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BANK OF PAPUA NEW GUINEA

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

PORT MORESBY

31 July 2006

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Queries on the contents of the Monetary Policy Statement should be directed to the Deputy Governor, Policy and Regulation on telephone number (675) 3227359 or Manager, Monetary Policy Unit on telephone number (675) 3227312, or both on fax number (675) 3200757. Copies of the Statement can be obtained from the Economics Department and it is also available on the Bank's website: <http://www.bankpng.gov.pg>. It will be reproduced in the June 2006 issue of the Quarterly Economic Bulletin (QEB).

Objective of Monetary Policy

The objective of monetary policy in Papua New Guinea (PNG) is to achieve and maintain price stability. If achieved it will lead to:

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

MONETARY POLICY STATEMENT (MPS) JULY 2006

Executive Summary

Papua New Guinea has experienced relative price stability since 2003. The Bank of Papua New Guinea (Bank) expects that this and other favourable macroeconomic conditions will continue in the second half of 2006 and over the medium-term. **Therefore, the Bank will maintain a neutral monetary policy stance during this period.** This stance is based on the following expectations:

- Headline and underlying inflation will remain at around 2.5 - 4.5 percent;
- Stable kina exchange rate against the currencies of PNG's major trading partners;
- Prudent fiscal management by the Government;
- Private sector credit growth will continue in 2006 and the medium term; and
- Gross Domestic Product (GDP) growth to be higher than the Government's projections of 3.5 percent, as indicated by the fast growth of private sector credit.

However, the risks to price stability include high volatility in the exchange rate, the potential adverse effects arising from rapid growth in monetary aggregates, the high crude oil prices and any fiscal slippages from the original 2006 Budget or the Supplementary Budget to be presented in August 2006, and in the lead up to the 2007 National Elections.

In this respect, the Bank will re-assess and if necessary make changes to the monetary policy stance to counter any adverse effects on the maintenance of price stability.

The effectiveness of monetary policy to curtail any threat to price stability will be limited if it is not supported by fiscal and other policy measures. Therefore, a closer co-ordination of policies by the Government and the Bank is necessary in sustaining macroeconomic stability and economic growth over the medium-term.

1.0 Monetary Policy Discussions

1.1 Monetary Policy Assessment and Issues

In the first half of 2006, the Bank maintained a neutral monetary policy stance. Consistent with the stance, the Kina Facility Rate (KFR) was maintained at 6.0 percent reflecting low inflation, stable exchange rate and favourable macroeconomic outcomes.

Macroeconomic outcomes for the first half of 2006 were broadly in line with the Bank's expectations outlined in the January 2006 MPS. Annual headline inflation was 2.3 percent to June 2006, driven by stability in the exchange rate and lower foreign inflation. The Trade Weighted Index (TWI) and Real Effective Exchange Rate (REER) remained relatively stable over the first half of 2006.

Interest rates have generally continued to remain low given the high level of liquidity in the banking system. The low interest rate environment combined with sound fiscal management, removal of foreign exchange control restrictions and political stability led to a pick up in business confidence and increased lending to the private sector by commercial banks. The increase in lending has enabled the private sector to expand business activity and generate employment.

Annual growth in broad money (M3*) and reserve money were 46.4 percent and 32.3 percent, respectively, to June 2006. The growth in broad money was accounted for by a significant increase in the net foreign assets of the Central Bank and net credit to private sector. The very fast growth in broad and reserve money are of concern to the Bank as they could lead to inflationary pressure.

Preliminary estimates of the fiscal operations of the National Government over the five months to May 2006 showed an overall budget surplus of 1.4 percent of nominal GDP, due to higher than budgeted mineral tax receipts. Given this outcome, the Government should be able to achieve its objectives within the original 2006 Budget parameters or the Supplementary Budget to be presented in August 2006. However, the Government should restrain recurrent expenditure because if the mineral prices fall in the future it will be difficult to adjust expenditure downward. The focus should be to increase development expenditure that will generate growth and reduce poverty as stated in the Medium Term Development Strategy (MTDS).

The Government's debt management strategy of restructuring debt from short to longer term to reduce refinancing risk has led to issuance of Inscribed stocks. This has in turn led to a very substantial increase in interest cost on domestic debt by 32.7 percent in the first five months to May 2006, compared to the same period in 2005. Such a substantive increase in interest expenses and recourse to domestic borrowing is in the Bank's view inconsistent with the medium term debt strategy. The Government was advised by the Bank to retire some of its expensive foreign debt and cease further issuance of Inscribed stocks.

The low domestic interest rate environment poses a concern to the Bank as interest rate differentials widen between PNG and its major trading partners. This could lead to capital outflow from PNG to substitute financial markets and create macroeconomic instability.

1.2 Monetary Policy Stance

Based on the Bank's assessment of macroeconomic developments in the first half of 2006 and expectations of low inflation, it will maintain a neutral monetary policy stance in the second half of 2006 and over the medium-term.

The neutral stance of monetary policy is based on the following expectations in 2006 and the medium-term:

- Inflation will be around 2.5 - 4.5 percent;
- Stable kina exchange rate;
- Continued prudent fiscal management;
- Credit growth to the private sector to continue; and
- GDP growth could be higher than the Government's projection of 3.5 percent as indicated by the faster growth in private sector credit in 2005 and 2006.

The Bank expects broad money to grow at 21.5 percent and reserve money at 11.0 percent in 2006, substantially higher than needed to support private sector activity. The high level of free liquid reserves, if lent by the banking system, is expected to continue to generate private sector growth, given the low interest rate environment, removal of foreign exchange control restrictions and other impediments to growth by the Government. In the medium-term, credit growth is expected to continue as commercial banks introduce new lending products, particularly to the mineral companies, which are now allowed under the liberalised foreign exchange control regime to borrow from the domestic banking system. The level of net foreign assets is expected to increase moderately in the medium-term.

