



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, 2012

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 is also available on the Bank's website: <http://www.bankpng.gov.pg>. It will be reproduced in the September 2012 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

In the first half of 2012, PNG continued to experience high economic growth, as indicated by increased employment and value of sales by the private sector. Whilst economic activity was high, the appreciation of the kina, combined with low imported inflation, led to a low inflation outcome of 1.4 percent over the year to June 2012. The Central Bank therefore eased its monetary policy stance in September 2012.

Real Gross Domestic Product (GDP) is projected by the Bank of Papua New Guinea (BPNG) to grow broadly in line with Government's forecast of 9.9 percent in 2012, as the construction of the PNG LNG project reaches its peak, commencement of production at the Ramu Nickel/Cobalt mine and increased Government expenditure. All sectors of the economy are expected to grow, led by the building and construction sector, while the petroleum sector is projected to fall due to the decline in oil reserves and production.

The Bank revised downwards its projected annual headline inflation for 2012 to be around 3.0 percent and both the exclusion-based and trimmed mean measures to be around 3.5 percent. The revisions reflect the lower inflation outcomes for the first two quarters of the year and the pass-through effect of the appreciation of the kina in the past twelve months.

PNG continues to experience high levels of liquidity as a result of the build-up in foreign reserves, largely from mineral tax receipts, as well as foreign exchange inflows related to the PNG LNG project and other private foreign direct investment.

The overall balance of payments is projected to be in surplus by K1,134.6 million in 2012. This outcome reflects investment inflows associated with the PNG LNG project and foreign direct investments by the private sector. By the end of 2012, the gross foreign exchange reserves are projected to be around US\$4,349.0 (K9,049.1) million, sufficient for 6.6 months of total and 19.4 months of non-mineral import covers.

In 2012, broad money supply is expected to increase by 13.3 percent, driven mainly by an increase in Net Foreign Assets (NFA) of the banking system. Monetary base and private sector credit are projected to grow by 32.6 percent and 10.1 percent, respectively.

The Government projects a deficit of K513.1 million for 2012 in its Mid-Year Economic and Fiscal Outlook (MYEFO), compared to a balanced budget projected in the 2012 National Budget approved by Parliament. The deficit is mainly due to lower than expected revenue forecast reflecting a fall in international commodity prices. The Government should prudently manage its budget now that revenues are declining. Past experience shows that financing the budget deficit through domestic debt issuance has had an inflationary impact.

The Bank is mindful of the projected strong domestic economic growth in 2012 and its potential impact on inflation. It is therefore important that the close coordination and cooperation between fiscal and monetary policies continue to ensure macroeconomic stability is maintained.

The Bank will maintain its policy monetary stance for the next six months, but may adjust it if economic and/or financial market developments warrant it.

