BANK OF PAPUA NEW GUINEA

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

PORT MORESBY
30th September 2009

Queries on the contents of the Monetary Policy Statement (MPS) 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. It will be reproduced in the September 2009 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 entails low inflation supported by stable interest and exchange rates. The maintenance of price stability leads to:

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

Executive Summary

Inflation intensified in 2008 mainly due to a larger than expected fiscal deficit and high international oil and food prices, with inflation reaching 13.5 percent in the September quarter of 2008. The large fiscal deficit in 2008, and high inflation outcomes in the second half of 2008 and early 2009 attest to the correlation between excessive Government expenditure and inflation as alluded to in the March 2009 Monetary Policy Statement (MPS). In spite of the understanding between the Bank and the Government to have the trust account funds moved to the Central Bank, most of these accounts continue to remain with commercial banks. As a result, the Bank did all it could to absorb excess liquidity and contain inflation by issuing a substantial amount of Central Bank Bills (CBBs) over the nine months to September 2009, in line with the tight monetary policy stance.

The Government has already revised its 2009 budget to a higher deficit of 1.2 percent of GDP. This is a matter of serious concern to the Bank as it can be a repeat of 2008 and the late 1990s where excessive Government spending translates to high domestic demand and high inflation.

Looking forward into the medium term, continuing high Government expenditure in addition to an expected increase in domestic demand associated with the Liquefied Natural Gas (LNG) project can further exacerbate inflationary pressures. The Central Bank on its own does not have enough instruments to deal with inflationary pressures generated by fiscal operations. Therefore, it is absolutely necessary that there must be close coordination between monetary and fiscal management to achieve and maintain price stability.

Inflation has come down over the first six months of 2009 to 6.7 percent in the June quarter, as a result of the lag pass-through of declines in international food and fuel prices, appreciation of the kina exchange rate in the second half of 2008, and lower prices of domestic seasonal produce. However, due to ongoing inflationary pressures, the Central Bank maintained its tight stance of monetary policy over the period, keeping the Kina Facility Rate (KFR) unchanged at 8.00 percent,

As a result of the tight stance of monetary policy, private sector credit slowed down to 19.5 percent, limiting the growth in money supply to 10.2 percent in August 2009. However, persistently high liquidity remained in the banking system for most of 2009, mainly as a result of Government expenditure. Consistent with the tight stance of monetary policy, the Central Bank utilized the available instruments to diffuse liquidity. This was done through the issuance of a substantial amount of CBBs over the nine months to September 2009. It is therefore important that the Government's management of fiscal policy, including efforts to transfer some of the trust account funds to the Central Bank, complements the Bank's effort at managing monetary policy.

The global recession that began in 2008 adversely impacted on PNG's export sector, resulting in the current account recording a deficit and the kina slightly depreciating in the nine months to September 2009. As a result, domestic economic activity and inflation slowed down.

Given the above developments, the Bank projects for 2009:

- Headline inflation to be around 6.5 percent;
- Private sector credit to grow by 15.0 percent; and
- Real Gross Domestic Product (GDP) growth to be around 5.0 percent.

With these projections and potential inflationary pressures, the Bank will maintain its current tight stance of monetary policy over the next six months.

Over the medium term, inflation is projected to be around 5.0 percent in 2010 and 6.0 percent in 2011. The major upside risks to the Bank's inflation forecasts are: a significant depreciation of the kina exchange rate; high imported inflation; excessive Government expenditure; a rapid draw down of trust account funds; and additional domestic demand pressures associated with the LNG project.

The Bank will assess these developments and their potential effects on price stability and make adjustments to the monetary policy stance as appropriate.

1.0 Monetary Policy Discussions

1.1 Monetary Policy Assessment and Issues

The large fiscal deficit of K478.5 million in 2008 contributed to the high domestic demand, resulting in high inflation outcomes in the second half of 2008 and early 2009. This outcome re-affirmed the correlation between excessive Government expenditure and inflation, which the Bank alluded to in the March 2009 MPS. Despite the consensus between the Bank and the Government to have the trust account funds with the commercial banks transferred to the Central Bank, most of the accounts continue to remain with commercial banks. Therefore the Bank did all it could to contain inflation by issuing a substantial amount of CBBs over the nine months to September 2009, to absorb excess liquidity in line with its tight monetary policy stance. The tight stance of policy led to lower growth in money supply, mainly resulting from a slowdown in private sector credit growth. This, combined with the pass-through of lower international food and fuel prices, and appreciation in the kina exchange rate contributed to the lower rate of inflation in the first half of 2009

Inflation has progressively declined over successive quarters, from a high of 13.5 percent in the September quarter of 2008 to 6.7 percent in the June quarter of 2009. Whilst the lower rate of inflation is a favorable development, the Bank is mindful of the upside risks in 2009 and the medium term that could come from: a weaker kina exchange rate; imported inflation; and domestic demand pressures associated with increased Government spending, especially a fast drawdown of trust account funds and the LNG project. Therefore, the Bank has maintained the tight stance of monetary policy leaving the KFR at 8.00 percent since December 2008.

Annual growth in broad money supply (M3*) and the monetary base were 10.2 percent and negative 14.3 percent, respectively, over the year to August 2009. The low growth in broad money supply, which was mainly attributed to the slow down in private sector credit to 19.5 percent in August 2009, and the negative growth in the monetary base reflected the tight stance of monetary policy. To diffuse excess liquidity from the banking system and counter inflationary pressures, the Bank issued net new CBBs totaling K1,520.9 million over the nine months to 2009. Every effort by the Government to transfer some trust accounts from commercial banks to the Central Bank and maintain expenditure within budget would support the Bank's management of monetary policy.

The Government has already revised its 2009 budget to a higher deficit of 1.2 percent of GDP. This is a matter of concern to the Bank as it can be a repeat of 2008 and the late 1990s, where excessive Government spending translates to high domestic demand and high inflation.

Looking forward into the medium term, continuing high Government expenditure in light of the LNG associated demands can further exacerbate inflationary pressures. Close coordination between monetary and fiscal management is therefore required to achieve and maintain price stability.

Global economic activity remained depressed in the first half of 2009, however there have been signs of recovery in recent months, following appropriate monetary policy actions and large fiscal stimulus measures in the major economies. In line with the decline in global demand, inflation in the major economies has been low. The global recession has adversely affected PNG's export sector, with the current account recording a deficit in the first half of 2009 and lowering growth prospects for the year.

In 2009, broad money supply is expected to grow by 7.4 percent, reflecting a moderation in growth of credit to the private sector, while monetary base is expected to grow by 4.1 percent, indicative of the tight monetary policy stance. Whilst this could counter inflation in the short term, the Bank is mindful of the impact of a further slowdown in credit growth and global recession on economic growth.

