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

PORT MORESBY

31 January 2005

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: httpl//www.bankpng.gov.pg. It will be reproduced in the December 2004 issue of the Quarterly Economic Bulletin (QEB).

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; [1] 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 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] *Refer to Box 1 on the definition of price stability, page 12.*

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EXECUTIVE SUMMARY

In the second half of 2004, economic conditions remained favourable, which provided a foundation for further easing of monetary policy by the Bank of Papua New Guinea (Bank of PNG). The developments in major economic indicators that support the above include:

- A decline in the annual headline inflation rate to 1.5 percent in September 2004;
- A stable kina exchange rate;
- A build up of international reserves to an unprecedented level of US$664.3 (K2,075.9) million on 31 December 2004;
- A declining trend in domestic interest rates; and
- Sound fiscal management by the Government.

The preliminary outcomes to December 2004 are mostly consistent with the Bank's projections for 2004 made in the July 2004 Monetary Policy Statement (MPS).

A key change in the presentation of the MPS is the inclusion of the medium term projections. A medium term focus on monetary policy accounts for the lagged nature of monetary policy transmission to its ultimate objective of price stability. The medium term framework sets the broad parameters for monetary policy in PNG, while temporary shocks will be corrected through the monthly Kina Facility Rate (KFR) announcements. The Bank expects the stability in macroeconomic conditions to continue in the first half of 2005 and over the medium term. Consequently, the Bank will maintain a neutral monetary policy stance in the first half of 2005 and over the medium term. However, the risk in achieving this stance will depend on the following factors:

- Inflation outcomes;
- Stability in the kina exchange rate;
- Fiscal discipline by the Government; and
- Unforeseen external and domestic shocks.

In the medium term the Bank expects the Government to achieve a balanced budget and increase development expenditure, which will create the impetus for growth. Consequently, the Bank expects the stability in macroeconomic conditions to continue in the medium term. This should provide an environment conducive for increased private sector activity and enable the achievement of positive economic growth. The growth in broad and reserve money are considered non-inflationary and adequate to support economic activity. Based on these expectations, the Bank's projections for 2005 and the medium term are as follows:

Indicators	2003	2004	2005	2006	2007
	(Annual growth - %)				
Headline inflation	8.4	1.9	2.6	2.8 - 3.8	2.9 - 3.9
Trimmed mean inflation	6.7	2.0	2.1	2.8	2.9
Private sector credit	-4.3	-1.7	5.2	6.5	7.0
Net credit to Government	0.5	15.5	7.6	2.8	-3.0
Net foreign assets	17.3	25.6	13.7	9.8	7.3
Broad money supply (M3*)	10.4	13.6	7.4	8.8	7.2
Reserve money	13.7	10.0	4.4	0.6	0.5

Monetary Policy Statement (MPS)

INTRODUCTION

The MPS is published pursuant to Section 11 of the CBA 2000 and represents a key requirement of transparency and accountability of the Bank of PNG. A key change introduced in the MPS is the inclusion of the medium term projections. The Policy Statement is presented in two parts. Section one covers the economic developments in 2004 and projections for 2005 and the medium term. The second section sets out and explains the rationale for the monetary policy stance for the first half of 2005 and how monetary policy will be implemented in line with the medium term outlook.

1. DEVELOPMENTS IN 2004 AND PROJECTED DEVELOPMENTS IN 2005 AND THE MEDIUM TERM

In formulating monetary policy, the Bank of PNG considers actual and projected developments in seven main areas:

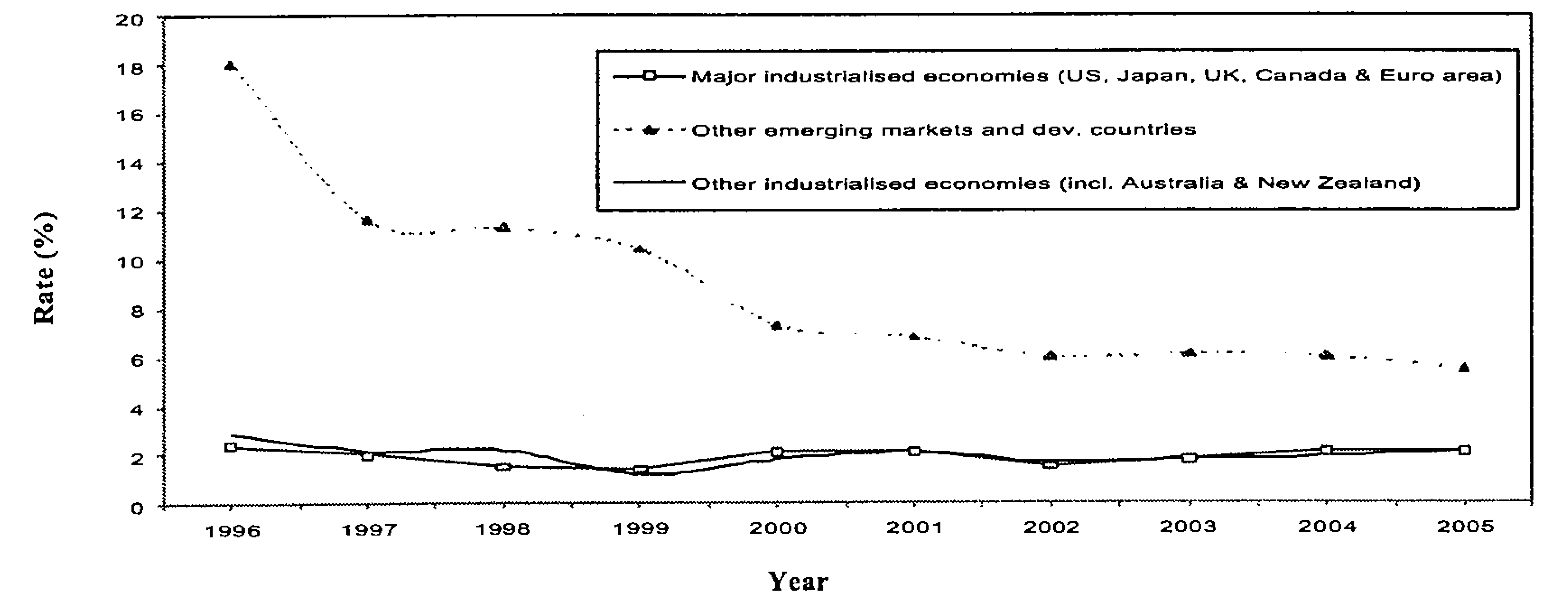
(a) The World Economy;
(b) Domestic Economic Activity;
(c) Balance of Payments;
(d) Fiscal Operations of the National Government;
(e) Exchange Rate;
(f) Inflation; and
(g) Monetary and Financial Market Developments.

