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 2015

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 March 2015 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

The milestone year of 2014, with the commencement of production and export of Liquefied Natural Gas (LNG), was the fourteenth consecutive year of economic growth. It was also the second year of expansionary fiscal policy, entailing another budget deficit that was financed from domestic sources. Continued high economic growth and increased Government spending contributed to high import demand and the depreciation of the Kina exchange rate. While inflation trended upwards in 2014, the levels are considered manageable. The Central Bank maintained the neutral stance of Monetary Policy throughout the year.

For 2015, economic growth will reflect a full year of LNG production and export. However, lower net inflows than earlier envisaged are expected from LNG exports. This may be compounded by the lower prices of other export commodities. The Government should revisit the 2015 Budget.

The exchange rate trading band, which was introduced in June 2014, resulted in alignment of the market rates with the official exchange rate. The exchange rate has depreciated by 9.3 percent since the banding. The shortage of foreign exchange in the market resulted in Central Bank intervention of US$570.9 million in 2014. The imbalance continued and was exacerbated by foreign banks conducting unauthorised banking business in the country, through their Vostro accounts by accepting kina deposits and matching their kina liabilities with foreign currency offshore. The Central Bank therefore introduced Foreign Exchange Directives on 5th March 2015 to stop such transactions, as well as directing exporters to abide to a three month retention period for export proceeds to be repatriated onshore.

In 2014, real Gross Domestic Product (GDP) is estimated by the Bank to have grown by higher than the 8.4 percent contained in the 2015 National Budget, due primarily to the early start of production and export of LNG. Real GDP is projected to grow by around 9.0 percent in 2015, driven mainly by expected increased production of LNG, nickel and cobalt. The non-mineral sector is also expected to grow, supported by the Government's continued investments in the priority areas of education, health, agriculture and physical infrastructure.

The 2014 inflation outcome of 6.6 percent was mainly due to high economic growth and the depreciation in the kina exchange rate. In 2015, the Bank projects the annual headline inflation to be around 6.0 percent. The underlying measures are projected to be between 3.0 and 4.0 percent, indicating lower inflationary pressures.

The overall balance of payments is projected to be in surplus of K1,167.7 million in 2015, with a surplus in the current account more than offsetting a deficit in the capital and financial account. By the end of the year, the level of international reserves is projected to be US$3,295.5 (K8,729.7) million, sufficient for 8.9 months of total and 14.1 months of non-mineral import covers.

The third phase of the new payment system, Kina Automated Transfer System (KATS) involving direct credits was launched in February 2015. The payment system is now efficient, safer and on par with the best payment systems in the world.

With the commencement of LNG production and export, it is important that the Sovereign Wealth Fund (SWF) is established with an appropriate structure that adequately caters for macroeconomic stability, the country's development needs and future generation.

Considering the growth prospects in 2015 and the projected inflation, the Bank will continue to maintain its Monetary Policy stance in the next six months.