Preliminary estimates of the Government's fiscal operations indicate a surplus of K387.7 million for the first six months of 2009. This was mainly due to the use of K423.0 million from the Gas Commercialization Trust Account held at the Central Bank and treated as revenue in 2009. Government expenditure and revenue were within budget but were below 50 percent of the budgeted amount in the first half of the year. Recurrent expenditure represented 47.7 percent and development expenditure represented 12.7 percent of the budgeted amounts. The poor performance of the development budget in the first half of the year is of concern, drawing attention to the on going capacity issues of implementing agencies. This has implications on the Government's Medium Term Development Strategy (MTDS). The Government has revised upwards its forecast of the budget deficit to 1.2 percent of GDP for 2009, due to lower than forecasted revenue. The deficit will be financed domestically, which has the potential to crowd out private sector credit and exert upward inflationary pressures.

For the medium term, the Bank's projections of key macroeconomic indicators have not taken into account the impact of the proposed LNG project, particularly on GDP and balance of payments (BOP), given the unavailability of relevant data and pending final project decision.

The Bank will closely monitor the above developments in the next six months and their potential impact on inflation and price stability, and make appropriate changes to the stance of monetary policy.

1.2 Monetary Policy Stance

Inflation has moderated in the first half of 2009. However, in view of the potential inflationary pressures, the Bank will maintain its current tight stance of monetary policy in the next six months.

In line with the stance, the Bank has issued a substantial amount of CBBs to absorb persistent excess liquidity in the banking system for most of 2009, which was mainly a result of Government expenditure. To achieve low inflation outcomes for 2009 and the medium term, a closer co-ordination is required between fiscal and monetary policies. In that regard, it is necessary that fiscal policy is prudently managed in line with the budget framework and the Government's medium term policies.

The Bank projects broad money supply to grow by 7.4 percent and the monetary base by 4.1 percent in 2009. Private sector credit is expected to slow further to 15.0 percent in 2009, as the increase in cost of borrowing will slow aggregate demand. This is considered sufficient to support economic activity.

The Bank projects headline inflation to be around 6.5 percent in 2009. Upside risks to this projection could arise from:

- A larger than expected depreciation of the kina exchange rate;
- Increase in imports for early works and construction and related activities with the LNG project;
- Excessive Government expenditure and a rapid draw down of trust account funds; and
- Other unforeseen external and domestic shocks.

The Bank will assess these developments and, if necessary, make appropriate adjustments to the stance of monetary policy in the coming six months.

1.3 Conduct of Monetary Policy

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

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

2.0 Developments and Expectations

2.1 International Developments

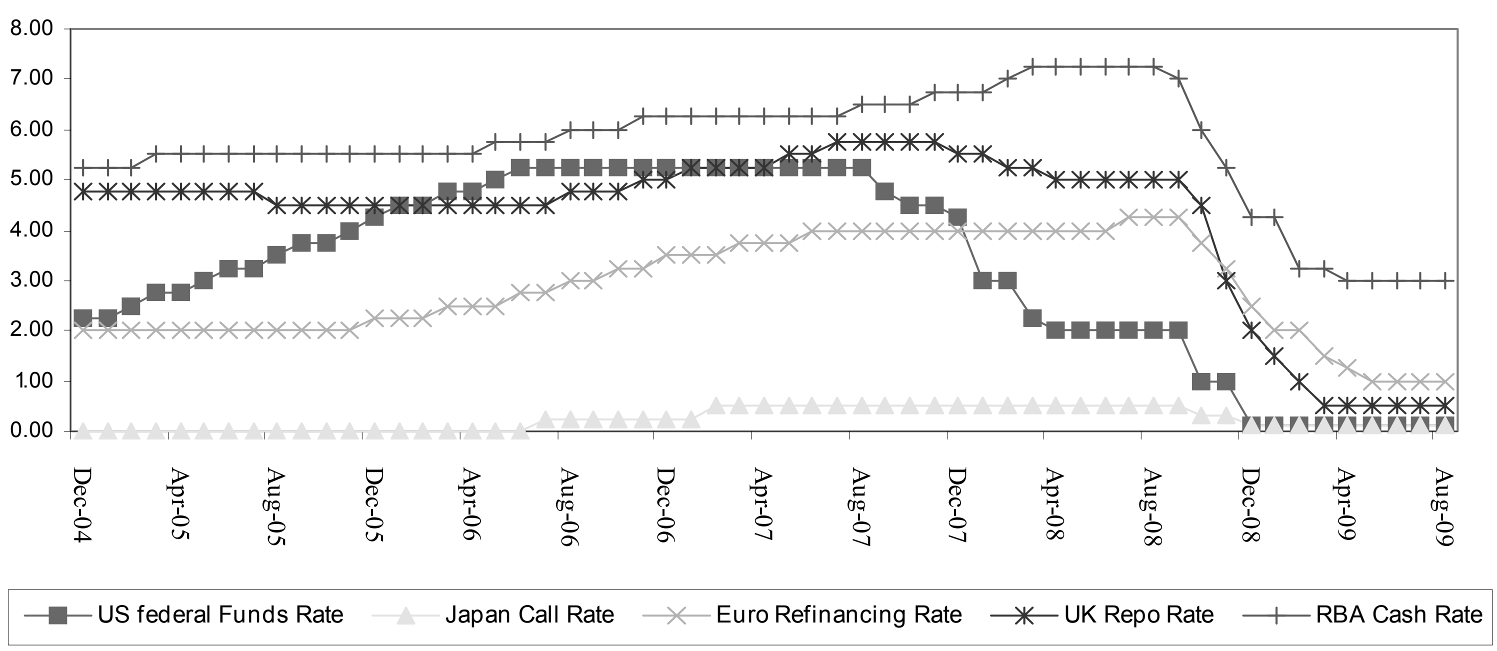
The global economic recession, which started in 2008, continued into the first half of 2009. The most severe part of the recession appears to have passed as the impact of stimulus measures taken by many economies around the world have begun to result in modest gains in some key financial and economic indicators. The positive indications include: the significant pick-up in economic growth in India and China; recovery in Australia following one quarter of negative growth; and some gains made in the manufacturing and industrial sectors in the USA, Japan and the Euro area for the first time since early 2008. The economic conditions, however, remain weak and fragile, and a recovery in global growth is not expected until 2010. According to the International Monetary Fund's (IMF) July update of its World Economic Outlook (WEO), global economic growth is expected to contract by 1.4 percent in 2009 before expanding by 2.5 percent in 2010.

