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BANK OF PAPUA NEW GUINEA

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

PORT MORESBY

31st March 2016

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 are also available on the Bank's website: http://www.bankpng.gov.pg. It will be reproduced in the March 2016 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

Papua New Guinea faced issues of low export commodity prices, temporary closures of two major mines and an oil refinery, and adverse El Niño effects on the agricultural sector but still recorded its fourteenth year of successive economic growth in 2015. The growth was mainly due to the full-year production of liquefied natural gas by the PNG LNG project, supported by the Government's continued expansionary fiscal policy, financed mainly through domestic financing. The low international commodity prices led to lower foreign exchange inflows and impacted adversely on National Government revenue. The foreign exchange earnings of the LNG exports are used to service loan commitments, which have the first call, and the balances are kept in offshore foreign currency accounts, as with other mineral projects, under the project development agreement. The expected tax and dividend payments from the LNG project were significantly lower than budgeted in 2015, due to lower prices and the provision of accelerated depreciation, which allows project partners to depreciate their fixed assets at a faster pace early in the project life.

All those factors contributed to the low supply of foreign currency relative to its demand in the domestic foreign exchange market, exacerbated by the backlog of import orders. With the imbalance in the foreign exchange market, the Central Bank continued to assist in meeting some of the import demand by selling foreign exchange from its reserve holdings. Since 2012, the amount used for intervention has been substantial. In 2015 the amount was US$828.5 million. This contributed to the decline in the international reserve level from US$2,342.1 (K5,980.7) million at the end of December 2014 to US$1,865.1 (K5,226.3) million at the end of December 2015.

In spite of the depreciation of the kina over 2015, headline inflation outcomes have been at manageable level, averaging 6.0 percent for the year. Annual headline inflation was 6.4 percent in 2015. Considering this and other relevant macroeconomic indicators, including inflationary expectations, the Bank maintained a neutral stance of monetary policy throughout the year. Annual headline inflation for 2016 is projected to be 6.5 percent, while the underlying inflation measures are expected to be between 4.0 percent and 5.0 percent. The lower economic growth and other projected developments for 2016 are not expected to be inflationary. The Bank will maintain its neutral stance of monetary policy over the next six months but may adjust the stance if changes in economic conditions warrant it.

The Central Bank has to tread a fine line between movement of kina exchange rate and being responsible for its monetary policy objective of price stability, both of which have been and are taken into account in its decisions on the conduct of monetary policy. The conduct of monetary policy is a challenge, given the above issues and when one of the channels of transmission of monetary policy does not work as efficiently as it should. Given the oligopolistic nature of the banking system in PNG, the transmission of monetary policy through the interest rate channel has been weak, especially under the prevailing high liquidity condition. The Bank is therefore considering an alternative monetary policy mechanism in the conduct of monetary policy that would enable a better transmission from the policy rate to market interest rates.