The Bank expects the Government to demonstrate prudent fiscal management and continue to redirect expenditure to priority areas such as health, education, law and order, and physical infrastructure. The implementation of public sector reforms, removal of impediments to trade and investment and export-led growth will also contribute towards moving PNG to a higher path of economic growth.

Whilst the Bank expects the medium-term assumptions to hold, the risks could come from:

- Volatile movements in the exchange rates of PNG's major trading partners;
- Fall in international commodity prices;
- Fiscal slippages arising from the Supplementary Budget and in the lead-up to the 2007 National Elections;
- Effects of past increases and any further increases of crude oil prices;
- The very fast growth in monetary aggregates; and
- Other unforeseen external and domestic shocks.

In this respect, the Bank will be cautious and if necessary make changes to the stance of monetary policy to counter any adverse developments that may threaten the maintenance of price stability in 2006 and the medium-term.

1.3 Conduct of Monetary Policy

The MPS provides the overall monetary policy framework, while the KFR remains the instrument for signaling the Bank's monetary policy stance with an announcement by the Governor at the beginning of each month. Following the announcement, Open Market Operations (OMOs) will be conducted to support the Bank's monetary policy stance. The OMOs will involve the auction of Central Bank Bills (CBB) to licensed financial intermediaries and Treasury bills to the public and the banking system, as well as Repurchase Agreement (Repo) transactions with commercial banks. The Bank's intervention strategy in the foreign exchange market will be to smooth out any volatility in the exchange rate where necessary. The implementation of monetary policy will be within the reserve money framework, where the Exchange Settlement Account (ESA) balances of commercial banks will be maintained at non-inflationary levels.

The Bank will seek to adopt appropriate monetary policy management strategies that will help sustain price stability over the medium-term.

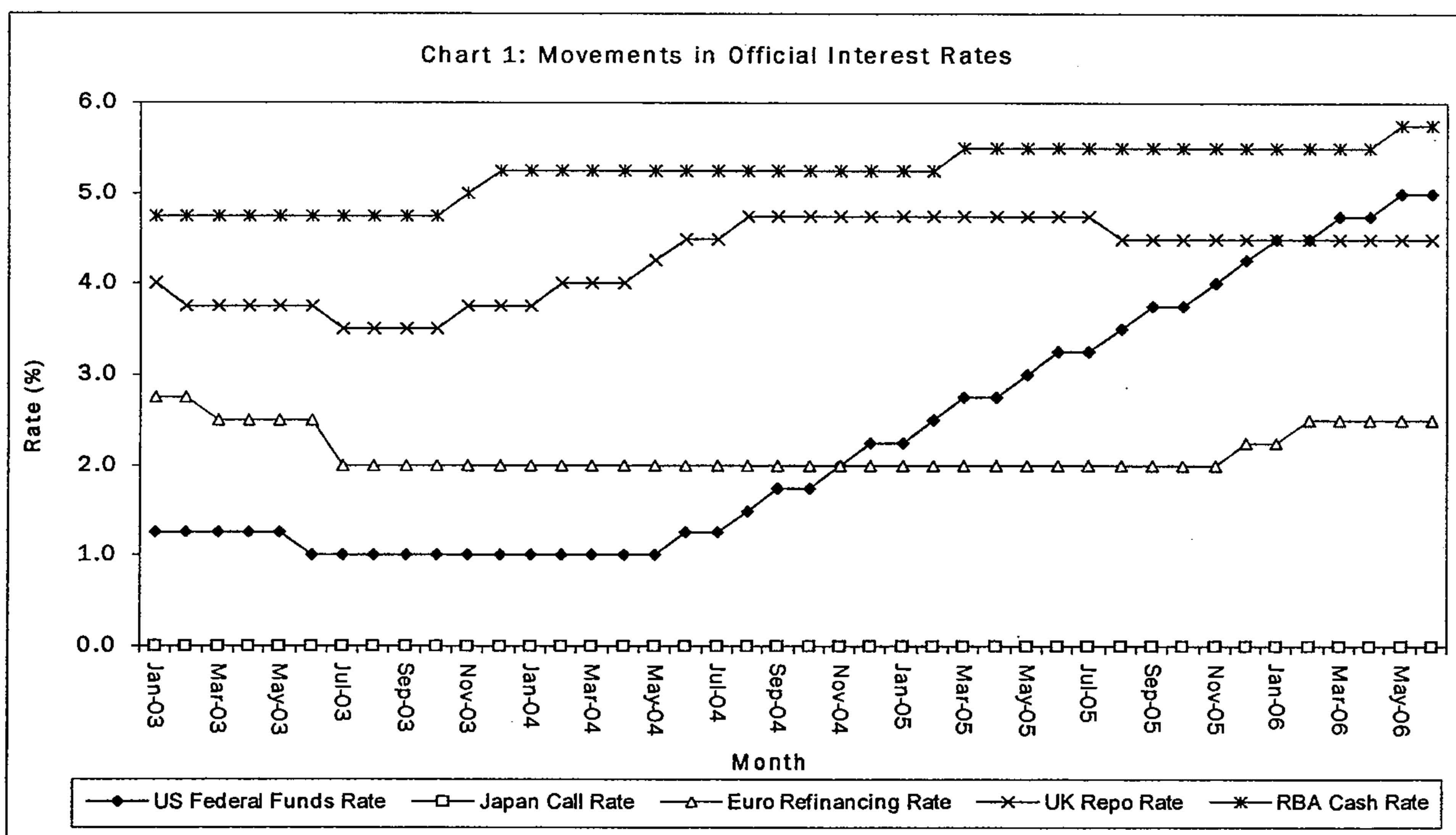
2.0 Developments and Expectations

2.1 International Developments

World economic growth is expected to be stronger in 2006, compared to 2005. In the latest World Economic Outlook (WEO) of April 2006, the International Monetary Fund (IMF) forecasts global real GDP growth of around 4.9 percent in 2006, and easing to 4.7 percent in 2007. The United States (US) and China are the main forces behind this growth, while the Japanese economy is also gaining momentum. The recovery in the Euro area is improving, while growth in the emerging economies like India and Russia remains strong.

