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 2017

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 2017 issue of the Quarterly Economic Bulletin (QEB).

Objective of Monetary Policy

The objective of monetary policy in Papua New Guinea (PNG) is to achieve and maintain price stability. This entails low inflation supported by stable interest and exchange rates. The maintenance of price stability 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

The improvement in PNG's external balance in 2016 continued into the first half of 2017, as projected in the March 2017 Monetary Policy Statement (MPS), with a surplus in the overall balance of payments. This was driven by increase in prices and production of some of the agricultural and mineral export commodities, including LNG. However, the improvement did not lead to higher Government revenue and significant foreign exchange inflows. As a result, the budgetary and foreign exchange situation that prevailed since 2015 continued in 2017. The Government therefore announced a Supplementary Budget in September 2017 with downward revisions in expenditure of K494.3 million and revenue of K494.1 million. This will maintain the deficit of K1,876.2 million as in the original 2017 Budget.

The Bank's assessment of foreign exchange market data shows that the total supply of foreign currency, including the Central Bank's intervention, was more than sufficient to clear the outstanding daily orders in the spot market. However, the Authorised Foreign Exchange Dealers (AFEDs) claim that the inflows are not enough to meet the demand for foreign exchange and the imbalance continues to persist. The outstanding orders by AFEDs reflect frontloading of orders, preference for serving small orders and others not backed with the required kina funds.

The Central Bank agreed for an intervention of US$100 million in the Government's 100 Day 25 Point Plan. The Deputy Prime Minister and Treasurer agreed with Oil Search, a domestic crude oil extractor and Puma Energy, the owner of the local oil refinery and the largest foreign currency user in the country, for 50.0 percent of the annual purchases of crude to be settled in kina. This will ease the demand for foreign currency in the market.

The improvement in the external sector is expected to continue in the second half of 2017 and in the medium-term, due to increases in prices and production of mining and non-mining export commodities. In line with this, the Bank projects real GDP growth to be around 2.7 percent as forecasted in the 2017 Supplementary Budget and expects further increases in the medium-term. The Bank considers that this forecasted growth would not exert pressure on inflation.

Considering these developments, the Bank will maintain a neutral policy stance over the next six months. It will continue to monitor developments in inflation and other macroeconomic indicators and may adjust its monetary policy stance as necessary.

Monetary Policy Discussions

1. Monetary Policy Assessment, Issues and Expectations

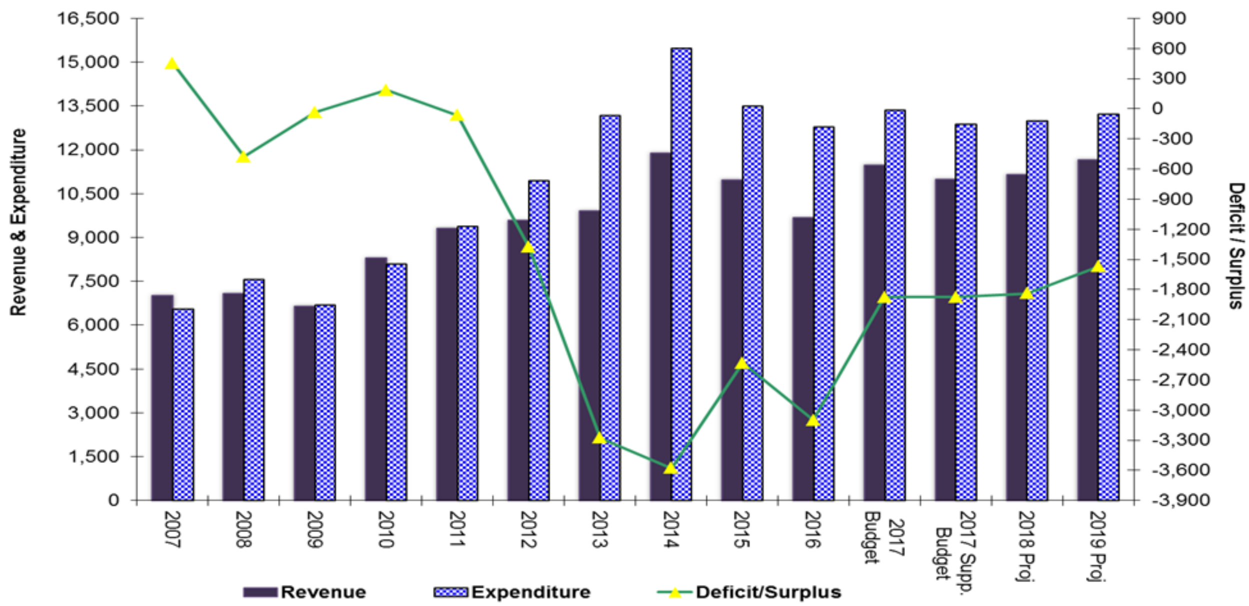
PNG experienced an improvement in the prices and production of some of its export commodities in the first half of 2017. This led to a surplus in the overall balance of payments, and relative stability in the kina exchange rate. However, Government revenue was not as high as the increase in expenditure. The Government resorted to more domestic financing with the issuance of securities to finance the budget deficit.

