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PORT MORESBY
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1. Overview

Economic indicators available to the Bank of Papua New Guinea (the Bank) indicate that economic activity picked up in the June quarter of 2010. This was supported by: an increase in the total level of employment; continued growth in credit extended by commercial banks to the private sector; increased export volumes and values of major commodities induced by higher international prices, increased Government expenditure; and increased domestic demand associated with the LNG project. The annual headline inflation rate was 6.2 percent in the June quarter of 2010, compared to 5.0 percent in the March quarter. The kina appreciated against most major currencies, except the US dollar and Japanese yen, and resulted in the Trade Weighted Index (TWI) appreciating by 0.4 percent in the June quarter. With the pick up in inflation and underlying inflationary pressures, the Bank has taken a cautious approach in its stance of monetary policy by maintaining the policy signaling rate, the monthly Kina Facility Rate, at 7.0 percent over the quarter.

Data from the Bank's Business Liaison Survey (BLS) showed that the total nominal value of sales in the private sector decreased by 2.0 percent in the March quarter of 2010, compared to an increase of 10.4 percent in the December quarter of 2009. Excluding the mineral sector, sales decreased by 1.2 percent in the March quarter, following an increase of 6.6 percent in the previous quarter. By sector, all sectors recorded decreases, except the building and construction, agriculture/forestry/fisheries, and transportation sectors. The decline was attributed to lower consumer demand after the Christmas-New year period, lower sales of oil and a drop in gold production. By region, sales declined in the National Capital District (NCD), Islands and Highlands regions, which more than offset the increases in the Southern, Morobe and Momase regions. Over the twelve months to March 2010, total sales increased by 23.0 percent.

The Bank's Employment Index shows that the level of employment in the formal private sector increased by 1.3 percent in the June quarter of 2010, following a decrease of 1.1 percent in the previous quarter. Excluding the mineral sector, the level of employment increased by 1.3 percent in the June quarter of 2010, after a drop of 1.2 percent in the previous quarter. By sector, employment increased in all the sectors, except the manufacturing and financial/business and other services sectors. The increase reflected higher activity associated with the construction phase of the LNG project, and the harvesting of coffee and palm oil. By region, employment picked up in the NCD, Highlands and Islands regions, while the Southern, Morobe and Momase regions recorded declines. Over the year to June 2010, the total level of employment increased by 1.6 percent, up from 1.4 percent over the year to March 2010. Excluding the mineral sector, the level of employment increased by 1.4 percent over the year to June 2010, compared to 1.3 percent over the year to March 2010.

Quarterly headline inflation, as measured by the Consumer Price Index (CPI), was 1.6 percent in the June quarter of 2010, up from 1.4 percent in the previous quarter. There were increases in all the expenditure groups, with the largest in the 'Food', 'Rents, council charges, fuel and power', 'Transport and communication' and 'Household equipment and operations' expenditure groups. Annual headline inflation was 6.2 percent in the quarter, up from 5.0 percent in the March quarter. The high annual rate of inflation was driven by increases in the prices of food, especially fruits and vegetables, fuel and household equipment and operations. The increase also reflected a pick up in consumer demand. By region, all urban areas recorded price increases in the quarter and over the year to the June quarter of 2010. Annual trimmed-mean inflation was 5.8 percent in the quarter, up from 4.3 percent in the March quarter, while annual exclusion-based inflation was 4.8 percent, compared to 3.8 percent in the previous quarter.

In the June quarter of 2010, the daily average kina exchange rate appreciated against most major currencies, except the US dollar and Japanese yen. The kina appreciated by 0.6 percent against the Australian dollar to 0.4225, by 2.8 percent against the pound sterling to 0.2394 and by 6.9 percent against the euro to 0.2947, while it depreciated against the US dollar by 1.6 percent to 0.3600, and remained stable against the yen at 31.88. These movements resulted in the daily average Trade Weighted Index appreciating by 0.4 percent in the June quarter of 2010 to 32.50, up from 31.67 in the March quarter.

Higher international prices for all mineral, agricultural, log and marine product exports resulted in a 39.1 percent increase in the weighted average kina price of Papua New Guinea's exports in the June quarter of

2010, compared to the corresponding quarter of 2009. There was a 44.1 percent increase in the weighted average price of mineral exports, with higher kina prices of all mineral exports. For the agricultural, log and marine product exports, the weighted average price increased by 15.9 percent and was accounted for by higher kina prices of all agricultural and log exports, which more than offset lower prices of marine product exports.

There was an overall surplus of K534 million in the balance of payments for the first six months of 2010, compared to a surplus of K664 million in the corresponding period of 2009. This was due to a surplus in the capital and financial accounts more than offsetting a deficit in the current account.

There was a deficit of K216 million in the current account for the first six months of 2010, compared to a deficit of K379 million in the corresponding period of 2009. The deficit in the current account was due to higher net service payments, which more than offset a higher trade account surplus and higher net transfer receipts.

The capital account recorded a net inflow of K81 million in the first six months of 2010, an increase of 68.8 percent from the corresponding period of 2009. This reflected higher transfers by donor agencies for project financing.

The financial account recorded a net inflow of K662 million in the first six months of 2010, compared to K1,023 million in the corresponding period of 2009. There were higher net inflows, mainly from Direct and Other investments. The increase in Direct investments reflected higher investment in the country by non-residents, while the net inflow from Other investments reflected drawdown from the foreign currency account balances of resident mineral companies. These more than offset net outflows from portfolio investments, reflecting investments in short-term money market instruments by resident entities, investments in financial derivative instruments through hedge arrangements, a build-up in the net foreign assets of the banking system, and higher net loan repayments by the Government.

The level of gross foreign exchange reserves at the end of June 2010 was K7,572.3 (US$2,580.5) million, sufficient for 10.9 months of total and 15.2 months of non-mineral import covers.

The Bank continued its cautious approach to monetary policy by maintaining the monthly Kina Facility Rate (KFR) at 7.00 percent throughout the June quarter of 2010, consistent with the March 2010 Monetary Policy Statement (MPS). The dealing margin for the Repurchase Agreements (Repos) was kept unchanged at 100 basis points on both sides of the KFR. Domestic interest rates for short-term securities and wholesale deposits declined during the quarter, compared to the March quarter. The declining rates are attributed to excess liquidity in the banking system, which is due to high foreign exchange inflows and increased Government spending.

The Bank continued to utilise Open Market Operation (OMO) instruments in the conduct of monetary policy over the June quarter of 2010. In addition to Central Bank Bills (CBB) issuances, Government Treasury bill and Inscribed stock auctions were conducted and helped to diffuse some of the excess liquidity. However, these actions were not sufficient to stem the decline in market interest rates. The commercial banks also utilised the interbank market to meet their liquidity needs. The Cash Reserve Requirement (CRR) and the Minimum Liquid Assets Ratio (MLAR) of commercial banks were maintained at 3.0 percent and 25.0 percent, respectively, over the June quarter.

The average level of broad money supply (M3*) increased by 6.4 percent in the June quarter of 2010, compared to a revised increase of 3.3 percent in the March quarter. This outcome was mainly due to an increase of 8.7 percent in average net foreign assets of depository corporations and an increase of 5.3 percent in average net private sector credit, which more than offset a decline of 10.2 percent in average net claims on the Central Government. Average domestic claims outstanding, excluding advances to the Central Government increased by 5.1 percent in the June quarter of 2010, compared to a revised increase of 6.1 percent in the previous quarter. The average level of monetary base (reserve money) increased by 19.3 percent in the June quarter of 2010, compared to a revised decline of 2.4 percent in the March quarter.

During the June quarter of 2010, total domestic credit extended by depository corporations to the private sector, public non-financial corporations, Provincial and Local Level Governments, and other financial corporations, increased by K344.6 million to K6,887.1 million, compared to a revised increase of K320.6 million in the March quarter. This was mainly due to an increase of K348.6 million in private sector credit and K22.5 million in public non-financial corporations, which more than offset a decline of K26.5 million in other financial corporations.

Preliminary estimates of the fiscal operations of the National Government over the six months to June 2010 show an overall surplus of K101.3 million, compared to a surplus of K290.1 million in the corresponding period of 2009. This represents 0.4 percent of nominal GDP.

Total revenue, including foreign grants, during the six months to June 2010 was K2,907.0 million, 12.6 percent higher than the receipts collected in the corresponding period of 2009. This represents 38.8 percent of the budgeted revenue. The increase in revenue mainly reflected higher tax revenue and foreign grants, which more than offset a decline in non-tax receipts. Total expenditure during the six months to June 2010 was K2,805.7 million, 22.5 percent higher than in the corresponding period of 2009 and represents 37.5 percent of the budgeted appropriation for 2010. This outcome was due to both higher recurrent and development expenditures.

As a result of these developments in revenue and expenditure, the Government recorded an overall budget surplus of K101.3 million. The surplus and domestic financing of K5.5 million was used to make net external loan repayments of K106.8 million. The net external loan repayments comprised of K85.1 million to concessionary and K21.7 million to extraordinary sources. The domestic financing comprised of K42.3 million and K5.8 million in net borrowing from financial corporations and public non-financial corporations, respectively. This more than offset K42.6 million in cheques presented for settlement.

Total public (Government) debt declined by K139.0 million to K6,875.8 million in the June quarter of 2010, compared to K7,014.8 million in the December quarter of 2009, resulting in the total debt to nominal GDP ratio decreasing to 31.9 percent from 33.1 percent between the two quarters. The decrease in external debt more than offset an increase in domestic debt.

2. International Developments

The global economy continued to expand in the first six months of 2010 but at varying rates, with the major advanced economies showing modest growth compared to strong growth in Asia and Latin America. Growth in Europe remains relatively weak as some countries continue to grapple with the huge debt problems. According to the IMF's July's World Economic Outlook (WEO) update, global economic growth is expected to be around 4.5 percent in 2010. This is an upward revision of about 0.5 percent from the April WEO. At the same time, downside risks to this forecast have increased amid renewed financial turbulences triggered by the Greek debt crisis, which has shaken confidence globally. To this end, the IMF encourages advanced economies to focus on credible fiscal consolidation, especially measures that enhance medium term growth prospects such as reforms to entitlements and tax systems, and continue accommodative monetary conditions. The IMF also stressed that policies in emerging countries should also help rebalance demand, which included structural reforms and, in some cases, greater exchange rate flexibility.

In June 2010, the G20 countries met in Toronto, Canada for their summit. Building on earlier achievements in addressing the global economic crisis, the group discussed ways to reform and strengthen financial systems to fight protectionism, promote trade and investment, and to create a strong, sustainable and balanced global growth and employment. Member countries noted that serious challenges still remain as the recovery is uneven and fragile, with unemployment in many countries at unacceptable levels, and the social impact of the crisis is still widely felt. The group emphasized the need to deliver on existing stimulus plans, while working to create the conditions for robust private demand. Further progress is also required on reform to increase transparency and strengthen the balance sheets of their financial institutions, and support credit availability. Members also noted that there was a pressing need to complete the reforms of the international financial institutions.

Also in June, the 7th ministerial-level meeting of the Energy Dialogue between the European Union (EU) and the Organization of the Petroleum Exporting Countries (OPEC) took place in Brussels, Belgium. The talks centered on the current economic crisis and its impact on the two groups, especially with respect to oil. Participants reiterated their mutual interest in stable, transparent, and predictable oil markets. They also emphasized the need for an overall reshaping of the global financial sector, with adequate regulatory reforms, in order to minimize the risk of excessive market volatility. Both parties agreed on the importance of sharing information on future demand and supply scenarios.

In May 2010, the 43rd Annual Meeting of the Asian Development Bank (ADB) was held in Tashkent, Uzbekistan, and brought together participants from governments, development partners, civil society organizations, academia and the media. With Asia leading the world in recovery from the global financial crisis, discussions focused on how to sustain the region's recovery in the long-term. The President of the ADB, Mr. Kuroda stressed the need to balance the region's sources of growth, with increased focus on domestic demand, instead of reliance on the external sector.

In the United States (US), real GDP increased by 1.6 percent over the year to June 2010, compared to a contraction of 4.1 percent over the same period in 2009. The increase primarily reflected positive contributions from nonresidential fixed investment, exports, personal consumption expenditures, private inventory investment, federal government spending, and residential fixed investment. The slowdown, compared to the first quarter, reflects a larger net trade deficit and a slowdown in inventory investments. The latest IMF forecast is for real GDP to grow by 3.3 percent in 2010.

Industrial production declined by 0.1 percent over the year to June 2010, following a decline of 0.4 percent over the same period in 2009. The Institute of Supply Management's Purchasing Managers Index was at 56.2 in June 2010, indicating an increase in the manufacturing industry. An index below 50 indicates contraction while an index above 50 indicates expansion in the manufacturing industry. Retail sales increased by 4.8 percent over the year to June 2010, after a decline of 4.9 percent over the same period in 2009 while the annual unemployment rate was 9.5 percent over the year to June 2010, the same as in the corresponding period of 2009.

Consumer prices increased by 1.1 percent over the year to June 2010, compared to decline of 1.4 percent over the same period in 2009. The increase was a result of a gradual pick up in consumer spending but still remained constrained by high unemployment, modest income growth, lower household wealth, and tight credit. Broad money supply increased by 1.8 percent over the year to June 2010, compared to 9.0 percent over the corresponding period in 2009. Given the weak recovery, the Federal Reserve (Fed) left the Federal Funds Rate unchanged at a range of 0 to 0.25 percent in June 2010 for the 18th conservative month.

The trade deficit was US$49.9 billion over the year to June 2010, compared to a deficit of US$27.1 billion over the year to June 2009. Decreased exports of farm products, computers, and telecommunications led to a net decline in exports, while imports, especially of consumer goods and goods from China, increased.

In Japan, real GDP increased by 0.4 percent over the year to June 2010, following a decline of 6.9 percent over the same period in 2009. Japan's economic growth slowed sharply in the second quarter, well short of expectations as stagnant consumption and flagging exports weighed on an economy already impacted by deflation and an appreciating yen. The latest IMF forecast is for real GDP to grow by 2.4 percent in 2010.

Industrial production increased by 17.3 percent over the year to June 2010, after a drop of 22.5 percent over the same period in 2009. The increase reflects a pick up in economic activity in its main trading partners over the year, but, compared to monthly growth over the first six months of 2010, it reflects a slow down amid widespread concerns that Japan's fragile economic recovery may be affected by growth in key export markets slowing down.

Retail sales increased by 3.2 percent over the year to June 2010, following a decline of 4.9 percent over the corresponding period in 2009. The increase was due to gains in auto sales, fuel and summer clothes. Retail sales have been increasing since early 2010 supported by government subsidies, but, are now showing signs of slowing. The unemployment rate was 5.3 percent over the year to June 2010, the same as the corresponding period in 2009.

Consumer prices fell by 0.7 percent over the year to June 2010, compared to a decline of 1.8 percent over the year to June 2009, reflecting a general slowdown in the economy.

Broad money supply grew by 2.2 percent over the year to June 2010, following an increase of 1.7 percent over the same period in 2009. The Bank of Japan maintained the overnight call rate at around 0.1 percent.

The current account surplus was US$686.4 billion over the year to June 2010, up from US$487.0 billion over the same period in 2009 as exports rose but the pace of increase slowed for the fourth straight month, indicating that the recovery may slow down as overseas demand moderates.

In the Euro area, real GDP increased by 1.7 percent over the year to June 2010, following a decline of 4.9 percent over the same period in 2009. The growth was due to Germany's strong export performance, which was aided by a decline in the value of the euro. In contrast, Greece, Ireland, Spain and Portugal struggled notably in the second quarter, with soaring sovereign debt yields in the wake of the Greek bail-out. The latest IMF forecast is for real GDP to grow by 1.0 percent in 2010.

Industrial production increased by 8.2 percent over the year to June 2010, after a fall of 17.9 percent over the corresponding period in 2009. Retail sales increased by 0.1 percent over the year to June 2010, compared to a 2.4 percent drop over the same period in 2009, as consumer confidence slowly picked up. The unemployment rate was 10.0 percent over the year to June 2010, up from 8.9 percent over the same period in 2009.

Consumer prices in the Euro area increased by 1.4 percent over the year to June 2010, up from a decline of 0.1 percent over the year to June 2009, reflecting a general improvement in the Euro area economy. With consumer confidence still low in Euro area, there has been little sign so far of a pick up in domestic demand.

Broad money supply increase by 0.2 percent over the year to June 2010, compared to 3.6 percent over the corresponding period in 2009. The European Central Bank (ECB) continued to pursue an accommodative monetary policy stance, as it maintained the Euro Refinancing Rate unchanged at a record low of 1.0 per cent for the 12th consecutive month to June 2010.

The trade account of the Euro area was in surplus by US$2.4 billion over the year to June 2010, an improvement from a deficit of US$5.4 billion over the corresponding period in 2009, reflecting an improvement in exports.

In Germany, real GDP strengthened by 3.7 percent over the year to June 2010, following a decline of 5.6 percent over the same period in 2009. The improvement mainly reflected a pick up in exports supported by a depreciating euro. The latest IMF forecast is for real GDP to grow by 1.4 percent in 2010.

Industrial production grew by 10.8 percent over the year to June 2010, following a decline of 17.1 percent over the same period in 2009 as a result of increased demand by Germany's main trading partners. Retail sales increased by 4.7 percent over the year to June 2010, compared to a decline of 2.5 percent over the corresponding period in 2009. The unemployment rate was 7.7 percent over the year to June 2010, lower than the 8.3 percent over the corresponding period in 2009.

Consumer prices increased by 0.9 percent over the year to June 2010, a pick up from 0.1 percent over the same period in 2009, as the German economy slowly recovers.

The current account surplus was US$14.1 billion over the year to June 2010, improving from the US$12.3 billion surplus over the corresponding period in 2009. The surplus was due to an increase in exports which increased by US$86.5 billion, compared to US$67.3 billion in the corresponding period of 2009.

