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BANK OF PAPUA NEW GUINEA

The Semi-Annual Monetary Policy Statement by the Governor of the Bank of Papua New Guinea, Mr L. Wilson Kamit

Port Moresby
14th July, 2000

OBJECTIVES OF THE CENTRAL BANK

"For the advantage of the people of Papua New Guinea, the objectives of the Central Bank are -

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

Central Banking Act 2000, Section 7

POLICY STATEMENTS

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

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

SEMI-ANNUAL MONETARY POLICY STATEMENT, JULY 2000

INTRODUCTION

This semi-annual Monetary Policy Statement is the first under the Central Banking Act 2000, which came into effect on 16 June. This and the following Statements, to be presented every six months, represent a key element of the transparency and accountability arrangements built into the new Central Banking Act. This Policy Statement is presented in 4 sections. The first explains the rationale for the adoption of price stability as the objective of monetary policy. The second section covers economic developments and projections for 2000. Section three sets out the rationale for the monetary policy stance for the next six months, and section four covers the conduct of monetary policy.

1. OBJECTIVE OF MONETARY POLICY

The Bank of Papua New Guinea has opted to target price stability, compared to the previous broad goal of monetary stability. The main reason for setting price stability as the primary goal for monetary policy is the experiences in both developing and industrialised economies that low inflation helps to promote economic efficiency and growth in the long run. The fact that high inflation is detrimental to the economy has long been recognised. Countries experiencing high inflation usually exhibit poor economic performance. Among the costs of high inflation are:

- Poor functioning of product and labour markets. If prices of products and/or labour increase significantly, the decision making process with respect to the supply and demand of goods, services, capital and labour, will impact negatively on economic efficiency and growth.
- Distributional effects with associated social consequences. Purchasing power of wage income will decline as real wages are reduced. Income distribution will deteriorate, because low income earners have less possibilities to insulate their income and savings from inflation than high/middle income earners;
- Over-expansion of the financial system, as individuals and businesses devote more and more of their resources to avoiding the effects of inflation on their financial holdings;
- Increased possibility of a financial crisis. The public and especially foreign investors will move their wealth out of countries with high inflation to avoid large financial losses. This behaviour, which is called capital flight, makes the financial system more fragile; and
- Costs for businesses of frequent re-pricing and renegotiating contract prices with customers and suppliers, due to the instability in the general level of prices.

Maintaining price stability in a small open economy like Papua New Guinea requires amongst other things, relative stability in the exchange rate. Downward pressure on the kina exchange rate can arise from domestic sources, most commonly fiscal imbalances and increased private sector credit, and from external sources, such as developments in international markets or natural disasters.

The appropriate monetary policy response to a depreciating currency and rising inflation, is a tightening of monetary conditions. Tight monetary conditions are meant to encourage domestic residents to keep their wealth in kina denominated assets, and discourage domestic consumption and import demand. A less desirable side effect, but one which also tends to reduce imports and thus downward pressure on the exchange rate, is the decline in domestic investment. The reduction in consumption and investment will in turn impact negatively on private sector activity and growth.

To obviate these negative effects of tight monetary policy, it is essential that a responsible fiscal policy is adopted. Excessive Government expenditure and borrowings from the domestic market to finance Budget deficits, in particular financing from the Central Bank, impact negatively on monetary conditions. Direct borrowing by the Government from the Central Bank will increase the level of reserve money and the monetary base, which can lead to downward pressure on the exchange rate and an increase in inflation.

By limiting Government spending and borrowing from the domestic banking system, the "crowding out" of the private sector is limited and public confidence in the overall management of the economy will tend to increase. In recognition of this, the Government has commenced retiring Government debt, especially that held by the bank of Papua New Guinea, and plans further repayments as the year progresses

Box 1. STRUCTURAL REFORMS OF THE BANK OF PAPUA NEW GUINEA

a) Background

During the 1990's Papua New Guinea's economy was adversely affected by the failures in good governance and Govemment expenditure controls, combined with the El-Ninõ related drought and the Asian financial crisis, which undermined private sector and international confidence. These developments led to a significant decline in real Gross Domestic Product (GDP) and a deterioration in the Government's fiscal position from near balance in 1997 to a deficit of 3.7 percent in the first half of 1999. The Government deficit was financed mainly by recourse to Central Bank financing which resulted in a significant increase in the level of domestic liquidity and imports, and a decline in both net official international reserves and the external value of the kina.

With weak confidence in the policy environment, and falling export volumes and prices due to the drought and depressed global demand, intervention in the foreign exchange market by the Bank was unsuccessful in stemming the downward movement of the kina which contributed to growing inflationary pressures. The annual rate of inflation rose to around 20 percent at the end of 1998 and early 1999.

In the second half of 1999, the Government moved to contain the overall deficit for 1999 to 2.5 percent of GDP and significantly reduced net credit to the Government from the Central Bank. It also formulated an economic and financial programme for 2000, which seeks to establish the foundations for sustainable growth through the restoration of macroeconomic stability and key structural reforms. In March 2000, the International Monetary Fund endorsed this programme and approved Papua New Guinea's request for US$115 million under a 14-month stand-by arrangement. In June 2000, the World Bank approved a US$90 million structural adjustment loan covering a comprehensive range of reform initiatives and paving the way for additional adjustment support from various donor countries.

b) Reforms to the objectives, powers, independence and accountability of the Bank of Papua New Guinea

The developments in the 1990s, especially failures in Government expenditure controls, large Government borrowings from the Central Bank and frequent changes in Governors, highlighted the need to increase the powers and independence of the Bank of Papua New Guinea. The view shared by the Bank, and the Government was that structural reforms of the Central Bank would be necessary to achieve stability of the economy in the medium term. Of all the Government's tools for influencing the economy, monetary policy has proven to be the most flexible instrument for achieving medium-term stabilisation objectives, through its direct effect on inflation.

The Bank of Papua New Guinea was therefore placed at the centre of the Government's initial structural reform efforts. In March 2000, a new Central Banking Act (CBA) and in April, a revised Banks and Financial Institutions Act (BFIA) were passed by Parliament which increase the Bank's independence, redefine its objectives, and improve regulation and supervision of the financial system.

Under the new Central Banking Act, significant changes were made in the relationship between the Bank and the Government to safeguard against excessive financing of Budget deficits by the Central Bank, to achieve and maintain price stability and to increase independence. The reforms include: the introduction of price stability as the monetary policy objective, the separation of debt management from the conduct of monetary policy, limiting Central Bank credit to the Government to an operating overdraft of up to K100 million, and appointing the Governor for a fixed term of five to seven years.

With greater independence and stronger powers comes greater accountability and transparency to Parliament and the public on the part of the Central Bank and the Governor:

- The Central Bank will publish semi-annual monetary policy statements, outlining developments, the policy stance and projections, which will enhance the effectiveness of the transmission of monetary policy;
- The role of the Board of the Bank is to advise and review the performance of the Governor of the Bank;
- In addition to an annual audit, the Minister for Finance and Treasury may at any time call for an external managerial or financial audit of the Bank; and
- Conditions relating to dismissal of the Governor and the Deputy Governors are streamlined, transparent and open.

