BANK OF PAPUA NEW GUINEA

MONETARY POLICY STATEMENT
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PORT MORESBY

31st March 2022

Objectives of the Central Bank (*Section 7, Central Banking Act 2000* (as amended in 2021))

"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 promoting employment and economic growth, especially of the non-mineral and non-petroleum sector; and
b) to formulate financial regulation and prudential standards to ensure stability and development of the financial system in Papua New Guinea; and
c) to promote an efficient national and international payments system; and
d) to provide efficient and responsive banking services to the Government."

Objectives of Monetary Policy

The objectives of monetary policy in Papua New Guinea (PNG) are to achieve and maintain price stability and promoting employment and economic growth, especially of the non-mineral sector. Price stability entails stable inflation, interest and exchange rates, while at the same time creating an enabling environment for growth and employment in the economy. This implies finding a balance between the optimal economic growth path for creating employment in the non-mineral sector, with a tolerable level of inflation.

Executive Summary

The recovery in economic activity in 2021 from the ongoing COVID-19 Pandemic is expected to continue in 2022. However, the challenges from the pandemic, supply-chain disruptions, high oil prices and inflation, and the current Russia-Ukraine war could derail the recovery. The war, if prolonged, could benefit PNG from increased mineral prices, while higher imported prices could lead to rising domestic costs.

The Bank of PNG (the Bank) projects real Gross Domestic Product (GDP) growth to further pick-up in 2022 reflecting increased activity in both the mineral (including mining, oil and gas) and non-mineral sectors. In the medium term, growth is expected to continue mainly reflecting the reopening of the Porgera mine. To build resilience and support overall growth, the Government is encouraged to prudently manage its fiscal operations and fast-track structural reforms to assist activity and growth.

The amendments in December 2021 to the *Central Banking Act (CBA) 2000*, have broadened the objectives of the Central Bank to include employment and economic growth, and efficient and responsive banking services to the Government. It has also allowed for improvement in the governance framework and increased financing to the Government. The amendments allow for fiscal dominance over monetary policy where BPNG can now fund Government Budget deficit and poses the challenge for monetary policy to pursue these multiple objectives.

The Government continues its expansionary fiscal policy in 2022 with a Budget deficit to be financed mainly from external sources. The level of debt is projected to increase further, raising concerns about debt sustainability. Therefore, the Bank encourages the Government to adhere to its Medium-Term Fiscal Strategy including managing debt to avoid any debt distress and threat to macroeconomic stability.

The Bank projects Balance of Payments (BOP) surpluses in 2022 and in the medium term due to surpluses in the current account. However, most of the surpluses in the current account, mainly from mineral export receipts do not flow back into the domestic economy as allowed for under their respective Project Development Agreements (PDAs). For the country to benefit, the State should review the current regime governing the PDAs to maximize gains to the nation.

The Bank forecasts annual headline inflation to remain elevated in 2022. The imported inflation from higher crude oil and food prices would be largely responsible for domestic inflationary pressures. Over the medium term, inflation is expected to ease.

The projected growth in total money supply is mainly driven by the expansionary fiscal policy contributing to high liquidity in the banking system. Private sector credit and monetary base are projected to increase in 2022 to support the recovery in the non-mineral sector. In the medium term, increase in monetary aggregates will moderate reflecting the Government's fiscal consolidation strategy.

In view of the projected developments in the global economy and macroeconomic indicators, the Bank will maintain the accommodative stance of monetary policy for the next six months to September 2022 to support the economic recovery. It will continue to monitor the ongoing concerns of high inflation and its impact on growth and employment as well as developments in other macroeconomic indicators. The Bank may adjust its stance of policy if required to achieve its objectives, and ensure macroeconomic stability.

1. Developments, Issues and Projections

The global economy recovered in 2021 following the easing in COVID-19 restriction measures and rollout of vaccination programs. There was recovery in the non-mineral sector in PNG, while activity in the mineral sector declined. The global economic recovery is expected to continue in 2022 from the impact of the COVID-19 pandemic, while concerns remain on the emergence of new variants, high fuel costs and rising inflationary pressures. The current Russia-Ukraine war will also impact on prices and growth. Economic growth is expected for PNG in 2022, driven by increased activity in both the mineral and non-mineral sectors. The Government's continued expansionary fiscal policy will incur additional public debt and therefore spending should be directed to key development priorities especially on infrastructure and economic sectors. Uncertainties relating to the ongoing impact of the COVID-19 pandemic and low vaccination rate may continue to affect domestic economic activity.

