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

PORT MORESBY

30 January 2004

OBJECTIVES OF THE CENTRAL BANK

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

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

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

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

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

Central Banking Act (CBA) 2000, Section 7

POLICY STATEMENTS

"The Governor 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 business 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.

EXECUTIVE SUMMARY

The performance in the second half of 2003 was encouraging. The stability in the exchange rate, which was due to favourable developments in the foreign exchange market, led to the following:

- A declining headline inflation trend consistent with the expectation by the Bank of Papua New Guinea (BPNG);
- A build up of international reserves to unprecedented levels of around US$520 million;
- A declining trend in interest rates; and
- Strong growth in the non-mineral export sector.

The preliminary outcomes for 2003 measured against the projections in the July Monetary Policy Statement (MPS) are as follows:

- Broad money increased by 1.0 percent, compared to a forecasted growth of 3.1 percent, due mainly to an increase in the gross international reserves of the Central Bank;
- Reserve money grew by 5.9 percent compared to a forecasted decline of 2.4 percent, mainly as a result of combined increases in deposits of commercial banks with the Central Bank and currency in circulation;
- Private sector credit fell by 2.8 percent compared to a forecasted increase of 1.1 percent, mainly attributed to low demand for credit and high interest rates; and
- Net foreign assets increased by 5.8 percent compared to a projected decline of 3.6 percent, due to a decrease in the foreign assets of commercial banks.

The Central Bank expects economic conditions to stabilise in 2004, which should provide the conditions for further easing of monetary policy. Based on these expected conditions the Central Bank projects the following for 2004.

Annual headline inflation rate	8.2 percent
Private sector credit growth	9.0 percent
Net credit to Government	-6.5 percent
Net foreign assets	27.7 percent

The major risks of achieving the above targets remain any lapse in fiscal discipline of the Government, and the threat to stability in the exchange rate arising from poor supply response to favourable international commodity prices.

MONETARY POLICY STATEMENT
JANUARY 2004

INTRODUCTION

The MPS is published under the CBA 2000, and represents a key element of the transparency and accountability arrangements of the Act. The Policy Statement is presented in two parts. The first covers economic developments in 2003 and projections for 2004. The second sets out the rationale for the monetary policy stance for 2004 and the conduct of monetary policy.

1. DEVELOPMENTS IN 2003 AND PROJECTED DEVELOPMENTS FOR 2004

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

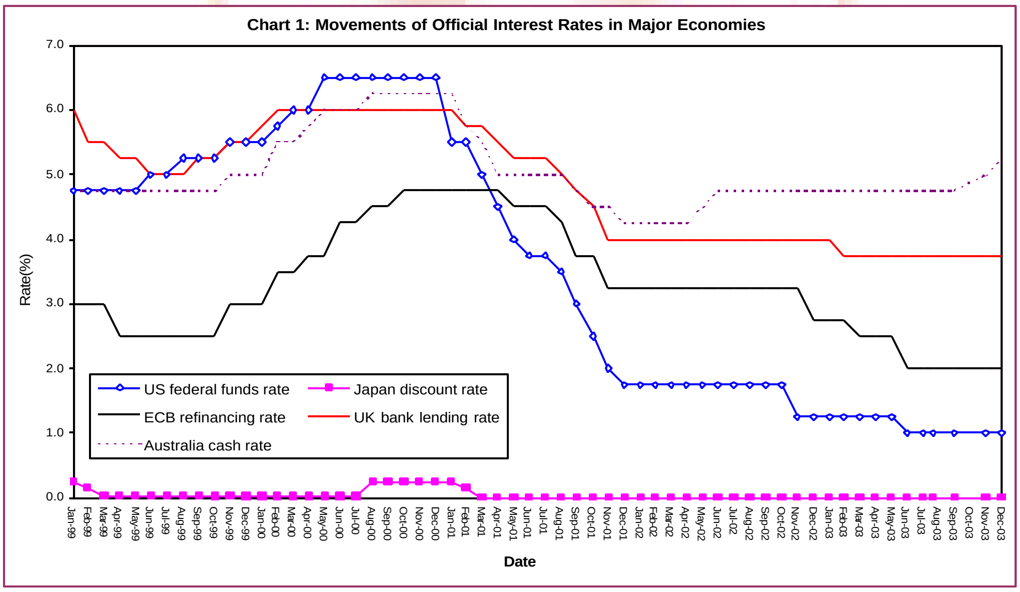
(a) The World Economy;
(b) Domestic Economic Activity;
(c) Balance of Payments;
(d) Fiscal Operations of the Government;
(e) Exchange Rate;
(f) Inflation; and
(g) Monetary and Financial Market Developments.

(a) The World Economy

In the latest World Economic Outlook released in September 2003, the International Monetary Fund (IMF) forecasts real gross domestic product (GDP) growth in the world economy in 2003 to be 3.2 percent, with growth in the United States (US) and Japan expected to contribute to increases in global production and trade. The IMF revised upward real GDP forecasts for US and Japan to grow by 2.6 percent and 2.0 percent, respectively. The other industrialised economies and the Euro zone are expected to grow modestly. The emerging markets in Asia are expected to grow by 6.4 percent, while developing countries as a whole are expected to grow by 5.0 percent. GDP is projected to grow by 4.1 percent in 2004.