In the Unite Kingdom (UK), real GDP increased by 1.6 percent over the year to June 2010, following a contraction of 5.9 percent over the same period in 2009. The return to positive territory was attributed mainly to higher output by the business services, finance and construction sectors. The latest IMF forecast is for real GDP to grow by 1.2 percent in 2010.

Industrial production grew by 1.3 percent over the year to June 2010, compared to a decline of 10.6 percent over the same period in 2009. Retail sales increased by 3.0 percent over the year to June 2010, compared to 2.5 percent over the same period in 2009. The unemployment rate was 7.8 percent over the year to June 2010, the same as the corresponding period in 2009.

Consumer prices increased by 3.2 percent over the year to June 2010, compared to an increase of 1.8 percent over the same period in 2009, attributed mainly to the return of Value Added Tax (VAT) and pass through of past increases in oil and import prices. Broad money supply increased by 3.1 percent over the year to June 2010, compared to an increase of 13.6 percent over the corresponding period in 2009. The Bank of England continued to maintain its official Bank Rate at 0.5 percent over the June quarter of 2010, for the 15th consecutive month.

The trade deficit was US$135 billion over the year to June 2010, following a deficit of US$139 billion over the same period in 2009, reflecting increased exports supported by a weaker pound.

In Australia, real GDP grew by 3.3 percent over the year to June 2010, compared to an increase of 0.6 percent over the year to June 2009. Unlike the other advanced economies, Australia did not fall into recession as a result of a well insulated banking system supported by successful monetary and fiscal policies. The economy continues to expand as investment increased, supported by high export commodity prices. The latest IMF forecast is for real GDP to grow by 3.0 percent in 2010.

Industrial production increased by 5.6 percent over the year to June 2010, after a decline of 3.8 percent over the year to June 2009. Retail sales increased by 1.9 percent over the year to June 2010, down from 8.1 percent over the same period in 2009. The unemployment rate was 5.1 percent over the year to June 2010, compared to 5.8 percent over the same period in 2009.

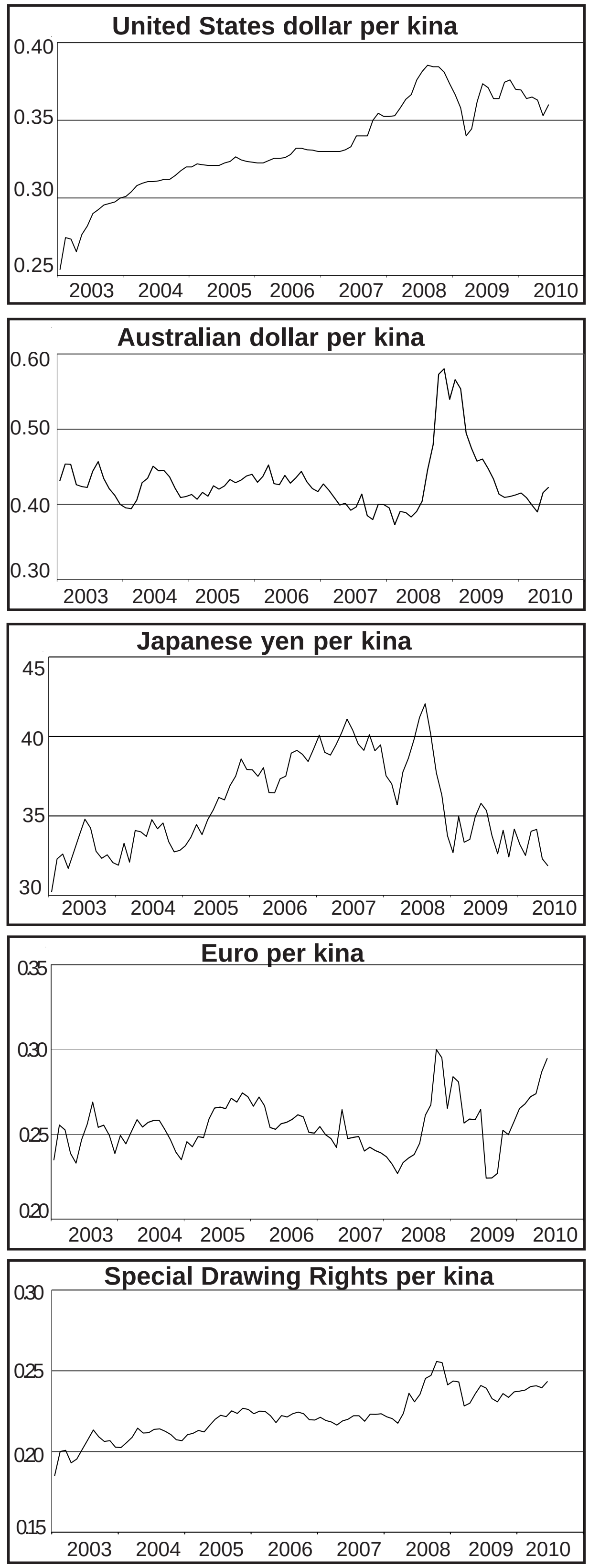
Consumer price rose by 3.1percent over the year to June 2010, higher than the 1.5 percent recorded in the corresponding period in 2009. Broad money supply increased by 4.6 percent over the year to June 2010, compared to 15.2 percent over the same period in 2009. The Reserve Bank of Australia (RBA) raised its Cash Rate by another 50 basis points in the June quarter to 4.5 percent.

The trade surplus was US$3.12 billion over the year to June 2010, compared to a surplus of US$5.7 billion over the same period in 2009. Australian exports boomed, compared to the previous quarters, as its mineral commodity exports to Asia increased.

During the June quarter of 2010, the US dollar appreciated against all the major currencies, reflecting the relative strength of the US economy, pick up in its exports, and capital inflows resulting from the sovereign debt crisis in the Euro zone and the UK budget deficit. The US dollar appreciated by 7.9 percent against the euro, 4.4 percent against the pound sterling, 1.6 percent against the yen and 2.2 percent against the Australian dollar.

In the June quarter of 2010, the daily average kina exchange rate appreciated against most major currencies, except the US dollar and Japanese yen. The kina appreciated by 0.6 percent against the Australian dollar to 0.4225, by 2.8 percent against the pound sterling to 0.2394, and by 6.9 percent against the euro to 0.2947, while it depreciated against the US dollar by 1.6 percent to 0.3600. It remained stable against the yen at 31.88. These movements resulted in the daily average Trade Weighted Index appreciating by 0.4 percent in the June quarter of 2010 to 32.50, up from 31.67 in the March quarter.

EXCHANGE RATES



3. DOMESTIC ECONOMIC DEVELOPMENT

DOMESTIC ECONOMIC ACTIVITY

Data from the Bank's Business Liaison Survey (BLS) show that the total nominal value of sales in the private sector decreased by 2.0 percent in the March quarter of 2010, compared to an increase of 10.4 percent in the December quarter of 2009. Excluding the mineral sector, sales decreased by 1.2 percent in the March quarter, following an increase of 6.6 percent in the previous quarter. By sector, there were declines in all sectors, except the building and construction, agriculture/forestry/fisheries, and transportation sectors. By region, sales declined in NCD, Highlands, and Islands regions, which more than offset the increases in the Southern, Morobe and Momase regions. Over the twelve months to March 2010, total sales increased by 23.0 percent.

In the retail sector, sales decreased by 6.5 percent in the March quarter of 2010, compared to an increase of 13.5 percent in the December quarter of 2009. The decrease was mainly associated with lower demand after the festive season in the previous quarter. Over the twelve months to March 2010, sales increased by 21.6 percent.

In the wholesale sector, sales decreased by 6.0 percent in the March quarter of 2010, compared to an increase of 2.0 percent in the December quarter of 2009. The decrease was associated with weak consumer demand and fall in the sales of fuel-based products. Over the twelve months to March 2010, sales increased by 22.1 percent.

In the mineral sector, sales dropped by 3.2 percent in the March quarter of 2010, after an increase of 17.9 percent in the previous quarter. The fall was due to lower oil sales and realised prices, and reduction in gold production resulting from lower gold concentrate. Over the twelve months to March 2010, sales increased by 23.3 percent.

In the manufacturing sector, sales decreased by 2.8 percent in the March quarter of 2010, after an increase of 7.4 percent in the previous quarter. The decrease was mainly due to lower consumer demand after the festive season. Over the twelve months to March 2010, sales increased by 9.8 percent.

In the financial/business and other services sector, sales declined by 1.3 percent in the March quarter of 2010, following a decrease of 13.3 percent in the December quarter of 2009. The decline was mainly due to lower interest income in the financial sector, which offset growth in guest turnovers at hotels, catering, real estate and security activities. Over the twelve months to March 2010, sales increased by 23.5 percent.

In the agriculture/forestry/fisheries sector, sales grew by 14.7 percent in the March quarter of 2010, compared to an increase of 5.4 percent in the December quarter of 2009. There was an increase in the agriculture sub-sector attributed to higher palm oil exports as a result of improved production and higher international prices. Over the twelve months to March 2010, the value of sales increased by 45.1 percent.

In the building and construction sector, sales increased by 11.8 percent in the March quarter of 2010, following an increase of 8.6 percent in the previous quarter. Projects in the Southern region associated with the LNG Project and other road maintenance projects were the main drivers of this growth. Over the twelve months to March 2010, sales increased by 57.8 percent.

In the transportation sector, sales increased by 7.4 percent in the March quarter of 2010, after an increase of 14.4 percent in the December quarter of 2009. The increase was mainly due to higher cargo haulage by the sea transport sub-sector, which offset lower passenger travel by the air transport sub-sector. Over the twelve months to March 2010, sales increased by 54.8 percent.

By region, sales declined in the NCD, Highlands, and Islands regions, which more than offset increases in the Southern, Morobe and Momase regions. In the Highlands region, sales declined by 14.2 percent in the March quarter of 2010, after a growth of 14.0 percent in the December quarter of 2009. The reduction was mostly in the mineral sector due to a decrease in oil production and prices. The decreases in the wholesale sector and agriculture sub-sector were due to lower coffee production. Lower consumer demand also affected the retail sector, as automobile and supermarket and retail outlet sales declined. Over the twelve months to March 2010, sales increased by 17.4 percent.

In NCD, sales decreased by 6.8 percent in the March quarter, after increasing by 11.5 percent in the previous quarter. The decrease was in the manufacturing, transportation, wholesale and retail sectors, all driven by lower consumer and fuel demand and less travel after the festive season. A significant decrease in hedging income also contributed to the decline in the manufacturing sector. Over the twelve months to March 2010, sales increased by 22.2 percent.

In the Islands region, sales fell by 8.6 percent in the March quarter, following a 20.7 percent increase in the previous quarter. The decline was mostly in the mineral and wholesale sectors. The fall in the mineral sector was mostly due to reduced gold production resulting from lower grade ores. Lower sales in the wholesale sector was associated with a decrease in demand after the festive season. Over the twelve months to March 2010, sales dropped by 11.6 percent.

In the Southern region, sales increased by 19.7 percent in the March quarter of 2010, compared to an increase of 2.7 percent in the previous quarter. The increase was mainly driven by the mineral sector and agriculture sub-sector. In the mineral sector, the increase was attributed to higher copper exports. The increase in the agriculture sub-sector was due to higher palm oil exports, resulting from a pick-up in production and higher international prices. Over the twelve months to March 2010, sales increased by 69.0 percent.

In Morobe, sales grew by 3.6 percent in the March quarter, following an increase of 9.5 percent in the previous quarter. The growth was mainly driven by the retail and manufacturing sectors. In the retail sector, the increase was due to increased vehicle supplies to a mining company. In the manufacturing sector, the pick up was driven by high production and sales of canned food and poultry products, combined with favourable prices of forestry products. Over the twelve months to March 2010, sales declined by 29.5 percent.

In the Momase region, sales increased by 3.4 percent in the March quarter, compared to an increase of 1.4 percent in the previous quarter. The increase was mainly from the manufacturing sector, where sales rebounded after a slow December quarter. Over the twelve months to March 2010, sales increased by 50.9 percent.

EMPLOYMENT

The Bank's Employment Index shows that the level of employment in the formal private sector increased by 1.3 percent in the June quarter of 2010, following a decrease of 1.1 percent in the previous quarter. Excluding the mineral sector, the level of employment increased by 1.3 percent in the June quarter of 2010, after a drop of 1.2 percent in the previous quarter. By sector, employment increased in all the sectors, except the manufacturing and financial/business and other services sectors. By region, employment picked up in the NCD, Highlands and Islands regions, while the Southern, Morobe and Momase regions recorded declines. Over the year to June 2010, the total level of employment increased by 1.6 percent, while excluding the mineral sector, it increased by 1.4 percent.

In the transportation sector, the level of employment increased by 3.7 percent in the June quarter of 2010, following an increase of 0.3 percent in the previous quarter. The increase was mainly due to the acquisition of two new planes by a major airline company, increased travels and cargo haulage associated with the LNG project, and expansion of two third level airline companies following the awarding of LNG related contracts. The increase is also associated with the recruitment of cadets by a shipping company for its training program. Over the year to June 2010, employment in the transportation sector grew by 6.6 percent, compared to the corresponding period in 2009.

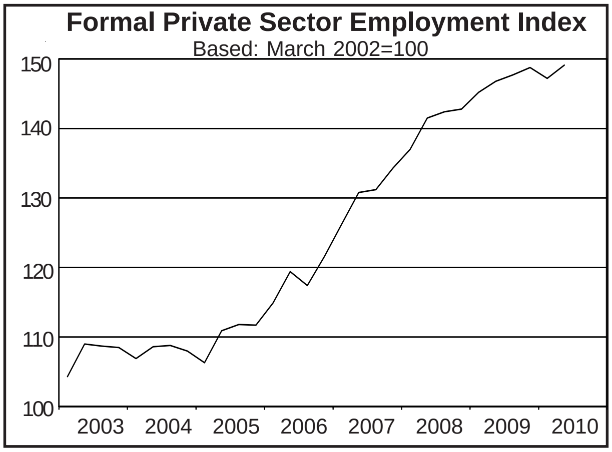
In the wholesale sector, the level of employment increased by 1.3 percent in the June quarter of 2010, following a decrease of 0.4 percent in the March quarter. In the retail sector, the level of employment rose by 3.3 percent in the quarter, after declining by 3.8 percent in the previous quarter. The increase in both sectors were mainly associated with the expansion of operations into other centers, recruitment and training for the operations of a major retail outlet in NCD, and increased business activitiesassociated with new clients , including a new contract between wholesalers of electrical and industrial goods with a mining company. Over the year to June 2010, employment in the wholesale sector increased by 2.6 percent, while it rose by 4.6 percent in the retail sector, compared to the same period in 2009.

In the agriculture/forestry/fisheries sector, the level of employment increased by 2.9 percent in the June quarter of 2010, following an increase of 2.0 percent in the March quarter. The increase was in the agriculture and forestry sub-sectors. The increase in the agriculture sub-sector was due to the recruitment of casual employees for the coffee season in the Highlands region and harvesting of palm oil in the Southern region. The increase in the forestry sub-sector was associated with the commencement of sawmill operations by a timber company in Madang. Over the year to June 2010, the level of employment increased by 4.5 percent, compared to the same period in 2009.

In the mineral sector, the level of employment rose by 1.1 percent in the June quarter of 2010, which is below the 1.5 percent increase in the March quarter. The increase was mainly due to the progress of the construction work on the LNG project and exploration activities. Over the year to June 2010, the level of employment increased by 3.3 percent, compared to the same period in 2009.

In the building and construction sector, the level of employment grew by 0.4 percent in the June quarter of 2010, after increasing by 3.2 percent in the March quarter. The lower increase was attributed to road maintenance projects and completion or near completion of residential and commercial property development. Over the year to June 2010, the level of employment increased by 8.1 percent, compared to the corresponding period in 2009.

In the manufacturing sector, the level of employment declined by 1.3 percent in the June quarter of 2010, following a decline of 7.3 percent in the previous quarter. The decline was due to faulty machines and equipment, and delays in shipment of raw materials due to bad weather conditions, terminations and



downsizing by a major manufacturing company due to separation of business units. In addition, a major tuna loining company scaled down its daily shift operations from two to one per day. Over the year to June 2010, the level of employment dropped by 3.5 percent, compared to the corresponding period in 2009.

In the financial/business and other services sector, the level of employment declined by 0.1 percent in the June quarter of 2010, up from a decline of 0.2 percent in the March quarter. The decline was mainly due to casual employees being laid off due to low occupancy rate at a major hotel, no new contracts in the catering and cleaning services, and downsizing of operations by a security firm. Over the year to June 2010, the level of employment dropped by 1.9 percent, compared to the corresponding period in 2009.

By region, the level of employment increased in the Highlands, NCD and Islands regions, while the Southern, Morobe and Momase regions recorded decreases. In the Highlands region, the level of employment increased by 8.5 percent in the June quarter of 2010, after growing by 2.7 percent in the previous quarter. The increase was in the mineral, wholesale and retail sectors and the agriculture sub-sector. The increase in the mineral sector was due to on-going construction work and related activities associated with the LNG project, while the increase in the wholesale and retail sectors was associated with increased turnover of sales. The pick-up in the agriculture sub-sector was mainly associated with the coffee season. Over the year to June 2010, the level of employment dropped by 2.1 percent, compared to the same period in 2009.

In NCD, the level of employment increased by 1.9 percent in the June quarter of 2010, following a 0.5 percent drop in the March quarter. The increase was in the building and construction, retail, wholesale and transportation sectors. The pick-up in the building and construction sector was attributed to new building and road maintenance projects, while the increase in the wholesale and retail sectors was due to expansion and improvement in business activity, and the recruitment for a new shopping mall. The pick-up in the transportation sector was associated with the acquisition of planes by a major airline company, increased travels and cargo haulage associated with the LNG project, and expansion of third level airlines for LNG related contracts. A shipping company continued to recruit cadets for its training program. Over the year to June 2010, the level of employment increased by 5.9 percent, compared to the same period in 2010.

