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

30th September 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 September 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 high economic growth previously projected for Papua New Guinea (PNG) in 2015 has been revised downwards. This is attributed to expected significant declines in the mining and manufacturing sector activities, slower growth in other sectors as a result of lower international commodity prices and Government spending, and the adverse effects of the El Niño phenomenon. With lower international commodity prices, including oil, and the temporary shutdown of the Ok Tedi mine, Government revenue is significantly lower than budgeted and will impact on public spending. The Government has already identified cuts in certain areas and is expected to introduce a supplementary budget for 2015. Low foreign exchange inflows from the LNG project and other key export commodities have not been sufficient to meet the persistent excess demand for imports and contributed to the depreciation of the kina. Therefore, the Central Bank has been intervening to assist in meeting some of the demand in the foreign exchange market.

After the initial concerns surrounding the functioning of the exchange rate trading band, the market has now embraced it, with the Authorized Foreign Exchange Dealers trading within the band. The kina continued to depreciate after the introduction of the band in June 2014, due to the short supply of foreign currency relative to its demand, demonstrating that the exchange rate is moving in line with market forces. This is consistent with a floating exchange rate regime, contrary to some views that PNG might have moved to a pegged or fixed exchange rate regime. Following the introduction of the Exchange Control Directives in March 2015, an audit on domestic foreign currency accounts, Vostro accounts of foreign banks and outward transfers was completed. The Bank is now reviewing the findings of the audit.

Annual inflation has progressively eased from 6.6 percent in December 2014 to 5.7 percent in the June quarter of 2015. Considering the outcomes and the projected inflation, and in-part to support economic activity, the Bank continued to maintain a neutral stance of monetary policy. It maintains its projection of annual headline inflation at 6.0 percent for 2015, while revising upwards the trimmed-mean and exclusion-based measures to 4.0 percent and 4.5 percent, respectively.

The Bank revised downwards its real economic growth forecast to less than the 9.0 percent projected in the March 2015 MPS. The temporary closure of the Ok Tedi mine, lower than budgeted Government expenditure, lower international commodity prices and a slowdown in the non-mineral sector were the main factors for this revision. For broad-based economic growth in the medium to long-term, greater emphasis by the Government on inclusive growth policies and public utilities reform, as well as increased investment in the sustainable sectors such as agriculture, fisheries, forestry and tourism is crucial.

The Bank forecasts growth in broad money supply of 9.2 percent in 2015 and private sector credit of 3.9 percent. It considers the projected growth in monetary aggregates sufficient to support activities in the non-mineral private sector in 2015.

The overall balance of payments is projected to be in deficit of K504.6 million in 2015, with a deficit in the capital and financial account more than offsetting a surplus in the current account. By the end of 2015, the level of international reserves is projected to be US$1,923.2 (K5,394.7) million, sufficient for 7.9 months of total and 15.6 months of non-mineral import covers.

The new Organic Law on Sovereign Wealth Fund (SWF) was passed by Parliament in July 2015. This now paves the way for authorities to establish the SWF. Once established, the Government should prudently manage revenue inflows from LNG and other mineral projects in a sustainable manner.

Considering the growth prospects, projected inflation and other developments in the economy, the Bank will continue to maintain its neutral monetary policy stance in the next six months. It will closely monitor developments and may adjust its stance as necessary.

Monetary Policy Discussions

1. Monetary Policy Assessment, Issues and Expectations

Real Gross Domestic Product (GDP) in 2015 is expected to grow by less than projected in the March MPS. While the full year of LNG production will make a significant contribution to the overall growth, the decline in the mining sector and slowdown in the non-mineral sector will contribute to the lower growth. With lower international commodity prices, including oil, adverse effects of the El Niño phenomenon and the temporary shutdown of the Ok Tedi mine, Government revenue is lower than budgeted and will impact on public spending. If the Government adjusts spending in line with lower revenue, this will ease financing requirements and interest costs. Consistent with the fiscal outcome to date, the Government has already announced plans to introduce a supplementary budget to keep the deficit within the 2015 Budget. Due to lower international prices for PNG's key export commodities and lower than expected inflows from the LNG project, the supply of foreign currency has been lower than the demand, which contributed to the depreciation of the kina. Therefore, the Bank has been intervening to assist in meeting some of the demand in the foreign exchange market.

