



**BANK OF PAPUA NEW GUINEA**

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

**PORT MORESBY**

31 July 2008

*Queries on the contents of the Monetary Policy Statement (MPS) should be directed to the Manager, Economics Department on telephone number (675) 3227311 or Manager, Monetary Policy Unit on telephone number (675) 3227312, or both on fax number (675) 3200757. Copies of the Statement can be obtained from the Economics Department and is also available on the Bank's website: <http://www.bankpng.gov.pg>. It will be reproduced in the June 2008 issue of the Quarterly Economic Bulletin (QEB).*

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## Objective of Monetary Policy

The objective of monetary policy in Papua New Guinea (PNG) is to achieve and maintain price stability. This entails low inflation supported by stable interest and exchange rates. The maintenance of price stability leads to:

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

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## Executive Summary

Based on the high inflation outcome in the March quarter of 2008 and expectations that inflation will be higher for the year, the Bank of Papua New Guinea (Bank) tightened its monetary policy stance in June 2008 by increasing the Kina Facility Rate (KFR) to 6.25 percent from 6.0 percent. Annual headline inflation was 7.5 percent in the March quarter. The outcome was due to higher imported inflation resulting from increases in international oil and food prices and depreciation of the kina against the Australian dollar. Domestic factors including faster growth in monetary aggregates, higher Government spending emanating from the 2006 and 2007 Supplementary Budgets, the second round effect of fuel price increases on goods and services and higher aggregate demand also contributed to the outcome.

Whilst external sources of inflation such as international oil and food prices are beyond the authorities' control, prudent management of fiscal and monetary policies is important to help contain domestic demand. On its part, the Bank issued additional Central Bank Bills (CBBs) to absorb excess liquidity and prevent interest rates from falling and also intervened in the foreign exchange market to allow the kina to appreciate against the US dollar in the first half of 2008. But these were not enough to contain the inflation that is largely driven by external sources.

Inflationary pressures are expected to remain strong throughout the remainder of 2008. The Bank will pursue a tightening monetary policy stance in 2008.

This stance is based on the following expectations for 2008:

- Inflation of around 9.0 percent;
- Credit growth to the private sector to continue; and
- Real Gross Domestic Product (GDP) growth rate to be 7.6 percent.

The upside risks to the inflation expectation will arise from: further increases in international oil and food prices, higher imported inflation from PNG's major trading partner countries, depreciation of the kina exchange rate against the currencies of PNG's major trading partner countries, higher growth in monetary aggregates, increases in wages, further increases in Government expenditure and fast drawdown of trust account funds, increase in aggregate demand, and other unforeseen external and domestic shocks.

The return to price stability requires close coordination between the Government and the Bank. In this respect, the Bank will assess these developments and their potential effects on restoring price stability, and make appropriate adjustments to the stance of monetary policy in 2008 and over the medium term.

## 1.0 Monetary Policy Discussions

### 1.1 Monetary Policy Assessment and Issues

The high inflation outcome for the March quarter<sup>1</sup> of 2008 and expectations of continued inflationary pressures prompted the Bank of Papua New Guinea to tighten monetary policy after maintaining a neutral stance since September 2005. Hence, the KFR was increased by 25 basis points to 6.25 percent in June 2008.

Annual headline inflation was 7.5 percent in the March quarter. The outcome was due to higher imported inflation resulting from increases in international oil and food prices (*see Box 1*) and

depreciation of the kina against the Australian dollar. Domestic factors including the fast growth in monetary aggregates, higher Government spending from the 2006 and 2007 Supplementary Budgets, second round effect of fuel price increases on goods and services and higher aggregate demand also contributed to the outcome. Inflationary pressures are expected to remain strong throughout 2008.

The kina depreciated against the Australian dollar by 2.3 percent to A\$0.3906 at the end of June 2008 from December 2007. This added to inflationary pressures as Australia is a major source of PNG's imports. However, against the US dollar, the kina appreciated by 6.7 percent to US\$0.3760, which

#### **Box 1: Causes of high international food and fuel prices and their pass-through to inflation in the domestic economy**

High international fuel and food prices have contributed strongly to rising global inflation over the last couple of years and especially in 2008<sup>1</sup>. These high prices have largely been due to imbalances between supply and demand.

##### Causes

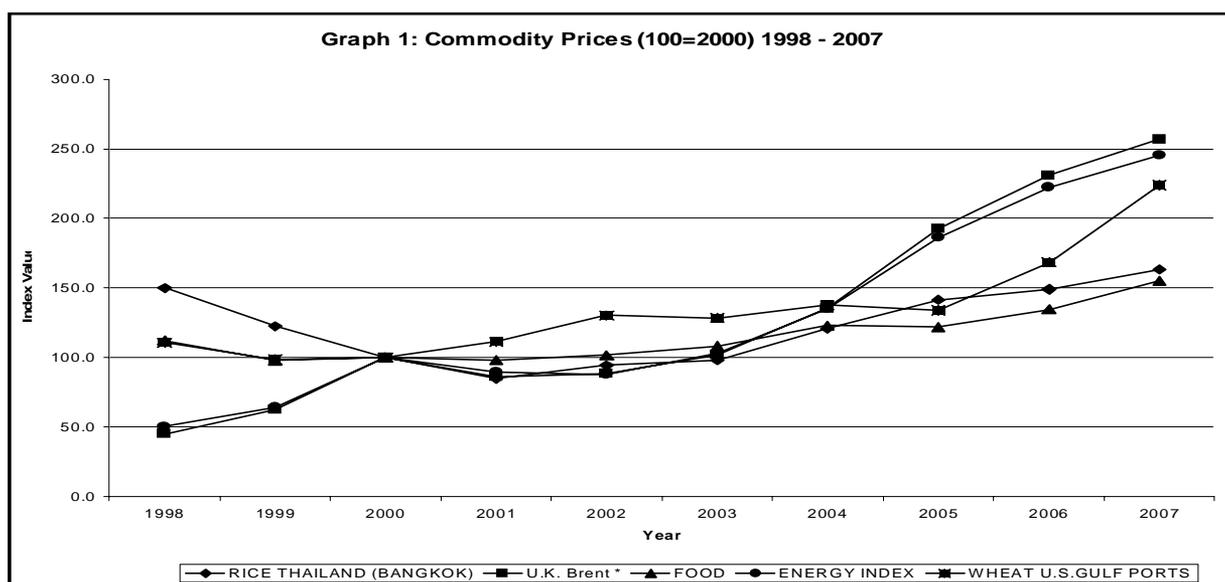
The high growth rates of emerging and developing economies such as China and India have fueled the increased demand for fuel, base metals and food products. The nature of growth in these economies is commodity-intensive with fuel for production, base metals for manufacturing and construction and food for consumption. Demand has grown tremendously, but due to supply constraints, prices have risen sharply.

Global demand for oil has caught up with supply after a long period of spare capacity. The supply response to this increased demand has been slow due to geo-political factors, high investment costs, technological, geological and policy constraints, which include OPECs reluctance to increase supply. The geo-political factors due to instability in the Middle East, the nationalisation of oil assets in Venezuela

and the tension in Nigeria have all contributed to the shortfall in oil supply.

Financial market developments, such as falls in key central banks' policy interest rates have fuelled speculation and the depreciation of the U.S. dollar allowing investors to switch away from money market instruments to commodity futures. These have contributed to upward price pressure over the last year.

