Papua New Guinea

National Gazette

PUBLISHED BY AUTHORITY

(Registered at the General Post Office, Port Moresby, for transmission by post as a Qualified Publication)

No. G346] PORT MORESBY, FRIDAY, 8th AUGUST [2014

BANK OF PAPUA NEW GUINEA

MONETARY POLICY STATEMENT BY THE GOVERNOR OF THE BANK OF PAPUA NEW GUINEA, MR. LOI M. BAKANI

PORT MORESBY

31st March 2014

Queries on the contents of the Monetary Policy Statement (MPS) should be directed to the Manager, Economics Department on telephone number (675) 3227430 or Manager, Monetary Policy Unit on telephone number (675) 3227278, or both on fax number (675) 3200757. Copies of the Statement can be obtained from the Economics Department and are also available on the Bank's website: http://www.bankpng.gov.pg. It will be reproduced in the March 2014 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. This entails low inflation supported by stable interest and exchange rates. The maintenance of price stability leads to:

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

Executive Summary

Papua New Guinea's economy continued to grow for the thirteenth consecutive year in 2013 and inflation remained below forecasts. On account of low international commodity prices and high demand for imported goods and services, the kina depreciated against the major currencies to the benefit of PNG farmers and exporters, though it has put pressure on domestic prices and prompted BPNG (the Bank) to introduce new measures in the foreign exchange market to stabilize the kina exchange rate. To support this growth and in consideration of the inflationary pressures, the Bank continued to take a cautious approach by maintaining the monetary policy signaling or Kina Facility Rate (KRF) at 6.25 percent.

Economic growth continued at a modest pace in 2013. The latest estimate for growth in real Gross Domestic Product (GDP) by the Bank shows that the economy expanded at a slower pace than the National Budget forecast of 5.1 percent. The Bank projects a growth of 4.4 percent in 2014, lower than the Budget forecast of 6.2 percent. This growth is expected to be supported by the production and export of liquefied natural gas (LNG) and Government's fiscal stimulus.

The 2013 inflation outcome of 4.7 percent, while on an upward trend, was below the Bank's annual forecast of 5.5 percent. The Bank forecasts a higher annual inflation rate of 6.5 percent in 2014, reflecting imported inflation and some pass-through of the kina depreciation.

The average kina exchange rate depreciated by 12.6 percent against the US dollar between March 2013 and March 2014. In 2013, the kina came under downward pressure due to lower export receipts and higher import demand, and ongoing payments related to the PNG LNG project. In the last quarter of 2013, the Bank restricted the placement of forward orders in the interbank market and limited it only to spot orders. Consequently, the kina mid-rate has since stabilised at US$0.4130.

The overall balance of payments is projected to remain in deficit in 2014 by K1,143 million , reflecting higher imports, net service and income payments. By the end of the year, the gross foreign exchange reserves are projected to be around US$2,785.5 (K6,744.6) million, sufficient for 5.3 months of total and 9.7 months of non-mineral import covers.

Broad money supply is expected to increase by 7.2 percent in 2014, driven mainly by an increase in the net domestic assets of the banking system, reflecting increases in net credit to Government and the private sector. The monetary base and private sector credit are expected to grow by 6.1 percent and 15.3 percent, respectively.

The 2014 National Budget continues on the fiscal stimulus path started in 2013 to support economic growth in light of the winding down of construction of the PNG LNG project. The 2014 budget deficit is projected to be K2,353.0 million or 5.9 percent of nominal GDP. Effective and efficient implementation of major infrastructure developments is key to ensuring the fiscal stimulus achieves its desired development outcomes. For this to happen, the Government must address implementation capacity constraints, which are still a major concern. In addition, the Government should not be constrained by the limits on its total debt, as long as this debt-financing is strategically targeted to developments and activities that increase the income generating capacity of the economy in the long term. This revenue generating capacity can then sustain future economic growth and repayment of debt.