Annual headline inflation was 5.7 percent in the June quarter of 2015, slightly below the 6.1 percent in the March quarter. The outcome is predominantly due to increase in prices for food, rent and excise items, such as tobacco and alcohol. Although prices for imported food have eased over the year, fruit and vegetable prices rose considerably driving the increase in the domestic food prices. Rental prices also rose reflecting strong demand for housing, especially in Port Moresby and Lae. However, there was some downward pressure from the transportation sector as the effect of weaker international oil prices fed through to the domestic prices. The fall in international food and oil prices, increased competition and cheaper imports, more than offset the pass-through effects of the depreciation of the kina to domestic prices. The annual trimmed-mean and exclusion-based measures for underlying inflation were 3.5 percent and 3.6 percent, respectively, during the June quarter of 2015.

The Bank maintains its projection of annual headline inflation at 6.0 percent for 2015 and revises upwards the trimmed-mean and exclusion-based measures to 4.0 percent and 4.5 percent, respectively. These projections are based on a lower growth outlook for the domestic economy, lower foreign inflation from our major trading partners, mainly attributed to declines in the international oil and food prices, and a low pass-through of kina depreciation to domestic prices.

In the medium term, the Bank projects annual headline inflation to be 7.0 percent in 2016 and 6.5 percent in 2017 (see Chart 1). These projections take into account the growth prospects of the domestic economy, higher inflation in PNG's main trading partner economies and diminishing effects of the recent oil price fall.

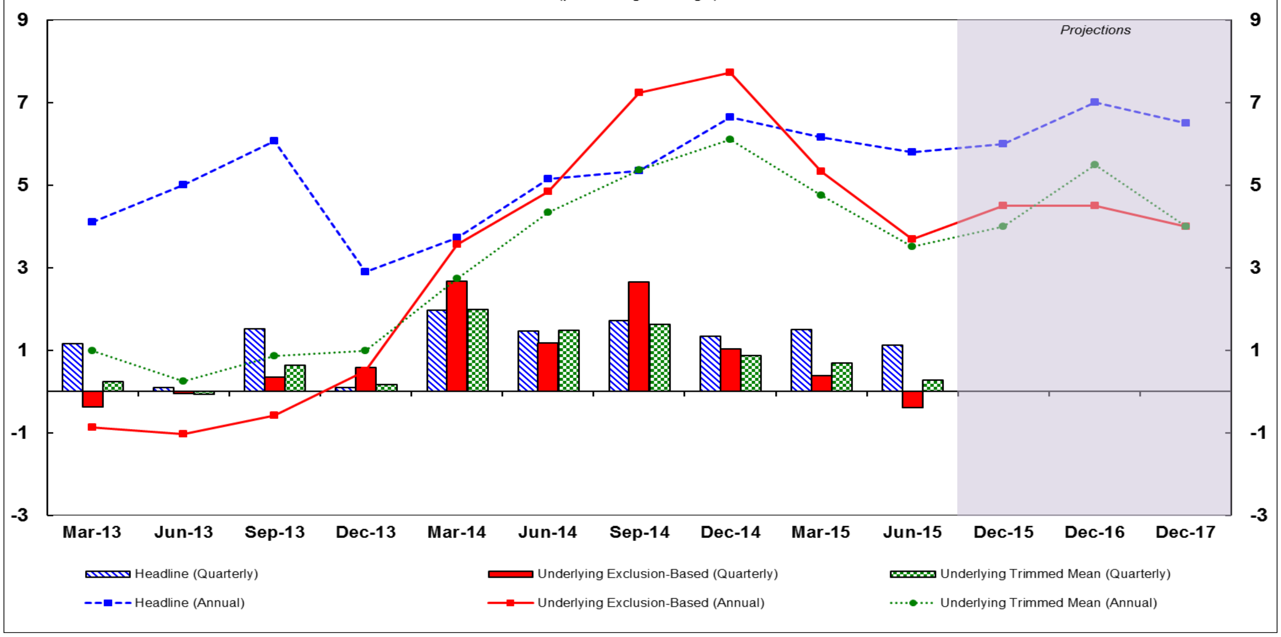


Chart 1: Consumer Price Index Inflation
(percentage change)

