BANK OF PAPUA NEW GUINEA

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

PORT MORESBY
31 July 2002

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 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."

Central Banking Act 2000, Section 11, Sub-section 1

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 (675) 3227 312, e-mail: gawap@bankpng.gov.pg or fax number (675) 3200757. Copies of the Staement can be obtained from the Manager, Public Information Unit on telephone number 3227 326 or fax number 3200 757. This information is also available on our website: bankpng.gov.pg

SEMI-ANNUAL MONETARY POLICY STATEMENT, JULY 2002

INTRODUCTION

The Semi-Annual Monetary Policy Statement (MPS) is published under the Central Banking Act 2000, and represents a key element of the transparency and accountability arrangements of the Act. The Policy Statement is presented in two parts. The first covers economic developments in the first half of the year and revised projections for 2002. The second discusses the rationale for the policy stance and the conduct of monetary policy in 2002.

1. DEVELOPMENTS IN THE FIRST HALF AND PROJECTED DEVELOPMENTS FOR 2002

In designing monetary policy for 2002, the Central Bank considers actual and projected developments in six main areas with particular attention to their impact on monetary aggregates and prices:

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

a) The World Economy

As of April 2002, the International Monetary Fund (IMF) projects that the real growth in the world economy will be 2.8 percent in 2002, 0.4 percent higher than the December 2001 forecast, and compares with an actual outturn of 2.5 percent in 2001. The higher growth is attributed to a faster than expected pick-up in activity in the United States (US), the easing of monetary policies in the major industrialised countries during 2001 and an overall decline in oil prices. The leading indicators, which also support this forecasted growth include a pick-up in consumer and business confidence, firmer industrial production and a recovery in the information technology (IT) sector. The IMF further revised upwards their 2002 real growth projections with major industrialised countries, as a group, expected to grow by 1.5 percent. Real GDP is projected to grow by 2.3 percent in the US and by 1.4 percent in the Euro area; reflecting growth of 2.0 percent in the United Kingdom and 0.9 percent in Germany. In Japan, real GDP is projected to decline by 1.0 percent in 2002, with few signs of sustained recovery in domestic demand. In the emerging markets, there are also signs of recovery in a number of Asian economies, particularly South Korea, which is aided by the improvement in the IT sector. In most Latin American countries, activity remains subdued.

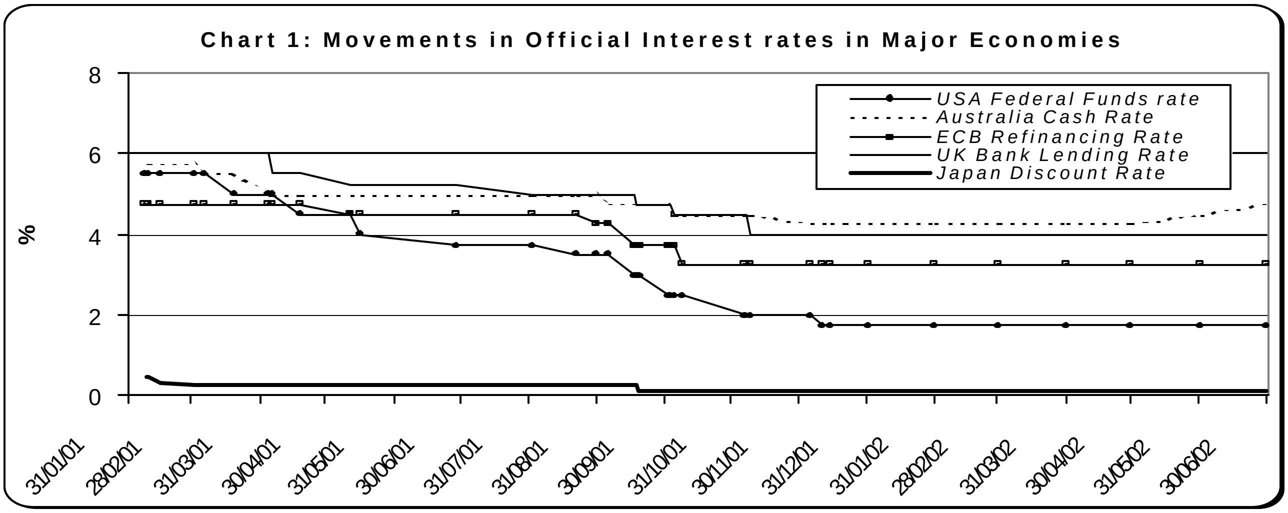
The IMF expects global inflation in the major industrialised countries to decline in 2002, mainly due to an overall decline in oil prices. With inflationary pressure expected to subside, the US Federal Reserve continued to maintain an accommodative monetary policy stance by leaving the Federal Funds rate unchanged at 1.75 percent over the first half of 2002. Most major central banks left their official interest rates unchanged over the first half of 2002. The Bank of Japan and the Bank of England maintained their official rates at 0.1 percent and 4.0 percent, respectively. The European Central Bank (ECB) also maintained its cash rate at 3.25 percent. The ECB is thus balancing concerns about the current recovery in the European and global economies against concerns about the possibility of high inflation. However, the Reserve Bank of Australia increased its cash rate from 4.25 percent in December 2001 to 4.75 percent in June 2002, as a result of an increase in inflation towards the top end of its target range (see Chart 1).

Renewed weakness in the global equity market has dominated trading in the financial markets over the last

BOX 1: OBJECTIVE OF MONETARY POLICY

In pursuing monetary policy in Papua New Guinea, the Bank of Papua New Guinea (Bank of PNG) 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 the Government a foundation for stable revenue flows; and
- Potentially lead to a stable macroeconomic environment.

