CONTENTS

PORT MORESBY

14th March, 2005

1. GLOSSARY OF TERMS AND ACRONYMS

Balance of Payments
A statistical statement that systematically summarises a country's economic transactions with the rest of the world, over a specific time period. It comprises the Current and Capital and Financial Accounts.

Broad Money Supply (M3*)
Total volume of money comprising narrow money (M1*) and quasi money in the economy at a point in time. See narrow and quasi money.

Cash Reserve Requirement (CRR)
A requirement imposed on commercial banks to hold cash as a percentage of total deposits and other prescribed liabilities at all times.

Capital Account
Records all transactions that involves the receipts or transfers of capital and acquisitions/disposal of non-produced, non-financial assets such as purchase of production facilities, i.e. plants and machinery, etc.

Central Bank Bill (CBB)[1]
An indirect monetary policy instrument used by the Central Bank for liquidity management. The CBB is a liability of the Central Bank and has similar features as the Government Treasury bills.

Current Transfers Account
This account records all foreign transactions that are not transfers of capital and can not be repaid. These includes donations, gifts and grants, superannuation funds and licensing fees.

Exchange Settlement Account (ESA)
Accounts of the commercial banks with the Central Bank for settlement transactions with each other.

Exclusion-based CPI measure
This involves zero weighting of volatile sub-groups or items such as fruit & vegetables, betelnut and prices which are largely determined by non-market (seasonal) forces, as well as alcoholic drinks, cigarettes & tobacco, etc. See 'Underlying CPI'.

Financial Account
Records all transactions associated with changes of ownership of foreign financial assets such as holdings of monetary gold, special drawing rights (SDR), claims on non-residents and foreign liabilities of an economy.

Headline Consumer Price Index (CPI)
A measure of inflation as calculated and published quarterly by the National Statistical Office (NSO).

Income Account
Records foreign transactions such as compensation of employees, which covers wages, salaries, and other benefits in cash and kind, dividends and interest earned on investments.

Inscribed Stock
A Government bond or debt instrument sold to the public for a maturity term of one year or longer for the purpose of Budget financing. A coupon is paid to the holders every six months.

Kina Facility Rate (KFR)
Official benchmark rate used by the Bank of Papua New Guinea to signal its monetary policy stance. The KFR is announced monthly by the Governor and published in the newspapers and on the Bank's website.

Liquid Assets
Assets of the commercial banks, which are near liquid form, comprising cash, ESA balances, Treasury bills and Inscribed stocks less than 3 years to maturity.

Minimum Liquid Asset Ratio (MLAR)
A prudential requirement imposed by the Central Bank on commercial banks

[1] (See 'For the Record: p.34 in the September 2004 QEB)

	to hold liquid assets as a percentage of total deposits and other prescribed liabilities at all times.
Monetary Base	Comprised of currency held by the public and liquidity assets of the commercial banks, including deposits held with the Central Bank under the Repurchase Agreement Facility (RAF) or Repos.
Narrow Money	A component of total money supply that is considered liquid or can be converted easily to cash on demand, and comprises of currency in circulation (held outside the banking system) and demand deposits.
Open Market Operations (OMO)	Operations of liquidity management conducted by the Central Bank with commercial banks and other financial intermediaries involving Government securities, Repos and foreign exchange trading to influence short-term interest rates.
Over the year CPI	Percentage change in the CPI of a quarter compared to the corresponding quarter of the previous year (Also called 'annual' CPI).
Portfolio Investment	Investments, mainly in equity and debt securities such as bonds and notes, money market debt instruments and financial derivatives, as well as long-term debt, equity and securities.
Quasi Money	A component of total money supply that is not easily convertible to cash on demand and comprises of savings and term deposits.
Repurchase Agreement Facility (RAF)	An agreement between the commercial banks and the Central Bank to sell and repurchase a Government security (e.g. Government Treasury bills) for overnight to 14 days. Transaction can be collateralised or unsecured (Also called Repos).
Reserve Money	A measure of money, which includes currency holdings of commercial banks and their deposits at the Central Bank and money in circulation.
Tap Facility	A facility conducted by the Central Bank for sale of Treasury bills and Inscribed stocks to the public.
Temporary Advance Facility	A statutory mechanism stipulated under Section 54 of the Central Banking Act 2000, that provides the National Government with access to short-term financing to meet mismatches in revenue.
Trade Account	Records all economic transactions associated with merchandise exports and imports of physical goods. A surplus means that exports have exceeded imports, while the reverse will result in a deficit.
Treasury bill	Government security or debt instrument sold at a discount value, but redeemed at face value on maturity for purposes of Budget financing. In PNG, Treasury bills are issued for 28,61,91 and 182 day maturities.
Trimmed-mean CPI measure	A fixed proportion of prices at each end of the distribution of price changes are zero weighted and the mean of the remaining price changes recomputed. See also 'Underlying CPI'.
Underlying CPI	A measure of inflation that excludes short-term volatile movements in prices, such as seasonal factors (prices of fruit, vegetables and betelnut), Government policy decisions (tax system reforms, etc.) and price controlled items. The exclusion-based and trimmed-mean CPI measures are both underlying CPI measures.

2. GENERAL OVERVIEW

The indicators available to the Bank of PNG show that 2004 was a year of stability and growth for the economy. High international prices of major export commodities drove a strong export performance which helped ensure stability in the exchange rate, a balance of payments surplus and record foreign exchange reserves. Domestically, there was continued growth in private sector activity and employment. Fiscal discipline and higher tax receipts resulted in a K234.0 million budget surplus in 2004. With a stable exchange rate and restrained government spending annual inflation fell to 2.4 percent, the lowest level since 1989. Interest rates also fell to historically low levels following the Central Bank's easing of monetary policy.

The Bank's latest quarterly Business Liaison Survey results show that private sector economic activity, excluding the mineral sector and the North Solomons Province (NSP), continued to grow in the September quarter of 2004, compared to the corresponding period in 2003. The total nominal value of output increased by 1.8 percent, reflecting increases in all sectors except the wholesale and transportation sectors.

The Bank's quarterly Employment Survey indicates that the level of employment in the formal private sector, excluding the mineral sector and the NSP, grew by 0.2 percent in the September quarter of 2004, compared to the corresponding period in 2003. The increase was broad based across all sectors except the agriculture/forestry/fisheries sector. By region, increases in the NCD and Islands regions more than offset declines in the other regions.

Annual headline inflation, as measured by the Consumer Price Index (CPI), was 2.4 percent in 2004, compared to 8.4 percent in 2003. The 'Food', 'Household equipment and operation' and 'Transport and communication' expenditure groups experienced deflation during 2004. By urban areas, all CPI surveyed areas except Lae recorded price increases in 2004.

Annual trimmed mean inflation for 2004 was 1.9 percent, while the exclusion based inflation was 1.0 percent compared to 6.7 and 10.0 percent respectively, in 2003.

During 2004 the kina steadily appreciated against a weak US dollar, ending the year up 6.7 percent. The exchange rate against the Australian dollar fluctuated over the course of the year, but showed no significant trend in either direction. The quarterly average exchange rate against the Australian dollar appreciated by 0.5 percent over the year.

Higher international prices for mineral exports and most agricultural export commodities resulted in the weighted average kina price of Papua New Guinea's exports increasing by 11.5 percent in 2004, relative to 2003. There was an increase of 15.3 percent in the weighted average kina price of mineral exports, with higher prices of all mineral exports. For agricultural, forestry and marine product exports, the weighted average kina price declined by 1.8 percent due to lower prices of cocoa, tea and forestry product exports, which more than offset the increase in the prices of coffee, copra, copra oil, palm oil, rubber and marine products. The lower kina prices of some of the agricultural export commodities reflected the appreciation of the kina against the US dollar. The international prices of coffee, copra, copra oil, rubber and tea increased in 2004, while prices of cocoa and palm oil decreased.

The overall surplus in the balance of payments was K335 million in 2004, compared to a surplus of K353 million in 2003. This outcome was due to a surplus in the current account, which more than offset a net outflow in the financial and capital account.

The surplus in the current account was K310 million in 2004, down from K496 million in 2003. This outcome was due to deteriorations in the goods, services and transfer balances more than offsetting an improvement in the income balance. The capital and financial account recorded a net outflow of K18 million in 2004 compared to a net outflow of K183 million in 2003. The deficit was the result of a net outflow in portfolio and financial derivative assets, which more than offset a net inflow of direct investment flows, combined with the draw down of foreign currency account balances by mineral companies.

The level of gross foreign exchange reserves at the end of December 2004 was K2,066 (US$664.3) million, sufficient for 5.3 months of total and 6.7 months of non-mineral import cover.

The Bank of Papua New Guinea gradually eased monetary policy during 2004, influenced mainly by the lower quarterly inflation outcomes, a stable exchange rate and sound fiscal management. The Kina Facility Rate (KFR) was reduced by 7.0 percentage points in aggregate from 14.0 percent in December 2003 to 7.0 percent by December 2004. The easing stance of monetary policy, net sale of kina in the foreign exchange market and retirement of Treasury bills by the Government led to a high level of liquidity in the banking system and a decline in domestic interest rates.

To sterilise the build up in liquidity and stabilise interest rates, the Central Bank introduced the Central Bank Bill (CBB) in August 2004. The Central Bank also increased the minimum bid for Treasury bills at the auction from K100,000 to K500,000 in August 2004 then to K1,000,000 in December 2004. This change also aimed to encourage the development of a secondary market for Government securities.