Monetary Policy Discussions

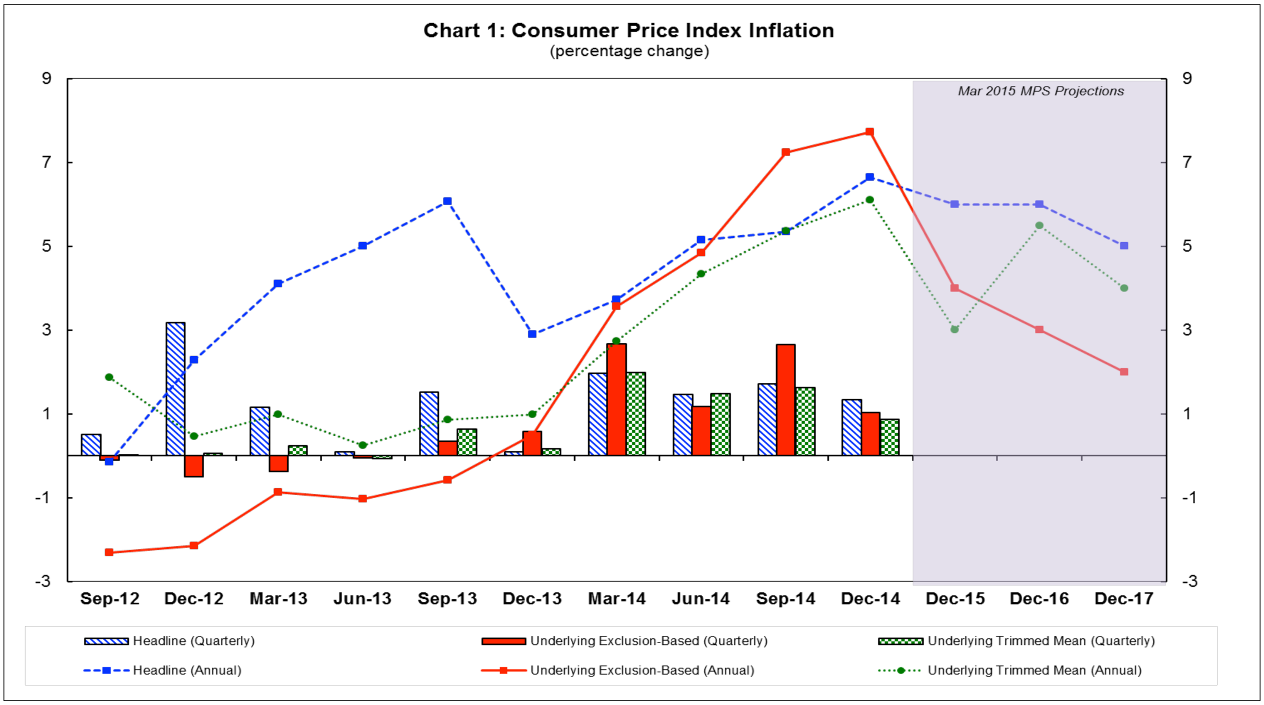
1. **Monetary Policy Assessment, Issues and Expectations**

In 2014, economic growth was higher than in 2013 with the commencement of production and export of LNG and increased Government spending on priority areas; education, health, agriculture, district and local level Governments (LLGs), and major infrastructure projects, including construction of sporting facilities for the 2015 Pacific Games. Higher Government spending and lower revenue than budgeted resulted in higher domestic financing. The Government's domestic borrowing has nearly doubled in the last two years, from K6.0 billion at the end of 2012 to around K11.5 billion in 2014. The domestic financing of the budget deficit led to an increase in interest rates for Government securities, and the increased Government spending contributed to continued high liquidity levels in the banking system. High economic growth led to increased import demand and the depreciation of the kina.

There was progressive increase in annual headline inflation in each quarter of 2014, reaching 6.6 percent in the December quarter. This level is considered manageable in view of the high economic growth. The Bank therefore maintained a neutral stance of Monetary Policy.

The annual inflation outcome was mainly influenced by increases in the 'Food and Non- Alcoholic beverages', 'Health', 'Housing', 'Household equipment', 'Clothing and Footwear' and 'Transport' expenditure groups. Underlying annual inflation, as measured by the trimmed-mean and exclusion based measures were 6.1 and 7.7 percent, respectively, in December 2014.

The Bank projects the annual headline inflation for 2015 to be around 6.0 percent, and the trimmed-mean inflation and the exclusion-based inflation to be 3.0 and 4.0 percent, respectively. Over the medium term, the Bank projects annual inflation to be around 6.0 percent in 2016 and 5.0 percent in 2017 (see Chart 1). These projections take into account the lagged effects of domestic inflation, a slow pick up in foreign inflation and continued economic growth.