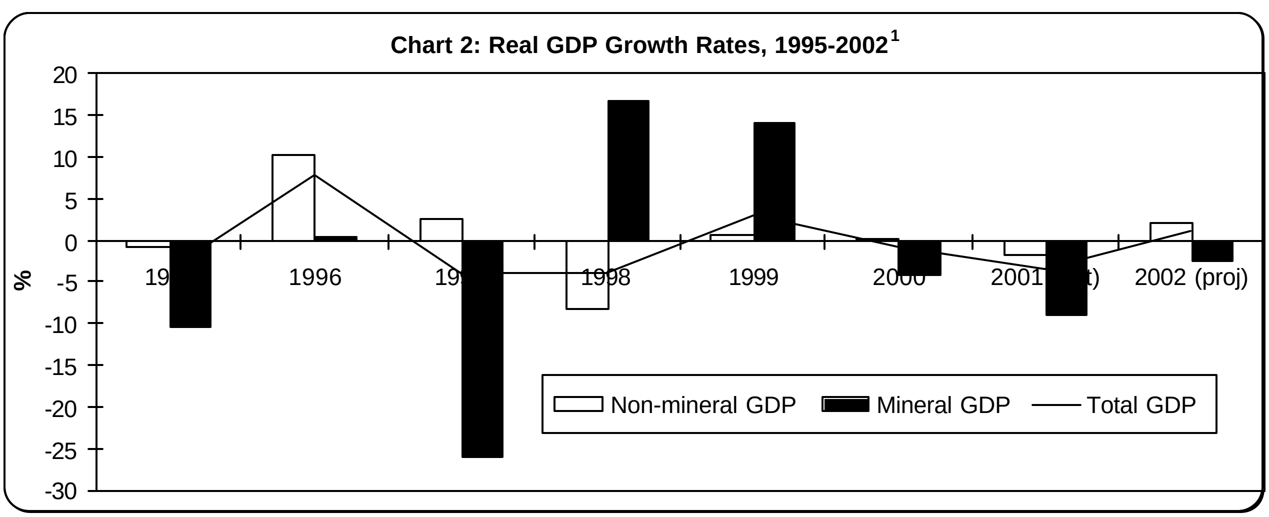


Sources: Various Reserve Banks' web-sites.

six months. The US Dow Jones index has fallen below the 9,000 level over concerns of the health of large corporations in America. Concerns about future revenues were compounded by improper accounting disclosure practices. This has led to a sharp decline in long-term bond yields as the global bond market has benefited from safe haven investment flows. In the foreign exchange market, the US dollar has weakened substantially against all the major currencies, reflecting developments in the US equity market. As a result, the yen has strengthened from 130 to 115 against the US dollar over the period and the euro is now approximately back at par with the US dollar. The Australian dollar also strengthened against the US dollar.

b) Domestic Economic Activity

Preliminary estimates of economic activity in Papua New Guinea (PNG) indicate that total real GDP declined further in 2001, following a real decline of 0.8 percent in 2000. Latest estimates are for economic activity to remain depressed in 2002, with real GDP growth revised downwards from the projected growth of 1.2 percent (see Chart 2). The revision was mainly due to expected declines in the mineral sector and subdued activity in the agriculture/forestry/fisheries sector. The expected decline in the mineral sector is due to lower crude oil production, while subdued activity in the agriculture/forestry/fisheries sector reflects lower



Sources: National Statistical Office (NSO) and *National Budget 2002*, Dept. of Treasury.

[1] Real GDP growth rates for 2000 to 2002 were from Table 2.1 of the 2002 Budget document.

coffee and cocoa production, depressed international prices for the major agricultural exports, poor road infrastructure, and disruptions to harvesting during the National Elections.

The Bank's Business Liaison Survey of the private sector supports the view that the outlook for the first half of 2002 is weak, reflecting the depressed state of aggregate demand. At the beginning of 2002 the private sector projected the overall value of sales to decline over the first six months of 2002, with falls in the retail, wholesale, construction and transportation sectors. The value of sales in the agriculture/forestry/fisheries sector is projected to increase in the first half of 2002 as a result of higher production of palm oil. The increase in palm oil production is expected to more than offset lower production in the other main agricultural export commodities. Other indicators also show the depressed state of the economy: lending to the private sector declined by 4.9 percent over the first half of 2002, while private sector employment fell by 0.2 percent in the March quarter of 2002. The decline in employment has occurred in the wholesale, manufacturing, construction, transportation and finance/business services sectors.

c) Inflation

(i) Actual to March 2002

During the March quarter of 2002 and the December quarter of 2001, headline inflation increased by 1.7 and 1.2 percent, respectively. During the corresponding periods, the Underlying CPI trimmed mean price measure increased by 2.8 and 1.9 percent, respectively.

The rate of underlying inflation, both the Exclusion-based and Trimmed Mean measures, were higher than the headline inflation rate. The differences are explained by the following factors:

- Government education subsidies on school fees in March 2002;
- On the 1st of December 2001, there was a 2.5 percent increase in excise tariffs on cigarettes, tobacco and alcohol. There are potential inflationary pressures because industries may be temporarily absorbing the effect of excise duties in profit margins;
- The upward price movement of price-controlled fuel products. Further inflationary pressure may come about from fuel price impact on the cost of transportation;
- Telikom announced significant price increases for their communication services in January 2002 and Air Niugini also increased airfares by 5.0 percent early in the year; and
- The prices of fruits, vegetables and betelnut declined sharply in the six months to March 2002 due to seasonal price fluctuations.

