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PORT MORESBY
02nd May 2012

1.0 GENERAL OVERVIEW

Economic indicators available to the Bank of Papua New Guinea (the Bank) show that economic growth continued to be strong in 2011, following the high growth in 2010. This was driven by: the construction phase of the PNG LNG project and its spillover effects to the other sectors of the economy such as building and construction and transportation; high export commodity prices; and increased Government expenditure. Growth in employment, an increase in business activity in the non-mineral private sector, and continued but lower growth in private sector credit are all indicative of this growth. Inflation moderated in 2011 with an annual headline inflation of 6.9 percent in the December quarter, compared to the 7.2 percent in the December quarter of 2010. This was attributed to lower and stable prices of food and fuel and the appreciation of the kina over the year, especially against the US dollar. The kina appreciated against all major currencies in the December quarter and resulted in the daily average Trade Weighted Index (TWI) appreciating by 6.4 percent. Although inflation eased in the second half of the year, domestic demand pressures associated with the strong economic growth remained high in 2011. The Bank therefore, took a cautious approach by maintaining the Kina Facility Rate (KFR) at 7.75 percent in the December quarter, after the increases from 7.0 percent between June and September.

Data from the Bank's Business Liaison Survey (BLS) show that the total nominal value of sales in the private sector declined by 0.2 percent in the September quarter of 2011, compared to a decline of 7.6 percent in the June quarter. Excluding the mineral sector, sales increased by 3.4 percent in the September quarter of 2011, compared to an increase of 6.8 percent in the June quarter. Sales declined in the mineral, manufacturing and retail sectors, which more than offset increases in the agriculture/forestry/fisheries, building and construction, wholesale, transportation, and financial/business/other services sectors. By region, NCD, Highlands, Islands and Momase recorded declines, while the Morobe and Southern regions experienced increases. Over the twelve months to September 2011, total sales declined marginally by 0.6 percent.

The Bank's Employment Index shows that the level of employment in the private sector increased by 0.2 percent in the December quarter of 2011, compared to a decline of 0.2 percent in the previous quarter. Excluding the mineral sector, the level of employment declined by 0.1 percent in the December quarter, following a decline of 0.03 percent in the September quarter. By sector, the level of employment declined in the agriculture/forestry/fisheries and manufacturing sectors, while it increased in the financial/business/other services, mineral, wholesale, retail, and building and construction sectors. By region, Islands and Highlands recorded declines, while Momase, Morobe, NCD and Southern experienced increases. In 2011, the total level of employment increased by 6.2 percent. Excluding the mineral sector, the level of employment increased by 6.2 percent in 2011, as the change in the mineral sector was negligible.

Quarterly headline inflation, as measured by the Consumer Price Index (CPI), was 1.2 percent in the December quarter of 2011, compared to 0.2 percent in the previous quarter. There were increases in the 'Transport and Communication', 'Household equipment and operations', 'Drinks, tobacco and betel nut', 'Clothing and footwear' and 'Miscellaneous' expenditure groups, while 'Food' and 'Rent, council charges, fuel and power' expenditure groups recorded declines. Annual headline inflation was 6.9 percent in the December quarter of 2011, lower than the 8.4 percent in the September quarter. The lower outcome was due to a fall in imported prices of food and fuel, combined with the appreciation of the kina against the currencies of Papua New Guinea's (PNG) major trading partners. All surveyed urban areas recorded price increases in the December quarter of 2011, except Rabaul. The annual underlying inflation as measured by the exclusion-based and trimmed-mean inflation rate was 7.7 percent and 6.5 percent, respectively in 2011.

In the December quarter of 2011, the daily average kina exchange rate appreciated against all the major currencies, reflecting continued high foreign exchange inflows associated with higher commodity prices and construction of the PNG Liquefied Natural Gas (LNG) project. It appreciated against the US dollar by 3.5 percent to 0.4665, pound sterling by 6.1 percent to 0.2914, euro by 8.6 percent to 0.3605, Australian dollar by 7.5 percent to 0.4591 and the Japanese yen by 2.9 percent to 36.17, compared to the September quarter. These movements resulted in the daily average Trade Weighted Index (TWI) appreciating by 6.4 percent to 37.3 over the quarter.

Higher international prices of PNG's mineral and most agricultural exports resulted in a 14.0 percent increase in the weighted average kina price of exports in 2011, compared to 2010. There was a 13.9 percent increase in the weighted average price of mineral exports, with higher kina prices of gold, copper and crude oil. For agricultural, logs and marine product exports, the weighted average kina price increased by 14.4 percent. This was accounted for by higher prices of coffee, palm oil, copra, copra oil, rubber and marine products.

The balance of payments recorded an overall surplus of K1,096 million in 2011, compared to a surplus of K1,065 million in 2010. This outcome was due to a surplus in the capital and financial accounts, which more than offset a deficit in the current account. The financial account recorded a net inflow of K1,087 million in 2011, compared to a net inflow of K2,934 million in 2010, a result of net inflows from portfolio and other investments. The capital account recorded a net inflow of K73 million in 2011, compared to K101 million in 2010, reflecting lower transfers by donor agencies for project financing.

The current account recorded a lower deficit of K114 million in 2011, compared to the deficit of K1,721 million in 2010. The deficit was accounted for by higher net services and income payments, which more than offset a trade surplus and net transfer receipts.

The level of gross foreign exchange reserves at the end of December 2011 was K9,226.4 (US$4,340.1) million, sufficient for 11.5 months of total and 16.7 months of non-mineral import covers.

Although, inflation outcomes eased in the second half of 2011, the Bank of PNG kept the KFR at 7.75 percent in the December quarter of 2011, in light of underlying inflationary pressures and expectations arising from strong domestic demand associated with the PNG LNG project and related activities, combined with high Government spending and international commodity prices. The dealing margin for the Repurchase Agreements (Repos) was maintained at 100 basis points on both sides of the KFR. Domestic Interest rates for short-term securities showed increasing trends across all maturities during the quarter.

The Bank continued to utilise its Open Market Operation (OMO) instruments in the conduct of monetary policy in 2011. There was limited Treasury bill auction during the quarter due to the Government's positive cash flow position, reflecting high export and mineral tax receipts. The high receipts contributed to the increase in the level of liquidity of the banking system. Some of the excess liquidity was diffused through the issuance of Central Bank Bills (CBB). The liquidity in the banking system was unevenly distributed at times, thus prompting trading in the interbank market, as banks borrowed from each other to maintain positive Exchange Settlement Account (ESA) balances.

The average level of broad money supply (M3*) increased by 13.4 percent in 2011, compared to an increase of 17.0 percent in 2010. This outcome was due to an increase of 14.2 percent in average net foreign assets of depository corporations and an increase of 11.8 percent in average net private sector credit. Average net domestic claims outstanding, excluding net claims on the Central Government, increased by 11.4 percent in 2011, compared to an increase of 16.5 percent in the corresponding period. The average level of monetary base (reserve money) grew by 38.4 percent in 2011, compared to an increase of 20.4 percent in the corresponding period.

The average net foreign assets of the financial corporations increased by 10.9 percent in 2011, compared to an increase of 11.4 percent in 2010, following an increase in holdings by other depository corporations (ODC) and other financial corporations (OFC). Average net claims on the Central Government declined by 47.4 percent in 2011, compared to an increase of 34.5 percent in the corresponding period. This was accounted for by an increase in Central Government deposits, mainly in trust accounts.

In 2011, 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 K363.3 million to K8,836.5 million, compared to an increase of K1,276.7 million in 2010. This was mainly due to an increase of K441.5 million in net credit to the private sector.

The provisional budget outcome of the fiscal operation of the National Government in 2011 showed an overall deficit of K63.7 million, compared to a surplus of K186.3 million in 2010. The deficit represents 0.2 percent of nominal Gross Domestic Product (GDP), reflecting high expenditure, which more than offset an increase in revenue.

Total revenue, including foreign grants, was K9,324.9

million in 2011, 12.6 percent higher than in 2010. This represents 94.8 percent of the revised budget revenue for 2011. The increase in revenue reflected higher tax revenue, which more than offset a decline in foreign grants and non-tax receipts. Total expenditure was K9,388.6 million in 2011, 16.0 percent higher than in 2010 and represents 94.6 percent of the revised budget appropriation for 2011, accounted for by higher recurrent expenditure, which more than offset a decline in development expenditure.

As a result of these developments in revenue and expenditure, the Government recorded an overall budget deficit of K63.7 million in 2011. The budget deficit was financed by a net external borrowing of K25.7 million and the domestic sector with K38.0 million. The net external loan borrowing was K88.9 million from concessionary sources, while repayments comprised K19.4 million to commercial and K43.8 million to extraordinary financing sources. The domestic financing comprised of K544.2 million in cheques floats not yet presented for payment, which more than offset K506.2 million in net negative financing by the financial corporations. Negative financing mainly comprised of Government deposits at the Central Bank.

Total public (Government) debt outstanding at the end of the December quarter of 2011 was K7,238.4 million, K658.7 million higher than in the December quarter of 2010. The increase reflected higher domestic debt, which more than offset a decline in external debt. The increase in domestic debt was due to increased issuance of Treasury bills and Inscribed stocks. The decrease in external debt reflected loan repayments and the appreciation of the kina against the US dollar.

The total amount of Government deposits in the depository corporations increased by K1,525.6 million to K4,788.0 million in the December quarter of 2011, compared to K3,262.4 million in the December quarter of 2010.The balance of Government trust accounts held at the Central Bank increased by a net of K516.5 million to K729.4 million between the end of December 2010 and December 2011.

2. International Development

Global economic recovery remained weak in 2011, reflecting the slowdown in the major advanced economies. The International Monetary Fund (IMF) , in January 2012, revised downward its estimate for the global economic growth in 2011 to 3.8 percent, reflecting a lower growth of 1.6 percent in the advanced economies and 6.2 percent in the emerging and developing economies. The growth in the United States (US) economy was sluggish reflecting the depressed housing market, high Government debt, a very weak labour market and falling real incomes. Growth in Japan declined following the earthquake and tsunami natural disasters in March 2011, while the deepening of the European debt crisis affected financial markets and growth in many euro-zone economies. The IMF revised downward its forecast for 2012 to 3.3 percent from 4.0 percent made earlier in the September 2011 World Economic Outlook (WEO). This is due to a downward revision for advanced economies to grow by 1.2 percent in 2012, while emerging and developing economies are projected to grow by 5.4 percent.

The Group of Twenty (G20) countries met in Cannes, France, from 3rd - 4th November 2011 to discuss the European debt crisis and find solutions to minimise its impact on Greece and other European countries. During the meeting, members reaffirmed their commitment to: foster employment and social protection; build a more stable and resilient International Monetary System; increase the benefits from financial integration and resilience against volatile capital flows to foster growth; and strengthen their capacity through strong collaboration between the IMF and Regional Financial Arrangements. The G20 also pledged to ensure that additional resources are effectively mobilized and contributions to IMF, Special Drawing Rights (SDRs) and other voluntary contributions are administered within the IMF structure. Other key agendas discussed include strengthening IMF surveillance, implementing and deepening financial sector reforms and meeting G20 commitments on over-the-counter (OTC) derivatives, and improving the capacity of credit rating agencies to monitor deficiencies in the financial system.

The 160th Meeting of the Organization of the Petroleum Exporting Countries (OPEC) was convened in Vienna, Austria, on the 14th of December 2011, to review the recent oil market developments and its outlook for 2012. Member countries noted that the heightened price volatility witnessed during 2011, mainly reflected the high level of speculation in commodity markets, and further exacerbated by geopolitical tensions rather than as a result of supply and demand fundamentals. Global demand for oil is expected to increase slightly in 2012, and this will be partly offset by an increase in the supply of oil from non-OPEC countries. OPEC members agreed to maintain the current production level of 30.0 million barrels per day, including production from Libya. The members agreed to closely monitor the developments to ensure that the oil supply to consumers are at price levels that are not detrimental to the global economy.

In mid-December, trade ministers attended the 8th World Trade Organization (WTO) Ministerial Conference in Geneva, Switzerland to discuss the importance of the Multilateral Trading System and, the WTO Trade and Development and Doha Development Agenda. The ministers agreed on a number of issues regarding intellectual property rights, electronic commerce, accession of least developed countries and trade policy reviews. During the Conference, accessions of Russia, Samoa, Montenegro and Vanuatu were approved. It was stressed that joining the organisation should lead to stronger multilateral cooperation, improved global trade rules, resist protectionism and help member countries return to sustainable growth and development. The impact of the European debt crisis on trade was also discussed.

In the US, real GDP increased by 1.8 percent in 2011, compared to a growth of 3.0 percent in 2010. The slowdown was due to lower private sector investment, falling real incomes and depressed labour market. The housing sector remained weak and high Government debt continued to constrain growth. The latest IMF forecast is for real GDP to grow by 1.8 percent in 2012.

Industrial production grew by 3.6 percent in 2011, compared to a growth of 6.8 percent in 2010. The Institute of Supply Management Purchasing Managers Index was 53.9 in December 2011, compared to 52.7 in November, indicating expansion in employment and production in the manufacturing sector for the 29 consecutive months (An index above 50 indicates expansion in the manufacturing industry). Retail sales grew by 7.7 percent in 2011, compared to 6.4 percent in 2010, reflecting a pick up in consumer spending. The unemployment rate was 8.5 percent in 2011, down from 9.4 percent in 2010, as labour market conditions across different sectors begin to improve.

Consumer prices increased by 3.0 percent in 2011, compared to an increase of 1.5 percent in 2010. Broad money supply increased by 9.6 percent in 2011, compared to 3.3 percent in 2010. Concern over the economic recovery has prompted the Federal Reserve to maintain its accommodative monetary policy stance. The federal fund rate remain at historical lows of between zero percent and 0.25 percent in the December quarter of 2011.

The trade deficit was US$558.0 billion in 2011, lower than the US$643.4 billion deficit recorded in 2010.

In Japan, real GDP contracted by 0.9 percent in 2011, following a decline of 2.2 percent in 2010, as a result of a slowdown in exports, following the March 2011 earthquake and tsunami disaster. This affected supply chains and production capacity of Japanese manufacturing companies. The latest IMF forecast is for real GDP to grow by 1.7 percent in 2012.

Industrial production declined by 3.5 percent in 2011, compared to an increase of 16.4 percent in the previous year as a result of the natural disasters. The fall was mainly in the production of telecommunication equipment, cars and other transport equipment and electronic products and parts. Retail sales increased by 2.5 percent in 2011, compared to an increase of 2.1 percent in 2010. The unemployment rate was 4.6 percent in 2011, compared to 4.9 percent in 2010.

Consumer prices fell by 0.1 percent in 2011, compared to a decline of 1.7 percent in 2010. Broad money supply (M3) grew by 2.6 percent in 2011, compared to an increase of 1.8 percent in 2010. To stimulate economic activity, the Bank of Japan kept its policy rate at zero to 0.1 percent in the December quarter of 2011.

The trade deficit was US$32 billion in 2011, its first deficit since 1980, compared to a surplus of US$91.2 billion in 2010. This was mainly due to a significant fall in exports, combined with increased imports associated with the earthquake and tsunami disasters.

In the Euro area, real GDP grew by 1.6 percent in 2011, compared to an increase of 1.9 percent in 2010. The growth in the region continues to be undermined by the debt crisis and austerity measures undertaken by the Governments, combined with low business confidence. The latest IMF forecast is for real GDP to decline by 0.5 percent in 2012.

Industrial production fell by 1.8 percent in 2011, after an increase of 8.1 percent in 2010. Retail sales declined by 0.6 percent in 2011, compared to a 1.1 percent drop in 2010, reflecting lower consumer demand as the debt crisis continue to take its toll on household income and consumer spending. The unemployment rate was 10.4 percent in 2011, up from 10.0 percent in 2010, reflecting the deterioration in economic conditions as the region's debt crisis deepened.

Consumer prices in the Euro area, as measured by the Harmonized Index of Consumer Prices (HICP), increased by 2.7 percent in 2011, compared to an increase of 2.2 percent in 2010. Broad money supply increase by 1.8 percent in 2011, compared to 1.7 percent in 2010. The European Central Bank (ECB) reduced its refinancing rate by 25 basis points to 1.0 percent in December 2011 to support the liquidity situation of European banks.

The trade account was in surplus of US$11.7 billion in 2011, compared to a deficit of US$22.7 billion in 2010.

In Germany, real GDP grew by 3.0 percent in 2011, following an increase of 3.6 percent in 2010. The slow down was a result of lower exports as the debt crisis dampened demand across the Euro region. The latest IMF forecast is for real GDP to grow by 0.3 percent in 2012.

Industrial production grew by 4.5 percent in 2011, compared to an increase of 11.5 percent in 2010, mainly as a result of a slowdown in exports. Retail sales increased by 0.6 percent in 2011, compared to an increase of 0.7 percent in 2010. The unemployment rate was 6.8 percent in 2011, compared to 7.4 percent in 2010. Consumer prices increased by 2.1 percent in 2011, compared to a rise of 1.7 percent in 2010.

The trade surplus was US$20.1 billion in 2011, compared to US$18.7 billion surplus in 2010.