Similarly for agricultural crops, supply levels have not kept up with rising demand in recent years. In addition, unfavourable weather conditions in the major wheat, rice and corn producing countries in 2007 caused lower harvests and led to rising prices. Rising bio-fuel production, induced by higher oil prices and generous policy support, has resulted in reduction in food supply and caused their prices to rise. Substitution effect has also led to higher demand and prices for other food crops. Moreover, there have been adoptions of trade policies to raise domestic food supplies and lower domestic prices. This has resulted in lower exports from major food producers, putting upward pressure on world prices. These factors have not only pushed up corn, rice and other



Source: International Monetary Fund (IMF)

<sup>1</sup> In Papua New Guinea's case, high prices for the country's export commodities, which have been experienced recently, also contribute to inflationary outcomes through their strengthening effect on domestic demand.

<sup>1</sup> March quarter inflation outcomes became available in May 2008.

**Box 1 continued.....**

food prices but also, to a lesser extent, meat and poultry products.

**Pass-through to inflation in the PNG Economy**

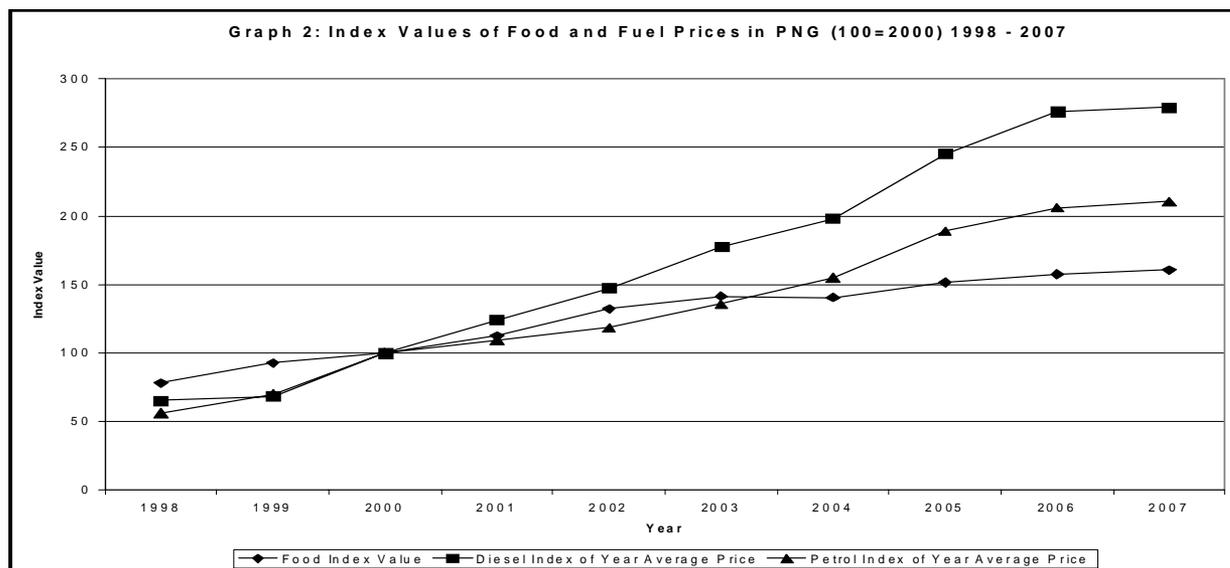
Papua New Guinea is a small open economy and is vulnerable to financial and economic developments in the rest of the world. Food and fuel products constitute a major share of PNG's consumption basket. High international prices of oil mean that prices of imported fuel and refined fuel products from the domestic oil refinery will increase as they are priced at import parity price ex-Singapore. As a result, the prices of fuel products such as petrol at the pump-stations will rise. This is referred to as the first round effect of oil price increase and is due to an external shock over which PNG has no control. The first round effect has both imported inflation and exchange rate components.

The second round effect of the oil price rise is realised when the buyers of the fuel products face a rise in the cost of their operations and have to increase the prices of their goods and services for consumers. For example, when farmers take their goods to the market during a period of oil price increases they have to pay more for transportation freight and passenger fare. The farmers are then forced to increase their prices at

the market place to make up for the extra costs that are incurred. Similarly, because of the higher prices employees will demand higher wages which increases the cost of production and demand leading to an increase in prices.

International food prices impact on prices for the imported food products directly. Imported flour and rice are all susceptible to international prices. When the retailer is charged higher prices by the supplier it must at some point pass these higher prices onto the consumer. For example, poultry products become more expensive during these times as chickens are fed on stockfeeds whose prices are based on international food prices.

Graphs 1 and 2 show that prices of food and oil based products on international markets and markets in PNG have followed a similar trend since 1998. Food and oil based products, that are susceptible to high international food and fuel prices constitute a large portion of the weighting to sub-groups and groups that have a large weight in the CPI basket. For example, the 'cereals' sub-group, which consists of commodities whose prices are subject to movements in international prices for rice and flour contribute 10.0 percent to the total CPI outcome. As a result, increasing international food and fuel prices can contribute to CPI inflation.



reflected increased foreign exchange inflows and Central Bank intervention to help dampen inflationary pressures.

Interest rates remained low due to the high level of liquidity in the banking system. The low interest rate environment combined with a fiscal surplus and improved business confidence led to the continuation of the strong growth in lending to the private sector by other depository corporations (ODCs)<sup>2</sup>. The increase in lending enabled the private sector to continue to expand business activity and increase employment in the first half of 2008. This contributed to the increase in domestic demand and inflationary pressures.

Despite the low interest rate environment compared to Papua New Guinea's substitute financial markets and the liberalisation of the capital account in September 2007, there was no significant capital outflow and downward pressure exerted on the exchange rate. This is due to the low level of portfolio investment and the shallowness of the domestic capital market. As an alternative form of investment, the growth in the domestic capital market was reflected by the high turnover at the Port Moresby Stock Exchange (POMSoX) in the first half of 2008.

Annual growth in broad money supply (M3\*) and the monetary base were 27.5 percent and 33.2 percent, respectively, over the year to June 2008.

<sup>2</sup>As of June 2006, the Bank adopted the new International Monetary Fund (IMF) reporting format for Monetary and Financial Statistics, which extended the coverage to include financial institutions other than the Central Bank and commercial banks. Refer to the June 2006 Quarterly Economic Bulletin (QEB) for details.

The growth in broad money supply was accounted for by an increase in the net foreign assets of the Central Bank and net claims on the private sector by ODCs. To diffuse excess liquidity from the banking system and address concerns of inflationary pressures, the Bank issued new CBBs totalling K1.4 billion over the first six months of 2008. Since its introduction in September 2005, the level of CBBs outstanding reached K4.0 billion as at 25<sup>th</sup> July 2008.

Preliminary estimates of the Government's fiscal operations recorded a surplus of K317 million during the five months to May 2008. However, recurrent expenditure increased by 31.5 percent in the first five months of 2008 compared to the corresponding period in 2007, due to frontloading of warrants in January 2008. While the Bank endorses the achievement of fiscal surpluses by the Government, the fast pace of increases in recurrent expenditure and drawdown of trust account funds, can contribute to aggregate demand and inflationary pressure.

Excluding foreign grants, there was a marginal increase in development expenditure, reflecting the ongoing capacity constraints of implementing agencies. It is important that the Government addresses this problem to enhance service delivery and ensure sustained economic growth.

The growth in the monetary aggregates and recurrent expenditure has contributed to the higher than expected inflation outcome and forced the Bank to tighten monetary policy. The Bank will closely monitor the changes in the monetary aggregates and recurrent expenditure and continue its close coordination with the Government, where necessary, to restore price stability which will assist in enabling continued economic growth.

## 1.2 Monetary Policy Stance

Based on the high inflation outcome in the March quarter of 2008 and expectations that inflation will be higher for the year, the Bank will pursue a tightening monetary policy stance in 2008.