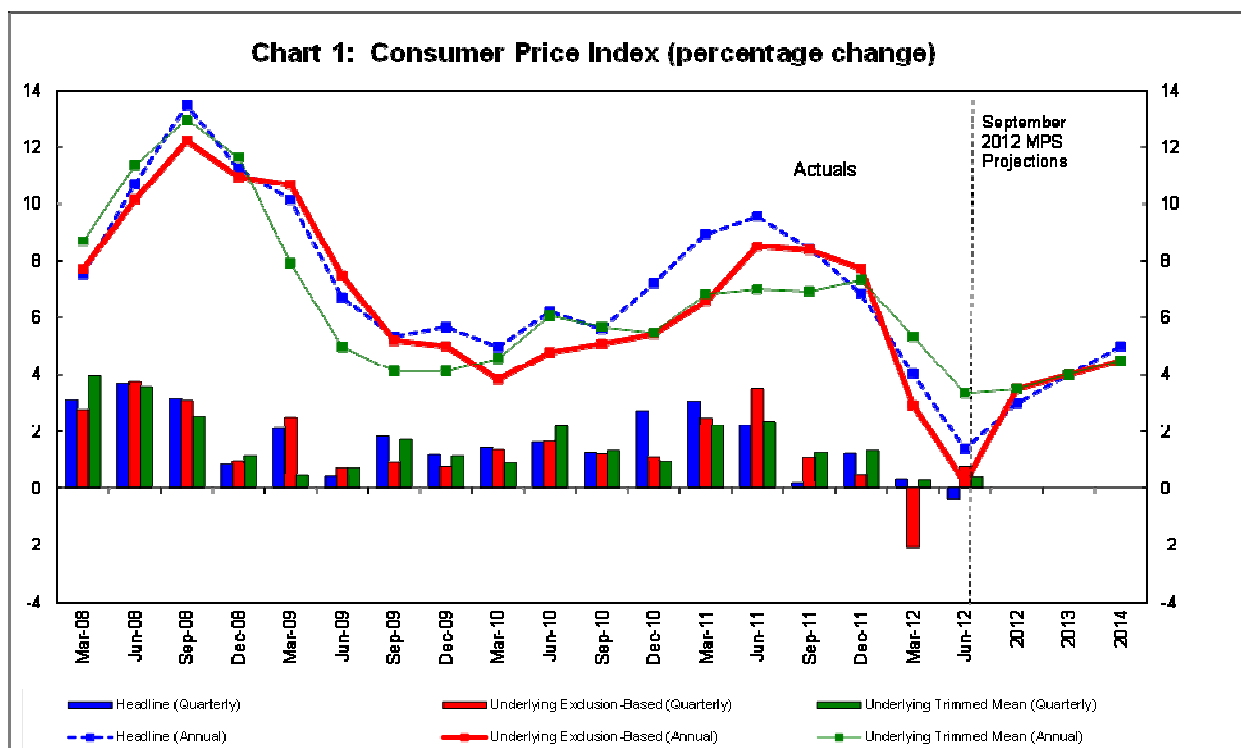
1.0 Monetary Policy Discussions

1.1 Monetary Policy Assessment, Issues and Expectations

Whilst economic activity was high in the first half of this year, the appreciation of the kina, combined with low imported inflation, led to a low inflation outcome of 1.4 percent over the year to June 2012. The Central Bank therefore eased its monetary policy stance in September 2012.

The Bank revised downwards its annual headline inflation projection for 2012 to around 3.0 percent. The trimmed-mean and exclusion-based inflation measures were also revised downwards to around 3.5 percent each. Inflation in PNG's major trading partners eased significantly. The pass-through effects on inflation of lower international food prices and appreciation of the kina are expected to continue throughout the year. The Government's free-education policy, which consequently set the price of education to zero in the Consumer Price Index (CPI) measurement, and extension of the tariff reduction program would also contribute to lower inflation in 2012.

Over the medium term, the Bank projects annual headline inflation to be around 4.0 percent in 2013 and 5.0 percent in 2014 (see Chart 1). These projections are based on a number of factors, including the winding down of the construction phase of the PNG LNG project in late 2013 and easing in global demand.



