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

30th September 2016

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 2016 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

Papua New Guinea (PNG) continued to experience low export commodity prices during the nine months to September 2016. These resulted in low foreign exchange inflows and lower Government revenue. Consequently, the real GDP growth forecast for 2016 by Treasury Department was revised downwards to 2.2 percent from its earlier forecast of 4.3 percent. The Parliament passed a Supplementary Budget in August 2016 to realign spending to revenue to maintain the deficit level planned in the original budget.

The Government obtained an external commercial loan of US$200 million in August 2016, to assist finance the 2016 Budget. The foreign currency component was used by the Central Bank to assist the foreign exchange market. The intervention by the Central Bank totaled US$395.0 million in the nine months to September 2016. By the end of 2016, the level of foreign exchange reserves is projected to be US$1,724.7 (K5,466.6) million.

Starting in the second quarter of 2016 there has been an increase in foreign currency inflows, particularly from the mining and agriculture sectors. Together with the intervention by the Central Bank, these assisted in meeting some of the import orders in the foreign exchange market and slowed the pace of depreciation of the kina exchange rate. The supply of foreign currency from these sources was sufficient to clear the outstanding import orders in the spot market. However, this did not happen because authorised foreign exchange dealers (AFEDs) used some of the spot inflows for foreign currency loans (trade finance) and forward contracts, instead of serving the spot market. As a result, the Bank has issued further Directives to AFEDs in September 2016 to address this behaviour by the AFEDs.

Annual headline inflation continued on an upward trend, albeit gradually, from 6.4 percent in December 2015, to 6.8 percent in the June quarter of 2016, attributed mainly to price increases of seasonal items in the CPI basket. The underlying inflation measures were low between 1.7 percent and 2.6 percent in the June quarter. For 2016, the underlying inflation measures are projected to be between 4.0 percent and 5.5 percent, while the headline inflation is revised upwards to 7.0 percent, mainly due to volatile movements in prices of seasonal items and some effect of the depreciation of kina exchange rate.

The inflation outcomes are still considered manageable and therefore the Bank has and will maintain its neutral monetary policy stance over the next six months. However, the Bank is mindful of the upward trend in inflation and the projected increase, and will closely monitor developments and may adjust its monetary policy stance as necessary.

In the March Monetary Policy Statement (MPS), the Bank made an announcement to have an alternative policy mechanism to address the weak transmission of the Kina Facility Rate (KFR) to market interest rates. The mechanism is still being assessed in consultation with stakeholders, both domestic and external. The aim is to have a mechanism that will be more effective in ensuring that the policy signaling rate transmits to market interest rates.

Monetary Policy Discussions

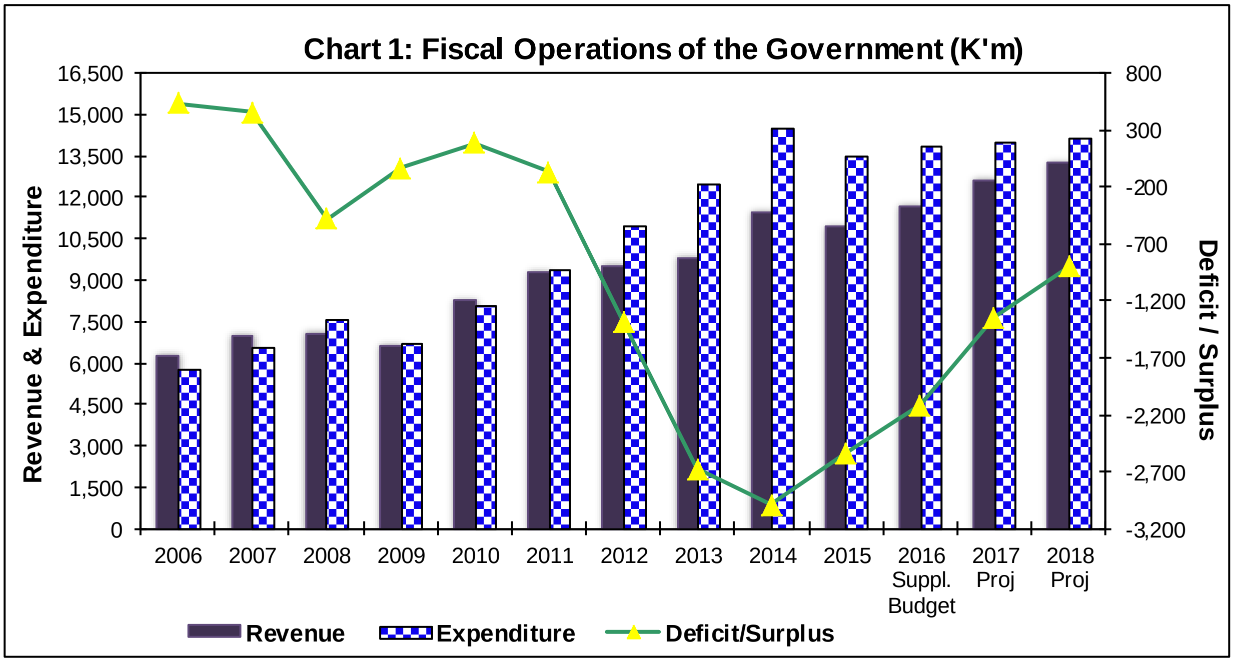
1. Monetary Policy Assessment, Issues and Expectations

