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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, CMG

PORT MORESBY

31st March 2018

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 December 2017 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 is expected to lead to:

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

Executive Summary

With continued improvement in the external sector, underpinned by higher international prices and production of some of PNG's major exports, particularly mineral commodities, real GDP growth in 2017 is estimated by the Central Bank to be higher than projected in the 2018 National Budget. For 2018, real GDP growth is projected by the Bank to be close to 3.0 percent, higher than 2.4 percent in the 2018 National Budget, mainly driven by an increase in activity in the non-mineral sector. This will be supported by higher Government spending relating to the hosting of Asia- Pacific Economic Cooperation (APEC) meetings. The mineral sector is also expected to contribute to the growth, however, the recent earthquake and its adverse impact on production of mineral and LNG will affect growth outlook for 2018. The full impact of this disaster is yet to be assessed.

The 2018 National Budget plans for a deficit of K1,987.2 million or equal to 2.5 percent of nominal GDP. To finance the deficit, the Government intends to raise funds mostly from external sources. This external financing will assist liquidity in the foreign exchange market.

For the first time since becoming a member in 1993, PNG is hosting APEC meetings in 2018. These meetings will be concluded with the Leaders' Summit in November. The hosting of APEC is expected to have a positive impact on the economy, raising the profile of PNG internationally and promoting it as an investment and tourism destination.

Inflation has been on a downward trend reflecting low economic growth, relative stability in the kina exchange rate and lower prices of seasonal food items. Annual headline inflation was 4.7 percent in 2017, compared to 6.6 percent in 2016. For 2018, annual headline inflation is projected to be slightly higher at 5.0 percent, taking into account the marginal increase in imported inflation from PNG's major trading partners and increased demand from APEC related activities. In the medium term, the Bank projects annual headline inflation to be around 4.5 percent in 2019 and 4.0 percent in 2020.

Considering these developments and projections, the Central Bank will maintain a neutral stance for monetary policy over the next six months, but will continue to closely monitor developments in inflation and other macro-economic indicators and may adjust its stance as necessary.

Monetary Policy Discussions

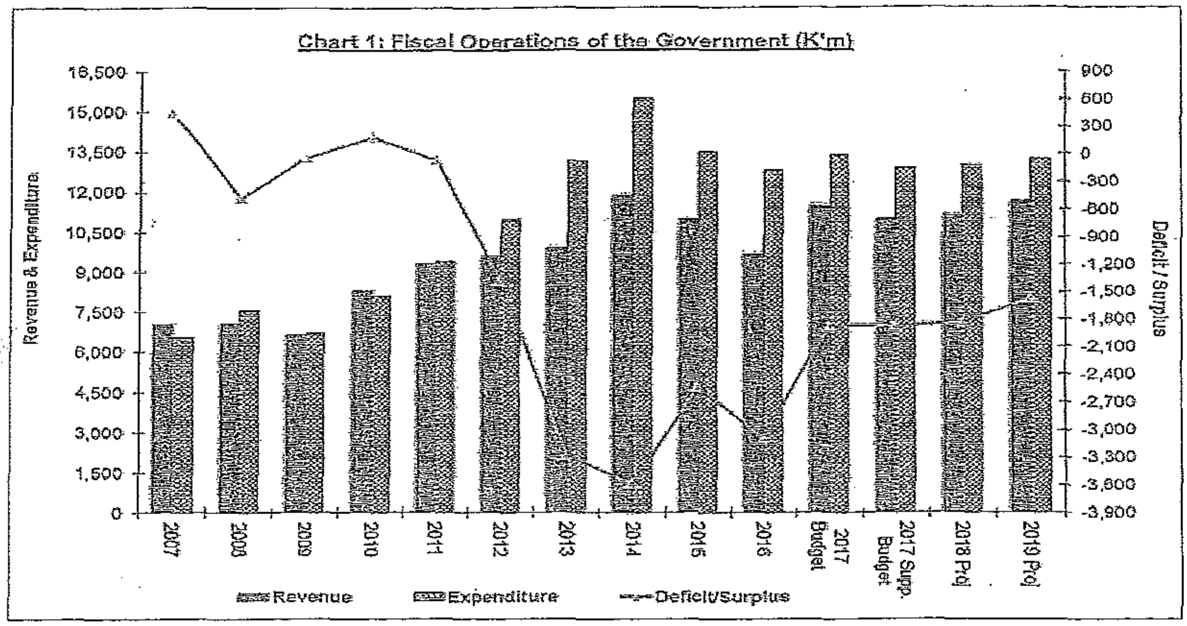
1. **Monetary Policy Assessment, Issues and Expectations**

