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 2018

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 2018 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 is expected to lead to:

- Confidence in the kina exchange rate;
- A foundation for stable fiscal operations of the Government;
- Certainty for businesses to plan for long-term investment;
- Confidence in management of the economy; and
- A stable macroeconomic environment conducive to economic growth.

Executive Summary

The higher than anticipated recovery in production of LNG following the earthquake in February 2018 along with improved prices and production of some of PNG's major export commodities contributed to ongoing economic activity during the first half of 2018. The improvement in the external sector resulted in relatively high inflows of foreign exchange. While recovery in the post-earthquake period has been noteworthy, it may not fully offset the downside impact. The Government therefore revised downwards its real GDP growth forecast for 2018 to 1.0 percent from 2.4 percent. The Central Bank projects growth for 2018 to be slightly above Treasury's projection. The overall GDP growth is expected to be driven by the non-mineral sector. High Government expenditure, Asia-Pacific Economic Cooperation (APEC) related activities and the turnaround in private sector credit will also contribute to growth in economic activity.

Papua New Guinea has been hosting the APEC meetings throughout the year and will conclude with the Leaders' Summit in November 2018. The hosting of APEC is expected to positively impact the economy, increasing business activity and raising the profile of PNG as an investment and tourism destination. The short term impact maybe limited, however it may have a significant impact on growth in the long-run.

PNG's foreign exchange earnings are significant as reflected by the high current account surplus and can more than adequately cover all domestic demand for foreign currency. However, the Project Development Agreements (PDAs) allow developers of various extractive industry projects to keep export earnings in foreign currency accounts offshore to meet external liabilities. The inflows into the economy are mainly from the agriculture exports, tax revenue, and other sources. While there has been an improvement in foreign exchange inflows into the domestic market, the backlog of orders continue to remain high. To address this issue, the Central Bank will use the foreign exchange inflows from the external financing sources and mining and petroleum taxes to support the market over time.

In the 2018 Mid Year Economic & Fiscal Outcome (MYEFO), the higher than projected total revenue led to an upward revision in the total expenditure for 2018 by an equal amount of K213.2 million, thus maintaining the budget deficit of K1,987.2 million. The deficit will be financed from external sources, while domestic financing will be lower reflecting retirement of short term domestic debt. The Medium Term Fiscal Strategy (MTFS) 2018-2022, encompassing reforms in revenue, expenditure and debt management will assist the Government to manage its fiscal operations prudently as well as broadening its tax-revenue base.

The high level of liquidity in the banking system has contributed to the weakening of the transmission of monetary policy and its impact on the economy. The Bank will therefore undertake refinements to its monetary policy framework to improve the transmission of monetary policy in the economy. This would include refinements to the reserve money framework and the open market operations to better influence and align market interest rates to the policy rate.

The Bank has revised downwards its projection of annual inflation to around 4.5 percent in 2018, mainly reflecting lower prices of seasonal items. In the medium term, the Bank projects annual headline inflation to be around 5.0 percent in 2019 due to the expected depreciation of the kina before coming down to 4.0 percent in 2020.

In considering these developments and projections, the Central Bank will maintain a neutral stance of monetary policy over the next six months. The Bank will closely monitor developments in inflation and other macroeconomic indicators, and may adjust its stance as necessary. It will also monitor the outcomes from the proposed strategy for the foreign exchange market and changes in the conduct of monetary policy to ensure that long term macroeconomic stability is maintained.

Macroeconomic and Monetary Policy Discussions

1. Developments

The external sector continued to improve in the first half of 2018, with a higher surplus in the current account more than offsetting a deficit in the capital and financial account, resulting in an overall balance of payments surplus of K98.7 million during that period. This led to an increase in foreign exchange inflows and higher mining and petroleum taxes. Together with an increase in domestic tax and non-tax revenue from improved compliance, Government revenue was on par with the budget or better and enabled the Government to maintain its priority expenditures in education, health and other areas including APEC related activities. These developments point to continued growth in the economy in the first six months of the year.

Total export receipts improved in the second quarter of the year due to increases in international prices and production of some of PNG's major export commodities. This more than offset the fall in export earnings in the first quarter, associated with the temporary shutdown of LNG and crude oil facilities and Porgera mine following the earthquake in February, and resulted in the current account surplus for the first half of 2018. This improvement combined with inflows from budget support assisted in meeting some of the outstanding sell kina orders in the foreign exchange market.