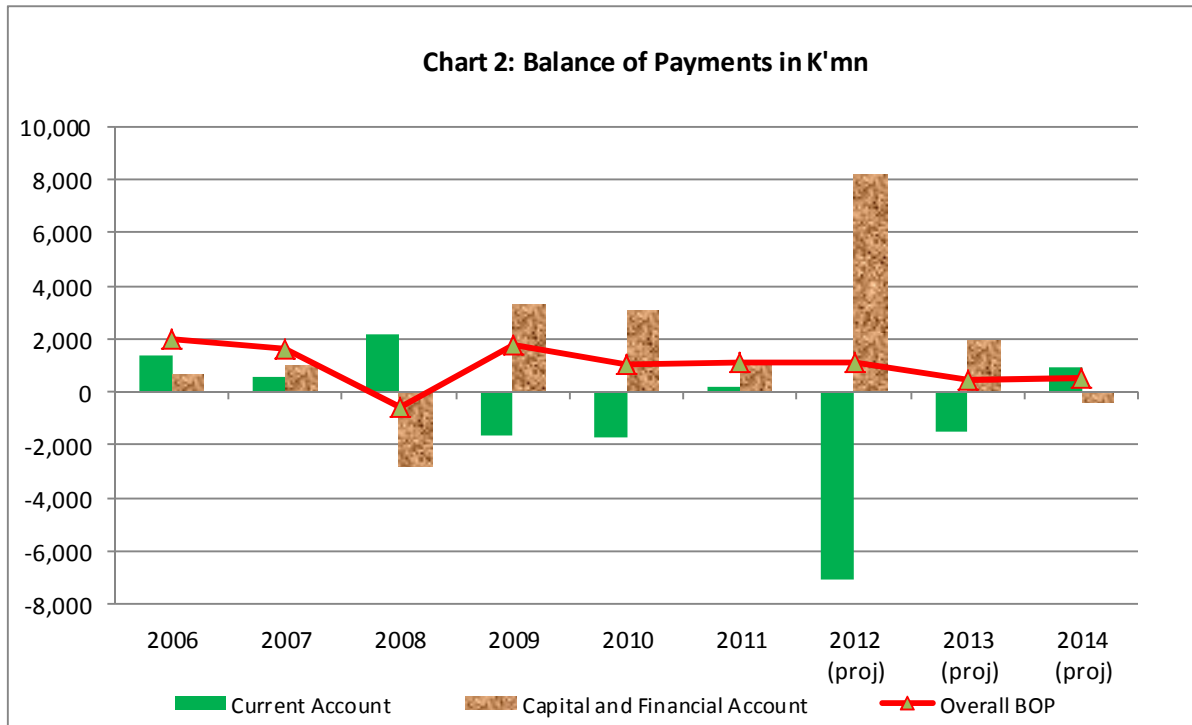
Source: National Statistical Office and Bank of PNG

There are upside risks to these projections, including resurgence in global economic activity, further increases in international food and fuel prices, a depreciation of the kina and any supply shocks.

Annual headline inflation was 1.4 percent in the June quarter of 2012, lower than the 4.0 percent in the March quarter of 2012. The lower outcome was due to a decline in the price of betelnut and lower imported prices of food and fuel, supported by the appreciation of the kina exchange rate. The Government's free education policy also contributed to the low inflation. Underlying inflation as indicated by the exclusion-based and trimmed mean measures were 0.2 and 3.4 percent in the June quarter of 2012, respectively.

In 2012, broad money supply is expected to increase by 13.3 percent, driven mainly by an increase in NFA of the banking system. Monetary base and private sector credit are projected to grow by 32.6 percent and 10.1 percent, respectively. The Bank considers the projected growth in monetary aggregates more than sufficient to support economic growth (see Appendix-Table 1).

The overall balance of payments is projected to be in surplus by K1,134.6 million in 2012, with a surplus in the capital and financial account more than offsetting a deficit in the current account. The deficit in the current account is projected to be K7,061.4 million, attributed to a higher trade deficit, net service and income payments related mainly to the PNG LNG project. The surplus in the capital and financial account is projected to be K8,196.2 million, reflecting inflows associated with the PNG LNG project as it reaches its peak construction period and foreign direct investments by the other private sector (see Chart 2).

