## SEMI-ANNUAL MONETARY POLICY STATEMENT, JULY 2001

## INTRODUCTION

This Semi-Annual Monetary Policy Statement is the second for 2001 under the Central Banking Act 2000. The Statement is presented in two parts. The first covers economic developments in the first half of 2001 and revised projections for 2001. Section two sets out the rationale for the monetary policy stance for the second half of 2001 and the conduct of monetary policy.

### 1. DEVELOPMENTS IN THE FIRST HALF AND PROJECTED DEVELOPMENTS FOR 2001

In designing monetary policy for 2001, the Central Bank considered actual and projected developments in six main areas, and their impact on the monetary aggregates, exchange rate and prices:

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

### a) The World Economy

World economic growth as measured by Gross Domestic Product (GDP) is projected to increase by 3.2 percent in 2001, compared to 4.8 percent in 2000. The lower growth in 2001 is mainly attributed to the slowdown in the major industrialised economies, particularly the United States (US) and Euro-zone and continued recession in Japan, following the after-effects of higher oil prices, sharp falls in equity prices and the lagged effects of the tight monetary policy regimes pursued in those economies. The slowdown in the US was attributed to a sluggish growth in activity in the manufacturing sector coupled with the weak foreign and domestic demand. For the remainder of 2001, global economic activity will depend on how deep and prolonged the slowdown in the US will be. However, there are positive indications that the slowdown will be short-lived following significant cuts in short term interest rates in the US, with long term interest rates already on a declining trend and, with inflationary risks receding, most advanced economies have begun to ease monetary policy.

With low level of inflation in the US, the US Federal Reserve Bank was given more room to ease monetary policy, and consequently, the Federal Funds rate was progressively reduced by 250 basis points between January and June 2001, in a move to stimulate economic growth. Subsequently, other major Central Banks also relaxed their monetary policy stance, with the Bank of Japan and Bank of England reducing their official interest rates by 15 and 25 basis points respectively, at the beginning of the year. The European Central Bank also eased its monetary policy stance through a reduction of the cash rate by 25 basis points to 4.50 percent on 10 May 2001. In Australia, the Reserve Bank reduced its cash rate by 125 basis points from 6.25 to 5.00 percent this year.

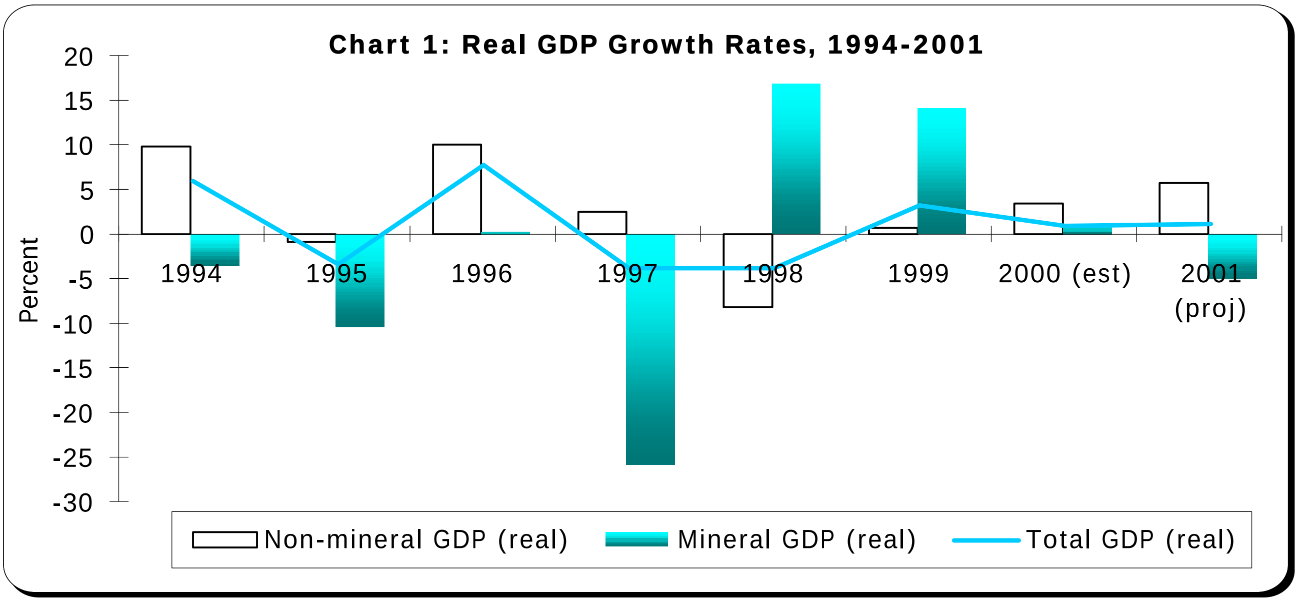
### b) Domestic Economic Activity

Preliminary estimates of economic activity in Papua New Guinea (PNG) indicate that total real GDP increased marginally in 2000. Latest estimates are for economic activity to remain subdued in 2001, with real GDP growth revised downwards from the projected 3.1 percent (See Chart 1). The revision was mainly due to lower activity expected in the agriculture/forestry/