(a) The World Economy

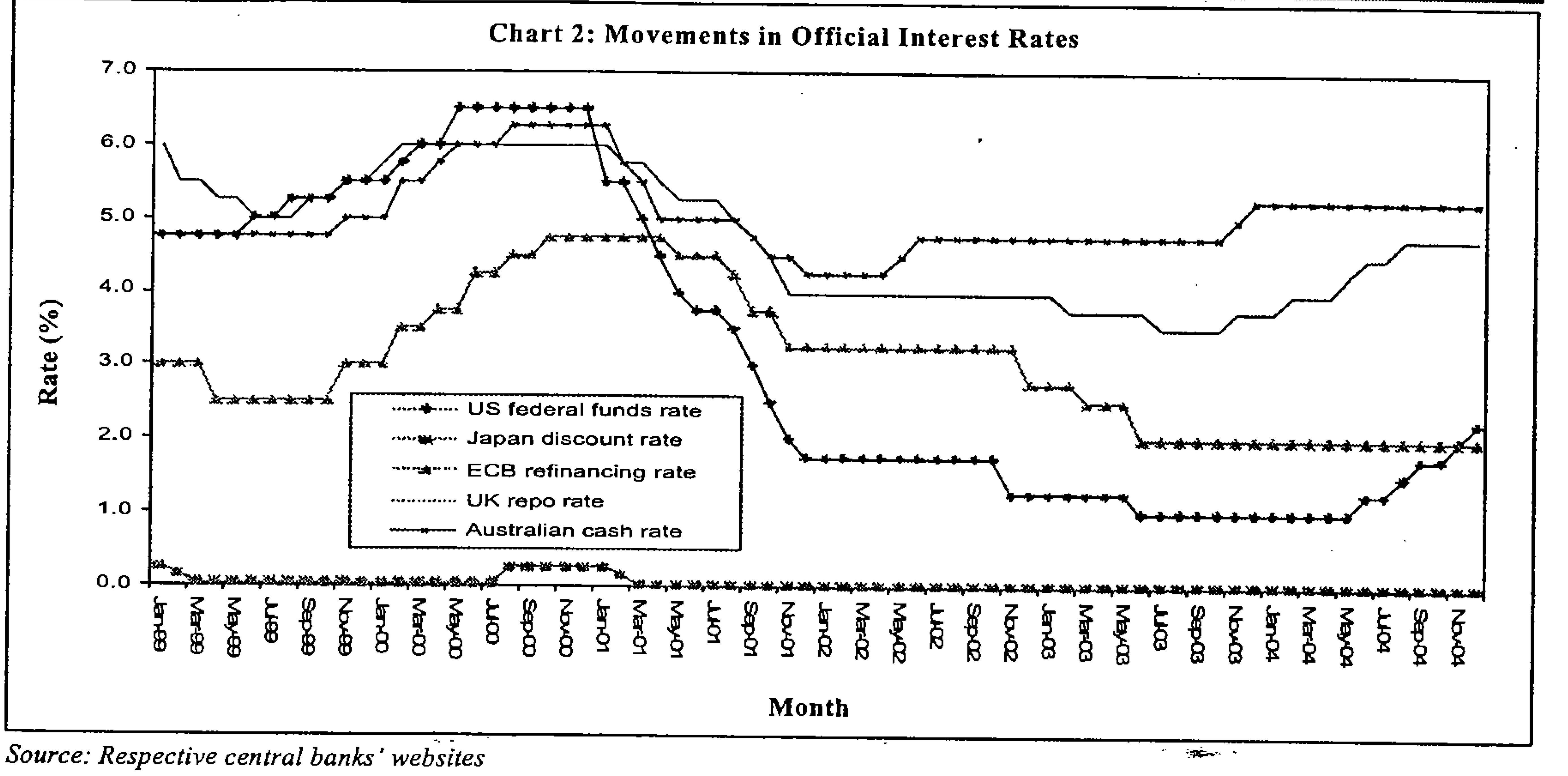
In the latest World Economic Outlook in September 2004, the International Monetary Fund (IMF) forecasts real GDP growth in the world economy in 2004 to be 5.0 percent, compared to 3.9 percent in 2003, with growth of 4.3 percent in the United States (US) and 4.4 percent in Japan. The growth in the US was associated with increased consumer spending and strong private investments as a result of high business confidence. In Japan, the growth was due to further improvement in economic conditions. The other industrialised economies and the Euro area are expected to grow by 3.8 and 2.2 percentages, respectively. The emerging markets and developing countries as a whole are expected to grow by 6.6 percent. For 2005, world real GDP is projected to grow by 4.3 percent. The industrialised economies are projected to grow by 2.9 percent, with slower growth in most economies, mainly reflecting the adverse effects of the high oil prices on economic activity. A lower growth is also projected for the emerging markets and developing countries.

In September 2004, the IMF projected global inflation to remain low, with increases of around 2.1 percent in the industrialised countries and 6.0 percent in other emerging markets and developing countries (see Chart 1). The monetary policy stances adopted by the major central banks reflected their varying economic conditions. The US Federal Reserve Board and the Bank of England tightened monetary policy, reflecting concerns over rising inflationary pressure. In the second half of 2004, the US Federal Reserve Board raised the Federal Funds Rate by 100 basis points in aggregate to 2.25 percent, while the Bank of England raised its Repo rate from 4.50 percent to 4.75 percent in August. The European Central Bank (ECB) left its official interest rate unchanged at 2.0

Chart 1: Global Inflation Trends



Source: IMF



Source: Respective central banks' websites

percent as growth in the Euro zone lost momentum due to higher oil prices, a strong Euro and weak domestic demand. The Bank of Japan also maintained its zero interest rate policy despite the economic recovery, while the Reserve Bank of Australia (RBA) kept its cash rate at 5.25 percent (see Chart 2). For 2005, inflation is projected to be 2.1 percent for the industrialised countries and 5.5 percent for the emerging markets and developing countries.

Global financial markets were influenced by the sharp rise in oil prices, a weak US dollar and the continuing current account deficit in the US in 2004. Oil prices increased to a high of over US$50 per barrel. The rise in oil prices mainly reflected increased demand and supply disruptions from some of the oil-exporting countries, including Russia and Iraq.

At the beginning of 2004, the US dollar appreciated against all the major currencies supported by expectations of higher US interest rates and buoyant US economic growth. However, further deterioration in the US current account and fiscal deficits led to the depreciation of the US dollar to significantly low levels against the other major currencies. The Australian dollar appreciated against the US dollar to a high of US$0.79 before settling at US$0.77.

(b) Domestic Economic Activity

Preliminary Government estimates in the 2005 National Budget put real GDP growth in 2004 at 2.6 percent, compared to an earlier projection of 2.8 percent. After three years of contraction, the economy started to recover in 2003 with an estimated real GDP growth of 2.8 percent. The improvement continued in 2004 as a consequence of strong growth in the agriculture sector, boosted by high international commodity prices, combined with growth in the other sectors including mining, construction, transportation and manufacturing (see Chart 3).

Data from the Bank's Business Liaison Survey (BLS) show that total nominal value of output in the September quarter of 2004 grew by 2.2 percent, compared to the corresponding period of 2003.[2] Output increased for all sectors except commerce, mining and quarrying and transportation. The growth was mainly driven by the agriculture/forestry/fisheries sector due to higher export commodity prices and the manufacturing sector. BLS data and interviews indicate that businesses welcome the current economic stability. However, plans for new investment depend on the sustainability of the current macroeconomic conditions.

The Bank's Employment Index showed employment growth of 0.2 percent in the September quarter of 2004, compared to 9.2 percent in the corresponding period of 2003. This is consistent with the steady growth in the economy. All sectors recorded growth in employment except the agriculture/forestry/fisheries sector. Lower growth in employment was associated with reduction in staff levels in the forestry and fisheries sub-sectors, reflecting the scaling down in operations by some logging firms and a fishing company.

[2] *The BLS is now conducted quarterly for the large companies and annually for all the small to medium sized companies in the sample.*

Projections for 2005 and the Medium Term

In 2005, the Government expects real GDP to grow by 2.9 percent, building on the two previous years' positive growth. The non-mineral economy is projected to grow by 2.8 percent. The agriculture/forestry/fisheries sector is projected to grow by 3.0 percent in 2005, with higher fisheries and agricultural production. Production of all major agricultural commodities is projected to increase in 2005, particularly for palm oil and cocoa. The mining sub-sector is projected to grow by 3.2 percent in 2005 as a result of higher gold and copper production and the commencement of the Kainantu and Simberi gold mines. In the petroleum sub-sector, a strong growth of 6.7 percent is projected, following a decline of 5.8 percent in 2004, with higher crude oil production at the Moran oil field as a result of accelerated production and improved recoverable reserves and commencement of production in new oil fields.

Over the medium term, with sustained macroeconomic stability and institutional reforms, improved production is expected across all sectors of the economy. The Government projects real GDP growth of 1.7 percent in 2006 and 2.6 percent in 2007. The Government plans to achieve this growth through reforms designed to achieve:

- A stable investment climate;
- An efficient, effective and affordable public sector; and
- A competitive and dynamic private sector.

The Government's 'Export Driven Growth Strategy' aims to increase agricultural production and exports by improving market accessibility and providing an environment conducive for investment. The success of this strategy will be vital if the Government is to achieve non-mineral GDP growth.