Production and export of LNG will start in the second half of 2014. However, export receipts and revenue for the Government would be minimal and therefore expectations of windfall revenue and any associated appreciation of the kina might not materialize in the near term.

It is important that the Sovereign Wealth Fund becomes operational before the LNG related revenue starts to flow to the Government. This would assist in managing the LNG revenues in a sustainable manner to help mitigate any Dutch Disease effects.

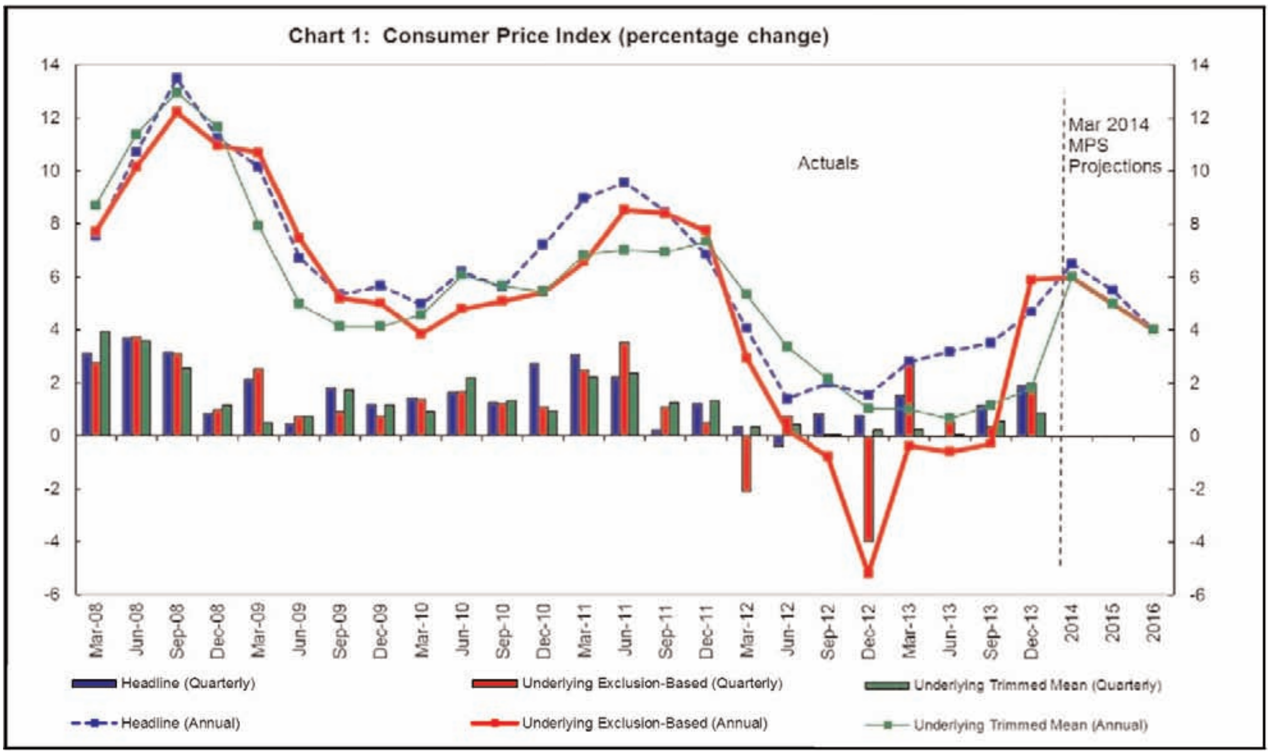
Based on the projected inflation path, the Bank will maintain the current stance of monetary policy in the next six months of 2014. The Bank will continue to assess the economic conditions to ensure that inflation is at a tolerable level and financial stability is maintained, as well as to support economic activity.

