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PORT MORESBY

17th March 2006
1. GLOSSARY OF TERMS AND ACRONYMS

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<th>Term</th>
<th>Definition</th>
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<tbody>
<tr>
<td>Balance of Payments</td>
<td>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.</td>
</tr>
<tr>
<td>Broad Money Supply (M3*)</td>
<td>Total volume of money comprising narrow money (M1*) and quasi money in the economy at a point in time. See ‘narrow’ and ‘quasi’ money.</td>
</tr>
<tr>
<td>Cash Reserve Requirement (CRR)</td>
<td>A requirement imposed on commercial banks to hold cash as a percentage of total deposits and other prescribed liabilities at all times.</td>
</tr>
<tr>
<td>Capital Account</td>
<td>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.</td>
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<tr>
<td>Central Bank Bill (CBB)1</td>
<td>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.</td>
</tr>
<tr>
<td>Current Transfers Account</td>
<td>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.</td>
</tr>
<tr>
<td>Exchange Settlement Account (ESA)</td>
<td>Accounts of the commercial banks with the Central Bank for settlement transactions with each other.</td>
</tr>
<tr>
<td>Exclusion-based CPI measure</td>
<td>An underlying inflation measure which involves zero weighting of volatile sub-groups or items such as fruit &amp; vegetables, betelnut and prices that are largely determined by non-market (seasonal) forces, as well as alcoholic drinks, cigarettes &amp; tobacco, etc. See ‘Underlying CPI’.</td>
</tr>
<tr>
<td>Financial Account</td>
<td>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.</td>
</tr>
<tr>
<td>Headline Consumer Price Index (CPI)</td>
<td>A measure of inflation as calculated and published quarterly by the National Statistical Office (NSO), which measures the total price movements in goods and services in the basket.</td>
</tr>
<tr>
<td>Income Account</td>
<td>Records transactions such as compensation of employees, which cover wages, salaries, and other benefits in cash and kind, dividends and interest earned on investments between PNG and the other countries.</td>
</tr>
<tr>
<td>Inscribed Stock</td>
<td>A Government bond or debt instrument sold to the public for a maturity term of one year or longer for Budget financing.</td>
</tr>
<tr>
<td>Kina Facility Rate (KFR)</td>
<td>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.</td>
</tr>
<tr>
<td>Liquid Assets</td>
<td>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.</td>
</tr>
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1 (See ‘For the Record: p.34 in the 2004 September QEB)
<table>
<thead>
<tr>
<th>Term</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Minimum Liquid Asset Ratio (MLAR)</strong></td>
<td>A prudential requirement imposed by the Central Bank on commercial banks to hold liquid assets as a percentage of total deposits and other prescribed liabilities at all times.</td>
</tr>
<tr>
<td><strong>Monetary Base</strong></td>
<td>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.</td>
</tr>
<tr>
<td><strong>Narrow Money</strong></td>
<td>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.</td>
</tr>
<tr>
<td><strong>Open Market Operations (OMO)</strong></td>
<td>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.</td>
</tr>
<tr>
<td><strong>Over the year CPI</strong></td>
<td>Percentage change in the CPI of a quarter compared to the corresponding quarter of the previous year (Also called ‘annual’ CPI).</td>
</tr>
<tr>
<td><strong>Portfolio Investment</strong></td>
<td>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.</td>
</tr>
<tr>
<td><strong>Quasi Money</strong></td>
<td>A component of total money supply that is not easily convertible to cash on demand and comprises of savings and term deposits.</td>
</tr>
<tr>
<td><strong>Repurchase Agreement Facility (RAF)</strong></td>
<td>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. Transactions can be collateralised or unsecured (Also called Repos).</td>
</tr>
<tr>
<td><strong>Reserve Money</strong></td>
<td>A measure of money, which includes currency holdings of commercial banks and their deposits at the Central Bank and money in circulation.</td>
</tr>
<tr>
<td><strong>Tap Facility</strong></td>
<td>A facility conducted by the Central Bank for sale of Treasury bills and Inscribed stocks to the public.</td>
</tr>
<tr>
<td><strong>Temporary Advance Facility</strong></td>
<td>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.</td>
</tr>
<tr>
<td><strong>Trade Account</strong></td>
<td>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.</td>
</tr>
<tr>
<td><strong>Treasury bill</strong></td>
<td>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, 182 and 364 day maturities.</td>
</tr>
<tr>
<td><strong>Trimmed-mean CPI measure</strong></td>
<td>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’.</td>
</tr>
<tr>
<td><strong>Underlying CPI (exclusion-based and trimmed-mean CPI measures)</strong></td>
<td>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.</td>
</tr>
</tbody>
</table>
2. GENERAL OVERVIEW

Indicators available to the Bank of PNG suggest that 2005 was a year of continued macroeconomic stability and modest economic growth. Strong export performance driven by high international prices resulted in a large current account surplus and mild appreciation in the exchange rate, and led to low inflation outcomes. The Bank of PNG therefore maintained a neutral monetary policy stance throughout the year. Interest rates remained low and lending to the private sector increased substantially. The level of employment also increased across most sectors of the economy. For long term sustainable economic growth the Government must take advantage of the current macroeconomic stability by spending more on infrastructure, addressing inefficiencies of public utilities and removing impediments to conducting business in Papua New Guinea.

Over the year to December 2005, the Bank’s formal private sector Employment Index increased by 3.4 percent, although it decreased by 0.1 percent in the December quarter of 2005, compared to the September quarter. By industry, the mineral and wholesale/retail sectors recorded increases, while all other sectors recorded decreases. By region, the NCD, Southern and Morobe regions recorded increases while the Highlands, Islands and Momase (excluding Morobe) regions recorded decreases.

Annual headline inflation rate, as measured by the Consumer Price Index (CPI) was 4.6 percent in 2005, compared to 2.4 percent in 2004. The higher headline inflation was due to large increases in the price of seasonal produce during the December quarter. By urban areas, all CPI surveyed centres recorded higher prices except Rabaul.

Annual trimmed mean inflation for 2005 was 3.3 percent, while exclusion-based inflation was negative 1.4 percent compared to 1.9 percent and 1.0 percent, respectively in 2004. The Bank of PNG considers the trimmed mean inflation to be the better indicator of underlying inflation trends and its outcome in 2005 was broadly in line with the Bank’s projections.

During 2005, the kina continued to strengthen against all the major currencies. The kina ended the year at 32.30 US cents, from 32.00 US cents at the end of 2004. The daily average kina exchange rate appreciated by 4.0 percent against the US dollar to 32.23 US cents. The kina was worth 44.00 Australian cents on 31st December 2005, a 7.2 percent appreciation on the rate at the end of 2004. The daily average exchange rate for the December quarter was 43.58 Australian cents, compared to 41.78 Australian cents in the December quarter of 2004. These movements resulted in the daily average Trade Weighted Index (TWI) appreciating by 0.9 percent over the year.

Higher international prices for most of the Papua New Guinea’s mineral and agricultural export commodities more than offset the appreciation of the kina against the US dollar. This resulted in a 13.0 percent increase in the weighted average kina price of exports in 2005, compared to 2004. There was a 15.6 percent increase in the weighted average kina price of mineral exports, with higher prices of copper and crude oil. For agricultural, logs and marine product exports, the weighted average kina price increased by 2.6 percent. This was accounted for by higher prices of coffee, tea, rubber and logs.

The overall surplus in the balance of payments was K255 million in 2005, compared to a surplus of K329 million in 2004. This outcome was due to a higher surplus in the current account, which more than offset a significant deterioration in the financial and capital accounts.

The current account recorded a huge surplus of K1,881 million in 2005, compared to a surplus of K393 million in 2004. This outcome was the result of higher surpluses in the trade and transfers accounts.

The capital and financial accounts recorded a deficit of K1,664 million in 2005, compared to a lower deficit of K80 million in 2004. The significant deterioration reflected a build up in foreign currency account balances of mineral companies, an increase in net foreign assets holdings of the banking system and outstanding trade credits owed to PNG resident companies.

The level of gross foreign exchange reserves at the end of December 2005 was K2,316 (US$774) million, sufficient for 6.0 months of total and 8.2 months of non-mineral import covers.

The Bank of PNG generally maintained a neutral monetary policy stance based on favourable macroeconomic outcomes and inflation outlook. Consistent with the Bank’s expectations as stated in the
January and July Monetary Policy Statements (MPS), the Kina Facility Rate (KFR) was maintained at 7.0 percent until September when it was reduced to 6.0 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 Bank of PNG also utilised Repurchase Agreements (Repos) and Central Bank Bills (CBBs) to manage liquidity in the banking system. In September 2005 the Bank separated the auction of Government’s Treasury bills from the CBBs to improve the effectiveness of monetary policy signalling.