In the United Kingdom (UK), real GDP increased by 0.8 percent in 2011, following an increase of 1.5 percent in 2010. The sluggish growth was attributed to weak production in the manufacturing sector, while activity in the services sector stagnated. The latest IMF forecast is for real GDP to grow by 0.6 percent in 2012.

Industrial production fell by 3.3 percent in 2011, compared to a growth of 3.3 percent in 2010. Retail sales increased by 6.2 percent in 2011, higher than 1.5 percent increase in 2010. The unemployment rate was 8.4 percent in 2011, increasing from 7.9 percent in 2010.

Consumer prices increased by 4.2 percent in 2011, compared to an increase of 3.7 percent in 2010. Broad money supply increased by 1.4 percent in 2011.The Bank of England's official bank rate was maintained at 0.5 percent over the December quarter of 2011.

The trade deficit was US$1.7 billion in 2011, compared to US$5.7 billion deficit in 2010, mainly due to an increase in exports and a drop in imports.

In Australia, real GDP grew by 2.8 percent in 2011, compared to an increase of 2.7 percent in 2010, reflecting strong growth in mining investment, recovery in mining production from rain and flooding, and higher commodity export prices.

Industrial production increased by 3.0 percent in 2011, following an increase of 5.0 percent in 2010. Retail sales increased by 2.6 percent in 2011, compared to 2.1 percent in 2010, reflecting pick up in consumer spending. The unemployment rate was 5.2 percent in 2011, compared to 5.1 percent in 2010. The latest IMF forecast is for real GDP to grow by 3.3 percent in 2012.

Consumer prices increased by 3.1 percent in 2011, higher than 2.1 percent in 2010, mainly reflecting increased prices in non-tradable goods. Broad money supply increased by 7.5 percent in 2011, compared to 10.2 percent in the previous year. On the back of a slowdown in global growth, high unemployment and inflation outlook remaining within the target range of 2-3 percent, the Reserve Bank of Australia (RBA) lowered its Cash Rate by 50 basis points to 4.25 percent in the December quarter of 2011.

The trade surplus was US$30.2 billion in 2011, compared to US$18.1billion surplus in 2010, reflecting strong export demand from Asia.

In the December quarter of 2011, the US dollar appreciated against all the major currencies, reflecting investors appetite for safe-haven investments. The US dollar appreciated by 4.6 percent against the euro, 2.4 percent against the British pound sterling, 0.6 percent against the Japanese yen, and 3.7 percent against the Australian dollar.

In the December quarter of 2011, the daily average kina exchange rate appreciated against the US dollar, euro, pound sterling, Australian dollar and the yen, reflecting high foreign exchange inflows. It appreciated against the US dollar by 3.5 percent to 0.4577, euro by 8.6 percent to 0.3397, pound sterling by 6.1 percent to 0.2914, Australian dollar by 7.5 percent to 0.4530 and the yen by 2.9 percent to 31.29. In the trade weighted index, the kina appreciated by 7.2 percent in the December quarter of 2011 to 36.53 from 34.06 in the September quarter.

3.DOMESTIC ECONOMIC DEVELOPMENTS

DOMESTIC ECONOMIC ACTIVITY[1]

Data from the Bank's Business Liaison Survey (BLS) show that the total nominal value of sales in the private sector declined by 0.2 percent in the September quarter of 2011, compared to a decline of 7.6 percent in the June quarter. Excluding the mineral sector, sales increased by 3.4 percent in the quarter, compared to an increase of 6.8 percent in the June quarter. Sales declined in the mineral, manufacturing and retail sectors, which more than offset increases in the agriculture/forestry/fisheries, building and construction, wholesale, transportation, and financial/business/other services sectors. By region, NCD, Highlands, Islands and Momase recorded declines, while the Morobe and Southern regions experienced increases. Over the twelve months to September 2011, total sales declined marginally by 0.6 percent.

In the retail sector, sales declined by 15.3 percent in the September quarter of 2011, compared to an increase of 1.8 percent in the previous quarter. This reflected a drop in sales of machinery and equipment, information technology and communication products, general electrical appliances and consumer goods. Over the twelve months to September 2011, sales decreased by 25.6 percent.

In the manufacturing sector, sales decreased by 8.0 percent in the September quarter of 2011, compared to

[1]Some companies engaged in the LNG project are not covered in the BLS and Employment Survey sample.

an increase of 10.9 percent in the June quarter. The decline was attributed to a fall in production and export price of crude oil and petroleum products, a drop in sugar production due to wet weather conditions, and disruption to electricity supply for the maintenance of hydro power turbines by PNG Power Ltd. Over the twelve months to September 2011, sales decreased by 20.0 percent.

In the mineral sector, sales declined by 7.4 percent in the September quarter of 2011, compared to a decrease of 21.3 percent in the June quarter. The fall was mainly associated with the shutdown of a mining plant for maintenance and high rainfall at the Lihir gold mine, lower output at the Hidden Valley mine and, low metal grades and disruptions at the Porgera gold mine due to breakdown of an underground mining machine. Over the twelve months to September 2011, sales decreased by 9.9 percent.

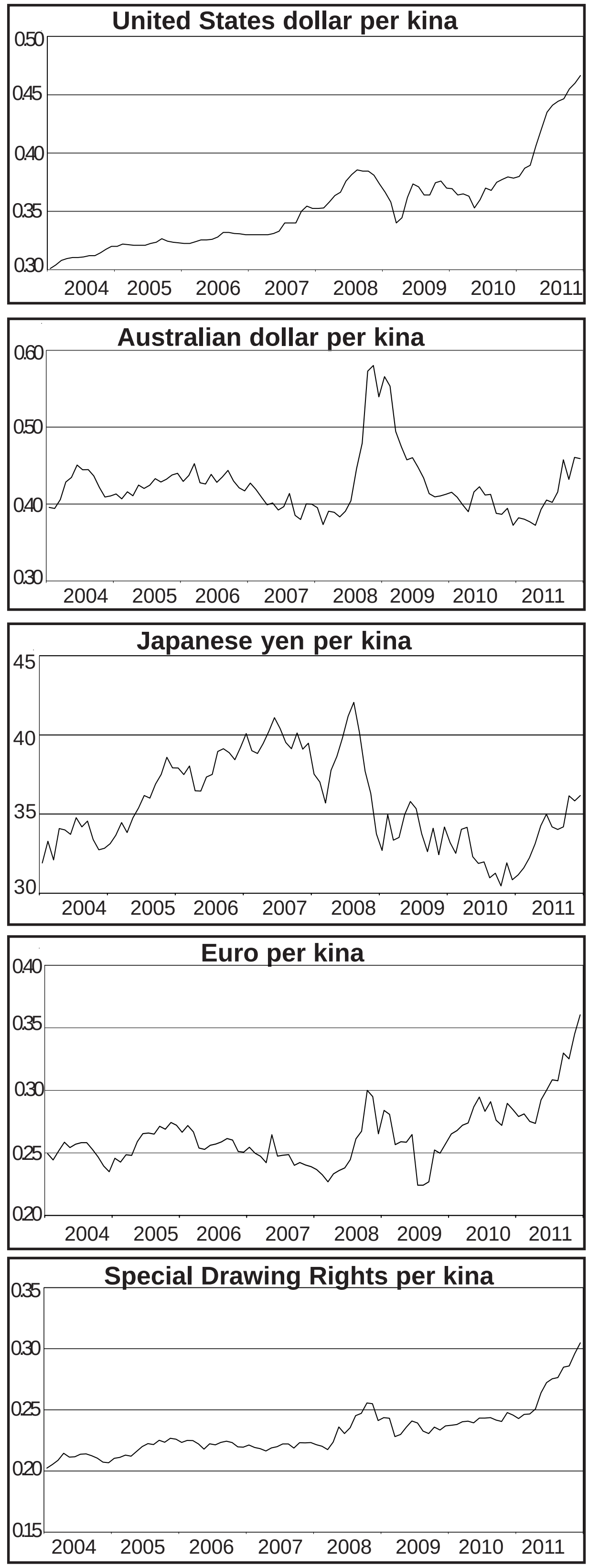
In the building and construction sector, sales increased by 23.5 percent in the September quarter of 2011, compared to an increase of 0.7 percent in the June quarter. The increase was due to the maintenance and upgrading of roads in NCD, Lae and the Highlands region by the Government and donor agencies, a new contract with Ok Tedi mine for road maintenance, on-going construction activity associated with the LNG project and other building projects undertaken by the private sector. Over the twelve months to September 2011, sales increased substantially by 113.2 percent.

In the agriculture/forestry/fisheries sector, sales increased by 20.4 percent in the September quarter of 2011, following a decline of 25.8 percent in the June quarter. The increase, attributed to higher prices and production of palm oil and coffee in the agriculture subsector, more than offset the declines in the other subsectors. Over the twelve months to September 2011, sales declined by 2.3 percent.

Sales in the wholesale sector increased by 16.2 percent in the September quarter of 2011, compared to an increase of 14.1 percent in the previous quarter. The increase came from high demand for fuel products and general consumer goods, and an expansion of operations by a major wholesale company. Over the twelve months to September 2011, sales increased by 46.8 percent.

In the transportation sector, sales increased by 12.3

EXCHANGE RATES



percent in the September quarter of 2011, compared to an increase of 3.9 percent in the previous quarter. The increase was due to higher passenger travel and cargo haulage in the air transportation sub-sector. Over the twelve months to September 2011, sales increased by 10.4 percent.

In the financial/business/other services sector, sales increased by 5.1 percent in the September quarter of 2011, following an increase of 11.6 percent in the previous quarter. The rise reflected increased foreign exchange trading activity by the commercial banks, and strong growth in the security and hotel services. Over the twelve months to September 2011, sales increased by 28.4 percent.

By region, sales declined in the Islands, NCD, Highlands, and Momase regions, while the Morobe and Southern regions experienced increases. In the Islands region, sales decreased by 13.1 percent in the September quarter of 2011, compared to a decline of 2.6 percent in the previous quarter. The decrease was mainly in the mineral sector and was associated with a fall in gold production at the Lihir mine, which more than offset increases in the other sectors. Over the twelve months to September 2011, sales dropped by 2.3 percent.

In NCD, sales decreased by 2.8 percent in the September quarter of 2011, compared to an increase of 13.2 percent in the previous quarter. The decrease was mainly in the manufacturing and retail sectors. In the manufacturing sector, the decline was mainly due to a fall in production and export price of crude oil and petroleum products, and disruption of electricity supply due to maintenance of hydro power turbines by PNG Power Ltd. In the retail sector, the drop was due to lower demand for machinery and equipment, information technology and communication products, general electrical appliances and consumer goods. Over the twelve months to September 2011, sales increased by 3.5 percent.

In the Highlands region, sales dropped by 2.7 percent in the September quarter of 2011, compared to an increase of 13.8 percent in the previous quarter. The decline was mainly in the mineral sector, which more than offset the increases in the other sectors. There was a disruption at the Porgera gold mine due to the breakdown of an underground mining machine. Over the twelve months to September 2011, sales increased by 34.2 percent.

In the Momase region, sales decreased by 0.8 percent in the September quarter of 2011, compared to an increase of 5.6 percent in the June quarter. The drop was mainly in the manufacturing sector, associated with lower production of sugar stemming from wet weather conditions. Over the twelve months to September 2011, sales increased by 10.3 percent.

In Morobe, sales increased by 30.8 percent in the September quarter of 2011, compared to an increase of 4.1 percent in the previous quarter. There were increases in the manufacturing and wholesale sectors. The increase in the manufacturing sector was associated with higher production of industrial chemicals and beverages, while in the wholesale sector, the increase reflected strong demand for tyres, soft drinks and general consumer products. Over the twelve months to September 2011, sales declined by 12.1percent.

In the Southern region, sales increased by 5.6 percent in the September quarter of 2011, compared to a decline of 45.6 percent in the June quarter. The increase was in the wholesale sector and the agriculture sub-sector. The increase in the wholesale sector was mainly associated with higher demand for general merchandise goods, while the increase in the agriculture sub-sector was due to higher price and production of palm oil. Over the twelve months to September 2011, sales decreased by 24.3 percent.

EMPLOYMENT

The Bank's Employment Index shows that the level of employment in the private sector increased slightly by 1.0 percent in the December quarter of 2011, compared to a decline of 0.2 percent in the previous quarter. Excluding the mineral sector, the level of employment increased by 0.3 percent. The level of employment increased in all sectors, except the agriculture/forestry/fisheries and manufacturing sectors. By region, Momase, Morobe, NCD,Highlands and Southern regions experienced increases, while Islands recorded a decline. In 2011, the total level of employment increased by 6.2 percent. Excluding the mineral sector, the level of employment also increased by 6.2 percent, as the change in the mineral sector was negligible.

In the mineral sector, the level of employment increased by 8.6 percent in the December quarter of 2011, following a decline of 2.0 percent in the previous quarter. The increase was due to the recruitment of new staff by a mining company, while a company involved with the PNG LNG project recruited skilled workers for the installation of pipelines from the Southern highlands to the Central province. In 2011, the level of employment increased by 9.7 percent.

In the retail sector, the level of employment rose by 4.1 percent in the December quarter of 2011, compared to an increase of 2.7 percent in the September quarter. The increase was due to the: hiring of casual workers by various retail companies to meet higher demand during the Christmas period; and the opening of new branches of a major automotive company in Port Moresby and Goroka. In 2011, the level of employment increased by 3.2 percent.

In the transportation sector, the level of employment increased by 3.4 percent in the December quarter of 2011, compared to a decline of 6.4 percent in the previous quarter. This was due to the recruitment of casual employees by a major shipping company to meet higher demand during the festive period. In 2011, the level of employment increased 35.2 percent.

In the wholesale sector, the level of employment increased by 2.0 percent in the December quarter of 2011, compared to a growth of 4.5 percent in the September quarter. The increase reflected the recruitment of casual staff for increased trading during the Christmas period, and expansion of business operations in NCD and Morobe by the wholesale companies. In 2011, the level of employment increased by 16.5 percent.

In the building and construction sector, the level of employment increased by 1.3 percent in the December quarter of 2011, compared to an increase of 2.3 percent in the previous quarter, accounted for by the on-going road maintenance projects in Morobe, NCD and the Highlands regions. In 2011, the level of employment declined by 8.3 percent.

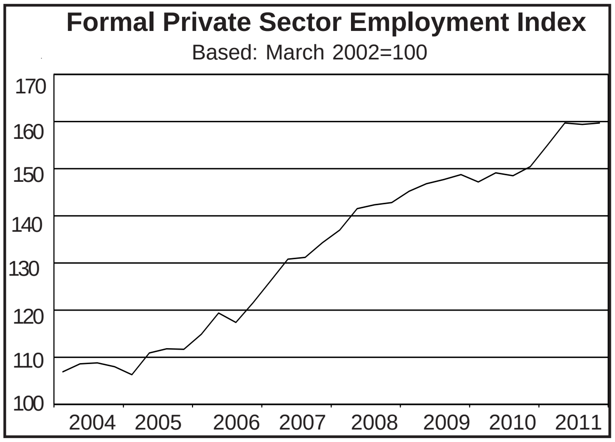
In the financial/business/other services sector, the level of employment increased by 0.7 percent in the December quarter of 2011, compared to a decline of 0.9 percent in the September quarter. The increase was associated with a recruitment drive by a telecommunication company reflecting the expansion of its network and an expansion of operations by a major hotel company. In 2011, the level of employment increased by 2.2 percent.

In the agriculture/forestry/fisheries sector, the level of employment fell by 1.5 percent in the December quarter of 2011, following a decline of 0.6 percent in the previous quarter. In the agriculture sub-sector, there was a laying off of casual employees by an oil palm company and scaling down of operations by two major coffee exporters, reflecting the end of the coffee season. The decline in the fisheries sub-sector was a result of lower fishing activity, stemming from bad weather conditions. In 2011, the level of employment declined by 12.0 percent.

In the manufacturing sector, the level of employment decreased by 3.1 percent in the December quarter of 2011, compared to an increase of 1.3 percent in the September quarter. The decrease was associated with the laying-off of casual workers involved in the sugar and fish production due to wet weather conditions. In addition, a company engaged in the manufacturing and export of wood products laid off workers due to lower performance as a result of declines in international prices. In 2011, the level of employment declined by 1.3 percent.

By region, the NCD, Highlands, Southern, Momase and Morobe regions recorded increases, while the Islands region recorded a decline. In the Southern region, the level of employment increased by 3.5 percent in the December quarter of 2011, compared to an increase of 1.4 percent in the previous quarter. The increase was in the building and construction, wholesale, retail and mineral sectors. The increase in the building and construction sector was due to road maintenance work in Milne Bay and Gulf provinces, while the growth in the wholesale sector was due to increased trading during the Christmas period. In the mineral sector, the increase in employment reflected higher production. In 2011, the level of employment increased by 11.9 percent.

In NCD, the level of employment increased by 2.6 percent in the December quarter of 2011, compared to a decline of 0.3 percent in the previous quarter. The increase was in the building and construction, retail, and financial/business/other services sectors. The increase in the building and construction sector was due to on-going road projects in NCD and Central province. In the retail sector, the increase reflected increased trading during the Christmas period. The increase in the other services sub-sector, especially hotel and communication services, was attributed to increased demand during the Christmas period, and recruitment of staff by a telecommunication service



provider to expand its services. In 2011, the level of employment increased by 4.0 percent.

