MONETARY POLICY STATEMENT
BY THE GOVERNOR OF
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PORT MORESBY

30th September 2020

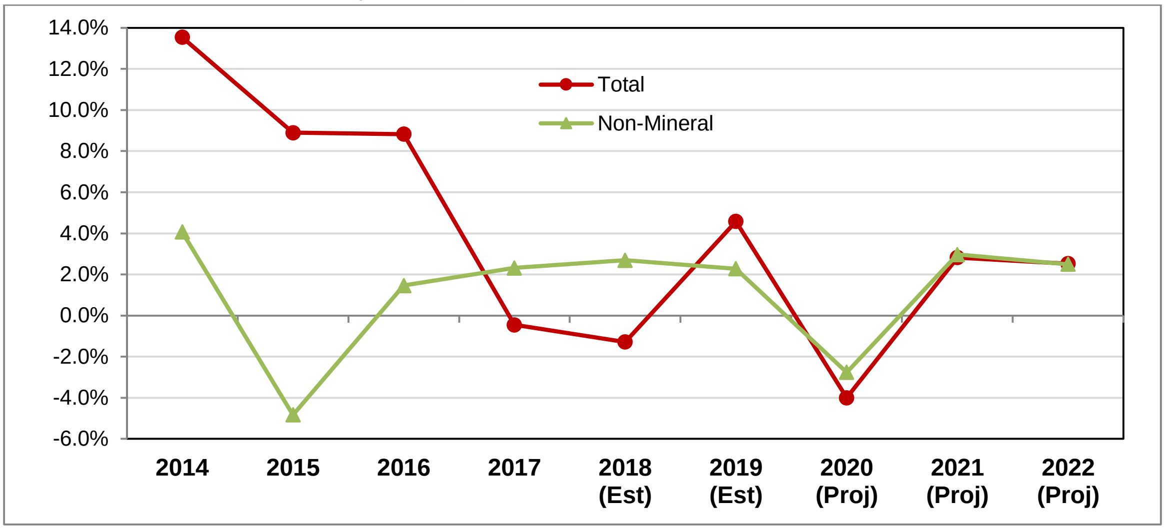
The year 2020 is experiencing an unprecedented economic downturn brought on by a global health crisis. The COVID-19 pandemic and measures implemented to contain it resulted in the largest contraction in global economic growth in decades. Papua New Guinea (PNG) is also affected with rising cases of COVID-19 infections which led to the Government imposing a State of Emergency (SOE), lockdowns and various measures to contain the virus. These measures have constrained mobility of labour and resources, affecting supply chains and limiting business operations, thus adversely impacting on economic growth. To counter this, the authorities implemented a number of policy and stimulus measures. The Central Bank expects the impact of COVID-19 pandemic to continue for the remainder of 2020 and in 2021.

For 2020, the Bank projected GDP to decline by around 4.0 percent compared to the earlier growth forecast of 0.3 percent in the March 2020 Monetary Policy Statement (MPS) (See Chart 1). The revision reflects the negative growth in PNG's major trading partners, containment measures imposed by the Government which impacted businesses and Government operations and supply chains, and temporary scale-down/shutdown of major mining operations. The closure of Porgera Mine since April, 2020 due to the expiry and non-renewal of the Special Mining Lease for the operator, Barrick (Niugini) Limited, also contributed to this negative growth. In the non-mineral sector, most sectors are expected to record lower growth. The transportation, construction, financial and insurance services, and accommodation (hotels) and food services sectors are the worst affected. To maintain their operations, most firms have reduced their costs by laying off workers, reducing working hours and delaying investment plans.

The Bank conducted a Business Pulse Survey around the country to assess the impact of the COVID-19 containment measures on the Micro, Small, and Medium Enterprises (MSMEs) sector in the first six months. Over two thirds of those surveyed have scaled down operations while the rest were temporarily closed and are expected to resume in the second half of the year. This was across all sectors of the economy, mainly in the construction, manufacturing, information and professional services. MSMEs experienced disruptions in their supply chains and cash flow, lower demand, reduced workforce and increased arrears to service providers and on loans.

Growth is projected to be positive in the medium term as economic activity recovers, businesses adjust to the 'new normal' environment and restoration of full operations at the Porgera Mine. If large new resource projects in the pipeline come on stream, growth will be higher.

Chart 1: Real GDP Growth (percent)



Source: National Statistical Office (Actuals to 2017), Department of Treasury (Estimates for 2018-2019) and BPNG (Projections for 2020-2022)

The fiscal operations of the Government were adversely impacted by COVID-19 over the six months to June 2020. The Mid-Year Economic and Fiscal Outlook (MYEFO) Report showed a deficit of K2,085.8 million, compared to a deficit of K1,667.4 million in the corresponding period of 2019. This represents 2.5 percent of nominal GDP, compared to 1.9 percent in the corresponding period of 2019.

