BANK OF PAPUA NEW GUINEA

MONETARY POLICY STATEMENT

September 2023

Issued by the Board of the Bank of Papua New Guinea and delivered to the Minister for Treasury by the Acting Governor, Ms Elizabeth Genia AAICD

This September 2023 Monetary Policy Statement is issued following consideration by the Board and is endorsed as the Monetary Policy Stance of the Bank of Papua New Guinea
for the following six months.

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Copies of the Monetary Policy Statement (MPS) can be obtained from the Bank's Economics Department and is available on the Bank's website: www.bankpng.gov.pg

Please direct queries on the content of the MPS to:

Manager, Economics Department	or	Manager, Monetary Policy Unit
(675) 322 7309		(675) 322 7312

Email: info@bankpng.gov.pg

Executive Summary

Papua New Guinea's real Gross Domestic Product (GDP) is expected to grow at around 2.5 percent in 2023, compared to the 3.2 percent projected in the March 2023 Monetary Policy Statement.

The Bank expects short-term growth to be driven by the non-mineral sector, offsetting a decline in the mineral sector largely caused by lower production. However, a projected decline in international commodity prices, from a slowdown in the global economy, will also affect the PNG domestic economy. BPNG sees growth picking up in both the mineral and non-mineral sectors in 2024.

The Bank's projection for the overall balance of payments is for it to be in deficit in 2023, driven by a deficit in the financial account, which more than offset a surplus in the current and capital account. The gross foreign reserves are projected to decline in 2023, affected by increased monthly interventions by the Bank and Government payments to service its external debt.

With global inflation easing, PNG's headline inflation has trended downward. However, the core inflation measures indicate that inflationary pressures remain. The Consumer Price Index (CPI) for the June quarter of 2023, published by the National Statistical Office, showed the annual headline inflation at 1.4 percent, compared to 1.7 percent in the March quarter. The Bank forecasts annual domestic inflation to be around 3.0 percent for 2023, increasing to around 4.0 percent in the medium term.

In March 2023 the Government entered into an IMF Program aiming to improve PNG's economic performance and restore macroeconomic stability and growth. The Program includes fiscal policy reforms to consolidate the budget in the medium term and for BPNG to undertake reforms to its monetary and exchange rate frameworks.

The Bank will keep a close eye on inflation risks over the next six months to March 2024, to make sure the current reforms are successfully implemented and inflationary pressures are minimised. BPNG will continue to manage liquidity using both new monetary policy tools such as the 7-day Central Bank Bills and fine-tune existing tools to improve transmission of monetary policy.

The Bank will pursue a neutral monetary policy stance over the next six months. The monetary policy stance will be adjusted, when and if required to ensure price stability, employment creation and economic growth, and to ensure macroeconomic stability.

Objectives of the Bank of Papua New Guinea

The objectives of the Bank of Papua New Guinea, set out in Section 7 of the *Central Banking Act* 2000 (as amended in 2021) are:

a) to formulate and implement monetary policy with a view to achieving and maintaining price stability and promoting employment and economic growth, especially of the non-mineral and non-petroleum sector; and
b) to formulate financial regulation and prudential standards to ensure stability and development of the financial system in Papua New Guinea; and
c) to promote an efficient national and international payments system; and
d) to provide efficient and responsive banking services to the Government.

Objectives of Papua New Guinea's Monetary Policy

Papua New Guinea's objectives for monetary policy are to achieve and maintain price stability, and to promote employment and economic growth, especially in the non-mineral sector. Price stability aims to ensure stable inflation, interest and exchange rates, while at the same time creating an enabling environment for growth and employment in the economy. The Bank of Papua New Guinea's mission is to achieve a balance between optimal economic growth to create employment, especially in the non-mineral sector, while still maintaining an acceptable level of inflation.