Domestic revenue collections continue to improve following the implementation of the Medium Term Revenue Strategy (MTRS) 2018-2022, which entails improving tax administration and compliance. This combined with the budget support from external sources assisted the Government to maintain expenditure on priority areas such as education, health, infrastructure and APEC related activities. For the first half of 2018, the MYEFO reported that the budget deficit was K324.9 million, representing 0.4 percent of nominal GDP, with total revenue of K5,553.3 million and expenditure of K5,878.2 million.

Annual headline inflation for the March quarter 2018 was 4.5 percent, compared to 6.0 percent in the March quarter of 2017. The fall in inflation was due to lower prices of seasonal items and lower imported inflation. High competition, imports from cheaper sources and some import substitution effect also contributed to the downward trend in inflation outcomes.

The impact of the earthquake in the Highlands region in February 2018 on prices was minimal. In consideration of the downward trend in annual headline inflation from a quarterly average of 6.7 percent in 2016 to a quarterly average of 5.4 percent in 2017, and the Bank's expectation of headline inflation to be within its initial forecast of 5.0 percent in 2018, the Bank maintained a neutral monetary policy stance by keeping the monthly policy signalling rate, the Kina Facility Rate (KFR), at 6.25 percent throughout January to September, 2018.

2. Issues

While there has been an improvement in foreign exchange inflows into the domestic foreign exchange market, demand for foreign currency continues to be greater than supply and consequently there is still a backlog of sell kina orders. With the improvement in the foreign exchange inflows and interventions by the Central Bank, the time taken in serving import orders has declined. Total outstanding orders have declined from K2.2 billion in March 2018 to K1.7 billion at the end of August. The Central Bank will use the foreign exchange inflows from the external loans and mining and petroleum taxes to support the foreign exchange market and help clear the backlog of sell kina orders.

A depreciating kina under the current foreign exchange market conditions should make PNG's exports more competitive and therefore production should increase in the short term, and improve the external sector towards a sustainable economic growth path. There is some evidence of a positive impact on the overall exports to a depreciation of kina, although not all export commodities may respond in the same manner. A weaker kina should encourage some import-replacement products, particularly in the agriculture sector. There has been an increase in the production of food items such as rice, poultry and a few import replacement products such as dairy milk and vegetables by some local industries.

In total, PNG's foreign exchange earnings should more than adequately cover all the demand for foreign currency. This is not happening because various Project Development Agreements (PDAs) allow developers of the various extractive industry projects to keep export receipts in foreign currency accounts offshore. This explains why the current account surplus does not translate to a significant increase in foreign exchange inflows, and why there continues to be a deficit in the financial and capital account.

This raises the need for better co-ordination and consultation amongst all relevant State agencies during project negotiation stage to come up with better terms and conditions of PDAs for the country. To improve the negotiation capacity of the Government in PDAs, the Central Bank is liaising with the relevant State agencies to address the issues and concerns relating to revenue and foreign exchange. The Government in providing concessions to the extractive industries has contributed to the challenges of raising revenue to fund its expansionary fiscal policy. After realising these challenges and the financial and development risks associated with the increase in public debt, the Government is now implementing the MTFS 2018-2022 to reign in on expenditure and improve revenue collection. This has led to improvement in Government's fiscal position and cash-flow. As part of its fiscal consolidation, it should consider aligning expenditure with revenue, and reduce its public debt from any windfall revenue. While the reforms are intended to better manage Government's expenditure, effective spending on priority areas of income generation such as infrastructure, agriculture/forestry/fishery sector and the SMEs, is important. This would help broaden revenue and export base of the economy and increase foreign exchange inflows to meet the increasing import demand.

The transmission of monetary policy to market interest rates continues to be weak and remains a challenge for the Central Bank. Government deficit financing contributes to the already high level of liquidity in the banking system, which weakens the transmission process. The transmission of monetary policy works better in a tight liquidity situation. In 2018, the Central Bank's intervention in supplying US dollar into the foreign exchange market diffused total kina liquidity of K870.1 million to the end of August. There was also a diffusion of K130.7 million from the Tap Facility over the same period. However, the absorption is not sufficiently large to reduce the high level of liquidity. With the continued relatively high level of liquidity, deposit rates continue to remain low however the lending rates remain high.

