



MONETARY POLICY STATEMENT

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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

High economic activity continued in the first half of 2019 following the rebound in the second half of 2018, mainly driven by the mineral sector reflecting higher production and export of crude oil, liquefied natural gas (LNG) and gold. The non-mineral sector also supported the activity with favourable international prices and higher production of some commodities. While there were improved inflows to the domestic foreign exchange market, the overall balance of payments over the first half of 2019 recorded a deficit mainly due to higher debt service. For 2019, the Central Bank projects the overall real GDP growth to be slightly above the Government's forecast of 4.4 percent in the Mid-Year Economic and Fiscal Outlook (MYEFO) report, mainly driven by the mineral sector. Continued growth in private sector credit as projected by the Central Bank will support growth in the non-mineral sector. Growth in the medium term is projected to moderate, but would be higher when several large impact projects in the pipeline, such as the Papua LNG, Pasca A, P'nyang, Frieda River and Wafi-Golpu reach construction phase.

The improved foreign exchange inflows up to the end of September 2019 combined with Central Bank's intervention assisted in reducing outstanding import orders. As a result, the average waiting period for foreign exchange orders to be served continues to improve. Although the outstanding orders have been reduced, total orders in the foreign exchange market remains elevated due to increase in new orders. The retention of surplus cash in the offshore foreign currency accounts of resource projects as allowed under the Project Development Agreements (PDAs) continue to limit foreign exchange inflows. If this surplus cash are converted to kina, it would improve the inflows of foreign exchange and reduce import orders.

The overall balance of payments deficit in the first half of 2019 was attributed to a deficit in the capital and financial account, mainly due to debt service payments by the Government and resource companies. This more than offset the prevailing surplus in the current account. The outlook of the balance of payments indicates an overall surplus in 2019, which is expected to continue into the medium term.

The fiscal operations of the national government in the first half of 2019 recorded a deficit of K1,667.3 million, higher than the deficit of K324.9 million in the same period of 2018, reflecting total expenditure significantly exceeding total revenue. This represents 90 percent of the deficit in the 2019 Budget. The deficit for 2019 is projected in the MYEFO to widen by K506.4 million to K2,373.1 million. The high deficit is a concern as the Government is facing challenges in raising sufficient revenue and other sources of financing to fund the high expenditure level. A prudent fiscal strategy implemented through a supplementary budget would be necessary to align expenditure to revenue.

The Bank continues to refine its monetary policy operations. Borrowings under the Repurchase Agreement (Repo) Facility have been securitized through government securities and Central Bank Bills (CBBs) in April 2019, in addition to offering the Intra-day Liquidity Facility (ILF). In doing so, the dealing margin of the Repo was reduced from 100 basis points to 75 basis points from the monthly policy rate, Kina Facility Rate (KFR).

Annual headline inflation has been falling since December 2018, from 4.8 percent to 4.0 percent in June 2019. Lower imported inflation, stability in the kina exchange rate, cheaper sources of imports, and lower prices of seasonal produce combined with improvements in the domestic supply chain and competition on prices contributed to this outcome. With these developments, the Bank projects annual headline inflation at 4.0 percent in 2019. In the medium term, headline inflation is projected to be 4.5 percent in 2020 and 3.5 percent in 2021.

Taking into account the fall in inflation, the Bank eased its stance of monetary policy by reducing the KFR by 25 basis points to 6.00 percent in July 2019, and a further 50 basis points to 5.50 percent in August. The easing stance is to support lending by banks to private sector to stimulate economic activities. With these developments and inflation projections, the Bank will maintain its stance over the next six months. It will closely monitor developments in inflation and other macroeconomic indicators, and may adjust its stance as necessary.