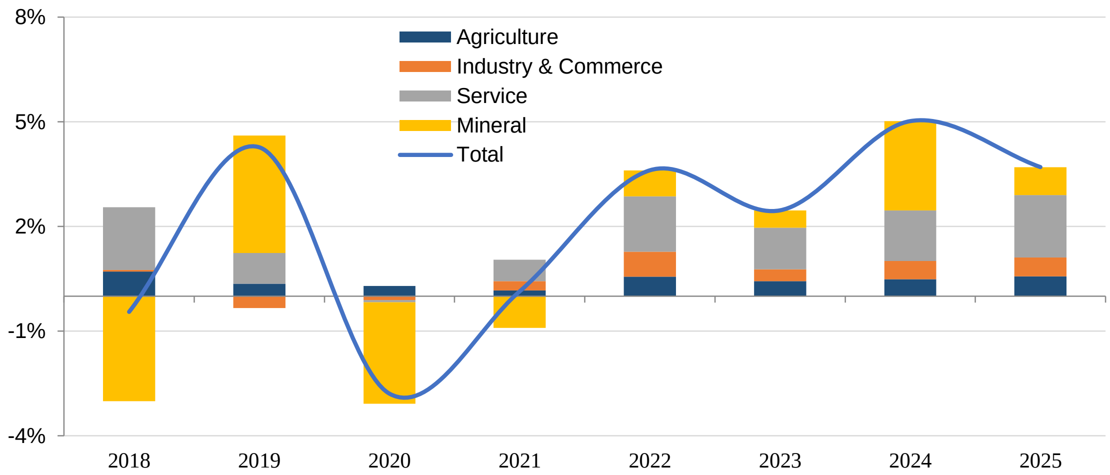
Developments, Issues and Projections

Global economic growth is projected to slow to 3.0 percent in 2023 (2022: 3.5 percent).[1]

The lower growth rate reflects the fact that central banks have been tightening monetary policy to counter high levels of global inflation. In 2023, global price increases are projected to stabilise at 6.8 percent (2022: 8.7 percent). BPNG notes the Federal Reserve's and the Bank of England's recent pause in their tightening cycles. However, the major downside risks of further slowdown in global growth will be uncertainties in the global financial markets, tighter financial conditions and an escalation of geo-political tensions.

The Bank expects these international developments, combined with lower production of extractive exports in PNG, will have a negative impact on domestic growth. Scheduled maintenance on the LNG plant site and the continued closure of Porgera gold mine are expected to weaken domestic growth. However, on the upside, the Agriculture/Forestry/Fisheries (AFF) sector and the Services sector are expected to drive growth. The increase in AFF is driven by increased production of palm oil, cocoa, copra and copra oil. Growth in the information and communication technology industry is driven by a new entrant in the telecommunications market. The finance and insurance sector will be driven by continued business activity. The transportation and storage sector is expected to grow reflecting increased demand for domestic travel and cargo haulage. Higher Government spending will also support activities in the non-mineral sector and contribute to overall growth. Based on these expected developments, the Bank projects GDP to grow by around 2.5 percent in 2023, a downward revision from 3.2 percent in the March 2023 MPS.