The impact of the COVID-19 pandemic on revenue and expenditure contributed to the Government introducing a Supplementary Budget in September 2020. The Supplementary Budget has a planned expenditure of K17,989.3 million and revenue of K11,359.1 million. This gives a deficit of K6,630.2 million, an increase of K1,999.1 million from the original Budget. The deficit equates to 8.1 percent of nominal GDP. To finance the deficit, the Government plans to raise K4,261.6 million from external sources and K1,923.0 million domestically and draw down cash balances of K445.6 million from Trust Accounts. This includes funds raised through the COVID Bond issuance and the IMF Rapid Credit Facility (RCF) in the first half of the year. A fall in both tax and non-tax revenues was a result of the slowdown in business activities. The significant decline in revenue should have resulted in a significant reduction in expenditure to ease pressure on financing and ensure debt sustainability.

The shut-down of the Porgera Mine will add to further tax revenue losses. It is therefore important that the mine resumes production as soon as practicable. The Government will also have to step up efforts to improve revenue collection, broaden the tax base and get the major mineral projects in the pipeline to operational stage.

The Government's expansionary fiscal policy since the end of the PNG LNG Project construction phase was partly financed through increasing debt. The current public debt level stands at K36,874 million as at the end of June 2020, and is projected to be K39,057.8 million by year end which is 48.0 percent of GDP. Given the low revenue, the Government, while focusing on COVID-19 related expenditure, should not lose focus on key areas including agriculture, infrastructure and the Small Medium Enterprises that will stimulate and support growth.

The authorities should continue to implement structural reforms, including those under the Staff Monitored Program with the IMF. The key reforms include improving revenue generation and expenditure controls, as well as restructuring State Owned Enterprises to be more efficient, transparent and accountable, and contributing to Government revenue. In line with the

Government's efforts, the Central Bank is implementing adjustments to its monetary and exchange rate policies to support economic growth.

The Government announced plans to reform the Central Banking Act (CBA) 2000. In his speech to Parliament on the 2020 Supplementary Budget, the Treasurer proposed to increase the cash advances to the Government under the Temporary Advance Facility (TAF) and a review of the CBA. The method of calculating the TAF limit will change from one based on general price movements to that of a percentage of the average recurrent Government revenue in the immediate preceding three years. This will significantly increase the TAF amount from the current K300 million. The implications of this change are: 1) a possible inference that advances to the Government should not take into consideration the Central Bank's objectives such as the price stability objective when in fact they always must; 2) heavy reliance on Central Bank financing rather than focusing on revenue raising and expenditure control; and 3) printing of money which can adversely impact on effective monetary policy management. Repayment of the TAF is also changed to now be expected within a year, compared to the current six months.

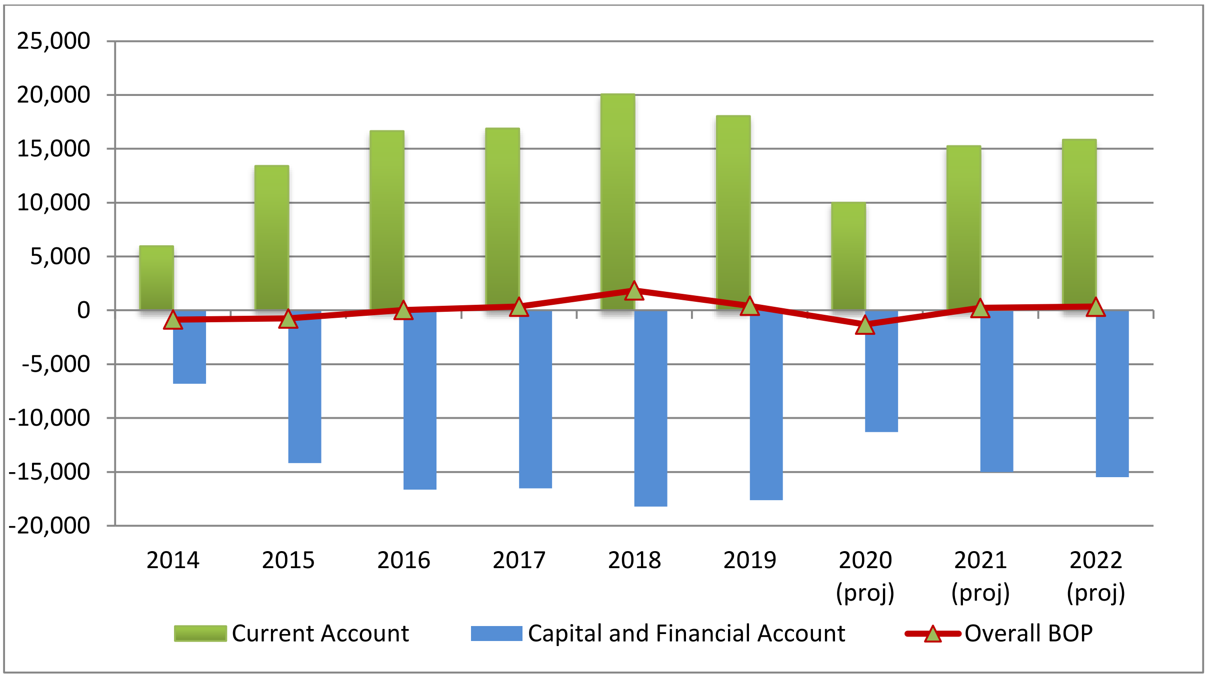
The fourth objective of the CBA 2000, subject to the other three objectives as stipulated under Section 7, is "to promote macroeconomic stability and economic growth in PNG". In line with this provision, the Central Bank can always assist the Government during emergencies, while maintaining its independence and monetary policy objective of price stability. This would include policy measures and the Quantitative Easing (QE)[1] program which assisted the Government raise funds through the COVID Bond issuance in the first half of the year.