**_BOX 1: OBJECTIVE OF MONETARY POLICY_**

In pursuing monetary policy in Papua New Guinea, the Bank of Papua New Guinea (BPNG) targets price stability. Maintaining price stability in a small open economy like PNG 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 foundation for stable revenue flows of Government; and
- Potentially lead to stable macroeconomic environment.




fisheries and mineral sectors. The decline in the agriculture/forestry/fisheries sector reflected lower cocoa, copra and copra oil production, while in the mineral sector, the decline is due to lower crude oil, gold and silver production.

### c) Balance of Payments

Preliminary outcome of the balance of payments for the first five months of 2001, show an overall surplus of K180 million. This resulted from a surplus in the current account of K418 million, which more than offset a deficit of K279 million in the capital account. The current account surplus was attributed to higher values of merchandise exports, mainly crude oil, copper and forestry products, which more than offset the decline in most agricultural exports, higher imports and net service payments. The deficit in the capital account was due to loan repayments by the Government, net purchases of short-term money market instruments by the mineral companies combined with an increase in net foreign assets of the non-official monetary sector.

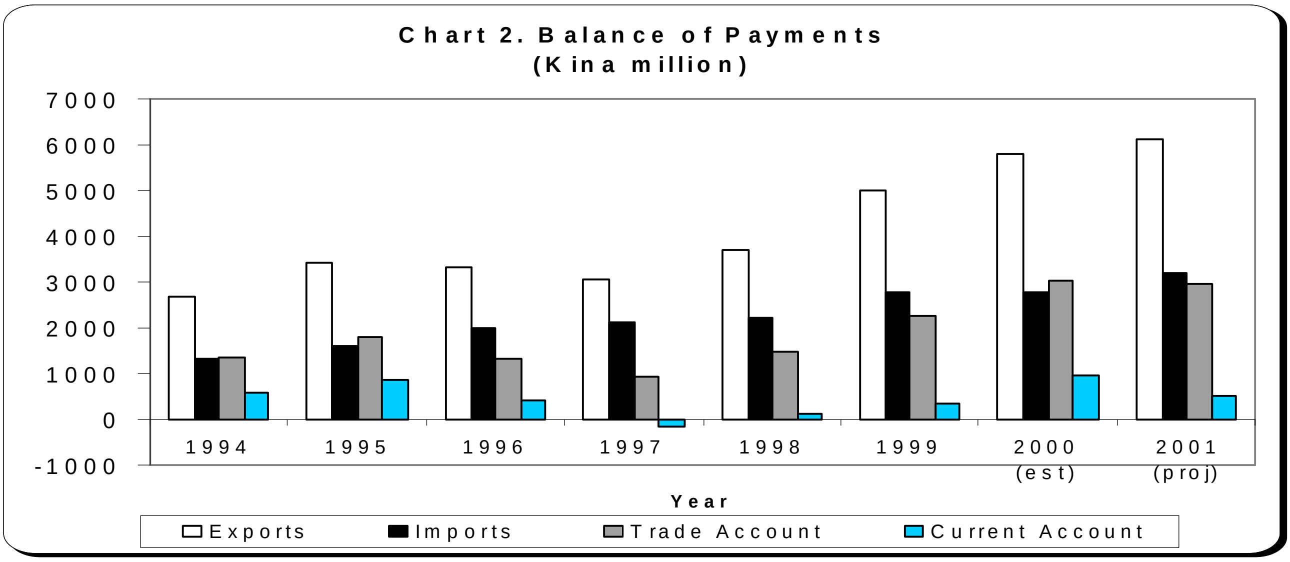
The level of gross foreign exchange reserves at the end of May 2001 was US$330 (K1,090) million, sufficient for 4.5 months of total and 7.9 months of non-mineral import cover.

The balance of payments for 2001, which includes extraordinary financing associated with the Structural Adjustment Programme (SAP), but excludes balance of payments support from the International Monetary Fund (IMF) is projected to show a surplus of K200 million, compared to a surplus of K359 million in 2000. This outcome is attributed to a lower surplus in the current account, which more than offset a lower deficit in the capital account. The current account is projected to record a surplus of K352 million, compared to a surplus of K974 million in 2000, and reflects higher net service payments and a lower trade surplus. The capital account, including the external extraordinary financing, is projected to record a deficit of K332 million in 2001, compared to a deficit of K651 million in 2000, reflecting lower loan repayments by resident companies and higher loan draw downs by the Government (See Chart 2).