   The external sector continued to improve with increases in the international prices and production of some of PNG's major exports, especially the mineral commodities, leading to a higher surplus in the current account for 2017. Consequently, the Central Bank estimates a higher real GDP growth in 2017.

The objective of APEC is to promote and facilitate free trade and investment among the APEC member economies. The theme for the meeting is: "Harnessing Inclusive Opportunities and Embracing the Digital Future". Three immediate priorities to support the APEC objectives are improving digital connectivity and deepening regional economic integration, promoting inclusive and sustainable growth, and strengthening inclusive growth through structural reform. The hosting of APEC is expected to have a positive impact on the economy from increased activity and employment. This will also raise the profile of PNG internationally and promote it as an investment and tourism destination.

The outcome of the National Government fiscal operations for 2017 show a revenue of K11,525.0 million, expenditure of K13,319.7 million and a deficit of K1,794.6 million or equal to 2.4 percent of nominal GDP, compared to the deficit of K3,086.9 million in 2016, which was 4.6 percent of nominal GDP.

In the 2018 National Budget, the planned expenditure is K14,717.9 million and revenue is K12,730.7 million, giving a deficit of K1,987.2 million or equal to 2.5 percent of nominal GDP. To finance the deficit, the Government intends to raise funds mostly from external sources. The Government aims to support growth in the agriculture and Small to Medium Enterprises (SMEs) sectors. The efforts of the Government to focus its attention on the non-mineral sectors such as agriculture and tourism, to diversify the export base and promote inclusive economic growth is commended, as this will lead to broader revenue stream and sustainable economic growth in future.



Source: 2017 Budget and 2017 Supplementary Budget

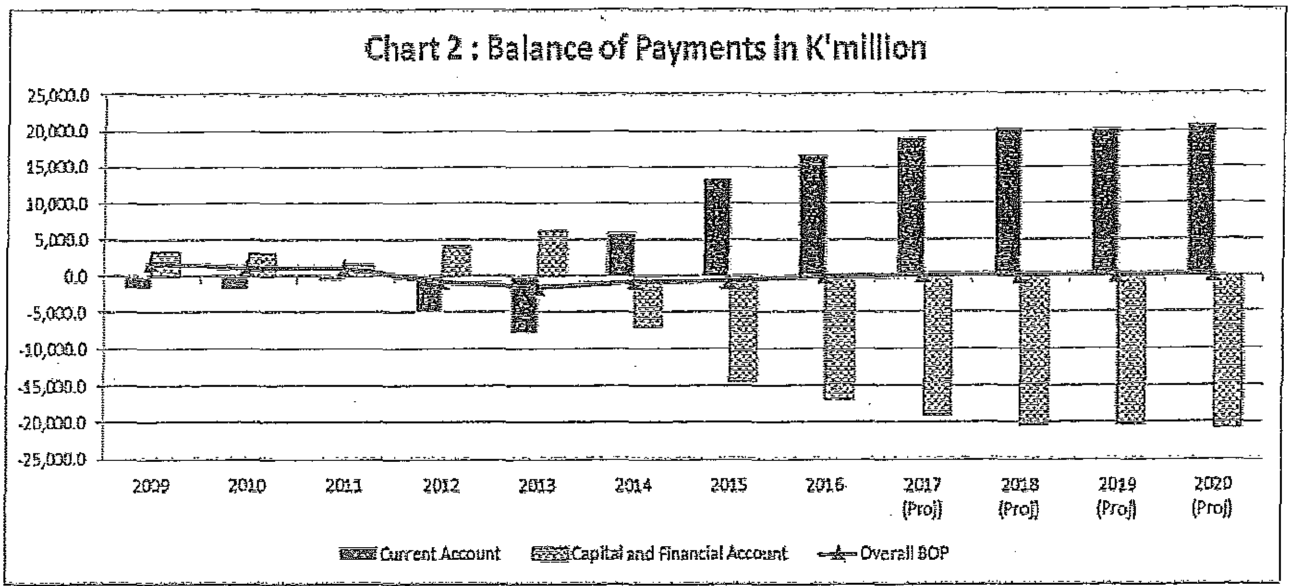
Financing of the budget deficit continues to be a challenge with some domestic financiers reaching their exposure limits on sovereign debt. The Government should pursue the balance of the second tranche of the Credit Suisse syndicated loan.