2. PROJECTED ECONOMIC DEVELOPMENTS IN 2000

In designing monetary policy for 2000, the Central Bank considered projected developments in five main areas, and their impact on the monetary aggregates, prices and exchange rate:

a) International Developments;
b) Domestic Economic Activity;
c) Headline and Underlying Inflation;
d) Balance of Payments; and
e) Fiscal Operations of the Government.

a) International Economic Developments

The global economy grew rapidly during the first half of this year and it is on target to post an economic growth rate of 4.6 percent this year after expanding by 3.3 percent last year. Favourable financial and monetary conditions were responsible for this impressive economic growth. These conditions are gradually tightening as reflected by the declines in equity prices and interest rates hikes by most central banks. Global core inflation has increased this year due to higher oil prices and robust domestic demand in most economies. Global inflation is projected to increase by 3.1 percent this year compared to an increase of 2.8 percent in 1999.

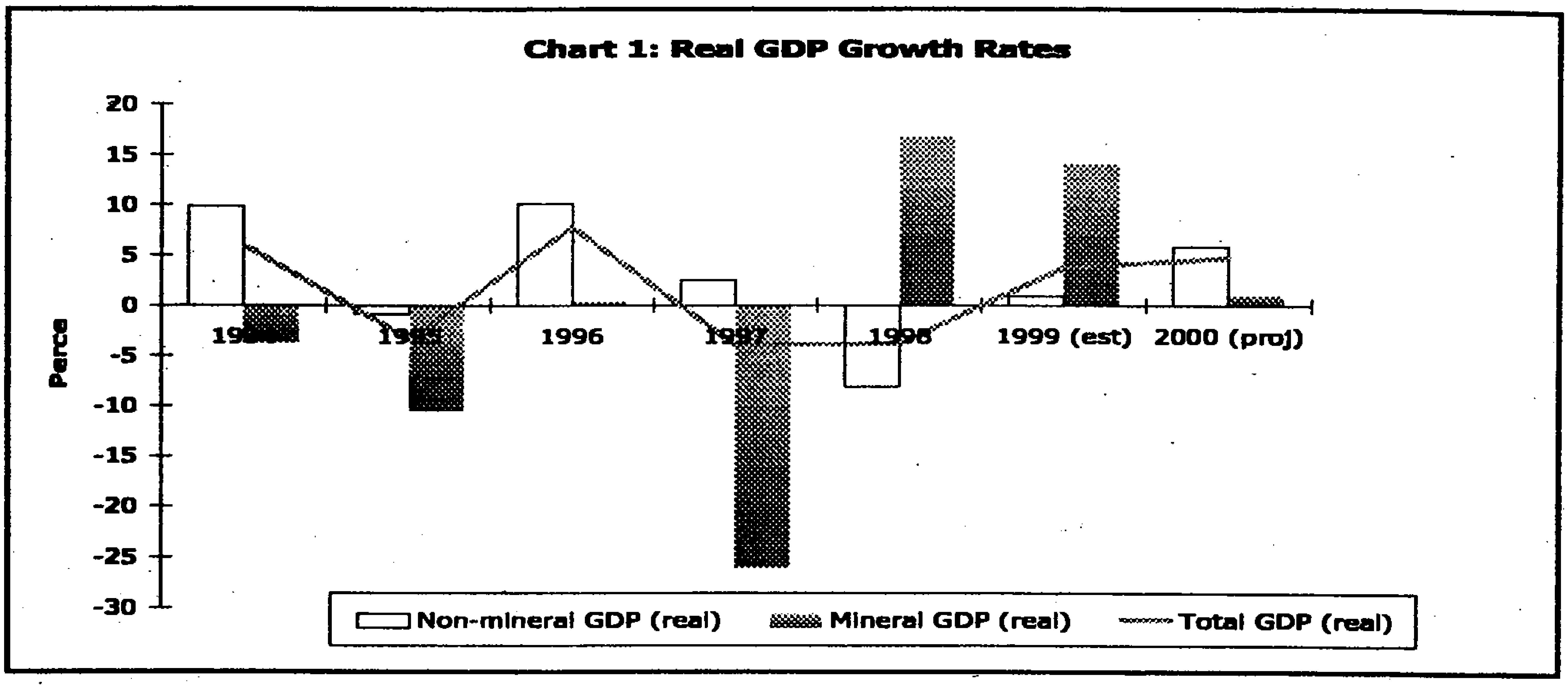
Economic growth has increased in all the major industrial economies following the economic recovery in Japan and acceleration of economic growth in Europe. Most central banks have increased their interest rates significantly during the first half of this year to keep inflationary pressures at bay. The Bank of Japan has indicated that it will end its policy of monetary easing in the near future following recent data releases which indicate that the Japanese economy is now out of the doldrums. In the US, GDP growth rose by 5.5 percent in the first quarter of this year versus an increase of 5.4 percent in the last quarter of 1999. The economic growth rate is expected to show a decline in the second quarter, mainly because of weaker retail spending and the large trade deficit. Inflationary pressures in the US continued to edge higher in the first half of this year due to higher oil prices, tight labour markets and robust domestic demand. The US Consumer Price Index (CPI) increased by 0.1 percent in May after it remained unchanged in April. Production increases by the OPEC countries and the expected slow down in the US economy should cap any further increases in inflation.

In Japan, the much awaited economic recovery is now at hand. The latest Bank of Japan economic report showed a marked improvement in the economy. Economic recovery in the Asian emerging economies has fuelled increased demand for Japanese exports. Recent manufacturing sector performance and the near term outlook continued to look strong. Industrial production increased by 0.2 percent in May following a decline of 0.6 percent in April. The unemployment rate has dropped, reflecting solid recovery in the corporate sector. After peaking at 4.9 percent in February and March, the unemployment rate fell by two tenths to 4.6 percent in May. In the Euro-zone economies, economic expansion has gathered momentum, with GDP forecasted to rise by 3.4 percent in year 2000 after growing by 2.3 percent in 1999. Economic growth has been driven by supportive financial conditions, the weak currency, moderation in labour costs and significant corporate restructuring. Inflationary pressures have emerged from the higher oil prices and the weakness in the euro currency. Inflation is projected to increase by 1.8 percent this year from 1.1 percent last year. In Australia, the economic growth is expected to grow by 3.75 percent in year 2000, down from a robust growth rate of 4.25 percent in 1999. The slow down in growth is expected as a result of the decline in consumer spending due to the introduction of the Goods and Services Tax and the reduction in Sydney Olympics related expenditure. Recent interest rate hikes have also dampened spending.

b) Domestic Economic Activity

A preliminary estimate of economic activity, based upon information available to the Bank of Papua New Guinea, indicates that total real GDP grew by over 2.0 percent in 1999 (see Chart 1), following the recovery in 1998. The growth was due to increased activity in the mining and petroleum sectors, while activity was subdued in the non-mineral sector.

