BANK OF PAPUA NEW GUINEA

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QUARTERLY ECONOMIC BULLETIN
DECEMBER QUARTER 2012

Mr. Loi M. Bakani, Governor of the Bank of Papua New Guinea (Bank of PNG), today released the December 2012 Quarterly Economic Bulletin (QEB). This statement provides an overview of the economic and financial developments for the December 2012 quarter and the developments since December 2012.

1. UPDATE ON DEVELOPMENTS SINCE DECEMBER 2012

The global economic growth is expected to remain weak in 2013, mainly reflecting the on-going debt crisis in the Euro-zone area and slow recovery in the advanced economies, especially the US and Japan. Against this background, the International Monetary Fund (IMF), in its January 2013 World Economic Outlook (WEO) Update Report revised downward its global growth forecast to 3.2 percent for 2013. Growth is projected at 1.4 percent for the advanced economies, and 5.5 percent for the emerging market and developing economies. While growth in advanced economies remains weak, it remained strong in some emerging market economies, especially China and India. In the US, growth is projected to be 2.0 percent in 2013, reflecting improvement in underlying economic conditions, including a supportive financial market environment and an improvement in the housing market, which is expected to improve household balance sheets and strong private consumption growth. The growth in the euro area is projected to decline by 0.2 percent in 2013 reflecting the on-going effects of the debt crisis. The Japanese economy is into a recession, and is expected to recover in 2013 with growth projected at 1.2 percent. Given this outlook, the downside risks remain significant, with slow recovery in the Japanese economy, renewed setbacks in the euro area and risks of excessive near-term fiscal consolidation in the United States.

IMF forecast on global demand remains weak and hence, commodity prices are projected to remain low in 2013. Against this background, Governor Bakani mentioned that the prices of agricultural and mineral export commodities will continue to trend downward in 2013, while crude oil prices remain volatile. The international price of crude oil decreased modestly to below US$91 per barrel in early March due to indications that oil markets are over supplied, fall in demand from China, cuts in US Government spending and a drop in sentiment on euro area recovery. The slowdown in the global economy and decline in commodity prices will impact adversely on PNG's exports. This, combined with high import demand would exert downward pressure on the exchange rate.

Global inflation is expected to remain low on the back of weak global demand. The IMF projected inflation of 1.6 percent in advanced economies and 6.1 percent in developing economies for 2013. International food prices have remained unchanged at 210 points in January 2013, the lowest index since June 2012. Low foreign inflation can have a favorable impact on the domestic economy, however, the Governor raised the concern that the high import demand is currently exerting downward pressure on the kina exchange rate and the Bank of PNG is mindful of its potential effect to drive domestic prices up in 2013.

Governor Bakani also noted that the winding down of the construction phase of the PNG Liquefied Natural Gas (LNG) project will likely affect economic growth and employment. All the sectors which benefited from the spin-off activities of the LNG project will be affected. On the other hand, the winding down will free up a lot of resources, including manpower and capital goods, which can be utilised in other sectors of the economy to maintain the momentum of economic activity. The strong level of investment in the non-mineral private sector, combined with the Government's fiscal stimulus in the 2013 budget is expected to partly offset the decline in activity as the PNG-LNG Project winds down.

Governor highlighted that the 2013 budget is very ambitious, which aims to drive economic growth by rehabilitating major infrastructures and investing significantly in priority areas such as education, health and agriculture as well as to other sectors of the economy. This will also involve significant funding to the provincial and local level governments. While this is a commendable undertaking to shift resources to the rural majority, Governor Bakani cautioned that implementation capacity at lower levels of Government is still a major concern. Lack of capacity to spend efficiently and effectively can result in mismanagement of scarce resources.

Given the low inflation outcome in the December quarter of 2012, the Bank of PNG eased its monetary policy stance by reducing the Kina Facility Rate (KFR) by 50 basis points to 6.25 percent in March 2013. However, the upside risk to inflation associated with the depreciation of the kina exchange rate resulting from the high import demand and the imposition of tariff will exert inflationary pressures in 2013.

The daily average kina exchange rate depreciated against the US dollar, euro and Australian dollar, while it appreciated against the pound sterling and the Japanese yen. As at the 20th of March 2013, it depreciated by 1.0 percent against the US dollar to 0.4685, 1.0 percent against the Australian dollar to 0.4514 and 3.1 percent against the euro to 0.3638. The kina appreciated by 2.0 percent against the pound sterling to 0.3106 and 11.9 percent against the yen to 44.5300. The depreciation of the kina exchange rate against the US dollar, euro, and the Australian dollar was mainly attributed to high import demand, lower foreign exchange inflows and the appreciation of the US dollar, while the appreciation against the pound sterling and yen mainly reflected cross currency movements.

The level of gross foreign exchange reserves declined to K7, 962.4 (US$3,766.2) million as at 25th of March 2013, from K8340.8 (US$4,007.8) at the end of December 2012.

