BANK OF PAPUA NEW GUINEA

This September 2024 *Monetary Policy Statement* is issued by the Board of the Bank of Papua New Guinea pursuant to Section 11 of the *Central Banking Act* 2000. The Board met on 2nd October 2024 and approved the release of the September 2024 Monetary Policy Statement.

In early September, Parliament passed amendments to the Central Banking Act, which, when in effect, will transfer responsibility for monetary and exchange rate policies to a new Monetary Policy Committee (MPC). The MPC will consist of the Governor, Deputy Governor, and three external appointees, of whom one will be a non-resident monetary policy expert. The amended legislation establishes a clear statutory mandate to achieve and maintain price stability. It also enhances transparency around monetary policy decision-making, requiring the MPC to publish a statement after each meeting, including individual members' votes and their rationales.

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

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Objective of the Bank of Papua New Guinea's Monetary Policy

The objective of monetary policy as stipulated in Section 7 of the *Central Banking Act* 2000 (as amended and passed by the Parliament in September 2024) is to achieve and maintain price stability as the primary objective; and, to the extent not inconsistent with this and as secondary objectives, to ensure financial stability, promote sustainable medium term economic growth, especially in the non-mineral and non-petroleum sector, and to promote the development of the financial sector of Papua New Guinea's financial system.

In the short run, the emphasis on price stability seeks to mitigate excessive fluctuations in interest rates, exchange rates, and consumer price index inflation, thereby fostering a conducive environment for economic growth and employment. In the medium term, the Bank aims to achieve low and stable inflation, and promote growth.

Executive Summary

Economic growth in Papua New Guinea (PNG) continues to show resilience, with growth projected to be higher in 2024 and further increase in 2025. Headline inflation recorded a historical low of 0.1 percent in June 2024, with underlying trimmed-mean inflation of around 3.2 percent, reflecting significant falls in prices of seasonal items and lower prices for key imports. Inflation in PNG is among the lowest in the region and below its long-term trend. Liquidity in the foreign exchange (FX) market has improved, reducing the time taken to meet outstanding orders. The Bank of Papua New Guinea (BPNG) has largely achieved its goal in maintaining price stability, however the Bank is mindful of the inflationary risks in the near to medium term emanating from global uncertainties, exchange rate adjustment and domestic price pressures.

The March 2024 Monetary Policy Statement foreshadowed a tighter policy stance in anticipation of inflationary risks in late 2024 and 2025, and to support the exchange rate crawl. The Board initiated a tightening of monetary policy commencing March 2024. We expect inflationary risks to remain and anticipate seasonal increases in some prices and continued adjustment in the kina exchange rate.

Growth in the domestic economy has been robust and driven by the mineral sector, while the non-mineral sector has experienced slower expansion. Papua New Guinea's growth forecast for this year is approximately 3.0 percent due mainly to increased prices and production of mineral export commodities. Growth in the non-mineral sector is driven by construction activity and higher prices for some agricultural exports (notably cocoa and coffee) and is supported by Government spending. However, risks from tighter global liquidity conditions, ongoing geopolitical tensions, and lower prices for other key export commodities pose challenges to this growth outlook. In the foreign exchange market, conditions have improved in response to increased availability of foreign exchange, and to some extent the tighter monetary policy stance has contained import demand.

Our reforms to liquidity management, including the introduction of an interest rate corridor and reserve averaging for commercial banks, are assisting in strengthening the monetary policy transmission mechanism. The tightening in monetary policy has resulted in a steeper short end of the yield curve. We remain vigilant in assessing how the monetary policy and exchange rate policy reforms would impact inflation and growth. On-going reforms to the exchange rate framework, including the shift to a crawl-like exchange rate arrangement starting in January 2024 and the introduction of a foreign exchange auction system, will assist with improving the functioning of the FX market. An increase in the intervention amount by BPNG, now sold through a weekly FX auction, has led to improved FX availability and shorter waiting time for order fulfilment. These reforms are expected to gradually help underpin export competitiveness and growth in the non-mineral sectors, which are anticipated to strengthen business confidence. Nonetheless, we assess that the Kina remains overvalued against a broad basket of trading partner currencies, which continues to

undermine export competitiveness and FX availability. We have sought to improve exchange rate flexibility in a manner that is predictable and progressive to achieve full convertibility, and which does not elevate risks to price stability.