Global inflation is expected to remain low, with increases of around 1.8 percent in the industrialised countries, and 5.9 percent in the developing countries. Most major central banks maintained accommodative monetary policy during 2003, in order to support the recovery in production following subdued levels of inflation. With the exception of the Reserve Bank of Australia (RBA), which increased its cash rate by 50 basis points in aggregate to 5.25 percent by December 2003, all other major central banks maintained their official rates in the second half of the year (see Chart 1).

Global financial markets were influenced by the war in Iraq and a recovery in economic activity in 2003. Equity markets have performed well since the official end of the Iraqi conflict led by the US Nasdaq stock market index, which



Source: RBA Website

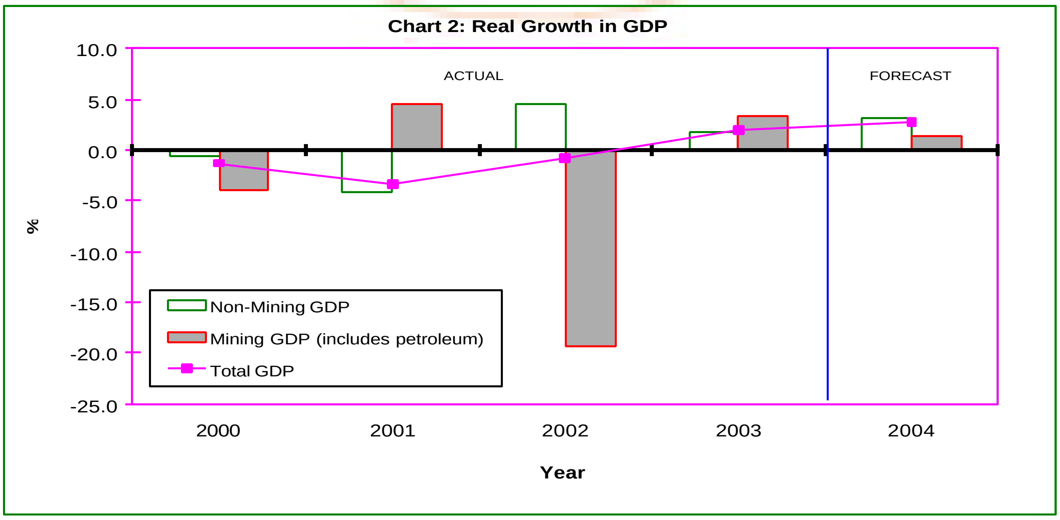
increased by 50 percent since the start of 2003. Increased investments by US companies, a stabilising labour market and robust consumer spending has also led US companies to increase forecasts for corporate profits. All major stock indices ended the year higher, while bond yields recovered from historic lows earlier in 2003.

The US dollar remained weak against the other major currencies as the US current account deficit continued to widen. In recent months, disinvestments from the US to other major financial centres, including the Euro zone, has supported the appreciation of the euro against the US dollar, while the Australian dollar has appreciated to a three year high of US$0.75. Gold continued to benefit from global uncertainties and remained strong around US$400 per ounce.

(b) Domestic Economic Activity

Preliminary assessment of economic activity in Papua New Guinea (PNG) indicates that total real GDP is estimated to increase by 2.0 percent in 2003, compared to an earlier estimate by the BPNG of 2.4 percent. Excluding the mining and petroleum sector, real GDP is estimated to grow by 1.7 percent in 2003 (see Chart 2). The upward revision was attributed to stronger growth in the mining and petroleum sector, accompanied by the recovery in the agriculture/forestry/fisheries sector. The estimated growth of 1.6 percent in the agriculture/forestry/fisheries sector was due to increased production of cocoa, coffee, palm oil, rubber, tea and copra oil. The mining and petroleum sector is estimated to grow by 3.3 percent, mainly reflecting higher production from the Moran Petroleum Development Licence (PDL5) oil project and gold and copper from the Ok Tedi, Porgera and Tolukuma mines. The remaining sectors of the economy including manufacturing, electricity/gas/water, wholesale/retail and transport/storage/communication, are all estimated to grow due to the spin-offs from the mineral and agriculture/forestry/fisheries sectors.

For 2004, real GDP is expected to grow by 2.8 percent with a projected real growth of 1.4 percent in the mining and petroleum sector. Oil production is expected to improve as production at the PDL5 oil project reaches its full production. Economic activity in the agriculture/forestry/fisheries sector is expected to contribute strongly with a forecasted growth of 3.1 percent as prices for all agricultural commodities improve, due to the strengthening of the world economy. The Government's Export-Driven Growth Strategy is likely to have a significant boost in these sectors, especially as a result of the tax incentives. This includes concessional tax deduction for primary production extension services, agricultural research and development, a 20.0 percent concessional income tax rate, excise duty exemption for businesses and individuals importing tractors for usage in agriculture and forestry, and a reduction in log export tax by 5.0 percent. Mineral exploration is also expected to recover due to the tax incentives and improved confidence. The medium-term prospects for sustained recovery in the economy will be dependent on the following developments:



Source: 2004 National Budget

- Renewed political and financial stability;
- Continuation of structural reforms;
- Development of new mineral and non-mineral projects; and
- Increased expenditure on maintenance of existing infrastructure.