The average level of broad money supply (M3*) increased by 21.3 percent in 2005, compared to a revised increase of 6.6 percent in 2004. The growth resulted from increases of 20.2 percent, 17.5 percent and 13.2 percent in average net foreign assets of the banking system, average net credit to the Government and average net domestic credit to the private sector, official entities and non-monetary financial institutions, respectively. The increase in average net foreign assets was a result of high mineral tax inflows and the full repayment of the Bank’s liabilities to the International Monetary Fund (IMF). The average level of the monetary base increased by 22.4 percent in 2005, compared to an increase of 30.4 percent in 2004. The growth was due to higher holdings of Government securities, particularly Inscribed stocks.

Over the year to December 2005, total domestic credit extended by the banking system to the private sector, official entities and non-monetary financial institutions increased by K376.1 million to K1,827.1 million, compared to a decrease of K46.1 million in 2004. The significant growth in credit to the private sector of K339.9 million mainly reflected advances to the building and construction, agriculture/forestry/fisheries, transport and communication, mineral, retail and private household sectors.

Preliminary estimates of the fiscal operations of the National Government for 2005 showed an overall surplus of K46.9 million, compared to a surplus of K201.9 million in 2004, and represents 0.3 percent of nominal Gross Domestic Product (GDP). The lower surplus reflected higher revenue, which more than offset an increase in expenditure.

Total revenue, including grants, during 2005 was K5,313.2 million, 22.2 percent higher than the receipts collected in 2004, and represents 105.1 percent of the 2005 revised budget. The increase was attributed to higher collections in all categories of tax revenue and non-tax revenue, combined with higher project grants.

Total expenditure during 2005 was K5,266.3 million, 27.0 percent higher than in 2004, and represents 102.2 percent of the revised budgeted expenditure for 2005. The increase reflected higher recurrent and development expenditures, which more than offset savings from lower interest payments.

The surplus combined with domestic borrowing of K190.9 million was used to make a net overseas loan repayment of K237.8 million. The domestic financing mainly reflected the new issuance of Inscribed stocks by the Government, which were taken up by the commercial banks, while financing from other domestic sources reflected the high volume of unpresented cheques issued in 2005.
3. INTERNATIONAL DEVELOPMENTS

The world economy continued to grow in 2005 led by developments in the industrialised countries, including the United States (US), Germany and the United Kingdom (UK), and the recovery in Japan, as well as strong demand in China, Brazil and India. The Organisation of Economic Co-operation and Development’s (OECD) latest outlook, released in November 2005, estimated a real Gross Domestic Product (GDP) growth of 2.7 percent for its member countries. The growth reflected robust consumer and business spending, despite high oil prices.

In October, talks on cuts to agricultural protection in the Doha round of trade negotiations continued. The European Union (EU) offered to cut its farm tariffs by an average of 39 percent after an earlier offer of 24 percent was rejected by other countries, including the Group of 20 (G20), which include Australia, Brazil, India and China. The G20 instead requested a cut of 54 percent, and the US called for 75 percent after it offered to cut its farm subsidies by 60 percent.

In November, leaders of the 21-member Asia-Pacific Economic Cooperation (APEC) forum met in Pusan, South Korea for their annual summit. The leaders discussed the forth-coming World Trade Organisation (WTO) Summit, international terrorism, and the bird (avian) flu outbreak, amongst other regional and international issues.

In December, trade ministers and officials from the 149-member WTO met in Hong Kong. Whilst disagreements persisted, they agreed to end farm export subsidies by 2013, as well as open up markets in the industrialised nations for imports from developing countries. They also agreed to finalise a deal on increased agricultural market access by April 2006.

Also in December, the US and China reached an agreement to regulate trade in textiles and clothing between the two countries over the next three years. China agreed to reduce its textile and clothing exports to the US in exchange for guaranteed access to the US market.

Gold prices continued to rise in the December quarter of 2005, reaching US$541 an ounce in December, the highest level in 24 years. The high price reflected the rising oil prices, increased global liquidity, demand from Asia, as well as a hedge against inflation and a possible economic downturn. Other metals also reached high levels in December: with silver at US$9.17 an ounce, the highest level in 18 years; platinum at a 25-year high of US$1,000 an ounce; aluminium at a 15-year high of US$2,225 a tonne; and copper at US$4,175 a tonne.

Whilst oil prices declined from their high levels in the September quarter to around US$60 a barrel in the December quarter, members of the Organisation of Petroleum Exporting Countries (OPEC) agreed in December to maintain output at around 28.4 million barrels a day, the highest level in 25 years. They had earlier agreed in September to remove their production quotas to increase supply to meet rising demand from the growing economies of China and India, and offset disruptions to oil productions caused by hurricanes in the US and civil unrest in Nigeria.

In the US, real GDP grew by 3.1 percent in 2005, compared to 3.8 percent in 2004. However, real GDP grew by an annualised rate of 1.6 percent in the December quarter of 2005, the slowest growth in three years. The slowdown reflected the impact of high interest rates and inflation, weak consumer spending, declining business investment and productivity, and slowing housing construction, as well as the widening trade deficit and lower Government spending.

Industrial production increased by 2.8 percent over the year to December 2005, compared to an increase of 4.4 percent in 2004. The Institute for Supply Management’s Purchasing Managers’ index was 55.6 percent in December 2005, compared to 58.6 percent in December 2004. An index over 50 percent indicates expansion in the manufacturing sector. The slowdown reflected reduced inventory restocking and reconstructions following Hurricanes Katrina, Rita and Wilma. New home sales declined to their lowest levels in twenty months in December 2005. Retail sales increased by 4.4 percent in 2005 compared to an increase of 5.9 percent in 2004. The unemployment rate was 4.9 percent in December 2005, compared to 5.4 percent in December 2004, the lowest rate in four years.

Consumer prices rose by 3.4 percent in 2005, compared to an increase of 3.3 percent in 2004. Broad money supply increased by 7.8 percent in 2005, compared to an increase of 6.2 percent in 2004. The US President, Mr. George W. Bush selected Dr. Ben Bernanke to replace Dr. Alan Greenspan as the Chair-
man of the Board of the US Federal Reserve in February 2006. To contain inflation and support economic growth, the Federal Open Market Committee (FOMC) tightened monetary policy in 2005. From the beginning of 2005, the federal funds rate was progressively increased from 2.25 percent to 4.25 percent in the December quarter of 2005, with the last increase from 3.75 percent.

The trade deficit increased to US$782.1 billion in 2005 from a deficit of US$665.2 billion in 2004, reflecting higher oil prices as well as increased imports, mainly from Asia.

In Japan, real GDP grew by 4.2 percent in 2005, compared to a decline of 0.5 percent in 2004. The growth reflected a pick-up in domestic demand, with strong exports and corporate capital investments, combined with rising consumer spending. There were improved job prospects, higher wages and surging stock prices. In December, the Japanese Government announced plans to cut new debt below ¥30 trillion and cuts to spending of ¥79.7 trillion, the first time in eight years that Government spending is to be below the ¥80 trillion level.

Industrial production increased by 3.8 percent in 2005, compared to an increase of 1.4 percent in 2004. Retail sales increased by 1.2 percent in 2005, compared to a decline of 1.0 percent in 2004. With the increase in economic activity, the unemployment rate fell slightly to 4.4 percent in December 2005 from 4.5 percent in December 2004.

Consumer prices decreased by 0.1 percent in 2005, compared to an increase of 0.2 percent in 2004. Broad money supply increased by 2.0 percent in 2005, the same as in 2004. Whilst the Bank of Japan maintained it’s zero percent interest rate policy, it indicated its intention in November to exit the policy in the coming six to twelve months as forecasts suggested inflation was returning.

The current account surplus was US$164.0 billion in 2005, compared to a surplus of US$171.8 billion in 2004.

In Germany, real GDP grew by 1.0 percent in 2005, compared to a decline of 0.9 percent in 2004, reflecting a build-up in inventories, which offset declines in private consumption, Government spending and overseas trade. A new Chancellor, Ms. Angela Merkel was
elected in November as the first female head of the Government. In December, the Government agreed to increase the value added tax (VAT) from 16 to 19 percent, besides cutting subsidies and tax loopholes to close a $35 billion budget deficit by 2007 and to be in line with EU rules.

Industrial production increased by 3.4 percent in 2005, compared to an increase of 0.9 percent in 2004. Retail sales declined by 0.9 percent in 2005, compared to a decline of 5.9 percent in 2004. The unemployment rate was 11.2 percent in December 2005, compared to 10.8 percent in December 2004.

Consumer prices increased by 2.1 percent in 2005, the same as in 2004.

The current account surplus was US$112.8 billion in 2005, compared to a surplus of US$96.0 billion in 2004.

The latest OECD estimate is for real GDP growth of 1.4 percent for the Euro area in 2005. In December, the European Central Bank (ECB) raised its benchmark Refinancing Rate by 0.25 percentage points to 2.25 percent. The increase was the first in five years and was to counter threats of inflation from rising oil prices and credit expansion, and support economic growth and employment creation.

In the United Kingdom (UK), real GDP increased by 1.7 percent in 2005, compared to an increase of 3.0 percent in 2004.