PNG continued to experience low export commodity prices during the nine months to September 2016. This resulted in relatively low foreign exchange inflows and lower Government revenue, and reduced expenditure on development budget. Consequently, the real GDP growth forecast for 2016 by the Treasury Department was revised downwards to 2.2 percent from its earlier forecast of 4.3 percent. Parliament passed a Supplementary Budget in August to realign spending and maintain the deficit level planned in the original budget. The deficit will be in part funded from external sources. The low foreign exchange inflows and persistent import demand contributed to the imbalance in the foreign exchange market and led to the depreciation of the kina. The Central Bank continued to intervene by selling foreign currency to assist meet some of the demand.

The preliminary outcome of the fiscal operations of the National Government over the six months to June 2016 show an overall deficit of K624.8 million, compared to a deficit of K942.0 million in the corresponding period of 2015. This represents a deficit of 0.9 percent of nominal GDP.

The 2016 Supplementary Budget entails expenditure cuts of K928.0 million and additional revenue of K958.0 million to adjust for the projected shortfall in revenue of K1,886.0 million reported in the Mid-Year Economic and Fiscal Outlook (MYEFO) report. With these adjustments, the expenditure is projected to be K13,834.6 million and revenue to be K11,722.1 million. The budget deficit is projected to remain at K2,112.5 million, or 3.1 percent of GDP (see Chart 1). Lower external financing in the first half of the year also affected Government's expenditure program. The budget deficit is to be funded from both domestic and external sources. There is reduced domestic appetite for Government debt instruments due to credit exposure limits of some market participants.

In the third quarter of this year, the Government secured US$200 million of the first tranche of Credit Suisse commercial loan as part of external financing for the budget. The second tranche through a syndicated loan is being worked on. This and the planned sovereign bond placement, if successful, would bring in much needed foreign exchange and financing for the budget. The Government should ensure that the planned external financing eventuates to relieve pressure on domestic financing.



Source: 2016 National Budget & 2016 Supplementary Budget

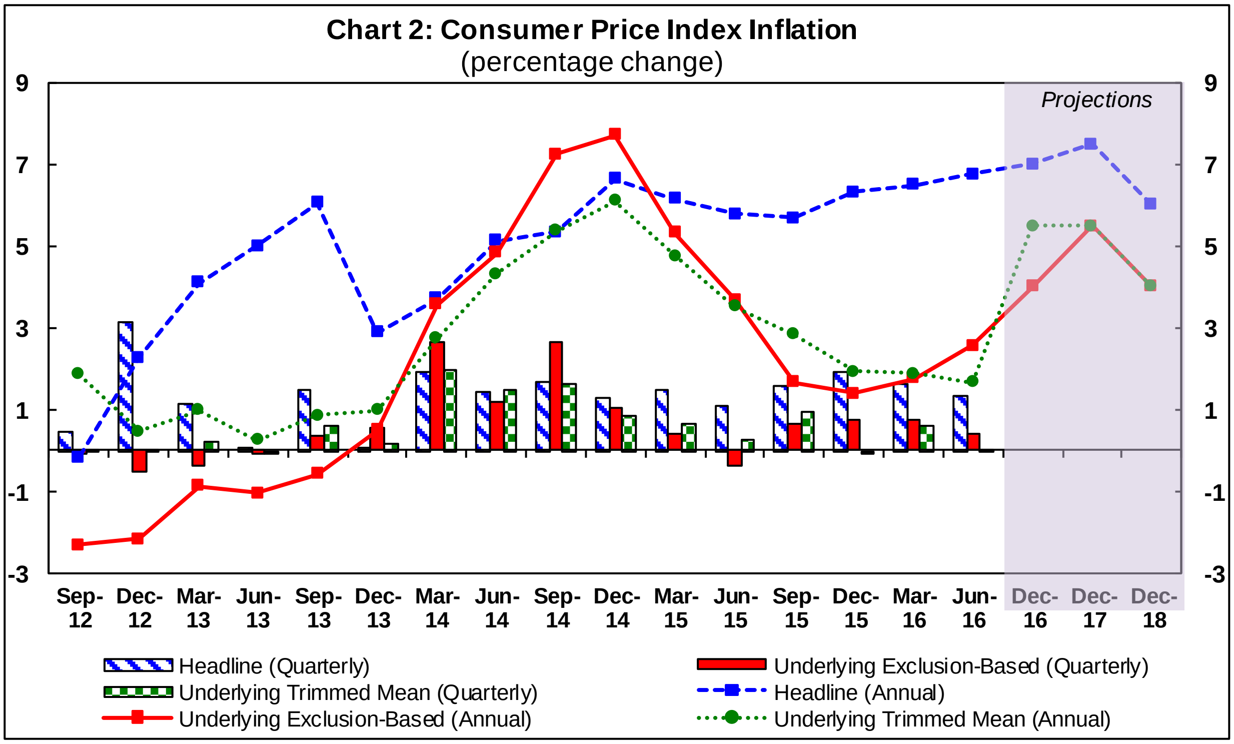
Low revenue for the Government has affected expenditure for delivery of goods and services as well as payment for service providers. According to the Bank's business survey, some service providers in the private sector raised concerns about the Government not paying them on time, affecting their operations. Given this concern, the Government should manage its cash-flow prudently and effectively. In the past, the Central Bank has advised the Government to save windfall revenue for spending during times of economic slowdown. There have been experiences of lost opportunities in the past where surpluses were not saved for the future.