The preliminary fiscal outcome of the National Government continued to be in deficit for the seven months to July 2017. Over this period, both total revenue and expenditure comprised 50.1 percent of the 2017 Supplementary Budget.

The newly-elected Government introduced a 100 Day 25 Point Plan in August followed by a Supplementary Budget in September 2017, to ensure macroeconomic stability. The Government aims to maintain the deficit-to-GDP ratio of 2.5 percent. This will be achieved through reduction in expenditure and improved revenue collections. The Government plans to stimulate economic activity through spending in key priority areas that would improve the productive capacity of the economy as well as promoting import substitution industries mainly in the agriculture sector.

The debt level has risen significantly from K8.5 billion in 2012 to K24.1 billion as at end of June 2017. It is projected to decline to K23.8 billion by the end of the year compared to the 2017 original Budget estimate of K21.6 billion.

Chart 1: Fiscal Operations of the Government (K'm)



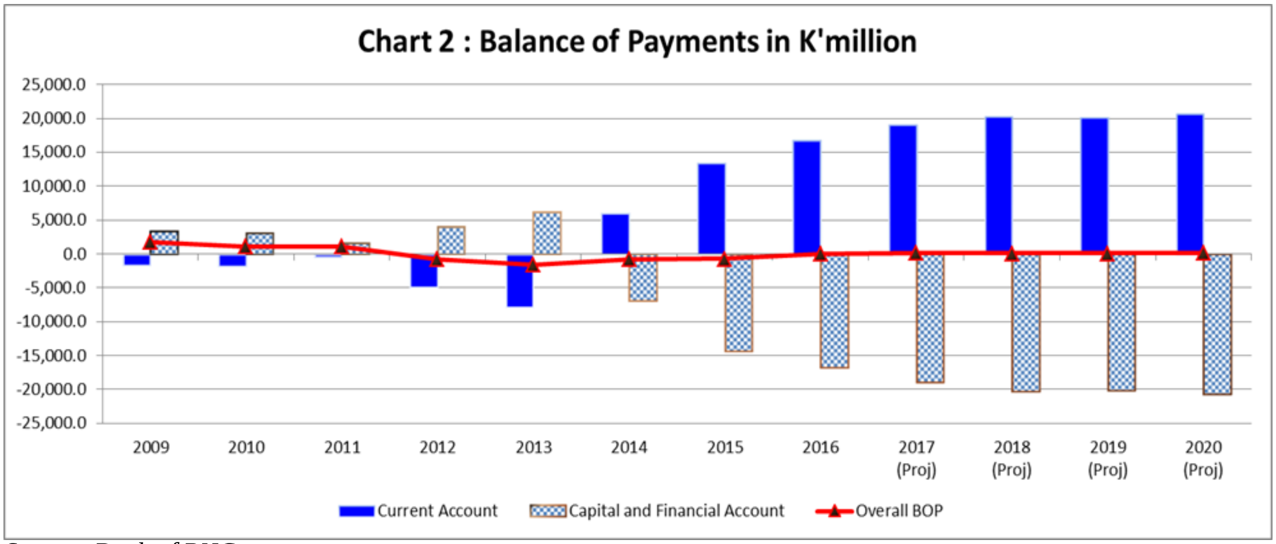
Source: 2017 Budget and 2017 Supplementary Budget

