
BANK OF PAPUA NEW GUINEA



**MONETARY POLICY STATEMENT
BY THE GOVERNOR OF
THE BANK OF PAPUA NEW GUINEA,
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PORT MORESBY

31 July 2003

OBJECTIVES OF THE CENTRAL BANK

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

- (a) to formulate and implement monetary policy with a view to achieving and maintaining price stability; and
- (b) to formulate financial regulation and prudential standards to ensure stability of the financial system in Papua New Guinea; and
- (c) to promote an efficient national and international payments system; and
- (d) subject to the above, to promote macro-economic stability and economic growth in Papua New Guinea.

Central Banking Act (CBA) 2000, Section 7

POLICY STATEMENTS

“The Governor shall, within one month of the coming into operation of this Act, and every six months thereafter, issue a policy statement setting out the monetary policy of the Central Bank to achieve and maintain price stability for the following six months.”

CBA 2000, Section 11, Sub-section 1

EXECUTIVE SUMMARY

In the January 2003 Monetary Policy Statement (MPS) the Governor announced the following for 2003:

- Inflation rate would decline to 9.0 percent;
- Private sector credit would increase by 4.8 percent;
- Net credit to the Government would decline by 13.7; and
- Net foreign assets would decline by 22.6 percent.

However, the inflation outcome for the March quarter was much higher than earlier anticipated due to significant increases in food prices, excises, increase in school fee and the feed through from the depreciation in the exchange rate in 2002. In order to combat the increase in inflation, the Central Bank increased the Kina Facility Rate (KFR) by 2.0 percent in aggregate to 16.0 percent, from 14.0 percent at the beginning of 2003. The tightening of monetary conditions and raising of interest rates contributed to the achievement of the following outcomes:

- An appreciation of the kina exchange rate from US\$0.2500 to US\$0.2885 on 30 July 2003;
- Reduced aggregate demand and therefore import demand, which prevented the pressure on the exchange rate; and
- Net accumulation of foreign exchange reserves from US\$342 million at the end of 2002 to over US\$372 million as at 30 July 2003.

However, private sector credit declined due to crowding out by the Government and lack of demand for credit resulting from low economic activity and high interest rates on loans. This is despite the high level of free liquidity reserves with commercial banks available for lending.

In the second half of 2003 inflation is projected to decline, and without risking the objective of price stability, the Central Bank revised its 2003 forecast as follows:

- Annual inflation rate is expected to be 13.8 percent;
- GDP growth is expected to be moderate, at around 2.4 percent;
- Net credit to the Government is expected to increase by 5.7 percent;
- Small growth in private sector credit of 1.1 percent is expected; and
- Net foreign assets are expected to decline by 3.6 percent.

The major risk of achieving the above forecast remains the fiscal discipline of the Government.

MONETARY POLICY STATEMENT JULY 2003

INTRODUCTION

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

1. DEVELOPMENTS IN THE FIRST HALF AND PROJECTED DEVELOPMENTS FOR 2003

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

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

(a) The World Economy

In the latest World Economic Outlook released in April 2003, the International Monetary Fund (IMF) forecasts growth in the world economy in 2003 to be 3.2 percent, which is 0.5 percent lower than its September 2002 projection. According to the IMF projections, economic activ-

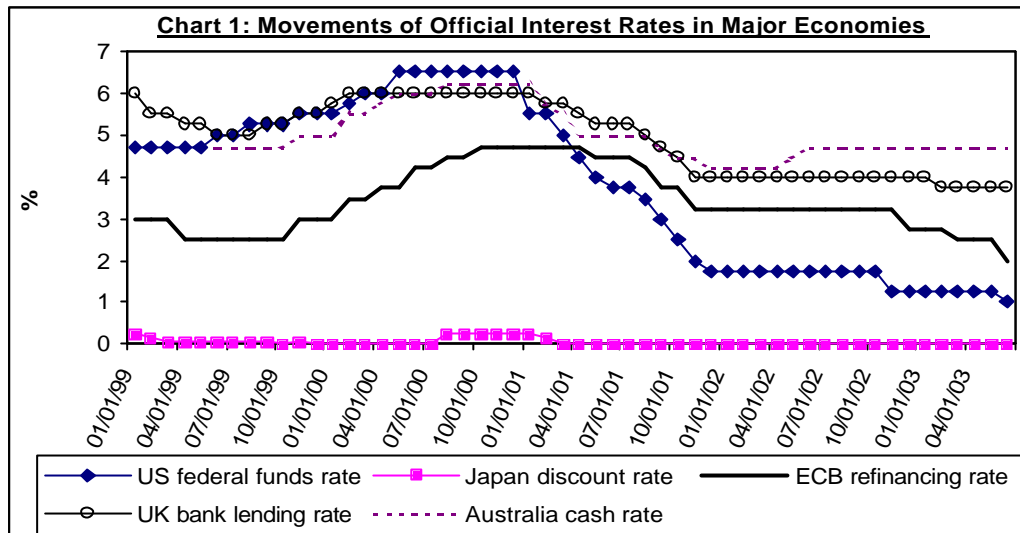
ity in 2003 is expected to increase following the global recovery in 2002. Growth in the United States (US) and the turnaround in Japan are expected to lead to an increase in global production and trade. However, the pace of recovery has slowed, mainly due to the uncertainties relating to the US led war on Iraq and the outbreak of the severe acute respiratory syndrome (SARS) virus. Real gross domestic product (GDP) is projected to grow by 2.2 percent in the US, by 2.0 percent in the United Kingdom (UK), by 1.1 percent in the Euro zone and by 0.8 percent in Japan. The emerging markets in Asia are expected to grow by 4.1 percent, while developing countries are expected to grow by 5.0 percent, with higher growth expected in all regions.

