BANK OF PAPUA NEW GUINEA

MONETARY POLICY STATEMENT BY THE GOVERNOR OF THE BANK OF PAPUA NEW GUINEA, MR. LOI M. BAKANI

PORT MORESBY

31st March 2013

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 is also available on the Bank's website: http://www.bankpng.gov.pg. It will be reproduced in the March 2013 issue of the Quarterly Economic Bulletin (QEB).

Objective of Monetary Policy

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

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

Executive Summary

PNG continued to experience high economic growth in 2012. However, the key enablers of this growth are receding and the economic growth in 2013 will slow down as a result. In response to low inflation outcomes and to support economic activity, alongside Government's expansionary fiscal policy, the Bank of PNG further eased its monetary policy stance in March 2013. The decision aims to encourage private sector lending, primarily in the non-mineral sectors, in light of the winding down of the PNG LNG project construction phase and the associated decline in the spin-off activities.

Whilst economic activity was high in 2012, the appreciation of the kina in the first half of the year, low imported inflation, easing in domestic demand pressures and other factors led to an annual inflation outcome of 1.6 percent. For 2013, the Bank projects headline inflation to be around 5.5 percent, with the trimmed-mean and exclusion-based inflation measures to be around 4.5 and 5.0 percent, respectively.

Real Gross Domestic Product (GDP) is projected by the Bank to grow broadly in line with the Government's forecast for 2013 of 4.0 percent, as the construction of the PNG LNG project and spin-off activities wind down, partially offset by the expansionary fiscal policy and increased production at Ramu Nickel/Cobalt mine. Most sectors are expected to record lower growth throughout the year, whilst the petroleum sector is expected to decline.

The overall balance of payments is projected to be in deficit by K684 million in 2013 reflecting high imports and net service and income payments. By the end of the year, the gross foreign exchange reserves are projected to be around US$3,700 (K8,222.2) million, sufficient for 9.4 months of total and 17.4 months of non-mineral import covers.

Broad money supply is expected to increase by 12.8 percent, driven mainly by an increase in net domestic assets of the banking system, reflecting increases in net credit to the Government and private sector credit. Monetary base and private sector credit are projected to grow by 15.4 percent and 13.6 percent, respectively.

The Government budget of K13 billion in 2013, with a deficit of K2.5 billion or 7.2 percent of GDP, is intended to stimulate economic activity. The record size of the budget and the considerable deficit financing needs are likely to pose many challenges. Capacity constraints should be addressed to minimize the risk of inefficient spending and to avoid a build-up of deposits in the Government's accounts with the commercial banks. All Government trust accounts should be held with the Bank of Papua New Guinea, to reduce the cost of the build up in liquidity to both the Government and the public.

To finance the deficit, the Government should only consider domestic financing sources rather than raising funds in the international financial markets. Using domestic financing will bring about benefits reflected in lower cost in real terms, fewer risks and the opportunity to develop the domestic financial market.

In anticipation of LNG production in 2014, it is important that the Sovereign Wealth Fund (SWF) becomes operational in 2013. This would assist in managing the LNG revenues in a sustainable manner throughout the duration of the project and beyond.

Given the increase in demand resulting from the easing monetary stance and the expansionary fiscal policy, the Bank will continue to assess the trade-off between higher economic growth and inflationary pressures. It will therefore maintain its current policy stance for the next six months but may adjust it to ensure that inflation is appropriately managed.