In the Islands region, the level of employment increased by 1.3 percent in the June quarter of 2010, the same as in the March quarter. The increase was in the building and construction, mineral, retail and wholesale sectors. The increase in the building and construction sector was driven by new building and road projects in East and West New Britain provinces, while the increase in the mineral sector was due to exploration activities. The increase in retail and wholesale sectors were due to expansion of operations and influx of tourists associated with the 16th Mask festival in East New Britain province. Over the year to June 2010, the level of employment increased by 2.3 percent, compared to the corresponding period in 2010.

In the Southern region, the level of employment declined by 1.3 percent in the June quarter of 2010, after a drop of 3.5 percent in the previous quarter. The fall was in the financial/business and other services sector, associated with the decline in tourism activity and completion of cleaning service projects in Tabubil. Over the year to June 2010, the level of employment picked up by 0.7 percent, compared to the same period in 2009.

In Morobe, the level of employment increased by 0.3 percent in the June quarter of 2010, an improvement from the 1.3 percent drop in the previous quarter. The increase came from the building and construction sector, wholesale and retail, and mineral sectors. The increase in the building and construction sector mainly reflected new contracts associated with the LNG project and some building and road projects in and around Morobe province. The increase in the wholesale and retail sectors were due to growth in sales and expansion of operations by major retailers and wholesalers, and a new contract between an electrical wholesaler with Hidden valley gold mine. The increase in mineral sector was due to increased activity by a major drilling company. Over the year to June 2010, the level of employment dropped by 0.4 percent, compared to the same period in 2009.

In the Momase region, the level of employment dropped by 4.5 percent in the June quarter of 2010, following a decline of 7.9 percent in the March quarter. The decline was in the manufacturing and financial/business and other services sectors and the fisheries sub-sector. The decline in the manufacturing sector was due to the laying off of casual employees, fall in supply of raw materials and the reduction in working shifts by a major firm. The fall in the financial/business and other services sector was attributed to the casuals being laid off reflecting low occupancy rate at a major hotel, while the drop in the fisheries sub-sector was due to laying off of casual staff owing to bad whether conditions. Over the year to June 2010, the level of employment declined by 4.1 percent, compared to the corresponding period in 2009.

INFLATION

Quarterly headline inflation, as measured by the Consumer Price Index (CPI), was 1.6 percent in the June quarter of 2010, compared to 1.4 percent in the March quarter. There were increases in all the expenditure groups, with the largest in the 'Food', 'Rents, council charges, fuel and power', 'Transport and communication' and 'Household equipment and operations' expenditure groups. Annual headline inflation was 6.2 percent in the quarter, up from 5.0 percent in the March quarter. The higher annual rate of inflation was driven by increases in the prices of food, mainly fruits and vegetables, fuel and household equipment and operations. The increase also reflected a pick-up in consumer demand. By region, all urban areas recorded price increases in the quarter and over the year to the June quarter of 2010.

The CPI for the 'Food' expenditure group increased by 2.4 percent in the June quarter of 2010, compared to an increase of 0.8 percent in the March quarter. The increase was in all sub-groups with the fruits and vegetables category having the highest increase. This expenditure group contributed 1.0 percentage points to the overall movement in the CPI.

In the 'Drinks, Tobacco and Betelnut' expenditure group, prices increased by 0.7 percent in the June quarter of 2010, compared to an increase of 3.8 percent in the previous quarter. All sub-groups had price increases, except for betelnut. This expenditure group contributed 0.1 percentage points to the overall movement in the CPI.

In the 'Clothing and Footwear' expenditure group, the CPI increased by 1.0 percent in the June quarter of 2010, compared to a decline of 2.2 percent in the March quarter. Prices for men's and boys' clothing, and other clothing and footwear increased, while prices for women and girls clothing fell. This expenditure group contributed 0.1 percentage points to the overall movement in the CPI.

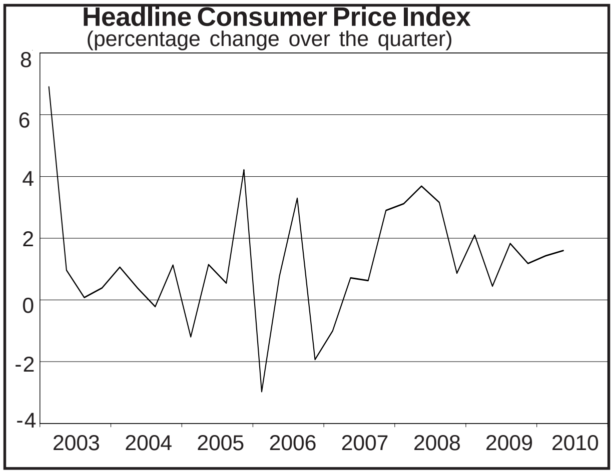
The CPI for the 'Rents, Council charges, Fuel and power' expenditure group increased by 3.0 percent in the June quarter of 2010, compared to an increase of 0.2 percent in the previous quarter. The increase was mainly in the fuel and power sub-group, as well as the council charges, water, sewerage, and garbage sub-group. This expenditure group contributed 0.2 percentage points to the overall movement in the CPI.

The CPI for the 'Household equipment and operations' expenditure group increased by 3.5 percent in the June quarter of 2010, compared to an increase of 2.8 percent in the previous quarter. The increase was in all sub-groups. This expenditure group contributed 0.2 percentage points to the overall movement in the CPI.

In the 'Transport and Communication' expenditure group, prices increased by 1.0 percent in the June quarter of 2010, compared to an increase of 2.2 percent in the March quarter. The increase was in all sub-groups, the largest contribution being the motor vehicle operations. This expenditure group contributed 0.1 percentage points to the overall movement in the CPI.

In the 'Miscellaneous' expenditure group, prices increased by 0.6 percent in the June quarter of 2010, compared to a decline of 1.3 percent in the previous quarter. The increase was in all sub-groups. This expenditure group's contribution to the overall movement in the CPI was negligible.

By urban areas, quarterly headline inflation increased in all the surveyed centers in the June quarter of 2010. Madang recorded the highest increase of 3.0 percent followed by Lae with 2.9 percent, Goroka with 2.5 percent, Rabaul with 1.6 percent, and Port Moresby



with 0.5 percent.

In Madang, prices increased by 3.0 percent in the June quarter of 2010, compared to a 2.9 percent increase in the previous quarter. There were increases in all the expenditure groups, with 'Food' recording the highest increase of 4.8 percent. The 'Rent, council charges, Fuel and power', 'Drinks, tobacco and betelnut', 'Miscellaneous', 'Transport and communication', 'Household equipment operations' and 'Clothing and footwear' groups recorded increases of 3.1 percent, 1.8 percent, 1.1 percent, 0.9 percent, 0.8 percent and 0.7 percent, respectively.

In Lae, prices increased by 2.9 percent in the June quarter of 2010, compared to a decrease of 0.7 percent in the March quarter. All expenditure groups recorded increases, except the 'Miscellaneous' expenditure group. The largest increase was in the 'Household, equipment and operations' group at 4.9 percent, followed by 'Drinks, tobacco and betelnut' group at 4.1 percent. The 'Rent, council charges, Fuel and power', 'Transport and communication', 'Food' and 'Clothing and footwear' groups recorded increases of 3.0 percent, 2.6 percent, 2.4 percent and 1.7 percent, respectively.

In Goroka, prices increased by 2.5 percent in the June quarter of 2010, compared to an increase of 2.3 percent in the previous quarter with all expenditure groups recording increases. The 'Household equipment and operations' group dominated, with the highest increase of 6.6 percent, followed by 'Rents, Council charges, Fuel and power' group with 3.8 percent. This was followed by increases in the 'Food', 'Clothing and footwear' and 'Drinks, tobacco and betelnut' groups with 3.6 percent, 2.9 percent and 2.7 percent, respectively. The 'Transport and communication' and 'Miscellaneous' groups recorded increases of 0.7 percent and 0.4 percent, respectively.

In Rabaul, prices increased by 1.6 percent in the June quarter of 2010, compared to an increases of 0.6 percent in the previous quarter. All expenditure groups recorded increases, except the 'Drinks, tobacco and betelnut' group, which recorded a decline of 0.7 percent as a result of a fall in betelnut price. The 'Food', 'Rent council charges fuel', 'Clothing and footwear', Transport and communication', 'Miscellaneous' and 'Household, equipment and operations' groups has increases of 3.0 percent, 2.9 percent, 2.1 percent, 1.4 percent,1.4 percent, and 0.9 percent, respectively.

In Port Moresby, prices increased by 0.5 percent in the June quarter of 2010, compared to an increase of 1.4 percent in the March quarter. All expenditure groups recorded increases except the 'Drinks, tobacco and betelnut' and 'Clothing and footwear' group. The 'Household, equipment and operations' group contributed the most with a 3.5 percent increase, followed by 'Rent council charges fuel power' group with 2.9 percent, 'Food' group with 1.3 percent, 'Transport and communication' group with 0.8 percent and 'Miscellaneous' group with 0.6 percent .

The quarterly exclusion-based and trimmed-mean inflation were 1.7 percent and 2.2 percent, respectively, in the June quarter of 2010, compared to increases of 1.4 and 0.9 percent, respectively, in the previous quarter. The annual exclusion-based inflation was 4.8 percent in the quarter, compared to 3.8 percent in the March quarter. Annual trimmed-mean inflation was 5.8 percent in the quarter, compared to 4.3 percent in the previous quarter.

4. EXPORT COMMODITIES REVIEW

The total value of merchandise exports in the June quarter of 2010 was K3,985 million, 48.4 percent higher than in the corresponding quarter of 2009. All export commodities recorded an increase, with the exception of cocoa, logs and marine products. Mineral export receipts, excluding crude oil, were K2,668.9 million and accounted for 67.0 percent of total merchandise exports in the June quarter of 2010, compared to K1,721.1 million or 64.1 percent in the corresponding quarter of 2009. Crude oil exports totalled K471.4 million and accounted for 11.8 percent of total merchandise exports in the quarter, compared to K263.4 million or 9.8 percent in the June quarter of 2009.

The value of agricultural, marine products, and other non-mineral exports, excluding forestry and refined petroleum product exports, was K527.7 million and accounted for 13.2 percent of total merchandise exports in the June quarter of 2010, compared to K512.7 million or 19.1 percent in the corresponding quarter of 2009. Forestry product exports were K80.6 million and accounted for 2.0 percent of total merchandise exports in the quarter, compared to K114.8 million or 4.3 percent in the corresponding quarter of 2009. Refined petroleum product exports were K236.4 million and accounted for 5.9 percent of total merchandise exports in the June quarter of 2010, compared to K74.0 million or 2.8 percent in the corresponding quarter of 2009.

The weighted average price of Papua New Guinea's exports was 39.1 percent higher in the June quarter of 2010, compared to the corresponding quarter of 2009. There was a 44.1 percent increase in the weighted average price of mineral exports, with higher kina prices of all mineral exports. For the agricultural, forestry and marine product exports, the weighted average price increased by 15.9 percent and was accounted for by higher kina prices of all agricultural and forestry exports, which more than offset lower prices of marine product exports. Excluding logs, the weighted average price of agricultural and marine product exports increased by 18.8 percent in the quarter, compared to the corresponding period of 2009. The higher kina export prices reflected increases in international prices.

Mineral Exports

Total mineral export receipts were K3,140.3 million in the June quarter of 2010, compared to K1,984.5 million in the corresponding quarter of 2009. This outcome was due to combined increases in the export volumes and prices of gold, copper and crude oil.

The volume of gold exported in the June quarter of 2010 was 16.6 thousand tonnes, an increase of 1.8 percent from the corresponding quarter of 2009. The increase was due to a full year of production at the Hidden Valley mine. This more than offset lower production at the Porgera, Lihir, Tolokuma and Simberi mines. The average free on board (f.o.b.) price received for Papua New Guinea's gold exports was K106.0 million per tonne during the quarter, an increase of 29.3 percent from the corresponding period of 2009. This was attributed to higher international prices, resulting from increased global demand. The average gold price at the London Metal Exchange increased by 29.8 percent to US$1,193 per fine ounce in the quarter, from the corresponding quarter of 2009. The increase was due to higher demand for gold based investments following volatility in the credit and financial markets, combined with lower receipts from investments in money market instruments. The combined increase in export volume and price resulted in a 31.6 percent increase in export receipts to K1,758.8 million in the June quarter of 2010, from the corresponding quarter of 2009.

Copper export volumes increased by 40.3 percent to 44.2 thousand tonnes in the June quarter of 2010, from the corresponding quarter of 2009. The increase was due to higher shipment of stocks, despite lower production associated with a workers industrial strike at the Ok Tedi mine in April. The average f.o.b. price of Papua New Guinea's copper exports increased by 69.1 percent to K20,036 per tonne in the quarter, compared to the corresponding quarter of 2009. This outcome was mainly due to higher international prices as a result of strong demand, especially from China, reflecting recovery in the global economy. The combined increase in export volume and price resulted in a 137.2 percent increase in export receipts to K885.6 million in the quarter, compared to the June quarter of 2009.

Crude oil export volumes increased by 5.3 percent to 2,130.0 thousand barrels in the June quarter of 2010, from the corresponding quarter of 2009. The increase reflected higher extraction at the Moran and Gobe Main oil fields, which more than offset declines at the Kutubu, South East Gobe and South East Mananda projects. The average export price of crude oil increased by 70.0 percent to K221 per barrel in the quarter, from the June quarter of 2009. This outcome was due to an increase in international prices of crude oil, resulting from a decline in production by member countries of the Organisation of Petroleum Exporting Countries (OPEC), combined with higher demand from the United States (US), Europe and Asian countries, mainly Japan, China and India. The combined increase in export volume and price resulted in export receipts increasing by 79.0 percent to K471.4 million in the quarter, from the corresponding quarter of 2009.

Export receipts of refined petroleum products from the Napanapa Oil Refinery increased substantially by

219.5 percent to K236.4 million in the June quarter of 2010, from the corresponding period of 2009. The outcome was due to higher prices of different refined petroleum products in the quarter, compared to the corresponding quarter of 2009.

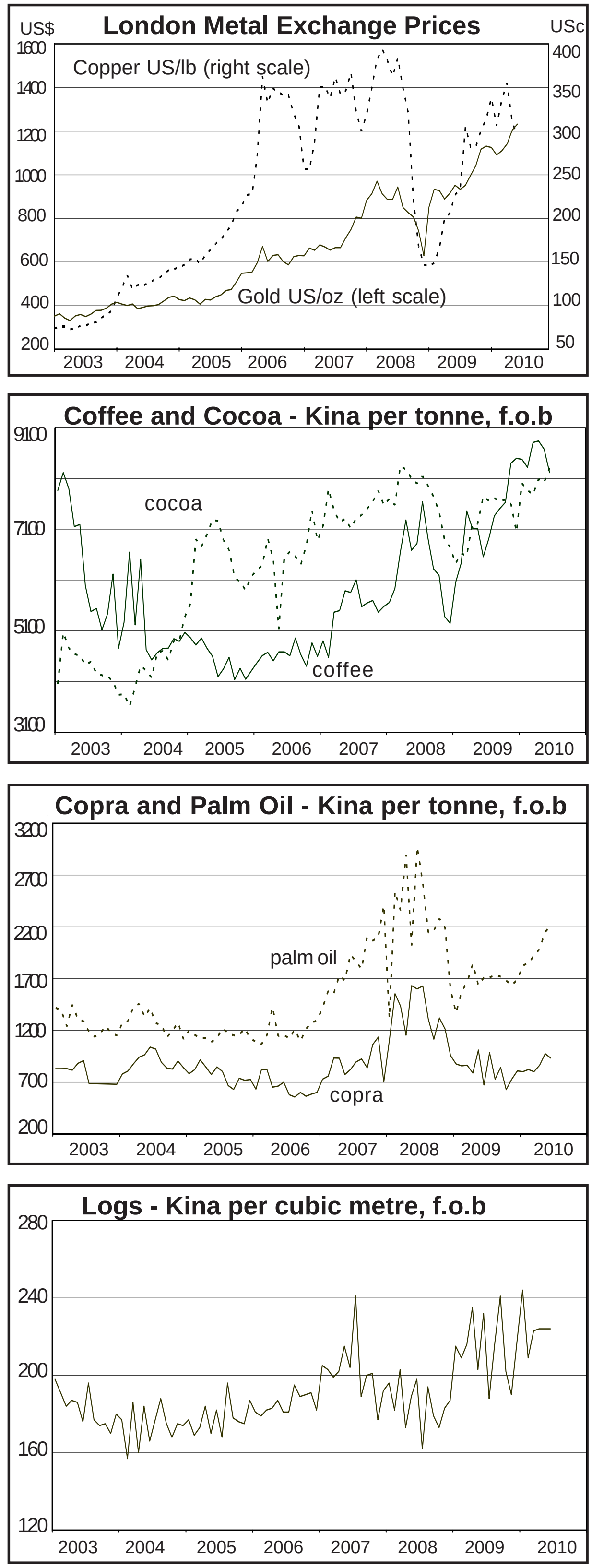
Agriculture, Logs and Fisheries Exports

Export prices of all agricultural export commodities increased in the June quarter of 2010, from the corresponding quarter of 2009. Coffee prices increased by 9.8 percent, cocoa by 24.3 percent, copra by 32.2 percent, copra oil by 21.8 percent, palm oil by 21.9 percent, tea by 26.3 percent and rubber by 35.5 percent. The average export price of logs increased by 0.9 percent to K223 per cubic meter in the quarter, compared to the corresponding quarter of 2009. The average export price of marine products declined by 10.7 percent in the quarter, from the corresponding period of 2009. The increase in the export prices of all agricultural commodities and logs more than offset the decline in the price of marine products, resulting in a 15.9 percent increase in the weighted average price of agricultural, logs and marine product exports.