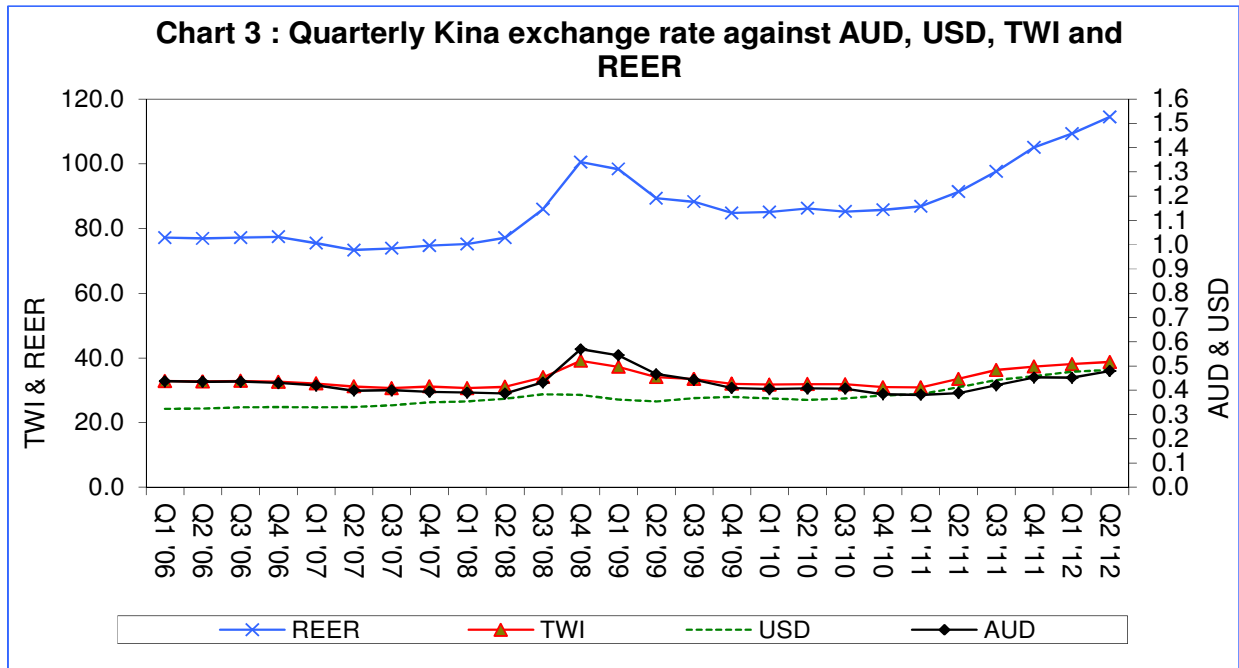


Source: Bank of PNG

Note: 2012 to 2014 includes flows related to the PNG LNG project, compared to the actuals, which do not include LNG figures.

By the end of 2012, the gross foreign exchange reserves are projected to be around US\$4,349.0 (K9,049.1) million, sufficient for 6.6 months of total and 19.4 months of non-mineral import covers. Gross reserves are projected to be higher in the medium term with the production at the Ramu Nickel/Cobalt mine and exports of LNG by the PNG LNG project (See Appendix – Table 2). As at 25th September 2012, the level of gross foreign exchange reserves was US\$4,035.7 (K8,312.4) million.

The daily average kina exchange rate appreciated against both the US and Australian dollars by 8.9 percent and 10.0 percent to US\$0.4813 and A\$0.4636, respectively, between September quarter 2011 to 26th September 2012. The appreciation of the kina against the US dollar reflected higher foreign exchange inflows related to the PNG LNG project and foreign direct investment to the other sectors. The appreciation against the Australian dollar was attributed to cross currency movements. The Trade Weighted Index (TWI) appreciated by 8.5 percent during the June quarter of 2012, compared to the corresponding period of 2011. The Real Effective Exchange Rate (REER) also appreciated by 4.7 percent during the same period (see Chart 3).