Chart 1: Industry contribution to real GDP growth, 2010-2022



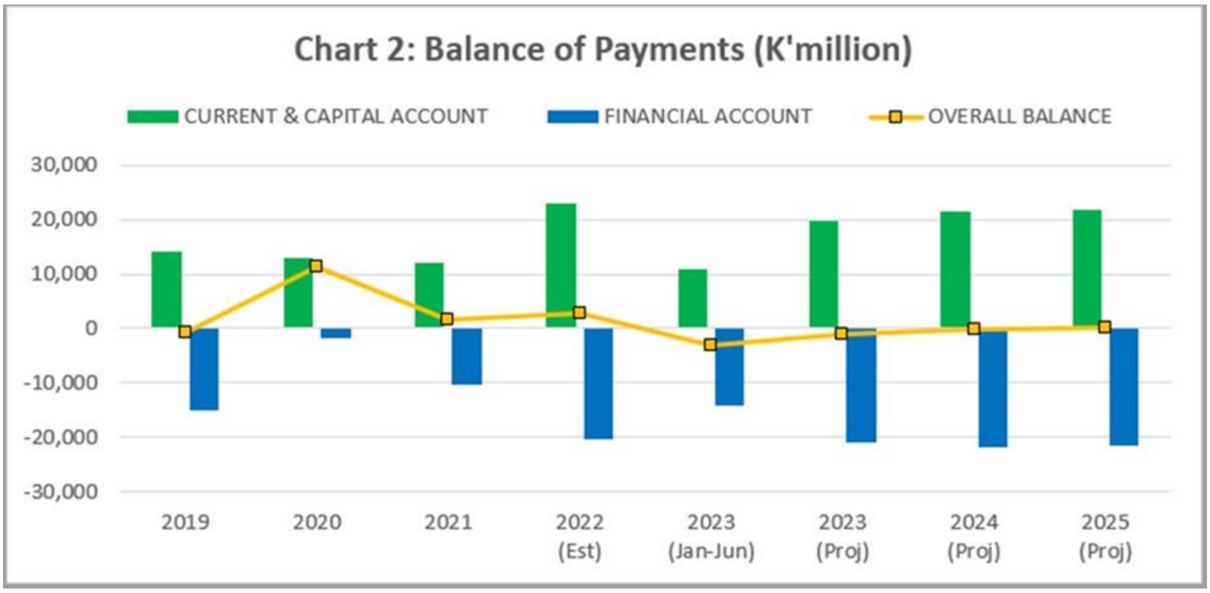
Source: Bank of PNG

[1] International Monetary Fund's (IMF) *World Economic Outlook Update* for July 2023

In the medium term, growth is projected to be around 5.0 percent in 2024 and 3.7 percent in 2025. These projections assume the resumption and a full year of production from the Porgera gold mine, and higher production of other major commodities over this period. The commencement of early works, and the announcement of the Final Investment Decision on the Papua LNG Project in the first quarter of 2024, will further contribute to this overall growth.

The overall Balance of Payments (BOP),[2] which summarises PNG's transactions with the rest of the world, recorded a deficit of K1,154.5 million for the first six months to June 2023 (Chart 2). This was due to a deficit in the financial account, which more than offset a surplus in the current and capital account.

The outcome in the current and capital account was driven mainly by a surplus in the trade account, reflecting high international prices and production of some of PNG's major export commodities. The deficit in the financial account was primarily due to a net outflow of funds from offshore foreign currency accounts for investments and external loan repayments by mineral companies, including LNG project partners.



Source: Bank of PNG

The developments in the balance of payments are heavily influenced by flows related to the concessions and exemptions provided for under the various project development agreements. Large financial outflows and the buildup of deposits in their offshore foreign currency accounts have trapped foreign currency from flowing into the domestic economy, thus creating the imbalance in the domestic foreign exchange market.

In 2023 the Bank projects an overall BOP deficit of K974.9 million, with higher net outflows in the financial account more than offsetting a surplus in the current and capital account. The financial account is projected to

[2] The Balance of Payment reporting uses the framework of Balance of Payments and International Investment Position Manual 6

have a deficit of K20,900.7 million, reflecting outflow of funds from offshore foreign currency accounts for offshore investments and external loan repayments by mineral companies, including LNG project partners.