Monetary Policy Discussions

1. Monetary Policy Assessment, Issues and Expectations

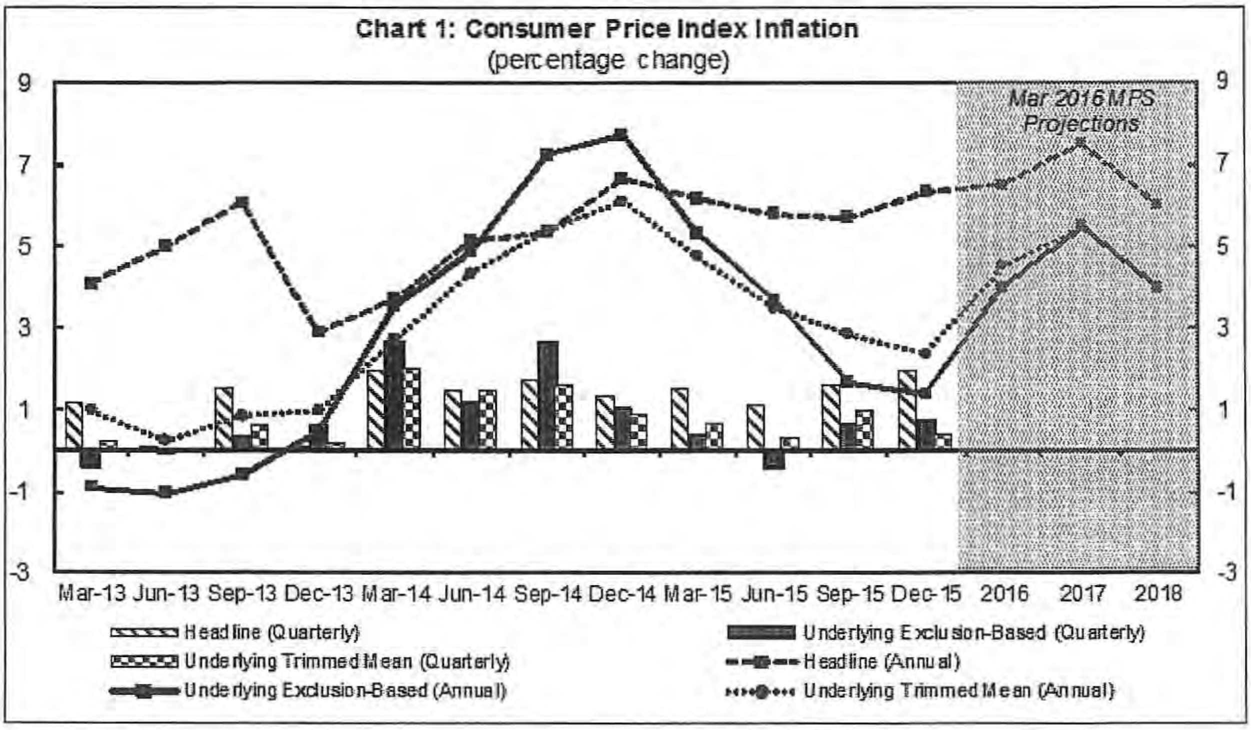
Economic growth was lower in 2015 compared to 2014. Declines in economic activity in the mining sector, as a result of the temporary closures of the Ok Tedi and Porgera mines and Napa Napa Oil refinery and lower production and exports of some agriculture commodities partially offset a significant increase in LNG production and export. The low commodity prices resulted in lower than budgeted revenue for the Government, which led to passage of a Supplementary Budget, in which expenditure was revised downwards and additional revenue measures were introduced. This led to lower provisional budget deficit of 3.2 percent compared to the 4.9 percent in the Supplementary Budget. The budget deficit was financed from domestic sources. High import demand and lower foreign exchange inflows from LNG and other export commodities, contributed to the imbalance in the foreign exchange market and the depreciation of the kina. The Bank continued to intervene by selling foreign currency in the foreign exchange market to assist meet some of the demand.

For this year, real GDP growth is projected to be 4.3 percent as per the 2016 National Budget, driven by activity in the non-mineral sectors, resumption of production at Ok Tedi mine, increased production at Ramu Nickel and Cobalt mine and an increase in activity in some parts of rural PNG as a result of infrastructure development.The prevailing low international commodity prices, low export receipts and downward pressure on the kina exchange rate are expected to continue in 2016. The Government has provisioned for external financing to fund its infrastructure and development programs as well as to refinance domestic debt.

The non-mineral sectors have the potential for inclusive growth and employment opportunities. It is therefore critical that the Government implement the Small Medium Enterprise (SME) initiatives, agriculture reforms, structural reforms and introduce appropriate trade and investment policies to help boost growth in the non-mineral sectors. The Government's initiatives to encourage more SME participation with adequate funding and monitoring and evaluation will support and generate more employment opportunities and encourage greater participation in economic activity. Innovation in agriculture production through research and development, increased agricultural extension programs, improved quality controls and accessibility to markets are vital to boost production in the agriculture sector. This would broaden the economic base and encourage investments in down-stream processing that will expand the manufacturing sector. Also, appropriate concessions are needed to attract more foreign direct investments into the non-mineral sector. All these will help reduce the economy's dependence on the mineral sector. These initiatives must be supported by further improvement to key infrastructure and reforms to public utility services to enhance reliability and efficiency. Continued investment in health, education and law and order is also important. The Government should take a holistic approach in its policies to encourage growth and job creation in all productive sectors of the economy.

Although the kina continued to depreciate over 2015, inflation in Papua New Guinea has been manageable and close to the Central Bank's projections. Annual headline inflation was 6.4 percent in 2015, compared to 6.6 percent in 2014. This outcome was mainly due to the pass-through effects of the depreciation of the kina exchange rate and the El Niño weather phenomenon, which more than offset the effects of low international food and oil prices, increased competition and cheaper imports. The annual trimmed-mean and exclusion based measures for underlying inflation were 2.4 percent and 1.4 percent, respectively, in 2015.