The volume of coffee exported increased by 1.5 percent to 13,700 tonnes in the June quarter of 2010, from the corresponding quarter of 2009. There was a supply response to the higher international prices, combined with the recovery of coffee trees from rehabilitation programs. The average export price of coffee increased by 9.8 percent to K8,168 per tonne in the quarter, from the corresponding quarter of 2009. International prices increased as a result of lower production from Brazil, Columbia and some Central American countries, caused by unfavourable wet weather conditions and berry borer disease. The combined increase in export volume and price resulted in a 11.5 percent increase in export receipts to K111.9 million in the quarter, from the corresponding period of 2009.

The volume of cocoa exported declined by 32.7 percent to 7,000 tonnes in the June quarter of 2010, from the corresponding quarter of 2009. This outcome was mainly due to the cocoa pod borer disease in major cocoa producing regions. The average export price of cocoa increased by 24.3 percent to K8,629 per tonne in the quarter, from the corresponding period of 2009. This stemmed from higher international prices, as a result of lower production from the Ivory Coast and Ghana, two of the world's major producers, caused by dry weather conditions. The decline in export volume

EXPORT COMMODITY PRICES



more than offset the increase in export price resulting in a 16.3 percent decline in export receipts to K60.4 million in the quarter, from the June quarter of 2009.

The volume of copra exported increased by 96.6 percent to 5,700 tonnes in the June quarter of 2010, from the corresponding quarter of 2009. The increase was attributed to a supply response to higher international prices. The average export price for copra increased by 32.2 percent to K912 per tonne in the June quarter of 2010, from the corresponding quarter of 2009. The outcome was due to lower production from the Philippines, combined with strong demand from the US and Europe. The combined increase in export volume and price resulted in a 160.0 percent increase in export receipts to K5.2 million in the June quarter, from the corresponding period of 2009.

The volume of copra oil exported increased by 63.6 percent to 10,800 tonnes in the June quarter of 2010, from the corresponding period of 2009. The increase was mainly due to a supply response to higher international prices, which resulted in higher quantities of copra sold to the two domestic copra mills, combined with provision of vessels by the mill owners to collect copra from the outer islands. The average export price of copra oil increased by 21.8 percent to K2,528 per tonne in the quarter, from the corresponding period of 2009. The outcome was mainly due to lower production from the Philippines and higher demand from the US. The combined increase in export volume and price resulted in export receipts increasing by 99.3 percent to K27.3 million in the June quarter, from the corresponding period of 2009.

The volume of palm oil exported increased by 6.7 percent to 119,100 tonnes in the June quarter of 2010, from the corresponding period of 2009. There was higher production and shipment by most of the palm oil producers resulting from the harvest of high yielding crops. The average export price of palm oil increased by 21.9 percent to K2,079 per tonne in the quarter, from the corresponding quarter of 2009, reflecting higher international prices as demand by China increased. The combined increase in export volume and price resulted in a 30.0 percent increase in export receipts to K247.6 million in the June quarter, from the corresponding period of 2009.

The volume of tea exported increased by 16.7 percent to 1,400 tonnes in the June quarter of 2010, from the corresponding quarter of 2009. The increase was due to higher production associated with favourable wet weather conditions in the major tea producing regions. The average export price of tea increased by 26.3 percent to K4,000 per tonne in the quarter, from the corresponding period of 2009. The increase was due to higher international prices, attributed to lower production from Kenya and Sri Lanka as a result of heavy rainfall, which affected road transport infrastructure, combined with strong demand from Russia and the United Arab Emirates. The combined increase in export volume and price resulted in a 47.4 percent increase in export receipts to K5.6 million in the quarter, from the corresponding period of 2009.

The volume of rubber exported declined by 25.0 percent to 900 tonnes in the June quarter of 2010, from the corresponding period of 2009, with lower production in the rubber producing regions. The average export price increased by 35.5 percent to K6,889 per tonne in the quarter, from the corresponding period of 2009, as demand in Asia increased. The increase in the export price, more than offset the decline in volume, resulting in a 1.6 percent increase in export receipts to K6.2 million in the June quarter of 2010, from the corresponding period of 2009.

The volume of logs exported declined by 24.1 percent to 350 thousand cubic metres in the June quarter of 2010, from the corresponding period of 2009, the result of lower shipment from major logging projects due to wet weather conditions. The average export price of logs increased by 0.9 percent to K223 per cubic metre in the quarter, from the corresponding period of 2009. This stemmed from higher international prices, reflecting increased demand for tropical hardwoods, especially from China and India. The decline in export volume, more than offset the increase in price, resulting in a 23.2 percent decline in export receipts to K78.1 million in the quarter, from the corresponding period of 2009.

The value of marine products exported declined by 91.8 percent to K6.4 million in the June quarter of 2010, from the corresponding period of 2009, due to a combined decline in export volume and price.

5. BALANCE OF PAYMENTS

There was an overall surplus of K534 million in the balance of payments for the first six months of 2010, compared to a surplus of K664 million in the corresponding period of 2009. This was due to a surplus in the capital and financial accounts, which more than offset a deficit in the current account.

The deficit in the current account was due to higher net service payments, which more than offset a higher trade account surplus and higher net transfer receipts. The surplus in the capital account reflected net inflow of capital transfers. The surplus in the financial account was due to higher net inflows from other investments, combined with foreign direct investments.

The trade account recorded a surplus of K3,195 million in the first six months of 2010, an increase of 88.4 percent from the corresponding period of 2009. 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 in the first six months of 2010 was K7,352 million, an increase of 33.5 percent from the corresponding period of 2009, attributed to higher values of all export commodities, with the exception of cocoa and marine products.

The value of merchandise imports increased by 9.1 percent to K4,157 million in the first six months of 2010, from the corresponding period of 2009. The increase was due to higher mining and general imports, which more than offset a decline in imports by the petroleum sector. Imports by the mining sector increased by 23.8 percent to K790 million in the first half of 2010, from the corresponding period of 2009. The increase reflected higher capital expenditure undertaken by all mines, except the Ok Tedi mine. General imports increased by 6.4 percent to K2,983 million in the first six months of 2010, from the corresponding period of 2009. This reflected increased domestic demand resulting from the Liquefied Natural Gas (LNG) driven economic activity. There was K85 million worth of imports directly related to the LNG project. Petroleum sector imports decreased by 19.0 percent to K299 million in the first six months of 2010, from the corresponding period of 2009. The decline was due to lower capital expenditure by the existing oil projects.

The deficit in the services account was K3,397 million in the first half of 2010, an increase of 86.6 percent from the corresponding period of 2009. This was due to higher payments for transportation associated with higher imports, travel, education, financial, communication, other business, cultural and recreational, Government services n.i.e, construction and refining and smelting services, which offset higher service receipts, mainly from construction services.

The deficit in the income account was K498 million in the first half of 2010, a decline of 4.4 percent from the corresponding period of 2009, accounted for by lower interest and dividend payments, combined with lower income receipts.

The surplus in the transfers account was K484 million in the first half of 2010, an increase of 81.3 percent from the corresponding period of 2009. This outcome was due to higher receipts from superannuation funds, gifts and grants, tax receipts, and licensing fees, combined with lower transfer payments.

As a result of these developments in the trade, services, income and transfers accounts, the current account recorded a deficit of K216 million in the first six months of 2010, compared to a deficit of K379 million in the corresponding period of 2009.

The capital account recorded a net inflow of K81 million in the first six months of 2010, an increase of 68.8 percent from the corresponding period of 2009. This reflected higher transfers by donor agencies for project financing.

The financial account recorded a net inflow of K662 million in the first six months of 2010, compared to K1,023 million in the corresponding period of 2009, mainly from Direct and Other investments. The increase in the Direct investments reflected high investment in the country by non-residents, while the net inflow from Other investments reflected drawdowns from the foreign currency account balances of resident mineral companies. These more than offset net outflows from portfolio investments reflecting investments in short-term money market instruments by resident entities, investments in financial derivative instruments through hedge arrangements, a build-up in the net foreign assets of the banking system, and higher net loan repayments by the Government.

In the June quarter of 2010, the balance of payments recorded an overall surplus of K776 million, compared to a lower surplus of K341 million in the corresponding quarter of 2009.

The value of merchandise exports increased by 48.4 percent to K3,985 million in the June quarter of 2010, from the corresponding quarter of 2009, due to higher values of all export commodities, except for cocoa, logs and marine product exports.

The value of merchandise imports increased by 5.6 percent to K2,057 million in the June quarter of 2010, from the corresponding quarter of 2009. There were higher mining and general imports, which more than offset a decline in the petroleum sector and LNG related imports. Imports by the mining sector were K406 million in the quarter, an increase of 30.1 percent from the corresponding quarter of 2009. This was due to higher capital expenditure by all the mines, except the Ok Tedi mine. General imports were K1,480 million in the quarter, an increase of 1.0 percent from the corresponding quarter of 2009. Petroleum sector imports were K156 million in the quarter, a decline of 8.8 percent from the corresponding quarter of 2009. This was due to lower capital expenditure by the existing oil projects. There were K15 million worth of imports directly related to the LNG project .

The deficit in the services account was K1,468 million in the June quarter of 2010, an increase of 49.5 percent from the corresponding quarter of 2009. This outcome was due to higher payments for travel, other financial, communication, other business, cultural and recreational, Government services n.i.e and construction services, which more than offset higher service receipts for resident entities.

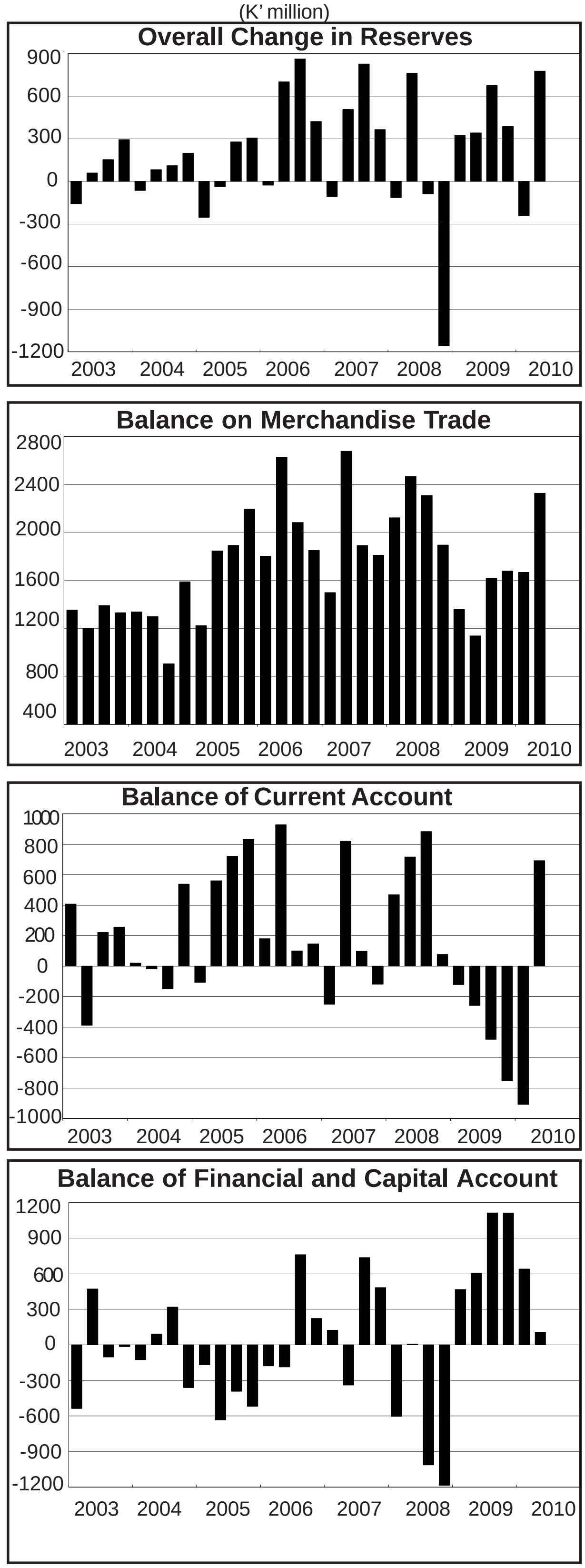
The deficit in the income account was K184 million in the June quarter of 2010, a decline of 36.8 percent from the corresponding quarter of 2009, attributed to lower compensation of employees and interest payments, combined with lower income receipts.

There was a surplus in the transfers account of K416 million in the June quarter of 2010, an increase of 50.2 percent from the corresponding period of 2009. This outcome was due to higher receipts for superannuation funds, gifts and grants and tax receipts, combined with lower transfer payments.

As a result of these developments in the trade, services, income and transfers accounts, the current account recorded a surplus of K692 million in the June quarter of 2010, compared to a deficit of K258 million in the corresponding quarter of 2009.

The capital account recorded a net inflow of K57 million in the June quarter of 2010, an increase of 42.5 percent from the corresponding period of 2009, due to higher

BALANCE OF PAYMENTS
(K' million)



transfers by donor agencies for project financing.

The financial account recorded a net inflow of K47 million in the June quarter of 2010, compared to a net inflow of K565 million in the corresponding period of 2009. The outcome was due to a net inflow of Direct and Other investments, reflecting higher investments in the country by non-residents and drawdowns in the foreign currency account balances of resident mineral companies, respectively. This more than offset net outflows from portfolio investments, reflecting investments in short-term money market instruments and investments in financial derivative instruments through hedge arrangements, net foreign assets of the banking system, and net loan repayments by the Government.

The level of gross foreign exchange reserves at the end of June 2010 was K7,572.3 (US$2,580.5) million, sufficient for 10.9 months of total and 15.2 months of non-mineral import covers.

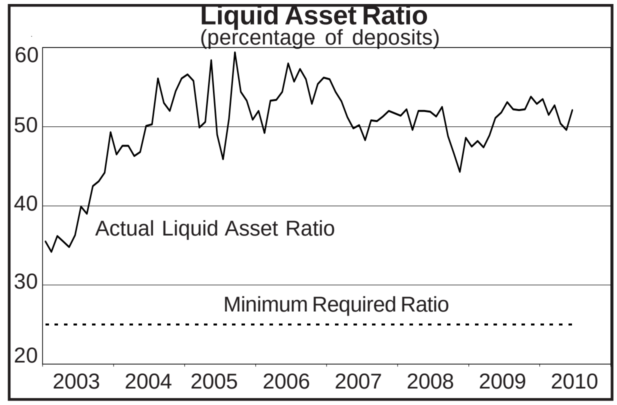
6. MONETARY DEVELOPMENTS

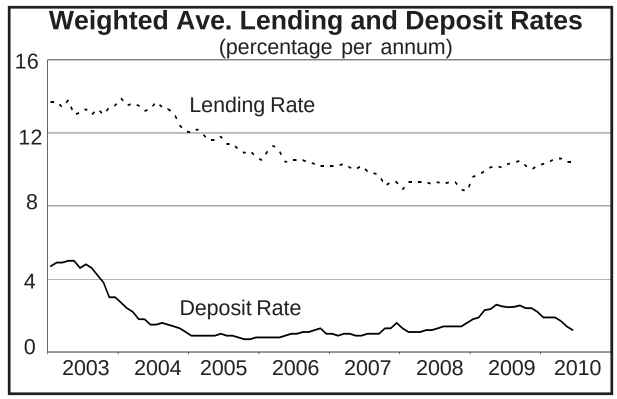
INTEREST RATES AND LIQUIDITY

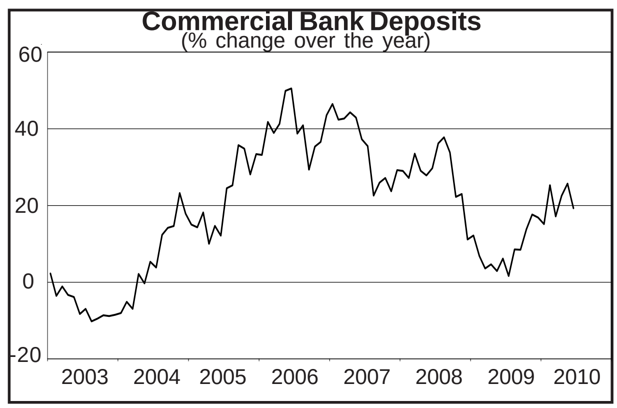
The Bank continued its cautious approach to monetary policy by maintaining the monthly Kina Facility Rate (KFR) at 7.00 percent throughout the June quarter of 2010, consistent with the March 2010 Monetary Policy Statement (MPS). The dealing margin for the Repurchase Agreements (Repos) was kept unchanged at 100 basis points on both sides of the KFR.

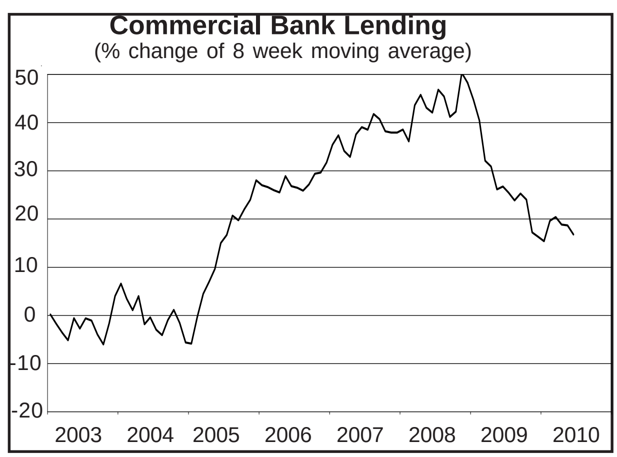
Interest rates for short-term securities and wholesale deposit rates declined during the June quarter of 2010 reflecting excess liquidity conditions in the banking system, despite the Central Bank's efforts to diffuse it. At the Central Bank Bill (CBB) auction, the 28-day rate declined from 4.21 percent to 3.28 percent, the 63-day rate from 4.54 percent to 3.33 percent and the 91-day weighted average rate from 4.54 percent to 3.32 percent. At the Treasury bill auction, there was no auction for the 91-day maturity. The 182-day Treasury bill rate declined from 6.07 percent to 4.42 percent and the 365-day rate from 6.17 percent to 4.95 percent.

