



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 2011

Queries on the contents of the Monetary Policy Statement (MPS) should be directed to the Manager, Economics Department on telephone number (675) 3227430 or Manager, Monetary Policy Unit on telephone number (675) 3227278, or both on fax number (675) 3200757. Copies of the Statement can be obtained from the Economics Department and is also available on the Bank's website: <http://www.bankpng.gov.pg>. It will be reproduced in the December 2010 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

Economic activity as measured by growth in real Gross Domestic Product (GDP) is estimated to have increased by around 8.0¹ percent in 2010, in line with the projections of the September 2010 Monetary Policy Statement (MPS). Growth was driven by the commencement of construction of the LNG project that in turn increased activity in the building and construction, transportation, manufacturing, housing, and some service industries. Increase in Government expenditure, which included the Supplementary Budget of K653.3 million passed in November 2010, also contributed to the growth. High international prices of copper, gold, oil, and agricultural commodities funded the increase in Government expenditure. Increased income from exports, combined with income from those industries benefiting from the LNG project, and the payments to landowners, led to an increase in private sector consumption and capital formation.

In 2011, continued construction of the LNG project, commencement of production at the Ramu Nickel/Cobalt mine, and higher expected international prices for mineral and agricultural commodities, as already seen in the first three months of the year, will result in high domestic demand by the Government and the private sector as well as capital formation at levels similar to those in 2010. Based on these developments, the Bank projects that real GDP growth in 2011 will be high at around 9.5 percent.

Annual headline inflation in 2010 was 7.2 percent in line with the Bank's projection in the September 2010 MPS of 7.0 percent. This was largely due to price increases of seasonal items. Underlying inflation was around 5.5 percent, indicating that inflationary pressures still remained. The Bank projects that inflation in 2011 will be around 8.5 percent. This is considered by the Bank as tolerable at a time of high economic growth.

To support the Bank's efforts in achieving and maintaining price stability in 2011 and the medium term, it is crucial that the following be pursued under the country's macroeconomic management agenda.

- Government expenditure will be as per the 2011 National Budget;
- All trust accounts, including some of the existing balances at commercial banks, will be maintained at the Central Bank for liquidity management purposes;
- The Bank will open an offshore bank account for the Government, to insulate unbudgeted foreign currency tax flows from impacting on domestic liquidity;
- The Government to appropriate in the 2012 Budget for interest payments on Treasury Bills, Inscribed Stock and Central Bank Bills (CBB's) to be placed on Tap for the public;
- Government to refrain from competing with the private sector for limited production resources and instead should concentrate on maintaining existing transportation and social sector infrastructure that have deteriorated in many parts of the country, in order to improve health, education, and law and order, during the construction phase of the LNG project;
- The Government should increase capacity of the workforce by providing appropriate training in schools and colleges. This would also allow for the utilization of the expertise, physical and human resources that are built up by the LNG project development, to be efficiently and productively used as and when they are released from the project;

¹ The numbers on real sector used in the text are BPNG's. These differ from those in the Appendix which are Treasury's.

- The private sector should behave prudently and responsibly in passing on the lower imported goods prices sourced from lower cost countries like China, India and other developing nations in our region. Agencies responsible for monitoring prices should strengthen their activities to ensure proper pass-through of price changes; and
- The Bank will revamp the payment system, and embark on a financial inclusion and education project, which are necessary for the benefits of development to reach the majority of the population.

If the above recommendations will be accepted and implemented, the Bank is confident that the *Dutch Disease*² phenomena will be minimized, and inflation would be contained to an acceptable rate of below the two digit level during the construction and the production stages of the LNG project. When the flows from dividends, royalties, and taxes of the LNG project commence, the nation will be ready to use them in a sustainable, efficient, and productive way that will benefit the majority of the population. This, combined with the Sovereign Wealth Fund to care for future generations, will secure the orderly development of the traditional and the introduction of more sophisticated industries. It will move Papua New Guinea from a developing to an emerging market economy, with high economic growth, acceptable levels of inflation and a continuous increase in the standard of living. The development of traditional and value-adding industries will move the country towards realizing its Vision 2050 objectives.

1.0 Monetary Policy Discussions

1.1 Monetary Policy Assessment and Issues

The global economy continued to recover in 2010, despite some setbacks as a result of the European debt crisis. Fears of a double-dip recession did not eventuate after the effects of the stimulus packages wore off. The recovery in PNG's major trading partners was not inflationary and contributed to the low imported inflation in PNG. For 2011, global economic recovery is expected to pick up in the US and the European countries. The recent events of the political unrests in North Africa and the Middle East and the earthquake and tsunami in Japan might adversely impact on the recovery.

Economic activity as measured by real GDP growth is estimated to be around 8.0 percent in 2010. This is in line with the projection of 7.5 percent in the September 2010 MPS. Growth was driven by construction of the LNG project that led to increased activity in the building and construction, transportation, manufacturing, housing, and some service industries. Increase in Government expenditure that included the Supplementary Budget of K653.3 million passed in November 2010 also contributed to the growth. High international prices of copper, gold, oil, and agricultural commodities funded the increase in Government expenditure. The increase in metal and oil prices were the outcome of an increase in demand by the industrialized countries, coming out of the

² *Dutch Disease* refers to an economic condition where a resource boom leads to an appreciation of the real exchange rate, which in turn depresses outputs in the traditional tradable sector. The real exchange rate appreciation can occur in two ways. First, a surge in exports from the booming sector leads to an appreciation of the nominal exchange rate, resulting in a rise in the domestic prices of tradable and a consequent reduction in the export of traditional tradable, non-tradable being unaffected. Second, the increase in income from the resource boom may lead to an increase in demand for domestic non-traded goods and a consequent increase in their prices.

recession of 2008 and 2009, as well as the relatively high demand from the major emerging market economies of China, India, Brazil and to a lesser extent Russia. Increased income from exports, combined with income from those industries benefiting from the LNG project, and the payments to landowners, led to an increase in private sector consumption and capital formation.

In 2011, the continued construction of the LNG project, the commencement of production at the Ramu Nickel/Cobalt mine, and with higher expected international prices for mineral and agricultural commodities, as seen in the first three months of the year, will result in high domestic demand by the Government and the private sector as well as capital formation at levels similar to those in 2010. Based on these developments, the Bank projects that real GDP growth in 2011 will be high at around 9.5 percent.

Annual headline inflation in 2010 was 7.2 percent in line with the Bank's projection in the September 2010 MPS of 7.0 percent, reflecting increases in seasonal items. Underlying inflation is relatively stable and does not indicate that there are major inflationary pressures. The Bank projects that inflation in 2011 will be around 8.5 percent. A single digit inflation rate is considered tolerable by the Bank at a time of high economic growth. If inflation is largely driven by external factors such as higher food and fuel prices, which could be worsened by the political unrests in North Africa and the Middle East, it will exacerbate domestic demand pressures thereby making it difficult to maintain price stability. It is important that the private sector should behave prudently and responsibly in passing on the lower imported goods prices sourced from lower cost countries like China, India and other developing nations in our region. Agencies responsible for monitoring prices should strengthen their activities to ensure proper pass-through of price changes.

Annual growth in broad money supply (M3*) and monetary base were 10.0 and 11.1 percent, respectively, in 2010. The growth in broad money supply resulted mainly from increases in net foreign assets of depository corporations and private sector credit, which grew by 20.2 percent and 17.9 percent, respectively. The growth in monetary base is attributed to an increase in currency in circulation combined with higher deposits of the commercial banks at the Central Bank. The Bank issued net new CBBs of K481 million. Liquidity continued to remain high during the year, causing downward pressure on domestic interest rates. As a result, the Bank also utilised its direct policy instruments in October 2010. The Cash Reserve Requirement (CRR) was increased from 3.0 to 4.0 percent. The increase in the CRR diffused around K130 million. Commercial banks had high liquid asset ratios in excess of 50 percent, well above the Minimum Liquid Asset Ratio Requirement (MLAR) of 25 percent, prompting the Bank to reduce it to zero, as it was no longer appropriate. The Bank is considering introducing a supervisory liquidity ratio requirement. In addition, the Bank is considering issuing CBBs on Tap to promote savings by small investors and aid the transmission of monetary policy.