Global inflation is expected to remain low, with less than 2.0 percent increase in the industrial countries, and less than 6.0 percent increase in the developing countries. Most major Central Banks maintained accommodative monetary policy during the first half of 2003. The US Federal Reserve cut the federal funds rate by 25.0 basis points in June to 1.0 percent, while the Reserve Bank of Australia maintained the cash rate at 4.75 percent. In the UK, the Bank of England cut its interest rate in February by 25.0 basis points to 3.75 percent, whilst the European Central Bank reduced its rate to 2.50 percent in March, then a further 50.0 basis points reduction in June to 2.0 percent. The Bank of Japan (BoJ) maintained the interest rate at zero and announced further changes to stimulate monetary expansion (see Chart 1). Among the announced changes include the maintenance of an easy monetary policy, promoting financial system stability and improvement of financial and capital markets.

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 business to plan for long-term investment and development;
- Minimise volatility and price distortions;
- Provide the Government a foundation for stable revenue flows; and
- Potentially lead to a stable macroeconomic environment.



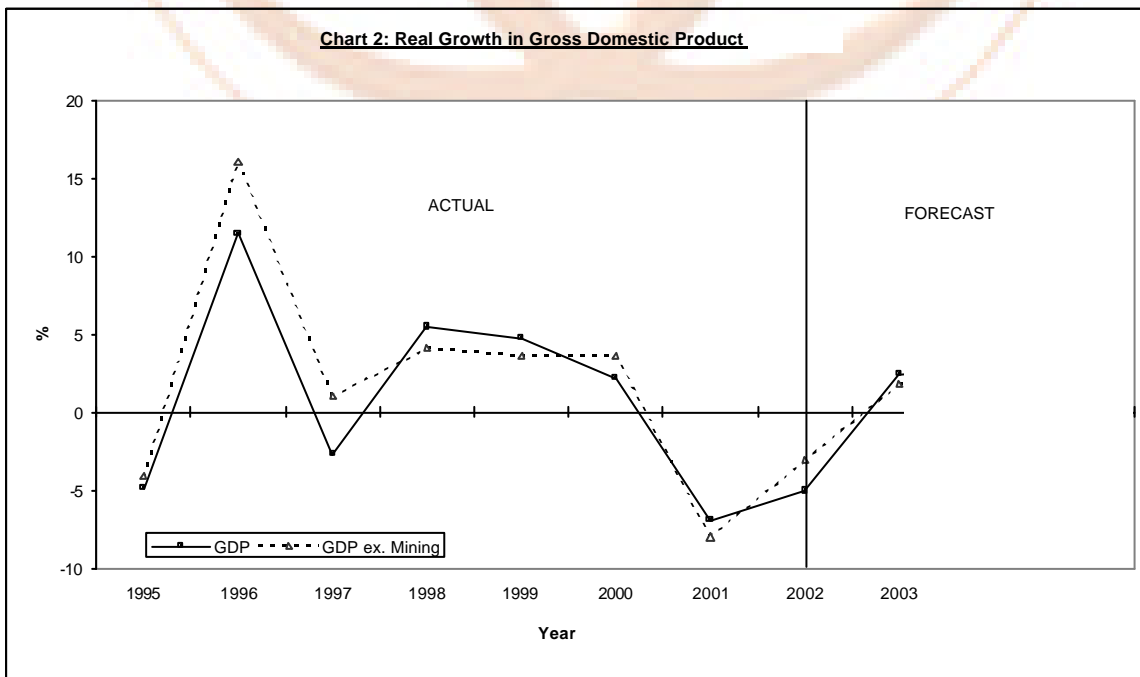
Source: Various Central Banks' websites and Reuters

Over the last six months, financial markets were influenced by the weakness in stock markets, the war in Iraq, and the weakness in the global economy. Equity markets have plummeted on the back of weak global demand, over production, saturated markets, lower profits and increased corporate debts. The value of the US technology sector, as measured by the US Nasdaq stock market index, is now half the level it was 12 months ago. Reflecting the weakness in the global stock market and accommodative monetary policy stance adopted by central banks, bond yields have declined to historical lows. In the foreign exchange market, the US

dollar weakened against the major currencies initially on the back of the decline in the US economy. In recent months, disinvestments from the US to other major financial centres has led to the euro appreciating to above par against the US dollar, while the Australian dollar has appreciated to a three year high of US\$0.66. Gold continued to benefit from global uncertainties and remained strong around US\$370 per ounce.

(b) Domestic Economic Activity

The Bank of PNG's preliminary assessment of



Source: Commodity Boards, Departments of Mining and Petroleum & Energy, PNG Power, Bank of PNG's BLS and Quarterly Economic Bulletin (QEB), and commercial banks' annual reports.

economic activity shows that the annual real growth rate of GDP is expected to be 2.4 percent, compared to the 2003 Budget projection of 1.8 percent. Excluding the mining and petroleum sector, real GDP is expected to grow by 2.1 percent (see Chart 2). The improved performance of the economy is primarily driven by the projected growth in the mineral sector of 6.7 percent, and the agricultural, forestry and fisheries sector of 2.2 percent. Higher prices of agricultural and mineral exports combined with increased production will fuel this forecasted recovery.

The recovery of the agricultural and mineral sectors is expected to spillover into other sectors of the economy. According to forecasts made by the private sector through the Business Liaison Survey (BLS) conducted by the Bank, steady growth in business activity is expected in the manufacturing, wholesale/retail, transportation, and finance sectors. Economic activity will be generated in the construction sector from work on the Napa Napa Oil Refinery and Wewak Tuna Processing projects, as well as continued major road maintenance work such as the Highlands Highway and other on-going infrastructure projects funded by international financial institutions and aid agencies.