Despite the positive outlook for economic growth, there are three major uncertainties. Firstly, the high crude oil prices whose impact have been moderate than generally expected, is still a concern as the full effect of the price increase may not have passed on to consumers. This situation could worsen given the crisis in the Middle East. Crude oil prices remained well above US\$60 per barrel throughout the first half of 2006, and are trading around US\$75 per barrel in July 2006. Secondly, the narrowing of interest rate differentials between the US and the other industrialised countries could lead to an appreciation of the US dollar. The high interest rates in the US could also dampen investment and lead to a slow down in economic growth. Finally, the continued global trade imbalance created by the current account and fiscal deficits in the US, funded by surpluses in China, Japan and India and oil exporting countries, has a further upside risk for an appreciation of the US dollar.

Inflationary pressures have resulted in tightening of monetary policies by major central banks following rising crude oil prices, growing capacity utilisation and tight labour markets (see Chart 1). The IMF inflation forecast for 2006 is expected to average around 2.3 percent in industrialised economies, and 5.4 percent in other emerging market economies and developing countries. For 2007, the IMF forecasts slightly lower inflation of 2.1 percent in industrialised economies, and 4.8 percent in other emerging market economies and developing countries.



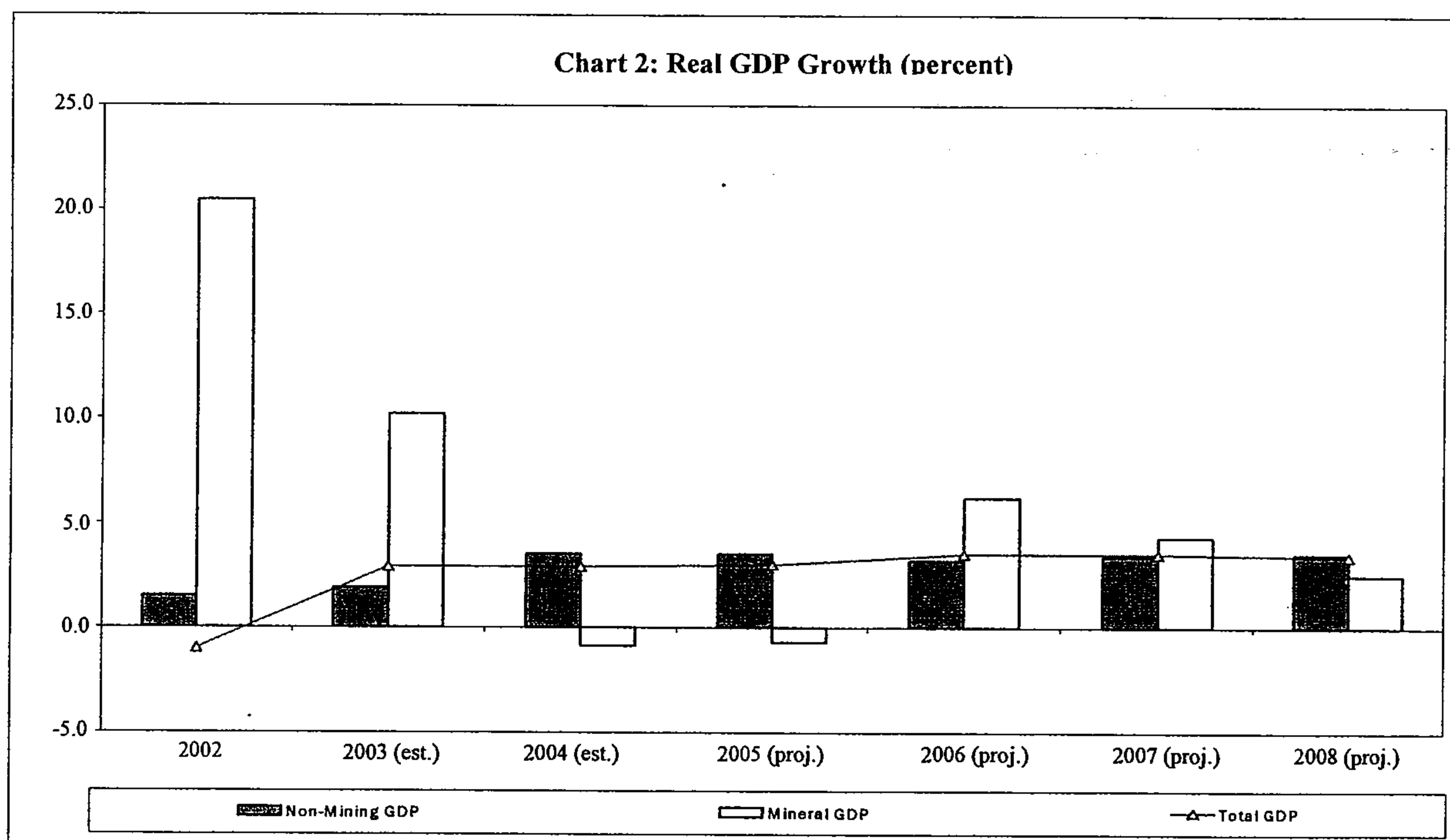
Source: Respective central banks' websites

In the foreign exchange market, the US dollar weakened against the other major currencies in the first half of 2006 reflecting expectations that the US Federal Reserve is close to ending its interest rate tightening cycle. Consequently, the US dollar depreciated by 1.25 percent against the Australian dollar, 7.22 percent against the euro, 2.35 percent against the yen and 6.33 percent against the British pound sterling.

2.2 Domestic Economic Conditions

Data from the Bank's Business Liaison Survey (BLS) indicates strong growth in nominal sales of 27.0 percent in 2005 and 16.7 percent in the March quarter of 2006. There were higher sales by all sectors in the March quarter of 2006. Formal private sector employment grew in the March quarter of 2006 by 8.1 percent, compared to the corresponding period in 2005. This was due to higher employment in all sectors except the transportation sector. Based on these and the strong increase in private sector credit, the Bank expects that real GDP growth could be higher than the Government's forecast of 3.5 percent (see Chart 2).

