



National Gazette

PUBLISHED BY AUTHORITY

(Registered at the General Post Office, Port Moresby, for transmission by post as a Qualified Publication)

No. G208]

PORT MORESBY, MONDAY, 4th JUNE

[2012

BANK OF PAPUA NEW GUINEA



**MONETARY POLICY STATEMENT
BY THE GOVERNOR OF
THE BANK OF PAPUA NEW GUINEA,
MR. LOI M. BAKANI**

PORT MORESBY

30th March 2012

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 2011 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

In 2011, PNG realized high economic growth as measured by the increase in real Gross Domestic Product (GDP) of 8.9 percent, while inflation for the year was a moderate 6.9 percent.

Real GDP growth is expected to remain buoyant in 2012 of around 8.0 percent, supported by strong domestic demand, as construction activity for the PNG Liquefied Natural Gas (LNG) project peaks, production at the Ramu Nickel/Cobalt mine commences, other private sector investments come on line, and high public and private spending ensues in the lead up to the national elections. All sectors are expected to grow, led by manufacturing, building and construction, and transportation/storage/communication.

The Bank projects annual headline inflation for 2012 to be around 8.0 percent, and both the exclusion-based and trimmed mean measures to be around 7.5 percent.

PNG has also experienced significant levels of excess liquidity within the banking system in recent years, which poses a threat to the soundness of the financial system and to macroeconomic stability. The main source of liquidity is the foreign exchange reserve build-up, stemming largely from dollar-denominated mineral tax earnings, inflows related to the PNG LNG project and other private foreign direct investments. Whilst liquidity does not seem to currently have an impact on inflation via private sector credit, despite strong economic growth, the Bank of PNG (Central Bank) is concerned about its potential adverse impact on price stability.

The balance of payments recorded a surplus in 2011 and is projected to increase further in 2012. This outcome is associated with inflows for the PNG LNG project and high export earnings. At the end of 2012, the gross foreign exchange reserves are projected to be around US\$5,087 (K10,598) million, sufficient for 7.6 months of total and 19.9 months of non-mineral import covers.

The increase in international reserves led to growth in the money supply and liquidity. The trends in growth of monetary aggregates as experienced in 2011 are expected to continue in 2012. In 2012, broad money supply is projected to increase by 14.8 percent, driven mainly by an increase in the Net Foreign Assets (NFA) of the banking system. Monetary base and private sector credit are projected to grow by 33.2 percent and 7.0 percent, respectively.

The Government projects a balanced budget of K10.5 billion for 2012, with emphasis on key priority areas, consistent with its medium term plans. However, any further increases in Government expenditure in relation to the national elections and rapid draw down of trust accounts at the Central Bank would exacerbate the already high levels of liquidity. It is therefore important that there is close coordination between fiscal and monetary policy to ensure macroeconomic stability.

In anticipation of the sizeable revenue inflows from the PNG LNG project, the Government enacted the Sovereign Wealth Fund (SWF) Act in February 2012. The SWF is expected to contribute to macroeconomic stability and provide ongoing funding to the Government budget. The funds will be managed on-shore and invested off-shore and therefore will minimise the effect of large foreign exchange inflows on domestic liquidity and reduce upward pressure on the exchange rate.

Given the projected strong domestic economic growth and associated demand pressures in 2012, the Bank will continue to assess the trade-off between high economic growth and inflation. The Bank will therefore maintain the tight policy stance and may adjust it to ensure the high level of liquidity is managed appropriately so that inflation is at an acceptable level and stability in the financial system is maintained.