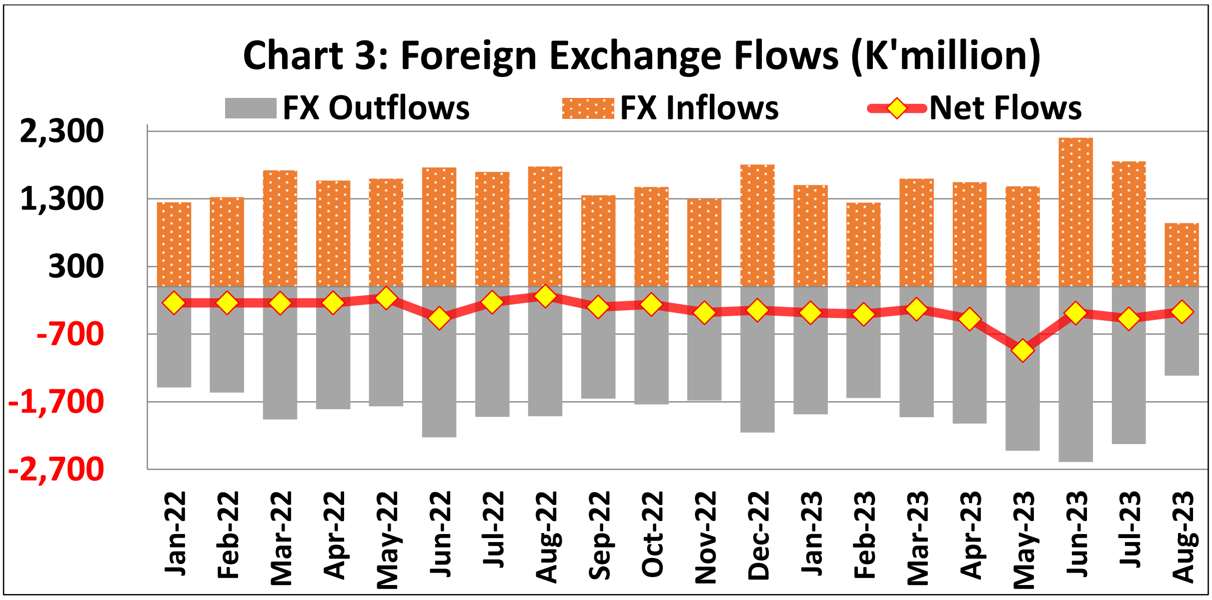
The current and capital account is projected to be in a surplus of K19,925.8 million, largely reflecting international prices and production of major export commodities.

In the medium term, the Bank projects an improvement in the overall BOP position as economic activity picks up, including the re-opening of the Porgera gold mine. This outlook would improve further should there be a significant increase in net capital inflows relating to gas projects in the pipeline, such as the Papua LNG project.

At 30th June 2023 the gross foreign reserves were US$3,760.7 (K13,083.8) million. This is sufficient for 10.4 months of total and 19.6 months of non-mineral import covers.

Between 31st December 2022 and 22nd September 2023, the Kina exchange rate depreciated against the US dollar (USD) by 3.17 percent to US$0.2750, while it appreciated against the Australian dollar (AUD) by 2.17 percent to AU$0.4281. The depreciation of the Kina against the USD indicated the excess demand over supply for foreign currency. The appreciation of the Kina against the AUD reflected the strengthening of the USD against the AUD.

High commodity prices in the eight months to August 2023 has led to total inflows of K12,372.0 (US$3,494.0) million. [(2022: K12,705.1) (US$3,609.5 million)]. Supply of foreign exchange (FX) continued to be dominated by the mining and agriculture sectors. Over the same period, FX outflows totalled K16,1356.0 (US$4,556.8) million, mainly driven by the retail and wholesale, manufacturing, finance and business, petroleum (fuel) and transportation sectors.



Source: Bank of PNG

By 30th August 2023 outstanding FX orders had increased to K1,300.0 (US$364) million [(End December, 2022: K900.0) (US$255.6 million)], mainly import orders. In May 2023 the Bank made a one-off intervention of K968.0

(USD273.0) million to clear all outstanding orders in the FX market. However, the outstanding orders increased again to the pre-intervention level. Adding in the monthly intervention of USD100.0 million in the FX market, this resulted in a total intervention of K3,453.6 (US$973.1) million by the end of August 2023 [(2022: K1,892.5) (US$537.7 million)].

