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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, CBE

PORT MORESBY
31st July, 2001

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 2001

INTRODUCTION

This Semi-Annual Monetary Policy Statement is the second for 2001 under the Central Banking Act 2000. The Statement is presented in two parts. The first covers economic developments in the first half of 2001 and revised projections for 2001. Section two sets out the rationale for the monetary policy stance for the second half of 2001 and the conduct of monetary policy.

1. DEVELOPMENTS IN THE FIRST HALF AND PROJECTED DEVELOPMENTS FOR 2001

In designing monetary policy for 2001, the Central Bank considered actual and projected developments in six main areas, and their impact on the monetary aggregates, exchange rate and prices:

a) The World Economy;
b) Domestic Economic Activity;
c) Balance of Payments;
d) Fiscal Operations of the Government;
e) Inflation; and
f) Monetary and Financial Market Developments.

a) The World Economy

World economic growth as measured by Gross Domestic Product (GDP) is projected to increase by 3.2 percent in 2001, compared to 4.8 percent in 2000. The lower growth in 2001 is mainly attributed to the slowdown in the major industrialised economies, particularly the United States (US) and Euro-zone and continued recession in Japan, following the after-effects of higher oil prices, sharp falls in equity prices and the lagged effects of the tight monetary policy regimes pursued in those economies. The slowdown in the US was attributed to a sluggish growth in activity in the manufacturing sector coupled with the weak foreign and domestic demand. For the remainder of 2001, global economic activity will depend on how deep and prolonged the slowdown in the US will be. However, there are positive indications that the slowdown will be short-lived following significant cuts in short term interest rates in the US, with long term interest rates already on a declining trend and, with inflationary risks receding, most advanced economies have begun to ease monetary policy.

With low level of inflation in the US, the US Federal Reserve Bank was given more room to ease monetary policy, and consequently, the Federal Funds rate was progressively reduced by 250 basis points between January and June 2001, in a move to stimulate economic growth. Subsequently, other major Central Banks also relaxed their monetary policy stance, with the Bank of Japan and Bank of England reducing their official interest rates by 15 and 25 basis points respectively, at the beginning of the year. The European Central Bank also eased its monetary policy stance through a reduction of the cash rate by 25 basis points to 4.50 percent on 10 May 2001. In Australia, the Reserve Bank reduced its cash rate by 125 basis points from 6.25 to 5.00 percent this year.