Activity in the agriculture/forestry/fisheries sector increased in 1999, following the turn-around in 1998, due to higher production of some of the major agricultural commodities and higher demand for logs following the recovery from the Asian financial crisis of 1997 and 1998. In the mining and petroleum sectors, the growth reflected higher production of gold at the Porgera, Lihir and Misima mines, copper at the Ok Tedi mine and crude oil at the Gobe Main and South East Gobe oil fields.



For 2000, real GDP is projected to grow by 4.5 percent, with increases in the mineral sector GDP of 1 percent and the non-mineral sector GDP of 5.6 percent. The projected real growth in the non-mineral private sector is mainly due to an improvement in the agriculture/forestry/fisheries sector, as well as increased activity in the manufacturing, construction and commerce sectors. Activity in the agriculture/forestry/fisheries sector is expected to increase due to higher agricultural production, particularly for cocoa, coffee, copra oil and palm oil, combined with higher log production. The continued improvement in the agriculture/forestry/fisheries sector is particularly encouraging to economic activity in Papua New Guinea, since this sector has strong spin-off effects given its importance as a source of income generation for the majority of the population. The expected growth in the agriculture/forestry/fisheries and mining sectors will have positive feed through effects on other non-mineral sectors, including manufacturing, commerce and transportation.

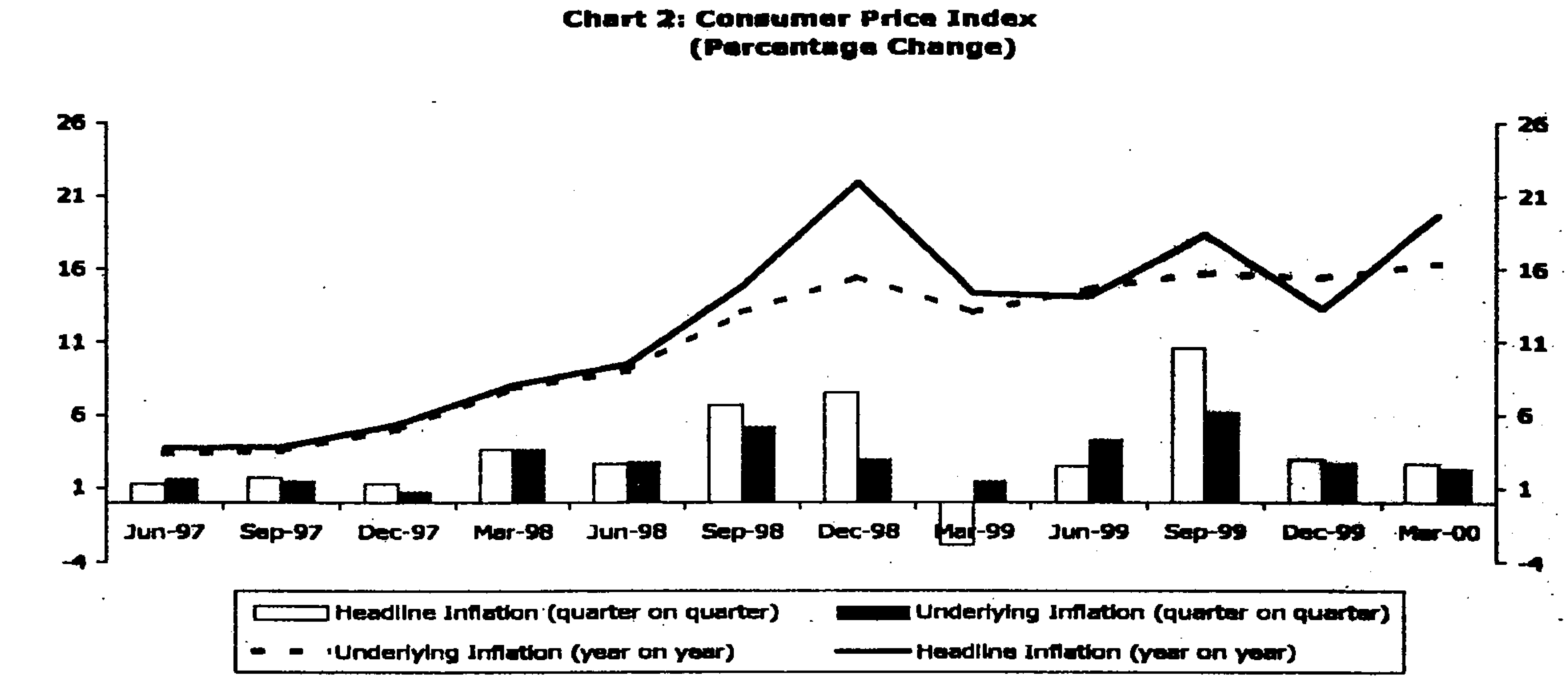
Real growth in the construction sector is projected to increase in 2000 and is attributed to the maintenance and construction of the Lae road project, preliminary work on the Ramu Nickel and PNG-Queensland gas pipeline projects, the Rabaul restoration program, continuation of the Madang-Ramu Road and an increase in the Government funded projects under the Development Budget.

c) Headline and Underlying Inflation

During the March quarter 2000, headline inflation, as measured by the CPI, increased by 2.6 percent compared with December and by 19.6 percent over the year (March quarter 2000 on March quarter 1999). This compared to 2.9 percent in the December quarter 1999 and 13.2 percent over the year to December 1999. (Table 1 and Chart 2). The increase in CPI inflation can be attributed to:

- Imported inflation: The movement in the exchange rate is the most influtential factor impacting on headline and underlying inflation. From March 1999 to March 2000 the kina depreciated by 25 percent against both the US and Australian dollar. The depreciation of the kina and its impact on import prices contributed significantly to the higher rate of inflation, due to Papua New Guinea's high import dependence.
- Domestic Inflation: There are three main factors that impacted on domestic inflation. Firstly, the new tax measures that were introduced in the 1999 Supplementary Budget, which included the increase in the excise rates of fuel, beer, spirits and luxury vehicles, and the introduction of the value added tax (VAT). Secondly, the prices of several price controlled items were increased, including petrol and tinned meat. Thirdly, public servant wages were raised by 5 percent in 1999.

The measure of underlying inflation presented in Table 1 and Chart 2, which excludes betelnut and policy effects of the 1999 Supplementary Budget and VAT, increased more gradually than headline inflation in 1999 and 2000. Fluctuations in the price of betelnut have been excluded as they impact significantly on headline inflation. Betelnut has a relatively large weight-



ing of 2.7 percent of household expenditure in the calculation of the CPI. In the March quarter of 2000, underlying inflation, increased by 2.4 percent and by 16.3 percent over the year (March quarter 2000 on March quarter 1999) compared to 2.7 percent in the December quarter and 15.3 percent over the year to December 1999.