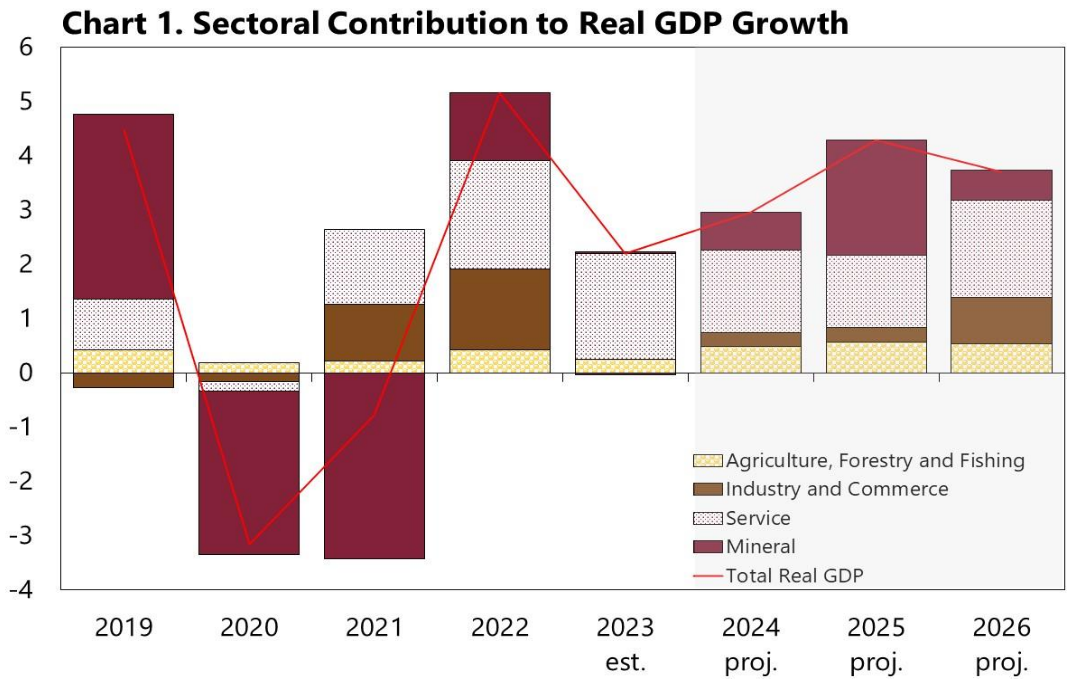
To support the exchange rate crawl, BPNG will closely monitor the impact of liquidity management reforms and exchange rate movements on the broader economy and will adjust the policy stance as necessary to ensure price and financial stability over the medium term.

1. Economic and Inflation Developments and Projections

The PNG economy continues to show resilience on the back of moderate global growth and increase in domestic activity. The Bank forecast real GDP growth of 3.0 percent in 2024, driven by activity in both the mineral and non-mineral sectors with higher production and export of gold and silver, cocoa and other export commodities. Increased activity is expected in sectors including finance and insurance, construction, transportation, information and communication, accommodation and food services. Our growth forecast for 2025 and 2026 is around 4.3 percent and 3.7 percent, respectively, reflecting increased capacity and full year production by the Porgera gold mine and construction activity in other resource projects.

Prices of PNG's agriculture export commodities remain high, but most are easing from their 2022 peaks. Gold and copper remain strong, while other metals are easing. Oil and gas prices have come down from the Russia-Ukraine war induced highs as supply increases, including further falls in recent months, helping to moderate global inflationary pressures but potentially reducing profitability for PNG's extractive industries[1], and with implications for the Government's tax revenue.