(c) Balance of Payments

Actual to October 2003

Preliminary balance of payments data for the ten months to October 2003 showed an overall surplus of K56 million, compared to a deficit of K96 million in the corresponding period of 2002. The surplus in the current account was due to higher exports, lower imports, and net inflows in private and official transfers. The deficit in the capital and financial accounts mainly reflected the withdrawal of foreign direct investments by a mineral company, combined with higher loan repayments by the Government.

The level of gross foreign exchange reserves at the end of October 2003 was US$405.1 (K1,434) million, sufficient for around 4.4 months of total and 5.9 months of non-mineral import covers. At the end of December 2003, the reserve level increased to US$522.5 (K1,744.4) million, compared to a revised estimate of US$341.1 (K1,371.0) million at the end of 2002. The significant accumulation of foreign reserves reflected the high inflows of export receipts, mineral taxes paid to the Government, and the purchase of foreign currency by the Central Bank.

2004 Projections

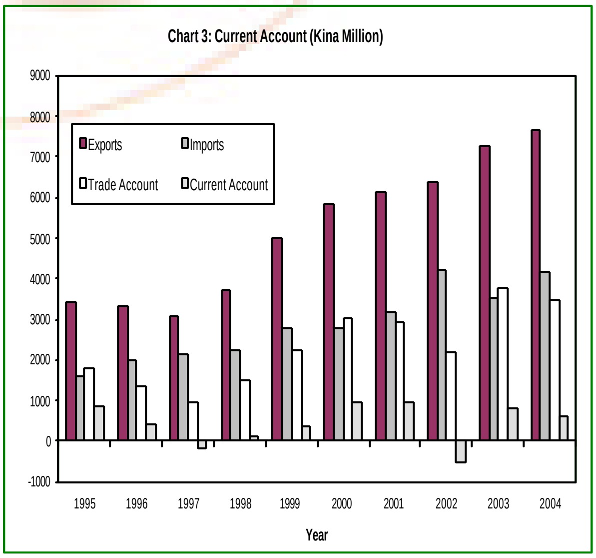
The latest IMF price projections[1] indicate that the international prices of all of PNG's exports will be higher in 2004, compared to 2003, with the exception of cocoa and tea exports. Coffee export price is projected to increase by 6.3 percent, palm oil by 7.2 percent, copra oil by 17.8 percent, rubber by 4.2 percent, logs by 7.0 percent, copper by 23.7 percent and crude oil by 3.8 percent.

In addition, the export volumes of all of PNG's major agricultural and mineral export commodities are projected to increase, compared to 2003, with the exception of tea, copra oil, silver and copper. The projected increases are mainly due to improved supply response from higher international prices, combined with some improvement in road infrastructure and access to markets. The projected increase in gold production is due to the mining of higher ore grades, while the increase in crude oil production is due to full production from the PDL5, which more than offset the natural decline in the Kutubu oil fields.

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

- Stability in the exchange rate;
- No significant capital inflows for development of any new projects;
- The enhanced cooperation package from Australia is not included;
- The budgeted concessional project loans will be partially drawn down, due to capacity constraints by the implementing agencies; and
- The Asian Development Bank (ADB) loan for the Public Sector Reform Program (PSRP) is not included.

Accordingly, the balance of payments for 2004 is projected to show an overall deficit of K72 million, compared to an estimated surplus of K619 million in 2003. The deterioration reflects a projected deficit of K749 million in the capital and financial accounts, mainly attributed to an increase in Government loan repayments and higher balances in offshore accounts by mineral



Source: Bank of PNG

[1] Latest IMF price projections, which differ from those published in the 2004 National Budget (Dept. of Treasury).

companies. This is expected to more than offset the projected surplus of K677 million in the current account (see Chart 3).

The level of gross foreign exchange reserves by end of 2004 is projected to reach US$502.4 (K1,794.3) million, sufficient for around 5.2 months of total and 8.1 months of non-mineral import covers.

(d) Fiscal Operations of the Government

Actual to October 2003

Preliminary estimates of the fiscal operations of the National Government to October 2003 showed an overall surplus of K26.2 million, compared to a deficit of K252.0 million in the corresponding period of 2002, and represents 0.2 percent of nominal GDP (see Table 1). The surplus is due to higher tax and non-tax revenue.

The budget surplus, combined with a net domestic financing of K264.5 million and a net commercial loan draw down of K13.1 million relating to the Yumi Yet Bridges Program was used to repay net overseas concessional loan of K303.8 million. Domestic financing was mainly from the non-banking sector through increased holdings of Government securities, which more than offset net repayments to the banking system and other domestic sources.

