BANK OF PAPUA NEW GUINEA

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

PORT MORESBY

31st March 2017

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 December 2016 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 Papua New Guinea (PNG) economy recorded a turnaround in its external balance in 2016. This followed the resumption of operations at Ok Tedi and Porgera mines and recovery in production by the agriculture sector after the end of the El Nino drought, and an increase in the prices of a few export commodities. With most of the export commodities' prices still relatively low and tax concessions given to project developers, Government revenue was significantly lower than in the Supplementary Budget introduced in August 2016. Notwithstanding these developments, the economy recorded its fifteenth successive year of growth in 2016.

A further improvement in the external sector is expected in 2017. Expected increases in production and export from the agriculture and mining sectors, in response to higher prices for some of the commodity exports, will translate to a slightly higher growth in 2017 compared to 2016, supported by full year production at Ok Tedi mine. However, the recovery in commodity prices is not expected to be strong enough and therefore Government revenue will still be lower than the Budget. The Government plans to raise external financing to partly fund the budget deficit.

The improvement in some of the commodity prices have resulted in an increase in the inflow of foreign exchange, as experienced in the second half of 2016 and is expected to continue into 2017. Careful management of the foreign exchange market by the Central Bank together with the Authorized Foreign Exchange Dealers (AFEDs), and fiscal operations by the Government within the parameters of the 2017 Budget and Medium Term Fiscal Framework will see the country through this challenging period.

Annual headline inflation was 6.6 percent in 2016, compared to 6.4 percent in 2015. The increase was due to higher prices of seasonal items in the CPI basket. Underlying inflation continued to remain low, with the annual trimmed mean and exclusion-based measures at 2.0 percent and 2.2 percent, respectively, in 2016. For 2017, the Central Bank projects annual headline inflation to be around the 2016 level and trimmed mean and exclusion-based measures at 3.5 percent and 3.0 percent, respectively.

Considering these inflation outcomes and projections for 2017, the Bank will maintain a neutral monetary policy stance over the next six months. It will continue to monitor developments in inflation and other macroeconomic indicators and may adjust its monetary policy stance as necessary.

Monetary Policy Discussions

1. Monetary Policy Assessment, Issues and Expectations

There was an improvement in PNG's overall balance of payment which recorded a surplus in 2016 compared to a deficit in 2015, with a surplus in the current account more than offsetting a deficit in the capital and financial account. This was mainly due to a decline in imports and a small increase in exports. Prices for export commodities continued to remain low in the first-half of 2016. This impacted on Government revenue. The recommencement of Ok Tedi mining operations, increase in a few of the export commodity prices and external financing, resulted in improvements in foreign exchange inflows and stability in the kina exchange rate, especially in the second half of 2016.

