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BANK OF PAPUA NEW GUINEA

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

PORT MORESBY

30th September 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

2014 is a milestone year for Papua New Guinea – after five years of construction work, the PNG LNG project has commenced production delivering the first LNG cargo to its overseas customers ahead of schedule. With this major development, the economy enters a period of significant growth including the non-mineral sector, underpinned by an expansionary fiscal policy. Inflation has been on an upward trend since the March quarter. Over the six months to September the Bank maintained a neutral stance of monetary policy.

Under lower international commodity prices, lower export volumes and strong import demand, the kina started to depreciate in May 2012, a turn-around from the appreciation between 2010 and April 2012 to a peak of US$0.4845. The depreciation continued in 2013 exacerbated by a reduction in foreign exchange inflows, reflecting a decline in commodity prices, lower export volumes and strong import demand. Real sector demand for imports remained high, exacerbated by high Government expenditure, including construction of facilities for the 2015 Pacific Games. The imbalance in the foreign exchange flows led to a kina depreciation of about 15 percent to US$0.4130 by October 2013, despite BPNG's US$1.6 billion intervention in the foreign exchange market.

The official interbank mid-rate was stable at US$0.4130 from October 2013 to May 2014, while the actual trading exchange rates of the authorised dealers were well below that, with a big spread between the buy and sell kina rates. Consequently, the Bank introduced several measures, including an exchange rate trading band in June 2014, to align the trading rates to the official interbank mid-rate and reduce the unacceptable wide margins between buy and sell kina rates. The exchange rate regime remains floating, with the interbank rate fluctuating subject to demand and supply conditions in the foreign exchange market.

Given the lower than expected revenue in the first half of 2014, the Government increased domestic financing for both budgeted and unbudgeted expenditures. The subsequent rise in domestic financing costs has led to an agreement between the Treasury Department and the Bank for the latter to take up under subscriptions at the Treasury bill and Inscribed stock auctions and to on-sell them to the public. This arrangement will not only reduce interest costs to the Government but also assist in diffusing liquidity.

Real GDP is projected by the Bank to grow by 6.0 percent in 2014, stronger than expected due primarily to the early commencement of LNG production and export. The expansionary fiscal policy continues to enhance the growth in the non-mineral sectors. All sectors are expected to increase except for the petroleum, and building and construction sectors. The near-term outlook for economic growth remains broadly unchanged, with the mineral sector output expected to pick up significantly next year. Beyond that, the Government should continue with its initiatives to actively develop and increase investments in the renewable sectors of the economy, including agriculture, tourism and other vital infrastructure projects to enhance the productive capacity of the economy, create employment opportunities and improve the livelihood of the rural population. It should also implement programs to improve capacity and efficiency in service delivery that will speed up implementation of projects.

Annual headline inflation was 5.1 percent in June 2014. This measure is based on the new consumer basket and weights announced by the National Statistical Office (NSO) in May. Notable changes include increases in education, communication and housing expenditure. More importantly, dwelling rental prices are being collected too. The Bank welcomes these long overdue changes which are a better reflection of the consumption patterns and the price movements experienced by the urban population in PNG.

In light of these changes and the recent economic developments, the Bank revised its forecast for annual inflation to 8.0 percent this year. In the medium-term, inflation is expected to stabilise as international commodity prices improve and LNG export proceeds start flowing into the economy.

The Bank is concerned about the lack of progress on establishing a Sovereign Wealth Fund (SWF) for PNG. It is important that the SWF has an appropriate structure that adequately caters for macroeconomic stability, the country's development needs and future generation.

Taking account of the present economic conditions and inflation prospects in the near term, the Bank will consider tightening its monetary policy stance. It will continue to assess economic conditions to ensure that inflation is at a manageable level, whilst financial and macroeconomic stability is maintained.