(c) Balance of Payments

Actual to November 2004

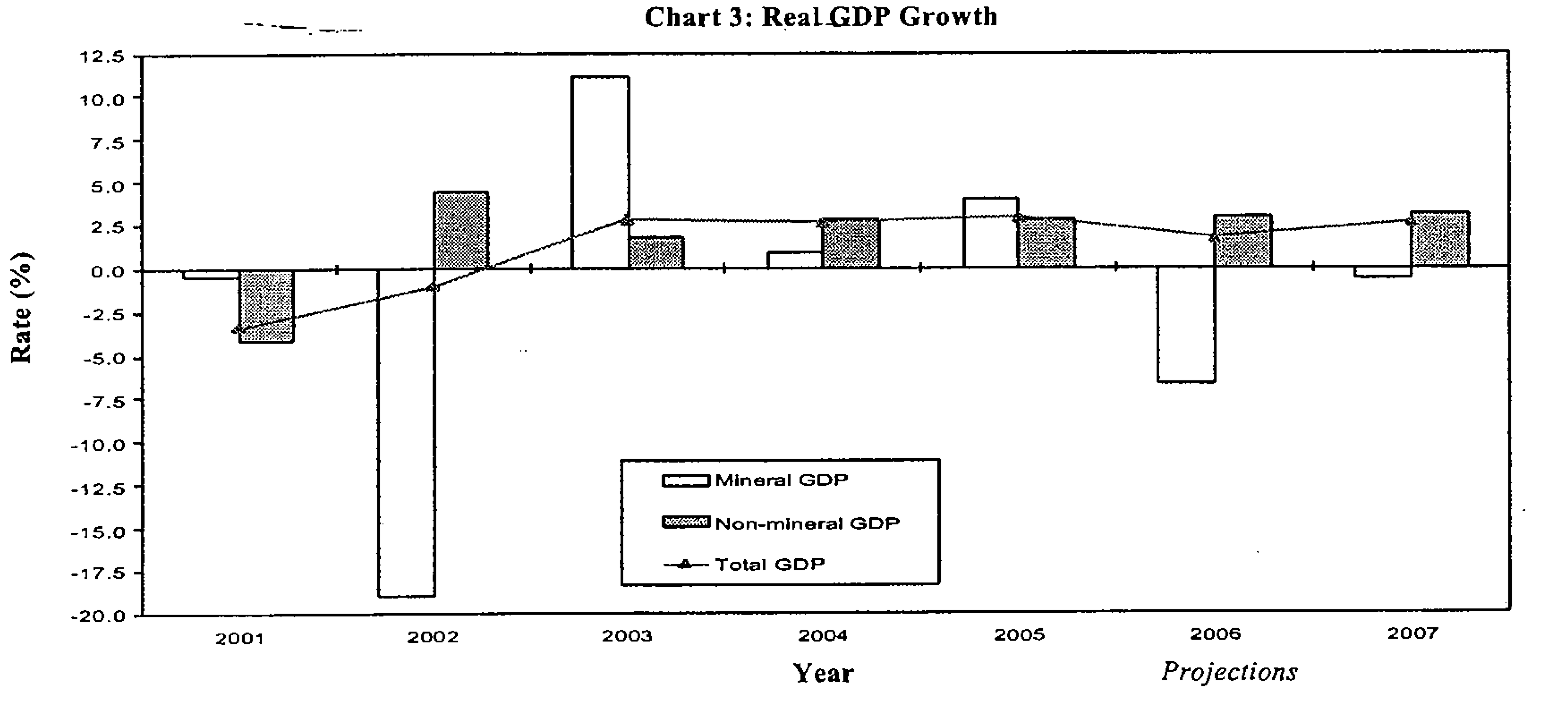
Preliminary balance of payments data for the eleven months to November 2004 showed an overall surplus of K434 million, compared to a surplus of K288 million in the corresponding period of 2003. This surplus was due to an improvement in the capital and financial accounts, reflecting a net inflow in the financial account, associated with direct equity inflows by the mineral companies. This more than offset a deficit in the current account resulting from a lower trade surplus, higher net service payments and lower net transfer receipts (see Chart 4).

The level of gross foreign exchange reserves at the end of November 2004 was US$690.2 (K2,165.3) million, sufficient for 5.5 months of total and 6.9 months of non-mineral import cover. As at 31 December 2004, the gross foreign exchange reserve level was US$664.3 (K2,075.9) million.

Projections for 2005 and the Medium Term

The latest IMF price projections indicate that the international prices of all of PNG's agricultural exports will be lower in 2005, compared to 2004, with the exception of cocoa and log exports. The coffee export price is projected to decline by 6.0 percent, palm oil by 6.3 percent, copra by 3.5 percent, copra oil by 9.1 percent, tea by 0.5 percent and rubber by 10.3 percent. The prices of copper and silver are

Chart 3: Real GDP Growth



Source: 2005 National Budget

projected to decline by 25.8 percent and 30.5 percent, respectively, while gold and crude oil prices are projected to increase.

The export volumes of all of PNG's major agricultural and mineral export commodities are projected to increase in 2005, compared to 2004. The projected increases are mainly due to the lagged supply response to the previous improvement in export commodity prices, combined with higher cocoa production from the North Solomons Province (NSP). The increase in palm oil is associated with maturity and harvesting of new plantings. 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 the commencement of production from Northwest (NW) Moran and Southeast (SE) Mananda oil fields, which more than offset the natural decline in the Kutubu oil fields.

Other main assumptions underlying the balance of payments projections for 2005 include:

- Stability in the kina exchange rate;
- Kina expenditure from Front End Engineering Design (FEED) associated with PNG-Queensland Gas Pipeline will be minimal since major expenditure will be realised offshore;
- The Enhanced Co-operation Package (ECP) from Australia is not included; and
- Foreign Exchange Control (FEC) liberalisation will have a neutral impact.

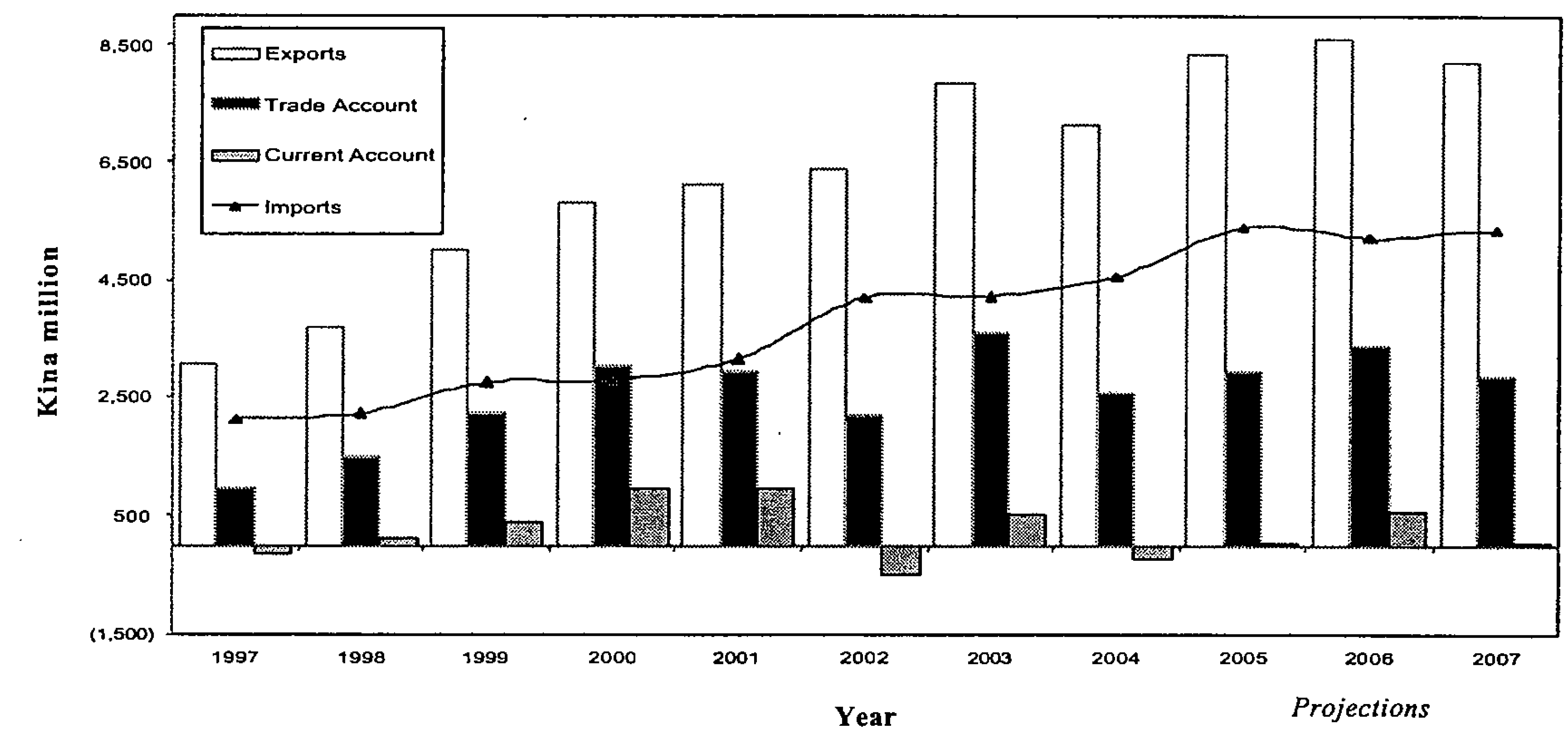
Accordingly, the balance of payments for 2005 is projected to show an overall surplus of K3.0 million, compared to an estimated surplus of K447 million in 2004. The lower surplus is due to a small current account surplus of K590 million, combined with a net outflow of K587 million in the capital and financial accounts, mainly attributed to increased offshore portfolio investments by mineral companies.