Industrial production declined by 2.7 percent in 2005, compared to an increase of 0.3 percent in 2004. Retail sales increased by 4.0 percent in 2005, compared to an increase of 3.2 percent in 2004. The unemployment rate in December 2005 was 5.1 percent, compared to 4.7 percent in December 2004.

Consumer prices rose by 2.0 percent in 2005, compared to an increase of 1.6 percent in 2004. Broad money supply increased by 12.6 percent in 2005, compared to an increase of 8.6 percent in 2004. The Bank of England maintained its benchmark Repo Rate at 4.50 percent in the December quarter of 2005. The Bank of England’s inflation target rate is 2.0 percent.

The trade deficit was US$119.1 billion in 2005, compared to a deficit of US$105.5 billion in 2004.

In Australia, real GDP grew by 2.7 percent in 2005, compared to 0.6 percent in 2004. However, real GDP grew by only 0.5 percent in the December quarter of 2005, reflecting subdued activity in the manufacturing and export sectors and low consumer spending. The Government announced a budget surplus for the 2005 calendar year of A$17.4 billion.

Industrial production increased by 1.3 percent over the year to September 2005, compared to an increase of 4.2 percent over the year to September 2004. Total building approvals fell by almost 9.0 percent in December 2005, compared to December 2004, due to declines in approvals for private sector housing, as well as for flats, units and apartments, which more than offset an increase in non-residential construction activity. Retail sales increased by 1.9 percent in 2005, compared to an increase of 2.2 percent in 2004. Despite the economic growth, employment growth was stagnated, due to rising labour costs and lower profit margins. The unemployment rate was 5.1 percent in 2005, the same as in 2004.

Consumer prices increased by 2.8 percent in 2005, compared to an increase of 2.6 percent in 2004. This is still within the Reserve Bank of Australia (RBA)’s inflation target range of 2.0 to 3.0 percent. However, it is a concern to the RBA because the inflation is now at the upper end of the range. The increase reflected higher prices for food, alcohol and tobacco, health, transportation, housing and education. Broad money supply increased by 9.1 percent in 2005, compared to an increase of 9.2 percent in 2004. The RBA maintained its official cash rate at 5.50 percent over the December quarter of 2005 since the increase in the March quarter from 5.25 percent.

The trade deficit was US$13.6 billion in 2005, compared to a deficit of US$18.0 billion in 2004. The deficit was the lowest level in 18 months and reflected increased exports, mainly mineral exports to Asia, and lower imports.

In 2005, the US dollar appreciated against the Japanese yen and pound sterling, while it depreciated against the euro and Australian dollar. The appreciation of the US dollar reflected strong economic growth and rising interest rates in the US, as well as increased holdings of US dollar deposits by OPEC members as a result of the high oil prices.

During 2005, the kina continued to strengthen against
all the major currencies. The kina ended the year at 32.30 US cents, from 32.00 US cents at the end of 2004. The daily average kina exchange rate appreciated by 4.0 percent against the US dollar to 32.23 US cents. The kina was worth 44.00 Australian cents on 31st December 2005, a 7.2 percent appreciation on the rate at the end of 2004. The daily average exchange rate for the December quarter was 43.58 Australian cents, compared to 41.78 Australian cents in the December quarter of 2004. These movements resulted in the daily average Trade Weighted Index appreciating by 0.9 percent over the year.

4. EMPLOYMENT

According to the Bank’s Employment Index, the level of employment in the formal private sector declined by 0.1 percent in the December quarter of 2005, compared to the September quarter of 2005. By industry, the mineral and wholesale/retail sectors recorded increases, while the other sectors recorded decreases. By region, the NCD, Southern and Morobe regions recorded increases while the Highlands, Islands and Momase (excluding Morobe) regions recorded decreases. Over the twelve months to December 2005, the level of employment increased by 3.4 percent.

In the building and construction sector, the level of employment decreased by 6.6 percent in the December quarter of 2005, compared to the September quarter. The decrease was due to the completion of projects in various regions, the onset of the wet season, especially in the Islands region (East New Britain province in particular), which hampered construction projects, and the laying-off of casual employees due to the lack of contracts. Over the twelve months to December 2005, the level of employment increased by 9.7 percent.

In the agriculture/forestry/fisheries sector, the level of employment decreased by 2.1 percent in the December quarter of 2005, compared to the September quarter. The decrease was due to the laying-off of casual employees, lower production levels, the temporary downsizing of operations by a fishing company and resignations. Over the twelve months to December 2005, the level of employment increased by 2.3 percent.

In the transportation sector, the level of employment decreased by 0.7 percent in the December quarter of 2005, compared to the September quarter. The decline was mainly due to the closure of a branch by a land transportation company. Over the twelve months to December 2005, the level of employment fell by 3.6 percent.

In the manufacturing sector, the level of employment increased by 1.0 percent in the December quarter of 2005, compared to the September quarter. The decline was mainly due to the laying-off of casual employees, the completion of jobs and training of students. A major manufacturer in the Momase region also temporarily shut down its operations for maintenance work on its plant. Over the twelve months to December 2005, the level of employment increased by 8.2 percent.

In the finance/business and other services sector, the level of employment decreased by 0.1 percent in the December quarter of 2005, compared to the September quarter. The decline was due to terminations, changes in ownership and a general lack of demand which resulted in the closure of some firms. Over the twelve months to December 2005, the level of employment decreased by 0.7 percent.

In the retail/wholesale sector, the level of employment increased by 6.1 percent in the December quarter of 2005, compared to the September quarter. Although the bulk of this increase was seasonal and reflected the hiring of casual employees to meet seasonal demand.
demand, a few companies also expanded their operations and took on extra permanent staff. Over the twelve months to December 2005, the level of employment increased by 2.9 percent.

In the mining/quarrying/petroleum sector, the level of employment increased by 0.1 percent in the December quarter of 2005, compared to the September quarter. The increase was due to new contracts associated with mining activity and recruitment of new trainees. Over the twelve months to December 2005, the level of employment increased by 8.3 percent.

By region, the NCD, Southern and Morobe regions recorded increases while the Highlands, Islands and Momase regions recorded decreases in the December quarter of 2005, compared to the September quarter. In the Highlands region, employment decreased by 7.8 percent in the December quarter of 2005. The decrease was in the retail/wholesale, agriculture and mining/quarrying/petroleum sectors. In the retail/wholesale and agriculture sectors, the decrease was due to the coffee off-season, which more than offset higher casual employment particularly in the manufacturing sector. Over the twelve months to December 2005, the level of employment increased by 3.8 percent.

In the Islands region, the level of employment decreased by 1.0 percent in the December quarter of 2005, compared to the September quarter. The decrease was in the building/construction and agriculture/forestry/fisheries sectors. In the building/construction sector, the decrease was attributed to the rainy season, which hampered construction work, completion of projects and the laying-off of school vacation employees. In the agriculture/forestry/fisheries sector, the decline was due to lower production levels and takeovers, which resulted in the laying-off of workers. Over the twelve months to December 2005, the level of employment increased by 1.1 percent.

In the Momase region, the level of employment decreased by 0.6 percent in the December quarter of 2005, compared to the September quarter. The decline was mainly in the manufacturing sector, while the construction and finance/business and other services sectors declined marginally. In the manufacturing sector, the decrease was attributed to the temporary closure of a manufacturing plant to allow for maintenance work. Over the twelve months to December 2005, the level of employment increased by 3.8 percent.

In NCD, the level of employment increased by 2.3 percent in the December quarter of 2005, compared to the September quarter. The increase was in the manufacturing, retail/wholesale and finance/business and other services sectors. In all three sectors the increase was mainly due to the hiring of casual and student vacation employees over the festive season. Over the twelve months to December 2005, the level of employment increased by 2.4 percent.

In the Southern region, the level of employment increased by 1.9 percent in the December quarter of 2005, compared to the September quarter. The growth was mainly in the construction, retail/wholesale and finance/business and other services sectors, while the transportation sector increased marginally. In the construction sector, the increase was attributed to the awarding of new contracts. In the retail/wholesale and finance/business and other services sectors, the increase was mainly due to the hiring of casual and vacation employees for the festive season. Over the twelve months to December 2005, the level of employment increased by 6.5 percent.

In Morobe, the level of employment increased by 1.5 percent in the December quarter of 2005, compared to the September quarter. The increase was in the retail/wholesale and mining/quarrying/petroleum sectors. In the retail/wholesale sector, the increase was due to the recruitment of casual employees for the festive season and the expansion of a number of business operations. In the mining/quarrying/petroleum sector, the increase was due to drilling activity and mining related construction jobs. Over the twelve months to December 2005, the level of employment increased by 4.0 percent.