In 2011, broad money supply is expected to increase by 9.6 percent driven by growth in credit to the private sector arising from increased economic activities associated with the LNG project and Government expenditure. Monetary base is expected to grow by 9.2 percent. The growth in the monetary aggregates is considered sufficient to support the anticipated increase in economic activity and is non-inflationary. Business activities directly related to the LNG project would be funded by the developers, while other companies would continue to use their own resources.

Preliminary estimates of the Government's fiscal operations in 2010 show an overall surplus of K186.3 million, or 0.7 percent of nominal GDP, compared to a deficit of K36.3 million in 2009,

mainly reflecting higher mining and petroleum tax revenue resulting from high international commodity prices. From the surplus generated during 2010, the Government appropriated K653.3 million in the 2010 Supplementary Budget. The key expenditure items are funding for the Umbrella Benefit Sharing Agreement (UBSA) commitments to land owners of the LNG project, road infrastructure, and other outstanding administrative costs. During the construction phase of the LNG project, Government should adhere to the parameters of its annual budgets, and prioritize its expenditure so as not to compete with the private sector on the limited resources within the country, especially in areas of construction, civil works, earthmoving and other infrastructure developments. It should instead concentrate on maintaining existing transportation and social sector infrastructure that have deteriorated in many parts of the country, in order to improve health, education, and law and order status, as well as the traditional industries such as agriculture that will not directly benefit from the LNG project.

In late 2010, the Government agreed to open all new trust accounts at the Central Bank, which included K592 million from the 2010 Supplementary Budget. As of 25th March 2011, only K399 million has been deposited at the Central Bank. Government deposits, including trust accounts, in commercial banks continue to remain high totaling K2,243 million. Depositing all trust account funds at the Central Bank will support monetary policy management and inflation objectives. A fast pace of drawdown of the trust account funds and Government spending, especially the LNG landowner-related payments, will impact on liquidity and inflation. Close monitoring of these trust accounts is required to ensure proper application of these funds and to minimize the impact on liquidity. The Bank reiterates the need for closer coordination and cooperation between the Treasury and Finance Departments and the Bank in the conduct of fiscal and monetary policies to achieve price stability.

In November 2010, the Government decided to establish an offshore SWF to manage revenue inflows from the LNG and mineral projects. The SWF comprises three components, namely a savings fund, a stabilization fund, and an infrastructure fund. The objective of the SWF is to improve the Government's management of the large revenue windfalls by ensuring prudent use of the funds and reduce the impact of these inflows on domestic liquidity, the exchange rate, and inflation. Prior to the establishment of the SWF, the Government should refrain from appropriating windfall mineral tax revenues and allow the Bank to manage them in an offshore bank account. The Bank already has experience and expertise from managing the nation's foreign exchange reserves and therefore can manage this offshore account.

The Government should increase capacity of the workforce by providing appropriate training in schools and colleges and improve the performance of implementing agencies. This would also allow for the utilization of the expertise, physical and human resources that are built up by the LNG project development, to be efficiently and productively used as and when they are released from the project.

All these are part of good macroeconomic management and will help minimize the effects of *Dutch Disease*. For 2011 and the medium term, continued high Government expenditure, private sector aggregate demand and capital formation emanating from the LNG project, high international food and fuel prices, and recovery in the global economy will contribute to inflationary pressures. This would be exacerbated by capacity constraints in the domestic economy. The Bank will continue to carefully assess the trade-off between high economic growth and inflation in an effort to support domestic economic activity while containing inflation.

1.2 Monetary Policy Stance

Inflation generally moderated in 2010, although there were concerns on inflationary pressures associated with high domestic demand as a result of construction of the LNG project and increased Government expenditure. Although headline inflation increased in the December quarter, underlying inflation remained relatively stable and below expectations. As a result, the Bank of PNG pursued a cautious approach to its monetary policy stance, and kept the KFR unchanged at 7.0 percent throughout the year.

Economic growth is expected to continue in 2011, but at a higher pace than in 2010, mainly reflecting the construction of the LNG project and spin-offs to the other industries, increased Government expenditure, and private sector aggregate demand and capital formation. Domestic demand pressures arising from this growth, and any wage increases would add to inflationary pressures.

The Bank projects broad money to grow by 9.6 percent, monetary base by 9.2 percent and private sector credit by 13.2 percent in 2011. The growth in the private sector credit and other monetary aggregates is considered sufficient to support economic activity and is non-inflationary.

The Bank projects headline inflation to be around 8.5 percent in 2011. Upside risks to this projection could arise from:

- the effect of recent political unrest in North Africa and the Middle East on oil prices;
- further increases in international food and fuel prices;
- any new appropriation of windfall mineral tax revenue to increase Government expenditure;
- any wage increases; and
- the effect of adverse weather conditions (La Niña) on supply of domestic food produce.

In view of the expected strong economic growth and associated demand pressures in 2011, combined with high international food and fuel prices, the Bank will continue to assess the trade-off between high economic growth and inflation, and will consider tightening monetary policy as necessary to contain inflation under the double digit level.

1.3 Conduct of Monetary Policy

Monetary policy will be conducted within the reserve money framework. The Monetary Policy Statement provides the overall monetary policy stance, while the monthly KFR remains the instrument for signalling this stance or any changes through an announcement by the Governor. Following the announcement, Open Market Operations (OMOs) will be conducted to support the Bank's monetary policy stance. The OMOs involve Repurchase Agreement (Repo) transactions with commercial banks and the auction of CBBs to licensed Other Depository Corporations (ODCs) and Treasury bills and Inscribed Stock to the general public.

The Bank may also use direct instruments, including increasing the Cash Reserve Requirement to assist in the management of monetary policy.

2.0 Developments and Expectations

2.1 International Developments

The recovery in the global economy continued during the second half of 2010 as growth in advanced economies picked up while emerging economies continued to expand at a rapid pace. According to the International Monetary Fund's (IMF) World Economic Outlook (WEO) Update of January 2011, global economic growth is estimated to be 5.0 percent in 2010. For 2011 growth is projected to be 4.5 percent, with advanced economies projected to grow by 2.5 percent and emerging and developing countries by 6.5 percent. The outlook for economic growth in advanced economies remains positive, supported by low interest rates. However, this outlook is being threatened by the potential sovereign debt crises in peripheral European countries, the disasters in Japan, and political unrest in North Africa and Middle East.

In the United States (US), real GDP in the fourth quarter of 2010 increased at an annual rate of 2.8 percent following a 2.6 percent increase in the previous quarter. Growth was mainly driven by consumer spending and exports, which more than offset negative contributions from private inventory investment. The US economy is expected to grow at a rate of 3.0 percent in 2011. In Japan, real GDP contracted at an annual rate of 1.1 percent in the fourth quarter compared to an increase of 3.3 percent in the third quarter. The contraction mainly reflected a slowdown in exports which was due to a stronger Japanese yen. Private consumption in Japan also weakened during the fourth quarter. Japan's economy is expected to grow at a rate of 1.6 percent in 2011 but this could now be affected by the recent disasters. In the Euro-zone, real GDP increased at an annual rate of 0.3 percent during the December quarter of 2010 reflecting severe winter storms that affected economic activity and the implementation of tight fiscal measures. The Euro-zone is projected to grow by 1.5 percent in 2011. Emerging economies grew at an annual rate of 7.1 percent in 2010, supported by private consumption, investments and exports. Emerging economies are projected to grow by 6.5 percent in 2011, led by growth in China and India of 9.6 percent and 8.4 percent, respectively.