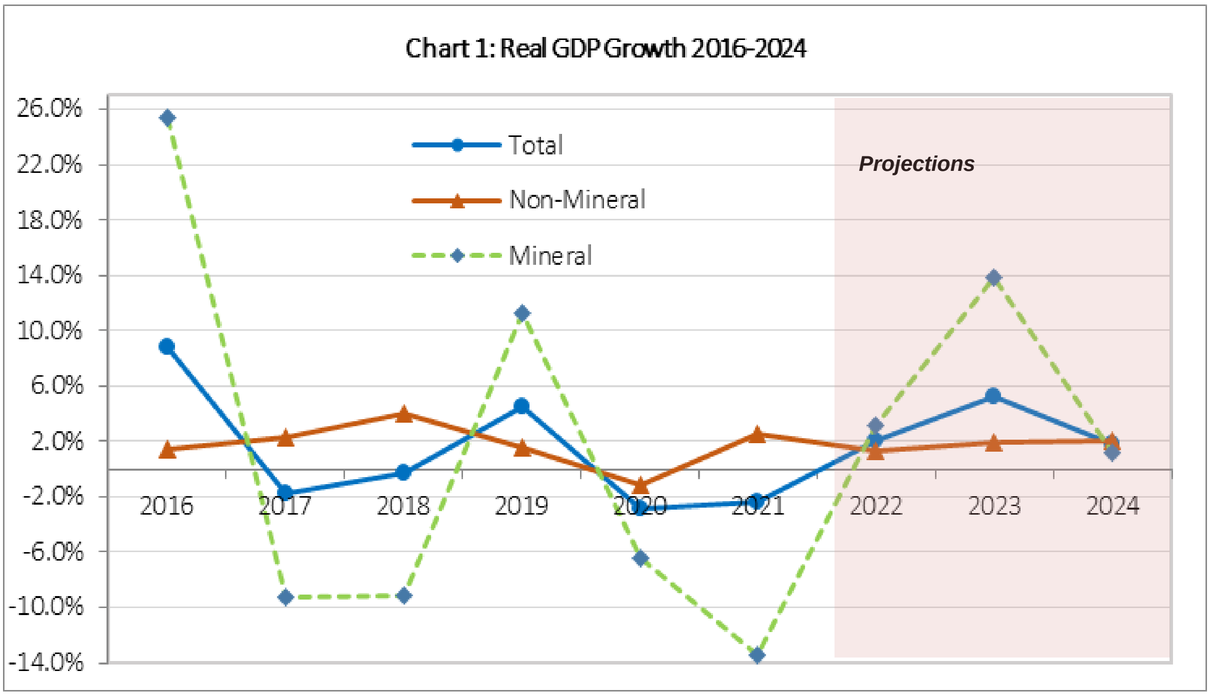
The *CBA 2000* was amended by Parliament and gazetted in December 2021 (see Box 1). The amendments entailed changes to the Central Bank's objectives, and governance, accountability and transparency arrangements, as well as increased Government financing, including during an emergency. The amendments pose a challenge to the Bank of PNG in finding a balance in achieving the multiple monetary policy objectives.

The global economic growth is estimated to be 5.9 percent in 2021, according to the International Monetary Fund's (IMF) *World Economic Outlook Update* of January 2022, even though COVID-19 cases resurged. The recovery in the advanced economies was driven by their fiscal stimulus packages, accommodative monetary policies and easing of restrictive measures mainly on trade and travel following the rollout of vaccination programs. The recovery in the emerging markets and developing economies continued to be impacted by low vaccination rates, disruptions to supply chains and China's financially distressed real estate sector. For 2022, the IMF forecasts a growth of 4.4 percent given the ongoing impact of COVID-19 and supply-chain disruptions.

The current Russia-Ukraine war is having a major impact on the global economy. Russia and Ukraine are major producers and suppliers of various mineral commodities, including crude oil, natural gas and gold, and food items such as grains and vegetable oils. Disruptions to production and supply of these commodities, combined with the sanctions imposed against Russia would impact on global supply and prices. This poses a downside risk to the global growth forecast for 2022. PNG stands to benefit from the higher prices of the mineral commodities, while the increase in oil price and imported inflation would result in higher domestic costs if the war drags on.

In 2021, economic activity in PNG is estimated by Bank of PNG to have declined by 2.4 percent, mainly reflecting a decline in production in the mineral sector. The non-mineral sector however, grew by 2.5 percent reflecting higher production and international prices of most export commodities, easing in restriction measures of the COVID-19 pandemic and the Government's expansionary fiscal policy. The Bank projects real GDP to grow by around 2.0 percent in 2022 (see Chart 1), mainly reflecting higher international prices and production for most export commodities. These, including higher Government expenditure, are expected to drive growth in the agriculture and other non-mineral sectors of the economy, especially the transportation, wholesale and retail sectors. Growth in the mineral sector is driven mainly by increase in gold and copper productions in 2022. The latest data from the Bank's Business Sentiment Survey also show that employment and sales are expected to increase in 2022.

For the medium term, the Bank expects growth to increase in 2023 mainly reflecting the reopening of the Porgera gold mine, and to moderate thereafter. To support growth, the Government should effectively implement its various programs, especially in the non-mineral sector, such as the agriculture freight subsidy and price support schemes, and development of the Micro, Small and Medium Enterprise sector. It should also increase its support to the agriculture/forestry/fishing (AFF) sector, especially the activities to increase export receipts and inflows of foreign exchange. The downside risks to these forecasts are the further delay in the resumption of Porgera gold mine, new COVID-19 variants, low vaccination rate throughout the country, reintroduction of containment measures, and the various ongoing geo-political tensions.