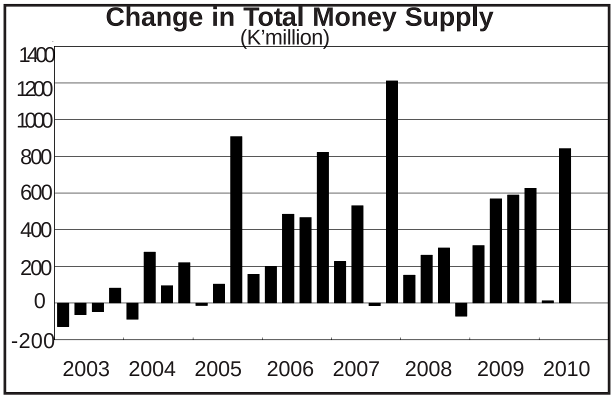
The weighted average deposit rates quoted by commercial banks on wholesale deposits (K500,000 and above) also decreased across all maturities during

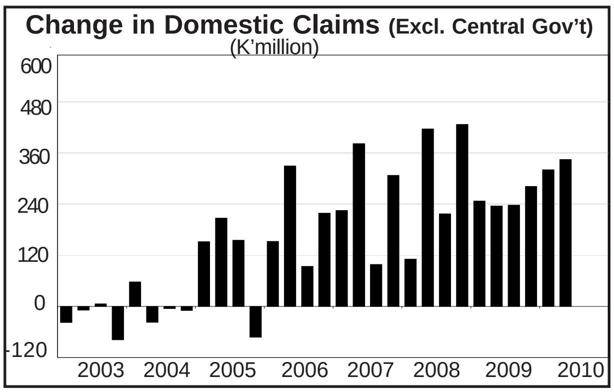


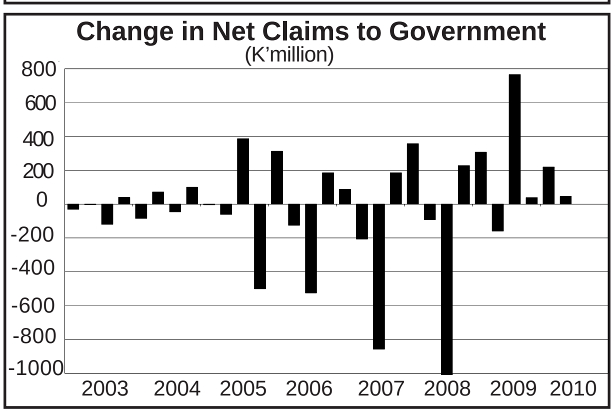


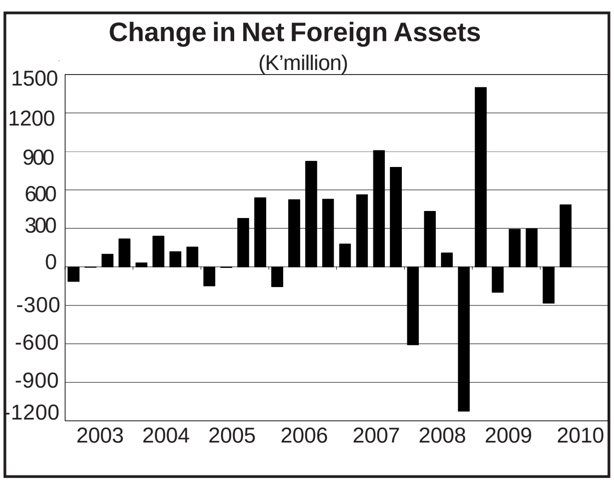












the June quarter of 2010. The 30-day rate declined from 3.70 percent to 1.35 percent, 60-day rate from 3.73 percent to 1.45 percent, 90-day rate from 3.87 percent to 1.86 percent and 180-day rate from 4.92 percent to 2.12 percent. The weighted average interest rate on total deposits paid by commercial banks declined from 1.9 percent to 1.2 percent, and the weighted average interest rate on total loans declined from 10.6 percent to 10.4 percent. The commercial banks' Indicator Lending Rates (ILR) spread remained at 10.95 – 11.95 percent during the period.

The Bank continued to utilise Open Market Operation (OMO) instruments in the conduct of monetary policy over the June quarter of 2010. In addition to CBB issuances, Government Treasury bill and Inscribed stock auctions were conducted, which helped to diffuse some of the liquidity. However, these actions were not sufficient to stem the decline in market interest rates. The commercial banks also utilised the interbank market to meet their liquidity needs. The Cash Reserve Requirement (CRR) and the Minimum Liquid Assets Ratio (MLAR) of commercial banks were maintained at 3.0 percent and 25.0 percent, respectively, over the June quarter.

MONEY SUPPLY

The average level of broad money supply (M3*) increased by 6.4 percent in the June quarter of 2010, compared to a revised increase of 3.3 percent in the March quarter. This outcome was mainly due to an increase of 8.7 percent in average net foreign assets of depository corporations and an increase of 5.3 percent in average net private sector credit, which more than offset a decline of 10.2 percent in average net claims on the Central Government. The decline in average net claims on the Government in the June quarter of 2010 resulted mainly from an increase in average Government deposit held by ODCs. Average domestic claims outstanding, excluding advances to the Central Government increased by 5.1 percent in the June quarter of 2010, compared to a revised increase of 6.1 percent in the March quarter. The average level of monetary base (reserve money) increased by 19.3 percent in the June quarter of 2010, compared to a revised decline of 2.4 percent in the March quarter. The increase reflected higher deposits of commercial banks at the Central Bank and an increase in currency in circulation.

The average level of narrow money supply (M1*) increased by 6.0 percent in the June quarter of 2010, compared to a revised increase of 4.7 percent in the March quarter. This was due to increases in both transferable deposits and currency outside depository corporations. The average level of quasi money increased by 7.0 percent in the June quarter of 2010, compared to a revised increase of 1.8 percent in the March quarter, mainly due to an increase in average term deposits.

The average level of deposits of the ODCs increased by 6.5 percent to K11,752.6 million in the June quarter of 2010 from K11,028.3 million in the March quarter, due to an increase in other deposits and Central Government deposits.

LENDING

During the June quarter of 2010, total domestic credit extended by depository corporations to the private sector, public non-financial corporations, Provincial and Local Level Governments, and other financial corporations, increased by K344.6 million to K6,887.1 million, compared to a revised increase of K320.6 million in the March quarter of 2010. This was mainly due to an increase of K348.6 million in private sector credit and K22.5 million in public non-financial corporations, which more than offset a decline of K26.5 million in other financial corporations. Credit to the private sector was broad based reflecting lending to the manufacturing, transport and communication, finance, commerce, building and construction and other business services, as well as the household sector for housing advances. The annualised growth in domestic credit, excluding Central Government and advances under the price support schemes was 32.7 percent in the June quarter of 2010.

7. PUBLIC FINANCE

Preliminary estimates of the fiscal operations of the National Government over the six months to June 2010 showed an overall surplus of K101.3 million, compared to a surplus of K290.1 million in the corresponding period of 2009. This represents 0.4 percent of nominal GDP. The surplus mainly reflected higher revenue, which more than offset an increase in expenditure.

Total revenue, including foreign grants, during the six months to June 2010 was K2,907.0 million, 12.6 percent higher than the receipts collected in the corresponding period of 2009. This represents 38.8 percent of the budgeted revenue. The increase in revenue mainly reflected higher tax revenue and foreign grants, which more than offset a decline in non-tax receipts.

Total tax revenue amounted to K2,676.6 million, 33.4 percent higher than the receipts collected during the same period in 2009, and represents 46.7 percent of the budgeted tax receipts. Direct tax receipts totalled K1,871.7 million, 40.9 percent higher than the receipts collected during the corresponding period in 2009, and represents 46.5 percent of the budgeted amount. This outcome reflected higher personal and company taxes, which more than offset a decline in other direct tax receipts. The increase in personal income tax was due to higher remuneration and employment reflecting growth in domestic economic activity. The increase in company tax receipts reflected profitability by companies due to continued growth in economic activity. The decline in other direct tax was attributed to lower dividend withholding tax receipts.

Indirect tax receipts totalled K805.0 million, 18.8 percent higher than in the corresponding period in 2009, and represents 47.2 percent of the budgeted revenue for 2010. The increase reflected higher collections in excise duties, export tax and import tax, which more than offset declines in goods and services tax (GST) and other indirect tax receipts. The increase in excise duties reflected higher consumption of domestically produced and imported items. The increase in import tax resulted from high import volumes. The increase in export tax was attributed to higher volume of exports, while the decrease in GST reflected lower collections in the main contributing provinces.

Total non-tax revenue amounted to K44.5 million, 90.9 percent lower than in the corresponding period of 2009 and represents 11.1 percent of the budgeted amount. The decrease mainly reflected the non-recording of injections from trust accounts combined with lower collections from services provided by the National Departments and low dividend payments by statutory bodies. Foreign grants to June 2010 totalled K186.0 million, 114.0 percent higher than in the corresponding period in 2009. Infrastructure tax credits were not recorded.

Total expenditure during the six months to June 2010 was K2,805.7 million, 22.5 percent higher than in the corresponding period of 2009 and represents 37.5 percent of the budgeted appropriation for 2010. This outcome was due to both higher recurrent and development expenditures.

Recurrent expenditure over the six months to June 2010 was K1,991.3 million, 1.6 percent higher than in the corresponding period in 2009, and represents 48.6 percent of the budgeted appropriation for 2010. The increase was due to higher spending by National Departments and Provincial Governments combined with higher interest payments, which more than offset lower grants to statutory bodies. National Departmental expenditure totalled K1,166.2 million, 5.5 percent higher than the amount spent in the corresponding period of 2009, and represents 49.0 percent of the 2010 budgeted appropriation. The increase mainly reflected higher payments for departmental goods and services and an increase in disbursement of personnel emoluments. Provincial Government expenditure amounted to K476.6 million, 14.8 percent higher than in the same period in 2009, and represents 48.5 percent of the 2010 budgeted amount. This outcome resulted from increases in payments for goods and services and conditional grants for transport infrastructure maintenance and village services. Interest payments totalled K202.3 million, 8.1 percent higher than in the corresponding period of 2009, and represents 43.3 percent of the budgeted appropriation. The increase mainly reflected higher interest payments on Inscribed stock and Treasury bills associated with the increase in debt issuance.

Total development expenditure for the six months to June 2010 was K814.4 million, 146.3 percent higher than in the same period in 2009, and represents 24.0 percent of 2010 budgeted appropriation. The substantially high development outlay mainly reflected the implementation of the Development Budget for 2010 with an increase in funding by the Government.

As a result of these developments in revenue and expenditure, the Government recorded an overall budget surplus of K101.3 million. The surplus and domestic financing of K5.5 million was used to make net external loan repayments of K106.8 million. The net external loan repayments comprised of K85.1 million to concessionary and K21.7 million to extraordinary sources. The domestic financing comprised of K42.3 million and K5.8 million in net borrowing from financial corporations and public non-financial corporations, respectively. This more than offset K42.6 million in cheques presented for settlement.

Total public (Government) debt declined by K139.0 million to K6,875.8 million in the June quarter of 2010, compared to K7,014.8 million in the December quarter of 2009, resulting in the total debt to nominal GDP ratio decreasing to 31.9 percent from 33.1 percent between the two quarters. A decline in external debt more than offset an increase in domestic debt. The decrease in external debt reflected loan repayments combined with the appreciation of the kina against most of the major currencies. The increase in domestic debt resulted from new issuance of Government securities[1].

The total amount of Government deposits in the depository corporations increased by K16.1 million to K2,603.6 million in the June quarter of 2010, compared to K2,587.5 million in the December quarter of 2009. At the Central Bank, the amount of trust account funds declined to K326.9 million in the June quarter of 2010, from K427.0 million in the December quarter of 2009.

[1] The total domestic debt does not include Treasury bills issued outside of the normal auction that is conducted by the Central Bank, as the Government's legitimate agent in issuing Government securities.

MONETARY POLICY STATEMENT (MPS) SEPTEMBER 2010

Executive Summary

The PNG economy continued to grow in 2010, mainly driven by the commencement of construction of the Liquefied Natural Gas (LNG) project and related activities and recovery in the international export prices, despite a downward revision to growth of Gross Domestic Product (GDP) in 2010. Most other macroeconomic indicators were broadly in line with projections outlined in the March 2010 Monetary Policy Statement (MPS).

Inflation increased in the June quarter of 2010, reflecting exchange rate depreciation over the last three quarters and increased domestic demand from activities associated with the construction of the PNG LNG project and high Government expenditure. However, imported inflation remained low due to the slow recovery in the global economy. Given these developments and inflationary concerns, the Bank kept the Kina Facility Rate (KFR) at 7.00 percent over the six months to September 2010.

For 2010, the Bank revised downwards its projected annual headline inflation made in the March MPS to around 7.0 percent from 8.0 percent. The revision is based on the following factors: lower than expected inflation outcomes in the March and June quarters, which may reflect limited pass-through of real inflation to the official measures; lower imported inflation as world economic recovery in 2010 is expected to be slower than anticipated; a relatively stable kina exchange rate; and downward revision to GDP growth.

Real GDP growth has been revised downwards to 7.5 percent from 8.5 percent in 2010, mainly reflecting the delay in the commencement of production from the Ramu Nickel/Cobalt project. This is still considered high and is underpinned by the construction phase of the LNG project. As a result, the Bank will carefully assess and evaluate the trade-off between high economic growth and inflation so as not to discourage domestic economic activity and ensure inflation does not go into double digit level.

Broad money supply grew by 16.9 percent over the twelve months to August 2010 mainly due to increases in net foreign assets of depository corporations (DCs) and private sector credit. A growth of 11.9 percent in monetary base was associated with drawdown of Government trust account funds. In 2010, the Bank projects growth of 20.6 percent in broad money supply, influenced mainly by a 16.0 percent growth in credit to the private sector, and 14.9 percent in monetary base. Whilst, the Bank is mindful of the inflationary impact of growth in private sector credit, the projected growth in monetary aggregates is considered adequate to support economic growth.

Preliminary estimates of the fiscal operations of the Government to August 2010 show a surplus of 2.7 percent of nominal GDP, which was mainly due to higher than expected mineral tax revenue. The Government projected a budget surplus of K533.3 million for 2010 in its Mid Year Economic and Fiscal Outlook (MYEFO) report, and plans to use the surplus in a Supplementary Budget later this year.

The Central Bank issued net new Central Bank Bills (CBBs) totalling K773.3 million over the nine months to September 2010 to diffuse some of the excess liquidity.

It is encouraging that the Government has given an undertaking to open all future trust accounts with the Central Bank, which would assist mitigate the cost to monetary policy management through reducing the level of liquidity in the banking system.

The Government's intention to establish a Sovereign Wealth Fund (SWF) is a positive move and should finalise the proposal for its establishment. This will help limit exchange rate pressures and control the Government's drawdown of the revenues from the LNG project and other major exports. Until the establishment of the SWF, the Government should allow the Bank of PNG to keep additional mineral tax revenue, not budgeted for immediate use, in offshore foreign currency accounts. This would reduce the impact of these inflows on domestic liquidity, the exchange rate and inflation.

The Bank will assess the impact of the very low official short term interest rates (the CBB real interest rates are negative) on the economy and the monetary developments.

In light of the high liquidity condition, the Cash Reserve Requirement (CRR) will be increased from 3.0 to 4.0 percent of commercial bank deposits and the Minimum Liquid Asset Ratio (MLAR) will be reduced from 25.0 to zero percent in October 2010. The Bank of PNG will continue to review its monetary policy management and operations and adopt appropriate strategies to contain inflation and support economic growth.

1.0 Monetary Policy Discussions

1.1 Monetary Policy Assessment and Issues

Domestic macroeconomic outcomes over the six months to September 2010 were broadly in line with the Bank's projections outlined in the March 2010 MPS. Delays in the commissioning of the Ramu Nickel/Cobalt project resulted in a downward revision of GDP growth in 2010. Annual headline inflation increased by 6.2 percent in the June quarter of 2010 from 5.0 percent in the March quarter. The turnaround in annual inflation following successive declines from a high of 13.5 percent in the September quarter of 2008 largely reflected exchange rate depreciation since the fourth quarter of 2009 and may also be attributable to a pickup in domestic demand associated with the construction of the LNG project and increased Government spending. However, this outcome is below the Bank's inflation forecast of around 8.0 percent for 2010 in the March MPS, which could be attributed to a weaker than expected global recovery and lower than anticipated pass-through of domestic demand pressures to official measures of inflation. In view of continued inflationary pressures the Bank pursued a cautious approach to its monetary policy stance by maintaining the Kina Facility Rate (KFR) at 7.0 percent.

Annual growth in broad money supply (M3*) and the monetary base were 16.9 percent and 11.9 percent, respectively, over the year to August 2010. The growth in broad money supply was mainly due to increases in the net foreign assets of the DCs and private sector credit growth extended by Other Depository Corporations (ODCs). The growth in the monetary base reflected draw downs of trust account balances by the Government, which increased currency in circulation and deposits of commercial banks at the Central Bank. Liquidity remained at high levels and exerted downward pressure on domestic interest rates. To diffuse excess liquidity from the banking system, the Bank issued net new CBBs totalling K773.3 million over the nine months to September 2010.