Economic conditions among advanced economies continue to remain weak although the rate of deterioration is diminishing. US economic growth during the second quarter of 2009 contracted by 1.0 percent compared to a contraction of 6.4 percent during the first quarter, mainly reflecting an increase in government spending. In Japan, GDP in the second quarter increased by 3.7 percent after an 11.7 percent decrease in the previous quarter due to a recovery in exports and consumer spending. GDP in the Eurozone fell by only 0.1 percent during the June quarter after contracting by 2.5 percent in the previous quarter, reflecting growth in Germany and France. In the UK, GDP declined by 0.8 percent during the second quarter after contracting by 1.9 percent in the first quarter. The outcome mainly reflected an improvement in business investment and an increase in government expenditure. However, economic activity among the advanced countries continues to be weighted down by deteriorating labor market conditions as unemployment rates continue to surge.

Emerging and developing economies are expected to grow by 1.5 percent in 2009, led by China. GDP in China picked up momentum during the second quarter at an annual rate of 7.9 percent after expanding at its slowest pace in a decade during the first quarter of 6.1 percent. The rebound was mainly attributed to large fiscal stimulus provided by the government to encourage investment and increase bank lending. Other countries in Asia have also benefited from China's economic growth along with their own fiscal stimulus measures. Less sophisticated financial systems in these emerging and developing economies have also helped them overcome the financial market stress that many advanced economies are still in.

Global inflationary pressures have declined in line with weakening global demand. Headline inflation in advanced economies declined further into negative territory in July as weakening demand contributed to lower commodity prices. Headline inflation in July for the US, Eurozone and Japan declined by 2.1 percent, 0.7 percent and 2.2 percent, respectively. Whilst commodity prices are

Chart 1: Monthly Movements in Official Interest Rates (Percent)



Source: Various central banks' websites generally lower compared to a year ago, improving economic conditions in emerging market economies have exerted some upward momentum on commodity prices in recent months. These gains are likely to be minimal given the subdued economic conditions in the advanced economies. Inflation is expected to remain low with the IMF projecting inflation in advanced economies at 0.1 percent in 2009 and 0.9 percent in 2010, compared to 3.4 percent in 2008. In comparison, inflation in emerging and developing countries is projected to be at 5.3 percent in 2009 and 4.6 percent in 2010, lower than 9.3 percent recorded in 2008.

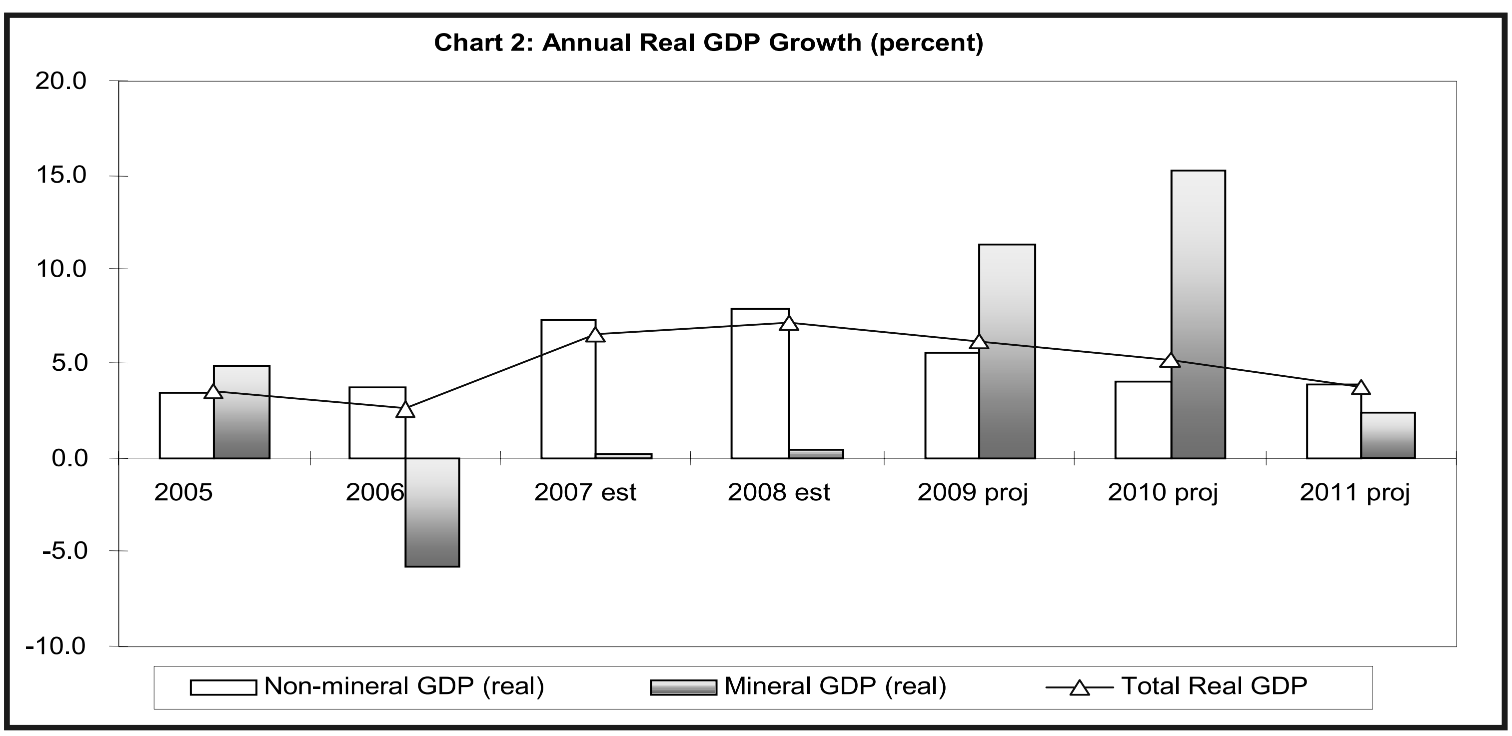
The price of crude oil has increased by about 55 percent since the start of 2009 to currently trading around US$70 per barrel. The increase mainly reflects increasing demand from emerging and developing economies and optimism about global growth. The prices of precious metals such as gold and silver have also increased since the start of 2009. The increase in the price of gold and silver has mainly been attributed to the weakening US dollar. Gold is currently trading around US$950 per ounce and is about 7.0 percent higher from the end of 2008, while silver is trading around the US$16 per ounce.

Major Central Banks maintained an accommodative monetary policy stance in the first half of 2009. They have also continued to inject liquidity to their respective financial systems in various forms, including the buy back of illiquid financial instruments, to foster a gradual improvement in financial conditions. These efforts are expected to continue throughout the remainder of 2009 and into 2010. Since the start of 2009, the US Federal Reserve and the Bank of Japan have maintained their benchmark rates at 0.25 and 0.10 percent, respectively. The European Central Bank and the Bank of England have reduced their official rates by 150 basis points each to 1.00 and 0.50 percent respectively, while the Reserve Bank of Australia has cut its overnight cash rate by 125 basis points to 3.0 percent.

