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

PORT MORESBY

29 July 2005

Queries on the contents of the Monetary Policy Statement should be directed to the Manager, Economics Department 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 is also available on the Bank's website: http//www.bankpng.gov.pg. It will be reproduced in the June 2005 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; 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
- Lead to a stable macroeconomic environment and economic growth.

CONTENTS

EXECUTIVE SUMMARY

In the first half of 2005, economic conditions remained favourable. The high level of liquidity in the banking system and prevailing low domestic interest rates relative to substitute financial markets, were the basis for the Bank of Papua New Guinea (Bank of PNG) to adopt a neutral monetary policy stance. The developments in major economic indicators that support this stance include:

- A decline in the annual headline inflation rate to 0.9 percent in June 2005;
- A stable kina exchange rate;
- High international reserve levels of US$573.2 (K1,791.4) million on 30 June 2005;
- A declining trend in domestic lending interest rates; and
- Sound fiscal management by the Government.

The preliminary outcomes of the major economic indicators to June 2005 are mostly consistent with the Bank's projections for 2005 made in the January 2005 Monetary Policy Statement (MPS).

The MPS takes into account medium term projections because 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 second half of 2005 and over the medium term. Consequently, the Bank will maintain a neutral monetary policy stance in the second half of 2005 and over the medium term. However, maintaining this stance would depend on the following factors:

- Low inflation outcomes;
- Stability in the exchange rate;
- Fiscal discipline by the Government; and
- No major external and domestic shocks.

Government expenditure is expected to be lower as a result of the decline in interest rates and adherence to the fiscal framework set in the 2005 National Budget. The savings from lower interest expenditure should be used to increase expenditure in areas that will create an impetus for growth. The stability in macroeconomic conditions is expected to continue in the medium term, thereby creating an environment conducive for increased private sector activity. The projected growth in broad and reserve money are considered non-inflationary. Based on these expectations, the Bank's projections of major economic indicators for 2005 and the medium term are as follows:

Indicators	**2003**	**2004**	**2005**	**2006**	**2007**
	(Annual growth - %)				
Headline inflation	8.4	2.4	2.9	3.4-4.4	3.4-4.4
Trimmed mean inflation	6.7	1.9	4.6	3.7	3.7
Private sector credit	-4.3	-2.2	14.6	8.5	7.0
Net credit to Government	-5.7	23.2	7.5	2.0	8.7
Net foreign assets	17.3	34.5	-5.3	3.7	2.6
Broad money supply (M3*)	-3.6	15.7	8.3	8.2	8.1
Reserve money	13.7	10.0	1.8	6.6	7.2

Monetary Policy Statement

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. The Policy Statement is presented in two parts. Section one covers the economic developments in the first half of 2005 and revised projections for the medium term. The second section sets out and explains the rationale for the monetary policy stance for the second half of 2005, and how monetary policy will be implemented in line with the medium term outlook.

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

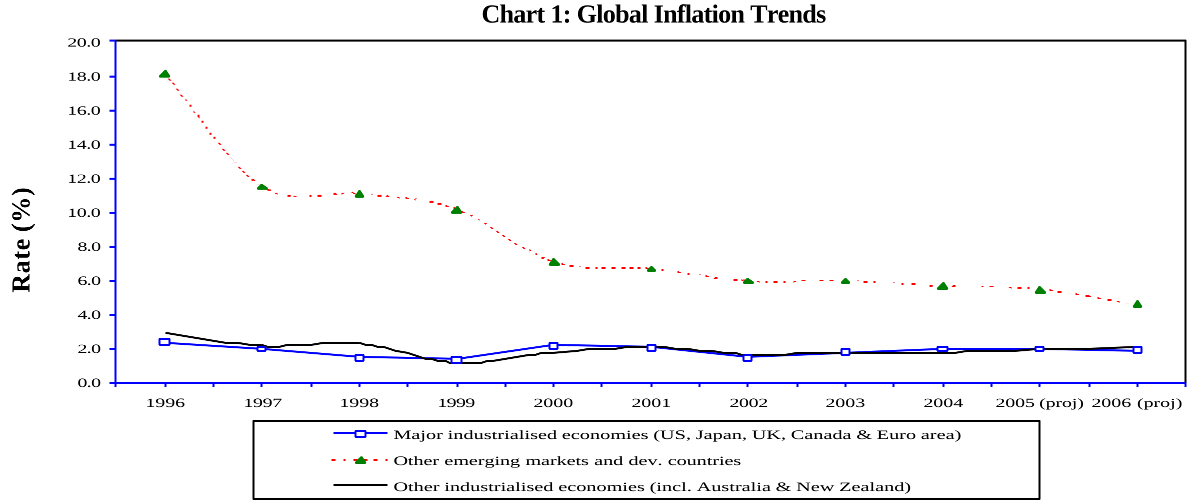
(a) The World Economy

World economic output in 2005 is expected to slow slightly from the high growth recorded in 2004. According to the April 2005 World Economic Outlook (WEO), the International Monetary Fund (IMF) forecasts real gross domestic product (GDP) growth in the world economy to be 4.3 percent in 2005, compared to 5.1 percent in 2004. The expected slow down in economic activity is due to the adverse impact of higher oil prices combined with a fall in industrial production and weak consumer demand. The global growth conceals substantial differences in performance between countries. Economic growth in the United States (US) and China remains strong, buoyed by strong production and consumption. In contrast, economic growth in Japan and Euro area has been undermined by declining exports and weak domestic demand.