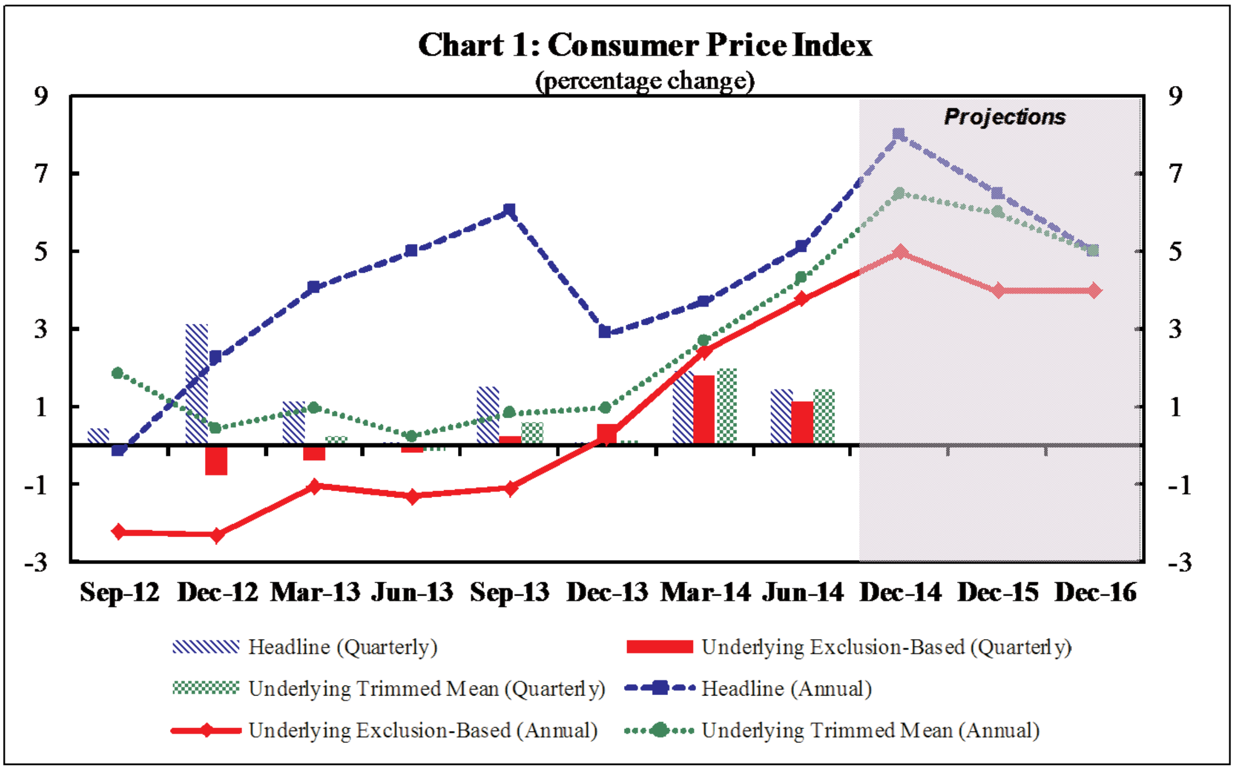
Monetary Policy Discussions

1. Monetary Policy Assessment, Issues and Expectations

In 2014, economic growth is expected to be higher than in 2013 mainly due to the commencement of production and export of LNG. The non-mineral sector will continue to grow, mainly supported by the expansionary fiscal policy. The depreciation of the exchange rate and imported inflation led to an inflation outcome of 5.1 percent over the year to June 2014. This is within the Bank's projection of 6.5 percent made in the March MPS, and therefore the neutral stance of monetary policy was maintained. However, the Bank increased the Cash Reserve Requirement (CRR) from 9.0 percent to 10.0 percent in September 2014 to diffuse some of the excess liquidity in the banking system.

Annual headline inflation in June 2014 was 5.1 percent, compared to 3.8 percent in March based on the new CPI basket released by NSO which provides a more comprehensive coverage of household spending, incorporating more expenditure items and three additional urban centers. The increase mainly reflects exchange rate depreciation, higher housing rental prices and prices of seasonal items. The lower domestic demand associated with the completion of the construction of the PNG LNG project was an offsetting factor. Underlying annual inflation, as measured by the trimmed-mean and exclusion-based measures were 4.3 percent and 3.8 percent respectively, in June 2014.

The Bank revised upward its projected annual headline inflation for 2014 to be around 8.0 percent. The trimmed–mean and exclusion based inflation measures are also revised to 6.5 percent and 5.0 percent, respectively. Following kina's recent depreciation, import prices, which have been weighing down on inflation in recent years, are now rising. Their impact on inflation though, may be lower if businesses do not fully pass on these higher import prices to customers but instead reduce their margins. The remaining spare capacity in the economy, released from the PNG LNG project, is expected to be absorbed at a slow pace, and some excess capacity is likely to persist until next year. Over the medium term, the Bank projects annual headline inflation to be around 6.5 percent in 2015 and 5.0 percent in 2016. These projections are based on a number of factors, mainly including anticipated LNG revenue inflows in the second half of 2015 and improvement in international commodity prices, which would more than offset effects of imported inflation and increased Government expenditure (see Chart 1).