(c) Balance of Payments

Actual to April 2003

Preliminary balance of payments data for the four months to April 2003 showed an overall deficit of K191 million, compared to a surplus of

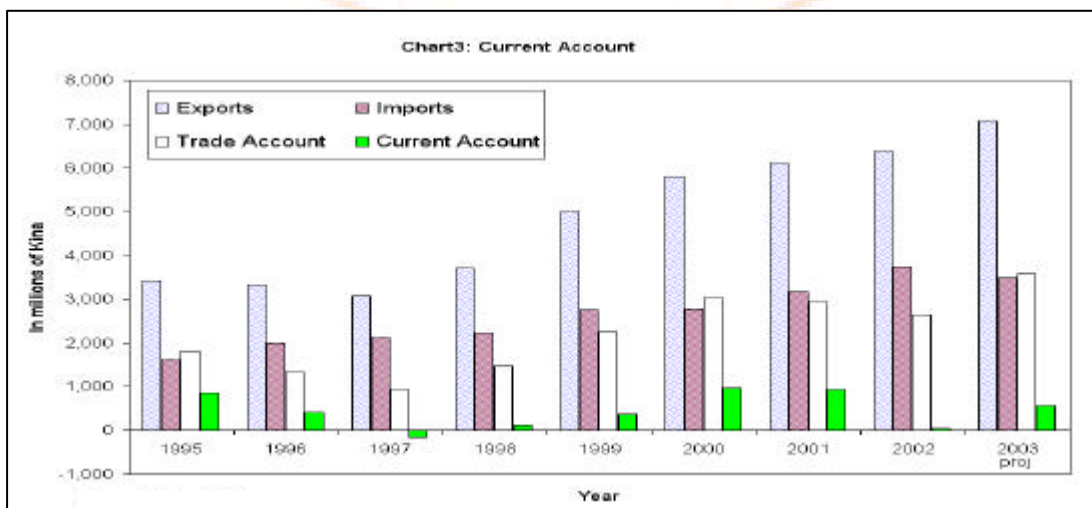
K77 million in the corresponding period of 2002. The surplus in the current account was due to a high trade surplus resulting from increased exports and lower imports, which more than offset higher net services, income and transfer payments. The deficit in the capital and financial accounts was due to a higher net outflow in the financial account reflecting an increase in foreign asset holdings in direct, portfolio, and other investments by resident companies. Foreign liabilities also declined, as a result of higher net loan repayments by the private sector and the Government.

The level of gross foreign exchange reserves at the end of April 2003 was US\$342.4 (K1,187.4) million, sufficient for around 4.3 months of total and 6.4 months of non-mineral import cover. As at 30 July 2003, the level of gross reserves was US\$372.3 (K1,286.8) million.

Revised 2003 Projection

Export volumes of most of PNG's major agricultural and mineral export commodities are projected to increase in 2003, with the exception of palm oil and rubber. The projected increases in export volumes are mainly in response to higher international prices. The projected increase in gold, copper and crude oil production are due to mining of higher ore grades, increased production, commencement of production from the Moran Petroleum Development Licence (PDL5) and higher production from the Gobe field, respectively.

The other main factors underlying the balance



Source: Bank of PNG

of payments projections for 2003 are that:

- The exchange rate will remain stable;
- The Asian Development Bank (ADB) Public Sector Reform Program (PSRP) loan will be drawn down in the last quarter of 2003;
- The repayments of the IMF loan were deferred from 2003 to 2004;
- There is no foreign currency component of asset sales;
- No new foreign loans will be obtained to fund the budgetary financing gap;
- A lower than budgeted loan draw down from concessional sources; and
- Exclusion of the gas pipeline and any new mineral projects.

Accordingly, the balance of payments for 2003 is projected to show a significant improvement with an overall deficit of K18 million, compared to a deficit of K239 million in 2002. This improvement reflects a higher surplus of K575 million in the current account, attributed to increases in production and prices for the major agricultural and mineral exports (see Chart 3).

The level of gross foreign exchange reserves for 2003 is projected to be US\$337.0 (K1,259.2) million, sufficient for 4.0 months of total and 6.0 months of non-mineral import cover.

(d) Fiscal Operations of the Government

Preliminary estimates provided by the Department of Treasury on the fiscal operations

of the National Government to May 2003 showed an overall surplus of K16.2 million, compared to a deficit of K141.9 million in the corresponding period of 2002, and represents 0.1 percent of projected nominal GDP (see Table 1). The surplus was primarily the result of higher revenue. Total revenue and grants amounted to K1,219.9 million during the five months to May 2003, compared to K1,017.6 million during the same period in 2002, while total expenditure was K1,203.7 million, K41.4 million higher than in the corresponding period in 2002.