During the first half of 2005, the high current account deficit in the US continued to reinforce the trade imbalances amongst the major economies. In the year to March 2005, the US current account deficit reached 6.4 percent of GDP with strong domestic demand continuing to offset the effect of the lower US dollar. In contrast Japan, China, Euro area and the Middle East oil exporting countries have substantial current account surpluses.

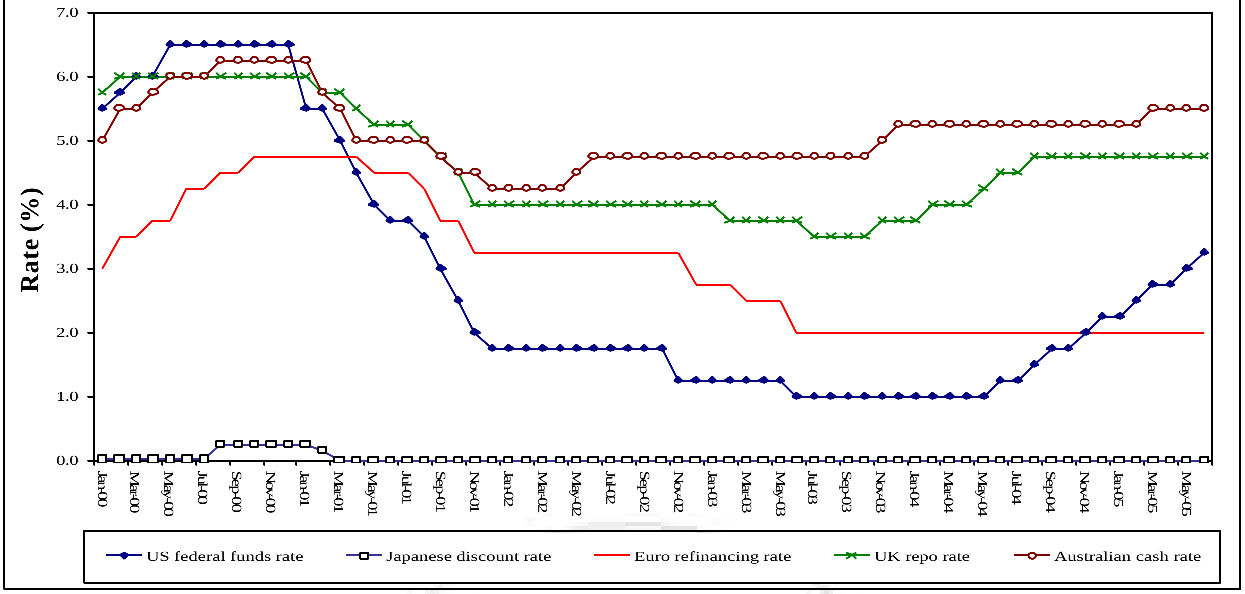
Crude oil prices continued to move upwards in the first six months of 2005. In June it exceeded US$60 per barrel. The higher prices have been attributed to global supply constraints, particularly in refining capacity and increased global demand. In spite of the inflationary stimulus these price increases have created, global inflation remains low. The IMF projects 2005 inflation of 2.0 percent in the industrialised economies and 5.5 percent in other emerging markets and developing countries (see Chart 1).

Chart 1: Global Inflation Trends



Source: World Economic Outlook, IMF

Chart 2: Movements in Official Interest Rates



Source: Respective central banks' websites

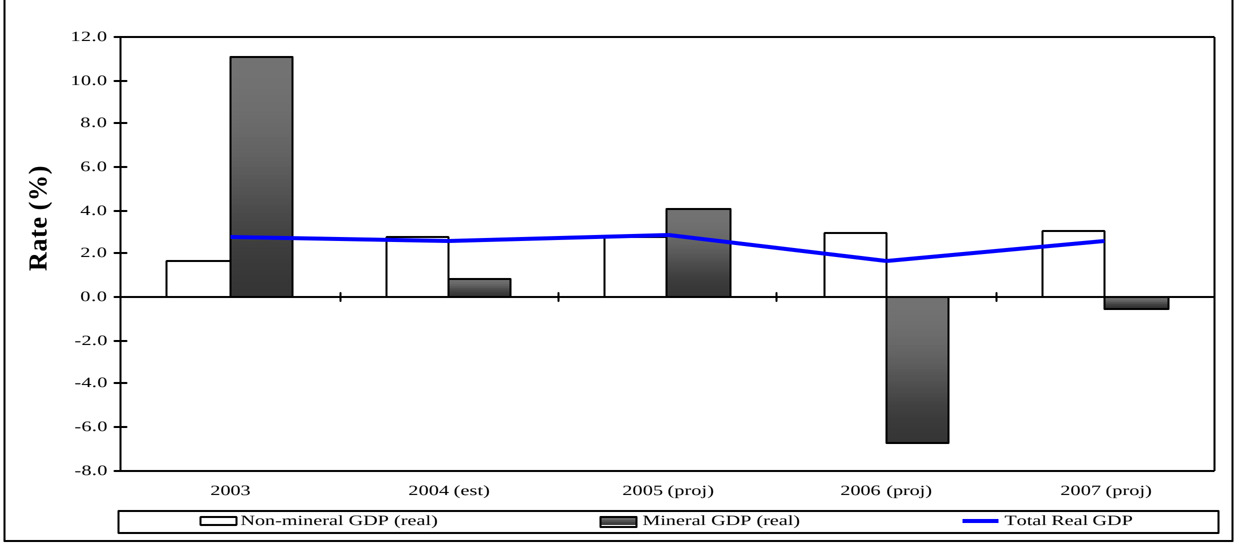
The US Federal Reserve Board continued to tighten monetary policy by raising the Federal Funds Rate by 100 basis points during the first half of 2005 from 2.25 to 3.25 percent. The Reserve Bank of Australia (RBA) also tightened its monetary policy when it increased its Cash Rate by 25 basis points to 5.50 percent in March 2005. Other major central banks left their monetary policy unchanged (see Chart 2).