Monetary Policy Discussions

1. **Monetary Policy Assessment, Issues and Expectations**

   Annual headline inflation in December 2013 was 4.7 percent, lower than the Bank's forecast of 5.5 percent and higher than the 3.5 percent recorded in September. Whilst higher import and excise duties, fuel and betelnut prices, and some pass-through of the exchange rate depreciation contributed to the increase, more competition in some economic sectors and cheaper sources of imports mitigated the increase, resulting in the lower outcome. The lower domestic demand associated with the winding down of the construction phase of the PNG LNG project was also an offsetting factor. The quarterly headline inflation was 1.9 percent in December and 1.2 percent in September. Underlying annual inflation, as measured by the trimmed-mean and exclusion-based measures, was 1.8 percent and 5.9 percent respectively, in December 2013. In light of these outcomes and to support economic activity, the Bank maintained a neutral stance of monetary policy since the easing in March 2013.

The Bank projected annual headline inflation for 2014 to be around 6.5 percent. The trimmed– mean and exclusion based inflation measures are projected to be 6.0 percent each. These forecasts are based on continued high domestic import demand combined with imported inflation as the global economy improves. Over the medium term, the Bank projects annual headline inflation to be around 5.5 percent in 2015 and 4.0 percent in 2016. These projections are based on a number of factors, mainly including stable and low inflation in PNG's main trading partners and improvement in commodity prices (see Chart 1).



Source: Bank of PNG & National Statistical Office (NSO)

The main upside risks to these projections would emanate from any major supply side shocks such as adverse weather conditions affecting the supply of goods for domestic and export markets and higher than expected imported inflation from our trading partners.

In 2014, broad money supply is expected to increase by 7.2 percent, driven mainly by an increase in net domestic assets of the banking system, attributed to higher Government and private sector borrowing. Monetary base and private sector credit are projected to grow by 6.1 percent and 15.3 percent, respectively. The Bank considers the projected growth in monetary aggregates sufficient to support the projected economic growth in 2014 (see Appendix-Table 1).

The overall balance of payments is projected to be in deficit of K1,143 million in 2014, with a deficit in current account more than offsetting a surplus in the capital and financial accounts. The deficit in the current account is projected to be K7,235 million, due to higher imports, service and income payments. The surplus in the capital and financial account is projected to be K6,089 million, mainly reflecting inflows associated with the final stage of the PNG LNG project construction (see Chart 2). In the medium term, the current account is projected to record surpluses due to inflows from the LNG exports combined with mineral and non-mineral export revenue.

Source: Bank of PNG
Note: 2014 to 2017 includes flows related to the PNG LNG project, compared to the actuals, which do not include LNG figures.

As at December 2013, the level of gross foreign exchange reserves was US$2,854.7 (K6,912.1) million. By the end of 2014, the level of gross foreign exchange reserves is projected to be US$2,785.5 (K6,744.6) million, sufficient for 5.3 months of total and 9.7 months of non-mineral import covers. Gross reserves are projected to be higher in the medium term due to foreign exchange inflows related to commodity exports (See Appendix – Table 2).

The daily average kina exchange rate depreciated against the US dollar by 12.6 percent to US$0.4130 between the March quarter of 2013 and March 2014, but appreciated against the Australian dollar by 1.6 percent to A$0.4622. The depreciation of the kina against the US dollar reflected the effects of lower export receipts caused by weak international commodity prices and low production volumes, as well as higher foreign exchange outflows as a result of high import and service payments.