Financial markets have remained volatile in the first half of 2009 with market sentiment driven mainly by economic fundamentals and changes in investor risk appetite. Equity markets have strengthened quite significantly from their lows in March 2009 on the back of better than expected earnings reports and optimism for global recovery. Global bond yields have also increased since the start of 2009, mainly on the back of increased issuance of government securities as part of the stimulus measures. The US dollar has weakened against other major currencies since the beginning of 2009 as investors reverse safe haven trades that have supported the US dollar since the peak of the financial market crisis. These trends in financial markets are expected to continue throughout the remainder of 2009.

2.2 Domestic Economic Conditions

The Bank's Employment Index over the year to the June quarter of 2009 indicates that the total level of employment in the formal private sector increased by 3.8 percent. The increase was in the



Source: Department of Treasury

building and construction, agriculture/forestry/fisheries, wholesale, mineral and financial/business and other services sectors, which more than offset the decline in the transportation, manufacturing and retail sectors. Excluding the mineral sector, the employment level increased by 3.9 percent over the year to the June quarter. All regions recorded increases, except the Islands and Southern regions.

The Bank revised downwards its GDP growth projection for 2009 in light of the global recession and falling demand. The Bank's projection is slightly higher than the Government's revised projection of 4.8 percent. Decline in sales and lower employment growth in the first half of 2009 support the moderation in growth. All sectors are expected to grow in 2009, except the commerce and petroleum sectors, with notable growth from the building and construction, mining and quarrying sectors, and the communication sub-sector. The increase in the construction sector and its spill-over effects to the other sectors is attributed to the Ramu Nickel/Cobalt and Hidden Valley mines, some early works and initial construction and related activities on the LNG project and major transport infrastructure and building projects undertaken by the Government and private sector. The growth in the mining and quarrying sector will come from increased production of gold at existing mines and commencement of production at the Hidden Valley mine, while the increase in the communication sub-sector reflects the expansion of mobile phone networks by the two mobile phone companies.

For the medium term, the economy is expected to continue to grow at a lower pace. Growth in the building and construction sector is associated with the remaining construction of the Ramu Nickel/Cobalt mine and ongoing construction of Government and private sector funded projects. The increase in the mineral sector reflects the commencement of production by the Ramu Nickel/Cobalt mine, as well as increased production of gold at Lihir and Hidden Valley. Whilst the LNG project was not included in these projections, its full construction and related activities will further support growth.

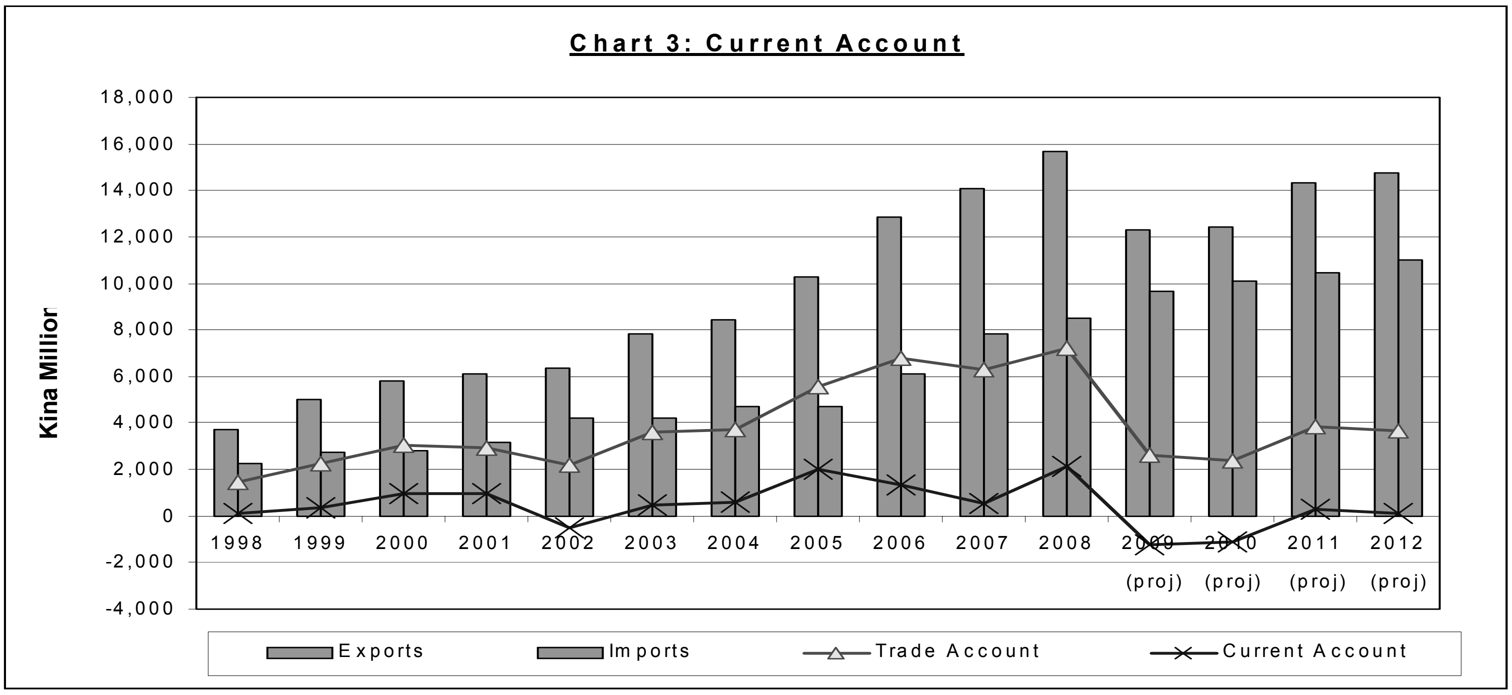
2.3 Balance of Payments

Preliminary balance of payments data for the six months to June 2009 showed an overall surplus of K663.6 million, compared to a surplus of K648.3 million in the corresponding period of 2008. This outcome was due to a surplus in the capital and financial account, which more than offset a deficit in the current account. The surplus in the capital and financial account was mainly due to a higher net inflow from direct investments reflecting share placements by a resident mineral company to raise capital for on-going capital and operation expenditures. In addition, the surplus reflected investments in financial derivative instruments through hedge arrangements. These more than offset net outflows from investments in short-term money market instruments and other investments, combined with lower net loan repayments by the government. The net outflow from other investments was due to a build-up in the net foreign assets of the banking system and foreign currency account balances of resident mineral companies. The deficit in the current account was mainly attributed to a lower trade account balance and lower net transfer receipts. The lower trade account balance resulted from a significant decline in export receipts due to lower international prices of most commodities.

