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

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Queries on the contents of the Monetary Policy Statement should be directed to the Deputy Governor, Policy & Regulation on telephone number (675) 3227359 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 it is also available on the Bank's website: http//www.bankpng.gov.pg. It will be reproduced in the December 2005 issue of the Quarterly Economic Bulletin (QEB).

TABLE OF CONTENTS

OBJECTIVE OF MONETARY POLICY

The objective of monetary policy in Papua New Guinea (PNG) is to achieve and maintain price stability. This requires amongst other things, relative stability in the exchange rate. If achieved it will lead to:

- Confidence in the local currency and management of the economy;
- A foundation for stable fiscal operations of the Government;
- Certainty for private sector businesses to plan for long-term investment and development;
- A stable macroeconomic environment; and
- Conditions conducive to economic growth.

Executive Summary

The Bank of Papua New Guinea (Bank of PNG) expects that the stability in macroeconomic conditions to date will continue in the first half of 2006 and over the medium-term. As a result, the Bank of PNG will maintain a neutral monetary policy stance during this period. This stance is based on the following expectations:

- Headline and underlying inflation will remain low at around 3.0 - 4.5 percent;
- Stable kina exchange rate against the currencies of PNG's major trading partners;
- Sound fiscal management by the Government with the view of achieving a balanced budget;
- Private sector credit growth of around 7.0 - 9.0 percent; and
- Gross Domestic Product (GDP) growth to be in line with the Government's projections of around 3.5 percent.

The Bank expects growth in broad money to be around 9.9 percent and reserve money by 7.5 percent in 2006, which are considered to be non-inflationary and sufficient to support private sector credit growth.

Any adverse effects of unforeseen shocks on price stability will be minimised through adjustments to the monthly Kina Facility Rate (KFR. The effectiveness of monetary policy to curtail any adverse impact on macroeconomic stability will be limited if it is not supported by fiscal and other policy adjustments. Therefore, a closer coordination of macroeconomic policies by the Government and the Bank of PNG is necessary in sustaining stability and growth over the medium-term.

Monetary Policy Statement

1. 0 Monetary Policy Discussions

1.1 Monetary Policy Assessment and Issues

In the second half of 2005, the Bank of PNG generally maintained a neutral monetary policy stance. Consistent with the stance, the KFR was maintained at 7.0 percent until September 2005, when it was reduced to 6.0 percent reflecting favourable exchange rate, inflation and other macroeconomic outcomes.

Macroeconomic outcomes for the second half of 2005 were broadly in line with the Bank of PNG's expectations as outlined in the July 2005 MPS. Annual headline inflation of 4.6 percent was within the expected range, driven by the stability in the exchange rate. Private sector credit grew much faster in 2005 from a lower base in 2004. Net credit to Government was maintained within the parameters of the 2005 National Budget, mainly as a result of favourable tax receipts following high international commodity prices and savings from the lower interest expenditure.

Inflation remained low as a result of stability in the exchange rate. In 2005, the kina appreciated against the United States (US) dollar and the currencies of PNG's other major trading partners. This led to an appreciation in the Real Effective Exchange Rate (REER).

Low domestic interest rates and new loan products offered by the commercial banks has enabled the private sector to borrow, expand business activity and generate employment in the second half of 2005. The significant decline in interest rates emanated from the high level of liquidity due to the easing of the monetary policy stance adopted by the Bank of PNG since 2003, combined with injection of liquidity from higher mineral tax receipts in 2005. This combined with stability in macroeconomic conditions has led to the increase in lending. However, the decline in interest rates to levels lower than PNG's substitute financial markets has given rise to concerns for potential capital outflow although the Bank of PNG expected a neutral impact on the balance of payments, following the partial liberalisation of Foreign Exchange Controls (FECs) on 1 June 2005. The Bank of PNG has also maintained real interest rates on Government securities at reasonable levels to mitigate destabilising capital outflows. This was supported by the public's expectation of a stable exchange rate.

Monetary policy management has become increasingly challenging and achieving price stability has been at a higher cost to the Bank of PNG. During 2005 the Government restructured its debt by retiring Treasury bills and issuing of Inscribed stocks in line with its Medium-Term Debt Strategy. This led the Bank to issue more Central Bank Bills (CBBs) to mitigate the decline in short-term interest rates, partially to sterilise liquidity and minimise distortions between market interest rates and the KFR.

1.2 Monetary Policy Stance

Based on the Bank of PNG's assessment of macroeconomic developments in 2005 and its expectations, the Bank will maintain a neutral monetary policy stance in 2006 and over the medium-term. The Bank will also regularly assess the effects of short-term shocks to mitigate any adverse impact with the aim of maintaining price stability over the medium-term. However, if there are structural changes in the economy then the underlying assumptions used for these medium-term projections will be revised.

The neutral stance of monetary policy is based on the following expectations in 2006 and the medium-term.

- Inflation will remain low at around 3.0 - 4.5 percent;
- Stable exchange rates;
- Maintenance of fiscal discipline;
- Continued credit growth to the private sector; and
- GDP growth to be in line with the Government's projections.

The Bank of PNG expects broad money to grow by 9.9 percent and reserve money by 7.5 percent in 2006, which are considered non-inflationary levels. The high liquidity in the banking system, underpinned by low inflation and interest rates, will set the foundation for private sector growth. In the medium-term, credit growth will continue, mainly due to the Government's program on removal of impediments to trade and investment, the promotion of agriculture sector exports and possible new loan products offered by the commercial banks. The level of net foreign assets is expected to increase moderately in the medium-term (see Appendix – Table 1).