Annual headline inflation was 6.8 percent in the June quarter of 2016, up from 6.5 percent recorded in the March quarter of 2016, and 6.4 percent in the December quarter of 2015. The increase was primarily driven by price increases for betelnut, fruit and vegetables, cereals, and rentals. Increases in these seasonal items and cereals were mainly due to supply constraints and the depreciation of the kina. The annual trimmed-mean and exclusion-based measures of underlying inflation were 1.7 percent and 2.6 percent respectively, in the June quarter of 2016.

For 2016, the Bank revised upwards its projection of annual headline inflation to around 7.0 percent from the 6.5 percent projected in the March MPS. For 2017, the projection is for 7.5 percent. The trimmed mean and exclusion-based measures are projected to be around 5.5 and 4.0 percent, respectively in 2016 and 5.5 percent for both measures in 2017 (see Chart 2). The upward trend in the projections reflects the volatile movements in prices of seasonal items, and expectations for some feed-through of the kina depreciation. The impact of increased government expenditure associated with the National Elections in 2017 and APEC meeting to be hosted in 2018, and gradual pick-up in global economic activity will also contribute to the increase.

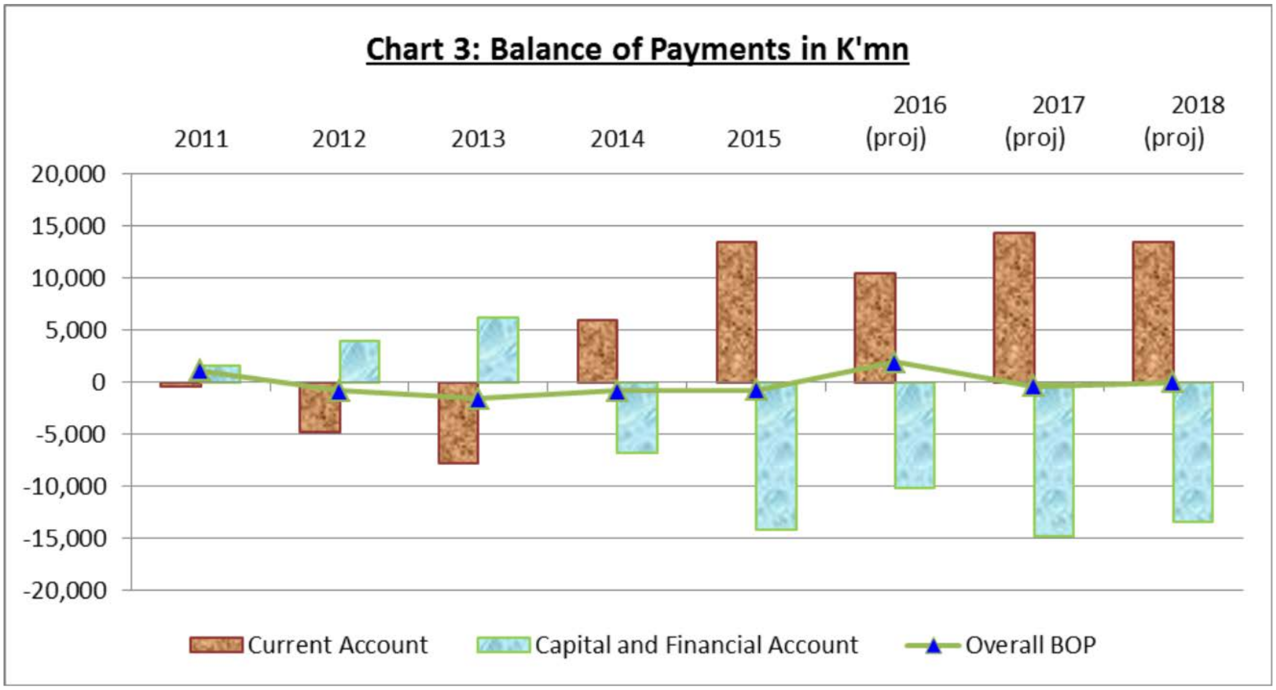
The inflation outcomes are still considered manageable but the Bank is mindful of the upward trend in inflation and the projected increase, and may adjust its monetary policy stance as necessary.

