BANK OF PAPUA NEW GUINEA

MONETARY POLICY STATEMENT
BY THE GOVERNOR OF
THE BANK OF PAPUA NEW GUINEA,
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PORT MORESBY

31st March 2018

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 2017 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 is expected to lead to:

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

Executive Summary

With continued improvement in the external sector, underpinned by higher international prices and production of some of PNG's major exports, particularly mineral commodities, real GDP growth in 2017 is estimated by the Central Bank to be higher than projected in the 2018 National Budget. For 2018, real GDP growth is projected by the Bank to be close to 3.0 percent, higher than 2.4 percent in the 2018 National Budget, mainly driven by an increase in activity in the non-mineral sector. This will be supported by higher Government spending relating to the hosting of Asia-Pacific Economic Cooperation (APEC) meetings. The mineral sector is also expected to contribute to the growth, however, the recent earthquake and its adverse impact on production of mineral and LNG will affect growth outlook for 2018. The full impact of this disaster is yet to be assessed.

The 2018 National Budget plans for a deficit of K1,987.2 million or equal to 2.5 percent of nominal GDP. To finance the deficit, the Government intends to raise funds mostly from external sources. This external financing will assist liquidity in the foreign exchange market.

For the first time since becoming a member in 1993, PNG is hosting APEC meetings in 2018. These meetings will be concluded with the Leaders' Summit in November. The hosting of APEC is expected to have a positive impact on the economy, raising the profile of PNG internationally and promoting it as an investment and tourism destination.

Inflation has been on a downward trend reflecting low economic growth, relative stability in the kina exchange rate and lower prices of seasonal food items. Annual headline inflation was 4.7 percent in 2017, compared to 6.6 percent in 2016. For 2018, annual headline inflation is projected to be slightly higher at 5.0 percent, taking into account the marginal increase in imported inflation from PNG's major trading partners and increased demand from APEC related activities. In the medium term, the Bank projects annual headline inflation to be around 4.5 percent in 2019 and 4.0 percent in 2020.

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

Monetary Policy Discussions

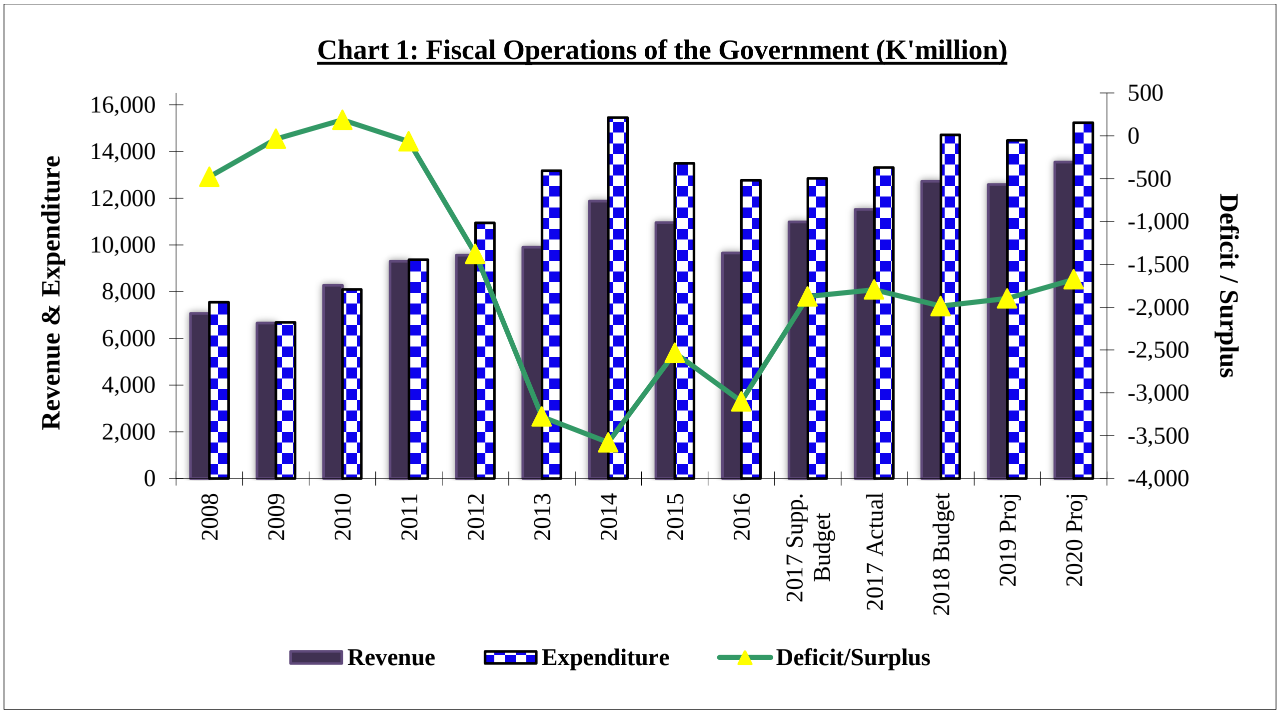
1. Monetary Policy Assessment, Issues and Expectations