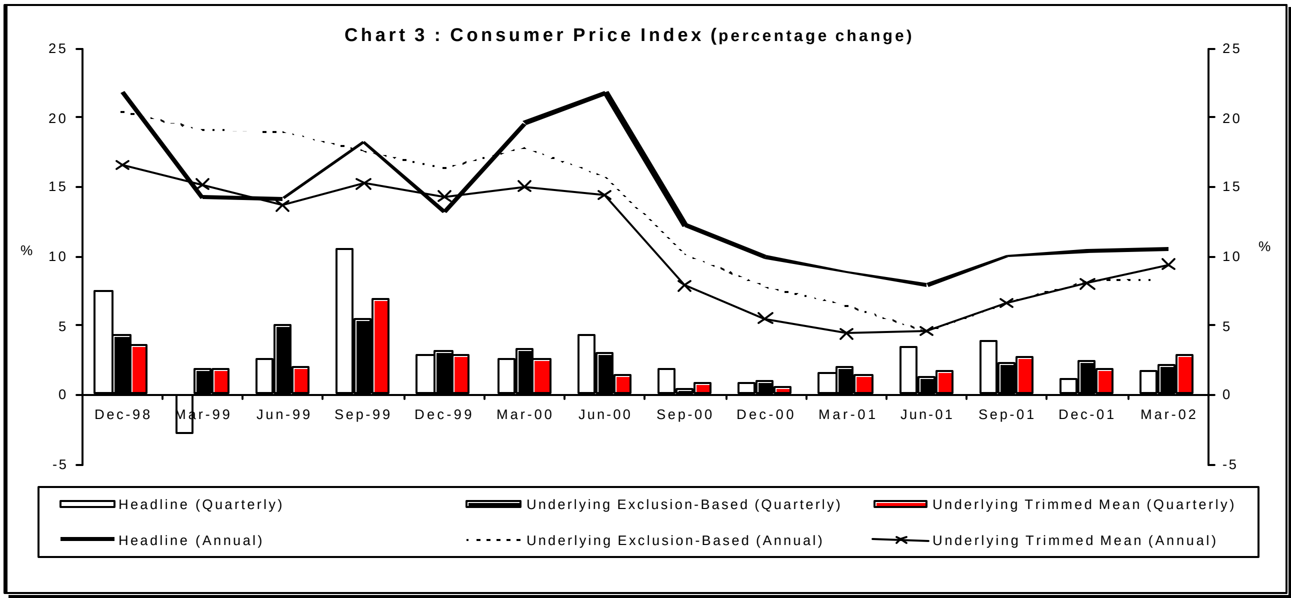
Chart 3 clearly shows an upward trend in the annual underlying inflation rate since the beginning of 2001.

Table 1. Consumer Prices Indices (annual percentage change [2,3])

Inflation Measures	Actual				Forecast	
	1998	1999	2000	2001	2002 (Jan MPS)	2002 (Jul MPS)
Headline	21.8	13.2	10.0	10.3	8.8	11.2
Underlying						
CPI Exclusion-based [4]	20.4	16.3	7.8	8.2	8.5	11.8
CPI Trimmed mean	16.6	14.3	5.5	8.0	N/A	11.2

Source: NSO for *Headline* and Bank of PNG for *Underlying* measures.

[2] December on December.
[3] All annual inflation figures are rounded to one decimal place.
[4] CPI excluding seasonal, excise and selected price control items.



Sources: NSO for headline and Bank of PNG for underlying measures.

The depreciation of the exchange rate increased the price of imported goods, contributing to the increasing trend in underlying inflation. The exchange rate has an important effect on consumer prices because PNG urban households spend a large percentage of their income on imported goods. The import-weighted index (IWI) has continued to depreciate, falling by 3.4 percent in the first half of 2002. The exchange rate depreciation is mainly the result of an increasing current account deficit in the non-mineral sector. This deficit has widened because of sustained import-demand, mainly fuelled by fiscal expansion and because of low export receipts from the agricultural sector. The uncertainty surrounding the outcome of the 2002 National Elections has also contributed to the weakness of the kina. In addition, the strength of the Australian dollar against the US dollar is significant because Australia is PNG's main trading partner. The exchange rate would have depreciated further if it were not for the intervention by the Central Bank in the foreign exchange market. The net cumulative level of intervention by the Central Bank to the 29th of July 2002 was K378.5 million.

The 7.0 percent increase in public sector wages in January 2002 will have contributed to domestic price pressures. Also, many private sector companies adjusted staff wages for CPI increases early in 2002 or towards the end of 2001.

(ii) Revised 2002 Projections

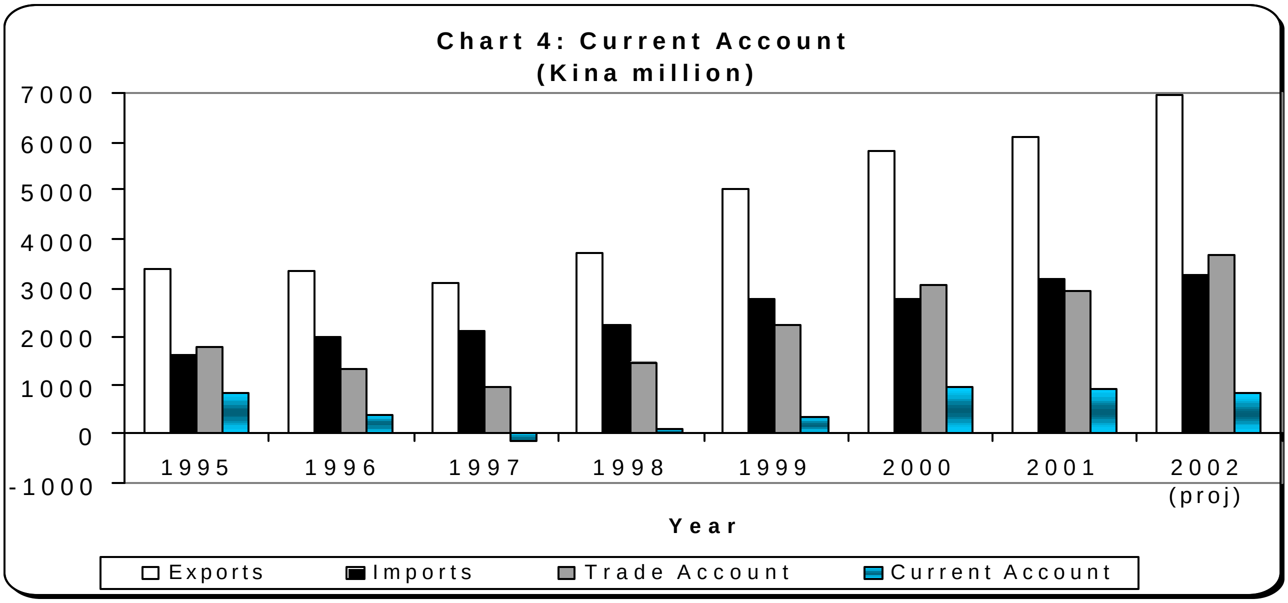
The 2002 inflation projections have been revised upwards from the projections made in the January MPS, mainly due to the depreciation of the kina against the currencies of PNG's major trading partners in the seven months to July 2002. The latest projections take into account a 7.2 percent depreciation in the IWI to July 2002. The revised headline inflation projection also takes into account a 2.5 percent increase in excise duty on CPI items in the cigarettes & tobacco and alcoholic drinks sub-groups, that will be effective from the 1st of December 2002, as well as the seasonal price pattern of betelnut, fruits and vegetables.