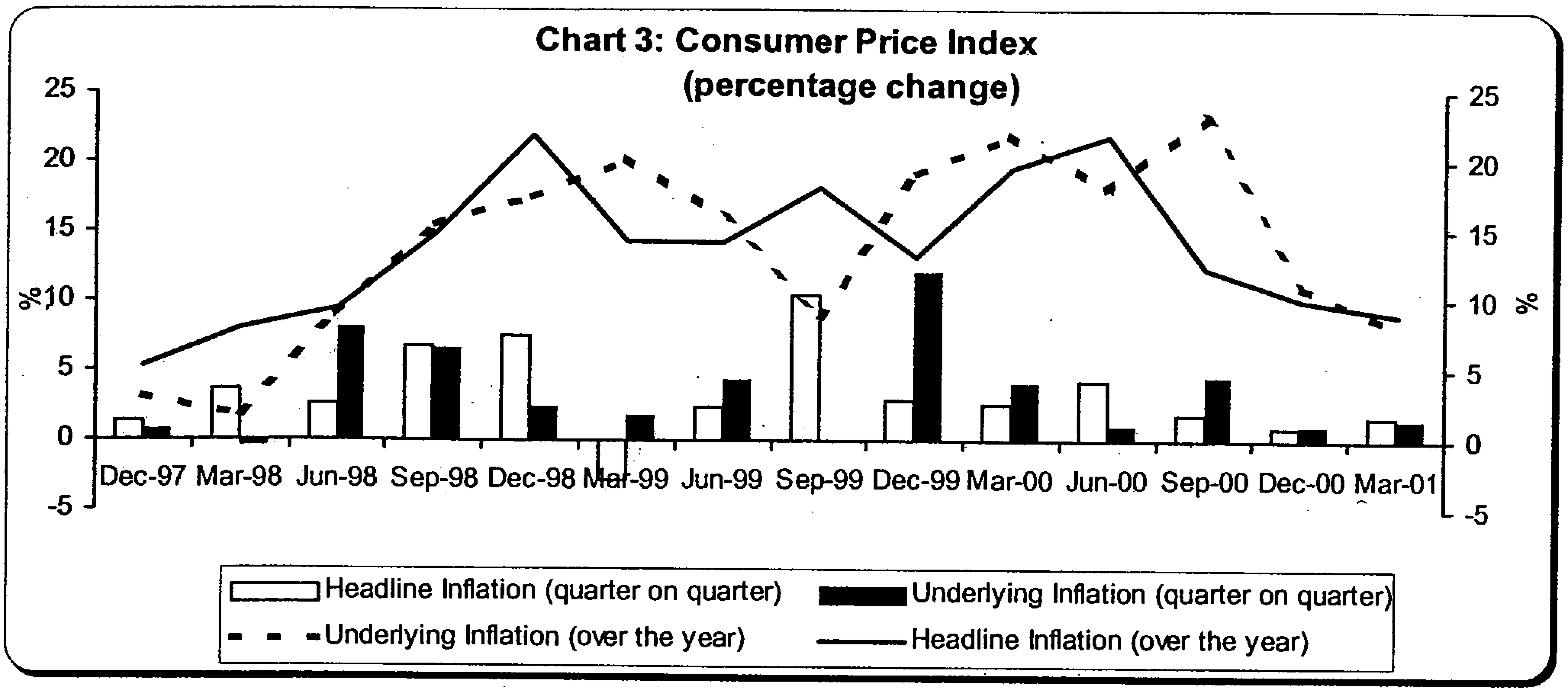
b) Domestic Economic Activity

Preliminary estimates of economic activity in Papua New Guinea (PNG) indicate that total real GDP increased marginally in 2000. Latest estimates are for economic activity to remain subdued in 2001, with real GDP growth revised downwards from the projected 3.1 percent (See Chart 1). The revision was mainly due to lower activity expected in the agriculture/forestry/

BOX 1: OBJECTIVE OF MONETARY POLICY

In pursuing monetary policy in Papua New Guinea, the Bank of Papua New Guinea (BPNG) targets price stability. Maintaining price stability in a small open economy like PNG requires amongst other things, relative stability in the exchange rate which can:

- Improve confidence in the local currency and management of the economy;
- Provide certainty for private sector businesses to plan for long term investment and development;
- Minimise volatility and price distortions;
- Provide foundation for stable revenue flows of Government; and
- Potentially lead to stable macroeconomic environment.



areas including health, education, law and order, agriculture and livestock, transport and works, civil aviation and revenue raising measures. These were the only areas where additional funding was allocated, while others experienced reduced funding. In addition, the 2001 Budget included a total extraordinary financing of K424.2 (US$140.0) million, of which K63.6 million was already received from the Australian Government under the SAP.

Further delays in the disbursement of external extraordinary funding and the privatisation programme poses a potential risk of not achieving the objectives of the 2001 Budget, as shortfalls in external financing and privatisation receipts would exert pressure on the Government's cash-flow. Under such circumstances, the Government is likely to resort to domestic financing, which in previous experiences led to higher inflationary pressures. Increase in domestic borrowing not only makes monetary management difficult, but also jeopardises the current improvement in monetary conditions and prospects for economic recovery.

e) Inflation

Headline Inflation

During the March quarter of 2001, headline inflation, as measured by the Consumer Price Index (CPI), increased by 1.6 percent, compared with the December quarter of 2000 and by 8.9 percent over the year. This compared to 0.9 percent in the December quarter of 2000 and 10.0 percent over the year to December 2000. The lower increase in inflation was attributed to:

- **Imported inflation:** The movement in the exchange rate is the most influential factor impacting on headline and underlying inflation. From

Table 2: Measures of Consumer Prices
(percentage change)

		Actual 1999	Actual 2000	Forecast 2001
Headline CPI	Year on Year	14.9	15.6	9.1
	Over the Year	13.2	10.0	9.7
Underlying CPI	Year on Year	16.0	18.2	8.4
	Over the Year	19.2	11.0	8.3