The external sector continued to improve with increases in the international prices and production of some of PNG's major exports, especially the mineral commodities, leading to a higher surplus in the current account for 2017. Consequently, the Central Bank estimates a higher real GDP growth in 2017.

The objective of APEC is to promote and facilitate free trade and investment among the APEC member economies. The theme for the meeting is: "Harnessing Inclusive Opportunities and Embracing the Digital Future". Three immediate priorities to support the APEC objectives are improving digital connectivity and deepening regional economic integration, promoting inclusive and sustainable growth, and strengthening inclusive growth through structural reform. The hosting of APEC is expected to have a positive impact on the economy from increased activity and employment. This will also raise the profile of PNG internationally and promote it as an investment and tourism destination.

The outcome of the National Government fiscal operations for 2017 show a revenue of K11,525.0 million, expenditure of K13,319.7 million and a deficit of K1,794.6 million or equal to 2.4 percent of nominal GDP, compared to the deficit of K3,086.9 million in 2016, which was 4.6 percent of nominal GDP.

In the 2018 National Budget, the planned expenditure is K14,717.9 million and revenue is K12,730.7 million, giving a deficit of K1,987.2 million or equal to 2.5 percent of nominal GDP. To finance the deficit, the Government intends to raise funds mostly from external sources. The Government aims to support growth in the agriculture and Small to Medium Enterprises (SMEs) sectors. The efforts of the Government to focus its attention on the non-mineral sectors such as agriculture and tourism, to diversify the export base and promote inclusive economic growth is commended, as this will lead to broader revenue stream and sustainable economic growth in future.



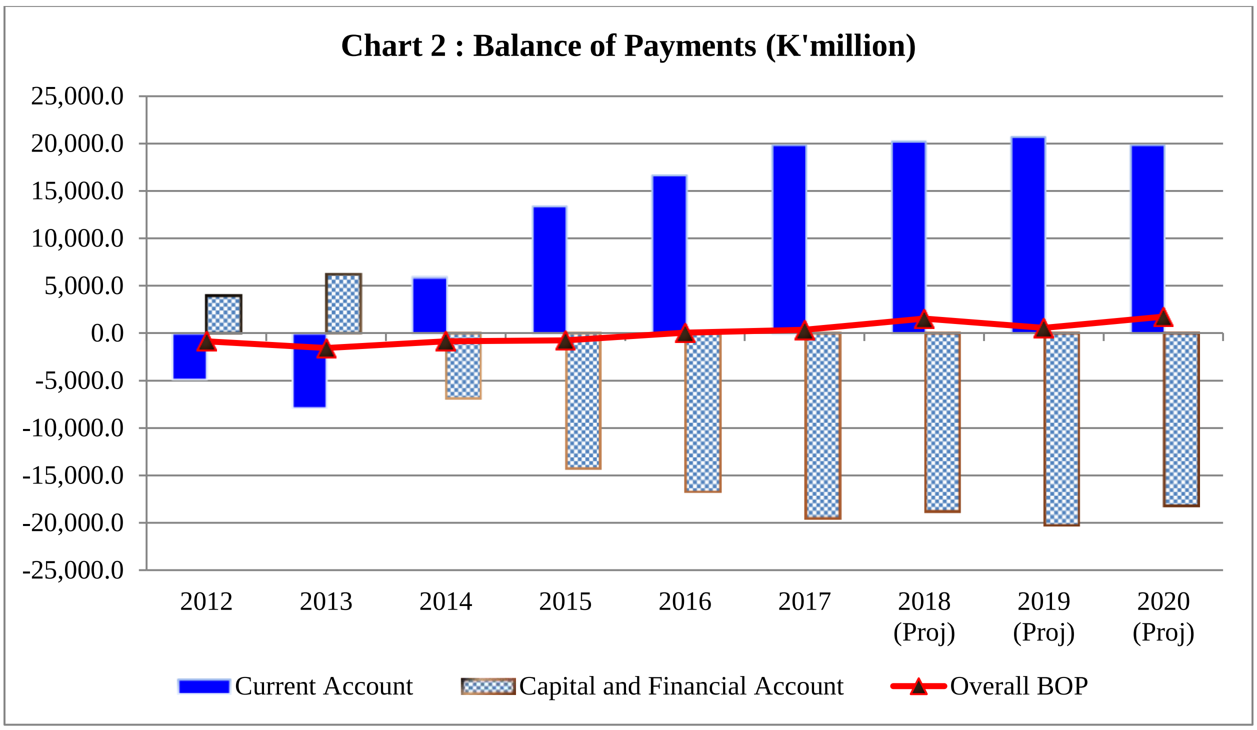
Source: 2017 Final Budget Outcome and 2018 Budget