2. OVERVIEW OF THE DEVELOPMENTS IN THE DECEMBER QUARTER OF 2012

Economic indicators available to the Bank of Papua New Guinea (the Bank) show that growth in economic activity in the domestic economy continued to be strong in 2012. However, there are signs pointing to an easing in the spin-off effect from the construction phase of the PNG Liquefied Natural Gas (LNG) project to the non-mineral private sector. The growth was primarily driven by the LNG project, Government spending in key sectors of the economy, stable growth in commercial banks credit to the private sector and business activity in the non-mineral private sector. These contributed to an increase in the level of employment in the private sector in 2012. With low global demand, due to the adverse effects of the sovereign debt crisis in the Euro-area and the slowdown in some advanced economies, the international commodity prices for PNG's major exports declined. This, combined with higher import demand resulted in a significant balance of payments deficit for 2012. In the December quarter of 2012, the Trade Weighted Index (TWI) exchange rate depreciated as the Australian dollar appreciated against the US dollar and the kina. Inflation was 1.6 percent in 2012, compared to 6.9 percent in 2011, attributable to lower imported inflation and the pass-through effect of the appreciation of the kina in the first half of the year on domestic prices. In response to the lower inflation outcome for 2012 and to support economic activity, the Bank of PNG maintained its stance of monetary policy throughout the December quarter after the last reduction in the Kina Facility Rate (KFR) in September 2012.

Data from the Bank's Business Liaison Survey (BLS) show that the total nominal value of sales in the private sector declined by 0.4 percent in the September quarter of 2012, compared to a decline of 2.7 percent in the June quarter. Excluding the mineral sector, sales increased by 3.1 percent in the September quarter of 2012. Sales declined in the agriculture/forestry/fisheries, wholesale and mineral sectors, while the building and construction, retail, manufacturing, transportation and financial/business and other services sectors experienced increases. By region, Highlands and Morobe recorded declines, while Southern, Islands, Momase and National Capital District (NCD) experienced increases. Over the twelve months to

September 2012, total sales declined by 3.0 percent, while excluding the mineral sector, it increased by 3.1 percent.

The Bank's Employment Index shows that the total level of employment in the private sector increased by 0.6 percent in the December quarter of 2012 compared to an increase of 1.6 percent in the previous quarter. The level of employment increased in all sectors, except the agriculture/forestry/fisheries, and financial/business and other services sectors. Excluding the mineral sector, the level of employment increased by 0.5 percent. There were increases in all regions, except the Southern region. In 2012, the total level of employment increased by 6.4 percent, while excluding the mineral sector, it increased by 6.5 percent.

Quarterly headline inflation, as measured by the Consumer Price Index (CPI), was 0.8 percent in the December quarter of 2012, the same as in the September quarter. There were increases in all the expenditure groups, except the 'Food' group. The annual headline inflation rate was 1.6 percent in the December quarter, compared to 2.0 percent in the September quarter. The outcome was attributed to lower imported inflation, the government's tariff reduction program and pass through effect of the kina appreciation in the first half of 2012. By region, all urban areas recorded price increases in the December quarter except Port Moresby, which recorded a decline. The annual exclusion-based inflation declined by 1.9 percent in 2012, following an increase of 7.7 percent in 2011, while the annual trimmed-mean inflation increased by 0.6 percent in 2012, compared to an increase of 7.0 percent in 2011.

In the December quarter of 2012, the daily average kina exchange rate depreciated against all the major trading partners' currencies, except the Japanese yen. It depreciated against the US dollar by 0.7 percent to 0.4780, Australian dollar by 0.6 percent to 0.4604, and pound sterling by 2.6 percent to 0.2977. Against the yen, it appreciated by 2.6 percent to 38.8280. These movements resulted in the depreciation of the daily average Trade Weighted Index (TWI) exchange rate to 37.68 in the December quarter of 2012 from 38.06 in the September quarter. For the year as a whole, the kina appreciated against all the major currencies. It appreciated by 13 percent against the US dollar to 0.4799, Australian dollar by 13 percent to 0.4637, pound sterling by 14 percent to 0.3031, yen by 13 percent to 38.3033 and euro by 22 percent to 0.3733. Against the TWI exchange rate, it appreciated by 13.5 percent to 37.64.

Higher international prices for some of PNG's export commodities resulted in an 11.4 percent increase in the weighted average kina prices in 2012, compared to the corresponding period of 2011. There was a 22.4 percent increase in the weighted average price of mineral exports, with higher prices for gold, copper and crude oil. The weighted average price of non-mineral exports declined by 16.0 percent as a result of the appreciation of the kina against the US dollar and lower international prices for all agricultural commodities, logs and marine products.

The overall deficit in the balance of payments was K850 million in 2012, compared to a surplus of K1,096 million in 2011. This outcome was due to a deficit in the current account, which more than offset a surplus in the capital and financial account.

The current account recorded a deficit of K4,061 million in 2012, compared to a deficit of K407 million in 2011. The significant deficit in the current account was due to higher net services and income payments, which more than offset a trade surplus and net transfer receipts.