Due to the appreciation of the kina from end December 1999 to end June 2000, inflation is projected to be lower in 2000. In addition, year on year inflation is expected to be lower in the September and December quarters of 2000, as a result of the dropping out of the policy factors of 1999 (excise tax and VAT), which had increased year on year inflation rates in 1999 and the first half of 2000. This and the recovery of the kina are expected to more than offset the carry-over effects of high inflation in 1999 and an expected increase in public sector wages. It is important to note that there will probably be a time-lag before the strengthening of the kina is translated into lower inflation, as businesses rebuild margins compressed over much of 1999. In 2000 the average yearly headline inflation rate is projected at 12 percent, compared to an increase of 14.9 percent in 1999. Over the year headline inflation (December quarter on December quarter) is projected to be around 5.0 percent in 2000 compared to 13.2 percent in 1999.

d) Balance of Payments

Preliminary balance of payments data for the March quarter of 2000 show an overall deficit of K91 million, with the surplus in the current account of K363 million more than offset by the deficit of K420 million in the capital account and K34 million in balancing item. The current account surplus was attributed to higher value of merchandise exports, mainly mineral, forestry and marine products, which more than offset the decline in other agriculture exports and higher imports. The deficit in the capital account was due to higher net loan repayments by the Government and mineral companies, a build up in offshore account balances of the mineral companies, and a lower draw down in the net

Table 1: Measures of Consumer Prices
(Percentage change)

	Quarterly		Year on Year	
	Dec-99	Mar-00	Dec-99	Mar-00
Headline CPI	2.9	2.6	13.2	19.6
Underlying CPI	2.7	2.4	15.3	16.3

BOX 2. MEASURES OF INFLATION

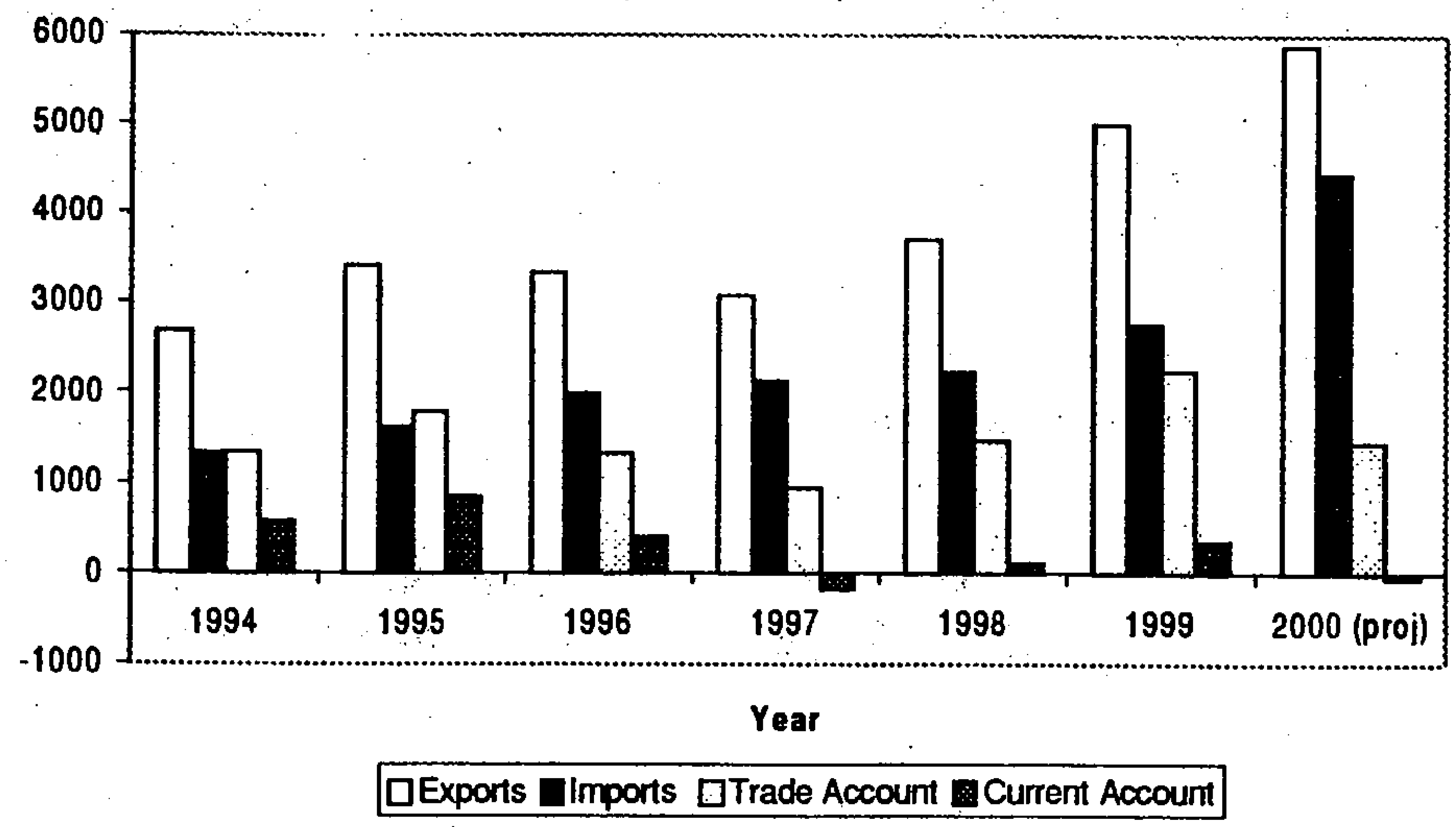
The analysis of price changes becomes central to the assessment of macroeconomic conditions and the conduct of monetary policy, given the Bank's objective of achieving and maintaining price stability. The CPI, published by the National Statistics Office, measures the changes in the cost of purchases made by households in urban centres, and is seen as a key indicator of price changes. It has been used as the measure of so-called 'headline' inflation in Papua New Guinea and although it is an adequate indicator for inflation over the long-term, it is not a good measure of underlying inflationary pressures that are acting on the economy over the short-term. This is because a large number of items in the CPI basket of goods and services are affected by highly volatile factors, Government policy decisions and seasonal factors.

Highly volatile price movements may be caused by climatic conditions (e.g. droughts or floods), or actions, such as price wars, industrial disputes and trade embargoes. Government policy decisions also affect prices through revenue raising, (e.g. increases in excise rates and VAT), or regulation. Seasonality affects price movements where items become available only at the same time(s) each year (eg betelnut, fruits and vegetables) or higher demand arises for some items at certain times each year. The movements in the prices of such items mask the so-called 'underlying' or 'core' rate of inflation.

An underlying rate of inflation measures the inflationary pressures in the economy that are predominately due to markets forces, i.e. changes in prices that reflect only the longer-run supply and demand conditions in the economy. As a monetary authority with the primary objective of achieving and maintaining price stability, the Bank of Papua New Guinea has to distinguish between temporary price shocks, caused by highly volatile, seasonal or policy factors, and persistent shocks to the rate of inflation. This distinction has to be made because of the time-lag that exists between monetary policy action and its influence on inflation. Due to this lag, monetary policy must be implemented in a pre-emptive way. In order to do this, it becomes crucial for monetary policy to gauge and respond appropriately to the underlying rate of inflation by removing the effect of factors assessed as temporary from the measured headline inflation rate.