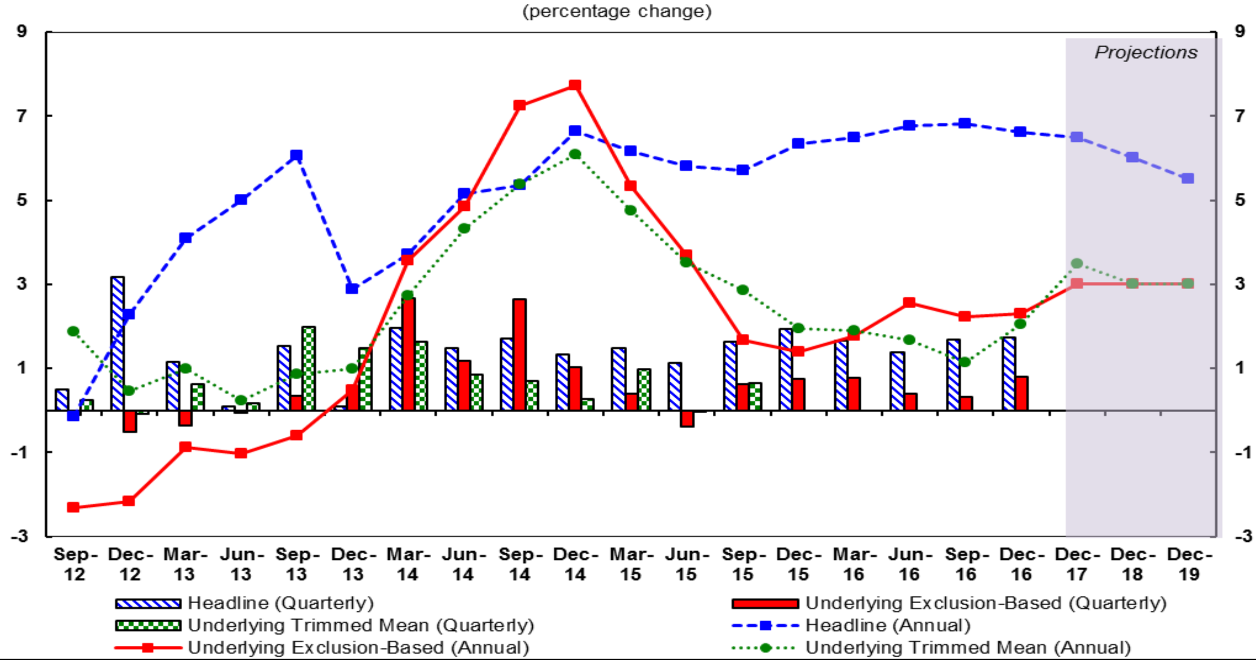
Real GDP growth is estimated to have been 2.0 percent in 2016, compared to 11.8 percent in 2015. For 2017, real GDP growth is expected to be 2.8 percent as projected in the 2017 National Budget, driven by expected increase in activity in the non-mineral sectors, full year production at Ok Tedi mine, and increased production at Lihir, Ramu and Porgera mines. The improvement in international prices of some export commodities and the increase in foreign exchange inflows is expected to continue in 2017.

Annual headline inflation was 6.6 percent in 2016, compared to 6.4 percent in 2015. This outcome was driven by price increase of some domestic items in the CPI basket. Price increases in seasonal items such as betelnut and fruit and vegetable were due to supply constraints. The annual trimmed mean and exclusion-based measures for underlying inflation were 2.0 percent and 2.2 percent, respectively, in 2016.

The Bank projects annual headline inflation to be around the 2016 level. This projection takes into account, fluctuations in prices of domestic seasonal items, and spending associated with the 2017 National Election and 2018 APEC meetings. The projection also considered stability in the kina exchange rate as a result of improvement in volume and prices of some export commodities and low domestic economic activity. The underlying inflation measures of trimmed mean and exclusion-based measures are projected at 3.5 percent and 3.0 percent, respectively.

In the medium-term, the Bank projects annual headline inflation to be around 6.0 percent in 2018 and 5.5 percent in 2019 (see Chart 1). The upside risks to these projections include increased domestic demand arising from spending related to the APEC meetings in 2018 and higher imported inflation from PNG's trading partners, and any supply shocks.

Chart 1: Consumer Price Index Inflation
(percentage change)



Source: National Statistical Office & Bank of PNG

The overall balance of payments recorded a surplus of K31 million in 2016. This is expected to further improve in 2017 to a surplus of K1,360 million, with a surplus in the current account more than offsetting a deficit in the capital and financial account. The projected current account surplus of K13,029 million for 2017, is mainly due to an improvement in international commodity prices, on-going LNG exports and higher production of some other export commodities. The capital and financial account is projected to be in a deficit of K11,669 million, mainly reflecting outflows from ongoing debt servicing by the PNG LNG Project. This trend is expected to continue in 2018 and 2019 (see Chart 2). However, in the event that any of the major projects in the mining and LNG sectors advance to development stage over the coming two years, the capital and financial account will turn into surplus, reflecting inflows of foreign exchange.

As at 31st December 2016, the level of gross foreign exchange reserves was US$1,678.2 (K5,257.5) million, sufficient for 7.2 months of total and 12.6 months of non-mineral import covers[1]. It is projected that the level of foreign exchange reserves will be US$2,106.6 (K6,617.5) million at the end of 2017. The increase in the level of reserves mainly reflects improved inflows from non-mineral export receipts, expected proceeds from external financing, and receipts for royalty and development levy associated with the PNG LNG Project, as well as concessional loan drawdowns from bilateral and multilateral sources (see Appendix Table 2).

