



Bank of Papua New Guinea

SEPTEMBER 2014 MONETARY POLICY STATEMENT

Mr LOI M. BAKANI

GOVERNOR

BANK OF PAPUA NEW GUINEA

**Port Moresby Chamber of Commerce and Industry
Tuesday 30th September 2014**



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Presentation Outline

- International background
- Domestic developments
 - Balance of Payments/FX Reserves
 - Gross Domestic Product (GDP)
 - Inflation
 - Exchange Rate Developments
 - Fiscal Operations
 - Monetary Aggregates
- Monetary Policy Stance
- Other developmental issues



Monetary Policy

The objective of monetary policy in PNG is to achieve and maintain price stability. This entails low inflation supported by stable interest and exchange rates.

If achieved, price stability will lead to:

- Confidence in the kina exchange rate and management of the economy;
- A foundation for stable fiscal operations of the Gov't;
- Certainty for private sector businesses to plan for long-term investment and development; and
- A stable macroeconomic environment conducive to economic growth.



International Background

- Global economy is slowly recovering and inflation remains low;
- Improvement in international prices for some commodities such as coffee and palm oil;
- Most major central banks maintained an easy monetary policy stance aimed at stimulating economic activity in their respective economies.
- Potential for inflation to increase as economic growth picks up



Balance of Payments

- The overall BOP deficit for the first six months of 2014 was K16mn;
- The BOP will continue to be in deficit in 2014 reflecting high imports, lower export receipts and lower FDI flows;
- Still in deficit in 2015 and into surplus in 2016;
- By end 2014, gross foreign exchange reserves level expected to be US\$2,620.0mn (K6,485.1mn), sufficient for 4.6 months of total and 7.8 months of non-mineral import covers.



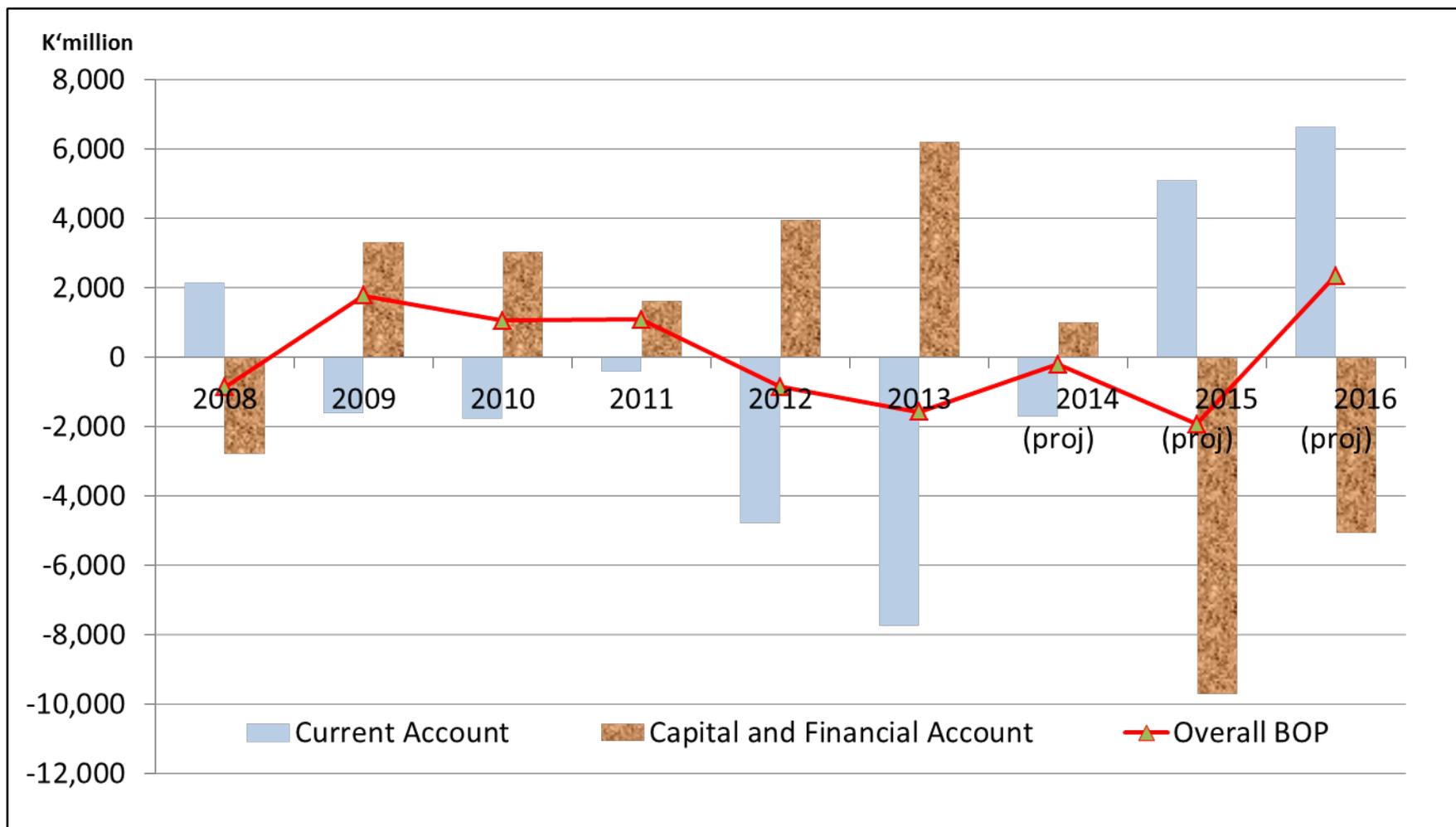
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Balance of Payments

