



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 2013

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 September 2013 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

Economic growth will continue in 2013, but at a lower rate than at the peak of the PNG LNG project construction phase. Spin-off activities in the non-mineral sector associated with the LNG project are already declining. To encourage economic growth under a low inflation environment, the Bank maintains its stance of monetary policy since the easing in March 2013, alongside the Government's expansionary fiscal policy.

The average kina exchange rate depreciated by 8.7 percent against the US dollar since September 2012. The depreciation reflected a higher import demand and lower export receipts, combined with lower foreign direct investment inflows as the construction phase of the PNG LNG project winds down. The annual headline inflation outcome in the June quarter of 2013 was 3.2 percent, while the quarterly increase was 1.6 percent in the March quarter and 0.0 percent in the June quarter. The annual underlying inflation outcomes remain low, with the trimmed-mean and exclusion-based measures recording an increase of 0.7 percent and a decline of 0.6 percent, respectively.

Real Gross Domestic Product (GDP) is projected by the Bank to grow around 5.0 percent in 2013, lower than Government's forecast of 6.1 percent in the 2013 Mid-Year Economic and Fiscal Outlook (MYEFO) report. All sectors, except the petroleum sector, are expected to grow in 2013. The Government's expansionary fiscal policy is key to stimulating economic activity and therefore it is important that it fully implements the 2013 Budget effectively and efficiently.

The overall balance of payments is projected to be in deficit by K585 million in 2013, mainly reflecting higher imports and net service and income payments. By the end of the year, the gross foreign exchange reserves are projected to be around US\$3,000 (K6,904.5) million, sufficient for 5.9 months of total and 12.1 months of non-mineral import covers.

Broad money supply is expected to increase by 11.9 percent, driven mainly by an increase in the net domestic assets of the banking system, reflecting increases in net credit to Government and the private sector. The monetary base and private sector credit are expected to grow by 6.1 percent and 17.5 percent, respectively.

In the 2013 MYEFO Report, the Government revised its deficit upwards to K2.7 billion from K2.5 billion. To June, it had spent 43 percent of the recurrent budget and only 30 percent of the development budget. On-going capacity constraints continue to hamper the effective implementation of the development budget. The likely build up in Government trust accounts at commercial banks and its associated costs to the Government, the Bank and the public is of concern. The utilization of the skilled manpower and machines and equipment released from the PNG LNG project as the construction phase winds down can help in Government's infrastructure projects. Reforms to improve transparency and accountability are also key to efficient and effective budget implementation.

The Government has financed its deficit from the domestic banking system and is expected to continue to do so, at least for the remainder of the year. As the financing needs increase, the Government needs to ensure that it has a well-communicated debt strategy that can be accommodated by the domestic market and allows for good coordination between fiscal and monetary policies. Prudent management and implementation of the budget within the confines of the Fiscal Responsibility Act will ensure that a sustainable debt to GDP ratio is maintained.

It is important that the Sovereign Wealth Fund (SWF) becomes operational prior to the commencement of LNG production in 2014. This would assist in managing the LNG revenues in a sustainable manner and minimize potential *Dutch Disease* effects.

To create a more inclusive and competitive financial system that enhances economic growth, the Bank will continue to lead initiatives such as the Microfinance Expansion Project, branchless banking, and the National Payment System.