Source: NSO (actuals to 2019), BPNG estimates for 2020 & 2021 and projections for 2022-2024

The fiscal operations of the Government in 2021 improved mainly due to higher commodity prices and easing of COVID-19 restrictions. The higher than expected revenue resulted in a Supplementary Budget, which was passed in November 2021. The preliminary fiscal outcome for the eleven months to November 2021 showed a deficit of K3,398.1 million, lower than the deficit of K5,638.4 million in the corresponding period of 2020. The deficit was financed from both domestic sources of K2,956.7 million and external sources of K441.5 million.

The 2022 National Budget has a planned expenditure of K22,174.8 million and revenue and grants of K16,190.2 million, resulting in a deficit of K5,984.7 million. The deficit equates to 5.9 percent of projected 2022 nominal GDP. To finance it, the Government plans to raise K3,744.7 million in net external borrowing and K2,240.0 million domestically. Of the total net external financing, K708.2 million is from concessional sources and K3,056.2 million is from extraordinary sources, offsetting a net repayment of K19.7 million to commercial sources. The sources of most of the external extraordinary financing are yet to be identified. It is therefore important that the Government improve its revenue raising efforts and prudently manages its expenditures. Further increases to the crude oil and natural gas prices, in the event that the Russia-Ukraine war is prolonged, may have a positive impact on Government revenue. On the other hand, the increase in these prices and imported inflation may have the opposite effect.

Over the medium and long term, the Government should also continue to implement its Medium-Term Fiscal and Revenue Strategies to achieve a balanced budget.

Total public debt is projected to be K52,756.2 million at the end of 2022, compared to K46,781.2 million in 2021. This is 51.9 percent of the projected 2022 nominal GDP. While this debt level is below the 60.0 percent debt-to-GDP ratio allowed under the *Fiscal Responsibility Act*, the Government should ensure its borrowings are put to productive use to stimulate growth. The Bank encourages the Government to adhere to its Medium-Term Debt Strategy, which would lead to sustainable debt levels and avoid any debt distress.

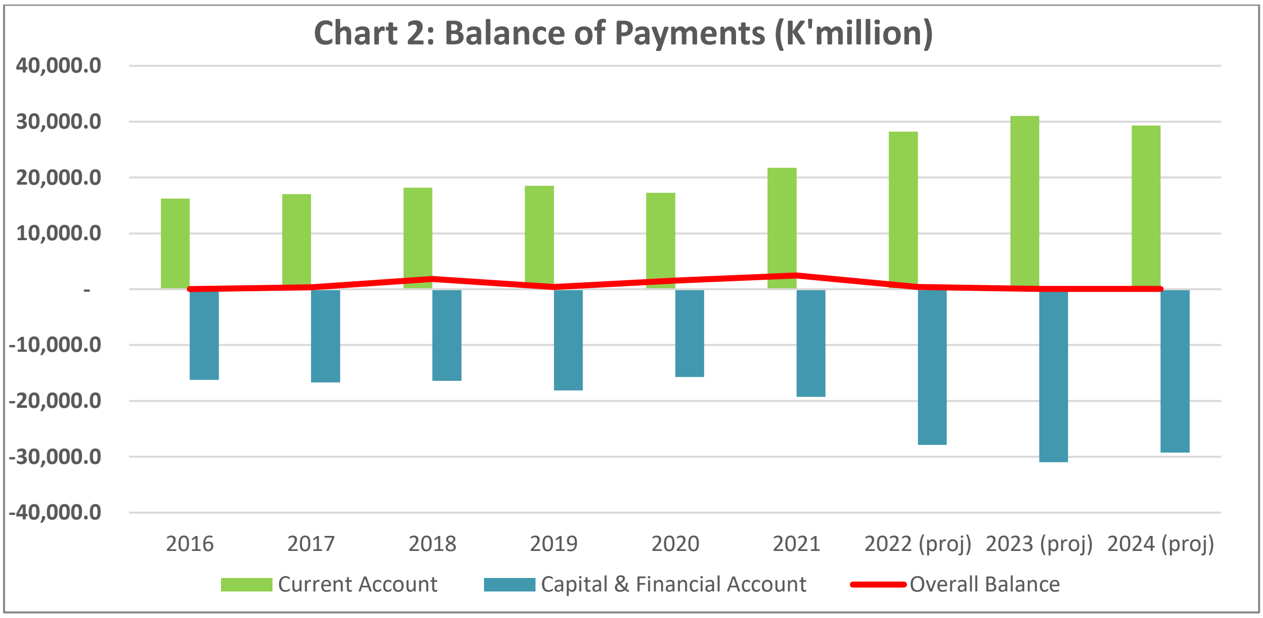
The Government agreed to a second IMF Staff Monitored Program (SMP) to run for six months from December 2021. The program builds on from the initiatives undertaken in the first SMP that would help achieve macroeconomic stability. These initiatives include improving revenue collection, management of tax arrears, improving expenditure control and cash-flow management, strengthening liquidity management and budget execution, minimise risk to fiscal and financial stability and fast-tracking State Owned Enterprise (SOE) reforms. Over the medium term, these would enable the Government to align expenditure to revenue, increase capital expenditure and reduce debt to sustainable levels. The Bank met its targets under the program (foreign exchange reserve levels, intervention amount and zero monetary financing of the budget) by the test date of December 2021.