Examples of factors that have been assessed as temporary in Papua New Guinea include: changes in the prices of betelnut, fruit and vegetables, and the price effects of VAT and excise tax increases. It is essential to note that there is important information on price movements in both headline and underlying measures of inflation, and the Bank of Papua New Guinea will therefore continue to monitor movements in both these series for monetary policy purposes.

Chart 3. Balance of Payments (Kina million)



foreign assets of the commercial banks.

The level of gross foreign exchange reserves at the end of the June quarter of 2000 was US$255.1 (K671.1) million, sufficient for 2.7 months of non-mineral import cover.

The balance of payments is particularly important in small open economies like Papua New Guinea through its effects on the exchange rate and thus on inflation. The balance of payments for 2000, which includes extraordinary financing associated with the Structural Adjustment Programme (SAP) is projected to show a surplus of K456 million, compared to a surplus of K160 million in 1999. The surplus is attributed to an improvement in the current account surplus, which more than offsets the higher deficit in the capital account. The projected improvement in the current account surplus primarily reflects higher non-mineral export receipts driven by increased production, combined with expected higher mineral export receipts. The capital account, including the external extraordinary financing, is projected to record a deficit partly reflecting the investment of surplus funds offshore by the mineral companies, which more than offset lower loan repayments by resident companies and higher loan draw downs by the Government in 2000.

Extraordinary financing, excluding balance of payments support from the IMF associated with the SAP, is projected to total US$180 (K474) million in 2000. The draw down includes US$90 (K237) million from the World Bank, US$50 (K131) million from the Japanese Government and US$40 (K106) million from other bilateral donors. The balance of payments support from the IMF in 2000 is US$65.5 (K172) million, with the remaining US$49.5 (K130.3) million to be drawn down in 2001. Gross official foreign exchange reserves at the end of 2000 are projected to be around K995 (US$378) million, sufficient to provide over 5.9 months of non-mineral import cover.

e) Fiscal operations of the Government

Latest available fiscal data to May 2000, show that the Government incurred a Budget surplus of K37 million. Total revenue and grants represent 34 percent of the projected amount under the Budget, while total expenditures comprised 30 percent of the budgeted annual level. The Budget surplus and net repayments to external sources of K54 million left a total domestic financing requirement of K17 million, which is made up of positive financing from the non-bank financial system and other domestic financing more than offsetting a net repayment to the banking system. The increase in financing from the non-bank financial system reflects the sale of treasury bills to the public through the tap issue, which reduced the holdings of the Central Bank.

The fiscal strategy of the 2000 National Budget presented to Parliament on 02 November 1999 is to restore stability and integrity to the economy and banking system by delivering a balanced Budget. This strategy dictates that all expenditures will be funded from revenue and grants, with no allowance for general budget financing from domestic borrowing. In addition, the 2000 Budget included total external extraordinary financing of US$200 (K526) million under the SAP with the IMF/World Bank and PNG's traditional bilateral donor countries.

The projected 2000 headline Budget deficit of K215 million is 1.7 percent of nominal GDP, compared to a revised deficit of K232 million in 1999. The 2000 headline Budget deficit is made up of K100 million in one-off arrears payments incurred before 1999, K101 million in structural adjustment payments and a modest K14 million underlying budget deficit. It is important to note that the deficit will be fully funded from revenue, grants and a World Bank structural adjustment loan.

In order to achieve a headline Budget deficit of K215 million and an underlying Budget deficit of K14 million, the Government will focus on maintaining strictly controlled recurrent expenditure across all departments. Domestic interest payments are expected to decline, as a substantial proportion of domestic debt held by the Bank of Papua New Guinea was offset against the balance held in Mineral Resources Stabilisation Fund (MRSF) at end 1999 with further retirement of domestic debt in 2000. External interest payments are expected to rise with the higher external financing requirements placed on the 2000 Budget and the completion of grace periods on some concessionary loans. Development expenditure is budgeted to increase by 0.8 percent of GDP in 2000, reflecting the shifts in Australian aid from general budgetary support to project grants. In addition, the 2000 Budget also includes an appropriation for the Government's structural reform agenda that is to be funded from the World Bank structural adjustment loan. Net concessionary loan repayments of K139 million have been budgeted,

Table 2: Summary of Fiscal Operations of Government
(Kina million)

	1995	1996	1997	1998	1999	2000 Budget	May-00 Prelim.
Total Revenue & Grants	1722	1898	2024	1991	2569	2867	977
Total Expenditure	1756	1860	2009	2129	2801	3082	939
Deficit/ Surplus	-34	37	15	-137	-232	-215	37
Percentage of GDP (%)	-0.6	0.5	0.2	-1.7	-2.5	-2.1	0.4
Financing (net)	34	-37	-15	138	232	215	-37
External	-44	10	-73	-116	178	343	-54
Domestic	78	-47	58	254	54	-128	17
Of which:							
BPNG	-185	-243	177	410	-35	-128	-346
Commercial Banks	266	325	-77	-350	9	0	161
Other Domestic Financing	-3	-129	-42	194	80	0	202

Source: *Quarterly Economic Bulletin*, Bank of PNG.

which include K233 million in gross loan repayments in 2000, and extraordinary financing associated with the SAP is projected at K526 million, while commercial loan repayments are expected to be K44 million.