Macroeconomic and Monetary Policy Developments and Outlook

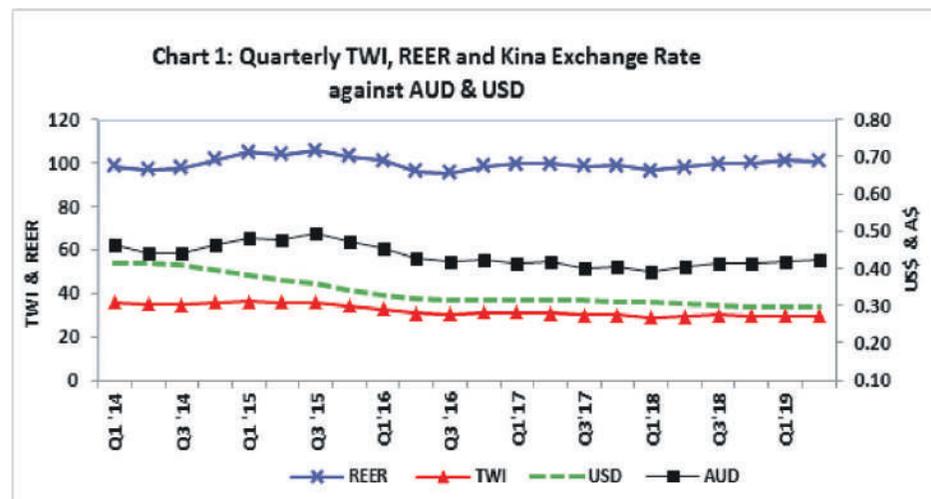
1. Developments

The overall balance of payments recorded a deficit of K389 million in the first half of 2019. A higher deficit in the capital and financial account more than offset the prevailing surplus in the current account. The deficit was mainly due to higher external debt service payments by the mineral companies and the government, and investments abroad by the former. The surplus in the current account was mainly driven by higher production and favourable international prices for most of the major export commodities which resulted in improved inflows of foreign exchange to the domestic market.

Given the developments in the external sector, the level of gross foreign exchange reserves was US\$2,045.7 (K7,069.0) million as at 30th June 2019, compared to US\$2,296.1 (K7,457.0) million as at the end of December 2018. This level is sufficient for 5.3 months of total and 11.3 months of non-mineral import covers. The level of reserves was US\$1,920.1 (K6,421.6) million as at 26th September 2019.

The kina exchange rate was relatively stable in 2019 against the US dollar and Australian dollar. It depreciated against the US dollar from US\$0.2970 at the end of December 2018 to US\$0.2945 at the end of June 2019, and to US\$0.2940 as at 27th September. The overall depreciation against the US dollar to September was 1.0 percent. Against the Australian dollar, the kina depreciated from A\$0.4208 at the end of December 2018 to A\$0.4200 at the end of June 2019, and appreciated to A\$0.4349 as at 27th September. The overall appreciation of the kina against the Australian dollar to September was 3.4 percent and mainly reflected cross currency movements as the Australian dollar weakened against the US dollar.

The Trade Weighted Index (TWI) increased by 0.62 percent in the June quarter of 2019, compared to a decline of 1.01 percent in the March quarter. The annual Real Effective Exchange Rate (REER) had a lower appreciation of 2.7 percent in the June quarter of 2019, compared to 4.8 percent in the March quarter of 2019, largely due to the appreciation of kina against AUD, which more than offset the effect of the depreciation against USD and Japanese Yen. The appreciation of REER implies a weakening of the competitiveness of PNG's exports (See Chart 1).