PNG has not adequately benefited from revenues generated and foreign exchange inflows, under the current ownership and development arrangements in the extractive resource sector. Going forward, the Government needs to introduce relevant policies and legislations to change the arrangements under which the extractive resource sector operates. These include enactment of the Production Sharing Arrangements Bill, which will ensure the State gets its revenue share upfront rather than after profits are declared. It should also include strengthening the capacity of State regulatory agencies and passing other related legislations. The Government should ensure its SOEs in the extractive industry are properly set up to operate commercially as a contractor with proper governance, transparency and accountability framework. The revenue and foreign exchange generated from the extractive sector can be used to develop the non-resource sector, especially the AFF sector, through the budgetary process. The Government should also expedite the reforms to the SOEs (non-mineral sector) to improve efficiency in service delivery and revenue generation.

The preliminary overall BOP recorded a surplus of K2,466.1 million in 2021 (see Chart 2). The outcome was due to a surplus in the current account, which more than offset a deficit in the capital and financial account. The outcome in the current account was mainly driven by a surplus in the trade account as a result of higher production and international prices of major export commodities. The outcome in the capital and financial account was mainly due to higher net balances in offshore foreign currency accounts of mineral companies allowed under their respective PDAs and repayments of debt by the mineral companies and the Government.

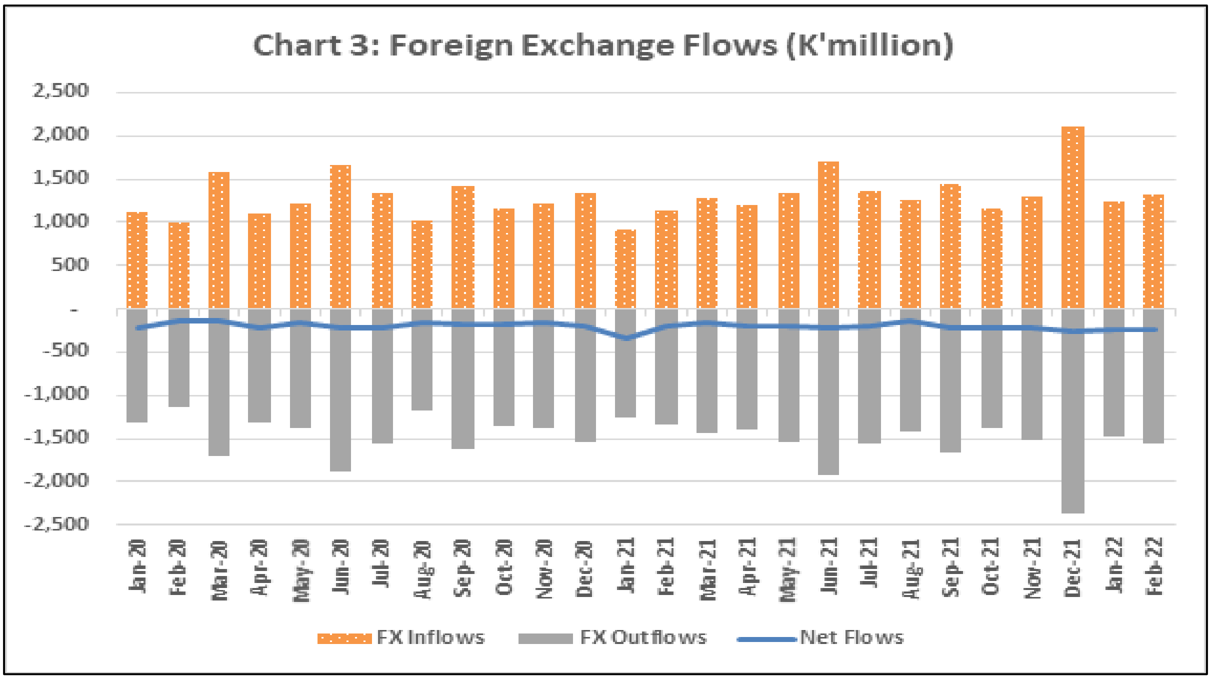
The Bank projects a BOP surplus of K389.6 million for 2022, with a surplus in the current account more than offsetting a deficit in the capital and financial account. The current account is projected to have a surplus of K28,286.3 million, reflecting higher international prices and production of most export commodities. The capital and financial account is projected to have a deficit of K27,846.7 million, mainly reflecting debt servicing by the PNG LNG Project partners and Government. In the medium term, the Bank projects surpluses in the overall BOP, with surpluses in the current account more than offsetting deficits in the capital and financial account (see Chart 2). This outlook includes the reopening of the Porgera gold mine. It would improve further if the other major extractive projects in the pipeline come on stream, combined with higher than expected prices of major export commodities.