The level of gross foreign exchange reserves at the end of June 2009 was US$2,263.7 (K5,985.2) million, sufficient for 9.9 months of total and 13.8 months of non-mineral import covers. As at 31st August 2009, the level of gross foreign exchange reserves was US$2,287.0 (K6,197.9) million.

The IMF's September 2009 price forecasts indicate that international prices of most of PNG's non-mineral exports will be lower in 2009, compared to 2008. According to the mineral companies, prices of most mineral exports are also expected to be lower in 2009, except for gold. The lower prices reflect the downturn in global economic activity. In the medium term, international commodity prices are expected to improve as the world economy recovers from the recession.

The volumes of most of PNG's major non-mineral commodities are projected to decline in 2009 compared to 2008, with the exception of palm oil. The declines are mainly due to lower production as a supply response to lower international prices. In the medium term, non-mineral export volumes are projected to increase as producers anticipate international prices to improve. Mineral commodity export volumes are projected to decline in 2009 compared to 2008, with the exception of gold. The decline in copper exports reflects maintenance work on one of Ok Tedi's processing



Source: Bank of PNG

plants, lower ore grades and delays in shipment. The increase in gold production is due to the upgrading of the processing plant at the Lihir mine, commencement of production from the Simberi and Hidden Valley mines and the mining of higher ore grades from existing mines. The export volumes of the mining sector are projected to increase in the medium term mainly due to the commencement of production from the Ramu Nickel/Cobalt mine in the second half of 2010. In the petroleum sector, production is projected to decline in 2009 and over the medium term due to the natural decline in reserves at the existing oilfields.

The main assumptions underlying the balance of payments projections for 2009 and the medium term are:

- Stability in the kina exchange rate in the forecast period;
- The continuation of construction at Ramu Nickel/Cobalt mine in 2009 and expected commencement of production in 2010; and
- A recovery in the world economy, including increases in the prices and volumes of PNG's exports from 2010.

The LNG project is not considered in the current projections until more concrete details become available.

The current account is projected to record a deficit in 2009 mainly due to lower export receipts. However, this will be more than offset by a surplus in the capital and financial account reflecting inflows mainly associated with the draw down of equity funds from share placements offshore, for the upgrading of the processing plant at Lihir. As a result, the overall balance of payments is projected to be in surplus by K539 million in 2009, compared to a deficit of K598 million in 2008. At the end of 2009 the gross foreign exchange reserves are projected to be around US$2,287.6(K6,305.4) million, sufficient for 7.8. months of total and 12.4 months of non mineral import cover. Gross reserves are projected to increase over the medium term (see Appendix - Table 2).

2.4 Fiscal Operations of the National Government

Preliminary estimates of the fiscal operations of the National Government over the six months to June 2009 showed an overall surplus of K387.7 million, compared to a surplus of K304.3 million in the corresponding period of 2008. This represents 1.8 percent of nominal GDP and reflects higher non-tax revenue, which more than offset an increase in recurrent expenditure. The budget surplus was used to make net repayments of overseas loans totalling K86.3 million and net negative financing of K301.4 million to domestic sources. The net settlement of cheque floats totalling K362.2 million to other resident sectors more than offset net drawdown of Government deposits of K60.8 million mainly from the Central Bank.

Total revenue, including foreign grants, represented 38.7 percent of the 2009 Budget while total expenditure represented 32.9 percent over the six months to June 2009. The increase in non-tax revenue was mainly due to a reappropriation of K423.0 million from the Gas Commercialisation Trust Account to one-off expenditures. The increase in recurrent expenditure was attributed to higher domestic interest payments and grants to statutory bodies. Development expenditure declined by 16.4 percent during the same period and represented 12.7 percent of the budget. This was due to ongoing capacity constraints of implementing agencies combined with non-reporting of projects funded by international aid donors. The Government deposits in depository corporations between end of 2008 and July 2009 increased by K442.8 million to K3,782.2 million, mainly reflecting net deposits at ODCs.

Total debt to nominal GDP ratio increased to 30.0 percent from 27.0 percent between the end of December 2008 and June 2009 reflecting the net issuance of domestic securities. Total domestic debt increased by 26.1 percent to K3,884.8 million, due to higher interest payments and issuance of Inscribed stocks and Treasury bills. Foreign debt decreased by 8.4 percent to K2,778.3 million, reflecting Government repayment of external loans.

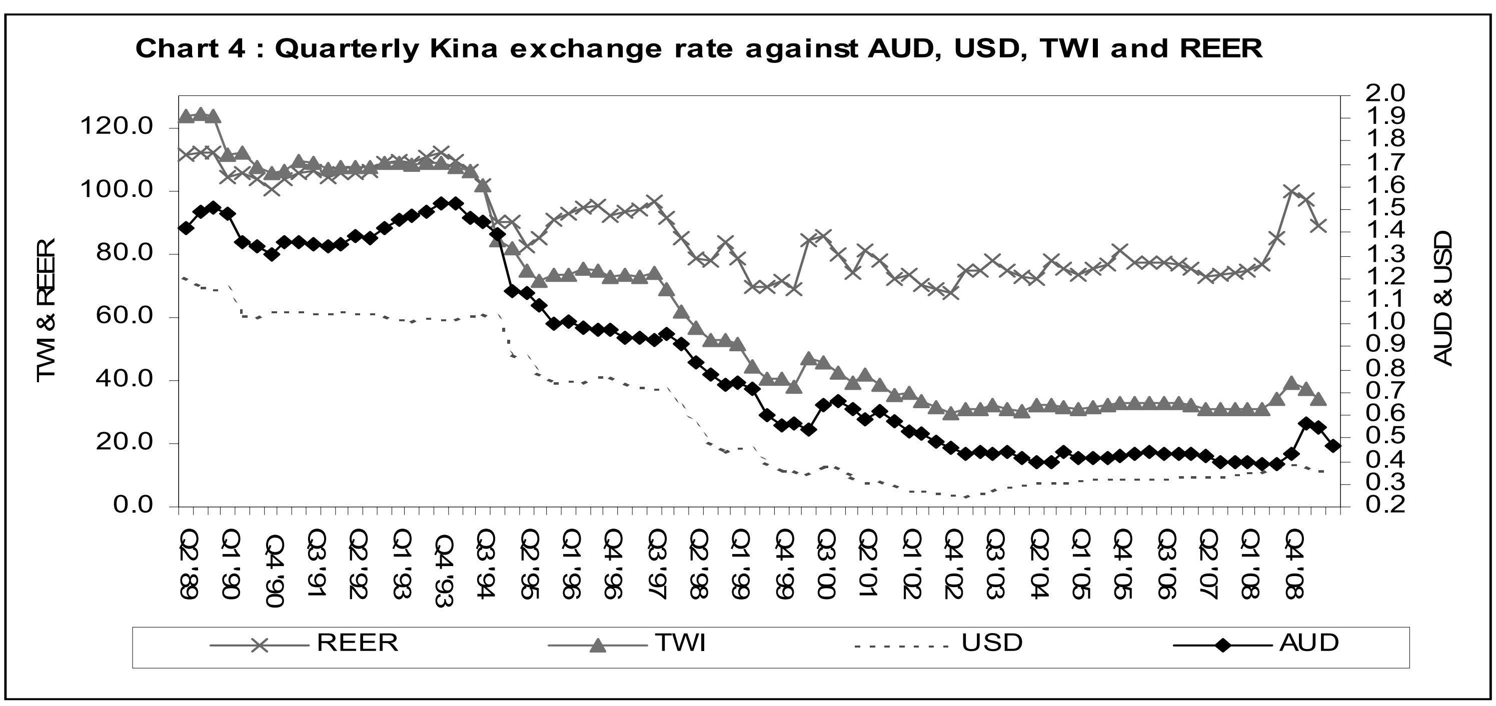
In July, the Government revised its forecast for the 2009 budget deficit to be K249.6 million or 1.2 percent of GDP from a K10.3 million deficit in the original budget. This outcome is due to lower mineral taxes, dividend payments from statutory bodies and lower foreign grants.