The high current account surplus in 2016 was driven by LNG exports. This did not translate into foreign exchange inflows into the domestic economy because of provisions for accelerated depreciation write-off on allowable capital expenditure under the LNG Project Development Agreement. Developers of mining, gas and petroleum projects are also allowed to have offshore foreign currency accounts, from which their offshore liabilities are paid and any surpluses are brought onshore for domestic expenditures.

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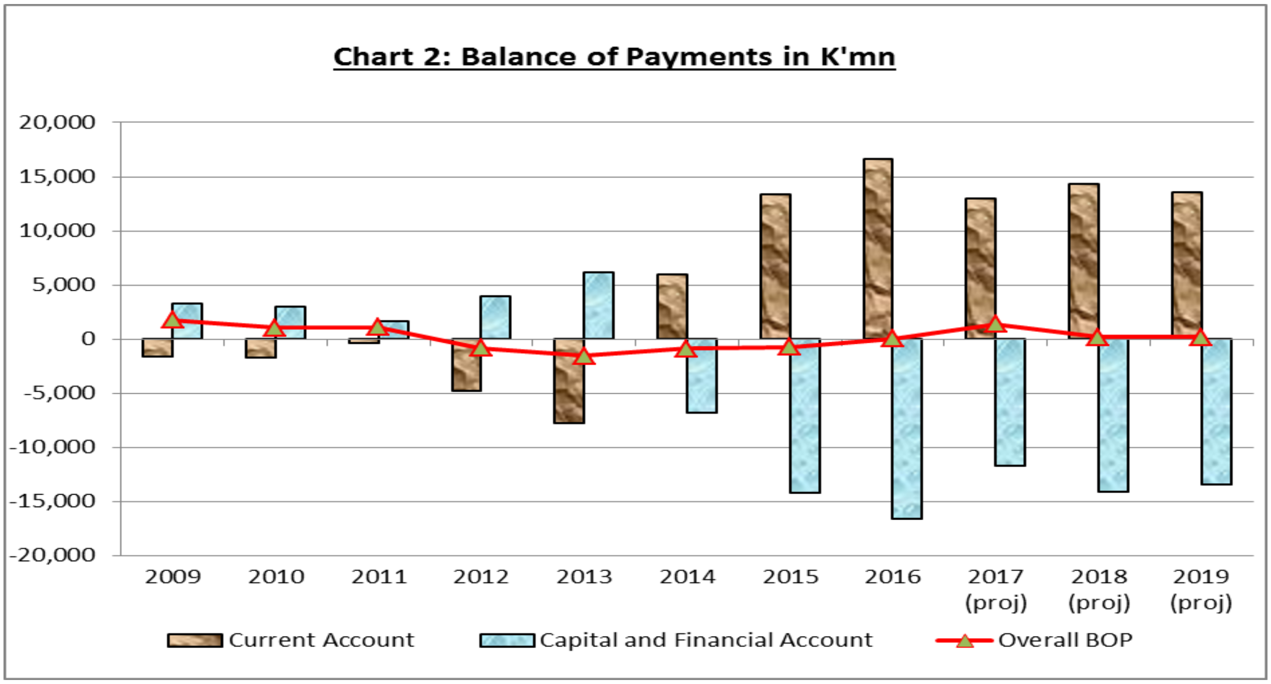
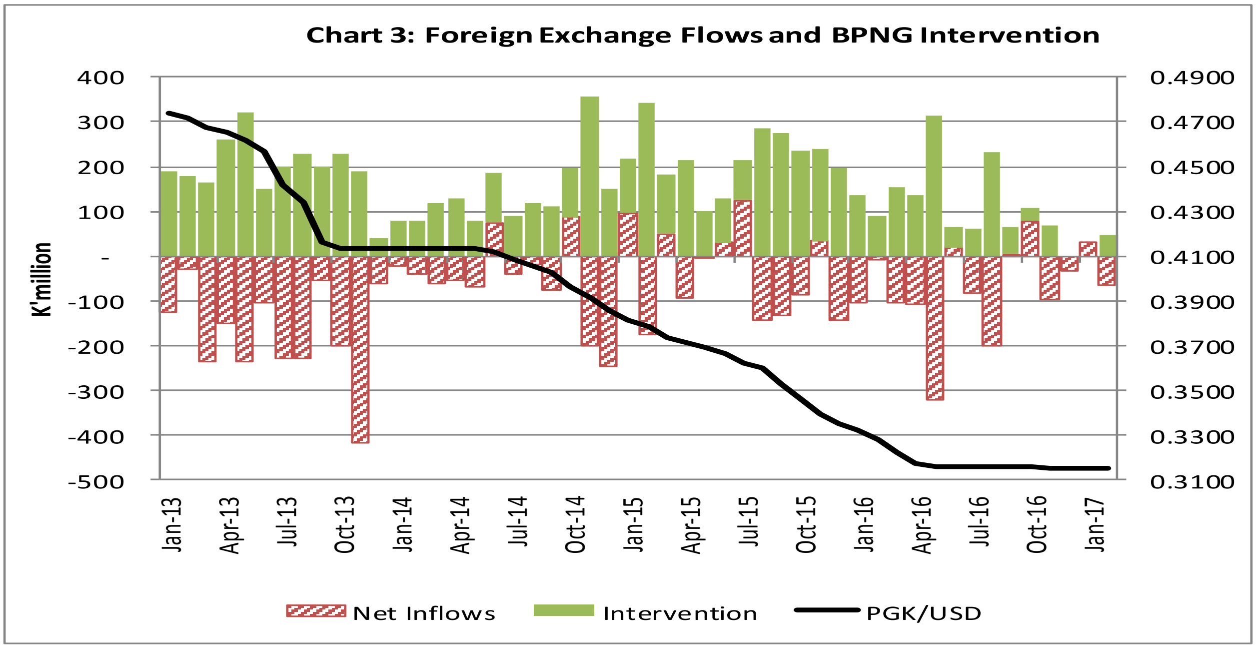
[1] The calculation of the import covers includes import of both goods and services.