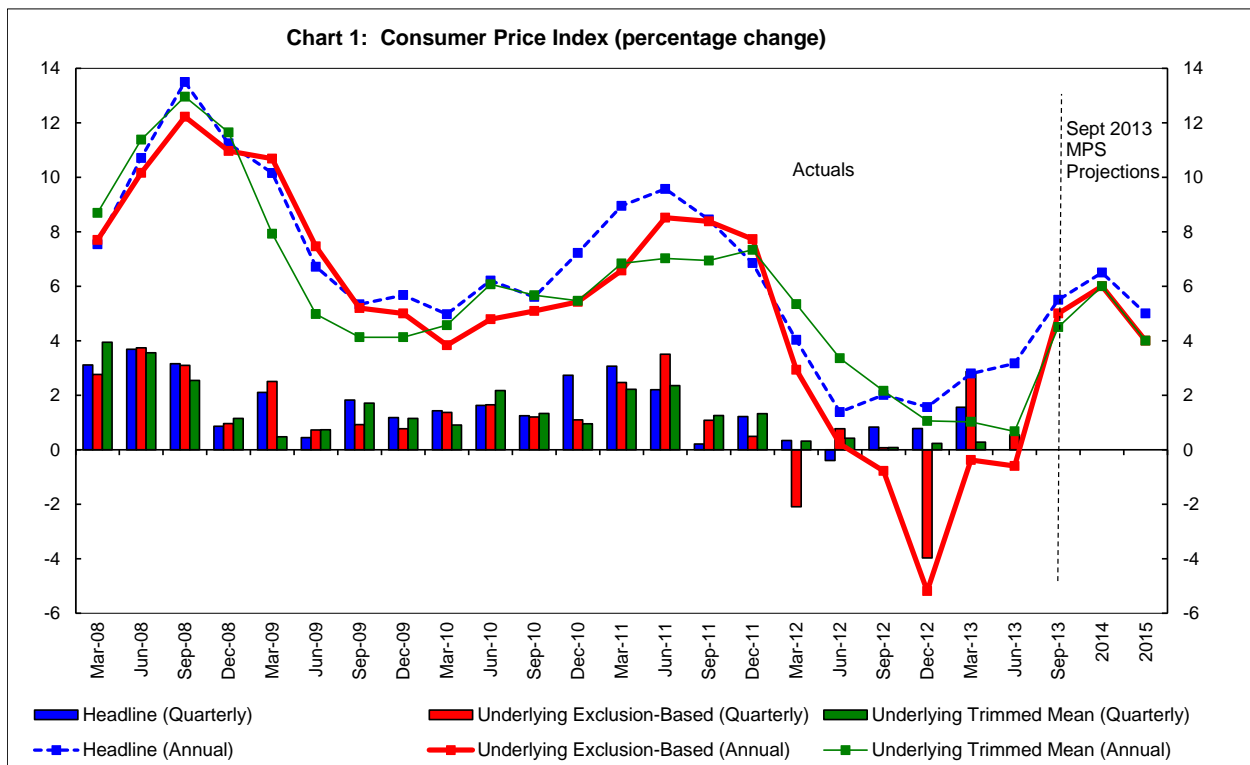
In light of the low inflation environment and the future outlook, the Bank will maintain its current stance of monetary policy for the next six months. This stance would support Government's expansionary fiscal policy to encourage economic activity. The Bank will continue to assess the economic conditions to ensure that financial stability is maintained and inflation is at an acceptable level.

Monetary Policy Discussions

1. Monetary Policy Assessment, Issues and Expectations

Headline inflation continues to be low but on an upward trend, recording an outcome of 3.2 percent over the year to June 2013. This outcome mainly reflects higher import and excise duties and some pass through of the depreciation of the kina. However, underlying inflation remained low. In light of this outcome and to support economic activity, the Bank decided to maintain its monetary policy stance since the easing in March 2013.

The Bank maintains its annual headline inflation projection for 2013 at around 5.5 percent. The trimmed-mean and exclusion based inflation measures are also maintained at 4.5 percent and 5.0 percent, respectively. This is based on the assumptions that there is lower pass through of depreciation of the kina, and lower imported inflation and domestic demand. Over the medium term, the Bank projects annual headline inflation to be around 6.5 percent in 2014 and 5.0 percent in 2015. These projections are based on a number of factors, including improved Government spending with higher impact on domestic demand, the commencement of LNG production in 2014, as well as better prospects for the global economy in the medium term (see Chart 1).