Despite the constraints on budget financing, including partial realisation of asset sales and further delays in drawing down the US$35 million ADB PSRP loan, fiscal discipline by the Government through expenditure rationalisation measures contributed to the favourable budget outturn.

Revised 2003 Estimates

The estimated budget deficit for 2003 was revised to K197.6 million, 1.7 percent of nominal GDP compared to a projected deficit of 2.0 percent of GDP in the original Budget. The improvement is due to higher revenue and restrained expenditure. The deficit and net external loan repayment was financed through domestic borrowing.

During 2003, the Government issued new Treasury bills totalling K585.7 million, which increased the total stock to K2,754.8 million at the end of the year. While total external debt has declined, the volume of domestic debt has increased correspondingly. The higher interest rate on Treasury bills in 2003 has placed significant pressure on the 2003 Budget as other recurrent and development expenditures were cut to allow for the payment of debt service costs (see Box 1).

2004 National Budget

The 2004 National Budget passed by Parliament in December 2003, aims to consolidate the fiscal adjustments in the 2003 Budget. The Budget continues to focus on the Government's Export-Driven Growth Strategy with measures that would assist in achieving macroeconomic stability and provide the conditions necessary for promoting sustainable economic growth. The fiscal strategy for 2004 recognises the difficult

Table 1: Fiscal Operations of the Government (Kina million)

	2001	2002	2002 Jan-Oct	2003 Jan-Oct (p)	2003 Est	Adjusted 2004 Budget
Total Revenue & Grants	3184.8	3231.3	2479.0	3018.9	3682.0	3837.0
Total Expenditure	3544.2	3681.5	2731.0	2992.7	3879.6	4032.6
Surplus/Deficit	**-359.4**	**-450.2**	**-252.0**	**26.2**	**-197.6**	**-195.6**
% of Nominal GDP	-3.6	-4.1	-2.3	0.2	-1.7	-1.5
FINANCING						
External	**241.9**	**-126.6**	**-124.0**	**-290.7**	**-126.8**	**-180.7**
Concessional	-151.9	-177.9	-165.9	-303.8	-62.9	-171.6
Commercial	-83.7	51.3	41.9	13.1	-6	176.4
Exceptional	477.5	0.0	0.0	0.0	-57.9	-185.5
Domestic	117.5	576.8	376.0	264.5	324.4	376.3
Bank of PNG	-247.1	245.1	455.4	-288.6	0.0	0.0
Commercial Banks	-12.1	-124.9	-137.0	149.9	0.0	0.0
Non-Banks	226.1	70.1	197.1	506.5	0.0	0.0
Other Domestic	150.6	386.5	-139.5	-103.3	324.4	0.0
Asset Sale	0	201	201.0	40.0	40.0	0.0
Others	150.6	185.5	-340.5	-143.3	284.4	0.0
TOTAL	**359.4**	**450.2**	**252.0**	**-26.2**	**197.6**	**195.6**

Source: Bank of PNG & National Budget 2004, Department of Treasury

BOX 1: THE NECESSITY OF A SUSTAINABLE PUBLIC DEBT MANAGEMENT PROGRAM

PNG as a developing economy has financed development through expansionary fiscal policy (budget deficit). Traditionally, the Government has funded its budget deficit through borrowing mainly from concessional multilateral sources. However, the high level of debt position accumulated over the years has largely constrained the Government's ability to borrow from external sources. As a result, the Government has increasingly financed its budget deficit from domestic sources. The increased domestic borrowing over the years has crowded out private sector, and reduced lending to the private sector.

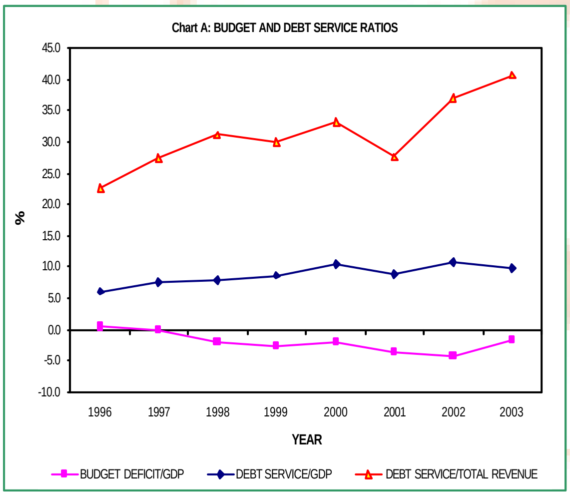
Total debt as a ratio of nominal GDP fell from 75 percent to 65 percent of nominal GDP in 2003 due to a moderate recovery in nominal GDP, and a decline in external debt due to the appreciation of the kina against the major currencies. Although the ratio of debt to GDP declined in 2003, the high domestic interest rates led to an increase in debt service as a ratio of total revenue to over 40 percent in 2003, forcing the Government to make drastic cuts in other expenditure areas.