The overall balance of payments recorded a surplus of K141 million in the first half of 2017. It is expected to record a surplus at the end of the year. A higher surplus in the current account more than offset a deficit in the capital and financial account. The projected current account surplus of K18,917 million for 2017, is mainly due to an improvement in some international commodity prices, LNG exports and higher production of some commodities. The capital and financial account is projected to be in deficit of K18,803 million, mainly reflecting outflows for debt servicing of the PNG LNG Project loan (See Chart 2).

In the medium-term, the current account is projected to record higher surpluses from mineral and non-mineral export receipts as commodity prices and production increase. The capital and financial account is expected to record deficits, mainly reflecting debt service payments by PNG LNG project partners and a build-up in offshore foreign currency account balances of mining, oil and gas companies. As a result, the overall balance of payments position is projected to record surpluses in 2018 and 2019. If any of the planned major resource projects including the Papua LNG, Frieda River or Wafi-Golpu advance to development stage over the coming two years, there will be positive contributions to the balance of payments.

As at 30th June 2017, the level of gross foreign exchange reserves was US$1,697.8 (K5,398.4) million, sufficient for 6.2 months of total and 9.9 months of non-mineral import covers. The level of reserves was US$1,769.3 (K5,572.4) million as at 27th September, 2017 and is projected to end the year at US$1,714.1 (K5,450.2) million. The lower level of reserves mainly reflects Central Bank's intervention to assist the spot market and the repayment of external loans (See Appendix – Table 2).