The performance of the agricultural export sector and the level of Government expenditure and their impact on aggregate demand during the second half of the year will be the key factors in determining the inflation path for the remainder of 2002. The expected subdued level of private sector activity due to a lack of major development projects and the adverse income effect from low agricultural export earnings may negate imported price pressures.

d) Balance of Payments

i) Five months to May 2002

Preliminary balance of payments data for the five



Source: Bank of PNG.

months to May 2002, showed an overall surplus of K88 million, compared to a surplus of K180 million in the corresponding period in 2001. This outcome was due to a surplus in the capital account, which more than offset a deficit in the current account. The surplus in the capital account was due to a net sale of short-term money market instruments abroad including the sale of the Government's share in Orogen Minerals Ltd to Oil Search Ltd. When combined with the draw down in foreign currency account balances of the mineral companies and a net reduction in the foreign assets of the non-official monetary sector, the inflows more than offset higher net loan repayments by the Government. The current account deficit reflected lower values of merchandise exports, mainly crude oil, copper, most agricultural and forestry exports, higher imports and net service payments, which more than offset a net transfer receipts.

The level of reserves at the end of June 2002 was US$409 million.

ii) Revised 2002 Projections

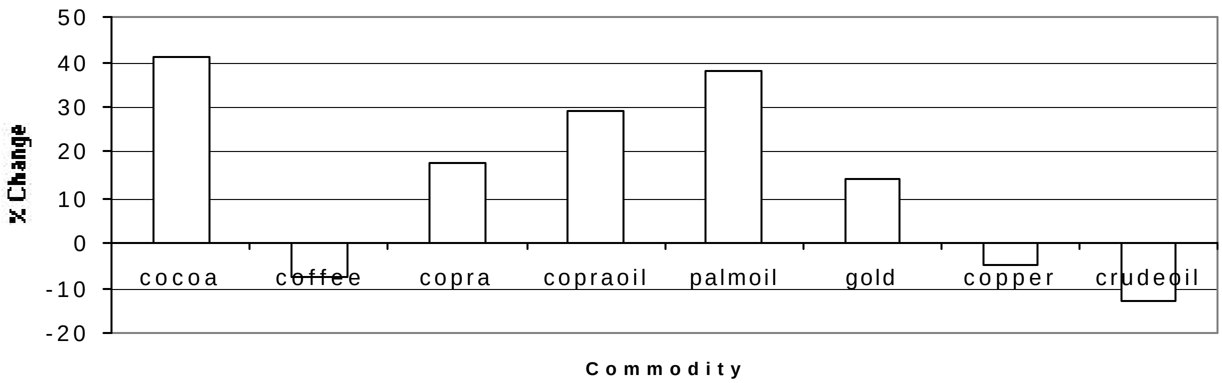
The balance of payments for 2002, is projected to show an overall surplus of K71 million, compared to a surplus of K708 million in 2001. This outcome is attributed to a surplus in the current account, which more than offset the deficit in the capital account. The current account is projected to record a surplus of K800 million in 2002, compared to a surplus of K943 million in 2001 (see Chart 4). The capital account, which includes the Asian Development Bank (ADB) Public Sector Reform Program loan of US$35 (K130) million, is projected to record a deficit of K730 million in 2002, compared to a deficit of K264 million in 2001. The higher deficit reflects higher net loan repayments by the Government and resident companies.

The level of gross foreign exchange reserves at the end of 2002 is projected at US$444 million, sufficient for 5.9 months of total and 8.4 months of non-mineral import cover. This level of foreign exchange reserves is due to the draw down of funds under the Government's Structural Adjustment Program (SAP) and not from economic activity generated within the country. When repayment for some of these loans commence in 2003, this would place added pressure on the Government's ability to service its external debt, and may limit the Central Bank's ability to stabilise the exchange rate.

iii) International Price Developments

When compared to the corresponding period in 2001, the average international prices for most of PNG's major export commodities improved during the five months to May 2002, with the exception of copper, crude oil and coffee. Chart 5 shows that most of the non-mineral commodity prices have increased as a result of declining supply in the world market, combined with higher demand for the commodities from major consuming regions.

Chart 5: Average Percentage Change in International Prices Between Jan-May 2001 and Jan-May 2002



Source: Bank of PNG.

Gold prices increased due to higher demand from Asia and North America. Cocoa prices increased as a result of lower production from major producers in West Africa. Palm oil prices increased due to declines in production in Malaysia and Indonesia, the world's major palm oil producers. Copra and copra oil prices increased as a result of lower copra production in the Philippines.