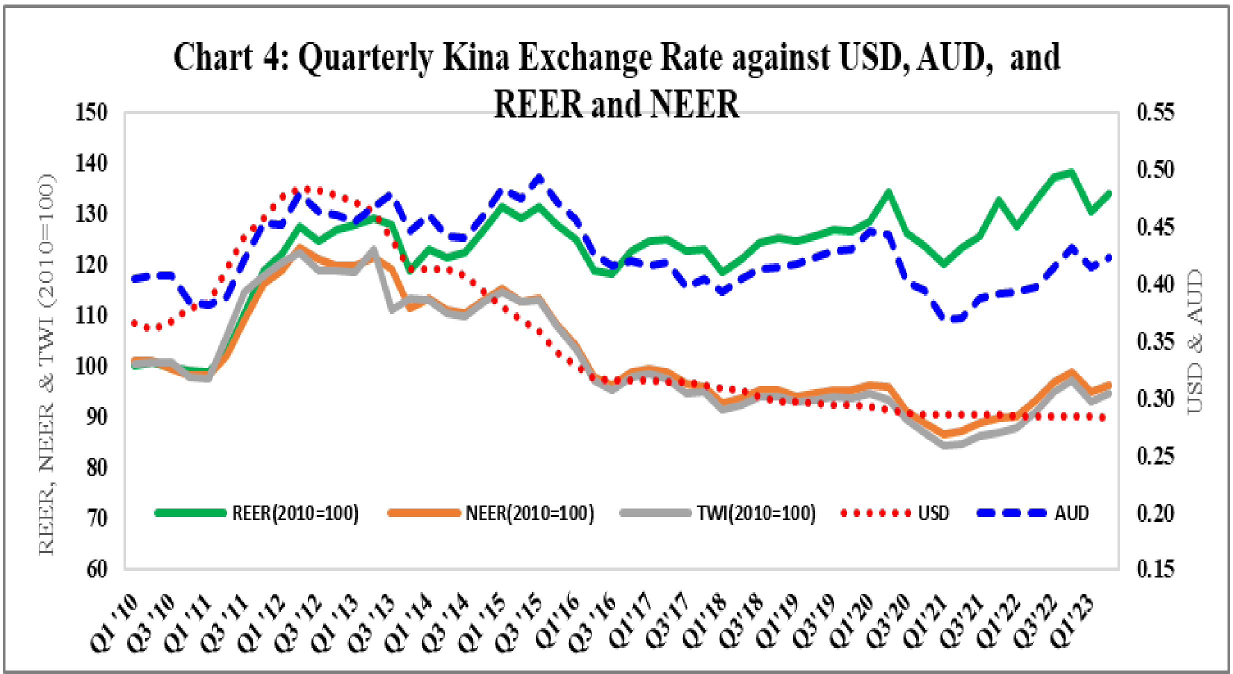
BPNG's international FX reserves decreased by K1,068.2 (US$299.1) million to stand at K13,592.6 (US$3,883.1) million at 31st August 2023. The decline was mainly attributed to the Bank's FX interventions and Government's external debt payments (Chart 3), which more than offset inflows, mainly from LNG taxes.

The IMF Program requires several structural reforms, including FX market operations. *(For more details about the IMF Program, see page 12).*

Moving quickly to establish a market-based exchange rate is critical, to ensure sustainability of the FX reserves and restore the normal functioning of the FX market. This would imply greater flexibility in the exchange rate, which may put pressure on inflation and increase prices for goods and services. The Bank is mindful of the inflationary impact on the economy. To mitigate that pressure, the Bank will ensure that the adjustment in the exchange rate is measured and gradual, and stands ready to tighten monetary policy to preserve price stability.

The annual Trade Weighted Index (TWI) increased by 3.8 percent in the June quarter of 2023 (2022: 7.8 percent increase). See Chart 4. The increase reflected the appreciation of the Kina against PNG's major trading partners, notably the Australian dollar, Japanese yen and the Chinese yuan as they depreciated against the US dollar.

The annual Real Effective Exchange Rate (REER) appreciated by 1.0 percent in the June quarter of 2023 (2022: 7.6 percent appreciation). This outcome was largely due to the appreciation of the Kina against the Australian dollar, Japanese yen and Chinese yuan, combined with relatively higher foreign inflation for major trading partners.