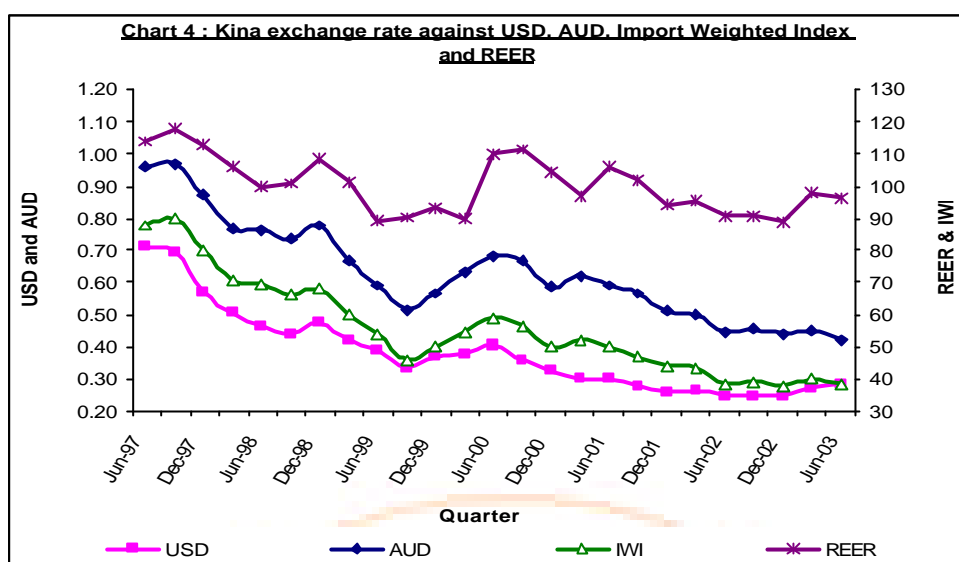
The budget surplus, combined with a net K104.6 million raised through the issuance of Treasury bills from domestic sources was used to finance net overseas loan repayment of K120.8 million.

The Bank's adjusted 2003 Budget scenario shown in Table 1 is based on the following assumptions:

- Overall budgeted expenditure will remain unchanged because higher domestic interest cost will be offset through cuts in other expenditure areas, including lower development expenditure as financing from concessional loans is expected to be lower than the budgeted level ; and
- Proceeds from asset sales as announced by the Government recently is expected to be around K120 million, and not K200 million as budgeted, with the shortfall to be financed through domestic borrowing.

| | 2001 | 2002 | 2003 Budget | Jan '03 MPS | Jul '03 MPS Adjusted Scenario | 2002 Jan -May | 2003 Jan -May |
|-----------------------------------|---------------|---------------|----------------|----------------|--|------------------|------------------|
| Total Revenue & Grants | 3184.8 | 3231.3 | 3489.9 | 3489.9 | 3489.9 | 1017.6 | 1219.9 |
| Total Expenditure | 3544.2 | 3681.5 | 3733.0 | 3734.0 | 3734.0 | 1162.4 | 1203.7 |
| Surplus/Deficit | -359.4 | -450.2 | -244.0 | -244.1 | -244.1 | -144.8 | 16.2 |
| % of GDP | -3.7 | -4.2 | -2.0 | -2.0 | -2.0 | -1.3 | 0.1 |
| FINANCING | | | | | | | |
| Net External | 241.9 | -126.6 | -135.3 | -78.1 | -375.8 | -128.7 | -120.8 |
| Net Domestic | 117.5 | 576.8 | 379.3 | 322.2 | 619.9 | 273.5 | 104.6 |
| Bank of PNG | -247.1 | 245.1 | | | | 228.0 | -32.0 |
| Commercial Banks | -12.1 | -124.9 | | | | 25.9 | 43.6 |
| Other Domestic Financing | 376.7 | 456.6 | | | | 19.6 | 93.0 |
| Asset Sale | 0.0 | 201.0 | 200.0 | 200.0 | 120.0 | 0.0 | 0.0 |

Source: Department of Treasury for Budget and actual, and Bank of PNG for adjusted 2003 scenario.



Source: Bank of PNG

Under this scenario, the level of domestic financing in 2003 is expected to increase to K620 million, compared to K379 million in the 2003 Budget. The large amount of domestic financing leads to continued high interest rates and crowding out of the private sector, which jeopardises the Government's Export Led Growth Strategy and worsens the prospects for economic recovery.

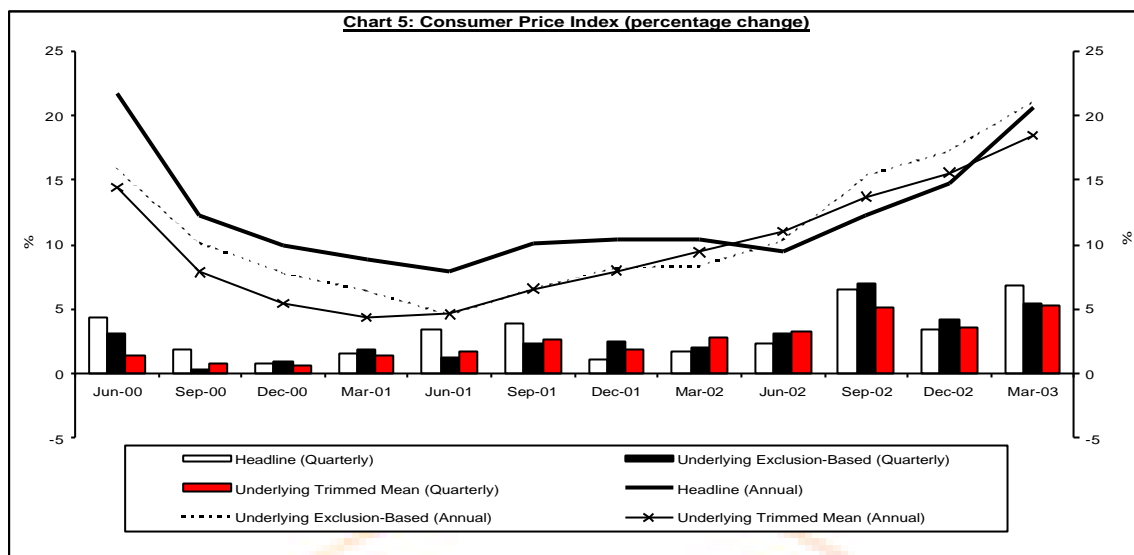
As at 25 July 2003 the Government has issued a net of K435 million in Treasury bills, which increased the total stock outstanding to K2,605 million. On the other hand, net Inscribed stock declined by K45.3 million to K238.6 million. This level of domestic debt, which represents 23.4 percent of GDP is high and unsustainable, and has diverted resources from achieving the development objectives of the Budget. In addition, total external debt outstanding at end March 2003 was K5,011.8 million. This level of total debt for the country is excessively high.