This stance is based on the following expectations for 2008:

- Inflation of around 9.0 percent;
- Credit growth to the private sector to continue; and

- Real GDP growth rate to be 7.6 percent.

The Bank expects broad money supply to grow by 20.7 percent and the monetary base by 16.3 percent in 2008. The increase in broad money supply is mainly due to the projected growth in the net foreign assets of the Central Bank and private sector credit. If private sector credit is directed to expanding productive capacity it will reduce inflationary pressures in the long run. A tightening monetary policy stance will raise the cost of borrowing and reduce aggregate demand through lower lending growth in 2008.

The Bank expects the Government to prudently manage its fiscal operations in 2008 by avoiding excessive recurrent expenditure, effectively spending on the priority areas of health, education, law and order and physical infrastructure and continuing to repay debt in line with the Medium Term Debt Strategy. Efforts should be made to improve implementation capacity for development expenditure so that economic growth is sustained in the medium term. The fast tracking of public sector reforms and removal of other impediments to trade and investment consistent with the medium term development, fiscal and debt strategies are also necessary to support economic growth.

The upside risks to the inflation expectation will arise from:

- Further increases in international oil and food prices;
- Higher imported inflation from PNG's major trading partner countries;
- Depreciation of the kina exchange rate against the currencies of PNG's major trading partner countries;
- Higher growth in monetary aggregates;
- Increases in wages;
- Further increases in Government expenditure and fast drawdown of trust account funds;
- Increase in aggregate demand; and
- Other unforeseen external and domestic shocks.

The Bank will assess these developments and their potential effects to restoring price stability, and make appropriate adjustments to the stance of monetary policy in 2008 and over the medium term.

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## 1.2 Conduct of Monetary Policy

Monetary policy will be conducted within the reserve money framework. The Monetary Policy Statement (MPS) provides the overall monetary policy framework, while the monthly KFR remains the instrument for signalling the Bank's monetary policy stance through an announcement by the Governor. Following the announcement, Open Market Operations

(OMOs) will be conducted to support the Bank's monetary policy stance. The OMOs involves Repurchase Agreement (Repo) transactions with commercial banks and the auction of CBB to licensed ODCs and Treasury bills to the general public.

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

## 2.0 Developments and Expectations

### 2.1 International Developments

Global economic growth is expected to weaken in 2008. According to the International Monetary Fund's (IMF) World Economic Outlook (WEO) Update of July 2008, global real GDP growth is projected to be 4.1 percent in 2008, compared to 5.0 percent in 2007. The lower growth is mainly driven by the slowdown in the US economy and its contagion effect on the rest of the world. It is expected that in advanced economies, growth rates will be 1.7 percent and 1.4 percent in 2008 and 2009 respectively, compared to 2.7 percent in 2007. Emerging and developing economies are also expected to slow marginally to 6.9 percent and 6.7 percent, in 2008 and 2009 respectively, from 8.0 percent in 2007.

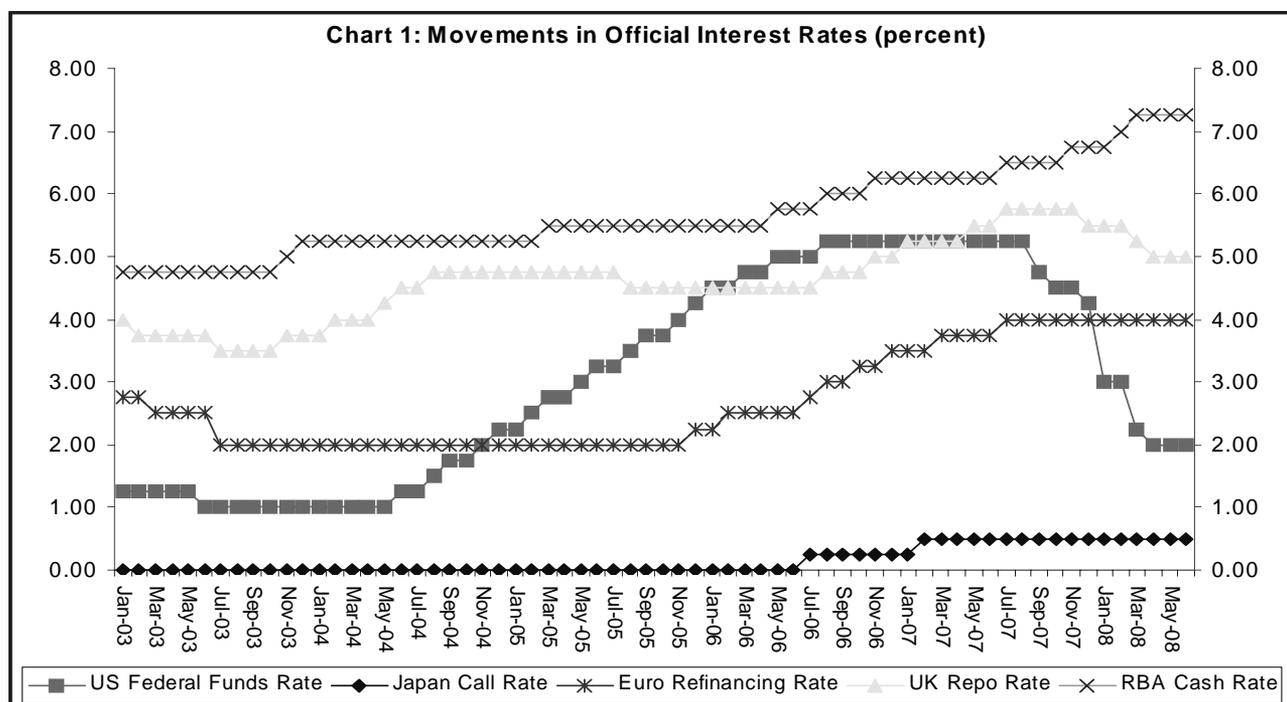
In the US, economic growth slowed rapidly in the first quarter of 2008 reflecting the ongoing sub-prime mortgage crisis and rising oil prices. In 2008, the US economy is expected to grow at a much lower rate of 1.3 percent, down from 2.2 percent in 2007. The impact of the slow down in the US economy on other advanced economies<sup>3</sup>, through the financial market turmoil and reduced trade, is significant. In the Euro area, economic growth is expected to decelerate to 1.7 percent from 2.6 percent in 2007, reflecting a fall in demand caused by reduced trade, high oil prices and financial market turbulence. The Japanese economy is projected to slow to 1.5 percent from 2.1 percent in 2007, mainly due to the slump in housing

investment, the dampening impact of the appreciation of the yen against the US dollar on export growth, and rising oil and food prices. For emerging and developing economies, economic growth is expected to decelerate but remain robust at 6.9 percent in 2008, compared to 8.0 percent in 2007, driven mainly by developing Asia.

Crude oil prices rose to record highs above US\$140 per barrel in June 2008 on the back of geopolitical tensions, capacity constraints and volatile world financial markets. Oil prices are expected to remain high for the remainder of the year. Similarly, gold prices continue to remain strong at around US\$900 an ounce after reaching a historic high of US\$1,007 per ounce in March this year. Except for tea, all other commodities experienced price booms, largely due to supply constraints and strong demand from emerging and developing economies.

The risks to the global economic outlook include further volatility in financial markets due to the slow down in the US, further increases in international oil, food and other commodity prices, strong inflationary pressures and trade imbalances.