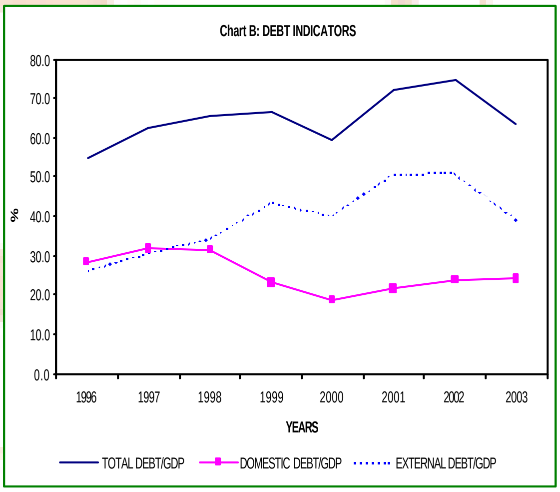
The increase in debt relative to the growth in GDP over the years is high by comparison to the average level of developing countries. This poses serious problems for the future, as the nation will bear the burden of servicing the debt. Like commercial institutions, the Government faces a situation where future tax revenue must be sufficient to meet the sum of all future obligations (expenditure) and all past obligations that have not been paid (debt). That is, budgetary allocations must be directed to areas that will yield high future returns to sustain repayment of these debts. These productive areas include transport infrastructure, education and health, all of which produce real returns in the future.

For the Government to achieve a sustainable level of public debt, it should:

- Restructure domestic debt maturities from short-term to long-term;
- Strengthen the capacity of revenue-generating agencies;
- Ensure the timely release of counterpart funding for project loans; and
- Strengthen the implementation capacity for draw down of concessional project loans.

In support of the debt management strategy, the Government should utilise any excess revenue to retire domestic debt and continue to pursue structural reforms to improve the productive capacity of the economy. Over the medium term, the Government should aim for low budget deficits or balanced budgets.





Source: Bank of PNG & Department of Treasury

economic environment that PNG confronts and the need to adjust expenditure and introduce new revenue measures.

The Budget introduced several new revenue measures and a number of tax reforms in an effort to offset revenue decreases in the mineral sector. The two major tax measures include an import levy of 2.0 percent, and a reduction in rebates for dependents from four to three. Additional amendments have been made to the relevant tax Acts to prevent tax avoidance and protect the existing revenue base.

The new expenditure control measures planned for 2004 include:

- Improving expenditure controls;
- Freeze on recruitment and termination of non-essential casual employees; and

- Tightening of controls to eliminate overruns on salaries and wage outlays and remove ghost workers on the payroll and other anomalies.

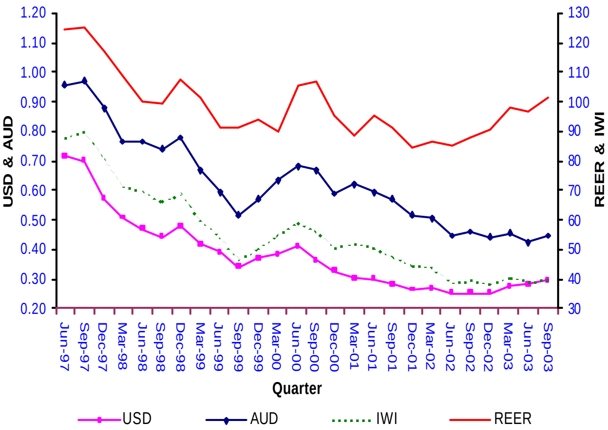
The projected Budget deficit of K195.6 million for 2004 is 1.5 percent of nominal GDP, compared to an estimated 1.7 percent of GDP for 2003. This deficit and the net external loan repayments to concessional and extraordinary sources are expected to be financed by net commercial loan of K176.4 million and domestic borrowing of K376.3 million. Domestic borrowing is increased from the budgeted amount as a result of the partial draw down of concessional project loans. If external borrowing does not eventuate, the Government may resort to further domestic borrowing. This would lead to a rise in domestic interest rates and debt service costs.

(e) Exchange Rate

The kina appreciated by 6.4 percent against the US dollar in the second half of 2003, following an appreciation of 13.3 percent over the six months to June 2003, while it depreciated against the Australian dollar (see Chart 4). The favourable developments in 2003 were due to the following factors:

- The tightening of monetary policy in the first half of the year as a result of the March quarter inflation outcome, which was higher than the Central Bank's expectation;
- Supply response to improved prices of mineral and non-mineral exports, resulting in a net accumulation of gross international reserves by the Central Bank;
- Higher real domestic interest rates on Treasury bills, which provided incentives for residents to hold financial assets on-shore; and
- Restrained Government expenditure.

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



Source: Bank of PNG

The real effective exchange rate (REER) continued to increase during the second half of the year, mainly attributed to the appreciation in the nominal exchange rate as measured on a trade weighted basis. This led to a loss of competitiveness.