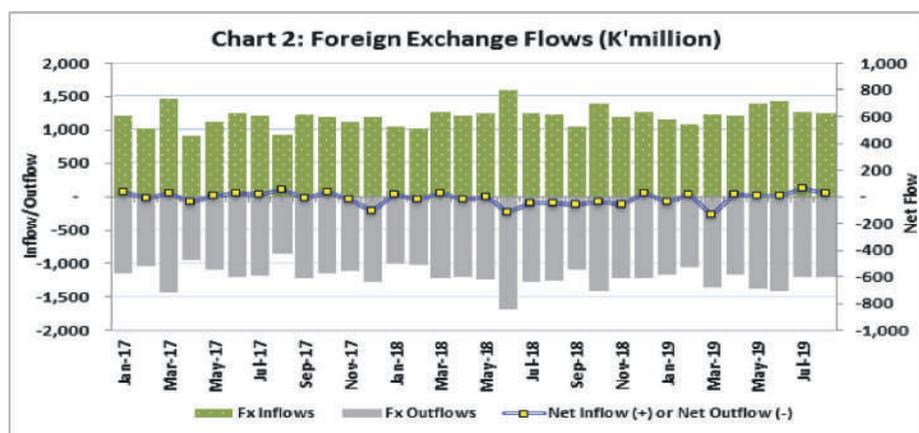


Source: Bank of PNG

Economic activity increased in the first six months of 2019, mainly driven by the recovery in the mineral sector and higher production in the Agriculture/Forestry/Fisheries (AFF) sector. This was supported by an increase in private sector credit and improvement in the foreign exchange market, which enabled firms to carry out capital investments to increase production and import consumption goods. The Bank's Employment Survey showed that formal private sector employment increased by 4.2 percent over the year to June 2019. The recent Business Liaison Survey showed an increase in the total nominal value of sales by 7.9 percent over the year to the March quarter of 2019, while

excluding the mineral sector, sales increased by 9.5 percent, which were indicative of this growth. These outcomes were driven by higher business activity and hiring of additional workers in the AFF, mineral, wholesale, retail and the construction sectors. Government spending also contributed to the increase in activity.

The foreign exchange inflows improved in the second half of 2018, reflecting budget financing from external sources as well as increased inflows from the mining sector, which continued into the first half of 2019. The inflows were used to reduce outstanding foreign exchange orders as well as meet current orders to within a reasonable clearing timeframe. Total sell kina orders declined to K1.2 billion as at the end of August 2019 from K1.9 billion a year ago. The backlog of orders was also reduced as a result of BPNG's interventions. The average time taken for orders worth K3 million and above to be cleared has reduced from six months in 2018, to less than three months in 2019. These are positive developments in terms of meeting foreign exchange requirements of the private sector and its development needs. Most of the foreign exchange inflows have been served to the retail, manufacturing and finance and business sectors. Current orders, however, continue to be higher than the inflows of foreign exchange and therefore total demand in the market continues to remain high (See Chart 2).



Source: Bank of PNG

In the 2019 MYEFO report, total revenue and grants was K5,810.6 million (40.7 percent of budget) and total expenditure of K7,478.0 million (46.4 percent of budget), which gave a deficit of K1,667.3 million for the first six months of 2019. This outcome was due to the lower than anticipated tax and non-tax revenues attributed to declines in company tax and mining and petroleum taxes (MPT) and non-tax collections. This was partially offset by higher trade, and personal income and withholding taxes. The increase in total expenditure was mainly in recurrent expenditure (49.5 percent of budget).

Annual headline inflation was 4.0 percent in the June quarter of 2019, down from 4.5 percent in the March quarter of 2019 and 4.8 percent in the December quarter of 2018. The lower inflation outcomes over the last few quarters reflected lower pass-through of imported inflation to domestic prices, cheaper sources of imports, high competition and lower prices of seasonal produce of fruits and vegetables and betelnut, combined with improvements in the supply chain. The lower prices were also recorded in the 'Transportation', 'Housing', 'Health', 'Clothing and Footwear', 'Recreation', 'Miscellaneous', 'Communication', 'Education' and 'Household Equipment' expenditure groups. The annual trimmed mean and exclusion-based measures were 2.5 percent and 1.4 percent, respectively.

In consideration of the fall in annual headline inflation from September quarter 2018 to March quarter 2019, stability in the kina exchange rate, and lower outcomes of the Bank's monthly Retail Price Index to June 2019, the Bank eased its monetary policy stance by reducing the policy signaling rate, the KFR, from 6.25 percent to 6.00 percent in July, 2019 and further to 5.50 percent in August. As part of the refinements to its monetary policy operations, the Bank securitised borrowings under the Repurchase Agreement (Repo) Facility with government securities and CBBs in April 2019, in addition to introduction of the Intra-day Liquidity Facility (ILF). Following this transition, the dealing margin for the Repo was reduced from 100 basis points to 75 basis points from the KFR.