In Morobe, the level of employment increased by 2.8 percent in the December quarter of 2011, compared to an increase of 0.7 percent in the previous quarter. The increase was in the retail and wholesale sectors, reflecting increased trading of merchandise goods over the Christmas period. In 2011, the level of employment increased by 12.0 percent.

In the Momase region, the level of employment increased by 0.9 percent in the December quarter of 2012, compared to a decline of 0.9 percent in the previous quarter. The increase was in the fisheries and forestry sub-sectors, mainly associated with the recruitment of casual employees to meet higher demand during the Christmas period. In 2011, the level of employment increased by 6.0 percent.

In the Highlands region, the level of employment increased by 0.7 percent in the December quarter of 2011, compared to an increase of 2.4 percent in the previous quarter. The increase was in the mineral and retail sectors. The growth in the mineral sector was due to a major mining company recruiting additional security personal to protect its assets from illegal miners, while the increase in the retail sector was due to engagement of extra workers to cater for the busy Christmas festive season. In 2011, the level of employment increased by 18.3 percent.

In the Islands region, the level of employment declined by 3.3 percent in the December quarter of 2011, compared to a decline of 2.4 percent in the September quarter. The decline was in the manufacturing and, building and construction sectors and the agriculture sub-sector. The decline in the building and construction sector was attributed to the laying off of workers due to the completion of a contract. In the manufacturing sector, staff were laid off as a result of lower overseas demand. The decline in the agriculture sub-sector was due to laying-off of casual employees by a palm oil company. In 2011, the level of employment increased by 0.1 percent.

CONSUMER PRICE INDEX

Quarterly headline inflation, as measured by the Consumer Price Index (CPI), was 1.2 percent in the December quarter of 2011, compared to 0.2 percent in the previous quarter. The increase was in the 'Transport and Communication', 'Household equipment and operations', 'Drinks, tobacco and betel nut', 'Clothing and footwear' and 'Miscellaneous' expenditure groups, while 'Food' and 'Rent, council charges, fuel and power' expenditure groups recorded declines. Annual headline inflation was 6.9 percent in the December quarter of 2011, lower than 8.4 percent in the September quarter. The lower outcome was due to declines in imported prices of food and fuel, combined with the strengthening of the kina. All surveyed urban areas recorded price increases in the December quarter of 2011, except Rabaul.

The CPI for the 'Food' expenditure group decreased by 0.1 percent in the December quarter of 2011, following an increase of 2.0 percent in the September quarter. The decrease was in the cereals sub-group, which more than offset increases in all the other sub-groups. The prices in the cereals sub-group declined by 7.0 percent, which more than offset the increases in the fruits and vegetables sub-group of 6.4 percent, meat and fish sub-group of 2.2 percent and the miscellaneous food items of 0.3 percent. The contribution of this expenditure group to the overall movement in the CPI was negligible.

In the 'Drinks, tobacco and betelnut' expenditure group, prices increased by 1.9 percent in the December quarter of 2011, following a decrease of 2.4 percent in the previous quarter. The increase was in the betelnut and, alcoholic drinks sub-groups. The 'betelnut' sub-group recorded the biggest increase of 18.2 percent, while alcoholic drinks sub-group increased by 0.1 percent. The CPI for 'soft drinks' sub-group remained unchanged, while the 'Cigarettes and tobacco' sub-group declined by 0.1 percent. This expenditure group contributed 0.4 percentage points to the overall movement in the CPI.

The CPI for the 'Transport and communication' expenditure group increased by 3.8 percent in the December quarter of 2011, following a decline of 0.5 percent in the September quarter. The increase was in the motor vehicle purchase and, airline, bus and PMV fares sub-groups by 5.3 percent and 3.4 percent, respectively. This, more than offset a fall in the CPI for motor vehicle operations sub-group of 0.2 percent. This expenditure group contributed a negative 0.5 percentage points to the overall movement in the CPI.

The CPI for 'Rents, council charges, fuel/power' expenditure group declined by 1.1 percent in the December quarter of 2011, compared to a decline of 4.7 percent in the previous quarter. The decline was in the 'fuel/power' sub-group, which fell by 2.0 percent reflecting lower fuel prices. The fall more than offset the increase in the 'council charges, water sewerage and garbage' subgroup of 0.7 percent. This expenditure group contributed a negative 0.3 percentage points to the overall movement in the CPI.

In the 'Clothing and footwear' expenditure group, prices increased by 1.6 percent in the December quarter of 2011, compared to an increase of 1.8 percent in the September quarter. All sub-groups recorded price increases. In the men's and boy's clothing and, women and girls clothing sub-groups, prices increased by 1.7 percent each, while in the other clothing and footwear sub-group, prices increased by 1.4 percent. This expenditure group contributed a decline of 0.1 percentage points to the overall movement in the CPI.

The CPI for the 'Household, equipment and operations' expenditure group increased by 2.2 percent in the December quarter of 2011, compared to an increase of 2.6 percent in the previous quarter. All sub-groups recorded increases with the durable goods sub-group recording the highest of 4.1 percent, followed by the semi-durable goods sub-group with 2.4 percent, and the non-durable goods sub-group with 1.8 percent. This expenditure group contributed 0.1 percentage points to the overall movement in the CPI.

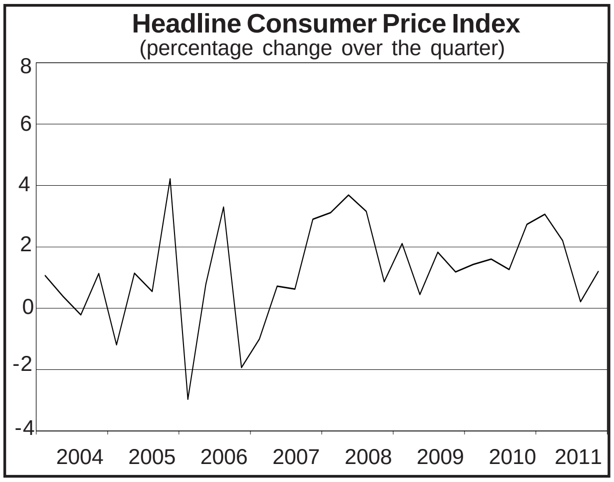
In the 'Miscellaneous' expenditure group, the prices increased by 0.6 percent in the December quarter of 2011, compared to an increase of 0.8 percent in the September quarter. The increase was in the medical and health care and, other goods sub-groups. The medical and health care sub-group recorded an increase of 1.4 percent, while the other goods sub-group recorded an increase of 1.7 percent. The contribution of this expenditure group to the overall movement in the CPI was negligible.

By urban areas, price increases were recorded in all the surveyed centres in the December quarter of 2011, except Rabaul which declined by 0.3 percent. In Lae, prices increased by 2.1 percent, followed by Port Moresby with 1.2 percent, Madang with 1.1 percent and Goroka with 1.0 percent.

In Port Moresby, prices increased by 1.2 percent in the December quarter of 2011, compared to a decrease of 0.4 percent in the September quarter. All expenditure groups recorded increases, except the 'Food' and 'Rent, council charges, fuel and power' groups. The 'Transport and communication' expenditure group recorded the biggest increase of 3.5 percent, followed by the 'Drinks, tobacco and betelnut' group with 3.2 percent, the 'Household equipment and operations' group with 2.9 percent, the 'Clothing and footwear' group with 0.2 percent and the 'Miscellaneous' group with 0.1percent. The CPI for the 'Rent, council charges fuel/power' expenditure group declined by 1.1 percent, while the 'Food' group decreased by 0.8 percent.

In Lae, prices increased by 2.1 percent in the December quarter of 2011, compared to an increase of 0.4 percent in the September quarter. All the expenditure groups recorded increases, except the 'Rents, council charges, fuel/power' group, which declined by 1.2 percent. The CPI for the 'Transport and communication' expenditure group recorded the highest increase of 7.8 percent, followed by the 'Clothing and footwear'' expenditure group with 4.2 percent. The 'Drinks, tobacco and betelnut' expenditure group increased by 3.3 percent, the 'Household equipment and operations' group by 2.5 percent, the 'Food' group by 0.4 percent, and the 'Miscellaneous' group by 1.2 percent.

In Goroka, prices increased by 1.0 percent in the December quarter of 2011, compared to an increase of 0.3 percent in the September quarter. The increase was in all expenditure groups, except the 'Food' and 'Rents, council charges, fuel and power' groups, which declined by 0.1 percent and 1.5 percent, respectively. The CPI for the 'Transport and communication' group recorded the highest increase of 3.4 percent, followed by the 'Household equipment & operation' group with 0.9 percent, the 'Clothing and footwear' group with 0.1 percent, the 'Drinks, tobacco and betelnut' group with



0.6 percent and the 'Miscellaneous' group with 0.5 percent.

In Madang, prices increased by1.1 percent in the December quarter of 2011, compared to an increase of 0.1 percent in the previous quarter. The increase was in all expenditure groups, except the 'Rents, council charges, fuel and power' group, which declined by 0.4 percent. The 'Clothing and footwear' group recorded the highest increase of 3.8 percent, followed by the 'Household equipment & operation' group with 2.3 percent. The CPI for the 'Transport and communication' group increased by 1.9 percent, the 'Drinks, tobacco and betelnut' group with 1.6 percent, the 'Food' group with 0.4 percent and the 'Miscellaneous' group with 1.1 percent.

In Rabaul, prices dropped by 0.3 percent in the December quarter of 2011, following an increase of 2.6 percent in the previous quarter. The decline was in the 'Drinks, tobacco and betelnut' and the 'Rents, council charges, fuel and power' expenditure groups, which declined by 3.6 percent and 1.6 percent, respectively. This, more than offset the increase in the other expenditure groups. The CPI for the 'Food' expenditure group increased by 1.1 percent, the 'Transport and communication' group by 1.9 percent, the 'Household equipment and operations' group by 1.0 percent, 'Clothing and footwear' group by 0.8 percent and the 'Miscellaneous' group by 1.1 percent.

The two underlying inflation measures, the trimmed mean and exclusion-based both increased on a quarterly and annual basis. The quarterly exclusion-based inflation increased by 0.5 percent, while the trimmed-mean inflation increased by 1.0 percent in the December quarter of 2011, compared to an increase of 1.1 percent and 0.8 percent, respectively, in the previous quarter. The annual exclusion-based and trimmed-mean inflation was 7.7 percent and 6.5 percent, respectively in 2011. The exclusion-based inflation is higher than the headline rate, reflecting high demand in the economy.

4.0 EXPORT COMMODITIES REVIEW

The total value of merchandise exports was K16,101 million in 2011, an increase of 3.1 percent from 2010. There were increases in the value of crude oil, coffee, palm oil, copra, copra oil, rubber, marine products and other non-mineral exports with the exception of gold, copper, cocoa, tea and refined petroleum products.

The total value of agricultural, marine products and other non-mineral exports, excluding forestry products and refined petroleum products exports was K3,419.4 million and accounted for 21.2 percent of total merchandise exports in 2011, compared to 15.9 percent in 2010. Forestry products export was K674.1 million and accounted for 4.2 percent of total merchandise export in 2011, compared to 4.8 percent in 2010. Refined petroleum products export was K473.6 million and accounted for 2.9 percent of total merchandise exports in 2011, compared to 3.9 percent in 2010. Mineral export receipts, excluding crude oil was K9,099.8 million and accounted for 56.5 percent of total merchandise exports in 2011, compared to 61.2 percent in 2010. Crude oil exports totalled K2,434 million and accounted for 15.1 percent of total merchandise exports in 2011, compared to 14.2 percent in 2010.

The weighted average kina price of PNG's exports increased by 14.0 percent in 2011, from 2010. The increase was associated with high international commodity prices reflecting a strong demand from major emerging markets of Asia, especially China and India. There was a 13.9 percent increase in the weighted average kina price of mineral exports, with higher kina prices of all mineral exports. For agricultural, logs and marine product exports, the weighted average kina price increased by 14.4 percent due to higher prices of coffee, palm oil, copra, copra oil, rubber and marine products with the exception of cocoa, tea and logs. Excluding logs, the weighted average price of agricultural and marine product exports increased by 21.3 percent in 2011, from 2010.

Mineral Exports

Total mineral export was K11,533.8 million in 2011, a decline of 2.1 percent from 2010. The decline was due to lower export volumes of all mineral exports, which more than offset the increase in prices of all mineral exports.

Gold export volume was 51.0 tonnes in 2011, a decline of 17.1 percent from 2010. The decrease was associated with a decline in production at the Ok Tedi and Simberi mines due to a damage in the pipeline, and mill repair and maintenance, respectively. The average free on board (f.o.b.) price for PNG's gold exports was K116,663 million per tonne in 2011, an increase of 12.5 percent from 2010. The increase was attributed to higher global demand for gold. The average gold price at the London Metal Exchange was US$1,570 per fine ounce in 2011, an increase of 30.6 percent from 2010. The increase was due to higher demand for gold based investments as a result of high volatility in the credit and financial markets, combined with higher demand from India and China, two of the world's largest buyers. A decline in gold export volume more than offset the increase in export price, and resulted in a 6.7 percent decline in export receipts to K5,949.8 million in 2011,from 2010.

Copper export volume was 143.6 thousand tonnes in 2011, a decline of 7.2 percent from 2010. The decline was associated with the extraction of lower ore grade at the Ok Tedi mine, combined with a shutdown of its production plant due to a damage in the pipeline. The average f.o.b. price of PNG's copper exports was K21,219 per tonne in 2011, an increase of 6.3 percent from 2010. This outcome was mainly attributed to higher demand from China and other emerging market economies, combined with lower production in Chile and Peru, two of the world's major copper producers. The decline in export volume more than offset an increase in export price, and resulted in a decline of 1.4 percent in export value to K3,047.1 million in 2011, compared to 2010.

Crude oil export volume was 8,784.1 thousand barrels in 2011, a decline of 15.5 percent from 2010. The outcome reflected lower extraction and production of oil due to the declining oil reserves at the Kutubu, Gobe main, South East Gobe and Moran oil fields. The average export price of crude oil was K277 per barrel in 2011, an increase of 29.4 percent from 2010. The increase reflected higher global demand due to lower production and supply of oil from North Africa, especially Libya, and the imposition of production quota by the members of the Organisation of Petroleum Exporting Countries (OPEC). The increase in export price more than offset the decline in export volume, and resulted in a 9.4 percent increase in export value of K2,434.0 million in 2011, from 2010.

Export receipts of refined petroleum products from the Napa Napa Oil Refinery in 2011 totalled K473.6 million, a decline of 23.2 percent from 2010. This outcome was due to lower export of refined petroleum products associated with the natural decline in oil production at the major oil fields.

Agriculture, Logs and Fisheries Exports

Export prices for coffee, palm oil, copra, copra oil and rubber increased while prices for cocoa and tea declined in 2011, compared to 2010. Prices of coffee increased by 35.4 percent, palm oil by 22.7 percent, copra by 37.6 percent, copra oil by 35.9 percent and rubber by 38.3 percent. The export price of cocoa declined by 18.0 percent and tea by 11.3 percent. The average export price of logs declined by 10.2 percent in 2011, from 2010. The increases in the export prices of most agricultural and marine products, more than offset the decline in export price of logs resulting in a 14.4 percent increase in the weighted average price of agricultural, logs and marine exports. Excluding the log exports, the weighted average price of agricultural and marine products increased by 21.3 percent in 2011, compared to 2010.

The volume of coffee exported was 73.5 thousand tonnes in 2011, an increase of 31.5 percent compared to 2010. The increase was due to higher international prices, combined with favourable weather conditions. The average export price of coffee was K12,618 per tonne in 2011, an increase of 35.4 percent from 2010. This was attributed to increased global demand and low supply from Indonesia, the third largest coffee producer, due to unfavourable wet weather conditions. The combined increase in export price and volume resulted in 78.0 percent increase in export receipts to K927.4 million in 2011, compared to 2010.