Source: Bank of PNG

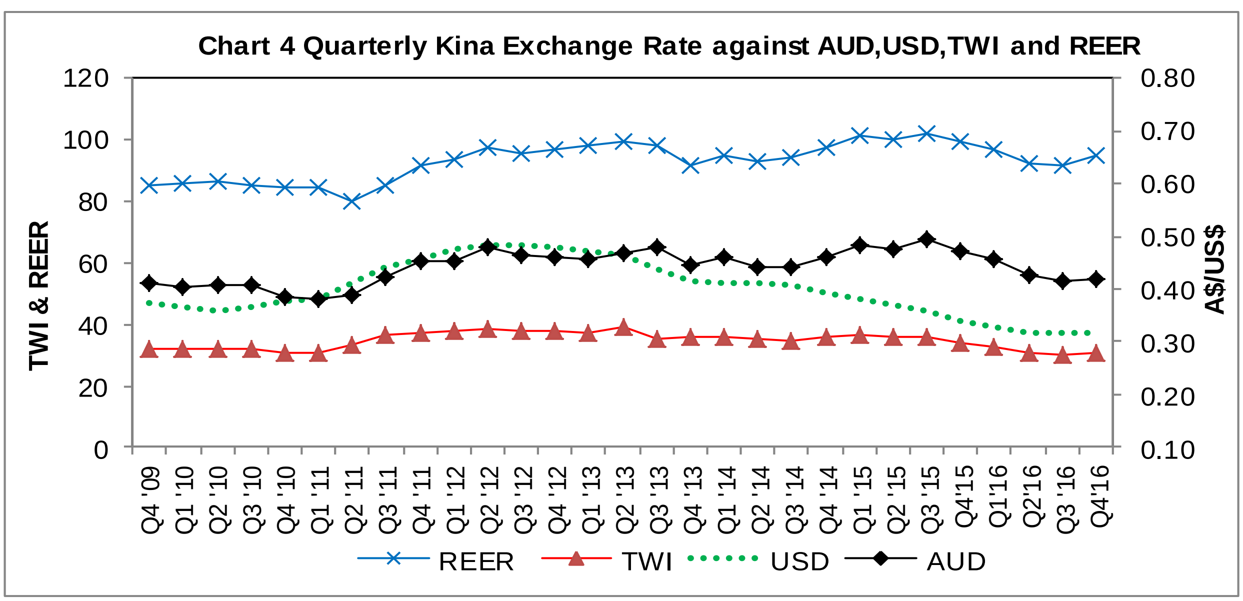
There have been some good foreign exchange inflows since the second half of 2016, from the mining sector, mainly from the Ok Tedi mine, and recovery in the agriculture sector after the El Nino drought. These, together with the intervention by the Central Bank assisted in meeting some of the import orders. The intervention by the Central Bank totaled US$425.1 million in 2016.