- Reserves declined due to Gov't new borrowing
 - Nautilus investment
 - UBS loan repayments
- In 2015/16, BOP surplus implies increase in int'l reserves. If refinancing of UBS loan then surplus in 2015, instead of a deficit.



Balance of Payments



Source: Bank of PNG

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



Gross Domestic Product - PNG

- The Bank projects Real GDP growth of 6.0% in 2014, higher than the revised budget forecast of 5.4%.
- This is attributed to the early commencement of the Liquefied Natural Gas (LNG) production and export, and the expansionary fiscal policy.
- The stimulus effect of Govt's deficit budget is dependent on its ability to effectively implement the 2014 Budget.
- Infrastructure projects (Pacific Games) and transport infrastructure taking place mainly in rural areas



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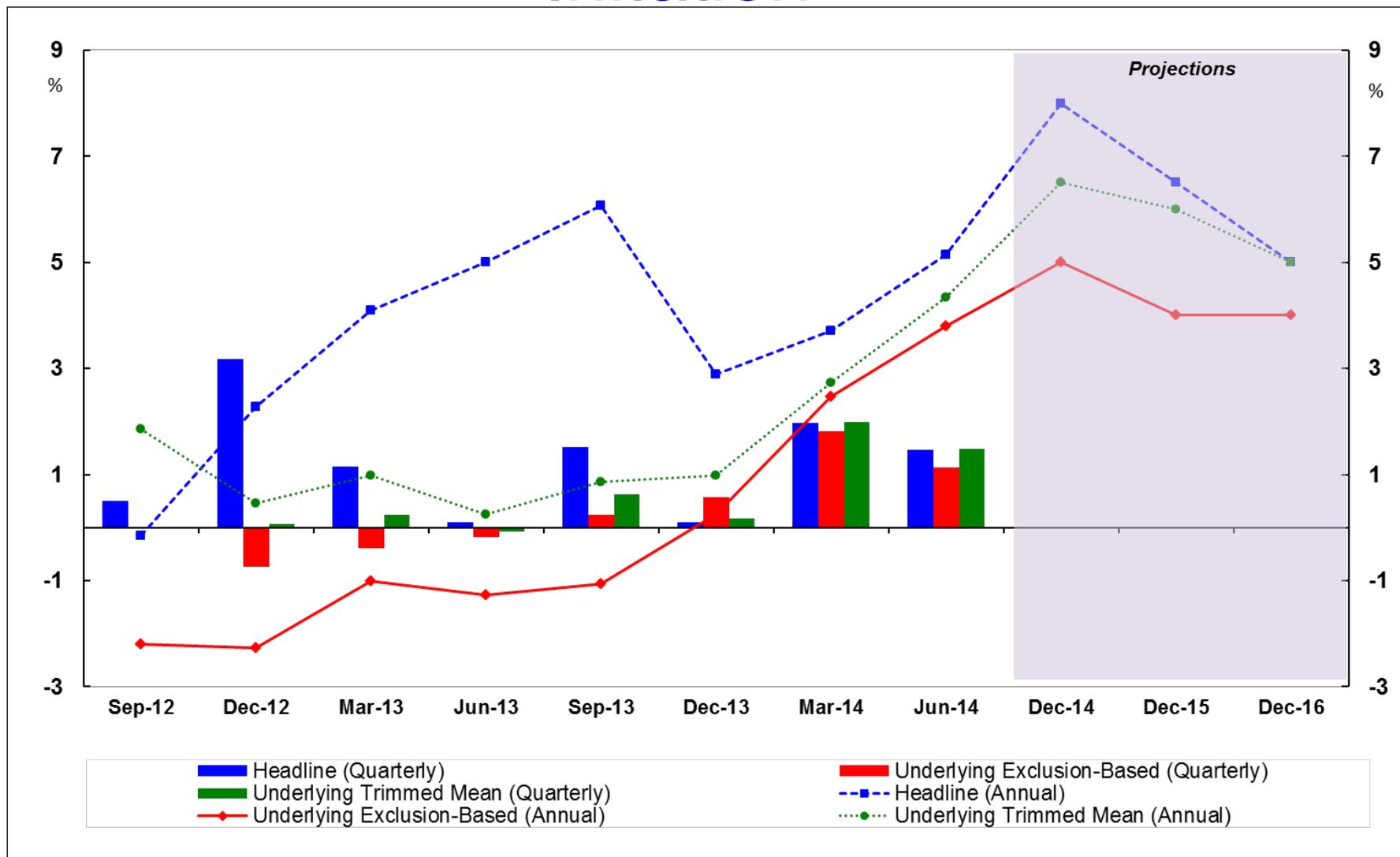
Inflation

- The Bank projects annual headline inflation for 2014 to be around 8.0%, up from its original forecast of 6.5%.
- This is based on:
 - Consecutive increases in the headline CPI, with an outcome of 5.1% in June 2014 based on the revised CPI basket (increased coverage includes – additional expenditure items and regions);
 - Persistently high level of high import demand and subsequent depreciation of kina exchange rate;
 - In 2015/16, inflation expected to decline due to favourable exchange rate movements

Upside risks: Unbudgeted Gov't expenditure, any major supply side shocks, further depreciation of the kina and higher than expected imported inflation from our trading partners.



Inflation



Source: Bank of PNG & National Statistical Office

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



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Exchange Rate Developments

- Since mid-2013 kina depreciated reflecting decline in FDI and low export earnings. FDI decreased after LNG project construction.
- Several consultation with dealers on issues concerning exchange rate led to introduction of the trading band
- On 4th June 2014, the Bank introduced an exchange rate trading band;
- The band involves:
 - a 150 basis points spread, that is, 75 basis points above and below the inter-bank rate.
 - all currencies and all products, except for foreign currency banknotes which have large associated costs.