The level of gross foreign exchange reserves by the end of 2005 is projected to reach US$665.1 (K2,078.4) million, sufficient for 4.6 months of total and 6.4 months of non-mineral import cover.

Over the medium term, the balance of payments is projected to show overall surpluses of K235 million and K189 million in 2006 and 2007, respectively. These are due to strong performance of the export sector supported by the 'Export Driven Growth Strategy' of the Government, despite the projected decline in the prices of some of the export commodities over the medium term.

The export volumes of all of PNG's major agricultural and mineral export commodities are projected to increase over the medium term. These increases are associated with maturity of new plantings of agricultural export crops and additional production from the NSP combined with production from high yielding cocoa trees. Additionally, the projected increase in mineral exports reflects commencement of the Kainantu and Simberi gold mines in 2005. Crude oil production will be boosted by additional production from the NW Moran and SE Mananda fields.

Chart 4: Current Account



Source: Bank of PNG

The gross foreign exchange reserves are projected to increase to US$739.3 (K2,310.3) million in 2006 and US$799.7 (K2,499.0) million in 2007. The projected reserves are sufficient for 5.8 months of total and 7.5 months of non-mineral, and 6.1 months of total and 7.9 months of non-mineral import cover in 2006 and 2007, respectively.

(d) Fiscal Operations of the National Government

Actual to November 2004

Preliminary estimates of the fiscal operations of the National Government to November 2004 showed an overall surplus of K758.9 million, compared to a deficit of K211.5 million in the corresponding period in 2003. This represents 6.0 percent of nominal GDP (see Table 1). The surplus was attributable to higher tax revenue combined with lower debt service costs.

The budget surplus was used to make a net overseas loan repayment of K341.2 million and a net domestic loan repayment of K417.7 million. The proceeds from the asset sale of K25.0 million were used to retire domestic debt. The favourable cash flow position enabled the Government to retire some Treasury bills and made funds available for other priority areas.

During 2004, the Government restructured its debt by switching K500 million worth of Treasury bills to Inscribed stock as well as issuing K240 million in new Inscribed stock. The restructuring from short to long-term debt was to reduce rollover and refinancing risk.

2005 National Budget and the Medium Term Projections

The 2005 National Budget passed by Parliament in December 2004, continues to focus on the Government's 'Export Driven Growth Strategy' with measures and programs designed to achieve macroeconomic stability and provide the conditions necessary for promoting sustainable economic growth. The 2005 Budget is framed against improved economic and fiscal conditions in 2004, which are expected to continue in 2005.

The Budget neither introduced any new tax measures nor increased existing tax rates. It also ceased the import levy in 2005 and introduced phased reductions in the mining levy to continue to attract foreign investment. The Government renewed the infrastructure tax credit scheme for the rehabilitation of the Highlands Highway. The focus of the Government's revenue efforts in 2005 will be to improve compliance with existing tax laws.

The expenditure control measures planned for 2005 include:

- Further improvements to expenditure controls;
- Continue to re-allocate spending to high priority areas; and
- Reassess the proportion of recurrent expenditure on wages and salaries, goods and services and continue public sector down sizing.

The projected budget deficit of K137.7 million for 2005 is 1.0 percent of nominal GDP, compared to an

Table 1: Fiscal Operations of the National Government (K' million)

	2003 Actual	2004 Budget	2004 Revised Budget	2003 Jan - Nov	2004 Jan - Nov	2005 Budget	2006 Projections	2007 Projections
Total Revenue & Grants	3,610.2	3,837.1	4,283.7	3,279.1	3,791.9	4,639.7	4,704.4	4734.6
Total Expenditure	3,734.3	4,032.6	4,129.1	3,490.6	3,033.0	4,777.4	4,789.8	4762.0
Surplus/Deficit	-124.1	-195.5	154.6	-211.5	758.9	-137.7	-85.4	-27.4
% of GDP	-1.1	-1.5	1.1	-1.8	6.0	-1.0	-0.6	-0.2
FINANCING								
Net External	-307.0	-70.3	-155.9	-309.0	-341.2	-190.3	-96.2	-42.9
Concessional	-136.5	-60.9	-83.0	-317.5	-169.5	-19.1	-78.3	-25.0
Commercial	11.3	176.3	0.3	8.5	-9.9	-5.8	-17.9	-17.9
Extraordinary	-181.8	-185.7	-73.2	0.0	-161.8	-165.4	0.0	0.0
Net Domestic	431.1	265.8	1.3	520.5	-417.7	328.0	181.6	70.3
Bank of PNG	-378.6	0.0	0.0	-466.0	-307.5			
Commercial Banks	295.9	0.0	0.0	174.1	338.0			
Non-Bank System	565.5	0.0	0.0	409.9	-210.5			
Other Domestic Sources	*-51.7*	*265.8*	*1.3*	*402.5*	*-237.7*	*328.0*	*181.6*	*70.3*
Asset sales	40.0	0.0	0.0	40.0	25.0			
Other	-91.7	265.8	1.3	362.5	-262.7	328.0	181.6	70.3
Total	124.1	195.5	-154.6	211.5	-758.9	137.7	85.4	27.4

Source: 2005 National Budget & Bank of PNG estimated surplus of 1.1 percent for 2004. The deficit and net loan repayments to external sources will be financed by net domestic borrowing of K328.0 million.

For the medium term, the budget deficit is expected to decline to 0.6 percent and 0.2 percent of nominal GDP in 2006 and 2007, respectively. This reflects a commitment by the Government towards sound fiscal management to sustain confidence and promote private sector activity. Total revenue including grants is projected to grow by 1.4 percent to K4,704.4 million in 2006 and 0.6 percent to K4,734.6 million in 2007. The increase reflects the projected income from the agricultural sector, due to the Government incentives. Total expenditure is projected to increase by 0.3 percent to K4,789.8 million in 2006 and decline by 0.6 percent to K4,762.0 million in 2007. The growth in 2006 reflects marginal increase in salaries, while the decline in 2007 is due to lower expenditure in some other categories.

The budget deficits and net external loan repayments for 2006 and 2007 will be financed through domestic borrowing.

(e) Exchange Rate

The kina continued to gain ground against the US dollar, appreciating by 3.1 percent in the second half of 2004. However, the kina depreciated by 8.9 percent against the Australian dollar, mainly reflecting the strengthening of the Australian dollar against the US dollar over the same period.

