The global economic recovery in 2021 is overshadowed by the ongoing impact of the COVID-19 pandemic. The recovery reflects the impact of stimulus packages and vaccination programs, mainly in the advanced economies. The improvement in global trade and international commodity prices will support the recovery in Papua New Guinea (PNG). The PNG Government’s fiscal support, easing of containment measures, adjustments to the new-normal working environment, and vaccination rollout will also aid the recovery. The projected growth in PNG’s Gross Domestic Product (GDP) is mainly driven by activity in the non-mineral sector. On its part, the Bank of PNG (Bank) has maintained an accommodative monetary policy stance to support the recovery.

The global economy is projected to recover strongly by 6.0 percent in 2021 from the effects of the COVID-19 pandemic, following the contraction of 3.2 percent in 2020, according to the International Monetary Fund’s (IMF) World Economic Outlook Update of July 2021. The recovery reflects a rebound in advanced economies supported by the fiscal stimulus packages, accommodative monetary policies and the easing of containment measures mainly on trade and travel restrictions with the rollout of vaccine programs. The growth in the emerging markets and developing economies was revised downwards due to rising COVID-19 infections and low rates of vaccination. For 2022, the IMF forecasts global economic growth of 4.9 percent.

The Bank projects real GDP in 2021 to grow by around 1.0 percent, compared to the earlier forecast of 2.5 percent in the March Monetary Policy Statement (see Chart 1). The lower than expected recovery for 2021 is mainly due to the projected decline in the mineral sector and uncertainties associated with the ongoing impact of the COVID-19 pandemic. The growth in the mineral sector is revised downwards mainly due to the continued closure of Porgera Gold mine, while the non-mineral sector is expected to remain resilient. The expected growth in the non-mineral sector reflected favourable international prices, increased production, further easing of COVID-19 containment measures and the Government’s price support and freight subsidy programs for selected agricultural commodities. Preliminary survey data available to the Bank also points to higher employment in the second half of 2021, compared to the first half. Growth in employment is expected to be broad-based reflecting adjustments to the new-normal working environment, with higher activity in the agriculture/forestry/fishing, wholesale and retail, manufacturing, mining and the other services sectors.

For the medium term, the reopening of Porgera Gold mine and commencement of other resource projects currently in the pipeline should boost growth. The Bank is also mindful of the negative impact on economic activities from the ongoing COVID-19 pandemic and the risks associated with it.

In the 2021 Mid-Year Economic and Fiscal Outlook (MYEFO) report, total revenue and grants for the first six months of 2021 was K5,506.4 million (42.3 percent of budget), 14.3 percent higher than in the corresponding period of 2020. Total expenditure was K8,196.9 million (41.8 percent of budget), 18.7 percent higher than in the same period of 2020. This gives a deficit of K2,690.5 million, compared to K2,085.8 million in June 2020. The outcome was due to higher recurrent expenditure mainly on goods and services, and compensation of employees. Capital expenditure also increased by 57.4 percent, compared to June 2020. To finance the deficit, there was a net external financing of K753.4 million, mainly from the Japanese International Cooperation Agency (JICA) and a net domestic financing of K1,937.1 million.

The 2021 National Budget has a planned deficit of K6,612.8 million or 7.3 percent of nominal GDP. To finance it, the Government plans to raise K4,612.8 million from external sources. In August 2021, the IMF approved an increase in Special Drawing Rights (SDR) allocations to assist member countries deal with the impact of the COVID-19 pandemic. Accordingly, PNG received an increase of SDR252.3 million (K1,254.6 million). The Government has indicated to use the SDR allocation as part of the external financing in the budget. Given this is a SDR allocation, the Government is not required to repay it, but only service the interest payments and other charges. With the strong external support for the budget in this challenging environment, the Government should continue with its revenue raising reforms, ensure prudent fiscal management and prioritize development projects and programmes to support the recovery.

Total public debt was K33,666.9 million in 2019, K40,168.1 million in 2020, and is projected to be K46,464.3 million in 2021. The increases reflect higher deficit financing of the budget due to the decline in Government revenue. The debt-to-GDP ratio was 40.0 percent in 2019, 49.2 percent in 2020 and is projected to be 51.1 percent in 2021. These compare with the Fiscal Responsibility Act (FRA) limit of 45.0 percent in 2019 and 60.0 percent for 2020 and 2021. While debt levels have increased, when put to productive use, the borrowed funds would expand the revenue and export base of the country, and contribute to debt sustainability.