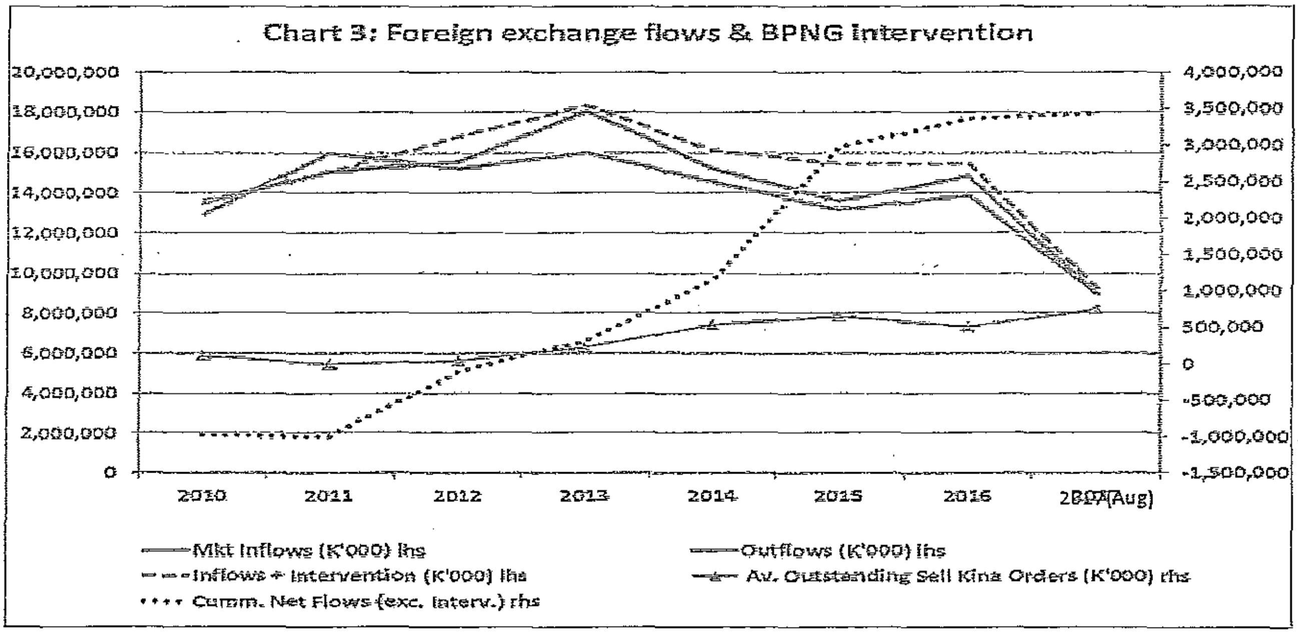
Implementation of the foreign exchange market Directives issued since September 2016, including closure of some of the onshore foreign currency accounts and cessation of trade finance loan arrangements, contributed to an increase in the availability of foreign currency in the spot market. As a result, the Central Bank reduced its intervention in the foreign exchange market, totaling US$81.7 million so far this year to September.



Source: Bank of PNG

To further improve the functioning of the foreign exchange market, a Foreign Exchange Market Directive was issued in April 2017 to the AFEDs to cease providing trade finance loans in all currencies, including kina, to be settled in foreign currency. By the end of April, all trade finance loans have matured. In addition, the trading margin was extended to other currencies and transactions except over-the-counter cash exchange transactions.

The Bank's assessment of foreign exchange market data shows that the total supply of foreign currency, including the Central Bank's intervention, was sufficient to clear the outstanding import orders in the spot market (See Chart 3). However, AFEDs are still reporting outstanding orders. This reflects frontloading of some import orders, preference for serving small orders and others not backed by the required kina funds.



Source: Bank of PNG

The kina exchange rate against the USD was stable at US$0.3145 from 23rd March to 27th August 2017, then depreciated by 20 basis points in September 2017, to US$0.3125. The stability against the USD was supported by an increase in foreign exchange inflows mainly from mineral and agriculture sectors. Against the AUD, the kina exchange rate depreciated from A$0.4411 at end of March 2017 to A$0.3893 as at 18th September 2017, as the AUD appreciated against the USD following increases in international commodity prices.

The Bank will continue to sterilise liquidity generated from the slack arrangement by on-selling of the Government securities to the public and issuing Central Bank Bills (CBB). At the end of December 2017, the Bank's holding of Government's securities under the slack arrangement was K1,328 million. The Central Bank issued CBBs and Tap totalled K2,095 million, which means that the slack liquidity was fully sterilised and had no inflationary impact as evident from the low inflation outcome in 2017.

For 2018, real GDP growth is projected by the Bank to be close to 3.0 percent (2018 Budget is 2.4 percent). This growth will be broad-based across all sectors of the economy, reflecting increases in activity in the non-mineral sectors, notably in the agriculture/forestry/fisheries (AFF), wholesale, retail, accommodation and food services and, transport and storage sectors. Higher prices and production in the AFF, and higher Government spending including the hosting of APEC meetings will support this growth. The mineral sector will also contribute to the growth. The recent earthquake in the Highlands that caused damages to transport infrastructure and the gas, oil and mining projects, resulting in the temporary shutdown in their operations will have an adverse impact on exports and GDP growth in 2018. But any restoration work in the affected provinces may have positive impact on GDP growth. The full impact of this disaster is yet to be assessed.