Source: Bank of PNG & NSO

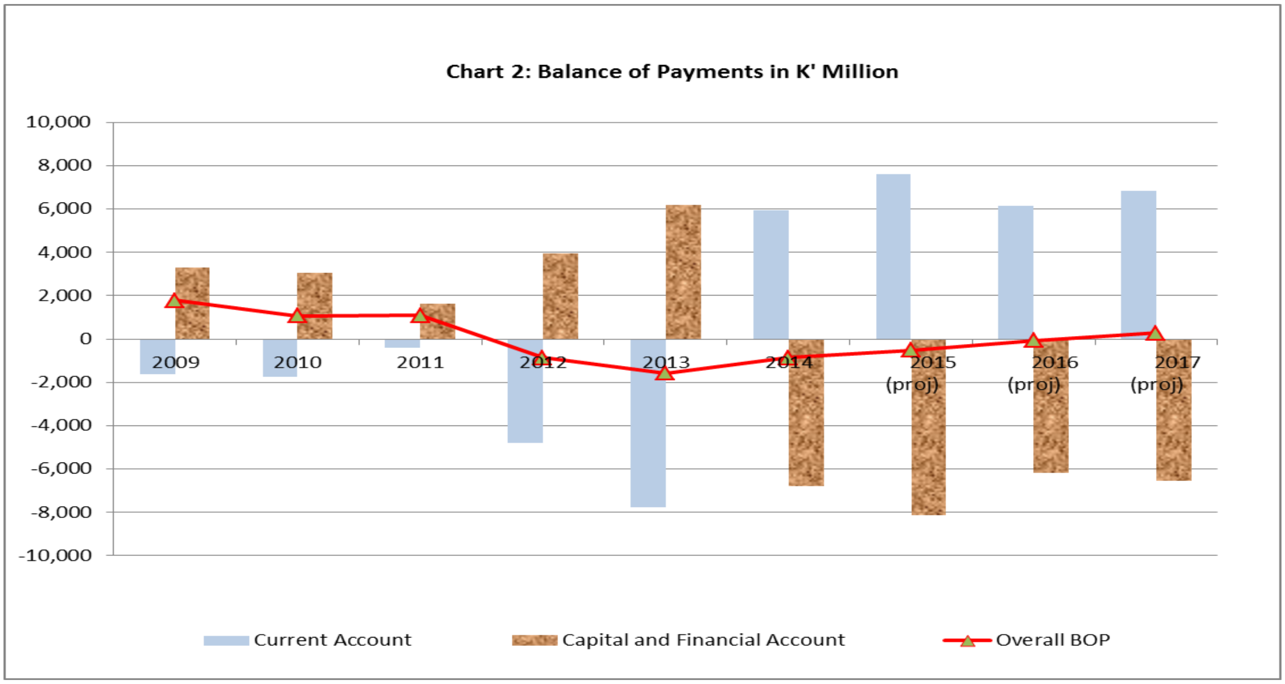
Note: Following the CPI basket revisions in 2014, BPNG constructed synthetic series for historical analysis of inflation through linear interpolation of the weights, from December 1975 to June 2012. Due to this procedure, the annual series shown here from March to June 2013 might differ from those published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

There are upside risks to these projections. An important concern is the uncertainty surrounding the impact of the El Niño phenomenon which could cause a supply-shock, beyond the effect currently anticipated, higher government expenditure including funding for the 2017 General Election and the 2018 APEC meeting, and higher than expected imported inflation from our trading partners.

The Bank forecasts growth in broad money supply of 9.2 percent in 2015 compared to 3.4 percent in 2014, resulting from an expected increase in net domestic assets of the banking system, particularly net credit to the Government. Monetary base and private sector credit are projected to grow by 8.9 percent and 3.9 percent, respectively. The growth in monetary base arises from higher commercial bank deposits at the Central Bank, while the projected low growth in private sector credit continues to reflect firms utilising own cash-flow to fund their activities, high lending rates and funding by the Government for specific infrastructure projects. The Bank considers the projected growth in monetary aggregates sufficient to support activities in the non-mineral private sector in 2015 (see Appendix-Table 1).