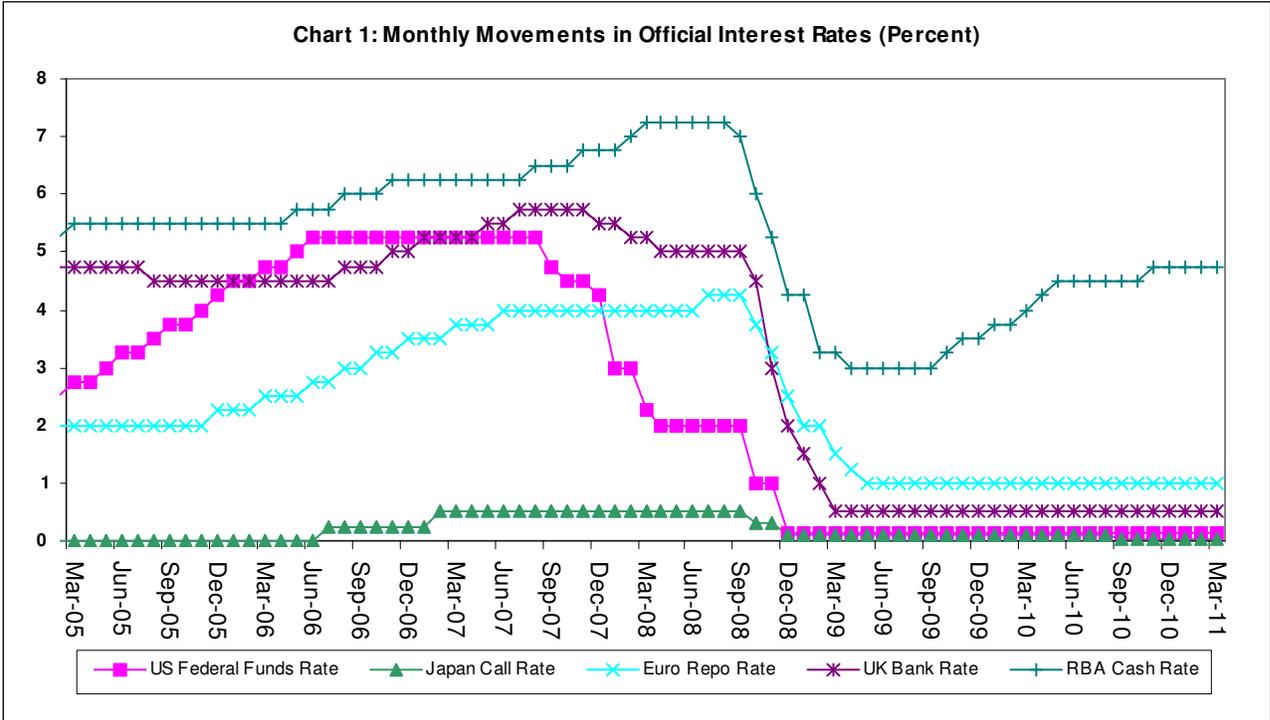
The US Federal Reserve has noted that the current pace of recovery in the US is still not sufficient to significantly lower unemployment, which recorded a 9.0 percent rate in January 2011. The impact of the winter storms during December 2010 and January 2011 also contributed to the high unemployment rate. In January 2011, the unemployment rate for the Euro-zone was at 9.9 percent and Japan was at 4.9 percent. The unemployment rate for the United Kingdom (UK) was 7.9 percent in December 2010, while in Australia the unemployment rate was 5.0 percent in February 2011.

Global inflation increased in 2010, driven mainly by higher commodity prices, as evident in the rising cost of food, minerals and energy products. Other factors such as supply constraints associated with adverse weather conditions, increased demand due to on-going economic recovery and a weaker US dollar also contributed to the increase. Annual inflation in January 2011 was 1.5 percent in the US, 2.3 percent in the Euro-zone, 4.0 percent in UK and -0.2 percent in Japan. Inflation in Australia was 2.7 percent in the December quarter. Inflation in January 2011 was 4.9 percent in China, 9.3 percent in India and 6.0 percent in Brazil. The recent political unrest in North Africa and the Middle East, which led to a spike in oil prices, has raised concerns on global inflation and its likely impact on global economic recovery.

Central banks in advanced economies kept their respective policy interest rates unchanged in the March quarter of 2011 to further stimulate economic growth, despite the inflation challenges. In March 2011, official interest rates were at 0.125 percent for the US, 0.05 percent in Japan, 0.5 percent in the UK and 1.0 percent in the Euro-zone. However, inflation in the Euro-zone and UK are above their respective ceiling targets of 2.0 percent. In contrast, a number of emerging and developing economies have started or are continuing to tighten monetary policy to curb inflation stemming from strong domestic economic growth and high food and energy prices.

Global financial markets remain focused on developments in Europe’s sovereign debt crises. Government bond spreads for peripheral countries such as Ireland, Portugal and Spain remained wide reflecting high budget deficits and default risks. In response and as a first step, the European Union and the IMF announced that they will jointly fund an €85 billion financial assistance package for Ireland. Other peripheral countries planned to increase their government bond issuance in 2011 to raise funds. They would tie in their issuance programme with fiscal prudential reforms. Global stock markets picked up strongly since December 2010 in light of better than expected earnings reports and improving economic data in the US. However, equities have retreated slightly following the political unrest in North Africa and the Middle East. As a result of the unrest, oil prices surged to a 29-month high of US\$103.4 a barrel on 24th February 2011.

In the foreign exchange markets, the US dollar generally depreciated against the major currencies during the first two months of 2011. Over this period it depreciated by 1.6 percent against the euro, 5.4 percent against the British pound sterling and 1.5 percent against the Australian dollar. Expectations of an increase in official interest rates in the Euro-zone and UK later in 2011 have resulted in the appreciation of the euro and the pound sterling. The Australian dollar continued to be supported by higher commodity prices while the Japanese yen has remained stable.



Source: Various Central banks’ websites

2.2 Domestic Economic Conditions

The PNG economy is estimated by the Central Bank to have expanded strongly by around 8.0 percent in 2010, in line with the projection made in the September 2010 MPS, mainly attributed to growth in the building and construction, transportation, storage and communication, manufacturing and commerce sectors. The increase was associated with the construction of the LNG project and its spill-over effects to the rest of the economy, higher Government funding of infrastructure, as well as higher production of non-mineral export commodities due to increased prices. The economy continued to expand rapidly in spite of the delay in the production of the Ramu Nickel/Cobalt mine.

In 2011, the economy is projected to grow by around 9.5 percent, driven by increased activity in the mineral sector and a pick up in construction of the LNG project and its spill-over effects to most sectors of the economy. The manufacturing, commerce, transportation, storage and communication, agriculture/forestry/fisheries, and finance/business and other services sectors are also expected to contribute to the growth. The increase in the building and construction sector is also associated with public investment on infrastructure and new building projects as well as those undertaken by the private sector. The growth in the mineral sector reflects the anticipated commencement of production at the Ramu Nickel/Cobalt mine and increased production at existing mines, which more than offset a decline in petroleum production. The increases in the manufacturing and commerce sectors are associated with the pick up in construction activity and higher prices of export commodities, respectively. The growth in the transportation, storage and communication sector is driven by the transportation sub-sector, reflecting increased activity in shipping, air and land transportation, associated with higher passenger travel and cargo haulage.

For the medium term, the Bank expects the economy to continue to grow in 2012 and 2013, but at a lower rate. This is due to the completion of the construction phase of the LNG project, especially in 2013. The growth will be driven mainly by the full year production by Ramu Nickel/Cobalt mine and increased production of gold at the Lihir, Hidden Valley and Simberi mines. High prices and production of non-mineral export commodities will also contribute to the growth. Other sectors are also expected to grow over this period.