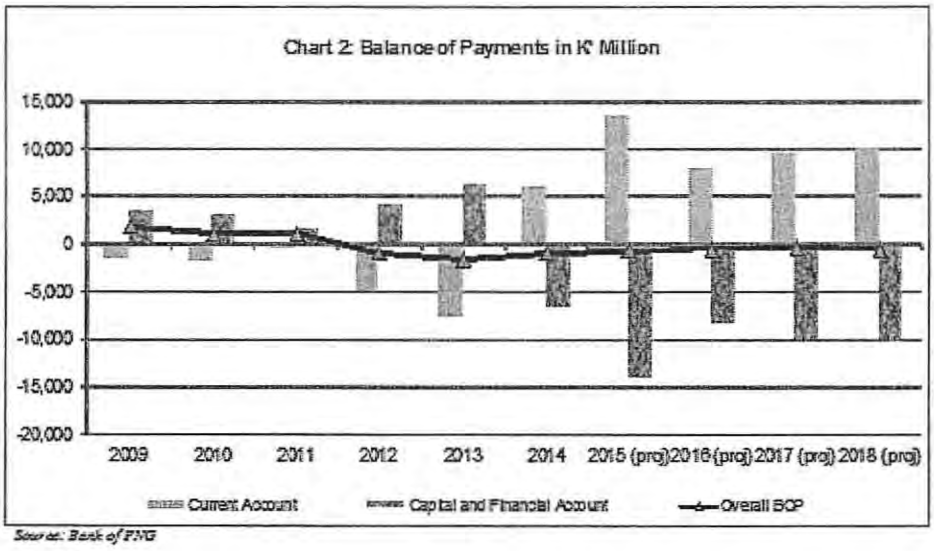
The Bank projects annual headline inflation in 2016 to be 6.5 percent and the trimmed-mean and the exclusion-based underlying measures to be 4.5 and 4.0 percent, respectively. Over the medium term, the Bank projects annual headline inflation to increase to 7.5 percent in 2017 and then ease to 6.0 percent in 2018 (see Chart 1). The projections for 2016 assume a weaker outlook for the domestic economy. The effect of the depreciation of kina is being partly offset by lower international oil prices, lower imported inflation feeding through and firms absorbing a part of the cost of depreciation due to competition. In 2017, inflation is expected to increase in line with an anticipated gradual recovery in the global economy, National Election related expenditures, and spending associated with preparations for hosting the APEC meetings in 2018.



Source: Bank of PNG &NSO

There are upside risks to these projections. These include higher than expected imported inflation from our major trading partners, any excessive Government spending and unforeseen supply shocks, such as adverse weather conditions.

The overall balance of payments is projected to be in deficit of K510.4 million in 2016, with a deficit in the capital and financial account more than offsetting a surplus in the current account. The current account is projected to be in surplus of K7,962.6 million, mainly due to expected higher exports reflecting increased production of nickel and cobalt, resumption of production at the Ok Tedi mine and on-going production of LNG, condensate and naphtha. The capital and financial account is projected to be in deficit of K8,472.9 million, mainly reflecting expected outflows associated with debt service payments by the PNG LNG project partners and balances in offshore foreign currency accounts (FCAs) by mineral and petroleum companies (see Chart 2).



Source: Bank of PNG

In the medium term, the current account is projected to record surpluses when there are increased inflows from mineral receipts. The capital and financial account is expected to record deficits reflecting LNG revenue held in offshore foreign currency accounts for loan repayments by PNG LNG project partners.