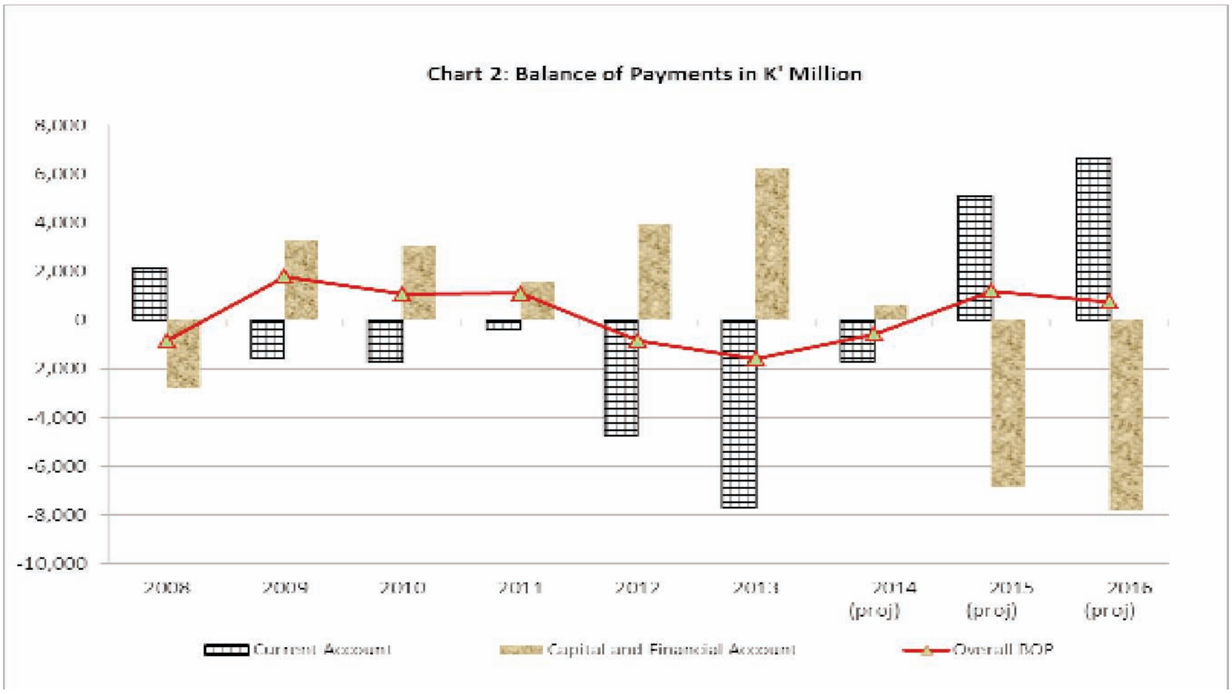
Source: Bank of PNG & NSO

Note: Following the CPI basket revisions in 2014, BPNG constructed synthetic series for historical analysis of inflation through linear interpolation of the weights, from Dec 1975 to Jun 2012. Due to this procedure, the annual series shown here from Sep 2012 to Jun 2013 might differ from those published by NSO. All other figures are based on the revised CPI basket.

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

The Bank forecast growth in broad money supply of 6.6 percent in 2014, emanating from an expected increase in net domestic assets of the banking system, attributed to high Government borrowing. Monetary base and private sector credit are projected to grow by 17.6 percent and 6.7 percent, respectively. The increase in monetary base takes into account higher commercial bank deposits at the Central Bank. This would offset the impact of lower growth in net foreign assets and private sector lending, on broad money. The lower projected growth in private sector credit is due to firms utilising their own cash-flow to fund their activities (see Appendix-Table 1).

The overall balance of payments is projected to be in deficit of K196 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 K1,699 million, mainly due to higher imports, service and transfer payments. The surplus in the capital and financial account is projected to be K988 million, mainly reflecting inflows associated with the final stage of the PNG LNG project construction in the first half of the year (see Chart 2). In the medium term, the current account is projected to record surpluses due to inflows from mineral and non-mineral export receipts, with the overall balance of payments position showing improvement in 2015 and 2016.