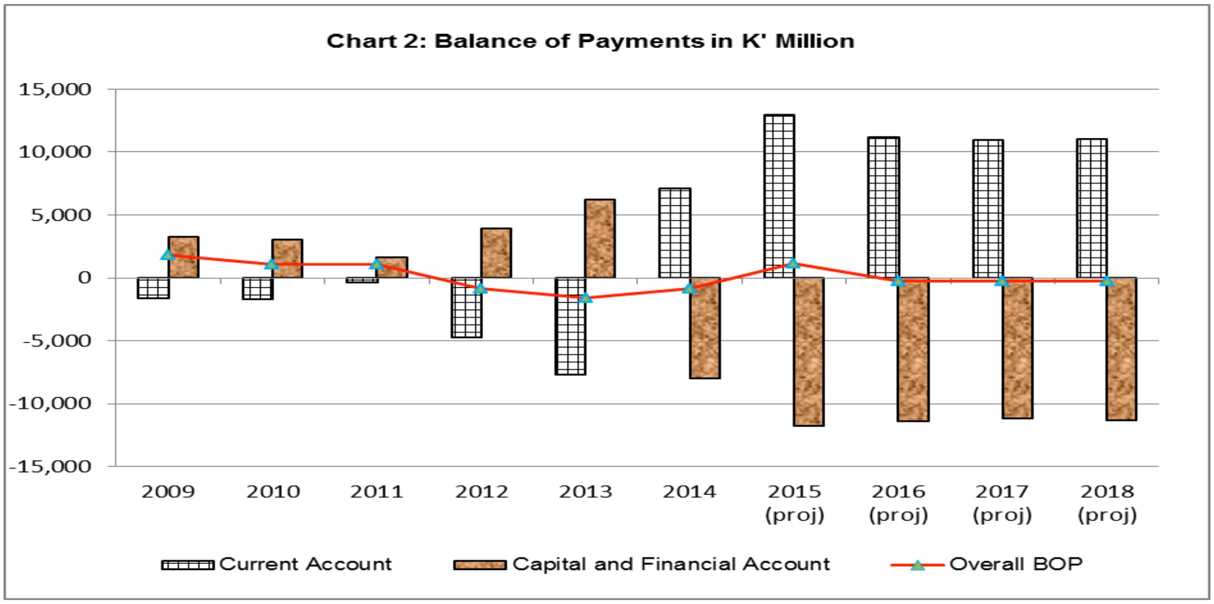
Source: Bank of PNG & NSO

Note: Following the CPI basket revisions in 2014, BPNG constructed synthetic series for historical analysis of inflation through linear interpolation of the weights, from December 1975 to June 2012. Due to this procedure, the annual series shown here from September 2012 to June 2013 might differ from those published by NSO. All other figures are based on the revised CPI basket.

The upside risks to these projections would emanate from continued high import demand associated with high economic growth and Government expenditure, lower than expected inflows of LNG export receipts and other supply side shocks. A significant turnaround in international oil prices and stronger pick-up in global inflation would also pose upside risks to domestic inflation.

The Bank forecasts growth in broad money supply of 6.3 percent in 2015, compared to 1.2 percent in 2014, emanating from an expected increase in net foreign assets of the banking system, attributed to higher holdings of foreign exchange by the Bank of PNG. Monetary base and private sector credit are projected to grow by 7.6 percent and 4.8 percent, respectively. The increase in monetary base takes into account higher commercial bank deposits at the Central Bank. The slow pick-up in the projected growth in private sector credit continues to reflect firms utilising own cash-flow to fund their activities and funding by the Government. The Bank considers the projected growth in monetary aggregates sufficient to support economic growth in the non-mineral private sector in 2015 (see Appendix-Table 1).

The overall balance of payments is projected to be in surplus of K1,167.7 million in 2015, with a surplus in current account more than offsetting a deficit in the capital and financial account. The current account is projected to be in surplus of K12,957.6 million, mainly due to higher exports reflecting full-year production of LNG, condensate and naphtha combined with full capacity production of nickel and cobalt. The capital and financial account is projected to be in deficit of K11,789.9 million, mainly reflecting outflows associated with the debt service payments by the LNG project partners and other financing arrangement (see Chart 2).



Source: Bank of PNG
Note: 2014 to 2017 includes flows related to the PNG LNG project, compared to the actuals, which do not include LNG figures.