The average level of broad money supply (M3*) increased by 13.0 percent in 2004, compared to a revised decline of 2.7 percent in 2003. The growth resulted from an increase of 49.9 percent in average net foreign assets of the banking system, which more than offset a decline of 4.7 percent in average net domestic credit to the private sector, official entities and non-monetary financial institutions. The average level of the broad monetary base increased by 30.4 percent in 2004, compared to a decline of 1.4 percent in 2003. The substantial increase was due to higher holdings of Government securities, reflecting purchases of new Inscribed stocks and an increase in commercial bank deposits at the Bank of PNG.

Total domestic credit extended by the banking system to the private sector, official entities and non-monetary financial institutions decreased by K46.1 million to K1,451.0 million. Lending to the private sector and official entities declined by K23.5 million and K26.9 million, respectively. This more than offset an increase of K4.3 million in lending to the non-monetary financial institutions. The decline in private sector lending mainly reflected repayments by the commerce sector, particularly retail trade, manufacturing and transport and communication sectors. The annual rate of decline in domestic credit, excluding the Central Government and outstanding loans under the price support schemes, was 3.2 percent over the year to December 2004.

Preliminary estimates of the fiscal operations of the National Government for 2004 showed an overall surplus of K234.0 million, compared to a deficit of K124.1 million in 2003.This represents 1.7 percent of nominal GDP. The surplus was due to higher revenue combined with lower expenditure.

Total revenue, including grants during 2004 was K3,939.5 million, 9.1 percent higher than the receipts collected in 2003, and represents 92.0 percent of the revised budgeted revenue. The increase was attributed to higher collections in all categories of tax revenue, which more than offset lower project grants.

Total expenditure during 2004 was K3,705.5 million, 0.8 percent lower than in 2003, and represents 89.7 percent of the revised budgeted expenditure for 2004. The decrease was due to lower interest payments and development expenditure.

The surplus combined with domestic borrowing of K103.6 million was used to make a net overseas loan repayment of K337.6 million. The domestic financing was through the net issuance of Government securities and proceeds from the sale of assets.

3. INTERNATIONAL DEVELOPMENTS

Global economic growth was exceptionally strong in 2004. The International Monetary Fund (IMF) estimates world GDP at purchasing-power-parity to have increased by 5.0 percent in 2004, the highest rate of increase in nearly 30 years. The increase was driven by strong growth rates in the United States (US) and Asia, with the US recording a 3.8 percent increase and China with 9.5 percent. The Euro area and Japan grew more slowly with growth rates of 1.8 percent and 2.6 percent respectively in the third quarter of 2004. The global growth has been achieved in spite of high oil prices, which were at the US$40-50 per barrel range for much of 2004, rising interest rates in the US and the United Kingdom (UK) and continued geo-political uncertainty resulting from international terrorism, the on-going conflict in Iraq and the Israeli-Palestinian crisis. However, global growth is expected to slow slightly in 2005 due to these factors.

In October, finance ministers and central bank governors met in Washington D.C., USA, for the annual World Bank/IMF meetings.

In November, leaders of the 21-nation Asia Pacific Economic Co-operation (APEC) forum held their annual meeting in Santiago, Chile. They discussed issues regarding international security, as well as their on-going free trade issues. The leaders endorsed a US-promoted Santiago Initiative for further trade and investment liberalisation, and steps to encourage trade through reducing red tape and adopting similar standards.

In the US, real GDP grew by 3.8 percent in 2004, compared to 4.3 percent in 2003. The increase was due to continued strong domestic demand with higher consumer spending, and the fiscal stimulus provided by a budget deficit estimated to be 4.4 percent of GDP. Concerns on the US economy relate to the twin deficits of the current account and budget, and the consequent weakening of the US dollar. In November, President George W. Bush was re-elected to his second term in office.

Industrial production increased by 4.4 percent during 2004 compared to an increase of 2.3 percent in 2003. The Institute for Supply Management's (ISM) purchasing managers' index was 57.3 percent in December 2004, compared to 62.1 percent in December 2003. The index was above 50.0 percent throughout 2004, indicating an expansion in the manufacturing sector. Retail sales increased by 5.9 percent in 2004 compared to 8.3 percent in 2003. The unemployment rate in December was 5.4 percent, the same as in September, but down from 5.7 percent in December 2003.

Consumer prices increased by 3.3 percent in 2004 compared to a 1.9 percent increase in 2003. However, the US Federal Reserve measure of core personal-consumption prices, which excludes food and energy prices only increased by 1.7 percent in 2004. Broad money supply increased by 6.2 percent in 2004, compared to 3.3 percent in 2003. Despite the economic growth and low core inflation, the Federal Reserve slowly increased the Federal Funds Rate during 2004 with a 25 basis points rise each in November and December. The rate at the end of December 2004 was 2.25 percent, 125 basis points higher than at the start of the year.

The trade deficit was US$665.2 billion in 2004, compared to a deficit of US$489.4 billion in 2003, reflecting high costs of energy imports. The deficit has been largely funded by purchases of US dollars by Asian central banks to prevent their own currencies from appreciating.

In Japan, real GDP declined by 0.5 percent in 2004, compared to an increase of 3.4 percent in 2003. Real GDP growth in the December quarter was 0.6 percent.

Industrial production increased by 1.4 percent in 2004, compared to an increase of 5.7 percent in 2003. Retail sales decreased by 1.0 percent in 2004 compared to a decline of 1.8 percent in 2003. The unemployment rate was 4.4 percent in December 2004, compared to 4.9 percent in December 2003.

Consumer prices decreased by 0.4 percent in 2004 compared to a decline of 0.3 percent in 2003. Broad money supply increased by 2.0 percent in 2004. To counter the effects of deflation experienced over the previous six years, the Bank of Japan kept interest rates constant throughout 2004, maintaining its zero interest rate policy and injecting cash into the economy.

The current account recorded a surplus of US$171.8 billion in 2004, compared to a surplus of US$136.0 billion in 2003. The large surplus is a counterpart of the US current account deficit.

In Germany, real GDP declined by 0.9 percent in 2004, compared to an increase of 0.2 percent in 2003, while it grew by 1.5 percent in the December quarter of 2004.

Industrial production increased by 0.9 percent in 2004, compared to an increase of 3.5 percent in 2003. Retail sales decreased by 5.9 percent in 2004 compared to a decline of 1.0 percent in 2003. The unemployment rate was 10.8 percent in December 2004, compared to 10.5 percent in December 2003.

The current account surplus was US$96.0 billion in 2004, compared to a surplus of US$56.3 billion in 2003.

With many Asian countries preventing their currencies from appreciating against the US dollar, the weak US dollar impacted strongly on the Euro area. The strong euro combined with weak domestic demand resulted in sluggish economic growth. Euro area consumer price inflation was 2.4 percent in 2004, compared to 2.0 percent in 2003. The European Central Bank left its refinancing rate unchanged at 2.0 percent throughout the December quarter.

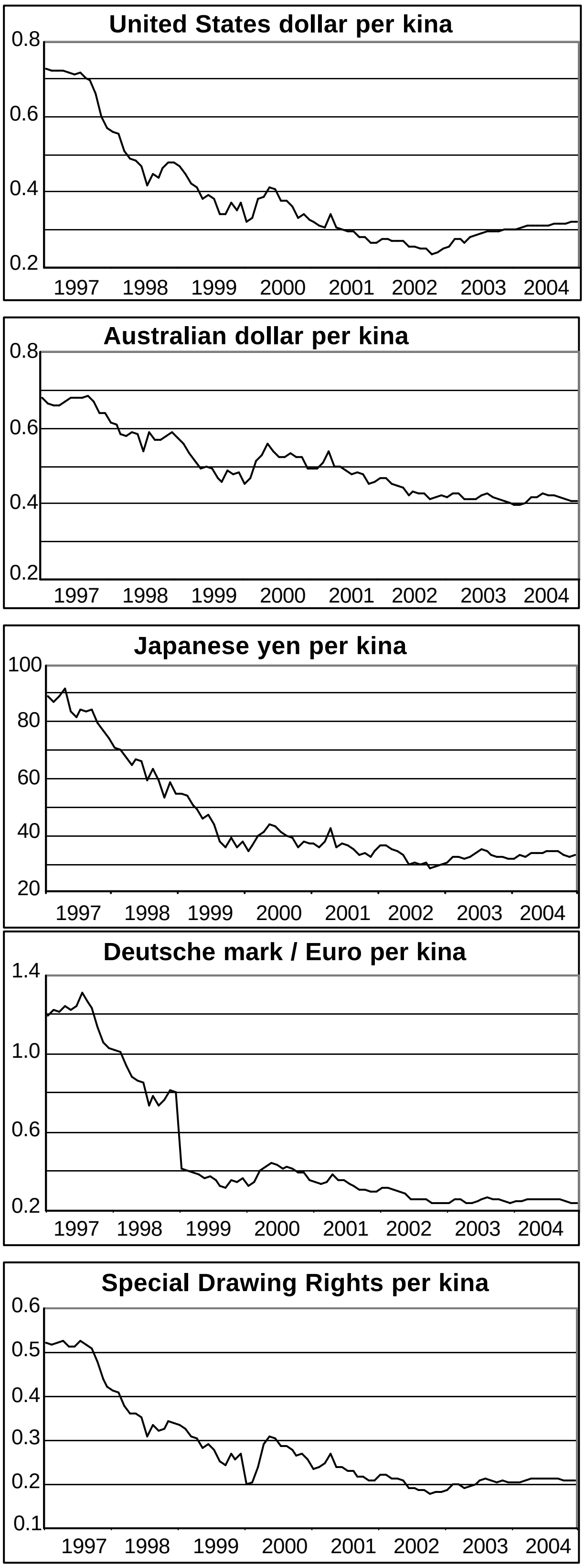
In the UK, real GDP grew by 3.0 percent in 2004, compared to an increase of 2.8 percent in 2003. GDP growth in the December quarter was 2.8 percent. Industrial production increased by 0.3 percent in 2004, compared to a decrease of 0.8 percent in 2003. Retail sales however increased by 3.2 percent in 2004 compared to an increase of 4.0 percent in 2003. The unemployment rate was 4.7 percent in December 2004, compared to 4.9 percent in December 2003.