Downside risks to PNG's growth in the near to medium term include increasing instability in the Middle East and the ongoing Russia-Ukraine war, contracting demand in response to earlier monetary policy tightening, fall in commodity prices and natural disasters. Upside risks to growth might be the earlier than expected construction of the major resource projects and pick up in production due to the higher kina prices of export commodities.



Source: NSO (actuals: 2019 – 2022) & Bank of PNG (estimate for 2023, and projections 2024 – 2026)

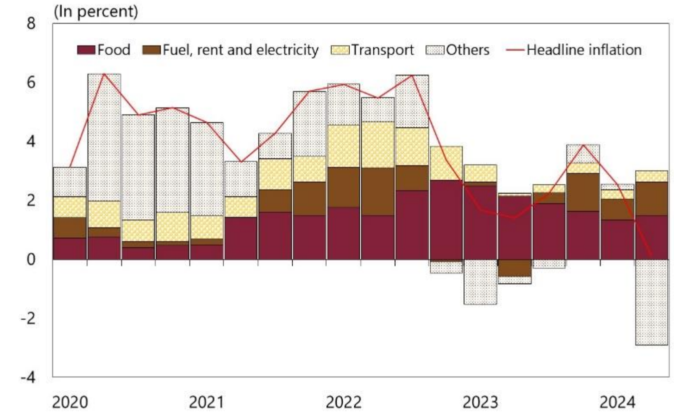
[1] World Bank Commodity Markets Outlook, April 2024 and current prices.

The Bank's Business Sentiment Survey, conducted in July 2024 indicates that most firms are already operating in a high-cost environment, which is adversely impacting their operations. They expect to maintain high prices while trying to source cheaper alternatives to manage costs and increase revenue and profit margins. We expect an increase in business activity into the second half of 2024 and expect further improvement into 2025 driven by higher activity in the construction, agriculture, wholesale and retail, finance and insurance, and mining sectors.

Headline inflation has been trending downward since 2023, reaching a record low of 0.1 percent in June 2024 due to significant declines in the prices of betelnut and communication services. If betelnut is excluded, inflation will be at 3.1 percent. Lower imported inflation to PNG on the back of a drop in energy prices and increased supply has also contributed to a fall in domestic inflation. Core inflation measures, the trimmed-mean and exclusion-based inflation, increased by 3.2 percent and 5.5 percent respectively. Inflationary pressures are narrowing and we expect pressure to be driven by domestic goods, notably an anticipated rebound in the betelnut price toward the December quarter. An expected rebound in betelnut prices will exert upward pressure on inflation in the second half of 2024.

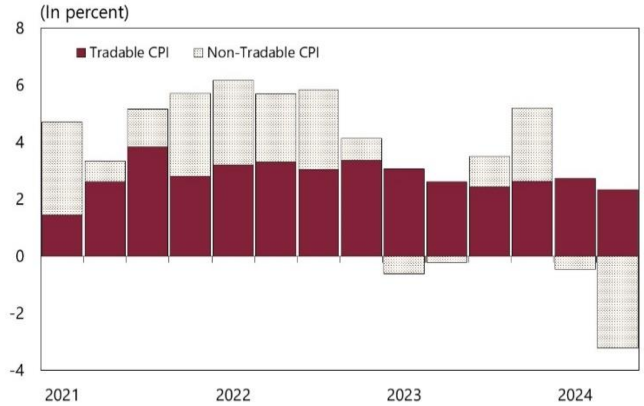
The Bank maintains the headline inflation projection at 5.0 percent and underlying measures at 5.5 percent in 2024, with inflation expected to moderate in the outer years, as the kina exchange rate stabilizes and global inflation moderates. A tighter monetary policy stance may be necessary to manage these inflation risks, given the probability of global commodity price shocks and further price stability risks associated with adjustments in the Kina exchange rate under the crawl-like exchange rate arrangement. In 2025, inflation is expected to moderate to 4.5 percent contingent on stable commodity prices and exchange rate movements.