5. CONSUMER PRICE INDEX

The headline inflation rate, as measured by the Consumer Price Index (CPI) was 4.3 percent in the December quarter of 2005, compared to an increase of 0.4 percent in the September quarter of 2005. The increase was in the ‘Drinks, tobacco and betelnut’ expenditure group which reflected higher prices of betelnut and alcoholic drink, and in the ‘Food’ group resulting from higher fruit and vegetable prices. These, combined with an increase in the ‘Rents, council charges, fuel and power’ group more than offset declines in the remaining groups. All urban areas recorded higher prices with
The CPI for the 'Drinks, tobacco and betelnut' expenditure group recorded the highest inflation of 14.2 percent in the December quarter of 2005, compared to 0.7 percent in the September quarter of 2005. The increase was driven by higher betelnut prices, which recorded the highest quarterly change since 1994. Betelnut prices alone contributed 4.0 percentage points to the overall movement in the December quarter CPI. Alcoholic drinks also recorded its highest price rise since September 1999 and contributed 0.5 percentage points to the overall movement in the CPI. This expenditure group contributed 2.9 percentage points to the overall movement in the quarterly CPI.

The CPI for the 'Food' expenditure group increased by 2.0 percent in the December quarter of 2005, compared to an increase of 1.4 percent in the September quarter of 2005. The increase was driven by higher prices of fruits and vegetables and a small increase for miscellaneous food items. This expenditure group contributed 0.8 percentage points to the overall movement in the CPI.

The CPI for the 'Rents, council charges, fuel and power' expenditure group increased by 3.8 percent in the December quarter of 2005, compared to a decline of 4.2 percent in the September quarter of 2005. The increase reflected higher prices for water, sewerage and kerosene.

The CPI for the 'Household equipment and operations', 'Miscellaneous', 'Transport and communication' and 'Clothing and footwear' expenditure groups declined in the December quarter of 2005.

The inflation rate for the 'Household equipment and operations' expenditure group was negative 2.4 percent in the December quarter of 2005, compared to negative 3.0 percent in the September quarter of 2005. This group contributed a negative 0.1 percentage point to the overall movement in the CPI.

Inflation for the 'Miscellaneous goods and services' expenditure group was negative 0.3 percent in the December quarter of 2005, compared to an increase of 0.1 percent in the September quarter of 2005. The decline was due to lower prices for personal hygiene goods and entertainment items such as cassette tapes.

The price indices for the 'Clothing and footwear' and 'Transport and communication' expenditure groups both declined by 0.2 percent in the December quarter of 2005, compared to declines of 0.8 percent and 0.5 percent, respectively in the September quarter of 2005. The decline in the 'Clothing and footwear' group was attributed to lower prices in women's, girls' and other clothing, while the decline in the 'Transport and communication' group was due to lower prices for motor vehicles.

By urban areas, all CPI surveyed areas recorded increases in the December quarter of 2005. Goroka recorded the highest increase of 9.9 percent, compared to an increase of 0.7 percent in the previous quarter, followed by Port Moresby with an increase of 6.4 percent, compared to negative 0.9 percent in the previous quarter. Madang recorded an increase of 0.7 percent, compared to an increase of 2.2 percent in the previous quarter and Lae recorded an increase of 0.5 percent, compared to 2.0 percent in the previous quarter. Rabaul recorded the smallest increase of 0.2 percent in the December quarter of 2005, compared to an increase of 0.4 percent in the previous quarter.

The exclusion-based inflation measure recorded a decrease of 1.7 percent in the December quarter of 2005, compared to a negative 0.1 percent outcome in the previous quarter. This is the lowest inflation outcome since the kina float in 1994. The trimmed-mean measure recorded an increase of 0.1 percent in the December quarter of 2005, compared to an increase of 0.7 percent in the previous quarter. Annual exclusion-based inflation was negative 1.4 percent in the Decem-
ber quarter of 2005, compared to negative 1.0 percent in the September quarter of 2005. Annual trimmed mean inflation was 3.3 percent in the December quarter of 2005, compared to 3.2 percent in September 2005.

6. EXPORT COMMODITIES REVIEW

The total value of merchandise exports was K9,922 million in 2005, an increase of 20.5 percent from 2004. There were increases in the values of coffee, copra, copra oil, rubber, logs, marine products, copper, crude oil and refined petroleum product exports. The value of agricultural, marine products and other non-mineral exports, excluding forestry product and refined petroleum product exports was K1,480.1 million and accounted for 14.9 percent of total merchandise exports in 2005, compared to 19.0 percent in 2004. Forestry product exports were K476.3 million and accounted for 4.8 percent of total merchandise exports in 2005, compared to 5.6 percent in 2004. Refined petroleum product exports were K496.8 million and accounted for 5.0 percent of total merchandise exports in 2005, compared to 2.5 percent in 2004. The increase was due to a full year of production and export in 2005, compared to only two quarters in 2004. Mineral export receipts, excluding crude oil were K5,252.0 million and accounted for 52.9 percent of total merchandise exports in 2005, the same ratio as in 2004. Crude oil exports totalled K2,216.8 million and accounted for 22.3 percent of total merchandise exports in 2005, compared to 20.1 percent in 2004.

The weighted average kina price of Papua New Guinea’s exports increased by 13.0 percent in 2005, relative to 2004. There was an increase of 15.6 percent in the weighted average kina price of mineral exports, with higher kina prices of copper and crude oil exports. For agricultural, forestry and marine product exports, the weighted average kina price increased by 2.6 percent and was attributed to higher prices of coffee, tea, rubber and log exports, which more than offset the declines in the prices of cocoa, copra, copra oil, palm oil and marine products. The higher kina prices of some of the agricultural export commodities reflected higher international prices, while the decline in other commodities reflected lower international prices combined with the appreciation of the kina in 2005, compared to 2004. Excluding logs, the weighted average price of agricultural and marine product exports increased by 3.2 percent in 2005, compared to 2004.

Mineral Exports

Total mineral export receipts were K7,468.8 million in 2005, an increase of 24.3 percent from 2004. The increase was due to higher kina prices and increased export volumes of copper and crude oil, which more than offset declines in the kina export price and volume of gold.

Gold export volumes were 66.5 tonnes in 2005, a decline of 1.2 percent from 2004. The decline was due to the mining of lower ore grades from the Lihir and Tolukuma mines, which more than offset higher production from the Ok Tedi and Porgera mines. The average free on board (f.o.b.) price received for Papua New Guinea’s gold exports was K40.9 million per tonne in 2005, 1.1 percent lower than in 2004. The decline was mainly attributed to the appreciation of the kina against the US dollar, as international prices remained high during the year. The average gold price at the London Metal Exchange increased by 8.0 percent to US$443 per fine ounce in 2005, compared to 2004. The increase was due to higher demand from investors for gold-based investments, increased demand for gold products and the uncertainty surrounding the US dollar. The combined decline in the kina export price and volume resulted in export receipts of K2,717.5 million in 2005, a decline of 2.2 percent from 2004.

Copper export volumes were 226.1 thousand tonnes in 2005, an increase of 30.0 percent from 2004. The increase was due to higher production and shipment of copper ore from the Ok Tedi mine as a result of higher water levels at the Fly river. The average f.o.b. price of Papua New Guinea’s copper exports was K11,047 per tonne in 2005, an increase of 24.4 percent from 2004. 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 combined increase in export price and volume resulted in export receipts of K2,497.7 million in 2005, an increase of 61.7 percent from 2004.

Crude oil export volumes were 12,748.5 thousand barrels in 2005, an increase of 1.5 percent from 2004. The increase reflected higher extraction rates and increased production from the Moran field and the newly developed wells at Kutubu. The average export price of crude oil was K174 per barrel in 2005, an increase of 32.8 percent from 2004. The higher interna-
tional prices were associated with supply disruptions in the Gulf of Mexico due to hurricane Katrina, increased global demand resulting from lower Strategic Reserve Levels in North America, combined with slow recovery of oil production in Iraq and continued global fears on terrorism. The increase in export price and volume resulted in export receipts of K2,216.8 million in 2005, an increase of 34.2 percent from 2004.

Export receipts of refined petroleum products from the Napanapa Oil Refinery increased significantly by 145.0 percent to K496.8 million in 2005, compared to 2004. The increase reflected a full year of production in 2005, compared to two quarters of production in 2004. The refinery commenced production in late July 2004.

**Agriculture, Logs and Fisheries Exports**

Export prices of most agricultural export commodities declined in 2005, compared to 2004. Cocoa prices declined by 14.5 percent, copra by 13.4 percent, copra oil by 4.1 percent and palm oil by 11.1 percent. Coffee prices increased by 44.7 percent, tea by 3.6 percent and rubber by 3.2 percent. The average export price of logs increased by 0.6 percent to K178 per cubic metre in 2005, compared to 2004. The increase in export price of coffee, tea, rubber and logs more than offset the decline in the prices of cocoa, copra, copra oil, palm oil and marine products resulting in a 2.6 percent increase in the weighted average price of agricultural, forestry and marine product exports. Excluding logs, the weighted average price of agricultural and marine product exports increased by 3.1 percent in 2005, compared to 2004.

The volume of coffee exported was 72,100 tonnes in 2005, an increase of 14.4 percent from 2004. The increase was due to higher production attributed mainly to the biennial coffee production cycle and supply response to higher international prices. The average export price of coffee was K6,533 per tonne in 2005, an increase of 44.7 percent from 2004. The increase was mainly due to higher international prices resulting from a decline in world supply due to unfavourable weather conditions in Brazil, the world’s major coffee producer. The combined increase in export price and volume resulted in export receipts of K471.0 million in 2005, an increase of 66.0 percent from 2004.