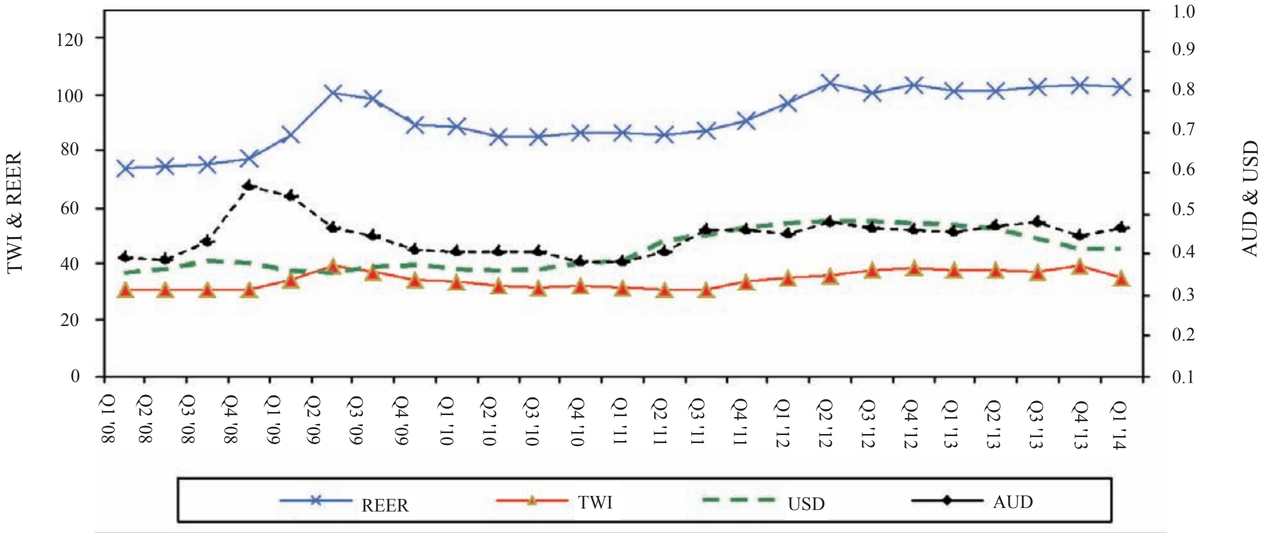
With low export receipts, supply of foreign currency was low relative to its demand. As a result, importers undertook forward contracts to cover their exposures, resulting in a substantial increase in the volume of forward orders, in addition to the high spot orders. The outstanding orders for foreign currencies in the interbank market were always in excess of supply. This influenced much of the kina depreciation. During the last quarter of 2013, BPNG restricted the inclusion of forward orders from the interbank market and limited it only to spot orders. These measures have since stabilized the kina at US$0.4130 in the interbank market (mid-rate), though commercial banks have traded well below this rate with their customers.

The kina appreciated against the Australian dollar as a result of cross currency movements, as the Australian dollar weakened against the US dollar. The Trade Weighted Index (TWI) declined by 4.6 percent during the December quarter of 2013, compared to the corresponding period of 2012. The Real Effective Exchange Rate (REER) also depreciated by 3.5 percent during the same period (see Chart 3).

In the context of falling international prices, the depreciating kina provided some relief to PNG farmers and exporters. It was also expected to boost agricultural exports, but due to poor transport infrastructure and other industry-specific constraints, there was little, if any, supply response in production. This re-emphasizes the need for the Government to invest in the development of the agriculture sector, through the introduction of new technological innovation for production and processing of all major agriculture commodities and food varieties.