The level of gross foreign exchange reserves at the end of 2001 is projected at US$362 million, sufficient for 4.1 months of total and 6.1 months of non-mineral import cover.

### d) Fiscal operations of the Government

The fiscal operations of the Central Government over the six months to June 2001 showed an overall surplus of K13 million, compared to a deficit of K25 million in the corresponding period in 2000. Total revenue receipts and grants amounted to K1116 million, K138 million lower than in the corresponding period in 2000, and represents 35 percent of the budget amount. Total expenditure over the first six months of 2001 amounted to K1103 million, K176 million lower than in the




corresponding period in 2000, and represents 33 percent of the budgeted expenditure in 2001 (See Table 1).

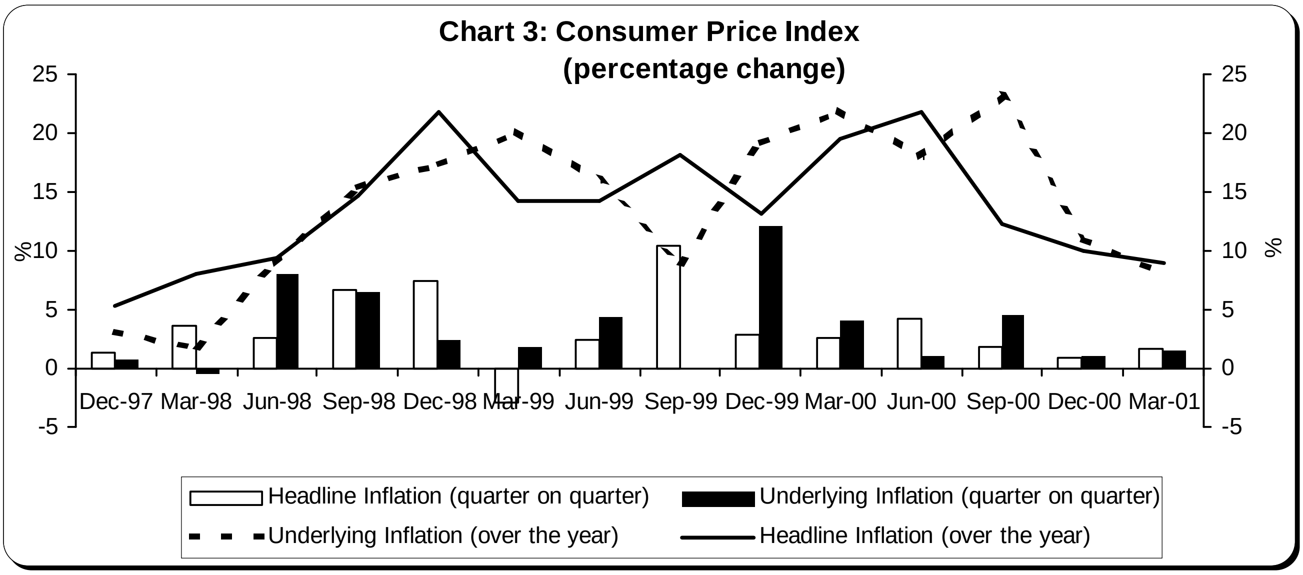
Total tax collections were lower over the six months to June 2001, compared to the corresponding period in 2000 reflecting a down turn in economic activity. This, combined with lower foreign grants, tighter control on recurrent and lower development expenditure resulted in a surplus over the six months to June 2001.

The budget surplus combined with a positive total domestic financing of K81 million resulted in a net repayment to external sources of K94 million. Domestic financing of K112 million from other domestic sources reflecting increased holdings of Government securities, more than offset a negative financing of K31 million from the banking system. On 12 April 2001, the Government endorsed the new issuance of K35 million in Inscribed Stocks with maturities of 1-3 years to lengthen its domestic debt structure. From this issuance, K26 million has already been sold to the public. The fiscal strategy for the 2001 National Budget continues to aim at a balanced budget. To achieve this objective would mean instilling fiscal discipline amongst institutions of the State in order to finance priority

**Table 1: Summary of Fiscal Operations of Government**
**(Kina million)**

| | 1999 | 2000 | 2001 Budget | 2000 Jan-Jun | 2001 Jan-Jun (p) |
|---|---|---|---|---|---|
| Total Revenue & Grants | 2569 | 3009 | 3223 | 1254 | 1116 |
| Total Expenditure | 2801 | 3201 | 3364 | 1279 | 1103 |
| Deficit/ Surplus | -232 | -192 | -141 | -25 | 13 |
| % of GDP | -2.5 | -2.0 | -1.3 | -0.3 | 0.1 |
| Financing (net) | 232 | 192 | 141 | 25 | -13 |
| External | 178 | 70 | 231 | -62 | -94 |
| Domestic | 54 | 122 | -90 | 87 | 81 |
| *of which* | | | | | |
| BPNG | -35 | -362 | 0 | -298 | 17 |
| Commercial Banks | 9 | 256 | 0 | 163 | -48 |
| Other Domestic Financing | 80 | 228 | -90 | 222 | 112 |