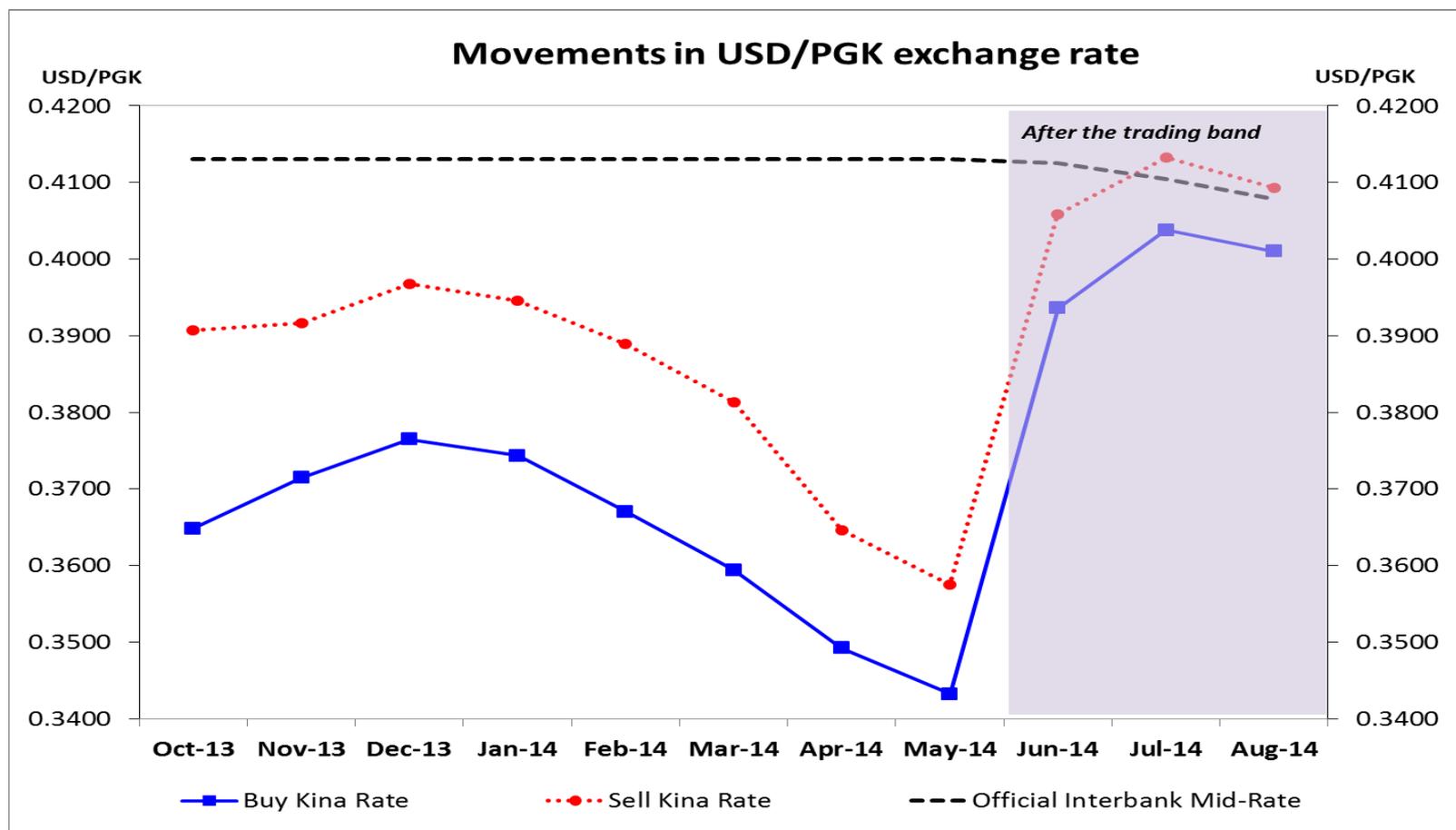
Exchange Rate Developments

- Several factors were considered:
 - The authorised dealers were trading the kina away from the interbank mid-rate, resulting in a spread of around 600 basis points.
 - The use of BPNG's international reserves for funding the forward transactions in the spot market – reserves declined (K1.6 bn).
 - No cost to dealers as it was not funded from their sources (parent or counterpart borrowing)
 - The dealers had lost their price making ability, instead becoming price takers dictated by the foreign exchange suppliers.
 - It was considered as market failure and prompted Central Bank intervention to correct this
 - Now agreed with dealers on operational guidelines, including reports/documentation and penalties for breaches