1.0 Monetary Policy Discussions

1.1 Monetary Policy Assessment and Issues

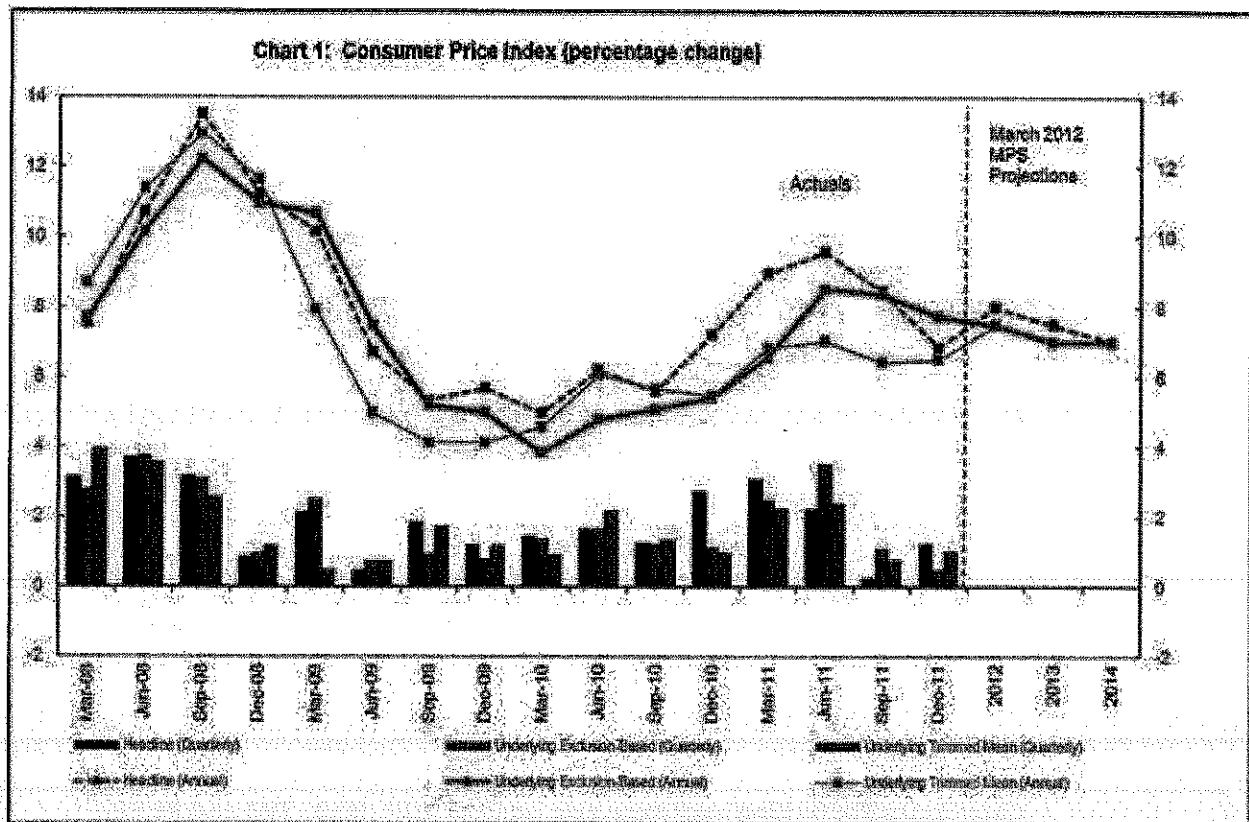
Annual headline inflation was 6.9 percent in the December quarter of 2011, lower than 7.2 percent in the December quarter of 2010, after peaking at 9.6 percent in the June quarter of 2011. The lower outcome was attributed to a decline in the price of betelnut and lower imported prices of food and fuel, supported by the appreciation of the kina exchange rate. Underlying inflation as indicated by the exclusion-based and trimmed mean measures were 7.7 percent and 6.5 percent in the December quarter of 2011, respectively. These outcomes were lower than the forecast made in the September 2011 MPS, despite the strong domestic demand associated with the PNG LNG project and high Government expenditures.

The Bank projects annual headline inflation for 2012 to be around 8.0 percent, while trimmed-mean and the exclusion-based inflation are projected to be around 7.5 percent. The forecasted headline inflation is lower than the 8.4 percent average for 2011, due to the strength of the kina, lower imported inflation, and stable international food and fuel prices. The kina is expected to remain strong through 2012, mainly due to high capital inflows and export receipts. While this has the effect of lowering inflation, it can adversely affect the traditional export sector. On the other hand, firms must be fair in the conduct of their businesses by passing the benefit of kina appreciation through lower prices to consumers. Inflation in PNG's major trading partners eased in the second half of 2011 and is expected to pass through to domestic inflation in 2012. Food, in particular cereal, and fuel prices dropped in the second half of 2011, though both have increased slightly in the first few months of 2012.

¹These foreign exchange inflows are then converted by the Bank of PNG into kina, and either spent or re-deposited by the Government largely at commercial banks, thereby adding to liquidity.

However, inflationary pressures still prevail, attributable to domestic demand pressures arising from the ongoing construction of the PNG LNG project and subsequent increase in business activity in 2012, and increased private and public spending in relation to the national elections. The elections will also increase the transactions demand for money. Supply-side shocks in early 2012, attributable to bad weather and subsequent damage to agricultural output and transport infrastructure are also expected to contribute to inflation.

For the medium term, headline inflation is projected to be around 7.5 percent in 2013 and 7.0 percent in 2014. These projections are based on a number of factors including the winding-down of the construction phase of the LNG project in late 2013, the continued strengthening of the kina and easing global demand (see Chart 1).