In the foreign exchange market the US dollar appreciated against all the major currencies supported by strong economic growth and higher interest rate differentials. Against the euro it appreciated by 11 percent during the first six months of 2005. The strength of the US dollar is expected to stimulate export and accelerate economic growth in Japan and the Euro area. The Australian dollar strengthened slightly against the US dollar during the first quarter, but came under pressure during the second quarter on the back of declining commodity prices and concerns over the impact of the prolonged drought on rural exports. The decision by the RBA to leave interest rates unchanged during the second quarter of 2005 also undermined the Australian dollar. At the end of June 2005 the Australian dollar was worth US$0.76, compared to US$0.78 at the end of 2004.

(b) Domestic Economic Activity

The Bank of PNG's preliminary assessment of economic activity supports the Government's forecasted GDP growth of 2.9 percent for 2005 (see Chart 3). The projected growth is supported by the Bank's March quarter Business Liaison Survey

Chart 3: Real GDP Growth Rates



Source: 2005 National Budget

(BLS), which indicates growth in both nominal and real sales in 2005, combined with increases in employment levels. The growth is expected to be driven by high international commodity prices combined with increases in the production of PNG's major exports.

The broad based growth experienced in 2004 is expected to continue. The manufacturing sector projects strong growth in sales based on the export of petroleum products from the Napa-Napa oil refinery and processed tuna and canned mackerel and tuna. Projected growth in the construction sector is associated with the Ramu Nickel project and donor funded projects including the Highlands Highway, hospitals and school buildings, hotels and residential units. The developments in these sectors and projected growth in the agriculture/forestry/fisheries and mineral sectors should have spillover effects into the other sectors including transportation, commerce and other service sectors.

The current macroeconomic stability provides a conducive environment for the Government to undertake the reforms necessary to promote growth and reduce poverty in the longer term.

(c) Balance of Payments

Four months to April 2005

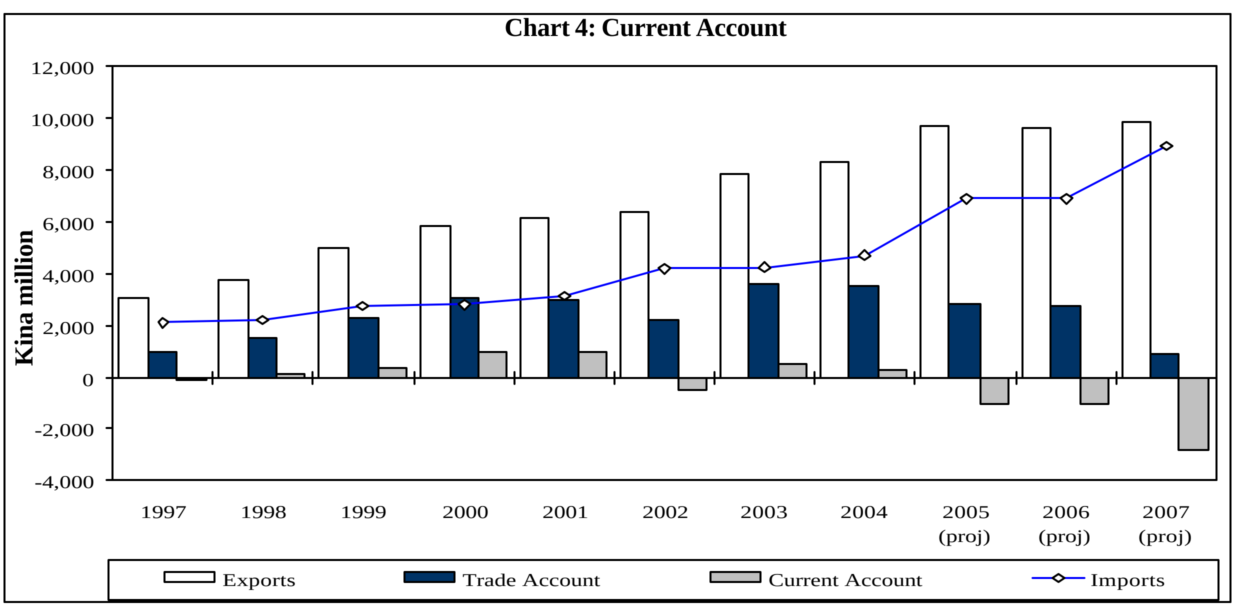
Preliminary balance of payments data for the four months to April 2005 showed an overall deficit of K269 million, compared to a deficit of K86 million in the corresponding period of 2004. The higher deficit was due to a deterioration in the current account as a result of lower trade surplus and net transfer receipts. This more than offset an improvement in the capital and financial accounts, which were attributed to higher trade credits, draw down in foreign currency account balances by mineral companies and lower loan repayments by the Government.