Chart 2. Contribution to Headline Inflation
(In percent)

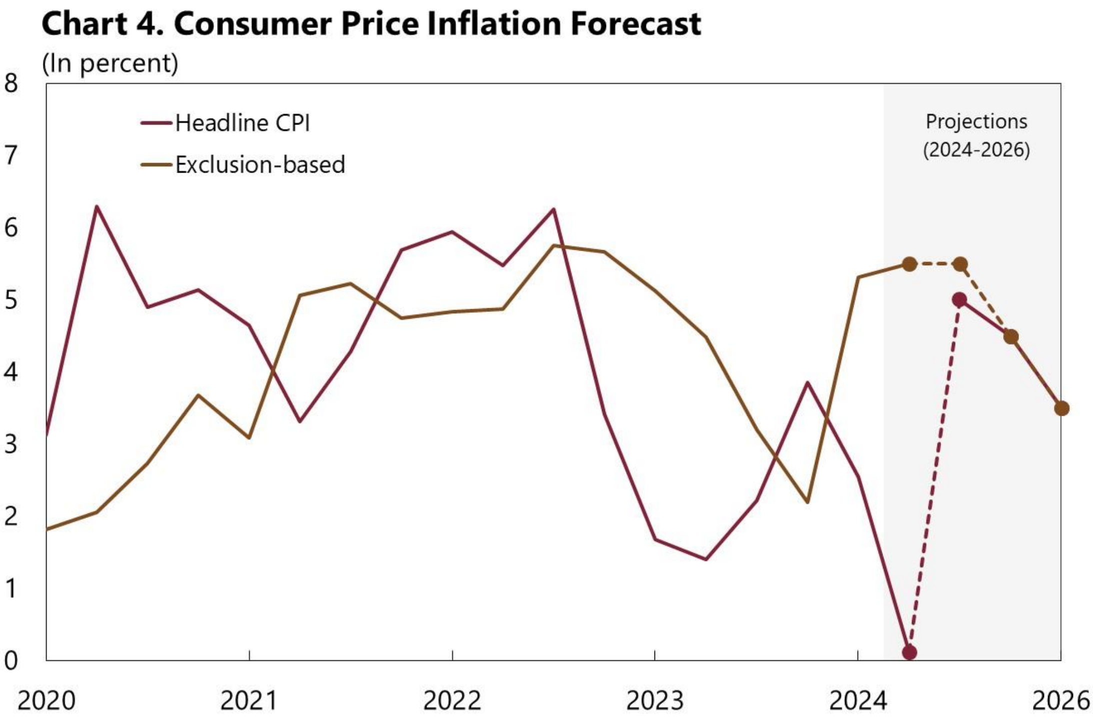


Source: NSO

Chart 3. Tradable Contribution to Headline Inflation
(In percent)



Source: NSO and Bank of PNG



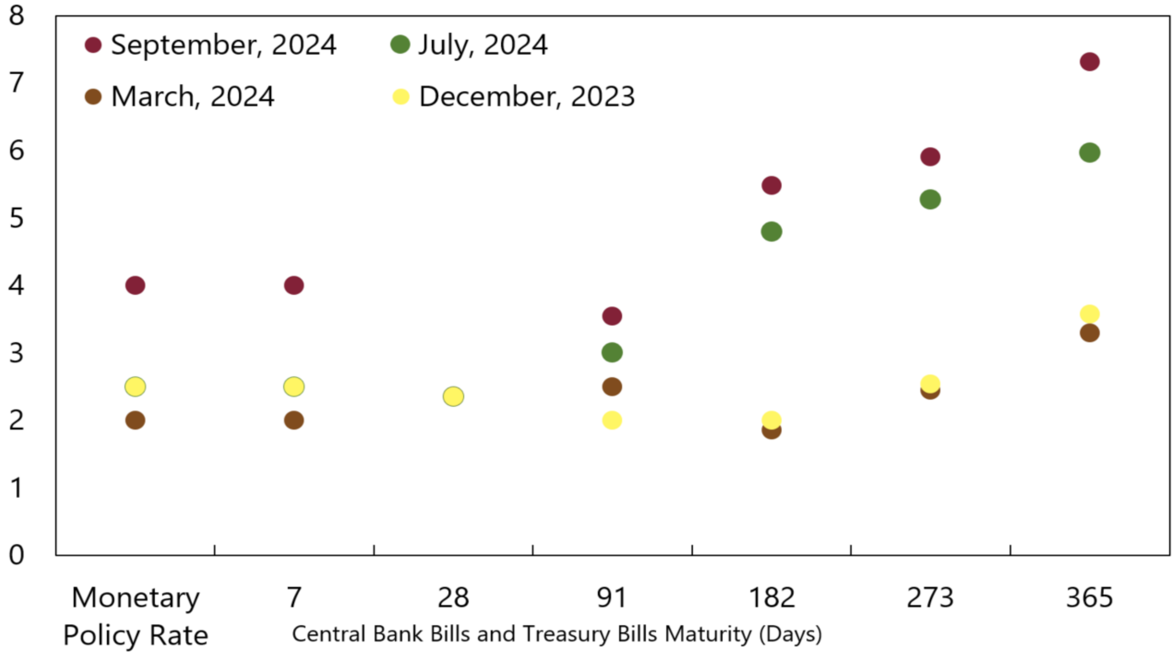
Source: NSO (actuals: 2020Q1 – 2024Q2) and Bank of PNG (projections: 2024 – 2026)