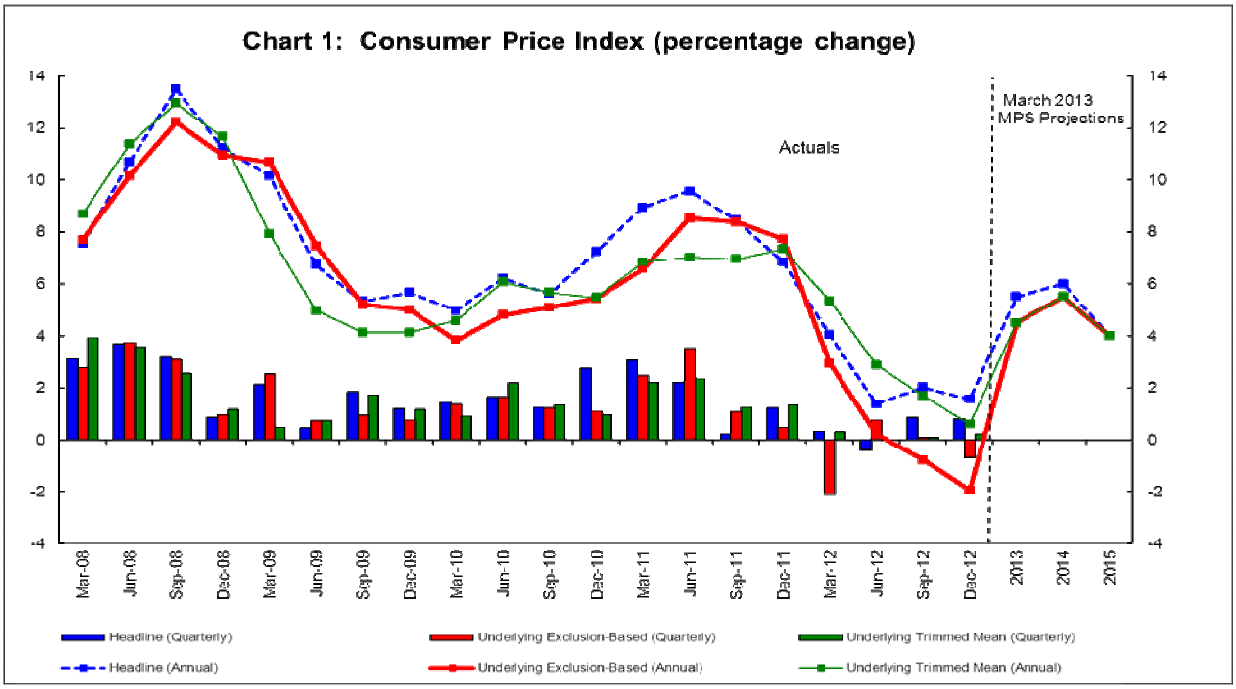
Monetary Policy Discussions

1. Monetary Policy Assessment, Issues and Expectations

Inflation remained low throughout 2012, in spite of increased economic activity driven mainly by the construction of the PNG LNG project. The appreciation of the kina in the first half of the year, low imported inflation and easing in domestic demand pressures led to a low annual inflation outcome of 1.6 percent in 2012. The Central Bank further eased its monetary policy stance in March 2013.

The Bank projects the annual headline inflation for 2013 to be around 5.5 percent. The trimmed-mean and exclusion-based inflation measures are projected to be around 4.5 percent and 5.0 percent, respectively. Projected inflation in PNG's major trading partner economies is generally low, given the weak global economic activity. The effects of the depreciation of the kina since the second half of 2012, high Government expenditure and the higher import tariffs on some items will more than offset the effects of low imported inflation and depressed international commodity prices and are expected to result in higher inflation.

Over the medium term, the Bank projects annual headline inflation to be around 6.0 percent in 2014 and 4.0 percent in 2015 (see Chart 1). These projections are based on a number of factors, including the commencement of production of the PNG LNG project in 2014, high Government expenditure and easing in international commodity prices.