Over the medium term, macroeconomic stability, the Government's policy on removal of impediments to trade and investment, promotion of export-led growth and production for domestic consumption, infrastructure improvements and institutional reforms will stimulate growth in economic activity. Resource-based projects including the PNG Gas project, the Ramu Nickel mine and other smaller mines should also contribute to the expected growth and employment over the medium term.

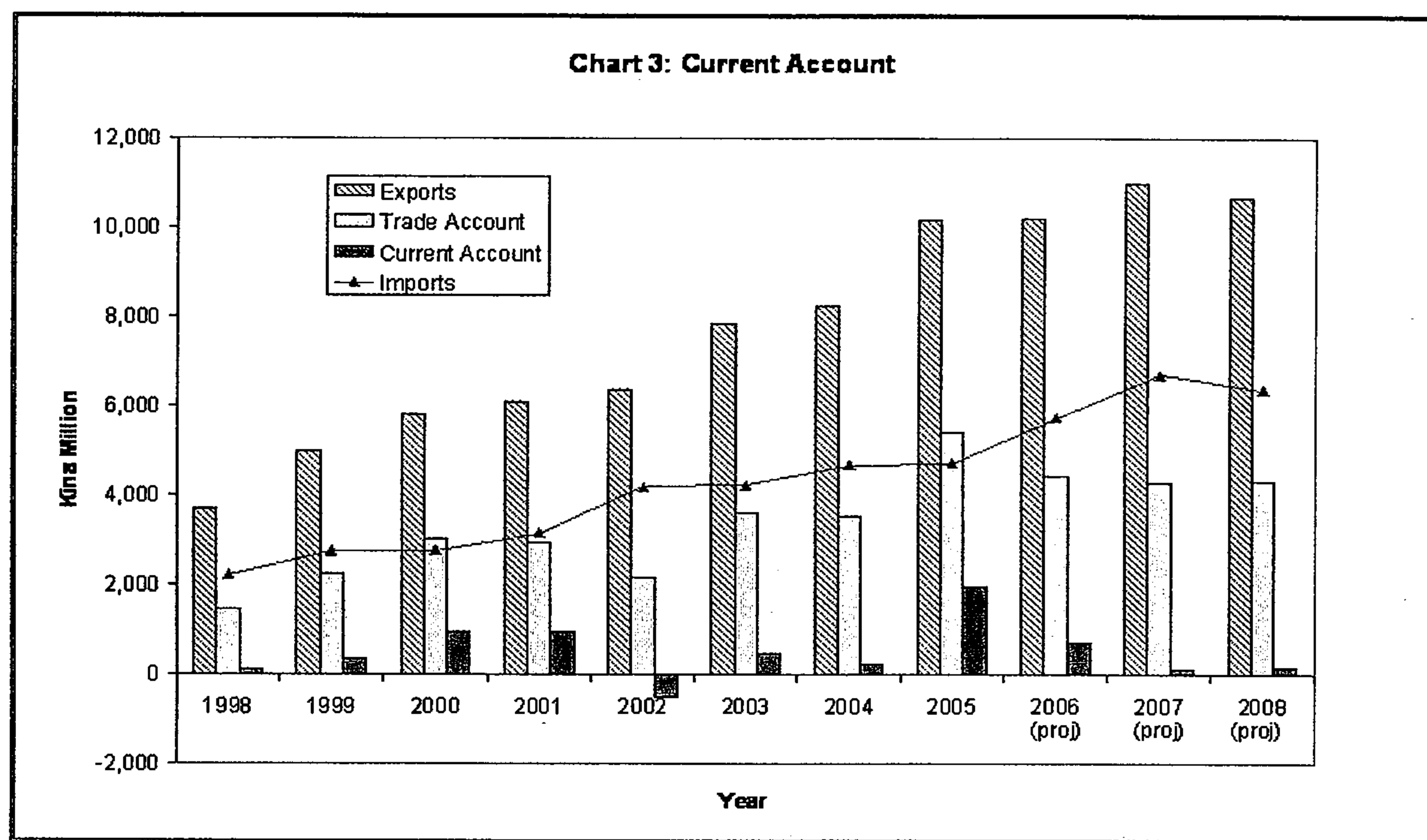


Source: 2006 National Budget

2.3 Balance of Payments

Preliminary balance of payments data for the five months to May 2006 showed an overall surplus of K545.0 million, compared to a deficit of K182.7 million in the corresponding period of 2005. This outcome was the result of combined surpluses in the current and capital and financial accounts. The surplus in the current account was due to a higher trade surplus and lower net service payments. The

surplus in financial and capital accounts was due to net inflows of foreign direct investment to the mineral sector, liquidation of short-term money market assets, drawdown of foreign currency account balances of mineral companies and increase in net foreign assets of commercial banks.



Source: Bank of PNG

Consistent with the Bank's expectations, the liberalisation of exchange controls in June 2005 had a limited impact on the balance of payments. Outward portfolio investments increased in the twelve months to May 2006, compared to the corresponding period of 2005. The increase was due to short-term money market investments by residents. In addition, the removal of the Exchange Control Regulation Clause on the retention period of export receipts led to an increase in funds held offshore. However, higher current account receipts more than offset these developments, which contributed to the stability in exchange rate.

In 2006, the balance of payments is projected to show an overall surplus of K677 million, compared to a surplus of K255 million in 2005. This outcome reflects a projected current account surplus of K722 million in 2006, which is partially offset by a lower deficit of K45 million in the capital and financial accounts. In the medium term, the balance of payments is projected to show surpluses in the overall balances (see Appendix - Table 2).