2. Financial and FX Market Developments and Reforms

In the March Monetary Policy Statement, the Board foreshadowed a series of tightening measures, to continue removing the overhang of excess liquidity and to lean against the inflationary impact of the exchange rare depreciation. The most effective of the policy adjustments in recent months has been the increase in the Cash Reserve Requirement (CRR) from 10 per cent to 12 per cent. This tightening absorbed a considerable amount of excess liquidity and necessitated the use of BPNG's overnight repo facility by some commercial banks to help manage their liquidity. The recent tightening in conditions has been most evident in wholesale interest rates on Government securities, which have increased significantly to around pre-COVID levels, while the response on deposit rates has been slow. However, we have observed that one or two of the banks have significantly raised term deposits rates to lure some of the major deposit holders. In the third quarter of 2024, the commercial banks' indicator lending rates (ILR) were between 7.20 percent and 11.70 percent, with only one bank increasing its ILR to 7.20 percent. There was little change in interest rate spreads, with weighted average deposit rates at 0.23 percent and lending rates around 8.00 percent. Competition in 2025 will be improved through the entry of three new commercial banks, two of which began operating in the third quarter of 2024.

The Bank has implemented several reforms to address the persistent structural excess liquidity that produced mispricing in market risk and hampered investment. These reforms included the introduction of an interest rate corridor (specifically, banks are now able to lend to BPNG overnight in addition to borrowing at an interest rate 150 basis points either side of the Kina Facility Rate) and reserve averaging for banks. The minimum cash reserve requirement (CRR) on banks was also raised from 10.0 percent to 11.0 percent in May, and to 12.0 percent in June 2024. These complementary measures were designed to absorb excess liquidity from the banking system and strengthen the monetary policy transmission mechanism. This will give the Bank greater control over monetary conditions and should, over time, help ensure that adjustments to the KFR itself are transmitted to market interest rates. The Bank has commenced offering small volumes of longer-dated Central Bank Bills (28-days) by auction, and in time the restoration of this market-based instruments may provide room for less reliance on the CRR.

Chart 5. Kina Facility Rate and Treasury Bill Yield Curve
(In Percent)