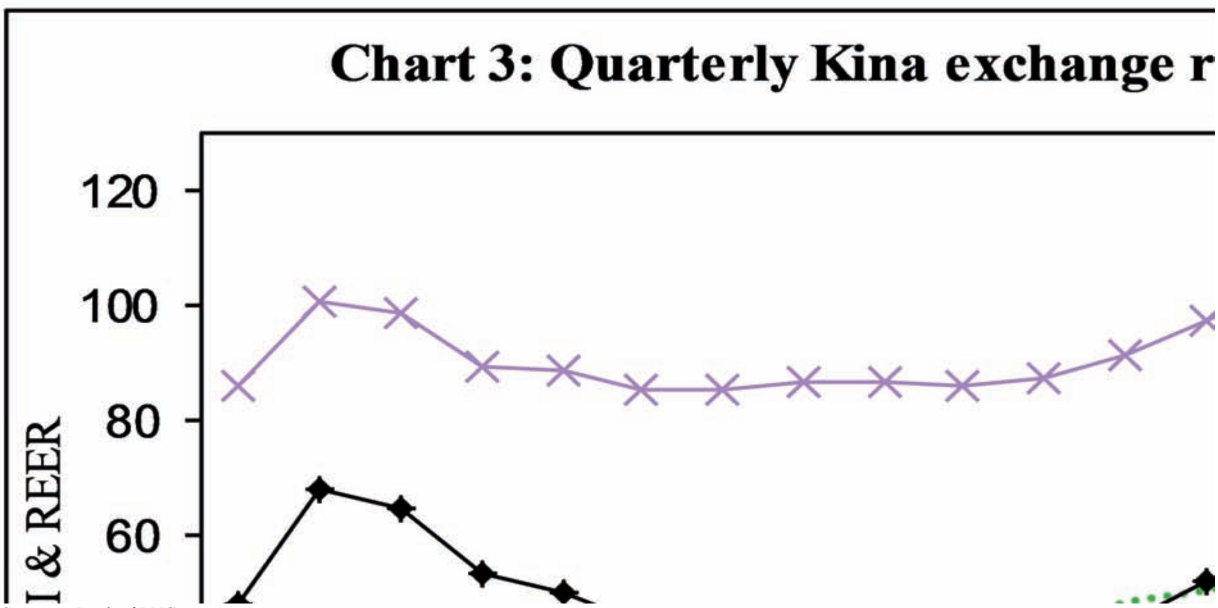
Source: Bank of PNG
Note: 2014 to 2017 includes flows related to the PNG LNG project, compared to the actuals, which do not include LNG figures.

As at 25th September 2014, the level of gross foreign exchange reserves was US$2,496.0 (K6,117.6) million. By the end of 2014, the level of gross foreign exchange reserves is projected to be US$2,620.0 (K6,485.1) million, sufficient for 4.6 months of total and 7.8 months of non-mineral import covers. In the medium term, the increase in foreign exchange reserves is due to foreign exchange inflows related to high export volumes of some major commodities and full year of inflow from LNG exports (See Appendix – Table 2).

The daily average kina exchange rate depreciated against the US dollar by 11.2 percent to US$0.4117 over the twelve months to 26th September 2014. It also depreciated against the Australian dollar by 3.9 percent to A$0.444 over the same period. The depreciation of the kina against the US dollar reflected the strengthening of the US dollar in the international financial markets and the effects of lower export receipts due to low production volumes as well as high import demand.

Following the measures introduced in the last quarter of 2013 by the Central Bank to restrict forward orders from the interbank foreign exchange market, the mid-rate stabilised at US$0.4130. However, authorised foreign exchange dealers continued to trade well away from this rate with their customers at margins of 600 basis points and more. To correct this market failure, in June 2014 the Bank introduced an exchange rate trading band on authorised foreign exchange dealers, while maintaining the floating exchange rate regime. This measure restored order by aligning the market rates with the official interbank mid-rate (see Box 1). The kina has depreciated by 2.5 percent to US$0.4030 since the introduction of the trading band.

The Trade Weighted Index (TWI) declined by 7.4 percent in the 12 months to August 2014, compared to the corresponding period of 2013. The Real Effective Exchange Rate (REER) also depreciated by 6.2 percent over the 12 months to June 2014 (see Chart 3). The depreciation is beneficial to PNG exporters through higher kina prices and producers should take advantage of that to increase production.