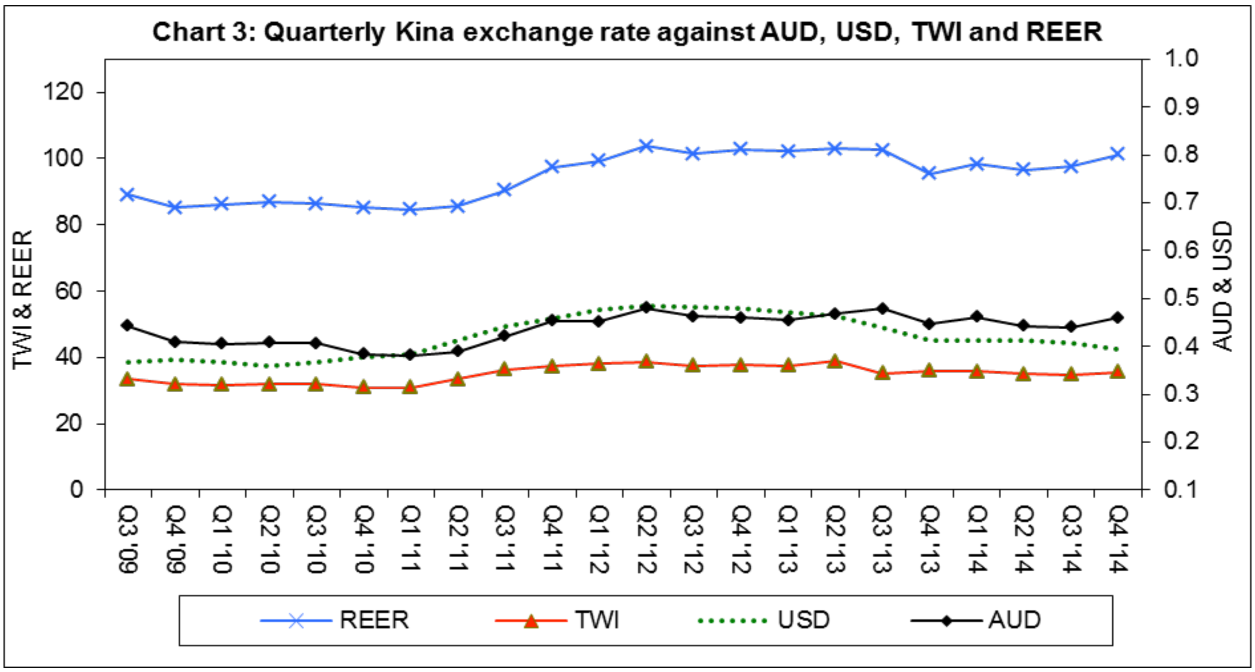
In the medium term, whilst the current account is projected to record surpluses due to inflows from mineral and non-mineral export receipts. The capital and financial account is expected to record higher deficits reflecting outflows, associated with loan repayments. As a result, the overall balance of payments position is expected to record deficits in 2016 and 2017.

As at 31st December 2014, the level of gross foreign exchange reserves was US$2,342.1 (K 5,980.7) million, sufficient for 8.0 months of total and 11.4 months of non-mineral import covers. By the end of 2015, the level of international reserves is projected to be US$3,295.5 (K8,729.7) million, sufficient for 8.9 months of total and 14.1 months of non-mineral import covers. The higher level of reserves mainly reflects proceeds from the sale of 4.27 percent of the Government's equity in the PNG LNG project to Provincial Governments and landowners. In 2016 and 2017, the repayments of external loans by the LNG project and Government will more than offset the net inflows of foreign exchange from LNG and other commodity exports, reducing the level of international reserves (See Appendix – Table 2).

The continued depreciation of the kina against the US dollar was due to high economic growth that led to increased import demand, while there were lower foreign exchange inflows. The appreciation against the Australian dollar reflects the strengthening of the US dollar against the Australian dollar, as the US economy continues to recover. Since the introduction of the trading band in June 2014, the kina exchange rate has moved in-line with the supply and demand of foreign currency. The exchange rate has depreciated by 9.3 percent since the banding, from US$0.4130 to US$0.3745 as at 27th March 2015.