Source: Treasury Department & *Quarterly Economic Bulletin*, Bank of PNG.
(a) Budget surplus may not add up due to rounding.
(p) Preliminary.




areas including health, education, law and order, agriculture and livestock, transport and works, civil aviation and revenue raising measures. These were the only areas where additional funding was allocated, while others experienced reduced funding. In addition, the 2001 Budget included a total extraordinary financing of K424.2 (US$140.0) million, of which K63.6 million was already received from the Australian Government under the SAP.

Further delays in the disbursement of external extraordinary funding and the privatisation programme poses a potential risk of not achieving the objectives of the 2001 Budget, as shortfalls in external financing and privatisation receipts would exert pressure on the Government's cash-flow. Under such circumstances, the Government is likely to resort to domestic financing, which in previous experiences led to higher inflationary pressures. Increase in domestic borrowing not only makes monetary management difficult, but also jeopardises the current improvement in monetary conditions and prospects for economic recovery.

## e) Inflation

### Headline Inflation

During the March quarter of 2001, headline inflation, as measured by the Consumer Price Index (CPI), increased by 1.6 percent, compared with the December quarter of 2000 and by 8.9 percent over the year. This compared to 0.9 percent in the December quarter of 2000 and 10.0 percent over the year to December 2000. The lower increase in inflation was attributed to:

- **Imported inflation**: The movement in the exchange rate is the most influential factor impacting on headline and underlying inflation. From

**Table 2: Measures of Consumer Prices**
**(percentage change)**

| | | Actual | | Forecast |
|---|---|---|---|---|
| | | 1999 | 2000 | 2001 |
| Headline CPI | Year on Year | 14.9 | 15.6 | 9.1 |
| | Over the Year | 13.2 | 10.0 | 9.7 |
| Underlying CPI | Year on Year | 16.0 | 18.2 | 8.4 |
| | Over the Year | 19.2 | 11.0 | 8.3 |

**BOX 2: MEASURES OF INFLATION**

The analysis of price changes is central to the assessment of the conduct of monetary policy, given the Central Bank's objective of achieving and maintaining price stability. The Consumer Price Index (CPI), published by the National Statistical Office, measures the changes in the cost of purchases made by households in urban centres, and is a key indicator of price changes. It has been used as the measure of so-called 'headline' inflation in PNG and although it is an adequate indicator for inflation over the long-term, it is not a good measure of underlying inflationary pressures that are acting on the economy over the short-term. This is because a large number of items in the CPI basket of goods and services are affected by highly volatile factors, Government policy decisions and seasonal factors. The movements in the prices of such items hide the so-called 'underlying' or 'core' rate of inflation. An underlying rate of inflation measures the inflationary pressures in the economy that are predominantly due to market forces, i.e. changes in prices that reflect only the longer-run supply and demand conditions in the economy. As of September 2000, the CPI sub-grouping of fruit and vegetable, in addition to the price effects of betelnut, excise tax and VAT increases, were excluded from the calculations of headline inflation. These exclusions would ensure that any policy changes should be driven by economy demand-side effects, and not supply-side effects of unpredictable seasonal commodities and Government interventions. It is therefore important that the Central Bank responds appropriately to the underlying rate of inflation by removing the effect of factors assessed as temporary from the measured headline inflation rate.

March 2000 to March 2001 the kina depreciated by 9.3 percent against the US dollar, while it appreciated by 7.8 percent against the Australian dollar (A$). The appreciation of the kina against the A$ contributed significantly to the lower rate of inflation, due to the relatively high level of imports from Australia.

- **Domestic Inflation**: The main factor that impacted on domestic inflation was the 2.0 percent increase in wages and salaries of public servants in January 2001, as well as increases in prices of some price controlled items including petrol.

**Underlying Inflation**

During the March quarter of 2001, underlying inflation, which excludes effects of excise duties and fluctuations in the price of betelnut and fruit and vegetables on consumer prices, increased by 1.7 percent, from December 2000 and by 6.0 percent over the year. This compared to 1.0 percent in the December quarter of 2000 and 11.0 percent over the year to December 2000.