With the budgeted deficit financing for 2018, public debt is expected to increase from the level in 2017. Of the total financing, 81.0 percent is expected from external sources and 19.0 percent from domestic sources. The Government's intention to restructure its debt profile by reducing short term domestic debt and increase external debt is commended, given the low level of external debt which is mostly concessional.

The balance of payments recorded an overall surplus of K350.0 million in 2017. A higher surplus in the current account more than offset a deficit in the capital and financial account. In 2018[1], the balance of payments is expected to record a higher surplus of K1,533.0 million, with a surplus in the current account more than offsetting a deficit in the capital and financial account. It is projected that there will be a surplus of K20,219.2 million in the current account, due to an increase in LNG export and higher prices and production of other export commodities. The capital and financial account is projected to be in a deficit of K18,704.6 million, mainly reflecting debt service payments for the PNG LNG Project (See Chart 2) and a build-up in offshore foreign currency account balances of these resource projects.

[1] The projection does not take into account the impact of the recent earthquake which disrupted operations of some of the major mining, oil and gas projects, due to unavailability of information.

In the medium term, the current account is projected to record surpluses from higher prices and production of mineral commodities. The capital and financial account is expected to record deficits, mainly reflecting debt service payments and a build-up in offshore foreign currency account balances of mining, oil and gas companies for payment of their foreign liabilities. The surpluses in the current account will be greater than the deficits in the capital and financial account. The balance of payments is projected to record surpluses in 2019 and 2020. If any of the pipeline resource projects move into development stage during this period, this will contribute positively to the balance of payments.



Source: Bank of PNG

As at 31st December 2017, the level of gross foreign exchange reserves was US$1,735.6 (K5,607.7) million, sufficient for 5.9 months of total and 9.7 months of non-mineral import covers. It is projected that the level of foreign exchange reserves will be US$2,202.9 (K7,140.5) million at the end of 2018. The increase mainly reflects improvement in inflows from mining and petroleum tax, dividends from the State's share in the mining and petroleum projects, and royalty and development levy from the PNG LNG Project. External financing of the budget deficit from concessional, commercial and other sources will also contribute to the increase in reserve level.

Inflows into the foreign exchange market improved in 2017 following the pickup in prices of some export commodities. The Central Bank's intervention also assisted the foreign exchange market. A significant share of the export receipts are kept in offshore foreign currency accounts by the mining, gas and oil companies under the provisions of the various project development agreements. This situation is unfortunate given the foreign exchange shortage faced by the country during the last few years. Future negotiations of development agreements should avoid such situation from happening.

Based on the latest business survey conducted by the Bank, the private sector has reiterated concerns about the accessibility to foreign currency and how it is affecting their business operations. They have either scaled down or switched to local suppliers to meet their business needs, which has led to some import substitution. In addition, production of agriculture commodities is constrained by high cost of doing business emanating from poor transport infrastructure and accessibility to market.

