main trading partners and the lagged effect of fuel price increases.

In 2007, headline inflation is projected to be 6.0 to 8.0 percent. The higher inflation forecasts are due to the depreciation of the TWI and higher foreign inflation in PNG’s main trading partners. For the medium-term, all inflation measures are projected to be around 4.0 percent (see Chart 4 and Appendix). The medium-term projections are based on the assumptions that the kina exchange rate and commodity and energy prices remain stable. The main risks to these forecasts include adverse movements in the kina exchange rate, especially against the Australian dollar, significant declines in export prices and further increases in monetary aggregates.

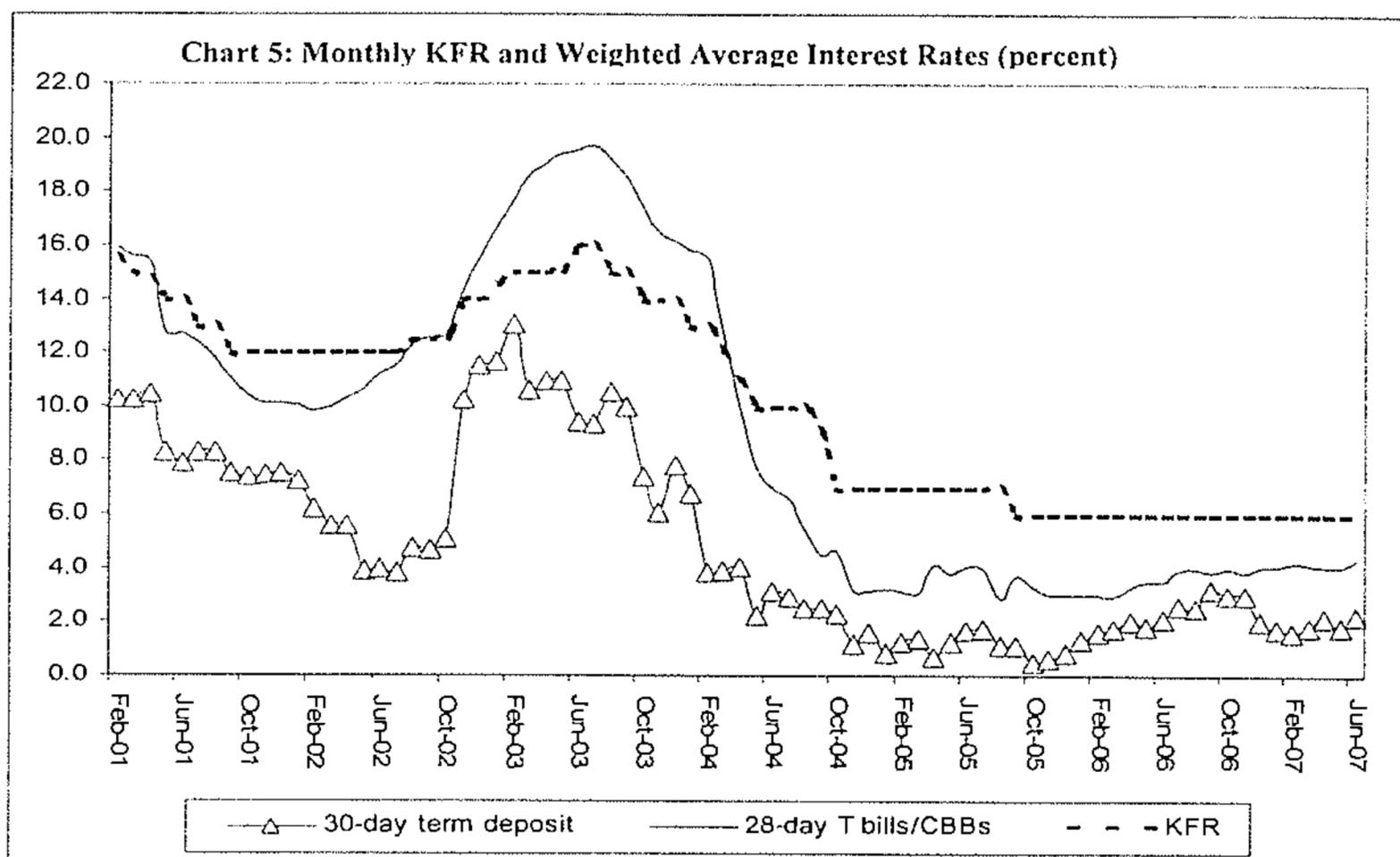


Source: Bank of PNG & National Statistical Office (NSO)

2.7 Monetary and Financial Market Developments

The Bank maintained a neutral monetary policy stance during the first half of 2007, with the KFR remaining unchanged at 6.0 percent (see Chart 5). The trading margin for the Repo was left unchanged at 150 basis points on both sides of the KFR during the same period.