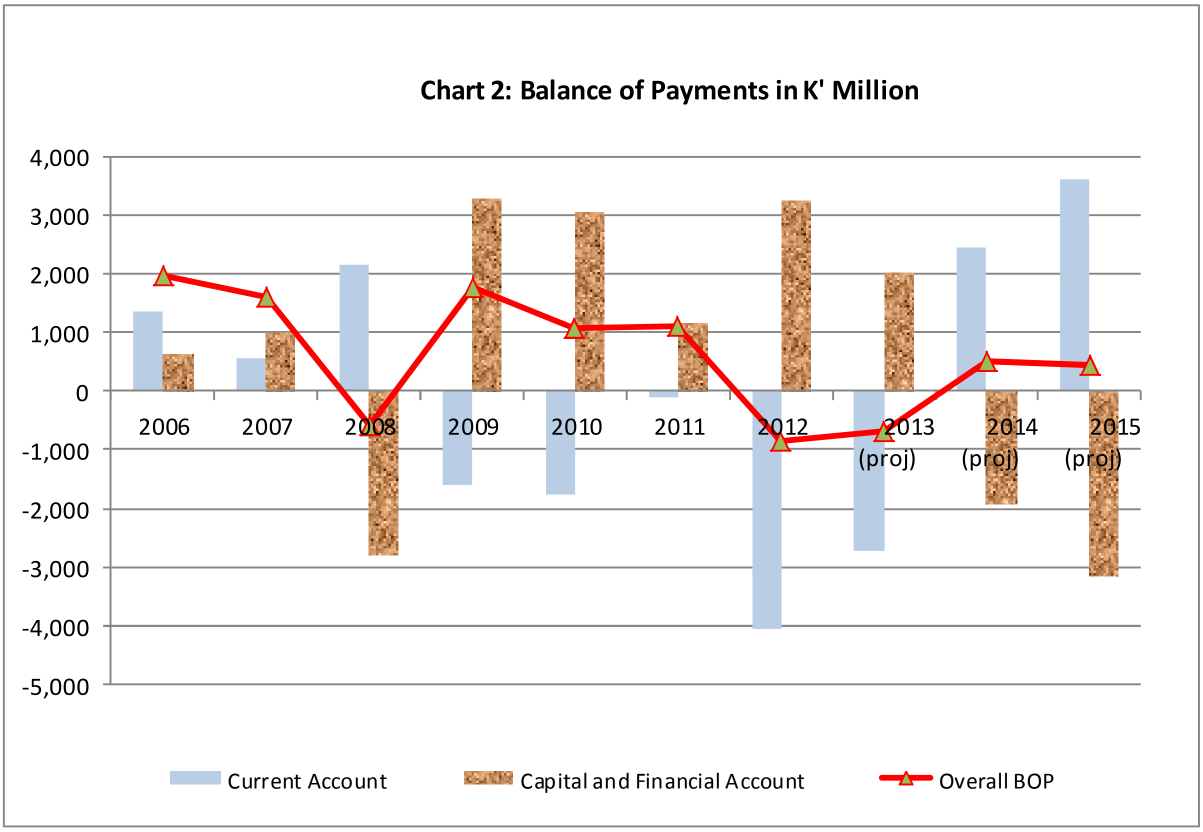
Source: Bank of PNG & National Statistical Office (NSO)

There are upside risks to these projections, including excessive Government spending, kina depreciation, any supply shocks and a resurgence in global economic activity.

Annual headline inflation was 1.6 percent in the December quarter of 2012, lower than the 2.0 percent in the September quarter of 2012. The lower outcome was mainly due to the appreciation of the kina in the first half of 2012, lower imported food prices, a decline in soft drinks and betelnut prices, and the Government's free education policy and import tariff reduction program. This is also due to the easing in domestic demand pressures, and therefore lower inflationary expectations, as a result of lower spinoff activity to the non-mining private sector from the PNG LNG project. In the same period, underlying annual inflation as indicated by the trimmed mean and exclusion-based measures was 0.6 percent and negative 1.9 percent, respectively.

In 2013, broad money supply is expected to increase by 12.8 percent, driven mainly by an increase in net domestic assets of the banking system, reflecting increases in net credit to the Government and private sector credit. Monetary base and private sector credit are projected to grow by 15.4 percent and 13.6 percent, respectively. The Bank considers the projected growth in monetary aggregates more than sufficient to support the lower projected economic growth in 2013 (see Appendix – Table 1).

The overall balance of payments is projected to be in deficit by K684 million in 2013, with a deficit in current account more than offsetting a surplus in the capital and financial account. The deficit in the current account is projected to be K2,714 million, due to higher imports and net service and income payments. The surplus in the capital and financial account is projected to be K2,030 million, mainly reflecting inflows associated with the foreign direct investment relating to the completion of the PNG LNG project (see Chart 2). In the medium term, the current account is projected to record surpluses due to inflows from mineral sector revenue, including LNG revenues.