The Government continues to use the Temporary Advance Facility (TAF) with the Bank to support cash-flow mismatches. The existing TAF limit of K1,500.0 million calculated in 2020 is based on 12.0 percent of the average revenue and grants in the previous three years. Any outstanding balances under the TAF are to be fully repaid by November 2021, one year after the first drawdown. A new limit will then come into effect. Given that drawdowns under the current TAF are much lower than the limit, the Government should reduce the level for calculating the TAF to between 5.0 percent and 8.0 percent. This would also be in line with international practice.

The overall balance of payments (BOP) recorded a deficit of K312.9 million in the first half of 2021, compared to a surplus of K43.5 million in the corresponding period of 2020. This outcome was due to a deficit in the capital and financial account, which more than offset a surplus in the current account. The outcome in the capital and financial account was mainly due to higher net balances in offshore foreign currency accounts of mineral companies and debt service payments by the mineral companies and the Government. The surplus in the current account was mainly due to higher production and favorable international prices for all the major export commodities, except for logs and tea. The development in the current account reflects the recovery in the world economy. The Bank projects a turnaround in the overall BOP to a surplus in the second half of 2021, mainly driven by the current account.

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Chart 1: Real GDP Growth (%) 2015-2023

Source: National Statistical Office (actuals to 2018), Department of Treasury (estimates for 2019 & 2020) and Bank of PNG (projections for 2021-2023)
For 2021, the Bank projects a surplus of K232.3 million in the overall BOP driven by a higher surplus in the current account reflecting the recovery in the global economy. The current account is projected to be in a surplus of K19,856.4 million due to higher international prices and production of most export commodities. The capital and financial account is projected to be in a deficit of K19,624.2 million, mainly reflecting external debt service payments by the mineral companies and the Government (see Chart 2).

In the medium term, the overall BOP positions are projected to be in deficits, reflecting net outflows in the capital and financial account, which more than offset surpluses in the current account. The projected current account surpluses would be driven by both mineral and non-mineral export receipts, stemming from higher international prices and production of most major export commodities and reopening of the Porgera Gold mine. The projected deficits in the capital and financial account would mainly reflect high net balances in the foreign currency accounts of mineral companies, combined with debt service payments by the Government. The overall BOP outlook would improve if the Papua, Pasca A and P’nyang LNG projects, and the Wafi-Golpu gold project come on stream.

As at 30th June 2021, the gross foreign reserves was US$2,491.8 (K8,625.1) million, compared to US$2,709.4 (K9,437.9) million at the end of December 2020. This is sufficient for 8.6 months of total and 16.2 months of non-mineral import covers. As at 28th September 2021, the gross foreign exchange reserves increased to US$2,611.4 (K9,004.8) million. The increase reflected the inflow of the SDR allocation from the IMF.

The kina exchange rate was stable against the US dollar (USD), while it appreciated against the Australian dollar (AUD), between the end of December 2020 and 28th September 2021. The kina was unchanged at US$0.2850 against the USD, while it appreciated against the AUD from A$0.3699 to A$0.3900, reflecting cross-currency movements as the AUD weakened against the USD. The favorable inflows to the foreign exchange (FX) market was mainly from the mineral sector. These were able to meet most of the import demand as the economy continues to recover from the COVID-19 pandemic (see Chart 3). The Bank’s interventions of K1.7 billion over the same period also helped clear some of the orders in the market. These have resulted in a significant reduction in the clearing time of large import orders to between two to three months, while small orders continue to be cleared on time.

The annual Trade Weighted Index (TWI) declined by 9.4 percent in the June quarter of 2021, compared to a decline of 10.7 percent in the previous quarter. The decline reflected the depreciation of the kina against the currencies of PNG’s major trading partners. The annual Real Effective Exchange Rate (REER) depreciated by 6.8 percent in the June quarter of 2021, compared to a depreciation of 5.9 percent in the previous quarter. This outcome was due to the depreciation of the kina and higher foreign inflation over the second quarter of 2021. The depreciation of REER implies an improvement in the competitiveness of PNG’s exports (see Chart 4).