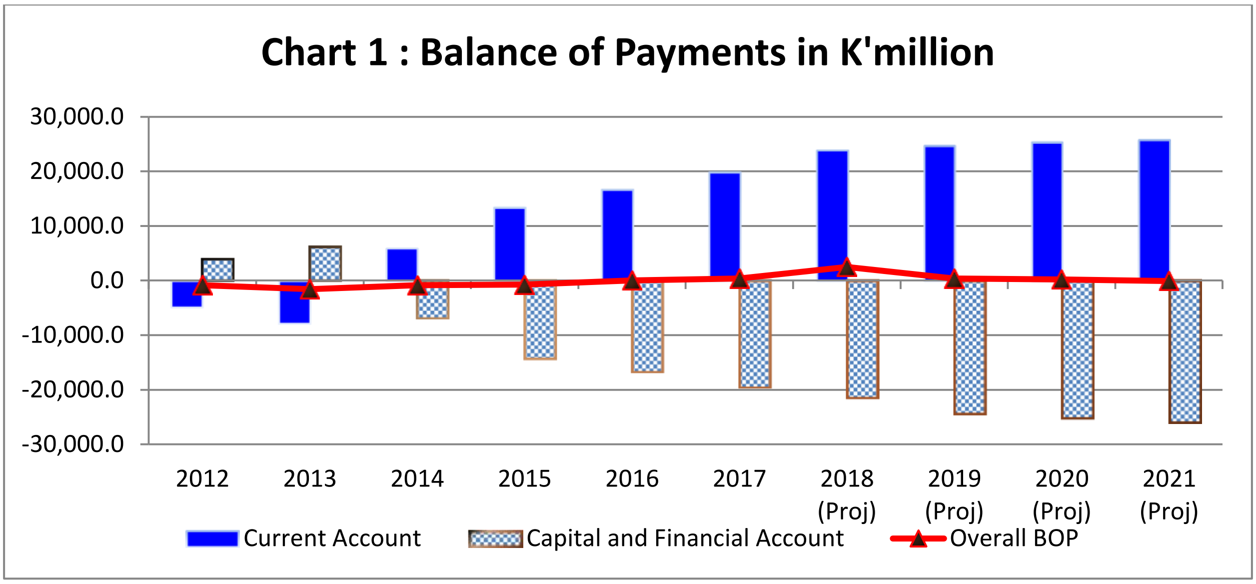
Coordination between fiscal and monetary policies needs to be strengthened to limit injection of excessive liquidity into the financial system and improve the transmission of policy. The Bank is undertaking a series of policy and operational measures to improve transmission, including moving to collateralised Repurchase Agreement Facility (Repo), introduction of the intra-day lending facility and improving the flexibility in the use of the overnight Repo for liquidity management.

3. Forecasts and Expectations

It is projected that in 2018[1], the balance of payments will record a higher surplus of K2,494.7 million, with a higher surplus in the current account more than offsetting a deficit in the capital and financial account. There will be a surplus of K23,840.1 million in the current account, due to higher prices and production of most export commodities. The capital and financial account is expected to record a deficit of K21,345.4 million, mainly reflecting debt servicing by the partners in the PNG LNG Project and the Government, and build up in offshore foreign currency account balances of the resident mineral companies (See Chart 1). This trend in the balance of payments will continue into the medium term, with projected surpluses in the current account more than offsetting deficits in the capital and financial account. As a result, overall balance of payments is projected to record surpluses in 2019 and 2020. The surpluses projected in the medium term are expected to further improve foreign exchange inflows that would assist in meeting the foreign currency needs. Furthermore, if any of the forthcoming resource projects progress to development stage during the period, this will contribute positively to the balance of payments, foreign exchange inflows, and reserve level.

As at 30th June 2018, the level of gross foreign exchange reserves was US$1,723.3 (K5,706.3) million, sufficient for 4.8 months of total and 8.3 months of non-mineral import covers. The level of foreign exchange reserves will be US$2,476.7 (K8,200.9) million at the end of 2018. The increase reflects improvement in inflows from mining and petroleum tax (MPT), dividends from the State's share in the mining and petroleum projects, and royalty and development levy from the PNG LNG Project. In addition, external financing of the budget deficit from sovereign bond, concessional, commercial and other sources will also contribute to an increase in foreign exchange reserves. The proceeds of the successful issuance of the State's inaugural sovereign bond of US$500 million in September 2018, is expected to be received in early October 2018.