The level of gross foreign exchange reserves at the end of April 2005 was US$574.2 (K1,792.0) million, sufficient for around 4.1 months of total and 5.7 months of non-mineral import covers. As at 22 July 2005, the level of gross foreign exchange reserve increased to US$580.0 million. The increase in reserves reflected higher inflows of mineral taxes.

Projections for 2005 and the Medium Term

The latest IMF and World Bank commodity price projections indicate that the international prices of all of PNG's exports will be higher in 2005, compared to 2004, with the exception of palm oil, copra oil and rubber. Coffee export prices are projected to increase by 46.3 percent, cocoa by 4.4 percent, copra by 10.5 percent and tea by 7.1 percent. The prices of copper and crude oil are projected to increase by 8.3 and 34.4 percent, respectively.

The volumes of all of PNG's major agricultural and mineral export commodities are projected to increase in 2005, compared to 2004 with the exception of silver. The projected increases are mainly due to supply response from higher international prices for coffee, copra, copra oil and rubber, combined with increased production from Bougainville for cocoa. The increase in palm oil is associated with harvesting of new plantings coming to maturity. The projected



Source: Bank of PNG

increase in gold production is due to the mining of higher ore grades. The increase in crude oil production is due to the commencement of production from the North West (NW) Moran oil project, which will offset the natural declines in the Kutubu, Gobe Main and South East oil fields.

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

- Stability in the exchange rate;
- Expenditure from Front End Engineering Design (FEED) associated with PNG-Queensland Gas Project will be minimal since major expenditure will be realised offshore; and
- Exchange Control Liberalisation will have a limited effect.

Despite the increase in international prices and export volumes, the balance of payments for 2005 is projected to show an overall deficit of K212 million, compared to a surplus of K330 million in 2004. The deterioration reflects a projected current account deficit of K1,163 million in 2005, mainly attributed to expected higher import and service payments from increased capital expenditures undertaken by some of the major mines, ongoing capital expenditure undertaken at the Kainantu mine and NW Moran oil project (see Chart 4). This is expected to more than offset the projected surplus of K951.0 million in the capital and financial account. The level of gross foreign exchange reserves by end of 2005 is projected to be US$571.3 (K1,785.3) million, sufficient for around 3.1 months of total and 4.2 months of non-mineral import covers.

Over the medium term the balance of payments is projected to show small overall surpluses due to strong performance of the export sector.

The export volumes of all of PNG's major agricultural export commodities are projected to increase over the medium term due to maturity of new plantings, additional production from Bougainville and from high yielding cocoa trees. Mineral export volumes are projected to increase, reflecting commencement of production at the Kainantu Gold Mine. Over the medium term, crude oil production will trend downwards as a result of the natural decline in the oil reserves. The construction of the Ramu nickel project is expected to commence in 2007.

The gross foreign exchange reserves are projected to increase to around US$ 580 (K 1,824.1) million in 2006 and 2007. The projected reserves are sufficient for around 3.0 months of total and 4.0 months of non-mineral import cover over the medium term.

(d) Fiscal Operations of the National Government

Five months to May 2005

Preliminary estimates of the fiscal operations of the National Government over the five months to May 2005 showed an overall surplus of K257.8 million, compared to a surplus of K233.5 million in the corresponding period of 2004. This represents 1.8

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

	2003	2004	2005	2004	2005	2006	2007
	Actual	Actual	Budget	Jan - May	Jan - May	Projections	
Total Revenue & Grants	**3,610.2**	**3,939.5**	**4,639.7**	**1,409.5**	**1,624.0**	**4,704.4**	**4734.6**
Total Expenditure	**3.734.3**	**3.705.5**	**4.777.4**	**1.176.0**	**1.366.2**	**4.789.9**	**4762.0**
Surplus/Deficit	**-124.1**	**234.0**	**-137.7**	**233.5**	**257.8**	**-85.5**	**-27.4**
% of GDP	-1.1	1.7	-1.0	-1.8	1.8	-0.6	-0.2
FINANCING							
Net External	**-307.0**	**-337.6**	**-190.2**	**-196.9**	**-144.9**	**-96.2**	**-42.9**
Concessional	-136.5	-159.6	-19.0	-96.9	-135.9	-78.3	-25.0
Commercial	11.3	-9.8	-5.8	-19.8	-9.0	-17.9	-17.9
Extraordinary	-181.8	-168.2	-165.4	-80.2	-	-	-
Net Domestic	**431.1**	**103.6**	**327.9**	**-36.6**	**-112.9**	**181.7**	**70.3**
Bank of PNG	-378.6	-254.6	-	-261.7	17.6	-	-
Commercial Banks	295.9	479.3	-	32.8	-41.1	-	-
Non-Bank System	565.5	-119.9	-	286.6	34.4	-	-
Other Domestic Sources	*-51.7*	*-1.2*	-	*-94.3*	*-123.8*	-	-
Asset sales	40.0	25.0	-	-	-	-	-
Other	-91.7	-26.2	-	-94.3	-123.8	-	-
Total	**124.1**	**-234.0**	**137.7**	**-233.5**	**-257.8**	**85.5**	**27.4**

Source: 2005 National Budget & Bank of PNG percent of nominal GDP. The surplus was due to higher revenue, which more than offset an increase in expenditure (see Table 1).