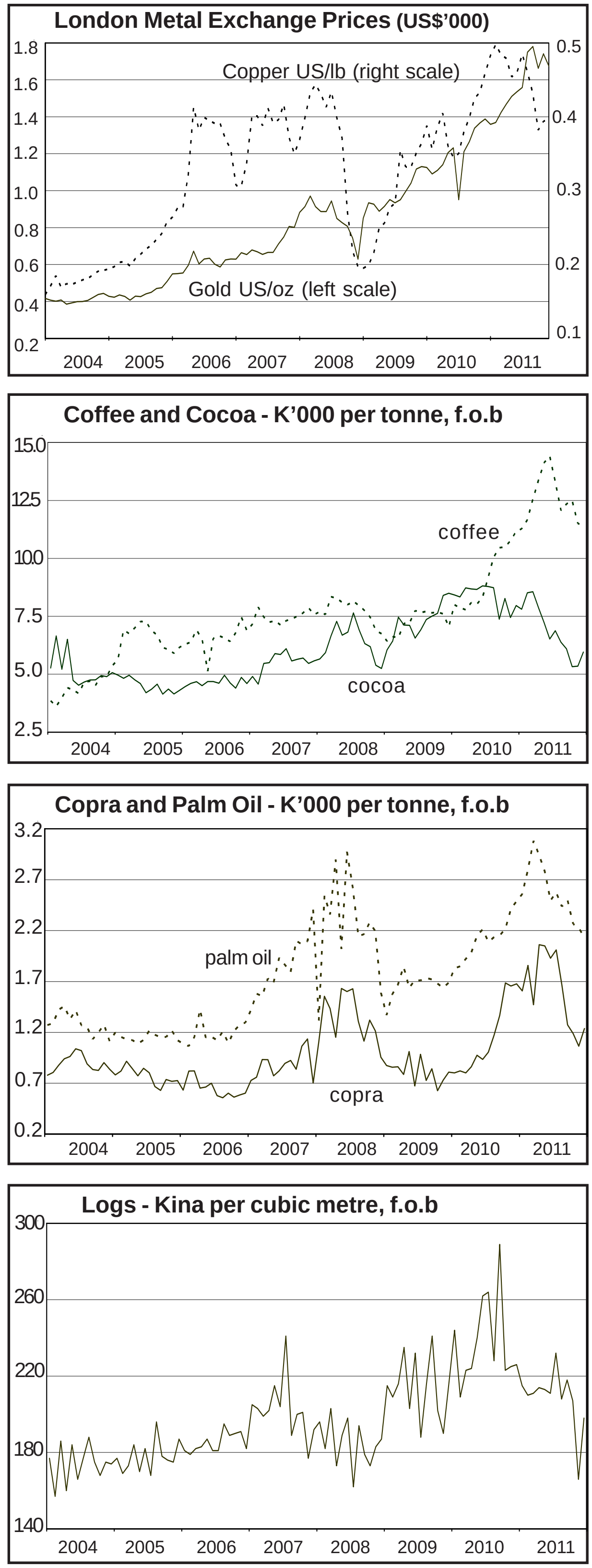
The volume of cocoa exported was 40,900 tonnes in 2011, a decline of 1.0 percent from 2010. The decline was attributed to low production, associated with the cocoa pod borer disease with a low recovery in output from the East New Britain Province and other major producing regions. The average export price of cocoa was K6,905 per tonne in the 2011, a decline of 18.0 percent from 2010. The decline in export price was due to increased supply from Indonesia, Nigeria and countries from South America. The combined decrease in export price and volume resulted in 18.8 percent decline in export receipts to K282.4 million in 2011, compared to 2010.

The volume of copra exported in 2011 was 43,700 tonnes, an increase of 134.9 percent compared to 2010. The significant increase was mainly attributed to higher international prices, which resulted in higher production, combined with awareness on quality control which attracted premium prices by Kokonas Industri Koporasen. The average export price of copra increased by 37.6 percent to K1,620 per tonne in 2011 from 2010. The outcome was mainly due to lower production from the Philippines reflecting the drought during the first half of the year. The combined increase in price and volume resulted in a significant increase of 223.3 percent in export receipts to K70.8 million in 2011, from 2010.

The volume of copra oil exported was 45,200 tonnes in 2011, a decline of 1.7 percent from the corresponding period of 2010. The decline was due to the closure of the copra depot in Madang, combined with lower production by two domestic copra oil mills as producers preferred exporting overseas at higher prices. The average export price of copra oil was K3,847 per tonne in the 2011, an increase of 35.9 percent from 2010. The increase was due to higher international prices reflecting lower production from the Philippines. The increase in the export price more than offset the decline in the export volume, and resulted in 33.6 percent increase in an export receipt of K173.9 million in 2011, from 2010.

The volume of palm oil exported was 559,100 tonnes in 2011, an increase of 15.1 percent from 2010. The outcome was due to high production and shipment as a result of supply response to higher international prices, as well as favourable dry weather conditions. The average export price of palm oil was K2,590 per tonne in 2011, an increase of 22.7 percent from 2010. The increase was due to lower production and shipment from Malaysia and Indonesia, resulting from flood in the early part of 2011. The combined increase in export price and volume resulted in export receipts of K1,448.2 million in 2011, an increase of 41.3 percent from 2010.

EXPORT COMMODITY PRICES



The volume of tea exported in 2011 was 4,000 tonnes, a decline of 13.0 percent from 2010. This outcome was due to lower production caused by unfavourable dry weather conditions and shortage of labour during the peak harvesting period. The average export price of tea was K3,550 per tonne in 2011, a decline of 11.3 percent from 2010. The combined decline in export volume and price resulted in a 22.8 percent decrease in export receipts to K14.2 million in 2011, compared to 2010.

The volume of rubber exported in 2011 was 4,200 tonnes, a decline of 8.7 percent from 2010, due to lower production and delayed shipment. The average export price was K9,738 per tonne in 2011, an increase of 38.3 percent from 2010. This resulted from higher international prices due to lower production in Indonesia and Thailand, combined with high demand from China. The increase in export price more than offset the decline in export volume resulting in a 26.2 percent increase in export receipts to K40.9 million in 2011, from 2010.

The volume of logs exported was 3,022 thousand cubic metres in 2011, an increase of 0.8 percent from 2010. The outcome was attributed to higher production and shipment from major logging areas due to dry weather conditions. The average export price of logs was K211 per cubic metre in 2011, a decline of 10.2 percent from 2010. This, resulted from a fall in the construction activity and destocking in Japan, following the peak in the reconstruction program for tsunami disaster areas. The decline in export price more than offset an increase in export volume resulting in a 9.6 percent decrease in export receipts to K638.1 million in 2011, from 2010.

The value of marine products exported in 2011 was K151.1 million, an increase of 32.5 percent from 2010. This outcome was the result of combined increase in volume and price.

5.0 BALANCE OF PAYMENTS[2,3]

The overall surplus in the balance of payments was K1,096 million in 2011, compared to a surplus of K1,065 million in 2010. This outcome was due to a surplus in the capital and financial accounts, which more than offset a deficit in the current account. The surplus in the capital and financial accounts reflect net inflows from capital transfers, portfolio and other investments, which more than offset net outflows from foreign direct investments and financial derivative instruments. The 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. In 2011, the kina appreciated against all the currencies of Papua New Guinea's major trading partner countries, compared to 2010. The appreciation resulted in a decline in the kina value of balance of payments transactions.

The trade account recorded a surplus of K6,452 million in 2011, an increase of 7.1 percent from 2010. The higher surplus was due to an increase in the value of merchandise exports, which more than offset an increase in the value of merchandise imports. The value of merchandise exports was K16,101 million in 2011, an increase of 3.1 percent from 2010. The increase was attributed to higher export values of all export commodities, except gold, copper, cocoa, tea, forestry and refined petroleum products exports.

The value of merchandise imports was K9,649 million in 2011, an increase of 0.5 percent from 2010. The increase was due to higher imports by the mineral sector, which more than offset a decline in general imports. Imports by the mining companies increased by 14.2 percent to K2,042 million in 2011, compared to 2010. The increase was due to higher capital expenditure undertaken by the Ok Tedi, Lihir and Porgera mines. Imports by the petroleum companies increased by 38.0 percent to K945 million in 2011, compared to 2010. The outcome reflected higher capital expenditure by the Kutubu oil project and higher exploration activity associated with the Mananda oil field. General imports declined by 5.3 percent to K6,662 million in 2011, compared to 2010.

The deficit in the services account was K5,927 million in 2011, a decline of 10.9 percent from 2010. The outcome was due to lower payments for transportation, travel, insurance, other financial, communication, other business, cultural and recreational, refining and smelting, and construction services, combined with higher service receipts by resident companies.

The deficit in the income account was K1,305 million in 2011, a decline of 18.9 percent from 2010. The

[2] LNG flows relating to import, service and income payments and receipts and financial account transactions were not captured due to non-submission of data by the project participants.
[3] Unrequited transfers, both current and capital, are for only one donor agency, i.e. AusAID.

outcome was mainly due to lower dividend payments, combined with lower income receipts by residents.

The surplus in the transfers account was K666 million in 2011, an increase of 29.1 percent from 2010. This outcome was mainly due to higher receipts from family maintenance, gifts and grants, tax and licensing fees, which more than offset higher transfer payments.

As a result of these developments in the trade, services, income and transfers accounts, the current account recorded a lower deficit of K114 million in 2011, compared to a deficit of K1,721 million in 2010.

The capital account recorded a net inflow of K73 million in 2011, compared to K101 million in 2010, reflecting lower transfers by donor agencies through direct project financing.

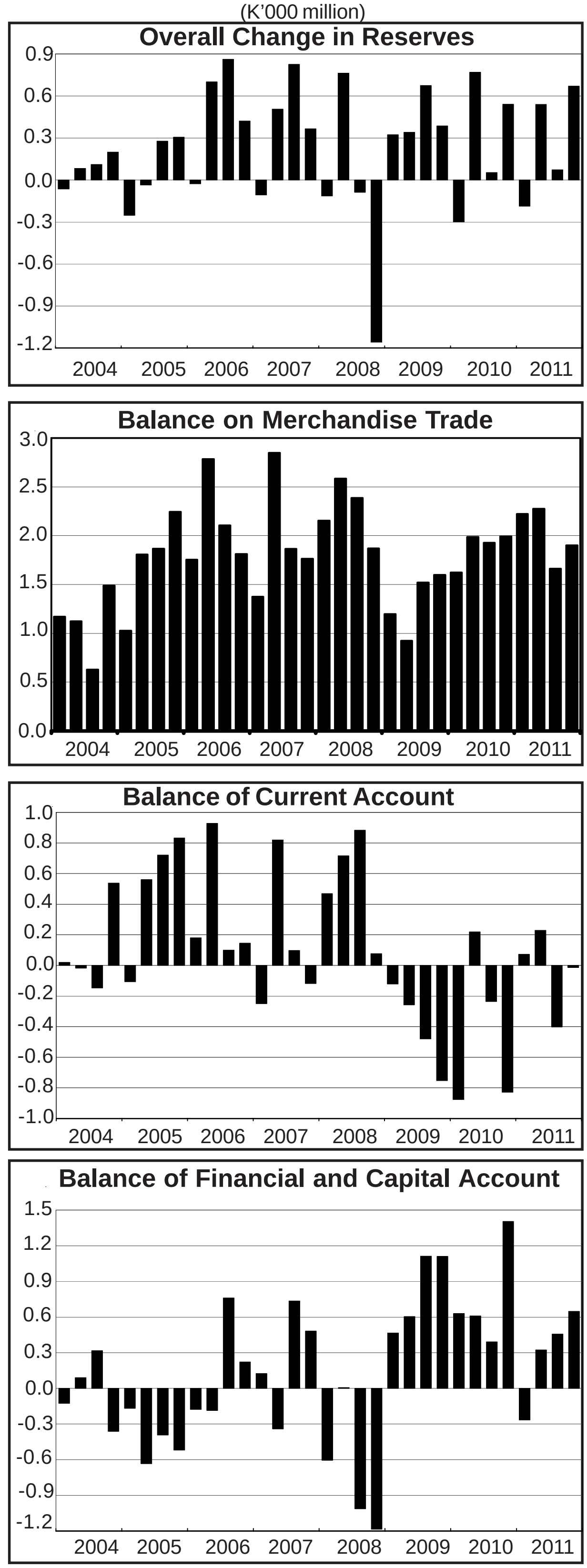
The financial account recorded a net inflow of K1,087 million in 2011, compared to a net inflow of K2,934 million in 2010. This outcome was due to net inflows from portfolio and other investments. Net inflows from portfolio investments reflected the sale of short term money market instruments by resident entities, whilst other investments was due to higher trade credit receipts to PNG resident entities. These more than offset net outflows from foreign direct investments associated with the purchase of shares by a resident mineral company, and investments in financial derivative instruments from hedge arrangements by resident companies.

As a result of these developments, the capital and financial accounts balance recorded a surplus of K1,160 million in 2011, compared to a significant surplus of K3,035 million in 2010.

In the December quarter of 2011, the balance of payments recorded an overall surplus of K670 million, compared to a surplus of K541 million in the corresponding quarter of 2010. This outcome was due to a surplus in the capital and financial accounts, which more than offset a deficit in the current account.

The value of merchandise exports was K3,465 million in the December quarter of 2011, a decline of 17.0 percent from the corresponding quarter of 2010. The decline was due to lower export values of gold, copper, crude oil, cocoa, copra oil, tea, rubber, marine and forestry products. Agricultural, forestry, marine products and other non-mineral exports, excluding refined

BALANCE OF PAYMENTS
(K'000 million)



petroleum products export were K842 million. This comprises 24.3 percent of the total merchandise exports in the December quarter of 2011, compared to 20.0 percent in the corresponding quarter of 2010. Refined petroleum product exports totalled K95.2 million in the December quarter of 2011 and accounted for 2.7 percent of total merchandise exports, compared to 2.2 percent in the corresponding quarter of 2010. Mineral exports totalled K2,523 million and accounted for 72.8 percent of total merchandise exports in the December quarter of 2011, compared to 77.7 percent in the corresponding quarter of 2010.

The value of merchandise imports was K1,943 million in the December quarter of 2011, a decline of 24.6 percent from the corresponding quarter of 2010. The outcome reflected lower general imports, which more than offset higher mineral sector imports. General imports declined by 39.3 percent to K1,056 million in the December quarter of 2011, compared to the corresponding quarter of 2010. Imports by mining companies increased by 2.8 percent to K622 million in the December quarter of 2011, compared to the corresponding quarter of 2010. This outcome was due to higher capital expenditure by the Ok Tedi and Lihir mines, which more than offset a decline in the Porgera mine. Imports by the petroleum companies increased by 13.7 percent to K265 million in the December quarter of 2011, compared to the corresponding quarter of 2010. The outcome reflected higher capital expenditure by the Kutubu oil project and increased exploration activity.

The deficit in the services account was K1,330 million in the December quarter of 2011, a decline of 25.3 percent from the corresponding quarter of 2010. The deficit was due to a decline in payments for transportation, travel, communication, other business, government n.i.e., and other services. Lower service receipts by resident companies also contributed to the decline.

The deficit in the income account was K341 million in the December quarter of 2011, a decline of 55.0 percent from the corresponding quarter of 2010. This outcome was due to lower interest and dividend payments, which more than offset the increase in income receipts.

The surplus in the transfers account was K135 million in the December quarter of 2011, an increase of 17.4 percent, compared to the corresponding quarter of 2010. This outcome was mainly due to lower payments for family maintenance, gifts and grants, tax and licensing fees, which more than offset lower transfer receipts.

As a result of these developments in the trade, services, income and transfers accounts, the current account recorded a deficit of K14 million in the December quarter of 2011, compared to a deficit of K828 million in the corresponding quarter of 2010.

The capital account recorded a net inflow of K10 million in the December quarter of 2011, compared to K18 million in the corresponding quarter of 2010, reflecting lower capital transfers by donor agencies through direct project financing. The financial account recorded a net inflow of K637 million in the December quarter of 2011, compared to a net inflow of K1,387 million in the corresponding period of 2010. This outcome was due to net inflows from direct investments due to equity inflow, portfolio investments reflecting the sale of short term money market instruments by resident entities and a draw down in foreign currency account balances of resident entities. These more than offset net outflows from investments in financial derivative instruments reflecting hedge payments by resident companies, and other investments reflecting higher trade credit funds owed to PNG resident companies, build-up in net foreign assets of the banking system and net loan repayments by the Government.

As a result of these developments, the capital and financial accounts balance recorded a surplus of K647 million in the December quarter of 2011, compared to a surplus of K1,405 million in the corresponding quarter of 2010.

The level of gross foreign exchange reserves at the end of December 2011 was K9,226.1 (US$4,350.1) million, sufficient for 11.5 months of total and 16.6 months of non-mineral import covers.

6.0 MONETARY DEVELOPMENTS

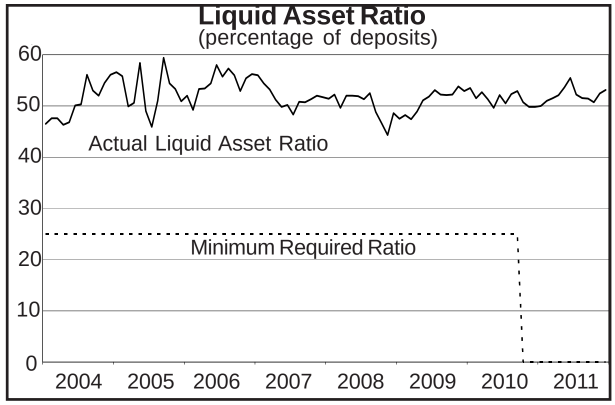
INTEREST RATES AND LIQUIDITY

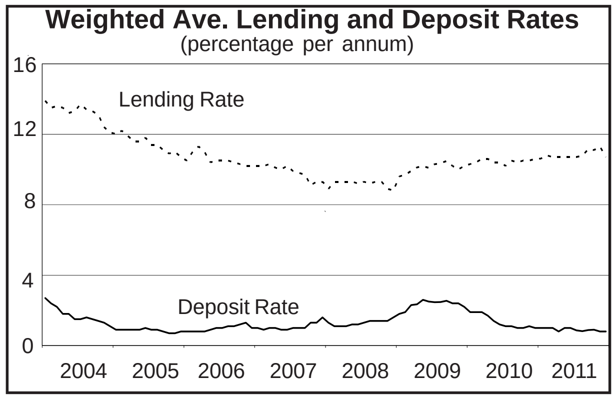
Although inflation outcomes eased in 2011, the Bank of PNG kept the KFR unchanged at 7.75 percent in the December quarter of 2011, in response to high inflationary pressures and expectation arising from strong domestic demand associated with the PNG LNG project and related activities, combined with high Government spending and international commodity prices. The dealing margin for the Repurchase Agreements (Repos) was maintained at 100 basis points on both sides of the KFR.