The overall balance of payments is projected to be in deficit of K504.6 million in 2015, with a deficit in the capital and financial account more than offsetting a surplus in the current account.

This is a turnaround from the earlier projection for a surplus of K1,167.7 million made in the March 2015 MPS. The current account surplus is projected to be lower at K7,629.7 million, largely as a result of lower than expected LNG related revenue inflows, temporary closure of the Ok Tedi mine and downward revisions of the international commodity prices. The capital and financial account is projected to be in deficit of K8,134.4 million, partly reflecting the retention of funds offshore by the LNG project partners for debt service payments.



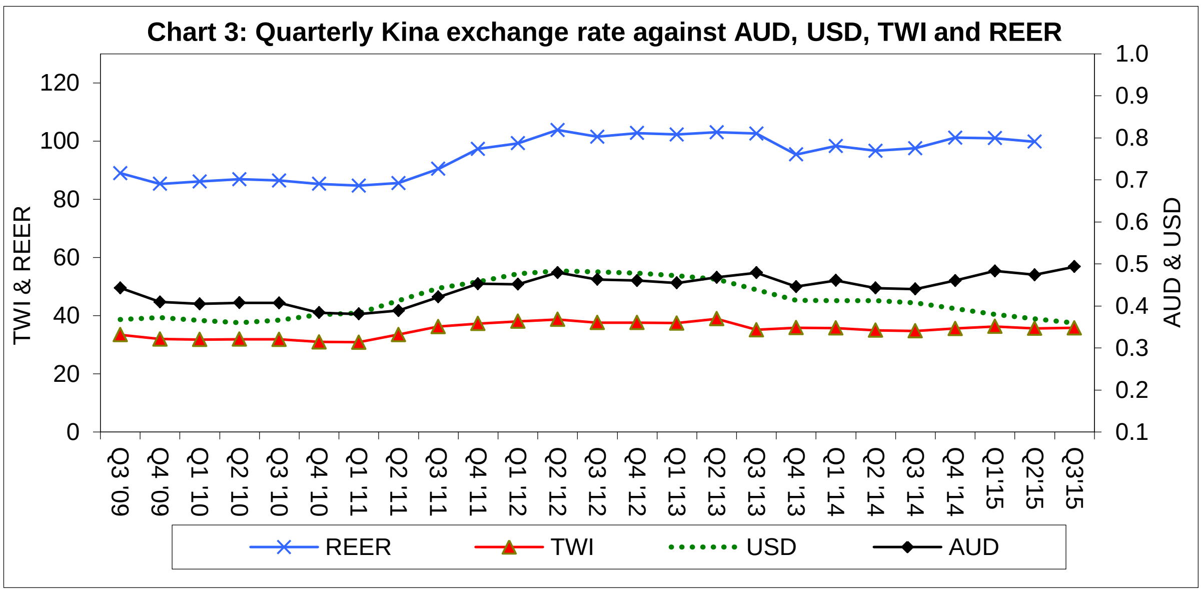
Source: Bank of PNG

In the medium term, the overall balance of payments is expected to improve. The current account is projected to be in surplus due to inflows from mineral and non-mineral export receipts, with a notable increase in 2017. The capital and financial account is expected to be in deficit, reflecting the retention of funds offshore associated with LNG and UBS loan repayments and investments abroad mainly by mineral companies. As a result, the overall balance of payments position is expected to record a deficit in 2016 and return to a surplus in 2017 (see Chart 2).

As at 28th September 2015, the level of gross foreign exchange reserves was US$1,972.3 (K5,579.4) million. By the end of 2015, the level of international reserves is projected to be US$1,923.2 (K5,394.7) million, sufficient for 7.9 months of total and 15.6 months of non-mineral import covers. The decline in reserves mainly reflects lower foreign currency inflows. These projections do not take into account any proceeds from the planned sovereign bond issuance and the anticipated sale of the 4.27 percent of Government's equity in the PNG LNG project to Provincial Governments and landowners. In 2016, without taking into account the equity sale, the foreign exchange reserves are expected to decline, but increase in 2017 (See Appendix – Table 2).