Global inflationary pressures will continue throughout 2008. This will be due to the high international prices of commodities, especially base metals, food and energy, reflecting robust demand from emerging and developing economies, particularly China and India, as well as safe haven investment combined with supply constraints. Annual inflation in the March quarter of 2008 was 3.9 percent in the US, 3.6 percent in the Euro area,



Source: Respective Central Bank's websites

<sup>3</sup> Includes the Euro area, United Kingdom (UK) and Japan.

1.2 percent in Japan and 4.2 percent in Australia. In the emerging and developing economies, China and India recorded inflation of 11.1 percent and 8.8 percent, respectively, over the same period. Despite increased inflationary pressures, the major central banks' approach to monetary policy over the first half of 2008 differed. The US Federal Reserve and Bank of England reduced their official interest rates to 2.0 and 5.0 percent, respectively, in April 2008 due to concerns over the significant slowdown in economic growth. However, the Reserve Bank of Australia raised its Official Cash Rate in February to 7.00 percent and in March 2008 to 7.25 percent to contain inflationary pressures, while the European Central Bank and Bank of Japan kept their policy rates unchanged at 4.0 and 0.5 percent, respectively, although concerns over increased inflationary pressures remained.

Global financial markets have been under considerable stress since the last quarter of 2007 due to tight credit and liquidity conditions emanating from the mortgage crisis in the US. The performance of financial markets were also affected by the attitude of investors to bear risk, difficulties in valuing complex financial products, uncertainties about the exposures of major financial institutions to credit losses, and concerns about the weaker outlook for the global economy. During the first half of 2008, the major central banks made a concerted effort to address liquidity constraints by providing access to funds to minimise disruptions to their financial markets. This included expanding access to central banks lending facilities and the range of collaterals offered to financial institutions.

In the foreign exchange markets, the US dollar depreciated against most major currencies in the first half of 2008 reflecting the mortgage crisis in the US. Government bond markets, which started the year on a strong note on the back of the turmoil in financial markets, have now weakened due to rising global inflation and inflation expectations.

### 2.3 Domestic Economic Conditions

Preliminary data from the Bank's Business Liaison Survey (BLS) indicates that nominal value of sales by the private sector grew by 17.1 percent in the March quarter of 2008, compared

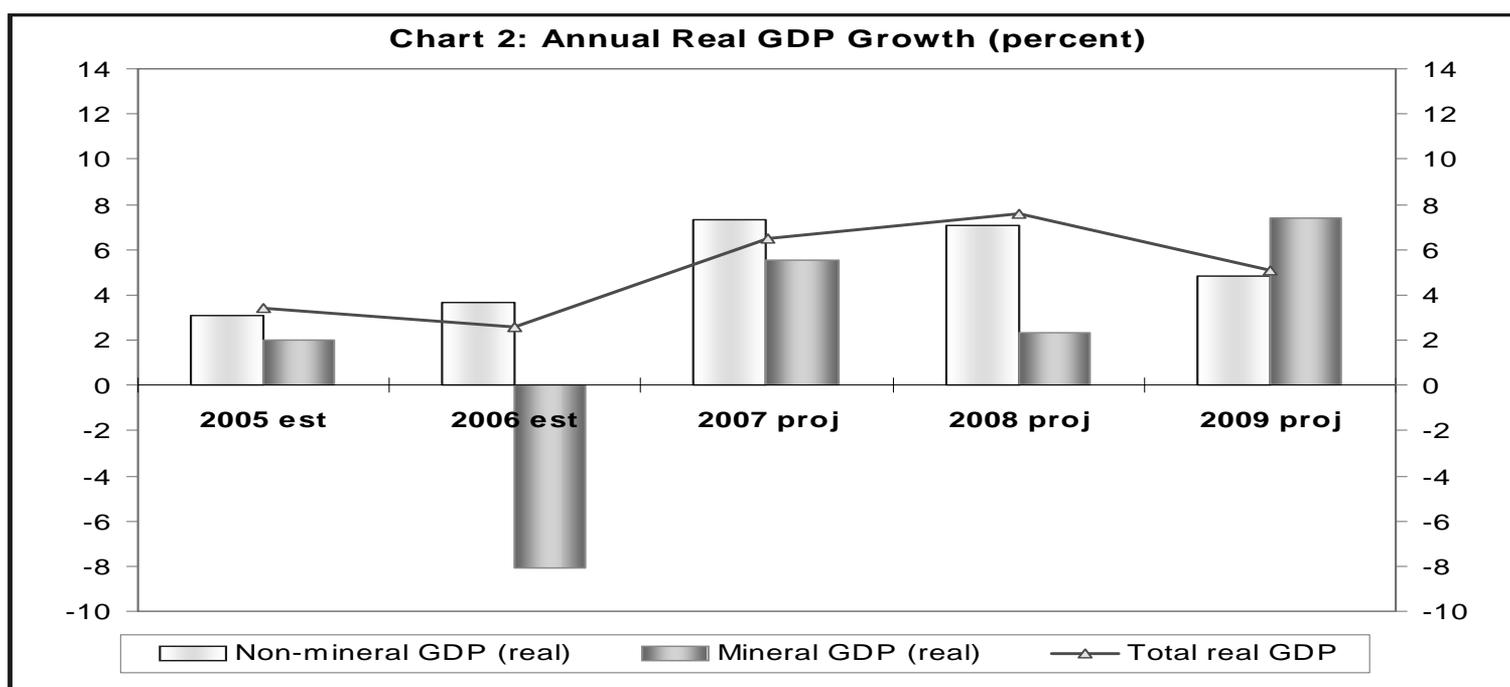
to the December quarter of 2007. Excluding the mineral sector, economic activity increased by 6.9 percent in the March quarter of 2008, with higher sales across all sectors except the wholesale, retail and transportation sectors. Over the twelve months to March 2008, the value of sales increased by 26.7 percent.

The Bank's Employment Index indicates that the total level of employment in the formal private sector continued to increase on a quarterly basis throughout 2007 and the first quarter of 2008. The level of employment in the March quarter of 2008 grew by 8.5 percent compared to the December quarter of 2007. Excluding the mineral sector, employment levels increased by 2.9 percent. The growth in March 2008 was across all sectors except the wholesale/retail and mineral sectors. Over the twelve months to March 2008, employment increased by 8.4 percent.

The Bank's Business Sentiment Survey (BSS)<sup>4</sup> indicates that business confidence is high and economic activity will continue to increase for the rest of 2008. Profits and employment are expected to increase further in the second half of 2008, compared to the first six months of 2008. Although, there is a positive outlook for the remainder of 2008, companies are concerned about high inflation and its associated costs of doing business. Consequently, companies have passed on some of the increasing costs to customers in the first half of 2008 with further increases expected in the second half of 2008.

The Bank estimated that real GDP in 2007 grew by more than the Government's estimate of 6.5 percent, with robust growth in all sectors of the economy, except the mineral sector (*see Chart 2*). There were strong growth in the manufacturing, construction and commerce sectors and the transport, communication and finance sub-sectors. In 2008, the Bank forecast real GDP growth to be in line with the Government's projection of 7.6 percent. All sectors are projected to grow in 2008, especially in the agriculture, construction, manufacturing and commerce sectors and the finance sub-sector. The notable increase in the construction sector and its spill-over effects to the other sectors is attributed to the construction of the Ramu Nickel/Cobalt and the Hidden Valley mines. The

<sup>4</sup> The BSS is a qualitative survey conducted biannually with company executives on their business outlook.



Source: Department of Treasury

growth in the other sectors is mainly due to higher production and prices of all mineral and most agricultural export commodities. Higher Government expenditure and continued growth in private sector credit are also expected to contribute to this growth.