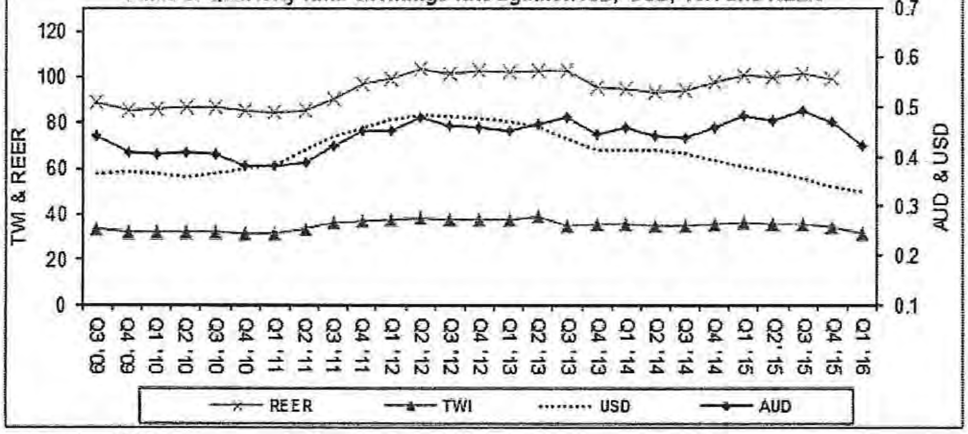
As at 31st December 2015, the level of gross foreign exchange reserves was US$1,865.1 (K5,226.3) million, sufficient for 10.0 months of total and 15.8 months of non-mineral import covers. By the end of 2016, the level of foreign exchange reserves is projected to be US$1,700.0 (K5,182.9) million. The lower level of reserves mainly reflects further declines in international commodity prices due to lower global demands combined with increased demand for imports. If the planned sovereign bond issue or other foreign exchange borrowings are successful, the reserves level would be higher than projected and would assist in clearing some of the outstanding orders in the foreign exchange market (See Appendix – Table 2).

The kina exchange rate continued to depreciate due to the persistent imbalance in the foreign exchange market. Demand for foreign currency remained high relative to supply due to high Government expenditure, backlog of import orders and low inflows. The kina depreciated against the US dollar (USD) from US$0.3855 at the end of December 2014 to US$0.3325 at the end of December 2015 by 13.7 percent. Over the three months to 30th March 2016, the kina exchange rate depreciated by 2.7 percent against the USD to US$0.3235 due to the strengthening of the USD, and lower export receipts. The kina exchange rate also depreciated against the Australian dollar (AUD) over the same three months period by 5.6 percent to AU$0.4236 as the AUD strengthened against the USD on the back of favourable economic data, including GDP outcome for the final quarter of 2015.

The Trade Weighted Index (TWI) decreased by 5.6 percent over the three months to 30th March 2016. The Real Effective Exchange Rate (REER) depreciated by 2.4 percent in the December quarter of 2015, compared to the September quarter, reflecting the depreciation of kina against all major currencies (see Chart 3).

The depreciation of the kina over 2015 and over the first quarter of 2016 has been significant. This would have benefited exporters through higher kina prices and income and should have induced a supply response in exports. Poor transport infrastructure, a lack of market accessibility and senility in trees are among factors that contribute to a weak supply response in agriculture commodity production and exports. On the other hand, the depreciation should have discouraged import demand, but this has not happened because of PNG's high dependency on imports and firms diversifying to cheaper sources. Given the foreign exchange market conditions, companies are re-adjusting their business operations to sustain their profitability. How far should the kina depreciate to clear the market? The conventional argument for free movement in exchange rate to clear the market may not necessarily hold in PNG. The Central Bank has to tread a fine line between movement of kina exchange rate and being responsible for its monetary policy objective of price stability, both of which have been and are taken into account in its decisions on the conduct of monetary policy.

Chart 3: Quarterly Kina exchange rate against AUD, USD, TWI and REER



Source: Bank of PNG

The Foreign Exchange Control (FEC) Directives announced by the Governor in March 2015 requires the authorized foreign exchange dealers and their customers comply with the directives and all exporters not operating under a project development agreement to repatriate export proceeds onshore within three months from shipment date. A ban on opening of new domestic and offshore FCAs remains in force, however, any interested applicant with a genuine need for a FCA can apply directly to the Bank. In addition, documentation requirements were introduced to ensure only goods and services related orders are fully documented and prioritised for settlement.

The Bank commenced an exercise in 2015 to identify the number of offshore FCAs held by resident companies and individuals. The aim of the exercise was to establish if there were surpluses in the FCAs that can be repatriated onshore to assist the foreign exchange market. The FCAs held offshore belong to the mineral and petroleum companies and were approved by the Bank, while those opened under the LNG project development agreement were granted exemption by the State from the application of exchange control requirements. Other offshore FCAs are owned by non-mineral companies.

The preliminary fiscal outcome of the National Government for 2015 shows a deficit of K1,613.6 million or 3.2 percent of nominal GDP compared to a deficit of K2,491.8 million or 4.9 percent of nominal GDP in the 2015 Supplementary Budget. The lower deficit is partly attributed to some deferred expenditures from the 2015 Budget. Revenue was much lower than the initial estimates mainly due to lower commodity prices and LNG tax revenue. Therefore, a supplementary budget was passed in November 2015, in which the Government introduced some expenditure cuts and additional revenue measures including dividend payments from State Owned Enterprises (SOE) and increased tax collection from outstanding dues. Public debt to GDP ratio was 34.7 percent.