As at 31st December 2021, the gross foreign reserves of the Central Bank was US$3,240.1 (K11,368.7) million, compared to US$2,689.8 (K9,437.9) million at the end of December 2020. This level can cover 9.1 months of total and 15.9 months of non-mineral imports. As at 25th March 2022, the gross foreign exchange reserves decreased to US$3,107.7 (K10,753.4) million.



Source: Bank of PNG

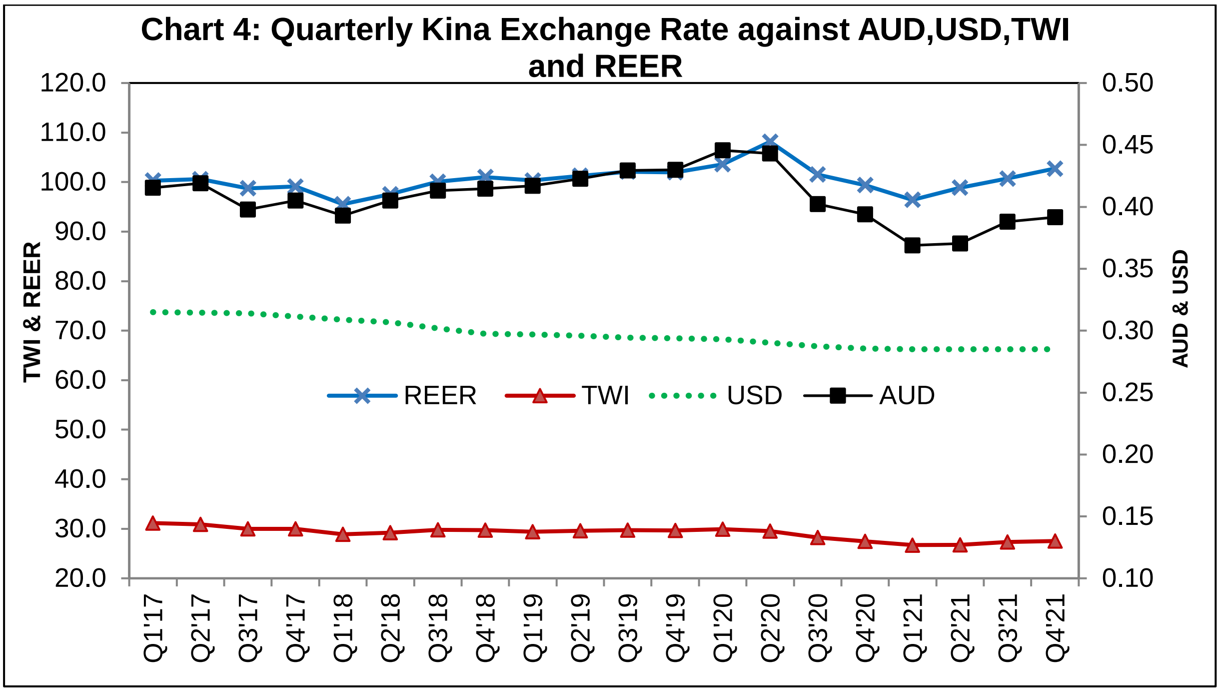
Total foreign exchange (FX) inflows in 2021 was K22,655.2 (US$6,456.7) million. Of this, K4,922.8 (US$1,403.0) million was Government external borrowing for Budget financing that came through the Central Bank and K17,732.4 (US$5,053.7) million were flows from exports and other receipts by the private sector through the domestic market. The total demand in the FX market which includes the total outflow of K18,812.1 (US$5,361.4) million, plus the total outstanding orders of K1,063.8 (US$303.1) million amounted to K19,875.9 (US$5,664.6) million. The market supply of FX was not sufficient to meet the demand, hence the intervention by the Central Bank of K2,329.1 (US$663.8) million to assist the market. The supply of FX to the domestic market by the private sector was mainly from the mining, business and finance, AFF and petroleum sectors, while the demand was mainly from the retail, business and finance (including communication), manufacturing and transport sectors (see Chart 3). While high import orders continue to feature prominently in the FX market, most of these orders have a normal clearing timeframe of three months for settlement after the imports reach the shores of PNG or from the invoice date. These are not considered as backlog, but are orders that need to be met within the invoice timeframe. The authorized FX dealers will continue to allocate, including the FX provided to them by the Central Bank, where necessary to ensure equitable distribution to all importers. The Bank is committed to ensure that the FX market will continue to function and orders are met within a reasonable timeframe. The Bank is also mindful of the imbalance between FX inflows and outflows. The high future demands for FX and loan repayment obligations would have a call on the FX reserves and therefore will require prudent management of the reserves.