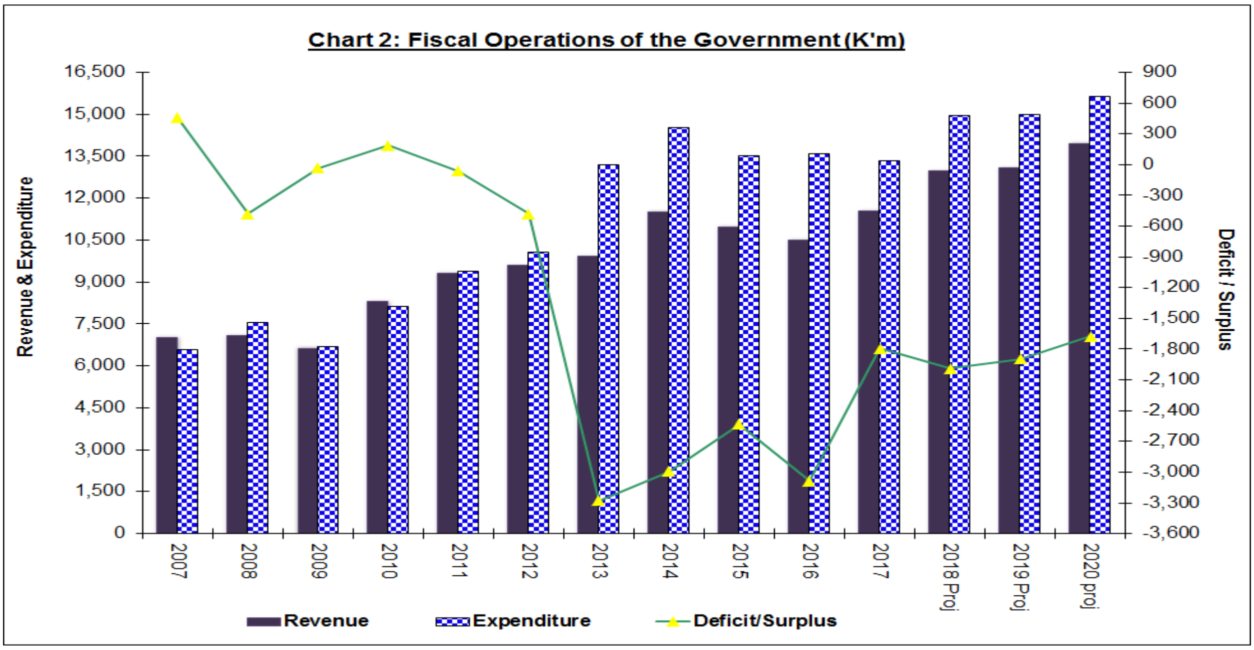
[1] The projection takes into account recovery in operations of the major mining, oil and gas projects that were impacted by the 7.5- magnitude earthquake in February, 2018.



Source: Bank of PNG

In the 2018 MYEFO, the Government's fiscal position for 2018 is projected to be a deficit of K1,987.2 million, consistent with the 2018 Budget. Both the total revenue and total expenditure were revised upward equally by K213.2 million. The projected increase in revenue reflected improvements in tax revenues while the projected increase in expenditure is mainly from the operational (recurrent) expenditure. Net external borrowing will be K3,344.3 million which will more than cover the total budget deficit of K1,987.2 million, with the remaining surplus contributing to a negative net domestic borrowing of K1,357.1 million[2]. The Bank acknowledges that the Government intends to use the surplus funds from the external borrowing to restructure its domestic debt and partly fund the deficit for 2019. According to the Government's 2019 Budget Strategy Paper, it is projecting a deficit of K1,897.5 million for 2019. Total revenue and grants are projected to be K13,058.3 million and total expenditure and is K14,955.8 million. This will be in line with the Government's target to reduce the deficit level over the medium term (See Chart 2).

[2] The balance of K1,357.1 million is negative domestic financing and can be regarded as Government deposit for use later.