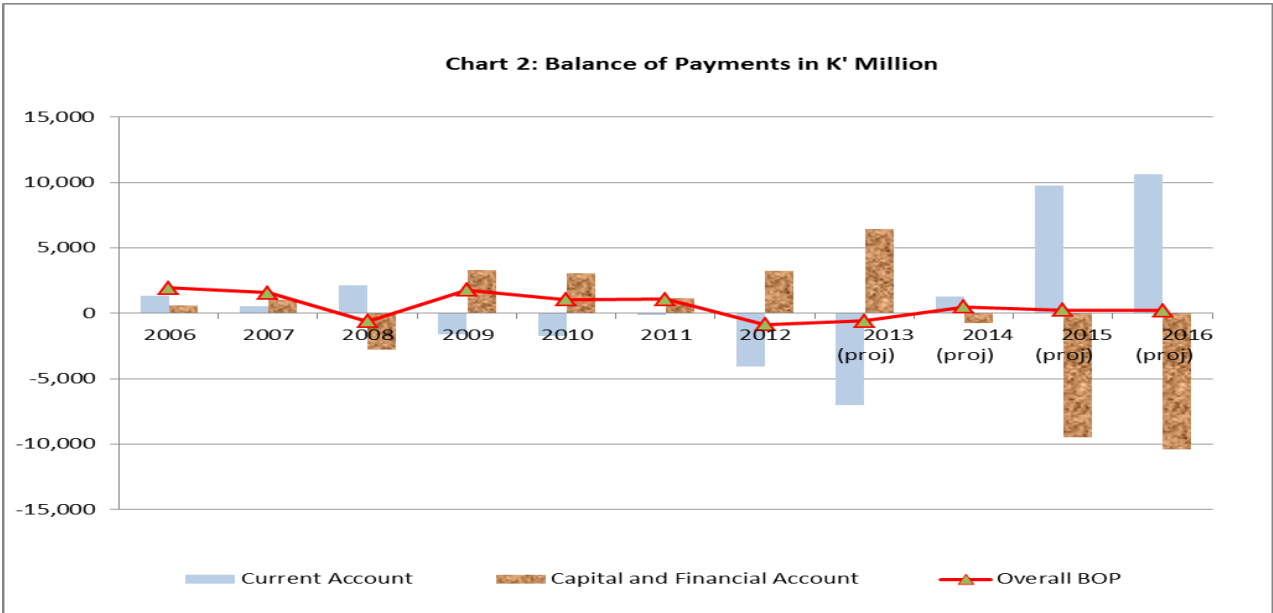
Source: Bank of PNG & National Statistical Office (NSO)

The upside risks to these projections would emanate from larger government expenditure, resurgence in global economic activity, significant pass through of the kina depreciation, and any supply-side shocks.

Annual headline inflation was 3.2 percent in June from 2.8 percent in March 2013. This outcome reflects seasonal factors, some pass-through from the depreciation of the kina, and higher import and excise duties. These factors were partially offset by lower domestic demand associated with the winding down of the PNG LNG project construction phase and lower spending of the Government’s development budget, which was only about 30 percent executed by June. The lower impact of the depreciation of the kina was mainly due to increased competition in some economic sectors and cheaper sources of imports. The quarterly increase was 1.6 percent in March and 0.0 percent in June. Underlying annual inflation, as indicated by the trimmed-mean and exclusion-based measures, was 0.7 percent and negative 0.6 percent, respectively.

In 2013, broad money supply is expected to increase by 11.9 percent, driven mainly by an increase in net domestic assets of the banking system, attributed to increases in net claims on the Government and private sector credit. Monetary base and private sector credit are projected to grow by 6.1 percent and 17.5 percent, respectively. The Bank considers the projected growth in monetary aggregates sufficient to support the lower projected economic growth in 2013 (see Appendix-Table 1).