The exchange rate has depreciated by 15.6 percent since the introduction of the exchange rate trading band, from US$0.4130 to US$0.3485 as at 28th September 2015. The depreciation of the kina against the US dollar is due to the strengthening of the US dollar and the persistent imbalance in the external sector as the supply has been lower than the demand for foreign currency. The decline is also explained by less LNG-related inflows, as well as lower receipts from LNG exports due to first call on loan repayments and accelerated asset depreciation.

The kina exchange rate appreciated against the Australian dollar, as the latter weakened against the US dollar following the strengthening of the US economy and a slowdown in the Chinese economy. The Trade Weighted Index (TWI) increased by 1.9 percent in the twelve months to September 2015, compared to the corresponding period of 2014. The Real Effective Exchange Rate (REER) depreciated by 3.2 percent over the twelve months to June 2015 (see Chart 3). The depreciation would have benefited exporters, through higher kina prices and incomes, and induced an increase in production. However, the anticipated supply response was weak due to structural constraints, such as poor infrastructure.



Source: Bank of PNG

After the initial concerns surrounding the functioning of the exchange rate trading band, the market has now embraced it, with the authorized foreign exchange dealers trading within the band. The kina continued to depreciate after the introduction of the band in June 2014, due to the short supply of foreign currency relative to its demand, demonstrating that the exchange rate is moving in line with market forces. This is consistent with a floating exchange rate regime, contrary to some views that PNG might have moved to a pegged or fixed exchange rate regime. The issue is not about the trading band itself but about the pace of depreciation in light of the ongoing short supply of foreign currency relative to the demand in the foreign exchange market. On the one hand, some proponents have argued for the kina to depreciate faster to reach a market clearing exchange rate that will eliminate the excess demand for foreign currency. On the other hand, a faster pace of depreciation may not necessarily have the desired results of clearing the market and inducing a supply response, and may only be inflationary as PNG is heavily reliant on imports, as past experience has shown.

Following the introduction of the Foreign Exchange Directives in March 2015 the Central Bank commissioned an audit on the opening and operations of onshore foreign currency accounts, transactions by foreign banks through their Vostro accounts with commercial banks in PNG and kina transfers offshore by the Authorised Foreign Exchange Dealers. The purpose of the audit was to ascertain compliance with the current regulations and the use of these accounts by market participants. The persistent demand for foreign currency in the foreign exchange market is exacerbated by excess orders that also include those that are not for immediate needs and lacking full and proper supporting documentation. Going forward, the Bank will ascertain the genuineness of payment orders that are brought to the interbank market.

Real GDP is projected by the Bank to be less than 9.0 percent in 2015, a downward revision from the March MPS. This is due to the temporary closure of the Ok Tedi mine, lower than budgeted Government expenditure, lower international commodity prices and a slowdown in the non-mineral sector. In the non-mineral sector, lower activity in the construction sector and weakening manufacturing activity is expected to offset any improvements in the other sectors. Although the agricultural, forestry and fisheries sector is expected to grow, this growth will be lower as the El Niño phenomenon will impact on domestic food production.

For the medium to long-term, greater emphasis by the Government on inclusive policies and direct investment to target the non-mineral sectors is critical. Reducing the costs of utility services, addressing law and order concerns, improving physical infrastructure, and streamlining government regulations and policies and its delivery mechanisms would assist in developing these sectors. Agricultural, fisheries & forestry sector, tourism, manufacturing, and small to medium enterprises (SMEs) demand greater attention as they can broaden the economy, reduce reliance on imported food and create employment opportunities for the majority of the population. Serious investment in these sectors can also reduce the economy's dependence on the mineral sector, increasing its resilience to adverse shocks, such as falling mineral prices or unexpected adverse weather conditions. With an increased focus on SMEs, commercial banks and other non-bank lending institutions should place some emphasis on lending to this sector. These will also diversify the country's exports and expand the Government's revenue base.

The Government should encourage increased competition in strategically important industries such as manufacturing of food and refined petroleum products, telecommunications and utilities in order to reduce monopoly type business.