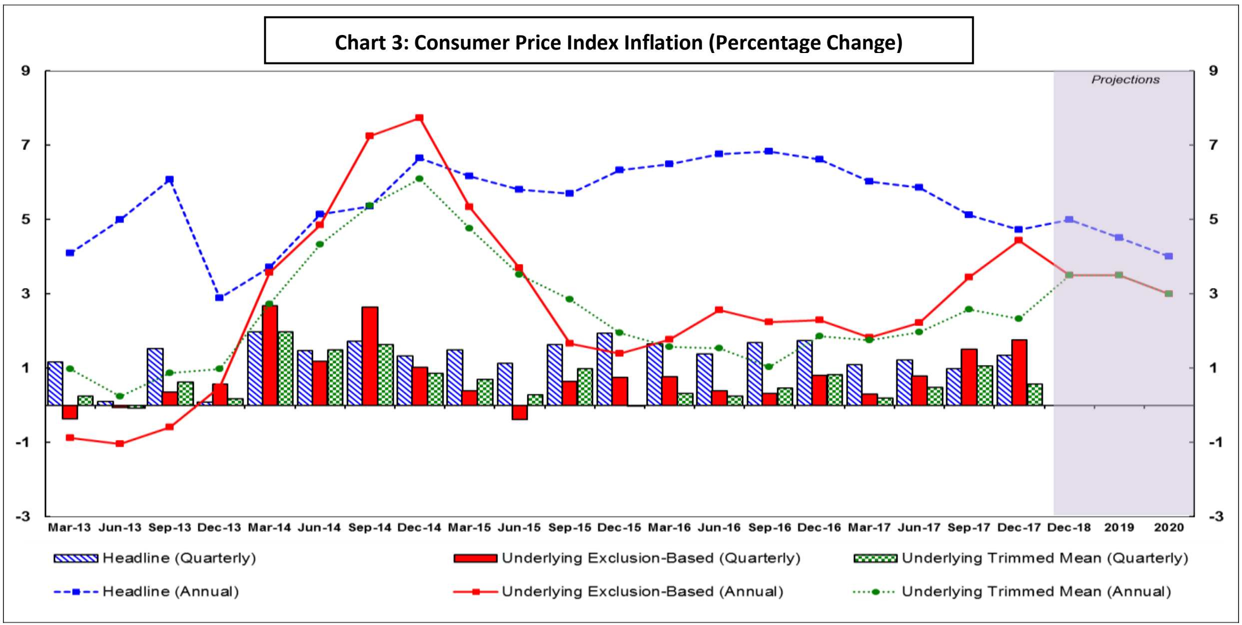


Source: 2018 Budget and MYEFO

Real GDP growth in 2018 is projected by the Bank to be slightly above Treasury's projection of 1.0 percent in the MYEFO. The significant downward revision to the projected growth for 2018 is due to the disruption of production in LNG, crude oil and condensate, and mining following the earthquake and aftershocks in February. The growth is expected to be driven by other sectors of the economy which more than offset the decline in the mineral sector. The early restart and ramp up of production of LNG and condensate and gold production by a major mine minimised the impact of the earthquake. Growth in the non-mineral GDP is broad based mainly driven by the agriculture/forestry/fishery, wholesale and retail, construction, transportation and storage, finance and insurance, and accommodation and food service sectors. Higher donor and Government spending including the hosting of APEC meetings will also contribute to this growth. Over the medium term, total real GDP growth is expected to pick up to around 3.0 percent in 2019, with a return to full year production of LNG, crude oil and condensate, and mineral commodities. A lower growth of around 2.0 percent is projected for 2020.

The Bank revised downward its projection of annual headline inflation for 2018 to 4.5 percent, from 5.0 percent in the March MPS (See Chart 3). The downward revision is accounted for mainly by lower prices of seasonal items. However, projections for both the trimmed mean and exclusion-based measures were revised upward to 4.0 percent, reflecting the pass-through effects of kina depreciation and the increase in import duty on some of the imported items. To maintain prices, the firms continue to import from cheaper sources and substitute for domestically produced goods as well as reducing cost through efficient methods of operations. The projections for 2018 may also be affected by the hosting of the APEC, especially prices in the hotel & restaurant, and retail sectors.