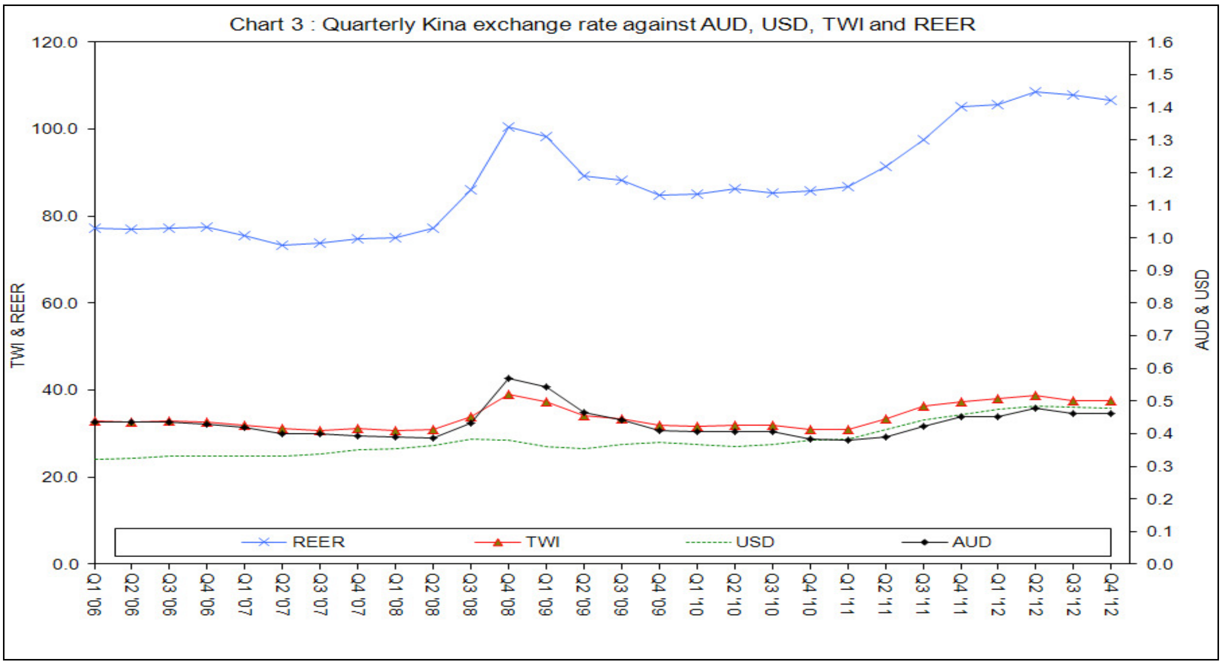


Source: Bank of PNG

Note: 2013 to 2015 includes flows related to the PNG LNG project, compared to the actuals, which do not include LNG figures.

By the end of 2013, the gross foreign exchange reserves are projected to be around US$3,700 (K8,222.2) million, sufficient for 9.4 months of total and 17.4 months of non-mineral import covers. Gross reserves are projected to be higher in the medium term due to foreign exchange inflows related to the exports by the Ramu Nickel/Cobalt mine and the PNG LNG project (See Appendix – Table 2). As at 25th March 2013, the level of gross foreign exchange reserves was US$3,766.0 (K7,962.4) million.

The daily average kina exchange rate depreciated against the US dollar by 0.8 percent to US$0.4727 between March quarter 2012 to 22nd March 2013, while it appreciated against the Australian dollar by 0.9 percent to AU$0.4556. The depreciation of the kina against the US dollar reflected higher foreign exchange outflows as a result of high import demand and service payments. The appreciation against the Australian dollar was attributed to cross currency movements, as the Australian dollar weakened against the US dollar. The Trade Weighted Index (TWI) appreciated by 4.5 percent during the December quarter of 2012, compared to the corresponding period of 2011. The Real Effective Exchange Rate (REER) also appreciated by 2.7 percent during the same period (see Chart 3).



Source: Bank of PNG

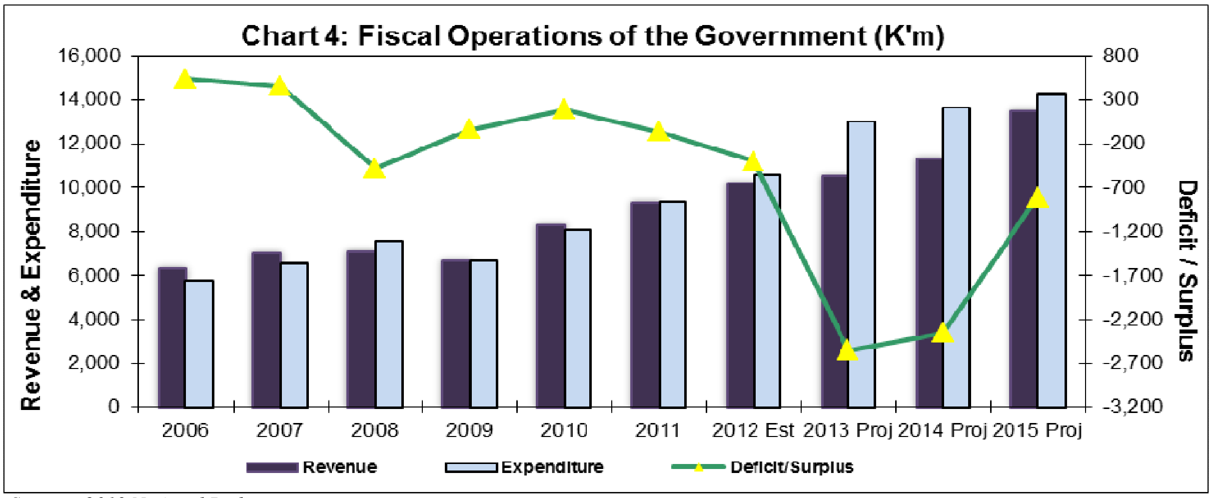
PNG continued to experience high economic growth in 2012, due to peak in construction of the PNG LNG project, higher private sector investments and an increase in Government funding of its development budget for infrastructure projects, especially road maintenance and other building projects. However, there are signs that spin-off activity of the non-mineral private sector from the PNG LNG project is slowing down, as indicated by the lower increases in employment and the value of sales by the private sector.