BOX 2: MEASURES OF INFLATION

The analysis of price changes is central to the assessment of the conduct of monetary policy, given the Central Bank's objective of achieving and maintaining price stability. The Consumer Price Index (CPI), published by the National Statistical Office, measures the changes in the cost of purchases made by households in urban centres, and is a key indicator of price changes. It has been used as the measure of so-called 'headline' inflation in PNG 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. The movements in the prices of such items hide the so-called 'underlying' or 'core' rate of inflation. An underlying rate of inflation measures the inflationary pressures in the economy that are predominantly due to market forces, i.e. changes in prices that reflect only the longer-run supply and demand conditions in the economy. As of September 2000, the CPI sub-grouping of fruit and vegetable, in addition to the price effects of betelnut, excise tax and VAT increases, were excluded from the calculations of headline inflation. These exclusions would ensure that any policy changes should be driven by economy demand-side effects, and not supply-side effects of unpredictable seasonal commodities and Government interventions. It is therefore important that the Central Bank responds appropriately to the underlying rate of inflation by removing the effect of factors assessed as temporary from the measured headline inflation rate.

March 2000 to March 2001 the kina depreciated by 9.3 percent against the US dollar, while it appreciated by 7.8 percent against the Australian dollar (A$). The appreciation of the kina against the A$ contributed significantly to the lower rate of inflation, due to the relatively high level of imports from Australia.

- **Domestic Inflation**: The main factor that impacted on domestic inflation was the 2.0 percent increase in wages and salaries of public servants in January 2001, as well as increases in prices of some price controlled items including petrol.

Underlying Inflation

During the March quarter of 2001, underlying inflation, which excludes effects of excise duties and fluctuations in the price of betelnut and fruit and vegetables on consumer prices, increased by 1.7 percent, from December 2000 and by 6.0 percent over the year. This compared to 1.0 percent in the December quarter of 2000 and 11.0 percent over the year to December 2000.

Inflation Forecast

In line with previous expectations, inflation is forecast to trend downwards during the remainder of 2001. The projected year on year and over the year headline inflation rates are 9.1 and 9.7 percent, an improvement on the January 2001 Monetary Policy Statement forecasts of 11.4 and 11.9 percent, respectively. The lower inflation forecasts are as a result of a lower than expected March quarterly inflation rate. The lower increase in inflation was due to reduction in price-cost margins by businesses, as a result of depressed domestic aggregate demand. However, consumer price changes in the second quarter of the year are still expected to be adversely effected by the depreciation of the kina towards the end of 2000 and the first quarter of 2001. The exchange rate feed through to consumer prices will depend largely on the reaction of businesses to increased import costs. Inflation in the latter half of the year is expected to be lower as support of the kina from export receipts and extraordinary financing boost private sector confidence and lead to more stable consumer prices.

The projected year on year and over the year underlying inflation rates for 2001 have been revised to 8.4 percent and 8.3 percent, respectively, from earlier projections published in the January 2001 Monetary Policy Statement.

f) Monetary and Financial Market Developments

The Central Bank relaxed its tight monetary policy stance in the first half of 2001, following a downward trend in inflation as anticipated and stability in exchange rates. The lower than expected increase in inflation in the December quarter of 2000 and March quarter of 2001 was a major contributing factor that led the Central Bank to reducing the Kina Facility Rate conditions underpinning inflationary projections and monetary developments. The Central Bank, therefore will take a cautious approach to any further easing of the monetary policy stance. Consistent with earlier projections stated in the January 2001 Monetary Policy Statement, the underlying inflation rate continue to trend downwards, with the average and over the year rates projected at 8.4 percent and 8.3 percent, respectively. However, the pace and extent of further adjustments to the stance of monetary policy in the second half of 2001 will also depend on the following factors and their combined influence on the underlying inflation rate and price stability:

- A gradual, rather than rapid, pick-up in private sector credit implicit in recent falls in interest rates, with further cuts in bank lending rates expected as commercial banks' average cost of funds continues to decline. This depends on the responsiveness of commercial banks to the competitive opportunities offered by lower cost of funds;
- Fiscal consolidation and prioritisation of expenditure by Government as necessary. A cautious approach by Government is needed to ensure new domestic borrowing does not raise possible conflict with the direction of monetary policy. The progress on domestic debt reduction depends on realisation of the Govemment's privatisation programme;
- An improvement in the balance of payments through a recovery in the prices of PNG's key exports and draw down of external extraordinary financing. A continuation of the rebuilding of PNG's foreign reserves should provide added support to confidence;
- Continued moderation in supply side cost pressures, especially wages and salaries, and price increases for price controlled goods; and
- On-going progress on structural reform and funding assistance from bilateral sources and multilateral institutions. In this context, the forthcoming Consultative Group Meeting and the extent of ongoing support from international financial institutions and "Friends of PNG" will be important.