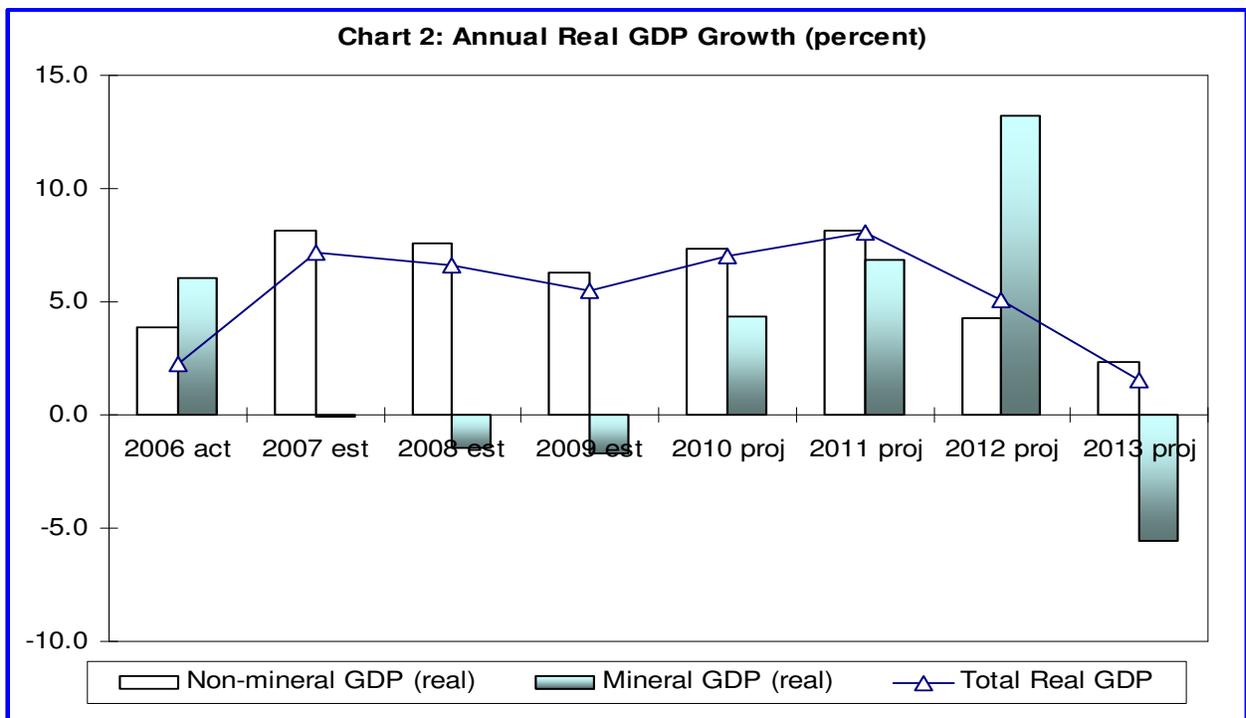
The main downside risks to these projections include:

- any delays to the Ramu Nickel/Cobalt and the PNG LNG Projects;
- a slowdown in the world economic growth;
- lower international commodity prices;
- impact of the natural disaster in Japan on PNG's trade; and
- adverse weather conditions (La Niña and El Niño).

The Bank's private sector Employment Index indicated an increase in the level of employment of 1.9 percent in 2010, compared to an increase of 4.2 percent in 2009. The continued growth in employment was mainly in the building and construction, wholesale & retail, manufacturing, mineral and finance/business and other services sectors. By region, the level of employment increased in NCD, Highlands, Morobe and Islands regions, while Southern and Momase regions recorded declines over the same period. Total employment, excluding the mineral sector, increased by 1.2 percent in 2010. Employment level is expected to grow with the increase in LNG

construction work and spin-off activities. There is some movement of labour from some industries to the LNG project. This is making it difficult and expensive for firms to find replacements from the domestic labour market.

Data from the Bank’s Business Liaison Survey (BLS) showed that over the twelve months to September 2010, total sales increased by 20.4 percent, compared to 15.3 percent in the June quarter. Total sales excluding the mineral sector, increased by 28.5 percent, compared to 37.2 percent over the same period. Both the mineral and non-mineral sectors recorded increased sales as a result of improved business conditions, expansion of business operations, increased investments, high commodity prices and increased disposable incomes. The mineral, agriculture/forestry/fisheries and retail/wholesale sectors have benefited from higher international commodity prices for PNG exports, while the transportation sector increased as a result of spin-off activities from the resource sector.



Source: 2011 National Budget

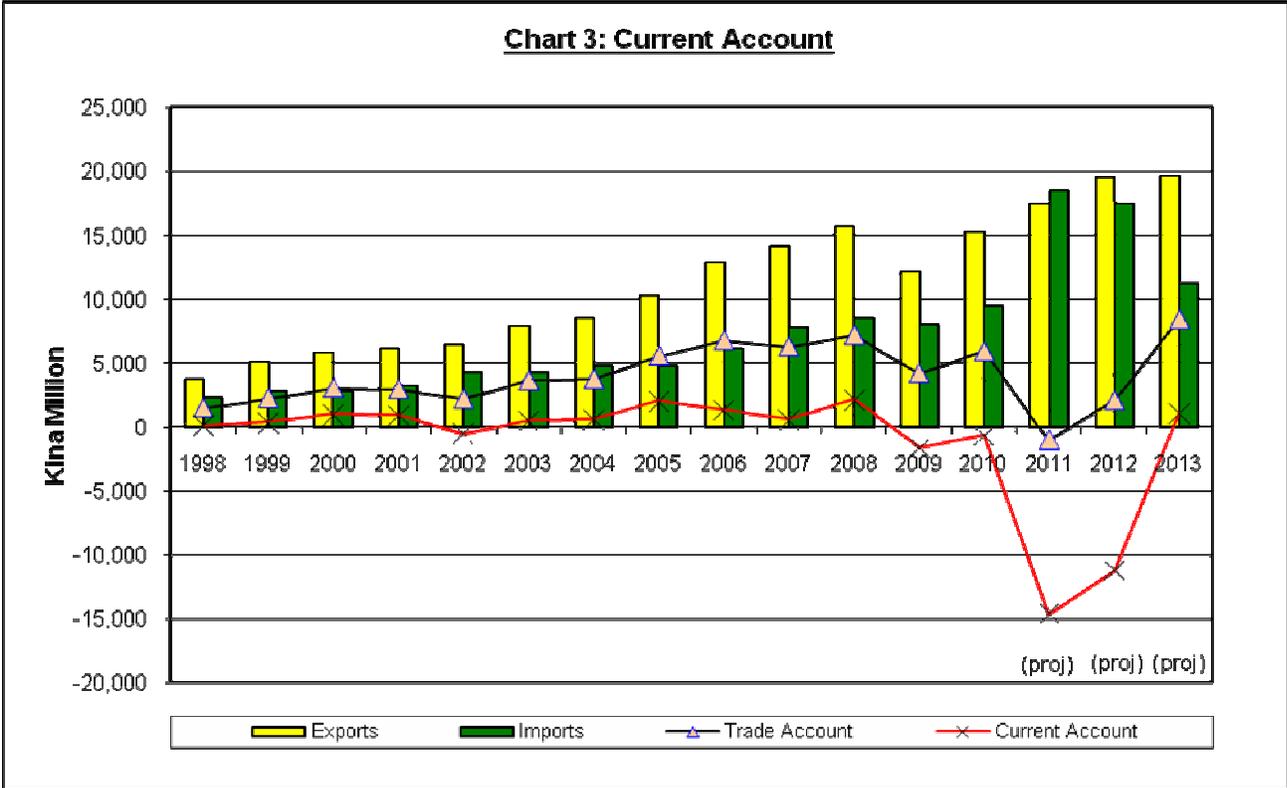
2.3 Balance of Payments

Preliminary balance of payments data for 2010 showed an overall surplus of K1,066 million, compared to a higher surplus of K1,725 million in 2009. This outcome was due to a surplus in the capital and financial accounts, which more than offset a deficit in the current account (see Chart 3). The deficit in the current account was due to higher net service payments, which more than offset a higher trade surplus, lower net income payments and higher net transfer receipts. The surplus in the capital and financial accounts was due to net inflows from foreign direct and other investments. Net inflows from direct investments reflected equity inflows whilst other investments was due to draw-downs in foreign currency account balances of mineral companies and higher trade credits owed to PNG firms by foreign entities. These more than offset net outflows from portfolio

investments, reflecting investments in short-term money market instruments, investments in financial derivative instruments, a build-up in the net foreign assets of the banking system, and higher net loan repayments by the Government.