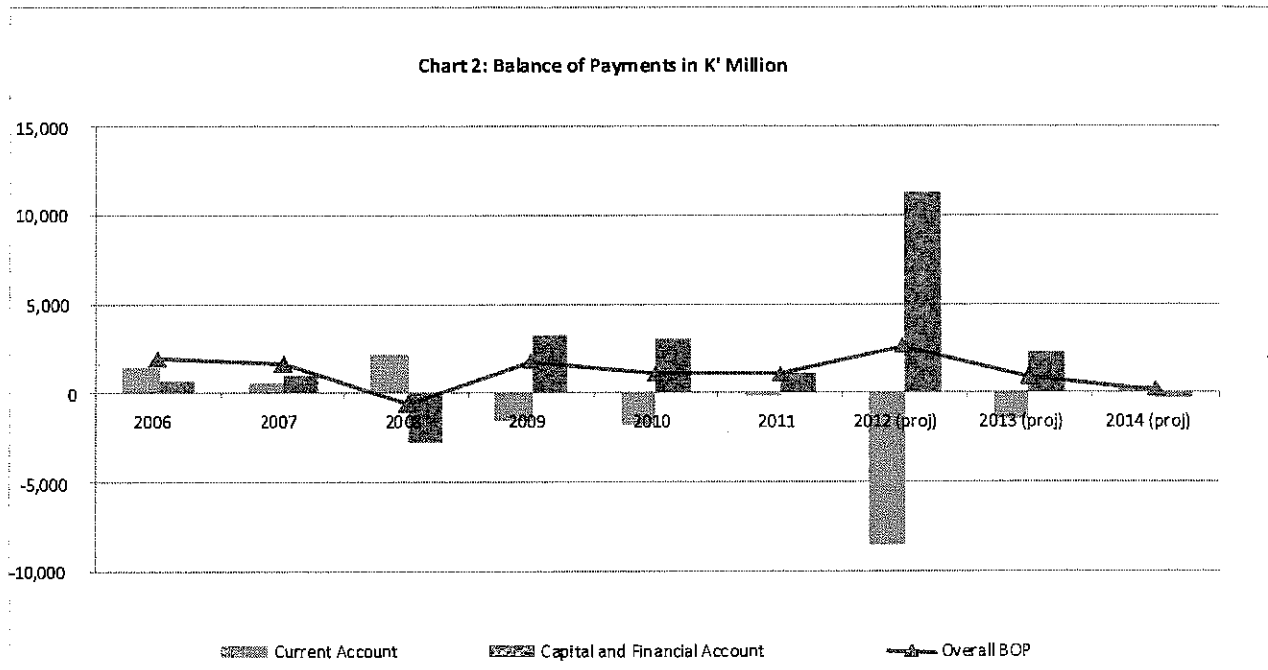


Source: National Statistical Office and Bank of PNG

There are upside risks to these projections, including higher domestic demand and associated inflation expectations by firms due to the PNG LNG project, any substantial increase in food and fuel prices, as well as higher than expected inflation in PNG's major trading partners. The European debt crisis and oil export embargo on Iran embodies further risks to global macroeconomic stability.

The global economic recovery continued to slow down during the second half of 2011, mainly driven by lower economic growth in both the advanced and emerging economies. The International Monetary Fund (IMF) accordingly revised downwards its global growth estimate for 2011 to 3.8 percent in the January 2012 World Economic Outlook (WEO) Update, from 4.0 percent in the September 2011 WEO. Global growth is now forecast to be at 3.3 percent in 2012 and 3.9 percent in 2013, down from 4.0 percent and 4.5 percent, respectively, projected in the September 2011 WEO. Easing inflation and concern over economic recovery has prompted central banks in the advanced economies to maintain their accommodative monetary policy stance, except for the European Central Bank (ECB) and Reserve Bank of Australia (RBA). Financial market volatility was high in the second half of 2011, mainly due to the European debt crisis, which caused investors to retreat to safe haven assets such as US government securities and gold.

