Economic Analysis - Papua New Guinea's July Monetary Easing Likely A One-Off For 2019

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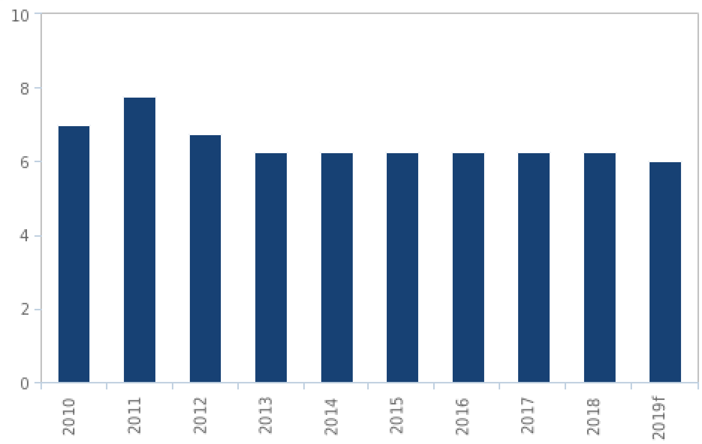
Key View

- The Bank of Papua New Guinea (BPNG) cut its policy Kina Facility Rate by 25bps to 6.00% in July, from 6.25% previously, to stablise prices in the economy.
- We at Fitch Solutions forecast the central bank to hold its Kina Facility Rate at 6.00% for the remainder of 2019, as a stabilisation of inflation over H219 should reduce the need for further easing.
- We highlight downside risks to our forecast as BPNG could decide to ease further should this cut be insufficient to stem the slide in price growth or growth slumps due to disruptions from natural disasters.

The Bank of Papua New Guinea (BPNG) eased its monetary policy in July, cutting its policy Kina Facility Rate by 25bps to 6.00%, from 6.25% previously. In the accompanying press release, a slowdown in headline consumer price index (CPI) inflation and inflation excluding housing to 4.5% y-o-y and 4.2% y-o-y, respectively in Q119, from 4.8% y-o-y and 5.5% y-o-y in Q418, was the key factor behind BPNG's decision. **We at Fitch Solutions forecast BPNG to keep its interest rates on hold at 6.00% for the remainder of 2019, as inflation is likely to stabilise in the second half of 2019, which should reduce the central bank's need to ease.**

Likely One And Done For 2019

Papua New Guinea - Kina Facility Rate, %

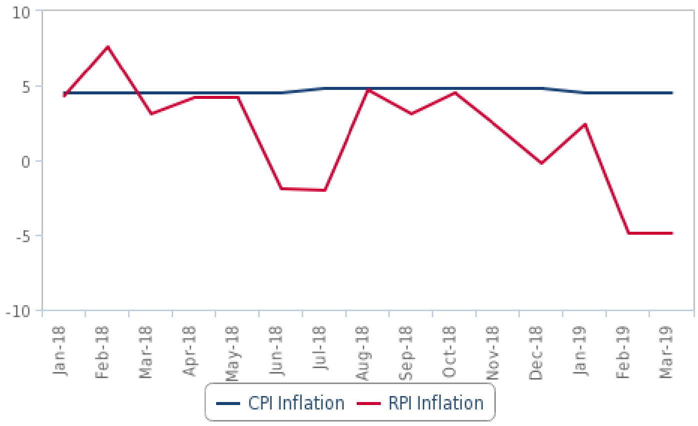


f = Fitch Solutions forecast. Source: Bank Of Papua New Guinea, Fitch Solutions

Inflation is likely to face further downside pressure over Q219 before stabilising in H219 and we forecast CPI inflation to average 4.2% in 2019, slightly lower than the 4.5% average in 2018. The BPNG uses two main price indices to measure inflation in the economy, the quarterly CPI, released by the National Statistical Office, and BPNG's own monthly Retail Price Index (RPI). Despite CPI inflation remaining in positive territory, RPI inflation appears to be telling a different story. RPI inflation printed -4.9% y-o-y in February and March 2019, marking a sharp reversal as compared to the -0.2% y-o-y to 4.7% y-o-y range between August 2018 and January 2019. In March, broad deflation across many categories including a 26.5% y-o-y price decline in 'healthcare', 11.3% y-o-y price decline in 'alcoholic beverages, tobacco, and betel nut' and a 3.9% y-o-y decline in 'communications', more than offset price increases in the other categories. In February, a 13.1% y-o-y deflation in 'alcoholic beverages, tobacco, and betel nut' and 11.5% y-o-y deflation in 'transport' prices outweighed price increases in the other categories.

Inflation To Pick Up In H219

Papua New Guinea – CPI And RPI Inflation, % chg y-o-y



Source: Bank Papua New Guinea, Fitch Solutions. CPI Inflation is released on a quarterly basis

RPI deflation should begin to recede over the coming months before returning to inflationary territory sometime in H219 due to two factors. On the one hand, transport deflation is likely to continue pressuring headline RPI inflation in Q319 due to lower oil prices as compared to the corresponding period in 2018, before we see transport inflation turning positive again the final quarter. On the other hand, we expect healthcare prices to return to inflation in Q319, possibly as soon as July, on the back of the volcanic eruptions at the end of June which resulted in volcanic ash blanketing the region with micro particles which can cause permanent lung damage which could lead to sickness or death. According to the International Federation of the Red Cross and Red Crescent Societies, almost 15,000 people have fled their homes and taken shelter in refuge centres as of June 30, and we believe that a surge in demand for healthcare products will see a re-inflation in healthcare prices. The deflation in healthcare from March 2019 was due to high base effects following the 7.5 magnitude earthquake at the end of February 2018, which resulted in a subsequent surge in healthcare demand amid a supply shortage due to widespread damage to health clinics putting upside pressure on prices in the months that followed.

The interest rate cut should also provide some support to growth. We forecast real GDP to grow by 3.0% in 2019, up from our 0.5% estimate in 2018 and also the central bank's estimate to be 'lower than the government's 0.3% forecast'. Our 2019 forecast lies below the central bank's projection for growth to be 'higher than Government's 2019 Budget forecast of 4.0%'. We note that monetary policy transmission is weak, with interest on business loans above 11% per annum, almost double the Kina facility rate of 6%. That said, we believe that monetary easing should still somewhat signal for banks to lower their interest rates, however little it may be, to further boost private sector credit growth, which strengthen to 6.7% y-o-y in February, from 4.2% y-o-y in January. We highlight that economic disruptions due to political uncertainty during the constitutional crisis between February and May, as well as the volcanic eruptions at the end of June, pose downside risks to our growth forecast.

Risks to our view are weighted to the downside. A persistent slide in prices or a sharp growth deceleration due to natural disasters could prompt the central bank to ease even more to maintain price stability and support growth.