To enable the Government to fund priority expenditure items relating to APEC meetings, Tuition Fee Free Education, Health and natural disaster relief, the Central Bank has agreed on a new slack arrangement in February 2018 to acquire the under subscription of Government securities at the weekly auctions. This arrangement will cease in April 2018. Part of the external funding will be used to retire the short term domestic debt held by the Central Bank.

The Bank will continue to sterilise liquidity generated from the slack arrangement by on-selling of the Government securities to the public and issuing Central Bank Bills (CBB). At the end of December 2017, the Bank's holding of Government's securities under the slack arrangement was K1,328 million. The Central Bank issued CBBs and Tap totalled K2,095 million, which means that the slack liquidity was fully sterilised and had no inflationary impact as evident from the low inflation outcome in 2017.

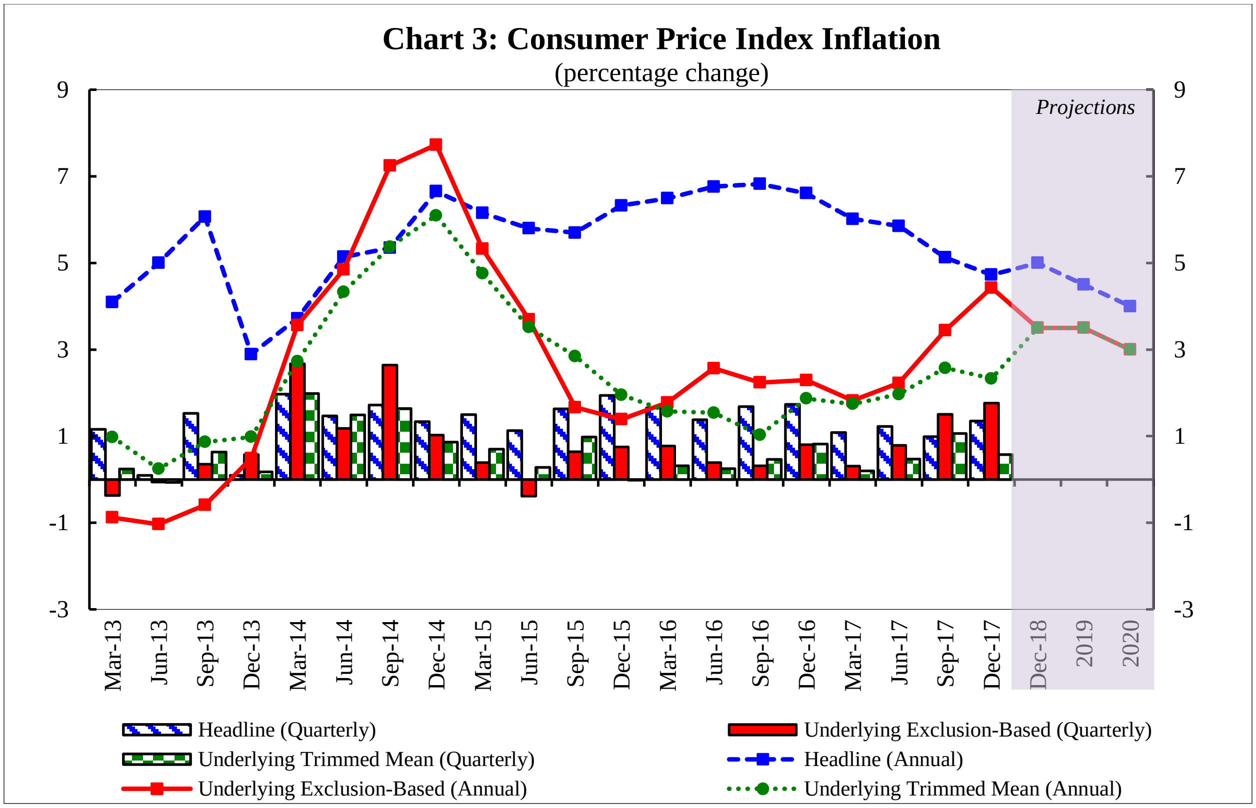
For 2018, real GDP growth is projected by the Bank to be close to 3.0 percent (2018 Budget is 2.4 percent). This growth will be broad-based across all sectors of the economy, reflecting increases in activity in the non-mineral sectors, notably in the agriculture/forestry/fisheries (AFF), wholesale, retail, accommodation and food services and, transport and storage sectors. Higher prices and production in the AFF, and higher Government spending including the hosting of APEC meetings will support this growth. The mineral sector will also contribute to the growth. The recent earthquake in the Highlands that caused damages to transport infrastructure and the gas, oil and mining projects, resulting in the temporary shutdown in their operations will have an adverse impact on exports and GDP growth in 2018. But any restoration work in the affected provinces may have positive impact on GDP growth. The full impact of this disaster is yet to be assessed.