(f) Inflation

Actual to September 2003

Annual headline inflation declined sharply to 11.8 percent in September 2003, after peaking at 20.7 percent in March 2003. All measures of annual underlying inflation declined in the June and September quarters of 2003, after a sustained increasing trend since the beginning of 2001 (see Chart 5).

The stability of the kina in 2003 and a weaker domestic demand for imports contributed to the declining trend in inflation. This was supported by tight expenditure controls by the Government. In addition, the BPNG also made amendments to the Treasury bills operations to avoid substantial injection of liquidity from maturing bills into the system, as in 2002.

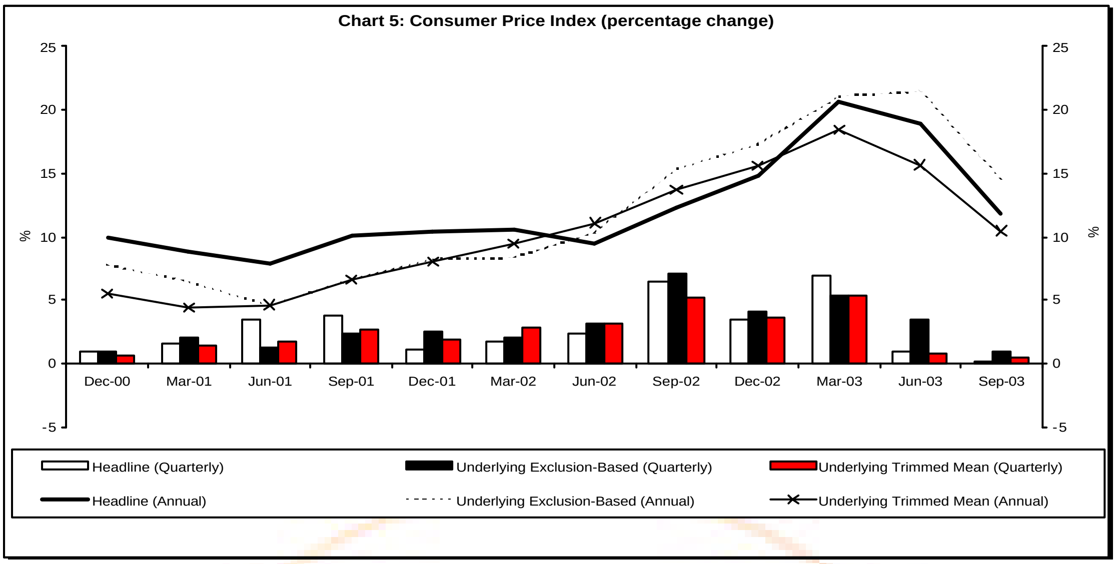
Inflation Estimates for 2003 and Projections for 2004

The 2003 December quarter inflation estimate is expected to be low due to the stability of the

Table 2. Consumer Price Indices (annual percentage changes)

	ACTUAL				FORECAST		
Inflation Measures	2000	2001	2002	Sep-03	2003 (Jul MPS)	2003	2004 (Jan MPS)
Headline	10.0	10.3	14.8	11.8	13.8	10.1	8.2
Underlying							
CPI Exclusion-based	7.8	8.2	17.3	14.5	13.9	10.4	4.0
CPI Trimmed-mean	5.5	8.0	15.6	10.4	12.3	7.5	3.3

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



Source: Bank of PNG and NSO

kina. As a result, the annual headline inflation for 2003 is estimated to be around 10.1 percent, compared to 13.8 percent projected in the July MPS, and significantly lower than 14.8 percent in 2002. The exclusion-based and trimmed-mean inflation measures have been revised downwards for the corresponding period (see Table 2).

The annual inflation outcome for 2004 is largely dependent on the stability of the exchange rate, which is also influenced by the following factors:

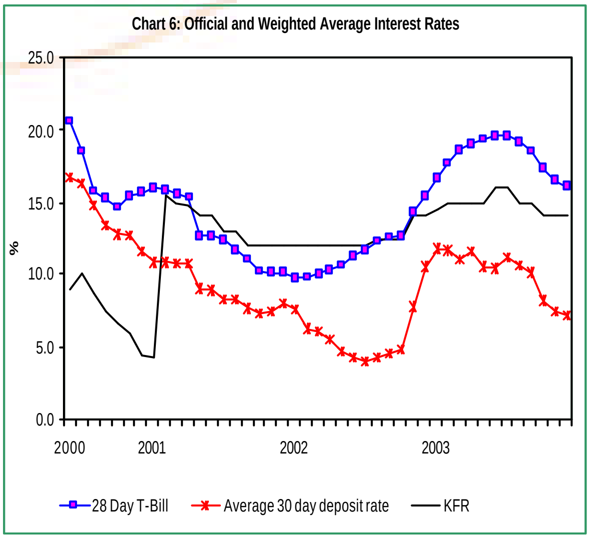
- The expenditure control measures and budgeted financing of the Government; and
- Developments in the world commodity prices for PNG's main exports being consistent with projections.