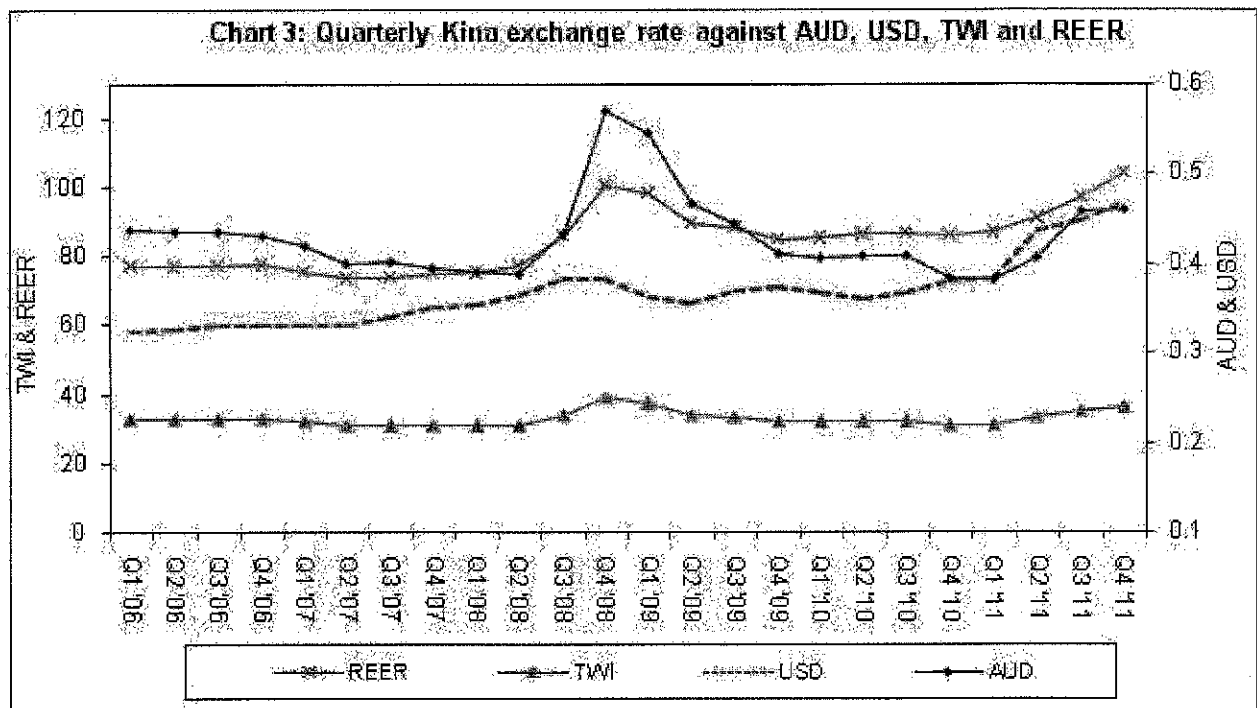
The overall balance of payments is projected to be in surplus by K1,371.3 million in 2012. This projected outcome is mainly associated with the inflows for the PNG LNG project and other private sector foreign direct investments. The current account is projected to record a deficit in 2012, attributed mainly to increased imports and higher net services and income payments related to the PNG LNG project (see Chart 2).



Source: Bank of PNG

By the end of 2012, the gross foreign exchange reserves are projected to be around US\$5,087 (K10,598) million, sufficient for 7.6 months of total and 19.9 months of non-mineral import covers. Gross reserves are projected to be higher in the medium term due to increased inflows associated mainly with high volumes of PNG's export commodities (See appendix - Table 2). As at 28th March 2012, the level of gross foreign exchange reserves was US\$4,283.4 (K8,794.6) million.

Reflecting the developments in the balance of payments, the daily average kina exchange rate appreciated against the US dollar by 19.9 percent to US\$0.4458 between the March quarter of 2011 and 28th March 2012. The appreciation reflected high agricultural and mineral export receipts, combined with inflows related to the construction phase of the PNG LNG project. The kina appreciated against the Australian dollar by 8.3 percent to A\$0.4276 over the same period. The appreciation was attributed to cross currency movements, as the Australian dollar weakened against the US dollar. As a result, the Trade Weighted Index (TWI) appreciated by 12.6 percent during the same period. The Real Effective Exchange Rate (REER) also appreciated by 7.6 percent during the December quarter of 2011 (see Chart 3)