The total supply of foreign currency, including the Central Bank’s intervention, should have cleared most of the outstanding orders in the spot market (see Chart 3). However, this did not happen because of the way Authorized Foreign Exchange Dealers (AFEDs) used the inflows. They used some of the inflows to provide foreign currency loans (trade finance) and for forward contracts, and other purposes. Therefore, the Central Bank issued Foreign Exchange Market Directives in September and November 2016 to AFEDs to address these matters and induce proper functioning of the domestic foreign exchange market.



Source: Bank of PNG

The kina exchange rate depreciated against the USD from US$0.3325 at the end of December 2015 to US$0.3150 at the end of December 2016, where it remained up to 22nd March 2017, before depreciating by 5 basis points to US$0.3145 on 23rd March. The stability against the USD was due to an increase in foreign exchange inflows mainly from mining and agriculture sectors. Against the AUD, the kina exchange rate depreciated from A$0.4354 at end of December 2016 to A$0.4127 as at 24th March 2017, as the AUD strengthened against the USD following increases in international commodity prices; growth in China, which helped Australia's export sector; increased capital expenditure; and higher consumer demand and construction activity in Australia, which led to increases in retail sales.

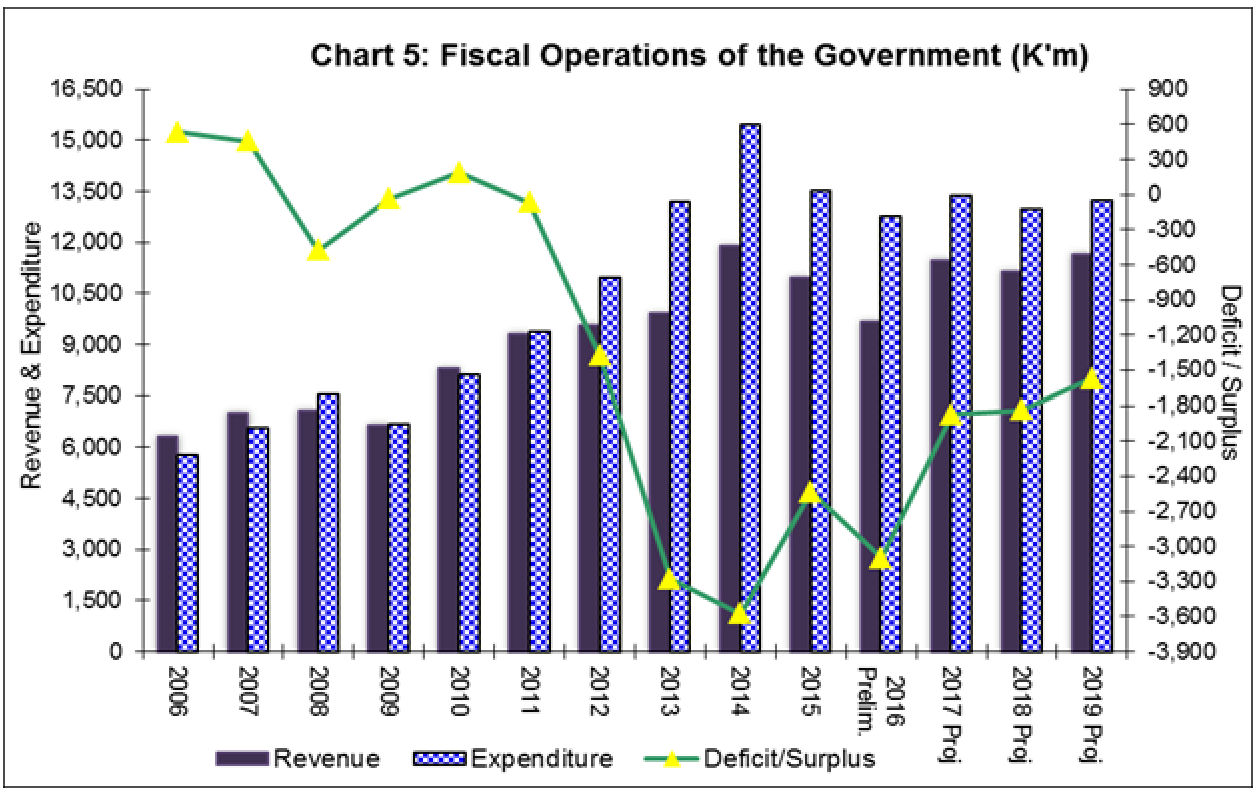


Source: Bank of PNG

The Trade Weighted Index (TWI) decreased by 1.7 percent over the three months to 15th March 2017. The Real Effective Exchange Rate (REER) appreciated by 3.4 percent in the December quarter of 2016, compared to the September quarter, reflecting appreciation of kina against most major currencies (see Chart 4).

The preliminary fiscal outcome of the National Government of 2016 shows a deficit of K3,086.9 million, compared to a deficit of K2,532.6 million in 2015 (see Chart 5). This represents 4.6 percent of nominal GDP. The higher deficit is mainly attributed to lower revenue at K10,485.4 million, which is short by K1,236.1 million, compared to the planned revenue in the 2016 Supplementary Budget. The lower revenue is mainly attributed to a significant decline in tax revenue by K404.2 million, and other non-tax revenue by K1,127.7 million. Total expenditure of K13,572.4 million is K262.3 million lower than the Supplementary Budget appropriation.

In the 2017 National Budget, the planned expenditure is K13,349.6 million and revenue is K11,473.1 million, with a deficit of K1,876.5 million or 2.5 percent of nominal GDP. To finance the deficit, the Government intends to raise funds mostly from external sources, with K128.6 million from concessional and K54.4 million from commercial sources, and K1,500 million from other external financing. The balance of K193.5 million will be from domestic sources.



Source: 2017 National Budget