Following the establishment of the National Payment System (NPS), the Kina Automated Transfer System (KATS), the Bank continues to roll out the National Switch Project with the launch of the Retail Electronic Payment System (REPS) in July 2019, to include the second tier financial institutions. The REPS will allow microfinance companies and micro-banks, Savings and Loans Societies and other smaller financial institutions entry into the NPS. It will connect all providers of electronic card and mobile phone payment services in PNG. The REPS and KATS together represent a complete modernisation of the PNG's NPS that will deliver efficiency, security and convenience in payments.

2. Issues

While there is improvement in the inflows of foreign currency from the second half of 2018 to the end of September 2019, the demand for foreign currency continues

to outstrip the supply. Although outstanding orders in the market have been reduced substantially by these inflows and interventions from the Central Bank, these were being replaced with new orders. Delays in accessing external budget financing in 2019 will also affect the inflow of foreign currency to support the market. It is therefore important that the government puts in place practical and credible expenditure controls and revenue raising measures to be able to drawdown these funds, and assist the foreign exchange market and government's cash flow. In addition, tax audits on resource companies should be fast tracked to ensure compliance so that any potential tax revenues and its foreign currency equivalent are provided to the market.

The growth in government tax revenue remains stagnant in the post-LNG period to 2018 despite the strong growth in GDP. The low revenues have been mainly due to PDAs, tax credit schemes and other concessions. On the other hand, Government expenditure continues to remain in excess of revenue and slippages in expenditure has become frequent, partly reflecting front loading of expenditure through borrowing in anticipation of future LNG revenues. The high recurrent expenditure relative to development expenditure reflects the diversion of funding from productive areas to consumption and limiting investment on economic infrastructure. These spending have resulted in large deficits prompting the government to resort to continuous borrowing and consequently increasing the national debt level. If the high debt and expenditure do not translate to high economic growth, this will raise serious concerns about the sustainability of debt. The Government must continue to implement the current and new reforms to address issues in revenue and expenditure, to ensure that debt is maintained at a sustainable level.

The current concession regime provided to resource projects under the Project Development Agreements (PDAs) does not adequately account for national interest. The Government should enact legislative changes to ensure that the country maximises the benefits from developments in the non-renewal sector. The recent proposed review of the Oil and Gas Act and the amendments to the Mining Act, are steps in the right direction. In addition, the government is encouraged to continue to diversify the economy and shift away from the reliance on the extractive sector. In this regard, the government has approved the establishment of a SME Credit Guarantee Corporation under the SME Policy to address access to finance and promote innovations and strategic partnership with local businesses. This and other policy reforms should increase investment in the non-mineral sector. The government's investment policy should give priority to the export sector, especially the AFF and tourism sectors to broaden the export and tax base, and promote import substitution.