The budget surplus was used to repay net overseas and domestic loans of K144.9 million and K112.9 million, respectively. The net domestic loan repayment mainly reflected the settlement of cheque floats issued in 2004 combined with net repayments to the banking system. The Government continued to redeem Treasury bills and issue Inscribed stocks, as well as converting Treasury bills into Inscribed stocks to minimise refinancing risk. During the first half of 2005 it successfully raised K200 million in Inscribed stocks and switched K250 million from Treasury bills to Inscribed stocks.

(e) Exchange Rate

The value of the kina remained relatively stable during the first six months of 2005. Against the US dollar it appreciated marginally from US$0.3200 at the end of 2004 to US$0.3210 at the end of June 2005. Against the Australian dollar it appreciated by 2.4 percent. The Trade Weighted Index (TWI)[1] appreciated by 0.9 percent over the same period.

The stability in the kina exchange rate resulted from favourable foreign exchange inflows by the mineral and agriculture export sectors, and Central Bank support. Movements of the kina against the Australian dollar are determined by movements in the Australian dollar-US dollar exchange rate. The kina exchange rate is expected to remain stable for the remainder of 2005.

The Real Effective Exchange Rate (REER)[1] depreciated by 2.4 percent in the first quarter of 2005. This was due to the appreciation of the kina against the US dollar and 1.2 percent decline in PNG's Consumer Price Index (CPI) in the first quarter of 2005. This implies a gain in competitiveness of the export sector.

(f) Inflation

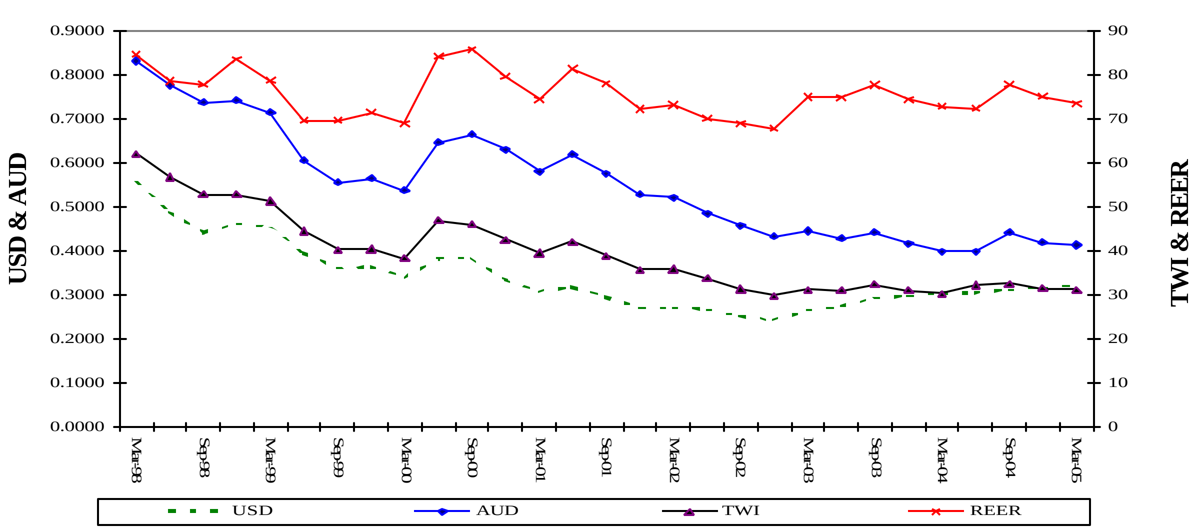
Six months to June 2005

Annual headline inflation remained very low in the first two quarters of 2005, the lowest headline inflation outcomes since the September quarter of 1994, recording 0.9 percent in June 2005, following a negative 0.3 percent in March 2005. Annual underlying inflation outcomes for the trimmed-mean was 2.6 percent, while the exclusion-based was negative 0.3 percent to June 2005 (see Table 2). Quarterly headline inflation outcomes in 2005 were very low, reflecting a negative 1.2 percent in the March quarter and 1.1 percent in the June quarter of 2005.

The main causes of low inflation were:

- Stability in the kina exchange rate;
- Low inflation levels at PNG's main trading partners;

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



Source: Bank of PNG

[1]*The TWI and REER have been reconstructed using the splicing and geometric averaging techniques. This is to account for changes in the weights, reflecting changing trade shares of PNG's trading partners and to make the calculation of the indices theoretically correct.*

Table 2: Consumer Price Index (annual percentage change)

	ACTUAL					FORECAST			
Inflation Measures	2002	2003	2004	Mar-05	Jun-05	2005 Jan MPS	2005 Jul MPS	2006 Medium Term	2007 Medium Term
Headline	14.8	8.4	2.4	-0.3	0.9	2.6	2.9	3.4 - 4.4	3.4 - 4.4
Underlying									
Exclusion-based	17.3	10.0	1.0	-1.1	-0.3	3.0	2.9	4.5	4.7
Trimmed-mean	15.6	6.7	1.9	3.3	2.6	2.1	4.6	3.7	3.7

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

- Moderate import demand; and
- Sound fiscal management by the Government.