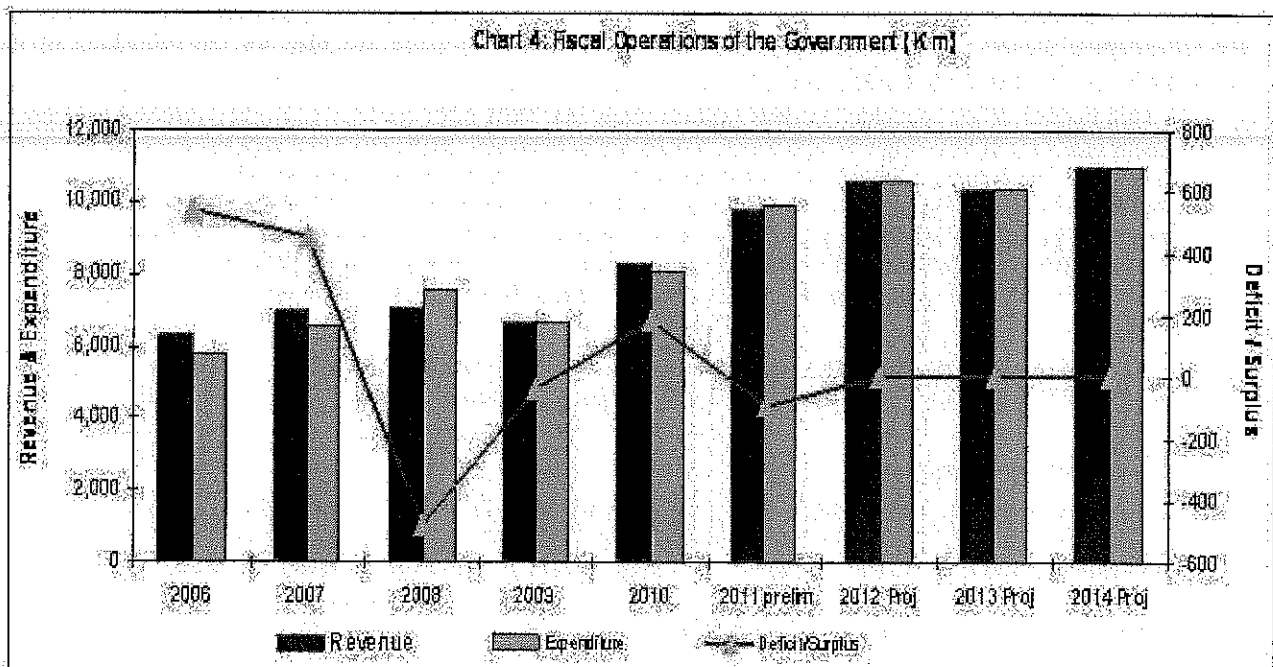
Source: Bank of PNG

The increase in international reserves led to the growth in money supply and liquidity. Annual growth in broad money supply (M3*) and monetary base in 2011 were 17.3 percent and 61.7 percent, respectively. The increase in broad money supply resulted mainly from increases in NFA of the depository corporations, while the substantial growth in monetary base mainly reflected increase in commercial bank deposits at the Central Bank. Lending to the private sector continued to grow moderately as a result of firms utilising own funds while those associated with the PNG LNG project received funding from the project. The Bank issued net new Central Bank Bills (CBBs) totaling K1,102.0 million, to diffuse some of the excess liquidity. However, domestic interest rates continued to fall, given the persistent high level of liquidity, with CBB rates at around 2.0 percent and Treasury bill rates at around 3.0 percent. Total liquidity of the banking system further increased by 37.2 percent to K8,888.4 million in 2011, due to high Government expenditure and foreign exchange inflows. Net claims on the Government declined by K846.7 million in 2011, mainly due to increased deposits in the trust accounts. In the first quarter of 2012, the Bank issued additional net CBBs of K92.4 million. Excess liquidity continued to remain high, therefore the Bank increased the CRR by an additional 1.0 percent.

In 2012, broad money supply is expected to increase by 14.8 percent, driven mainly by increase in NFA of the banking system. Monetary base and private sector credit are projected to grow by 33.2 percent and 7.0 percent, respectively. The Bank considers the projected growth in monetary aggregates appropriate to support economic growth, but is also mindful of their inflationary impact, for instance if growth in private sector credit picks up (see Appendix-Table 1).

Economic activity in PNG as measured by real GDP growth for 2011 is estimated by the Bank to be higher than the 8.9 percent projected in the 2012 National Budget, with increases in all sectors. The annual level of employment in the formal private sector² increased by 6.2 percent in the December quarter of 2011. The construction of the PNG LNG project, Government-donor funded projects, combined with strong growth in private sector activity contributed to higher employment. Excluding the mineral sector, the annual level of employment also grew by 6.2 percent in the December quarter of 2011. In addition, the total nominal value of sales by the private sector² remained high, over the twelve months to September 2011. Strong economic growth is expected to continue in 2012, as construction activity for the PNG LNG project reaches its peak, combined with high Government spending, especially related to the national elections and commencement of production by the Ramu Nickel/Cobalt mine. All sectors are expected to grow, led by the mining and quarrying, manufacturing, building and construction, and transportation/storage/communication sectors.