(e) Fiscal Operations of the Government

Preliminary estimates of the fiscal operations of the National Government over the six months to June 2002 showed an overall deficit of K210.2 million, compared to a surplus of K13.0 million in the corresponding period in 2001 as shown in Table 2. The deficit was the result of higher expenditure incurred by the Government, which more than offset an increase in revenue. The main fiscal developments are summarised below:

- A faster increase in recurrent expenditures relating to school fee subsidies, grants to provinces and statutory bodies, greater than expecetd expenditure on the 2002 National Elections, and the faster release of Electoral Development Funds;

- Increases in ordinary revenue was lower than the pace of expenditure; and

Table 2: Fiscal Operations of the Government (Kina millions)

	2000	2001	2001 Jan-Jun	2002 Budget	2002 (p) Jan-Jun
Total Revenue & Grants	3008.7	2864.4	1116.0	3102.0	1170.1
Total Expenditure	3201.0	3227.4	1103.0	3307.0	1380.3
Deficit / Surplus	*-192.3*	*-363.0*	*13.0*	*-205.0*	*-210.2*
% of GDP	-2.0	-3.6	0.1	-1.9	-2.0
Financing	192.0	362.9	-13.0	205.0	210.2
External	70.0	245.5	-94.0	230.0	-131.7
Domestic	122.0	117.4	81.0	-25.0	341.9
of which					
Bank of PNG	-361.6	-247.1	11.7	-	158.4
Commercial Banks	256.0	-12.1	-48.3	-	27.1
Other Domestic Financing	327.9	376.6	117.6	-	-66.0
Asset Sales	-	-	-	-	222.4

Source: *Quarterly Economic Bulletin*, Bank of PNG and *National Budget 2002*, Dept. of Treasury.

- Reliance on financing of the Budget deficit from domestic sources through the net issuance of new domestic debt. The raising of new domestic debt has increased the yield on Government securities, total domestic debt and debt servicing cost.

The original objective of the 2002 National Budget was to achieve a Budget deficit of 2.0 percent of nominal GDP with a net reduction in net domestic debt. However, the significant increase in expenditure, combined with the delays in the privatisation of other State assets and the inflow of external funding from the ADB, pose a major threat to the achievement of the 2002 Budget objectives.

Despite the increase in expenditure, the proceeds from the sale of PNGBC and part of the proceeds from the sale of the Government shares in Orogen Minerals Ltd were used to retire domestic debt. Up to July 2002, the Government made a net new issue of K167 million in Treasury bills and K35 million in Inscribed Stocks, of which K20 million was successfully sold to the public.

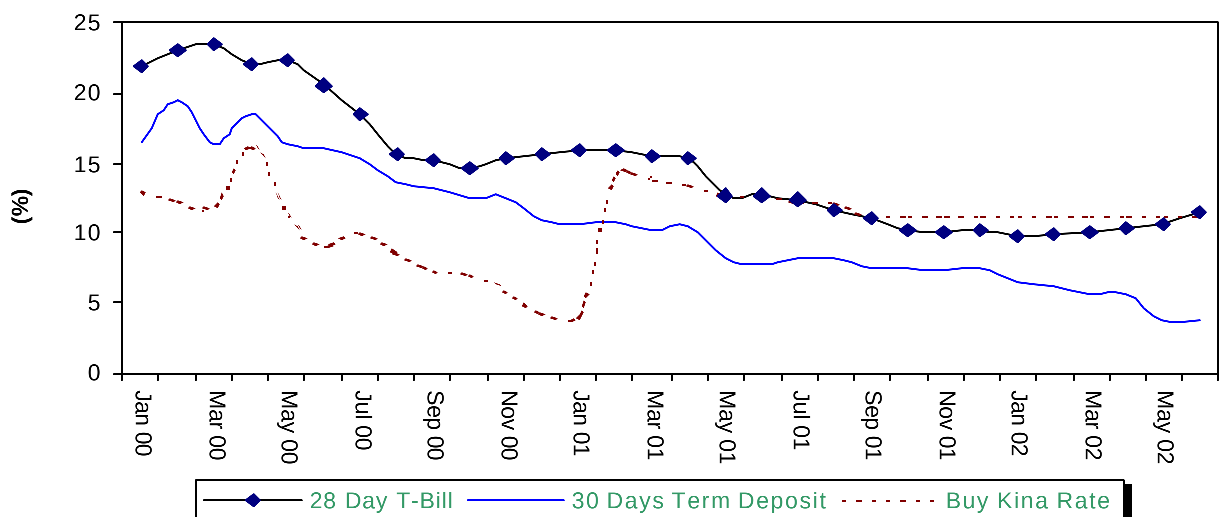
(f) Monetary and Financial Markets Developments

The Bank maintained a neutral monetary policy stance since September 2001 with the Kina Facility Rate (KFR) maintained at 12.00 percent up to July 2002. Although lending to the private sector by the commercial banks continue to decline and overall economic activity remained depressed, total Government expenditure increased significantly, which increased liquidity levels and exerted pressure on the exchange rate and underlying inflation. These factors weighed heavily on the decision to maintain the official interest rate at the current level.

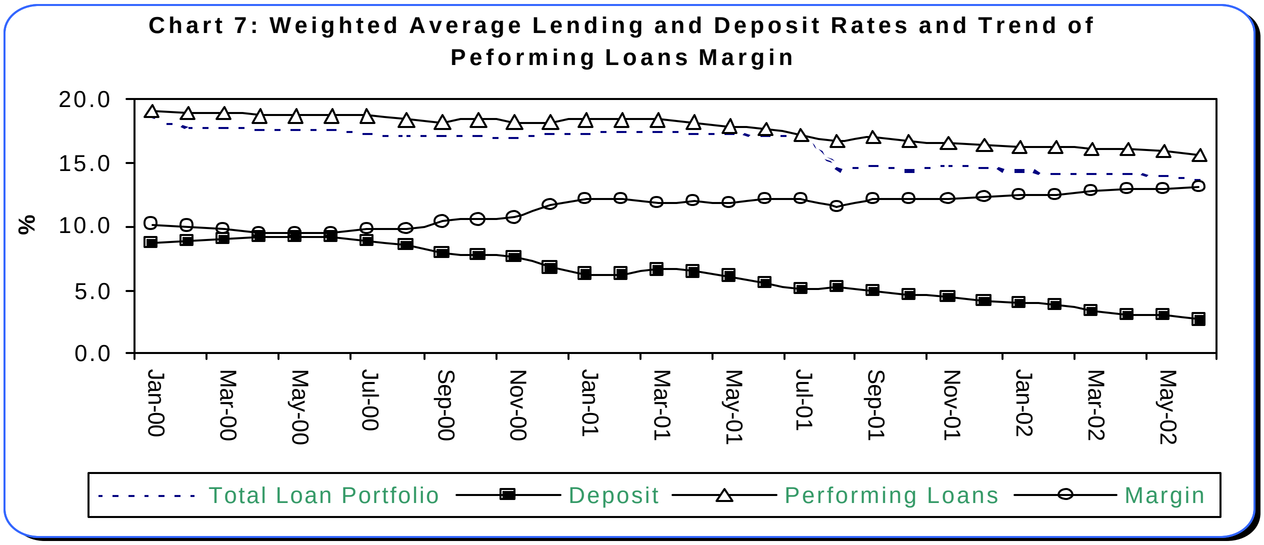
During the first half of 2002, total liquid assets of the banking system increased by 4.6 percent, mainly due to the following factors:

- High Government expenditures and cheque floats from 2001 financed by the draw down of deposits at the Central Bank, mainly during the March quarter of this year. The Government deposits were related to the extraordinary financing from the World Bank and Japanese Bank for International Corporation (JBIC), which were released in late 2001, following the successful conclusion of the SAP;
- Net new issuance of Government securities to finance the Government cashflow;
- Utilisation of the Temporary Advance Facility at the Central Bank to finance mismatches in the cashflow;
- The closure of the Tap Facility in January 2002; and
- Lower levels of lending to the private sector.

Chart 6: Weighted Average Interest Rates



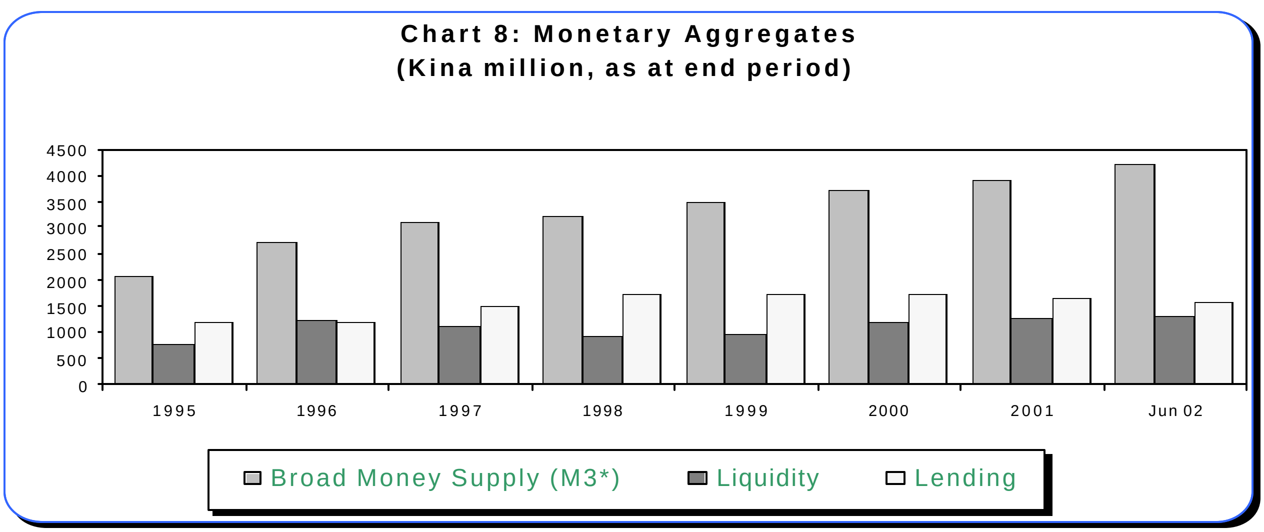
Source: Bank of PNG.



Source: Bank of PNG.

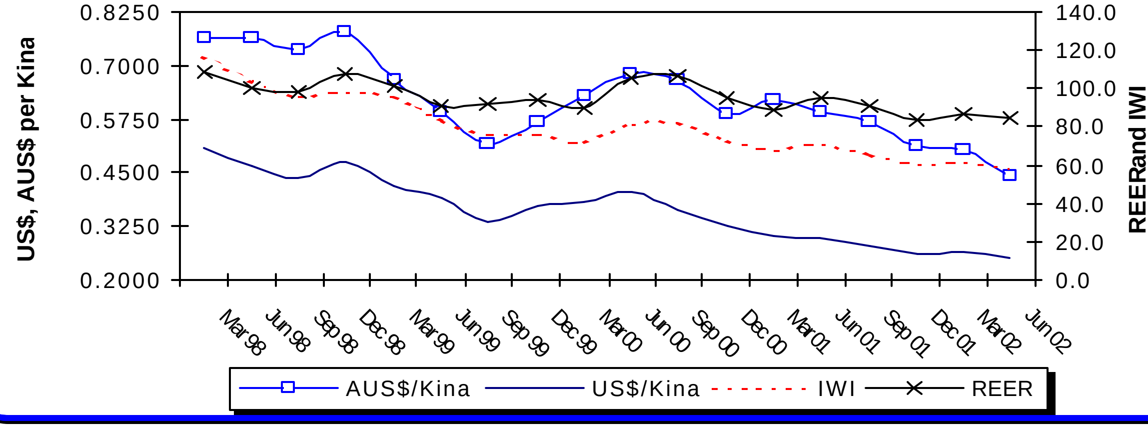
As a result of the increase in liquidity and reserve money, the weighted average deposit rate declined to 2.6 percent at the end of June 2002, from 4.1 percent at the end of December 2001 (see Chart 6). At the same time the commercial banks reduced their Indicator Lending Rates (ILRs) from 15.25 percent to a minimum of 13.75 percent over the first half of 2002. The decline in the ILRs can be attributed to the lagged nature of adjustment of the assets and liabilities of the banks to the changes in the KFR, and the lack of demand for credit by the private sector. This resulted in a decline in the weighted average lending rate of the commercial banks from 14.6 percent to 13.8 percent over the first six months of 2002 (see Chart 7). With the decline in the rates of return on both financial and non-financial assets, the commercial banks have maintained their interest rate spreads between lending and deposit rates to sustain maximum profitability, as reflected by the increasing trend in interest rate margin.