Projections for 2005 and the Medium Term

Inflation is expected to remain low during the second half of 2005 before picking up in 2006 and 2007[2]. Headline inflation is projected to be 2.9 percent in 2005 and be in the range of 3.4 - 4.4 percent in the medium term. The inflation outcome in the medium term will depend on the following factors:

- The stability in exchange rate;
- Inflation levels in our trading partner countries;
- The rate of growth of domestic demand;
- Sound fiscal management by the Government; and
- International commodity prices for our major exports.

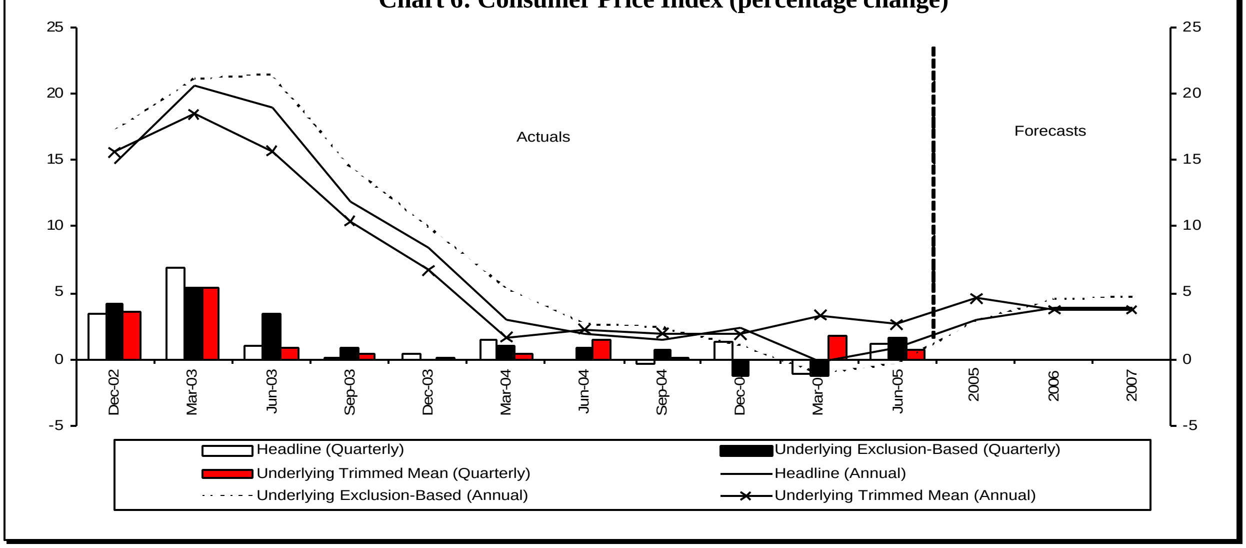
(g) Monetary and Financial Market Developments

The Bank of PNG maintained a neutral monetary policy stance in the first half of 2005, leaving the KFR unchanged at 7.0 percent between December 2004 and June 2005. Although macroeconomic indicators provided grounds for further easing of monetary policy, the above stance was pursued in consideration of the following factors:

- High level of liquidity;
- Low domestic short term interest rates; and
- Cautionary behaviour during the liberalisation of Foreign Exchange Controls.

As a result of the monetary policy stance domestic interest rates have stabilised, following rapid declines in 2004 (see Chart 7). Interest rates on Treasury bills increased across all maturities with the 28-day rate increasing from 3.14 percent in December 2004

Chart 6: Consumer Price Index (percentage change)



Source: Bank of PNG & NSO

[2] *The midpoints of the ranges have been used to plot annual inflation figures for 2006 and 2007 in Chart 6.*

to 4.06 percent in June 2005. Commercial banks reduced their Indicator Lending Rates (ILR) spread from 10.50-11.25 percent to 9.95-11.00 percent in June 2005. The weighted average rate on total deposits declined from 1.10 percent in December 2004 to 0.88 percent in May 2005, while the weighted average lending rate on total loans fell from 12.24 percent to 11.63 percent during the same period. However, 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 5.5 percent between December 2004 and May 2005, following a revised increase of 24.3 percent in the second half of 2004. Although liquidity level was high, inter-bank activity picked up in the first half of the year, reflecting uneven distribution of liquidity among commercial banks. There were no transactions under the Repurchase Agreement Facility (RAF) during the same period. Both the Cash Reserve Requirement (CRR) and the Minimum Liquidity Asset Ratio (MLAR) were maintained at 3.0 and 25.0 percent, respectively.

The level of broad money supply (M3*) increased by 0.7 percent between December 2004 and May 2005, as a result of growth in net domestic credit, which more than offset a decline in net foreign assets of the banking system. Reserve money declined by 3.7 percent over the five months to May 2005, following a reduction in commercial bank deposits at the Bank of PNG.

Macroeconomic stability has led to a turn around in investor confidence and investment decisions. As a result, lending to the private sector picked up over the first half of 2005. Notable growth in credit were to the palm oil and fisheries industries, and for personal housing, household consumption and construction, particularly in the National Capital District.