The overall balance of payments is projected to be in deficit by K585 million in 2013, with a deficit in the current account more than offsetting a surplus in the capital and financial account. The deficit in the current account is projected to be K6,993 million, due to higher imports and net service and income payments. The surplus in the capital and financial account is projected to be K6,408 million, mainly reflecting inflows associated with the foreign direct investment to complete the PNG LNG project (see Chart 2). In the medium term, the current account is projected to record surpluses due to revenue inflows from the mineral sector, including the LNG project.

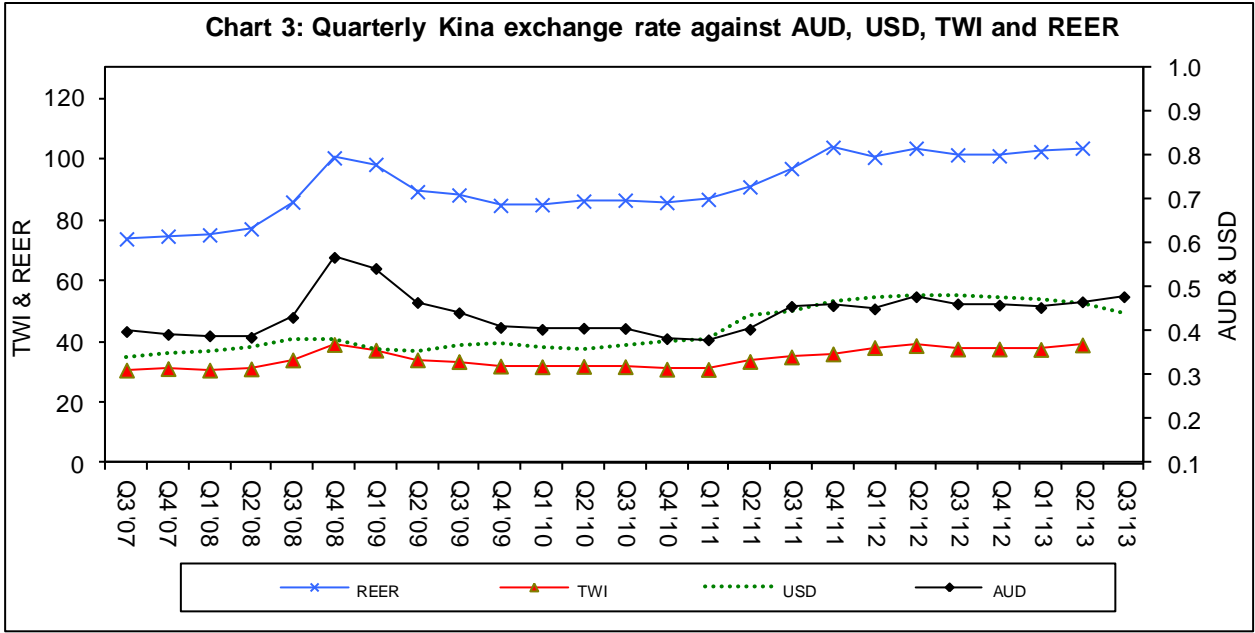


Source: Bank of PNG

Note: 2013 to 2015 includes flows related to the PNG LNG project, compared to the actuals, which do not include LNG figures.

By the end of 2013, the gross foreign exchange reserves are projected to be around US\$3,000 (K6,904.5) million, sufficient for 5.9 months of total and 12.1 months of non-mineral import covers. Gross reserves are projected to be higher in the medium term due to foreign exchange inflows related to the exports by the Ramu Nickel/Cobalt mine and the PNG LNG project (See appendix – Table 2). As at 26th September 2013, the level of gross foreign exchange reserves was US\$3,058.6 (K7,196.7) million.