The overall balance of payments (BOP) recorded a surplus of K43.5 million in the first half of 2020, compared to a deficit of K389.0 million in the corresponding period of 2019. This outcome was due to a higher surplus in the current account, which more than offset an increase in the deficit in the capital and financial account. The outcome in the current account was mainly driven by mineral exports and lower import payments, attributed to a further compression in imports as a result of the COVID-19 pandemic. For 2020, the Bank projects a deficit of K1,319.7 million in the overall BOP driven by a deficit in the capital and financial

[1] The QE program involves BPNG purchasing Government securities prior to their maturities from holders, who may have liquidity needs caused by the COVID-19 crisis.

account of K11,301.4 million. This mainly reflects debt servicing by the Government and private sector, and a build-up in offshore foreign currency account balances of mineral companies, including those allowed under the various Project Development Agreements. The current account surplus is projected to be K9,981.7 million (See Chart 2).

Chart 2: Balance of Payments (K'million)



Source: Bank of PNG

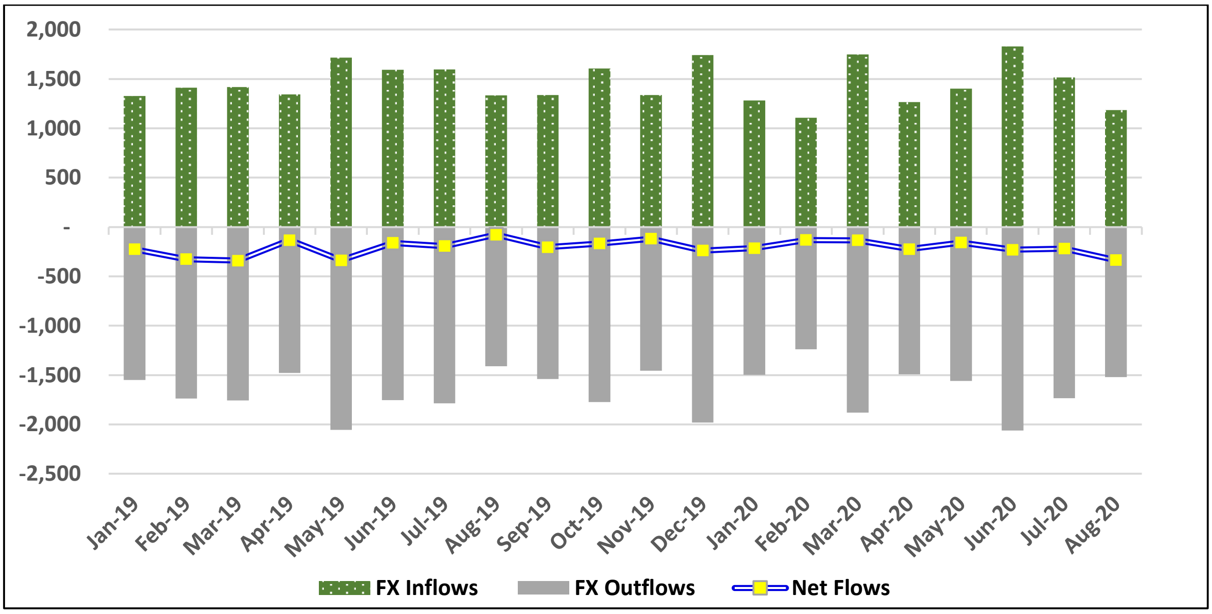
In the medium term, the current account is projected to record surpluses reflecting higher prices and production of some export commodities as the global economy recovers. The capital and financial account is projected to record deficits, reflecting debt service payments and a build-up in offshore foreign currency account balances of mineral companies. The overall BOP is projected to record surpluses in the medium term. If large resource projects in the pipeline come on stream, the surplus will be higher.