The Bank of PNG expects that the Government will continue to demonstrate fiscal discipline to help sustain the current level of interest rates on Government securities and encourage the non-bank public to make real investments to support economic growth. Implementation of the 2006 Budget must be consistent with the objectives of the Medium-Term Development Strategy (MTDS) and Medium-Term Fiscal Strategy (MTFS), all of which place emphasis on impact projects that will generate growth. However, the Government needs to strengthen

- Its ability to fully implement the planned development Budget and reduce recurrent expenditure;
- Its ability to successfully implement reforms to public sector and its policies like the Export-Driven Growth Strategy; and
- Its ability to successfully implement the Medium-Term Debt Strategy.

The Bank expects the medium-term assumptions to hold. However, risks to the assumptions could come from:

- Second round effect of past increases on domestic cost structure and any further increases of crude oil prices;
- Fiscal slippages in the lead-up to the 2007 National Elections;
- Unforeseen large movements in commodity prices;
- Volatile movements in the exchange rate of PNG's major trading partners; and
- Unforeseen external and domestic shocks.

1.3 Conduct of Monetary Policy

The MPS provides the overall monetary policy framework, while the KFR will remain the key instrument for signaling the Bank of PNG's monetary policy stance with an announcement by the Governor at the beginning of each month. Following the announcement, Open Market Operations (OMO) will be conducted to support the Bank's monetary policy stance. The implementation of monetary policy will be within the reserve money framework. The Bank's intervention strategy in the foreign exchange market will be to smooth out any volatility in the exchange rate where necessary without affecting the trend.

2.0 Developments and Expectations

2.1 International Developments

The world economy continues to perform strongly. In the September 2005 *World Economic Outlook* the International Monetary Fund (IMF) forecast global real GDP growth of 4.3 percent in 2005. This is lower than the 5.1 percent recorded in 2004, but remains above the long-term trend. However, growth has been unevenly distributed across countries. The US and China remain the main forces behind the global expansion, while the Euro area continues to grow at a sluggish pace. World economic growth in 2006 is expected to be similar to the 2005 level.

Despite the generally positive outlook for the world economy, two developments during 2005 are of particular concern because of their potential to dampen future growth. Firstly, the expanding current account imbalances that are affecting many countries. The IMF forecasts the US current account deficit in 2005 to be 6.1 percent of GDP. The counterpart to the US deficit is the large current account surpluses in Japan, China, the Middle East oil exporting countries and former Soviet republics.

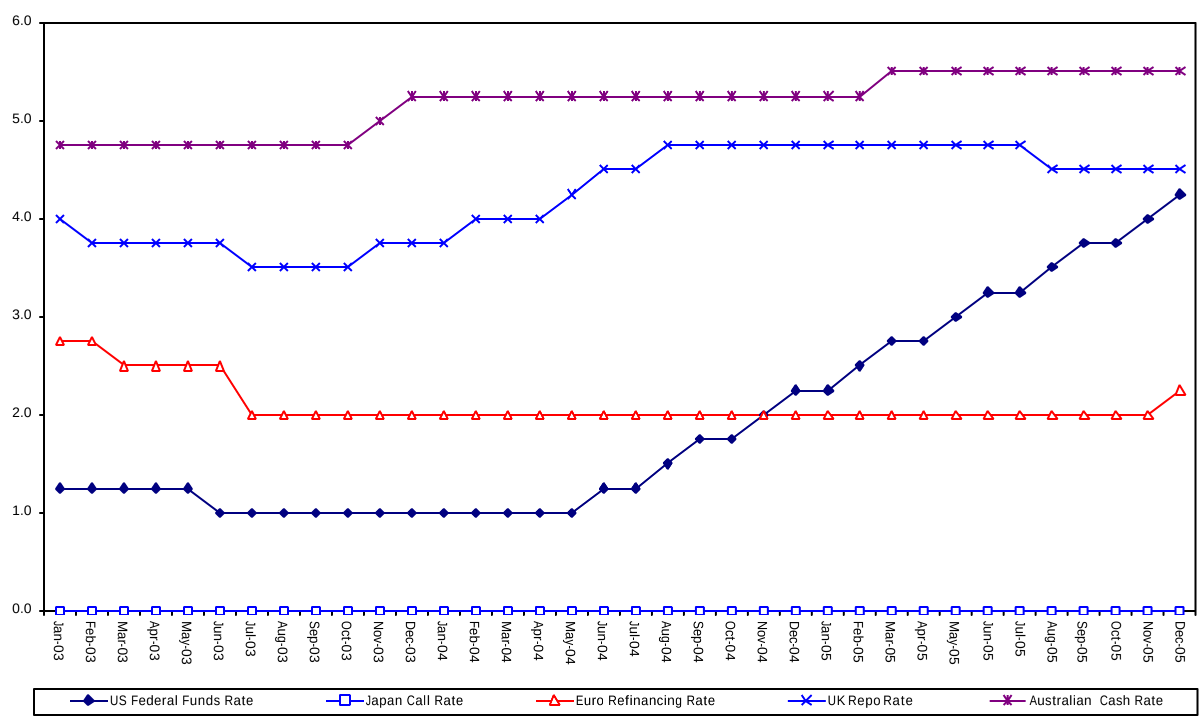
Further increases in interest rates in the US could potentially lead to higher capital inflows and result in an appreciation of the US dollar. Higher interest rates may suppress credit growth and investment, which could lead to global economic slowdown.