Source: Bank of PNG

Chart 3: Quarterly Kina exchange rate against AUD, USD, TWI and REER

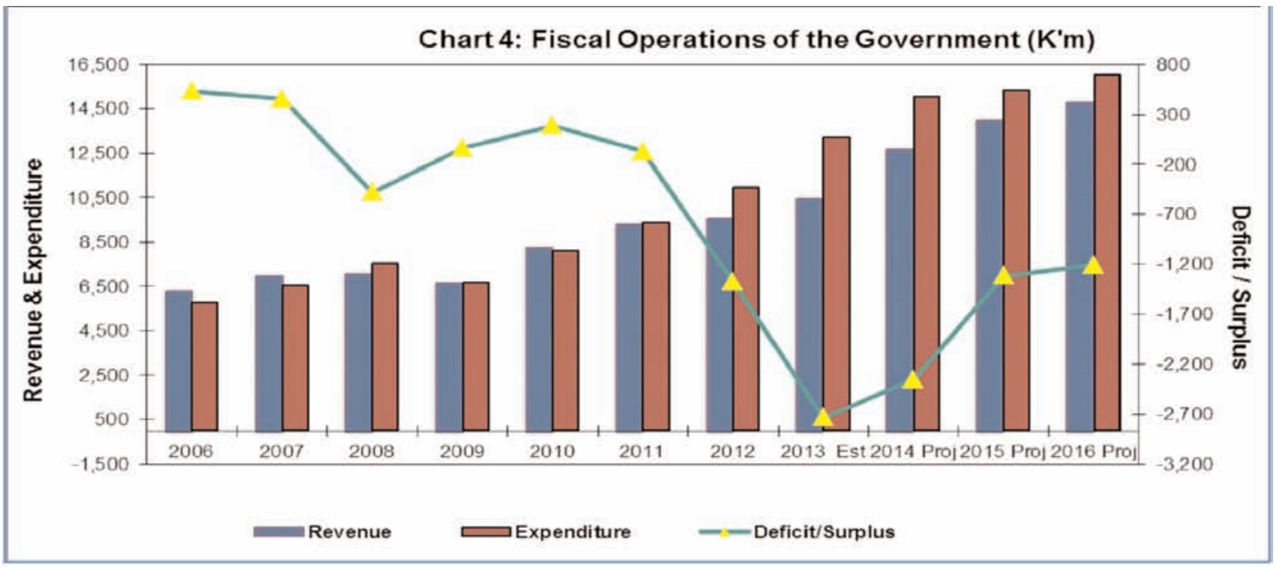


Source: Bank of PNG

In 2013, the real GDP is estimated by the Bank to have grown at a slower pace than previously forecasted and the projection in the National Budget of 5.1 percent. This is mainly due to the winding down of the construction phase of the PNG LNG project and declines in the agriculture, forestry & fishing and the petroleum sectors. Growth in 2013 was primarily driven by mining & quarrying, building & construction, utilities and manufacturing sectors.

Real GDP is projected to increase further in 2014 with the commencement of LNG production and Government's expansionary fiscal policy. The Bank projects real GDP to increase further in 2014 by around 4.4 percent, which is lower than the National Budget forecast of 6.2 percent. This growth is supported by the commencement of production of LNG, a full-year production at the Ramu Nickel/Cobalt mine, increased Government spending on high impact projects, including construction of roads and infrastructure for 2015 Pacific Games, and a pick-up in agricultural production associated with improved commodity prices.

The preliminary fiscal outcome for 2013 shows a deficit of K2,555.1 million. For 2014, the Government passed a K15,041.5 million budget with a deficit of K2,353.0 million or 5.9 percent of nominal GDP. The continued expansionary fiscal policy is intended to stimulate domestic economic activity in light of winding down of the construction phase of the PNG LNG project. As such, the Budget increased funding to Medium Term Development Plan enablers such as infrastructure, law and order, health and education services, including free education and free public health service. There is also ongoing funding to sub-national levels of Government. These priority areas are expected to increase the future capacity of the country in sustaining economic growth and improvements in the welfare of its population. Hence, the Government should not be constrained by the limits on its total debt, and as long as this debt-financing is strategically targeted to priority developments and activities that increase the income generating capacity of the economy in the long term. This revenue generating capacity can then sustain future economic growth and repayment of debt.



Source: 2014 National Budget

With the completion of the construction phase of the LNG project, the Government should coordinate its efforts and priorities towards utilizing the labour and capital that are released from the project. In addition, the Government should continue to develop the agriculture sector and invest in vital infrastructure projects in order to enhance the productive capacity of the economy. A diversified agriculture sector, including downstream processing, can broaden the export base and build PNG's resilience to withstand external shocks by lowering instability in export earnings.

Capacity constraints by implementing agencies of Government should be addressed to minimize the risk of inefficient spending and to avoid a build-up of deposits in trust accounts at commercial banks. All budget funded trust accounts should be held with the Bank, to reduce the cost of the buildup in liquidity to both the Government and the public.