The supply of foreign currency continued to be low relative to demand, reflecting low export receipts, and unauthorised banking business by foreign banks through their Vostro accounts, by accepting kina deposits and matching their kina liabilities with foreign currency offshore. These transactions exacerbated the imbalance in the foreign exchange market which prompted the Central Bank to introduce Foreign Exchange Directives effective 05th March 2015, under the Foreign Exchange Manual. These Directives include: the restriction of direct kina deposits into foreign banks' Vostro accounts; the imposition of a three month retention period for export proceeds to be repatriated onshore; and a restriction on the outward remittance of kina. In addition, a ban was imposed on the opening of onshore and offshore foreign currency accounts pending the outcome of audits on these accounts.

The Trade Weighted Index (TWI) declined by 0.8 percent in the 12 months to December 2014, compared to the corresponding period of 2013. The Real Effective Exchange Rate (REER) increased by 6.1 percent over the 12 months to December 2014 due to higher weighted kina exchange rate (see Chart 3). The strengthening in the REER implies that PNG exports have become less competitive.



Source: Bank of PNG

In 2014, real GDP is estimated by the Bank to have grown by higher than the 8.4 percent contained in the 2015 National Budget. This is due primarily to the early start of LNG production and export, supported by the mining, agricultural, forestry & fisheries, public utilities, finance, real estate, property & business, manufacturing, and commerce sectors.

Real GDP is projected by the Bank to increase by around 9.0 percent in 2015, driven mainly by the mineral sector reflecting full year of LNG production and increased nickel and cobalt production combined with Government's continued public investments expenditures. The non-mineral sector is also expected to grow, mainly driven by expected increases in activity in the agriculture, manufacturing, public utilities and commerce sectors. The expected increase in the agriculture sector would reflect improvements in prices and production of some commodities. Although the construction sector is expected to slow down due to completion of a number of major infrastructure projects funded by the Government, its spillover effects to other non-mineral sectors and ongoing construction of the 2015 Pacific Games facilities, and actual staging of the Games are expected to contribute to overall economic growth.

With the commencement of production and export of LNG, the Government should use the opportunity to invest in the non-mineral export sectors, especially, agricultural, fisheries and forestry sectors, to broaden the export base of the economy and reduce the economy's dependence on the mineral sector. This would also assist in providing employment opportunities, increasing the Government's revenue base and reducing the impact of the *Dutch Disease,* especially in the agriculture sector. The Government's investment in the agriculture sector is critical to improve production in export commodities such as coffee, cocoa and copra that are constrained by the lack of managerial skills, poor extension services, limited financial resources and poor access to markets. The Government has to ensure the past experiences are not repeated and the country does not miss out on the opportunities from the development of major resource projects. Failure to do so would mean another lost opportunity provided by the LNG project. Had the agriculture sector been more developed in the past, the economy would be in better stead to withstand the effects of declining oil and other commodity prices.