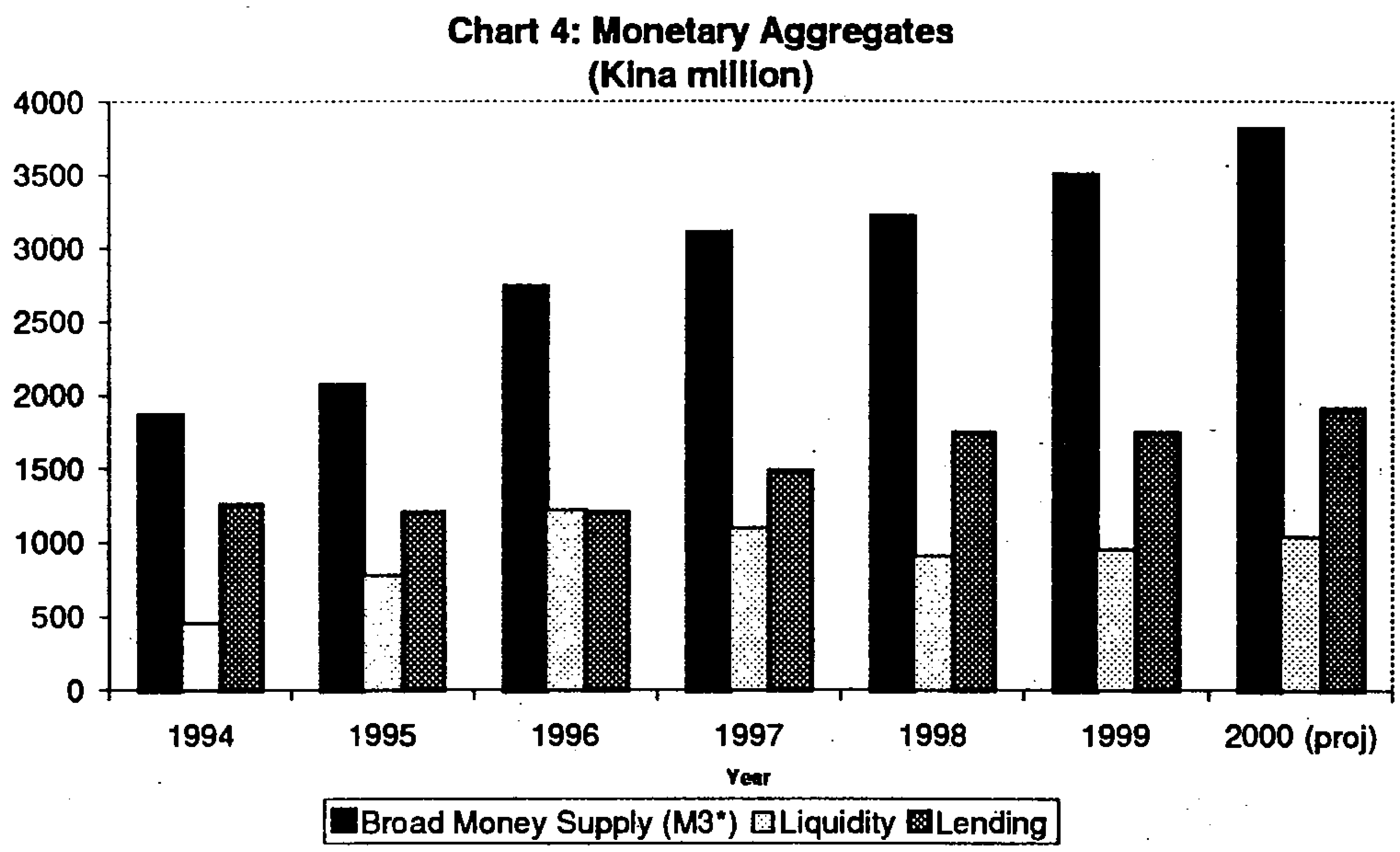
These developments in Government revenue and expenditure and available external financing as presented in the 2000 Budget are expected to result in a domestic debt repayment of K128 million. In June/July 2000, the Government has retired a total of K76 million in treasury bills from the holdings of the Central Bank. This reduction in debt from domestic sources is encouraging as it will reduce pressure on the banking system and free up resources that can be used for private sector credit.

3. MONETARY POLICY FOR 2000

a) Monetary and Financial Market Developments (January-June 2000)

The Central Bank Board reaffirmed its commitment to maintain a tight monetary policy stance throughout 1999 in a continued effort to mitigate the downward pressure on the exchange rate and increased inflationary pressures experienced during 1999. These pressures were a result of excess liquidity in the banking system resulting from an expansionary fiscal policy in 1998 and the first half of 1999. The Central Bank continued to maintain a tight stance of monetary policy during the first six months of 2000. Official rates declined (Chart 5) with the 182-day treasury bill rate falling from 20.44 percent at end December 1999 to 16.28 percent at end June 2000. However, this was driven by market expectations of easing in monetary conditions, as a result of the stability in the exchange rate in the December quarter of 1999 and a net appreciation of the kina in the first six months of 2000. Although Indicator Lending Rates (ILRs) remained unchanged, the weighted average lending rate declined over the first six months of 2000, reflecting the extension of a few large quality loans, while weighted average deposit rates depicted an increasing trend. As a result, the spread between lending and deposit rates declined (Chart 5).

Credit extended by the banking system to the private sector, official entities and non-monetary financial institutions remained unchanged over 1999, but increased marginally in the first six months of 2000. Net domestic credit to the Government increased by 11 percent (K110 million) over 1999, but declined significantly by 22 percent (K235.2 million) over the first six months of 2000.