Source: Bank of PNG

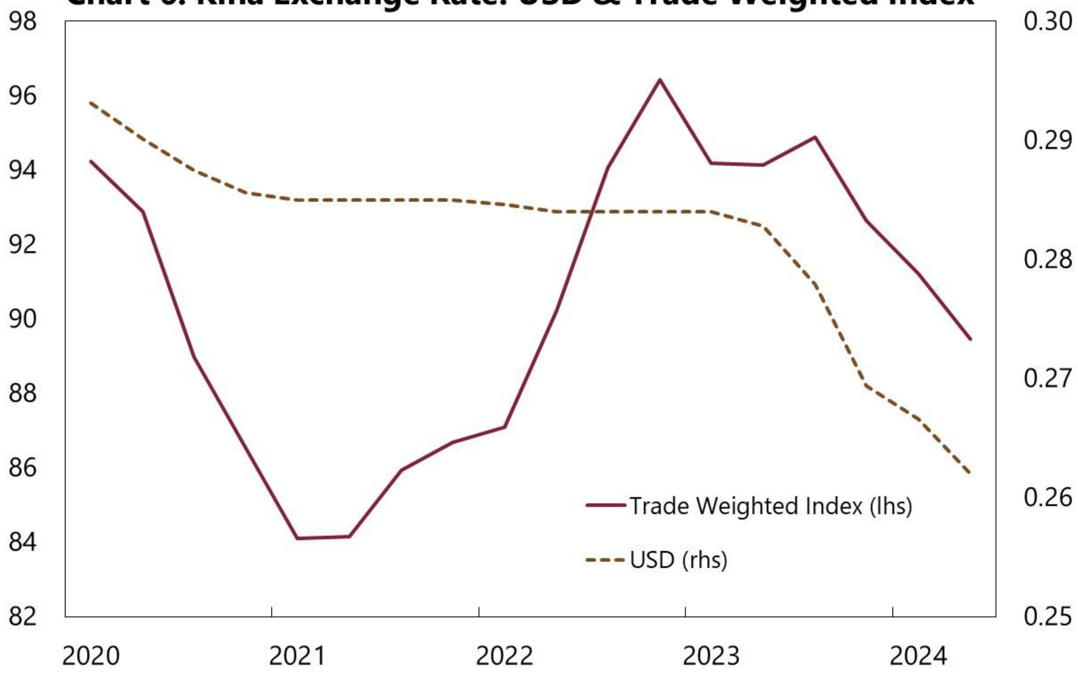
The Bank has begun to observe positive developments from these reforms. Short-term interest rates of Government securities started to normalize, with the 364-day Treasury bill rate nearing its pre-COVID level of around 8.0 percent in early October 2024. The factors driving this normalization include: (i) ongoing Treasury financing needs; and (ii) expectations of a more restrictive future monetary policy stance. The Bank will remain vigilant in assessing the impact of its liquidity management reforms on financial stability, particularly concerning the Treasury bill and Government Inscribed Stock (GIS) markets, as well as the availability of credit to the private sector.

Monetary policy in PNG has also been complicated by the persistently overvalued exchange rate since 2014 which, in the absence of effective capital mobility and shortfall in the supply of the foreign exchange from exports, has resulted in persistent excess demand for foreign exchange. This has forced the authorized foreign exchange dealers to ration FX. In 2024, several liquidity management and foreign exchange (FX) reforms have been undertaken to tackle issues that pose a challenge in managing monetary policy and hamper investment and economic activity. From 3 January 2024, the Bank has implemented a crawl-like exchange rate arrangement to reduce Kina overvaluation and ensure its price is more reflective of its market rate.

Access to FX has improved in 2024. While outstanding orders to remain high, averaging around PGK1.0 billion, there is more volume in the market and demand has picked up as backlog has cleared. Over the eight months to August 2024, the total FX market inflow was PGK12.8 (US$3.4) billion, while total FX outflow was PGK17.4 (US$4.6) billion. As a result, there was a net outflow of K4.6 (US$1.2) billion which was mainly met by BPNG's intervention of K3.8 (US$1.0) billion. The Bank continues to sell to the domestic FX market, supplying US$125 million each month which, together with the weekly FX auction and sustained FX inflows, has resulted in banks' reporting FX clearance times to have fallen from 6-8 weeks to 4-5 weeks. Outstanding FX orders are expected to fall further as inflows increase from the mineral sector, including a full year of production from the Porgera gold mine.