The level of gross foreign exchange reserves at the end of December 2010 was US\$3,146.5 (K8,169.6) million, sufficient for 10.5 months of total and 14.4 months of non-mineral import covers. As at 29th March 2011, the level of gross foreign exchange reserves was US\$3,174.5 (K8,067.4) million.

The IMF’s February 2011 price forecasts indicate that international prices for all of PNG’s non-mineral export commodities will be higher in 2011, compared to 2010, except for copra, copra oil and logs. According to the mineral companies, the prices of all mineral exports are expected to increase during 2011.



Source: Bank of PNG

The export volumes of all of PNG’s major non-mineral commodities are projected to increase in 2011 and the medium term, compared to 2010. The projected higher production is associated with higher international prices resulting from increased global demand. The volume of gold exports is expected to increase in 2011, compared to 2010, while copper and oil export volumes are projected to decline. The increase in gold exports is due to on-going expansion at the Lihir mine combined with mining of higher ore grades from the existing mines. Copper volumes are expected to decline due to production of lower ore grades. In the petroleum sector, the decline in exports is associated with the natural decline in the reserves of the existing oilfields.

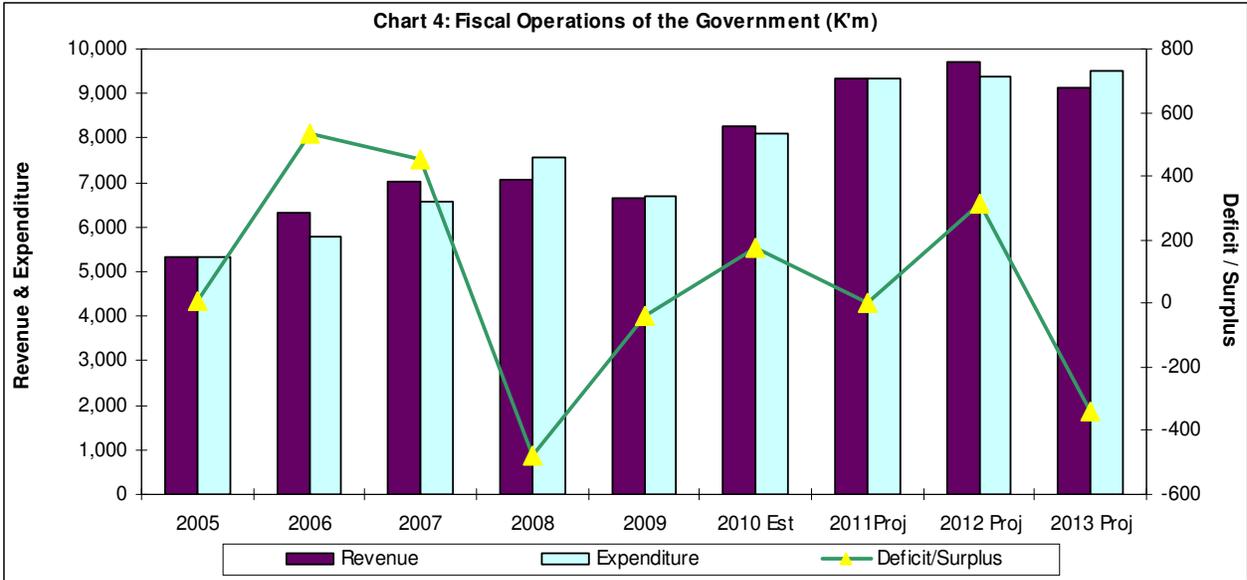
The main assumptions underlying the balance of payments projections for 2011 and the medium term are:

- a relatively stable kina exchange rate;
- ongoing construction of the LNG project;
- the commencement of production at Ramu Nickel/Cobalt mine in 2011; and
- the global economic recovery continues.

The current account is projected to record a significantly higher deficit in 2011, due to an increase in imports, service and income payments associated with the LNG project more than offsetting an increase in export receipts. This will be more than offset by a surplus in the financial account reflecting inflows, mainly associated with the injection of equity funds and the drawdown of loan funds for financing of the LNG project by the project partners. As a result, the overall balance of payments is projected to be in surplus by K1,412 million in 2011, compared to a surplus of K1,066 million in 2010. At the end of 2011, the gross foreign exchange reserves is projected to be around US\$3,683.1 (K9,677.0) million, sufficient for 6.3 months of total and 17.1 months of non-mineral import covers. Gross reserves are projected to be higher in the medium term due to increased inflows associated mainly with higher international prices of PNG's export commodities. The impact of the inflows originating from the construction of the LNG project on the level of foreign exchange reserves will be minimal, since most of the transactions will be conducted through offshore accounts (see Appendix – Table 2).

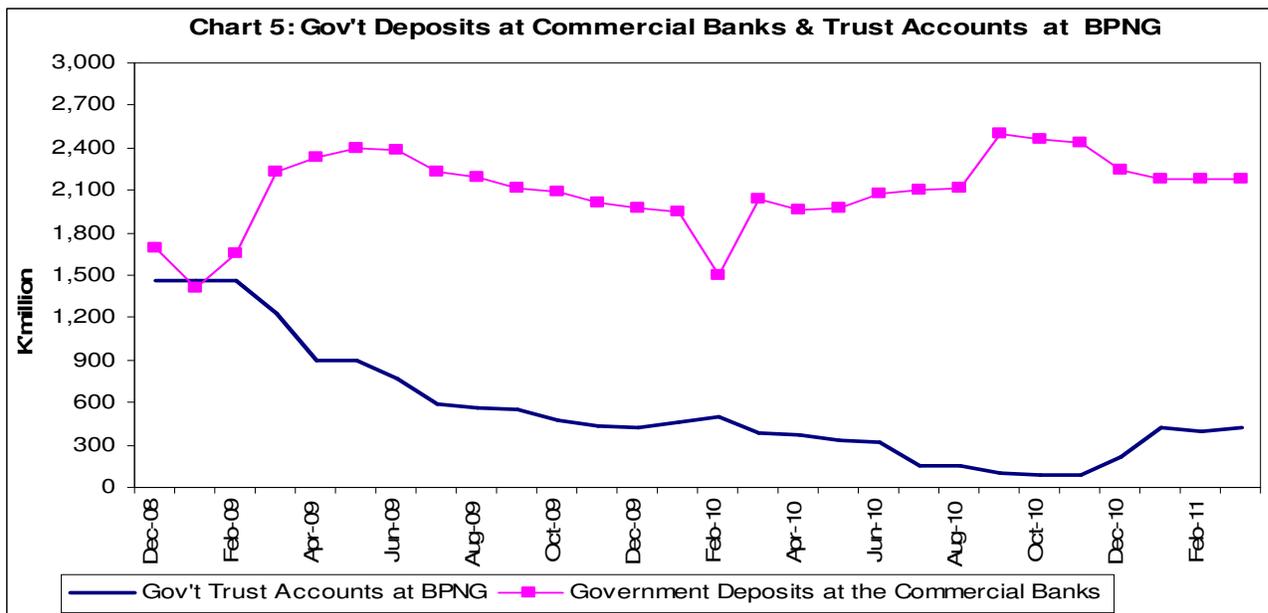
2.4 Fiscal Operations of the National Government

Preliminary estimates of the Government's fiscal operations in 2010 show an overall surplus of K186.3 million, or 0.7 percent of nominal GDP, compared to a deficit of K36.3 million in 2009. Total revenue, including foreign grants, increased by 24.5 percent in 2010 compared to 2009, and represents 100.4 percent of the 2010 revised budget. This outcome reflected higher tax receipts attributed to increased commodity prices and domestic economic activity combined with higher foreign grants, which more than offset lower non-tax receipts. Total expenditure increased by 21.1 percent and represented 98.2 percent of the 2010 revised budget due to higher development expenditure, which more than offset lower recurrent expenditure. The increase in development expenditure was mainly attributed to increase in funding for infrastructure projects and higher project grants by donors. The decrease in recurrent expenditure resulted from lower spending by Provincial Governments and lower interest payments, which more than offset higher spending by National Departments and higher transfer payments to statutory bodies.