In the medium term, real GDP growth is expected to trend downwards to around 2.2 percent and 2.0 percent in 2019 and 2020, respectively, as shown in the 2018 budget. If any of the pipeline resource projects move into development stage, GDP growth will be higher than projected.

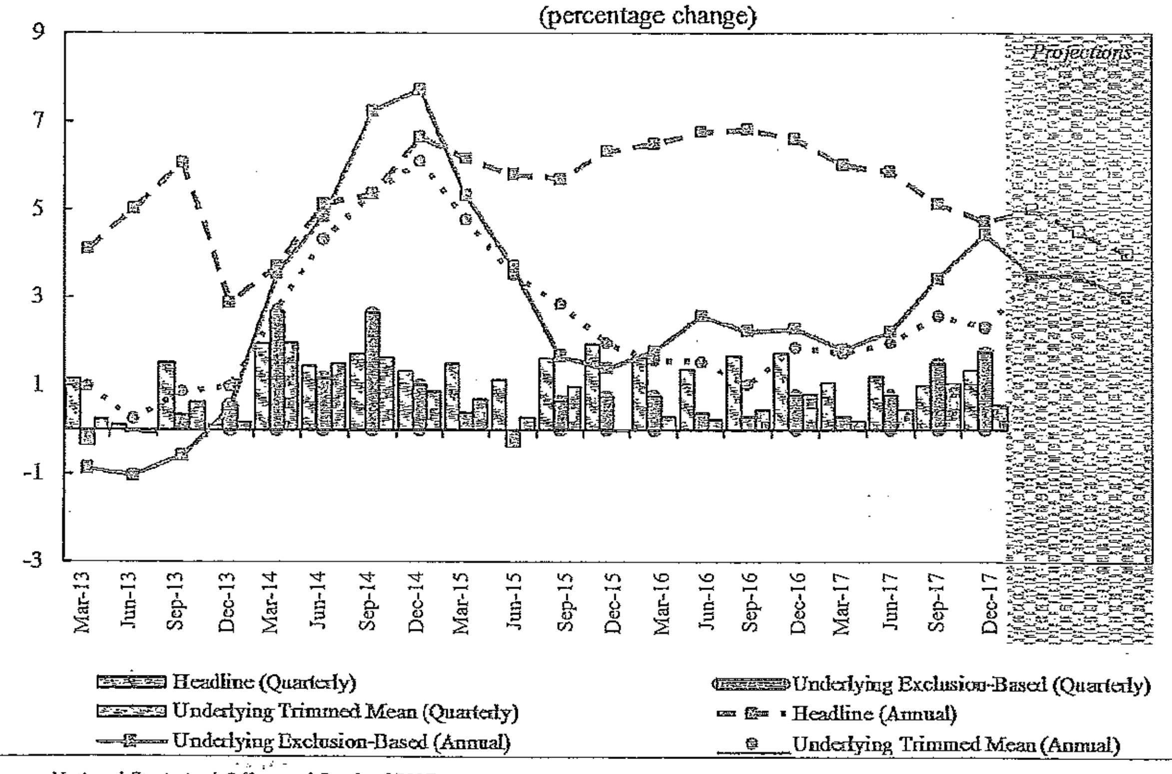
Annual headline inflation trended downward to 4.7 percent in 2017, from as high as 6.6 percent in 2016. Prices for all expenditure groups increased but at a lower rate than in 2016, mainly driven by seasonal factors. The annual trimmed mean and exclusion-based measures for underlying inflation were 2.3 percent and 4.4 percent, respectively in 2017.

The Bank projects slightly higher annual headline inflation for 2018 at 5.0 percent. This projection is based on the marginal increase in imported inflation from PNG's major trading partners and expected growth in non-mineral sector. The underlying inflation measures of trimmed mean and exclusion-based are both projected at 3.5 percent.

In the medium term, the Bank projects annual headline inflation to be around 4.5 percent for 2019 and 4.0 percent for 2020. Both trimmed mean and exclusion-based inflation measures are projected to be around 3.5 percent in 2019 and 3.0 percent in 2020 (See Chart 3).