(e) Exchange Rate

Over the six months to June 2003, the kina appreciated by 13.3 percent against the US dollar, while it depreciated by 3.9 percent against the Australian dollar (see Chart 4). The improvement in the exchange rate against the US dollar reflected increased inflows from both mineral and non-mineral exports, and support by Central Bank action in the foreign exchange market. The development in the kina was also attributed to cross currency movements, in which the Australian dollar and other currencies strengthened against the US dollar, hence the depreciation of the kina against the Australian dollar. The real effective exchange rate (REER) increased in the first half of 2003, reflecting the appreciation in the nominal exchange rate and the higher than expected headline inflation rate for the March quarter of 2003. The improvement in the nominal exchange rate resulted from increased export receipts from agricultural commodities in response to an improvement in

| Inflation Measures | Actual | | | | | Forecast | |
|---------------------|--------|------|------|------|----------|----------------|----------------|
| | 1999 | 2000 | 2001 | 2002 | Mar 2003 | 2003 (Jan MPS) | 2003 (Jul MPS) |
| Headline | 13.2 | 10.0 | 10.3 | 14.8 | 20.7 | 9.0 | 13.8 |
| Underlying | | | | | | | |
| CPI Exclusion-based | 16.3 | 7.8 | 8.2 | 17.3 | 21.1 | 9.4 | 13.9 |
| CPI Trimmed-mean | 14.3 | 5.5 | 8.0 | 15.6 | 18.4 | 10.6 | 12.3 |

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



Source: NSO and Bank of PNG

international prices, combined with higher mineral sector inflows (For REER, refer July 2001 MPS, page 6).

(f) Inflation

Actual to March 2003

The annual headline inflation to March 2003 was 20.7 percent. The exclusion-based and trimmed-mean inflation rates were 21.1 and 18.4 percent respectively, to March 2003.

The high headline inflation outcome for the March quarter of 2003 was the result of a sharp depreciation in the kina, which reached its historical low during the second half of 2002. The downward movement in the exchange rate reflected lower export receipts, a high level of Government domestic borrowing that led to a significant monetary expansion through the maturity of Treasury bills held by the Central Bank, and higher outward remittances of current account transactions. High price increases for fruit and vegetables, increases in excise on cigarettes and tobacco introduced in the 2003 National Budget, significant upward adjustments on selected price controlled items such as kerosene, and increased school fees reflecting a reduction in Government education subsidies all contributed to the increase in CPI.

The upward trend in the annual underlying inflation rate, evident since the beginning of 2001, continued into 2003 as illustrated in Chart 5. Excluding the impact of the Value Added Tax

(VAT), the 20.7 percent annual headline inflation rate to March 2003 is the highest inflation rate recorded since 1998.

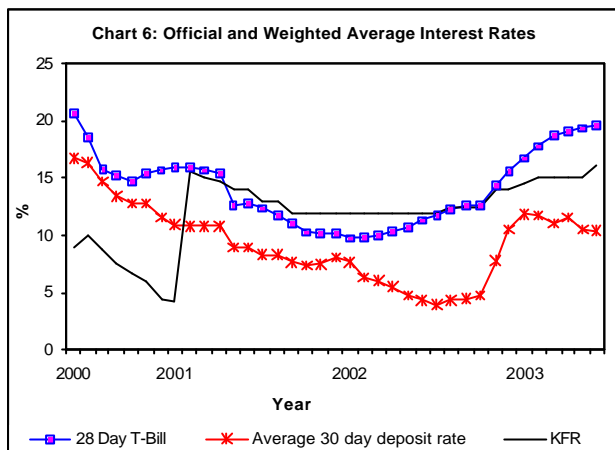
Revised 2003 Projections

The annual headline inflation forecast for 2003 has been revised upwards from the projection made in the January 2003 MPS of 9.0 to 13.8 percent. The exclusion-based and trimmed mean inflation rates have also been revised upwards for 2003 (see Table 2). The upward revision is because of the higher than expected inflation outcome for the March quarter, which is projected to remain high in the June quarter of 2003.

Inflation is still expected to trend downwards in the second half of 2003, because of the following factors:

- Stability in the exchange rate as a result of the continued favorable export receipts from the non-mineral sector. The kina has appreciated against the US dollar, while holding firm against the Australian dollar, since the beginning of the year.
- The tightening of monetary policy towards the end of 2002 and to date in 2003. Higher real returns on investments in Treasury bills have encouraged savings and curtailed capital outflows from PNG.