The volume of cocoa exported was 44,200 tonnes in 2005, an increase of 6.5 percent from 2004. The increase was attributed to harvesting from higher
yielding cocoa trees and favourable weather conditions in the major cocoa producing regions combined with increased production from Bougainville, as a result of the continued rehabilitation of cocoa plantations. The average export price of cocoa was K4,495 per tonne in 2005, a decline of 14.5 percent from 2004. The decline was due to lower international prices as a result of increased supply in the world market reflecting higher production from the Ivory Coast, and Asian and Latin American countries, combined with the appreciation of the kina against the US dollar. The decline in export price more than offset the increase in export volume resulting in an export value of K198.7 million in 2005, a decline of 8.9 percent from 2004.

The volume of copra exported was 22,300 tonnes in 2005, an increase of 16.1 percent from 2004. The increase was attributed to higher production from the major copra producing regions as a result of favourable weather conditions. The average export price of copra was K776 per tonne in 2005, a decline of 13.4 percent from 2004. The decline was due to lower international prices as a result of higher copra production from the Philippines and Indonesia, two of the world’s major copra producers, combined with the appreciation of the kina against the US dollar. The increase in export volume more than offset the decline in export price resulting in export receipts of K17.3 million in 2005, a marginal increase of 0.6 percent from 2004.

The value of marine product exports was K58.7 million in 2005, a marginal increase of 0.9 percent from 2004. This was a result of an increase in export volume, which more than offset the decline in export price.

higher production from Malaysia and Indonesia, two of the world’s major producers, combined with increased supply of other edible oils in the world market and the appreciation of the kina against the US dollar. The combined decline in export volume and price resulted in export receipts of K339.5 million in 2005, a decline of 22.6 percent from 2004.

The volume of tea exported was 6,900 tonnes in 2005, a decline of 14.8 percent from 2004. The decline was due to lower production mainly as a result of unfavourable weather conditions in the major tea producing areas. The average export price of tea was K2,905 per tonne in 2005, an increase of 3.6 percent from 2004. The increase in export volume more than offset the increase in export price resulting in export receipts of K20.2 million in 2005, a decline of 11.8 percent from 2004.

The volume of rubber exported was 4,800 tonnes in 2005, an increase of 26.3 percent from 2004. The increase was mainly attributed to favourable weather conditions and a supply-response to higher world market prices. The average export price was K3,750 per tonne in 2005, an increase of 3.2 percent from 2004. The increase was due to higher international prices as a result of lower supply in the world market. The increase in export volume and price resulted in an export value of K18.0 million in 2005, an increase of 30.4 percent from 2004.

The volume of logs exported was 2,270 thousand cubic metres in 2005, an increase of 12.8 percent from 2004. The increase was due to higher production and shipment of logs from major logging projects due to favourable weather conditions and the re-opening of dormant sites. The average export price of logs was K178 per cubic metre in 2005, an increase of 0.6 percent from 2004. The increase was due to higher international prices, reflecting lower supply of tropical hardwoods in the world market. The combined increase in export volume and price resulted in an export value of K404.9 million in 2005, an increase of 13.8 percent from 2004.

The volume of palm oil exported was 295,200 tonnes in 2005, a decline of 12.9 percent from 2004. The decline was due to lower production attributed to unfavourable weather conditions combined with delay in shipments from the major oil palm producing regions. The average export price of palm oil was K1,146 per tonne in 2005, a decline of 11.1 percent from 2004. The decline reflected lower international prices associated with
7. BALANCE OF PAYMENTS

The overall surplus in the balance of payments was K255 million in 2005, compared to a surplus of K329 million in 2004. This outcome was due to a higher surplus in the current account, which more than offset a significant deterioration in the financial and capital accounts. The outcome in the current account was due to a higher surplus in the trade account and net transfers receipts, which more than offset higher net service and income payments. The deficit in the capital and financial accounts was due to a net outflow in the financial account reflecting an increase in foreign asset holdings by resident companies, which more than offset an increase in foreign liabilities. In 2005, the kina appreciated against all the currencies of Papua New Guinea’s major trading partners, compared to 2004. This resulted in a decline in the kina value of some balance of payments transactions.

The trade account recorded a surplus of K5,257 million in 2005, compared to a surplus of K3,530 million in 2004. The higher surplus was due to an increase in the value of merchandise exports combined with a decline in the value of merchandise imports. The value of merchandise exports was K9,922 million in 2005, an increase of 20.5 percent from 2004. The increase was attributed to higher values of copper, crude oil, coffee, copra, copra oil, rubber, logs, marine products and refined petroleum products exports.

The value of merchandise imports was K4,665 million in 2005, a marginal decline of 0.8 percent from 2004. The decline was due to lower values of general imports, which more than offset increases in mining and petroleum sector imports. General imports declined by 8.0 percent to K3,389 million in 2005, compared to 2004. The decline was due to import substitution of refined petroleum products attributed to the commencement of production from the Napanapa oil refinery. Imports by the mining sector increased by 3.0 percent to K956 million in 2005, compared to 2004. The increase was due to higher capital expenditures undertaken by the Porgera, Ok Tedi and Kainantu mines. Imports by the petroleum sector increased significantly by 251.7 percent to K320 million in 2005, compared to 2004, mainly associated with capital expenditures undertaken at the North-West Moran and South-East Mananda oil projects.

The deficit in the services account was K2,611 million in 2005, compared to a deficit of K2,561 million in 2004. The higher deficit was associated with increased payments for construction, other financial services, refining and other services, combined with lower receipts for travel, education and other Government services by resident companies.

The deficit in the income account was K1,658 million in 2005, compared to a deficit of K1,406 million in 2004. This outcome was due to higher dividend payments combined with lower compensation of foreign employees and dividend receipts.

The surplus in the transfers account was K893 million in 2005, compared to a surplus of K830 million in 2004. The higher surplus was due to increased receipts of tax, gifts and grants combined with lower payments of superannuation funds and licensing fees.

As a result of these developments in the trade, services, income and transfers accounts, the current account recorded a surplus of K1,881 million in 2005, compared to a surplus of K393 million in 2004.

The capital account recorded no transactions during 2005, the same as in 2004.

The financial account recorded a net outflow of K1,664 million in 2005, compared to a net outflow of K80 million in 2004. This outcome was due to a net outflow of other investments totalling K1,818 million reflecting a build up in foreign currency account balances of mineral companies, an increase in net foreign asset holdings of the banking system and outstanding trade credits owed to PNG resident companies. There was a net outflow of K6 million in financial derivatives reflecting investment in financial derivative instruments. These more than offset net inflows of K84 million in direct investments and K76 million in portfolio investments, reflecting share placements by a mineral company to raise capital for exploration activities and working capital and the drawdown from short-term money market instruments, respectively. The Government made a net loan repayment of K293 million in 2005, compared to K391 million in 2004.

In the December quarter of 2005, the balance of payments recorded an overall surplus of K263 million, compared to a surplus of K199 million in the corresponding quarter of 2004. This outcome was due to a higher surplus in the current account, which more than offset a higher deficit in the capital and financial
accounts.

The value of merchandise exports was K2,634 million in the December quarter of 2005, an increase of 14.9 percent from the corresponding quarter of 2004. The increase was due to higher values of copper, crude oil, coffee, copra oil, rubber and other non-mineral exports, which more than offset declines in the values of gold, cocoa, copra, palm oil, tea, logs, marine products and refined petroleum product exports. Agricultural, forestry, marine products and other non-mineral exports, excluding refined petroleum product exports were K486.2 million and accounted for 18.5 percent of the total merchandise exports in the December quarter of 2005, compared to 21.6 percent in the corresponding period of 2004. Refined petroleum product exports totalled K63.0 million in the December quarter of 2005 and accounted for 2.4 percent of total merchandise exports, compared to 7.2 percent in the corresponding quarter of 2004. Mineral exports totalled K2,084.8 million or 79.1 percent of total merchandise exports in the December quarter of 2005, compared to 71.1 percent in the corresponding period of 2004.

The value of merchandise imports was K1,055 million in the December quarter of 2005, a decline of 4.3 percent from the corresponding quarter of 2004. The decline was due to lower general imports which more than offset increases in mining and petroleum sector imports. General imports declined by 10.1 percent to K738 million in the December quarter of 2005, compared to the corresponding quarter of 2004. The decline was due to import substitution of refined petroleum products attributed to a full year production from the Napanapa oil refinery. Imports by the mining sector increased by 2.3 percent to K264 million in the December quarter of 2005, compared to the corresponding quarter of 2004. This outcome was due to higher capital expenditures by the Porgera, Ok Tedi and Kainantu mines. Imports by the petroleum sector increased significantly by 130.4 percent to K53 million in the December quarter of 2005, compared to the corresponding quarter of 2004. This reflected higher capital expenditures undertaken at the NW Moran and SE Mananda oil projects.