The Bank introduced a weekly Foreign Exchange Auction in May 2024 to provide predictable and more frequent access to FX. The auction allows authorized foreign exchange dealers to place their bids at a rate within the trading margin, increasing transparency and competition. Under the current arrangements, dealers may bid within the trading margin (+/- 1%) and may trade with their clients at a wider margin (+/- 2.75%) from the daily reference exchange rate set by the Bank. At present, with persistent demand for foreign exchange, almost all bids for foreign exchange are at the highest permitted price.

Chart 6. Kina Exchange Rate: USD & Trade Weighted Index



Source: Bank of PNG

The introduction of a crawl for the Kina has seen it depreciate by 3.7 percent against the US dollar as of end July 2024. This, including the depreciation of the Kina against other major trading partner currencies, resulted in the trade weighted index declining. While outstanding FX orders remain substantial, averaging around PGK1.3 billion over 7 years, FX market turnover and liquidity has improved, and FX demand has picked up as order fulfillment has been cleared more quickly.

As of the end of August 2024, the Bank's gross FX reserves had fallen to US$3.4 billion, down from US$3.9 billion in December 2023. The net international reserve excluding IMF loans under the Program is at US$2,673 million, and with the IMF limit of US$2,200 million, we have US$473 million net intervention funds. Projected FX inflows is necessary for BPNG to maintain its monthly intervention.

Staff analysis suggests that the Kina remains overvalued relative to the currencies of key trading partners, which continues to reflect the imbalance in the FX market putting pressure on the reserves of the Central Bank. The shortfall in FX has dampened investment and economic activity.

Consequently, the Kina is expected to continue its gradual adjustment toward a market-clearing rate, which will further alleviate FX shortages that have hindered investment over the past decade. The crawl-like exchange rate arrangement is anticipated to stimulate export growth, boost FX inflows, and restore full Kina convertibility in the medium term.

3. Monetary Policy Stance and Reforms

Economic growth is estimated to have improved in 2024 while headline inflation performance has been better than historical levels. The Kina Facility Rate (KFR), the Bank's primary policy signaling rate, has been progressively raised from 2.0 percent in May to 4.0 percent by September in response to inflation risks from the depreciating exchange rate, and the normalization in financial conditions. It is likely that the KFR will need to be increased further to bring it more into line with wholesale market rates.

Nonetheless, the Bank assesses that inflationary risks persist due to global uncertainties, further downward pressure on the kina exchange rate and domestic price pressures. Any adjustment in the Kina against key trading partner country currencies combined with lower inflation outcome in PNG will further narrow its overvaluation against its market level. If domestic inflation increases relative to our trading partners then we can expect more downward adjustment in the exchange rate, which is likely to impact domestic inflation. It is important to note that exchange rate is not the only solution to our FX issue, and that other demand, investment and export growth policies are equally important to find a long-term solution. The tightening of monetary policy is intended to support the gradual adjustment of the Kina exchange rate under the crawl-like exchange rate arrangement toward full convertibility, while ensuring medium-term inflation remains low and stable. The Bank will also closely monitor the impact of liquidity management reforms and exchange rate movements on the broader economy and will adjust the policy stance as necessary to ensure price stability over the medium term.

The Central Banking Act and the BPNG's Monetary Policy Statement

Section 11(2) of the Central Banking Act (as amended in 2021) requires that Monetary Policy Statements "report on the meeting of the Board held prior to the issuance of the monetary policy statement, summarising the views of voting members, and noting any votes". The Monetary Policy Statement was adopted by a simple majority of the Board.

In finalising this Monetary Policy Statement, the Board was cognisant of the amendments to the Central Banking Act recently passed in Parliament, including a provision for the establishment of a new Monetary Policy Committee, independent of the BPNG Board. As a result, this document is largely, and intentionally, descriptive in nature with reference to the monetary policy decisions taken over the past six months to allow the incoming MPC to set future policy direction, with full autonomy, and as they deem appropriate.

All monetary policy decisions over the past six months have been made through a majority vote of Board members.

Individual members of the Board had, and have, a range of views on how best to proceed, bearing in mind the imperative of maintaining price stability while restoring foreign exchange market convertibility. Not all Board members share the view the adjustment to the exchange rate will prove helpful, while at least one believes that a faster return to a floating exchange rate would be desirable.