In 2009, the Bank projects real GDP growth to be higher than the Government's projection of 5.1 percent with growth expected in all sectors of the economy. Growth in the construction and mineral sectors is associated with the ongoing construction of the Ramu Nickel/Cobalt and the Hidden Valley mines and the commencement of production by these two mines in late 2009. In addition, Government initiatives to rehabilitate and develop infrastructure, remove other impediments to trade and investment, and continue with public sector reforms are also expected to contribute positively to the growth. The major risks to this outlook would stem from higher inflation, fluctuations in production and prices of export commodities, as well as the global demand for these commodities.

### 2.3 Balance of Payments

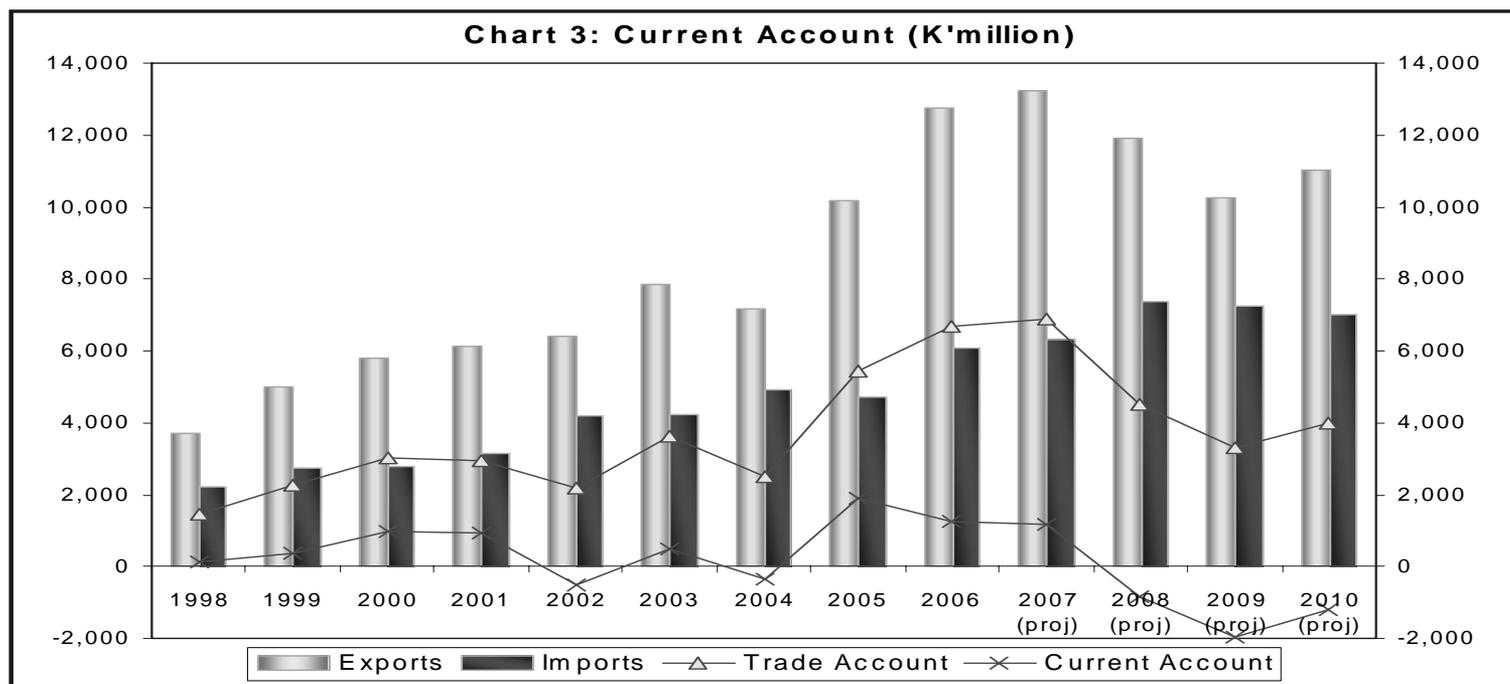
Preliminary balance of payments data for the five months to May 2008 showed an overall surplus of K649.5 million, compared to a surplus of K356.9 million in the corresponding period of 2007. This outcome was due to combined surpluses in the current and capital and financial accounts. The surplus in the current account was attributed to higher trade account balance and lower net income payments which more than offset higher net service and transfer payments. The surplus in the capital

and financial account was mainly due to a higher net inflow from investments in short term money market instruments and a drawdown in the net foreign assets of the banking system, which more than offset a build up in foreign currency account balances of the mineral companies and higher loan repayments by the Government.

The level of gross foreign exchange reserves at the end of May 2008 was US\$2,347.7 (K6,568.9) million, sufficient for 10.3 months of total and 15.2 months of non-mineral import covers. As at 28<sup>th</sup> July 2008, the level of gross foreign exchange reserves was US\$2,424.3 (K6,280.5) million.

The May 2008 World Bank price projections indicated that most international prices of PNG's non-mineral exports will be higher in 2008, compared to 2007. According to the mineral companies, prices of all mineral exports are expected to increase in 2008.

The export volumes of PNG's major commodities are projected to increase in 2008 (see Chart 3). The projected increases are mainly due to supply responses to higher international prices for most non-mineral commodities and improved road infrastructure associated with the Government's medium term objective of increasing agricultural output through the National Agricultural Development Plan (NADP). The non-mineral export volumes are projected to continue to increase in the medium term. In the mineral sector, the projected increase is due to mining of higher ore grades from existing mines combined with the upgrading of the processing plant in Lihir to



Source: Bank of PNG

boost production. The Ramu Nickel/Cobalt project is expected to commence production in the second half of 2009. In the petroleum sector, production is projected to decline over the medium term and is associated with the natural declines in the existing oilfields.

The Bank assumes a stable exchange rate in its balance of payments projections for 2008 and the medium term. The Liquefied Natural Gas (LNG) project was not included in the projections.

Accordingly, the overall surplus in the balance of payments is projected to be K2,086.7 million in 2008, compared to a surplus of K1,593.8 million in 2007. At the end of 2008, it is projected that gross foreign exchange reserves will be around US\$2,784.5 (K7,385.9) million, sufficient for 9.8 months of total and 16.9 months of non-mineral import covers. The gross foreign exchange reserves are projected to increase further over the medium term (see Appendix - Table 2).