In the medium term, real GDP growth is expected to trend downwards to around 2.2 percent and 2.0 percent in 2019 and 2020, respectively, as shown in the 2018 budget. If any of the pipeline resource projects move into development stage, GDP growth will be higher than projected.

Annual headline inflation trended downward to 4.7 percent in 2017, from as high as 6.6 percent in 2016. Prices for all expenditure groups increased but at a lower rate than in 2016, mainly driven by seasonal factors. The annual trimmed mean and exclusion-based measures for underlying inflation were 2.3 percent and 4.4 percent, respectively in 2017.

The Bank projects slightly higher annual headline inflation for 2018 at 5.0 percent. This projection is based on the marginal increase in imported inflation from PNG’s major trading partners and expected growth in non-mineral sector. The underlying inflation measures of trimmed mean and exclusion-based are both projected at 3.5 percent.

In the medium term, the Bank projects annual headline inflation to be around 4.5 percent for 2019 and 4.0 percent for 2020. Both trimmed mean and exclusion-based inflation measures are projected to be around 3.5 percent in 2019 and 3.0 percent in 2020 (See Chart 3).



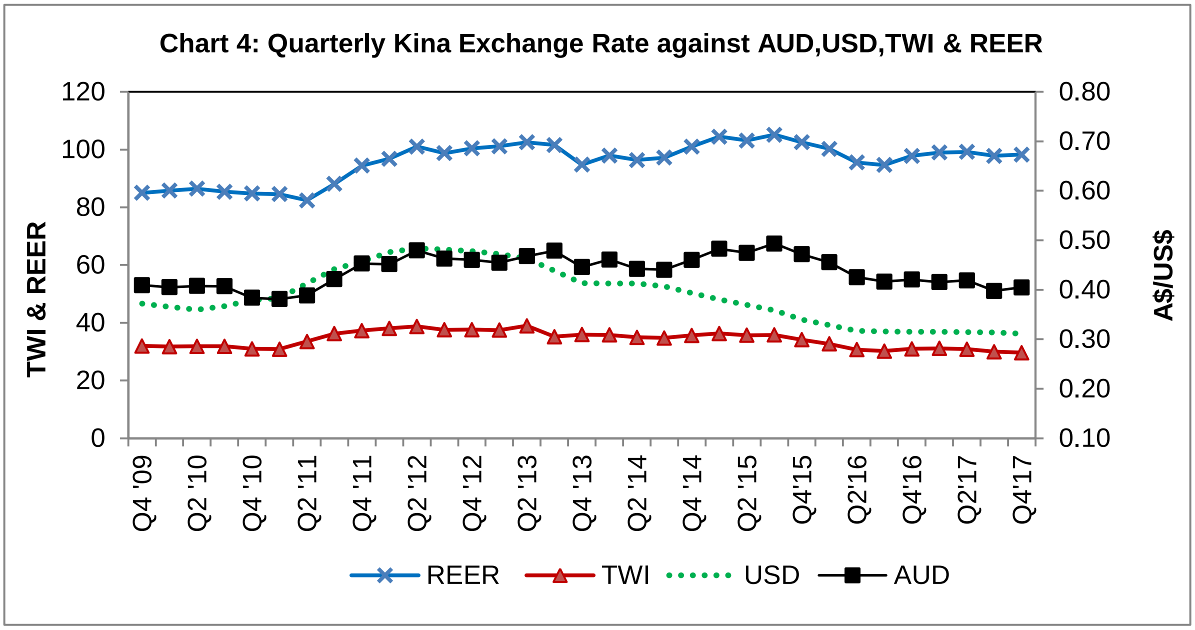
Source: National Statistical Office and Bank of PNG

The upside-risks to these projections include:

- increase in import demand;
- downward pressure on the kina exchange rate;
- impact of earthquake in the Highlands region on prices of fuel and consumer items;
- higher imported inflation from stronger global economic growth and the effect of the US imposition of tariffs on certain import items; and
- any other unforeseen supply and demand side shocks to the economy.