Interest rates for short-term securities continued to remain relatively stable in the first six months of 2007, with the 28-day CBB rate at around 4.00 percent. In the Treasury bill market, the 182-day and 364-day Treasury bill rates traded in the range of 4.06 – 5.01 percent.



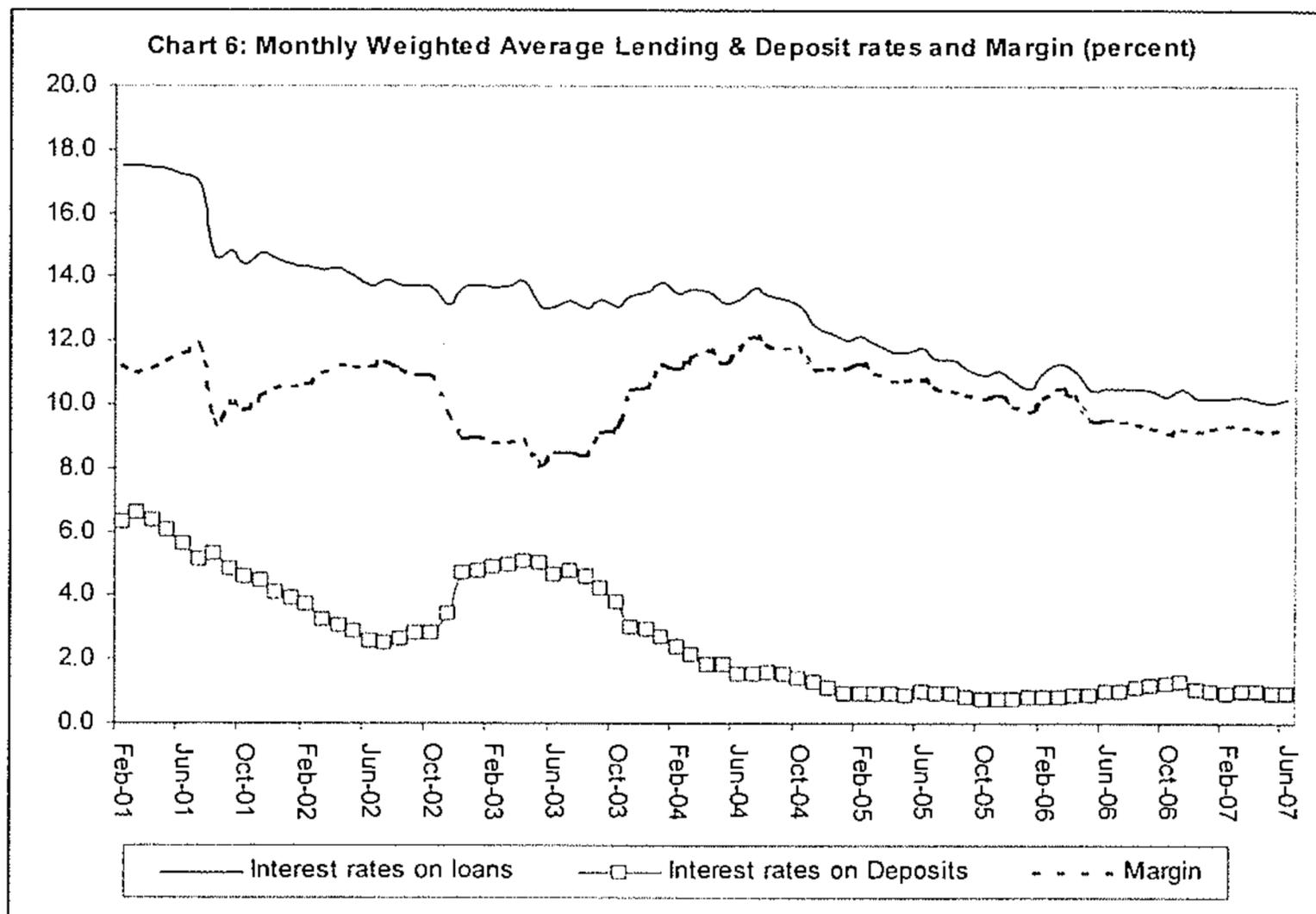
Source: Bank of PNG

Commercial banks reduced their Indicator Lending Rates (ILR) spread from 9.45 – 10.70 percent to 8.95 – 10.70 percent during the first half of 2007. The ILR reductions reflect the high level of liquidity in the banking system and increased competition. The weighted average interest rate on total deposits declined from 1.04 percent in December 2006 to 0.92 percent in June 2007, while the weighted average lending rate on total loans declined from 10.20 percent to 10.18 percent. As a result, the spread between the weighted average lending and deposit rates remained relatively stable (see Chart 6).