Under these conditions, the revised monetary and credit aggregates are expected to develop as follows in 2001 (See Table 3).

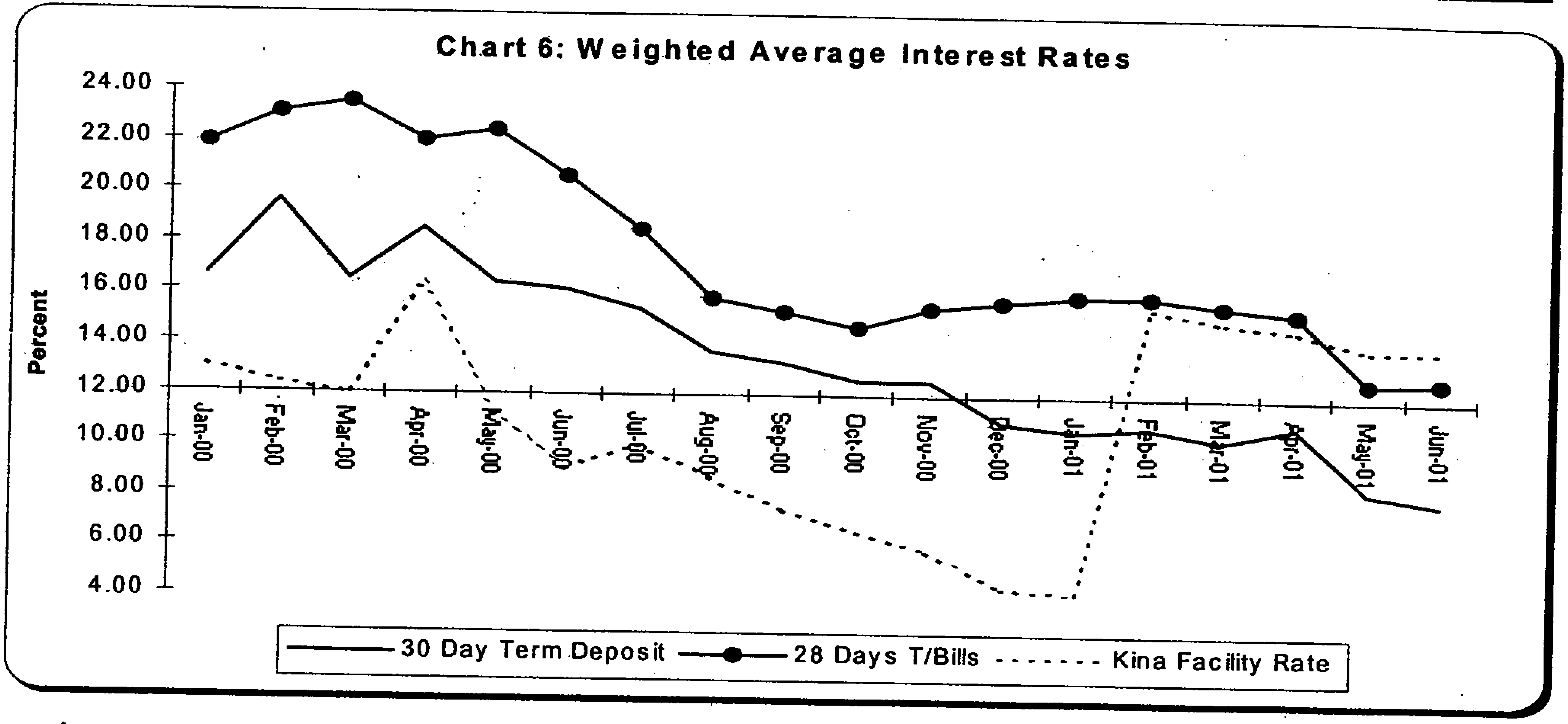
The Central Bank will monitor developments in the key macroeconomic indicators and if the assumptions that underpin the continued moderate inflation outcome hold, the Central Bank will be able to gradually and cautiously ease monetary policy in the remaining part of this year.