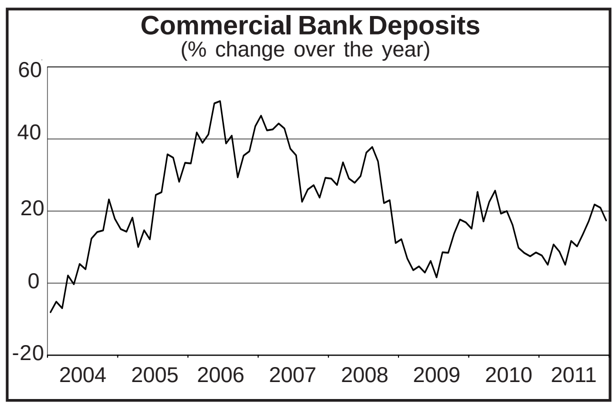
Interest rates for short-term securities showed increasing trends across all maturities over the year to December 2011. At the Central Bank Bill (CBB) market, the 28-day CBB rate increased from 2.35 percent to 2.69 percent, 63-day rate from 2.27 percent to 3.09 percent, the 91-day rate from 3.18 percent to 3.31 percent and 182-day rate from 3.43 percent to 3.85 percent. At the Treasury bill auction, the 182-day rate increased from 3.23 percent to 3.87 percent and the 365-day rate from 3.58 percent to 4.18 percent. There was no auction for the 91-day Treasury bill during the same period. The weighted average deposit rates offered by commercial banks on wholesale deposits (K500,000 and above) also showed increasing trends across all maturities over the year to December 2011 except the 180-day maturity. The 30-day rate increased from 1.54 percent to 1.79 percent, the 60-day rate from 1.63 percent to 2.15 percent and the 90-day rate from 1.50 percent to 2.13 percent, while the 180-day rate declined from 2.17 percent to 1.70 percent.

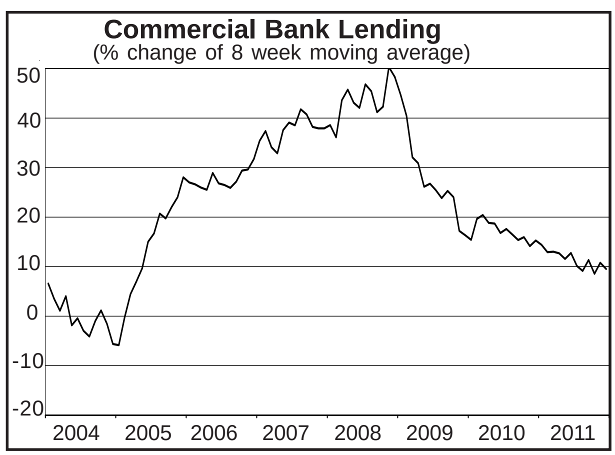
The turn around in the large term deposit was partly due to the tight stance of monetary policy, which was supported by increases to the Cash Reserve Requirement (CRR) of commercial banks. The weighted average interest rates on total deposits declined marginally from 1.0 percent to 0.8 percent over the year to December 2011, while the weighted average interest rates on total loans increased from 10.6 percent to 10.7 percent. All commercial banks increased their Indicator Lending Rates (ILR) in response to the tightening stance of monetary policy. The ILR spread increased from 10.95 – 11.95 percent to 11.45 – 12.20 percent in 2011.

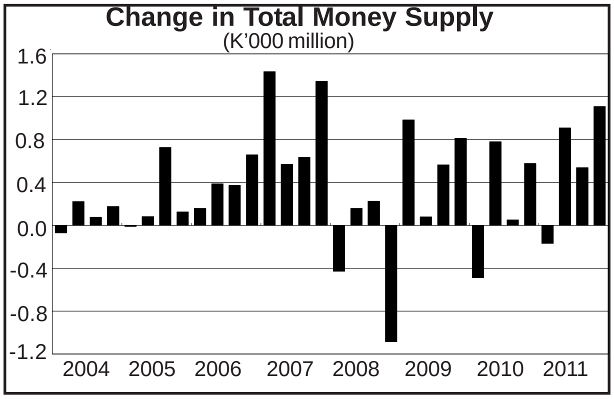
The Bank continued to utilise its Open Market Operation (OMO) instruments in the conduct of monetary policy in 2011. There was limited Treasury bill auction during the quarter due to the Government's positive cash flow position, reflecting high mineral tax and export receipts. This resulted in high level of liquidity, which was mainly diffused through issuance of the CBBs. The liquidity in the banking system was unevenly distributed at times, thus prompting trading in the interbank market as banks borrowed to maintain positive Exchange Settlement Account (ESA) bal-

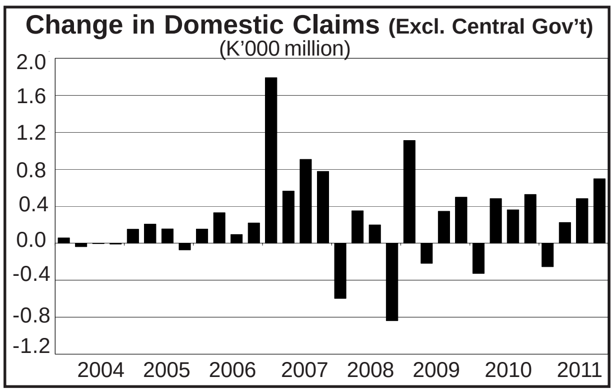


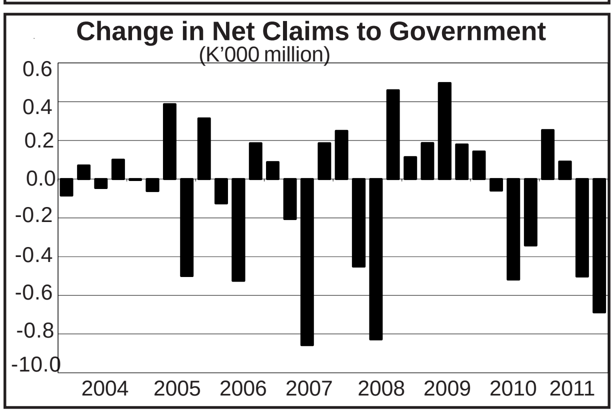


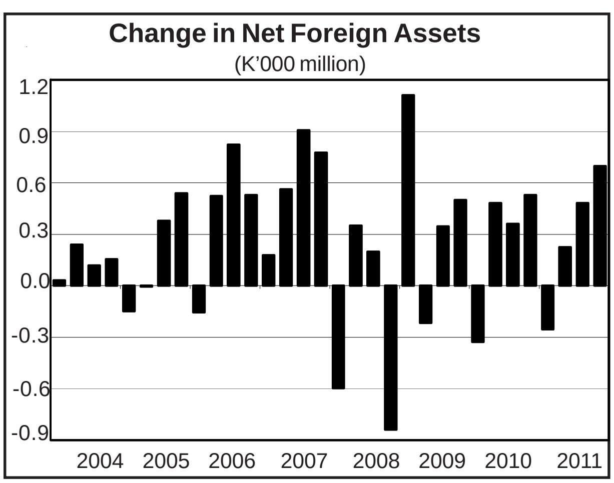












ances. The CRR was increased twice by 1.0 percentage points from 4.0 percent to 6.0 percent in 2011.

MONEY SUPPLY

The average level of broad money supply (M3*) increased by 13.4 percent in 2011, compared to an increase of 17.0 percent in 2010. This outcome was due to an increase of 14.2 percent in average net foreign assets of depository corporations and an increase of 11.8 percent in average net private sector credit. Average net domestic claims outstanding, excluding net claims on the Central Government, increased by 11.4 percent in 2011, compared to an increase of 16.5 percent in the corresponding period.

The average level of monetary base (reserve money) grew by 38.4 percent in 2011, compared to an increase of 20.4 percent in the corresponding period. This reflected increases in both average currency in circulation and deposits of ODCs at the Central Bank.

The average level of narrow money supply (M1*) increased by 21.9 percent in 2011, compared to an increase of 21.6 percent in 2010. This was due to increases in both average transferable deposits and currency outside depository corporations. The average level of quasi money increased by 3.0 percent in 2011, compared to an increase of 11.2 percent in the corresponding period, reflecting an increase in average term deposits.

The average level of deposits of the ODCs increased by 13.1 percent to K15,569.0 million in 2011 from K13,761.2 million in 2010. This reflected increases in transferable and other deposits including Central Government deposits.

The average net foreign assets of the financial corporations increased by 10.9 percent in 2011, compared to an increase of 11.4 percent in 2010, following an increase in holdings by ODCs and OFCs. Average net claims on the Central Government declined by 47.4 percent in 2011, compared to an increase of 34.5 percent in the corresponding period. This was due to an increase in Central Government deposits, mainly in trust accounts.

LENDING

In 2011, 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 K363.3 million to K8,836.5 million, compared to an increase of K1,276.7 million in 2010. This was mainly due to an increase of K441.5 million in net credit to private sector. The growth in private sector credit reflected advances by the ODCs to the manufacturing, transport and communication, commerce, building and construction, hotels and restaurants, real estate renting and other business services sectors, as well as the household sector for housing advances. The annualised growth in domestic credit, excluding Central Government was 4.8 percent in December 2011.

7.0 PUBLIC FINANCE

The provisional budget outcome on the fiscal operations of the National Government in 2011 showed an overall deficit of K63.7 million, compared to a surplus of K186.3 million in 2010. This represents 0.2 percent of nominal GDP and reflects high expenditure, which more than offset an increase in revenue.

Total revenue, including foreign grants was K9,324.9 million in 2011, 12.6 percent higher than in 2010. This represents 94.8 percent of the revised budgeted revenue for 2011. The increase in revenue reflected higher tax receipts, which more than offset the decline in non-tax receipts and foreign grants.

Total tax revenue amounted to K7,904.2 million in 2011, 22.8 percent higher than in 2010 and represents 100.0 percent of the revised budget for 2011. Direct tax receipts totalled K6,144.0 million, 31.6 percent higher than the receipts collected during 2010, and represents 101.1 percent of the revised budgeted amount. This outcome reflected higher personal income, company and other direct tax receipts. The increase in personal income tax was due to higher remuneration and an increase in employment, reflecting the continued growth in domestic economic activity. The growth in company tax receipts reflected exceptional performance by business firms attributed to increased economic activity, high international prices of PNG's exports and strong domestic demand. The increase in other direct taxes was mainly related to higher dividend and interest withholding tax receipts.

Indirect tax receipts totalled K1,760.2 million, 0.4 percent lower than in 2010 and represents 96.5 percent of the revised budgeted revenue for 2011. The decrease mainly reflected lower Goods and Services Tax (GST) collections and other indirect tax receipts, which more than offset higher receipts in other categories of indirect tax. GST declined as more refunds were made to the taxpayers. The increase in excise duties reflected higher consumption of imported and domestically produced items. The increase in import duties was due to higher import volumes, while the increase in export tax receipts resulted from higher log export volumes.

Total non-tax revenue amounted to K350.3 million in 2011, 19.5 percent lower than in 2010 and represents 98.1 percent of the revised budget amount for 2011. The decrease mainly reflected lower payment of dividends by some statutory bodies. Foreign grants during 2011 totalled K1,045.0 million, 24.9 percent lower than in 2010. This represents 68.5 percent of the revised budget and mainly reflected the appreciation of the kina against major currencies.

Total expenditure was K9,388.6 million in 2011, 16.0 percent higher than in 2010 and represents 94.6 percent of the revised budget appropriation for 2011. This outcome resulted from higher recurrent expenditure which more than offset a decline in the development expenditure.

Recurrent expenditure was K5,412.6 million in 2011, 30.1 percent higher than in 2010 and represents 101.4 percent of the revised appropriation for 2011. The increase was due to higher spending by National Departments and Provincial Governments, combined with higher interest payments and grants to statutory bodies. National Departmental expenditure totalled K3,396.9 million, 37.3 percent higher than the amount spent in 2010 and represents 97.4 percent of the 2011 revised budget appropriation. The increase mainly reflected higher payments for personnel emoluments and goods and services. Provincial Government expenditure amounted to K1,290.6 million, 23.4 percent higher than in 2010 and represents 116.8 percent of the 2011 revised budget appropriation. This outcome resulted from increases in payments for personnel emoluments, and goods and services. Interest payments totalled K416.3 million, 17.9 percent higher than in 2010 and represents 96.7 percent of the 2011 revised budget. The increase mainly reflected higher interest payments on domestic debt due to increased issuance of Government securities, mainly Inscribed stocks at high interest rates, despite the low interest rates in the market, especially for Treasury bills.

Total development expenditure in 2011 was K3,194.2 million, 2.6 percent lower than in the same period in 2010 and represents 81.4 percent of the 2011 revised budget appropriation. The lower development outlay mainly reflected lower foreign grants funding for infrastructure projects due to the appreciation of the kina against major currencies. Additional Priority Expenditure of K781.8 million was expended through a Supplementary Budget mainly to Education, Health and road infrastructures.

As a result of these developments in revenue and expenditure, the Government recorded an overall budget deficit of K63.7 million in 2011. The deficit was financed from net external borrowing of K25.7 million and domestic financing of K38.0 million. The external loan borrowing of K88.9 million was from concessionary sources, while repayments of K19.4 million and K43.8 million were made to commercial and extraordinary sources, respectively. The domestic financing comprised of K544.2 million in cheque floats yet to be presented for payment, which more than offset K506.2 million in net negative financing by the financial corporations. Negative financing mainly comprised of net Government deposits at the Central Bank.

Total public (Government) debt outstanding at the end of December quarter of 2011 was K7,238.4 million, K658.7 million higher than in the corresponding quarter of 2010. The increase reflected higher domestic debt, which more than offset a decline in external debt. The increase in domestic debt was due to increased issuance of Government securities, both Treasury bills and Inscribed stocks. The decrease in external debt reflected loan repayments and the appreciation of the kina against the US dollar.

The total amount of Government deposits in the depository corporations increased by K1,525.6 million to K4,788.0 million in the December quarter of 2011, compared to K3,262.4 million in the December quarter of 2010. Government trust accounts held at the Central Bank increased by a net of K516.5 million to K729.4 million between the end of December 2010 and December 2011.

THE 2012 NATIONAL BUDGET

The National Budget is the principal tool for fiscal policy; one component of a set of policy tools employed to achieve multiple objectives of macroeconomic management such as price stability and economic growth. At the macroeconomic level, the importance of the budget lies in its immediate impact on the level of aggregate demand and hence, overall economic activity.

This article reviews the 2012 National Budget, which was presented in Parliament on 6th December 2011. The 2012 Budget focuses on "*Sharing the Wealth and Empowering our People*" directed at ensuring that the benefits of the strong economic growth are shared fairly through better education, health, infrastructure and law and order. The implementation of the budget is guided by the Vision 2050, the Development Strategic Plan (DSP) 2010-2030, the Medium Term Development Plan (MTDP), the Medium Term Debt Strategy (MTDS), the Medium Term Fiscal Strategy (MTFS) 2008-2012, and the *Fiscal Responsibility Act 2006 (FRA).* As with previous budget articles the detailed budget data has been rearranged and aggregated. Some misclassification of data may occur as a result of this process, but the primary focus here is the broad aggregates and trends.

The fiscal strategy for 2012 is framed against a backdrop of increased uncertainty and volatility in the global economy combined with high domestic economic growth and inflation. The strong growth in domestic activity and investment associated with the PNG LNG project, has contributed to high inflation. With capacity constraints mainly in the construction sector and shortage of skilled labour, Government spending risks driving inflation further up. To avoid this scenario the Budget recognizes the need for coordinated restraint in both fiscal and monetary policies. A balanced Budget for 2012 is consistent with the MTFS, MTDS and *FRA*. The fiscal strategy contains three fiscal rules to ensure macroeconomic stability is maintained and guide the use of any additional revenue, which include: keeping ongoing expenditure in line with normal revenue defined as all non-mineral revenue plus mineral revenue equal to 4.0 percent of GDP; using additional revenue to pre-fund public investment projects and repay debts and other liabilities using a 70:30 ratio; and limiting the amount of public investment expenditure sourced from additional revenues (including trust account funds) to 4.0 percent of GDP. The MTFS aims to maintain a neutral fiscal policy stance by ensuring expenditures from trust accounts are offset by deposits into trust accounts from the 2012 Budget. This will assist mitigate inflationary pressures and crowding out private sector investment.