2.5 Exchange Rate

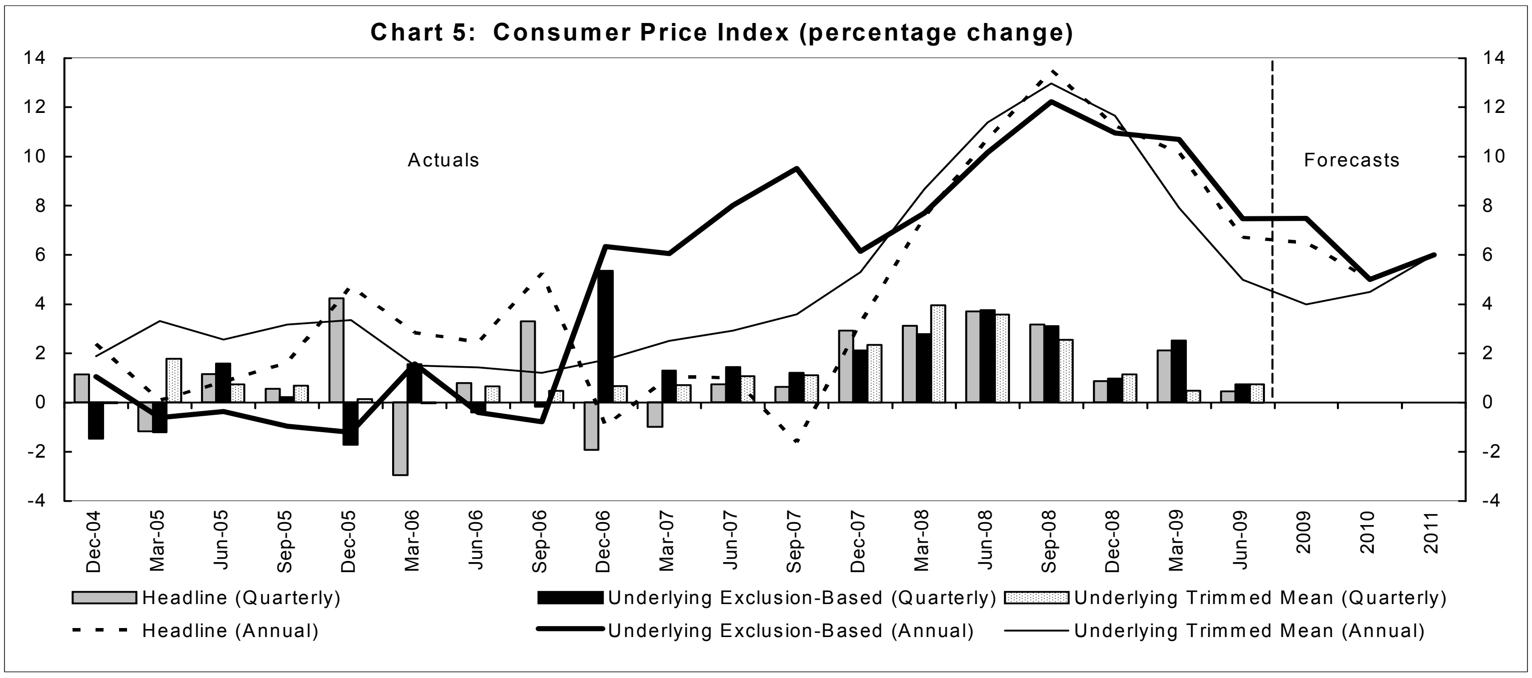
The kina weakened against the US and Australian dollars by 2.5 percent and 11.0 percent on average to US$0.3610 and AU$0.4852, respectively, during the nine months to September 2009. During the six months to June the Trade Weighted Index (TWI) depreciated by 3.0 percent, whilst the Real Effective Exchange Rate (REER) depreciated by 11.1 percent (see Chart 4). Between June 2009 and September 2009 the kina depreciated against the US dollar by 2.5 percent to average US$0.3682, while it depreciated against the Australian dollar by 8.9 percent to average AU$0.4431. The depreciation of the kina against the US and Australian dollars were due to an increase in import demand.

2.6 Inflation

Annual headline inflation was lower at 6.7 percent in the June quarter of 2009, compared to 10.2 percent in the March quarter. The moderation in inflation mainly reflected lower imported prices, lag effects of the exchange rate appreciation in the second half of 2008 and lower prices of seasonal produce. This was also attributed to a decline in domestic fuel prices reflecting lower international oil prices and appreciation of the kina. All urban areas recorded increases over the year to June 2009. Central Bank implementation of its tight monetary policy



Note: The REER uses IMF's revised CPI indices rebased to 2005, as contained in the June 2009 release of the International Financial Statistics (IFS), in contrast to the previous series with 2000 as the base year.
Source: Bank of PNG .



Source: Bank of PNG & National Statistical Office

stance through its OMO assisted in bringing inflation down.

The underlying inflation measures also subsided reflecting some easing in inflationary pressures. Annual exclusion-based inflation was 7.5 percent in the June quarter of 2009, following an increase of 10.7 percent in the previous quarter, while annual trimmed mean inflation recorded 5.0 percent in the June quarter, compared to 7.9 percent in the previous quarter (see chart 5).