Source: Bank of PNG

The kina exchange rate was stable against US dollar (USD) at US$0.2850, while it appreciated against the Australian dollar (AUD) by 6.2 percent to A$0.3928 in 2021. Between the end of December 2021 and 25th March 2022, it depreciated against the USD by 10 basis points to US$0.2840, reflecting continued high import demand. Against the Australian dollar, the kina depreciated to A$0.3773 from A$0.3928, over the same period mainly reflecting cross currency movements, with the AUD appreciating against the USD.

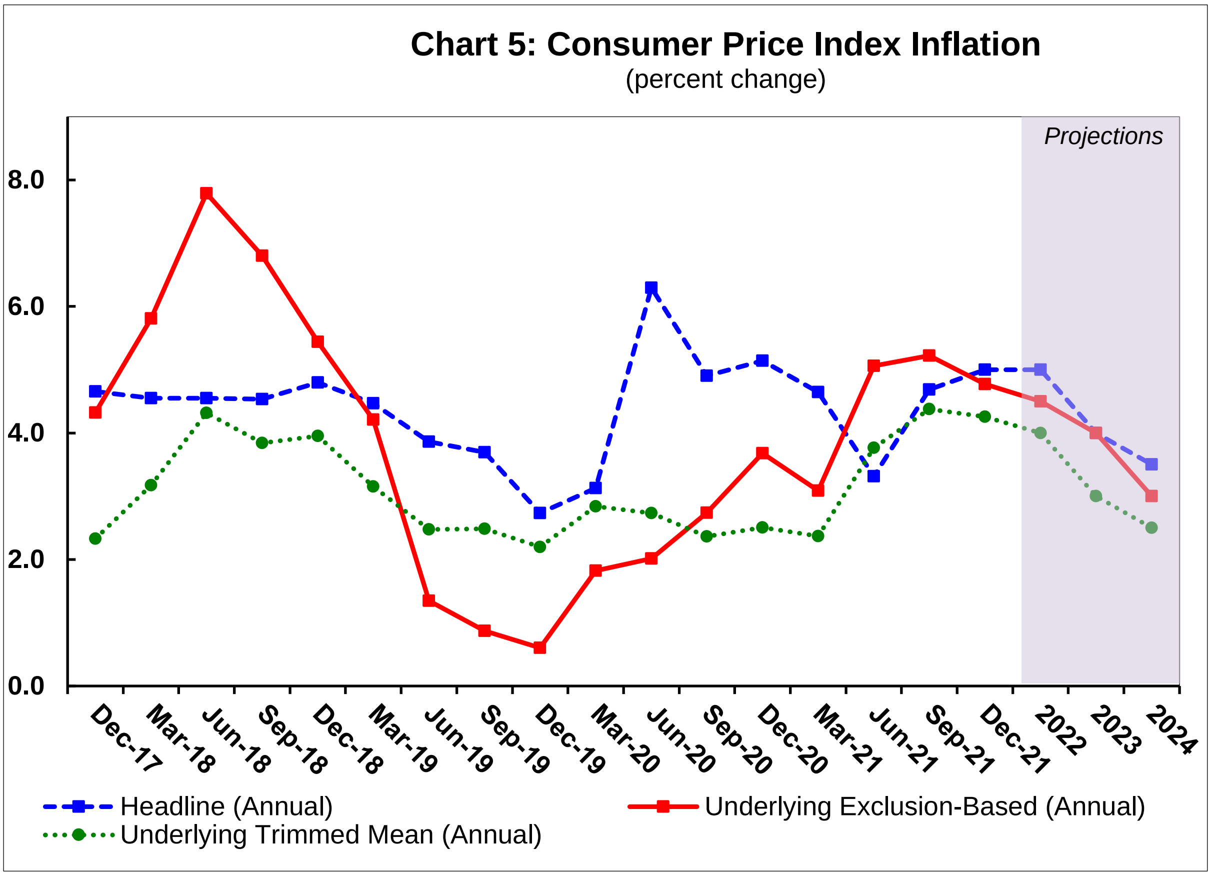
The annual Trade Weighted Index (TWI) increased by 0.2 percent in the December quarter of 2021, compared to a decline of 7.4 percent in the December quarter of 2020. The increase reflected the appreciation of kina against the currencies of PNG’s major trading partners, notably the Japanese Yen (JPY), while it depreciated marginally against AUD and USD. The annual Real Effective Exchange Rate (REER) appreciated by 3.4 percent in the December quarter of 2021, compared to a depreciation of 2.6 percent in the December quarter of 2020 (see Chart 4). This outcome was due largely to the appreciation of kina exchange rate against the JPY combined with higher domestic inflation relative to foreign inflation. The increase in the REER indicates a deterioration in the competitiveness of PNG's exports.