The daily average kina exchange rate depreciated against the US dollar by 8.7 percent to US\$0.4395 between the September quarter of 2012 and 26th September 2013, while it appreciated against the Australian dollar by 3.5 percent to A\$0.4795. The depreciation of the kina against the US dollar reflected combined effects of lower export receipts and higher foreign exchange outflows as a result of high imports and LNG-related service payments. The appreciation against the Australian dollar was attributed to cross currency movements, as the Australian dollar weakened against the US dollar. The Trade Weighted Index (TWI) appreciated by 0.5 percent during the June quarter of 2013, compared to the corresponding period of 2012. The Real Effective Exchange Rate (REER) also appreciated by 0.3 percent during the same period (see Chart 3). The depreciation of the kina against the US dollar since July 2012 is expected to have a positive impact on kina prices of PNG export commodities and producers should take advantage of this to increase their production volumes.



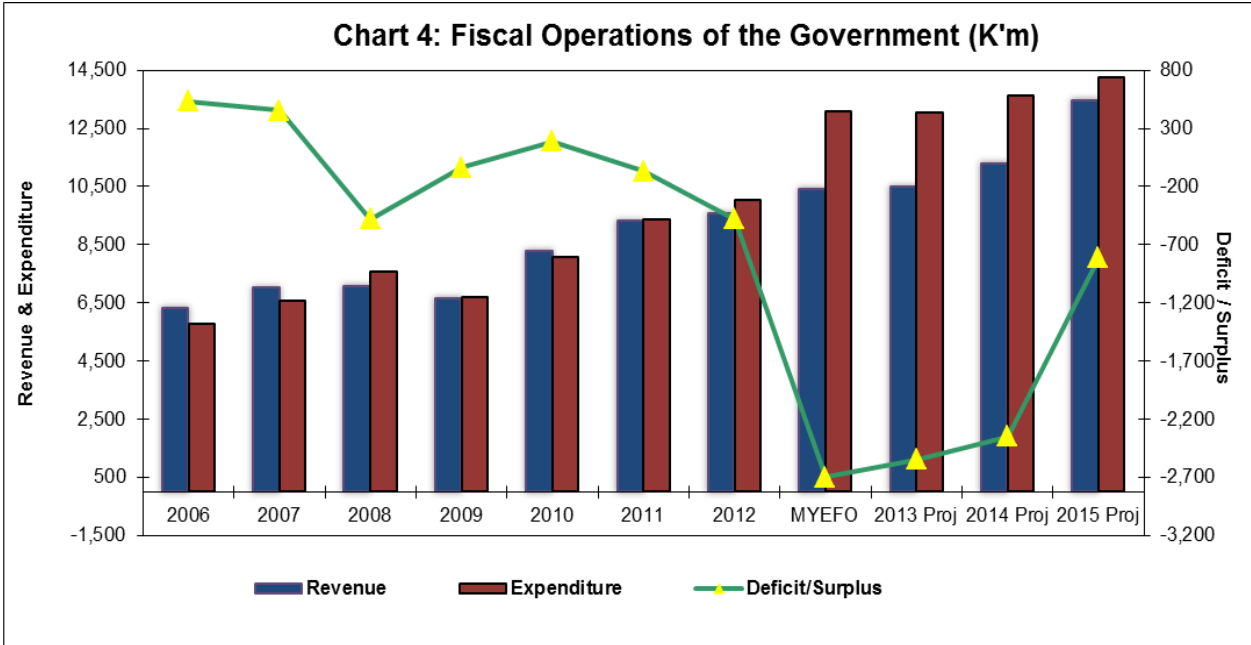
Source: Bank of PNG

Real Gross Domestic Product (GDP) is projected by the Bank to grow by around 5.0 percent in 2013, lower than the Government’s latest forecast of 6.1 percent and down from an estimate of 8.0 percent in 2012. This is due to the winding down of the construction phase of the PNG LNG project and lower crude oil production, reflecting the natural decline in reserves. There are indications that the spin off activity from the PNG LNG project to the non-mineral sector is declining, as shown by lower levels of sales and employment. Although spending by the

Government is expected to generate increased economic activity in 2013, capacity constraints are contributing to delays in project implementation and therefore causing a lower impact of spending on economic growth. The growth in 2013 will be mainly driven by improved production at the Ramu Nickel/Cobalt mine and existing gold mines, building and construction sector, and from public utilities. All other sectors of the economy are expected to record lower growth in 2013.