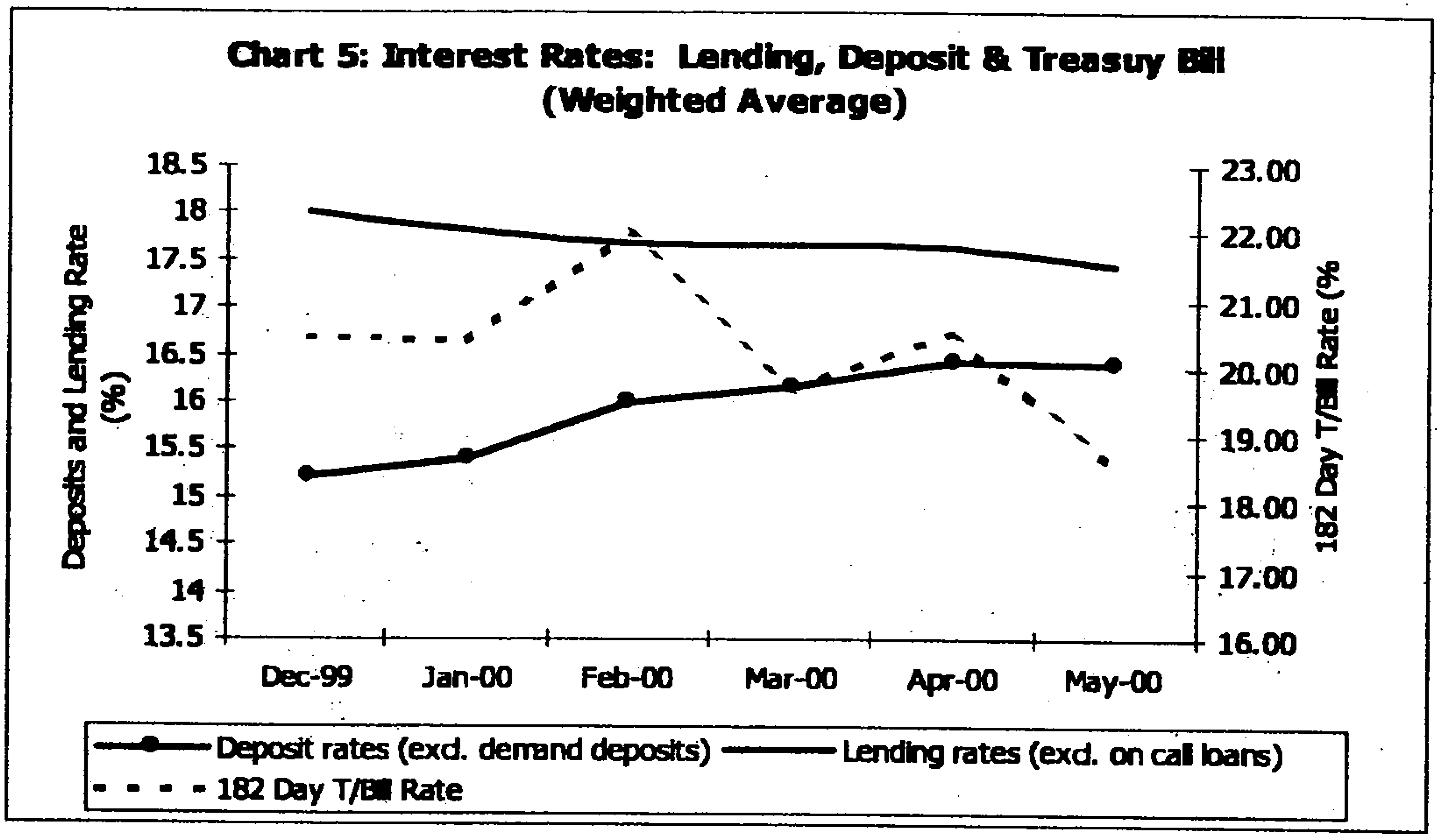


The level of broad money (M3) increased by 6 percent between 1998 and 1999 (see Chart 4), due to an increase in the net foreign assets of the banking system, which more than offset the decline in total domestic credit extended by the banking system. The increase in the net foreign assets of the banking system was mainly influenced by the US$80 million received under the swap facility between the Bank of Papua New Guinea and the Reserve Bank of Australia in December 1999. The decline in the total level of domestic credit extended by the banking system, was a result of the decline in net credit extended to the private sector, official entities and non-monetary financial institutions, which more than offset the increase in net credit extended to Government.

Over the first five months of 2000 however, the level of broad money declined by 5 percent. This resulted from declines in both the net foreign assets of the banking system and net domestic credit. The decline in the net foreign assets of the banking system mainly resulted from higher overseas loan repayments by Government, while the decline in net domestic credit was a result of a significant decline in net credit to the Government, which more than offset an increase in net credit to the private sector, official entities and non-monetary financial institutions. The significant decline in net credit to the Government reflected the decline in the Central Bank's holdings of treasury bills, as a result of increased sales to the public under the tap issue. In June and July, net credit to the Government was reduced further as the Government retired K76 million in treasury bills held by the Bank of Papua New Guinea.

The tight stance of policy maintained by the Central Bank during the first six months of 2000, was implemented through the use of its open market instruments and the Cash Reserve Requirement (CRR). Although no changes were made to the CRR and Minimum Liquid Asset Ratio (MLAR), the Central Bank sold substantial amounts of treasury bills under the tap issue to the public. This had the effect of tightening reserve money within the banking system and maintaining of market interest rates at high levels.

With tight monetary policy, the approval of a US$115 million stand-by credit from the IMF and increased confidence in the economy, the kina appreciated significantly against the currencies of its major trading partners. From end December 1999 to end June 2000, the kina appreciated by 10 percent against the US dollar, by 20 percent against the Australian dollar, by 14 percent against the Japanese yen and by 16 percent against the Euro (see Chart 6). Exchange rates can be volatile and the Bank preserves the right to intervene to smooth seasonal and cyclical variations around the market trend. In the first six months of 2000, the Bank has at times entered the foreign exchange market on both the buy and sell sides to



exert a stabilising influence on the rate of change of the exchange rate.

b) Monetary Policy Stance

In line with its objective of achieving and maintaining price stability, the Central Bank will continue to asses market developments and the main macroeconomic indicators, and take a cautious approach to any change to the stance of monetary policy. This includes key factors that impact materially on future inflation performance, mainly;

- Movements in the exchange rate;
- Maintenance over the reference period of positive (forecast) real interest rates;
- Developments in relevant money and credit aggregates;
- Prudent implementation of the 2000 Budget;
- Draw down of the budgeted external extraordinary financing; and
- Retirement of domestic debt by the Government.

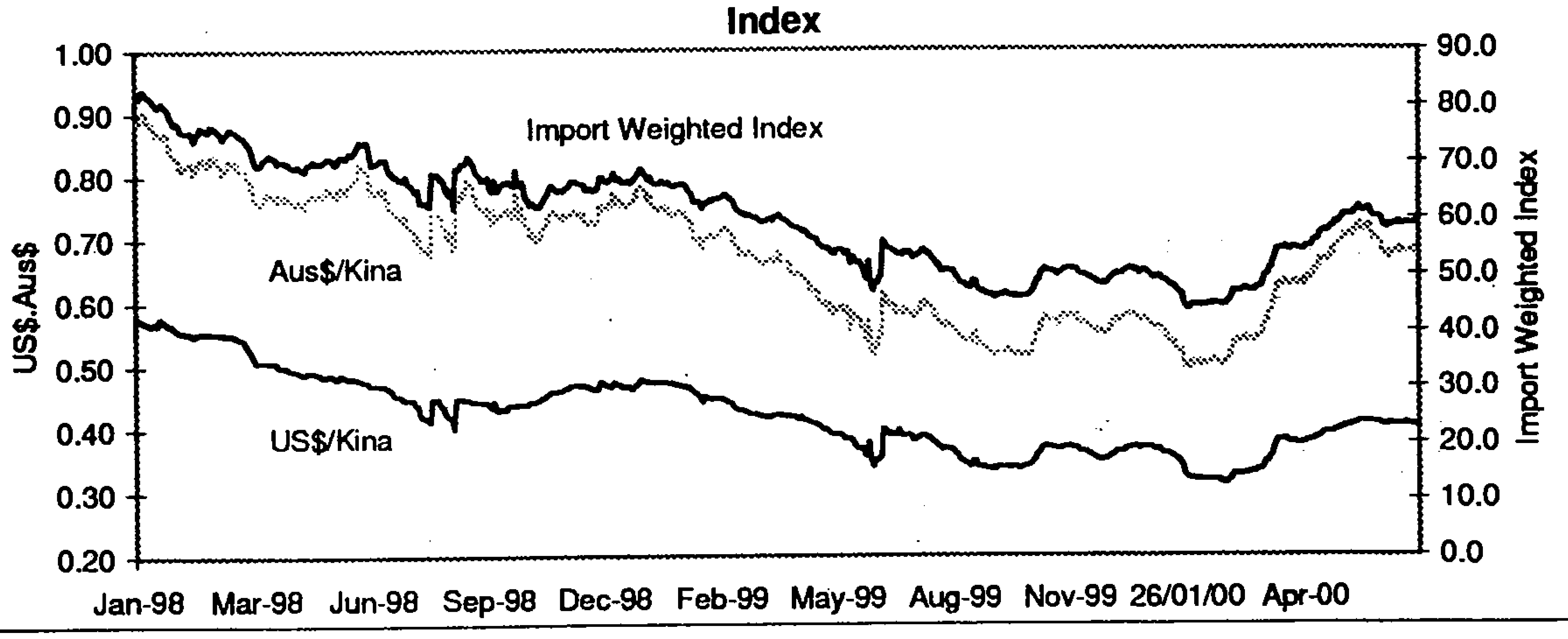
While inflation is below the peaks reached in 1999, it remained high in the March quarter and is subject to the influence of the lagged effects of high import prices and exchange rate movements in 1999 and early 2000. There are also second round effects on prices from such sources as domestic wage claims.