## 2.4 Fiscal Operations of the National Government

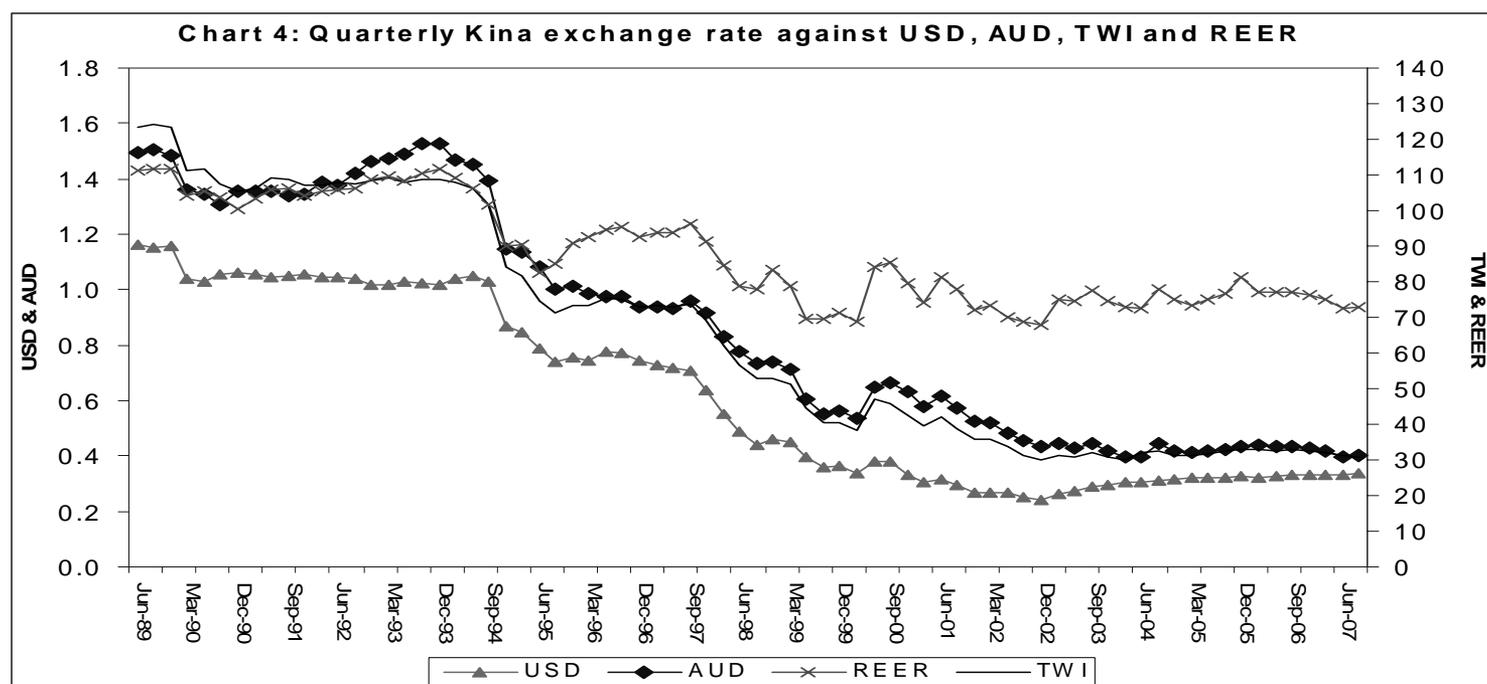
Preliminary estimates of the fiscal operations of the National Government over the five months to May 2008 showed an overall budget surplus of K317.0 million, compared to a surplus of K510.5 million in the corresponding period of 2007. This represents 1.6 percent of nominal GDP<sup>5</sup> and reflected higher revenue, which more than offset an increase in expenditure. The budget surplus was used to make net repayments

of overseas loans totalling K102.1 million and net settlement of cheques totalling K214.9 million to other resident sectors.

Total revenue, excluding foreign grants, represented 29.6 percent of the 2008 Budget while total expenditure represented 25.9 percent over the five months to May 2008. However, recurrent expenditure increased by 31.5 percent in May 2008, compared to May 2007 and represented 40.0 percent of the budgeted appropriations. This reflected the frontloading of warrants to National Departments and Provincial Governments in January 2008. Development expenditure, excluding foreign grants, increased by 0.2 percent during the same period and represented 17.6 percent of the budget. This reflects the ongoing capacity constraints of implementing agencies. Despite this, the Government fully drew down funds under the District Services Improvement Program (DSIP) totalling K356 million from the Central Bank, by July 2008.

Total debt to nominal GDP ratio declined to 31.9 percent from 33.6 percent between the end of December 2007 and June 2008 reflecting the higher growth in GDP combined with net retirement of domestic loans. Total domestic debt declined by 2.6 percent to K3,085.5 million, mainly resulting from the net retirement of Treasury bills and Inscribed stocks totalling K50.8 million and K33.2 million, respectively. Foreign debt increased by 4.6 percent to K3,214.0 million reflecting Government drawdown of external loans.

<sup>5</sup> GDP refers to the 2008 National Budget estimate



Source: Bank of PNG

## 2.5 Exchange Rate

The kina strengthened against the US dollar, while it weakened against the Australian dollar during the first half of 2008. The kina appreciated against the US dollar by 6.7 percent to US\$0.3760 at the end of June 2008 from US\$0.3525 in December 2007, due to foreign exchange inflows mainly from the mineral, communication and agriculture/forestry/fisheries sectors, and Central Bank intervention. The kina depreciated against the Australian dollar by 2.3 percent to A\$0.3906 from A\$0.3999 during the same period reflecting cross currency movements as the US dollar weakened against the Australian dollar due to interest rate differentials and high commodity prices. As a result, the Trade Weighted Index (TWI) depreciated by 0.6 percent during the same period. The Real Effective Exchange Rate (REER) appreciated by 0.4 percent during the March quarter of 2008 reflecting the high domestic inflation (*see Chart 4*).

Between the end of June and 29<sup>th</sup> July 2008 the kina appreciated against the US and Australian dollars by 55 and 77 basis points to US\$0.3815 and A\$0.3983, respectively.

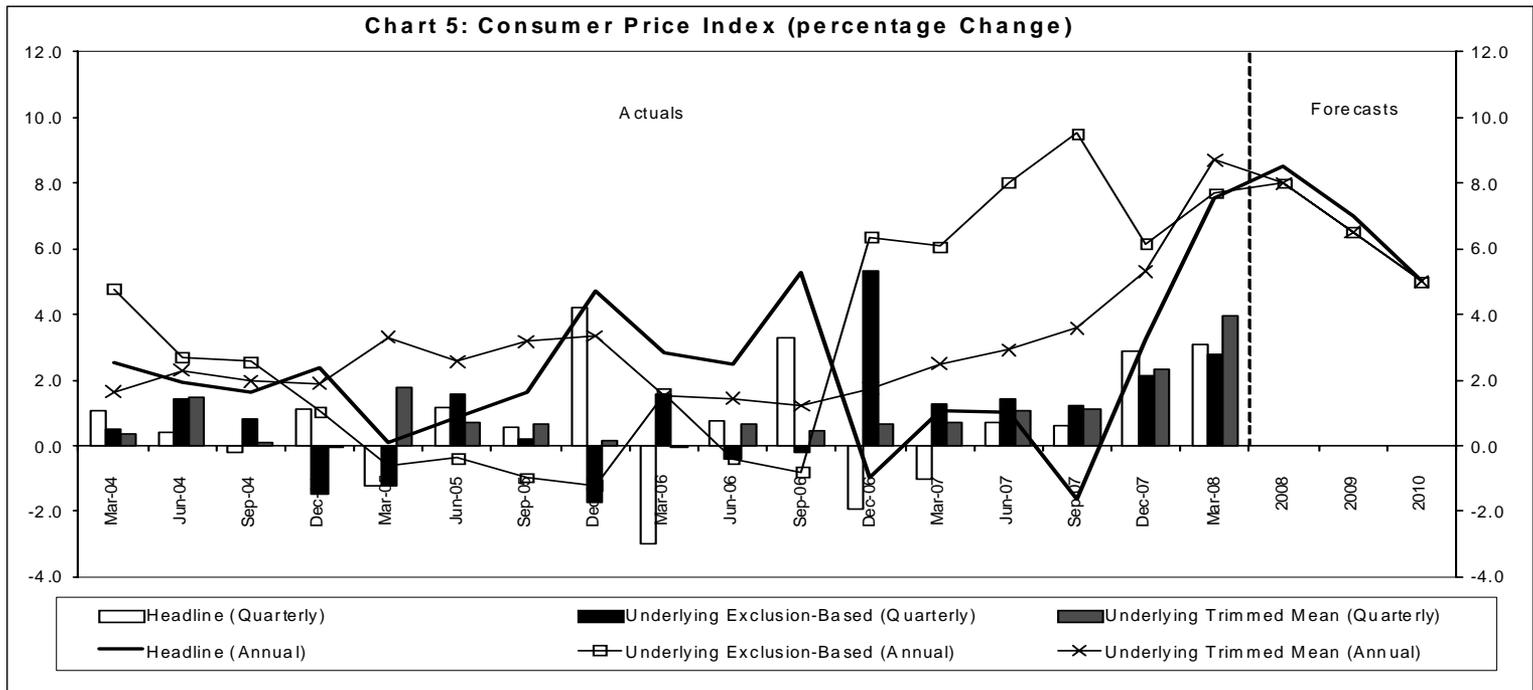
## 2.6 Inflation

Annual headline inflation was 7.5 percent in the March quarter of 2008, compared to 3.2 percent in the December quarter of 2007. This is the highest annual increase since December quarter 2003. There were increases in all expenditure groups particularly from the 'food' and 'rents, council charges, fuel and power' groups, reflecting high

international fuel and food prices, and increased prices of domestically produced fruits and vegetables.