The deficit in the services account was K598 million in the December quarter of 2005, compared to a deficit of K570 million in the corresponding quarter of 2004. The higher deficit was due to increases in transportation,
other financial, cultural and recreational, government services n.i.e, construction, refining and smelting and other service payments, combined with lower service receipts by resident companies.

The deficit in the income account was K393 million in the December quarter of 2005, compared to a deficit of K266 million in the corresponding quarter of 2004. This outcome was due to higher dividend payments combined with lower dividend and interest receipts.

The surplus in the transfers account was K135 million in the December quarter of 2005, compared to a surplus of K184 million in the corresponding quarter of 2004. This outcome was due to lower gift and grant receipts, combined with higher family maintenance payments.

As a result of these developments in the trade, services, income and transfers accounts, the current account recorded a surplus of K723 million in the December quarter of 2005, compared to a surplus of K538 million in the corresponding quarter of 2004.

The capital account recorded no transactions during the December quarter of 2005, the same as in the corresponding quarter of 2004.

The financial account recorded a deficit of K489 million in the December quarter of 2005, compared to a deficit of K361 million in the corresponding period of 2004. The higher deficit reflected net outflow of direct investment abroad totalling K20 million and net outflow of K39 million in portfolio investment, reflecting investment in short-term money market instruments. There was a net outflow of other investments totalling K430 million reflecting trade credits owed to PNG resident companies, increases in net foreign assets of the banking system and a build up in offshore account balances of the mineral companies.

The level of gross foreign exchange reserves at the end of December 2005 was K2,316 (US$774) million, sufficient for 6.0 months of total and 8.2 months of non-mineral import covers.

8. MONETARY DEVELOPMENTS

LIQUIDITY AND INTEREST RATES

The Bank of PNG generally maintained a neutral monetary policy stance based on favourable macroeconomic outcomes and inflation outlook during 2005. Consistent with the Bank’s expectations as stated in the January and July MPSs, the KFR was maintained at 7.0 percent until September when it was reduced to 6.0 percent. Treasury bill rates generally remained stable with the 28-day rate decreasing from 3.14 percent to 2.84 percent between December 2004 and August 2005. The 91-day Treasury bill rate increased from 3.70 percent to 3.84 percent and the 182-day rate from 4.57 percent to 4.91 percent over the year to December 2005. In June 2005 the 364-day Treasury bills were introduced and offered at 7.13 percent and by the end of the year the rate declined to 5.69 percent. Treasury bills were not traded for the 63-day term since March 2005. With the separation of auctions, the 28-day CBB rate initially traded at 3.71 percent in September before falling to 2.99 percent at the end of 2005. In 2005, the weighted average interest rates on wholesale deposits (K500,000 and above) quoted by commercial banks declined across all maturities. The 30-day rate decreased from 1.62 percent to 0.82 percent, the 60-day rate from 1.51 percent to 0.95 percent, the 90-day rate from 3.28 percent to 1.45 percent and the 180-day rate from 4.68 percent to 2.18 percent.

The Bank continued to utilise its OMO instruments in the conduct of monetary policy. In addition to trading in Government securities, the Bank of PNG also utilised the Repos and CBBs to manage liquidity in the banking system. In September 2005 the Bank separated the auction of Government’s Treasury bills from the CBBs. Under this arrangement only licensed financial institutions are allowed to participate in the CBB auction at a minimum bid of K2 million. This arrangement has greatly improved the Bank of PNG’s ability to influence short term interest rates. 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 low in 2005, as a result of the high level of liquidity in the banking system.

The average level of liquid assets held by the commercial banks in 2005 was higher relative to 2004. The monthly average level of liquid assets increased by 25.9 percent in 2005, following an increase of 37.9 percent in 2004. The increase reflected higher holdings of Government Inscribed stocks, CBBs and deposits with the Central Bank under the Repos and the Exchange Settlement Account (ESA). The increase in Inscribed stock holdings was due to new issuances of
stocks with maturities of less than 3 years. This is in line with the Government Debt Strategy to shift debt to longer term of two years or more.

The average level of liquid assets held by commercial banks increased by 18.7 percent in the second half of 2005 relative to the first half of the year, which grew by 4.0 percent. The growth in liquidity levels was mainly due to mineral tax receipts.

The weighted average interest rate on total deposits fell from 1.11 percent at the end of December 2004 to 0.75 percent at the end of December 2005, while the weighted average rate on lending fell from 12.13 percent to 10.71 percent. The weighted average rate on performing loans declined from 12.52 percent to 11.03 percent during the same period. Commercial banks reduced their Indicator Lending Rates (ILRs) during the year to a range of 9.45 - 10.70 percent by the end of December 2005.

MONEY SUPPLY

The average level of broad money supply (M3*) increased by 21.3 percent in 2005, compared to a revised increase of 6.6 percent in 2004. The growth resulted from increases of 20.2 percent, 17.5 percent and 13.2 percent in average net foreign assets of the banking system, average net credit to the Government and average net domestic credit to the private sector, official entities and non-monetary financial institutions, respectively. The increase in average net foreign assets was mainly due to the accumulation of foreign exchange reserves by the Central Bank as a result of high mineral tax inflows and the full repayment of the Bank's liabilities to the IMF. The average level of monetary base increased by 22.4 percent in 2005, compared to an increase of 30.4 percent in 2004. The growth was due to higher holdings of Government securities, particularly from the purchases of Inscribed stocks.

Between December 2004 and December 2005, net credit extended to the Government by the banking system declined by 24.7 percent, compared to an increase of 13.8 percent in 2004. The decline was mainly due to increases in Government deposits with the Bank of PNG and commercial banks.

The monthly average level of narrow money supply (M1*) grew by 33.6 percent in 2005, compared to an increase of 19.8 percent in 2004. The growth was due to an increase in both currency in circulation and demand deposits, reflecting a shift to ready cash and demand deposits as a result of the fall in domestic interest rates. The average level of quasi money increased by 4.5 percent in 2005, compared to a decrease of 7.5 percent in 2004 mainly due to an increase in average savings deposits.

The monthly average deposit base of the commercial banks increased by 23.4 percent from K3,173.0 million in 2004 to K3,914.6 million in 2005.

LENDING

Over the year to December 2005, total domestic credit extended by the banking system to the private sector, official entities and non-monetary financial institutions increased by K376.1 million to K1,827.1 million, compared to a decrease of K46.1 million in 2004. Lending to the private sector, official entities and non-monetary financial institutions increased by K339.9 million, K32.9 million and K3.3 million, respectively. The significant growth in credit to the private sector was mainly related to new loan products offered by commercial banks during the year. The advances were
mainly to the building and construction, agriculture/forestry/fisheries, transport and communication, mineral, retail and private household sectors. The increase in lending to official entities was mainly borrowings by public sector enterprises. The annual rate of growth in domestic credit, excluding the Central Government and outstanding loans under the price support schemes was 26.8 percent over the year to December 2005. At the end of December 2005, foreign currency lending to the private sector and official entities accounted for 5.9 percent of total lending to these sectors, compared to 8.4 percent in December 2004, with kina lending accounting for 94.1 percent of total lending.

Over the first six months of 2005, total domestic credit extended by banking system to the private sector, official entities and non-monetary financial institutions increased by K243.7 million to K1,694.7 million. Lending to the private sector and official entities increased by K229.9 million and K24.4 million, respectively, which more than offset a decline of K10.6 million in lending to non-monetary financial institutions. The increase in lending was mainly due to advances to the palm oil and fisheries sub-sectors, the household sector for consumption expenditures and the construction sector, particularly in the National Capital District.

Over the second half of 2005, the level of domestic credit extended by the banking system to the private sector, official entities and non-monetary financial institutions increased by K132.4 million to K1,827.1 million. Lending to the private sector, official entities and non-monetary financial institutions increased by K110.0 million, K8.5 million and K13.9 million, respectively. The growth in lending to the private sector was to the transport and communications, and building and construction sectors, as well as the retail and household sectors.

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. It is a 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. The utilisation rate, quarter on quarter, was 82.1 percent in December 2005, compared to 79.8 percent in December 2004.
9. PUBLIC FINANCE

Preliminary estimates of the fiscal operations of the National Government for 2005 showed an overall surplus of K46.9 million, compared to a surplus of K201.9 million in 2004, and represents 0.3 percent of nominal GDP. The surplus reflected higher revenue, which more than offset an increase in expenditure.

Total revenue, including grants, during 2005 was K5,313.2 million, 22.2 percent higher than the receipts collected in 2004, and represents 105.1 percent of the 2005 revised budgeted revenue. The increase was attributed to higher collections in all categories of tax and non-tax revenue, combined with higher project grants.

Total tax revenue amounted to K3,766.9 million, 15.7 percent higher than the receipts collected during 2004, and represents 107.9 percent of the revised budgeted tax receipts for 2005. The increase reflected higher direct taxes, which more than offset a decline in indirect tax receipts.