Public debt comprised mostly of domestic securities and external concessional borrowing. Papua New Guinea has a positive track record of debt management and has never defaulted, rescheduled or being late in its debt servicing.

In the 2016 National Budget, the Government plans for expenditure of K14,762.6 million and revenue of K12,650.1 million, a deficit of K2,112.5 million or 3.8 percent of nominal GDP. The Government continues to focus on priority areas such as infrastructure, agriculture, law and order, education and health services. Investments in these areas will support the non-mineral sector in increasing the productive capacity of the economy and sustaining economic growth. Some international commodity prices are already lower than those contained in the National Budget. If this persists, Government revenue could be lower than budgeted and the Government would need to pursue prudent fiscal management by adjusting expenditure to be in line with actual revenue.

To finance the deficit, the Government plans to raise funds mainly from external sources. It projects to borrow K765.5 million through concessional borrowing and K2,800.0 million from other offshore sources, from which it will fund infrastructure and development projects as well as refinance existing debt. The Government is expected to continue to issue Treasury bills and Treasury bonds (previously Inscribed Stocks) throughout the year to meet its cash flow requirements. In the domestic market, demand has declined as some major players have reached their limits on Government debt, although the market has sufficient liquidity. Public debt is projected to increase to 35.8 percent of GDP in 2016.

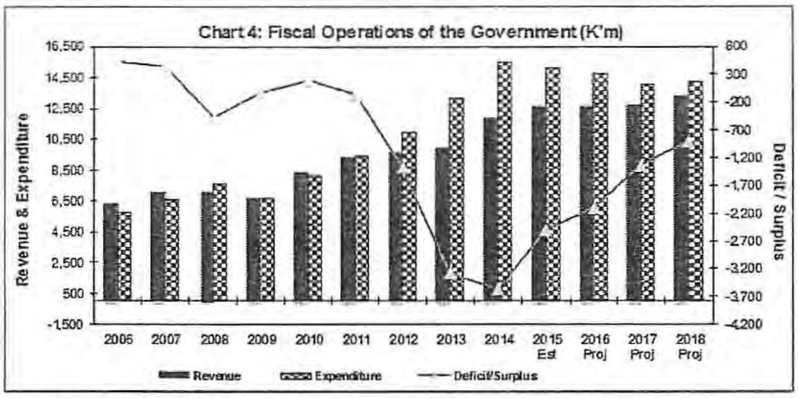
The Bank forecasts growth in broad money supply of 5.2 percent in 2016, compared to 6.7 percent in 2015, resulting from an expected increase in net domestic assets of the banking system, particularly net credit to the Government. Private sector credit is expected to grow by 4.4 percent, while monetary base is projected to increase by 2.2 percent. The increase in monetary base takes into account higher commercial bank deposits at the Central Bank. The Bank considers the projected increases in the monetary aggregates sufficient to support the forecast growth in the non-mineral private sector in 2016 (see Appendix-Table 1).

The persistent high level of liquidity in the banking system is contributing to the weak transmission of the KFR to market interest rates. The Bank is therefore considering an alternative policy mechanism that may work better in influencing market interest rates (See Box).

The implementation of the Kina Automated Transfer System (KATS) has made the national payment system more efficient, safer and cost effective. It has improved the intermediation process of payment and settlement. Cheques are now cleared within three days. More Government departments and agencies are using the system and this has enhanced their cash flow management.

To comply with international requirements on combating money laundering and terrorism financing, the Government had passed new laws in 2015. These laws were designed to meet the Financial Action Task Force standards to assist PNG meet its international obligations on these matters. PNG's Financial Intelligence Unit has been relocated from the Police Department to the Central Bank and renamed as Financial Analysis and Supervision Unit. This Unit is responsible under the Anti-Money Laundering/Counter Terrorism Financing Act 2015 for analyzing suspicious financial transaction and referring any transactions that are deemed suspicious of money laundering to law enforcement bodies for investigation and prosecution.