Annual exclusion-based inflation was 7.7 percent in the March quarter of 2008, compared to 6.1 percent in the December quarter of 2007. Annual trimmed-mean inflation was 8.7 percent in the March quarter of 2008, compared to 5.3 percent in the December quarter of 2007 (*see Chart 5*). The higher underlying inflation outcomes were driven mainly by the increase in imported inflation associated with the high international oil and food prices and the feed-through of domestic fuel prices to goods and services and the depreciation of the kina against the Australian dollar. Quarterly inflation outcomes for the core measures have also been increasing significantly since the September quarter of 2007.

In 2008, annual headline inflation is projected to be around 9.0 percent, while exclusion-based and trimmed-mean inflation are both projected to be around 8.0 percent. The upward revision from the projections made in the January 2008 MPS reflects the realised inflation in the March quarter, expected increase in both international and domestic cost pressures stemming from the high oil and food prices, feed-through of fuel price increases to the prices of domestic goods and services, increase in prices of public utilities and demand for higher wages. On the other hand, the demand pull inflationary pressures would come from increased aggregate demand reflecting higher commodity prices and increase in government expenditure and private sector credit.



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

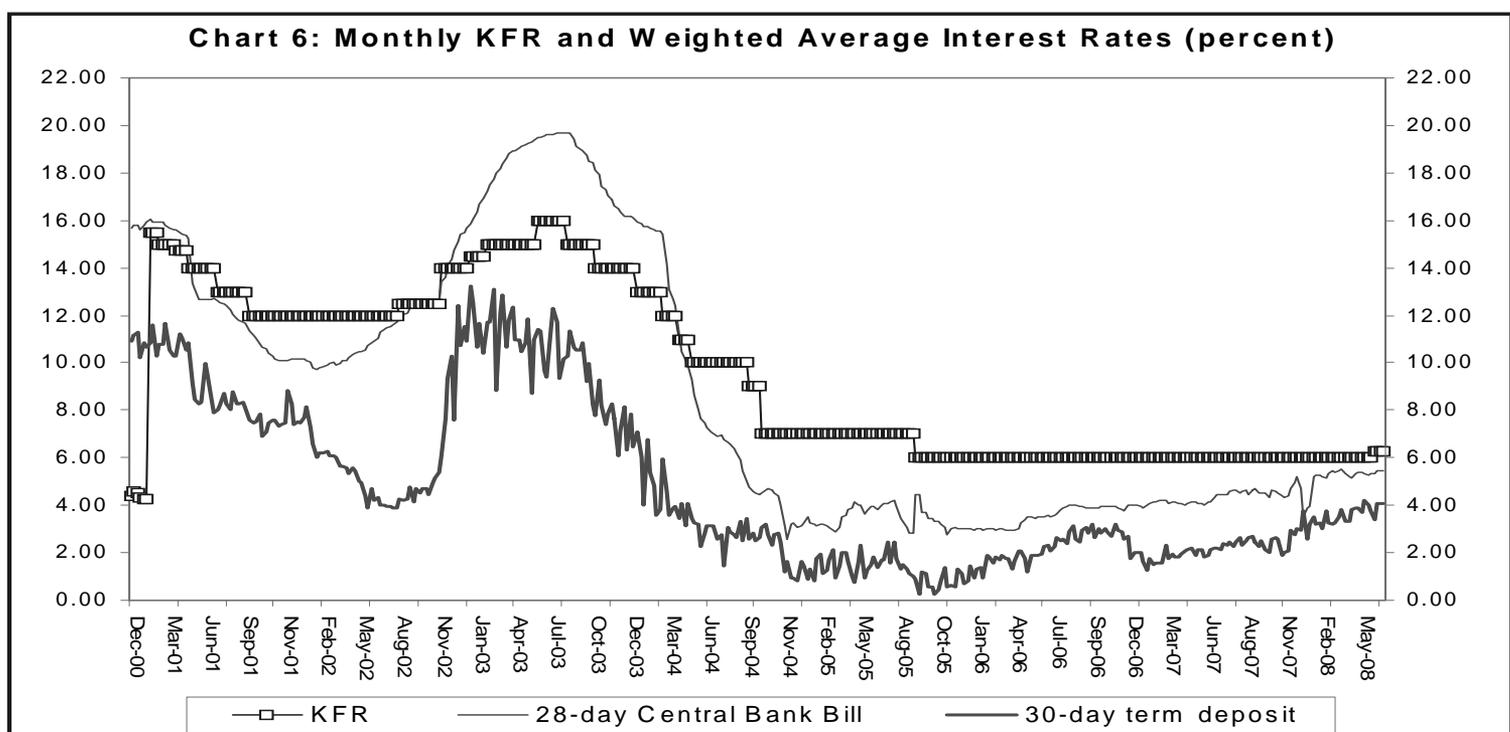
For the medium-term, headline inflation is expected to ease to around 5.0 percent, higher than the projections made in the January 2008 MPS (*see Appendix - Table 2*). The decline in medium-term inflation projections are based on the assumption that international oil and food prices will subside and inflation outcomes in PNG’s main trading partner countries will ease.

The risks to these projections would stem from: further increases in international oil, food and other commodity prices; higher inflation outcomes in PNG’s main trading partner countries; depreciation of the kina exchange rate; and the impact of other domestic factors such as a significant growth in government expenditure and increases in wages and monetary aggregates.

## 2.7 Monetary and Financial Market Developments

The high inflation outcome for the March quarter and expectations of continued inflationary pressures prompted the Bank of Papua New Guinea to tighten monetary policy after maintaining a neutral stance since September 2005. As a result, the KFR was increased by 25 basis points to 6.25 percent in June 2008 (*see Chart 6*). The trading margin for the Repo was maintained at 100 basis points on both sides of the KFR in the first half of 2008.

The Bank issued CBBs totalling K1,447.7 million to diffuse excess liquidity in the banking system in the first half of 2008. As a result, interest rates for short-term securities depicted an upward trend.