The preliminary outcome of the fiscal operations of the National Government over the six months to June 2015 shows an overall deficit of K942.0 million, compared to a deficit of K563.6 million in the corresponding period of 2014. This represents 1.8 percent of the nominal GDP. The Government has already announced its plans to introduce a supplementary budget, consistent with significant lower revenue in 2015 that will yield a deficit within the budget (see Chart 4). This will assist in reducing financing pressures and interest costs.

The Government must remain committed to support economic activity by focusing on priority areas of infrastructure, education and health services and, as much as possible, safeguard them from any cuts. This will encourage wider population and businesses participation in taking advantage of the infrastructure development to market their products.

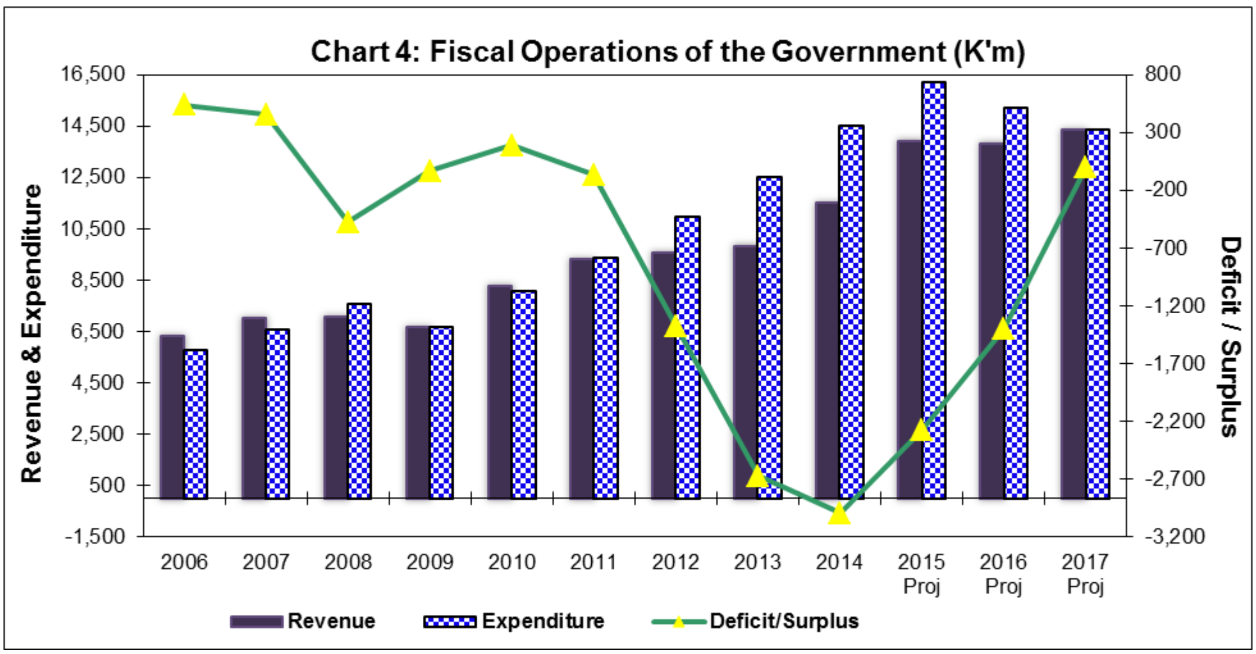
In addition, as a measure to increase revenue and help to address the recent low foreign exchange inflows, the Government should consider amending the tax concession policies, including terms of tax holidays given to resource projects. This includes reducing concessions or allowing companies to pay their tax obligations in foreign currency before any concessions are given in kina.

Furthermore, the granting of tax credit schemes should be accompanied by proper mechanisms for quality monitoring and evaluation of the work undertaken.

To finance the deficit, the Government continues to raise funds mainly from domestic sources. Although the domestic market has sufficient liquidity to finance the deficit and also meet private sector borrowing needs, the market for Government securities has saturated as some investors have reached their limits on Government debt. The Government has therefore commenced the process to issue an international sovereign bond which, when realized, will provide foreign exchange to the market and assist with the revenue.