Direct tax receipts totalled K2,793.9 million, 25.7 percent higher than the receipts collected in 2004, and represents 110.4 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 resulted from increased employment by the private sector. The increase in company tax receipts reflected improved profitability by companies due to higher mineral and agricultural production and prices. Other direct taxes increased due to higher receipts from gaming and dividend withholding taxes.

Indirect tax receipts was K973.0 million, 5.7 percent lower than in 2004, and represents 101.1 percent of the revised budgeted tax receipts. The decline in other indirect taxes more than offset increases in all categories of indirect tax. Other indirect tax receipts decreased as a result of lower mining levy. Import duty collections increased reflecting higher volume of imports due to strong domestic demand. The increase in excise duties was related to higher prices for fuel, while the growth in Goods and Services Tax (GST) reflected increased collections in the provinces.

Total non-tax revenue amounted to K263.2 million, 7.4 percent higher than the amount collected in 2004, and represents 94.6 percent of the revised budgeted amount. The increase mainly reflected higher dividend payments by the mineral sector. Foreign grants for development projects totalled K1,283.1 million, 51.0 percent higher than in 2004, due to increased commitments from donor countries and improved reporting of AusAID funded projects.

Total expenditure during 2005 was K5,266.3 million, 27.0 percent higher than in 2004, and represents 102.2 percent of the revised budgeted expenditure for 2005. The increase reflected higher recurrent and development expenditures, which more than offset savings from lower interest payments.

Recurrent expenditure in 2005 was K3,416.9 million, 21.1 percent higher than in 2004, and represents 102.6 percent of the revised budgeted appropriation. The increase was due to growth in National Government expenditure, which more than offset a decline in Provincial Government expenditure, lower grants to statutory authorities and reduced interest payments. The National Departmental expenditure was K2,223.6 million, 43.0 percent higher than in 2004, and repre-
sents 105.5 percent of the revised budgeted appropriation. The increase reflected higher education subsidies, payment of arrears and court orders, and expenses relating to the structural reforms and the funding of the Government’s equity share of the PNG Gas project. Provincial Government recurrent expenditure was K656.5 million, 5.0 percent lower than the expenditure level during 2004, and represents 96.7 percent of the revised budgeted amount. The slight decline was due to reduced staffing and administrative grants. Interest payments totalled K332.8 million, 11.7 percent lower than the amount paid in 2004, and reflected lower interest rates on Treasury bills combined with the appreciation of the kina against the US dollar.

Total development expenditure in 2005 was K1,849.4 million, 39.4 percent higher than in 2004 and represents 101.5 percent of the revised budgeted expenditure for 2005. The increase reflected increased commitments from donor countries and improved reporting of expenditures related to AusAID funded projects. The surplus combined with domestic borrowing of K190.9 million was used to make a net overseas loan repayment of K237.8 million. The net external loan repayments comprised of K64.5 million in concessionary, K16.5 million in commercial and K156.8 million of extraordinary sources. The domestic financing mainly reflected higher holdings of Government securities by commercial banks, while financing from other domestic sources reflected the higher level of unpresented cheques issued in 2005.
The National Budget is the principal tool for fiscal policy; one component of a set of policy tools employed to meet multiple objectives of macroeconomic management. The importance of the budget lies in its immediate impact on the level of aggregate demand and hence, on the economy as a whole.

This article reviews the 2006 National Budget against the 2005 revised Budget presented in Parliament in November 2005. The Budget focuses on sustaining the current macroeconomic stability and achieving positive economic growth through implementation of the Budget that is consistent with the Medium Term Fiscal Strategy (MTFS) and the Medium Term Development Strategy (MTDS). As with previous budget articles the detailed budget data has been rearranged and aggregated. Some misclassification of data may occur as a result of this process but the primary focus here is the broad aggregates and trends.

The fiscal strategy for 2006 and the medium term is framed on the back of sound macroeconomic fundamentals, which aims to sustain the conditions necessary for economic growth by reallocating expenditure to priority areas identified in the MTDS. To achieve macroeconomic stability the Government targets a budget deficit of 0.6 percent of GDP in 2006. Growth would be achieved by redirecting expenditure towards productive areas that generate export revenue, create employment and maximise social welfare in the medium term. The MTFS for 2006 recognises the vulnerability of the current economic environment in PNG, in particular the potential for adverse developments and therefore, the aim for continued sound economic management.

In line with this strategy, the Government has identified infrastructure development, education, health, law and order, agriculture, public service reforms and revenue raising as priority areas. The key initiatives introduced in the 2006 Budget were; tax cuts to personal and company income, tax incentives to specific sectors involved in promoting trade and investment including increase in infrastructure tax credit scheme for agriculture, funding of district initiatives and road improvement, cost rationalisation and expenditure cuts to non-priority government departments and strengthening of the Internal Revenue Commission (IRC) to improve revenue collection.

The Budget also incorporated the Government's Structural Reform Program (SRP) introduced in 2003, with emphasis on public sector reforms. Structural reforms such as improving public sector performance, removing barriers to trade and investment and promoting good governance are crucial in providing the appropriate conditions necessary for sustained macroeconomic stability and to achieve economic growth.

The Government recognises that project support grants from donor countries continue to provide significant funding for development projects, which otherwise could have been difficult to undertake alone. Total Project Support Grant is projected to decrease by K289.1 million to K994.0 million in 2006, largely due to declines in the Japanese International Co-operation Agency (JICA) and AusAID grants. This is due to the completion of major projects undertaken by JICA and the withdrawal of the police component of the Enhanced Co-operation Program (ECP), which was included in the 2005 Budget. However, other donors including the European Union (EU), New Zealand and China have increased their commitments in 2006.

The formulation of the Budget was based on the expected economic developments in 2006, which is expected to result in a real GDP growth of 3.5 percent. The higher economic growth is expected from all sectors of the economy. The projected growth in the agriculture sector reflects increases in production due to tax incentives provided to the sector. The favourable economic environment is expected to broaden economic growth in the other sectors, including construction and manufacturing associated with rising activity in the mineral sector.

Table 1 summarises fiscal developments from 2002 to 2005 and the Budget indicators for 2006. The preliminary outcome for 2005 appropriation is K115 million more than the revised Budget appropriation, due mainly to higher recurrent expenditures. In 2006, the fiscal burden on the economy, as represented by the appropriations/GDP ratio is expected to improve from the 2005 out-turn of 35.0 percent to 30.4 percent. The improvement reflects lower 2006 Budget appropriation.

The easing in the fiscal burden reflects the Government's focus on expenditure controls due to the anticipated decline in revenue growth in 2006. However, the role of the Government in many developing countries has been its direct and indirect involvement in both economic and social development. In the absence of a
measure of the efficiency of Government expenditure, it is not possible to estimate precisely the impact that Government has on economic growth.

The 2005 preliminary fiscal out-turn showed a surplus of 0.3 percent of nominal GDP, compared to the deficits projected for both the original and revised budgets. The budget surplus combined with net domestic financing, was used to make net external loan repayments.

The projected budget deficit of K90 million for 2006 is 0.6 percent of nominal GDP. The 2006 deficit comprises payment of arrears of K5 million, K69 million in payments relating to SRP and an underlying deficit of K16 million. Net external loan repayment of K124 million is budgeted, comprising mainly of K40 million to extraordinary sources, K18 million to concessionary sources and K66 million to commercial sources. A positive net domestic financing of K214 million is projected to be raised through the issuance of Inscribed stocks and new Treasury bills.

The primary balance (as shown in table 1) measures the effects of discretionary budgetary policy by excluding interest payments from the conventional measure of fiscal deficit. This deficit indicates how the fiscal actions of the Government affect the Government’s net debt position and is important in assessing the sustainability of fiscal deficit. A surplus in the primary

Table 1: Budgetary Indicators (K'million)

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<tr>
<th></th>
<th>2002 Actuals</th>
<th>2003 Revised Budget</th>
<th>2004 Preliminary Outcome</th>
<th>2005 Budget</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Internal Revenue &amp; Grants</td>
<td>3,286 r 3,650 r 4,350</td>
<td>4,640 5,054 5,313</td>
<td>4,739</td>
<td></td>
</tr>
<tr>
<td>Appropriations</td>
<td>3,737 r 3,774 r 4,148</td>
<td>4,777 5,151 5,266</td>
<td>4,829</td>
<td></td>
</tr>
<tr>
<td>Surplus/(Deficit) =1-2</td>
<td>-450 -124 202</td>
<td>-138 -97 47</td>
<td>-90</td>
<td></td>
</tr>
<tr>
<td>Primary Balance</td>
<td>-14 615 578</td>
<td>343 251 380</td>
<td>407</td>
<td></td>
</tr>
<tr>
<td>Financing</td>
<td>450 124 449</td>
<td>138 97 -47</td>
<td>90</td>
<td></td>
</tr>
<tr>
<td>External</td>
<td>127 r -307 325</td>
<td>-190 -156 -238</td>
<td>-124</td>
<td></td>
</tr>
<tr>
<td>Domestic</td>
<td>577 r 431 124</td>
<td>328 252 191</td>
<td>214</td>
<td></td>
</tr>
<tr>
<td>Asset sales</td>
<td>201 40 25</td>
<td>0 0 0</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>Borrowed Funds</td>
<td>1,013 814 1,434</td>
<td>1,150 1,330 1,544</td>
<td>1,383</td>
<td></td>
</tr>
<tr>
<td>GDP (Nominal)</td>
<td>11,567 r 12,765 r 13,692</td>
<td>14,491 15,041 15,041</td>
<td>15,886</td>
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<th>Ratios to Nominal GDP in %</th>
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<th>Growth rates in %, year on year</th>
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<td>GDP (Nominal)</td>
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<td>Headline Inflation (Over the Year)</td>
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The above figures may not correspond to S25 due to some reclassification.