In the medium term, the Bank projects annual headline inflation to be around 5.0 percent in 2019 and 4.0 percent in 2020. Both the trimmed mean and exclusion-based measures of underlying inflation are projected to be around 4.5 percent in 2019 and 3.0 percent in 2020. The projected increase in 2019 is mainly due to feed through of foreign inflation and pass-through effect of a weaker kina exchange rate.



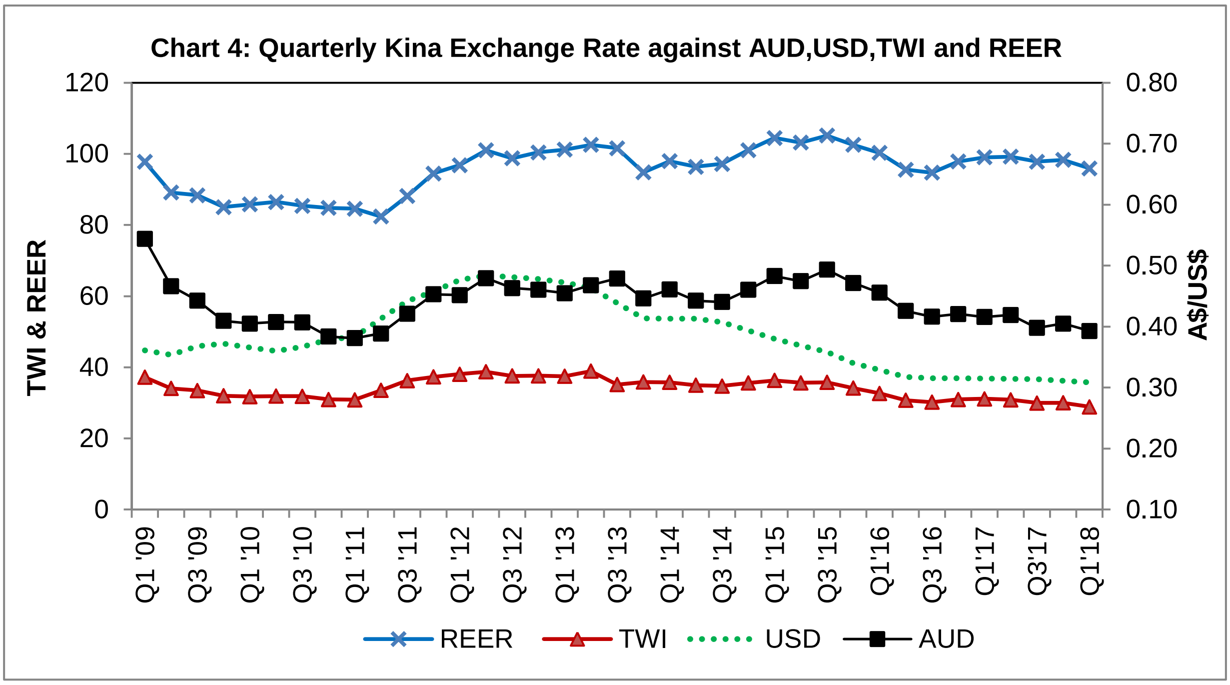
Source: National Statistics Office & Bank of PNG

The upside risks to these projections include higher pace of depreciation of the kina, unforeseen supply shocks, including natural disasters and higher imported prices from PNG's main trading partners, attributable to the trade war between US and China.

The kina depreciated against the USD from US$0.3075 at the end of March 2018 to US$0.3000 as at 21st September 2018. Against the AUD, the kina appreciated from A$0.4008 at the end of March 2018 to A$0.4112 as at 21st September 2018, as the AUD depreciated against the USD (See Chart 4).

The Trade Weighted Index (TWI) decreased by 7.3 percent in March quarter of 2018, compared to a decrease of 4.7 percent in the March quarter of 2017. The annual Real

Effective Exchange Rate (REER) depreciated by 3.1 percent in the March quarter of 2018, compared to a depreciation of 1.3 percent in the March quarter of 2017, mainly due to depreciation of kina against the currencies of some of PNG's major trading partners. The depreciation improves the competitiveness of PNG's exports.