Consumer prices increased by 1.6 percent in 2004, a slight rise from 1.3 percent in 2003. Broad money supply increased by 8.6 percent in 2004, compared to an increase 6.7 percent in 2003. With concerns on rising inflationary pressures and rapidly increasing house prices, the Bank of England tightened monetary policy by raising its Repo rate from 3.75 percent to 4.75 percent in 2004.

The trade deficit was US$105.5 billion in 2004, compared to US$74.7 billion in 2003.

In Australia, real GDP grew by 0.6 percent over the year to December 2004, compared to an increase of 2.0 percent in the corresponding period of 2003. 2004 was Australia's thirteenth consecutive year of growth, the longest expansion since 1945. The OECD expects growth in GDP to continue in 2005, with a 3.8 percent increase. In October, Prime Minister John Howard was

EXCHANGE RATES



re-elected for a fourth term in office.

Industrial production increased by 4.2 percent over the year to September 2004, compared to a decline of 0.1 percent in the corresponding period of 2003. Retail sales increased by 2.2 percent in 2004, compared to an increase of 7.4 percent in 2003. New car sales reached a peak of 955,229 vehicles in 2004. The unemployment rate was 5.1 percent in December 2004, compared to 5.8 percent in December 2003.

Consumer prices increased by 2.4 percent in 2004, the same as in 2003. Consumer prices increased by 2.6 percent in the December quarter of 2004, compared to an increase of 2.3 percent in September quarter. Broad money supply increased by 9.2 percent in 2004. With inflation within the Reserve Bank of Australia target range, the policy rate was left unchanged at 5.25 percent during the fourth quarter of 2004.

The trade account deficit was US$18.0 billion in 2004, compared to a deficit of US$15.3 billion in 2003, reflecting higher imports. This is despite strong global economic growth, cheaper imports and higher prices for exports.

During 2004 the US dollar depreciated against the other major currencies. The monthly average exchange rate depreciated by 8.9 percent against the euro, 3.8 percent against the yen and 3.9 percent against the Australian dollar. The depreciation was driven by the substantial US current account and budget deficits and low interest rates in the US.

In 2004 the kina steadily appreciated against the US dollar. One kina was worth 30.00 US cents on the 31st December 2003. One year later it was worth 32.00 US cents. The quarterly average exchange rate appreciated by 6.3 percent during the year to 31.59 US cents.

The kina exchange rate fluctuated against the Australian dollar over the course of the year driven by movements in the Australian dollar against the US dollar. The kina ended the year at 41.06 Australian cents, a 2.6 percent appreciation on the rate at the end of 2003. The quarterly average exchange rate for the December quarter was 41.78 Australian cents compared to 41.56 Australian cents in the December quarter of 2003.

4. DOMESTIC ECONOMIC DEVELOPMENTS

Information obtained from the Bank of PNG's Business Liaison Survey in conjunction with other economic indicators show that the level of business activity in the private sector, excluding mining and petroleum and the North Solomons Province (NSP), continued to show positive growth in the twelve months to September 2004. The total nominal value of output increased by 1.8 percent in the September quarter 2004, compared to the corresponding period in 2003. The increase reflected higher value of output in all sectors except the wholesale and transportation sectors. Although the Bank has started to cover the NSP, it is not included for comparison purposes due to data limitations.

The nominal value of output by the agriculture/forestry/fisheries sector grew by 4.6 percent in the September quarter of 2004, compared to the same period in 2003, and reflected increases in the Highlands, Morobe and Islands regions. The increase was mainly driven by high international prices for most agricultural commodities which more than offset lower volumes of production for all commodities except copra and tea.

The nominal value of output for the retail sector increased significantly by 46.1 percent, while the wholesale sector output decreased by 25.5 percent in the September quarter of 2004, compared to the corresponding period in 2003. The increase in the retail sector reflected significant growth in output in the NCD, Highlands and Lae regions. The wholesale sector output declined due to lower sales in the NCD, Morobe and Islands regions. The decline partly reflected lower volume of sale of petroleum products.

In the manufacturing sector, nominal value of output increased by 7.2 percent in the September quarter of 2004, compared to the corresponding period in 2003. The increase in the Momase and Morobe regions reflected higher production and export of canned mackerel and tuna and food items, while in the Southern region, increased export volume of processed logs and sawn timber accounted for the increase. The increase in the NCD reflected higher beverage sales in 2004, compared to the corresponding period in 2003.

The nominal value of output by the private sector excluding mining and petroleum in the Highlands region decreased by 2.0 percent in the September quarter of 2004, compared to the corresponding period in 2003. A higher decline in the transportation sector more than offset increase in output in the other sectors. Despite lower coffee production, producers benefited from high international prices of coffee.

The nominal value of output by the private sector in the Morobe region increased by 2.8 percent in the September quarter of 2004, compared to the corresponding period in 2003. The growth was due to high value of output by all sectors except the agriculture, wholesale and transportation sectors.

The nominal value of output by the private sector in the Momase region increased by 14.2 percent in the September quarter of 2004, compared to the corresponding period in 2003, attributed to higher sales in all sectors. The increase was mainly driven by the manufacturing sector, especially the production and export of tinned and fresh tuna to overseas markets, and higher demand and price of cigarettes and tobacco.

The nominal value of output by the private sector in the Islands region decreased by 16.1 percent in the September quarter of 2004, compared to the corresponding period in 2003. The construction, wholesale and retail sectors slowed down following buoyant performance over the year to June 2004. The drop in output was mainly attributed to a decline in the production and export of cocoa and palm oil as well as completion of construction projects in the region.

EMPLOYMENT

According to the Bank's Employment Index, employment in the formal private sector, excluding the mining and petroleum sector and the NSP, grew by 0.2 percent in the September quarter of 2004, compared to the corresponding period in 2003. The increase was broad based across all sectors except the agriculture/forestry/fisheries sector. By region, increases in the NCD and Islands regions more than offset declines in the other regions.

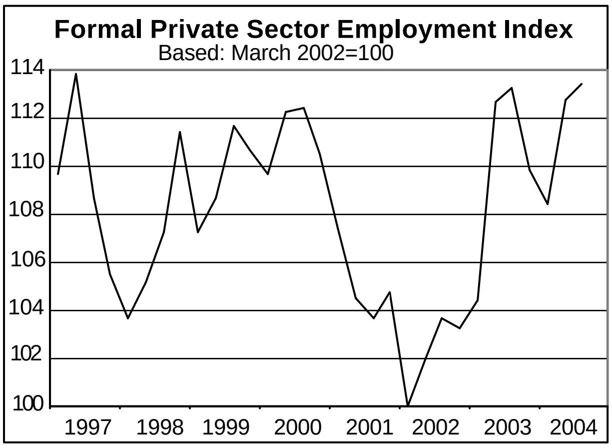
In the retail and wholesale sectors, the level of employment grew by 1.9 and 0.1 percent respectively, in the September quarter of 2004, compared to the corresponding period in 2003. In the retail sector, the increase reflected higher employment in the NCD, Southern, Momase and Islands regions. The recruitment of new staff in the NCD, Southern, Morobe, Momase and Islands regions accounted for the increase in the wholesale sector.

In the manufacturing sector, the level of employment grew by 3.3 percent in the September quarter of 2004, compared to the corresponding period in 2003. There were increases in all regions except the Highlands region. The increase in the NCD was due to demand for casual staff by the printing companies for printing and delivery of newspapers and stationeries. The increase in the Southern region was due to the hiring of casual employees to construct dinghies to meet increased orders, combined with higher production of sawn timber and ply wood. In Morobe, the growth was due to demand for sawn timber and ply wood, and increased casual staff associated with higher production of gas bottles and by a soft drink and beverage manufacturer for sales and promotional activities. In the Islands region, the increase was associated with the expansion of mining operations.

In the construction sector, the level of employment increased by 1.5 percent in the September quarter of 2004, compared to the corresponding period in 2003. The increase was attributed to higher employment in the NCD, Southern, Highlands and Islands regions. This mainly reflected new building and renovation projects especially for schools and hospitals, the repair and maintenance of main and feeder roads, and the construction of bridges.

In the transportation sector, the level of employment increased by 2.9 percent in the September quarter of 2004, compared to the corresponding period in 2003. Higher employment by the air transportation sub-sector was due to the recruitment of casual staff in preparation for the festive season and recruitment of operational staff in various ports by third level airlines. The increase in the land transportation sub-sector was associated with increased work by a mining company.