Despite the positive developments outlined above, the continued recourse to domestic borrowing by the Government may add



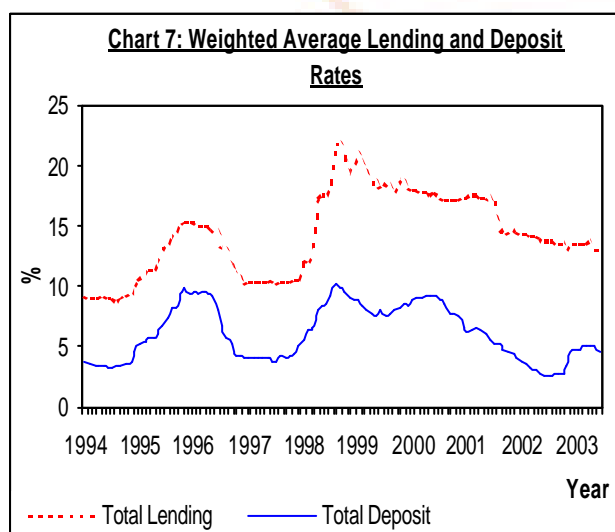
Source: Bank of PNG

pressure on the exchange rate and fuel inflation, if it is not fully sterilised by the Central Bank using its monetary instruments.

(g) Monetary and Financial Market Developments

The Central Bank maintained a tight monetary policy stance during the first half of 2003. As a result, the Bank increased the KFR by 2.0 percentage points in aggregate from 14.0 percent in December 2002 to 16.0 percent in June 2003 (see Chart 6). The stance of monetary policy was influenced by the increase in inflation in the March quarter of 2003 and the continuous high domestic borrowing by the Government to finance the 2003 Budget.

Over the six months to June 2003, total liquid assets of the commercial banks decreased by 5.2 percent, following a decline of 20.3 percent in the second half of 2002. The decline in liquid



Source: Bank of PNG

assets of the commercial banks was attributed to:

- The maturing of Government securities by commercial banks to meet foreign exchange obligations, including forward cover maturities; and
- An increase in holdings of Government securities by the non-bank private sector, which resulted in a decline in deposits with the commercial banks.

The weighted average deposit rate, which increased sharply in the second half of 2002, remained stable between 4.7 percent in December 2002 and 4.6 percent in June 2003. The weighted average lending rate on total loans also remained stable between 13.7 percent in December 2002 to 13.1 percent in June 2003, reflecting lending to prime customers with low credit risk and an increase in non performing loans (see Chart 7). Overall the spread between the lending and deposit rates remained wide between 9-10 percent during the period. The commercial banks' Indicator Lending Rate (ILR) remained at 13.25 to 15.00 percent in the first half of the year. Nonetheless, the 28-day Treasury bill rate increased from 15.48 percent in December 2002 to 19.59 percent in June 2003 (see Chart 6 & Box 2), reflecting the increase in demand for domestic financing of the Government's 2003 Budget.

Lending to the private sector declined reflecting the crowding out through continued high borrowing by the Government from the domestic banking system, and partly due to low economic activity. Credit extended by commercial banks was mainly for trade financing, but was offset by higher loan repayments, which resulted in the decline in outstanding advances.

The Central Bank continued to support its monetary policy stance by tightening liquidity conditions through the use of open market instruments. However, continued reliance on domestic financing by the Government crowded out sale of Treasury bills from the Central Bank's portfolio. This led to a significant maturity of Treasury bills to the public, which resulted in net injection of liquidity into the banking system, increases in interest rates on Treasury bills and the Bank's unsold stock, from K470 million to

BOX 2: High Government Borrowing and Interest Rates

The main reason for the high level of nominal interest rates on Treasury bills in PNG is because the Government continues to borrow excessively from the domestic market to finance the 2002 and 2003 Budgets. Whilst the Treasury bills interest rates have increased the commercial banks' indicator lending rates (ILRs) or base lending rates have remained unchanged between 13 and 15 percent for the last six months, consistent with the movement in the Central Bank's policy interest rate, the Kina Facility Rate (KFR), which has remained unchanged at 15 percent until June 2003 when it was raised to 16 percent. It is important for the public to appreciate that the Bank of PNG's policy interest rate is but one factor influencing Treasury bills and other market interest rates. Other factors that can influence interest rates include changes in perceptions of risk and inflation expectations by the public.

High interest rates are aimed at encouraging investors to retain their funds in PNG and avoid "Capital Flight", which would otherwise put pressure on the kina. The impact of the substantial depreciation of the kina in the second half of 2002 was evident in the high inflation rate recorded in the March quarter of 2003. If the Bank had not increased interest rates and used its international reserves to support the fall in the kina value, the inflation rate would have been much higher.

Since the Government is competing with the private sector for funds to finance its expenditures, this may

have crowded out private sector demand for credit. On the other hand, there has consistently been more than sufficient level of free liquidity within the banking system for lending to the public if there were feasible project proposals at all, but overall lending continued to fall. This crowding out by high Government financing needs may thus be adversely affecting the Government's Export Led Growth Strategy, which relies on private sector participation and investment. Furthermore, the debts accumulated by the Government over previous years for financing of excessive expenditure in non-productive areas are a legacy that the Government is leaving for the future generation of PNG to repay. Consequently, the high cost of domestic borrowing has taken up a large portion of recurrent expenditures, at the expense of development expenditures. If this trend continues with expenditure not directed to the productive areas, the economy would not be able to sustain any future impact of external and domestic shocks on Government operations, such as its revenue generation capacity, and may lead to a credit and financial crisis.

An appropriate fiscal strategy is for the Government to live within its means and finance its expenditure from internal revenue rather than through debt financing. This would reduce any risks of a financial crisis, improve public confidence on the management of the economy, and facilitate a reduction in interest rates, which is necessary to support private sector investment and the Government's "Export Led Growth Strategy".