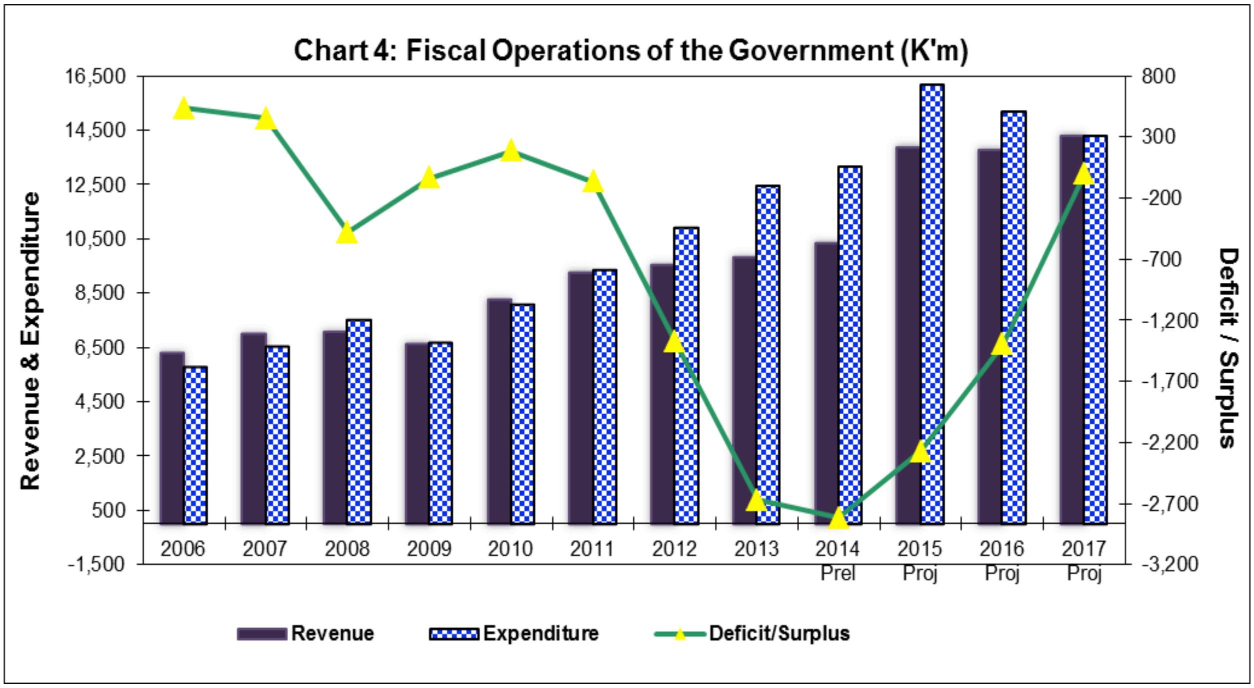
The preliminary fiscal outcome of the National Government for 2014 show a deficit of K2,815.2 million or 6.9 percent of nominal GDP. There was an increase in issuance of Government securities to finance the deficit and this resulted in a rapid increase in interest rates. Better coordination between the Treasury Department and the Bank in the auctioning of Government securities led to the interest rates being stabilized.

In the 2015 National Budget, the Government plans for an expenditure of K16,199.1 million and revenue of K13,927.3 million, giving a deficit of K2,271.8 million or 4.4 percent of nominal GDP. The expansionary fiscal policy is to support economic activity by focusing on key capital investments such as transport infrastructure, agriculture, law and order, education and health services. There is also increased funding to provincial, district and local levels of Government. These priority areas are expected to sustain economic growth by increasing the productive capacity of the economy. However, given the fall in oil and other commodity prices, Government revenue may be lower than budgeted and this will pose budgetary challenges. It is advisable that the Government aims for a reduction in expenditure and should only spend as and when there are revenue inflows, and cut non-essential expenditure, defer any non-priority expenditure and refrain from undertaking any new contracts. Unless these measures are implemented the Government will have to meet the cost of increased deficit financing. It is therefore important that the Government and Central Bank pursue an effective coordination of fiscal and monetary policies.

To finance the deficit, the Government plans to raise funds from both domestic and external sources. It projects to borrow K811 million or 36 percent from external concessional sources and K1,461.2 million or 64 percent from domestics sources. Although the domestic market has sufficient liquidity to finance the deficit and also meet private sector borrowing needs, demand has declined as some creditors have reached their limits on Government debt. Public debt is projected to decrease to 27.8 percent of GDP in 2015, compared to 35.5 percent in 2014, reflecting lower domestic debt combined with higher nominal GDP.

In the medium term, the Government's revenue would improve because of the anticipated proceeds from the LNG project. Projects that may not be implemented in 2015 because of revenue shortfalls and capacity constraints can then be carried out. It is important that the Government maintains prudent fiscal management by keeping within the Budget parameters.