The upside risks to these projections include a faster depreciation of the kina, higher than expected imported inflation from our trading partners and unforeseen supply shocks. Any further depreciation of the kina will not necessarily encourage increased production and exports, and inward investments to clear the outstanding import orders in the foreign exchange market, but will lead to higher inflation.



Source: Bank of PNG & NSO

The overall balance of payments is projected to be in a surplus of K193.5 million in 2016, with a surplus in the current account more than offsetting a deficit in the capital and financial account. The projected current account surplus of K10,419.3 million for 2016 is mainly due to expected higher exports, reflecting increased production from the Ok Tedi mine and on-going production at the PNG LNG Project, combined with improvement in prices of some export commodities. The capital and financial account is projected at a lower deficit of K10,225.8 million, attributed to the drawdown of the first tranche of the Credit Suisse loan. The outflows reflect a build-up in offshore foreign currency account (FCA) balances of the mineral and petroleum companies. These include debt service payments by the PNG LNG Project partners, given the accelerated write-off on allowable capital expenditure provisions stipulated under the Project Development Agreement (see Chart 3).



Source: Bank of PNG

In the medium term, the current account is projected to record surpluses as increased inflows from exports are expected from both the mineral and non-mineral sectors, through anticipated improvement in prices of most commodities. The capital and financial account is projected to record deficits, reflecting LNG revenue held in offshore FCAs for debt service payments by PNG LNG project partners given the provisions for the accelerated write-off on allowable capital expenditure under the Project Development Agreement. It is expected that once this provision for accelerated write-off ends after 2019, the project should start to pay taxes. Together with the development of any planned mineral and gas projects, this should turn the economy around as experienced in 2010-2012.

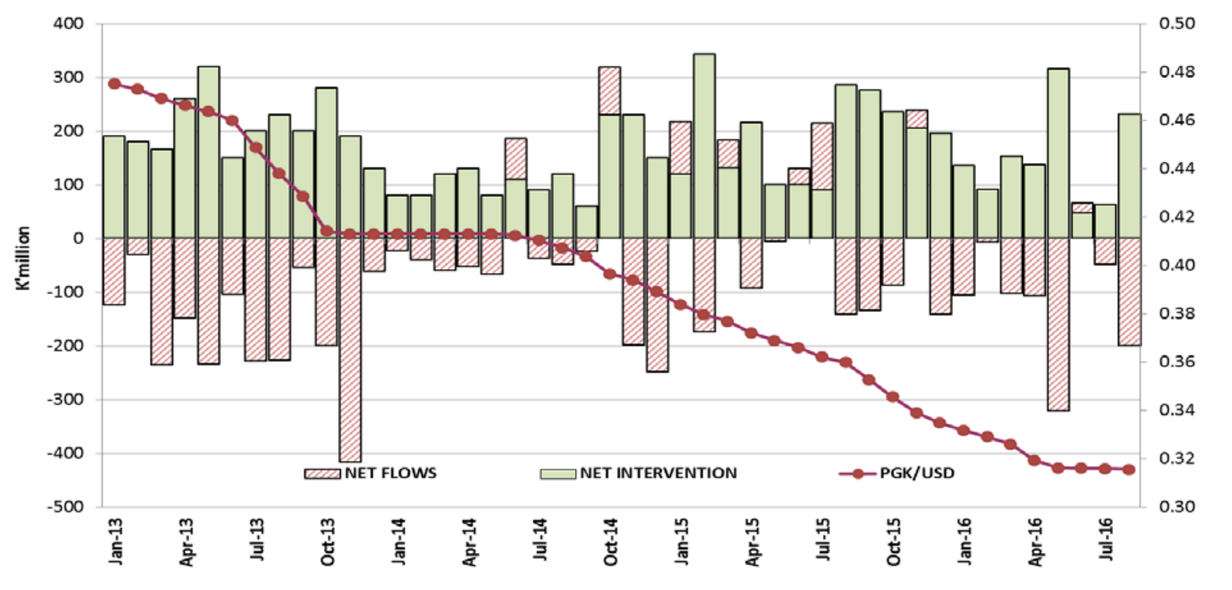
As at 30th June 2016, the level of gross foreign exchange reserves was US$1,664.5 (K5,153.1) million, sufficient for 10.6 months of total and 17.0 months of non-mineral import covers. By the end of 2016, the level of foreign exchange reserves is projected to be US$1,724.7 (K5,466.6) million, compared to US$1,865.1 million at the end of 2015. The lower level reflects the Central Bank's intervention in the foreign exchange market (see Appendix – Table 2). If the proceeds from the Sovereign Bond and syndicated commercial loan are included, the level of reserves would be higher. Some of the reserves would continue to be used to clear the backlog of import orders in the market.