Source: Bank of PNG

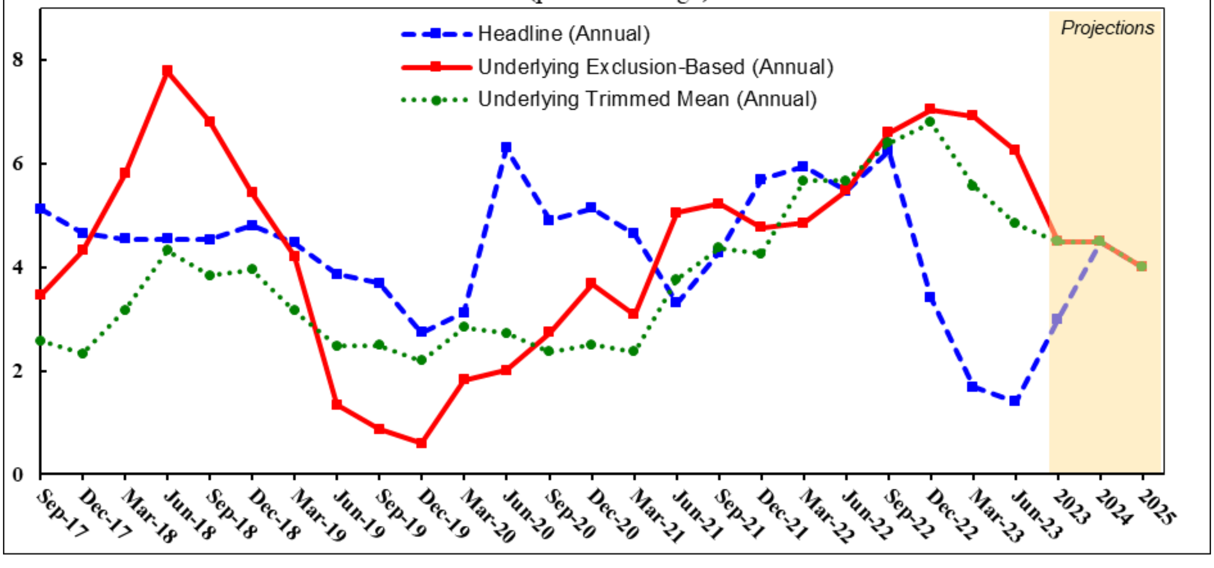
The trend in annual inflation since the September quarter of 2022 has been falling due to lower imported inflation and domestic price pressures (See Chart 5). Annual headline inflation was 1.4 percent in the June quarter of 2023 (2022: 5.5 percent). While the lower inflation outcome was due in part to the Government education program to fully subsidise school fees, it was primarily due to underlying weakness in the Australian dollar, which strengthened the PGK/AUD cross rate and kept import price inflation contained.

Annual underlying inflation measures remained largely unchanged, with the trimmed mean at 4.8 percent and exclusion-based inflation at 4.5 percent. While headline inflation subsided, the underlying measures indicate that domestic price pressures remain, including relatively high energy prices. The second-round effects of imported inflation remain a focus, particularly for higher transportation and power generation costs, as well as other imported input costs.

The Bank forecasts annual headline inflation to be around 3.0 percent in 2023. Inflation overseas is expected to ease, following increases in policy interest rates by the central banks of the advanced and trading partner economies, and improvements in the supply chain of energy and food products. Projections for underlying inflation measures are around 4.5 percent. Over the medium term, headline inflation is projected to be around 4.5 percent in 2024 and 4.0 percent in 2025, driven by prices of both tradeable and non-tradeable goods and services, reflecting a pick-up in global demand and the depreciation of the Kina exchange rate.

The upside risks to the projections include global supply shocks arising from geopolitical tensions, increase in oil prices, and adverse weather conditions affecting trade, and food and energy prices. The increase in FX inflows associated with the Papua LNG project may have a positive impact on the exchange rate, which could lead to the appreciation of the Kina and improvement in domestic prices.

Chart 5: Consumer Price Index Inflation
(percent change)



Source: NSO (actuals to June 2023) & Bank of PNG (projections for 2023-2025)

The Bank will pursue a neutral monetary policy stance. Relatively low inflation through the first half of this year, and an adjustment to the monetary policy framework in late August, led to an adjustment in the KFR to 3.0 percent in September.