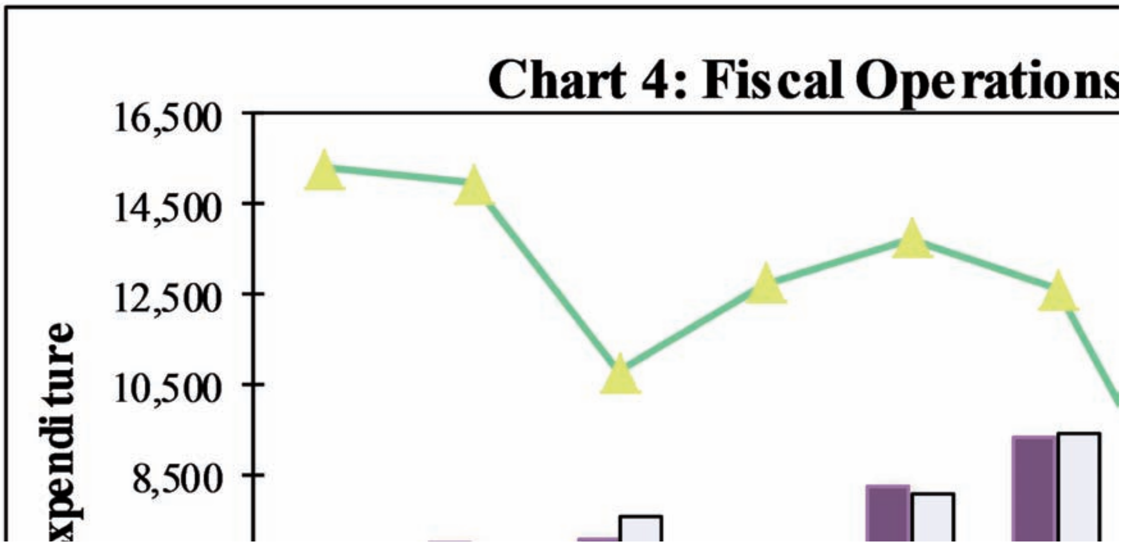


Source: : Bank of PNG

Real Gross Domestic Product (GDP) is projected by the Bank to increase further by 6.0 percent in 2014 with the earlier commencement of LNG production, combined with the Government's expansionary fiscal policy. The growth is also supported by higher production of nickel and cobalt, and increased activity in the manufacturing, utilities, and commerce sectors. Further Government spending on development projects, including construction of transportation infrastructures, facilities for the 2015 Pacific Games, and a pick-up in agricultural production associated with improved commodity prices will add to this growth. However, the impact of the LNG export revenue through Government spending on tangible growth will not happen until after the latter part of 2015.

The growth in the non-mineral sector continues to be affected by the high cost structure associated with electricity, logistics and shipping, relatively high wage rates compared to similar economies in the Asia/Pacific region and high security costs combined with lack of skilled manpower. These affect the competitiveness of PNG's products against cheaper imports resulting in low revenue and investment. In the agriculture sector, production of coffee, cocoa and copra mainly by small holders continue to face capacity constraints, such as lack of managerial skills, poor extension services and limited financial resources. It is therefore very important for the Government to address these issues affecting private sector development with increased funding, introduce appropriate policies and undertake necessary reforms such as improving efficiency of state-owned enterprises. This should grow the economic base of the country to achieve sustainable growth in the long term.

The preliminary estimates of the fiscal operations of the National Government over the six months to June 2014 show an overall deficit of K563.6 million, compared to a deficit of K679.9 million in the corresponding period of 2013. This represents 1.4 percent of nominal GDP. According to the Mid-Year Economic and Fiscal Outlook (MYEFO) report, 33.9 percent of the revised Budget was spent over the six months to June 2014 and only 24.9 percent of the allocated funds were spent on development projects. At this pace full expenditure of the Budget may not be realised, and its intention to support economic activity will not happen if such underspending continues.



Source: 2014 National Budget and MYEFO report

In the MYEFO report for 2014, the Government projects a budget deficit of K2,725.5 million or 6.9 percent of nominal GDP in 2014, compared to the deficit of K2,353.0 million in the 2014 Budget (see Chart 4). This mainly reflects lower than expected mining and petroleum taxes. Total public debt is projected to increase to K14,603.5 million or 37.1 percent of GDP, reflecting increases in both the domestic and external debts. In this scenario, the debt to GDP ratio will be above the stipulated limit of 35.0 percent. Considering that: much of the debt is domestic and the external component is on concessional terms; and PNG's debt to GDP ratio is within reasonable level, the potential increase in PNG's debt to GDP ratio is not necessarily a bad thing if there is effective and quality spending that will impact on the productive capacity of the economy and lives of the rural majority. However, it is important that Government agencies coordinate any external borrowing to be within the Budget framework.

In the first half of 2014, the Government has been raising its deficit financing from domestic sources to fund both budgeted and unbudgeted expenditures. Increased domestic financing has led to a rise in interest costs on Treasury bills and Inscribed stocks. The high cost of borrowing will result in reallocation of some of Government's financial resources away from the provisions of essential services to rural population and will increase the financial burden for future generations.

Given the revenue short fall and high cost of financing, the Bank cautions the Government to contain spending and refrain from any further unbudgeted expenditure. Non-priority spending should be deferred until the Government has sufficient revenue inflows. The Government should concentrate on priority expenditure items including Tuition Fee Free Education, health, agriculture and vital infrastructures.