The Bank expects the exchange rate to remain stable throughout 2004, as no significant price pressures are expected. Therefore, the headline annual inflation rate is expected to decline to 8.2 percent in 2004. This is significantly higher than the expected exclusion-based and trimmed-mean underlying annual inflation rates of 4.0 and 3.3 percent, respectively, because the headline measure includes the effect of the 2.0 percent import levy.

(g) Monetary and Financial Market Developments

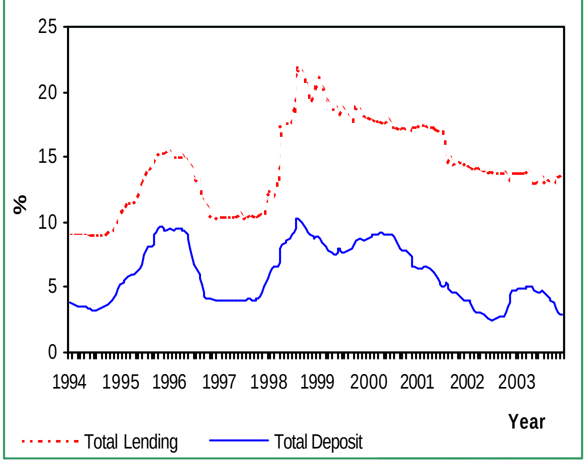
Following the better than expected inflation outcomes in the 2003 June and September quarters, the Central Bank eased monetary policy and reduced the KFR by 200 basis points in aggregate to 14.0 percent by the end of December 2003 (see Chart 6). This was supported by a reduction in the Cash Reserve Requirement (CRR) from 5.0 percent to 3.0 percent in October 2003. The reduction in the CRR of K57.0 million, combined with sales of kina in the foreign exchange market by the Central Bank, resulted in total liquidity increasing to high levels.

The weighted average total deposit rate declined from 4.60 percent in June to 2.95 percent in December 2003, while the weighted average lending rate on total loans increased. Consistent with the easing in liquidity conditions by the Central Bank, all the commercial banks reduced their ILRs during the second half of the year to a spread of 12.75 to 14.50 percent by December 2003. However, the spread between



Source: Bank of PNG

Chart 7: Weighted Average Lending and Deposit Rates



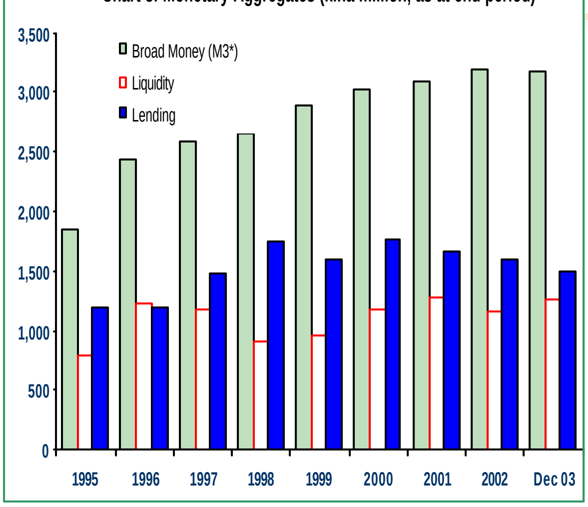
Source: Bank of PNG

the weighted average lending and deposit rates remained wide (see Chart 7). Other market interest rates also declined, including the 28 day Treasury bill rate, which decreased from 19.59 percent in June to 16.15 percent in December 2003.

Despite the decrease in the ILRs and the build up in liquidity levels, lending by the commercial banks to the private sector continued to remain depressed. This reflects the lack of demand for credit, partly attributed to low economic activity, and the crowding out of the private sector by the Government.

The level of broad money supply (M3*) increased by 1.4 percent between June and December 2003, as a result of an increase in net foreign assets. This more than offset a decline in net credit to the Government. The growth in reserve money of 17.7 percent in the second half of the year is mainly attributed to

Chart 8: Monetary Aggregates (kina million, as at end period)



Source: Bank of PNG

an increase in commercial bank deposits at the Central Bank and currency in circulation (see Chart 8).

The Bank continued to utilise its Open Market Operation (OMO) instruments to manage liquidity. As a measure to enhance liquidity management, a change to the Treasury bill auction allocation process was also implemented. This allows the Central Bank to accommodate its allocation for monetary policy considerations prior to any new issuance by the Government, and provides greater flexibility in managing liquidity. Complementing the changes to the auction allocation process, the concerns for upward bias bids were eliminated by offering non-competitive interest rates to licensed financial institutions based on the weighted average rate of the accepted bids. This gave the Central Bank greater flexibility in diffusing excess liquidity from the system, as well as smoothening the sharp movements in the Treasury bill rates.

2. MONETARY POLICY

Monetary Policy Stance

In the second half of 2003, lower inflation and improvement in macroeconomic indicators enabled the Central Bank to ease monetary policy. The Central Bank took a careful and cautious approach to easing of monetary conditions, in view of the potential for any fiscal slippages and increase in import demand during the Christmas period. However, the year ended firmer with no turnaround in the trend for the exchange rate, import demand, inflows of export receipts, Government expenditures and other price pressures.