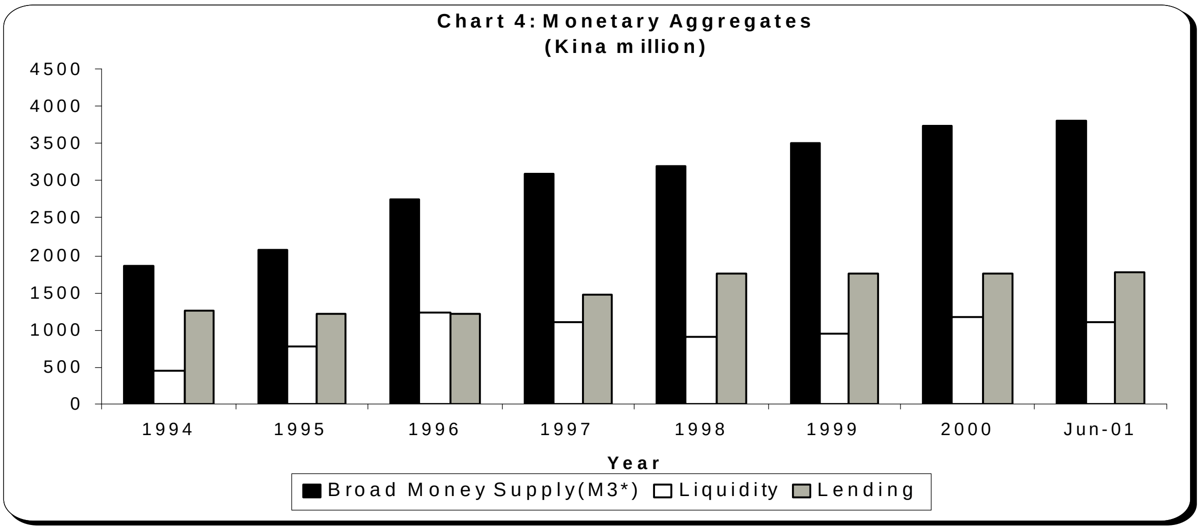
**Inflation Forecast**

In line with previous expectations, inflation is forecast to trend downwards during the remainder of 2001. The projected year on year and over the year headline inflation rates are 9.1 and 9.7 percent, an improvement on the January 2001 Monetary Policy Statement forecasts of 11.4 and 11.9 percent, respectively. The lower inflation forecasts are as a result of a lower than expected March quarterly inflation rate. The lower increase in inflation was due to reduction in price-cost margins by businesses, as a result of depressed domestic aggregate demand. However, consumer price changes in the second quarter of the year are still expected to be adversely effected by the depreciation of the kina towards the end of 2000 and the first quarter of 2001. The exchange rate feed through to consumer prices will depend largely on the reaction of businesses to increased import costs. Inflation in the latter half of the year is expected to be lower as support of the kina from export receipts and extraordinary financing boost private sector confidence and lead to more stable consumer prices.

The projected year on year and over the year underlying inflation rates for 2001 have been revised to 8.4 percent and 8.3 percent, respectively, from earlier projections published in the January 2001 Monetary Policy Statement.

**f) Monetary and Financial Market Developments**

The Central Bank relaxed its tight monetary policy stance in the first half of 2001, following a downward trend in inflation as anticipated and stability in exchange rates. The lower than expected increase in inflation in the December quarter of 2000 and March quarter of 2001 was a major contributing factor that led the Central Bank to reducing the Kina Facility Rate




(KFR) by 2.5 percentage points in aggregate from 15.5 percent in February to 13.0 percent in July 2001[1].

Consistent with the decline in the KFR all market interest rates declined, with the 182 days Treasury bill rate falling from 14.9 percent in December 2000 to 12.3 percent at the end of June 2001. The weighted average 28 day term deposit rate and the Indicative Lending Rates (ILR) of the commercial banks also declined during the period. Although the KFR was initially below the 28 day Treasury bill rate, these two interest rates have since converged (See Chart 6). However, spreads between the weighted average lending and deposit rates have widened reflecting a slower adjustment in the cost of borrowing and lending rates by commercial banks. If the Government reduces the stock of Treasury bill issues, crowding out of credit to the private sector would diminish and lending to this sector should grow. However, the retirement of Treasury bills by the Government depends on the success of the privatisation programme in 2001.

The level of broad money (M3*) increased by 2 percent between December 2000 and June 2001 (See Chart 4) as a result of higher net foreign assets of the banking system, which more than offset a decline in net credit extended by the banking system.

The Central Bank continued to utilise its open market instruments in implementing monetary policy in the first half of 2001, with no changes made to both the Cash Reserve Requirement (CRR) and Minimum Liquid Asset Ratio (MLAR).

From the end of December 2000 to the end of June 2001, the kina appreciated by 0.6 percent against the Australian dollar, while it depreciated by 7.8 percent against the US dollar during the same period. The Central Bank intervened in the foreign exchange market to smooth out short-term volatility in the exchange rate. The real effective exchange rate (REER)[2] has depreciated since September 2000, reflecting an increase in the international competitiveness of the export sector. The downward movements in the REER can be explained by the decline in the nominal exchange rate (Import Weighted Index), which more than offset relative price differentials between PNG and its partner trading countries. However, the benefits to the export sector of the increase in competitiveness were offset by the lower level of supply in response to the fall in international prices, coupled with other structural impediments (See Chart 5).