Source: Dep't of Treasury

In late 2010, the Government agreed to open all new trust accounts at the Central Bank. A total of K592 million from the 2010 Supplementary Budget is expected to be deposited in trust accounts at the Central Bank, of which only K399.0 million has been deposited as at 25th March 2011. However, Government deposits, including trust accounts, in commercial banks continue to remain high totaling K2,243 million (see Chart 5). Depositing all trust accounts at the Central Bank will support monetary policy management by reducing liquidity. In light of the LNG related payments to the landowners, more prudent and stringent fiscal strategies are required to adequately control current and future spending. Under these circumstances, the Bank reiterates the need for closer coordination and cooperation between the Treasury and Finance Departments and the Bank in the conduct of fiscal and monetary policies to achieve price stability.



Source: Bank of PNG

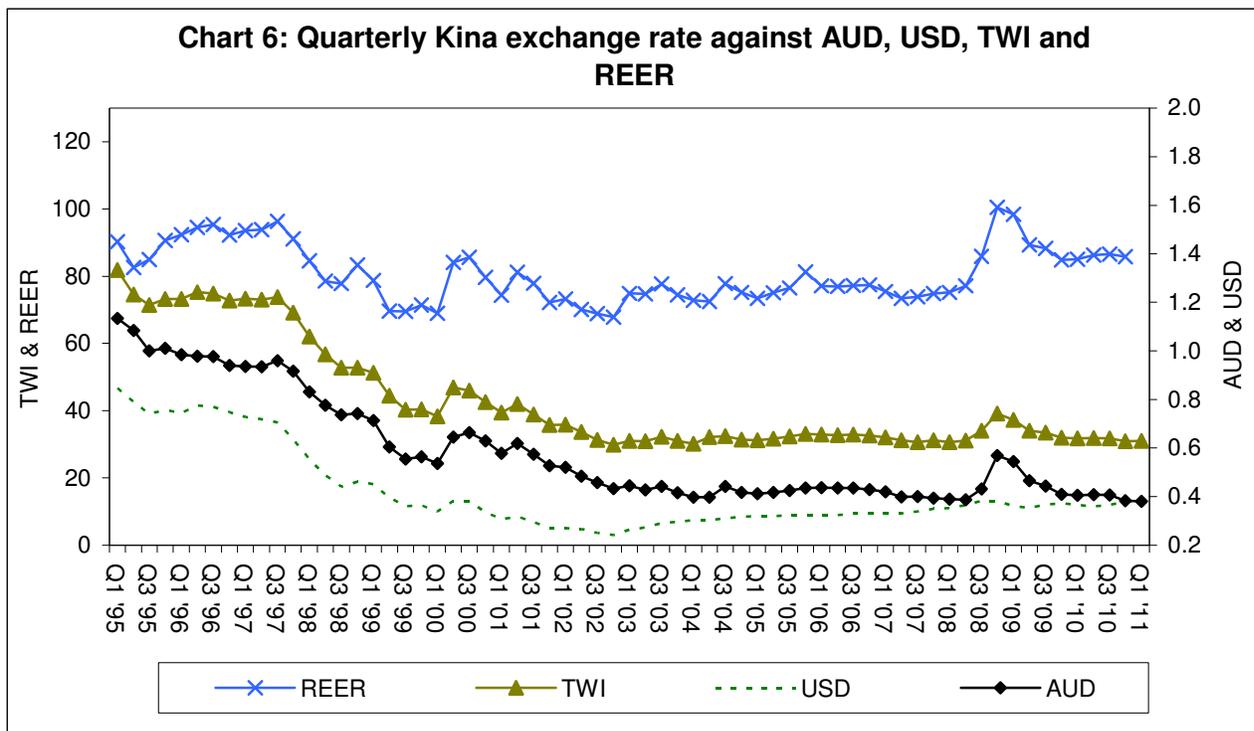
In November 2010, the Government agreed to the establishment of an offshore SWF to manage revenue inflows from the LNG projects through three integrated funds, namely a savings fund, a stabilization fund and an infrastructure fund. The SWF will improve the Government's management of the large revenue windfalls by ensuring prudent use of the funds and reducing the impact of these inflows on domestic liquidity, the exchange rate, and inflation.

Total public debt to nominal GDP ratio decreased to 26.4 percent in 2010 from 32.8 percent in 2009, mainly reflecting GDP growth combined with the net retirement of domestic debt and external loan repayments. Total domestic debt decreased by 3.5 percent to K4,077.8 million, mainly due to the retirement of Treasury bills. Foreign debt declined by 14.4 percent to K2,489.5 million, reflecting higher loan repayments. The appreciation of the kina against most of the major currencies during the year also reduced the kina value of foreign debt stock.

For 2011, a balanced budget is projected based on the global economic recovery and strong domestic economic growth driven by the construction phase of the LNG project and increased production from new and existing mines. The total projected revenue for 2011 is K9,328.1 million, 12.7 percent higher than the 2010 outcome due to increased commodity prices and tax revenue. Accordingly, total expenditure will increase from K8,092.7 million in 2010 to K9,328.1 million in 2011, with increases in both recurrent and development expenditures. The financing of the 2011 Budget comprises of net borrowing of K183.0 million from external sources and net negative financing of the same amount to domestic sources. Public debt is projected to be 24.1 percent of GDP in 2011. The Government projects a budget surplus for 2012 and a budget deficit for 2013 when mineral tax revenue declines.

2.5 Exchange Rate

Between December quarter 2010 and first quarter up to 25th March 2011, the daily average kina exchange rate appreciated against the US dollar by 1.0 percent to US\$0.3826 and depreciated against the Australian dollar by 0.5 percent to A\$0.3814. The appreciation of the kina against the US dollar reflected higher export receipts, whilst the depreciation against the Australian dollar was attributed to cross currency movements, as the Australian dollar strengthened against most major currencies due to increased demand for its exports and favourable interest rate differentials. As a result, the Trade Weighted Index (TWI) appreciated by 0.3 percent during the same period. The Real Effective Exchange Rate (REER) depreciated by 0.9 percent during the December quarter of 2010, increasing the competitiveness of PNG exports (see Chart 6).



Note: The REER uses IMF's revised CPI indices rebased to 2005, as contained in the June 2009 release of the International Financial Statistics (IFS), in contrast to the previous series with 2000 as the base year.

Source: Bank of PNG and IMF

2.6 Inflation

Annual headline inflation remained moderate between December 2009 and September 2010, but increased in the December quarter of 2010. Annual headline inflation in the December quarter of 2010 was 7.2 percent, higher than the 5.7 percent recorded in December quarter of 2009, but close to the Bank's projection of 7.0 percent. This higher outcome was mainly driven by price increases in the 'Drinks, tobacco and betelnut' expenditure group, especially betelnut prices. All expenditure groups and urban areas recorded increases during the quarter.