Consistent with the policy stance and to counteract the adverse impact of excess liquidity on the market interest rates and the exchange rate, the Central Bank utilised its indirect instruments to sterilise the excessive liquidity in the banking system. This involved increased sales of Treasury bills at the auction and higher volumes purchased under the Kina Facility to



Source: Bank of PNG.

Chart 9: Kina Exchange Rate against US$, AUS$, Import Weighted Index (IWI) and REER



Source: Bank of PNG.

diffuse the excess liquidity and sterilise the liquidity impact of the Tap Facility closure in January 2002. The high level of interventions by the Central Bank in the foreign exchange market to support the volatility in the exchange rate also contributed to this objective. These actions, combined with the net new issuance of Government securities to June 2002, contributed to the stabilisation of the declining trend in short-term interest rates of Government securities. In the second quarter of 2002, the 28 day Treasury bill rate increased to align with the KFR, which had diverged by 3.0 percentage points earlier. On the other hand, no changes were made to the Cash Reserve requirement (CRR) and Minimum Liquid Asset Ratio (MLAR).

Although the ILRs have fallen, lending to the private sector remains depressed, partly reflecting the crowding out by the Government's through a net new issuance of domestic debt, and lower investment level due to uncertainties relating to the outcome of the National Elections and lower demand for credit. If the Government repays it's domestic debt and returns to a sustainable fiscal deficit, then crowding out would diminish and credit to the private sector should grow.

The level of broad money supply (M3*) increased by 4.1 percent between December 2001 and June 2002 reflecting an increase in net foreign assets of the banking system, partly attributed to the effect of a lower exchange rate, combined with a substantial increase in net credit to Government (see Table 3). The growth in reserve money also reflected an increase in currency in circulation as individuals and political parties matured term deposits to fund election related expenses, while the cash holding and deposits of commercial banks with the Central Bank declined due to the tight liquidity strategy undertaken by the Bank.

Over the first half of 2002, the kina depreciated by 4.4 and 13.5 percent against the US and Australian dollars, respectively (see Chart 9). The Central Bank intervened in the foreign exchange market to smoothen out volatility in the exchange rate. The real effective exchange rate (REER) declined in the first half of 2002, reflecting the depreciation in the nominal exchange rate and the headline inflation outcome for the March quarter of 2002. However, the benefits to the export sector from the increase in competitiveness were offset by declines in international prices and structural impediments such as infrastructure, law and order and land tenure.

2. MONETARY POLICY

a) Monetary Policy Stance

The persistent growth in underlying inflation in 2001 and the March quarter of 2002, and the prospect for further increases in the remaining part of 2002, has had an important impact on the Bank's decision to maintain a neutral monetary policy stance. Despite the decline in economic activity and lending to the private sector, the following factors have also influenced the stance of monetary policy:

- A substantial increase in the Budget deficit equal to 2.0 percent of nominal GDP over the first six months of 2002;

- The significant increase in domestic financing of the Budget deficit;
- Significant growth in reserve money following increased Government expenditure and transactions demand for money, primarily relating to the National Elections;
- Continued decline in lending to the private sector, despite the reductions in the ILRs of the commercial banks, while the overall economy remains depressed. Real domestic lending rates still remain positive, while real deposit rates are negative;
- The increase in official interest rates of some of PNG's trading partners and prospect of increases in other countries as concerns for inflation re-emerged;
- The pressure on the exchange rate arising from a combination of sentiments related to the National Elections, a persistent deficit in the current account of the non-mineral private sector and increased Government expenditure; and
- Further delays in the draw down of the second tranche of the Public Sector Reform Program loan from the ADB.

Whilst there exists inflationary pressure fromincreased Government expenditure, businesses have been forced to accept lower price margins. Expectations of an increase in inflation remain high on the basis of historical experience and the depreciation of the exchange rate may lead to persistent inflation.

Section 13 (b) of the CBA 2000 requires the Governor to report to the Minister any developments that may threaten monetary stability, the formulation and implementation of monetary policy, and the achievement of financial and economic policies of the Government. Accordingly, the Central Bank advised the Government on the 6th of May 2002 to adjust and constrain expenditure to the level of revenue collections, and not to resort to further excessive domestic financing of the Budget. The Bank further advised that any fiscal slippages would negate the macroeconomic and price stability achieved, and may lead to a deterioration in public confidence in the Government's management of the economy.

On the 11th of July 2002, the Central Bank reiterated its earlier advice to the Government and strongly recommended that it severely limit new warrant issues for the remaining part of the year, in order to ensure prudent management of the Budget. The Bank also emphasised that excessive pressure on the exchange rate and upward movement in Treasury bills rates are a clear reflection of unsustainable expenditure levels. Further deterioration of the Budget could exacerbate the adverse monetary conditions and may lead to a financial crisis, as experienced in 1994 and 1999.

Consistent with the Bank's advice, it is imperative that the Government formulate a Supplementary Budget for 2002 that severely cuts expenditure over the remaining months of 2002, to restore fiscal responsibility and macroeconomic stability. The high level of expenditure to date is unsustainable. The Government must re-prioritise its expenditure in the 2002 Supplementary Budget to areas that can generate revenue and foster economic growth (see Box 2).

Table 3: Growth in Monetary and Credit Aggregates (percentages)

	2001	Jun' 2001 - Jun' 2002	Jan MPS 2002 (proj)	Jul MPS 2002 (proj)
Broad money supply	1.8	5.9	6.3	5.7
Reserve money	4.6	28.8	4.2	7.7
Private sector credit	-1.2	-10.9	8.7	-0.7
Net credit to Government	-27.5	29.7	28.3	2.7

Source: Bank of PNG.