Economic growth is expected to rebound in 2014 and remain strong over the medium term. The Bank projects real GDP growth to be higher than the 5.5 percent forecasted by the Government in 2014, following the commencement of production of LNG, a full-year production at the Ramu Nickel/Cobalt mine, increased Government spending on high impact projects, including roads and the 2015 Pacific Games, and pick-up in production associated with improved kina commodity prices. All sectors of the economy are expected to grow.

In the MYEFO Report for 2013, the Government projects a budget deficit of K2,700.8 million or 7.7 percent of nominal GDP in 2013. This is due to higher than expected expenditure on personnel emoluments by Provincial Governments combined with lower than expected revenue receipts. The deficit in the MYEFO compares to a deficit of K2,548.9 million in the 2013 Budget (see Chart 4). Public debt is projected to increase by K123.4 million to K11,491.6 million or 32.7 percent of nominal GDP. The Government has been raising its deficit financing from domestic sources which helped to avoid the risks associated with external borrowing and assisted with liquidity management. As the financing needs increase, the Government needs to ensure that it has a well-communicated debt strategy that can be accommodated by the domestic market and allows for good coordination between fiscal and monetary policies. Prudent management and implementation of the budget within the confines of the Fiscal Responsibility Act will ensure that a sustainable debt to GDP ratio is maintained.



Source: 2013 National Budget and MYEFO Report

The Budget gives emphasis on key priority areas such as infrastructure, health and education services, and law and order, with increased funding to sub-national levels of Government. If actual

quality spending takes place in these areas, it would stimulate domestic economic activity amid the winding down of the construction phase of the PNG LNG project. However, capacity constraints are adding to the delays in project implementation and the Government has to address them in order to deliver on its commitments. This is where the utilization of the skilled manpower and machines and equipment released from the PNG LNG project as the construction phase winds down can help in Government's infrastructure projects. Reforms to improve transparency and accountability are also key to efficient and effective budget implementation.

The recurrent expenditure on domestic consumption is likely to contribute positively to economic growth. However, high Government spending will increase import demand, which will exert downward pressure on the exchange rate causing inflationary pressure. If the development funds are underspent in the remaining months of the year, it may cause a large buildup of Government trust accounts at commercial banks and increase the level of liquidity in the banking system. The Bank re-emphasises the need to transfer all budget-funded trust accounts of the Government to the Central Bank to reduce the cost of liquidity management to the Government, Central Bank and the public. Government trust accounts held at the Central Bank amount to K177.2 million as at 27th September 2013, compared to around K1.0 billion with the commercial banks at end August 2013.

In the medium term budgets, the Government should continue to develop the renewable sectors including agriculture and tourism sectors and other vital infrastructure projects to enhance the productive capacity of the economy, create employment opportunities and improve the livelihood of the rural majority. These sectors are important sources for foreign exchange inflows together with mineral resource projects. Establishing the SWF well-ahead of LNG production would assist in managing the revenues in a sustainable manner. Altogether, these initiatives will help PNG manage the *Dutch Disease* phenomenon.

The Bank, on its part, will continue to lead the financial inclusion agenda with key stakeholders through the Microfinance Expansion Project, branchless banking and other products to get more of the non-banked population into the formal financial system. Improvement in this area would assist in the monetary policy transmission process as well as empowering the people for inclusive economic growth and development. The Kina Automated Transfer System (new national payment system) that is approaching completion will help in this course and greatly improve business efficiency through real time settlement of transactions. These initiatives together with encouragement of new entrants in the banking sector will lead to a more inclusive and competitive financial system.