In the medium-term, government revenue is projected to improve and projects that are not implemented in 2015 can then be carried out. It is important that the Government limits expenditure to anticipated revenue and maintains prudent fiscal management. Vision 2050 talks about a new service delivery model which will ensure that effective spending yields tangible developments. The Government must keep track on the progress made in this area.

The new Organic Law on Sovereign Wealth Fund was passed by Parliament in July 2015, giving effect to its implementation. It is now incumbent on the Government to prudently manage revenue inflows from LNG and other mineral projects in a sustainable manner. In the medium to long term, this will also help the country manage the effects of the *Dutch Disease* phenomenon on the other sectors of the economy.

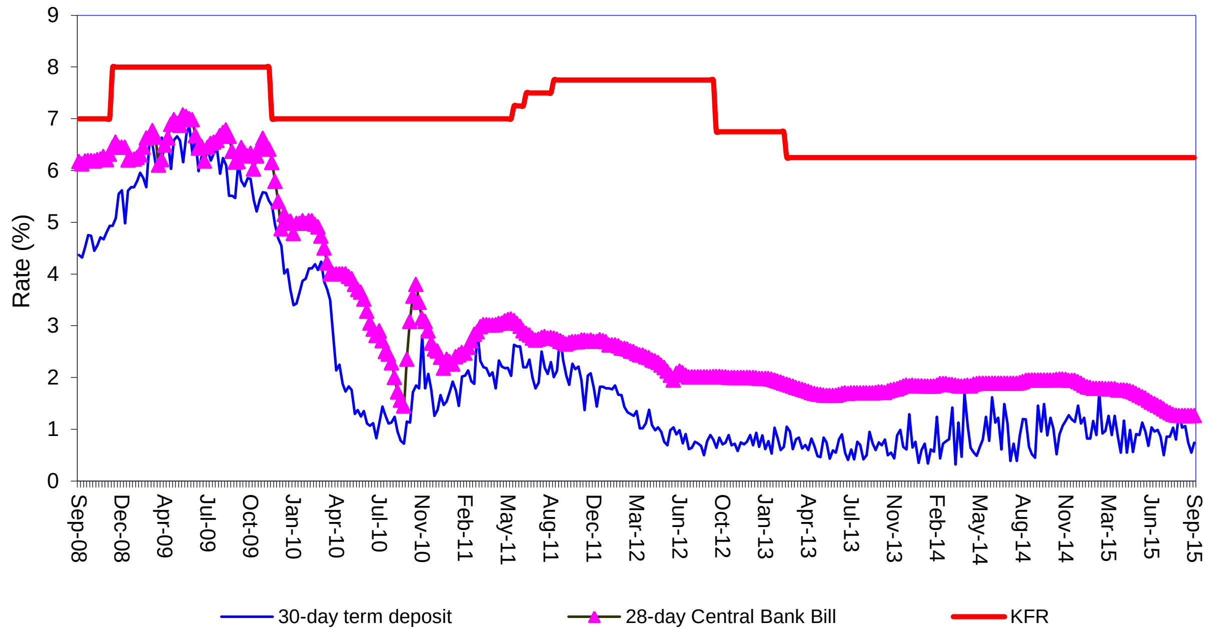


Source: 2015 National Budget

2. Monetary Policy Stance

The annual headline inflation is projected to be around 6.0 percent and the domestic economic growth outlook remains positive though slightly below the projections made in the March MPS. At the same time, while the fiscal stimulus and high liquidity conditions have contributed to domestic demand, they have not been inflationary. Considering all these, the Bank is taking a cautious approach by maintaining its neutral stance of monetary policy for the next six months (see Chart 5). It will continue to monitor the developments and may adjust its stance as necessary.

Chart 5: KFR, 28-day Central Bank Bills & 30-day Term Deposits W/average



Source: Bank of PNG

3. Conduct of Monetary Policy

Monetary policy is managed within the reserve money framework. The MPS provides the overall 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 stock to Other Depository Corporations and the general public, and Repo transactions with commercial banks.

Over the six months to September 2015, the Government made a net issuance of K969.3 million in Treasury bills and K1,041.4 million in Inscribed stock. On the other hand, the Central Bank matured K347.6 million of CBBs. The increased issuance of Government securities and the Central Bank's intervention in the foreign exchange market, conducted to ease the pace of depreciation of the kina and assist in meeting some of the high demand, helped to partly diffuse the excess liquidity in the banking system.