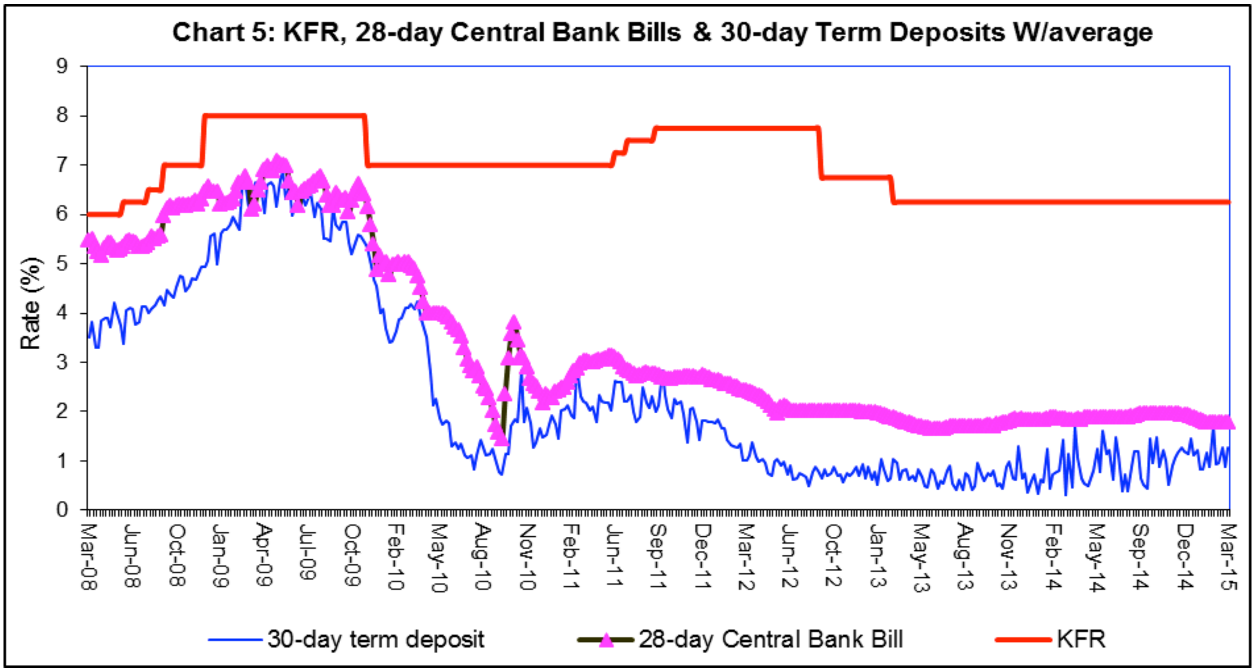
The new Organic Law on Sovereign Wealth Fund (SWF) was presented and passed the first and second readings of Parliament in February 2015 and is expected to pass the third and final reading in 2015. It is important that the Government maintains its commitment to have the SWF operational in 2016 to prudently manage revenue inflows from LNG and other mineral projects in a sustainable manner. This will also help the country manage the effects of the *Dutch Disease* phenomenon on the other sectors of the economy. Pending the establishment of the SWF, all mineral receipts including LNG to the Government should still flow through the Central Bank.



Source: 2015 National Budget. 2014 outcome is preliminary.

2. Monetary Policy Stance

Given the current economic conditions and expected developments, including the projected inflation of around 6.0 percent, the Bank will continue to maintain its stance of Monetary Policy. This stance is aimed at supporting economic activity and growth.



Source: Bank of PNG

3. Conduct of Monetary Policy

Monetary policy will be managed within the reserve money framework. The Monetary Policy Statement provides the overall monetary policy stance, while the monthly Kina Facility Rate signals this stance or any changes through an announcement by the Governor. Following the announcement, Open Market Operations (OMOs) will be conducted to implement the policy stance. The OMOs involve the auction of Central Bank Bills (CBB), Treasury bills and Inscribed stocks to Other Depository Corporations and the general public and Repo transactions with commercial banks.

To fund the Budget deficit in 2014, the Government made a net issuance of K1,419.9 million in Treasury bills and K1,563.3 million in Inscribed stocks, while there was a net retirement of K894.8 million in CBBs.

The CBB Tap facility will continue to operate to allow small retail investors to participate in the securities market and help develop a savings culture in the country. Participation however has been low mainly due to limited access to the facility from other centers of the country.