Source: Bank of PNG

The Bank forecasts an increase of 5.0 percent in broad money supply for 2018, compared to a decline of 0.7 percent in 2017. This is due to a projected increase in net foreign assets of the banking system of 30.9 percent, which will more than offset a projected decline of 9.4 percent in net domestic assets. The increase in net foreign assets is expected from higher export receipts due to improvement in prices and production of export commodities including mining and petroleum taxes and dividends, and inflows from external financing sources. The projected decline in net domestic assets is due to lower net claims on the Central Government of 28.4 percent, which more than offset a growth in the private sector credit of 7.5 percent. The growth in the private sector credit is an indication of some pickup in economic activity. The monetary base is projected to increase by 5.3 percent from a decline of 16.6 percent in 2017, influenced by the increase in net foreign assets. Given the projected turnaround in the monetary aggregates, the Bank considers the growth in broad money supply sufficient to support activity in the non-mineral sector and contribute to the overall economic growth in 2018.

4. Monetary Policy Stance & Conduct

The Central Bank maintained a neutral monetary policy stance over the six months to September 2018 by keeping the policy signalling rate, the monthly Kina Facility Rate (KFR), at 6.25 percent. In deciding the stance of policy, the Bank took into consideration the moderate global economic growth, downward trend in headline inflation outcomes, stable outlook for headline inflation, and the relative stability of the kina exchange rate over the year to September. Headline inflation is revised downward to 4.5 percent, however, the underlying inflation measures are revised upward to 4.0 percent for both trimmed mean and exclusion-based measures reflecting some pickup in inflationary pressures. The Central Bank will work out a plan of intervention based on expected foreign exchange inflows from external sources and mining and petroleum taxes to support the market. The Bank will continue to maintain a neutral stance of monetary policy over the next six months. It will closely monitor these developments and their impact on inflation and other macroeconomic indicators, and adjust its stance as necessary to ensure that long-term macroeconomic stability is maintained.

The monetary policy framework will be designed to accommodate these new measures to improve the transmission of monetary policy. This would include refinement to the reserve money framework and the implementation of monetary policy through open market operations to better influence and align market interest rates to policy rate, and improve the transmission of monetary policy. The spending of funds and retirement of domestic debt from the external sources by the Government will increase liquidity in the banking system. The sterilization of this additional liquidity through the Bank's intervention in the foreign exchange market and open market operations requires a better coordination between monetary and fiscal policies. Monetary policy will still be managed within the reserve money framework but with a focus on influencing market interest rates to better align with the policy rate. This involves managing liquidity through Open Market Operations (OMO) to influence interest rates that would in turn affect reserve and broad money towards achieving the mandated goal of price stability to support economic growth.

The MPS provides the overall policy stance for the next six months, while the monthly policy rate signals this stance or any changes through an announcement by the Bank. Following the announcement, OMO are conducted to implement the policy stance. This involves the auction of Central Bank Bills (CBB), Treasury bills and Treasury bonds to Other Depository

Corporations and the general public and Repo transactions with commercial banks. The Bank is also making further refinement to the repo facility by moving from unsecured to secured repo with the commercial banks as well as providing a new overdraft facility, Intraday Liquidity Facility (ILF).

The Central Bank will continue to use CBBs and Government securities as instruments to manage liquidity in the banking system, and may make changes to the direct instrument of Cash Reserve Requirement (CRR), if necessary.

Box 1: Refined Intra-day Liquidity Facility

Following the introduction of the Kina Automated Transfer System (KATS) in 2013 and the need to facilitate payments on real-time basis, the Bank has made refinements to the intra-day and overnight lending facilities with the latest introduction of the Intra-day Liquidity Facility (ILF) and the collateralised Repo facility as part of liquidity management. This will assist commercial banks to settle payments on time and allow customers to have quicker access to their funds. These facilities are also intended to avoid the Liquidity and Settlement risks to the customers and the payment system.

Under the ILF, BPNG makes available funds to the commercial banks to fund shortfalls in their Exchange Settlement Account (ESA) balances on a daily basis. The funding is available on request as and when needed during the day and repaid at the end of each day. The eligible amount for each commercial bank is determined by the BPNG and the funding is unsecured and at zero cost. If the commercial banks are unable to repay from their ESAs at the end of the day, they have the first option to borrow from the interbank market or the second option is to borrow from the Repo facility.

Both the ILF and Repo facilities, while providing for KATS requirements, are also liquidity management instruments that can influence interest rates in line with the monetary policy stance.