## 2. MONETARY POLICY

### a) Monetary Policy Stance

In addition to the favourable outcome of inflation in the March quarter of 2001 and the expectations for a

[1] Refer to Box 3. The KFR is similar to KAR described in the January 2001 Monetary Policy Statement.
[2] The REER is defined as the product of the nominal exchange rate and foreign prices divided by the domestic prices, and measures competitiveness of the export sector due to changes in the exchange rate and relative prices between PNG and its trading partners.

### BOX 3: KINA FACILITY RATE (KFR) AND OPERATIONAL MARGINS FOR LIQUIDITY INSTRUMENTS

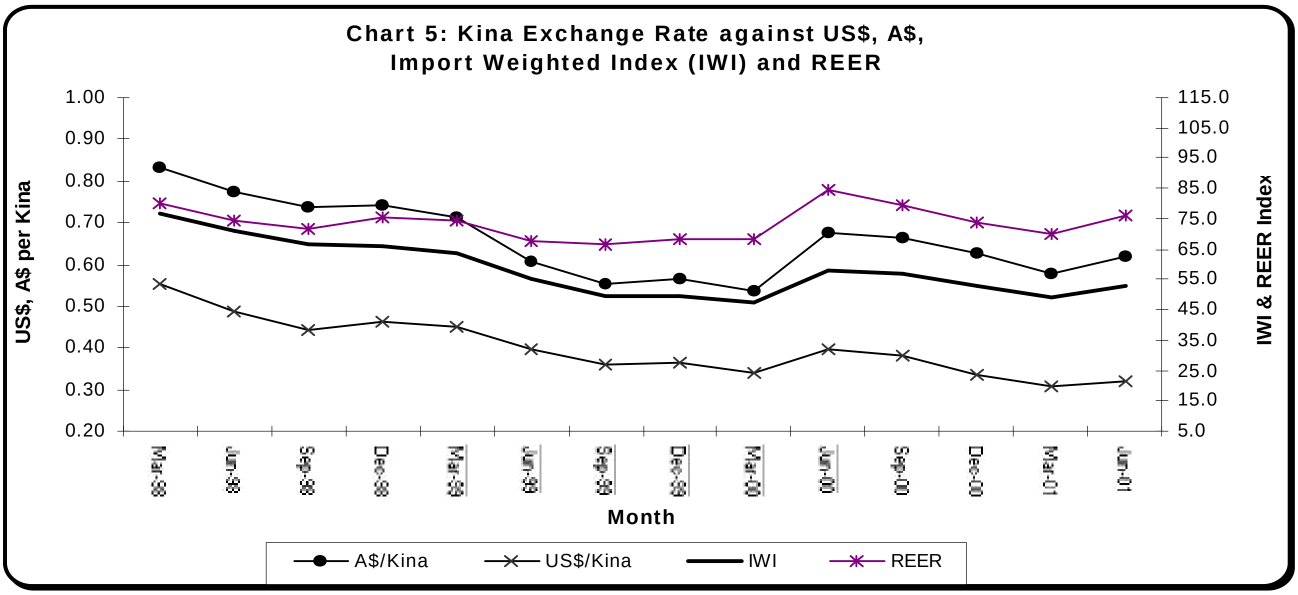
As foreshadowed in the January 2001 Monetary Policy Statement, the Central Bank introduced a new price based signalling mechanism on 5 February 2001. The KFR was introduced as a monthly benchmark rate to signal the stance of monetary policy taken by the Central Bank and used for inter-bank transactions. To strengthen the signalling mechanism of monetary policy and to ensure that market rates and transactions are conducted around the KFR, the Bank also introduced Repurchase Agreements for daily cash transactions, while the Kina Facility (KF) remained a weekly liquidity instrument.

At its inception, the KFR was set around the 28 day Treasury bill rate of 15.50 percent and dealing margins were set at 1.25 percent and 1.50 percent, above/below the KFR for the KF and Repurchase Agreements respectively. The sharp increase in the KF buy rate between January and February 2001 reflects this structural change in interest rates. Further reductions in the KFR were announced in March (50 basis points), April (25 basis points), May (75 basis points) and July (100 basis points), to 13.0 percent. No changes were made to the margins until July when they were reduced to 75 basis points for KF and 100 basis points for Repurchase Agreement from the KFR. Following these reductions in KFR, Treasury bill rates declined and commercial banks reduced their Indicator Lending Rates (ILRs) to the current spread of 15.75 – 16.75 percent.

further downward trend in the remaining months of the year, other developments, which have influenced the Bank's decision to gradually ease its stance of monetary policy are:

- The overall level of economic activity remains flat with few signs of any major recovery in the immediate future;
- Growth in money supply and credit aggregates are moderate;
- Domestic real interest rates remain positive;
- As overseas official interest rates fell sharply, following the actions by major central banks to ease monetary policy in order to stimulate economic activity, interest rate differentials between PNG and its key trading partners continue to widen;
- Reasonable progress continues to be made on the Government's reform program, despite some notable delays in implementation, in what now appears to have been an ambitious program; and
- Continued tight control on expenditures by Government, in light of lower tax revenue and delays in drawdown of external extraordinary financing.