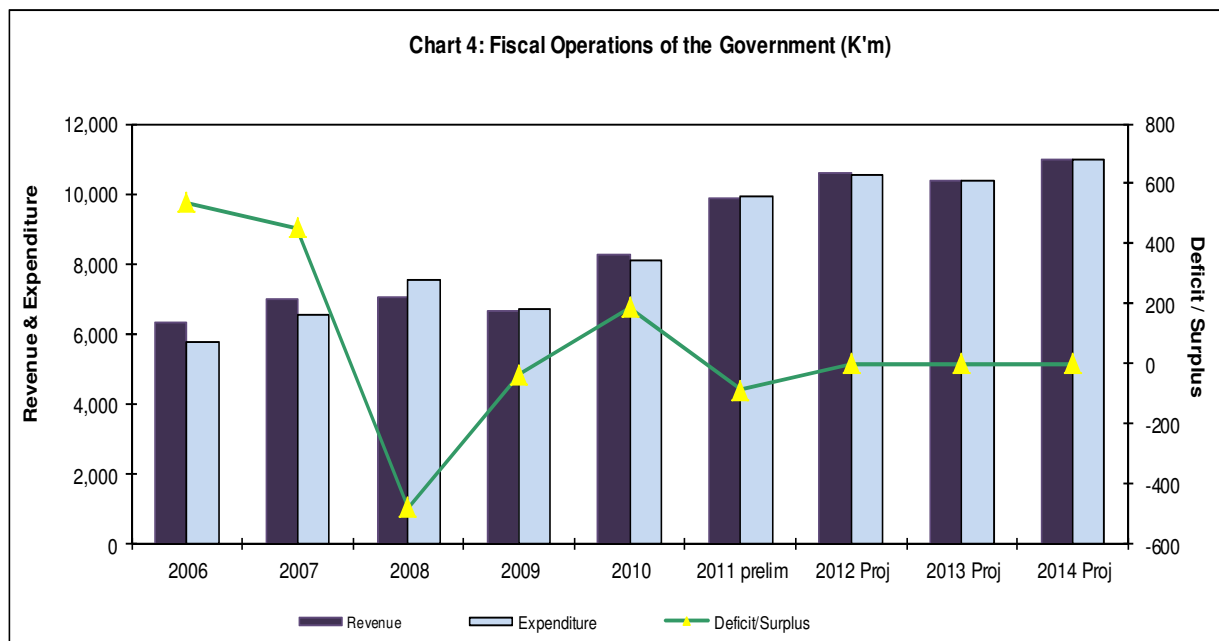


Source: Bank of PNG

Strong economic growth is expected to continue in 2012, with the Bank projecting real GDP to grow broadly in line with the Government’s forecast of 9.9 percent. This reflects the peak in construction activity of the PNG LNG project and spin-offs to other sectors, start of the production at the Ramu Nickel/Cobalt mine and increased Government spending. All sectors of the economy are expected to grow, led by the building and construction, manufacturing, mining and quarrying, commerce, financial/business/other services and transportation/storage/communication sectors, while the petroleum sector is projected to fall due to the decline in reserves and production.

For the medium term, the Bank projects economic growth to moderate in 2013 and 2014, reflecting the winding down of construction of the PNG LNG project. In addition, domestic demand is expected to ease due to the fall in international commodity prices and therefore, incomes.

In July 2012, the Government presented its MYEFO report which projects a deficit of K513.1 million or 1.5 percent of nominal GDP for the year. This compares to a balanced budget forecasted in the 2012 National Budget approved by Parliament (see Chart 4). The deficit is due to a lower than expected revenue forecast reflecting lower international commodity prices, combined with overspending mainly related to the National Elections. To finance the deficit, the Government plans to increase its issuance of domestic securities. Public debt is projected to increase to 25.6 percent of GDP, compared to 24.2 percent in 2011. With the lower revenue, the Government should focus on priority areas of expenditure in the coming years and plan for their implementation. Labour and capital that will be released on completion of the PNG LNG construction can be utilized for infrastructure development. In addition, the Government should focus on developing agriculture and vital infrastructure projects in order to enhance the productive capacity of the economy.



Source: 2012 National Budget

Close coordination and cooperation between the Treasury and Finance departments and the Central Bank in the conduct of fiscal and monetary policies is important to ensure macroeconomic stability is maintained. It is therefore important that the Government should prudently manage its budget, especially now that revenues are declining.