Source: Bank of PNG

Annual headline inflation outcome in the December quarter of 2021, as measured by the Consumer Price Index (CPI) and released by the National Statistical Office (NSO), was 5.7 percent, compared to 5.1 percent in the December quarter of 2020. Inflation in 2021 mainly reflected higher prices in the "food and non-alcoholic beverages", "alcoholic beverages, tobacco and betelnut", "household equipment", "transport" and "education" expenditure groups. This was mainly a result of an increase in imported inflation due to the ongoing impact of the COVID-19 pandemic and supply chain disruptions, and higher demand stemming from the fiscal stimulus packages. The annual underlying trimmed mean and exclusion-based measures were 4.3 percent and 4.8 percent, respectively.

The Bank forecasts annual headline inflation to be around 5.0 percent in 2022, driven by expectations of higher imported inflation, especially in crude oil and food prices, exacerbated by the impact of the Russia–Ukraine war (see Chart 5). The underlying inflation measures are also projected to increase. The upside risks to these projections would include increased COVID-19 infections due to the low rate of vaccination in PNG and any Government restrictions to contain the pandemic. Further depreciation of the kina, and a protracted Russia-Ukraine war will also contribute to the upside risk. Over the medium term, the headline inflation forecast is expected to ease to around 3.5 percent.



Source: Bank of PNG

Broad money supply increased by 11.8 percent in 2021. This was due to increases of 8.7 percent and 13.5 percent in Net Foreign Assets (NFA) and Net Domestic Assets (NDA), respectively. The increase in NFA mainly reflected proceeds from external borrowing for the 2021 National Budget. The increase in NDA was attributed to higher net claims on Central Government, reflecting increase in holdings of Government securities. Deposits at commercial banks have increased significantly driven by Government expenditure. The high liquidity did not translate into increased private sector credit (PSC). However, there was continued use of overdraft lending facilities by firms to sustain their operations. The high liquidity was mainly used to purchase Government securities and FX. The low demand for credit reflect the uncertainties with the recovery due to ongoing issues around the COVID-19 pandemic, and high cost of borrowing and doing business.

The Bank forecasts an increase of 14.7 percent in broad money supply for 2022, with increases in NDA of 6.9 percent, and 21.5 percent in NFA. The increase in NDA reflects increases of 12.7 percent and 3.4 percent in net claims on Central Government and PSC, respectively. The increase in net claims on Central Government reflects Government debt issuance. The growth in the PSC is associated with the pick-up in economic activity. External financing for the Budget is the main factor driving the increase in NFA. With these projections, the monetary base is expected to increase by 6.6 percent in 2022.

2. Monetary Policy Stance

In view of the projected developments in the global economy and macroeconomic indicators, the Bank will maintain the accommodative stance of monetary policy in the next six months to September 2022 to support the ongoing economic recovery. It will continue to monitor the ongoing concerns of high inflation and its impact on growth and employment as well as developments in other macroeconomic indicators. The Bank may adjust its stance of policy if required to achieve its objectives, and ensure macroeconomic stability.

3. Conduct of Monetary Policy

Monetary policy is implemented through the reserve money framework with the aim of influencing domestic market interest rates to align with the policy rate, the Kina Facility Rate (KFR). This involves managing liquidity in the banking system through Open Market Operations to influence interest rates to achieve price stability and create an enabling environment for economic growth and employment. The Bank will consider appropriate indicators or proxies to assess the outcomes its policy stance on the additional objectives of employment and growth.

The Monetary Policy Statement provides the overall policy stance for the next six months, while the monthly KFR signals this stance by the Bank.

Box 1: The *Central Banking Act 2000* (as amended in 2021)

1. Introduction

In Phase 1 of the Central Bank Review, the Government in December 2021 amended the *CBA 2000* after twenty years of it being in operation. The amendments entailed changes to the Central Bank's objectives, governance, accountability and transparency arrangements, and government financing, including for a national emergency. The key changes in the Amended *CBA 2000*, exclusive to monetary policy, and their implications are summarized herein.

2. Key amendments

The objectives of monetary policy now include promoting employment and economic growth in the non-mineral and non-petroleum sector, in addition to price stability. The objective of regulating the financial system now include encouraging its development. A new objective was added on covering efficient and responsive banking services to the Government.

A new Board, comprising members with professional experience, was appointed by the National Executive Council and will have greater oversight of the Bank's policy decision making and operations, based on a collegial approach. Various Board committees such as Audit & Risk, Governance and Budget & Investments will assist in this process to enhance accountability and transparency. The Board is responsible for the Monetary Policy decisions and other policies, and not solely the Governor.

The method of calculating BPNG's advances to Government under the Temporary Advance Facility of using the past three-years average revenue and grants now include loans. There is also a limit on Central Bank's holdings of Government securities of 25.0 percent based on the past three-years average revenues, grants and loans. This limit may go up to 40.0 percent in the event of a national emergency.

The term of office of the Governor and Deputy Governor(s) was reduced to a four-year term with the option of one additional term.