Appendix

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

INDICATOR	2015 (actual)	2016 (actual)	2017 (actual)	Mar 2018 (MPS)	Actual to Jun 2018	2018 (proj)	2019 (proj)	2020 (proj)
Broad Money Supply	8.0	10.9	-0.7	6.3	-2.9	5.0	6.4	5.7
Monetary Base	-2.2	24.4	-16.6	3.5	-8.8	5.3	4.1	3.1
Claims on the Private Sector	3.4	6.9	-3.4	3.2	6.3	7.5	6.5	6.7
Net Claims on Government	40.1	49.6	9.5	-4.6	-11.7	-28.4	-25.1	1.4
Net Foreign Assets	-8.4	-18.1	8.2	12.8	1.1	30.9	10.8	4.9

Source: Bank of PNG

Table 2: Summary of Other Macroeconomic Indicators

INDICATOR	2015 (actual)	2016 (actual)	2017 (actual)	Mar 2018 (MPS)	Actual to Jun 2018	2018 (proj)	2019 (proj)	2020 (proj)
CONSUMER PRICE INDEX (annual % changes)1								
Headline	6.4	6.6	4.7	5.0	n.a	4.5	5.0	4.0
Trimmed mean	2.3	1.9	2.3	3.5	n.a	4.0	4.5	3.0
Exclusion- based	1.4	2.2	4.4	3.5	n.a	4.0	4.5	3.0
BALANCE OF PAYMENTS (kina millions)								
Current Account	13,392	16,650	19,665.4	20,219	9,345.8	23,840.1	24,672.2	25,261.9
Capital & Financial Account	-14,188	-16,623	-19,433.4	-18,705	-9,233.2	-21,345.4	-24,294.4	-25,056.3
Overall Balance	-753	31	350.3	1,533	99	2,494.7	377.8	205.6
Gross International Reserves	5,227	5,257	5,607.7	7,141	5,706.3	8,200.9	8,578.8	8,784.4
IMPORT COVER (months)[2]								
Total	10.0	7.2	5.5	6.9	4.8	7.7	7.7	7.5
Non-mineral	15.8	12.6	9.7	13.8	8.3	13.8	12.7	12.5
EXPORT PRICE								
Crude oil (US$/barrel)*	51.6	42.1	54.1	55.7	67.1	69.0	71.7	73.2
Gold (US$/ounce)	1,147.6	1,199.2	1,227.6	1,231.3	1,261.6	1,251.3	1,241.7	1,243.8
Copper (USc/pound)	262.4	227.4	274.7	272.2	308.8	309.7	287.6	316.9
Nickel (US$/tonne)	11,568.9	9,521.9	10,192.8	10,381.1	13,475.8	13,497.8	14,075.5	15,024.8
Cobalt (US$/tonne)	28,178.0	25,725.1	55,901.2	60,373.3	81,338.7	82,174.7	91,507.9	92,672.8
LNG (US$/ mmbtu)	9.7	6.8	7.9	7.9	9.0	9.2	9.3	9.5
Condensate (US$/barrel)	51.0	50.7	54.8	54.2	71.4	72.7	73.7	74.5
FISCAL OPERATIONS OF THE GOVERNMENT**								
Surplus/Deficit (K'm)	-2,785.7	-3,086.9	-1,794.7	-1,987.2	-324.9	-1,987.2	-1,897.5	-1,676.0
% of GDP	-4.5	-4.6	-2.4	-2.5	-0.4	-2.4	-2.2	-1.8
REAL GROSS DOMESTIC PRODUCT (annual % growth) ***								
Total GDP	10.5	2.0	2.2	2.4	1.0	1.0	2.3	3.0
Non-mineral GDP	0.7	0.7	1.9	3.5	2.8	2.8	2.9	4.2

Source: Bank of PNG, NSO and Department of Treasury

* Prices take into account company hedging and differ from market prices.
**2017 figures are from the 2017 Final Budget Outcome, while 2018-2022 projections are from the 2018 National Budget and the MYEFO.
***GDP figures for 2015 to 2020 are from the 2018 National Budget.

[1] The CPI for the June quarter 2018 is yet to be released by the National Statistical Office
[2] The calculation of the import covers includes import of both goods and services as of 2016.