The kina exchange rate was claimed to be overvalued and less convertible given the high FX outstanding orders. The Bank notes these comments, but advises that the floating exchange rate regime introduced in 1994 remains in place. The kina exchange rate against the USD and AUD has significantly depreciated up to 2003, and thereafter remained relatively stable (see Chart 4). The exchange rate movements and FX flows in the market reflect the underlying structural conditions in the economy, characterized by a shallow financial market, with limited competition and few major FX suppliers, mainly from the large enclave mineral sector. This sector benefits significantly from various generous tax concessions and with much of the export receipts kept offshore as allowed for under the Project Development Agreements (PDAs). If these flows come in, including the State’s interest in the extractive industry, they will adequately meet the FX demand. The non-mineral export sector has a limited capacity and without the necessary infrastructure, is unable to fill the gap. Thus, the exchange rate movements reflect the prevailing market conditions and should not be relied upon as the remedy to addressing the external imbalance. Any large depreciation in the nominal kina exchange rate may not necessarily bring about the desired supply response but can lead to high inflation (see Box 1). A significant increase in inflation will seriously affect the welfare of average Papua New Guineans, including the rural population. It is therefore important that the Government implements cohesive policy measures to grow the export base and encourage import substitution. This would include addressing structural impediments such as: improving infrastructure; accelerate reforms to the mining, oil and gas sector legislations; increasing the State’s revenue from resource projects; increase downstream processing; and supporting the non-mineral export sector to access markets. In the medium to long term, these would improve FX liquidity and functioning of the FX market, as well as support the free-floating exchange rate regime.

Annual headline inflation outcome, as measured by the Consumer Price Index (CPI) and released by the National Statistical Office (NSO), trended downward from a peak of 6.3 percent in the June quarter of 2020 to 3.3 percent in the June quarter of 2021. This was due to lower prices of betelnut, medical services, restaurant services and hotel accommodations, mainly reflecting easing of the containment measures of the pandemic. The annual underlying trimmed mean and exclusion-based measures were 3.8 percent and 5.1 percent, respectively. The underlying measures, however, continue to increase due to high imported inflation from PNG’s major trading partners, reflecting the recovery in the global economy.

For 2021, the Bank maintains its forecast made in the March MPS for the annual headline inflation to be around 4.5 percent, driven by higher foreign inflation, especially in food and oil prices, as the recovery in the global economy continues in the second half of the year (see Chart 5). Prices driven by domestic
0.86 percent over the same period. In June 2021, while the weighted average rate for deposits declined to 0.29 percent from 0.42 percent in March 2021, the average lending rate declined to 7.69 percent in June from 8.33 percent in March 2021, on various products, as well as fees and charges, were reduced. The weighted average rate for deposits is between 10.00 percent and 11.70 percent. As a result, some lending interest rates were reduced. Kina Bank reduced its Indicator Lending Rate (ILR) to 6.25 percent in June 2021, whilst the other commercial banks maintained their ILRs at 11.65 percent. For instance, a proposed 20.0 percent depreciation of the nominal exchange rate would lead to an increase in inflation of around 8.0 – 10.0 percent, and a further 13.0 percent depreciation will lead to inflation increasing further by around 6.0 – 8.0 percent. This would give a total of 14.0 – 18.0 percent increase over a three-year period. If the exchange rate remains fixed at present levels, the central bank interest rates will have to be increased to prevent inflation from accelerating further. The projected growth in broad money supply reflects an increase in the NDA, more than offsetting a decrease in the NFA. The increase in NDA is due to an increase of 12.8 percent in net claims on Central Government, reflecting increased holdings of Government securities. An increase of 3.0 percent in the PSC, although lower than the earlier projection of 6.0 percent, also contributes to the increase. In line with these developments and projections, the monetary base is projected to increase by 3.3 percent, compared to the projection of 3.9 percent in the March MPS. The projected growth in broad money and PSC are expected to support economic activity.

Between April and September 2021, the Bank continued with its accommodative stance of monetary policy by maintaining the policy signalling rate, the Kina Facility Rate (KFR), at 3.00 percent. It mainly utilised its Open Market Operations (OMO) tools to manage liquidity. Between the end of December 2020 and June 2021, there was a net injection of K431.5 million through trade in Government securities and a net diffusion of K73.6 million from Central Bank Bill (CBB) and CBB Tap Facility.

Kina Bank reduced its Indicator Lending Rate (ILR) to 6.25 percent in June 2021, from 11.65 percent whilst the other commercial banks maintained their ILRs between 10.00 percent and 11.70 percent. As a result, some lending interest rates on various products, as well as fees and charges, were reduced. The weighted average lending rate declined to 7.69 percent in June from 8.33 percent in March 2021, while the weighted average rate for deposits declined to 0.29 percent from 0.86 percent over the same period.