The appreciation of the kina against the US dollar was attributed to the following:

- Depreciation of the US dollar against major currencies;
- High inflow of foreign exchange resulting from favourable international prices of both mineral and non-mineral exports;
- Sound fiscal management by the Government; and
- Confidence in management of the economy.

The real effective exchange rate (REER) appreciated in the second half of the year, mainly attributed to the appreciation in the nominal exchange rate, which more than offset the decline in domestic inflation (see Chart 5). This implied a loss of competitiveness in the export sector.

(f) Inflation

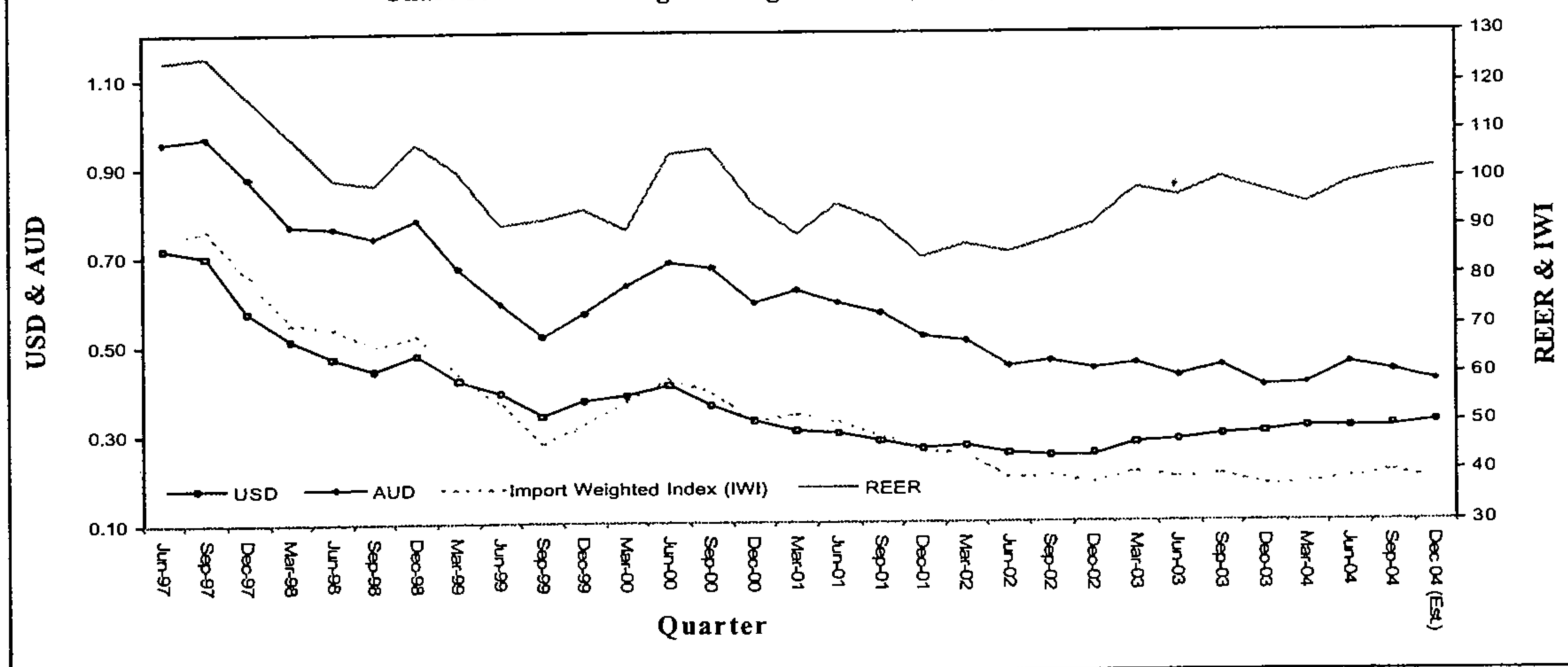
Actual to September 2004

Inflation continued to decline in the nine months to September 2004. Headline inflation for the 12 months to September 2004 was 1.5 percent, compared to 11.8 percent in September 2003 (see Chart 6). This is the lowest recorded inflation rate since the kina was floated in 1994.

The decline in headline inflation was in tandem with underlying inflation. The exclusion-based and trimmed-mean inflation rates were 2.4 percent and 2.0 percent respectively in the twelve months to September 2004 (see Table 2).

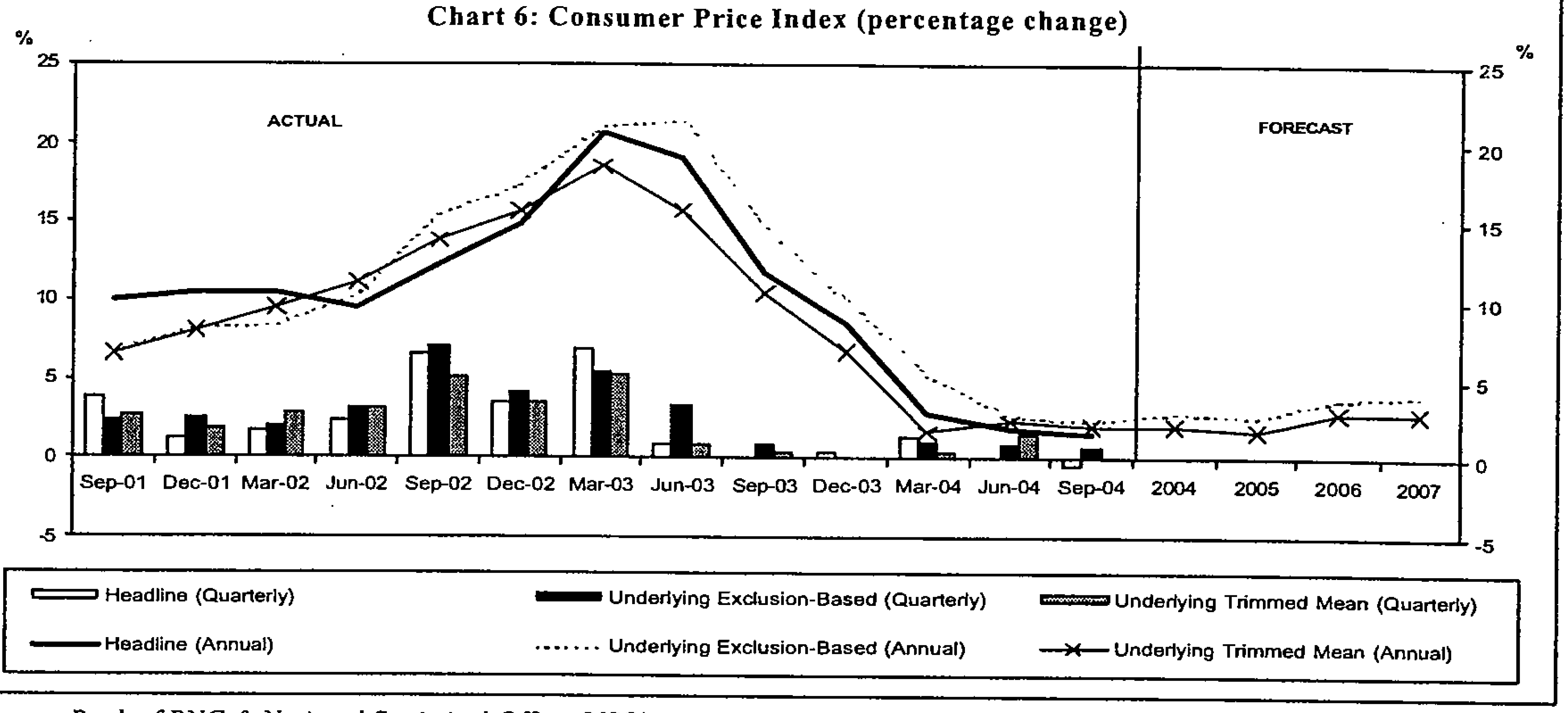
Both domestic and external factors contributed to the low inflation outcome to September 2004. On the back of strong export performance the kina appreciated against the US dollar, while it remained

Chart 5: Kina exchange rate against USD, AUD, IWI and REER



Source: Bank of PNG

Chart 6: Consumer Price Index (percentage change)



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

relatively stable against the Australian dollar thereby reducing imported inflation and insulating domestic consumers from the effects of the rise in international oil prices. Domestic inflationary pressures were constrained by the Government's maintenance of fiscal discipline and the lack of private sector borrowing in response to falling interest rates. Deflation in fruit and vegetables and betel nut prices also contributed to the low headline inflation outcome.