In the agriculture/forestry/fisheries sector, the level of employment decreased by 3.7 percent in the September quarter of 2004, compared to the corresponding period in 2003 due to lower employment in the Southern, Highlands, Morobe and Momase regions. The decline was associated with reduced casual employment by the agricultural sub-sector including palm oil, cocoa and coffee producers as a result of lower production. The lay-off of casual staff by poultry and



cattle farms also contributed to the decline.

In the finance and other business services sector (which includes real estate, hotel and restaurants, finance and security services), the level of employment increased by 3.4 percent in the September quarter of 2004, compared to the corresponding period in 2003. The increase was due to the recruitment of new staff by hotels and restaurants associated with increased activity, and by the security firms, legal and accountancy companies.

In the mining/quarrying/petroleum sector, the level of employment decreased marginally by 0.8 percent in the September quarter of 2004, compared to the corresponding period in 2003. The decline was due to the laying-off of temporary staff by the mining and petroleum reflecting the slow-down in exploration activities. The decline was also attributed to the dry season which affected the shipment of smelted copper along the Fly river.

By region, higher employment in the NCD and Islands regions more than offset declines in the other regions. In the NCD, the level of employment increased by 6.2 percent in the September quarter of 2004, compared to the corresponding period in 2003 and mainly reflected higher casual employment. Higher employment by bakeries, manufacturers of soft drinks, beverage, cereals and food items and sheet metal fabricators accounted for the increase in the manufacturing sector. Increased employment by the civil and building contractors accounted for the growth in the construction sector. The increase in employment for delivery and retailing activity in preparation for the festive season contributed to the increase in the retail and wholesale sectors. The increase in the finance and other services sector reflected higher employment by the hotels and catering and security firms.

In the Islands region, the level of employment increased by 3.9 percent in the September quarter of 2004, compared to the corresponding period in 2003. The increase reflected higher employment by all sectors except the finance and other business services sector. The increase in the agriculture/forestry/fisheries sector was due to higher employment by the copra and cocoa plantations, and the forestry sub-sector. The manufacturing sector continued to record higher employment with more staff engaged by bakeries, beverage manufacturers, and processors and exporters of processed timbers.

In the Southern region, the level of employment decreased by 6.7 percent in the September quarter of 2004, compared to the corresponding period in 2003. The decline mainly reflected lower employment in the agriculture/forestry/fisheries sector and was associated with reduced employment by the palm oil plantations and the laying-off of fishermen by some fishing companies.

In the Highlands region, the level of employment decreased by 7.2 percent in the September quarter of 2004, compared to the corresponding period in 2003. The decline was in all sectors except the construction, and finance and other services sectors. Reduced employment in the agriculture sector was due to lower employment by the coffee plantations due to lower production. Lower employment in the manufacturing sector reflected the laying-off of casual staff by bakeries, steel and sheet metal fabricators, and furniture manufacturers. The decline in the retail and wholesale sectors reflected lower employment by the general merchandise companies due to lower demand, while the decline in the transportation sector was associated with lower haulage of general cargo.

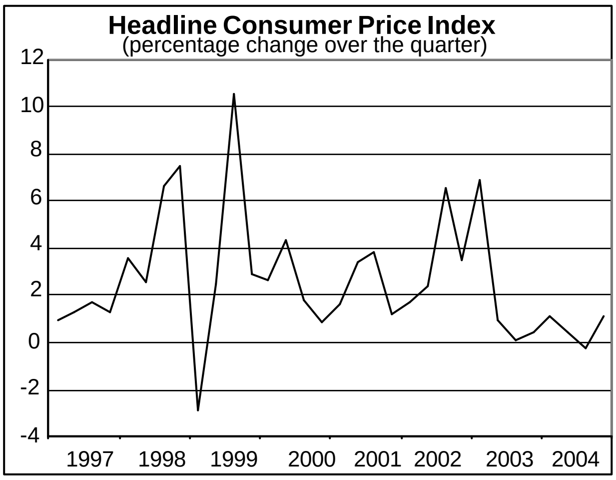
In the Momase region, the level of employment decreased by 1.4 percent in the September quarter of 2004, compared to the corresponding period in 2003. The decrease reflected lower employment in the agriculture/forestry/fisheries and construction sectors. Reduction in casual staff by the copra and cocoa plantations and the lay-off of fishing crew accounted for decline in the agriculture/forestry/fisheries sector. The completion of on-going civil and building projects, combined with the lack of new projects accounted for the decline in the construction sector.

In Morobe, the level of employment decreased marginally by 0.8 percent in the September quarter of 2004, compared to the corresponding period in 2003. The decline was due to lower employment by the agriculture/forestry/fisheries, construction and retail sectors. In the agriculture/forestry/fisheries sector, the decline was due to the laying-off of staff by a fishing company and a reduction in temporary staff by the poultry farms. The decline in the construction sector was due to lower civil and building projects during the period.

CONSUMER PRICE INDEX

The headline inflation rate as measured by the Consumer Price Index (CPI) was 1.3 percent in the December quarter of 2004, compared to negative 0.3 percent in the September quarter of 2004. The increase was driven by betelnut prices, which caused an increase in the index of the 'Drinks, tobacco and betelnut' group and fuel price increases, which caused an increase in the index of the 'Rent council charges and fuel power' group. These increases more than offset decreases in the other groups. By region all urban areas from which CPI is collected recorded increases in the December quarter of 2004, except Lae, which recorded a decrease. The annual headline inflation rate as measured by the CPI was 2.4 percent in the December quarter of 2004, compared to 8.4 percent in the corresponding period in 2003.

The CPI for the 'Food' expenditure group decreased by 1.7 percent in the December quarter of 2004, compared to a decline of 0.9 percent in the previous quarter. This was mainly attributed to decreases in the cereal and meat and fish sub-groups. For the 'Drinks, tobacco and betelnut' expenditure group, the CPI increased by 8.2 percent in the December quarter of 2004, compared to a decrease of 2.1 percent in the previous quarter. This was mainly attributed to betelnut prices, which doubled and marginal increases in the prices of soft drinks and alcoholic drinks. The 'Clothing and footwear', 'Household equipment and operations', 'Transport and communication' and 'Miscellaneous' expenditure groups all experienced moderate deflation during the December quarter. By contrast, the 'Rents, council charges, fuel and power' expenditure group recorded a 5.1 percent increase. This was mainly the result of higher international oil prices, which caused a 9.9 percent increase in the fuel and power sub-group index.



By urban areas, all CPI surveyed areas except Lae recorded increases in the December quarter of 2004. Madang recorded the highest increase of 3.3 percent compared to a decrease of 0.4 percent in the previous quarter, followed by Rabaul with an increase of 2.7 percent compared to an increase of 1.3 percent in the previous quarter. Port Moresby reported an increase of 1.6 percent compared to a decrease of 0.1 percent in the previous quarter, while Goroka recorded the smallest increase of 0.9 percent in the December quarter of 2004 compared to a decrease of 2.1 percent in the previous quarter. Lae recorded a decrease of 0.9 percent in the December quarter of 2004 compared to a decrease of 0.5 percent in the previous quarter.

The exclusion-based inflation measure decreased by 1.3 percent in the December quarter of 2004, compared to an increase of 0.7 percent in the previous quarter. The trimmed-mean measure recorded zero inflation rate in the December quarter of 2004, compared to 0.1 percent in the previous quarter. The lower outcome was due to the appreciation of the kina against the US and the Australian dollars during the June and the September quarters and continued lack of domestic inflationary pressure.

5. EXPORT COMMODITIES REVIEW

The total value of merchandise exports was K8,151 million in 2004, an increase of 3.9 percent from 2003. There were increases in the values of copper, copra, copra oil, palm oil, rubber and tea exports. The value of agricultural, marine products and other non-mineral exports, excluding forestry product exports was

K1,766.5 million and accounted for 21.7 percent of total merchandise exports in 2004, compared to 19.6 percent in 2003. Forestry product exports were K427.7 million and accounted for 5.2 percent of total merchandise exports in 2004, compared to 5.3 percent in 2003. Mineral export receipts, excluding crude oil were K4,331.6 million and accounted for 53.1 percent of total merchandise exports in 2004, compared to 54.3 percent in 2003. Crude oil exports totalled K1,625.2 million and accounted for 19.9 percent of total merchandise exports in 2004, compared to 20.8 percent in 2003.

The weighted average kina price of Papua New Guinea's exports increased by 11.5 percent in 2004, relative to 2003. There was an increase of 15.3 percent in the weighted average kina price of mineral exports, with higher kina prices of all mineral exports. For agricultural, forestry and marine product exports, the weighted average kina price declined by 1.8 percent and was attributed to lower prices of cocoa, tea and forestry product exports, which more than offset increases in the prices of coffee, copra, copra oil, palm oil, rubber and marine products. The lower kina prices of some of the agricultural export commodities reflected the appreciation of the kina against the US dollar, as international prices of coffee, copra, copra oil, rubber and tea increased in 2004.

Mineral Exports

Total mineral export receipts were K5,956.8 million in 2004, an increase of 1.1 percent from 2003. The increase was due to higher kina prices of all mineral exports, which more than offset declines in export volumes.