Whilst inflation is projected to trend downwards in the second half of 2001, the BPNG will be mindful of any adverse developments in the key macroeconomic



conditions underpinning inflationary projections and monetary developments. The Central Bank, therefore will take a cautious approach to any further easing of the monetary policy stance. Consistent with earlier projections stated in the January 2001 Monetary Policy Statement, the underlying inflation rate continue to trend downwards, with the average and over the year rates projected at 8.4 percent and 8.3 percent, respectively. However, the pace and extent of further adjustments to the stance of monetary policy in the second half of 2001 will also depend on the following factors and their combined influence on the underlying inflation rate and price stability:

- A gradual, rather than rapid, pick-up in private sector credit implicit in recent falls in interest rates, with further cuts in bank lending rates expected as commercial banks 'average cost of funds continues to decline. This depends on the responsiveness of commercial banks to the competitive opportunities offered by lower cost of funds;
- Fiscal consolidation and prioritisation of expenditure by Government as necessary. A cautious approach by Government is needed to ensure new domestic borrowing does not raise possible conflict with the direction of monetary policy. The progress on domestic debt reduction depends on realisation of the Government's privatisation programme;
- An improvement in the balance of payments through a recovery in the prices of PNG's key exports and draw down of external extraordinary financing. A continuation of the rebuilding of PNG's foreign reserves should provide added support to confidence;
- Continued moderation in supply side cost pressures, especially wages and salaries, and price increases for price controlled goods; and
- On-going progress on structural reform and funding assistance from bilateral sources and multilateral institutions. In this context, the forthcoming Consultative Group Meeting and the extent of ongoing support from international financial institutions and "Friends of PNG" will be important.

Under these conditions, the revised monetary and credit aggregates are expected to develop as follows in 2001 (See Table 3).

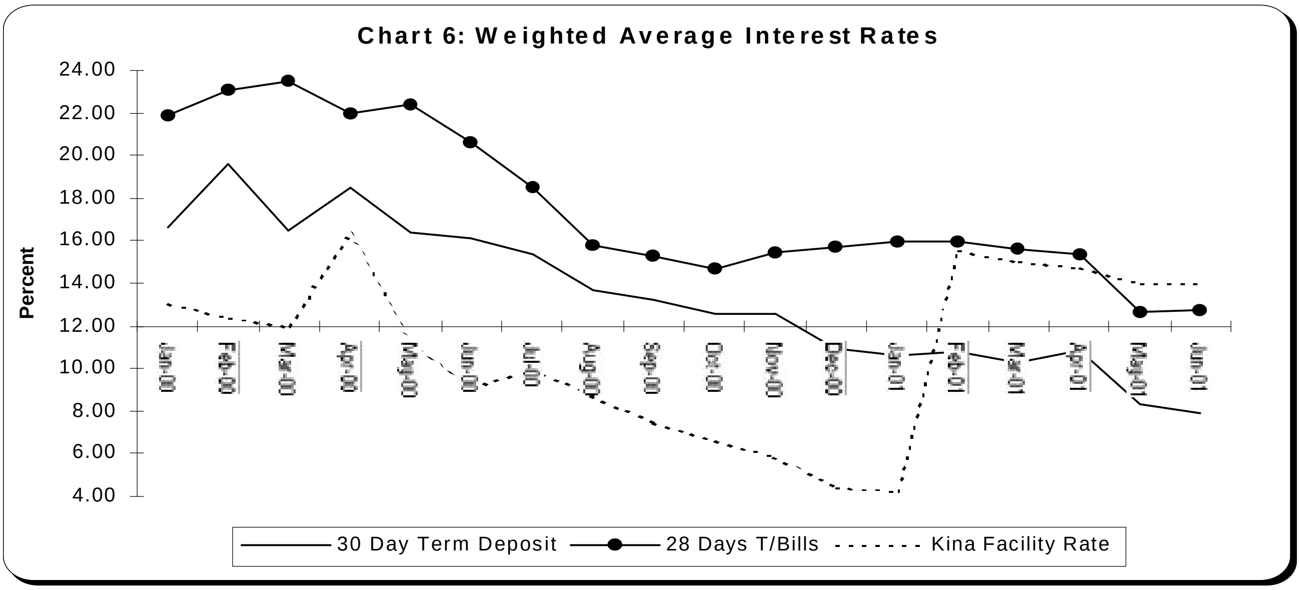
The Central Bank will monitor developments in the key macroeconomic indicators and if the assumptions that underpin the continued moderate inflation outcome hold, the Central Bank will be able to gradually and cautiously ease monetary policy in the remaining part of this year.