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

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

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

LNG, Frieda River or Wafi-Golpu advance to development stage over the coming two years, there will be positive contributions to the balance of payments.



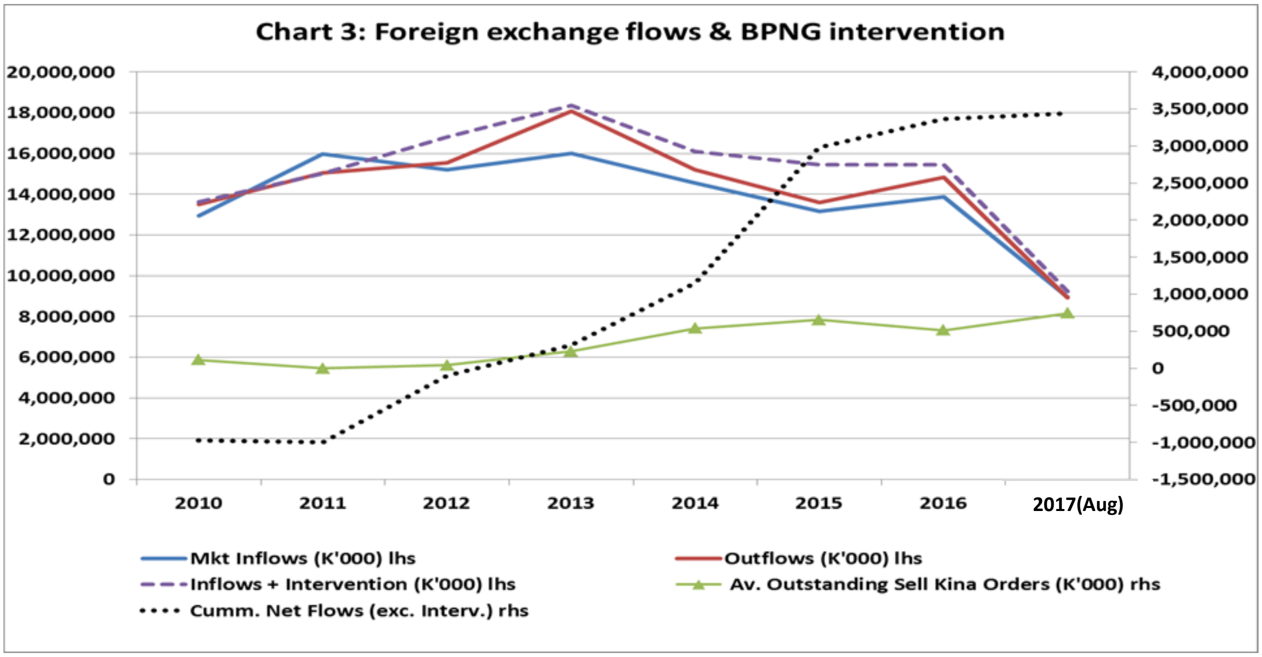
Source: Bank of PNG

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

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

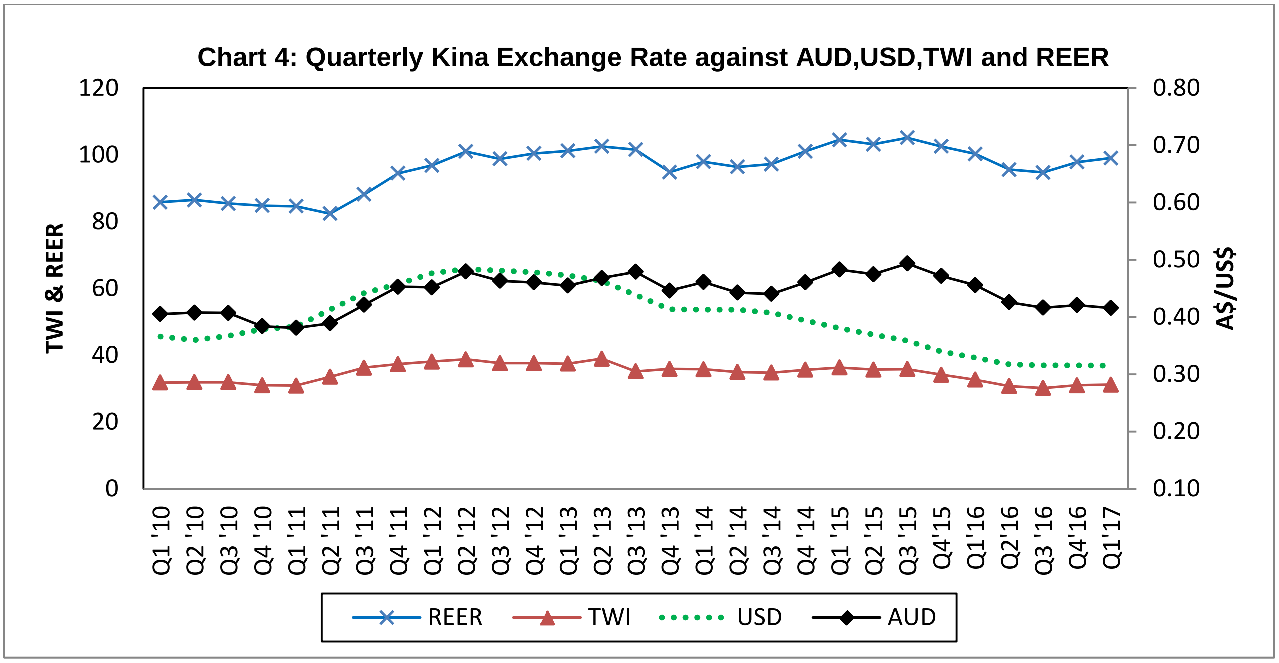
To further improve the functioning of the foreign exchange market, a Foreign Exchange Market Directive was issued in April 2017 to the AFEDs to cease providing trade finance loans in all currencies, including kina, to be settled in foreign currency. By the end of April, all trade finance loans have matured.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

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



Source: Bank of PNG

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



Source: Bank of PNG

The Trade Weighted Index (TWI) declined by 7.3 percent between end December 2016 and 18th September 2017. The Real Effective Exchange Rate (REER) appreciated by 1.2 percent in the March quarter of 2017, compared to the December quarter of 2016, reflecting the appreciation of kina against most major currencies (See Chart 4).

For 2017, the Bank projects real GDP growth to be around 2.7 percent as forecasted in the 2017 Supplementary Budget. The growth reflects full-year production at Ok Tedi mine, and increased production at Ramu Nickel and Cobalt, Lihir and Porgera mines, and in the 'Agriculture, Fishing and Forestry' (AFF) sector, supported by improvements in the prices of some of the export commodities. The rest of the non-mineral sector is expected to grow marginally.

In the medium-term, real GDP growth is projected to be around 2.7 percent for 2018 and 2019 as shown in the 2017 Budget. The growth is expected to be broad-based across almost all sectors, mainly driven by the AFF, mineral, manufacturing, construction, commerce, and transport sectors. One of the major factors that would impact on growth especially in 2018 is the hosting of the Asia-Pacific Economic Cooperation (APEC) meetings and other related activities.