The Government should implement programs to improve capacity and efficiency in service delivery that will speed up implementation of projects and avoid a build-up of deposits in Trust accounts at commercial banks. All budget funded Trust accounts should be transferred to the BPNG to reduce the cost of liquidity management on the government and the nation. Ensuring quality spending in productive areas and utilising the skilled labour and capital released from the construction phase of the PNG LNG project would support domestic economic activity.

In the medium term, it is important for the Government to actively develop the renewable sectors to broaden the export and revenue base rather than relying heavily on the mineral sector. This would include modernising the agriculture sector and promoting tourism and other vital infrastructure projects to enhance the productive capacity of the economy, create employment opportunities and improve the livelihood of the rural population.

The Bank is concerned about the lack of progress on establishing a Sovereign Wealth Fund (SWF) for PNG. It is important that the SWF has an appropriate structure that adequately caters for macroeconomic stability, the country's development needs and future generation.

On its part, the Central Bank is pursuing financial inclusion initiatives and improving the National Payments System to assist in the drive for inclusive and broad based growth. The new payment system is enabling commercial banks to improve their liquidity management with real time settlement of high value priority payments in the first phase of the project. The second phase involves cheque truncation where cheque imaging is transmitted electronically to the payee bank and was launched in September 2014, which will reduce the time for settlement. The third phase involving direct credits is being worked on. These enhancements would improve the safety, timeliness and overall efficiency of the payment system of the country.

Given the high import demand and increase in inflationary pressures, fiscal and monetary policies should work in tandem to maintain macroeconomic stability and business confidence for private sector to grow.

2. Monetary Policy Stance

The review on Kina Facility Rate (KFR) as the policy signaling rate confirms the weak transmission to market interest rates. For changes in the KFR to transmit to market interest rates there has to be a tight liquidity situation that promotes activity in the interbank market, which has not been the case for some time. The review therefore provided a few options on liquidity management to make KFR more effective as a policy signaling rate. These include measures to diffuse the excess liquidity such as increase in CRR, transfer of Government deposits to the Central Bank and refinements to the Repurchase Agreement (Repo) arrangements with commercial banks.

With continued economic growth in 2014 headline inflation has increased since the March quarter. The Government's fiscal stimulus is expected to boost domestic demand but at the same time increasing liquidity in the banking system. The excess liquidity has contributed to high import demand, which continues to be high and contributes to the depreciation of the exchange rate, causing inflationary pressures. In light of the present economic conditions as well as the future outlook, the Bank increased its issuance of Central Bank Bills (CBB) and the CRR to 10.0 percent in September 2014. It will consider other options over time.

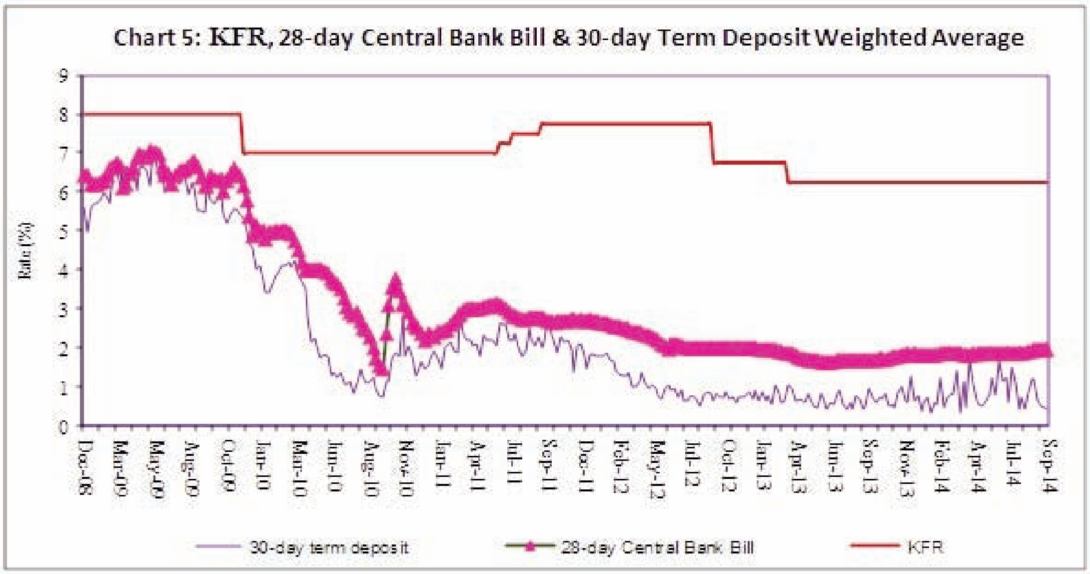


Chart 5: KFR, 28-day Central Bank Bill & 30-day Term Deposit Weighted Average

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 the auction of CBBs, Treasury bills and Inscribed stocks to Other Depository Corporations and the general public and Repo transactions with commercial banks. The Bank will also use its direct policy instrument, the CRR, where necessary to assist in liquidity management.