Estimates for 2004

As a result of the appreciation of the kina in the September quarter of 2004 and the unexpected falls in the prices of fruit and vegetables and betel nut, the estimated annual headline inflation has been revised downwards to 1.9 percent from a projection of 7.4 percent in the July 2004 MPS. Projections of the underlying measures are slightly higher with the exclusion-based and trimmed-mean measures projected to be 2.9 percent and 2.0 percent, respectively. The revisions made to the underlying measures due to the unexpected events in the September quarter are substantially smaller than those made to the headline measure. This demonstrates the value of the underlying measures as robust indicators of the inflation rate, compared to the headline measure.

Projections for 2005 and the Medium Term

Projected inflation for 2005 is in the 2-3 percent range for all three measures. These projections are based on the following assumptions:

- A continuation of the macroeconomic stability achieved during 2004;
- Stability in the exchange rate;
- The Government will not exceed budgeted expenditure;
- Inclusion of announced postal and water and sewerage rate increases; and
- Increases in crude oil prices.

However, risks to the above assumptions could come from:

Table 2: Consumer Price Index (annual percentage change)

	ACTUAL					FORECAST			
Inflation Measures	2001	2002	2003	Sep-04	Dec-04 (est.)	2004 Jul MPS	2005 Jan MPS	2006 Medium Term	2007 Medium Term
Headline	10.3	14.8	8.4	1.5	1.9	7.4	2.6	2.8 - 3.8	2.9 - 3.9
Underlying									
Exclusion-based	8.2	17.3	10.0	2.4	2.9	3.7	3.0	3.8	3.9
Trimmed-mean	8.0	15.6	6.7	2.0	2.0	2.5	2.1	2.8	2.9

Source: Bank of PNG & NSO

BOX 1: PRICE STABILITY

The CBA of 2000 stipulates that the Bank of PNG's objective of monetary policy is 'achieving and maintaining price stability'. The main reason for setting price stability as the primary goal for monetary policy is that experiences in both developing and developed countries show that low inflation helps to promote efficiency and growth in the long run. Whilst the Act does not specifically provide a specific definition of price stability, it is generally understood that price stability means a low and gradual change in the price level. Stability in price is therefore taken to mean stability in inflation, which can be defined as low inflation attained over a reasonable period of time. The precise meaning of "low" and "reasonable" is left to the discretion of policy makers because in a developing economy such as PNG, the desired inflation level may change over time and imposing a precise target would be an inappropriate constraint on policy. By being stable, inflation can be predictable, reduce uncertainty in the cost of doing business and enable planning for future investment decisions. Price stability requires steady movements in the exchange rate and other price variables.

As with other central banks, the Bank of PNG has decided that monetary policy would be set within a medium term perspective with inflation to be measured by the consumer price index (CPI). The medium term is defined as from one to three years.

- Any slippages in the implementation of the 2005 Budget;
- The uncertain effects of the wage increase awarded to public servants in December 2004; and
- The vulnerability of the economy to external shocks, including any adverse effects emanating from the liberalisation of Foreign Exchange Regulation in 2005.

The path of inflation over the medium term will be primarily determined by exchange rate movements, foreign inflation levels and the rate of growth of domestic demand.

The projections in Table 2 are based on the assumption of a stable exchange rate, foreign inflation remaining constant at its current level and domestic demand growing at a rate consistent with real GDP growth. Exclusion-based inflation is projected to be 3.8 percent in 2006 and 3.9 percent in 2007. Trimmed mean inflation is projected to be 2.8 percent in 2006 and 2.9 percent in 2007. The Bank only forecasts underlying inflation because over the medium term headline inflation should reflect underlying inflation.

(g) Monetary and Financial Market Developments

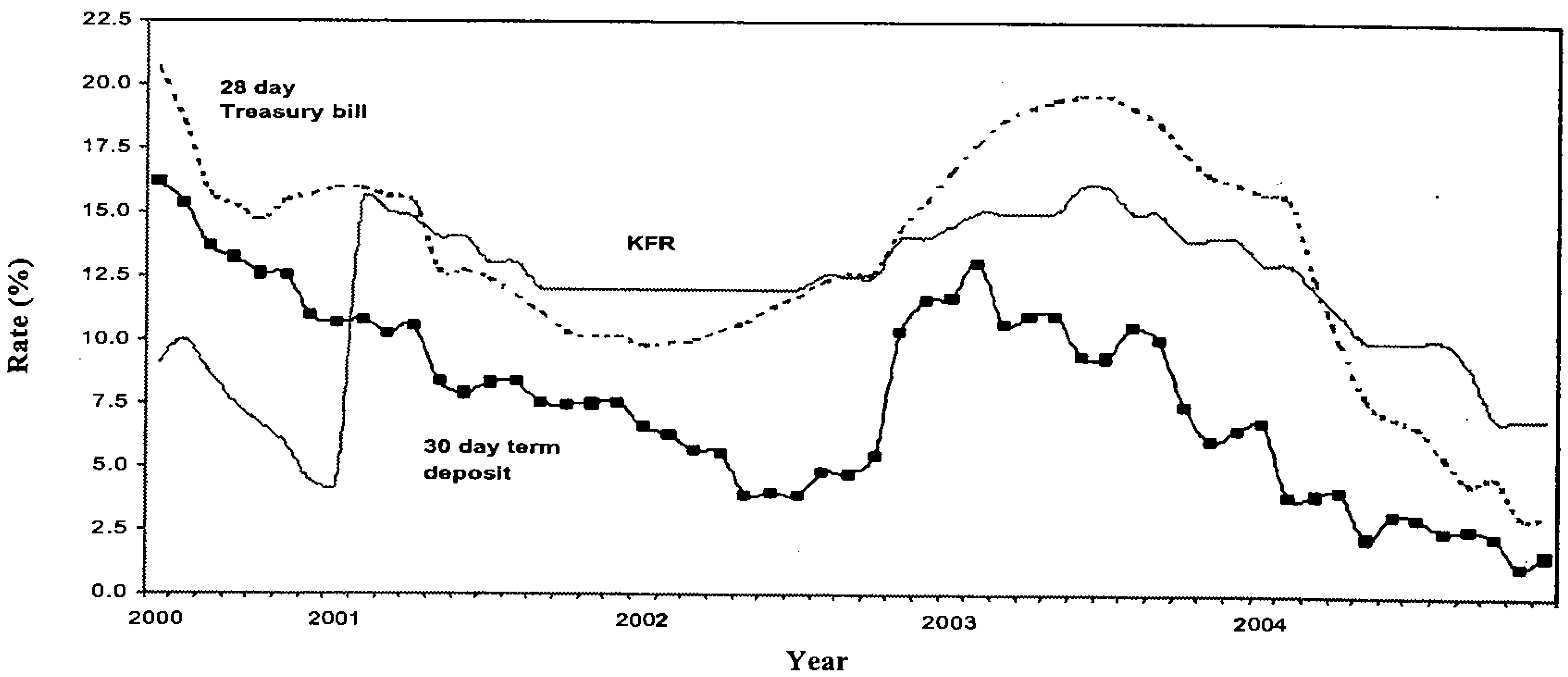
The Bank of PNG continued to ease monetary policy in the second half of 2004. Accordingly, the KFR was reduced by 300 basis points in aggregate to 7.00 percent by the end of October and remained unchanged in November and December 2004 (see Chart 7). The easing stance was due to improvements in the main macroeconomic indicators including:

- Continued lower inflation outcomes since March 2003, and prospects for further lower inflation in the December quarter of 2004 and the first half of 2005;
- Sound fiscal management by the Government;
- Significant build up of foreign exchange reserves; and
- A relatively stable kina exchange rate.

