BANK OF PAPUA NEW GUINEA

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QUARTERLY ECONOMIC BULLETIN
DECEMBER QUARTER 2010

Mr. Loi M. Bakani, Governor of the Bank of Papua New Guinea (Bank of PNG), today released the December 2010 Quarterly Economic Bulletin (QEB). The issue covers economic and financial developments for the December quarter of 2010 as well as for the year, and special articles on the 2011 National Budget and the March 2011 Monetary Policy Statement. This press statement provides an overview of the economic and financial developments for the December 2010 quarter as well as developments since December 2010.

1. UPDATE ON DEVELOPMENTS SINCE DECEMBER 2010

The global economic recovery is continuing at varying paces across different regions, led by very strong growth in the Asian region. The recent natural disasters in Japan and the ongoing political unrest in the Middle East may have some adverse effects on the recovery. The overall growth outlook has remained positive over recent months with the IMF projecting a growth of 4.5 percent in 2011. The recovery of the US economy has been moderate, with further improvement in the labor market and consumer spending, supported by increases in business investment and exports. However, the housing market remained subdued due to a weak demand and foreclose of distressed properties.

Headline inflation increased, mainly due to a surge in prices of crude oil and, food and other commodities, however underlying inflation and long run inflation trend remained stable.

In Europe, growth remains positive, largely due to robust GDP growth in Germany. An upward revision to growth in Germany, due to stronger domestic demand, is important for the economic performance of the Euro area. However, considerable financial stress remained in some parts of the Euro area and tighter fiscal control is in place for some member countries such as Greece, Portugal, Spain and Ireland. In Japan, weaker export growth and stagnant private consumption has stalled growth. Although, the Japanese economy is expected to grow in 2011, the recent natural disasters will have noticeable effect on its production and exports, which could impede growth prospects. Data from emerging and developing economies suggest that economic activity is still strong, with growth projected to be 6.5 percent in 2011. In Asia, notable growth in China and India combined with growth in other developing countries are also contributing to the overall growth. Headline inflation is generally expected to increase in 2011, mainly reflecting the pass-through effects of the increase in oil, food and other commodity prices stemming from rising global demand and supply shocks.

Increased demand associated with the strengthening of the global growth and supply disruptions have forced commodity prices up over recent months, especially for food and crude oil. World food prices declined for the first time in March 2011 after increasing for eight consecutive months since July 2010 due to disruptions of grain imports caused by the unrest in the Middle East and the natural disaster in Japan. However, the Food and Agriculture Organization (FAO) warned that prices will bounce back as global demand picks up. Increase in the oil prices will also force food prices higher as they increase the cost of food production.

For Papua New Guinea, export receipts are expected to be high this year, with the average prices of gold, copper, palm oil and coffee projected to be higher than in 2010. Up to March 2011, international prices of Papua New Guinea's major export commodities remained high. Gold, copper and crude oil prices have increased further since December 2010, while the non-mineral export commodity prices also remain high.

The high export commodity prices had contributed to a higher than budgeted revenue in 2010, and a subsequent overall budget surplus of K186.3 million in 2010. While this is commendable, the Bank is concerned about the fast pace of drawdown of funds held in trust accounts. Also, an increase in Government spending adds to the already high liquidity level in the banking system and can be inflationary. A close monitoring and control of the spending of the trust account funds is necessary to ensure the funds are appropriately spent for the intended purposes.

The trust account funds held at the Central Bank has increased to K297.6 million as at 21st April 2011 from K212.9 million as at the end of December 2010, reflecting an increase in deposits for existing accounts, and new trust accounts opened at the Bank in the first quarter of 2011. While this is welcomed and is reflective of the Treasury Minister's directive for all new trust accounts to be opened at the Central Bank, the total of trust account funds held at commercial banks is much higher. A more concerted effort is needed to change the balance to having more of the funds parked at the Central Bank for prudent management and to help the course of monetary policy management.

The US dollar depreciated against all the major currencies, reflecting ongoing concerns about the US economy and continued low domestic interest rates in the December quarter of 2010. The US dollar depreciated by 5.4 percent against the euro, 2.1 percent against the pound sterling, 4.1 percent against the yen, and 9.5 percent against the Australian dollar. As at end of March 2011, the US dollar continued to depreciate against other major currencies due to expectations of rising interest rates in UK and Euro, and a strong commodity-based Australian dollar, while appreciating against the yen.

As at the end of March 2011, the kina appreciated against the US dollar, reaching 38.95 cents and it appreciated further to 40.00 cents on the 21st of April 2011, mainly due to inflows of foreign exchange. During the same period, the kina depreciated against the Australian dollar to 37.42 cents as at 21st April 2011.