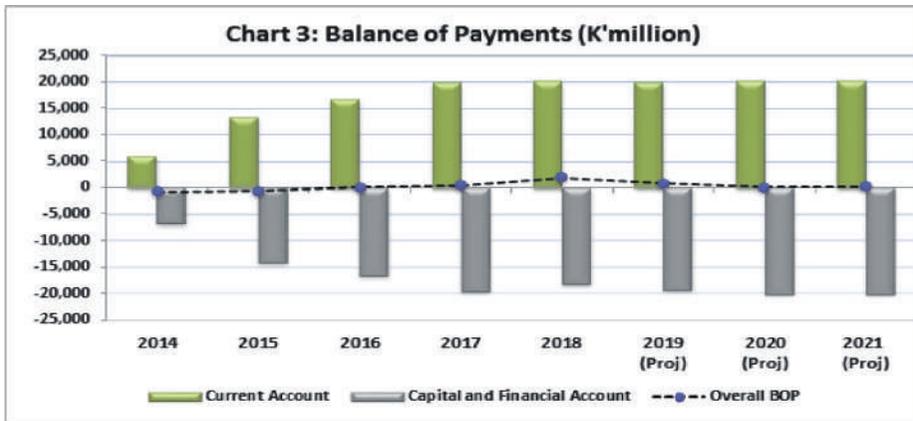
Increase in Government borrowing in recent years has not only contributed to the high level of public debt but also injected significant amount of liquidity into the banking system. Total Government debt has increased substantially, from K8,350 million in 2012 to K25,607 million in December 2018, and further to K27,373 million by June 2019. Most of this debt has been raised from domestic sources and large exposure to the government by existing debt holders may inhibit new purchases of government securities. Thus, it is important that the Government must pursue and realise the external financing for 2019. Increase in liquidity in the banking system will continue to exert challenges on the implementation of monetary policy in terms of lack of transmission of Central Bank's policy rate to market rates. To assist the Bank in managing liquidity in the system, the Government must coordinate effectively its financing strategy with the Central Bank and market to ensure consistency in policy initiatives.

The transmission of Monetary Policy continues to be weak in influencing the market interest rates and thereby limiting its impact on business activity. Although the Bank has reduced its KFR to 5.50 percent in August, the downward adjustment of market lending rates by commercial banks has not been immediate. While there was a downward adjustment in the indicator lending rate of a commercial bank following the reduction of KFR, most of the lending rates remain relatively high compared to very low deposit rates. Some downward movements in the housing loan rates recently by two commercial banks are in line with market conditions. However, the response of lending rates to changes in policy rate is not always determined by market conditions as the commercial banks have their own risk framework that normally determine the setting of lending rates on different products and fees and charges on services. Given these factors, the spread between the deposit and the lending rates as well as the KFR continues to remain wide. The Bank urges commercial banks to review their method of setting lending rates and fees and charges to be based more on market fundamentals rather than mainly on risk factors. In its effort to improve transmission, the Bank has refined its monetary policy operations by securitizing borrowing under the Repurchase Agreement (Repo) Facility with government securities and Central Bank Bills in April 2019, following the introduction of the Intra-day Liquidity Facility (ILF). In addition, the Bank is in the process of implementing financial consumer protection framework to address consumer concerns on financial services.

3. Forecasts and Expectations

The balance of payments is projected to record a surplus of K730 million by the end of 2019, influenced by a higher surplus in the current account. The current account

is projected to have a surplus of K19,990 million due to higher international prices of some commodities and production of most export commodities including LNG and gold. The capital and financial account is projected to be in deficit of K19,260 million, mainly reflecting external debt servicing by the government and joint-venture partners of the PNG LNG Project (See Chart 3).