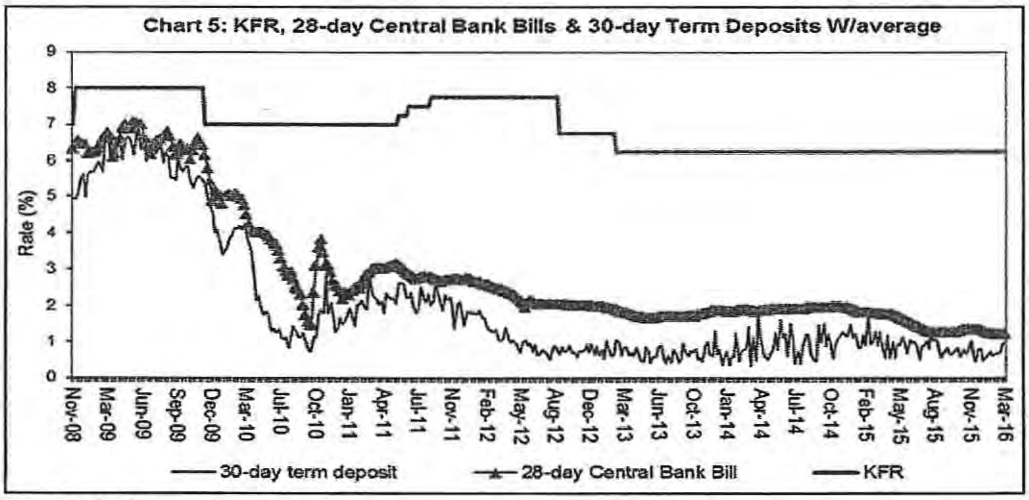
The enactment by Parliament of the new Organic Law on the Sovereign Wealth Fund in July 2015 repealed and replaced the previous Organic Law enacted in February 2012, pending gazettal to give effect. There are some proposed amendments to be enacted by Parliament. The Government will then proceed to develop the subordinate legislations and the necessary administrative structures, to fully operationalize the PNG SWF. These include the establishment of the SWF Board and the Administrative Secretariat. The Government needs to ensure an independent and self-sustaining PNG SWF is established for its intended objectives, including that of macroeconomic stabilization and benefits for future generation.



Source: 2016 National Budget & 2015 preliminary outcome.

2. Monetary Policy Stance

The lower economic growth and other expected developments in 2016 are not expected to be inflationary, as reflected in the projected inflation of 6.5 percent. The Bank will therefore maintain its neutral stance of monetary policy. This stance is aimed at supporting economic activity. The Bank will continue to monitor developments and may adjust its stance as necessary.



Source: Bank of PNG

3. **Conduct of Monetary Policy**

Monetary policy is managed within the reserve money framework. The MPS provides the overall policy stance, while the monthly policy rate signals this stance or any changes through an announcement by the Governor. Following the announcement, Open Market Operations (OMOs) are conducted to implement the policy stance. The OMOs involve the auction of Central Bank Bills (CBB), Treasury bills and Inscribed stock to Other Depository Corporations and the general public, and Repo transactions with commercial banks.

Over the three months to 11th March 2016, the Government made a net issuance of K510.2 million in Treasury bills, while retiring K194.5 million in Inscribed stock. On the other hand, the Central Bank issued K286.5 million of CBBs. The increased issuance of Government securities and Central Bank intervention in the foreign exchange market partly diffused some of the excess liquidity in the banking system.

The CBB Tap facility will continue to operate to allow small retail investors to participate in the securities market and help develop a savings culture in the country. Participation however has been low mainly due to limited access to the facility from other centers of the country and the interest withholding tax rate charged on the earnings.

The implementation of the Kina Automated Transfer System (KATS) has made the national payment system more efficient, safer and cost effective. It has improved the intermediation process of payment and settlement, and enhanced liquidity management by the participants. Government departments and agencies that are connected to the financial institutions by the KATS have improved their cash flow management. Cheques are now cleared within three days. There is scope to diversify participation in the TAP facility and Treasury bill sales to centers outside Port Moresby using the new payments system.

The Bank's internal research work shows that there is a weak transmission of the KFR to market interest rates. This is largely due to the high level of liquidity in the banking system since 2009. The Bank is considering replacing the KFR with a market determined interest rate that can influence market rates as its monetary policy signaling rate (see Box). This change to the monetary policy signaling rate will be announced at a later date.

Box: Reform to the Monetary Policy Signaling Rate

In an effort to enhance efficiency in the transmission of monetary policy and facilitate the continued development of the financial market, BPNG has decided to make some changes to its policy signaling rate and the conduct of monetary policy.