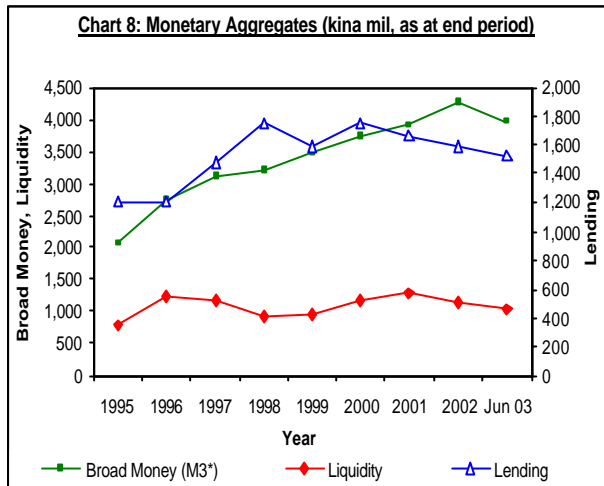
K529 million between December 2002 and 25 July 2003. The Central Bank undertook the following changes to its Open Market Operations (OMO) for effective liquidity management:

- Re-opening of the Tap Facility for Treasury bills in January 2003, with the removal of the limit on the maximum purchase amount;
- Closure of the weekly Kina Facility (KF) and the subsequent introduction of the term Repurchase Agreement Facility (RAF);
- Increase in RAF dealing margin from 100 to 150 basis points from the KFR on both sides of the market; and
- Changes to the Treasury bill auction

process, which includes the option to buy unsuccessful bids at the non-competitive rate based on the weighted average of accepted bids.

There were no changes made to both the Cash Reserve Requirement (CRR) and the Minimum Liquid Asset Ratio (MLAR), which were maintained at 5.0 and 25.0 percent, respectively.

The level of broad money supply (M3*) declined by 6.9 percent between December 2002 and June 2003, as a result of a decline in net foreign assets of the banking system, combined with decreases in credit to official entities, private sector and non-monetary financial institutions (see Chart 8). The decline in reserve money in



Source: Bank of PNG

the first half of the year reflected lower deposits of commercial banks with the Bank of PNG and currency in circulation.

2. MONETARY POLICY

Monetary Policy Stance

Persistent growth in underlying and headline inflation rates, and the risk for higher future inflation were the immediate factors that influenced the Central Bank's decision to tighten monetary conditions. The other factors, which heavily influenced the Central Bank's decision to tighten its monetary policy stance in the first half of 2003 were:

- The significant increase in financing of the Budget from domestic borrowing;
- The crowding out of the Central Bank in the Treasury bill auction by the Government, which has forced the Bank to mature bills, thereby injecting liquidity into the banking system and constrained its flexibility in the management of monetary policy;
- The need to maintain real interest rates to encourage residents to purchase domestic assets instead of investing offshore. In addition, positive real interest rates are necessary to suppress aggregate demand, reduce the demand for imports and maintain stability in the exchange rate to contain inflationary pressures;
- Continuous delays in the draw down of

- the PSRP loan from the ADB; and
- The uncertainty of the timing of asset sales by the Government.

Although the Central Bank took a cautious approach towards raising interest rates due to depressed aggregate demand, the increased demand for domestic financing of the 2003 Budget led to a faster increase in the Treasury bill rates (see Box 2), which caused a misalignment with the KFR.

Section 13 (b) of the CBA 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 Prime Minister and Economic Ministers on the consequences of high budget deficits on macroeconomic conditions and the Bank's objective of price stability. The Bank also emphasised the need to constrain expenditure, reduce domestic borrowing and seek immediate external funding in the short term. In the medium term the Bank emphasised the need for the Government to aim for a balanced budget, support the Government's Export Led Growth Strategy by re-directing expenditure to productive areas, and continue with the structural reforms that will lead to greater economic efficiency.

The revised monetary program for 2003 is based on several major assumptions:

- The 2003 Budget deficit will be financed from domestic sources, with the exception of the ADB loan for the PSRP;
- Only K120 million of asset sales are likely to be realised from the budgeted amount of K200 million;
- The shortfall in asset sales will be met through borrowing from domestic sources; and
- There will be no reduction in expenditure due to the significant increase in domestic interest cost. However, as debt service payments have first call on revenue, expenditure in other key areas will be lower than the budgeted levels.

In the second half of 2003, the prospects for lower inflation and macroeconomic stability may create an environment for the Central Bank to ease monetary policy, whilst maintaining the focus on price stability. However, the major risk to easing monetary conditions and maintaining price stability in the second half of the year remains the fiscal operation of the Government. Further fiscal slippages and continued recourse to domestic borrowing may erode the recent stability in the exchange rate, and make the conduct of monetary policy difficult. Accordingly, the Central Bank will take a cautious approach, and if necessary tighten monetary conditions in order to maintain the objective of price stability.

The monetary policy stance in the second half of the year will depend on the following factors:

- The inflation outcome. Although, inflation is expected to edge lower, continued financing of the Government's Budget deficit through domestic borrowing may give rise to serious credit risk issues;
- The stability in the exchange rate depends on the sustained improvement in the supply response to the high international commodity prices, the ability of the Government to restrain expenditure, the public's perception on the management of the economy and the ability of the Central Bank to maintain real interest rates to prevent any capital outflow. Improved export performance is a key element in ensuring exchange rate stability and the maintenance of a sustainable level of international reserves; and
- Achieving the 2003 Budgetary financing target, including the draw down of the ADB PSRP loan, the privatisation of state assets to improve economic efficiency and prioritising expenditure towards productive areas that will generate maximum returns in future.