b) 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. During 2001, the revised reserve money is expected to increase by 2 percent following a decrease of 19 percent in 2000. The decrease in 2000 was a result of the tight stance of monetary policy pursued by the Central Bank. The expected growth in reserve money is likely to have some impact on inflation, and the Central Bank will

Table 3: Growth in Monetary and Credit Aggregates (percentage)

	January - June 2001 (Actual)	January 2001. (Forecast)	Revised 2001 (Forecast)
Broad money supply	2	10	6
Reserve money	-7	12	2
Private sector credit	5	12	6
Net credit to Government	-3	-20	-10



continue to use its open market instruments to sterilise any excess reserve money in the banking system.

To improve efficiency of transmission of the monetary policy stance, the Central Bank introduced a new price based signalling mechanism on 5 February 2001 as shown in Box 3. However, to allow the market rates to adjust and to prevent the KFR from becoming a substitute for investment in Government securities and trading in the inter-bank market, a margin is applied. As the KFR is a benchmark rate, any change to it is expected to affect all relevant market interest rates over time, including the commercial banks' cost of funds.

To further strengthen the transmission mechanism of monetary policy, the Central Bank also introduced Repurchase Agreements on 5 February 2001 for daily liquidity management. The Repurchase Agreement is used at the discretion of the Central Bank with the buy and sell margins set around the KFR. The Master Agreement for the Repurchase and Reverse Repurchase will be completed in due course, but in the interim, over-night repurchase and reverse repurchase transactions involving only cash are conducted between the commercial banks and the Central Bank without the use of Government securities.

The price based signaling mechanism combined with the complementary Repurchase Agreements are intended to realign the linkage between Treasury bills, deposits and lending rates to increase the efficiency in transmission of monetary policy, facilitate a downward shift in the entire interest rate structure and establish a predictable yield curve.

BOX 4: RELATIONSHIP WITH GOVERNMENT

Operational Arrangements for the Temporary Advance Facility (TAF), came into effect from 02 January 2001, with the first draw down on the Facility on the same date. In March and April 2001, the legal limit of K100 million was temporarily exceeded. This was due to presentation of cheques issued in 2000 and high volume of warrants issued in March in anticipation of the loan draw downs from the World Bank and Australia, both of which were delayed. The TAF draw down was fully repaid in early May 2001, following the receipt of the Australian loan and mineral taxes. Subsequently, a new TAF was put in place on 01 May for repayment by 15 November 2001.

Measures taken to ensure the limit is not breached again include:

- Government issued a new Inscribe Stock of K35 million in May 2001;
- Prioritising of expenditures and warrant issuance by Government; and
- Introduction of operational arrangements within the Central bank to ensure Statutory requirements will be met.

The Treasury bill auction remains the main instrument for injecting and diffusing liquidity from the banking system. Refinements to the Treasury bill auction will improve the Central Bank's flexibility to adjust liquidity and influence the yield curve on Government securities. Treasury bill issues under the Tap Facility continues to encourage purchases by the non-bank entities and individuals directly from the Central Bank at interest rates, which are set at 1.0 percentage point below those obtained at the weekly auction. The Tap arrangement provides an alternative investment opportunity for non-participants in the weekly Treasury bill auction, thereby enhancing the competition for funds. Further refinements to the Treasury bill auction and the Tap Facility will be implemented by the Central Bank in the second half of 2001. The Central Bank will retain the Tap Facility in 2001 to actively promote the sale of Treasury bills to the non-bank financial sector. The Kina Facility and Repurchase Agreements will be utilised for short-term liquidity management, while the MLAR and CRR will be continuously reviewed to determine their appropriate levels consistent with the stance of monetary policy.

Queries on the contents of the Monetary Policy Statement should be directed to the Manager, Monetary Policy Unit, Economics Department at the Bank of Papua New Guinea on telephone number 3227 312 or fax number 3200 757. Copies of the Statement can be obtained from the Manager, Public Information Unit on telephone number 3227 326 or fax number 3200 757.

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