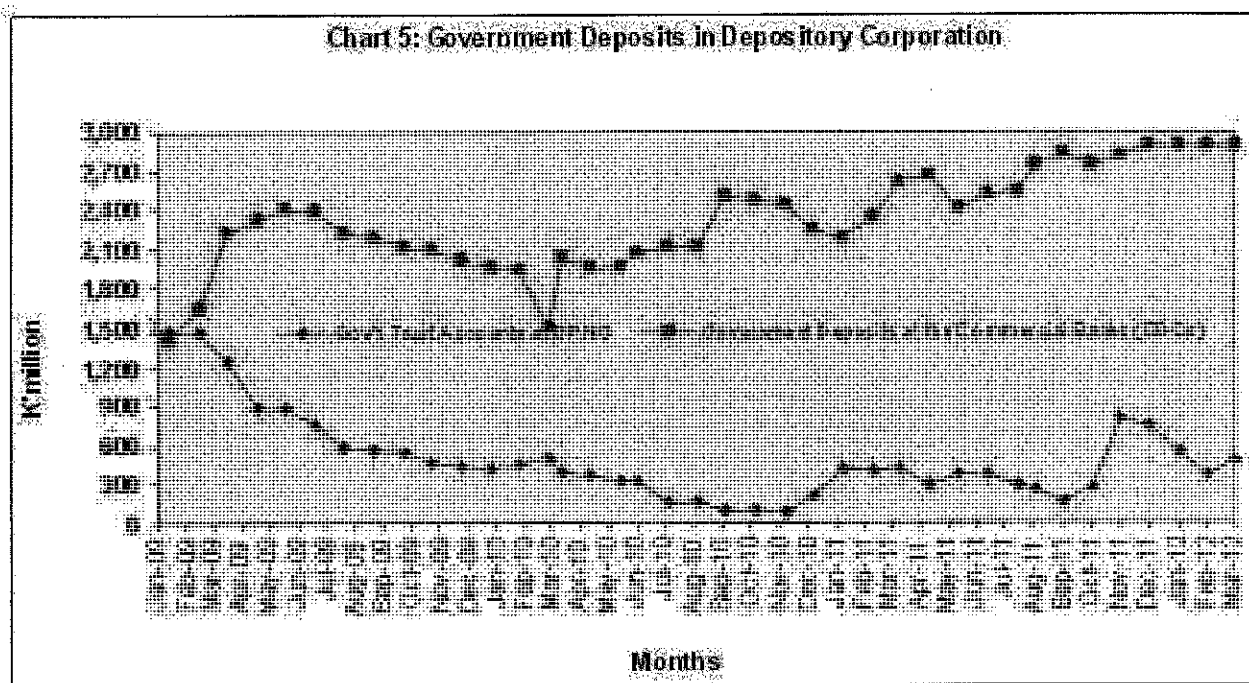
The 2012 National Budget was framed against the uncertainty in the global economy and high domestic economic activity. The Government projects a balanced budget of K10.5 billion, with emphasis on increased spending in the priority areas of education, transport, law and order, and health, consistent with the Medium Term Fiscal Strategy (MTFS) and Medium Term Development Plan (MTDP). The Government also projects balanced budgets for 2013 and 2014 of similar magnitude (see Chart 4). Public debt is projected to be 23.2 percent of GDP in 2012, compared to 24.1 percent in the 2011 revised estimates. The lower ratio is mainly due to an increase in GDP.



Source: Dept of Treasury

² Based on the Bank's surveys. Not all companies engaged in the PNG LNG project are included in the surveys.

Under the 2011 original budget, K723.2 million was appropriated for specific project trust accounts. This was not fully funded and therefore the 2011 Supplementary Budget allocated a further K648.5 million to be deposited in trust accounts at the Central Bank. However, only K433.0 million has been deposited as at December 2011. Despite the Government's undertaking to open and transfer trust account funds to the Central Bank, Government deposits including trust accounts in commercial banks continue to remain high totaling K2,884.3 million. Thus, at the Central Bank, the amount of trust account funds decreased from K741.3 million in September 2011 to K366.3 million as at 23rd March 2012 (see Chart 5).



Source: Bank of PNG & Dep't of Treasury

Depositing all Government trust account funds at the Central Bank and smooth spending of those funds over time will assist with liquidity management. In light of the PNG LNG project related payments and the national elections in 2012, the Government should prudently manage its fiscal operations within the parameters of the Budget. Furthermore, the Government should refrain from competing with the PNG LNG project and plan for the utilization of these resources when the construction phase ends.

In anticipation of the sizeable revenue inflows from the PNG LNG project and other mineral projects, the Government enacted the Sovereign Wealth Fund (SWF) Act in February 2012. The Fund will be managed through the Stabilisation and Development Funds, and is expected to contribute to macroeconomic stability and provide ongoing funding to the Government budget. It will be managed on-shore, with funds invested off-shore and spent on-shore. This will minimise large foreign exchange inflows and reduce upward pressure on the exchange rate, thereby mitigating the effect of Dutch Disease. Until the SWF comes into operation, the Government should deposit revenue inflows from mineral taxes in an offshore account to be managed by the Central Bank. This will also assist the Bank in its liquidity management efforts.