The Government obtained an external commercial loan of US$200 million in August 2016, to assist finance the budget deficit. The foreign currency component from the loan was used to assist the foreign exchange market. The intervention by the Central Bank totaled US$395.0 million in the nine months to September 2016.

Starting in the second quarter of 2016 there were some increases in foreign currency inflows, particularly from the mining sector with the resumption of production at the Ok Tedi mine and recovery in the agriculture sector after the El Nino drought. Together with the intervention by the

Bank, these assisted in meeting some of the import orders in the foreign exchange market and slowed the pace of depreciation in the kina exchange rate. The supply of foreign currency from these sources was sufficient to clear the outstanding orders in the spot market (see Chart 4). This did not happen because AFEDs used some of the inflows for foreign currency loans (trade finance) and forward contracts resulting in unfilled foreign currency orders remaining high. The Bank therefore issued further Directives to AFEDs in September 2016 to address this matter.

Chart 4: Foreign Exchange flows and BPNG Intervention

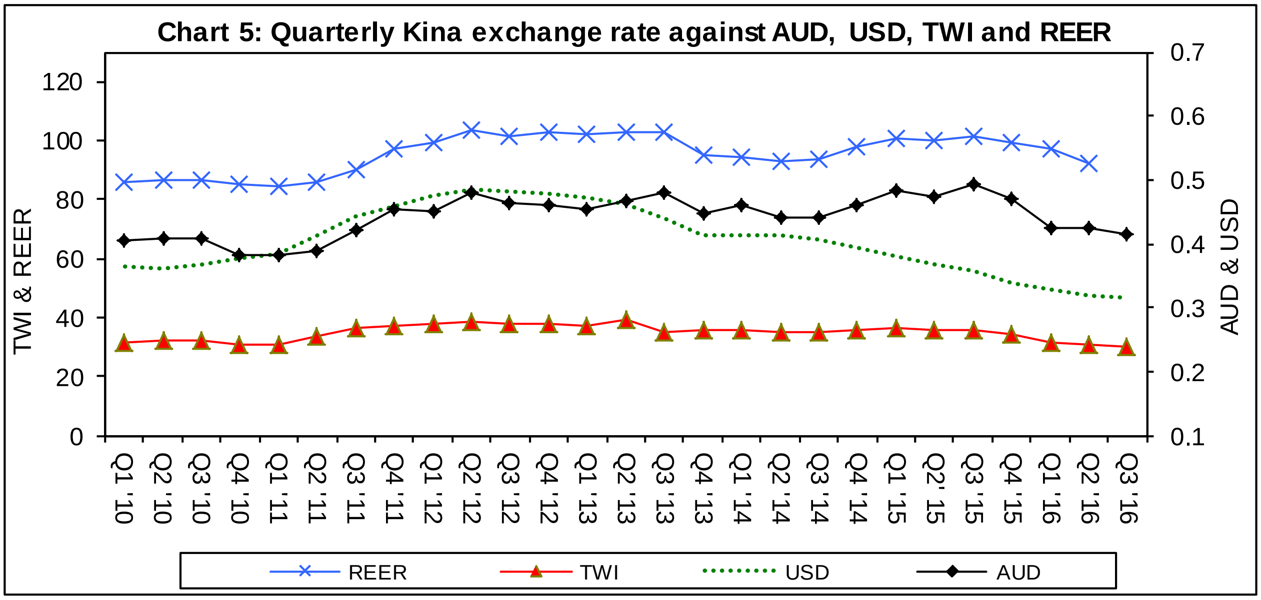


Source: Bank of PNG

The Directives entail the following. All holders of onshore FCAs are to re-apply to the Central Bank to justify their need of these accounts. All domestic lending in foreign currency such as Trade Finance must be approved by the Bank of PNG and repayment made in kina, as stipulated under Regulation 6 of the Exchange Control Regulations. Forward contracts have to be settled with forward flows and not from spot transactions. AFEDs are to separate their Trade Finance and Forward contracts from the Spot market orders. Central Bank interventions are not to be used for Trade Finance loans and settlement of Forward contracts. Orders in the spot market should only be for those orders that need to be filled within three business days. Spot inflows should only be used to clear spot market orders.

The kina depreciated against the US dollar (USD) from US$0.3485 at the end of September 2015 to US$0.3155 as at 28th September 2016 by 9.5 percent due to lower foreign exchange inflows and the strengthening of the USD. The kina exchange rate also depreciated against the Australian dollar (AUD) over the same period by 17.3 percent to A$0.4110.