**Chart 5: Consumer Price Index Inflation (percent change)**

| Source: NSO (actuals to June 2021) & Bank of PNG (projections for 2021, 2022 and 2023) |

**Box 1: The Current State of the Foreign Exchange Market**

The functioning of the FX market is determined by the supply of and demand for foreign currency. For PNG, the supply of FX is mainly from export proceeds, Government external loans and grants, and foreign direct investments. The demand for FX are mainly for import of goods and services, external debt servicing, dividend and income repatriation, and other remittances. The term of payment of physical goods other than non-goods (service, dividends, transfers and capital-related-flows) usually allows for up to two months before final remittances are done. The current FX orders are within this timeframe and therefore should not be misconstrued as outstanding orders.

After the float of the kina in 1994, the kina exchange rate has depreciated against the USD and AUD up to 2003, and thereafter remained relatively stable. The country did not take advantage of this opportunity to develop a robust non-mineral sector where the bulk of the population is engaged in, for employment, exports and revenue generation. The Government’s focus then, however, was mainly on the enclave extractive sector. With the special concessions allowed under the various PDAs, export proceeds of mineral companies are kept in their foreign currency accounts (FCAs) abroad. The country therefore did not fully benefit from sustained FX inflows. A significant structural shift occurred since 2012 with the development of the PNG LNG Project. This contributed to the huge current account surpluses, but without corresponding flows into the FX market. This has undermined the proper functioning of the FX market and its exchange rate setting role.

Given the development in the FX market and the exchange rate, a number of external researchers have suggested that the kina is overvalued and not convertible. Therefore, a large depreciation in the exchange rate is needed to attain external balance and support non-mineral private sector activity, especially for exports and import substitution. However, the Bank’s own internal assessment shows that a large depreciation may not necessarily lead to the desired supply response in the non-mineral private sector due to structural impediments. It also shows that activity in the non-mineral private sector is mainly driven by international commodity prices, domestic prices and Government spending relative to the impact of kina depreciation. Since the floating, the kina has depreciated by around 73.0 percent in nominal terms, while the impact on the supply response on agriculture production has been minimal. The large depreciation would also have a minimal impact on inflows by the mineral sector, and portfolio inflows.

Given that PNG is an import dependent economy, a large depreciation will increase the import prices and domestic inflation, which would adversely affect people’s welfare. For instance, a proposed 20.0 percent depreciation of the nominal exchange rate would lead to an increase in inflation of around 8.0 – 10.0 percent, and a further 13.0 percent depreciation will lead to inflation increasing further by around 6.0 – 8.0 percent. This would give a total of 14.0 – 18.0 percent increase over a three-year period. If other determinants of inflation are taken into consideration, inflation would be much higher.

The exchange rate movement is a reflection of the prevailing structural conditions of the economy, and therefore must not be seen as the remedy to addressing the external imbalance. While the Bank has undertaken measures to improve the functioning of the foreign exchange market, it is imperative for the Government to have cohesive policy measures to improve and diversify the export base and encourage imports substitutions.
Box 2: The Impact of AML/CTF Requirements on Monetary Policy Management

Monetary Policy is conducted under the Central Banking Act 2000, while crime proceeds and terrorism financing is monitored under the Anti-Money Laundering and Counter Terrorism Financing (AML/CTF) Act 2015, by the Financial Analysis and Supervision Unit (FASU), a unit within the Bank. It is operationally independent from the Bank. The AML/CTF Act is in line with the Financial Action Task Force’s (FATF) international standards. It requires commercial banks and financial institutions to undertake ongoing due diligence on their customers, and reporting suspicious transactions to FASU. The due diligence requirements are to combat transactions relating to crime and other illicit activities, but in the process have discouraged some genuine transactions from the financial system, including deposits. Most financial transactions in PNG, especially by the large informal sector and rural based population, are done through physical exchange of cash. Given this feature, customers or depositors who are unable to disclose their sources of funds are forced to keep them outside of the banking system. This would impact on the banks’ financial intermediation role of pooling funds from surplus sectors and lending to deficit sectors. In addition, the liquidity management and forecast of currency held by the public will remain challenging as well as the limited impact of monetary policy on the large informal and rural sectors. Thus, compounding the weak monetary policy transmission process. While the AML/CTF requirements contribute to the integrity of the domestic financial system and addressing the overseas correspondent banking relationships, it is also creating a challenge for monetary policy management and financial inclusion initiatives. BPNG, FASU and the commercial banks will work towards addressing these challenges.

Queries on the contents of the Monetary Policy Statement (MPS) should be directed to the Manager, Economics Department on telephone number (675) 3227309 or Manager, Monetary Policy Unit on telephone number (675) 3227312, or both on fax number (675) 3227182. 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.