In light of these developments, closer coordination and cooperation between the Treasury and Finance Departments and the Bank in the conduct of fiscal and monetary policies is necessary to maintain macroeconomic stability.

1.2 Monetary Policy Stance

The main issue that the Central Bank is confronted with is the increasing level of liquidity in the banking system in recent years, caused by the foreign exchange reserve build-up related largely to dollar-denominated mineral tax earnings, high export earnings, inflows related to the PNG LNG project and other private foreign direct investments. Whilst the high liquidity levels do not appear to influence inflation via the credit channel despite strong economic growth, it is still a threat to price stability and soundness of the financial system.

Upside risks to the Bank's projection of 33.2 percent in monetary base would come from:

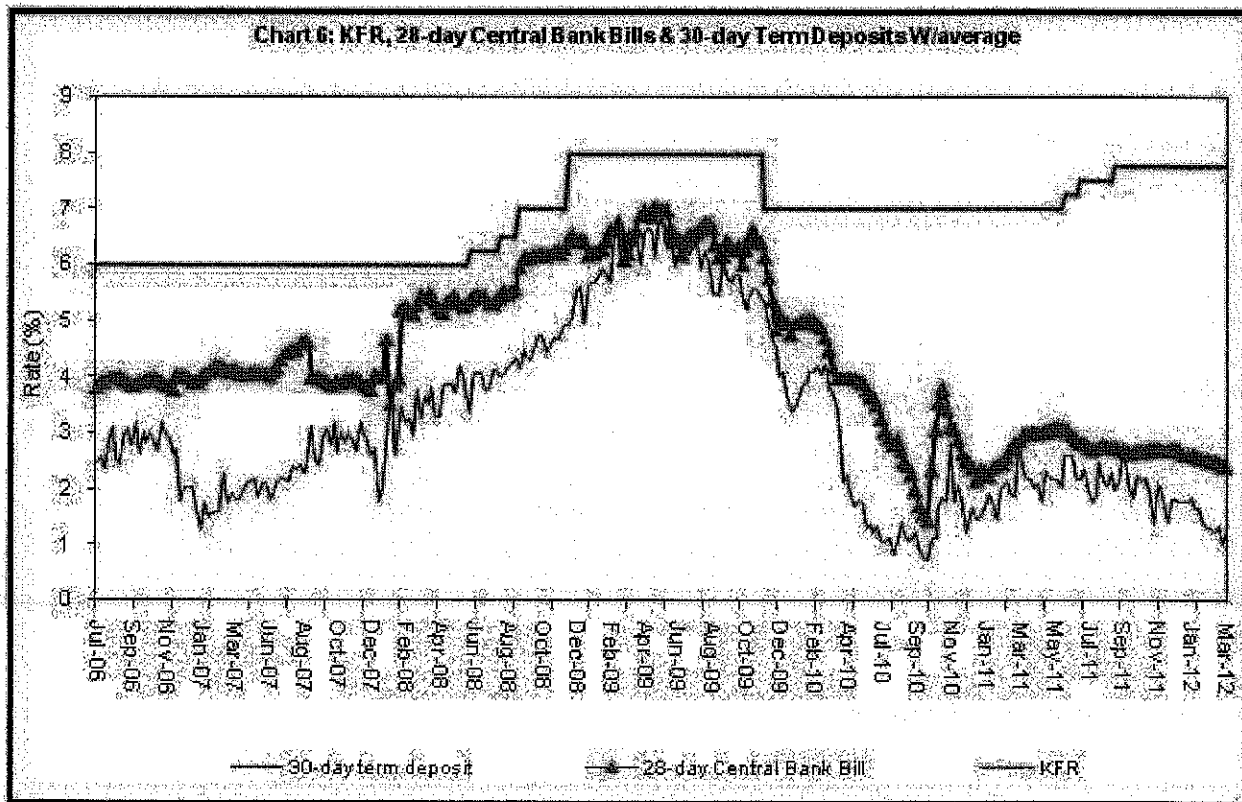
- faster drawdown of trust accounts from the Central Bank;
- higher than budgeted overall expenditure by the Government;
- higher transactions demand for money during the national elections; and
- continued high inflows of foreign exchange.

Some or all of these, if realized, could potentially lead to price instability and adversely affect business confidence.

In addition, the upside risks to the Bank's inflation projection of around 8.0 percent in 2012 include:

- significantly higher domestic demand pressures and inflation expectations;
- any substantial increase in food and fuel prices;
- higher than expected inflation in PNG's major trading partners;
- any supply-side shocks associated with bad weather; and
- impact of the European debt crisis and oil export embargo on Iran.