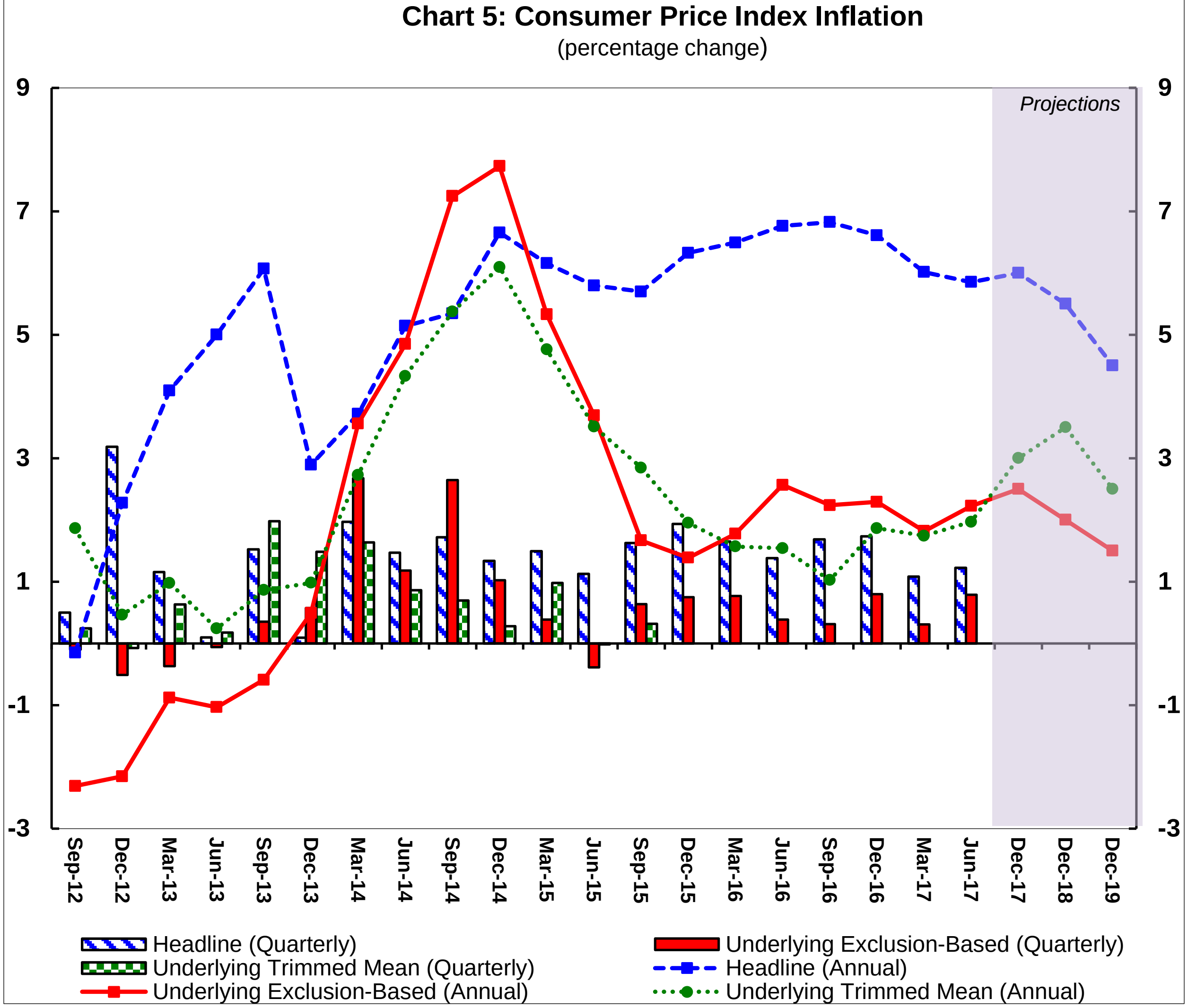
Annual headline inflation was 5.8 percent in the June quarter of 2017, down from 6.0 percent recorded in the March quarter of 2017 and 6.6 percent in the December quarter of 2016. This lower outcome was mainly driven by seasonal items, as prices of fruits, vegetables and betelnut have come down as the effect of El Nino drought ended and the pass-through of low imported inflation, slowing domestic economic activity, high competition and sourcing of cheaper imports. The annual trimmed-mean and exclusion-based measures for underlying inflation were 2.0 and 2.2 percent, respectively (See Chart 5).