The Trade Weighted Index (TWI) decreased by 14.4 percent over the twelve months to 20th September 2016. The Real Effective Exchange Rate (REER) depreciated by 4.7 percent in the June quarter of 2016, compared to the March quarter, reflecting the depreciation of kina against all major currencies (see Chart 5).



Source: Bank of PNG

The Bank forecasts growth in broad money supply of 7.7 percent in 2016, compared to 8.0 percent in 2015, resulting mainly from expected increase in net domestic assets of the banking system. Private sector credit is expected to grow by 7.3 percent, while monetary base is projected to increase by 1.3 percent. The lower growth in monetary base takes into account lower commercial bank deposits at the Central Bank. The Bank considers the projected increases in the monetary aggregates sufficient to support the forecasted growth in the non-mineral private sector in 2016 (see Appendix-Table 1).

The persistent high level of liquidity in the banking system is contributing to the weak transmission of the KFR to market interest rates. The Bank's decision to have an alternative policy mechanism is still being assessed in consultation with various stakeholders, both domestic and external. The aim is to have a policy rate that reflects the cost of funds and inflation expectations and a supporting mechanism that will improve the transmission to market interest rates.

The implementation of the Kina Automated Transfer System (KATS) has made the national payment system more efficient, safer and cost effective. The Bank is committed to reducing the reliance on cheques and, in particular, assist the Government to fully utilise electronic payments. In addition, the Bank has also advised commercial banks to reduce further the cheque dishonor period from three to two days, from the start of 2017, and is working on the introduction of a national switch for the payment system in the country.

The Bank has requested the Government to review their governance processes for payments in order to increase use of the Electronic Funds Transfer (EFT) facility, which was available since May 2016. In addition, the conversion of Customs payments to electronic means and automatic updating of Automated System for Customs Data (ASYCUDA) is being trialed with a group of private customs' clearing agents as a Pilot Project. This project is expected to be in full operation by the end of 2016. The Bank is also working with IRC to commence testing the automated processing and reconciliation of tax payments received through KATS.