Gold export volumes were 66.2 tonnes in 2004, a decline of 3.2 percent from 2003. The decline was due to lower production from all the mines, except the Lihir mine, resulting from the mining of lower ore grades combined with declines in shipment. The average free on board (f.o.b.) price for Papua New Guinea's gold exports was K41.6 million per tonne in 2004, 1.2 percent higher than in the corresponding period of 2003. The increase reflected higher international prices which more than offset the effect of the appreciation of the kina against the US dollar. The average gold price at the London Metal Exchange increased by 12.6 percent to US$410 per fine ounce in 2004. The increase was due to higher demand from Asia and North America, as investors considered gold based assets a safe haven investment after continued lower performance in the equity markets. Higher gold prices also reflected the depreciation of the US dollar against other major currencies, continued uncertainties surrounding the on-going conflict in Iraq and global fears of terrorism. The decline in the export volume more than offset the increase in the export price, resulting in a decline in export receipts by 2.0 percent to K2,755.9 million in 2004, compared to 2003.

Copper export volumes were 173.9 thousand tonnes in 2004, a decline of 24.6 percent from 2003. The decline was due to lower production and shipment of copper ore from the Ok Tedi mine as a result of lower water levels at the Fly river. The average f.o.b. price of Papua New Guinea's copper exports increased by 44.7 percent to K8,880 per tonne in 2004, due to higher international prices. The increase in international prices was due to lower stock levels at the London Metal Exchange combined with higher demand from Asia, one of the major copper consuming regions. The increase in the export price more than offset the decline in export volume resulting in an increase in export receipts by 9.1 percent to K1,544.2 million in 2004, compared to 2003.

Crude oil export volumes were 12,395.1 thousand barrels in 2004, a decline of 17.3 percent from 2003. The decline was attributed to a lower extraction rate from wells at the Kutubu, Gobe Main and South East Gobe oil projects reflecting the natural decline in reserve levels. The average export price of crude oil increased by 20.2 percent to K131 per barrel in 2004. Despite members of the Organisation of Petroleum Exporting Countries (OPEC) exceeding their official quotas, higher international prices were associated with increased global demand resulting from lower Strategic Reserve Levels in North America. This combined with the slow recovery of oil production in Iraq, uncertainties surrounding Russian oil production due to possible bankruptcy of Russia's leading oil company, strikes by oil workers in Venezuela and continued global fears on terrorism. The decline in the export volume more than offset the increase in the export price and resulted in a marginal decline in the export receipts by 0.4 percent to K1,625.2 million in 2004, compared to 2003.

Agriculture, Logs and Fisheries Exports

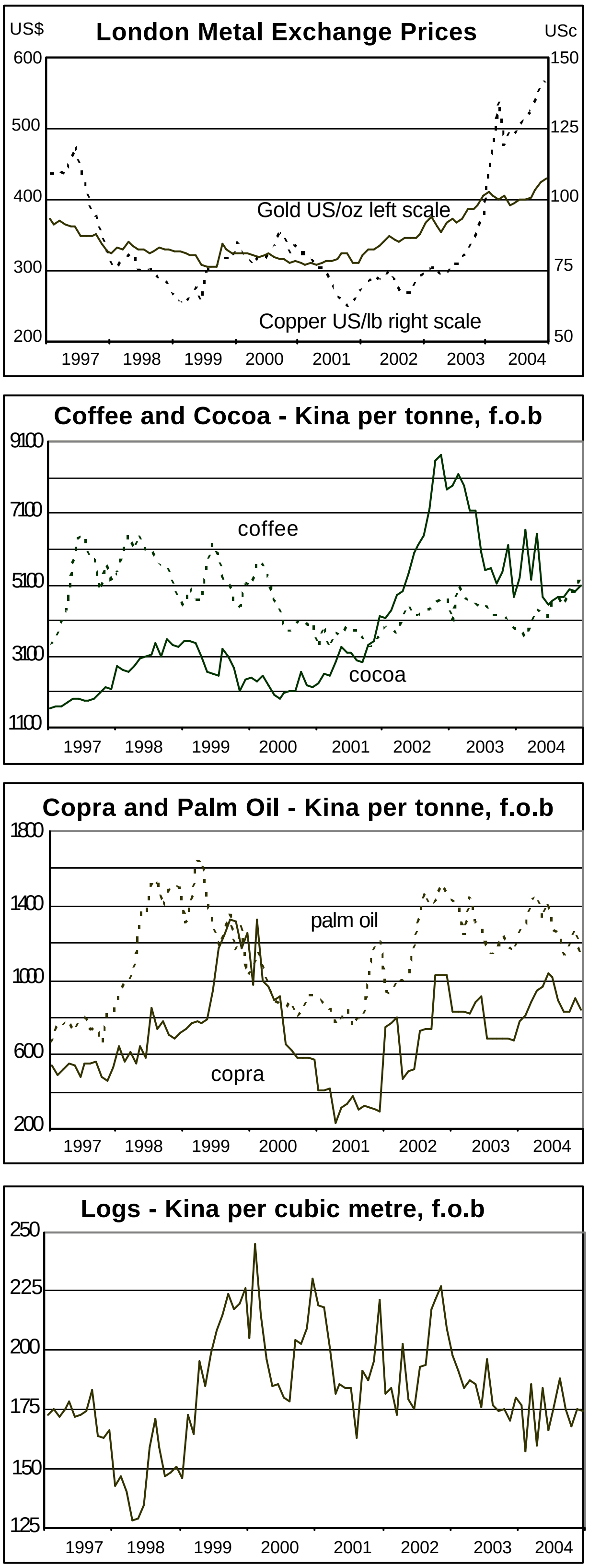
Export prices of most agricultural export commodities increased in 2004, compared to 2003. Coffee prices increased by 3.8 percent, copra by 15.8 percent, copra oil by 27.1 percent, palm oil by 0.4 percent and rubber by 24.0 percent. The average export price of logs was K175 per cubic meter in 2004, a decline of 4.4 percent from 2003. The decline in export price of logs, cocoa and tea more than offset the increase in prices of most agricultural export commodities resulting in a 1.8 percent decline in the weighted average price of agricultural, forestry and marine product exports. Excluding logs, the weighted average price of agricultural and marine product exports declined by 1.0 percent in 2004, relative to 2003.

The volume of coffee exported was 63,000 tonnes in 2004, a decline of 8.4 percent from 2003. The decline was due to lower production attributed mainly to the biennial coffee production cycle and deteriorating road infrastructure. The average export price of coffee increased by 3.8 percent to K4,505 per tonne in 2004, compared to 2003. The increase was mainly due to higher international prices resulting from a decline in world supply caused by unfavourable weather conditions in Brazil, the world's major coffee producer. The decline in export volume more than offset the increase in export price, resulting in a decline in export receipts by 4.9 percent to K283.8 million in 2004.

The volume of cocoa exported was 41,500 tonnes in 2004, an increase of 3.0 percent from 2003. The increase was attributed to higher production mainly as a result of favourable weather conditions in the major cocoa producing regions. The average export price of cocoa declined by 17.9 percent to K5,253 per tonne in 2004, relative to 2003. The decline was due to lower international prices resulting from higher world supply reflecting increased production from Africa, especially the Ivory Coast, Asia and Latin America. The decline in export price more than offset the increase in export volume resulting in a 15.4 percent decline in export value to K218.0 million in 2004.

The volume of copra exported increased significantly by 128.6 percent to 19,200 tonnes in 2004, compared to 2003. The increase was attributed to higher production from the major copra producing regions, resulting from a supply response to higher international prices as producers reduced sales to the domestic copra mills in favour of direct exports. The average export price of copra was K896 per tonne in 2004, an increase of 15.8 percent from 2003. The increase was due to higher international prices as a result of lower copra production from the Philippines and Indonesia,

EXPORT COMMODITY PRICES



two of the world's major copra producers. The combined increase in export price and volume resulted in a significant increase in export receipts by 164.6 percent to K17.2 million in 2004.

The volume of copra oil exported was 45,100 tonnes in 2004, a decline of 5.5 percent from 2003. The decline was attributed to lower quantities of copra purchased by the two domestic copra processing mills for processing. The average export price of copra oil increased by 27.1 percent to K1,796 per tonne in 2004, relative to 2003. The increase was due to higher international prices as a result of lower copra production from the Philippines and Indonesia, two of the world's major producers. The increase in export price more than offset the decline in export volume resulting in export receipts increasing by 20.2 percent to K81.0 million in 2004.

The volume of palm oil exported was 339,000 tonnes in 2004, an increase of 3.7 percent from 2003. The increase was due to higher production attributed to on-going expansion of plantations combined with higher shipment and favourable weather conditions in the palm oil producing regions. The average export price of palm oil increased by 0.4 percent to K1,294 per tonne in 2004. The combined increase in export price and volume resulted in an increase in export receipts by 4.1 percent to K438.7 million in 2004.

The volume of tea exported was 8,100 tonnes in 2004, an increase of 22.7 percent from 2003. The increase was due to higher production mainly as a result of favourable weather conditions combined with the commencement of exports by a recently rehabilitated plantation. The average export price of tea declined by 3.3 percent to K2,827 per tonne in 2004, compared to 2003. The decline was mainly due to the appreciation of the kina against the US dollar as international prices increased, as a result of lower supply in the world market. The increase in export volume more than offset the decline in export price resulting in a 18.7 percent increase in the export receipts to K22.9 million in 2004.