In January 2017, the Government secured US$110.0 million from the planned US$300.0 million of the second tranche of the Credit Suisse syndicated loan, as part of an external financing for 2016 National Budget. The funds were used to finance Governments priority development expenditures as well as retire some of its domestic debts. The State is working on disbursement of the balance of the second tranche.

Given the challenges in raising external financing, there could be a shift towards domestic sources. However, this is also becoming difficult given that major financiers may have already reached their limits on exposures to the Government.

Using the National Accounts for 2006 to 2014 released by the National Statistical Office (NSO)[2], the Debt to GDP ratio for PNG from 2013 to 2014 is between 27 to 29 percent, which is within the limit as stipulated under the Fiscal Responsibility Act 2006. Nominal GDP is on an upward trend, and similar Debt to GDP ratios can be estimated for 2015 and 2016. With prudent budget management, similar results can be attained for 2017 and beyond for debt to be at a sustainable level. Financing of the 2017 Budget deficit and achieving a balanced budget by 2021 would be challenging.

There are other issues that affect balance of payments and Government budget. For instance, Project Development Agreements (PDA) that were executed between the State and project developers often lack clarity and consistency with existing government policy or regulations to provide operational assurance and certainty to investors, particularly foreign investors. Over the years, negotiating project agreements have resulted in instances where they are being used by the project developers to obtain preferential treatment and concessions from the State in a very uncoordinated manner and without detailed analysis of the costs and benefits of such agreements. Also, the Internal Revenue Commission (IRC) still faces challenges in tax revenue collection. In 2017 the Government provisioned for increased funding to IRC to improve compliance and enforcement, including collection of tax arrears.

The Bank forecasts growth in broad money supply of 10.3 percent in 2017, compared to an increase of 10.9 percent in 2016, stemming from expected increases in both net foreign assets and net domestic assets of the banking system. The growth in net foreign assets will be driven by external budget financing, favourable export receipts and dividends from the mineral sector. The increase in net domestic assets will come from growth in net credit to the Government of 16.6 percent and the private sector credit of 6.9 percent. The monetary base is projected to increase by 2.5 percent, influenced by an increase in net foreign assets. The Bank considers the projected growth in monetary aggregates sufficient to support the growth in the non-mineral private sector in 2017 (see Appendix Table 1).