Secondly, the rapid increase in oil prices during the year from around US$40 per barrel at the end of 2004, peaking at over US$70 per barrel in August 2005, before ending the year at around US$60 per barrel. The price increases are the result of surging demand, especially from China, combined with global supply constraints, particularly in refining capacity.

Despite concerns over the potential price pressures resulting from the increased cost of oil, global inflation remained under control in 2005. The IMF forecasts 2005 average inflation of 2.2 percent in advanced economies and 5.9 percent in other emerging markets and developing countries, compared to 2.0 percent and 5.8 percent, respectively, in 2004. For 2006 the IMF forecasts lower inflation of 2.0 percent in advanced economies and 5.7 percent in other emerging markets and developing countries.

From a monetary policy perspective the main development during 2005 was the continued gradual tightening of policy by the US Federal Reserve. In order to control inflationary pressures resulting from the oil price increases and the strong growth of the US economy the Federal Funds Rate was raised by 200 basis points during the year from 2.25 percent to 4.25 percent. The Reserve Bank of Australia increased its Cash Rate from 5.25 percent to 5.50

Chart 1: Movements in Official Interest Rates



Source: Respective central banks' websites percent in March. The Bank of England reduced its Repo Rate from 4.75 percent to 4.50 percent in August amidst concerns of a possible slow down in the United Kingdom economy. The European Central Bank increased its Refinancing Rate from 2.00 percent to 2.25 percent in December, its first rate increase in five years. The Bank of Japan maintained its zero interest rate policy (see Chart 1).

Supported by rising US interest rates, the US dollar appreciated against other major currencies during 2005, increasing by 13 percent against the euro and 14 percent against the yen. Against the Australian dollar, which has remained strong because of favourable commodity prices, it appreciated by 6 percent. At the end of 2005 the Australian dollar was worth US$0.73, compared to US$0.78 at the end of 2004.

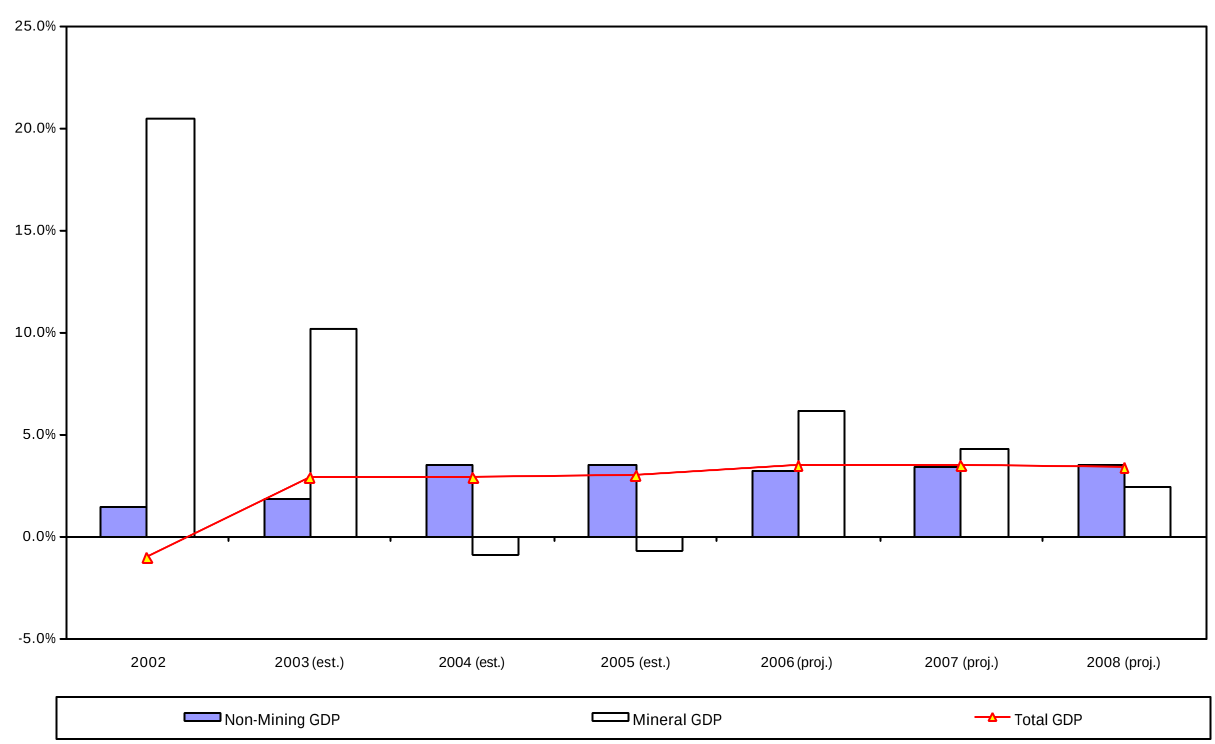
2.2 Domestic Economic Conditions

The Government's estimate is for total GDP to grow by 3.0 percent in 2005, while non-mining GDP is to grow by 3.5 percent (see Chart 2). The construction and agriculture/forestry/fisheries sectors contributed to the growth in 2005. New projects constructed in 2005 include, the Kainantu gold mine and the North West (NW) Moran and South East (SE) Mananda oil projects. In the agriculture/forestry/fisheries sector, increased harvest from new fishing licences and higher production of cash crops accounted for the increase in the sector.