The easing stance of monetary policy led to a high level of liquidity in the banking system and a decline in domestic interest rates in the second half of 2004. Interest rates on Treasury bills declined across all maturities, with the 28-day rate declining from 6.90 percent in June to 3.14 percent in December 2004. Consistent with the easing stance, all the commercial banks reduced their Indicator Lending Rates (ILR) to a range of 10.75 to 12.00 percent by December 2004. In January 2005, the range was further reduced to 10.50 to 11.75 percent. The weighted average total deposit rate declined from 1.51 percent in June 2004 to 1.29 percent in November 2004, while the weighted average lending rate on total loans declined from 13.88 percent to 12.41 percent during the same period. In spite of the decline in interest rates, the spread between the weighted average lending and deposit rates continued to remain wide (see Chart 8).

Total liquidity of the banking system grew by 34.3 percent between June and December 2004, following

Chart 7: KFR and Weighted Average Interest Rates



Source: Bank of PNG

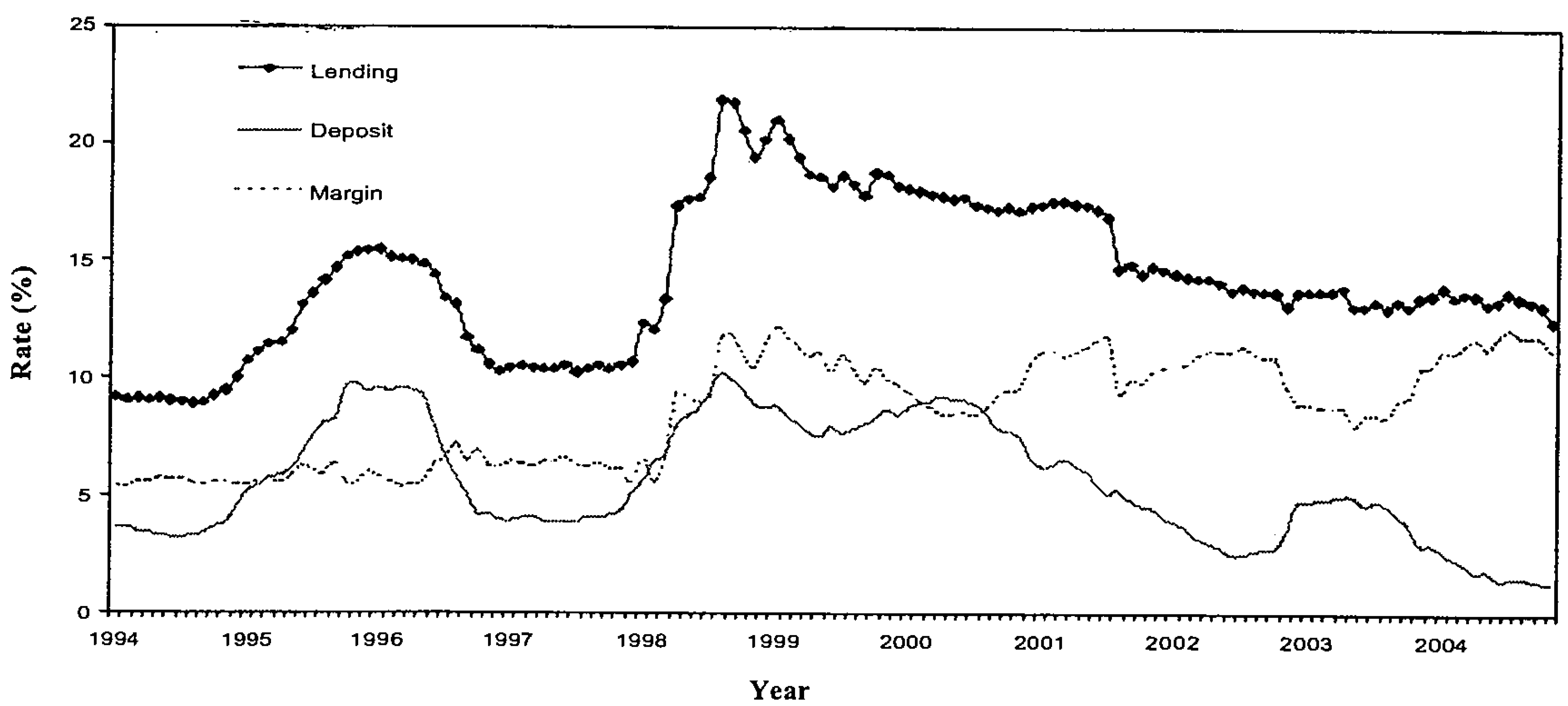
a revised growth of 7.6 percent in the first half of the year. The continued growth in liquidity was as a result of the Bank's intervention in the foreign exchange market to smoothen sharp movements in the exchange rate. The Bank utilised its open market instruments mainly Treasury bills and the Repurchase Agreement Facility (RAF) to sterilise the build up in liquidity. However, the liquidity overhang in the banking system resulted in sharp declines in Treasury bill rates. In order to mitigate the faster decline in interest rates on Treasury bills, the Bank of PNG introduced a new instrument, the Central Bank Bill (CBB) in August 2004 to complement the existing instruments. The Bank also increased the minimum bids at the Treasury bill auction from K500,000 to K1,000,000 on 8 December 2004 which was also aimed at encouraging secondary trading of Government securities.

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 7.2 percent between June and December 2004, mainly reflecting an increase in net foreign assets, which more than offset a decline in net domestic credit. Reserve money increased by 16.3 percent over the six months to December 2004, as a result of growth in commercial bank deposits at the Bank of PNG.

In spite of the decline in the ILRs and availability of excess liquidity, lending to the private sector continued to remain depressed. The lack of growth in credit reflects the lagged response to the current low interest rate environment and investment

Chart 8: Weighted Average Lending & Deposit Rates and Spread



Source: Bank of PNG

decisions by the private sector. Some of the concerns expressed by companies during the BLS interviews that contributed to this development include poor infrastructure, lack of skilled labour and increasing costs imposed by law and order problems. To encourage private sector credit, the Bank removed restrictions on lending to foreign-owned resident companies in September 2004.

2. MONETARY POLICY

Monetary Policy Stance for the First Half of 2005 and the Medium Term Outlook

In the second half of 2004, macroeconomic conditions were conducive for further easing of monetary policy. However, the Bank's decision to take a neutral stance in the December quarter was based on the prevailing low domestic interest rate environment relative to some of its major trading partners (see Chart 9).

The stability in price achieved in 2004 provides a good foundation for monetary policy in the first half of 2005 and the Bank's view on the medium term prospects. A medium term focus on monetary policy accounts for the lagged nature of monetary policy transmission to its ultimate objective of price stability. The Bank expects that with the low inflation and interest rate environment, commercial banks will increase lending and diversify their loan products to sustain medium-term economic growth.

The Bank expects that the imminent liberalisation of FEC (see Box 2) will have a neutral effect on the exchange rate and increase the foreign exchange turnover, thereby deepening the foreign exchange market. The local capital market (Port Moresby Stock Exchange) may see renewed interest from foreign investors as they make portfolio investments in domestic equities. In addition, foreign exchange transactions should be conducted with relative ease through the commercial banks.