Kina Facility Rate (KFR) to be replaced by a market-based interest rate- 63-day T-bill rate

The KFR will be replaced by a market based interest rate, the 63-day Treasury bill rate that is determined by the market at the primary auction. This new monetary policy rate will signal the Banks' monetary policy stance. The decision making process and announcement of the new monetary policy rate will remain unchanged. The new monetary policy rate will be used as the reference point for interbank transactions and transactions between the commercial banks and the Central Bank, including the Repurchase Agreement (Repo) facility. The 63-day Treasury bill rate is what the financial institutions, including commercial banks, earn on their investment. Changes to this rate can influence the deposit rates that the banks pay on the depositors' accounts, which in turn is expected to influence the lending rate. When this happens, there is transmission from the policy rate to market interest rates.

The Bank will implement the new monetary policy signaling rate following the release of the March 2016 Monetary Policy Statement (MPS) and after consultations and awareness with market stakeholders. Further details of these arrangements will be announced at a later date.

Appendix

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

INDICTOR	2013 (actual)	2014 (actual)	2015 (Actual)	2016 (proj)	2017 (proj)	2018 (proj)
Broad Money Supply	6.5	1.2	6.7	5.2	5.1	5.3
Monetary Base	0.5	37.1	-2.2	2.2	3.5	4.2
Claims on the Private Sector	17.3	2.2	4.9	4.4	4.6	5.9
Net Claims on Gov't	462.0	48.3	40.1	3.1	1.4	-1.7
Net Foreign Assets	-11.8	-16.0	-10.8	-12.7	-3.1	-13.9

Source: Bank of PNG

Table 2: Summary of Other Macroeconomic Indicators

INDICATOR	2013 (actual)	2014 (actual)	2015 (Actual)	2016 (proj)	2017 (proj)	2018 (proj)
CONSUMER PRICE INDEX (annual % changes)						
Headline	4.7	6.6	6.4	6.5	7.5	6.0
Trimmed-mean	1.8	6.1	2.3	4.5	5.5	4.0
Exclusion-based	5.9	7.7	1.4	4.0	5.5	4.0
BALANCE OF PAYMENTS (kina millions)[1]						
Current account	-7,775	5,964	13,431	7,963	9,656	9,973
Capital & Financial account*	6,189	-6,819	-13,949	-8,473	-9,961	-10,430
Overall balance	-1,574	-861	-753	-510	-305	-457
Gross Int. Reserves	6,842	5,980	5,227	5,183	4,878	4,421
IMPORT COVER (months)						
Total	6.7	7.5	10.0	6.7	6.2	5.5
Non-mineral	8.7	10.5	15.8	13.0	11.6	9.7
EXPORT PRICE						
Crude oil (US$/barrel)**	109.5	98.6	51.6	33.0	35.3	39.1
Gold (US$/ounce)	1,368.3	1,133.0	1,147.6	1,044.6	1,247.2	1,238.5
Copper (US$/pound)	332.8	296.4	262.4	224.9	260.0	300.0
Nickel (US$/tonne)	11,998.8	18,885.3	11,568.9	8,572.6	8,701.2	8,805.6
Cobalt (US$/tonne)	30,000	23,855.9	28,178.0	22,288.8	22,288.8	22,288.8
LNG (US$/000 mmbtu)	na	14.0	9.7	8.3	8.4	8.5
Condensate (US$/barrel)	na	86.8	51.0	32.0	35.0	38.0
FISCAL OPERATIONS OF THE GOVERNMENT* **						
Surplus/Deficit (K'm)	-2,672.4	-2,815.2	-2,491.8	-2,112.5	-1,346.2	-898.7%
% of GDP	-7.8	-6.9	-4.9	-3.8	-2.3	-1.5
REAL GROSS DOMESTIC PRODUCT (annual % growth) ****						
Total GDP	5.0	13.3	9.9	4.3	2.4	2.0
Non-mineral GDP	4.9	1.2	2.4	3.4	3.6	3.6

* Now includes Capital account

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

*** Preliminary fiscal operations up to December 2013, while 2014-2016 projections are from the 2014 National Budget.

**** GDP figures are from the 2014 National Budget and 2014 MYEFO.

Source: Bank of PNG, NSO and Department of Treasury

[1] PNG LNG exports are included in 2014. Full year annual productions occured from 2015.

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