Consistent with the Development Budget strategy, the MTDP outcomes will be achieved through a significant allocation of the Budget to the MTDP enablers. This allows the Government to increase appropriations in the Recurrent Budget for ongoing service delivery and align it to the Development Budget. The MTDP enablers are: Unlocking land for development; Improving law, order and justice; Establishing quality national transport corridors that connect rural populations to markets and services; Higher and technical education to address the severe skills shortage within PNG's labour force; Universal access to quality primary and secondary education; Provision of key utilities of electricity, clean water and sanitation and communication; and Improving health outcomes. In 2012, 78.0 percent of Government expenditure (direct financing, tax credit and loans) will be allocated to MTDP sectors of which 71.0 percent will be apportioned to the enablers, compared to 80.0 percent in 2011.

The 2012 Budget introduced a number of moderate taxation policy measures aimed at ensuring adequate funding for expenditure priorities such as free tuition fee education and the 2012 National Election. The main tax initiatives are: increase in the tax–free income threshold from K7,000 to K10,000 as tax relief to low income earners; increase in the Highlands Highway tax credit cap from 0.75 percent to 2.00 percent of assessable income for emergency repairs; extension of the tariff reduction program to include intermediate goods such as meat, shoes and steel aimed at reducing prices; tax concessions on redundancy payments to improve fairness in tax system during large scale closures; tax incentives for commercial banks opening new regional branches; and increase in excise duties on alcohol and tobacco products. Other minor policy changes and reforms were introduced to improve efficiency in tax administration.

The expenditure allocations for 2012 focus on the broad goals of increased appropriations for MTDP enablers, continued public sector reforms and removal of impediments to business and investment. The Recurrent Budget comprises of K3.0 billion or 49.3 percent funding for MTDP enablers, which is designed to address current supply-side and absorptive capacity constraints. The Government's on-going public sector reforms are vital in building the capacity of the institutions of public service delivery and creating a conducive environment for macroeconomic stability and economic growth. The benefits of past reforms have contributed to sustained economic growth that shielded the economy from the effects of external shocks and provided a good investment climate as evidenced by the PNG LNG project. In addition, lower prices and better services have evolved with competition in the mobile phone, air transport and banking services sectors.

Project support grants from donor countries are equally important to the Government's domestic funding of the Development Budget. In 2012, foreign grants are projected to decrease by K135.6 million to K1,390.5 million from the 2011 revised budget estimate. This is attributed to the appreciation of the kina against the major currencies, combined with the completion of a number of key donor funded projects in 2011 by ADB, JICA and World Bank. The Government has substantially increased its budgetary support for the Development Budget by K512.6 million to K4,437.0 million in order to achieve sustainable economic growth. The increase in the Governments contribution to the Development Budget is reflected in higher Direct Financing, Infrastructure Tax Credits and Concessional Loans. From a total of K4,437.0 million, 68.7 percent (K3,048.2 million) is from Government sources, while 31.3 percent (K1,388.8 million) represents foreign grants. For aid effectiveness, the programs and expenditure of development partner countries should be aligned to Government priorities. The project support grants continue to play an important role in the development process of the country.

The Budget was formulated on the back of slower growth in advanced economies and increased fiscal and financial uncertainty surrounding some advanced economies. This was compounded by the Japanese earthquake and tsunami, and unrest in some oil producing countries. On the domestic front, aggregate demand continued to remain strong mainly driven by construction activity, both from the PNG LNG project and investment in residential and commercial stock. In 2012, real GDP is projected to grow by 7.8 percent following an expected growth of 8.9 percent in 2011. This mainly reflects a moderation in the construction phase of the PNG LNG project after reaching its peak and progressing into advanced stages. However, it continues to underpin growth in other sectors, especially the construction, transport, storage and communication sectors. This growth also reflects strong performance

Table 1. Key Economic Assumptions of the 2012 National Budget

	2010 Actual	2011 Estimate	2012 Projection
Economic Growth (%)			
Real GDP Growth	7.6	8.9	7.8
Real Non-Mining Growth	8.5	10.8	7.4
Inflation (%)			
Year average	6.0	8.7	7.6
Dec on Dec	7.2	7.7	8.1
Interest Rates (%)			
Interest Rates (Treasury bills)	5.5	4.5	7.5
Inscribed stock (3 yr)	8.1	5.6	9.0
Fiscal balance (K'm)	186.3	-88.1	0.0
% of GDP	0.7	-0.3	0.0
Mineral Prices			
Gold (US$/Ounce)	1,225	1,566	1,884
Copper (US$/tonne)	7,538	8,800	8,819
Oil (US$/barrel)	79	90	85

in the mining and quarrying sector attributed to the commencement of production at Ramu Nickel/Cobalt mine and return to normal production at the Ok Tedi, Porgera and Lihir mines. Smaller mines including Simberi and Hidden Valley are also expected to expand operations. Higher growths are expected from the other non-mining sectors like wholesale and retail, manufacturing, finance, real estate and business services that will indirectly benefit from the PNG LNG project as disposable incomes and consumption spending increases. The agriculture, forestry and fisheries sector is expected to contribute steadily to the growth in 2012 reflecting higher production of coffee and cocoa combined with increased global demand. Growth in the petroleum sector is expected to decline as existing oil fields mature.

Table 1 shows the main assumptions used to frame the Budget such as GDP growth, inflation and mineral prices. The risks to these assumptions include: the fragility in global economic growth, which would impact on commodity prices and demand for PNG's exports; and inflationary pressures arising from strong domestic demand relating to higher Government spending.

Table 2 summarises fiscal developments from 2008 to 2011 and the Budget indicators for 2012. The fiscal burden on the economy, as represented by the appropriations/nominal GDP ratio and net external borrowing, is expected to decline marginally mainly due to the growth in GDP.

The 2012 Budget is considered to be a balanced budget when measured against GDP. Net financing is comprised of external borrowing of K291.2 million, which is projected to be offset by repayments of the same amount to domestic sources. The external borrowing will be mainly from concessional sources totaling K351.1 million, while external loan repayments will comprise of K18.3 million to commercial and K41.7 million to extraordinary sources. The external borrowing of concessional loans to fund development projects is consistent with the Debt Strategy by maintaining debt at sustainable levels and managing financial risks.

A balanced Budget in 2012 indicates that there will be a surplus in the primary balance (Table 2). This shows that net public debt to GDP ratio is expected to decline further mainly due to the growth in GDP. A reduction in

Table 2: Budgetary Indicators (K'million)

	2008	2009	2010	2011			2012
	Actuals			Original Budget	Revised Budget	December Outcome (p)	Budget
1. Total Internal Revenue & Grants	7,073	6,651	8,279	9,328	9,840	9,325	10,560
2. Appropriations	7,552	6,687	8,093	9,328	9,928	9,389	10,560
3. *of which:* Additional Priority Expenditure	2,155	0	0	0	666	782	0
4. Surplus/(Deficit) =1-2	-479	-36	186	0	-88	-64	0
5. Primary Balance	-97	413	539	430	353	353	467
6. *FINANCING*	***479***	***36***	***-17***	***0***	***88***	***64***	***0***
External	-385	-141	85	183	201	26	291
Domestic	863	177	-102	-183	-113	38	-291
Memorandum Items:							
7. Borrow ed Funds	2,769	2,315	2,013	2,186	2,534	3,913	2,360
8. GDP (Nominal)	21,601	22,331	26,395	28,718	29,842	29,842	33,991
(Ratios to Nominal GDP in %)							
9. Appropriations/GDP	35.0	29.9	30.7	32.5	33.3	31.5	31.1
10. Total Internal Revenue & Grants/GDP	32.7	29.8	31.4	32.5	33.0	31.2	31.1
11. Surplus or Deficit/GDP	-2.2	-0.2	0.7	0.0	-0.3	-0.2	0.0
12. Borrow ed Funds/GDP	12.8	10.4	7.6	7.6	8.5	13.1	6.9
(Growth rates in %, year on year)							
13. Appropriations	15.3	-11.4	21.0	39.5	48.5	40.4	6.4
14. GDP (Nominal)	14.9	3.4	18.2	28.6	33.6	33.6	13.9
15. Headline Inflation (Over the Year) (a)	11.2	5.7	7.2	7.7	7.7	8.7	8.1

The above figures may not correspond to Table 7.1 in the QEB due to some reclassification.

(a) Actual inflation figures are from the September 2011 QEB, while inflation figures for 2011 and 2012 is from the National Statistical Office and the 2012 Budget document, respectively. Annual inflation figures from the QEB are actual while those from the Budget documents are projections.

(p) Based on the Department of Treasury's provisional budget outcome.

Source: Bank of Papua New Guinea and 2012 Budget Papers, Volume 1, Department of Treasury and Finance.

the debt burden lowers the country's financial and currency risks and enables the Government to use the saved funds for development expenditure.

Table 3 depicts the revenue components of the 2012 Budget as a percentage of total revenue, which are projected to increase for all categories of revenue, except the foreign grants. The total budgeted revenue and grants for 2012 is projected to be 13.2 percent higher than the outcome for 2011.

In 2012, total direct taxes are projected to increase by 6.5 percent and account for 62.0 percent of total revenue, compared to the 2011 outcome. The increase is mainly due to higher personal income tax relating to strong employment and wages growth, and company tax receipts reflecting higher economic growth and ramp up in the PNG LNG project.

Indirect taxes, which represent domestic taxes on goods and services are expected to increase by 12.3 percent in 2012 and comprise of 18.7 percent of total income in 2012, compred to 2011. This mainly reflects higher collections in all categories of indirect tax receipts, except GST revenue and export duty. Non-tax revenue is expected to increase by 73.0 percent, compared to the actual outcome for 2011 mainly due to higher dividend payments, National Departmental revenue and the reallocation of trust account funds.

Total project grants are estimated to increase by 33.1 percent in 2012, compared to the 2011 outcome. The increase mainly reflects the increased drawdown of donor grants to fund infrastructure projects.

The 2012 Budget shows that total expenditure is 12.5 percent higher than the outcome in 2011. National Recurrent Expenditure is projected to increase by 16.9 percent, Development Expenditure by 38.9 percent, and Provincial Government recurrent spending by 1.0 percent, respectively.

Table 4 shows that the share of recurrent expenditure to total appropriation will increase to 45.6 percent in

Table 3: Distribution between Revenue and Financing items in the 2012 Budget (K' million)

	2008	2009	2010	2011			2012
	Actuals			Original Budget	Revised Budget	December Outcome (p)	Budget
1. Total Internal Revenue & Grants	7,073	6,651	8,279	9,328	9,840	9,325	10,560
2. Direct Taxes	4,353	3,520	4,668	5,292	6,074	6,144	6,543
3. Indirect Taxes	1,404	1,455	1,767	2,039	1,823	1,760	1,977
4. Department Rev. & Services	93	100	95	118	102	98	130
5. Revenue from Assets	222	178	359	353	305	278	392
6. Grants	1,002	878	1,391	1,526	1,526	1,045	1,391
7. Trust Account Injection		521	0	0	10	0	128
Memorandum Item:							
8. Borrowings	2,769	2,315	2,013	2,186	2,534	3,913	2,360
Ratios (%)							
9. Direct Taxes/Total Revenue	61.5	52.9	56.4	56.7	61.7	65.9	62.0
10. Indirect Taxes/Total Revenue	19.8	21.9	21.3	21.9	18.5	18.9	18.7
11. Dept. Revenue/Total Revenue	1.3	1.5	1.1	1.3	1.0	1.0	1.2
12. Revenue from Assets/Total Revenue	3.1	2.7	4.3	3.8	3.1	3.0	3.7
13. Grants/Total Revenue	14.2	13.2	16.8	16.4	15.5	11.2	13.2
Memorandum Item:							
14. Borrowings/Total Revenue	39.1	34.8	24.3	23.4	25.7	42.0	22.4

Source: Table 1

2012, compared to 43.9 percent in the 2011 outcome. This trend reflects increased funding to support the MTDP enablers and higher goods and services expenditure associated with the funding for tuition fee free education and 2012 National Elections. The share of Development Expenditure to total appropriation is 42.0 percent in 2012, compared to 34.0 percent in the 2011 outcome. The increase reflects the alignment of funding for the Development Budget with the MTDP priority areas through higher appropriation in the 2012 Budget.

The 2012 National Budget sets out the targets for revenue and expenditure which is expected to support a stable macroeconomic environment. A responsible Government should always maintain strict and coordinated expenditure controls within the parameters of the budget framework as it has implications on financing and the level of public debt. The threat to monetary conditions, exchange rate, liquidity and inflation remains if there are any fiscal slippages in the 2012 Budget, especially during an election year. For the Government to achieve sustainable economic growth, it should adhere to its overarching medium term strategies and effectively utilize any windfall revenue to fund capital investment in public infrastructure, retire debt or save it for future use. The large amount of trust account funds generated from high commodity prices held at depository corporations is considered non-inflationary as long as spending is spread over time based on the capacity of implementing agencies. In the medium term, the establishment of the Sovereign Wealth Fund (SWF)for PNG should assist the Central Bank in managing liquidity and its impact on inflation. The appreciation of the kina exchange rate resulting from large inflows of foreign exchange and a weak US dollar can be an opportunity to reduce foreign debt levels. Therefore, prudent public expenditure management by the Government is vital to achieve a balanced budget in 2012, sustainable debt levels and economic growth in the medium term.

In light of expectations of high inflationary pressures emanating from the domestic sector through increased

Table 4: Appropriation (K' million)

	2008	2009	2010	2011			2012
	Actuals			Original Budget	Revised Budget	December Outcome (p)	Budget
1. Total Appropriation	7,552	6,687	8,093	9,328	9,928	9,389	10,560
2. Current Expend. National Level (a)	2,912	3,120	3,114	4,178	4,234	4,122	4,819
3. Development Expenditure (b)	1,630	2,349	3,279	4,041	3,925	3,194	4,437
4. Provincial Governments (c)	855	1,046	1,046	1,109	1,104	1,291	1,304
5. Additional Priority Expenditure/Reappropriation to Trust Acco	2,155	173	653	0	666	782	0
6. Supplementary Budget							
Ratios (%)							
7. Current Expenditure/Total Appropriation	38.6	46.7	38.5	44.8	42.6	43.9	45.6
8. Dev. Expenditure/Total Appropriation	21.6	35.1	40.5	43.3	39.5	34.0	42.0
9. Provincial Govts/Total Appropriation	11.3	15.6	12.9	11.9	11.1	13.7	12.4

Source: Table 1

Notes:

(a) Current Expenditure, National Level includes interest payments and transfers to Statutory Authorities.

(b) Development expenditure includes Australian project grants

(c) Provincial Government's is recurrent expenditure only.

Government expenditure, and demand associated with construction of the PNG LNG project combined with investments in residential and commercial property, closer coordination and cooperation in the conduct of monetary and fiscal policies is necessary to maintain macroeconomic stability. The Central Bank will pursue an accommodative stance of monetary policy to support high economic growth while ensuring inflation is at an acceptable level. In line with that, the Government should refrain from overspending under the recurrent budget, while focusing on the effective use of development expenditure in the priority areas of health, education, law and order and physical infrastructure.

The increased funding for MTDP enablers, ongoing public sector reforms and removal of impediments to business and investment will assist efforts to sustain economic growth in the medium term. The Government should continue to spend within the parameters set out in the 2012 Budget without resorting to domestic financing to meet budgeted and unbudgeted expenditure levels. Any increase in domestic financing to cover shortfalls in revenue may undermine macroeconomic stability. In this context, it is important that the Government continue with the structural reforms and expenditure priorities are implemented effectively in order to achieve long-term sustainable growth.

The Central Bank will be faced with a number of challenges in 2012. The increase in expenditure to over K10 billion in 2012 will excarcebate the excess liquidity level when it is expended. Although the Government projects a balanced budget for 2012, recurrent expenditure will be higher as funds are spent on the free Tuition Fee Education, 2012 National Election, increased grants to Provinces including the Autonomous Region of Bougainville Government, and funding for the MTDP enablers. In addition, the continued growth in GDP due to the construction phase of the PNG LNG project and its flow on effects on other non-mining sectors of the economy, combined with the reduction in income tax and other incentive measures stand to increase consumption spending and impact on inflation. However, there are some positive developments that may help dampen inflationary pressures which include: The approval of the SWF to manage foreign exchange inflow and reduce its impact on liquidity; and the pass-through effect of the appreciation of the kina against the US and Australian dollars which has led to reduction in prices of some imported goods.

The Bank will have to ensure exchange rate volatility is minimised to provide confidence to the business sector and closely monitor the pace of appreciation of the kina on the traditional export sectors. Thus, the conduct of monetary policy will be challenging in an environment of high growth and increased inflationary pressures. This will require the Bank to utilise its policy tools selectively and effectively to ensure inflation is managed within acceptable levels, and not allowed to spiral out of control.

MONETARY POLICY STATEMENT

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[1], 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

[1]These 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.