To fund the Budget deficit, the Government made a net issuance of K533.6 million in Treasury bills and K1,248.7 million in Inscribed stocks, while there was a net retirement of K834.1 million in CBBs over the nine months to end of September 2014. The net issuance by the Government enabled retirement of CBBs and also assisted in diffusing some of the excess liquidity.

The issuance of Government securities led to a sharp increase in domestic interest rates, which increases the debt burden on future generations. Therefore, the Treasury Department agreed for the Bank to take up under-subscriptions at the Treasury bill and Inscribed stocks auctions to on-sell to the public for monetary policy purposes. This arrangement will not only reduce interest cost to the Government, but also assist in diffusing liquidity.

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. Participation however has been low due to low interest rate and limited access to the facility from other centers of the country.

The first two phases of the new payment system project enable real time settlement of high value priority payments and cheque truncation. The third phase involving direct credits is expected to be completed before the end of the year. These enhancements would improve the safety, timeliness and overall efficiency of the payment system of the country.

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 manageable level.

Box 1. The exchange rate trading band - the Rationale

On 4th June 2014, the Bank introduced an exchange rate trading band within which authorised foreign exchange dealers1 must trade currencies. This limits the pricing of foreign exchange to a band around the official interbank mid-rate that authorised dealers can quote to their customers. The band currently involves:

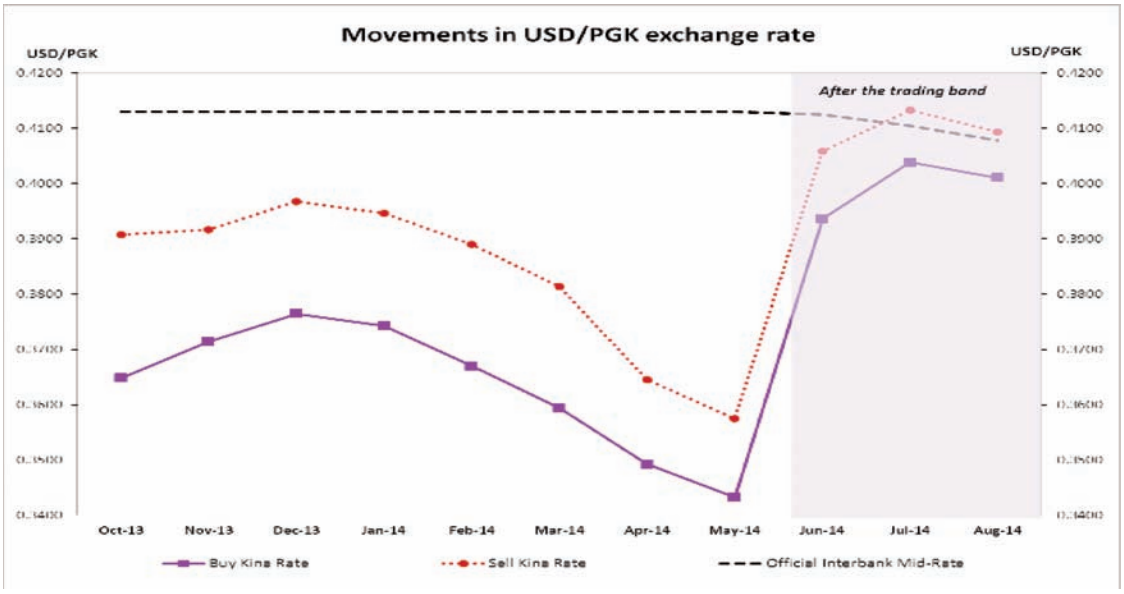
- a 150 basis points spread, that is, 75 basis points above and below the inter-bank rate. For example, at an official interbank mid-rate of US$0.4040, foreign exchange dealers can buy kina from importers at a minimum of US$0.3965 and sell kina to exporters at a maximum of US$0.4115; and

- all currencies and all products, except for foreign currency banknotes which have large associated costs.2

In making its decision to introduce the trading band, BPNG took into account several factors. First, the authorised dealers were trading the kina away from the interbank mid-rate, resulting in a spread of around 600 basis points. Second, the use of BPNG's international reserves in funding the forward transactions in the spot market, which led to a reduction in the international reserve level and a significant depreciation of the market exchange rate. Third, the dealers had lost their price making ability, instead becoming price takers dictated by the foreign exchange suppliers. All these were regarded as a market failure and prompted the Central Bank to intervene.