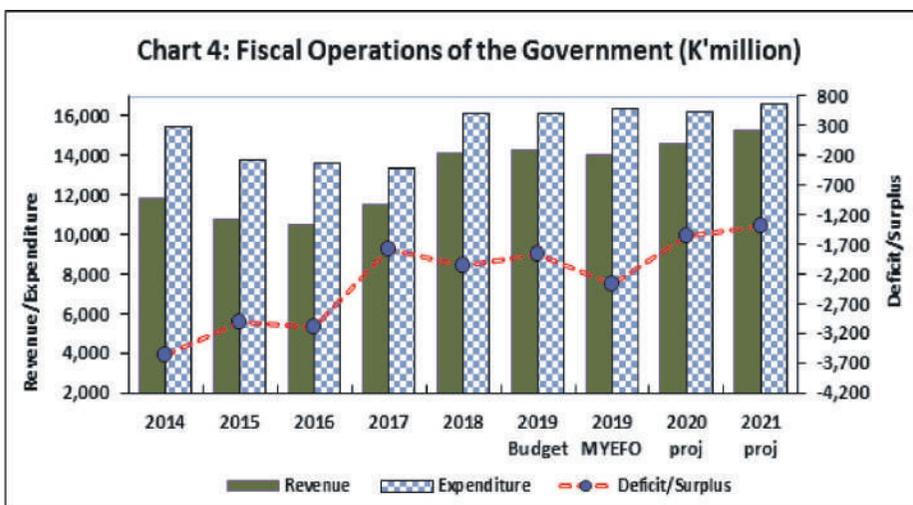


Source: Bank of PNG

In the medium term, the current account is projected to record higher surpluses due to increase in mineral and non-mineral export receipts stemming from higher international prices and production of major export commodities. The capital and financial account is expected to record deficits, mainly reflecting investments offshore by mineral companies and ongoing debt service payments by the government. As a result, the overall balance of payments position is projected to record surpluses in 2020 and 2021. When the planned major resource projects such as Papua LNG, Pasca A, P'nyang, Frieda River and Wafi-Golpu reach construction phase, there will be further improvements to the balance of payments.

The overall reserve level is projected to be US\$2,429.8 (K8,250.6) million at the end of 2019. The projected higher level of reserves mainly reflects drawdowns of planned external financing for the budget and concessional loans. This in turn is expected to support Central Bank's intervention in the foreign exchange market (See Appendix – Table 2).

In the 2019 MYEFO report, the Government noted the challenges in both revenue shortfalls and expenditure slippages in the fiscal operations. Given these developments, the MYEFO projects the fiscal deficit for 2019 to increase by K506.4 million to K2,373.1 million (2.7 percent of GDP), compared to K1,866.7 million (2.1 percent of GDP) in the 2019 Budget. The total public debt stock is projected to increase to K28,125.9 million from the 2019 Budget estimate of K27,322.2 million. This translates to an overall debt-to-GDP ratio of 31.8 percent, compared to 30.8 percent in the 2019 Budget (See Chart 4). The legislated debt limit is 30.0 percent to 35.0 percent in the Fiscal Responsibility Act.



Source: 2019 Budget and MYEFO

Total real GDP growth for 2019 is projected by the Bank to be slightly above the government's forecast of 4.4 percent in the MYEFO report. In line with the earlier projections made in March, the primary driver of this growth continues to be the rebound and full year production and export of LNG, crude oil, condensate and gold, which were severely affected by the earthquake in February 2018. Higher production and export of copper, nickel and cobalt will also support this growth. For the non-mineral sector, the Bank projects growth to continue in 2019 reflecting higher activity in the AFF, commerce, construction, communication, manufacturing, public utilities and the services sectors. These will more than offset the tapering off of APEC-related activities in 2019. Over the medium term, overall growth is projected to be mainly driven by the non-mineral sector, especially communication and AFF. The projected growth for the medium term would be higher when large impact gas and mining projects such as the Papua LNG, Pasca A, P'nyang, Frieda River and Wafi-Golpu reach construction phase.

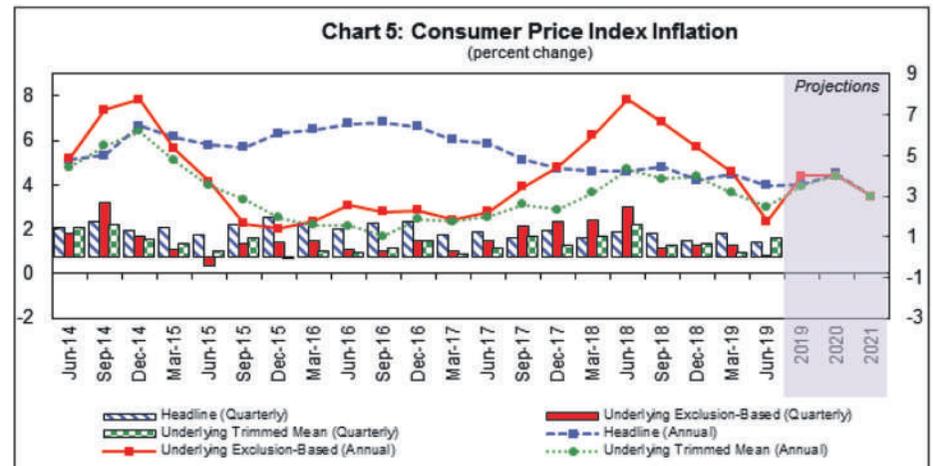
For 2019, the Bank maintains its inflation projections made in the March 2019 MPS. Annual headline inflation is projected to be around 4.0 percent and the core measures