Real GDP is projected by the Bank to grow broadly in line with Government's forecast of 4.0 percent for 2013, down from a high growth of 9.2 percent in 2012, as the construction of the PNG LNG project winds down. The growth is expected to be driven mainly by the Government's fiscal stimulus, partly offsetting the decline from the construction of the LNG project, and the increased production at Ramu Nickel/Cobalt mine and at other existing mines. The agriculture sector is also expected to increase due to higher production of PNG's export commodities. Other sectors of the economy are expected to record low growth in 2013, while the petroleum sector is projected to fall due to the decline in oil reserves and production.

Strong economic growth is expected in 2014 and over the medium term. The Bank projects real GDP to grow by around 8.0 percent in 2014. This will be driven by the commencement of production of liquefied natural gas, increased Government spending for infrastructure development and the pick-up in demand associated with increased income associated with LNG receipts. All sectors of the economy are expected to grow, while the petroleum sector is forecasted to decline as crude oil reserves are depleted.

In November 2012, the National Parliament passed a budget of K13 billion for 2013 with a budget deficit of K2.5 billion or 7.2 percent of nominal GDP, which represents a marked shift from recent years (see Chart 4). The 2013 deficit compares to a preliminary deficit of K494.6

million for 2012. The budget is aimed at rehabilitating infrastructure, improving the health and education services, and law and order in the country. These are commendable initiatives, which could stimulate economic activity through the fiscal multiplier effect. On the other hand, high Government spending on imports would exert downward pressure on the exchange rate causing inflationary pressure. (See Box 1). Constraints exist not only with Government implementing agencies but also at provincial and local Government levels where a lot of the funds will be channeled. There is therefore the risk of inefficient spending which may cause a large build up of Government trust accounts and increase the already high level of liquidity. All Government trust accounts should be held with the Bank of Papua New Guinea, to reduce the cost of the build up in liquidity to both the Government and the public.



Source: 2013 National Budget

To finance the deficit, the Government should only consider domestic financing sources rather than raising funds in the international financial markets. Using domestic financing will bring about several benefits:

- It provides avenues for the development of domestic savings and a savings culture that is essential for funding domestic investments.
- The cost in real terms of domestic Government debt is lower than funding it from offshore debt, when factors such as return, risk, exchange rate movements, timing and availability are considered.
- Domestic Government debt is the foundation for the establishment of a functioning financial market, which is a prerequisite for generating the resources for development of the economy and its people.

There is sufficient liquidity in the banking system to finance the deficit as well as meeting private sector borrowing needs. Public debt is projected to increase to 32.0 percent of GDP in 2013, compared to 26.1 percent in 2012.

With the winding down of the construction phase of the LNG project, the Government should coordinate its efforts and priorities towards utilizing the labour and capital that are released from the project. In addition, the Government should continue to develop agriculture and vital infrastructure projects in order to enhance the productive capacity of the economy. The planned establishment of the SWF in 2013 would assist in managing the LNG revenues in a sustainable manner throughout the duration of the project and beyond. These initiatives will help PNG to manage the *Dutch Disease* phenomenon.

Close coordination and cooperation between the Treasury and Finance departments and the Central Bank in the conduct of fiscal and monetary policies is important to ensure macroeconomic stability is maintained. It is therefore important that the Government prudently manages its budget, given the large fiscal deficit and expenditure plans for 2013.