Earlier attempts to move trust account funds from commercial banks to the Central Bank have been unsuccessful. However, the recent undertaking by the Government to establish future trust accounts only at the Central Bank would help support the Bank's management of monetary policy. Of concern to the Central Bank will be the pace of drawdown of these funds and previous windfall revenues deposited in trust accounts with commercial banks and its impact on liquidity and inflation, especially in the lead up to National Elections in 2012. The Bank therefore reiterates that closer coordination and cooperation between fiscal and monetary management is important to help mitigate inflationary pressures.

In the absence of a SWF the Government should let the Bank of PNG manage any windfall tax revenue from exports, not budgeted for immediate use, in offshore foreign currency accounts. This would reduce the impact of these inflows on domestic liquidity, exchange rate and inflation. The significant tax revenues from the export proceeds would lead to the appreciation of the kina exchange rate, adversely affecting the traditional export sectors, a condition commonly referred to as the *Dutch Disease*.

Preliminary estimates of the fiscal operations of the Government to August 2010 showed a surplus of K681.0 million or 2.7 percent of nominal GDP. The Government projected a fiscal surplus of K533.3 million for 2010 in its MYEFO report, compared to a balanced budget in the 2010 National Budget. This outcome is due to higher than expected mineral tax receipts, which enabled the Government to revise its revenue upwards. The surplus will be expended through a Supplementary Budget later this year. The effective use of additional revenue depends on the capacity of the Government agencies to implement planned projects.

In 2010, the broad money supply is expected to increase by 20.6 percent due to growth in credit to the private sector to cater for the increase in domestic economic activity. Monetary base is expected to increase by 14.9 percent. While the Bank is mindful of the inflationary impact of the growth in monetary aggregates, they are considered sufficient to support economic activity.

The recovery in the global economy was slower than anticipated. This was evident by a slowdown in China's high growth, European debt crisis and rising unemployment in most of the industrialised economies. This has resulted in lower imported inflation in PNG.

The commencement of the construction of the LNG project has increased economic activity particularly in the building and construction sector and the transport and storage sub-sector, as indicated by the Bank's business liaison survey (BLS) for March 2010. The LNG developer will construct a huge infrastructure corridor from the Southern Highlands to Port Moresby and the country's production capacity will be used far beyond its availability. Therefore, to avoid competing for limited resources during the construction phase, the Government should refrain from investing in infrastructure projects and concentrate on spending in priority areas like health, education, law and justice and maintenance of basic infrastructure.

For the next six months and the medium term continued high Government expenditure and increased demand associated with the LNG project will further exacerbate inflationary pressures. The Bank will carefully assess the trade off between high economic growth and inflation so as not to discourage domestic economic activity and ensure inflation does not go into double digit level. Therefore, close coordination between monetary and fiscal management, including opening of all new trust accounts with the Central Bank and establishment of the SWF by the Government, will assist to achieve and maintain price stability.

1.2 Monetary Policy Stance

Inflation increased in the June quarter of 2010, mainly driven by high domestic demand associated with Government spending and commencement of construction of the LNG project. Given these developments and concerns of inflationary pressures from imported inflation, kina exchange rate depreciation and the excess liquidity conditions, the Bank kept the KFR unchanged at 7.00 percent over the six months to September 2010.

The revised growth of GDP and inflation environment stemming from the LNG project poses challenges to the Bank and the Government. In order to contain inflation in 2010 and the medium term when the country is expected to experience high economic growth, coordination between fiscal and monetary policies is essential. This will entail the Government managing fiscal policy prudently in line with the budget framework and its medium to long term policies, while the Bank will take necessary measures to limit inflationary pressures.

The Bank projects broad money supply to grow by 20.6 percent and the monetary base by 14.9 percent in 2010. Private sector credit growth is expected to be around 16.0 percent in 2010, which is considered sufficient to support economic activity, including increased general business and LNG related activities.

The Bank projects headline inflation to be around 7.00 percent in 2010. Upside risks to this projection could arise from:

- Higher than expected domestic demand resulting from construction of the LNG project;
- Excessive Government expenditure;
- Higher inflation expectations by businesses;
- Depreciation in the kina exchange rate due to high import demand; and.

- Higher than expected imported inflation from PNG's major trading partners.

The Bank will assess these developments and, if necessary, make appropriate adjustments to the stance of monetary policy in the coming six months.

1.3 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 signalling 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 licensed ODCs and Treasury bills to the general public.

In light of the high liquidity condition, the CRR will be increased from 3.0 to 4.0 percent of commercial bank deposits and the MLAR will be reduced from 25.0 to zero percent in October 2010. The Bank of PNG will continue to review its monetary policy management and operations and adopt appropriate strategies to contain inflation and support economic growth.

2.0 Developments and Expectations

2.1 International Developments

The global economy continued to recover at a moderate pace during the second quarter of 2010. Economic growth among advanced economies has been subdued mainly reflecting economies with lower demand, hence lower capital utilisation. In addition, there was a slow down in economic activity in emerging and developing economies after consecutive quarters of robust growth. The unwinding of fiscal and monetary stimulus in emerging economies has also affected global growth. Despite these developments, the International Monetary Fund (IMF) remained upbeat about the global economic recovery in 2010. In the latest update of the "World Economic Outlook" for July 2010, the IMF revised up its 2010 world economic growth forecast by 0.4 percent to 4.6 percent, while the 2011 growth forecast was left unchanged at 4.3 percent. The growth forecast for both advanced and emerging and developing economies were also revised higher to 2.6 and 6.8 percent, respectively. The upward revisions were mainly due to stronger than expected growth outcomes for the first quarter of 2010. The IMF also noted increasing downside risks to growth stemming from the recent European fiscal crisis.

Real GDP in the United States (US) slowed to an annualized rate of 1.6 percent during the second quarter of 2010 compared to 3.7 percent in the first quarter. The slowdown in growth was mainly due to an increase in imports combined with declining inventory investments. Japan's GDP stalled during the second quarter, increasing by 0.4 percent after strong growth of 4.4 percent during the first quarter. The slowing of Japan's GDP was mainly due to stagnant private consumption and weaker export growth. The Euro zone's second quarter real GDP grew by 1.7 percent compared to 0.6 percent in the first quarter. Growth was mainly driven by Germany, which expanded by 3.7 percent during the second quarter and offset weak growth from other Euro zone member countries. Greece contracted by 3.5 percent in the second quarter while both Spain and Portugal contracted by 0.2 percent due to budgetary strains. In the United Kingdom (UK), real GDP for the June quarter increased by 1.1 percent on the back of a rebound in activity in the service, manufacturing and construction sectors. GDP in China increased by 10.3 percent in the June quarter compared to 11.9 percent in the previous quarter.

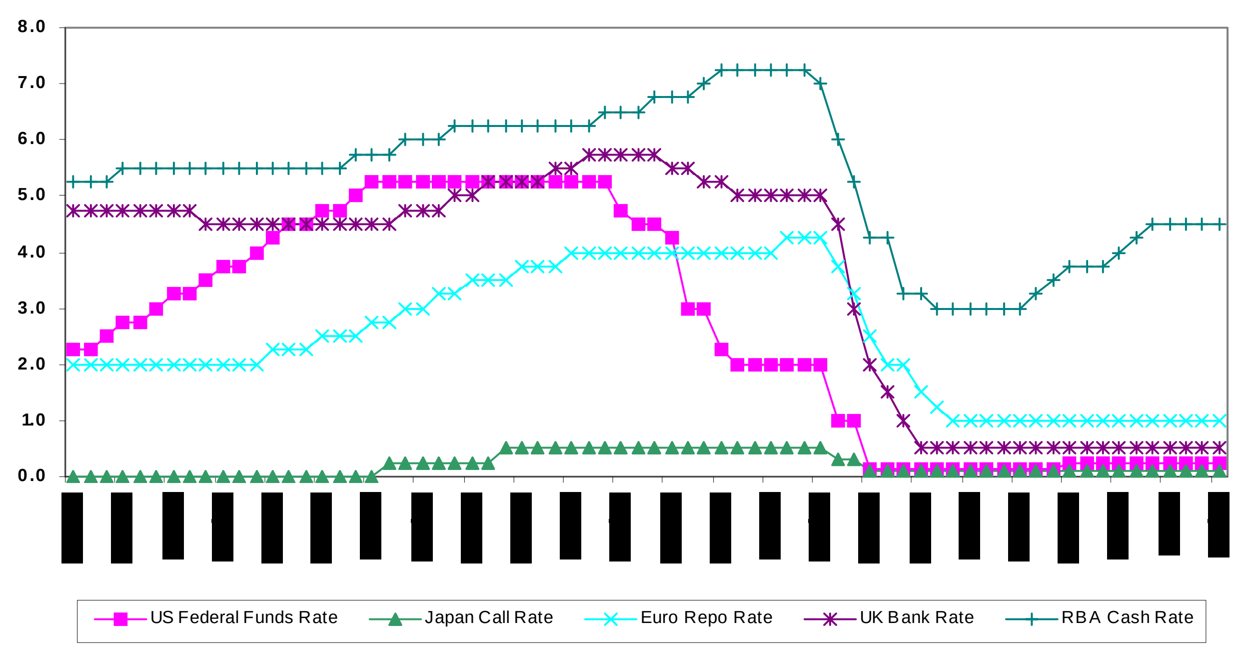
Unemployment rates remained high among advanced economies. In June and July 2010, US unemployment rate was at 9.5 percent, respectively, slightly down from 9.7 percent in May. However, the decline since May mainly reflected an increase in temporary census jobs which expired in August 2010. In Japan, the unemployment rate increased to a seven month high of 5.3 percent, while in the Euro zone it remained at a historical high of 10.0 percent in June. The unemployment rate for the UK was at 7.8 percent in June. In contrast, Australia's unemployment rate declined to 5.1 percent in June 2010 from 5.5 percent in December 2009.

Inflation among advanced economies continued to remain low due to weak domestic demand, excess capacity and high levels of unemployment. The core inflation rate in June 2010 for the US, Japan, Euro zone and the UK were 0.9, -1.4, 0.9 and 0.3 percent, respectively. In contrast, inflation among emerging and developing economies has remained high despite slight declines in recent months. Headline inflation for China was 2.9 percent in June compared to 3.1 percent in the previous month, while in India it was 13.7 percent, down from 14.0 percent over the same period. In Australia inflation was 3.1 percent in the June quarter of 2010.

Uncertainty over future economic growth among advanced economies has prompted major central banks to maintain an accommodative monetary policy stance in the eight months to August 2010. The US Federal Reserve rate was kept at 0.25 percent, the Bank of Japan at 0.1 percent, the European Central Bank at 1.0 percent and the Bank of England at 0.5 percent. In contrast, Australia, New Zealand, Sweden and a number of emerging and developing economies have started tightening monetary policy to curb inflation. However, with expectations of modest global economic growth in the coming quarters, it is unlikely that these countries will tighten interest rates further.

Global financial markets were mainly influenced by developments in the European fiscal crisis stemming from Greece's deteriorating fiscal position against the Euro zone fiscal target. The crisis spread to other Euro zone countries including Spain, Portugal, Italy and Ireland. European government bond spreads for these countries widened reflecting high default risk associated with investments in their respective government assets. In response, a special purpose facility was established by the European Union (EU) as a stabilisation mechanism to support these governments. The EU committed €440 billion and this led to some narrowing of government bond spreads. However, trading in some of these government assets remained highly illiquid. In contrast, spreads on German and France government bonds continued to narrow in line with bond yields of other major economies. Government bond yields in most advanced economies have declined over the period under review. This was due in part to safe haven demand for government bonds and reflected expectations that official benchmark interest rates would remain low for some time. Equity prices also declined over the period.

Chart 1: Monthly Movements in Official Interest Rates (Percent)



Source: Various Central banks' websites

The foreign exchange market has remained volatile, mainly reflecting uncertainty about future global economic growth. Since March 2010, the euro depreciated by 7.0 percent against the US dollar to €1.2600. The depreciation of the euro was mainly due to the Euro zone fiscal crisis while over the same period the Japanese yen and the British pound appreciated against the US dollar. The yen appreciated by 6.0 percent to ¥84.00 and the pound sterling has appreciated by 3.0 percent to 1.5300. The strength of the yen and the pound sterling were mainly due to US dollar weakness as a result of slowing US economic activity. Over the same period, the Australian dollar has recovered from a low of A$0.8100 against the US dollar in May 2010 to A$0.9000 in September, the same as in March 2010.

2.2 Domestic Economic Conditions

The PNG economy is expected to expand by slightly lower than 8.0 percent in 2010, a downward revision from 8.5 percent projection made in the March 2010 MPS. The downward revision was mainly due to the delay in the commencement of production at Ramu Nickel/Cobalt mine as well as a slow start to production at the Hidden Valley gold mine due to some technical problems associated with the production plant. Despite the downward revision, the economy is still expected to grow strongly in 2010 mainly due to domestic demand associated with the construction of the LNG project and increase in private sector investment, some of which are LNG related. The growth in 2010 is also expected to be supported by increased activity in the export sector reflecting high export commodity prices and volumes. Over the twelve months to March 2010, the Bank's Business Liaison Survey (BLS) shows that total sales by the private sector increased by 23.0 percent. Expectation for 2010 indicates that the total value of sales by the private sector will increase by around 15.0-20.0 percent.

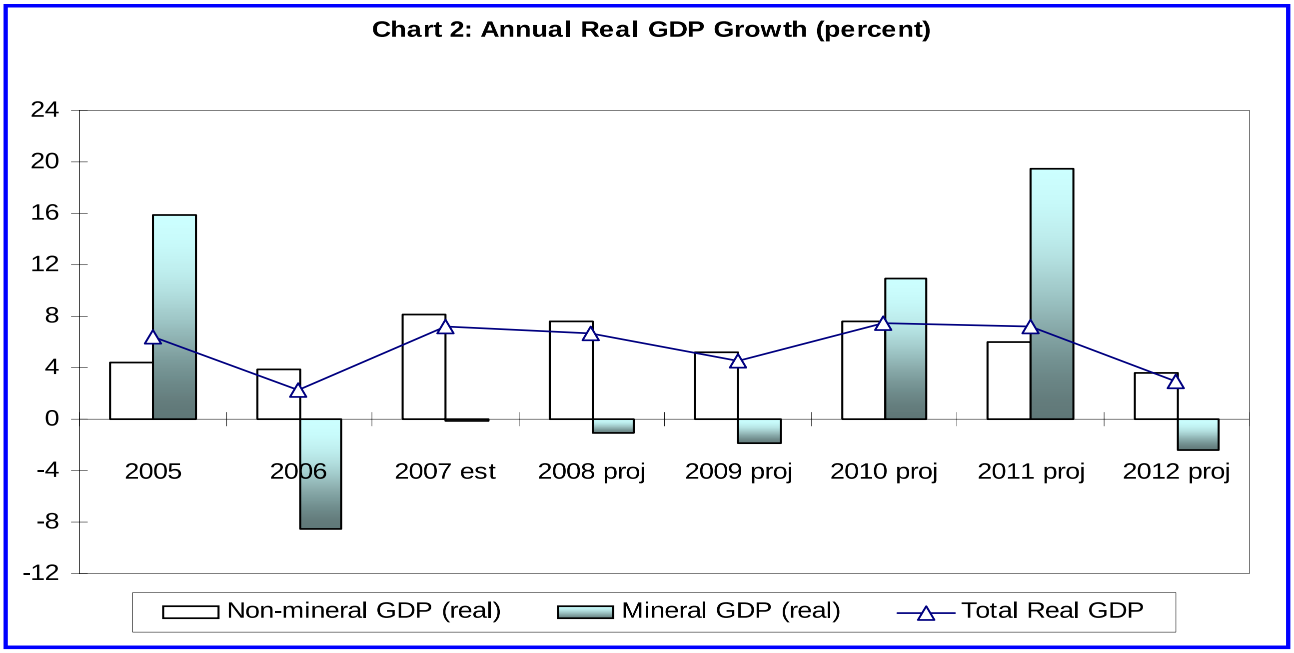
The Bank's GDP projection for 2010 is broadly in line with the Government's projection. Strong growth is expected in the building and construction, mining and quarrying, manufacturing, commerce, transportation, storage and communication and the agriculture/forestry/fisheries sectors, while the petroleum sector is expected to decline. The significant increase in the building and construction sector and its spill-over effects to the other sectors is attributed to the construction work for the LNG project and related activities, high level of public investment on infrastructure, and new building projects undertaken by the private sector. The growth in the mining and quarrying sector reflects increased prices and production of mineral commodities by the existing mines. The increase in the commerce and manufacturing sectors are driven by strong domestic demand associated mainly with construction activity and higher prices of export commodities. The growth in the transportation sub-sector reflects increased activity in shipping, air and land transportation associated with higher passenger travel and cargo haulage. Growth in the communication sub-sector is mainly due to the expansion of network coverage by the two mobile phone companies.

For the medium term, the Bank expects the economy to continue to grow strongly in 2011, slightly higher than the projection for 2010. The slightly higher growth for 2011 is mainly due to the assumption that the construction of the LNG project is expected to peak following its commencement in 2010. Impetus to growth is expected to come from increased activity in the building and construction sector mainly associated with the construction work for the LNG project, ongoing public investment on infrastructure by the Government and donor agencies, as well as private sector funded building projects. The increase in the mining sector reflects the commencement of production by the Ramu Nickel/Cobalt, and increased production at the Lihir, Hidden Valley and Simberi gold mines. Other sectors are also expected to grow and contribute to the overall growth in GDP.

However, main downside risks remain and could stem from the following factors:

- further disruptions to the major mining and petroleum projects, including Ramu Nickel/Cobalt and the PNG LNG Project;
- downturn in the world economy growth resulting in lower commodity prices;
- higher than expected inflation if increase in domestic demand is excessive; and
- excessive Government expenditure, which would add to liquidity and inflationary pressures.