Under these conditions the revised monetary and credit aggregates are expected to develop in 2003 as shown in Table 3. As a result of the projected high growth in net credit to Government, the level of credit to the private sector in 2003 is expected to remain low with a growth of 1.1 percent. If the net domestic

financing of the Government continues to increase, lending to the private sector may decline significantly and severely affect the Government's Export Led Growth Strategy. The level of net foreign assets is projected to decline due to large debt service payments by the Government, despite the net accumulation of reserves by the Central Bank in recent months. Consistent with these developments, the Central Bank expects to constrain the growth in reserve money and broad money.

The Central Bank will continue to monitor developments in the key macroeconomic indicators and if the assumptions that underpin the downward trend in inflation hold, the Central Bank will be able to gradually and cautiously ease monetary policy in the remaining part of 2003.

Conduct of Monetary Policy

The KFR will remain as an instrument for signaling the Central Bank's stance of monetary policy and any change to the KFR will be announced each month. Reinforcing the KFR, daily liquidity is managed within a reserve money framework. Reserve money is defined as currency in circulation and the deposits of commercial banks with the Central Bank. The level of liquid assets in relation to statutory requirements is an indicator of the banking system's capacity to finance new lending. Reserve money is projected to decline by 2.4 percent in 2003. The change 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 liquidity in the banking system. However, this must be

Table 3: Percentage changes in Monetary and Credit Aggregates

| | 2002 | Jun '02 - Jun '03 | Jan MPS 2003 | Jul MPS 2003 |
|--------------------------|------|----------------------|-----------------|-----------------|
| Broad money supply | 9.7 | -5.0 | 9.3 | 3.1 |
| Reserve money | 17.3 | 0.2 | -5.7 | -2.4 |
| Private sector credit | -4.6 | -3.5 | 4.8 | 1.1 |
| Net credit to Government | 82.0 | 41.0 | -13.7 | 5.7 |
| Net foreign assets | -0.9 | -21.9 | -22.6 | -3.6 |

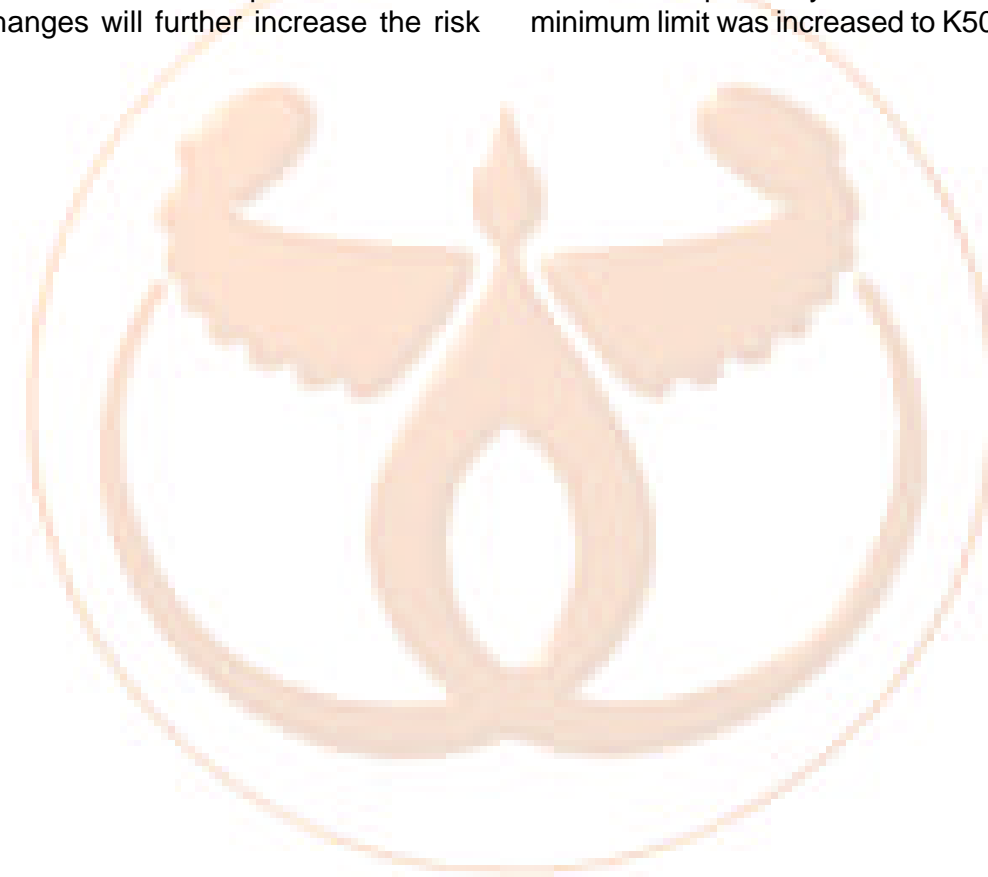
Source: Bank of PNG

supported by fiscal restraint by the Government.

To enhance the transmission mechanism of monetary policy, the RAF will be retained for daily and weekly liquidity management. Transactions under the RAF will continue to be unsecured until the development of a new registry system for Government securities is completed. The Treasury bill auction remains the main instrument for injecting and diffusing liquidity from the banking system. The Bank of PNG is planning to implement further changes to the Treasury bill auction process to ensure no further maturing of Treasury bills from its portfolio, and avoid a build up in unsold stock. These changes will further increase the risk

premium paid on the issuance of Treasury bills by the Government, and enable the Central Bank to actively participate in the auction to achieve its liquidity management objective.

Following the re-opening of the Tap Facility on 16 January 2003, an increasing number of non-bank institutions and individuals have participated in the auction, making the yields on Government securities more competitive. To avert administrative problems associated with the large volume of Tap participants and to encourage investment in Treasury bills by the general public, the upper limit on purchases under the Tap Facility was removed and the minimum limit was increased to K50,000.



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