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, Issues and Expectations

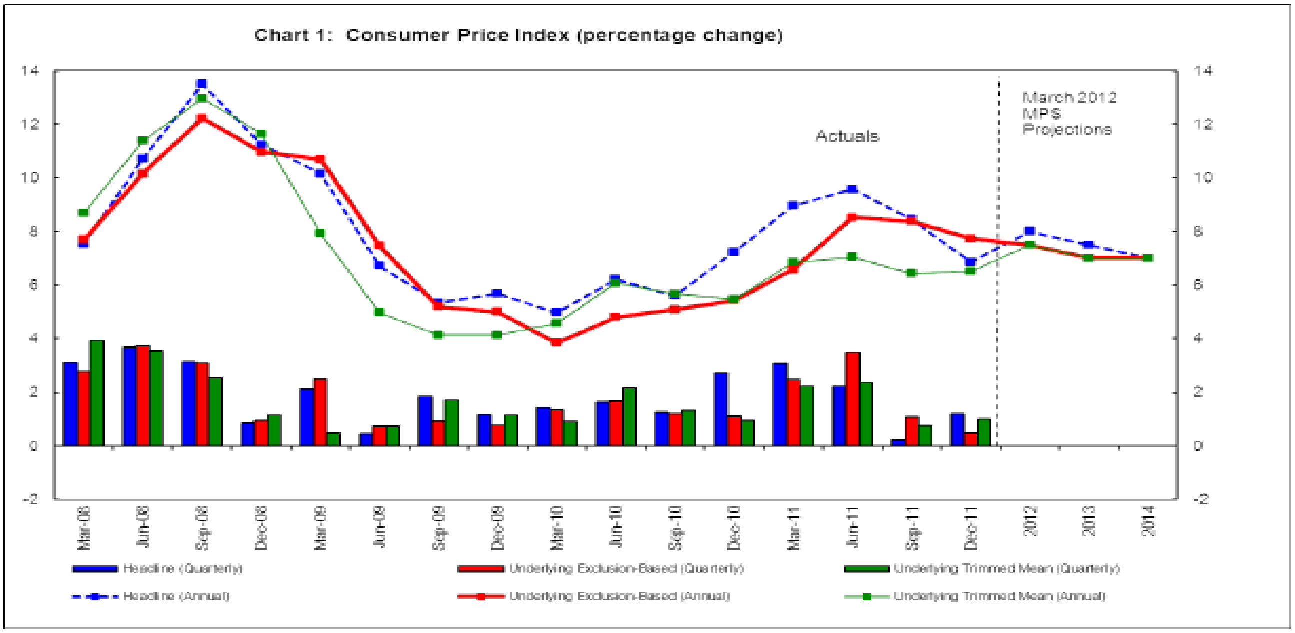
Annual headline inflation was 6.9 percent in the December quarter of 2011, lower than 7.2 percent in the December quarter of 2010, after peaking at 9.6 percent in the June quarter of 2011. The lower outcome was attributed to a decline in the price of betelnut and lower imported prices of food and fuel, 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.

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.

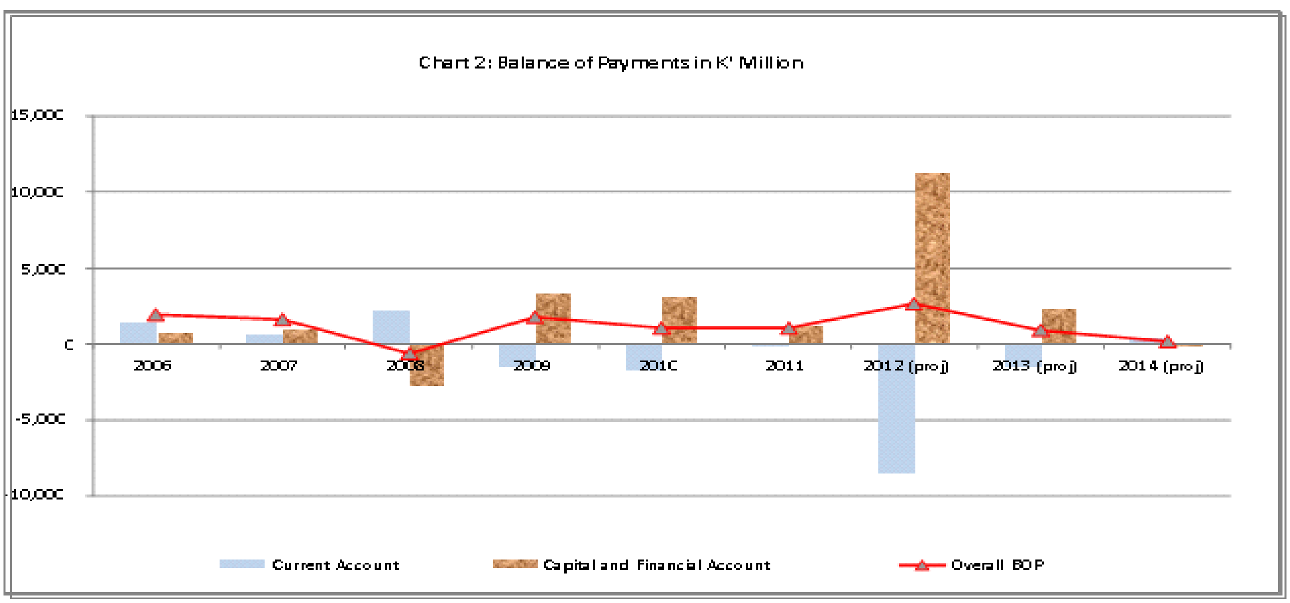
For the medium term, headline inflation is projected to be around 7.5 percent in 2013 and 7.0 percent in 2014. These projections are based on a number of factors including the winding-down of the construction phase of the LNG project in late 2013, the continued strengthening of the kina and easing global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

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.



Source: National Statistical Office and Bank of PNG

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.



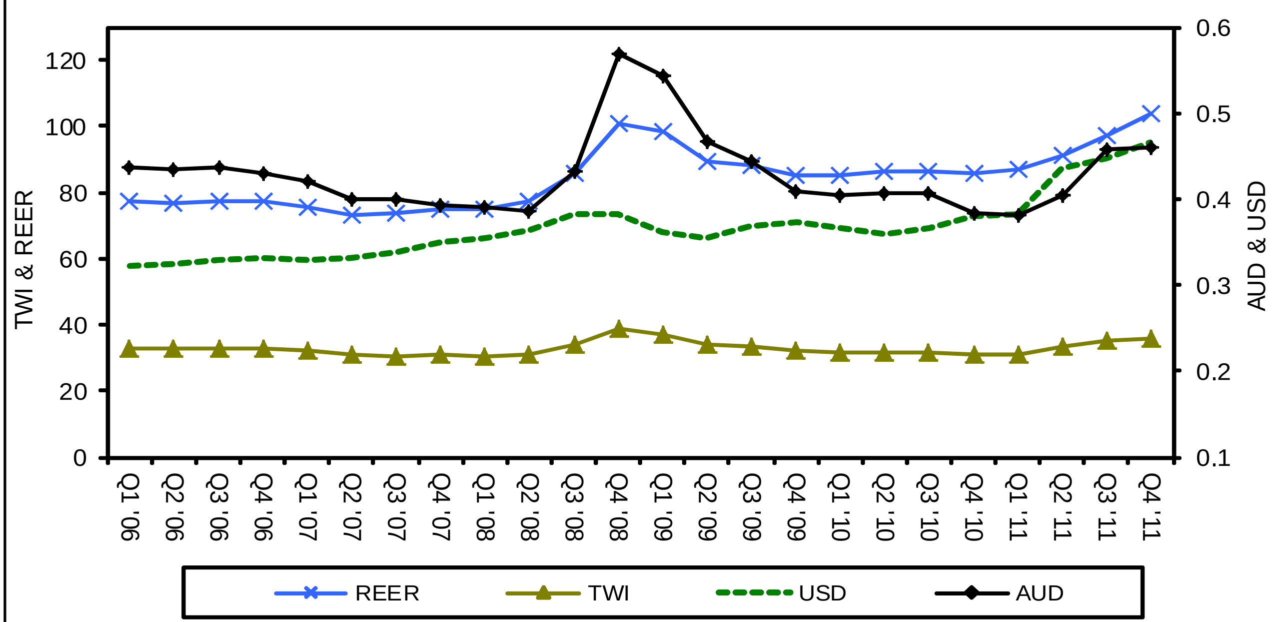
Source: Bank of PNG

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).

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).

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



Source: Bank of PNG

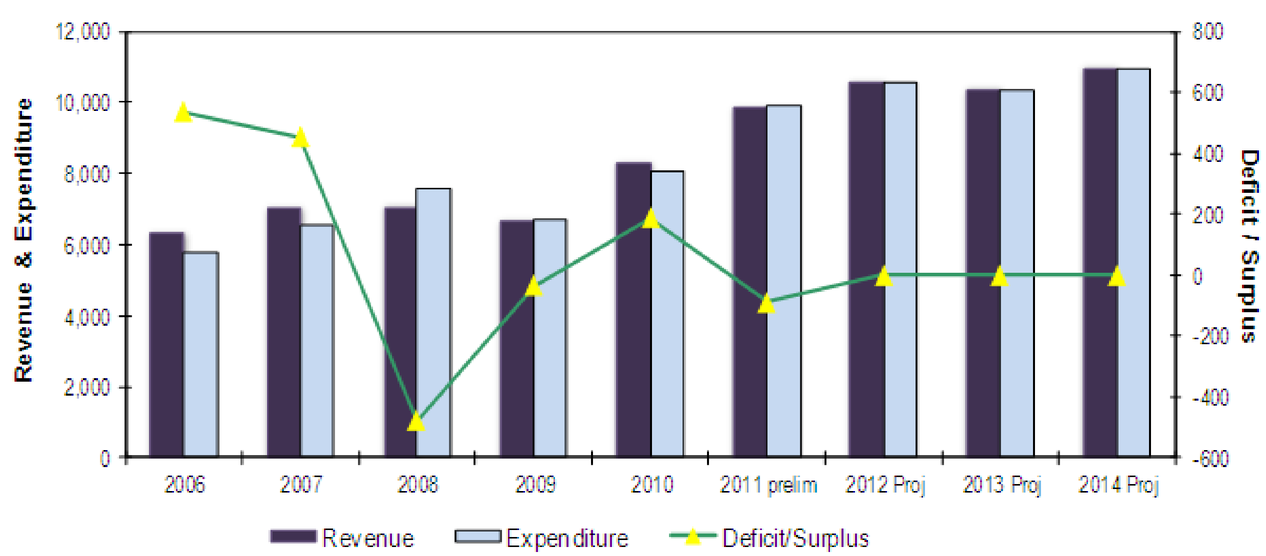
The increase in international reserves led to the growth in money supply and liquidity. Annual growth in broad money supply (M3*) and monetary base in 2011 were 17.3 percent and 61.7 percent, respectively. The increase in broad money supply resulted mainly from increases in NFA of the depository corporations, 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 sector[2] 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 sector[2] 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.

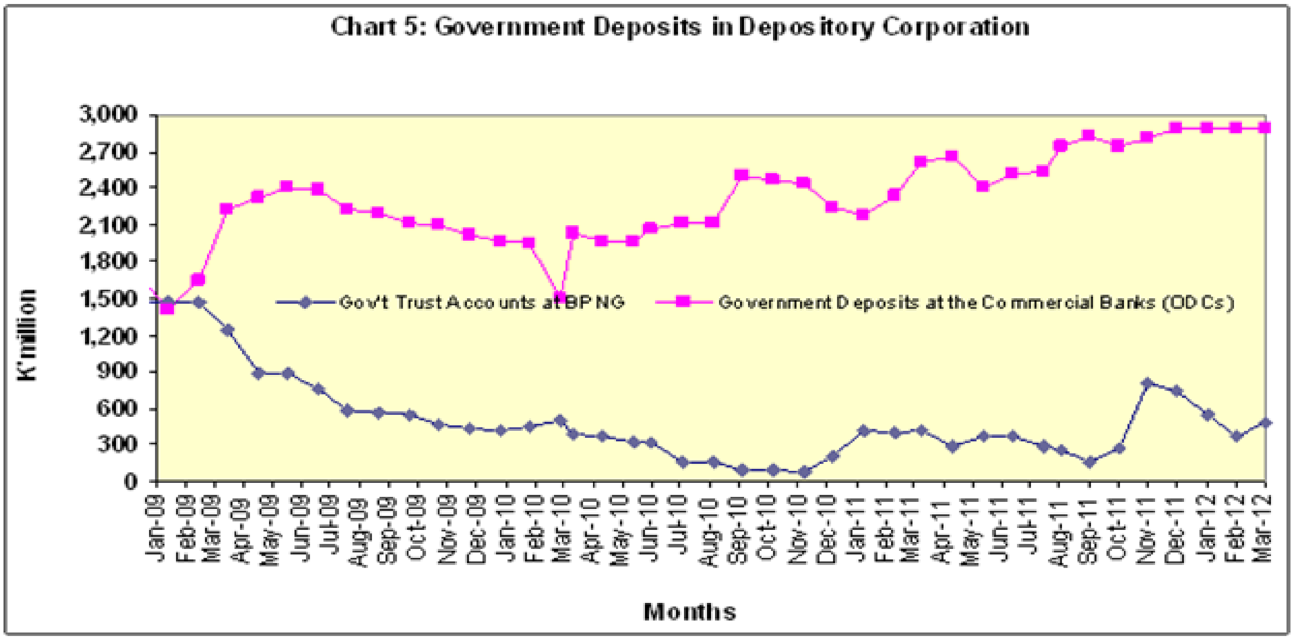
Chart 4: Fiscal Operations of the Government (K'm)



Source: Department of Treasury

[2]Based on the Bank of PNG'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 and Department 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.

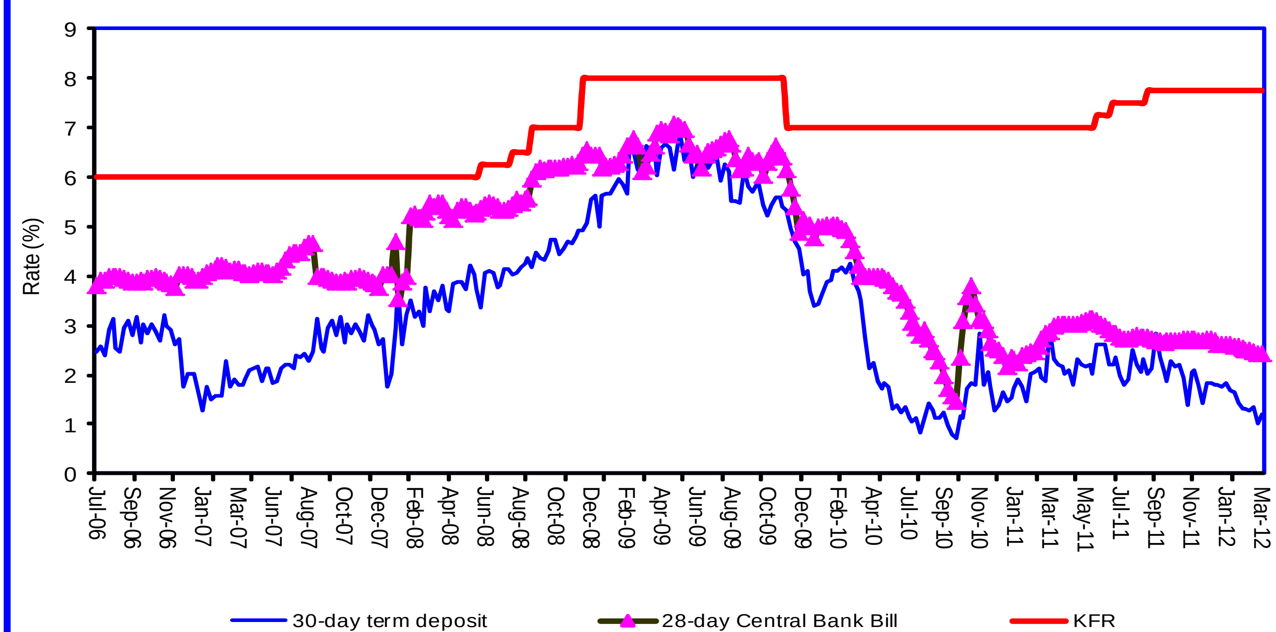
Some or all of these, if realized, could potentially lead to price instability and adversely affect business confidence.

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.

Chart 6: KFR, 28-day Central Bank Bills & 30-day Term Deposits W/average



Source: Bank of PNG

3.3 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 to ODCs 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.

MONTHLY KINA FACILITY RATE ANNOUNCEMENTS

The Central Bank introduced the Kina Facility Rate (KFR) in February 2001 as the official rate to indicate its stance of monetary policy. The KFR is a monthly rate and any changes to it should translate to changes in market interest rates. Changes to the KFR is based on assessment of economic fundamentals consistent with the overall objective of monetary policy of price stability in the economy. From January 2009, the KFR announcements by the Bank were;

2010	04 January	Maintained at 7.00 %
	01 February	Maintained at 7.00 %
	01 March	Maintained at 7.00 %
	06 April	Maintained at 7.00 %
	03 May	Maintained at 7.00 %
	07 June	Maintained at 7.00 %
	05 July	Maintained at 7.00 %
	02 August	Maintained at 7.00 %
	06 September	Maintained at 7.00 %
	04 October	Maintained at 7.00 %
	01 November	Maintained at 7.00 %
	04 December	Maintained at 7.00 %
2011	03 January	Maintained at 7.00 %
	07 February	Maintained at 7.00 %
	07 March	Maintained at 7.00 %
	04 April	Maintained at 7.00 %
	02 May	Maintained at 7.00 %
	06 June	Increased to 7.25 %
	04 July	Increased to 7.50 %
	01 August	Maintained at 7.50 %
	05 September	Increased to 7.75 %
	03 October	Maintained at 7.75 %
	07 November	Maintained at 7.75 %
	05 December	Maintained at 7.75 %
2012	02 January	Maintained at 7.75 %
	06 February	Maintained at 7.75 %
	05 March	Maintained at 7.75 %
	02 April	Maintained at 7.75 %
	07 May	Maintained at 7.75 %

For details of the KFR, see Table 6.3 (S34) of the QEB.
KFR announcements prior to January 2009 are reported in various bulletins starting with the March 2001 QEB.