Box 1: Quantifying the macroeconomic effects of the 2013 fiscal deficit

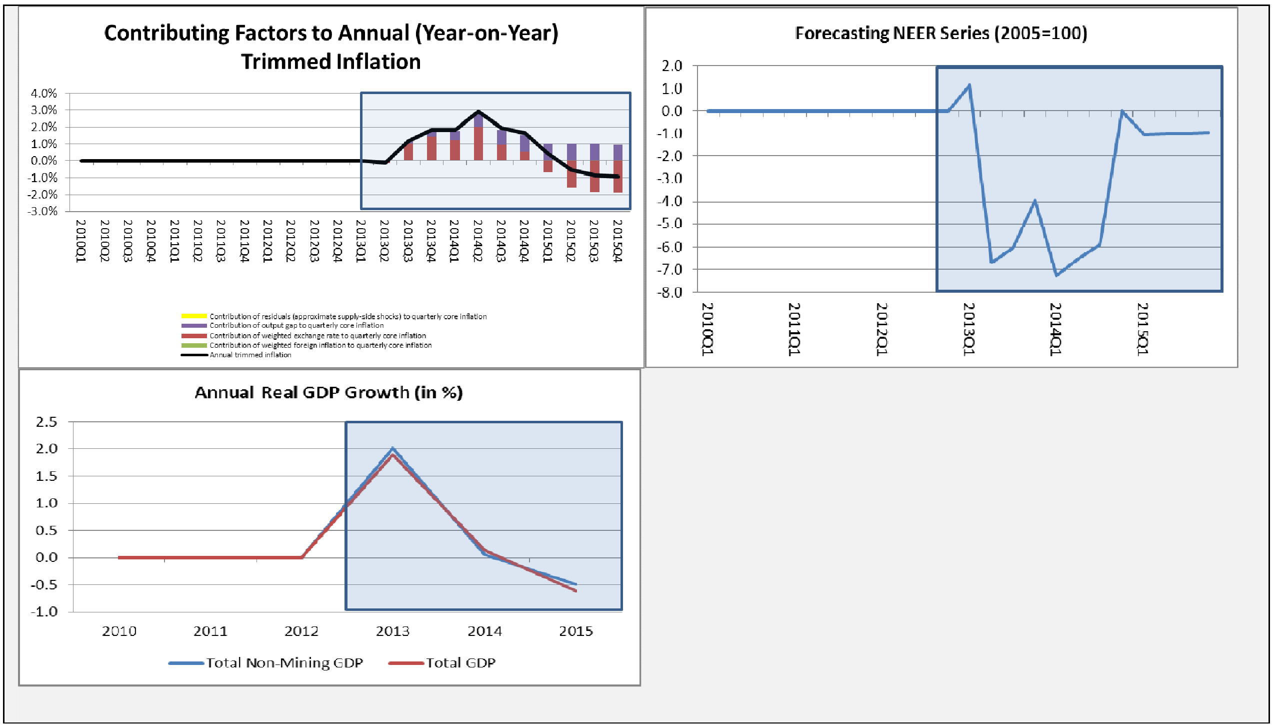
The Bank in collaboration with Pacific Financial Technical Assistance Centre (PFTAC) has developed a Financial Programming and Policies (FPP) framework for PNG. This box outlines the results from scenarios run using the FPP framework to capture the macroeconomic effects of the 2013 Budget. This exercise is experimental in nature, and should not substitute for the projections discussed throughout the rest of the text, which are the official projections.

The FPP framework is a holistic approach that incorporates and links the key components of the macroeconomy, namely the monetary, real, fiscal and external sectors. The exercise involves constructing two scenarios. The fiscal numbers for 2013 to 2015 under the "baseline" scenario are as contained in the 2012 Budget, whilst the "alternative" scenario is based on the 2013 Budget. This is the fundamental difference to be analyzed.

In the baseline, there is a mild depreciation of the nominal exchange rate in 2013, mainly caused by the slowdown of foreign direct investment inflows relating to the construction phase of the PNG LNG project, but stabilizes in the outer years. Real output falls in 2013, due to the completion of construction for the PNG LNG project, but then recovers. Headline inflation rises in 2013 in response to the nominal depreciation, and then stabilizes by 2014.