Exchange Rate Developments

- The trading band caused a *de facto* appreciation of the market exchange rate. The interbank mid-rate has since started to depreciate, reflecting market conditions, from US\$0.4130 to US\$0.4030 as at 29th September.



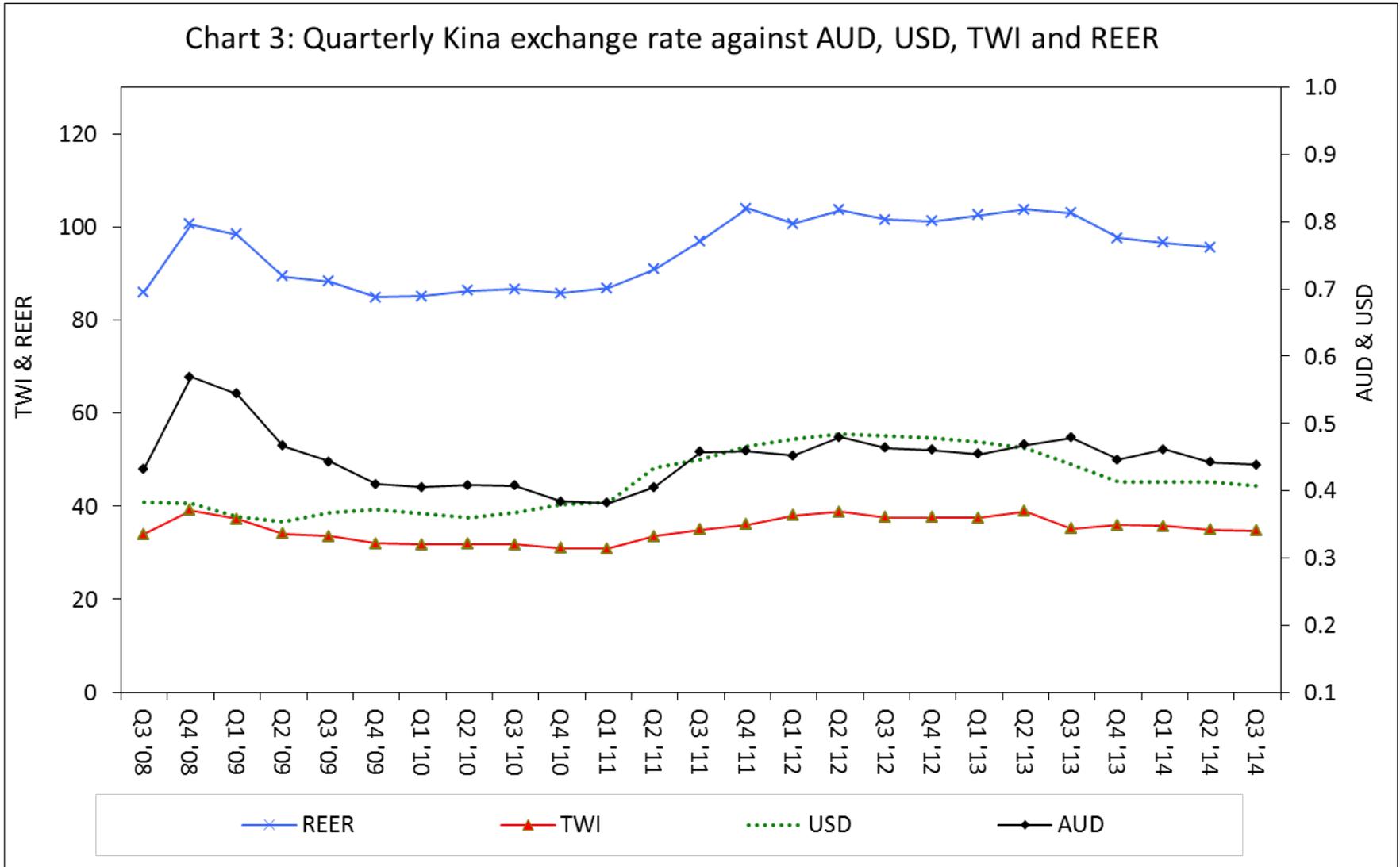


Exchange Rate Developments

- Whilst the measure may have disadvantaged exporters, macroeconomic stability remains the Bank's overriding concern and therefore it was seen as an important corrective measure.
- It does not, in any way, change PNG's exchange rate regime which remains a floating one, whereby the official interbank exchange rate is freely determined by the demand and supply of foreign currency in the market.
- The trading band follows movements in the official interbank rate. The Bank may intervene directly or indirectly to moderate the rate of change and prevent undue fluctuations, but its actions do not target a specific level of exchange rate.