The Bank has revised its annual headline inflation for 2009 to be around 6.5 percent, while trimmed-mean inflation and exclusion based measure are projected to be around 4.0 percent and 7.5 percent, respectively. The downward revisions in the headline and trimmed-mean measures from the projections made in the March 2009 MPS are based on the following factors:

- Lower international food and fuel prices in 2009 relative to 2008;
- Lower imported inflation from PNG's major trading partners;
- Stability in the exchange rates for the rest of 2009; and
- Slowdown in domestic demand as shown by lending, sales and employment data.

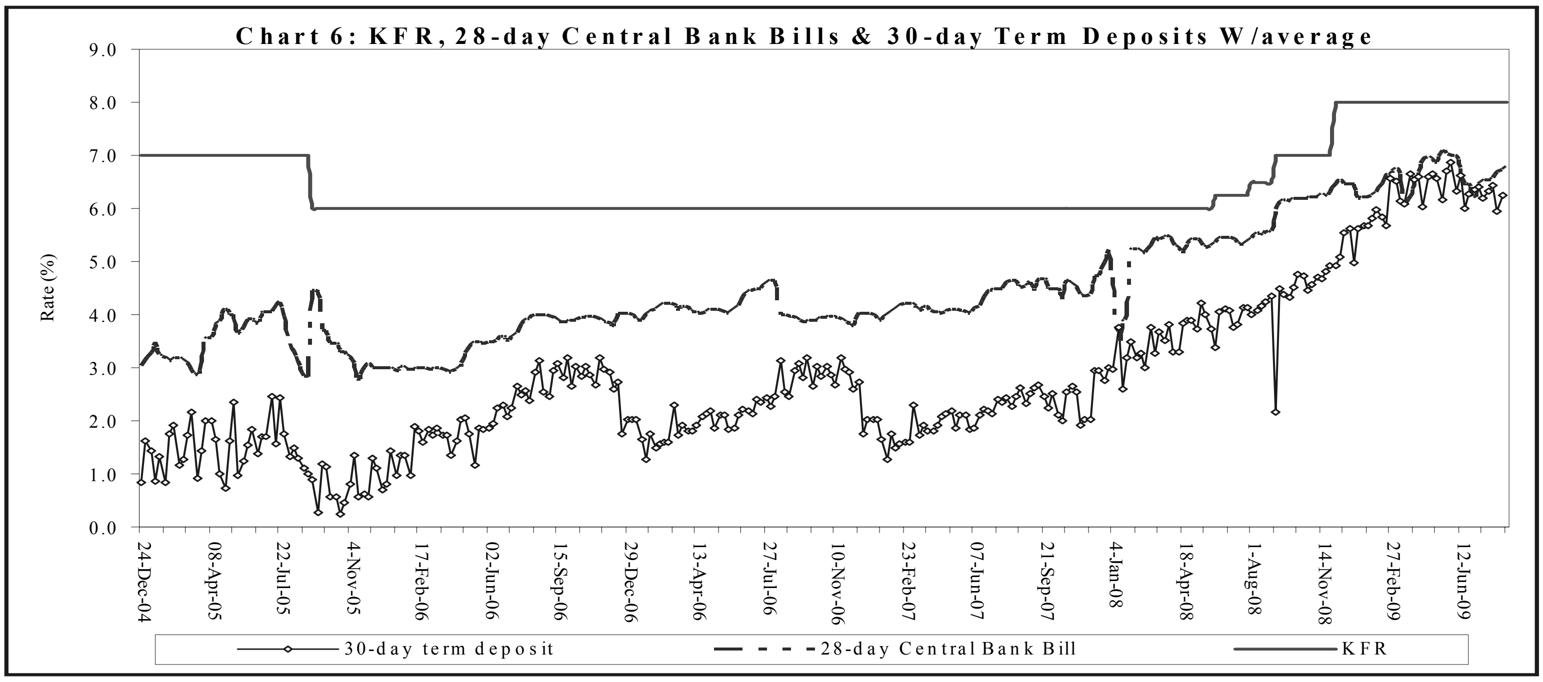
For the medium term, headline inflation is projected to be around 5.0 percent in 2010 and 6.0 percent in 2011. The main assumptions used for these projections are that all of PNG's major trading partners' currencies are expected to depreciate slightly against the US dollar. Inflation in PNG's major trading partners is also expected to increase gradually over the medium term. Domestic demand is also expected to generate inflationary pressures.

The upside risks to these projections would be the depreciation of the kina, increasing inflation in the major international economies, and domestic demand pressures associated with the LNG project.

2.7 Monetary and Financial Market Developments

Despite the moderation in inflation in the March and June quarters of 2009, expectations of strong domestic demand, a weaker kina exchange rate and a rapid draw down of Government trust account balances prompted the Bank of Papua New Guinea to maintain a tight monetary policy since March 2009. The KFR was maintained at 8.00 percent over the six months to September 2009 (See Chart 6). The trading margin for the Repo was maintained at 100 basis points on both sides of the KFR in the first half of 2009.

The Bank issued net new CBBs totalling over K1,520.9 million to diffuse excess liquidity in the banking system over the nine months to September 2009. As a result, CBB rates increased from over 6.00 percent to 7.00 percent in September 2009. Treasury bill rates increased from 7.0 percent to over 8.0 percent during the same period. The Indicator Lending Rates (ILR) spread increased from 9.95 - 10.95 percent to 10.95 - 11.95 percent in March 2009 and remain unchanged to September. The weighted average interest rate on total deposits increased from 1.35