For 2017, the Bank revised downwards its projection for annual headline inflation to 6.0 percent from 6.5 percent in the March MPS. The Bank also revised downwards its trimmed-mean and exclusion-based inflation projections to 3.0 and 2.5 percent, respectively. The revised projections are based on the general downward trend in inflation since June 2016 and the relative stability in the kina exchange rate.

In the medium-term, the Bank projects annual headline inflation to be around 5.5 percent in 2018 and 4.5 percent in 2019. The trimmed mean and exclusion-based inflation measures are projected to be around 3.5 percent and 2.0 percent, respectively, in 2018 and 2.5 percent and 1.5 percent in 2019.

The upside-risks to these projections include:

- significant increase in import demand;
- further depreciation in the kina exchange rate;
- increase in prices of seasonal items;
- stronger global economic recovery and pick-up in foreign inflation; and
- any unforeseen supply and demand side shocks to the economy.



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

In light of the Government's tight cash-flow and domestic financiers reaching their limit on sovereign exposure, the Central Bank had to assist the Government by buying Government Securities (Treasury bills and bonds) when the auctions were undersubscribed. The formal arrangement, referred to as the Slack Arrangement, was entered into by the Treasury Department and the Bank from September 2014 to March 2015. Thereafter, this arrangement continued through exchange of letters up to 2016.

The Bank has actively sterilised this liquidity generated by the Slack Arrangement through on-selling of the Government securities and CBBs to the market. As at the end of August, the Bank's holding of securities (Treasury bills and bonds) under the Slack Arrangement was K1.600 billion. It has issued CBB and Tap totalling K1.588 billion.

The Bank is now offering these Government Securities to the public under a new Tap Facility. The minimum amount for purchase is K5,000.00 to provide retail investors an alternative investment avenue and diversification of investment portfolios. The returns on these securities are attractive and provide investors with another investment avenue. The Tap Facility is another instrument in which the Bank is diffusing liquidity from the banking system as part of its monetary policy operations.

The Bank forecasts a growth in broad money supply of 8.0 percent in 2017, compared to an increase of 10.9 percent in 2016, due to an increase in net domestic assets and a small increase in net foreign assets of the banking system. The increase in net domestic assets is expected from growth in net credit to the Government of 15.1 percent and private sector credit of 2.5 percent. The monetary base is projected to increase by 7.3 percent, influenced by an increase in net domestic assets. The Bank considers the projected growth in monetary aggregates sufficient to support the growth in the non-mineral private sector (See Appendix Table 1).

PNG will continue to be exposed to external and domestic shocks and therefore will need to develop the non-mineral sector to broaden the economic base, thereby minimizing the impact of these shocks. Expanding the export sector including services, encouraging import substitution industries, and developing downstream processing activities would help address the challenges faced in sustaining revenue and the foreign exchange market.

2. Monetary Policy Stance

Inflation is on a downward trend reflecting the slowing down of the economy as well as lower imported inflation and relative stability in the kina exchange rate. As a result, the Central Bank revised downwards its inflation projections for 2017 made in the March MPS. The annual headline inflation is revised to 6.0 percent from 6.5 percent while the underlying inflation is revised to between 2.5 and 3.0 percent, from between 3.0 and 3.5 percent. Considering these projections, the Central Bank will maintain a neutral monetary policy stance over the next six months but will continue to closely monitor developments in inflation and other macroeconomic indicators and may adjust its monetary policy stance as necessary.