The outlook for 2006 and the medium-term are for continued economic growth. Growth in 2006 is expected to be 3.5 percent, which is broad based across all sectors of the economy. Over the medium-term economic growth is expected to be sustained with major resource projects coming into construction, notably the PNG Gas project followed by the Ramu Nickel mine. The Government's Export-Driven Growth Strategy and improvements in road and transport infrastructure are also expected to contribute to the growth in the non-mineral sector.

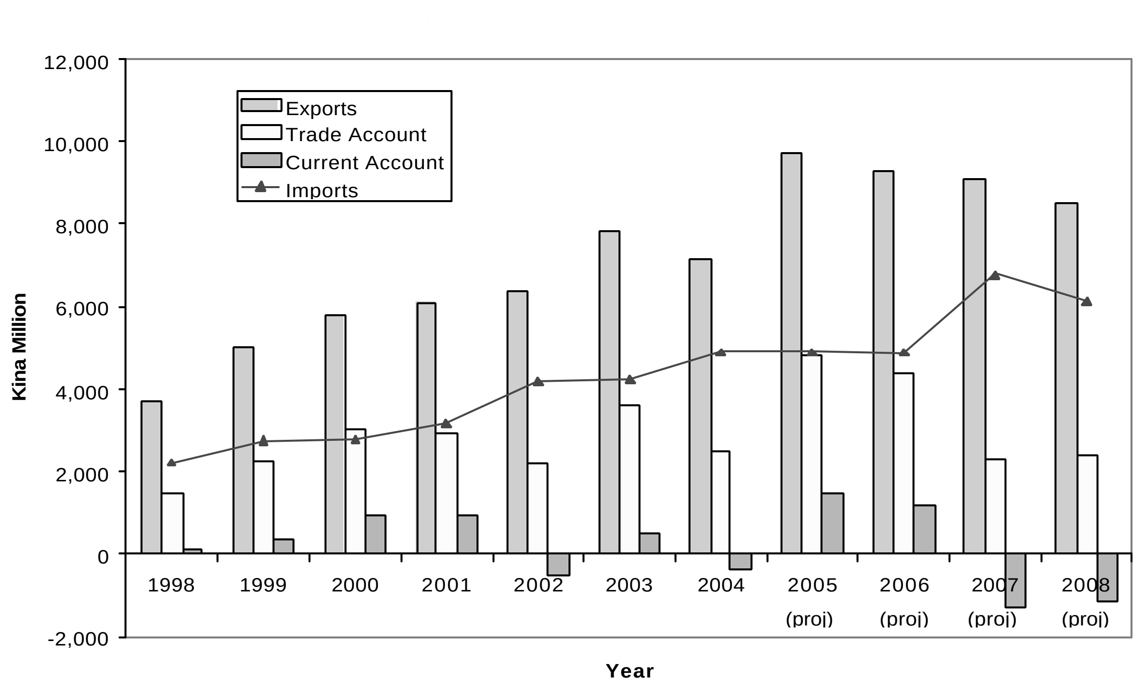
Formal private sector employment picked up in 2005, following a decline of 0.4 percent in 2004. In the year to September 2005, employment increased by 2.8 percent, driven by large increases in the manufacturing, mineral and construction sectors. Given the sustained growth of total GDP in 2006 and the medium-term, private sector employment is expected to continue to increase.

Chart 2: Real GDP Growth



Source: 2006 Budget

Chart 3: Current Account



Source: Bank of PNG

2.3 Balance of Payments

The balance of payments for 2005 is estimated to record an overall surplus of K430 million, compared to a surplus of K329.0 million in 2004. This outcome is due to combined surpluses in the current and capital and financial accounts (see Chart 3).

The lower surplus in the current account of K244.2 million was due to a reduced trade surplus, higher net service and income payments. The surplus in the capital and financial account of K185.2 million was due to foreign direct investment and liquidation of short-term portfolio investments by mineral companies.

The gross foreign exchange reserves increased to K2,396 (US$774) million at the end of 2005, from K2,061 (US$639) million in 2004, sufficient for 4.7 months of total and 9.0 months of non-mineral import covers.

The latest IMF price projections indicate that most international prices of PNG's major exports will be lower in 2006, compared to 2005, with the exception of cocoa, palm oil, copra and log exports. Both coffee and copra oil export prices are projected to decline by 3.5 percent, tea by 4.6 percent and rubber by 5.9 percent. The prices of gold, silver and copper are projected to decline by 2.3 percent, 40.0 percent and 41.1 percent respectively, while crude oil price is projected to increase by 12.0 percent.

The export volumes of most of PNG's major agricultural and mineral commodities are projected to increase in 2006, compared to 2005. The lagged supply response from previous improvement in prices for coffee, rubber and tea, combined with higher production of cocoa from Bougainville are expected to

account for the projected growth. The harvesting of new plantings coming to maturity contributed to the projected increase for palm oil. In the mineral sector, higher ore grades from existing gold mines, production from the Kainantu gold mine and production from NW Moran and SE Mananda oil projects are expected to contribute to the growth.

Accordingly, the balance of payments is projected to show an overall surplus of K36.0 million in 2006, compared to an estimated surplus of K430.0 million in 2005. This outcome reflects a projected current account deficit of K323.6 million in 2006, combined with a projected higher surplus of K359.4 million in the capital and financial accounts.

The level of gross foreign exchange reserves by the end of 2006 is projected to reach US$790 (K2,438) million, sufficient for around 4.8 months of total and 8.9 months of non-mineral import covers.