The volume of rubber exported was 3,800 tonnes in 2004, a decline of 9.5 percent from 2003. The decline was mainly attributed to unfavourable weather conditions and deteriorating road infrastructure in the rubber producing regions. The average export price increased by 24.0 percent to K3,632 per tonne in 2004, compared to 2003. The increase was due to higher international prices as a result of lower supply in the world market. The increase in export price more than offset the decline in export volume resulting in a 12.2 percent increase in the export value to K13.8 million in 2004.

The volume of logs exported was 1,859 thousand cubic meters in 2004, a decline of 7.8 percent from 2003. The decline was due to lower production and shipment of logs from major logging projects, due to unfavourable weather conditions. Production was also affected by the embargo imposed on the industry under the Forestry Conservation Program. The average export price of logs declined by 4.4 percent to K175 per cubic meter in 2004, relative to 2003. The decline was due to lower international prices, reflecting higher supply of tropical hardwood in the world market. The combined decline in export price and volume resulted in a 12.2 percent decline in the export value to K324.6 million in 2004.

The value of marine products exported was K58.2 million in 2004, a decline of 53.6 percent from 2003. This resulted from a decline in export volume, which more than offset an increase in export price.

6. BALANCE OF PAYMENTS

The overall surplus in the balance of payments was K335 million in 2004, compared to a surplus of K353 million in 2003. This outcome was due to a surplus in the current account, which more than offset a net outflow in the financial and capital account. The surplus in the current account was due to surpluses in goods and transfer payments, which more than offset deficits in services and income payments. The deficit in the capital and financial account reflected increases in portfolio and financial derivative assets abroad, which more than offset a net inflow of direct equity investment, combined with the draw down of foreign currency account balances by the mineral companies. In 2004, the kina appreciated against the currencies of Papua New Guinea's major trading partners, with the exception of the Australian dollar and British pound. This resulted in a decline in the kina value of some balance of payments transactions, as most transactions were made in US dollar.

The surplus in the trade account was K3,448 million in 2004, compared to a surplus of K3,611 million in 2003. This outcome was due to an increase in the value of merchandise exports which was offset by an increase in the value of merchandise imports. The value of merchandise exports increased by 3.9 percent to K8,151 million in 2004, compared to 2003. The increase was attributed to higher values of palm oil, copra, copra oil, tea, rubber and copper exports.

The value of merchandise imports was K4,703 million in 2004, compared to K4,231 million in 2003. The increase was due to higher values of imports across all sectors. General imports increased by 8.9 percent to K3,689 million in 2004, reflecting some pick-up in import demand and the kina depreciation against the strong Australian dollar. Imports by the mining sector increased by 22.6 percent to K923 million in 2004, compared to 2003. The increase was due to higher capital expenditure by the Ok Tedi, Lihir and Tolukuma mines. Imports by the petroleum sector increased marginally by 0.3 percent to K91 million in 2004, relative to 2003, reflecting capital expenditure by the Kutubu oil project.

The deficit in the services account was K2,402 million in 2004, compared to a deficit of K2,263 million in 2003. The higher deficit was due to lower service receipts in other financial, business and construction services in 2004, compared to 2003. Service payments by resident companies were lower during this period.

The deficit in the income account was K1,320 million in 2004, compared to a deficit of K1,699 million in 2003. This outcome was due to lower compensation of employees, interest and dividend payments.

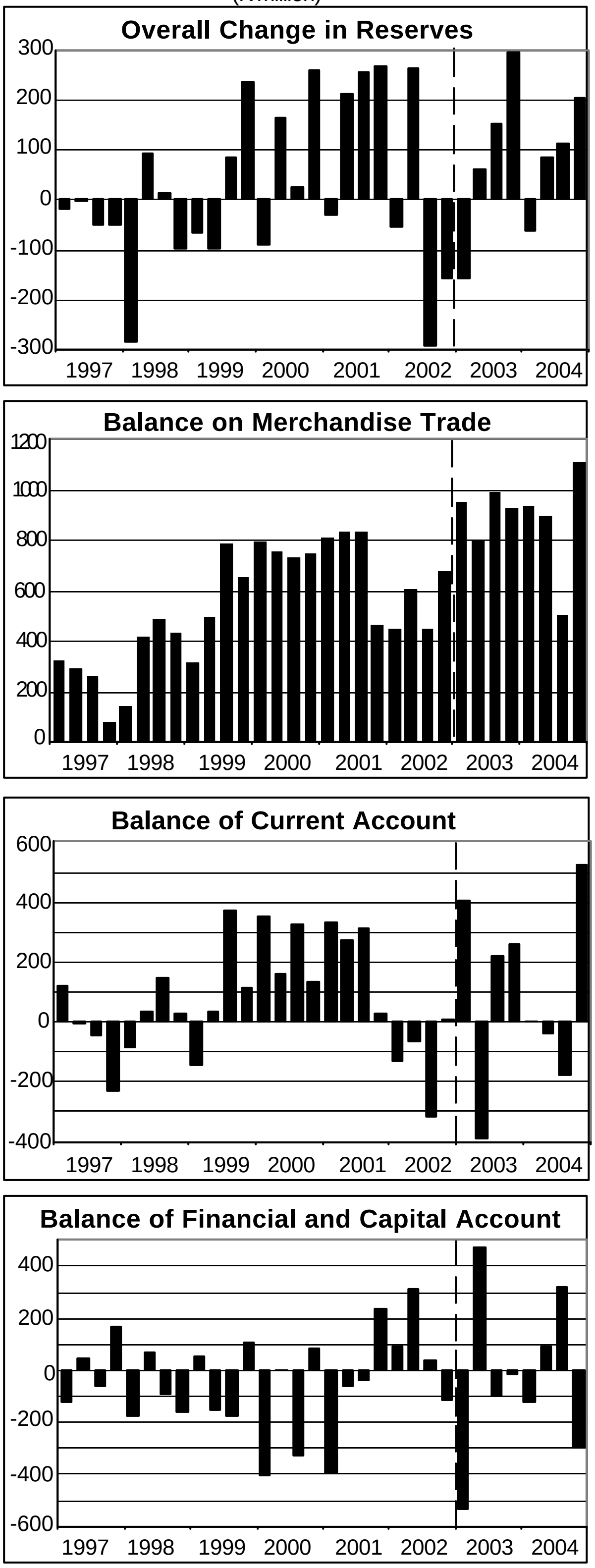
The surplus in the transfers account was K584 million in 2004, compared to a surplus of K847 million in 2003. The lower surplus was due to lower receipts from tax and gifts and grants receipts, which more than offset lower transfer payments.

As a result of these developments in the trade, services, income and transfers accounts, the current account recorded a surplus of K310 million in 2004, compared to a surplus of K496 million in 2003.

The capital account recorded no transactions during 2004, the same as in 2003.

The financial account recorded a net outflow of K18 million in 2004, compared to a net outflow of K183 million in 2003. This reflected increases in portfolio and financial derivative assets abroad, due to increased holding of short-term money market instruments and

BALANCE OF PAYMENTS[1]
(K'million)



[1] The dotted vertical lines indicate a break in series from 2002. See "For the Record" in March 2002 QEB on page 29.

hedging transactions by resident mineral companies. This more than offset a net inflow in equity capital associated with equity financing for a mineral project, combined with a draw down of foreign currency account balances by the mineral companies.

In the December quarter of 2004, the balance of payments recorded an overall surplus of K204 million, compared to a surplus of K295 million in the corresponding quarter of 2003. The surplus was due to an improvement in the current account, more than offsetting a net outflow in the capital and financial account.

The value of merchandise exports was K2,210 million in the December quarter of 2004, compared to K2,007 million in the corresponding quarter of 2003. The increase was due to higher values of crude oil, cocoa, palm oil, tea, copra, copra oil and rubber, which more than offset declines in the values of gold, copper, coffee, logs and marine product exports. Agricultural, forestry, marine products and other non-mineral exports totalled K630.2 million and account for 28.5 percent of the total merchandise exports in the December quarter of 2004, compared to 24.1 percent in the corresponding period of 2003. Mineral exports totalled K1,579.8 million or 71.5 percent of total merchandise exports in the December quarter of 2004, compared to 75.9 percent in the corresponding period of 2003.

The value of merchandise imports was K1,102 million in the December quarter of 2004, compared to K1,075 million in the corresponding quarter of 2003. The increase was due to higher imports from the mining and petroleum sectors. Imports by the mining sector increased by 21.0 percent to K254 million in the December quarter of 2004, relative to the corresponding quarter of 2003. This outcome was due to higher capital expenditure by the Ok Tedi and Lihir mines. Imports by the petroleum sector increased by 15.0 percent to K23 million in the December quarter of 2004, compared to the corresponding quarter of 2003, due to higher capital expenditure by the Gobe, Moran and Kutubu oil projects. General imports declined by 2.4 percent to K825 million in the December quarter of 2004, relative to the corresponding period in 2003.

The deficit in the services account was K425 million in the December quarter of 2004, compared to a deficit of K576 million in the corresponding quarter of 2003. The lower deficit was due to declines in transportation, insurance, other financial services, refining and smelting, education and other service payments. These more than offset lower service receipts combined with higher travel, computer and information, communication, government services n.i.e., and construction payments by resident companies.

The deficit in the income account was K180 million in the December quarter of 2004, compared to a deficit of K301 million in the corresponding quarter of 2003. The lower deficit was due to reduced compensation of employees, interest and dividend payments, combined with increased income receipts.