Chart 3: Consumer Price Index Inflation

(percentage change)



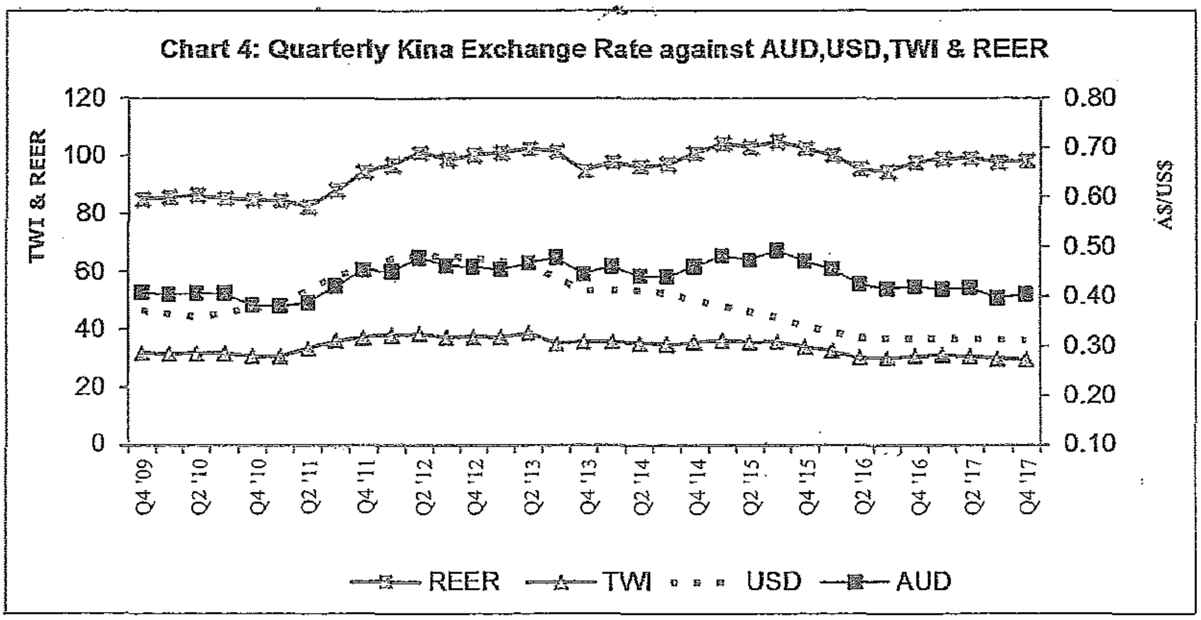
Source: National Statistical Office and Bank of PNG

The upside-risks to these projections include:

- increase in import demand;
- downward pressure on the kina exchange rate;
- impact of earthquake in the Highlands region on prices of fuel and consumer items;
- higher imported inflation from stronger global economic growth and the effect of the US imposition of tariffs on certain import items; and
- any other unforeseen supply and demand side shocks to the economy.

The kina depreciated against the USD from US$0.3150 at the end of December 2016 to US$0.3095 at the end of December 2017, and further depreciated to US$0.3075 at the end of March 2018. Against the AUD, the kina exchange rate depreciated from A$0.4354 at end of December 2016 to A$0.3967 at the end of December 2017. It appreciated to A$0.4008 at the end of March 2018.

The Trade Weighted Index (TWI) decreased by 4.3 percent in 2017, compared to a decline of 9.3 percent in 2016. Over the March quarter of 2018, it fell by 1.9 percent. The annual Real Effective Exchange Rate (REER) appreciated by 0.5 percent in the December quarter 2017, compared to a depreciation of 4.6 percent in the December quarter 2016, mainly due to the increase in domestic inflation relative to inflation in PNG's major trading partner countries. The appreciation in 2017 indicates that the competitiveness of PNG's exports has declined (See Chart 4).