GLOSSARY OF TERMS AND ACRONYMS

Balance of Payments
A statistical statement that systematically summarises a country's economic transactions with the rest of the world, over a specific time period. It comprises the Current and Capital and Financial Accounts.

Broad Money Supply (M3*)
Total volume of money comprising narrow money (M1*) and quasi money in the economy at a point in time. See 'narrow' and 'quasi' money.

Cash Reserve Requirement (CRR)
A requirement imposed on commercial banks to hold cash as a percentage of total deposits and other prescribed liabilities at all times.

Capital Account
Records all transactions that involves the receipts or transfers of capital and acquisitions/disposal of non-produced, non-financial assets such as purchase of production facilities, i.e. plants and machinery, etc.

Central Bank (CB)
The Bank of Papua New Guinea (BPNG) is the monetary authority in Papua New Guinea (PNG) that has legislative power over the financial system and is responsible for issuing currency, managing international reserves, undertakes transactions with the IMF and providing credit to the commercial banks.

Central Bank Bill (CBB)[5]
A monetary policy instrument of the Bank of PNG used to manage liquidity in the banking system by either injecting or defusing it in order to achieve a desired level of interest rate.

Central Bank Survey (CBS)
The CBS is the balance sheet of the Central Bank, which contains data on all components of the monetary base, comprising of currency in circulation and central bank liabilities to ODCs and other sectors.

Current Transfers Account
Records all foreign transactions that are not transfers of capital and cannot be repaid. This includes donations, gifts and grants, superannuation funds and licensing fees.

Depository Corporations Survey (DCS)
The survey is a consolidation of the CBS and the ODCS, which contains data on all depository corporations' liabilities in the national definition of broad money and data on depository corporations, assts that are claims on (i.e credit) other sectors of the economy, including the external sector.

[5]See 'For the Record' on page 34 in the 2004 September QEB.

Deposits	Deposits include all claims on the Bank of PNG and ODCs. These are further classified into transferable and other deposits. (I). Transferable deposits comprises all deposits that are: a). Exchangeable on demand at par and without penalty or restrictions; b). Directly usable for making payments by cheque, draft direct debit/credit or other direct payment facilities. ii.) Other deposits comprise all claims, other than transferable deposits. These include savings and term deposits and non transferable deposits in foreign currency.
Exchange Settlement Account (ESA)	Accounts of the commercial banks with the Bank of PNG for settlement transactions with each other.
Exclusion-based CPI measure	An underlying inflation measure which involves zero weighting of volatile sub-groups or items such as fruit &vegetables, betelnut and prices that are largely determined by non-market (seasonal) forces, as well as alcoholic drinks, cigarettes & tobacco, etc. See 'Underlying CPI'.
Financial Account	Records all transactions associated with changes of ownership of foreign financial assets such as holdings of monetary gold, special drawing rights (SDR), claims on non-residents and foreign liabilities.
Financial Corporations Survey (FCS)	The FCS is the broadest set of monetary and financial statistics in terms of institutional coverage. The survey contains consolidated balance sheet data for all institutional units within the financial corporations sector, thereby providing the stock and flow data for analyzing claims on and liabilities to all other sectors of theeconomy, including the external sector.
Financial derivatives	A financial instrument linked to a specific financial instrument, indicator or commodity and through which specific financial risks (such as interest rates, currency equity and commodity price risk, credit risk, etc.) can be traded in their own right in financial markets.
Headline Consumer Price Index (CPI)	A measure of inflation as calculated and published quarterly by the National Statistical Office (NSO), which measures the total price movements in goods and services in the basket.
Income Account	Records transactions such as compensation of employees, which cover wages, salaries, and other benefits in cash and kind, dividends and interest earned on investments between PNG and the other countries.
Inscribed Stock (bond)	A Government debt instrument sold to the public for

a maturity term of one year or longer for Budget financing.

Insurance Technical Reserves

Comprises of (i) net equity of households in life insurance corporations reserves, (ii) net equity of households in superannuation (pension) funds and (iii) prepayment of premiums. This is the major liability item of the superannuation funds and insurance corporations. On the assets side, this category records prepaid insurance premiums, which are relatively small amounts.

Kina Facility Rate (KFR)

Official benchmark rate used by the Bank of PNG to signal its monetary policy stance. The KFR is announced monthly by the Governor and published in the newspapers and on the Bank's website.

Liquid Assets

Assets of the commercial banks, which are in near liquid form, comprising cash, ESA balances, CBBs, Treasury bills and Inscribed stocks less than 3 years to maturity.

Minimum Liquid Asset Ratio (MLAR)

A prudential requirement imposed by the Bank of PNG on commercial banks to hold liquid assets as a percentage of total deposits and other prescribed liabilities at all times.

Monetary Base (or Reserve Money)

Comprised of currency held by the public and liquid assets of the commercial banks, including deposits held with the Bank of PNG under the Repurchase Agreement Facility (RAF) or Repos.

Narrow Money

A component of total money supply that is considered liquid or can be converted easily to cash on demand, and comprises of currency in circulation (held outside the banking system) and demand deposits.

Net Equity of Households in Life Insurance Reserves

Comprises of policyholders claims on the reserves of insurance corporations. These reserves must be ultimately used to provide benefits to policyholders, upon the occurrence of other specified events, or to compensate heirs upon the death of the policyholder. These claims constitute assets of the household sector rather than of insurance corporations.

Net Equity of Households in Pension Funds

Comprises policyholders' claims on pension funds. These reserves must be ultimately used to provide benefits to policyholders upon their retirement or to compensate heirs upon death of the policyholder. Pension funds are considered assets of the household sector rather than assets of the institutional units that manage the funds. Pension funds do not include social security funds, which are considered part of the general government sector.

Open Market Operations (OMO)	Operations of liquidity management conducted by the Bank of PNG with commercial banks and other financial intermediaries involving Government securities, CBB, Repos and foreign exchange trading to influence short-term interest rates.
Other Depository Corporations (ODCs)	The ODC sub-sector in PNG comprises of the commercial banks, finance companies, merchant banks, savings and loans societies and microfinance companies. These financial corporations are mainly engaged in financial intermediation and issue liabilities included in the definition of broad.
Other Depository Corporations Survey (ODCS)	The ODCS shows the consolidated stock and flow balance sheet data for the institutional units covered under the ODC sub-sector.
Other Financial Corporations (OFCs)	The OFC sub-sector is made up of the insurancec orporations, superannuation (pension) funds, other financial intermediaries and financial auxiliaries such as insurance brokers, investment managers and fund administrators.
Other Financial Corporations Survey (OFCS)	The OFCS contains consolidated stock and flow balance sheet data for insurance corporations, superannuation funds, other financial intermediaries and financial auxiliaries.
Over the year CPI	Percentage change in the CPI of a quarter compared to the corresponding quarter of the previous year (Also called 'annual' CPI).
Portfolio Investment	Investments, mainly in equity and debt securities such as bonds and notes, money market debt instruments and financial derivatives, as well as long-term debt, equity and securities.
Prepayment of Premiums and Reserves against Outstanding Claims	These are current claims of policyholders rather than net equity of insurance corporations. Prepayments of premiums, which are made by customers at the beginning of the periods covered by their policies, generate reserves for insurance corporations. Such prepayments are considered to be earned by an insurance corporation on a prorated basis during the policy period. These reserves are assets of policyholders. Reserves against outstanding claims are funds set aside by insurance corporations to cover the amounts that are not settled or claims that may be disputed. Reserves against such outstanding claims are considered to be assets of the beneficiaries and liabilities

of the insurance corporation. Policy benefits due to claimants are considered assets of the claimants. Until actually paid, these assets are held by insurance corporations as reserves.

Public non-financial corporations

Public non-financial corporations are resident non-financial corporations and quasi–corporations controlled by government units. Control may be exercised through ownership of more than half the voting shares, legislation, decree, or regulation that establish specific corporate policy or all the government to appoint the directors. In PNG this would include those institutions that are controlled by the Independent Public Business Corporation (IPBC).

Quasi Money

A component of total money supply that is not easily convertible to cash on demand and comprises of savings and term deposits.

Repurchase Agreement Facility (RAF)

A money market instrument used by Bank of PNG to lend to or borrow from the commercial banks, for liquidity management, and is unwound on maturity. The terms range from overnight to 14 days and can be collateralised, for instance, using Treasury bills.

Securities other than Shares

These are negotiable instruments serving as evidence that units have obligations to settle by means of providing cash, a financial instrument, or some other items of economic value. Common securities in PNG include treasury bills and inscribed stocks issued by the Government and Central Bank Bills (CBBs) issued by the Bank of PNG.

Shares and Other equity

Shares and other equity comprises all instruments and records acknowledging, after claims of all creditors have been met, claims on the residual value of a corporation. The components of shares and other equity include: (a). Funds contributed by owners; (b). Retained earnings; (c). Current year profit and loss; (d). General and special reserve; and (e). Valuation adjustments.

Tap Facility

A facility conducted by the Bank of PNG for sale of Treasury bills and Inscribed stocks to the public.

Temporary Advance Facility

A statutory mechanism stipulated under Section 54 of the Central Banking Act 2000, that provides the National Government with access to short-term financing to meet mismatches in revenue.

Trade Account

Records all economic transactions associated with merchandise exports and imports of physical goods.

Trade Weighted Index[6]

The Trade Weighted Index (TWI) measures the value of the kina against a basket of currencies of PNG's major trading partners.

Treasury Bill

Government security or debt instrument sold at a discount value, but redeemed at face value on maturity or purposes of Budget financing. In PNG, Treasury bills are issued for 28, 61, 91, 182 and 364 day maturities.

Trimmed-mean CPI measure

A fixed proportion of prices at each end of the distribution of price changes are zero weighted and the mean of the remaining price changes recomputed. See also 'Underlying CPI'.

Underlying CPI (exclusion-based and Trimmed-mean CPI measures)

A measure of inflation that excludes short-term volatile movements in prices, such as seasonal factors, Government policy decisions and price controlled items.

[6]See 'For the Record' p.24 in the 2005 September QEB.

REFERENCE "FOR THE RECORD"

Some issues of the Quarterly Economic Bulletin (QEB) have 'For the Record' as additional information relating to changes introduced to various statistical tables. The following 'For the Record' have appeared in the QEB since March 2000.

Issue		For the Record
Mar 2001	-	Introduction of Monthly Kina Facility Rate
Jun 2001	-	Changes to Table 10.2: Prices and Wages
Dec 2001	-	Measures of Inflation
	-	Changes to Table 7.1: Commercial Banks Interest Rates
	-	Changes to Table 7.2: Other Domestic Interest Rates
	-	Changes to Table 10.2 Prices and Wages
Jun 2002	-	Exclusion of QEB Tables 4.2: Rural Development Bank of PNG and Table 10.1: Indicators of Economic Activity
Mar 2003	-	Changes to Balance of Payments Tables
	-	Bank of PNG Employment Index: Changes to Table 10.4 and Table 10.5
	-	Regional and Industrial Classifications and Abbreviations
Jun 2003	-	Changes to Open Market Operations Instruments
	-	Directions of Merchandise Trade
Sep 2003	-	Changes to the Treasury Bills Auction Allocation Process
Dec 2003	-	Further Change to the Treasury Bills Auction Allocation Process
	-	Bank of PNG Employment Survey
Sep 2004	-	Introduction of Central Bank Bill (CBB)
Mar 2005	-	Changes to Table 9.5 to include Exports from Napanapa Oil Refinery
	-	Changes to Tables 1.2 and 1.3 'Other Items (Net)'
June 2005	-	Changes to Tables 8.2 and 8.5 'External Public Debt'
Sep 2005	-	Trade Weighted Exchange Rate Index
	-	Employment Index - Changes to Tables 10.4 and 10.5
	-	Central Bank Bill (CBB) Auction - Changes to Tables 3.8 and 7.2
Mar 2006	-	Updated Weights for the Trade Weighted Index (TWI)
June 2006	-	Expansion of Monetary and Financial Data Coverage
	-	Upgrade of PNG's Private Debt and Equity Recording System
Dec 2006	-	Changes to Table 8.1 - Capital Transfers
Jun 2007	-	Revisions to the March Quarter 2007 and December Quarter 2006 Consumer Price Index
Jun 2007	-	Debt Ratios
Sep 2007	-	Revisions to the Consumer Price Indices in June Quarter 2007 back to September Quarter 2005.
Mar 2008	-	Updated Weights for the Trade Weighted Index (TWI)
Mar 2009	-	Changed Monetary Policy Statement release month from January to March
Mar 2009	-	Updated Weights for the Trade Weighted Index (TWI)
Dec 2009	-	New Tables; 8.7, 8.8, 8.9 and 8.10 were included in the December Quarterly Economic Bulletin, resulting in subsequent renumbering of all other tables that follow.
Dec 2009	-	Revisions to Monetary and Financial Statistics tables in the December 2009 Quarterly Economic Bulletin.
Jun 2010	-	Expansion of Monetary and Financial Data Coverage.
Sep 2010	-	Recalculation of months of import cover
Mar 2011	-	Updated Weights of the Trade Weighted Trade (TWI)

REFERENCE

Each issue of the Quarterly Economic Bulletin contains a review of economic conditions for the past quarter and a comprehensive set of updated statistical tables. Articles of special interest to current economic policy are also prepared by Bank staff for inclusion in the Bulletin. The following articles have appeared in the Quarterly Economic Bulletin since December 1998.

Issue	Title
Dec 2001	Semi-annual Monetary Policy Statement, January 2002
Dec 2001	The 2002 National Budget
Jun 2002	Semi-annual Monetary Policy Statement, July 2002
Sep 2002	The 2002 Supplementary Budget
Dec 2002	Semi-annual Monetary Policy Statement, January 2003
Dec 2002	The 2003 National Budget
Mar 2003	Special article: Export Price Index, Volume Index and Weights Calculations Methodology
Jun 2003	Semi-annual Monetary Policy Statement, July 2003
Dec 2003	The 2004 National Budget
Dec 2003	Semi-annual Monetary Policy Statement, January 2004
Sep 2004	Semi-annual Monetary Policy Statement, July 2004
Dec 2004	Semi-annual Monetary Policy Statement, January 2005
Dec 2004	The 2005 National Budget
Jun 2005	Papua New Guinea's Total External Exposure
Jun 2005	Semi-annual Monetary Policy Statement, July 2005
Dec 2005	The 2006 National Budget
Dec 2005	Semi-annual Monetary Policy Statement, January 2006
Jun 2006	Papua New Guinea's Total External Exposure
Jun 2006	Semi-annual Monetary Policy Statement, July 2006
Dec 2006	The 2007 National Budget
Dec 2006	Semi-annual Monetary Policy Statement, January 2007
Jun 2007	Papua New Guinea's Total External Exposure
Jun 2007	Semi-annual Monetary Policy Statement, July 2007
Jun 2007	Supplement to the July 2007 Monetary Policy Statement
Dec 2007	The 2008 National Budget
Dec 2007	Semi-annual Monetary Policy Statement, January 2008
Jun 2008	Papua New Guinea’s Total External Exposure
Jun 2008	Semi-annual Monetary Policy Statement, July 2008
Dec 2008	The 2009 National Budget
Dec 2008	Monetary Policy Statement, January 2009 Update
Mar 2009	Monetary Policy Statement, March 2009
Jun 2009	Papua New Guinea’s Total External Exposure
Sep 2009	Monetary Policy Statement, September 2009
Dec 2009	The 2010 National Budget
Dec 2009	Monetary Policy Statement, March 2010
Mar 2010	Papua New Guinea’s Total External Exposure
Sep 2010	Monetary Policy Statement, September 2010
Dec 2010	The 2011National Budget
Dec 2010	Monetary Policy Statement, March 2011
Jun 2011	Papua New Guinea’s Total External Exposure
Sep 2011	Monetary Policy Statement, September 2011
Dec 2011	The 2012 National Budget
Dec 2011	Monetary Policy Statement, March 2012

STATISTICAL SECTION

Sources

Statistics for the commercial banks have been derived from returns submitted to the Bank. Statistics on Savings and Loan Societies and Papua New Guinea Government securities are derived from sources within the Bank.

Government financial statistics are supplied by the Department of Finance and Treasury.

Information on prices of Papua New Guinea exports are gathered from marketing boards or export producers; world indicator prices are reproduced from the Public Ledger published in London. Tea prices are from the Tea Market Report, London. The general indices of commodity prices are constructed from data published in The Economist, London.

Most other statistics are published initially by the National Statistical Office.

Symbols used

n.a	not available
..	figure less than half the digit shown
-	nil
e	estimate
f	forecast
p	provisional
r	revised
n.i.e	not included elsewhere