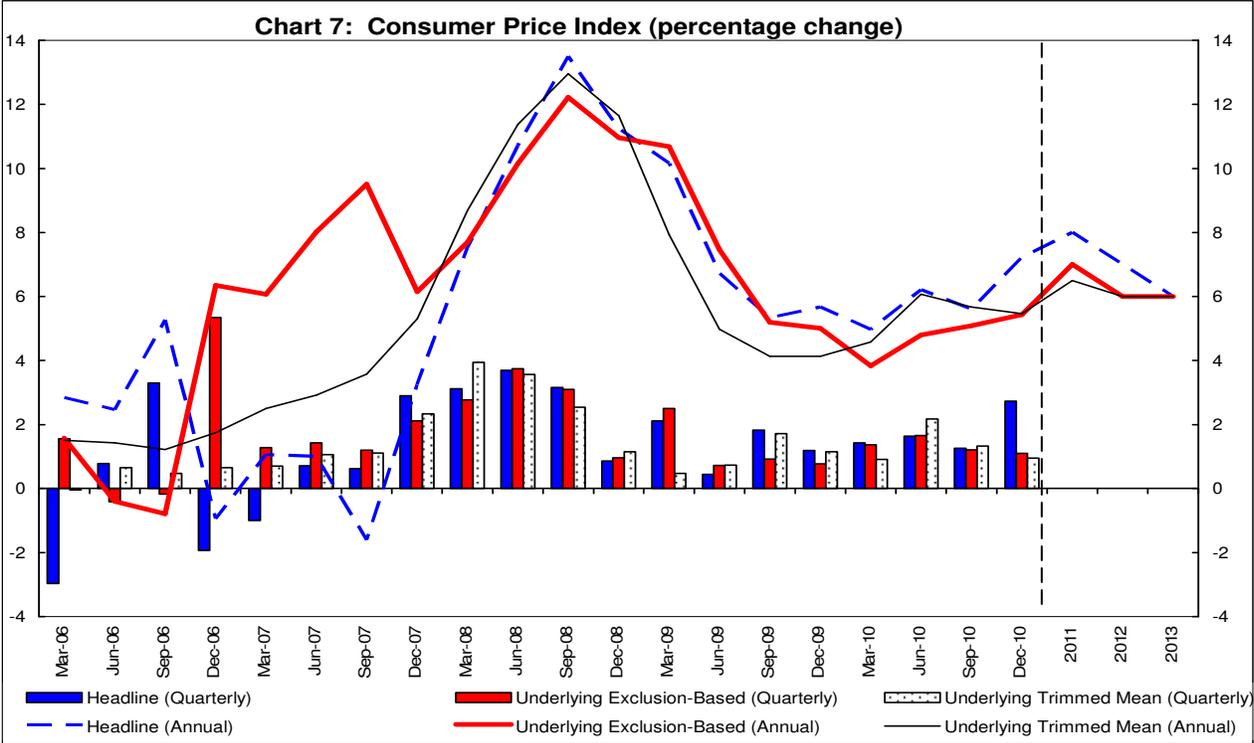
Underlying inflation also increased during the December quarter of 2010. Annual trimmed mean inflation was 5.5 percent, compared to 4.1 percent in the December quarter of 2009 while annual exclusion based inflation was 5.4 percent, compared to 5.0 percent. The increase is attributed mainly to imported inflation and a weak kina, especially against the Australian dollar.

The Bank projects annual headline inflation for 2011 to be around 8.5 percent, while trimmed-mean and the exclusion-based inflation are projected to be around 6.5 and 7.0 percent, respectively. The higher projected inflation is based on the following factors:

- Domestic demand pressures arising from the ongoing construction for the LNG project and associated activities, and increase in Government spending;
- Expected higher imported inflation from PNG's major trading partners, especially through higher food and fuel prices; and
- Higher inflation expectations by firms.

For the medium term, headline inflation is projected to be around 7.0 percent in 2012 and 6.0 percent in 2013. These projections are based on the expectation that most of PNG’s major trading partners’ currencies are expected to depreciate against the US dollar, as the recovery of US economy gains momentum. The LNG construction activity which is mainly driving the domestic inflationary pressures is expected to wind down in 2013.

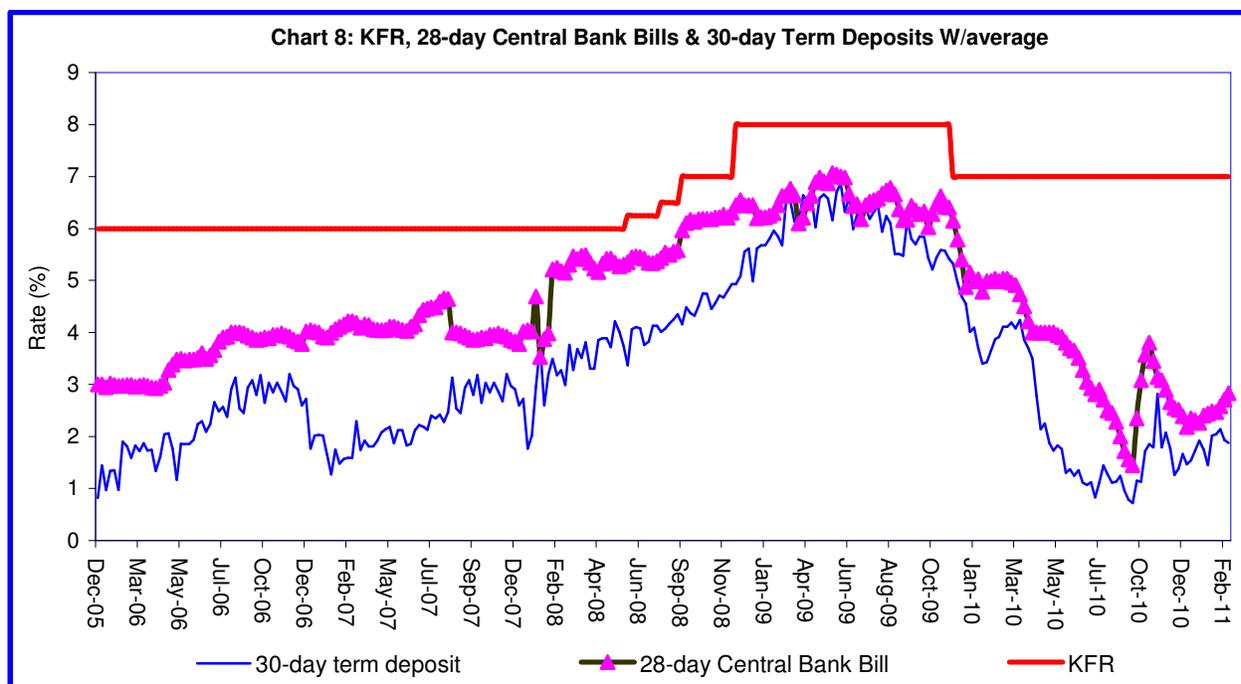
The upside risks to these projections include the depreciation of the kina, any excessive Government spending in the lead up to the National Elections in 2012, higher than expected increases in fuel and commodity prices, and higher inflation in the major economies.



Source: Bank of PNG & National Statistical Office

2.7 Monetary and Financial Market Developments

The Bank maintained a cautious approach to monetary policy in 2010 by keeping the KFR unchanged at 7.0 percent (see Chart 8). This was mainly in view of concerns on inflationary pressures from domestic demand arising from the LNG project and Government spending, in particular drawdown of trust account funds. The trading margin for the Repo was also maintained at 100 basis points on both sides of the KFR.