Source: Bank of PNG

The Bank forecasts a growth of 6.3 percent in broad money supply for 2018, compared to a decline of 0.7 percent in 2017, due to an increase in net foreign assets of the banking system of 12.8 percent, while net domestic assets is projected to decline by 1.1 percent. The increase in net foreign assets is expected from higher export receipts due to improvement in prices and production of export commodities, mining and petroleum taxes and dividends, and inflows from external financing. Although private sector credit is expected to grow by 3.2 percent, a decline of 4.6 percent in net claims on the Central Government is expected to contribute to the overall decline in net domestic assets. The monetary base is projected to increase by 3.5 percent from a decline of 16.6 percent in 2017, influenced by the increase in net foreign assets. Given the projected turnaround in the monetary aggregates, the Bank considers the growth in broad money supply sufficient to support activity in the non-mineral sector and hence, the overall economic growth in 2018 (See Appendix Table 1).

2. Monetary Policy Stance

The Central Bank maintained its policy signaling rate, the monthly Kina Facility Rate (KFR), at 6.25 percent throughout 2017, and in the first quarter of 2018. In deciding the stance of policy, the Bank took into consideration the moderate global economic growth, downward trend in inflation, expectations of manageable headline inflation, and the relative stability of the kina exchange rate over the year. In 2018, inflationary pressures as indicated by the projected increase in underlying inflation measures will be mainly from the pass-through of the kina depreciation on imports. As a result, the headline inflation is projected to be around 5.0 percent, while the underlying inflation is projected at 3.5 percent for both trimmed mean and exclusion-based measures. In considering these developments and projections, the Central Bank will continue to maintain a neutral stance of monetary policy over the next six months. The Bank will closely monitor developments in inflation and other macroeconomic indicators and may adjust its stance as necessary.

3. Conduct of Monetary Policy

Monetary policy is managed within the reserve money framework to achieve the Central Bank's objective of maintaining price stability. This involves, managing liquidity to impact interest rates which would in turn affect economic activity and inflation. The MPS provides the overall policy stance, while the monthly policy rate signals this stance or any changes through an announcement by the Governor. Following the announcement, Open Market Operations (OMOs) are conducted to implement the policy stance. The OMOs involve the auction of Central Bank Bills (CBB), Treasury bills and Treasury bonds to Other Depository Corporations and the general public, and Repo transactions with commercial banks. The Bank will introduce changes to the Repo arrangement (See Box 1).

The Central Bank continued to use CBBs and Government securities as instruments to manage liquidity in the banking system, and did not make any change to the direct instrument of Cash Reserve Requirement (CRR).

Box 1: New Arrangement on Liquidity Management

The Repurchase Agreement Facility (Repo) was introduced to the market by the Central Bank in 2001 as an instrument for Open Market Operations. The objective of the Repo is to give short term loans to the commercial banks to meet their kina liquidity shortfall and to improve the transmission of monetary policy. Since then, the Repo arrangement between commercial banks and Bank of PNG is unsecured or uncollateralized. Vice versa with the Reverse Repo, the Central Bank diffused excess liquidity by borrowing from the commercial banks.

The Central Bank will be introducing a new arrangement to secure the borrowings under the Repo. The commercial banks will pledge their holdings of Government securities against the borrowing.

In the first quarter of 2018, the Bank has commenced making changes to its monetary policy instruments and liquidity arrangements. These changes involve:

a) termination of borrowing under the existing Intraday Liquidity Facility (ILF);
b) accessing the Cash Reserves Deposits (CRD) for intraday funding; and
c) pledging of Government securities as collateral to borrow under the Repo facility.

Under the new operational arrangement, the CRD now replaces the ILF. The CRD will be made accessible only to fund any shortfalls in the Exchange Settlement Accounts (ESAs) on an intraday by the commercial banks. This funding of the ESA constitutes borrowing from the Central Bank. In the event that the ESA for a commercial bank is still negative before KATS closes at the end of the day, these borrowings will be transformed into a Repo. The Repo Facility will be available for up to 30 days. Conversely, a Reverse Repo will involve the Central Bank pledging its securities to diffuse liquidity from the commercial banks for monetary policy purposes.