The level of gross foreign exchange reserves at the end of May 2006 was US\$941.6 (K2,860.9) million, sufficient for 7.2 months of total and 9.9 months of non-mineral import covers. As at 26th July 2006, the level of gross foreign exchange reserves was US\$1,002.9 (K3,011.8) million. At the end of 2006, it is expected to be around US\$967.0 (K2,970.9) million, sufficient for 6.2 months of total and 10.7 months of non-mineral import covers.

The latest IMF price projections indicate that international prices of some of PNG's non-mineral exports will be higher in 2006, compared to 2005. According to the mineral companies, most of the mineral prices are expected to increase in 2006.

The export volumes of most of PNG's major non-mineral commodities and petroleum products are projected to increase in 2006, compared to 2005. Further increases in export volumes of most of PNG's major non-mineral commodities are projected over the medium-term, due to the Government's Export-Driven Growth Strategy, infrastructure developments, new plantings of crops and production from the Autonomous Region of Bougainville.

Other main assumptions underlying the balance of payments projections for 2006 and the medium-term are:

- Stability in the kina exchange rate;
- Exclusion of the PNG Gas project;
- The commencement of construction of the Ramu Nickel mine in 2006; and
- The commencement of construction of Simberi gold mine in 2007.

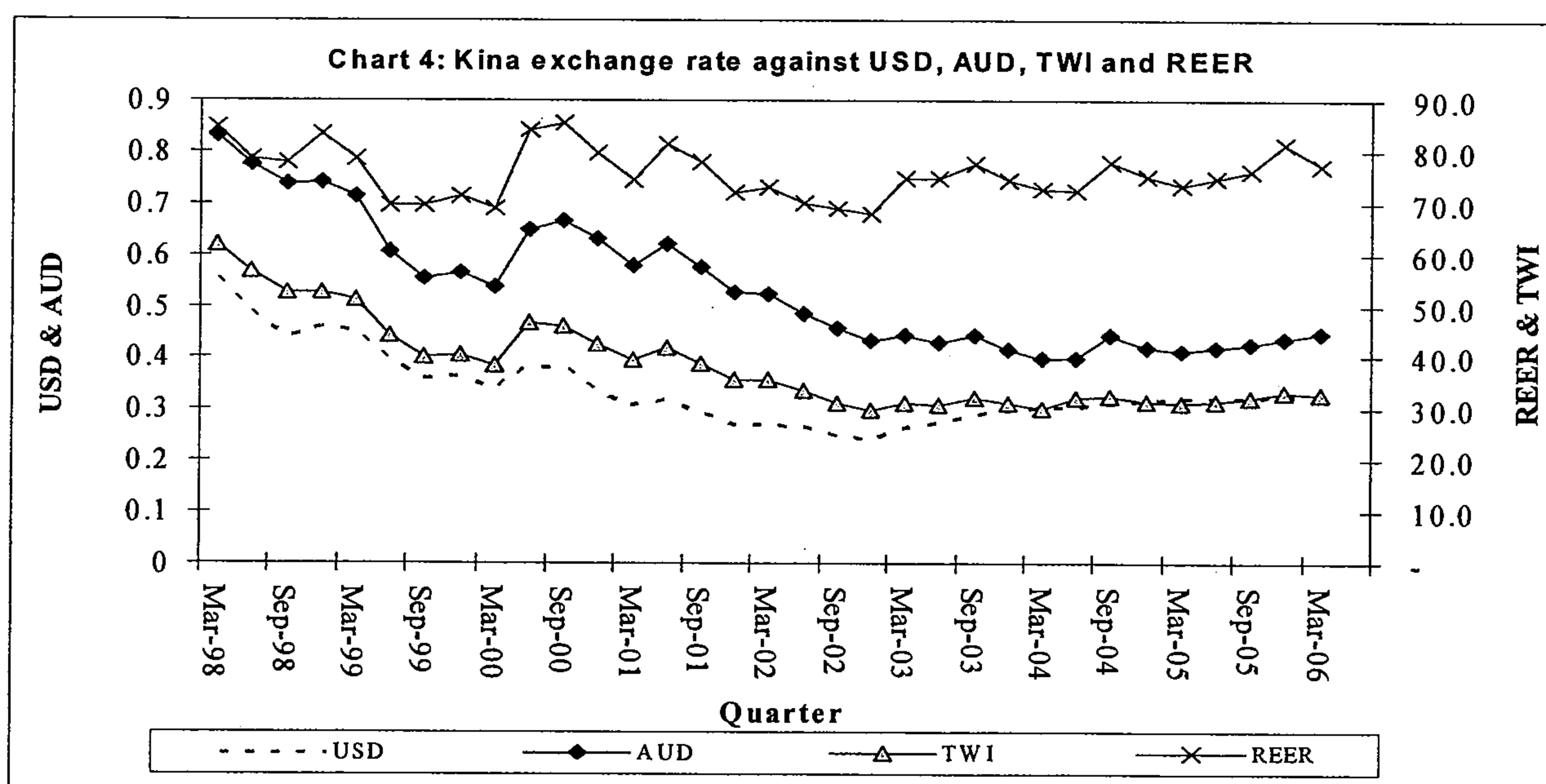
2.4 Fiscal Operations of The National Government

Preliminary estimates of the fiscal operations of the National Government over the five months to May 2006 showed an overall budget surplus of K222.7 million, compared to a surplus of K257.7 million in the corresponding period of 2005. This represents 1.4 percent of nominal GDP. The surplus reflected higher mineral tax receipts, which more than offset increases in recurrent and development expenditures. The budget surplus was used to repay net overseas and domestic loans of K88.0 million and K134.7 million, respectively.

The Government continued to redeem Treasury bills and issue Inscribed stocks. During the first half of 2006, the net retirement of Treasury bills was K210.4 million while net issuance of Inscribed stocks totalled K370.4 million.