Since the introduction of Kina Automated Transfer System (KATS), there has been a reduction in the volume of cheques presented for clearing from 135,688 in February 2015 to 98,112 in January 2017; and an increase in direct electronic payments from 128,183 to 196,164 over the same period. The Central Bank reduced the Cheque Dishonour Period (CDP) from three (3) to two (2) days in January 2017 to enable faster clearance and access to funds for companies, individuals and the Government.

The Bank is currently discussing with potential vendors to implement the National Switch for the payment system, which is expected to become operational in 2018. The Switch will enable interoperability between all payment service providers and products, including providers of mobile wallets, and extend the benefits currently available to commercial bank customers to those of non-

[2] The National Accounts for 2006 - 2014 was compiled with technical assistance from the Australian Bureau of Statistics and IMF's regional body, Pacific Financial Technical Assistance Centre (PFTAC).

bank financial institutions. The Switch will also facilitate the role of Digital Financial Services (DFS), an area that is emphasized in the National Financial Inclusion Strategy 2016-2020.

The Electronic Funds Transfer (EFT) facility developed in the Banking Services System (BSS) in 2016 is anticipated to be launched by Department of Finance in 2017. The automation of PNG Customs payments went live in January 2017, enabling e-payment process for all payments with automatic reconciliation with the ASYCUDA System. While tax payments for IRC are made electronically, work on the interface between the KATS and IRC's SIGTAS System is in progress.

Under the AML/CTF legislations of 2015, the Financial Analysis and Supervision Unit (FASU) has been established within the Bank of PNG and is now operational. FASU administers PNG's domestic and international AML/CTF obligations. A national risk assessment is being undertaken to identify areas of risk regarding money laundering and terrorism financing. This covers banks and financial institutions, and designated non-financial businesses and professionals.

The Central Bank is working on establishing the Administrative Secretariat of the Sovereign Wealth Fund (SWF) at the Bank, with external technical assistance. Treasury Department is responsible for the other aspects of establishing SWF, including the Board and staff.

The Government is also working on further reforms in the financial services sector, to enhance efficiency and extend provision of financial services to the majority of our population. The reforms will be contained in a Strategic Plan on Financial Services Sector, which will be presented to NEC for endorsement before it can be implemented.

PNG as a small open economy will continue to be exposed to external and domestic shocks. Developing the non-mineral sector is critical to build a resilient economy that can help minimize the impacts of these shocks. Increasing the productive capacity of the economy should involve expanding the export sector, encouraging import substitution industries, and developing downstream processing activities. This should also involve undertaking infrastructure development and structural reforms such as strengthening institutional capacity. In the agriculture sector, the Government should revive agricultural extension programs to improve quality controls in the sector. This together with the reform agenda on developing seven identified economic corridors (areas) in the country will improve market accessibility and boost production. The drive to promote Micro, Small and Medium Enterprises through financing and training on financial literacy and entrepreneurial skills will also contribute to increased productivity and inclusive growth. There needs to be an improvement in Government's implementation, monitoring and enforcement capacity. The Public-Private Partnership program through relevant government departments and or State Owned Enterprise working in partnership with the private sector will contribute to a more cost-effective service delivery framework.

2. Monetary Policy Stance

Inflationary pressures remain low as indicated by the underlying inflation projection of between 3.0 and 3.5 percent, while headline inflation is projected to be around 6.5 percent, in 2017. Considering these projections, the Central Bank will maintain a neutral monetary policy stance over the next six months but will continue to closely monitor developments in inflation and other macroeconomic indicators and may adjust its monetary policy stance as necessary.

3. Conduct of Monetary Policy

Monetary policy is managed within the reserve money framework to achieve the Central Bank's objective of maintaining price stability. This involves managing liquidity to impact interest rates which would in turn affect economic activity and inflation. The MPS provides the overall policy stance, while the monthly policy rate signals this stance or any changes through an announcement by the Governor. Following the announcement, Open Market Operations (OMOs) are conducted to implement the policy stance. The OMOs involve the auction of Central Bank Bills (CBB), Treasury bills and Inscribed stock to Other Depository Corporations and the general public, and Repo transactions with commercial banks.

To date, the Central Bank has relied on issuance of Central Bank Bills and Government securities as instruments to manage liquidity in the banking system, and did not make any change to the direct instrument of Cash Reserve Requirement (CRR).