**b) Conduct of Monetary Policy**

Consistent with the Bank of Papua New Guinea's objective of achieving and maintaining price stability, the conduct of monetary policy will be operated within a reserve money framework. Reserve money is defined as currency in circulation and deposits of commercial banks with the Central Bank and, along with the level of liquid assets in relation to statutory requirements, is an indicator of the capacity of the banking system to finance new lending. During 2001, the revised reserve money is expected to increase by 2 percent following a decrease of 19 percent in 2000. The decrease in 2000 was a result of the tight stance of monetary policy pursued by the Central Bank. The expected growth in reserve money is likely to have some impact on inflation, and the Central Bank will

**Table 3: Growth in Monetary and Credit Aggregates (percentage)**

| | January - June 2001 (Actual) | January 2001. (Forecast) | Revised 2001 (Forecast) |
|---|---|---|---|
| **Broad money supply** | 2 | 10 | 6 |
| **Reserve money** | -7 | 12 | 2 |
| **Private sector credit** | 5 | 12 | 6 |
| **Net credit to Government** | -3 | -20 | -10 |




continue to use its open market instruments to sterilise any excess reserve money in the banking system.

To improve efficiency of transmission of the monetary policy stance, the Central Bank introduced a new price based signalling mechanism on 5 February 2001 as shown in Box 3. However, to allow the market rates to adjust and to prevent the KFR from becoming a substitute for investment in Government securities and trading in the inter-bank market, a margin is applied. As the KFR is a benchmark rate, any change to it is expected to affect all relevant market interest rates over time, including the commercial banks' cost of funds.

To further strengthen the transmission mechanism of monetary policy, the Central Bank also introduced Repurchase Agreements on 5 February 2001 for daily liquidity management. The Repurchase Agreement is used at the discretion of the Central Bank with the buy and sell margins set around the KFR. The Master Agreement for the Repurchase and Reverse Repurchase will be completed in due course, but in the interim, over-night repurchase and reverse repurchase transactions involving only cash are conducted between the commercial banks and the Central Bank without the use of Government securities.

The price based signaling mechanism combined with the complementary Repurchase Agreements are intended to realign the linkage between Treasury bills, deposits and lending rates to increase the efficiency in transmission of monetary policy, facilitate a downward shift in the entire interest rate structure and establish a predictable yield curve.

***BOX 4: RELATIONSHIP WITH GOVERNMENT***

Operational Arrangements for the Temporary Advance Facility (TAF), came into effect from 02 January 2001, with the first draw down on the Facility on the same date. In March and April 2001, the legal limit of K100 million was temporarily exceeded. This was due to presentation of cheques issued in 2000 and high volume of warrants issued in March in anticipation of the loan draw downs from the World Bank and Australia, both of which were delayed. The TAF draw down was fully repaid in early May 2001, following the receipt of the Australian loan and mineral taxes. Subsequently, a new TAF was put in place on 01 May for repayment by 15 November 2001.

Measures taken to ensure the limit is not breached again include:

- Government issued a new Inscribe Stock of K35 million in May 2001;
- Prioritising of expenditures and warrant issuance by Government; and
- Introduction of operational arrangements within the Central bank to ensure Statutory requirements will be met.

The Treasury bill auction remains the main instrument for injecting and diffusing liquidity from the banking system. Refinements to the Treasury bill auction will improve the Central Bank's flexibility to adjust liquidity and influence the yield curve on Government securities. Treasury bill issues under the Tap Facility continues to encourage purchases by the non-bank entities and individuals directly from the Central Bank at interest rates, which are set at 1.0 percentage point below those obtained at the weekly auction. The Tap arrangement provides an alternative investment opportunity for non-participants in the weekly Treasury bill auction, thereby enhancing the competition for funds. Further refinements to the Treasury bill auction and the Tap Facility will be implemented by the Central Bank in the second half of 2001. The Central Bank will retain the Tap Facility in 2001 to actively promote the sale of Treasury bills to the non-bank financial sector. The Kina Facility and Repurchase Agreements will be utilised for short-term liquidity management, while the MLAR and CRR will be continuously reviewed to determine their appropriate levels consistent with the stance of monetary policy.

Queries on the contents of the Monetary Policy Statement should be directed to the Manager, Monetary Policy Unit, Economics Department at the Bank of Papua New Guinea on telephone number 3227 312 or fax number 3200 757. Copies of the Statement can be obtained from the Manager, Public Information Unit on telephone number 3227 326 or fax number 3200 757.