The improvement in price stability during 2003 is expected to be consolidated in 2004. This provides the necessary foundation for further easing of monetary policy. While there is evidence of growth in economic activity, the economy remains fragile. The Central Bank expects that the declining inflation and interest rates should encourage the commercial banks to lend to the private sector. This includes the provision of credit to the agriculture sector to sustain the present economic recovery over the medium-term.

BOX 2: THE GOVERNMENT'S ROLE IN ACHIEVING PRICE STABILITY

The outcome of the 2003 financial and macroeconomic indicators are encouraging in light of the Central Bank's endeavour to achieve price stability as the overriding objective of monetary policy. A combination of fiscal discipline and tight monetary policy in the first half of 2003 mitigated the risks of serious inflationary pressure in 2003. Trade Union demands for wage increases were harmonised and stability in the exchange rate, partly contributed to the declining inflation trend. Further stability in prices impinges on consolidation of the efforts achieved in 2003.

If the Government adheres to the parameters of the 2004 Budget, it will greatly assist the Central Bank in achieving its objective of price stability, and provide the necessary foundation for sustained macroeconomic stability and economic growth in 2004. In previous years, the Government's recourse to significant domestic borrowing, financed primarily through new issuances of Treasury bills and high utilisation of the Temporary Advance Facility (TAF) at the Central Bank, has created an environment for inflationary pressure. Inflation is a monetary phenomenon. In 2003, the injection of liquidity arising from the inflow of foreign exchange was adequately sterlised using monetary policy instruments. Further injection of liquidity by the Government in 2004 may restrain easing of monetary policy and reduction in interest rates that can generate private sector growth. The excess liquidity in the banking system has the potential to adversely affect the exchange rate and inflation, because of the country's high dependence on imports. Since changes in inflation are closely associated with exchange rate movements, relative stability in the exchange rate is necessary to curtail inflationary pressure.

Sustained price stability in the medium-term depends largely on the following factors:

- The achievement of the broad objectives of the 2004 Budget;
- An improvement in debt management that enables an efficient project loan draw down mechanism, which minimises continued recourse to domestic borrowing;
- Maintaining investor confidence in order to ensure sustained inflow of foreign exchange receipts from exports and encourage new investment;
- Improvement to economic infrastructures such as roads and bridges;
- Maintenance of closer dialogue with trade unions; and
- Improved dialogue with the international financial institutions and traditional development partners in the development of the country.

Table 3: Percentage changes in Monetary and Credit Aggregates

	2002	2003	Jun-Dec 2003	Jul MPS 2003	Jan MPS 2004
Broad Money Supply	9.7	1.0	1.4	3.1	7.3
Reserve Money	17.3	13.7	17.7	-2.4	1.4
Private Sector Credit	-4.6	-2.8	0.3	1.1	9.0
Net Credit to Government	82.0	-10.4	-9.5	5.7	-6.5
Net Foreign Assets	-0.9	5.8	34.0	-3.6	27.7

Source: Bank of PNG

The monetary policy stance in the first half of 2004 will depend on the following factors:

- The inflation outcome for the December quarter of 2003 and the first half of 2004;
- Stability in the exchange rate, which also depends on the supply response to the favourable international commodity prices, the ability of the Government to restrain expenditure, the public's perception on the management of the economy and the maintenance of real interest rates to prevent any capital outflow; and
- Timely draw down of external loans by the Government.

Under these conditions monetary and credit aggregates are expected to develop at moderate rates (see Table 3). The Central Bank expects to constrain the nominal growth in reserve and broad money to 1.4 percent and 7.3 percent, respectively, which are around the level of inflation in 2004. This rate of growth is considered non-inflationary. Given the decline in net credit to the Government and high free liquidity reserves in the banking system, private sector credit is projected to grow by 9.0 percent. The level of net foreign assets are expected to increase by 27.7 percent, due to large reduction in the BPNG's foreign liabilities.

Accordingly, the Central Bank will continue to take a cautious approach to any further easing of monetary policy, in light of the significant increase in liquidity levels and its potential to adversely affect the exchange rate and other key macroeconomic indicators.

Conduct of Monetary Policy

The KFR will remain as the instrument for signaling the Central Bank's stance of monetary policy with an announcement of the KFR each month. The transmission of monetary policy stance will continue to be reinforced within the reserve money framework. Reserve money is defined as currency in circulation and the deposits of commercial banks with the Central Bank. The excess level of liquid assets in relation to statutory requirements is an indicator of the banking system's capacity to finance new lending.

To enhance the transmission mechanism of monetary policy, the Repurchase Agreement Facility (RAF) will be retained for daily and weekly liquidity management. Transactions under the RAF will continue to be unsecured.

Treasury bills remain the main instrument for liquidity management. The changes to the Treasury bill auction allocation process has minimised crowding out of the Central Bank, and enabled it to actively participate in the auction to achieve its liquidity management objective. In addition, the Tap Facility for Treasury bills will be maintained at the discretion of the Central Bank.

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