Board members recognise that yields on government securities have adjusted to the tightening in liquidity conditions. Some members are concerned by just how quickly yields have responded, while others view it as an inevitable consequence of addressing the excess of liquidity in the market in recent years.

Appendix

Monetary and Credit Aggregates (annual % changes)							
INDICATORS	2022 (Actual)	2023 (Actual)	June 2024 (Actual)	Mar 2024 MPS	Sep 2024 MPS		
				2024 (Proj)	2024 (Proj)	2025 (Proj)	2026 (Proj)
Broad Money Supply	14.8	11.5	4.8	7.9	9.9	7.3	7.5
Monetary Base	29.5	-8.7	1.5	2.1	-2.3	7.8	7.0
Claims on Private Sector	6.9	19.0	8.9	12.0	11.5	12.3	13.6
Net Claims on Government	-5.4	33.1	13.7	2.7	19.9	0.9	4.4
Net Foreign Assets	52.4	3.9	-8.4	-1.4	-6.0	-4.3	4.2
Summary of Other Macroeconomic Indicators							
CONSUMER PRICE INDEX (CPI) (annual % changes)							
Headline	3.4	3.9	0.1	5.0	5.0	4.5	3.5
Trimmed mean	6.8	4.0	3.2	5.5	5.5	4.5	3.5
Exclusion-based	5.7	2.2	5.5	5.5	5.5	4.5	3.5
BALANCE OF PAYMENTS (kina millions)							
Current & Capital Account	23,797.5	18,120.6	10,734.4	25,601.1	21,663.9	26,063.6	23,188.7
Financial Account	-19,671.6	-7,864.4	-11,808.5	-20,900.7	-22,851.3	-24,144.9	-39,707.5
Overall Balance	2,856.1	200.0	-2,233.9	-974.9	-1,564.8	637.8	-350.1

Gross International Reserves	14,225.9	14,424.8	12,190.9	13,942.7	13,285.3	15,968.8	16,822.6
IMPORT COVER (months)							
Total	5.9	6.7	6.4	6.5	7.3	6.5	5.5
Non-mineral	8.1	13.0	13.9	11.0	13.3	10.4	9.4
Crude Oil (US$/barrel)	100.2	77.4	79.0	82.6	77.7	77.5	78.4
Gold (US$/ounce)	1,636.1	1,800.6	1,861.7	2,056.8	2,007.8	2,008.5	2,009.3
Copper (USc/pound)	385.2	370.8	405.7	406.2	401.0	405.3	406.7
Nickel (US$/tonne)	21,947.4	19,679.5	17,386.1	16,499.3	17,855.6	18,796.5	18,823.2
Cobalt (US$/tonne)	49,157.8	35,173	27,713.9	27,600	28,123.4	29,143.3	29,143.3
LNG (US$/mmbtu)	17.0	14.4	12.8	12.8	12.5	13.5	13.5
Condensate (US$/barrel)	98.6	75.7	80.0	80.8	76.0	76.0	76.2
FISCAL OPERATIONS OF THE GOVERNMENT*							
Surplus/Deficit (K'million)	- 5,851.8	- 4,934.9	-	- 3,983.7	- 3,983.7	- 2,654.2	- 1,314.2
% of GDP	- 5.4	- 4.4	-	- 3.3	- 3.3	- 2.0	- 0.9
REAL GROSS DOMESTIC PRODUCT** (annual % growth)							
Total GDP	5.2	2.7	-	3.0	3.0	4.3	3.7

Non-mineral GDP	5.2	4.5	-	3.1	3.1	2.1	2.7
Total Employment	5.0	2.5	-	-		-	-
Non-mineral Employment	5.4	1.7	-	-		-	-

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

*Fiscal projections for 2024 and the medium-term are from the 2024 National Budget.

**2022 actual from NSO, 2023 estimates are from BPNG. Projections for 2024, 2025 and 2026 are from BPNG.