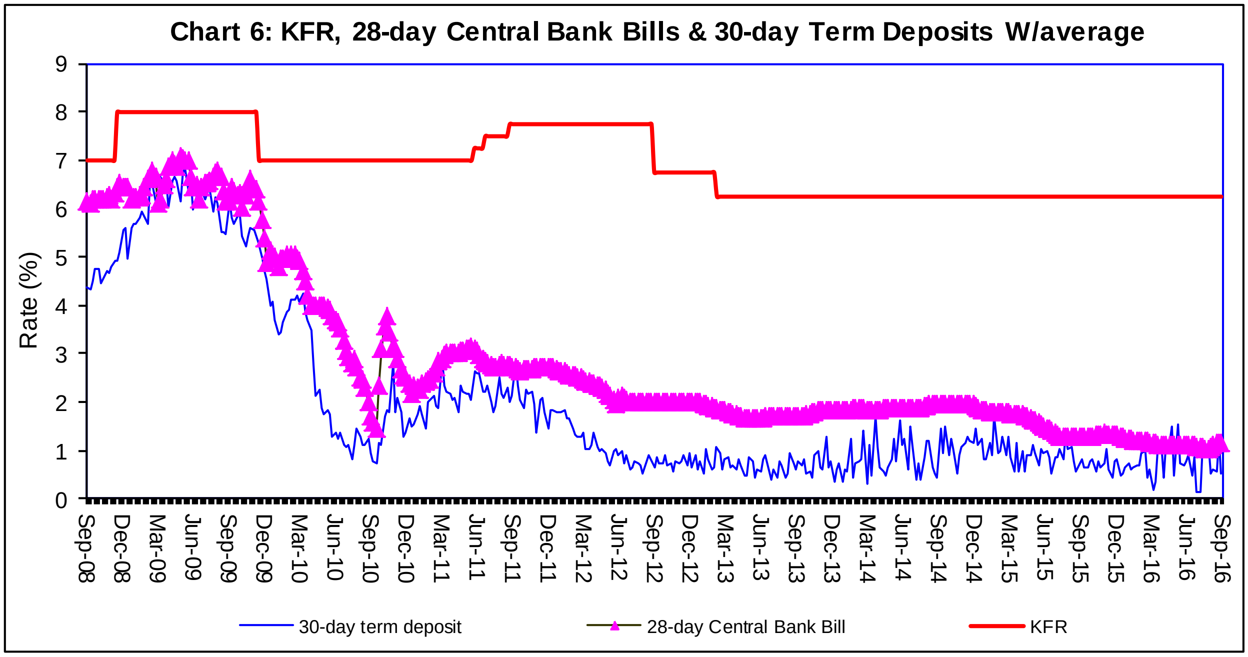
After the passage of a suite of laws in July 2015 on anti-money laundering and terrorism financing, certain measures were implemented, including the recruitment of key personnel for the Financial Analysis and Supervision Unit (FASU). In May 2016, the Asia Pacific Group (APG) conducted an onsite audit on progress made on meeting the requirements of the Financial Action Task Force (FATF). These led to the delisting of PNG from the gray-list by the FATF in June 2016.

The Government is expected to formalize the establishment of the Administrative Secretariat of the Sovereign Wealth Fund (SWF) of Papua New Guinea at the Central Bank. The Bank has sought external technical assistance to establish the Administrative Secretariat of the SWF. A technical report on the assessment of existing capacity in managing the assets and possible models for the establishment of the Secretariat was completed in July 2016. The Bank is now working on developing a suitable model for the establishment of the Secretariat.

PNG will continue to face issues of low international commodity prices and other supply shocks to the economy. Therefore, diversifying into import substitution and export-based industries and increasing the productive capacity of the economy is a crucial policy particularly for the agriculture and other non-mineral industries. This includes encouraging and supporting Small to Medium Enterprises (SMEs) by providing training on financial literacy and entrepreneurial skills, and financial inclusion initiatives. It is therefore vital that the Government continues to implement structural reforms and appropriate trade and investment policies that would boost investments and growth in the non-mineral sectors, especially agriculture. Given the constraints with the Government's implementation, monitoring and enforcement capacity, engaging in programs such as Public-Private Partnership (PPP) would assist in achieving its development plans. Any initiatives by State Owned Enterprise (SOEs) to work in partnership with the private sector should be encouraged and necessary legislations be put in place for a more cost effective service delivery framework.

2. Monetary Policy Stance

Headline inflation is projected to be around 7.0 percent in 2016, higher than the forecast of 6.5 percent in the March MPS, due primarily to upward movement in prices of seasonal items in the Consumer Price Index (CPI) basket and some effect of kina depreciation in the second half of the year. However, underlying inflation measures are expected to be lower between 4.0 and 5.5 percent. The inflation outcomes and projections are still considered manageable and therefore the Bank has and will maintain its neutral monetary stance over the next six months. This stance is also aimed at supporting economic activity. However, the Bank is mindful of the upward trend in inflation and the projected increase, and will closely monitor developments and may adjust its monetary policy stance as necessary.



Source: Bank of PNG

3. Conduct of Monetary Policy

Monetary policy is managed within the reserve money framework. 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. The OMOs involve the auction of Central Bank Bills (CBB), Treasury bills and Treasury bonds (previously Inscribed stocks) to Other Depository Corporations and the general public, and Repo transactions with commercial banks.

Over the six months to 23rd September 2016, the Government made a net issuance of K161.9 million in Treasury bills and K474.9 million in Treasury bonds to fund the budget deficit, while there was a net retirement of K210.1million in CBBs. The increased issuance of Government securities and the Central Bank's intervention in the foreign exchange market assisted in diffusing some of the excess liquidity in the banking system.