2. MONETARY POLICY

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

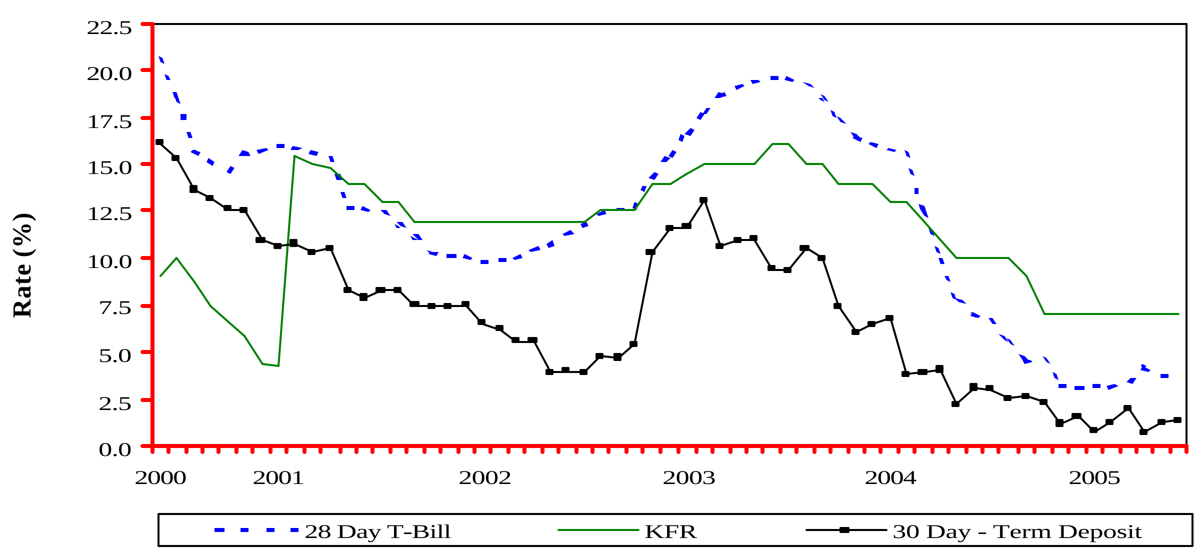
(a) Monetary Policy Stance

The Bank of PNG maintained a neutral monetary policy stance in the first half of 2005, on the back of high liquidity and low domestic interest rates.

As emphasised in the previous MPSs, sustained macroeconomic stability over a longer period can create an enabling environment for private sector activity. Accordingly, the Central Bank expects that with the low inflation and interest rate environment, commercial banks will continue to increase lending and diversify their loan products to various economic sectors.

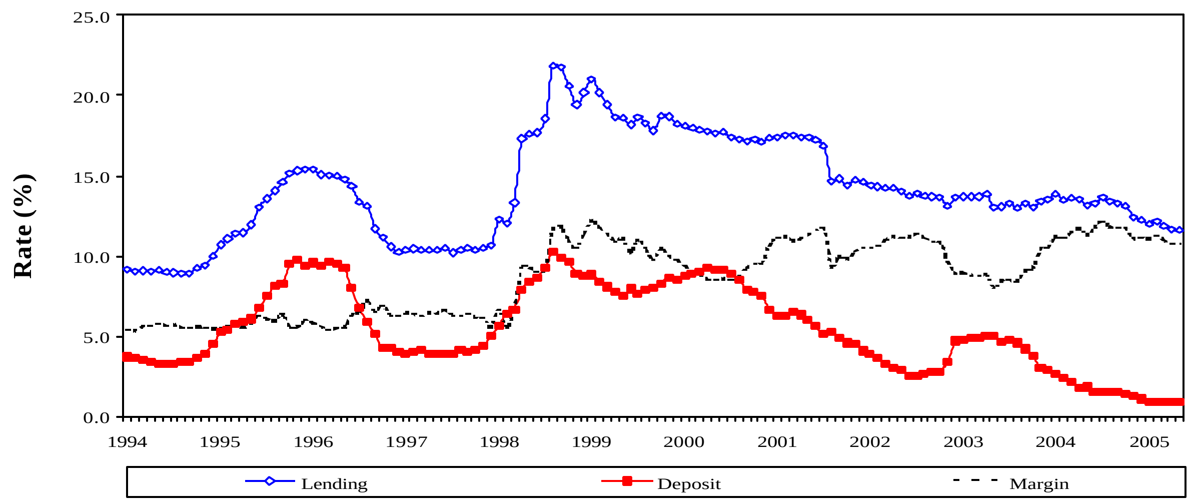
The low inflation rate, increase in lending, stability in the exchange rate and the fiscal surplus in the first half of 2005, provide the necessary foundation for the current monetary policy stance to be maintained in the remainder of 2005 and the medium term. A medium term focus on monetary policy accounts for the lagged nature of monetary policy transmission to

Chart 7: Weighted Average Interest Rates and KFR (2000 - 2005)



Source: Bank of PNG

Chart 8: Weighted Average Lending and Deposit Rate (1994 - 2005)



Source: Bank of PNG

its ultimate objective of price stability.

Although it is still early for a detailed assessment, the Bank expects that the liberalisation of foreign exchange controls on 1 June 2005 will have a limited effect on the exchange rate. This implies that there is optimism for increased turnover in the foreign exchange market in the medium term as investors become aware of the opportunities in the domestic capital market. In addition, foreign exchange transactions can be conducted with relative ease through the commercial banks. In the medium term the Central Bank expects to remove the remaining foreign exchange controls as part of the Government's policy to remove impediments to trade and investment (see Box 1).

The Central Bank will fully repurchase its obligations to the IMF by the end of 2005. This implies that the Bank will have greater flexibility in counteracting any adverse movements in the exchange rate.