The kina depreciated against the USD from US$0.3150 at the end of December 2016 to US$0.3095 at the end of December 2017, and further depreciated to US$0.3075 at the end of March 2018. Against the AUD, the kina exchange rate depreciated from A$0.4354 at end of December 2016 to A$0.3967 at the end of December 2017. It appreciated to A$0.4008 at the end of March 2018.

The Trade Weighted Index (TWI) decreased by 4.3 percent in 2017, compared to a decline of 9.3 percent in 2016. Over the March quarter of 2018, it fell by 1.9 percent. The annual Real Effective Exchange Rate (REER) appreciated by 0.5 percent in the December quarter 2017, compared to a depreciation of 4.6 percent in the December quarter 2016, mainly due to the increase in domestic inflation relative to inflation in PNG's major trading partner countries. The appreciation in 2017 indicates that the competitiveness of PNG's exports has declined (See Chart 4).



Source: Bank of PNG

The Bank forecasts a growth of 6.3 percent in broad money supply for 2018, compared to a decline of 0.7 percent in 2017, due to an increase in net foreign assets of the banking system of 12.8 percent, while net domestic assets is projected to decline by 1.1 percent. The increase in net foreign assets is expected from higher export receipts due to improvement in prices and production of export commodities, mining and petroleum taxes and dividends, and inflows from external financing. Although private sector credit is expected to grow by 3.2 percent, a decline of 4.6 percent in net claims on the Central Government is expected to contribute to the overall decline in net domestic assets. The monetary base is projected to increase by 3.5 percent from a decline of 16.6 percent in 2017, influenced by the increase in net foreign assets. Given the projected turnaround in the monetary aggregates, the Bank considers the growth in broad money supply sufficient to support activity in the non-mineral sector and hence, the overall economic growth in 2018 (See Appendix Table 1).

2. Monetary Policy Stance

The Central Bank maintained its policy signaling rate, the monthly Kina Facility Rate (KFR), at 6.25 percent throughout 2017, and in the first quarter of 2018. In deciding the stance of policy, the Bank took into consideration the moderate global economic growth, downward trend in inflation, expectations of manageable headline inflation, and the relative stability of the kina exchange rate over the year. In 2018, inflationary pressures as indicated by the projected increase in underlying inflation measures will be mainly from the pass-through of the kina depreciation on imports. As a result, the headline inflation is projected to be around 5.0 percent, while the underlying inflation is projected at 3.5 percent for both trimmed mean and exclusion-based measures. In considering these developments and projections, the Central Bank will continue to maintain a neutral stance of monetary policy over the next six months. The Bank will closely monitor developments in inflation and other macroeconomic indicators and may adjust its 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 Treasury bonds to Other Depository Corporations and the general public, and Repo transactions with commercial banks. The Bank will introduce changes to the Repo arrangement (See Box 1).

The Central Bank continued to use CBBs 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).

Box 1: New Arrangement on Liquidity Management

The Repurchase Agreement Facility (Repo) was introduced to the market by the Central Bank in 2001 as an instrument for Open Market Operations. The objective of the Repo is to give short term loans to the commercial banks to meet their kina liquidity shortfall and to improve the transmission of monetary policy. Since then, the Repo arrangement between commercial banks and Bank of PNG is unsecured or uncollateralized. Vice versa with the Reverse Repo, the Central Bank diffused excess liquidity by borrowing from the commercial banks.

The Central Bank will be introducing a new arrangement to secure the borrowings under the Repo. The commercial banks will pledge their holdings of Government securities against the borrowing.

In the first quarter of 2018, the Bank has commenced making changes to its monetary policy instruments and liquidity arrangements. These changes involve:

a) termination of borrowing under the existing Intraday Liquidity Facility (ILF);
b) accessing the Cash Reserves Deposits (CRD) for intraday funding; and
c) pledging of Government securities as collateral to borrow under the Repo facility.