To finance the budget deficit, the Government should continue to use domestic sources and concessionary foreign borrowing. Using domestic financing will generate benefits reflected in lower cost in real terms, fewer risks and the opportunity to develop the domestic financial market. There is sufficient liquidity in the banking system to finance the deficit as well as meeting private sector borrowing needs. The Government can also resort to other ways of raising funds from domestic sources like listing its securities on the stock market and private placement for targeted infrastructure funding.

Debt issuance by the Government in 2014 will partly diffuse excess liquidity in the banking system. Initially, this will enable BPNG to retire some of its Central Bank Bills (CBBs), which will reduce monetary policy cost. In the second round, spending by the Government using these funds will inject liquidity into the banking system. Increase in Government spending on unproductive areas can lead to kina depreciation, high interest rates, high inflation and loss of business confidence in a period of lower exports. Subsequently, the Bank has to absorb the excess liquidity to achieve its monetary policy objective of price stability.

Production and export of LNG will start in the second half of 2014. However, export receipts and revenue for the Government would be minimal and therefore expectations of windfall revenue and any associated kina appreciation might not materialize in the near term.

It is important that the Sovereign Wealth Fund becomes operational before LNG proceeds start to flow to the Government. This would assist in managing the LNG and other mineral revenues in a sustainable manner to help mitigate any Dutch Disease effects in years of significant foreign exchange inflows.

The Bank continued its initiatives to improve the financial system, including financial inclusion and the new payment system, the Kina Automated Transfer System (KATS), which became operational in October 2013. This system will enable real time settlement and payment of financial transactions, which will reduce transaction costs, improve efficiency and make payments safer. It will also improve Government's cash flow management by reducing leakages, administrative and overhead costs, and improving revenue collection and monitoring of expenditure.

While there is a low domestic demand and inflation environment, the Government has to still prudently manage its expansionary fiscal policy and assist the private sector to grow the economy. Close coordination between the Treasury and Finance departments and BPNG in the conduct of fiscal and monetary policies should continue to ensure macroeconomic stability is maintained.