2.5 Exchange Rate

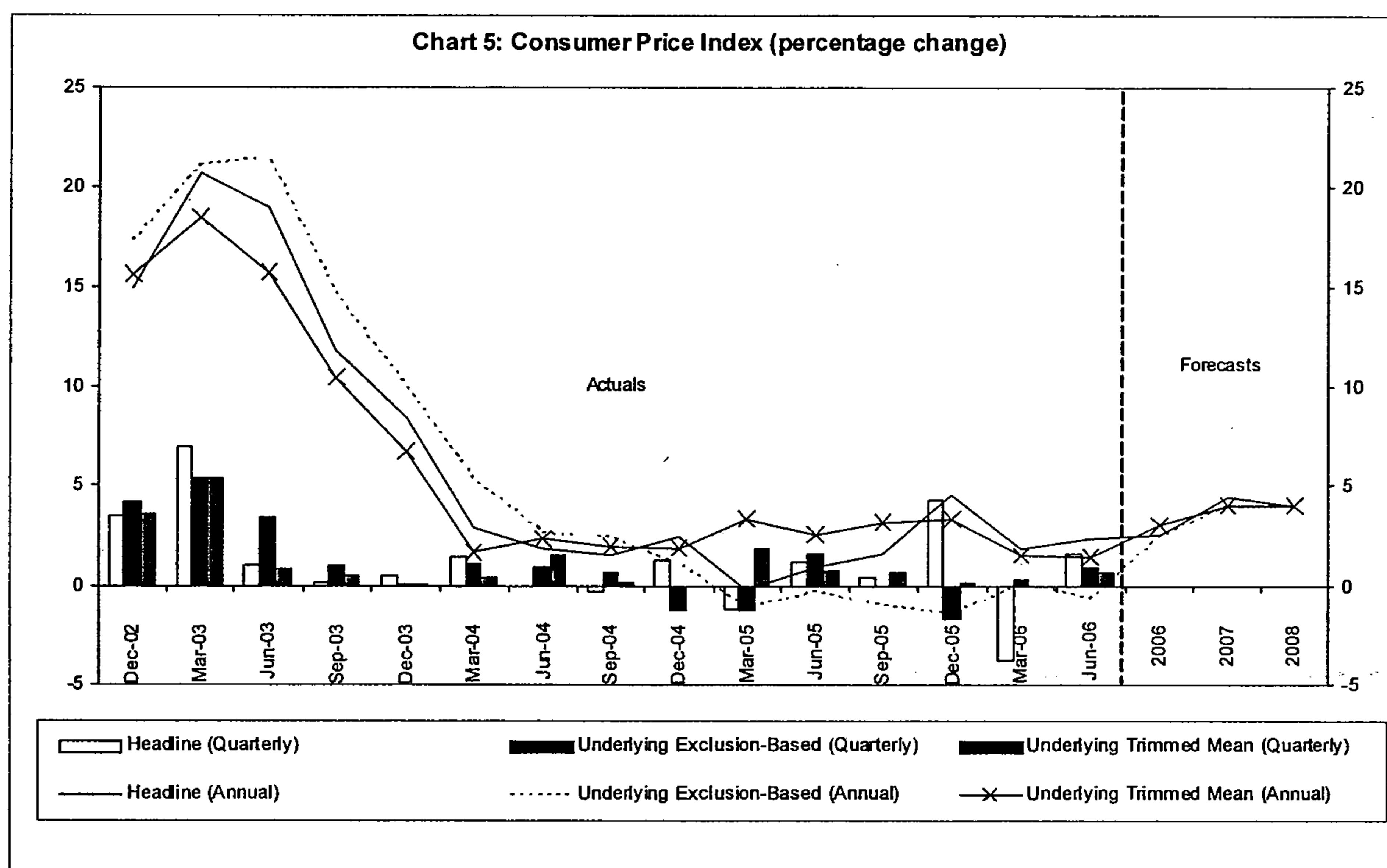
The kina continued to strengthen against the US and Australian dollars during the first half of 2006. It appreciated against the US dollar from US\$0.3230 at the end of December 2005 to US\$0.3260 at the end of June 2006. The kina also appreciated against the Australian dollar from A\$0.4400 to A\$0.4440 (see Chart 4). The appreciation of the kina exchange rate was a result of high foreign exchange inflows from export receipts. The TWI and REER remained relatively stable since 2003.



Source: Bank of PNG

2.6 Inflation

Annual headline inflation was 2.3 percent in June 2006, compared to 1.8 percent in March 2006. The low headline inflation outcome was matched by low underlying inflation rates during the quarter. Annual trimmed mean inflation was 1.4 percent, compared to 1.5 percent in the March quarter. Annual exclusion-based inflation was negative 0.6 percent, compared to 0.1 percent in the March quarter. The headline and underlying inflation for 2006 and the medium term are projected to be around 2.5 – 4.5 percent (see Chart 5 and Appendix -Table 2).