Total liquidity of the banking system declined marginally by 0.1 percent between January and June 2007, mainly due to net Government revenue and intervention in the foreign exchange market by the Central Bank. However, liquidity levels remained high, averaging at K3,775 million during the same period.

Lending extended by ODCs to the private sector increased by 35.2 percent over the year to June 2007. The growth in private sector credit was mainly to the retail, agriculture/fisheries/forestry, mining and quarrying, and other business sectors. Net claims on the Government declined by 36.6 percent over the year to June 2007, mainly due to increased deposits and the maturing of Government securities held by ODCs.

The level of broad money supply (M3*) increased by 35.1 percent over the year to June 2007 as a result of growth in net foreign assets and increase in private sector credit. The monetary base increased by 12.9 percent during the same period (see Appendix).



Source: Bank of PNG

Appendix

Table 1: Monetary and Credit Aggregates (annual % changes)

INDICATOR	2004 (actual)	2005 (actual)	2006 (actual)	JUN 2007 (actual)	JAN 2007 MPS (proj)	2007 (proj)	2008 (proj)	2009 (proj)
Broad Money Supply	30.2	30.7	39.0	35.1	25.5	27.9	14.3	14.5
Monetary Base	29.8	3.0	21.7	12.9	17.5	7.7	9.5	8.4
Claims on the Private Sector	-3.8	25.2	36.8	35.2	15.0	10.7	20.7	22.0
Net Claims on Gov't	23.0	-24.7	-11.6	-36.6	64.1	25.6	-18.8	-7.9
Net Foreign Assets	30.4	33.5	58.2	63.5	21.0	30.0	15.9	11.0

Source: Bank of PNG

Table 2: Summary of Other Macroeconomic Indicators

INDICATOR	2004 (actual)	2005 (actual)	2006 (actuals)	MAR 2007 (actual)	JAN 2007 MPS (proj)	2007 (proj)	2008 (proj)	2009 (proj)
CONSUMER PRICE INDEX (annual % changes)								
Headline	2.4	4.6	1.3	4.5	6.0	6.0	4.0	4.0
Trimmed-mean	1.9	3.3	0.4	6.0	4.0	7.5	4.0	4.0
Exclusion- based	1.0	-1.4	2.9	6.9	4.0	8.5	4.0	4.0
BALANCE OF PAYMENTS (kina millions)*								
Current account	393	1,987	1,254.8	-123.2	-649	533.3	2,442.2	1,257.7
Financial account	-80	-1,691	584.6	457.4	1,604	557.0	-1,468.7	-473.0
Overall balance	330	296	1,976.8	342.4	955	1,090.2	973.6	784.6
Gross Int. Reserves	2,072	2,368	4,344.7	4,687.1	5,350	5,438.2	6,411.8	7,196.4
IMPORT COVER (months)*								
Total	5.6	6.0	8.6	8.5	9.0	8.4	10.7	12.2
Non-mineral	7.5	8.2	12.6	16.1	18.1	14.9	17.9	18.9
EXPORT PRICE*								
Crude oil (US\$/barrel)	41	55	67.3	61.8	60	62.0	60.6	59.8
Gold (US\$/ounce)	398	403	554.7	627.0	523	635.3	603.7	579.4
Copper (US\$/pound)	124.9	161.6	296.6	271.3	230.0	275.0	270.0	270.0
FISCAL OPERATIONS OF THE GOVERNMENT*								
Surplus/Deficit (K'm)	80.6	7.6	430.2	514.0	-35.0	-35.0	223.7	85.0
% of GDP	1.6	0.6	2.5	2.9	-0.2	-0.2	1.2	0.4
REAL GROSS DOMESTIC PRODUCT (annual % growth)								
Total GDP	2.9	3.3	3.7	--	4.5	4.5	3.5	6.8
Non-mineral GDP	3.5	3.1	4.1	--	4.2	4.2	4.0	4.0

Source: Bank of PNG, NSO and Department of Treasury

* Actuals to May 2007