These impulses will however, be moderated by the impact of subsequent strengthening of the exchange rate in the first half of 2000. The lags of the latter are likely to be longer as importers rebuild margins compressed over much of 1999. Assuming that there are no unexpected shocks, the Central Bank expects inflation performance over the second half of the year to improve materially. In this environment, market expectations will be an important influence on the pace of interest rate declines. However, the Bank will need to be satisfied that inflation is firmly on a downward trend, before validating market expectations.

In the absence of unfavourable shocks, further positive developments in the above indicators are expected in 2000, which provide support for the Central Bank to consider a gradual easing of monetary conditions by lowering official interest rates. The gradual easing of interest rates would be consistent also with lower inflation. Expected developments in monetary and credit aggregates should also support the objective of price stability. Inflation and monetary and credit aggregates are expected to develop as follows in 2000;

- Over the year headline inflation (December quarter on December quarter) to fall to a projected level of 5.0 percent, and average yearly headline inflation to a level of 12 percent;
- Growth in broad money (M3) of around 8 percent;
- A 9 percent expansion of credit to the private sector, consistent with the objectives of growth in the non-mineral sector;
- A fall in net credit to Government from the Central Bank by over 60 percent in 2000, as the budgetary position and foreign financing permit net

Chart 6: Kina exchange rate against US$, Aus$ and Import Weighted Index



repayment of domestic debt; and

- A decline in domestic credit to Government of 13 percent.

These are restrictive conditions but essential to achieve price stability and encourage the external support necessary to assist domestic adjustment in the economy. The risk factors to the moderation of inflation include unexpected adverse developments in the foreign exchange market, as would occur if there were delays or withdrawals of expected concessionary funding, due to the failure of domestic authorities to meet the performance targets under the financial programme. It is important to note that these targets are on track at present. Also, any breakout of inflationary pressures as a result of a surge in domestic costs- such as wage inflation, would also risk programme targets with implications for the timing and extent of monetary policy easing. Finally, the response of the financial markets to any easing in interest rates will need to be carefully monitored and along with a market determined risk premium, will provide one practical constraint to the rate at which interest rates may adjust to their ultimate level.

In summary, there have been a number of positive developments in key macroeconomic indicators, including improvement in the balance of payments, stability in the exchange rate, some decline in interest rates, a significant reduction in domestic debt by the Government of K76 million in June and July with further reductions planned and most importantly, inflation is expected to decline in the second six months of the year.

Consequently, the Central Bank expects to be able to gradually ease its monetary policy stance in the second half of 2000. The pace and extent of adjustment will be strongly influenced by the risks associated with the sustainable achievement and maintenance of price stability in Papua New Guinea.

4. CONDUCT OF MONETARY POLICY

Consistent with the Bank of Papua New Guinea's objective of achieving and maintaining price stability, the conduct of monetary policy will be operated within a reserve money framework. Reserve money is defined as currency in circulation and deposits of commercial banks with the Central Bank and, along with the level of liquid assets in relation to statutory requirements, is an indicator of the capacity of the banking system to finance new lending. This affects demand and ultimately inflation, especially through the influence of the balance of payments on the exchange rate. During 2000, reserve money is expected to increase modestly, following growth of over 70 percent in 1999, as a result of higher broad money growth from the increase in net foreign assets of the Central Bank. To curtail the expected growth in reserve money and its impact on inflation, the Central Bank will continue to use its open market instruments to sterilise the excess reserve money in the banking system.

The Bank can influence the level of liquidity in the economy through its monetary policy operations and its increased powers, under the new CBA (see Box 3), to limit its lending to the Government.

Box 3: RELATIONSHIP WITH GOVERNMENT

In the new CBA, the powers and independence of the Bank of Papua New Guinea have been greatly expanded to facilitate the achievement of price stability. The following changes were made in the relationship between the Government and the Central Bank to safeguard against excessive financing of Budget deficits by the Central Bank and to achieve and maintain price stability:

- Separation of debt management from the conduct of monetary policy: As of January 2000, the interest rate on all treasury bills is market determined. Under the previous system the Central Bank was paid interest twice a year on the entire stock of treasury bills at an administered rate agreed with the Government. The Central Bank then paid interest at market rates to the holders of the bills. In effect, the responsibility for debt management policy has been passed back to the Department of Finance and Treasury. The Central Bank will continue to be responsible for conducting auctions of Government securities and tap issuance, but it will now only act as the Government's agent, rather than its underwriter;
- Restriction of Central Bank credit to the Government: Under the previous arrangement the Government could borrow from the Bank of Papua New Guinea within prescribed limits related to budget revenue, which were defined in the Central Banking Act. Under the new arrangement the Government can only obtain temporary advances from the Central Bank to cover temporary deficiencies of revenue. Also, any advances granted by the Central Bank to the Government must not exceed K100 million and must be repaid not more than six months from the date of the advance. The Central Bank is legally prohibited from explicitly financing a Government Budget deficit. Subject to rollover of its existing stock of securities, the Central Bank may only purchase Government securities for monetary policy purposes; and
- Term of Governor: The Governor will be appointed for a fixed term of five to seven years, which is well beyond the electoral cycle.

The Bank also hopes that a decline in inflation and interest rates, and the supply/demand balance for Government debt, will improve market confidence and enable a more traditional relationship to emerge between yields of public and private debt. Similarly, such factors should allow the re-establishment of a market for medium-long term Government debt at yields acceptable in terms of the debt burden.

In the last quarter of 1999 and the first six months of 2000 the Central Bank relied on market-based instruments of monetary policy, such as treasury bills and Kina Auctions, rather than on administrative-based changes in the level of MLAR and CRR to influence monetary conditions. In line with the adopted policy to reduce the outstanding stock of domestic debt, the Government has reduced its debt to the Bank of Papua New Guinea by K76 million by retiring treasury bills. As a result, the supply of treasury bills held by the banking system has fallen in 2000 to date, and is expected to fall further as the Government retires additional debt in the remaining part of the year.

To improve the efficiency of the money market, the Central Bank introduced the tap facility in 1998. This facility enables certain non-bank entities and individuals to purchase treasury bills directly from the Central Bank at interest rates related to those obtained during the latest auction. Its existence also enhances competition for funds, thereby making deposits and lending rates more responsive to changes in treasury bill yields. The improved linkage between treasury bills and deposit and lending rates is expected to increase the efficiency in transmission of monetary policy and help facilitate a downward shift in the entire interest rate structure as inflation declines over the year. The Central Bank will actively promote the sale of treasury bills on tap to the non-bank financial sector through a public awareness campaign.

The Kina Auction Facility will be retained to smooth short term liquidity movements, while the MLAR and CRR will be continuously reviewed to determine their appropriate levels consistent with the stance of monetary policy. In addition, the Central Bank will review new monetary policy instruments to strengthen its open market operations and make technical improvements to the existing instruments to enhance their effectiveness in transmitting monetary policy and to encourage a deepening of the domestic financial system.

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