Source: Bank of PNG

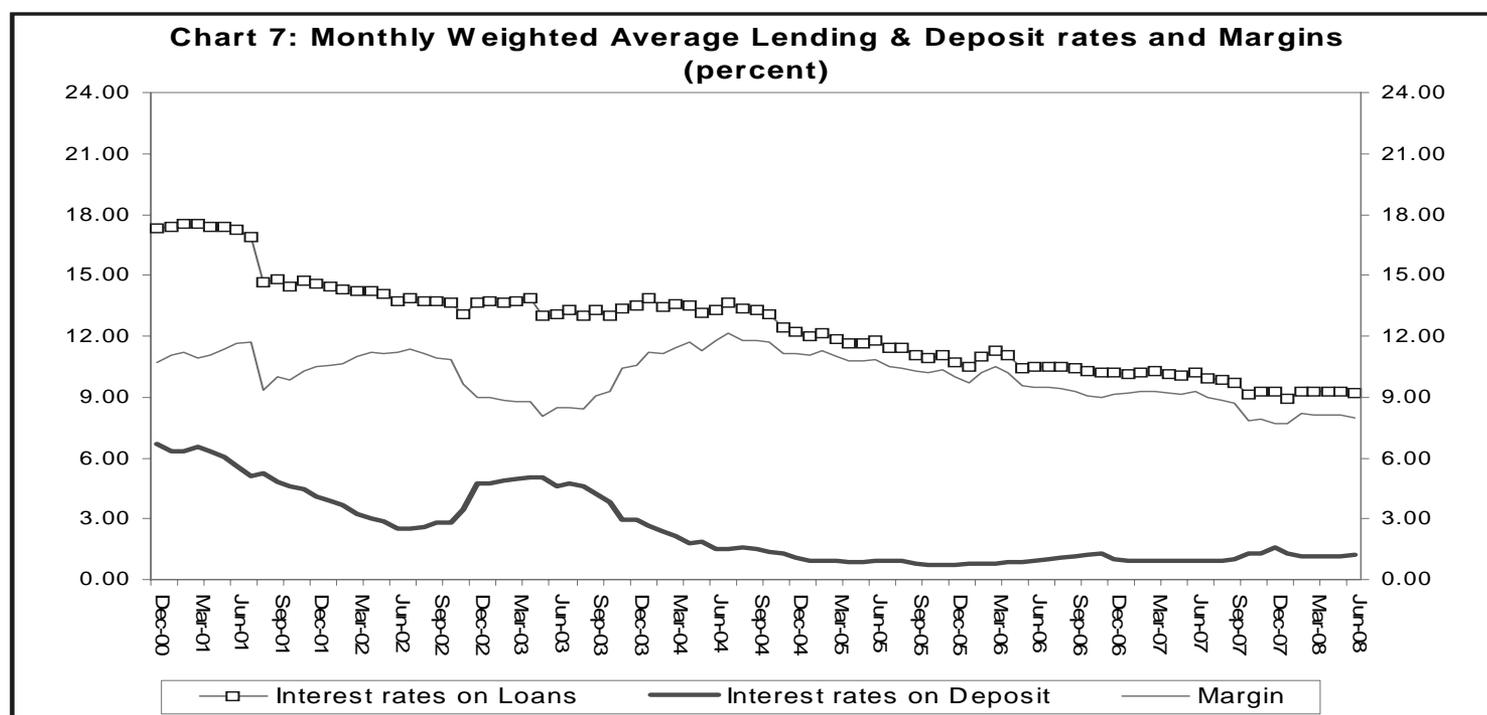
The CBB and Treasury bill rates all traded above 5.00 percent.

The Indicator Lending Rates (ILR) spread remained unchanged at 8.95 – 9.45 percent during the first half of 2008. Following the increase in the KFR, one commercial bank announced an increase in its ILR from 9.45 percent to 9.70 percent in July 2008. The weighted average interest rate on total deposits declined from 1.58 percent in December 2007 to 1.20 percent in June 2008, while the weighted average lending rate on total loans declined from 9.25 percent to 9.17 percent. As a result, the spread between the weighted average lending and deposit rates widened (*see Chart 7*).

Total liquidity of the banking system increased by 12.1 percent to K5,163.6 million between end of December 2007 and June 2008, mainly due to mineral sector inflows and higher Government expenditure. As a result, the Bank continued to utilise OMOs to diffuse the excess liquidity.

Lending extended by ODCs to the private sector increased by 35.3 percent over the year to June 2008. The growth in private sector credit was broad based across all sectors due to the low interest rate environment and improved business confidence. Net claims on the Government declined by 68.1 percent over the year to June 2008, due to increased deposits and retirement of debt held by the depository corporations (DCs).

The level of broad money supply (M3\*) increased by 27.5 percent over the year to June 2008 as a result of the growth in net foreign assets of the DCs combined with an increase in private sector credit. This more than offset the decline in net credit to the Government. The growth in net foreign assets is primarily accounted for by increased mineral tax receipts driven by high commodity prices. The monetary base increased by 33.2 percent during the same period due to higher commercial banks deposits at the Central Bank and currency in circulation (*see Appendix-Table 1*).



Source: Bank of PNG

## APPENDIX

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

INDICATOR	2005 (actual)	2006 (actual)	2007 (actual)	JUN 2008 (actual)	JAN 2008 MPS (proj)	2008 (proj)	2009 (proj)	2010 (proj)
Broad Money Supply	30.7	39.0	27.3	27.5	38.3	20.7	24.4	16.4
Monetary Base	3.0	21.7	61.8	33.2	15.0	16.3	15.5	15.2
Claims on the Private Sector	25.2	36.8	30.8	35.3	22.3	28.5	23.1	24.0
Net Claims on Gov't	-24.7	-11.6	-83.5	-68.1	115.5	-9.5	-22.2	-0.2
Net Foreign Assets	33.5	58.2	51.7	35.8	26.6	17.2	14.2	6.9

Source: Bank of PNG.

**Table 2: Summary of Other Macroeconomic Indicators**

INDICATOR	2005 (actual)	2006 (actual)	2007 (actual)	MAR 2008 (actual)	JAN 2008 MPS (proj)	2008 (proj)	2009 (proj)	2010 (proj)
<b>CONSUMER PRICE INDEX (annual % changes)</b>								
Headline	4.6	1.3	3.2	7.5	3.5	9.0	7.0	5.0
Trimmed mean	3.3	0.4	6.0	8.7	4.0	8.0	6.5	5.0
Exclusion based	-1.4	2.9	6.0	7.7	6.0	8.0	6.5	5.0
<b>BALANCE OF PAYMENTS (kina millions)*</b>								
Current account	1,887	1,255	366	417	-853.7	338	377	522
Financial account	-1,590	719	1,183	283	2,520.4	1,749	802	113
Overall balance	296	1,958	1,592	649	1,843.6	2,087	1,179	778
Gross Int. Reserves	2,368	4,326	5,919	6,568.9	7,763.0	7,386	8,565	9,200
<b>IMPORT COVER (months)*</b>								
Total	6.0	8.5	9.1	10.3	12.7	9.8	10.8	12.2
Non-mineral	8.2	11.5	13.0	15.2	21.2	16.9	18.0	18.1
<b>EXPORT PRICE*</b>								
Crude oil (US\$/barrel)	55.0	67.3	73	100.8	60.8	117.1	101.1	108.5
Gold (US\$/ounce)	403	554.7	671	840.7	538.1	890.4	865.1	832.6
Copper (USc/pound)	161.6	296.6	320	346.5	225.0	323.0	331.2	317.6
<b>FISCAL OPERATIONS OF THE GOVERNMENT*</b>								
Surplus/Deficit (K'm)	7.6	535.8	454.5	317.0	202.3	202.3	273.5	121.8
% of GDP (nominal)	0.1	3.1	2.4	1.6	1.0	1.0	1.3	0.6
<b>REAL GROSS DOMESTIC PRODUCT (annual % growth)**</b>								
Total GDP	3.4	2.6	6.5	--	6.6	7.6	5.1	4.2
Non-mineral GDP	3.1	3.7	7.3	--	6.5	7.1	4.8	4.0

Source: Bank of PNG, NSO and Department of Treasury

\* Actuals to May 2008 while GDP ratios reflect projections in the 2008 Budget

\*\* GDP projections are from Treasury Department while the actuals reflect estimates