Other main assumptions underlying the balance of payments projections for 2006 and the medium-term include:

- Stability in the exchange rate;
- The PNG Gas project is not included; and
- The commencement of construction of the Ramu Nickel mine in 2007.

Further increases in the export volumes of all PNG's major agricultural commodities are projected over the medium-term. The increases are mainly due to supply response from the Government's 'Export-Driven Growth Strategy', combined with transport infrastructure developments, new plantings of agricultural export crops and additional production from Bougainville.

The gross foreign exchange reserves are projected to increase to US$944 (K2,913) million in 2007 and US$1,050 (K3,239) million in 2008. These are sufficient for 4.3 months of total and 10.3 months of non-mineral, and 5.2 months of total and 11.1 months of non-mineral import covers in 2007 and 2008, respectively.

2.4 Fiscal Operations of the National Government

Despite recording a budget surplus over the year to November 2005, the revised budget deficit for 2005 of K96.7 million is 0.6 percent of total nominal GDP, compared to 1.0 percent of total GDP in the original 2005 Budget (see Appendix – Table2). The deficit and net external loan repayments of K155.7 million were financed through domestic borrowing of K252.4 million. The lower than expected deficit reflects the savings from lower interest payments and increased revenue from high commodity prices. This has enabled the Government to use K400.0 million to fund its share of the PNG Gas project.

The 2006 National Budget was framed against improved economic and fiscal conditions. The Budget focuses on the Government's MTDS and MTFS with measures designed to achieve macroeconomic stability and provide the conditions necessary for promoting sustainable economic growth in the medium-term.

The 2006 Budget introduced a number of tax reforms to improve economic efficiency and promote trade and investment. These include reforms to personal income tax, company tax and tax incentives to specific sectors including the agriculture sector.

The focus of the Government's revenue collection efforts in 2006 will be to improve compliance with existing tax laws. The expenditure control measures planned for 2006 include:

- Further improvements to existing expenditure controls;
- Re-allocate spending to high priority programs identified in the MTDS; and
- Continued public sector reforms.

The projected Budget deficit of K90.0 million for 2006 is 0.6 percent of total nominal GDP. The deficit and net loan repayments to external sources totalling K123.9 million will be financed through net domestic borrowing of K213.9 million. In the medium-term the Government plans to achieve a balanced budget by 2008.

2.5 Exchange Rate

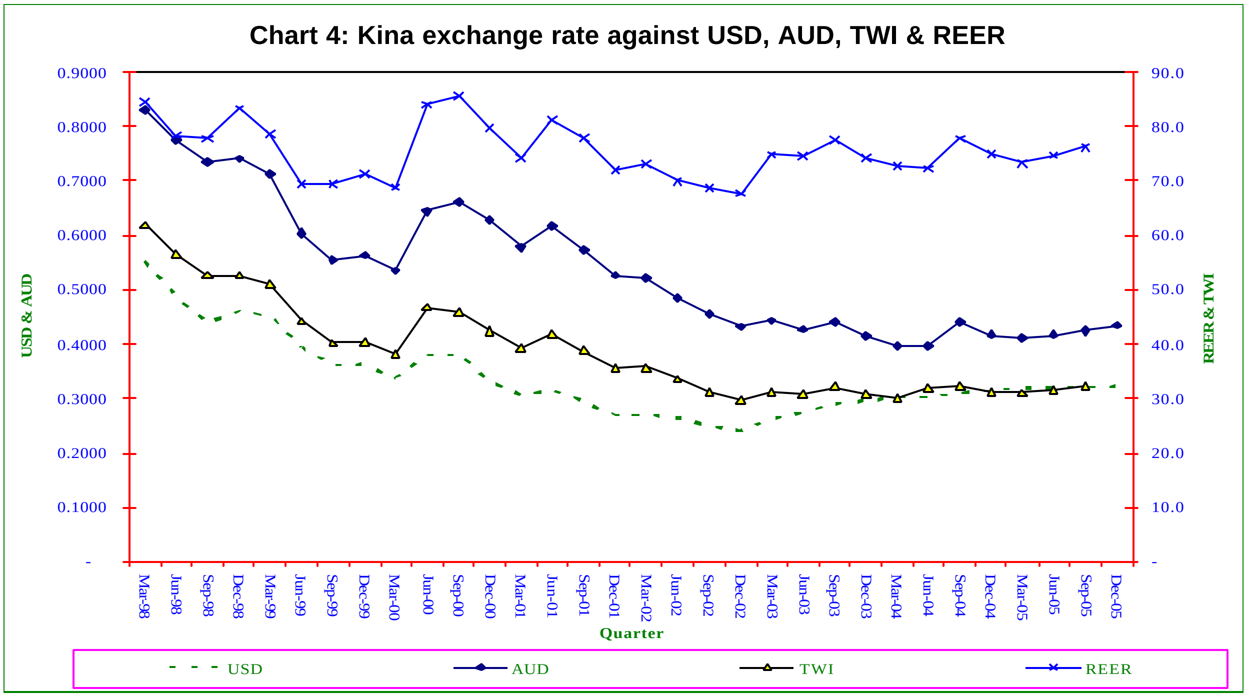
The kina continued to strengthen against the US and Australian dollars during the second half of 2005. It appreciated against the US dollar from US$0.3210 at the end of June 2005 to US$0.3230 in December 2005, whilst appreciating against the Australian dollar from AU$0.4202 to AU$0.4400 (see Chart 4). This led to an appreciation in the REER and the Trade Weighted Index (TWI) by 2.0 percent and 2.2 percent, respectively.