Under the new operational arrangement, the CRD now replaces the ILF. The CRD will be made accessible only to fund any shortfalls in the Exchange Settlement Accounts (ESAs) on an intraday by the commercial banks. This funding of the ESA constitutes borrowing from the Central Bank. In the event that the ESA for a commercial bank is still negative before KATS closes at the end of the day, these borrowings will be transformed into a Repo. The Repo Facility will be available for up to 30 days. Conversely, a Reverse Repo will involve the Central Bank pledging its securities to diffuse liquidity from the commercial banks for monetary policy purposes.

The pricing arrangement of the Repos remains unchanged. The Repos will be priced at the KFR and a margin.

Appendix

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

INDICATOR	2015 (actual)	2016 (actual)	Sep 2017 (MPS)	Actual to Dec 2017	2018 (proj)	2019 (proj)	2020 (proj)
Broad Money Supply	8.0	10.9	8.0	-0.7	6.3	5.9	5.8
Monetary Base	-2.2	24.4	7.3	-16.6	3.5	4.5	3.4
Claims on the Private Sector	3.4	6.9	2.5	-3.4	3.2	2.2	2.0
Net Claims on Government	40.1	49.6	15.1	9.5	-4.6	-2.7	-2.3
Net Foreign Assets	-8.4	-18.1	3.9	8.2	12.8	25.3	35.6

Source: Bank of PNG

Table 2: Summary of Other Macroeconomic Indicators

INDICATOR	2015 (actual)	2016 (actual)	Sep 2017 (MPS)	Actual to Dec 2017	2018 (proj)	2019 (proj)	2020 (proj)
CONSUMER PRICE INDEX (annual % changes)							
Headline	6.4	6.6	6.0	4.7	5.0	4.5	4.0
Trimmed mean	2.3	1.9	3.0	2.3	3.5	3.5	3.0
Exclusion- based	1.4	2.2	2.5	4.4	3.5	3.5	3.0
BALANCE OF PAYMENTS (kina millions)							
Current account	13,392	16,650	18,917	19,826	20,219	20,668	19,838
Capital & Financial account	-14,188	-16,623	-18,803	-19,433	-18,705	-20,129	-18,104
Overall balance	-753	31	114	350	1,533	539	1,734
Gross International Reserves	5,227	5,257	5,450	5,608	7,141	7,679	9,413
IMPORT COVER (months)[1]							
Total	10.0	7.2	6.2	5.9	6.9	7.2	8.6
Non-mineral	15.8	12.6	9.8	9.7	13.8	13.6	15.8
EXPORT PRICE							
Crude oil (US$/barrel)*	51.6	42.1	54.0	54.1	55.7	57.6	57.4
Gold (US$/ounce)	1,147.6	1,199.2	1,239.1	1,227.6	1,231.3	1,232.5	1,233.8
Copper (USc/pound)	262.4	227.4	258.1	274.7	272.2	269.9	267.9
Nickel (US$/tonne)	11,568.9	9,521.9	9,920.8	10,192.8	10,381.1	10,634.4	10,897.3
Cobalt (US$/tonne)	28,178.0	25,725.1	46,038.5	55,901.2	60,373.3	64,599.4	69,767.3
LNG (US$/ mmbtu)	9.7	6.8	8.5	7.9	7.9	7.8	7.7
Condensate (US$/barrel)	51.0	50.7	53.8	54.8	54.2	53.4	53.0
FISCAL OPERATIONS OF THE GOVERNMENT**							
Surplus/Deficit (K'm)	-2,785.7	-3,086.9	-1,876.6	-1,794.7	-1,987.2	-1,897.4	-1,675.7
% of GDP	-4.5	-4.6	-2.5	-2.4	-2.5	-2.2	-1.8
REAL GROSS DOMESTIC PRODUCT (annual % growth) ***							
Total GDP	10.5	2.0	2.7	2.2	2.4	2.2	2.0
Non-mineral GDP	0.7	0.7	3.0	1.9	3.5	3.5	3.6

Source: Bank of PNG, NSO and Department of Treasury

* Prices take into account company hedging and differ from market prices.

** 2017 figures are from the 2017 Final Budget Outcome, while 2018 - 2020 projections are from the 2018 National Budget.

*** GDP figures for 2015 to 2020 are from the 2018 National Budget.

[1] The calculation of the import covers includes import of both goods and services as of 2016.