namely the trimmed mean and exclusion-based, to be around 3.5 percent and 4.0 percent, respectively. These take into consideration the low pass-through of imported inflation and the resilience of domestic firms to remain competitive by sourcing domestically and maintaining efficiency.

Over the medium term, the Bank projects annual headline inflation to be around 4.5 percent in 2020 and 3.5 percent in 2021. The trimmed mean is projected to be around 4.0 percent in 2020 and 3.5 percent in 2021, while the exclusion-based inflation is projected to be around 4.5 percent in 2020 and 3.5 percent in 2021 (See Chart 5).

The upside risks to these projections include the following:

- Higher than expected depreciation of the kina exchange rate;
- Increase in imported inflation;
- Further slippages in Government expenditure and its impact on imports and the exchange rate; and
- Unforeseen supply and demand shocks.



Source: National Statistics Office & Bank of PNG

To support the projected growth in GDP, the Bank forecasts an increase of 3.3 percent in broad money supply for 2019, compared to a decline of 4.0 percent in 2018. This is due to a projected increase in net foreign assets of the banking system of 12.0 percent, which will more than offset a projected decline of 2.3 percent in net domestic assets. The increase in net foreign assets is expected from higher export receipts due to improvement in prices and production of some export commodities, mining and petroleum taxes and dividends, and budget financing from external sources. The projected decline in net domestic assets is due to lower net claims on the Central Government of 19.6 percent, which more than offset a growth in the private sector credit of 7.3 percent. The projected growth in the private sector credit is associated with the improvement in the inflows into the foreign exchange market and resilience in private sector activity. The recent easing in the stance of monetary policy is expected to support this growth. The monetary base is projected to increase by 3.0 percent, influenced by the increase in net foreign assets. The Bank considers growth in monetary aggregates to be sufficient to support economic activity in the non-mineral private sector. Considering that actual GDP is below potential level, any increase in domestic economic activity and growth is expected to be non-inflationary.

4. Monetary Policy Stance and Conduct

The Central Bank maintained a neutral stance of monetary policy since March 2013 to June 2019, before easing its stance by reducing the policy rate, the KFR, by 25 basis points to 6.00 percent in July and a further 50 basis points to 5.50 percent in August. In deciding the stance of policy, the Bank took into consideration the lower inflation outcomes for the last three quarters, slowdown in global economic growth, and the relative stability of the kina exchange rate. Given these outcomes and projections for 2019, the Bank will maintain an easing stance of policy in the next six months. It will closely monitor developments on inflation and other macroeconomic indicators, and adjust its stance as necessary to ensure macroeconomic stability.

Monetary policy will be managed within the reserve money framework with a focus on influencing market interest rates to better align with the policy rate. This involves managing liquidity through Open Market Operations (OMO) to influence interest rates that would in turn affect reserve and broad money towards achieving the mandated goal of price stability.