As at the end of August 2020, gross international reserve was US$2,141.2 (K7,333.0) million, sufficient for 5.5 months of total and 9.1 months of non-mineral import covers. It is projected that the level of reserves will be US$1,932.7 (K6,710.8) million at the end of 2020 and further improve in the medium term.

The foreign exchange inflows up to June 2020 improved mainly due to favorable inflows from the mineral sector, combined with the drawdown of US$363.6 (K1,240.6) million under the

IMF RCF for COVID-19 related expenditure. Since July, inflows have returned to their normal levels (See Chart 3).

Chart 3: Foreign Exchange Flows (K'million)



Source: Bank of PNG

The kina exchange rate depreciated against the US and Australian dollars between end December 2019 and September 2020. Over the period, it depreciated against the US dollar from US$0.2935 to US$0.2860 as at 30th September 2020, reflecting continued high import demand. Against the Australian dollar, the kina appreciated to A$0.4060 from A$0.3990 as at 30th September, 2020. The appreciation mainly reflected cross currency movements as the Australian dollar weakened against the US dollar.

The annual headline inflation, as measured by the Consumer Price Index, trended downwards from 4.8 percent in December 2018 to 3.1 percent in March 2020. The downward trend is a result of stable or low price increases in seasonal produce, high competition, low imported inflation and lower pass-through from the slow pace of depreciation of the kina exchange rate. Preliminary estimates by the National Statistical Office (NSO) indicate that the June inflation outcome would be higher than the March outcome mainly reflecting the impact of the COVID-19 pandemic. For 2020, the Bank will revise its annual inflation projections once the actual outcomes are released by the NSO. The upside risks to inflation include the impact of disruptions to domestic and external supply chains which can result in higher cost of goods and services.

Broad money supply is projected to grow by 3.1 percent in 2020, down from 5.4 percent in the March 2020 MPS, with a projected increase in Net Domestic Assets (NDA) more than offsetting a decline in Net Foreign Assets. The increase in the NDA reflects growth in net claims on Central Government of 10.4 percent and Private Sector Credit (PSC) of 8.0 percent. The increase in net claims on Central Government reflects the purchase of COVID Bonds and other domestic debt financing. The increase in PSC reflects the use of overdraft facilities by firms to maintain their operations during the downturn in the economy and is expected to continue in the remainder of 2020. Monetary base is projected to decrease by 8.8 percent, mainly reflecting diffusion through the purchase of COVID Bonds and other Government securities, including foreign exchange from the Central Bank. The projected growth in broad money supply and PSC are expected to support economic activity.

The Central Bank's policy responses to counter the effects of the COVID-19 pandemic included the reductions in the Kina Facility Rate (KFR) and the Cash Reserve Requirement (CRR), as well as the QE program. The reduction in CRR and the implementation of the QE program injected additional liquidity of around K1.4 billion into the banking system. The provision of liquidity through the CRR ensured the banking system liquidity was adequate to support lending to and withdrawals by the public. Despite the high liquidity level, lending by banks was low. The Bank also introduced a short-term credit facility for the second-tier financial institutions, and Parliament amended the Superannuation Act in September 2020, which allowed members early withdrawals of their own contribution to superannuation funds. A three-month moratorium on the principal and interest repayments on loans was also implemented by financial institution for their clients affected by the COVID-19 pandemic. The Bank will continue to assess the effectiveness and outcome of these policy measures and consider further actions, if appropriate.

Considering the macroeconomic developments and projections for 2020, the Bank will maintain its stance of monetary policy in the next six months. It will closely monitor the developments on inflation and other monetary and financial indicators, and will take further measures if necessary to ensure macroeconomic stability.

Monetary policy is implemented through the reserve money framework with the aim of influencing domestic market interest rates to align with the policy rate. This involves managing liquidity in the banking system through Open Market Operations to influence interest rates to achieve and maintain price stability. The MPS provides the overall policy stance for the next six months, while the monthly policy rate, the KFR, signals this stance or any changes through an announcement by the Bank.

Queries on the contents of the Monetary Policy Statement (MPS) should be directed to the Acting Manager, Economics Department on telephone number (675) 3227309 or Manager, Monetary Policy Unit on telephone number (675) 3227312, or both on fax number (675) 3227182. 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 2020 issue of the Quarterly Economic Bulletin (QEB).