Whilst it is acknowledged that the measure may have disadvantaged exporters, macroeconomic stability remains the Bank's overriding concern and therefore it was seen as an important corrective measure. This measure does not, in any way, change PNG's exchange rate regime which remains a floating one whereby the official interbank exchange rate is freely determined by the demand and supply of foreign currency in the market. The trading band follows movements in the official interbank rate. The Bank may intervene directly or indirectly to moderate the rate of change and prevent undue fluctuations, but its actions do not target a specific level of exchange rate.

The trading band caused a de facto appreciation of the market exchange rate at implementation (see chart below). The interbank mid-rate has since started to depreciate, reflecting market conditions, from US$0.4130 to US$0.4030 as at 29th September.



[1] They are the four commercial banks: Australia & New Zealand Banking Group (PNG) Ltd, Bank South Pacific Ltd, Maybank (PNG) Ltd and Westpac Bank (PNG) Ltd and two financial institutions: First Investment Finance Ltd and Heduru Moni (Moni Plus) Ltd.

[2] Associated costs refer to the costs involved in handling foreign currency which, amongst others, includes items such as transportation and insurance costs.

Appendix

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

INDICTOR	2012 (actual)	2013 (actual)	Mar 2014 (MPS)	2014 (actual to Jul)	2014 (proj)	2015 (proj)	2016 (proj)
Broad Money Supply	11.0	6.5	7.2	-0.6	6.6	6.7	8.8
Monetary Base	17.6	0.5	6.1	19.0	17.6	10.1	5.4
Claims on the Private Sector	12.2	17.3	15.3	-2.9	6.7	6.3	5.9
Net Claims on Gov't	-150.2	462.0	14.1	85.0	35.5	-4.3	5.4
Net Foreign Assets	-5.6	-11.8	2.5	-14.5	2.6	-8.2	27.4

Source: Bank of PNG

Table 2: Summary of Other Macroeconomic Indicators

INDICTOR	2012 (actual)	2013 (actual)	Mar 2014 MPS	2014 (actual to Jun)	2014 (proj)	2015 (proj)	2016 (proj)
CONSUMER PRICE INDEX (annual % changes)							
Headline	1.6	4.7	6.5	5.1	8.0	6.5	5.0
Trimmed-mean	0.6	1.8	6.0	4.3	6.5	6.0	5.0
Exclusion- based	-1.9	5.9	6.0	3.8	5.0	4.0	4.0
BALANCE OF PAYMENTS (kina millions)[1]							
Current account	-4,061	-7,401	-7,235	-1,393	-1,699	8,025.0	8,544.6
Capital & Financial account*	3,265	5,775	6,089	1,347	988	-6,836.9	-7,802.0
Overall balance	-851	-1,598	-1,143	-15.5	-196	1,188.1	742.6
Gross Int. Reserves	8,416	6,912	6,905	6,826	6,485	7,673.3	8,415.8
IMPORT COVER (months)							
Total	11.0	7.1	5.3	7.5	4.6	7.5	4.9
Non-mineral	15.9	9.6	9.7	10.5	7.8	10.5	8.3
EXPORT PRICE							
Crude oil (US$/barrel)**	114.5	109.5	104.1	108.4	104.1	103.7	99.2
Gold (US$/ounce)	1,659.6	1,368.3	1,206.7	1,255.3	1,206.7	1,193.3	1,182.7
Copper (US$/pound)	360.1	332.8	323.0	305.5	310.2	309.2	308.9
Nickel (US$/tonne)	17,541.7	15,141.4	14,168.6	17,979.1	18,010.0	18,727.5	18,351.7
Cobalt (US$/tonne)	30,000	30,000.0	30,000.0	32,077.5	33,000.0	30,000.0	30,000.0
LNG (US$/000 mmbtu)					15.5	15.0	14.7
Condensate (US$/barrel)					90	80	80
FISCAL OPERATIONS OF THE GOVERNMENT* **							
Surplus/Deficit (K'm)	-1,377.9	-2,672.4	-2,353.0	-563.6	-2,725.5	-1,315.0	-1,206.4
% of GDP	4.3	7.7	5.9	1.4	6.9	2.5	2.2
REAL GROSS DOMESTIC PRODUCT (annual % growth) ******							
Total GDP	8.0	5.5	6.2	-	5.4	21.2	2.7
Non-mineral GDP	9.1	5.3	1.6	-	1.1	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 and 2014 MYEFO.

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.

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