Exchange Rate Developments

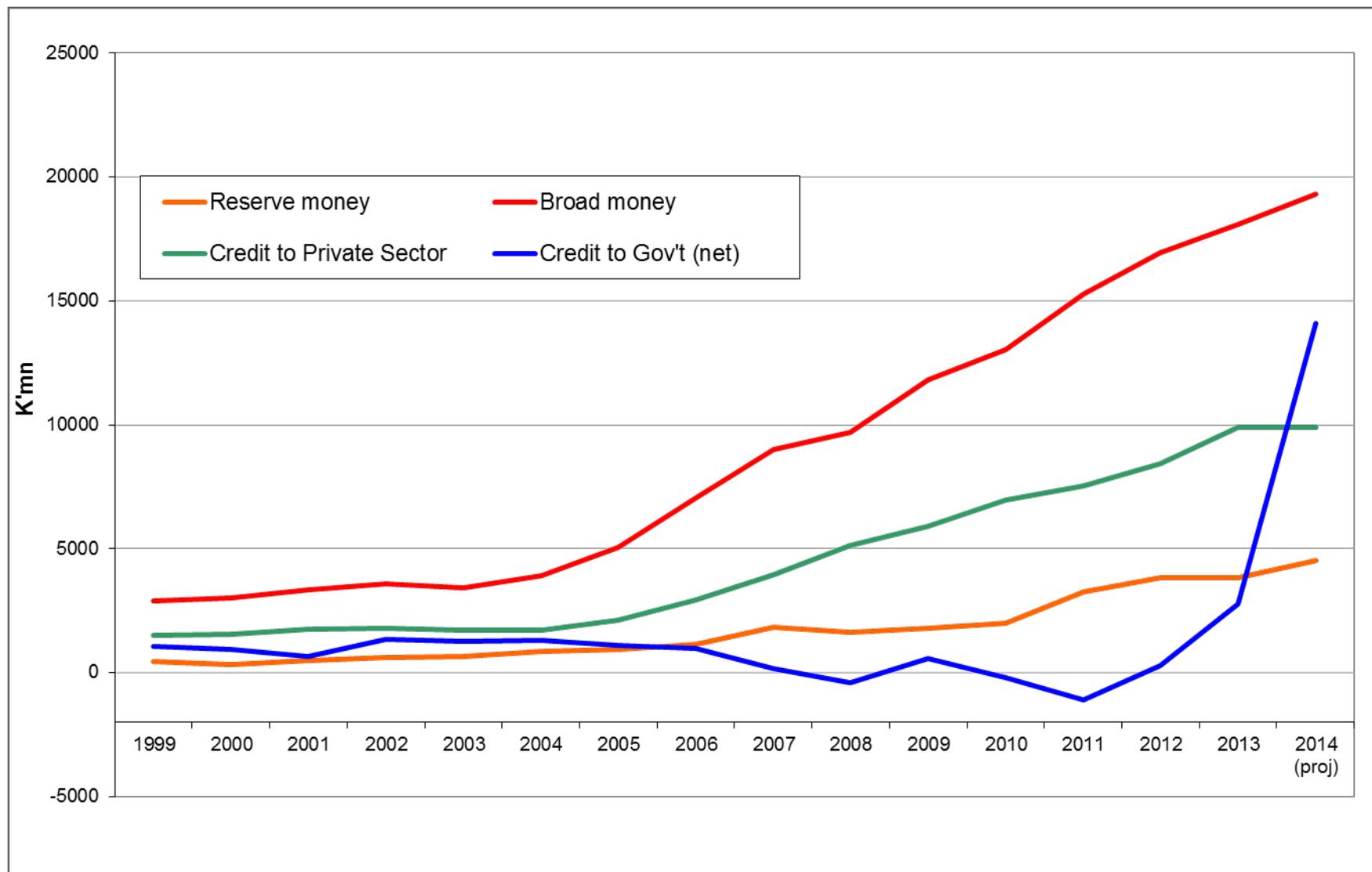


Source: Bank of PNG



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Monetary Aggregates





Fiscal Operations

- The preliminary estimates of fiscal operations to June 2014 shows an overall deficit of K563.6 million or 1.4 % of nominal GDP.
- This is the second successive stimulus budget with a large deficit of K2,725.5 million or 6.9% of nominal GDP. Its successful implementation is key to realising the economic stimulus the budget set out to achieve.
- To fund the budget deficit, the Gov't has increased its issuance of securities which led to a sharp increase in domestic interest rates. The high cost of borrowing will result in reallocation of some of Government's financial resources away from the provisions of essential services to rural population and will increase the financial burden for future generations.
- The Treasury Dep't agreed for the Bank to take up under-subscriptions at the Treasury bill and Inscribed stocks auctions to on-sell to the public for monetary policy purposes. This arrangement will not only reduce interest cost to the Government, but also assist in diffusing liquidity.
- 2015-16 – Refocus Budget on consolidation, continue to target priority expenditure