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

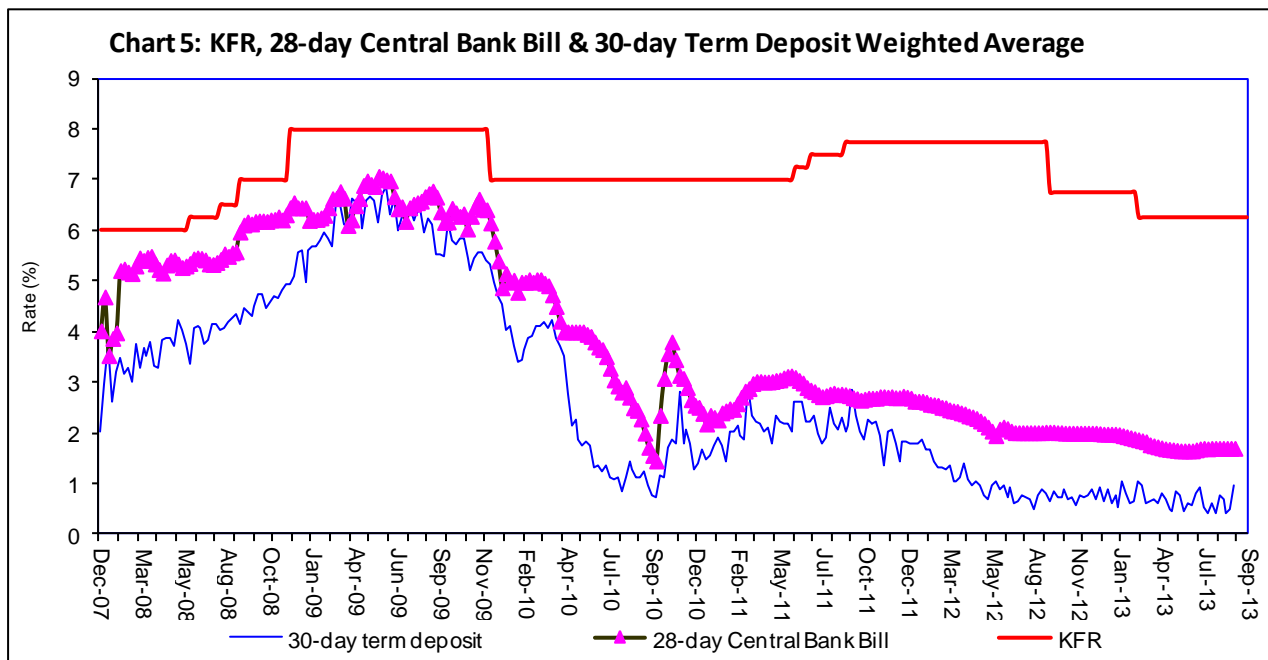
2. Monetary Policy Stance

Economic growth continues in 2013, but at a lower rate than during the peak of the PNG LNG construction phase. Inflation remains at moderate levels, but is projected to increase in 2014 and fall back to around 5.0 percent in 2015. The weakness in domestic demand as the PNG LNG construction project is winding down is expected to only partially be offset by the fiscal stimulus this year.

The high level of liquidity continues to be a concern for the Bank, especially in light of the expected increase in Government spending in the latter part of the year and high import demand.

In March 2013 the Bank eased its monetary policy stance as a result of low inflation outcomes (see Chart 5). In light of the present economic circumstances as well as the future outlook, it will maintain the current policy stance for the next six months, but may adjust it if developments in the economy and/or financial market warrant it. The Bank is taking a cautious approach, mindful of the Government spending and potential inflationary pressure that this could cause. This stance also aims to encourage economic activity by supporting lending to the private sector, which has continued to grow steadily over the past six months.

The weak transmission of the policy signaling rate to market rates is noted. In this regard, the Bank is assessing possible options with the aim of adopting a more market oriented policy rate.