3. Conduct of Monetary Policy

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

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

Appendix

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

INDICATOR	2014 (actual)	2015 (actual)	2016 (actual)	Mar 2017 (MPS)	Actual to Jun 2017	2017 (proj)	2018 (proj)	2019 (proj)
Broad Money Supply	3.4	8.0	10.9	10.3	6.6	8.0	8.9	7.3
Monetary Base	37.1	-2.2	24.4	2.5	14.3	7.3	7.1	6.9
Claims on the Private Sector	3.6	3.4	7.2	6.9	1.2	2.5	3.0	2.1
Net Claims on Gov't	51.1	28.4	48.3	16.6	19.6	15.1	12.9	8.9
Net Foreign Assets	-17.4	-13.8	-18.1	30.9	0.6	3.9	7.8	1.9

Source: Bank of PNG

Table 2: Summary of Other Macroeconomic Indicators

INDICATOR	2014 (actual)	2015 (actual)	2016 (actual)	Mar 2017 (MPS)	Actual to Jun 2017	2017 (proj)	2018 (proj)	2019 (proj)
CONSUMER PRICE INDEX (annual % changes)								
Headline	6.6	6.4	6.6	6.5	5.8	6.0	5.5	4.5
Trimmed-mean	6.1	2.3	1.9	3.5	2.0	3.0	3.5	2.5
Exclusion- based	7.7	1.4	2.2	3.0	2.2	2.5	2.0	1.5
BALANCE OF PAYMENTS (kina millions)[1]								
Current account	5,964	13,392	16,650	13,029	9,545	18,917	20,228	20,035
Capital & Financial account	-6,819	-14,188	-16,623	-11,669	-9,425	-18,803	-20,167	-19,981
Overall balance	-861	-753	31	1,360	141	114	61	54
Gross Int. Reserves	5,980	5,227	5,257	6,617	5,398	5,450	5,511	5,665
IMPORT COVER (months)[2]								
Total	7.5	10	7.2	5.6	6.2	6.2	6.0	5.8
Non-mineral	10.5	15.8	12.6	9.6	9.9	9.8	9.0	8.4
EXPORT PRICE								
Crude oil (US$/barrel)*	98.6	51.6	42.1	50.2	53.9	54.0	54.5	55.1
Gold (US$/ounce)	1,133.0	1,147.6	1,199.2	1,040.7	1,239.1	1,239.1	1,227.8	1,216.6
Copper (USc/pound)	296.4	262.4	227.4	259.6	258.1	258.1	260.7	263.3
Nickel (US$/tonne)	18,885.3	11,568.9	9,521.9	10,000.0	9,655.9	9,920.8	10,265.8	10,622.8
Cobalt (US$/tonne)	23,855.0	28,178.0	25,725.1	25,000.0	45,552.8	46,038.5	50,284.2	54,921.6
LNG (US$/ mmbtu)	14.0	9.7	6.8	8.7	8.0	8.5	8.6	8.9
Condensate (US$/barrel)	86.8	51.0	50.7	53.2	53.8	53.8	53.7	54.9
FISCAL OPERATIONS OF THE GOVERNMENT**								
Surplus/Deficit (K'm)	-2,815.2	-2,532.6	-3,086.9	-1,876.6	-941.8	-1,876.6	-1,839.1	-1,570.3
% of GDP	-6.9	-4.1	-4.6	-2.5	-1.3	-2.5	-2.3	-1.8
REAL GROSS DOMESTIC PRODUCT (annual % growth) ***								
Total GDP	12.5	11.8	2.0	2.8	-	2.7	2.7	2.7
Non-mineral GDP	3.3	2.0	2.5	3.0	-	3.0	3.5	3.5

Source: Bank of PNG, NSO and Department of Treasury

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

** Actuals for 2017 is up to July. 2017 projections from the Supplementary Budget. 2018 - 2019 projections are from the 2017 National Budget.

*** GDP figures for 2014 are from NSO and for 2015 to 2019 are from the 2017 National Budget.

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

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