1.2 Monetary Policy Stance

The main issue for the Central Bank is managing the continued high level of liquidity in the banking system.

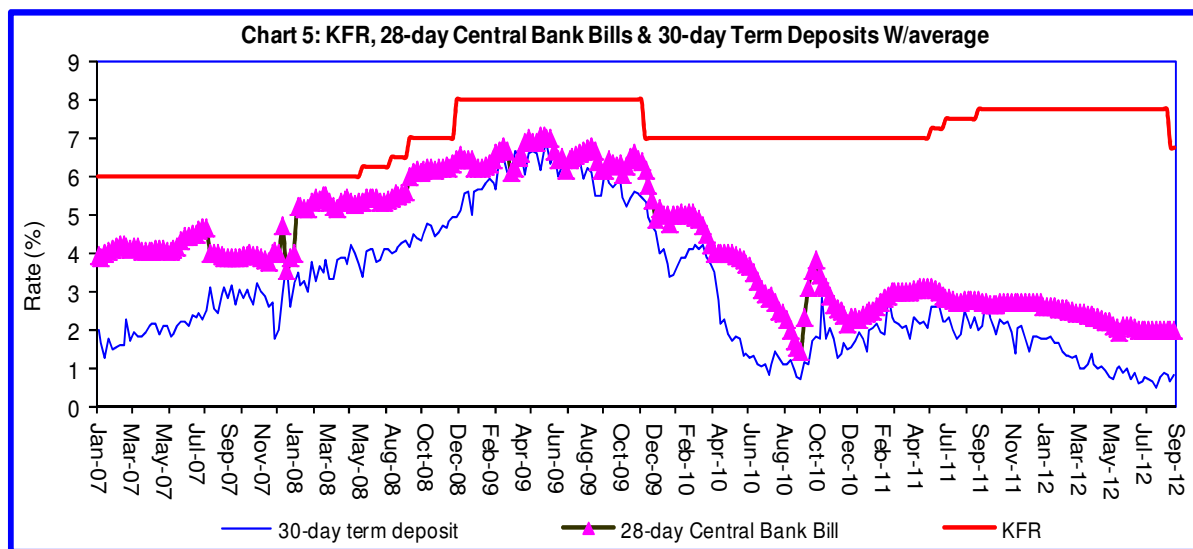
Upside risks to the Bank's projection of 32.6 percent growth in monetary base would come from:

- continued high inflows of foreign exchange;
- higher than budgeted overall Government expenditure; and
- fast drawdown of trust accounts from the Central Bank.

In addition, the upside risks to the Bank's inflation projection of around 3.0 percent for 2012 include:

- depreciation of the kina exchange rate;
- any substantial increase in international food and fuel prices;
- higher than expected inflation in PNG's major trading partners; and
- any supply-side shocks .

The Central Bank maintained a tight monetary policy stance between March and August 2012. To assist diffuse some of the excess liquidity, the Central Bank increased the Cash Reserve Requirement (CRR) from 7.0 percent to 8.0 percent in June 2012. In September 2012, monetary policy was eased by the reduction in the Kina Facility Rate (KFR) from 7.75 percent to 6.75 percent, following the release of the June quarter 2012 inflation outcome of 1.4 percent. The Bank is however mindful of the projected strong domestic economic growth in 2012 and its potential impact on inflation. The Bank will therefore maintain the current monetary policy stance for the next six months, and may adjust it if developments in the economy and/or financial market warrant it (see Chart 5).



Source: Bank of PNG

1.3 Conduct of Monetary Policy

Monetary policy will be conducted within the reserve money framework. The MPS provides the overall monetary policy stance, while the monthly KFR remains the instrument for signaling this stance or any changes through an announcement by the Governor. Following the announcement, Open Market Operations will be conducted to support 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 may also use its direct policy instrument, the CRR, where necessary to assist in liquidity management.