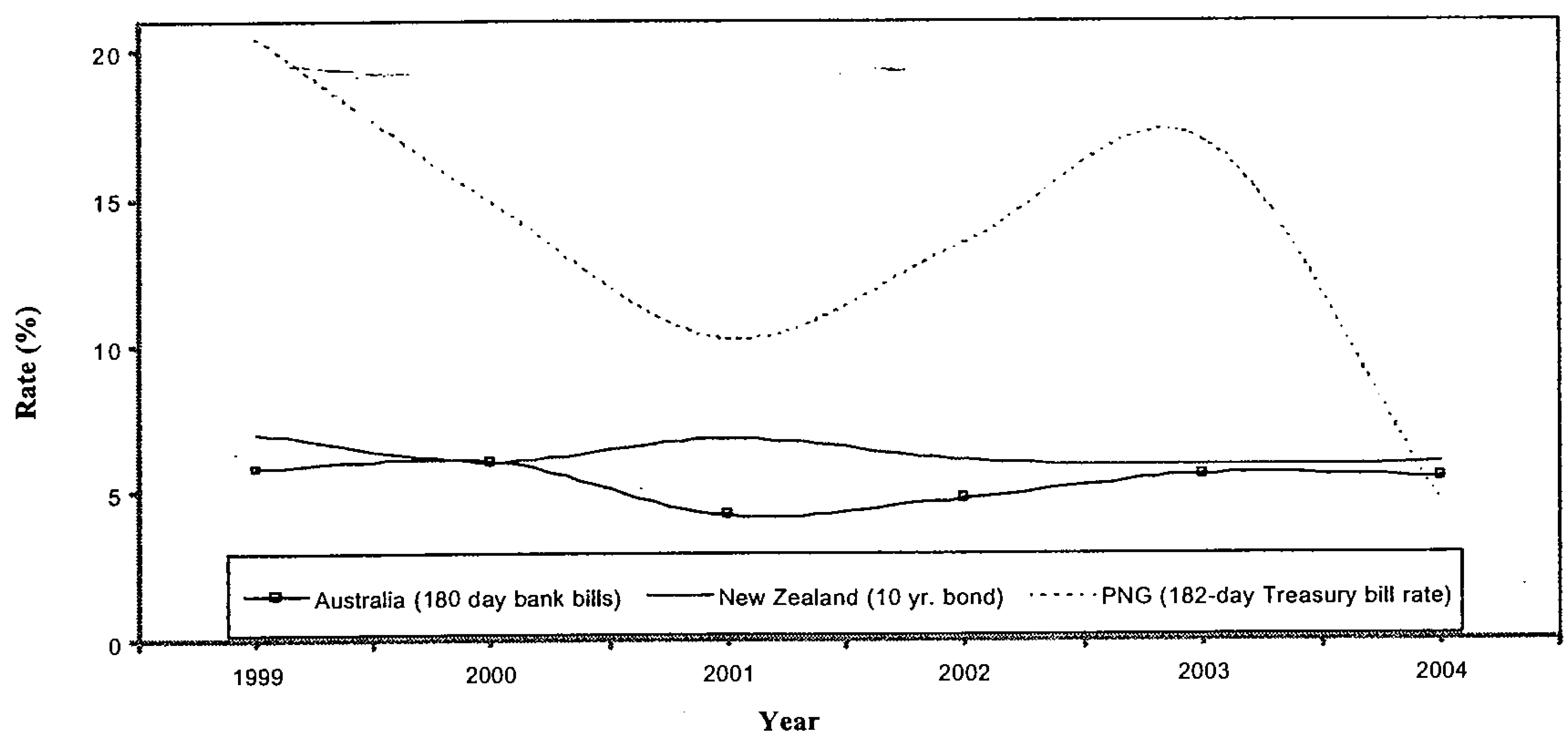
The Bank expects that the Government will adhere to the fiscal framework for the medium term stipulated in the 2005 National Budget by reducing the budget deficit from 1.0 percent of nominal GDP in 2005 to 0.2 percent in 2007. This will result in sustained low domestic interest rates and encourage the non-bank public to hold fewer financial assets and make real investment to support the economic growth envisaged.

Although the commercial banks have the capacity to finance private sector activity, it is expected that the private sector will make investments firstly from savings, currently held in financial assets. In addition to their savings, private sector borrowing from the commercial banks is expected to pick up over the medium term.

Whilst the medium term framework sets the broad parameters for monetary policy in PNG, temporary shocks will be corrected through the monthly KFR announcements. The monetary policy for the first half of 2005 will therefore depend on the following factors:

- The inflation outcome for the December quarter of 2004 and the first half of 2005;

Chart 9: Interest Rates on Government Securities



Source: Bank of PNG, RBA & Reserve Bank of New Zealand

BOX 2: LIBERALISATION OF FOREIGN EXCHANGE CONTROLS (FEC)

In December 2004, the Governor of the Bank of PNG announced the liberalisation of Foreign Exchange and Gold Regulation in PNG to become effective in 2005. This followed a review over 18 months of the economic and financial conditions and a consultative process with various stakeholders. Whilst current account transactions have always been liberal, the announcement means the removal of the remaining controls on capital transactions and the approval procedures in place at the Bank. The decision is in line with the Government's policy to remove impediments to trade and investment in the country, so as to stimulate economic growth. The Governor had earlier announced the removal of restrictions on lending to resident foreign-owned business entities by banks and financial institutions in September 2004.

FECs were introduced prior to independence in 1975 to manage foreign exchange reserves and support the balance of payments (BOP). The controls were an important component of the fixed exchange rate regime in place up until 1994. Under a floating exchange rate regime, FECs are not required and there were several occasions in the past when liberalisation was considered. The first was in 1994 following the float. The controls were retained then to allow the severely depleted reserves to be rebuilt to comfortable levels. Again in 1997 and 1998, the timing was inappropriate with adverse economic shocks to the country arising from the El Nino drought, Sandline crisis, Asian financial crisis and low confidence levels. On both occasions, the Bank did not have the independence to reign in the monetary expansion, resulting mainly from an expansionary fiscal policy and to be able to stop the pressure on the kina. Whilst the enactment of the CBA in 2000 gave the Bank independence, the controls were maintained to give the Bank time to develop appropriate monetary instruments to achieve the objective of price stability.

The favourable economic conditions experienced in 2004, with a stable currency, high reserve levels, fiscal discipline, low inflation, a stable financial system and improved confidence allow for the controls to be removed.

The liberalisation involved the granting of exemptions from the Foreign Exchange and Gold Regulation for the transfer and removal of currency out of PNG, the control of certain transactions such as, borrowing from residents offshore, issue and dispatch of securities and foreign securities. However, the Bank will retain the powers of licensing of foreign exchange dealers and gold. It will also conduct audit and impose penalties for breaches of these exemptions. The Bank will take on a monitoring role with detailed reporting from the authorised dealers, residents and non-residents of PNG.

The Bank will retain the Foreign Exchange and Gold Regulation and may reintroduce them in the event of a major BOP crisis.

- The stability in the kina exchange rate, which depends on the sustainability of foreign exchange inflows and capital flows; and
- The Government to remain within the parameters of the 2005 National Budget, including its ability to expedite development expenditure.

Under these conditions monetary and credit aggregates are expected to develop at moderate rates (see Table 3). The Bank expects broad money to grow by 7.4 percent in 2005. Reserve money is projected to grow by 4.4 percent in 2005, compared to a growth of 10.0 percent in 2004. The expansion in broad money supply is around the level of inflation and is considered to be non inflationary. Given the high free reserves in the banking system and the low interest and inflation rates environment, private sector credit is expected to grow by 5.2 percent in 2005. Over the medium term higher growth rates will be sustained given the Government's program on the removal of barriers to trade and investment and promotion of agriculture. The level of net foreign assets are expected to increase significantly following the repayment of the Bank's liabilities to the IMF by the end of 2005.

Based on the above expected developments, the Bank will maintain a neutral monetary policy stance in the first half of 2005 and over the medium term.

Table 3: Monetary & Credit Aggregates (percentage changes)						
	2002 Revised	2003	Dec-04 Prelim. Outcome	2005	2006	2007
Broad Money Supply (M3*)	3.4	10.4	13.6	7.4	8.8	7.2
Reserve Money	17.3	13.7	10.0	4.4	0.6	0.5
Private Sector Credit	-7.1	-4.3	-1.7	5.2	6.5	7.0
Net Credit to Government	75.6	0.5	15.5	7.6	2.8	-3.0
Net Foreign Assets	-7.7	17.3	25.6	13.7	9.8	7.3

Source: Bank of PNG

Conduct of Monetary Policy

The KFR remains the key instrument for the signaling of the Bank's monetary policy stance, with an announcement each month by the Governor. The open market operations will be conducted in line with the stance of monetary policy. The Bank's intervention strategy in the foreign exchange market will be to smoothen volatility in the exchange rate where necessary. The implementation of monetary policy will be conducted within the reserve money framework. The excess level of liquid assets, which averaged 28 percent in the second half of 2004, 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. The CBB will complement Treasury bills as the main instrument for liquidity management.

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