The capital account recorded a net inflow of K32 million in 2012, compared to K73 million in 2011, reflecting lower transfers by donor agencies for project financing. The financial account recorded a higher net inflow of K2,761 million in 2012, compared to a net inflow of K1,526 million in 2011. The outcome was due to inflows from portfolio and other investments in short term money market instruments by resident entities and drawdown in net foreign assets of the domestic banking system. There was also net an inflow from foreign currency account balances of mineral companies. These more than offset a net outflow, reflecting foreign direct investments abroad and investments in financial derivative instruments by resident entities.

The level of gross foreign exchange reserves at the end of December 2012 was K8,340.8 (US$4,007.8) million, sufficient for 11.0 months of total and 15.9 months of non-mineral import covers.

Following the reduction in the KFR by 100 basis points in September 2012, the Bank maintained its stance of monetary policy and kept the KFR at 6.75 percent throughout the December quarter of 2012. Domestic interest rates continue to remain low due to the high liquidity levels. Rates for short-term Government securities decreased across all maturities between the end of September and December 2012.

The Bank continued to utilise its Open Market Operation (OMO) instruments in the conduct of monetary policy in the December quarter of 2012. There was a net issuance of K21.6 million in CBBs during the quarter. The Government retired K557.6 million in Treasury bills due to its favourable cash flow position. A total of K136.7 million in Inscribed stocks was issued during the quarter, which assisted to diffuse some of the excess liquidity. The Cash Reserve Requirement (CRR) for the commercial banks was maintained at 8.0 percent in the December quarter.

The average level of broad money supply (M3*) increased by 2.1 percent in the December quarter of 2012, compared to an increase of 0.4 percent in the September quarter. This outcome was mainly influenced by an increase of 4.0 percent in average private sector credit. Average net domestic claims outstanding, excluding net claims on the Central Government, increased by 4.3 percent in the December quarter, following an increase of 4.8 percent in the September quarter. The average level of monetary base (reserve money) grew by 6.6 percent in the December quarter of 2012, following a decline of 7.6 percent in the September quarter.

The net foreign assets of the financial corporations, comprising of depository corporations (DCs) and other financial corporations (OFCs), increased by 4.2 percent to K10,074.2 million in the December quarter of 2012, compared to a decline of 5.0 percent in the previous quarter. This resulted from higher net foreign assets of the Central Bank and other depository corporations (ODCs), which more than offset a decline in the net foreign assets of OFCs. Net claims on the Central Government decreased by K8.2 million to K1,881.9 million in the December quarter of 2012, compared to an increase of K71.5 million in the previous quarter. This resulted from higher deposits in Government trust accounts and maturing of Government securities by ODCs.

Total domestic credit extended by financial corporations to the private sector, public non-financial corporations, Provincial and Local level Governments, and other financial corporations, increased by K299.4 million to K10,648.5 million in the December quarter of 2012, compared to an increase of K722.5 million in the September quarter of 2012. This was mainly due to an increase of K287.3 million in credit extended to the private sector. The growth reflected advances by the ODCs to the manufacturing, hotel and restaurant, mining and quarrying, commerce, building and construction and transport and communication sectors, as well as the household sector for personal advances. The annual growth in domestic credit, excluding the Central Government, was 17.6 percent.

Preliminary estimates of the fiscal operations of the National Government in 2012 showed an overall deficit of K494.6 million, compared to a deficit of K65.7 million in 2011. This represents 1.5 percent of nominal Gross Domestic Product (GDP) and is the result of a higher expenditure more than offsetting an increase in revenue.

Total revenue, including foreign grants was K9,442.2 million in 2012, 1.5 percent higher than the receipts collected in 2011. This represents 93.0 percent of the 2012 revised budgeted revenue. The marginal increase in revenue resulted from higher tax receipts, which more than offset the declines in non-tax revenue and foreign grants.

Total expenditure was K9,936.8 million in 2012, 6.0 percent higher than in 2011 and represents 94.1 percent of the revised budgeted appropriation for 2012. This resulted from higher expenditure in both the development and recurrent budgets.
The budget deficit of K494.6 million, was financed from external and domestic sources with K124.0 million and K370.6 million, respectively. External borrowing totalled K168.9 million from concessional sources, which more than offset loan repayments of K8.1 million to commercial and K36.8 million to extraordinary sources. Domestic financing comprised of a net drawdown of Government deposits at the Central Bank totalling K1,160.8 million, combined with net issuance of Government securities totalling K28.9 million and K342.9 million issued to ODCs and OFCs,

respectively. These more than offset K1,162.0 million for payments mostly in cheques presented by other resident sectors.

Total public (Government) debt outstanding at the end of 2012 was K7,841.8 million, K603.4 million higher than in 2011. Domestic debt increased, while external debt decreased. The increase in domestic debt resulted from the issuance of Treasury bills and Inscribed stocks, while the decrease in external debt mainly reflected loan repayments, combined with the effect of the appreciation of the kina. This resulted in the debt to nominal GDP ratio increasing to 24.0 percent in 2012, compared to 23.6 percent in 2011.