Source: Bank of PNG

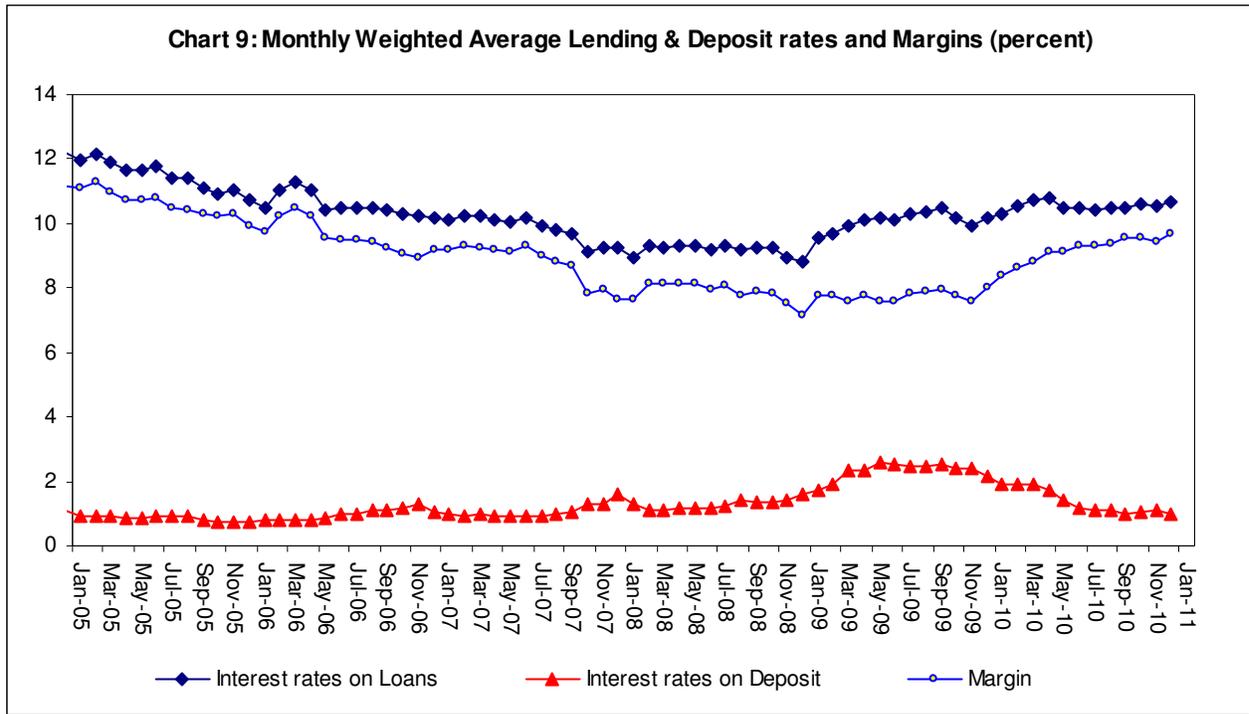
In 2010, the Bank issued CBBs totaling K4,613.1 million through its Open Market Operations, of which K481.2 million were net new CBBs, to diffuse excess liquidity in the banking system. However, CBB rates decreased from over 5.0 percent in 2009 to around 2.0 percent in 2010, due to high liquidity conditions. Treasury bill rates also decreased from over 6.0 percent to around 3.0 percent during the same period. In view of the persistently high liquidity conditions the Bank resorted to using its direct instruments of monetary policy. In October 2010, the Bank increased the CRR of the commercial banks from 3.0 to 4.0 percent, while the MLAR of commercial banks was reduced from 25.0 percent to zero. The increase in the CRR diffused around K130 million of liquidity and caused an increase in interest rates in October, before declining in November 2011. Indicator Lending Rates (ILR) of commercial banks remain unchanged at 10.95 – 11.95 percent in 2010. The weighted average interest rate on total deposits decreased from 2.2 percent in December 2009 to 1.0 percent in December 2010, while the weighted average lending rate on total loans increased from 10.2 percent to 10.6 percent. As a result, the spread between the weighted average lending and deposit rates widened over the year (see Chart 9).

Total liquidity of the banking system increased by 1.4 percent to K6,618.3 million in 2010, influenced mainly by draw downs in the trust account funds. Lending extended by ODCs to the private sector increased by 17.9 percent in 2010. The growth in private sector credit was broad based across all sectors, with notable increase to the transport and communication, finance, ‘electricity, gas and water supply’ and real estate and business services sectors, as well as personal loans. Net claims on the Government decreased by K776.4 million in 2010, mainly due to the net retirement of Treasury bills and increase in Government deposits in depository corporations.

The level of broad money supply increased by 10.0 percent in 2010 as a result of growth in private sector credit and increases in net foreign assets of the Central Bank and ODCs. The monetary base increased by 11.1 percent during the same period, mainly reflecting the increases in the Exchange

Settlement Accounts of the commercial banks held at the Central Bank and currency outside depository corporations.

In 2011, broad money supply is expected to grow by 9.6 percent, influenced mainly by growth in credit to the private sector to cater for the projected increase in domestic economic activity and an increase in net foreign assets of depository corporations. Monetary base is expected to grow by 9.2 percent and private sector credit by 13.2 percent. While the Bank is mindful of the inflationary impact of growth in private sector credit, the projected growth in monetary aggregates is considered sufficient to support economic growth (see Appendix-Table 1).



Source: Bank of PNG

Appendix

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

INDICATOR	2007 (actual)	2008 (actual)	2009 (actual)	Sep 2010 MPS	2010 (actual)	2011 (proj)	2012 (proj)	2013 (proj)
Broad Money Supply	27.3	11.2	21.8	20.6	10.0	9.6	7.9	5.5
Monetary Base	61.8	-12.0	11.9	14.9	11.1	9.2	8.1	6.5
Claims on the Private Sector	30.8	28.0	15.1	16.0	17.9	13.2	12.1	9.5
Net Claims on Gov't	-83.5	-174.3	-694.6	-21.3	-130.2	161.5	74.7	-22.3
Net Foreign Assets	51.7	-14.0	27.0	116.4	20.1	22.2	15.7	4.9

Source: Bank of PNG

Table 2: Summary of Other Macroeconomic Indicators

INDICATOR	2007 (actual)	2008 (actual)	2009 (actual)	Sep 2010 MPS	2010 (actual)	2011 (proj)	2012 (proj)	2013 (proj)
CONSUMER PRICE INDEX (annual % changes)								
Headline	3.2	11.2	5.7	7.0	7.2	8.5	7.0	6.0
Trimmed-mean	5.3	11.7	4.1	6.5	5.5	6.5	6.0	6.0
Exclusion- based	6.1	11.0	5.0	7.0	5.4	7.0	6.0	6.0
BALANCE OF PAYMENTS (kina millions)								
Current account	550	2,145	-1,611	-11,939	-1,762	-14,566	-11,225	-2,760
Financial account	888	-2,863	3,220	13,022	2,794	15,902	12,526	3,128
Overall balance	1,592	-598	1,725	1,138	1,066	1,412	1,385	442
Gross Int. Reserves	5,919	5,321	7,046	7,817	8,170	9,677	11,057	11,498
IMPORT COVER (months)								
Total	9.1	7.9	10.7	5.5	10.5	6.3	7.6	12.4
Non-mineral	13.0	11.4	14.6	15.7	14.4	17.1	17.8	17.2
EXPORT PRICE								
Crude oil (US\$/barrel)*	73.0	106.7	58.7	60.0	78.6	80.0	84.0	93.0
Gold (US\$/ounce)	671.0	850.9	968.6	1,119.2	1,187.3	1,265.8	1,282.6	1,238.9
Copper (US\$/pound)	320.4	327.8	217.6	323.9	333.4	350.0	300.0	300.0
FISCAL OPERATIONS OF THE GOVERNMENT**								
Surplus/Deficit (K'm)	476.2	-478.4	-36.3	533.3	186.3	0.0	312.8	-337.4
% of GDP	2.5	2.2	0.2	2.1	0.7	0.0	1.0	1.1
REAL GROSS DOMESTIC PRODUCT (annual % growth) ***								
Total GDP	7.2	6.6	5.5	7.5	7.1	8.0	5.1	1.8
Non-mineral GDP	8.1	7.6	6.3	7.6	7.3	8.2	4.3	2.3

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

** Preliminary fiscal operations up to December 2010. 2011 - 2013 projections are from the 2011 National Budget

*** GDP figures are from the 2011 National Budget

Source: Bank of PNG, NSO and Department of Treasury