Source: Bank of Papua New Guinea. 2006 Budget Papers, Volumes 1, Department of Finance and Treasury.
balance in 2006 indicates that the projected deficit is sustainable and implies that the Government’s net debt and total public debt to GDP ratio is expected to improve.

Table 2 depicts that the revenue components of the 2006 Budget as a percentage of total revenue increased for all tax revenue measures, except the project grants. The total budgeted revenue and grants for 2006 is 6.2 percent lower, compared to the 2005 revised budget. The decline was mainly due to lower direct taxes and project grants.

Total direct taxes are projected to decrease by 2.3 percent, compared to the 2005 revised budget. The decline is due to lower personal and company income tax receipts. However, total direct taxes as a percentage of total revenue is projected to increase to 52.1 percent in 2006, compared to 50.1 percent in the 2005 revised Budget. The increase in the ratio reflects a decline in total revenue by more than the decline in direct taxes.

Indirect taxes are expected to increase by 3.8 percent in 2006, compared to the 2005 revised Budget. The increase is due to higher Goods and Services Tax (GST) receipts and excise collections. Indirect taxes as a percentage of total revenue is projected to increase to 22.2 percent in 2006, compared to 20.0 percent in the 2005 revised budget. Non-tax revenue is expected to decline marginally due partly to lower dividend payments to the Government.

Total project grants are projected to decline by 22.5 percent in 2006, compared to the 2005 revised Budget. The significant decline was mainly the result of the reduced Enhanced Co-operation Programme (ECP) by the Australian Government. Total project grants as a percentage of total revenue is projected to decrease to 21.0 percent in 2006, compared to 25.4 percent in
The 2006 National Budget continues to implement recommendations of the Taxation Review Committee (TRC) with the aim of improving and simplifying tax administration, to encourage investment and economic growth in the long run. The Budget neither introduced any new tax measures nor increased existing tax rates. However, the only tax reforms introduced include tax reductions to personal income, removal of double taxing on company dividends, and tax incentives for specific sectors involved in tourism and agriculture. The Government will continue to focus on strengthening tax compliance including improvements in collection of non-tax revenue in 2006.

Table 3 shows that the share of recurrent expenditure to total appropriation will decrease to 49.6 percent in 2006, compared to 51.4 percent in the 2005 revised budget. This trend is consistent with the MTFS, which follows a path of deficit reduction to achieve a balanced budget in the medium term. The share of development expenditure to total appropriation is 34.9 percent in 2006, compared to 35.4 percent in the 2005 revised Budget. The slight fall in development expenditure reflects the decline in donor funding due to the exclusion of the police component of the ECP in 2006. However, the Government has increased funding for the Development Budget to partially cater for the shortfall in project grants. This is in line with the Government’s Export-Led Growth Strategy by increasing service delivery at the district level and improving the country’s road infrastructure.

The 2006 Budget shows that total expenditure is 6.3 percent lower than the 2005 revised Budget. National recurrent expenditure is projected to decrease by 9.6 percent and development expenditure by 7.4 percent, while recurrent Provincial Government spending is expected to increase by 9.9 percent, compared to the 2005 revised Budget. The decrease in National recurrent expenditure is due to lower goods and services, arrears and SRP payments. The decrease in development expenditure reflects a fall in donor funding. The increase in Provincial Government expenditure is due to higher salaries and wages.

The new expenditure control measures for 2006 include further improvements to existing expenditure controls, reallocating spending to high priority programs identified in the MTDS, and continued public sector reforms.

Achieving the 2006 Budget revenue and expenditure...
targets are important because of its implications on financing and the level of public debt. A responsible Government should always maintain strict expenditure controls within the budgeted appropriations and effectively utilise any windfall revenue to retire debt and finance public works or infrastructure. This would avoid excessive injections of liquidity into the monetary system, because of its implications on the exchange rate and domestic inflation. The major threat to monetary conditions, the exchange rate and inflation, remains any fiscal slippages in the 2006 Budget. Therefore, the Government's MTDS and MTFS, which encourages prudent management of Government finances to achieve balanced budget and sustainable debt levels in the medium term are the key to macroeconomic stability.

The appropriate fiscal policy that should be adopted must, in addition to being internally consistent and compatible with the broader objectives of the Government, be sustainable. If the budget deficit and a sustainable level of domestic financing are to be achieved in 2006, the Government must refrain from excessive expenditure over-runs and live within the parameters of the 2006 budget.

Given the neutral stance of monetary policy adopted by the Central Bank, continued fiscal discipline will complement the gains on macroeconomic stability. Moreover, if the targets for Government revenue and external financing fall short of expectations, expenditure levels should be reviewed and cut, rather than reliance on domestic financing to meet budgeted and unbudgeted expenditure levels. Any increase in domestic financing to cover shortfalls in revenue will undermine the macroeconomic stability gained over the last three years. In this context, it is important that the structural reforms are continued by the Government and expenditure priorities are implemented consistent with the MTDS in order to achieve long term sustainable growth.
MONTHLY KINA FACILITY RATE ANNOUNCEMENTS

The Central Bank introduced the Kina Facility Rate (KFR) in February 2001, as an official rate to indicate its stance of monetary policy. The KFR is a monthly rate and any changes to it should translate to changes in market interest rates. Changes to the KFR is based on assessment of economic fundamentals consistent with the overall objective of monetary policy of price stability in the economy. From January 2002, the KFR announced by the Bank were:

**2003**
- 06 January Increased by 50 basis points to 14.50%
- 03 February Increased by 50 basis points to 15.00 %
- 03 March Maintained at 15.00 %
- 07 April Maintained at 15.00 %
- 05 May Maintained at 15.00 %
- 02 June Increased by 100 basis points to 16.00 %
- 07 July Maintained at 16.00 %
- 04 August Reduced by 100 basis points to 15.00 %
- 01 September Maintained at 15.00 %
- 06 October Reduced by 100 basis points to 14.00 %
- 03 November Maintained at 14.00 %
- 01 December Maintained at 14.00 %

**2004**
- 05 January Reduced by 100 basis points to 13.00 %
- 02 February Maintained at 13.00 %
- 01 March Reduced by 100 basis points to 12.00 %
- 05 April Reduced by 100 basis points to 11.00 %
- 03 May Reduced by 100 basis points to 10.00 %
- 07 June Maintained at 10.00 %
- 05 July Maintained at 10.00 %
- 02 August Maintained at 10.00 %
- 06 September Reduced by 100 basis points to 9.00 %
- 02 October Reduced by 200 basis points to 7.00 %
- 01 November Maintained at 7.00 %
- 06 December Maintained at 7.00 %

**2005**
- 03 January Maintained at 7.00 %
- 01 February Maintained at 7.00 %
- 01 March Maintained at 7.00 %
- 04 April Maintained at 7.00 %
- 02 May Maintained at 7.00 %
- 06 June Maintained at 7.00 %
- 04 July Maintained at 7.00 %
- 01 August Maintained at 7.00 %
- 05 September Reduced by 100 basis points to 6.00 %
- 03 October Maintained at 6.00 %
- 07 November Maintained at 6.00 %
- 05 December Maintained at 6.00 %

For details of the KFR, see Table 7.2 (S23) of the QEB.
KFR announcements prior to January 2002 are reported in the December 2002 QEB.
Each issue of the Quarterly Economic Bulletin contains a review of economic conditions for the past quarter and a comprehensive set of updated statistical tables. Articles of special interest to current economic policy are also prepared by Bank staff for inclusion in the Bulletin. The following articles have appeared in the Quarterly Economic Bulletin since December 1992.

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STATISTICAL NOTES

Sources

Statistics for the commercial banks have been derived from returns submitted to the Bank. Statistics on Savings and Loan Societies and Papua New Guinea Government securities are derived from sources within the Bank.

Government financial statistics are supplied by the Department of Finance and Treasury.

Information on prices of Papua New Guinea exports are gathered from marketing boards or export producers; world indicator prices are reproduced from the Public Ledger published in London. Tea prices are from the Tea Market Report, London. The general indices of commodity prices are constructed from data published in The Economist, London.

Most other statistics are published initially by the National Statistical Office.

Symbols used

n.a not available
.. figure less than half the digit shown
- nil
e estimate
f forecast
p provisional
r revised
n.i.e not included elsewhere