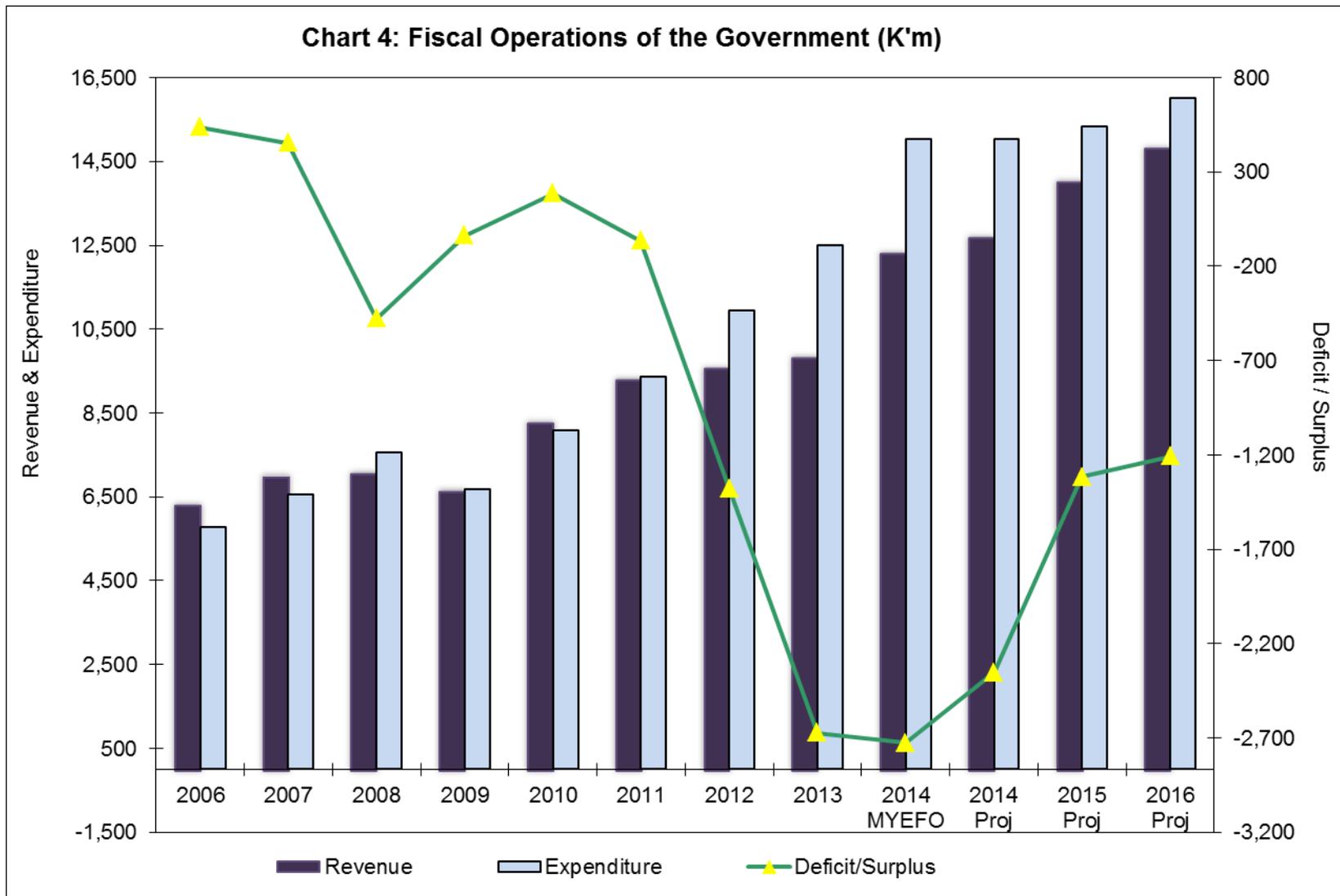


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- 2015-16 – Refocus Budget on consolidation, continue to target vital priority expenditure
- Build implementaion capacity to realize effectiveness and efficiency of Budget expenditure.



Fiscal Operations



Source: 2014 National Budget



Monetary Policy Stance

- The excess liquidity has contributed to high import demand, which continues to be high and contributes to the depreciation of the exchange rate.
- In light of the present economic conditions as well as the future outlook, the Bank increased its issuance of Central Bank Bills (CBB) and the CRR to 10.0 percent in September 2014.
- The Bank may consider tightening its monetary policy stance. It will continue to assess economic conditions to ensure that inflation is at a manageable level, whilst financial and macroeconomic stability is maintained.



Other developmental issues

- The Bank is concerned about the delayed progress on establishing a SWF for PNG. It is important that the SWF has an appropriate structure that adequately caters for macroeconomic stability, the country's development needs and future generation.
- The Bank is pursuing financial inclusion initiatives and improving the National Payments System to assist in the drive for inclusive and broad based growth.
- The first two phases of the new payment system project enable real time settlement of high value priority payments and cheque truncation. The third phase involving direct credits is expected to be completed before the end of the year. These enhancements would improve the safety, timeliness and overall efficiency of the payment system of the country.



Other developmental issues

- Building strategic infrastructure like highways enhances the development of agriculture sector and businesses.
- The agriculture sector should be developed using new technological innovations.
- Aim to diversify agriculture sector, including downstream processing & food production.
- This will broaden export base to build PNG's resilience to withstand external shocks and instability in mineral export earnings.
- Develop the SME sector
- Encourage competition in financial sector
- Develop capital market domestically
- SOEs – enhance efficiency to reduce costs and reliability for business and economic growth



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Thank You

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