The Bank of PNG projects headline inflation to be higher in 2011 compared to 2010. Inflationary pressures still remain in the first quarter of 2011 due to higher international food and oil prices, combined with increased domestic demand associated with the LNG project and increased government expenditure, partly relating to wage increases for public servants. It is important that the Government maintains prudent fiscal management to assist the Central Bank in its management of monetary policy in pursuit of price stability. Other measures proposed by the Bank of PNG in its March 2011 Monetary Policy Statement should be adhered to and implemented in order to achieve macroeconomic stability.

The level of gross foreign exchange reserves increased from US$3,146.5 (K8,169.6) million at the end of December 2010 to US$3,330.2 (K8,222.8) million as at 26th April 2011.

2. OVERVIEW OF THE DEVELOPMENTS IN THE DECEMBER QUARTER OF 2010

Economic indicators available to the Bank of Papua New Guinea show that economic activity picked up in 2010, compared to 2009. As the world economy continued to recover slowly from the recession, global demand for raw materials increased, which led to higher international prices. Improved Government's fiscal position and increased spending, continued lending by commercial banks and increased business activity in the private sector, as reflected by higher business revenue, and increased employment level are indicative of this growth. The increase in activity was largely due to the construction phase of the Liquefied Natural Gas (LNG) project. In the December quarter of 2010, the Trade Weighted Index (TWI) exchange rate depreciated slightly as a result of a strengthening Australian dollar. The balance of payments recorded an overall surplus as a result of increased investment inflows and the Government recorded a budget surplus. With increased economic activity, inflation increased to 7.2 percent in 2010 compared to 5.7 percent in 2009. The Bank is mindful of the underlying inflationary price pressures and will respond appropriately through its monetary policy where necessary to maintain price stability. The monthly Kina Facility Rate (KFR) was maintained at 7.0 percent throughout 2010.

Data from the Bank's Business Liaison Survey (BLS) show that the total nominal value of sales in the private sector increased by 8.8 percent in the September quarter of 2010, after increasing by 2.3 percent in the June quarter. Excluding the mineral sector, sales increased by 5.0 percent in the September quarter, compared to 16.1 percent in the previous quarter. By sector, there were increases in all sectors, except the building and construction, and financial/business and other services sectors. By region, sales picked up in all regions, except the Highlands region. Over the twelve months to September 2010, total sales increased by 20.4 percent.

The Bank's Employment Index shows that the level of employment in the formal private sector increased by 2.1 percent in the December quarter of 2010, following an increase of 0.4 percent in the previous quarter. Excluding the mineral sector, the level of employment increased by 1.2 percent in the December quarter of 2010, after a decline of 0.8 percent in the previous quarter. By sector, employment increased in the mineral, financial/business and other services, manufacturing, building and construction, wholesale and retail sectors while the agriculture/forestry/fisheries and transportation sectors recorded decreases. By region, employment increased in the NCD, Southern, Morobe, Momase, and Islands regions, while it decreased in the Highlands region. In 2010, the total level of employment increased by 1.9 percent, while excluding the mineral sector, employment increased by 1.2 percent.

The Governor cautioned that in interpreting the growth figures for both the BLS and the employment surveys, it is important to note that many companies engaged in the construction phase of the LNG project are currently not in the sample of companies covered by the surveys. These companies will be considered for inclusion in the sample when the re-sampling exercise is undertaken by the Bank.

Quarterly headline inflation, as measured by the Consumer Price Index (CPI), was 2.7 percent in the December quarter of 2010, compared to 1.3 percent in the September quarter. There were increases in all expenditure groups, mainly in the 'Drinks, Tobacco and Betelnut' expenditure group. Annual headline inflation was 7.2 percent in the December quarter, higher than the 5.6 percent in the previous quarter. By region, all urban areas recorded increases in the December quarter, with Rabaul having the highest increase and Madang the lowest.

In the December quarter of 2010, the daily average kina exchange rate appreciated against the US dollar, while it depreciated against the other major currencies. It appreciated against the US dollar by 3.3 percent to 0.3790, while it depreciated against the euro by 1.9 percent to 0.2789, pound sterling by 9.7 percent to 0.2398, Australian dollar by 5.7 percent to 0.3839 and the Japanese yen by 0.7 percent to 31.29. These movements resulted in the daily average TWI depreciating in the December quarter of 2010 to 30.96 from 31.80 in the September quarter.

The weighted average kina price of Papua New Guinea's exports increased by 28.5 percent in 2010, compared to 2009.There was an increase of 30.9 percent in the weighted average kina price of mineral exports, with higher prices of all mineral exports. For agricultural, logs and marine product exports, the weighted average kina price increased by 19.0 percent and was attributed to higher prices of coffee, copra, copra oil, palm oil, tea, rubber and logs, which more than offset the decline in prices of marine export products. The higher kina prices of all agricultural export commodities reflected higher international prices, due to increased demand associated with the recovery of the world economy from the global financial crisis. Excluding logs, the weighted average price of agricultural and marine product exports increased by 22.8 percent in 2010, compared to 2009.