The strengthening of the kina exchange rate resulted from high foreign exchange inflows from mineral and agriculture exports and was also attributable to the confidence by the business community. In 2006, the exchange rate is expected to remain stable.

The Bank of PNG does not set an exchange rate target and its intervention in the foreign exchange market is largely influenced by seasonal supply and demand for foreign exchange. Given the shallow market characteristics in the foreign exchange market with relatively thin trading volumes, intervention by the Bank of PNG is necessary to smooth out any volatility without affecting the trend and constrain the exchange rate from over or under shooting in the short run.

2.6 Inflation

Annual headline inflation, as measured by the Consumer Price Index (CPI), was 4.6 percent in 2005, compared to 2.4 percent in 2004. The higher

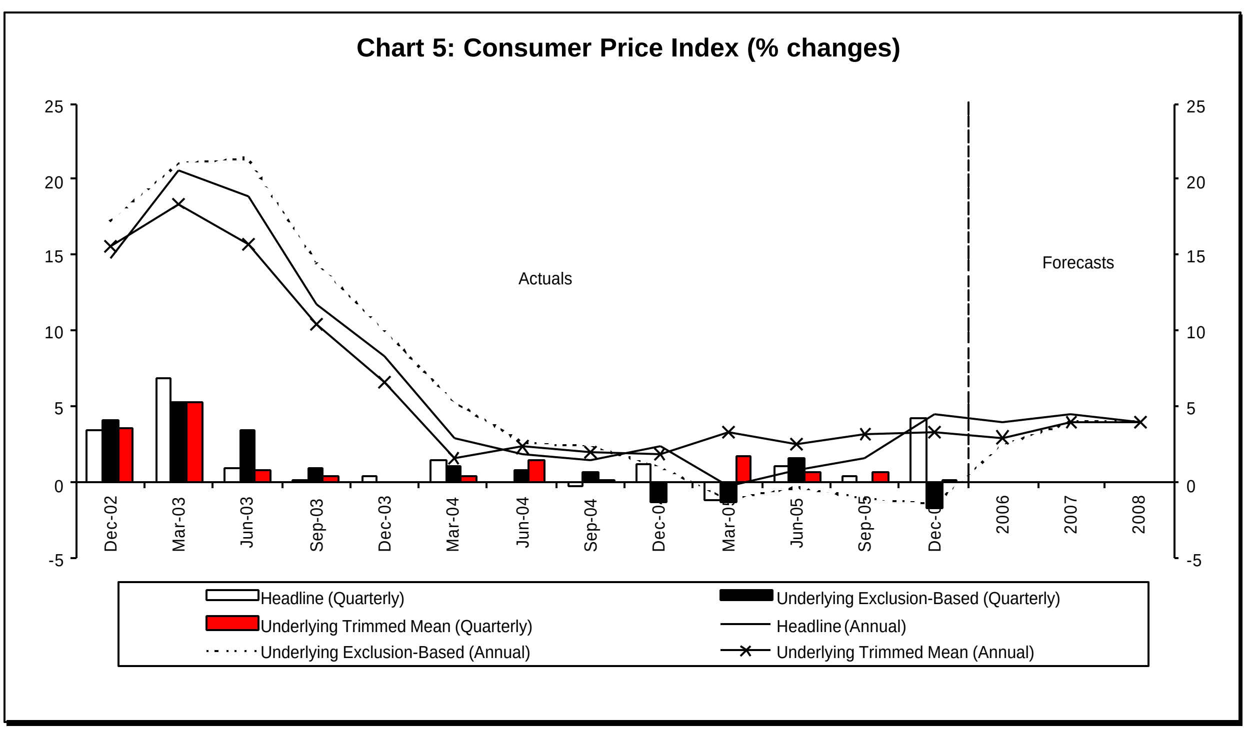


Source: Bank of PNG

headline inflation was due to the impact of higher international crude oil prices on domestic fuel prices and large increases in the price of seasonal produce during the December quarter. Annual underlying inflation in 2005 was lower than headline inflation. Trimmed mean inflation was 3.3 percent and exclusion-based inflation was negative 1.4 percent. Although the 2005 outcome is higher than in 2004, it is broadly consistent with the Bank's medium-term expectations.

Headline and underlying trimmed-mean inflation measures are forecasted to be around 3.0 percent to 4.5 percent in 2006 and the medium-term (see Chart 5 and Appendix -Table 2).

The forecasts are based on the assumption of stability in the exchange rate and low inflation in PNG's major trading partners. There are however some risks to these forecasts in 2006 and the medium-term. These are:



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

- The potential of a decline in the value of kina triggered by falls in commodity prices;
- Relaxation of expenditure control by the Government in the run-up to the 2007 National Elections;
- Destabilising capital outflows as a result of low domestic interest rates;
- Potential second round effects of the increase in international oil prices experienced during 2005 and any further increases in the medium-term; and
- A substantial movement in the value of the Australian dollar against the US dollar.

The Bank of PNG expects price increases for price-controlled services to be in line with the Independent Consumer and Competition Commission's (ICCC) approved price paths.