BOX 2: FISCAL RESPONSIBILITY AND PRICE STABILITY

Excessive deficits generally lead to higher inflation as Governments use seigniorage – i.e., revenue obtained by the Government from the creation of money, thereby increasing the burden of debt for the nation's future generation. A budget deficit is not necessarily bad if the excess expenditures are used on areas like infrastructure building and structural reforms, which will benefit future generations. Therefore, there is a trade-off between high development expenditure and inflation.

Government spending is inflationary through domestic and imported price pressures. Under a floating exchange rate regime, if domestic financing is used to finance imports, it can lead to a rapid depreciation of the exchange rate. This creates an upward movement in domestic prices (e.g., wages) and ultimately leads to higher inflation. The depreciation is a double-edged sword. While it promotes competitiveness on one hand (e.g., export sector), it also increases the country's debt burden denominated in foreign currency, and expands future budget deficits.

Sound monetary policy by the Central Bank does not guarantee price stability. This is because monetary and fiscal policies are intrinsically linked through the budget constraint or domestic financing. The achievement of price stability is also dependent on the prudent conduct of fiscal policy.

Under a flexible exchange rate regime, excessive Government expenditure may fuel inflationary pressure, and lead to macroeconomic instability. This suggests that monetary policy alone has limited capacity to restore macroeconomic and price stability, as this requires a comprehensive policy package, including fiscal policy.

A prudent policy is to make necessary adjustment to expenditure and introduce a program of policy reforms with the aim of achieving a sustainable fiscal policy, which would foster economic growth. With comprehensive reforms, the non-mineral sector of the economy may grow. Freeing up resources for priority areas, in the face of declining revenues, will require a strong commitment to fiscal discipline, public sector reform and improved governance.

The monetary policy stance in the second half of 2002 will be largely influenced by the following factors:

- The reduction in uncertainties following the formation of the Government;
- The Government's commitment to fiscal consolidation, to reduce the Budget deficit. Such commitment would reduce the interest rate costs facing the Government;
- The continuation of the structural reform programs;
- The underlying inflation outcomes for the June and September quarters of 2002;
- The recovery in international commodity prices and producers' response to higher kina prices of Papua New Guinea's major exports;
- The timely draw down of the second tranche of the Public Sector Reform Program loan from the ADB; and
- The continued recovery of the world economy, and the Bank's response to such developments to contain further domestic inflation.

If the Government takes appropriate measures to contain expenditure in the 2002 Supplementary Budget, the expected growth in monetary aggregates is as shown in Table 3. The broad and reserve money are expected to increase significantly in 2002, as a result of the higher net credit to the Government. Accordingly, the annual percentage changes in underlying (CPI Exclusion-based) and headline inflation are expected in 2002 to be 11.8 and 11.2 percent, respectively, compared to the lower projections in the January MPS. The assumption on the Budget used for the monetary program is based on a deficit increasing to 3.0 percent of nominal GDP in 2002 from the original Budget deficit of 2.0 percent of nominal GDP. This is due to a continued increase in expenditure and shortfall in revenue in 2002. However, the Central Bank expects to counteract the growth in monetary aggregates using its open market instruments to mitigate the inflationary impulse that would otherwise arise.

For 2003 onwards, it is crucial for the Government to take a stern approach to reducing the size of the Budget deficit, a strong commitment to continue the structural reform programs and to strive for a balanced

BOX 3: TAP FACILITY

The Tap Facility was established in 1999 by the Central Bank to encourage the non-bank public to purchase Government securities in order to: increase the competition for funds; development of a secondary market for Government securities; act as a means of diffusing liquidity from the banking system; align deposit rates with Government securities; and provide real positive rates of return on savings.

However, over time:

- A significant proportion of the Central Bank's Treasury bill portfolio was sold to the public, which made monitoring difficult and administration of the facility cumbersome;
- As an increasing proportion of the Central Bank's Treasury bill portfolio was sold under the Tap facility, the volumes offered at the auction were lower than the maturities, which consequently resulted in declines in Treasury bill rates for all maturities; and
- It became increasingly difficult to make liquidity projections because of the large volume of transactions and the uncertainty arising from longer gestation period for encashment or rollover of Treasury bills.

Given the administrative difficulties the Tap Facility was temporary closed. The Bank expects to reopen it once the electronic registry system is established.

Budget. Without prudent measures taken by the Government commencing from 2002, and given the probability of yet another El-Nino episode in 2003, the potential for a financial crisis as experienced in 1994 and 1999 is high. This would damage the hard earned macroeconomic and price stability achieved.

b) Conduct of Monetary Policy

Whilst the six-monthly monetary policy objectives are stated in the previous section, the KFR will remain as an instrument for signalling the Central Bank's policy stance.

Reinforcing the KFR, daily liquidity is managed within the reserve money framework. Reserve money is defined as currency in circulation and the deposit of commercial banks with the Central Bank, and the level of liquid assets in relation to statutory requirements is an indicator of the banking system's capacity to finance new lending. The revised reserve money growth is 7.7 percent, compared to 4.2 percent from the January 2002 projections. The growth in reserve money is unlikely to impact on inflation, as the Central Bank will continue to use its open market instruments to sterilise any excess reserve money in the banking system. However, this must be supported by fiscal restraint by the Government.

To enhance the transmission mechanism of monetary policy, the Repurchase Agreement Facility (RAF) will be retained for daily liquidity management. However, transactions under the RAF will continue to be unsecured until the development of a new registry system is completed. With the completion of the new registry system, over-night and term repurchase and reverse-repurchase transactions involving exchange of cash for Government securities will be conducted between the commercial banks and the Central Bank.

The Treasury bill auction remains the main instrument for injecting and diffusing liquidity from the banking system (see Box 3). Following the closure of the Tap Facility in January 2002, an increasing number of non-bank institutions and individuals have participated in the auction, making the yields on Government securities more competitive. The Tap Facility is expected to reopen as soon as the electronic registry system is established. The Bank anticipates that the excessively large spreads between the lending and deposit rates will contract if the Tap Facility is reopened.

Consistent with the increased levels of liquidity in the banking system and the likelihood of further increases due to high Government expenditure, the Central Bank will retain the MLAR and CRR, and consider any changes to them over time.