Data from the BLS show that the total nominal value of sales in the private sector over the twelve months to March



Source: *Department of Treasury*

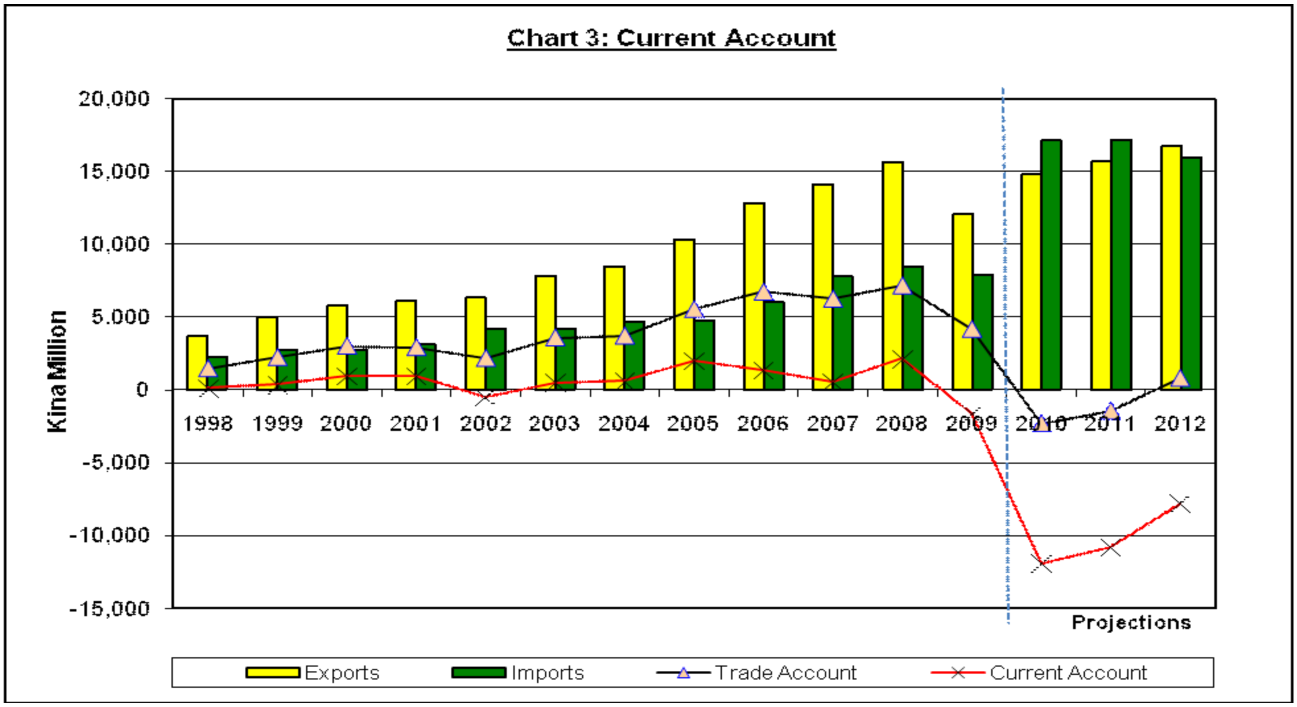
2010 increased by 23.0 percent, while excluding the mineral sector it increased by 23.9 percent. The increase in the non-mineral sector was broad–based, resulting from higher consumer demand and increased business activities.

The Bank's Employment Index indicate that the level of employment in the formal private sector increased by 1.6 percent over the year to the June quarter of 2010, following an increase of 3.8 percent over the corresponding period in 2009. The increase was across all sectors, except the manufacturing and financial/business and other services sectors. By region, the level of employment picked up in the National Capital District (NCD), Southern and Islands regions, while the Highlands, Morobe and Momase regions recorded declines. Excluding the mineral sector, the level of employment increased by 1.4 percent over the year to June 2010.

2.3 Balance of Payments

Preliminary balance of payments data for the six months to June 2010 showed an overall surplus of K526 million, compared to a higher surplus of K664 million in 2009. This outcome was due to a surplus in the capital and financial accounts, which more than offset a deficit in the current account (see Chart 3). The surplus in the capital account was the result of higher transfers by donor agencies through direct project financing. The surplus in the financial account reflected higher net inflows, mainly from other investments, combined with direct investments by non-residents. The net inflows from other investments reflected drawdowns in the foreign currency account balances of resident mineral companies, while the direct investment reflect high investment in the country by non-residents. These more than offset net outflows from portfolio investments reflecting investment in short-term money market instruments, investments in financial derivative instruments through hedge arrangements by resident entities and a build-up in the net foreign assets of the banking system, combined with higher net loan repayments by the Government. The deficit in the current account was due to a significantly higher net service payment, which more than offset a higher trade account surplus, higher net transfer receipts and lower net income payments.

The level of gross foreign exchange reserves at the end of June 2010 was US$2,580.5 (K7,572.3) million, sufficient for 10.9 months of total and 15.7 months of non-mineral import covers. As at 27th September 2010, the level of gross foreign exchange reserves was US$2,802.2 (K7,432.9) million.
The IMF's August 2010 price projections indicate that the international prices of cocoa, copra, copra oil, palm oil, rubber and logs will be higher in 2010, compared to 2009, with the exception of coffee and tea. According to the



Source: Bank of PNG

mineral companies, the prices of all mineral exports are expected to increase during the same period.

The export volumes of most of PNG's major non-mineral commodities are projected to increase in 2010 compared to 2009, with the exception of cocoa, tea and rubber exports. The projected higher production in 2010 and over the medium term is associated with increased international prices attributed to growth in global demand. Mineral commodity export volumes are projected to increase in 2010 compared to 2009, with the exception of crude oil. The increase in gold production is due to the on-going expansion at the Lihir mine, first full year production from the Simberi and Hidden Valley mines and the mining of higher ore grades from the existing mines. Copper export volumes are expected to increase due to higher production. In the petroleum sector, the decline in production is associated with the natural decline in the existing oil fields. The Ramu Nickel/Cobalt project is expected to commence production in 2011.

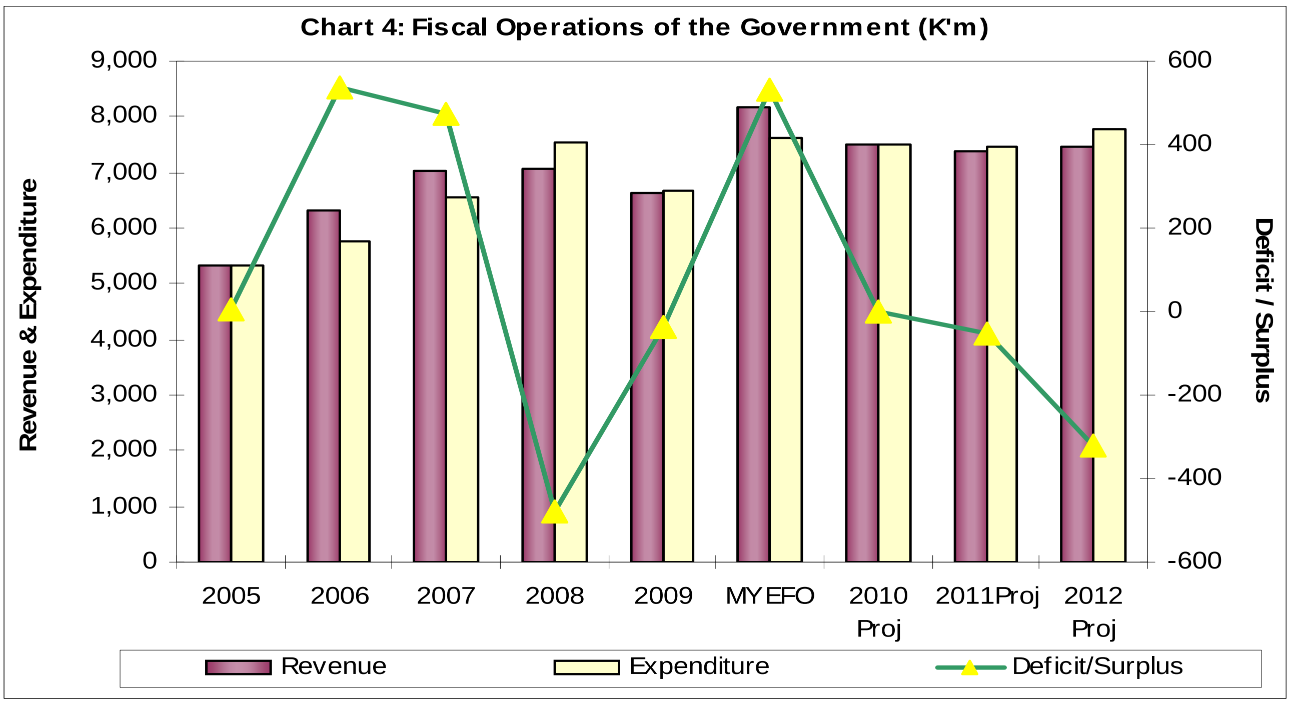
The main assumptions underlying the balance of payments projections for 2010 and the medium term are:

- relatively stable kina exchange rate;
- on-going construction of the LNG project;
- the commencement of production at Ramu Nickel/Cobalt mine in the first half of 2011, instead of late 2010, as reported in March 2010 MPS; and
- higher export prices and volumes, stemming from increased global demand as the world economic recovery continues.

The current account is projected to record a deficit in 2010, mainly due to increase in import and service payments associated with the LNG project. This will be more than offset by a surplus in the financial account reflecting inflows mainly associated with the injection of equity and drawdown of loan funds for the financing of the LNG project by the project partners. As a result, the overall balance of payments is projected to be in surplus by K1,137.8 million in 2010, compared to a surplus of K1,725 million in 2009. At the end of 2010, the gross foreign exchange reserve is projected to be around US$2,876.0 (K7,817.4) million, sufficient for 5.5 months of total and 15.7 months of non-mineral import covers. Gross reserves are projected to increase into the medium term due to higher inflows associated with higher international prices of PNG's export commodities, especially from the mineral sector. The impact of the inflows associated with the construction of the LNG project on the level of foreign exchange reserves will be minimal, since most of the transactions will be conducted through offshore accounts (see Appendix – Table 2).

2.4 Fiscal Operations of the National Government

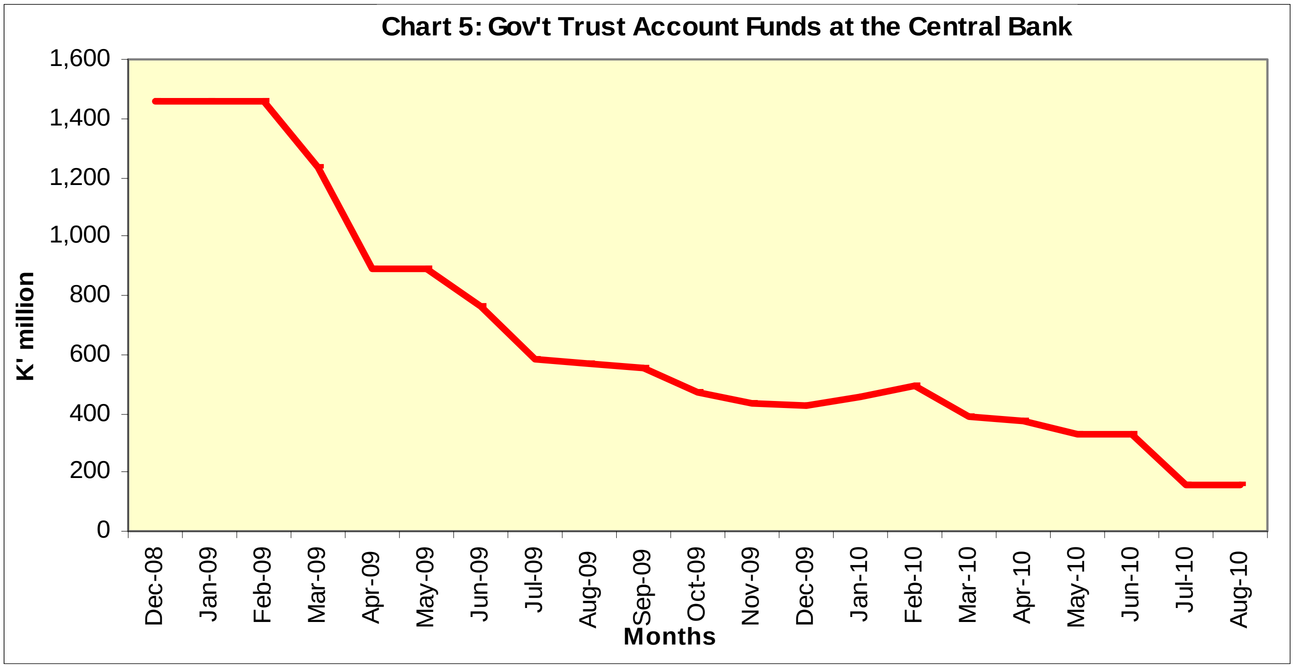
Preliminary estimates of the fiscal operations of the National Government over the eight months to August 2010 showed an overall surplus of K681.0 million, compared to a surplus of K128.7 million in the corresponding period of 2009. Total revenue, including foreign grants, increased by 24.9 percent in the first eight months of 2010 compared to the corresponding period in 2009, and represented 62.4 percent of the 2010 Budget. The increase in revenue mainly reflected higher tax receipts and foreign grants, which more than offset lower non-tax receipts. Total



Source: Department of Treasury

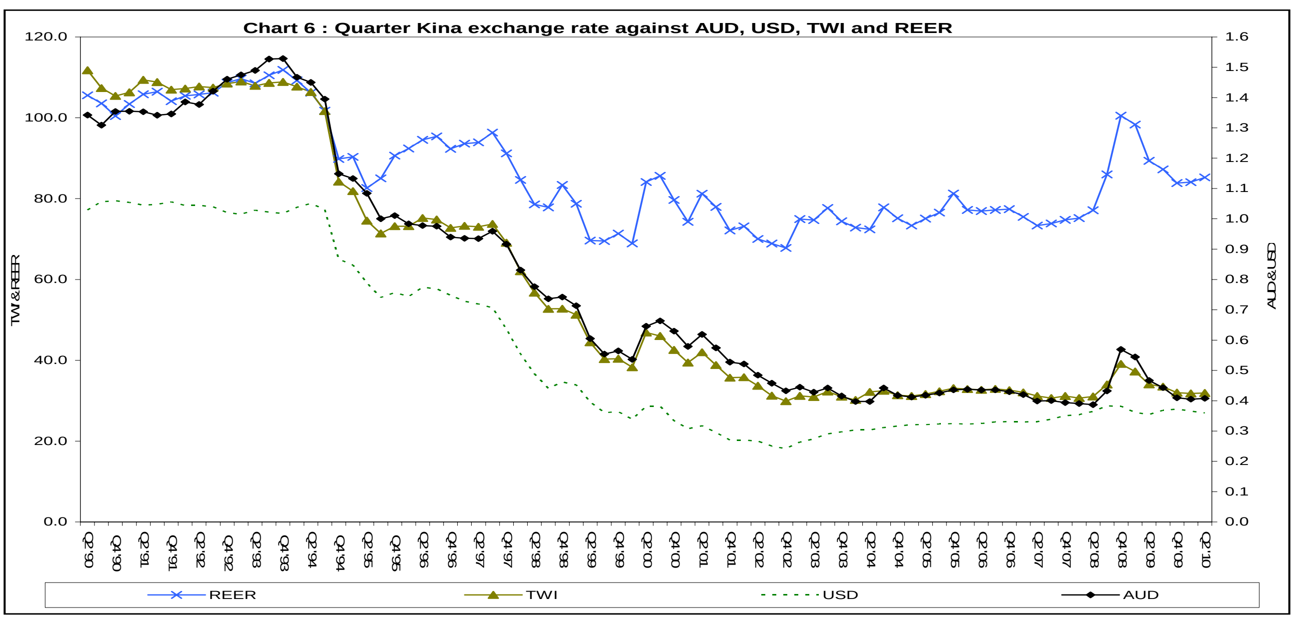
expenditure increased by 10.5 percent over the eight months to August 2010 compared to the corresponding period in 2009, and represented 53.3 percent of the Budget. The increase in recurrent expenditure is attributed to higher spending by National Departments and Provincial Governments and domestic interest payments. The increase in development expenditure reflects the implementation of the Development Budget for 2010, mainly with increased counterpart funding by the Government. The budget surplus was used to repay loans totalling K83.0 million to external sources and made a net negative financing of K598.0 million to domestic sources, mainly reflecting encashment of cheques.

The total amount of Government deposits in the depository corporations increased by K16.1 million to K2,603.6 million in the June quarter of 2010, compared to K2,587.5 million in the December quarter of 2009. At the Central Bank, the amount of Government trust account funds declined to K326.9 million at the end of June 2010 from K427.0 million at the end of December 2009 (see Chart 5). The Government has given an undertaking to establish future trust accounts only at the Central Bank. This will assist mitigate the high liquidity and save the Bank considerable cost it is currently incurring in diffusing liquidity. The establishment of a SWF to manage the huge proceeds anticipated from the LNG project and other mineral inflows will also address the build up of liquidity in the banking system and reduce inflationary pressures in the economy.



Source: Dep't of Treasury & Bank of PNG

Total debt to nominal GDP ratio decreased to 31.9 percent from 33.1 percent between the end of December 2009 and June 2010. Total public debt decreased by K139.0 million to K6,875.8 million in the June quarter of 2010, compared to K7,014.8 million in the December quarter of 2009. This reflected net external loan repayments combined with the appreciation of the kina against most of the major currencies, which more than offset the new issuance of Government securities, mainly Treasury Bills and Inscribed stocks.