The Bank plans to introduce the CBB Tap facility¹ in October 2012 for small retail investors to participate in the securities market.

The Bank will continue to assess developments in the market and use appropriate policy instruments at its disposal to ensure that financial stability is maintained and inflation is at an acceptable level.

¹ The introduction of the CBB Tap facility is intended to broaden participation in the securities market by targeting small investors, other than registered bidders currently participating in the primary market. This will also contribute towards the development of a retail market for securities.

Appendix

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

INDICATOR	2009 (actual)	2010 (actual)	2011 (actual)	Mar 2012 MPS	2012 (Actual to Jul)	2012 (proj)	2013 (proj)	2014 (proj)
Broad Money Supply	21.9	10.2	17.3	14.8	13.1	13.3	12.7	12.3
Monetary Base	11.9	11.1	61.7	33.2	46.2	32.6	19.0	16.2
Claims on the Private Sector	15.1	18.1	7.9	7.0	8.5	10.1	11.4	12.7
Net Claims on Gov't	-268.0	-130.2	399.4	-46.8	-205.0	-188.4	-45.9	-48.6
Net Foreign Assets	30.0	20.2	10.0	12.9	-2.2	-4.2	4.6	5.3

Source: Bank of PNG

Table 2: Summary of Other Macroeconomic Indicators

INDICATOR	2009 (actual)	2010 (actual)	2011 (actual)	Mar 2012 (MPS)	2012 (Actual to June)	2012 (proj)	2013 (proj)	2014 (proj)
CONSUMER PRICE INDEX (annual % changes)								
Headline	5.7	7.2	6.9	8.0	1.4	3.0	4.0	5.0
Trimmed-mean	4.1	5.5	6.5	7.5	3.4	3.5	4.0	4.5
Exclusion- based	5.0	5.4	7.7	7.5	0.2	3.5	4.0	4.5
BALANCE OF PAYMENTS (kina millions)²								
Current account	-1,612	-1,748	157	-8,551	-1,361	-7,061	-1,500	949
Financial account	3,220	2,934	1,162	11,127	681.9	8,196	1,932	-416
Overall balance	1,782	1,066	1,097	2,674	-604	1,135	432	533
Gross Int. Reserves	7,104	8,170	9,266	10,598	8,662	9,049	9,481	10,014
IMPORT COVER (months)								
Total	10.8	10.2	11.5	7.6	10.7	6.6	10.5	12.3
Non-mineral	14.8	13.9	16.7	19.9	15.5	19.4	19.2	19.0
EXPORT PRICE								
Crude oil (US\$/barrel)*	59.0	78.8	277.1	110.9	120.3	115.0	108.0	105.0
Gold (US\$/ounce)	968.6	1,187.3	3,565.3	1,716.8	1,652.4	1,786	1,807	1,801
Copper (US\$/pound)	217.6	333.4	962.8	393.1	367.9	369	386.0	390
FISCAL OPERATIONS OF THE GOVERNMENT**								
Surplus/Deficit (K`m)	-35.9	186.3	-65.7	0.0	-79.8	-513.1	0.0	0.0
% of GDP	0.2	0.7	0.2	0.0	0.0	1.5	0.0	0.0
REAL GROSS DOMESTIC PRODUCT (annual % growth) ***								
Total GDP	6.1	7.6	8.9	7.8	--	9.9	3.8	6.5
Non-mineral GDP	6.3	7.3	10.8	7.4	--	10.4	4.3	2.3

Source: Bank of PNG, NSO and Department of Treasury

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

** Preliminary fiscal operations up to December 2011. 2012 projections are from the MYEFO. 2013 - 2014 projections are from the 2012 National Budget.

*** GDP figures are from the 2012 National Budget. Only 2012 show projections from the MYEFO.

² For 2012, imports for the PNG LNG project are included in the annual projections but not in the actuals to December 2011.