The Bank expects that a disciplined fiscal stance will help sustain low domestic interest rates and encourage the non-bank public to make real investments to support economic growth. In addition, the Government needs to exercise caution on two fronts:

- Continued increase in domestic borrowing hinges on the capacity of the commercial banks to simultaneously finance fiscal operations and meet the demands of the private sector for credit; and
- The large domestic corporations are unlikely to undertake business ventures if they can earn high returns on Government securities. Therefore, private sector credit may not grow at the expected rate.

A synchronised approach to debt restructure, successful implementation of public sector reforms and improvement in expenditure quality is necessary in stimulating economic activity. Attempts to increase financing of the fiscal operation of the Government from domestic sources in the past have led to significant crowding out of the private sector and partly contributed to stagnation in economic activity.

The high liquidity levels in the banking system has led to significant declines in Treasury bills rates to below those of PNG's substitute financial markets. In order to mitigate the decline in interest rates, the Bank issued Central Bank Bills (CBB) to realign short-term interest rates to the KFR. Accordingly, in consultation with the Department of Treasury, the Bank will continue to work towards adopting strategies for monetary policy implementation that will result in sustaining the current macroeconomic stability over the medium term.

Whilst the medium term framework sets the broad parameters for monetary policy in Papua New Guinea, temporary monetary policy shocks will be corrected through the monthly KFR and semiannual monetary policy paths. Therefore, the monetary policy for the remainder of 2005 will depend on the following factors:

- The inflation outcome for the September quarter

Table 3: Monetary and Credit Aggregates (percentage changes)

	2003 (r)	2004	Jan MPS 2005	Jul MPS 2005	2006	2007
Broad Money Supply (M3*)	-3.6	15.7	11.7	8.3	8.2	8.1
Reserve Money	13.7	10.0	4.4	1.8	6.6	7.2
Private Sector Credit	-4.3	-2.2	5.2	14.6	8.5	7.0
Net Credit to Government	-5.7	23.2	7.6	7.5	2.0	8.7
Net Foreign Assets	17.3	34.5	13.7	-5.3	3.7	2.6

Source: Bank of PNG

of 2005;

- The stability in the exchange rate;
- The Government's commitment to remaining within the parameters of the 2005 National Budget; and
- Unforeseen external and domestic shocks.

While the prospects for lower inflation remain favourable, monetary and credit aggregates are expected to develop at moderate rates (see Table 3). The Central Bank expects to constrain nominal broad money to grow by 8.3 percent, while reserve money will increase by 1.8 percent. The expansion in broad money is considered non-inflationary. Given the high level of free reserves in the banking system, the low interest rates and inflation environment, private sector credit is expected to grow by 14.6 percent in 2005. In the medium term, credit growth will be sustained given the Government's program on the removal of trade barriers and promotion of agriculture. The level of net foreign assets are expected to increase moderately in the medium term.

In this context, the Bank will maintain a neutral monetary policy stance and regularly assess the short-term monetary policy cycle to mitigate any adverse impact of monetary shocks with the view of achieving and maintaining price stability over the medium term.

(b) Conduct of Monetary Policy

The MPS provides the overall monetary policy framework, while the KFR remains the key instrument for signaling the Bank's monetary policy stance, with announcement each month by the Governor. Following the KFR announcement, open market operations will be implemented to support the Bank's monetary policy stance. The Bank's intervention strategy in the foreign exchange market will be to smooth volatility in the exchange rate where necessary. The implementation of monetary policy will be conducted within the reserve money framework. The liquid assets in excess of the statutory reserve requirement are an indication of the capacity of the banking system to finance private sector activity.

To enhance the transmission mechanism for monetary policy the RAF will be retained for daily and weekly liquidity management. The CBB will also complement Treasury bills as the instruments for liquidity management.

BOX 1: LIBERALISATION OF FOREIGN EXCHANGE CONTROLS

The Bank of Papua New Guinea announced the liberalisation of Foreign Exchange Controls in Papua New Guinea effectively on 1 June 2005. In determining the appropriate form of liberalisation the Bank sought wider stakeholder views, which favoured partial liberalisation as the best form. Liberalisation was granted through exemptions from the Foreign Exchange and Gold Regulation. In other words, the Regulation was retained, so that, in the event of a major balance of payments crisis it may be invoked.

The liberalisation was in the following form:

- *All current account contracts and flows;*
- *All capital account contracts and flows of the Government; and*
- *All private capital account flows, whose contracts had been approved by the Bank of Papua New Guinea.*

The following were retained and require Foreign Exchange Control approval:

- *All Private Capital Account Contracts to acquire or deal with an asset within or outside of PNG;*
- *The opening of foreign currency (including Kina) accounts outside of PNG;*
- *Licensing of Gold Exporters; and*
- *Licensing of Foreign Exchange Dealers.*

The following exceptions were also imposed:

- *Approval is required to take physical currency in excess of K20, 000.00 (or foreign currency equivalent) out of PNG;*
- *Only Authorised dealers can conduct foreign exchange transactions; and*
- *A breach of regulation prior to 1 June is not exempted.*

An important aspect of liberalisation of the Foreign Exchange Control was the transfer of Taxation surveillance by the Bank to the Authorized Dealers and Internal Revenue Commission (IRC).

Whilst the liberalisation is expected to increase the volume of foreign exchange transactions between Papua New Guinea and the rest of the world, the Bank considers that accurate reporting of the transactions are critical for monitoring of financial system stability. In this respect, any breach of the Regulation will attract severe penalties.