In the alternative, the depreciation is stronger, as a result of the increased demand for imports from the government spending. This is based on the assumption that 65 percent of the additional expenditure arising from the deficit will be spent on imports. A fiscal multiplier was constructed by combining the Bank's Forecasting and Policy Analysis System (FPAS) with data from the Budget regarding the overall fiscal balance. The result was a fiscal multiplier of 0.19, implying that for every 100 kina spent domestically by government, there is a 19 kina value added contribution to overall output.

The two scenarios were compared to give an indication of the effect of the 2013 fiscal deficit on the key macroeconomic variables. The results show that the stimulus could boost real output by up to 2 percent in 2013 through both increased trade competitiveness due to the stronger depreciation and the direct multiplier effect. However, the medium-term effects would be minimal. The effect on inflation is more gradual, due to the lagged pass-through of the nominal depreciation and demand pressures on domestic prices. The fiscal stimulus could generate additional annual headline inflation of 1.5 percent in 2013, and 1.8 percent in 2014, normalizing in 2015.



2. Monetary Policy Stance

In 2013 economic growth is projected to slow down despite the expansionary fiscal policy aimed at stimulating domestic demand. The Bank aims to support domestic economic activity further through its monetary policy, while monitoring potential inflationary pressures.

The existing high level of liquidity remains a concern for the Bank. This is made even more challenging by the large fiscal deficit for 2013 and by the need to manage the liquidity impact of the large Government expenditure.

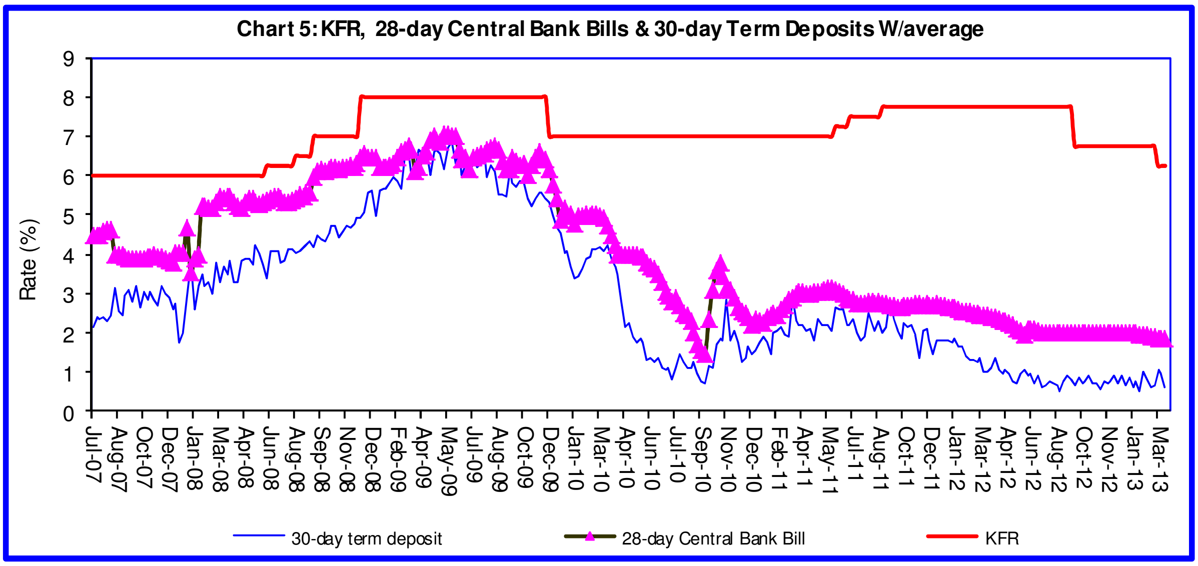
Upside risks to the Bank's projection of 15.4 percent growth in monetary base would come from:

- higher than projected inflows of foreign exchange;
- any unbudgeted Government expenditure; and
- build up of Government trust accounts at commercial banks.

In addition, the upside risks to the Bank's inflation projection of around 5.5 percent for 2013 include:

- further depreciation of the kina exchange rate;
- an increase in international food and/or fuel prices;
- higher than expected inflation in PNG's major trading partners; and
- any supply-side shocks.

The Bank eased its monetary policy stance in September 2012 following the low inflation outcomes. The KFR was further reduced from 6.75 percent to 6.25 percent in March 2013 following the release of the December quarter 2012 annual inflation outcome of 1.6 percent (see Chart 5). Lending by the commercial banks to the private sector has started to pick up and the easing in monetary policy will further encourage lending and support economic activity, especially in light of the construction phase of the PNG LNG project winding down. The Bank will maintain the current policy stance for the next six months, but may adjust it if developments in the economy and/or financial market warrant it.