The CBB Tap facility will continue to operate to allow small retail investors to participate in the securities market and help develop a savings culture in the country. Participation however has been low mainly due to limited access to the facility from other centers of the country and the interest withholding tax rate charged on the earnings. The bank has now allowed small licensed financial institutions such as Savings and Loan Societies to participate in the CBB Tap facility.

The persistent high level of liquidity in the banking system is contributing to the weak transmission of the KFR to market interest rates. The Bank's decision to consider an alternative policy mechanism is still being assessed following consultation with other stakeholders, including the IMF. The aim is to find a mechanism that will be more effective in ensuring that the policy signaling rate transmits to market interest rates.

The growth in money supply has mainly been a result of increases in net claims on Government due to increase in purchases of Government securities by the banks. This is likely to continue with further funding requirements of the budget. Private sector credit is projected to grow in line with GDP growth. However, increase in credit to Government may affect private sector activity and growth.

Appendix

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

INDICATOR	2014 (actual)	2015 (actual)	Mar 2016 (MPS)	Actual to July 2016	2016 (proj)	2017 (proj)	2018 (proj)
Broad Money Supply	3.4	8.0	5.2	11.0	7.7	6.7	6.0
Monetary Base	37.1	-2.2	2.2	6.2	1.3	3.7	4.5
Claims on the Private Sector	3.6	3.4	4.4	8.7	7.3	6.6	5.7
Net Claims on Gov't	51.1	28.4	3.1	76.9	1.8	-0.4	1.8
Net Foreign Assets	-17.4	-13.8	-12.7	-24.6	-4.9	-6.0	-3.3

Source: Bank of PNG

Table 2: Summary of Other Macroeconomic Indicators

INDICATOR	2014 (actual)	2015 (actual)	Mar 2016 (MPS)	Actual to June 2016	2016 (proj)	2017 (proj)	2018 (proj)
CONSUMER PRICE INDEX (annual % changes)							
Headline	6.6	6.4	6.5	6.8	7.0	7.5	6.0
Trimmed-mean	6.1	1.9	4.5	1.7	5.5	5.5	4.0
Exclusion- based	7.7	1.4	4.0	2.6	4.0	5.5	4.0
BALANCE OF PAYMENTS (kina millions)[1]							
Current account	5,964	12,153	7,963	7,376.6	10,419	14,355	13,439
Capital & Financial account*	-6,819	-12,831	-8,473	-7,514	-10,226	-14,755	-13,471
Overall balance	-861	-753	-510	-74	194	-400	-32
Gross Int. Reserves	5,980	5,227	5,183	5,153	5,467	5,136	5,104
IMPORT COVER (months)							
Total	7.5	10.0	6.7	10.6	7.4	8.1	7.8
Non-mineral	10.5	15.8	13.0	17.0	18.6	21.0	21.5
EXPORT PRICE							
Crude oil (US$/barrel)**	98.6	51.6	33.0	43.9	43.9	50.5	58.1
Gold (US$/ounce)	1,133.0	1,147.6	1,044.6	1,240.5	1,227.9	1,240.2	1,252.6
Copper (USc/pound)	296.4	262.4	224.9	244.2	225.0	260.0	300.0
Nickel (US$/tonne)	18,885.3	11,568.9	8,572.6	9,535.8	8,242.6	8,691.9	10,184.6
Cobalt (US$/tonne)	23,855.9	28,178.0	22,288.8	25,644.3	22,752.1	26,852.1	25,499.7
LNG (US$/ mmbtu)	14.0	9.7	8.3	6.8	6.0	6.1	6.3
Condensate (US$/barrel)	86.8	51.0	32.0	46.3	30.9	34.9	38.1
FISCAL OPERATIONS OF THE GOVERNMENT* **							
Surplus/Deficit (K'm)	-2,815.2	-2,491.8	-2,112.5	-624.8	-2,112.5	-1,346.2	-898.7
% of GDP	-6.9	-4.9	-3.1	-0.9	-3.1	-2.3	-1.5
REAL GROSS DOMESTIC PRODUCT (annual % growth) * **							
Total GDP	13.3	9.9	4.3	n.a.	2.2	2.4	2.0
Non-mineral GDP	1.2	2.4	3.4	n.a.	2.6	3.6	3.6

Source: Bank of PNG, NSO and Department of Treasury

* Now includes Capital account.
* * Prices take into account, company hedging and differ from market prices.
*** 2016 figures are from the 2016 Supplementary Budget, while 2017 - 2018 projections are from the 2016 National Budget.
n.a. not applicable

[1] PNG LNG exports are included in 2014. Full year annual production occurred from 2015 onwards.