The pricing arrangement of the Repos remains unchanged. The Repos will be priced at the KFR and a margin.

Appendix

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

INDICTOR	2015 (actual)	2016 (actual)	Sept 2017 (MPS)	Actual to Dec 2017	2018 (proj)	2019 (proj)	2020 (proj)
Broad Money Supply	8.0	10.9	8.0	-0.7	6.3	5.9	5.8
Monetary Base	-2.2	24.4	7.3	-16.6	3.5	4.5	3.4
Claims on the Private Sector	3.4	6.9	2.5	-3.4	3.2	2.2	2.0
Net Claims on Government	40.1	49.6	15.1	9.5	-4.6	-2.7	-2.3
Net Foreign Assets	-8.4	-18.1	3.9	8.2	12.8	25.3	35.6

Source: Bank of PNG

Table 2: Summary of Other Macroeconomic Indicators

INDICATOR	2015 (actual)	2016 (actual)	Sept 2017 (MPS)	Actual to Dec 2017	2018 (proj)	2019 (proj)	2020 (proj)
CONSUMER PRICE INDEX (annual % changes)							
Headline	6.4	6.6	6.0	4.7	5.0	4.5	4.0
Trimmed-mean	2.3	1.9	3.0	2.3	3.5	3.5	3.0
Exclusion- based	1.4	2.2	2.5	4.4	3.5	3.5	3.0
BALANCE OF PAYMENTS (kina millions)							
Current account	13,392	16,650	18,917	19,826	20,219	20,668	19,838
Capital & Financial account	-14,188	-16,623	-18,803	-19,433	-18,705	-20,129	-18,104
Overall balance	-753	31	114	350	1,533	539	1,734
Gross International Reserves	5,227	5,257	5,450	5,608	7,141	7,679	9,413
IMPORT COVER (months)[1]							
Total	10.0	7.2	6.2	5.9	6.9	7.2	8.6
Non-mineral	15.8	12.6	9.8	9.7	13.8	13.6	15.8
EXPORT PRICE							
Crude oil (US$/barrel)*	51.6	42.1	54.0	54.1	55.7	57.6	57.4
Gold (US$/ounce)	1,147.6	1,199.2	1,239.1	1,227.6	1,231.3	1,232.5	1,233.8
Copper (USc/pound)	262.4	227.4	258.1	274.7	272.2	269.9	267.9
Nickel (US$/tonne)	11,568.9	9,521.9	9,920.8	10,192.8	10,381.1	10,634.4	10,897.3
Cobalt (US$/tonne)	28,178.0	25,725.1	46,038.5	55,901.2	60,373.3	64,599.4	69,767.3
LNG (US$/ mmbtu)	9.7	6.8	8.5	7.9	7.9	7.8	7.7
Condensate (US$/barrel)	51.0	50.7	53.8	54.8	54.2	53.4	53.0
FISCAL OPERATIONS OF THE GOVERNMENT**							
Surplus/Deficit (K'm)	-2,785.7	-3,086.9	-1,876.6	-1,794.7	-1,987.2	-1,897.4	-1,675.7
% of GDP	-4.5	-4.6	-2.5	-2.4	-2.5	-2.2	-1.8
REAL GROSS DOMESTIC PRODUCT (annual % growth) ***							
Total GDP	10.5	2.0	2.7	2.2	2.4	2.2	2.0
Non-mineral GDP	0.7	0.7	3.0	1.9	3.5	3.5	3.6

Source: Bank of PNG, NSO and Department of Treasury

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

** 2017 figures are from the 2017 Final Budget Outcome, while 2018 - 2020 projections are from the 2018 National Budget.

*** GDP figures for 2015 to 2020 are from the 2018 National Budget.

[1] The calculation of the import covers includes import of both goods and services as of 2016.

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