Source: Bank of PNG

3. Conduct of Monetary Policy

Monetary policy will be conducted within the reserve money framework. The MPS provides the overall monetary policy stance, while the monthly KFR remains the instrument for signaling this stance or any changes through an announcement by the Governor. Following the announcement, Open Market Operations will be conducted to support the Bank's monetary policy stance. The OMOs involve Repurchase Agreement (Repo) transactions with commercial banks and the auction of CBBs to ODCs and Treasury bills to the general public. The Bank will also use its direct policy instrument, the CRR, where necessary to assist in liquidity management.

The Bank introduced the CBB Tap facility[1] in October 2012 for small retail investors to participate in the securities market and help develop a savings culture in the country.

The Bank will continue to assess developments in the market and use all the instruments at its disposal to ensure that financial stability is maintained and inflation is at an acceptable level.

[1] The introduction of the CBB Tap Facility is intended to broaden participation in the securities market by targeting small investors, other than registered bidders currently participating in the primary market. This will also contribute towards the development of a retail market for securities.

Appendix

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

INDICATOR	2010 (actual)	2011 (actual)	2012 (actual)	Sep 2012 MPS	2013 (proj)	2014 (proj)	2015 (proj)
Broad Money Supply	10.2	17.3	10.9	13.3	12.8	13.0	14.5
Monetary Base	11.1	61.7	17.6	32.6	15.4	13.1	12.5
Claims on the Private Sector	18.1	7.9	12.0	10.1	13.6	14.2	16.8
Net Claims on Gov't	-130.2	399.4	-127.6	-188.4	31.9	92.5	8.8
Net Foreign Assets	20.2	10.0	-6.4	-4.2	-1.9	2.9	2.8

Source: Bank of PNG

Table 2: Summary of Other Macroeconomic Indicators

INDICATOR	2010 (actual)	2011 (actual)	2012 (actual)	Sep 2012 MPS	2013 (proj)	2014 (proj)	2015 (proj)
CONSUMER PRICE INDEX (annual % changes)							
Headline	7.2	6.9	1.6	3.0	5.5	6.0	4.0
Trimmed-mean	5.5	6.5	0.6	3.5	4.5	5.5	4.0
Exclusion- based	5.4	7.7	-1.9	3.5	5.0	5.5	4.0
BALANCE OF PAYMENTS (kina millions) [2]							
Current account	-1,748	-406	-4,061	-7,061	-2,714	2,438	3,599
Capital & Financial* account	3,035	1,599	3,265	8,196	2,030	-1,935	-3,160
Overall balance	1,066	1,096	-851	1,135	-684	503	439
Gross Int. Reserves	8,170	9,266	8,416	9,049	8,222	8,726	9,164
IMPORT COVER (months)							
Total	10.2	11.5	11.0	6.6	9.4	10.5	9.9
Non-mineral	13.9	16.7	15.9	19.4	17.4	16.9	15.2
EXPORT PRICE							
Crude oil (US$/barrel)**	78.8	117.5	114.8	115.0	108.0	110	108
Gold (US$/ounce)	1,187.3	1,517.9	1,658.4	1,786	1,689	1,777	1,789
Copper (US$/pound)	333.4	408.2	360.1	369	350	370	380
FISCAL OPERATIONS OF THE GOVERNMENT* **							
Surplus/Deficit (K'm)	186.3	-65.7	-402.5	-513.1	-2,549	-2,352	-813
% of GDP	0.7	0.2	1.2	1.5	7.2	5.9	1.6
REAL GROSS DOMESTIC PRODUCT (annual % growth) ****							
Total GDP	7.6	11.1	9.2	9.9	4.0	5.5	20.0
Non-mineral GDP	7.3	13.2	9.8	10.4	3.4	1.1	4.2

* Now includes Capital account
* * Prices take into account, company hedging and differ from market prices.
*** Preliminary fiscal operations up to December 2012. 2013 - 2015 projections are from the 2013 National Budget.
**** GDP figures are from the 2013 National Budget.

Source: Bank of PNG, NSO and Department of Treasury

[2] For 2013, imports for the PNG LNG project are included in the annual projections but not in the actuals to December 2012.