Source: Bank of PNG

3. Conduct of Monetary Policy

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

Over the six months to September 2013, the Central Bank attempted to operationally tighten its monetary policy in an effort to absorb some of the excess liquidity. However, the intervention by the Bank in the foreign exchange market to smooth out the depreciation of the kina as well as the increased issuance of Treasury bills by the Government assisted in diffusing some of the liquidity in the banking system.

The CBB Tap facility will continue to operate so that small retail investors can participate in the securities market and help develop a savings culture in the country.

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

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

Appendix

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

INDICATOR	2011 (actual)	2012 (actual)	Mar 2013 MPS	2013 (actual to Jul)	Sep 2013 (Proj)	2014 (proj)	2015 (proj)
Broad Money Supply	17.3	10.9	12.8	3.5	11.9	13.0	14.1
Monetary Base	61.7	17.6	15.4	-7.2	6.1	8.2	7.9
Claims on the Private Sector	7.9	12.0	13.6	9.6	17.5	18.3	19.2
Net Claims on Gov't	399.4	-127.6	31.9	259.0	368.1	-14.4	-71.6
Net Foreign Assets	10.0	-6.4	-1.9	-9.7	-15.4	7.2	0.9

Source: Bank of PNG

Table 2: Summary of Other Macroeconomic Indicators

INDICATOR	2011 (actual)	2012 (actual)	Mar 2013 MPS	2013 (actual to Jun)	Sep 2013 (proj)	2014 (proj)	2015 (proj)
CONSUMER PRICE INDEX (annual % changes)							
Headline	6.9	1.6	5.5	3.2	5.5	6.5	5.0
Trimmed-mean	6.5	0.6	4.5	0.7	4.5	6.0	5.0
Exclusion- based	7.7	-1.9	5.0	-0.6	5.0	6.0	5.0
BALANCE OF PAYMENTS (kina millions)¹							
Current account	-406	-4,793	-2,714	-3,581	-6,993	1,276	9,752
Capital & Financial account*	1,599	3,971	2,030	2,138	6,408	-788	-9,509
Overall balance	1,096	-851	-684	-1,489	-585	488	244
Gross Int. Reserves	9,266	8,416	8,222	6,926	6,905	7,805	8,049
IMPORT COVER (months)							
Total	11.5	11.0	9.4	8.9	5.9	8.2	7.6
Non-mineral	16.7	15.9	17.4	14.2	12.1	13.0	12.3
EXPORT PRICE							
Crude oil (US\$/barrel)**	117.5	114.5	108	109.9	109.5	108.4	107.3
Gold (US\$/ounce)	1,517.9	1,659.6	1,689	1,531.8	1,405.3	1,474.7	1,581.3
Copper (US\$/pound)	408.2	360.1	350	345.2	319	310	320
Nickel (US\$/tonne)					16,000	16,000	18,000
Cobalt (US\$/tonne)					25,000	25,000	28,125
LNG (US\$/000 cubic ft)						11.8	11.5
Condensate (US\$/barrel)						90.0	81.0
FISCAL OPERATIONS OF THE GOVERNMENT***							
Surplus/Deficit (K'm)	-65.7	-402.5	-2,549	-679.9	-2,700.8	-2,352	-813
% of GDP	0.2	1.2	7.2	1.9	7.7	5.9	1.6
REAL GROSS DOMESTIC PRODUCT (annual % growth) ****							
Total GDP	11.1	8.0	4.0	4.0	6.1	5.5	20.0
Non-mineral GDP	13.2	9.1	3.4	3.4	5.5	1.1	4.2

* Now includes Capital account

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

*** Preliminary fiscal operations up to June 2013, while 2013 projections from the MYEFO and 2014 - 2015 projections are from the 2013 National Budget.

**** GDP figures for 2012 and 2013 from the 2013 MYEFO Report and 2014 & 2015 from the 2013 National Budget.

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

¹ For 2013, imports for the PNG LNG project are included in the annual projections but not in the actuals to December 2012.