2.7 Monetary and Financial Market Developments

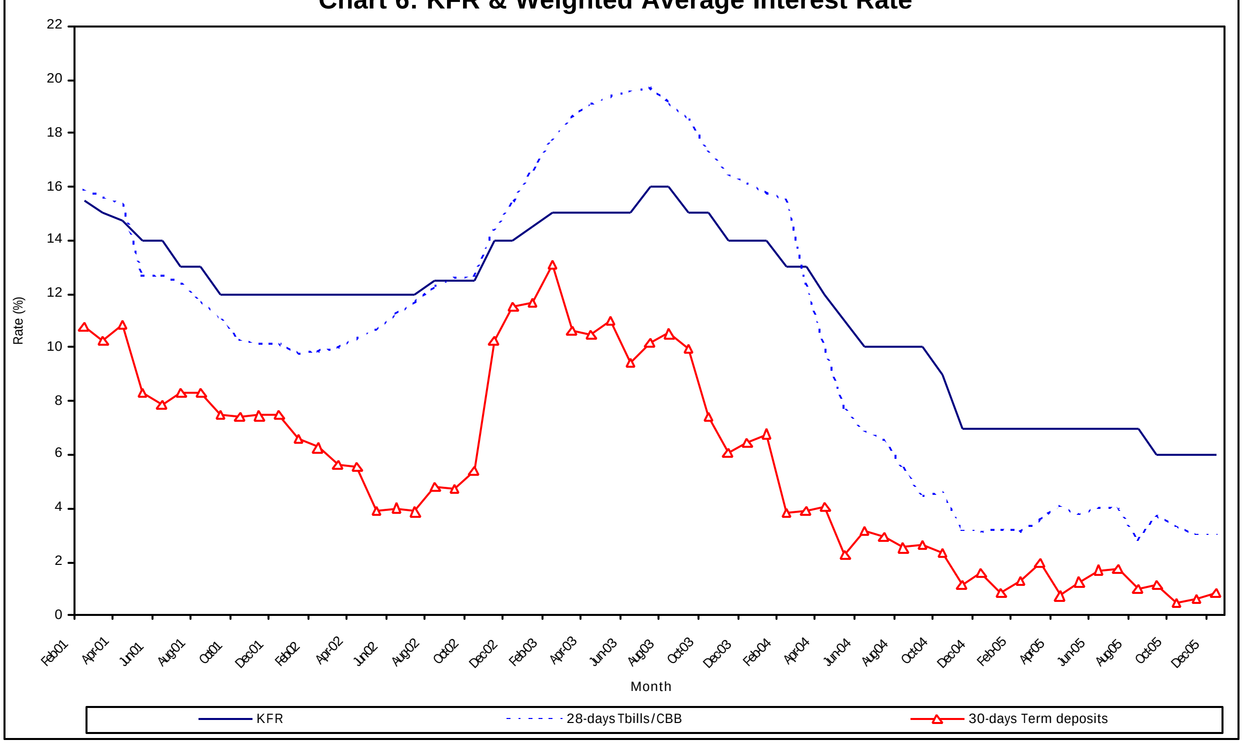
The Bank maintained a neutral monetary policy stance during 2005. The only change in the KFR made during the year was a reduction from 7.0 percent to 6.0 percent in September 2005 (see Chart 6). The trading margin for the repurchase agreement (repo) was maintained at 300 basis points on both sides of the KFR throughout 2005.

Domestic interest rates were broadly stable during 2005. The 28-day Treasury bill rate declined from 3.14 percent at the end of 2004 to 2.84 percent in September 2005. In September the securities market was reformed to separate the auction of Government issued Treasury bills from CBBs. Only licensed financial intermediaries are permitted to participate at the CBB auction. This has improved the effectiveness of the Bank's policy signalling. Following this change the 28-day CBB rate fell from 4.44 percent at the first auction in September to 2.99 percent at the end of 2005. The 91-day and 182-day Treasury bill rates increased from 3.70 percent and 4.57 percent at the end of 2004 to 3.84 percent and 4.91 percent, respectively, at the end of 2005. In June 2005 the Government introduced a 364-day Treasury bill.

Commercial banks reduced their Indicator Lending Rates (ILR) spread from 9.95-11.00 percent in June to 9.45-10.70 percent in December 2005. The weighted average interest rate on total deposits declined from 1.10 percent in December 2004 to 0.72 percent in November 2005, while the weighted average lending rate on total loans also fell from 12.24 percent to 11.01 percent during the same period. However, the spread between the weighted average lending and deposit rates continued to remain wide at around 10.0 percent (see Chart 7).

Total liquidity of the banking system grew by 13.9 percent between December 2004 and December