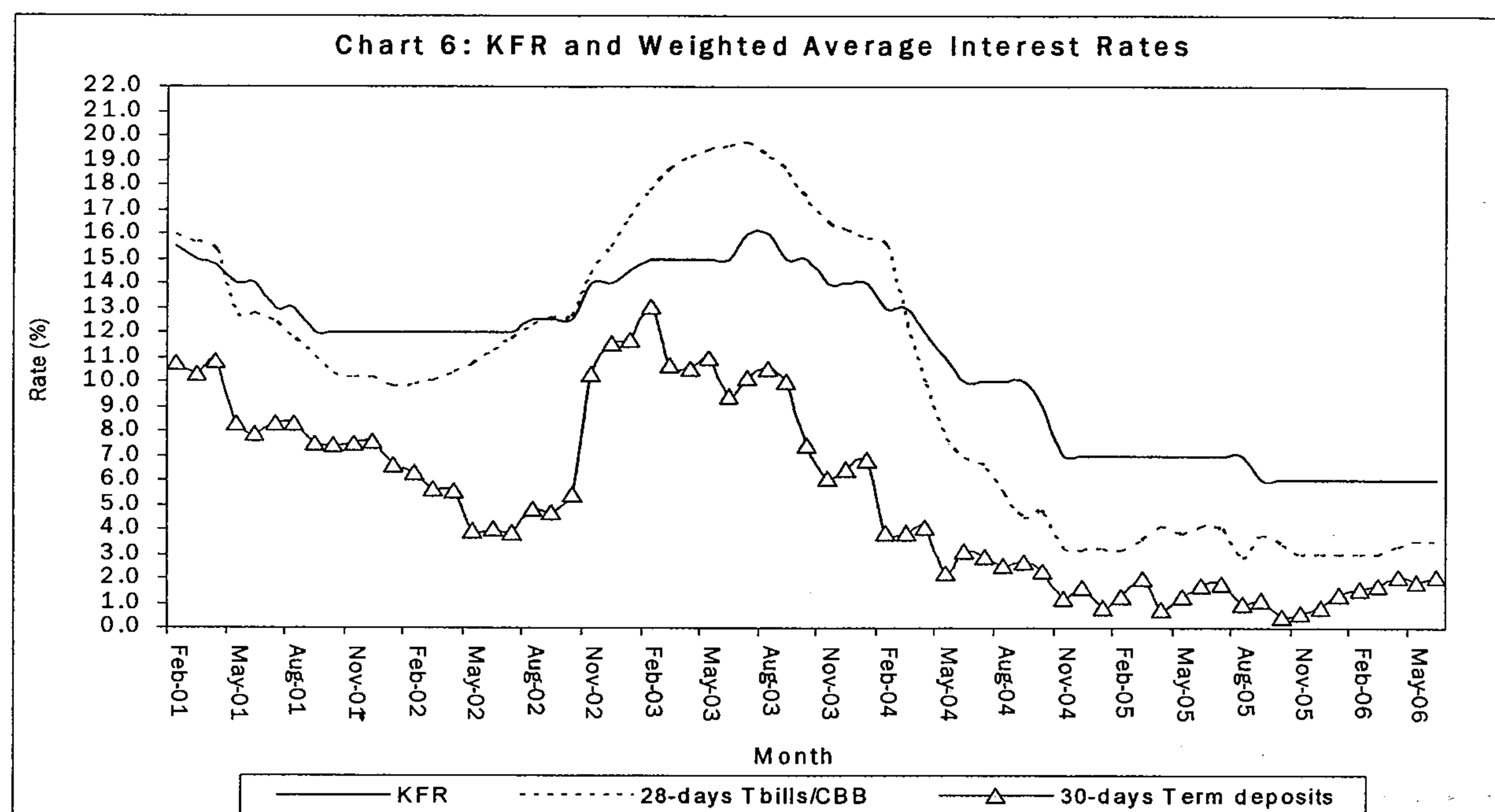
The expected low inflation in 2006 is based on the assumptions of stability in the kina exchange rate, low foreign inflation in PNG's major trading partners and prudent fiscal management by the Government. However, the risks to these assumptions are:

- Decline in the kina exchange rate triggered by a fall in international commodity prices;
- Further significant increases in monetary aggregates including broad money;
- Fiscal slippages arising from the Supplementary Budget and in the lead up to the 2007 National Elections;
- Further increase in crude oil prices and its second round effect; and
- Destabilising capital outflows as a result of low domestic interest rates.

2.7 Monetary and Financial Market Developments

The Bank maintained a neutral monetary policy stance during the first half of 2006. Whilst the KFR was kept unchanged at 6.0 percent (see Chart 6), the trading margin for the Repo was reduced by 1.0 percent in total to 200 basis points on both sides of the KFR.

Interest rates for short-term securities remained stable in the first six months of 2006. The Government did not issue Treasury bills since May 2006, following cash surpluses. As a result of the absence of the Government in the Treasury bill auction, the Bank issued additional CBBs to diffuse liquidity from the banking system and maintained ESA balances at around K100 – K150 million, compared to the higher levels in 2005. This enabled short-term deposit rates to increase during the period.