The MPS provides the overall policy stance for the next six months, while the monthly policy rate signals this stance or any changes through an announcement by the Bank. Following the announcement, OMOs are conducted to implement the policy stance. This involves the auction of Central Bank Bills (CBB), Treasury bills and Treasury bonds to Other Depository Corporations and the general public and Repo with the commercial banks. As part of refinement to the monetary policy operations, the Bank securitised borrowing under the Repo Facility with government securities and CBBs in April 2019, in addition to introduction of the Intra-day Liquidity Facility (ILF). The

Appendix

Part 1: Monetary and Credit Aggregates (annual % changes)								
INDICATORS	2016 (actual)	2017 (actual)	2018 (actual)	Mar 2019 (MPS)	Actual to Jun 2019	2019 (proj)	2020 (proj)	2021 (proj)
Broad Money Supply	10.9	-0.7	-4.0	4.2	-3.5	3.3	3.1	5.3
Monetary Base	24.4	-16.6	-1.6	4.1	-1.9	3.0	0.5	-3.9
Claims on Private Sector	6.9	-3.4	7.0	7.2	2.4	7.3	5.7	6.0
Net Claims on Government	49.6	9.5	-33.8	0.6	-17.7	-19.6	-2.3	8.0
Net Foreign Assets	-18.1	8.2	26.7	4.8	13.1	12.0	-0.1	1.5
Part 2: Summary of Other Macroeconomics Indicators								
CONSUMER PRICE INDEX (CPI) (annual % changes)								
Headline	6.6	4.7	4.8	4.0	4.0	4.0	4.5	3.5
Trimmed mean	1.9	2.3	4.0	3.5	2.5	3.5	4.0	3.5
Exclusion-based	2.2	4.3	5.5	4.0	1.4	4.0	4.5	3.5
BALANCE OF PAYMENTS (K'millions)								
Current Account	16,650.0	19,665.4	20,047.0	23,265.0	10,655.0	19,990.0	20,012.0	20,119.0
Capital & Financial Account	-16,623.0	-19,436.0	-18,196.0	-23,019.0	-11,043.0	-19,260.0	-19,978.0	-20,017.0
Overall Balance	31.0	350.3	1,850.0	246.0	-389.0	730.0	34.0	102.0
Gross International Reserves	5,257.0	5,607.7	7,457.0	7,703.0	7,069.0	8,251.0	8,285.0	8,387.0
IMPORT COVER (months)¹								
Total	7.2	5.5	6.7	6.2	5.3	6.1	5.7	5.5
Non-mineral	12.6	9.7	14.9	12.1	11.3	14.4	12.9	12.3
EXPORT PRICE								
Crude Oil (US\$/barrel)*	42.1	54.1	69.0	69.1	63.2	61.4	62.0	62.5
Gold (US\$/ounce)	1,199.2	1,227.6	1,227.4	1,228.7	1,293.3	1,319.4	1,322.2	1,324.8
Copper (US\$/pound)	227.4	274.7	291.5	292.9	274.0	292.0	301.9	302.9
Nickel (US\$/tonne)	9,521.9	10,192.8	12,650.0	12,663.5	11,098.8	10,876.8	11,420.7	11,737.0
Cobalt (US\$/tonne)	25,725.1	55,901.2	58,937.8	58,996.8	27,152.3	25,794.7	26,052.6	26,573.7
LNG (US\$/mmbtu)	6.8	7.9	10.4	10.5	10.7	10.5	10.6	10.7
Condensate (US\$/barrel)	50.7	54.8	70.4	71.1	64.7	62.0	63.0	64.0
FISCAL OPERATIONS OF THE GOVERNMENT**								
Surplus/Deficit (K'million)	-3,086.9	-1,794.7	-2,048.4	-1,866.7	-1,667.3	-2,373.1	-1,558.9	-1,389.4
% of GDP	-4.6	-2.4	-2.5	-2.1	-1.9	-2.7	-1.6	-1.3
REAL GROSS DOMESTIC PRODUCT (annual % growth)***								
Total GDP	2.0	3.0	-0.6	4.0	n.a	4.4	3.2	4.5
Non-mineral GDP	0.7	0.2	3.3	3.1	n.a	2.9	5.4	4.9
* Prices take into account company hedging and differ from market prices.								
** 2018 figures are from the 2018 FBO report, while 2019 to 2021 projections are from the 2019 National Budget and the MYEFO report.								
*** GDP growth rate for 2019 projection is from the 2019 MYEFO report, while for 2020 and 2021 are from the 2019 National Budget.								

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