The Bank plans to introduce a new Tap facility to on-sell Government securities, comprising both Treasury bills and Treasury bonds. This will allow for a broader participation from individuals, businesses, Government agencies, other institutions and offshore investors. The purpose is to develop a savings culture in the country, provide additional avenue for investment and encourage the development of the domestic capital market. In addition, this facility will help diffuse liquidity from the banking system.

Appendix

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

INDICATOR	2014 (actual)	2015 (actual)	Sep 2016 (MPS)	Actual to Dec 2016	2017 (proj)	2018 (proj)	2019 (proj)
Broad Money Supply	3.4	8.0	7.7	10.9	10.3	9.5	8.2
Monetary Base	37.1	-2.2	1.3	24.4	2.5	4.1	5.9
Claims on the Private Sector	3.6	3.4	7.3	7.2	6.9	7.8	7.4
Net Claims on Gov't	51.1	28.4	1.8	48.3	16.6	14.0	8.2
Net Foreign Assets	-17.4	-13.8	-4.9	-18.1	30.9	6.6	2.6

Source: Bank of PNG

Table 2: Summary of Other Macroeconomic Indicators

INDICATOR	2014 (actual)	2015 (actual)	Sep 2016 (MPS)	Actual to Dec 2016	2017 (proj)	2018 (proj)	2019 (proj)
CONSUMER PRICE INDEX (annual % changes)							
Headline	6.6	6.4	7.0	6.6	6.5	6.0	5.5
Trimmed-mean	6.1	2.3	5.5	2.0	3.5	3.0	3.0
Exclusion- based	7.7	1.4	4.0	2.2	3.0	3.0	3.0
BALANCE OF PAYMENTS (kina millions)[1]							
Current account	5,964	13,392	11,867	16,647	13,029	14,284	13,562
Capital & Financial account	-6,819	-14,188	-10,507	-16,632	-11,669	-14,127	-13,404
Overall balance	-861	-753	194	31	1,360	157	159
Gross Int. Reserves	5,980	5,227	6,704	5,257	6,617	6,774	6,933
IMPORT COVER (months)[2]							
Total	7.5	10	7.4	7.2	5.6	5.4	5.3
Non-mineral	10.5	15.8	18.6	12.6	9.6	9.0	8.5
EXPORT PRICE							
Crude oil (US$/barrel)*	98.6	51.6	43.9	42.1	50.2	51.2	52.2
Gold (US$/ounce)	1,133.0	1,147.6	1,227.9	1,199.2	1,040.7	1,094.5	1,159.8
Copper (US$/pound)	296.4	262.4	225.0	227.4	259.6	300.0	346.2
Nickel (US$/tonne)	18,885.3	11,568.9	8,242.6	9,521.9	10,000.0	10,545.0	12,356.0
Cobalt (US$/tonne)	23,855.9	28,178.0	22,752.1	25,961.6	25,000.0	29,505.0	28,019.0
LNG (US$/000 mmbtu)	14.0	9.7	6.0	6.8	8.7	8.9	9.2
Condensate (US$/barrel)	86.8	51.0	30.9	50.7	53.2	54.3	54.8
FISCAL OPERATIONS OF THE GOVERNMENT**							
Surplus/Deficit (K'm)	-2,815.2	-2,532.6	-2,112.5	-3,086.9	-1,876.6	-1,839.1	-1,570.3
% of GDP	-6.9	-4.1	-3.1	-4.6	-2.5	-2.3	-1.8
REAL GROSS DOMESTIC PRODUCT (annual % growth) ***							
Total GDP	12.5	11.8	2.2	2.0	2.8	2.7	2.7
Non-mineral GDP	3.3	2.0	2.6	2.5	3.0	3.5	3.5

Source: Bank of PNG, NSO and Department of Treasury

* Prices take into account, company hedging and differ from market prices.
** 2016 figures are from the 2016 Final Budget Outcome, while 2017 - 2019 projections are from the 2017 National Budget.
*** GDP figures for 2014 are from NSO and for 2015 to 2019 are from the 2017 National Budget.

[1] PNG LNG exports are included in 2014. Full year annual production occurred from 2015 onwards.
[2] The calculation of the import covers includes import of both goods and services as of 2016.