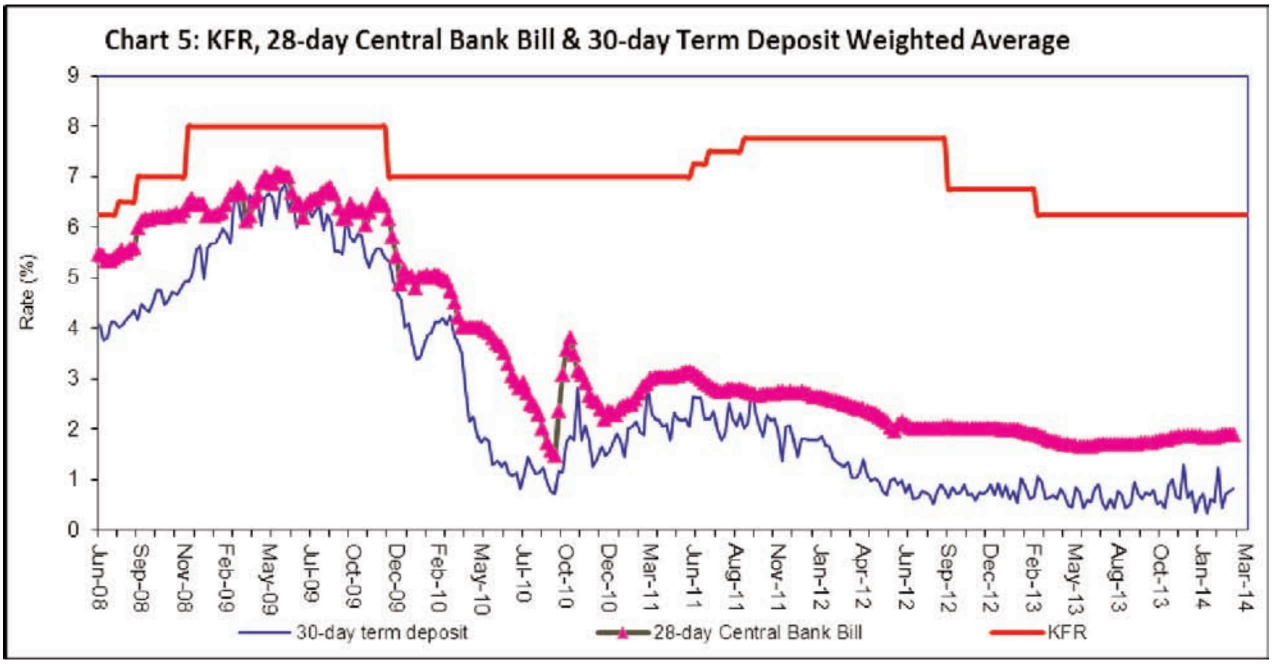
2. Monetary Policy Stance

The projected increase in economic growth in 2014 is expected to be accompanied by higher inflation. It is also expected that the net effect of Government's fiscal stimulus would result in continued high level of liquidity and increase in import demand. Although the high level of liquidity has not been inflationary in recent years, the Bank is concerned that this excess liquidity will continue to weaken the monetary policy transmission mechanism. When commercial banks hold reserves above the statutory requirements and their precautionary needs, they become unresponsive to BPNG's policy signals. As part of the strategy to absorb excess liquidity, the Bank increased the CRR to 9.0 percent in October 2013.

A review of the KFR as the policy signaling rate conducted by the Bank ascertained that the interest rate channel of monetary transmission is weak, with the KFR being ineffective in transmitting monetary policy signals to the market rates. This has become more prominent since early 2010 (see Chart 5), when liquidity increased significantly due to high foreign exchange inflows and deposits by government in trust accounts at commercial banks. In such a high liquidity environment, the interbank trading is limited or non-existent, thus, a change in the policy signaling rate does not translate into changes in market interest rates. As a result, an easing monetary policy, for example, might not be effective in stimulating economic activity through private sector credit growth, as lower (interbank) borrowing costs might not result in lower interest rates to businesses and consumers.

The Bank is aware of the implications of a weak monetary policy transmission mechanism and is considering various policy options going forward. This will be done in consultation with commercial banks such that it minimizes disruption to market operations.

In light of the present economic conditions as well as the future outlook, the Bank will maintain its current policy stance for the next six months, but may adjust it if developments in the economy and/or financial market warrant it. The Bank is taking a cautious approach, mindful of the expansionary fiscal policy and potential inflationary pressure that this could cause. This stance also aims to encourage economic activity by supporting lending to the private sector, which continued to grow steadily over 2013.



Source: Bank of PNG

3. Conduct of Monetary Policy

Monetary policy will be managed within the reserve money framework. The MPS provides the overall monetary policy stance, while the monthly KFR signals this stance or any changes through an announcement by the Governor. Following the announcement, Open Market Operations (OMOs) will be conducted to implement the Bank's monetary policy stance. The OMOs involve Repurchase Agreement (Repo) transactions with commercial banks and the auction of CBBs to ODCs and Treasury bills to the general public. The Bank will also use its direct policy instrument, the CRR, where necessary to assist in liquidity management.

To manage the high level of liquidity in the banking system and its potential impact on money supply and the exchange rate, the Bank increased the CRR to 9.0 percent in October 2013. The intervention by the Bank in selling foreign currency in the foreign exchange market as well as the increased issuance of Government securities assisted in diffusing some of the excess liquidity in the banking system. During 2014, the Government plans to finance the Budget deficit by issuing more domestic securities.

The CBB Tap facility will continue to operate so that small retail investors can participate in the securities market and help develop a savings culture in the country. The Bank plans to extend this facility to other centers in the country by utilizing the new payment system for payments and settlement of these small investments.