Following the implementation of two phases of the new payment system project that involved real time gross settlement of high value priority payments and cheque truncation, the third phase involving direct credits was launched in February 2015. The payment system is now efficient, safer and on par with the best payment systems in the world. This will improve the intermediation process of payment and settlement, and enhance liquidity management.

The Bank will continue to assess developments in the market and use all the instruments at its disposal to ensure that price and financial stability are maintained.

Appendix

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

INDICATOR	2012 (actual)	2013 (actual)	2014 (actual)	Sep 2014 MPS	2015 (proj)	2016 (proj)	2017 (proj)
Broad Money Supply	11.0	6.5	1.2	6.6	6.3	5.7	5.4
Monetary Base	17.6	0.5	37.1	17.6	7.6	6.5	5.9
Claims on the Private Sector	12.2	17.3	2.2	6.7	4.8	5.4	6.0
Net Claims on Gov't	-150.2	462.0	48.3	35.5	-43.6	20.6	-16.9
Net Foreign Assets	-5.6	-11.8	-16.0	2.6	36.8	-1.9	-3.0

Source: Bank of PNG

Table 2: Summary of Other Macroeconomic Indicators

INDICATOR	2012 (actual)	2013 (actual)	2014 (actual)	Sep 2014 MPS	2015 (proj)	2016 (proj)	2017 (proj)
CONSUMER PRICE INDEX (annual % changes)							
Headline	1.6	4.7	6.6	8.0	6.0	6.0	5.0
Trimmed-mean	0.6	1.8	6.1	6.5	3.0	5.5	4.0
Exclusion- based	-1.9	5.9	7.7	5.0	4.0	3.0	2.0
BALANCE OF PAYMENTS (kina millions)[1]							
Current account	-4,061	-7,401	7,084	-1,699	12,958	11,145	10,920
Capital & Financial account*	3,265	5,775	-8,000	988	-11,790	-11,398	-11,185
Overall balance	-851	-1,598	-861	-196	1,168	-253	-265
Gross Int. Reserves	8,416	6,912	5,980	6,485	8,730	8,477	8,477
IMPORT COVER (months)							
Total	11.0	7.1	8.0	4.6	8.9	8.2	8.3
Non-mineral	15.9	9.6	11.4	7.8	14.1	14.1	14.9
EXPORT PRICE							
Crude oil (US$/barrel)**	114.5	109.5	103.5	104.1	50.9	58.8	63.7
Gold (US$/ounce)	1,659.6	1,368.3	1,189.3	1,206.7	1,110.0	1,005.6	988.9
Copper (US$/pound)	360.1	332.8	311.1	310.2	280.0	280.0	280.0
Nickel (US$/tonne)	17,541.7	11,998.8	15,812.6	18,010.0	14,544.0	14,641.0	14,639.0
Cobalt (US$/tonne)	30,000	30,000	23,813.4	33,000	24,289.7	24,532.5	24,777.9
LNG (US$/000 mmbtu)			16.7	15.5	15.5	15.0	14.7
Condensate (US$/barrel)			92.5	90.0	90.0	89.0	87.0
FISCAL OPERATIONS OF THE GOVERNMENT* **							
Surplus/Deficit (K'm)	-1,377.9	-2,672.4	-2,815.2	-2,725.5	-2,271.8	-1,398.2	0.0
% of GDP	4.3	7.8	6.9	6.9	4.4	2.5	0.0
REAL GROSS DOMESTIC PRODUCT (annual % growth) ****							
Total GDP	8.0	5.0	8.4	5.4	15.5	5.0	2.3
Non-mineral GDP	9.1	4.9	1.4	1.1	4.0	3.9	3.7

* Now includes Capital account
* * Prices take into account, company hedging and differ from market prices.
*** Preliminary fiscal operations up to December 2014, while projections are from the 2015 National Budget.
**** GDP figures are from the 2015 National Budget.

Source: Bank of PNG, NSO and Department of Treasury

[1] PNG LNG exports are included in 2014. Full year annual productions are projected from 2015.