There was an overall surplus in the balance of payments of K1,066 million in 2010, compared to a surplus of K1,725 million in 2009. A surplus in the capital and financial accounts more than offset a deficit in the current account. The current account recorded a higher deficit of K1,762 million in 2010, compared to a deficit of K1,611 million in 2009. Higher net service and income payments more than offset the trade surplus and net transfer receipts.

The capital account recorded a net inflow of K101 million in 2010, compared to K74 million in 2009, reflecting higher transfers by donor agencies through direct project financing. The financial account recorded a net inflow of K2,794 million in 2010, compared to a net inflow of K3,220 million in 2009. This outcome was due to net inflows from foreign direct and other investments.

As a result of these developments, the capital and financial accounts recorded a lower surplus of K2,895 million in 2010, compared to a surplus of K3,294 million in 2009.

The level of gross foreign exchange reserves at the end of December 2010 was K8,169.6 (US$3,146.5) million, sufficient for 10.5 months of total and 14.4 months of non-mineral import covers.

The Bank of Papua New Guinea continued to maintain a cautious approach to its monetary policy stance by keeping the KFR at 7.00 percent in the December quarter of 2010. This was largely due to concerns regarding inflationary pressures reflecting high domestic demand associated with higher government spending, increased commodity prices and construction of the LNG project. The dealing margin for the Repurchase Agreements (Repos) was maintained at 100 basis points on both sides of the KFR.

The Bank continued to utilise Open Market Operation (OMO) instruments in the conduct of monetary policy in 2010. There was limited Treasury bill auction in 2010 due to the Government's positive cash flow position, while Inscribed Stock auctions were conducted in line with the Goverment's debt strategy to shift debt to longer term. As a result, excess liquidity in the banking system was mainly diffused through issuance of additional Central Bank Bills (CBBs). Although the level of liquidity was high, the commercial banks were actively involved in the inter-bank market throughout the year due to the uneven distribution of liquidity in the system. As part of the strategy to mop up excess liquidity, the Bank increased the Cash Reserve Requirement (CRR) of the commercial banks by 1.0 percentage point to 4.0 percent, while the Minimum Liquid Assets Ratio (MLAR) of commercial banks was reduced from 25.0 percent to zero in October 2010.

The average level of broad money supply (M3*) increased by 17.0 percent in 2010, compared to an increase of 13.9 percent in 2009. This outcome was due to an increase of 17.4 percent in average net private sector credit and an increase of 16.0 percent in average net foreign assets of depository corporations. Net domestic claims outstanding, excluding advances to the Central Government and outstanding loans under the Government's Agricultural export commodity support schemes increased by 16.5 percent in 2010, compared to an increase of 24.1 percent in 2009. The average level of monetary base (reserve money) grew by 20.4 percent in 2010, compared to an increase of 17.8 percent in 2009. The increase reflected higher deposits of Other Depository Corporations (ODCs) at the Central Bank and an increase in currency in circulation.

In 2010, total domestic credit extended by depository corporations to the private sector, public non-financial corporations, Provincial and Local Governments, and other financial corporations increased by K1,093.4 million to K7,184.6 million, compared to an increase of K811.1 million in 2009. This was due to an increase in private sector credit of K1,058.4 million.

Preliminary estimates of the fiscal operations of the National Government in 2010 showed an overall surplus of K186.3 million, compared to a deficit of K36.3 million in 2009. This represents 0.7 percent of nominal GDP. Out of the surplus realised in 2010, the Government expended K653.3 million through a supplementary budget.

Total revenue, including foreign grants, in 2010 was K8,278.9 million, 24.5 percent higher than in 2009. This represents 100.4 percent of the revised budgeted revenue. The increase in revenue reflected an increase in all categories of tax revenue combined with higher foreign grants, which more than offset lower non-tax receipts.

Total expenditure in 2010 was K8,092.6 million, 21.0 percent higher than in 2009 and represents 98.2 percent of the 2010 revised budget appropriation. This outcome reflects higher capital expenditure, which more than offset a decline in recurrent expenditure.

As a result of these developments in revenue and expenditure, the Government recorded an overall surplus of K186.3 million in 2010. The surplus was used to make a net external loan repayment of K84.8 million and a net negative financing of K101.5 million to domestic sources. The net external loan repayment comprised of K27.6 million, K19.4 million and K37.8 million to concessionary, commercial and extraordinary sources, respectively. The net negative domestic financing comprised of K363.4 million in Government deposits placed at the Central Bank and K32.0 million repayment to ODCs. These more than offset a borrowing of K70.9 million by Other Financial Corporations (OFCs) and K223.0 million in cheque floats held by other resident sectors.