The amendments require increased liaison between the Central Bank and Treasury Department as two key Government agencies responsible for macroeconomic policy design and implementation.

3. Implications of the amendments

i. Competing monetary policy objectives

The amendments with the new objectives of monetary policy may be competing at times. For example, a trade-off may arise between achieving price stability, and promoting employment and growth. The challenge for BPNG will be to find the balance or appropriate trade-offs between these objectives.

ii. Monetary Policy Tools

The Bank will have to look into the appropriate monetary policy tools to implement policy in line with the objectives of price stability, employment and growth. PNG does not have comprehensive and timely employment and GDP indicators to assess the effectiveness of monetary policy on them on a frequent and regular basis. The Bank will consider appropriate indicators or proxies to assess its policy stance on the additional objectives.

iii. Fiscal dominance

The amendments allow for fiscal dominance over monetary policy where BPNG can now fund Government Budget deficit. This is as opposed to previously where purchases of Government securities by BPNG was only for monetary policy purposes.

Phase 2 of the Central Bank Review will cover broader areas of financial systems development, the Board Monetary Policy Committee, payments system and other related matters. The Bank is working with the Government to complete this review.

Appendix

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

INDICATORS	2019 (Actual)	2020 (Actual)	2021 (Actual)	2022 (Proj)	2023 (Proj)	2024 (Proj)
Broad Money Supply	4.4	7.0	11.8	14.7	7.0	4.0
Monetary Base	12.7	2.2	10.8	6.6	7.4	4.6
Claims on Private Sector	4.0	4.3	0.4	3.4	4.7	4.6
Net Claims on Government	6.4	3.2	33.0	12.7	20.0	11.4
Net Foreign Assets	9.3	19.5	8.7	21.5	17.8	-6.0

Table 2: Summary of Other Macroeconomic Indicators

INDICATORS	2019 (Actual)	2020 (Actual)	2021 (Actual)	2022 (Proj)	2023 (Proj)	2024 (Proj)
CONSUMER PRICE INDEX (CPI) (annual % changes)						
Headline	2.7	5.1	5.7	5.0	4.0	3.5
Trimmed mean	2.2	2.5	4.3	4.0	3.0	2.0
Exclusion-based	0.5	3.7	4.8	4.5	4.0	3.0
BALANCE OF PAYMENTS (kina millions)						
Current Account	18,522.2	17,255.6	21,722.8	28,236.3	31,006.8	29,298.2
Capital & Financial Account	-18,119.0	-15.710.0	-19,256.3	-27,846.7	-30,970.9	-29,262.4
Overall Balance	423.0	1,557.9	2,466.1	389.6	35.9	35.8
Gross International Reserves	7,880.0	9,437.9	11,368.7	11,990.1	12,025.9	12,061.7
IMPORT COVER (months)						
Total	5.0	7.4	9.1	8.5	8.1	7.7
Non-mineral	8.2	11.8	15.9	15.3	14.0	12.9
Crude Oil (US$/barrel)	62.5	38.8	65.8	77.0	77.5	70.9
Gold (US$/ounce)	1,340.6	1,677.1	1,784.7	1,739.9	1,720.1	1,708.9
Copper (USc/pound)	270.5	273.8	433.0	409.7	381.8	349.2
Nickel (US$/tonne)	14,311.7	13,270.7	18,106.1	17,372.0	16,638.0	16,717.5
Cobalt (US$/tonne)	32,185.0	29,911.5	47,622.9	45,692.2	43,761.6	43,970.5
LNG (US$/mmbtu)	10.5	7.3	11.0	10.6	9.3	9.1
Condensate (US$/barrel)	62.1	38.3	69.0	73.0	64.1	64.5
FISCAL OPERATIONS OF THE GOVERNMENT*						
Surplus/Deficit (K'million)	-4,172.1	-7,304.4	-6,612.8	-5,984.7	-4,785.1	-3,798.7
% of GDP	-5.0	-8.9	-7.1	-5.9	-4.4	-3.3
REAL GROSS DOMESTIC PRODUCT (annual % growth)**						
Total GDP	4.5	-2.8	-2.4	2.0	4.5	2.0
Non-mineral GDP	1.6	-1.1	2.5	1.3	2.0	2.0

Source: Bank of PNG, NSO and Department of Treasury
**Projections for 2021, 2022 and the medium term are from the 2022 National Budget.*
***NSO (2019 actual), BPNG estimates for 2020 and 2021 and projections for 2022-2024.*

Queries on the contents of the Monetary Policy Statement (MPS) should be directed to the Manager, Economics Department on telephone number (675) 3227309 or Manager, Monetary Policy Unit on telephone number (675) 3227312 or email info@bankpng.gov.pg. Copies of the Statement can be obtained from the Economics Department and are also available on the Bank's website: https://www.bankpng.gov.pg. It will be reproduced in the March 2022 issue of the Quarterly Economic Bulletin (QEB).