Chart 6: KFR & Weighted Average Interest Rate



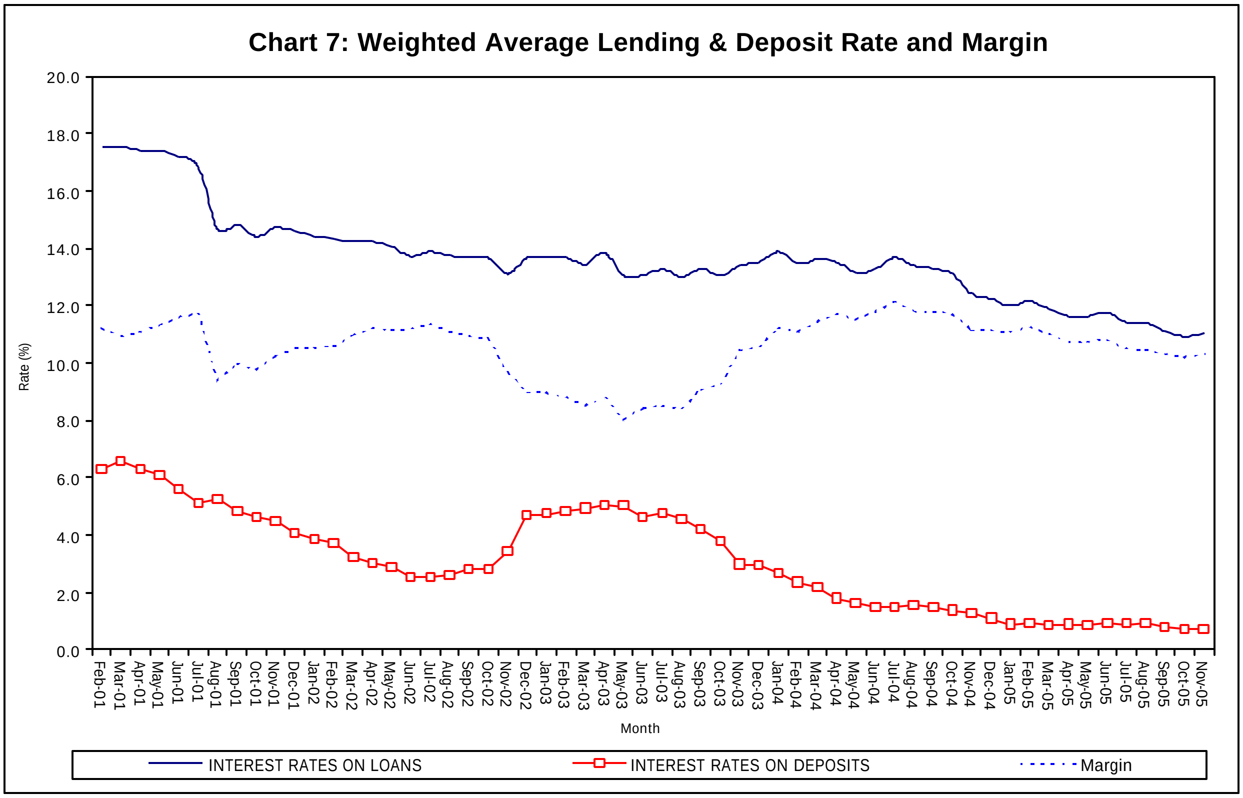
Source: Bank of PNG

2005, mainly due to mineral tax inflows. Given the high liquidity level, there were few inter-bank and repo transactions during the period. The Cash Reserve Requirement (CRR) and the Minimum Liquidity Asset Ratio (MLAR) were maintained at 3.0 percent and 25.0 percent, respectively.

Lending extended by the banking system to the private sector increased by 23.7 percent over the year to December 2005. This was mainly due to advances to the transport and communication sectors.

Net credit to the Government decreased by 11.0 percent during the same period due to an increase in Government deposits at the Bank of PNG.

The level of broad money supply (M3*) increased by 21.7 percent over the year to December 2005, as a result of growth in net domestic credit and net foreign assets of the banking system. Reserve money increased by 3.0 percent over the same period due to an increase in commercial bank deposits at the Bank of PNG (see Appendix – Table 1).



Source: Bank of PNG

Appendix

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

INDICATOR	2003 (actual)	2004 (actual)	July 2005 MPS (proj)	2005 (est)	2006 (proj)	2007 (proj)	2008 (proj)
Broad money supply	-3.7	30.2	8.3	21.7	9.9	8.1	9.0
Reserve money supply	0.1	29.8	1.8	3.0	7.5	3.7	4.6
Private sector sector	-2.8	-3.8	14.6	23.7	6.9	8.1	8.6
Net credit to Government	-5.7	23.0	7.5	-11.0	50.6	7.3	6.4
Netforeign assets	17.3	30.4	-5.3	36.3	1.2	15.7	9.6

Source: Bank of PNG

Table 2: Summary of Other Macroeconomic Indicators

INDICATOR	2003 (actual)	2004 (actual)	July 2005 MPS (proj)	2005* (est)	2006 (proj)	2007 (proj)	2008 (proj)
CONSUMER PRICE INDEX (annual % changes)							
Headline	8.4	2.4	2.9	4.6	4.0	4.5	4.0
Trimmed-mean	6.7	1.9	4.6	3.3	3.0	4.0	4.0
Exclusion-based	10.0	1.0	2.9	-1.4	2.5	4.0	4.0
BALANCE OF PAYMENTS (kina million)							
Current account	496	393	-1,163	244	-324	-2,821	-2,751
Financial account	-183	-80	951	185	359	3,296	3,076
Overall balance	353	329	212	430	36	476	326
Gross international reserves	1,682	2,061	1,785	2,402	2,438	2,913	3,239
IMPORT COVER							
Total	4.9	5.3	3.1	4.7	4.8	4.3	5.2
Non-mineral	6.1	7.2	4.2	9.0	8.9	10.3	11.1
Crude oil (US$/barrel)	30	41	40	55	56	49	45
Gold (US$/ounce)	355	398	409	440	430	400	360
FISCAL OPERATIONS OF THE GOVERNMENT							
Surplus/Deficit (K'm)	-124.3	201.9	-137.7	-96.7	-90.0	-35.1	0.0
% of GDP	-1.1	1.5	-1.0	-0.6	-0.6	-0.2	0.0
GROSS DOMESTIC PRODUCT (actual % growth)							
Total GDP	2.9	2.9	2.9	3.0	3.5	3.5	3.4
Non-mineral GDP	1.9	3.5	2.8	3.5	3.2	3.4	3.5

Source: Bank of PNG, NSO, Department of Treasury

* Actual for CPI and others are estimates