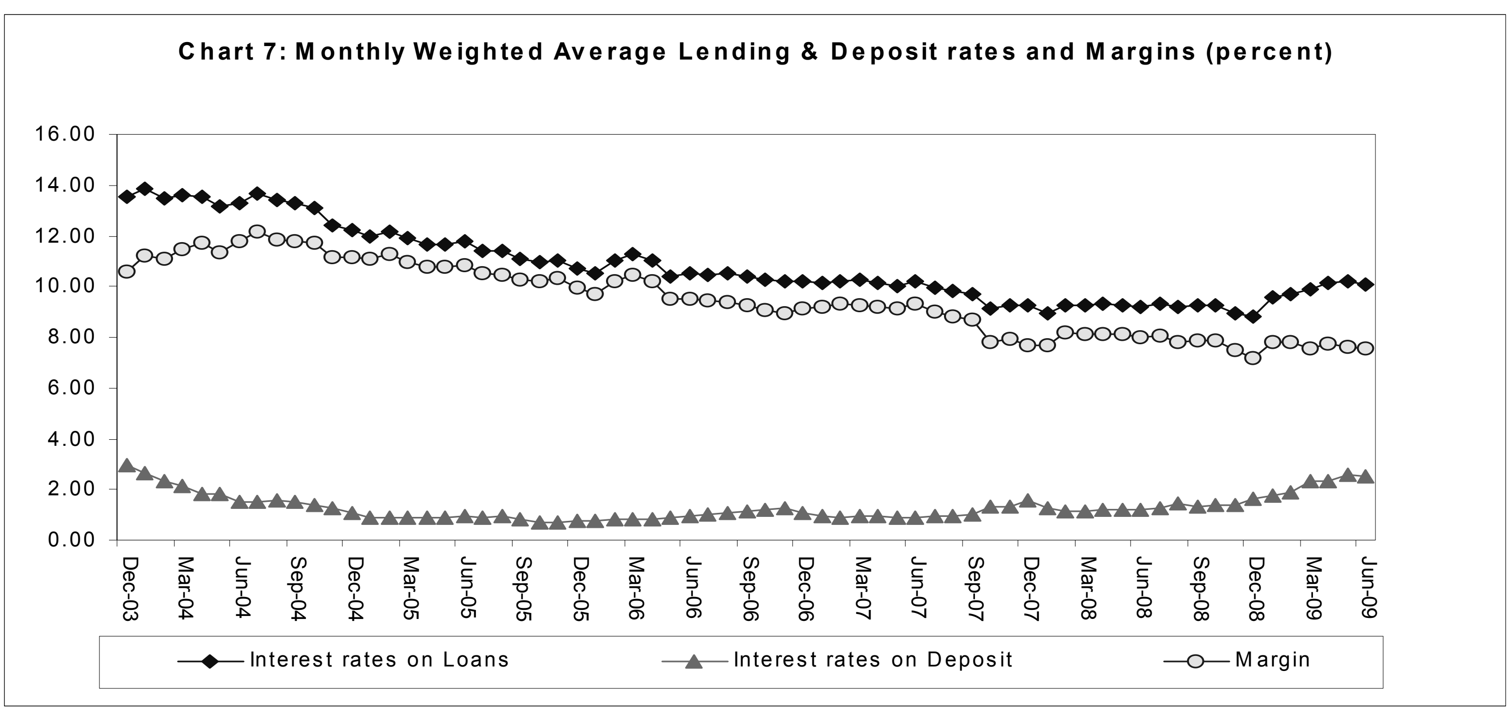


Source: Bank of PNG

percent in December 2008 to 2.58 percent in June 2009, while the weighted average lending rate on total loans increased from 9.25 percent to 10.09 percent. As a result, the spread between the weighted average lending and deposit rates remained largely unchanged (see Chart 7).

Total liquidity of the banking system increased by 25.6 percent to K6,178.2 million over the twelve months to August 2009, mainly due to increase in net Government expenditure. Lending extended by ODCs to the private sector increased by 19.5 percent over the twelve months to August 2009. The growth in private sector credit was broad based across all sectors, mainly to the mining, petroleum, retail/ wholesale and construction sectors. This was due to the continued strong domestic demand in the first half of 2009 and increased business activities partly associated with expectation of benefits from LNG projects. Net claims on the Government declined by K1,619.1 million over the twelve months to July 2009, mainly due to an increase in Trust Account deposits in ODCs.

The level of broad money supply (M3*) increased by 10.2 percent over the twelve months to August 2009 as a result of growth in private sector credit, which more than offset the decline in net credit to Government. The monetary base declined by 14.3 percent during the same period, mainly reflecting the decline in the Exchange Settlement Accounts of the commercial banks' held at the Central Bank (see Appendix-Table 1).



Source: Bank of PNG

APPENDIX

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

INDICATOR	2005 (actual)	2006 (actual)	2007 (actual)	2008 (actual)	2009 (actuals Aug)	Mar 2009 MPS	2009 (proj)	2010 (proj)	2011 (proj)
Broad Money Supply	30.7	39.0	27.3	11.2	10.2	11.5	7.4	6.0	9.9
Monetary Base	3.0	21.7	61.8	-12.0	-14.3	-9.7	4.1	3.4	7.2
Claims on the Private Sector	25.2	36.8	30.8	39.4	19.5	11.3	15.0	13.9	9.6
Net Claims on Gov't	-24.7	-11.6	-83.5	-174.3	-134.3	-473.4	122.1	-277.4	138.5
Net Foreign Assets	33.5	58.2	51.7	-9.4	-8.2	-1.1	13.4	-5.9	4.4

Source: Bank of PNG.

Table 2: Summary of Other Macroeconomic Indicators

INDICATOR	2005 (actual)	2006 (actual)	2007 (actual)	2008 (actual)	2009 (actual to Jun)	Mar 2009 MPS	2009 (proj)	2010 (proj)	2011 (proj)
CONSUMER PRICE INDEX (annual % changes)									
Headline	4.6	1.3	3.2	11.2	6.7	7.0	6.5	5.0	6.0
Trimmed-mean	3.3	0.4	6.0	11.7	5.0	7.0	4.0	4.5	6.0
Exclusion- based	-1.4	2.9	6.0	11.0	7.5	3.0	7.5	5.0	6.0
BALANCE OF PAYMENTS (kina millions)									
Current account	2,009	1,354	550	2,145	-361	-1,418	-1,269	1,102	278
Financial account	-1,714	618	1,001	-2,796	976	1,116	1,808	861	-2
Overall	296	1,958	1,592	-598	664	-255	538	-242	276
Gross Int. Reserves	2,368	4,326	5,919	5,322	5,985	5,558	6,305	6,064	6,340
IMPORT COVER (months)									
Total	6.0	8.5	9.1	7.9	9.3	7.0	7.8	7.2	7.3
Non-mineral	8.2	11.5	13.0	11.4	13.8	12.6	12.4	11.1	10.8
EXPORT PRICE									
Crude oil (US$/barrel)*	55	67.3	73	106.7	46.4	79.2	52.1	53.3	61.6
Gold (US$/ounce)	403	554.7	671.0	850.9	914.5	805.6	865.7	772.6	768.5
Copper (US$/pound)	161.6	296.6	320.0	327.8	167.6	250.0	168.0	160.0	175.0
FISCAL OPERATIONS OF THE GOVERNMENT**									
Surplus/Deficit (K'm)	7.6	535.8	476.2	-478.5	387.7	-10.3	-249.6	24.8	31.8
% of GDP	0.1	3.1	2.5	2.2	1.8	0.0	1.2	0.1	0.1
REAL GROSS DOMESTIC PRODUCT (annual % growth) ***									
Total GDP	3.3	3.7	6.5	7.2	6.2	7.6	6.2	5.2	3.7
Non-mineral GDP	3.1	4.1	7.3	7.9	5.6	7.1	5.6	4.1	3.9

* Prices take into account company hedging and differ from market prices.

** Fiscal operations for 2009 actuals to June 2009; 2009 projection is from Department of Treasury's Mid Year Economic and Fiscal Outlook (MYEFO), while 2011 is as per the original 2009 National Budget.

*** GDP figures are from the Department of Treasury.

Source: Bank of PNG, NSO and Department of Treasury