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 and the high interest withholding tax rate.

With the implementation of the national payment system, the Kina Automated Transfer System

(KATS), it is now more efficient, safer and cost effective to undertake transactions. This will improve the intermediation process of payment and settlement, and enhance liquidity management including the cash flow management by Government.

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	2013 (actual)	2014 (actual)	Mar 2015 (MPS)	Sep 2015 (Actual to Jul)	2015 (proj)	2016 (proj)	2017 (proj)
Broad Money Supply	6.5	1.2	6.3	4.3	9.2	6.8	5.0
Monetary Base	0.5	37.1	7.6	9.5	8.9	5.3	4.0
Claims on the Private Sector	17.3	2.2	4.8	-1.7	3.9	5.4	6.0
Net Claims on Gov't	462.0	48.3	-43.6	37.0	40.1	-11.8	-19.6
Net Foreign Assets	-11.8	-16.0	36.8	-0.9	-2.3	-2.1	5.2

Source: Bank of PNG

Table 2: Summary of Other Macroeconomic Indicators

INDICATOR	2013 (actual)	2014 (actual)	Mar 2015 (MPS)	Sep 2015 (Actual to Jun)	2015 (proj)	2016 (proj)	2017 (proj)
CONSUMER PRICE INDEX (annual % changes)							
Headline	4.7	6.6	6.0	5.7	6.0	7.0	6.5
Trimmed-mean	1.8	6.1	3.0	3.5	4.0	5.5	4.0
Exclusion- based	5.9	7.7	4.0	3.6	4.5	4.5	4.0
BALANCE OF PAYMENTS (kina millions)[1]							
Current account	-7,401	7,084	12,958	7,154	7,630	6,139	6,836
Capital & Financial account*	5,775	-8,000	-11,790	-7,547	-8,134	-6,202.6	-6,557.2
Overall balance	-1,598	-861	1,168	-388	-505	-63.7	279.1
Gross Int. Reserves	6,912	5,980	8,730	5,592	5,395	5,311.1	5,610.1
IMPORT COVER (months)							
Total	7.1	8.0	8.9	9.5	7.9	7.0	7.4
Non-mineral	9.6	11.4	14.1	15.2	15.6	14.6	14.3
EXPORT PRICE							
Crude oil (US$/barrel)**	109.5	103.5	50.9	53.0	51.6	50.6	50.4
Gold (US$/ounce)	1,368.3	1,189.3	1,110.0	1,146.8	1,039.2	1,017.7	1,000.9
Copper (US$/pound)	332.8	311.1	280.0	265.3	242.2	279.0	279.0
Nickel (US$/tonne)	11,998.8	15,812.6	14,544.0	13,145.8	11,218.8	10,491.8	10,491.8
Cobalt (US$/tonne)	30,000	23,813.4	24,289.7	26,782.8	25,443.6	24,934.7	24,685.4
LNG (US$/000 mmbtu)	-	16.7	15.5	9.7	8.0	8.1	8.1
Condensate (US$/barrel)	-	92.5	90.0	55.4	55.4	54.8	54.8
FISCAL OPERATIONS OF THE GOVERNMENT* **							
Surplus/Deficit (K'm)	-2,672.4	-2,815.2	-2,271.8	-942.0	-2,271.8	-1,398.2	0.0
% of GDP	7.8	6.9	4.4	1.8	4.4	2.5	0.0
REAL GROSS DOMESTIC PRODUCT (annual % growth) ******							
Total GDP	5.0	8.4	15.5	n.a.	11.0	5.0	2.3
Non-mineral GDP	4.9	1.4	4.0	n.a.	3.3	3.9	3.7

Source: Bank of PNG, NSO and Department of Treasury

* Now includes Capital account
* * Prices take into account, company hedging and differ from market prices.
*** Preliminary fiscal operations up to June 2015 and 2015 -2017 projections are from the 2015 National Budget.
**** GDP figures are from the 2015 Budget, while 2015 projection is from MYEFO report.
n.a. not applicable

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