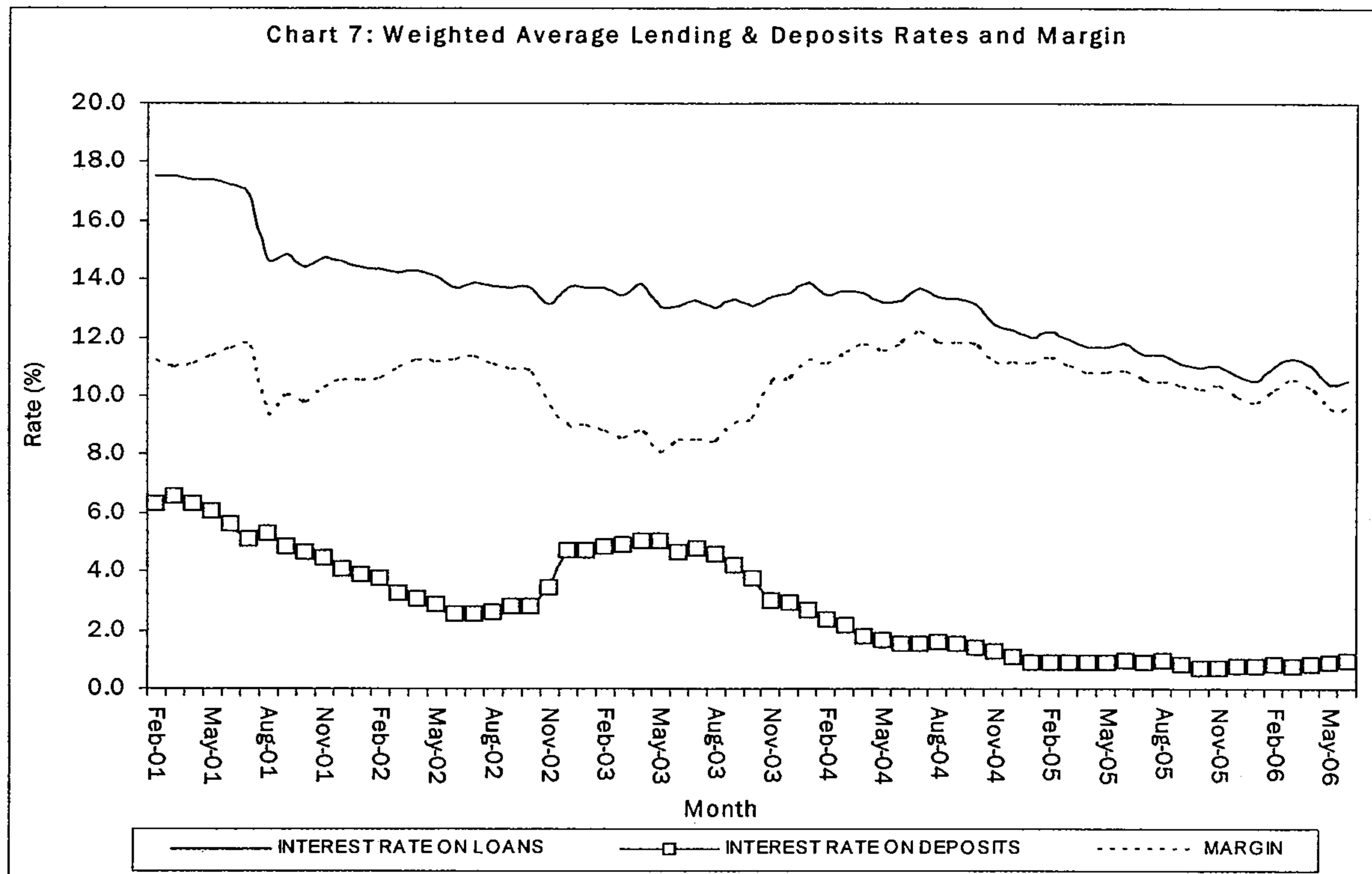
Source: Bank of PNG

Commercial banks maintained their Indicator Lending Rates (ILR) spread between 9.45 – 10.70 percent during the first half of the year. The weighted average interest rate on total deposits increased from 0.75 percent in December 2005 to 0.97 percent in June 2006, while the weighted average lending rate on total loans decreased from 10.71 to 10.49 percent during the same period. However, the spread between the weighted average lending and deposit rates continued to remain wide at around 10.0 percent (see Chart 7).

Total liquidity of the banking system increased by 18.1 percent between December 2005 and June 2006, mainly due to mineral tax inflows. As a result, Repo and CBB transactions were conducted to manage liquidity and maintain real interest rates.

Lending extended by the banking system to the private sector increased by 25.2 percent during the six months to June 2006. The advances were mainly to the building and construction, and transport sectors, reflecting increased activity in these sectors. The growth in private sector credit was broad-based with lending to the fisheries and forestry, building and construction, commerce, transportation and communication sectors as well as for alluvial mining, other businesses and households. Lending to the agriculture sector however declined since June 2005.

The level of broad money supply (M3*) increased by 14.3 percent during the six months to June 2006 as a result of growth in net domestic credit and net foreign assets of the banking system. Reserve money increased by 1.7 percent over the same period (See Appendix – Table 1).



Source: Bank of PNG

Appendix

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

INDICATOR	2003 (actual)	2004 (actual)	2005 (actual)	JUN 2006 (actual)	JAN 2006 MPS (proj)	JUL 2006 MPS (proj)	2007 (proj)	2008 (proj)
Broad money supply	-3.7	30.2	30.7	14.3	9.9	21.5	19.3	17.2
Reserve money	0.1	29.8	3.0	1.7	7.5	11.0	6.2	8.6
Private sector credit	-2.8	-3.8	25.2	25.7	6.9	28.2	16.5	16.2
Net credit to Gov't	-5.7	23.0	-24.7	23.5	50.6	34.6	5.7	6.2
Net foreign assets	17.3	30.4	33.5	15.3	16.8	16.8	14.0	8.5

Source: Bank of PNG

Table 2: Summary of Other Macroeconomic Indicators

INDICATOR	2003 (actual)	2004 (actual)	2005 (actual)	2006 JUN (actual)	JAN 2006 MPS (proj)	JUL 2006 MPS (proj)	2007 (proj)	2008 (proj)
CONSUMER PRICE INDEX (annual % changes)								
Headline	8.4	2.4	4.6	2.3	4.0	2.5	4.5	4.0
Trimmed-mean	6.7	1.9	3.3	1.4	3.0	3.0	4.0	4.0
Exclusion-based	10.0	1.0	-1.4	-0.6	2.5	2.5	4.0	4.0
BALANCE OF PAYMENTS* (kina millions)								
Current account	496	393	1,987	165	-324	722	156	183
Financial account	-183	-80	-1,689	343	359	-45	318	141
Overall balance	353	329	255	545	36	677	474	324
Gross Int. Reserves	1,682	2,061	2,316	2,861	2,438	2,971	3,445	3,769
IMPORT COVER* (months)								
Total	4.9	5.6	5.9	7.2	4.8	6.2	6.2	7.1
Non-mineral	6.1	7.5	8.9	9.9	8.9	10.7	11.7	12.0
EXPORT PRICE*								
Crude oil (US\$/barrel)	30	41	55	63	56	56	58	57
Gold (US\$/ounce)	355	398	403	558	430	510	506	504
Copper (US\$/pound)	77	124.9	161.6	230	154.8	150.0	110	110.0
FISCAL OPERATIONS OF THE GOVERNMENT*								
Surplus/Deficit (K'm)	-124.3	201.9	46.9	222.7	-90.0	-90.0	-35.0	0.0
% of GDP	-1.1	1.5	0.3	1.4	-0.6	-0.6	-0.2	0.0
REAL GROSS DOMESTIC PRODUCT (annual % growth)								
Total GDP	2.9	2.9	3.0 (proj)	-	3.5	3.5	3.5	3.4
Non-mineral GDP	1.9	3.5	3.5 (proj)	-	3.2	3.2	3.4	3.5

Source: Bank of PNG, NSO and Department of Treasury

* Actual to May 2006

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