High liquidity in the banking system continues to prevent monetary policy from influencing market interest rates. At the end of August the Bank introduced the Fixed-Rate-Full-Allotment (FRFA) auction, a non-competitive auction for 7-day Central Bank Bills (CBBs), to remove excess liquidity. In the FRFA auction all bids placed by market participants are accepted at a fixed rate of 2.0 percent. BPNG plans to continue working with this liquidity control method.

Monetary Policy Stance

The Bank will pursue a neutral monetary policy stance.

The Bank of Papua New Guinea will remain vigilant about inflation risks over the next six months to March 2024, to make sure the current reforms are successfully implemented and inflationary pressures are minimised.

BPNG will continue to assess the impact of the structural reforms being implemented and will closely monitor the move to exchange rate flexibility, which will be inflationary.

The Bank will also closely monitor macroeconomic developments and make necessary adjustments to its policy stance to keep inflationary pressures under control, to support growth and employment, and to ensure overall macroeconomic stability.

Conduct of Monetary Policy

The Bank of PNG will continue to use the reserve money framework to assist with monetary policy, by setting the policy interest rate, which aims to influence domestic market interest rates.

This will be conducted through the Bank's Open Market Operations (OMO) and other indirect measures to manage liquidity. As part of the reform of the monetary policy framework, the Bank introduced the weekly non-competitive FRFA auction for 7-day CBBs. Further review of the framework will include making changes to the operations of the Cash Reserve Requirement as a liquidity management tool.

The Monetary Policy Statement provides the overall policy stance for the next six months, while the monthly KFR signals this stance by the Bank.

IMF Extended Credit Facility and Extended Fund Facility Financing Program for Papua New Guinea (2023 - 2026)

In March 2023 the Government entered into a three-year IMF Program to undertake structural reforms, including monetary and exchange rate policy reforms. The program is mainly to fund Government fiscal reforms with funding of SDR684.3 million (US$918 million) under the Extended Credit Facility and Extended Fund Facility. Of this, US$88.3 million was drawn-down in the first half of the year. The reforms are expected to address a number of policy, structural and governance issues and to foster inclusive growth to ensure the country remains on a path of macroeconomic stability and development.

The IMF program has three main objectives:

- Strengthen debt sustainability through sustained fiscal consolidation
- Undertake monetary and exchange rate policy reforms, to address foreign exchange market shortages and Kina exchange rate convertibility issues, and
- Improve governance and strengthen the operations of the anti-corruption framework.

The funding comes with conditions in the form of structural benchmarks and quantitative targets that the Government and the Bank must meet to qualify for each tranche of funds to be drawn down.

On the part of BPNG, the program requires structural reforms to both the monetary and exchange rate policy frameworks. As part of these structural benchmarks, the Government is required to further amend the *Central Banking Act* by end of 2023 to strengthen the Central Bank's independence and governance, and prioritising price stability as the primary objective of monetary policy. The Bank will still support growth and employment objectives but subject to maintaining price stability.

Monetary policy reform aims to address policy transmission through the introduction of new monetary policy instruments, and fine-tune existing tools to diffuse and better manage liquidity. The new policy instrument, the 7-day CBB rate will work with the monetary policy rate, the KFR, to ensure that the policy rate has some influence over market rates. Under the Fixed-Rate Full-Allotment auction, the Bank will set the policy rate, and mop up the excess of liquidity from the commercial banks. This should trigger corresponding changes in domestic interest rates on deposits, lending and other financial instruments.

The exchange rate policy reform aims to address the structural imbalances in the foreign exchange market and the Kina convertibility issue. This would require the Central Bank to move to a crawl-like exchange rate arrangement to restore flexibility and ensure that outstanding orders in the market are cleared over the life of the program. The alignment of the monetary policy and the exchange rate frameworks will ensure international competitiveness by eliminating the exchange rate overvaluation and encouraging capital flows and investment. To address the Kina convertibility issue, the exchange rate is allowed to adjust based on market conditions.