The new payment system will facilitate a more frequent use of the Repo Facility, allowing commercial banks to improve their liquidity management on a real time basis.

The Bank will continue to assess developments in the market and use all the instruments at its disposal to ensure that financial stability is maintained and inflation is at a tolerable level.

Appendix

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

INDICTOR	2011 (actual)	2012 (actual)	2013 (actual)	Sep 2013 MPS	2014 (proj)	2015 (proj)	2016 (proj)
Broad Money Supply	17.3	11.0	6.5	11.9	7.2	9.1	7.8
Monetary Base	61.7	17.6	0.5	6.1	6.1	8.8	6.7
Claims on the Private Sector	7.9	12.2	17.3	17.5	15.3	16.7	15.6
Net Claims on Gov't	399.4	-150.2	462.0	368.1	14.1	-5.2	24.0
Net Foreign Assets	10.0	-5.6	-11.8	-15.4	2.5	31.6	3.7

Source: Bank of PNG

Table 2: Summary of Other Macroeconomic Indicators

INDICTOR	2011 (actual)	2012 (actual)	2013 (actual)	Sep 2013 MPS	2014 (proj)	2015 (proj)	2016 (proj)
CONSUMER PRICE INDEX (annual % changes)							
Headline	6.9	1.6	4.7	5.5	6.5	5.5	4.0
Trimmed-mean	6.5	0.6	1.8	4.5	6.0	5.0	4.0
Exclusion- based							
	7.7	-1.9	5.9	5.0	6.0	5.0	4.0
BALANCE OF PAYMENTS (kina millions)[1]							
Current account	-406	-4,061	-7,401	-6,993	-7,235	11,218	11,256
Capital & Financial account*	1,599	3,265	5,775	6,408	6,089	-10,751	-10799
Overall balance	1,096	-851	-1,598	-585	-1,143	469	455
Gross Int. Reserves	9,266	8,416	6,912	6,905	6,745	7,213	7,668
IMPORT COVER (months)							
Total	11.5	11.0	7.1	5.9	5.3	6.4	7.2
Non-mineral	16.7	15.9	9.6	12.1	9.7	10.4	11.4
EXPORT PRICE							
Crude oil (US$/barrel)**	117.5	114.8	109.4	109.5	104.1	103.7	99.2
Gold (US$/ounce)	1,517.9	1,658.4	1,368.3	1,405.3	1,206.7	1,193.3	1,182.7
Copper (US$/pound)	408.2	360.1	332.8	319	323.0	320.0	319.0
Nickel (US$/tonne)					14,168.6	14,531.0	14,781.4
Cobalt (US$/tonne)					30,000	30,000	30,000
LNG (US$/000 mmbtu)					17.3	17.3	17.3
Condensate (US$/barrel)					90	80	80
FISCAL OPERATIONS OF THE GOVERNMENT* **							
Surplus/Deficit (K'm)	-65.7	-1,377.9	-2,555.1	-2,700.8	-2,353.0	-1,315.0	-1,206.4
% of GDP	0.2	4.3	7.8	7.7	5.9	2.5	2.2
REAL GROSS DOMESTIC PRODUCT (annual % growth) ******							
Total GDP	11.1	8.0	5.1	6.1	6.2	21.2	2.7
Non-mineral GDP	13.2	9.1	4.7	5.5	1.6	4.3	3.6

* Now includes Capital account

* * Prices take into account, company hedging and differ from market prices.

*** Preliminary fiscal operations up to December 2013, while 2014-2016 projections are from the 2014 National Budget.

**** GDP figures are from the 2014 National Budget.

Source: Bank of PNG, National Statistical Office and Department of Treasury.

[1] For 2014, imports for the PNG LNG project are included in the annual projections but not in the actuals to December 2013.

Printed and Published by C. Lenturut, Acting Government Printer,
Port Moresby.—355.