As a result of this concern on high level of liquidity and potential impact on price stability, the Central Bank maintained a tight monetary policy stance by leaving the KFR unchanged at 7.75 percent in the December quarter of 2011 and March quarter of 2012 (see Chart 6). To support the tight stance, the CRR was increased from 6.0 percent to 7.0 percent in March 2012. Given the projected strong economic growth and associated demand pressures in 2012, the Bank will continue to assess the trade-off between high economic growth and inflation. The Bank will therefore maintain this policy stance and may adjust it to ensure the high level of liquidity is managed appropriately so that inflation is at an acceptable level.



Source: Bank of PNG

1.3 Conduct of Monetary Policy

Monetary policy will be conducted within the reserve money framework. The MPS provides the overall monetary policy stance, while the monthly KFR remains the instrument for signaling 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 and Treasury bills to the general public. The Bank will also consider using its direct policy instrument, the CRR, to assist in liquidity management.

In 2012 the Bank plans to introduce the Tap facility for small retail investors to participate in the Government securities market.

The Bank will continuously assess developments in the market and use all the instruments at its disposal to ensure that financial stability is maintained and inflation is at an acceptable level.

Appendix

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

INDICATOR	2008 (actual)	2009 (actual)	2010 (actual)	Sep 2011 MPS	2011 (Actual)	2012 (proj)	2013 (proj)	2014 (proj)
Broad Money Supply	11.2	21.8	10.2	14.6	17.3	14.8	10.8	7.4
Monetary Base	-12.0	11.9	11.1	48.7	61.7	33.2	18.6	16.0
Claims on the Private Sector	28.0	15.1	18.1	14.5	6.8	7.0	5.8	7.5
Net Claims on Gov't	-174.3	-694.6	-130.2	563.5 ³	-419.3	-46.8	-115.3	-51.3
Net Foreign Assets	-14.0	27.0	20.2	11.2	13.2	12.9	8.0	2.4

Source: Bank of PNG

Table 2: Summary of Other Macroeconomic Indicators

INDICATOR	2008 (actual)	2009 (actual)	2010 (actual)	Sep 2011 MPS	2011 (Actual)	2012 (proj)	2013 (proj)	2014 (proj)
CONSUMER PRICE INDEX (annual % changes)								
Headline	11.2	5.7	7.2	9.0	6.9	8.0	7.5	7.0
Trimmed-mean	11.7	4.1	5.5	8.0	6.5	7.5	7.0	7.0
Exclusion- based	11.0	5.0	5.4	8.5	7.7	7.5	7.0	7.0
BALANCE OF PAYMENTS (kina millions)⁴								
Current account	2,145	-1,612	-1,750	-13,297	-113	-8,551	-1,487	408
Financial account	-2,861	3,220	2,934	15,144	1,089	11,127	2,245	-300
Overall balance	-598	1,782	1,066	825	1,097	2,674	861	208
Gross Int. Reserves	5,321	7,104	8,170	8,995	9,266	10,598	11,458	11,667
IMPORT COVER (months)								
Total	7.5	10.8	10.2	6.5	11.5	7.6	13.0	13.3
Non-mineral	10.8	14.8	13.9	17.7	16.7	19.9	19.4	18.5
EXPORT PRICE								
Crude oil (US\$/barrel)*	106.7	59.0	78.8	107.2	117.5	110.9	109.7	108.4
Gold (US\$/ounce)	850.9	968.6	1,187.3	1,547.1	1,538.4	1,716.8	1,569.2	1,373.0
Copper (US\$/pound)	327.8	217.6	333.4	419.0	408.2	393.1	416.3	370.1
FISCAL OPERATIONS OF THE GOVERNMENT**								
Surplus/Deficit (K'm)	-478.5	-35.9	186.3	0.0	-85.8	0.0	0.0	0.0
% of GDP	2.2	0.2	0.7	0.0	0.3	0.0	0.0	0.0
REAL GROSS DOMESTIC PRODUCT (annual % growth) ***								
Total GDP	6.6	5.5	7.1	9.3	8.9	7.8	3.8	6.5
Non-mineral GDP	7.6	6.3	7.3	8.2	10.8	7.4	3.6	3.0

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

** Preliminary fiscal operations up to December 2011. 2012 - 2014 projections are from the 2012 National Budget.

*** GDP figures are from the 2012 National Budget. 2011 is an estimate, while 2012 - 2014 figures are projections.

Source: Bank of PNG, NSO and Department of Treasury

³ Reflects increased negative net claims on the Government associated with increased deposits at Depository Corporations.⁴ For 2012, imports for the PNG LNG project are included in the annual projections but not in the actuals to December 2011.