The exchange rate arrangement will be finalised by end of November for implementation in December 2023, based on the roadmap agreed to with the IMF. As part of the arrangement, the Bank would maintain its monthly foreign exchange intervention at US$100.0 million to achieve its indicative target of US$1.2 billion by end of 2023. During the program period, the Bank will prudently manage the reserves while undertaking a commitment to clear outstanding orders in the market with priority given to essential import orders. The expected inflows from the IMF, donor partners and resource projects should help eliminate outstanding orders, and restore the normal functioning of the market.

Information tables

Monetary and Credit Aggregates (annual % changes)

INDICATORS				March MPS	September MPS		
	2021 Actual	2022 Actual	June 2023 Actual	2023 Projected	2023 Projected	2024 Projected	2025 Projected
Broad Money Supply	11.8	14.1	11.4	10.1	19.5	8.7	7.2
Monetary Base	10.8	29.5	20.3	3.3	-5.2	5.0	5.1
Claims on Private Sector	0.4	4.7	12.7	5.7	5.2	7.3	7.4
Net Claims on Government	33.2	-5.4	-11.9	11.4	25.7	5.3	-2.5
Net Foreign Assets	-4.7	52.4	36.2	-4.1	-2.2	-0.1	0.9

Summary of Other Macroeconomic Indicators

INDICATORS				March MPS	September MPS		
	2021 Actual	2022 Actual	June 2023 Actual	2023 Projected	2023 Projected	2024 Projected	2025 Projected
Consumer Price Index (%)							
Headline	5.7	6.3	1.4	5.5	3.0	4.5	4.0
Trimmed mean	4.3	6.1	4.8	5.0	4.5	4.0	3.5
Exclusion-based	4.8	6.6	4.5	5.0	4.5	4.0	3.5
Balance of Payments (K'million)							
Current & Capital Account	12,182.4	23,112.5	10,813.5	28.921.4	19,925.8	23,068.6	24,574.4
Financial Account	-9,221.6	-20,357.4	-14,407.5	-30,065.0	-20,900.7	-23,213.5	-24,272.4
Overall Balance	1,930.8	2,857.3	-1,154.5	-1,143.7	-974.9	-144.9	302.0
Gross International Reserves	11,368.7	14,225.9	13,083.8	13,406.3	13,942.7	14,726.6	15,804.6
Import Cover (months)							
Total	5.4	7.4	10.4	10.5	7.3	6.7	6.6
Non-mineral	8.4	15.1	19.6	19.1	13.3	12.0	12.1
Crude Oil (US$/barrel)	62.7	100.2	76.2	83.5	78.0	76.0	77.0
Gold (US$/ounce)	1,847.1	1,636.1	1,774.9	1,698.4	1,805.0	1,718.8	1,662.5
Copper (USc/pound)	352.0	384.2	364.2	329.7	378.7	371.5	373.8
Nickel (US$/tonne)	14,943.2	21,947.4	24,156.2	21,297.2	21,930.0	20,312.5	20,000.0
Cobalt (US$/tonne)	42,092.9	49,157.8	36,484.9	43,010.0	33,518.0	32,000.0	31,000.0
LNG (US$/mmbtu)	11.6	17.0	15.9	14.3	15.5	14.6	14.5
Condensate (US$/barrel)	72.8	98.6	75.7	98.4	76.8	74.8	75.8
Fiscal Operations of the Government*							
Surplus/Deficit (K'million)	-6,270.3	-5,984.5	-2,858.3	-4,984.9	-4,984.9	-3,968.7	-3,462.4
% of GDP	-6.7	-5.9	-2.5	-4.4	-4.4	-3.3	-2.7
Real Gross Domestic Product ** (Annual % growth)							
Total GDP	0.1	4.6	n.a	3.2	2.5	5.0	3.7
Non-mineral GDP	4.8	4.5	n.a	2.2	3.2	3.9	4.4
Total Employment	1.6	3.9	2.0	-	-	-	-
Non-mineral Employment	-0.3	3.7	2.0	-	-	-	-

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

**Fiscal projections for 2023 is from the 2023 Mid-Year Economic Fiscal Outlook, while 2024 and 2025 are from 2023 National Budget.*

***2021 and 2022 GDP estimates & projections are from the 2023 National Budget. Projections for 2023, 2024 and 2025 are from BPNG.*