The surplus in the transfers account was K20 million in the December quarter of 2004, compared to a surplus of K201 million in the corresponding quarter of 2003. This outcome was due to lower gifts and grants receipts, combined with higher family maintenance payments.

These developments resulted in a current account surplus of K523 million in the December quarter of 2004, compared to a surplus of K256 million in the corresponding quarter of 2003.

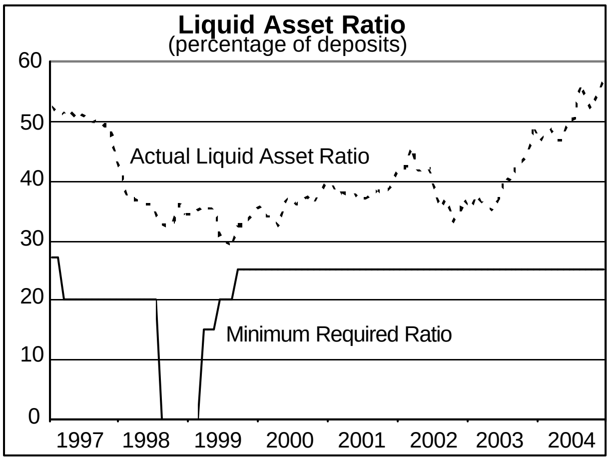
The deficit in the financial account was K300 million in the December quarter of 2004, compared to a deficit of K15 million in the corresponding period of 2003. The net capital outflow reflected an increase in portfolio investment and financial derivative assets abroad, associated with increased holdings of short-term money market instruments and hedging transactions by resident mineral companies. This combined with an increase in Other Investment assets, reflecting trade credits owed to residents by non-residents abroad, an increase in net foreign assets by the non-official monetary sector and the build up in offshore account balances of the mineral companies.

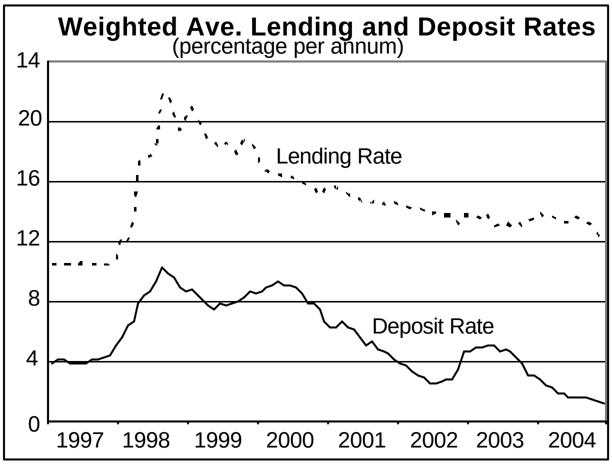
The level of gross foreign exchange reserves at the end of December 2004 was K2,066 (US$664.3) million, sufficient for 5.3 months of total and 6.7 months of non-mineral import cover.

7. MONETARY DEVELOPMENTS

LIQUIDITY AND INTEREST RATES

The Bank of Papua New Guinea gradually eased monetary policy during 2004, influenced mainly by the lower quarterly inflation outcomes, a stable exchange rate and sound fiscal management. The Central Bank reduced the Kina Facility Rate (KFR) by 7.0 percentage points in aggregate from 14.0 percent in December 2003 to 7.0 percent by December 2004. The easing stance of monetary policy, net sale of kina in the foreign exchange market and retirement of Treasury bills led to a high level of liquidity in the banking system and a decline in domestic interest rates. Treasury bill rates across all maturities decreased. The 28 day rate decreased from 16.13 percent to 3.14 percent, the 63 day rate from 16.36 percent to 3.44 percent, the 91 day rate from 16.30 percent to 3.70 percent and the 182 day rate from 16.91 percent to 4.57 percent. During the same period, weighted average interest rates on wholesale deposits (K500,000 and above) quoted by commercial banks also declined. The 30 day rate decreased from 6.44 percent to 1.62 percent, the 60 day rate from 5.65 percent to 1.51 percent, the 90 day rate from 5.99 percent to 3.28 percent and the 180 day rate from 6.23 percent to 4.68 percent.





The Bank continued to utilise its Open Market Operation (OMO) instruments in the conduct of monetary policy. In addition to trading in Government securities, the Central Bank also utilised the Repurchase Agreement Facility (RAF) to manage liquidity in the banking system. As a result of the significant increase in liquidity levels and rapid decline in interest rates, the Bank introduced the Central Bank Bill (CBB) in August 2004 to sterilise the build up in liquidity and stabilise interest rates. The Central Bank also increased the minimum bid for Treasury bills at the auction from K100,000 to K500,000 in August 2004 then to K1,000,000 in December 2004. This change was also aimed at encouraging the development of a secondary market for Government securities. The Cash Reserve Requirement (CRR) and the Minimum Liquid Assets Ratio (MLAR) were maintained at 3.0 percent and 25.0 percent, respectively. Trading in the inter-bank market remained relatively low throughout 2004, as a result of the high level of liquidity.

The average level of liquid assets held by the commercial banks in 2004 was high relative to 2003. The monthly average level of liquid assets increased by 37.9 percent in 2004, following a decrease of 4.1 percent in 2003. The increase reflected higher holdings of Government securities and deposits with the Central Bank under the RAF and the Exchange Settlement Account (ESA). Commercial banks continued to hold the majority of their liquid assets in the form of short-term Government Treasury bills.

The average level of liquid assets held by commercial banks increased by 23.9 percent in the second half relative to the first half of the year, during which it increased by 15.3 percent. The increase in liquidity levels was mainly due to Central Bank intervention in the foreign exchange market combined with net maturity of Treasury bills by the Government.

The weighted average interest rate on total deposits fell from 2.95 percent at the end of December 2003 to 1.11 percent at the end of December 2004, while the weighted average rate on lending fell from 13.52 percent to 12.13 percent. The weighted average rate on performing loans declined from 14.48 percent to 12.52 percent during the same period. Consistent with the easing monetary policy stance, commercial banks reduced their Indicator Lending Rates (ILRs) during the year to a range of 10.00 to 11.75 percent by the end of December 2004.

MONEY SUPPLY

The average level of broad money supply (M3*) increased by 13.0 percent in 2004, compared to a revised decline of 2.7 percent in 2003. The growth resulted from an increase of 49.9 percent in average net foreign assets of the banking system, which more than offset a decline of 4.7 percent in average net domestic credit to the private sector, official entities and non-monetary financial institutions. The increase in average net foreign assets was mainly due to the accumulation of foreign exchange reserves and repayment of external debts, including the Central Bank's liabilities to the International Monetary Fund (IMF). Domestic credit outstanding, excluding advances to the Central Government and loans under the Government's Agricultural export commodity price support schemes decreased by 3.2 percent in 2004, compared to a decline of 6.1 percent in 2003. The average level of the broad monetary base increased by 30.4 percent in 2004, compared to a decline of 1.4 percent in 2003. The substantial increase was due to higher holdings of Government securities, reflecting purchases of new Inscribed stocks and an increase in commercial bank deposits at the Bank of PNG.

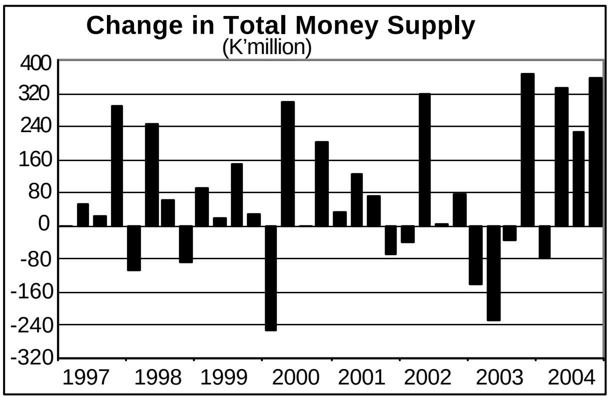
Over 2004, net credit extended to the Government by the banking system increased by 30.9 percent, compared to a decline of 10.6 percent in 2003. The growth was mainly due to increased purchase of Treasury bills and Inscribed stocks by commercial banks.

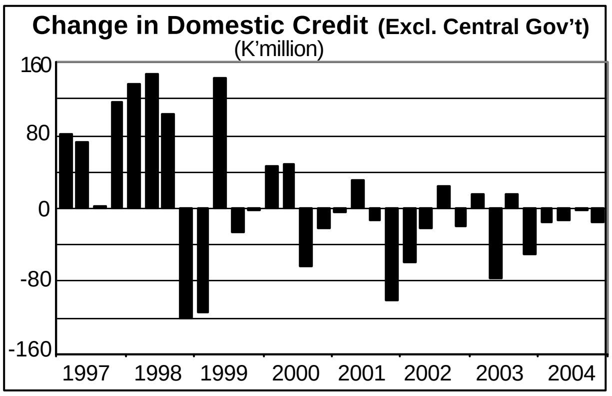
The monthly average level of narrow money supply (M1*), which includes currency outside banks and demand deposits increased by 19.8 percent in 2004, compared to an increase of 6.6 percent in 2003. The increase was due to a higher level of currency in circulation and demand deposits, reflecting a shift from term deposits to cash and demand deposits as a result of the fall in interest rates. The average level of quasi money decreased by 7.5 percent in 2004, compared to a decrease of 10.9 percent in 2003. This was due to a decline in term deposits associated with a shift to demand deposits.

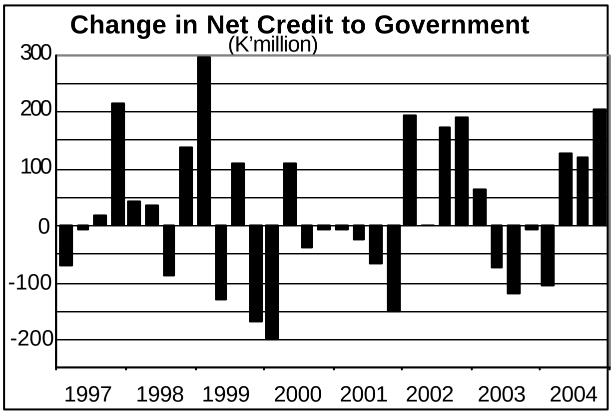
The monthly average deposit base of the commercial banks increased by 7.2 percent from K2,960.6 million in 2003 to K3,173.0 million in 2004.

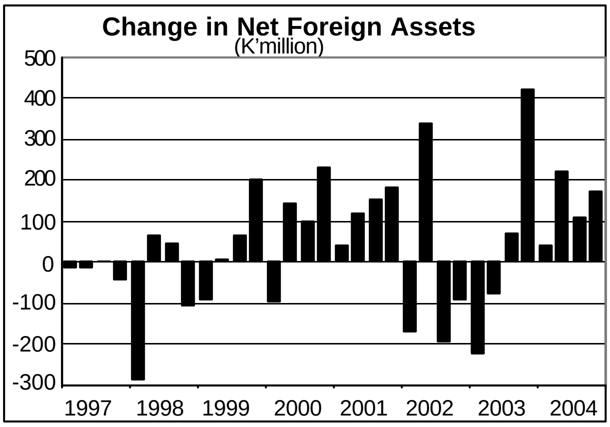
LENDING

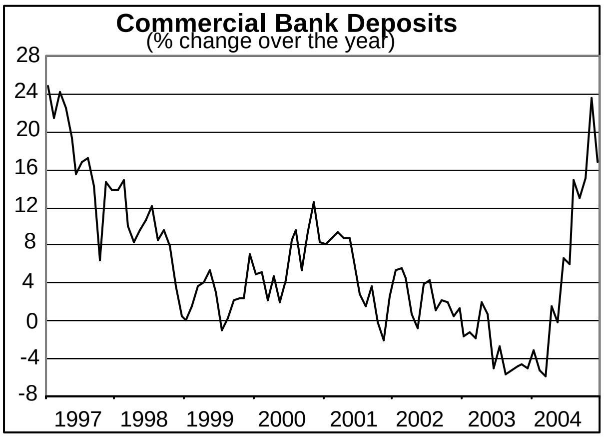
Over the year to December 2004, total domestic credit

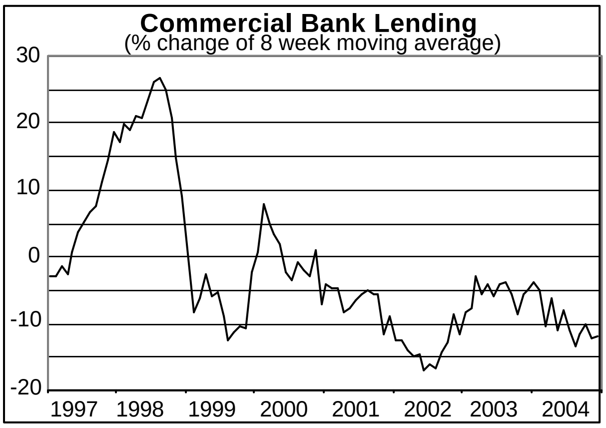












extended by the banking system to the private sector, official entities and non-monetary financial institutions decreased by K46.1 million to K1,451.0 million. Lending to the private sector and official entities declined by K23.5 million and K26.9 million, respectively. This more than offset an increase of K4.3 million in lending to the non-monetary financial institutions. The decline in the private sector was mainly due to repayments by the commerce sector, particularly retail trade, manufacturing and transport and communication sectors. The decline in lending to official entities resulted from repayments by public sector enterprises. The annual rate of decline in domestic credit, excluding the Central Government and outstanding loans under the price support schemes was 3.2 percent over the year to December 2004. At the end of December 2004, foreign currency lending to the private sector and official entities accounted for 8.4 percent of total lending to these sectors, compared to 6.7 percent in December 2003, with kina lending accounting for 91.6 percent of total lending.

Over the first six months of 2004, total domestic credit extended by commercial banks to the private sector, official entities and non-monetary financial institutions declined by K28.9 million to K1,468.2 million. Lending to private sector and non-monetary financial institutions declined by K28.6 million and K4.8 million, respectively, which more than offset an increase of K4.5 million in lending to official entities. The decline in lending by the private sector reflected repayments by the commerce and transport and communications sectors, as well as other businesses.

Over the second half of 2004, the level of domestic credit extended by the commercial banks to the private sector, official entities and non-monetary financial institutions declined by K17.2 million to K1,451.0 million. Lending to the official entities fell by K31.4 million, while lending to the private sector and non-monetary financial institutions increased by K5.1 million and K9.1 million, respectively. The decline in lending to official entities resulted from repayments by public enterprises.

The utilisation rate of credit is a fair indicator of the level of efficiency at which the private sector is able to draw down committed funds to fund their operations. It is the ratio of total credit outstanding to total commitments outstanding to the private sector, official entities and non-monetary financial institutions. A higher utilisation rate indicates that firms are efficient in drawing down funds and minimising commitment fees. Commitment fees include call and term lending and excludes any other contingent items. The utilisation rate, quarter on quarter, was 79.8 percent in December 2004, compared to 84.6 percent in December 2003.

8. PUBLIC FINANCE

Preliminary estimates of the fiscal operations of the National Government for 2004 showed an overall surplus of K234.0 million, compared to a deficit of K124.1 million in 2003, and represents 1.7 percent of nominal GDP. The surplus was due to higher revenue combined with lower expenditure.

Total revenue, including grants during 2004 was K3,939.5 million, 9.1 percent higher than the receipts collected in 2003, and represents 92.0 percent of the revised budgeted revenue. The increase was attributed to higher collections in all categories of tax revenue and non-tax revenue, which more than offset lower project grants.

Total tax revenue amounted to K3,220.2 million, 20.3 percent higher than the receipts collected during 2003, and represents 102.9 percent of the revised budgeted tax receipts. The increase reflected higher direct and indirect tax receipts.

Direct tax receipts totalled K2,223.3 million, K436.7 million more than the receipts collected in 2003, and represents 105.7 percent of the revised budgeted amount. The growth was due to increases in personal, company and other direct tax receipts. The growth in personal tax receipts reflected the adjustment in salaries and wages. The increase in company tax receipts reflected the improvement in the profitability by companies because of higher mineral and agricultural production and prices. Other direct taxes increased due to higher receipts from gaming and dividend withholding taxes.

Indirect tax receipts were K996.9 million, 11.8 percent higher than in 2003, and represent 97.2 percent of the revised budgeted receipts for 2004. All categories of indirect tax receipts increased except export tax. The increase in import duties reflected higher imports. Other indirect tax receipts also increased as a result of the 2.0 percent import duty, while the growth in goods and services tax (GST) reflect increased collections in the provinces. The decline in export tax receipts reflected lower log exports.

Total non-tax revenue amounted to K240.1 million, K0.9 million higher than the amount collected in 2003, and represents 78.9 percent of the revised budgeted amount. The increase mainly reflected higher dividend payments by Government Statutory bodies and the mineral sector. Foreign grants totalled K479.2 million, K213.8 million lower than in 2003, due to delayed reporting of counterpart funding for AusAID funded projects.

Total expenditure during 2004 was K3,705.5 million, 0.8 percent lower than in 2003, and represents 89.7 percent of the revised budgeted expenditure for 2004. The decline reflected lower interest payments and development expenditure.

Recurrent expenditure in 2004 was K2,801.9 million, 4.0 percent higher than in 2003, and represents 101.4 percent of the revised budgeted appropriation. The increase was due to growth in the National and Provincial Government expenditure and grants to statutory authorities, which more than offset lower interest payments. The National Departmental expenditure was K1,556.6 million, K364.2 million higher than in 2003, and represents 100.1 percent of the revised budgeted appropriation. The increase reflected higher wages and salaries, education subsidy, payment of arrears and expenses associated with the by-elections. Provincial Government recurrent expenditure was K672.2 million, 13.1 percent higher than the expenditure level during 2003, and represents 110.6 percent of the budgeted amount. The increase was due to higher administrative grants and salaries and wages. Interest payments totalled K375.6 million, K364.0 million lower than the amount paid in 2003, and reflected lower interest rates on Treasury bills combined with the retirement of some domestic debt, and the appreciation of the kina against the US dollar.

Total development expenditure in 2004 was K903.6 million, 13.0 percent lower than in 2003 and represents 66.2 percent of the revised budgeted expenditure for 2004. The decrease was partly related to delayed reporting of expenditures related to AusAID funded projects.

The surplus combined with domestic borrowing of K103.6 million was used to repay net overseas loans of K337.6 million. The net external loan repayments comprised of K159.6 million in concessionary, K9.8 million in commercial and K168.2 million of extraordinary loans. The domestic financing is mainly from the commercial banks. The proceeds from asset sales of K25.0 million were used to retire domestic debt.