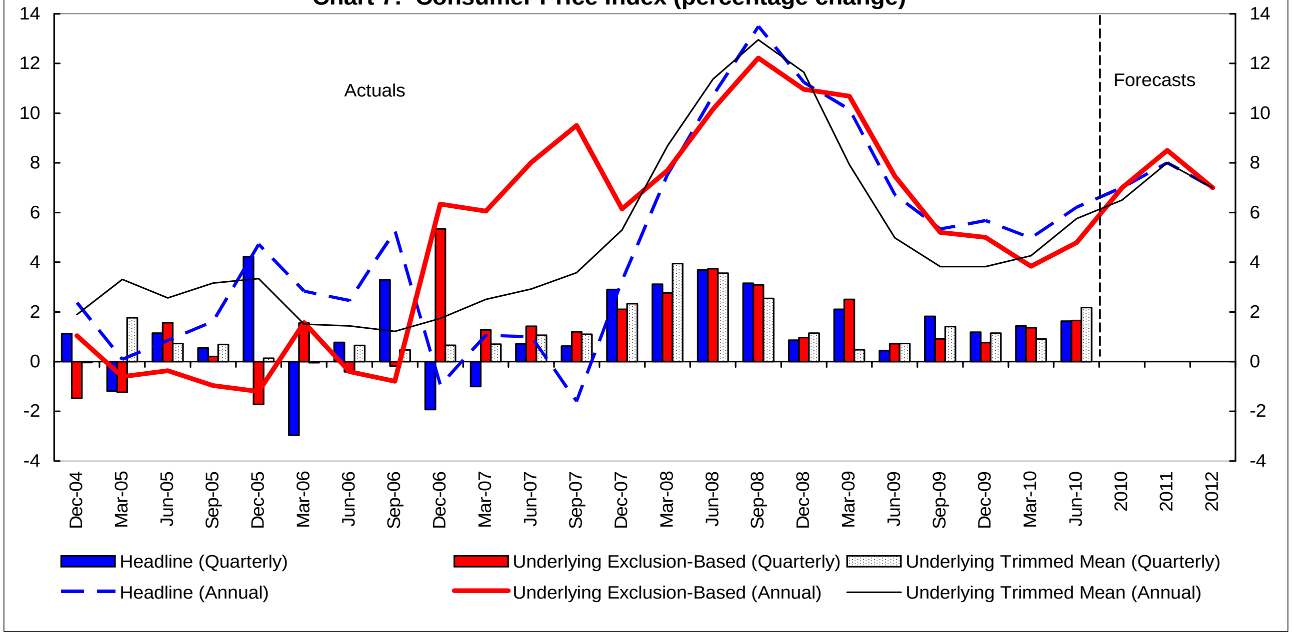
Note: The REER uses IMF's revised CPI indices rebased to 2005, as contained in the June 2009 release of the International Financial Statistics (IFS), in contrast to the previous series with 2000 as the base year.
Source: Bank of PNG and IFS

In the MYEFO report, the Government revised upwards its 2010 Budget projections to a surplus of K533.3 million or 2.1 percent of GDP from a balanced budget. This outcome is largely due to higher than anticipated revenue, mostly mining and petroleum taxes, which is partially offset by over expenditure on personnel emoluments. The Government plans to use this surplus through a Supplementary Budget.

2.5 Exchange Rate

The daily average kina exchange rate depreciated against both the US and Australian dollars by 1.1 and 6.1 percent to US$0.3635 and A$0.4079, respectively, during the eight months to 9th September 2010. The depreciation of the kina reflected lower export receipts and cross currency movements As a result, the Trade Weighted Index (TWI) depreciated by 0.4 percent during the same period. The Real Effective Exchange Rate (REER) depreciated by 1.3 percent during the September quarter of 2010, reflecting an improvement in PNG's terms of trade (see Chart 6).

Chart 7: Consumer Price Index (percentage change)



Source: Bank of PNG & National Statistical Office

2.6 Inflation

Annual headline inflation was 6.2 percent in the June quarter of 2010, up from 5.0 percent in the previous quarter. The high annual rate of inflation was mainly driven by pick up in the prices of food, mainly fruits and vegetables, fuel and household equipment and operations. All expenditure groups and urban areas recorded higher prices in the June quarter of 2010.

The underlying inflation measures also picked up in the June quarter of 2010. Annual exclusion-based inflation was 4.8 percent in the June quarter of 2010, up from 3.8 percent in the March quarter, while the annual trimmed-mean inflation was 5.8 percent, an increase from 4.3 percent in the previous quarter. The pick up in inflation also reflects increased domestic demand pressures mainly associated with the LNG project and Government expenditure (see Chart 7).

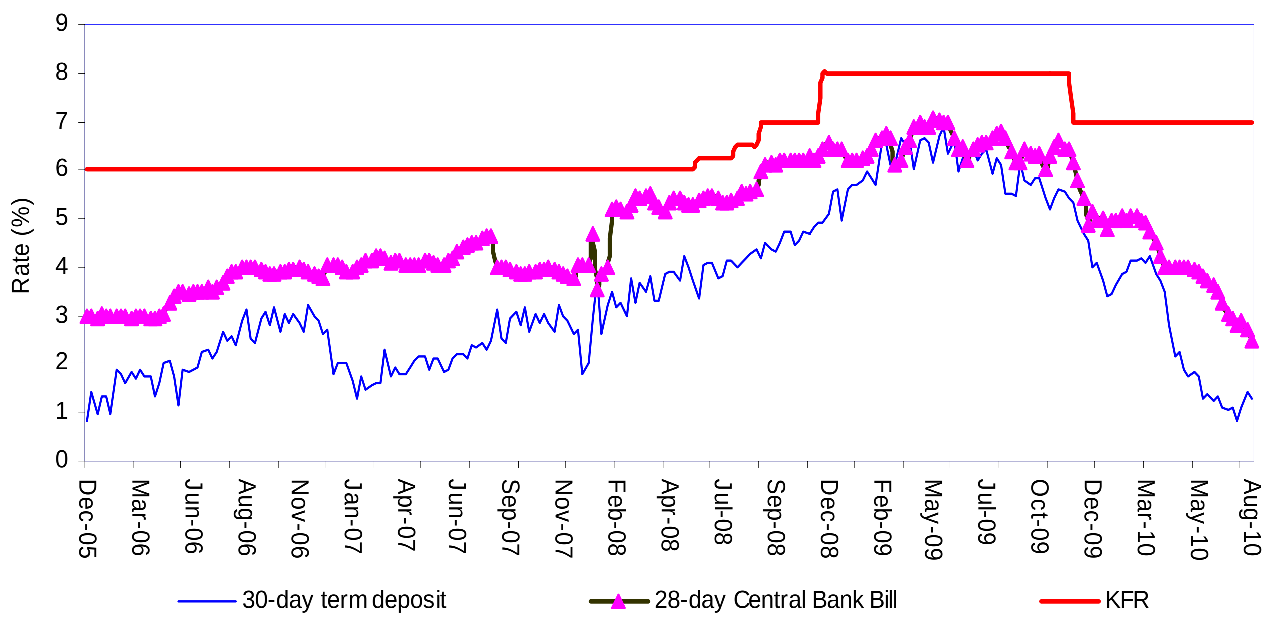
The Bank has revised its annual headline inflation for 2010 to be around 7.0 percent, while trimmed-mean inflation and the exclusion-based measure are projected to be around 6.5 and 7.0 percent, respectively. These downward revisions from the projections made in the March 2010 MPS are based on the following factors:

- lower than expected official inflation outcomes in the March and June quarters of 2010;
- downward revision on domestic inflation expectations;
- lower inflation rates in PNG's major trading partners as world economic growth is expected to moderate in 2010;
- lower inflationary impact from the LNG project than initially anticipated; and
- stability in the Kina/US dollar exchange rate for the rest of 2010.

For the medium term, headline inflation is projected to be around 8.0 percent in 2011 and 7.0 percent in 2012.

The upside risks to these projections are: the potential for depreciation of the kina, higher than expected domestic demand pressures due to the LNG project, higher inflation expectations by businesses, higher government spending, and a faster than expected global economic recovery which could push up fuel and commodity prices as well as inflation in the advanced economies. Downside risks to these projections include a weaker global economic recovery, which would lower demand and prices for PNG's exports and also lower imported inflation.

Chart 8: KFR, 28-day Central Bank Bills & 30-day Term Deposits W/average



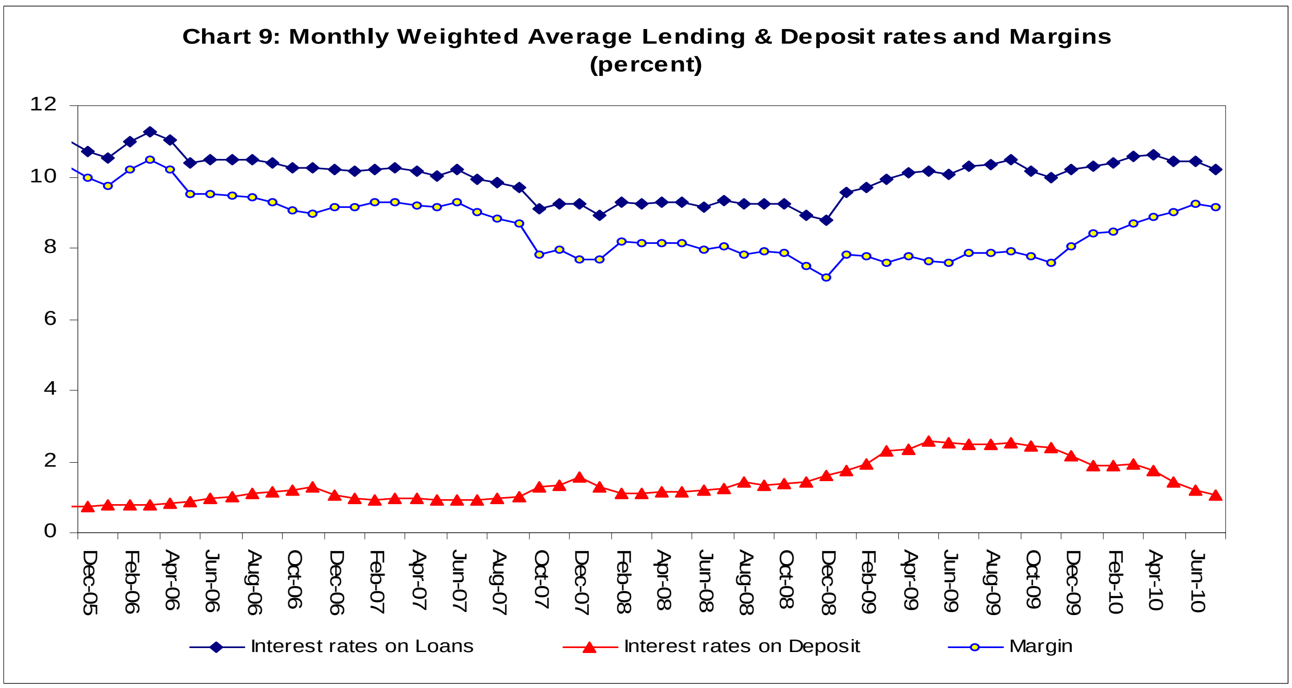
Source: Bank of PNG

2.7 Monetary and Financial Market Developments

The Bank continued to take a cautious approach to its monetary policy stance. Although annual headline inflation declined from 13.5 percent in the September quarter of 2008 to 5.0 percent in the March quarter of 2010, it increased to 6.2 percent in the June quarter of 2010. The increase indicates inflationary pressure from domestic demand mainly associated with early works on the LNG project and Government expenditure. The Bank also took into account other developments, including continued stable macroeconomic conditions and concerns about the lack of global recovery and took a cautious approach to its stance of monetary policy. Therefore, the KFR was maintained at 7.00 percent between March and September 2010 (see chart 8), and the trading margin for the Repo kept at 100 basis points on both sides of the KFR..

The Bank issued net new CBBs totalling K773.3 million to diffuse excess liquidity in the banking system between December 2009 and September 2010. However, CBB rates continued to decrease, with the 28 day CBB rate falling from 5.15 percent to 2.28 percent over the period. Treasury bill rates also decreased, with the 182 day rate declining from 7.00 percent to 4.06 percent during the same period. Indicator Lending Rates (ILR) of commercial banks remain unchanged at 10.95 – 11.95 percent over the nine months to September 2010. The weighted average interest rate on total deposits decreased from 2.16 percent in December 2009 to 1.06 percent in July 2010, while the weighted average lending rate on total loans increased from 10.19 percent to 10.20 percent. As a result, the spread between the weighted average lending and deposit rates increased (see Chart 9).

Total liquidity of the banking system increased by 11.6 percent to K6,878.3 million over the twelve months to August 2010, influenced mainly by foreign exchange inflows and Government expenditures. Lending extended by ODCs to the private sector increased by 17.5 percent over the twelve months to August 2010. The growth in private sector credit was broad-based, with increases to the finance, manufacturing, transport and communication, building and construction, hotels and restaurants and real estate and business services sectors, as well as personal loans. Net claims on the Government increased by K305.7 million over the twelve months to August 2010, mainly due to net



Source: Bank of PNG

issuance of domestic debt and draw down of Government deposits at ODCs.
The level of broad money supply (M3*) increased by 16.9 percent over the twelve months to August 2010 as a result of growth in private sector credit, increases in net foreign assets of DCs and net credit to Government. The monetary base increased by 11.9 percent during the same period, mainly reflecting the increases in the Exchange Settlement Accounts of the commercial banks held at the Central Bank and currency outside depository corporations.

In 2010, broad money supply is expected to grow by 20.6 percent, resulting from higher growth in credit to the private sector. Monetary base is expected to grow by 14.9 percent and private sector credit by 16.0 percent in 2010 (see Appendix-Table 1). While the Bank is mindful of the inflationary impact of growth in private sector credit associated with the LNG project, the projected growth in monetary aggregates is considered adequate to support economic growth.

Appendix

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

INDICATOR	2007 (actual)	2008 (actual)	2009 (actual)	Mar 2010 MPS	2010 (actual to August)	2010 (proj)	2011 (proj)	2012 (proj)
Broad Money Supply	27.3	11.2	21.8 r	21.3	16.9	20.6	19.8	16.1
Monetary Base	61.8	-12.0	11.9	15.3	11.9	14.9	13.0	14.1
Claims on the Private Sector	30.8	28.0	15.1	23.0	17.5	16.0	17.0	15.0
Net Claims on Gov't	-83.5	-174.3	-694.6	-99.8	141.3	-21.3	-27.2	0.1
Net Foreign Assets	51.7	-14.0	27.0	-2.5	23.1	16.4	5.1	4.3

Table 2: Summary of Other Macroeconomic Indicators

INDICATOR	2007 (actual)	2008 (actual)	2009 (actual)	Mar-10 MPS	2010 (actual to June)	2010 (Proj)	2011 (proj)	2012 (proj)
CONSUMER PRICE INDEX (annual % changes)								
Headline	3.2	11.2	5.7	8.0	6.2	7.0	8.0	7.0
Trimmed-mean	5.5	11.7	3.8	7.5	5.8	6.5	8.0	7.0
Exclusion- based	5.7	11.0	5.0	9.0	4.8	7.0	9.5	7.0
BALANCE OF PAYMENTS (kina millions)								
Current account	550.0	2145.0	-1613.0	-10872.0	-215.0	-11939.0	-10818.0	-7802.0
Financial account	888.0	-2861.0	2,,989	10021.0	1808.0	13022.0	11095.0	8020.0
Overall balance	1592.0	-598.0	1724.0	-759.0	527.0	1138.0	337.0	272.0
Gross Int. Reserves	5919.0	5322.0	7046.0	6202.0	727.0	7817.0	8154.0	8426.0
IMPORT COVER (months)								
Total	9.10	7.90	10.10	4.40	10.90	5.50	5.70	6.30
Non-mineral	13.00	11.40	15.30	11.20	15.20	15.70	14.90	14.40
EXPORT PRICE								
Crude oil (US$/barrel)*	73.0	106.7	58.7	60.0	76.6	60.0	70.0	70.4
Gold (US$/ounce)	671.0	850.9	959.2	999.4	1148.2	1119.2	1159.9	1175.8
Copper (US$/pound)	320.0	327.8	217.6	275.0	323.9	323.9	275.0	275.0
FISCAL OPERATIONS OF THE GOVERNMENT**								
Surplus/Deficit (K'm)	476.20	-478.40	-36.30	0.00	681.00	533.30	-54.00	-322.80
% of GDP	2.50	2.20	0.20	0.00	2.70	2.10	0.20	1.20
REAL GROSS DOMESTIC PRODUCT (annual % growth) ***								
Total GDP	7.20	6.70	6.70	8.50	6.20	7.50	6.20	2.90
Non-mineral GDP	8.10	7.60	7.60	8.10	5.60	7.60	5.40	3.50

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

** Preliminary fiscal operations up to August 2010. 2010 projection is from the Mid Year Fiscal and Economic Outturn (MYEFO) report; 2011 - 2012 projections are from the 2010 National Budget

*** GDP figures for 2010 from MYEFO and 2011 - 2012 from 2010 National Budget

Source: Bank of PNG, NSO and Department of Treasury

FOR THE RECORD

EXPANSION OF MONETARY AND FINANCIAL DATA COVERAGE

Background

In June 2006, the Bank of Papua New Guinea first undertook reforms in monetary and financial statistics data compilation as per the *Quarterly Economic Bulletin (QEB)* issue. New tables were included through increased coverage and revisions were done to existing ones (See for the Record *June 2006 QEB*). However, the Bank acknowledges that the existing data sources had limitations in terms of correct instrument classification, sectorization and valuation fully consistent with the *Monetary and Financial Statistics Manual (MFSM 2000).* In addition, given the expansion and growth of the financial sector it was important to have good quality and comprehensive data coverage. As a result, a new call report form FC1 was designed with the continued technical assistance of the IMF and issued to all licensed financial corporations in March 2008 for the reporting of balance sheet items. During that period form FC1 was reported concurrently with the existing call report forms for balance sheet reports for the other depository corporations (ODCs) until March 2010 when FC1 superseded these forms. Hence, current data reported is now sourced from FC1 with historical data dating back to March 2008 on the existing tables, and indicated by a break-in series. For the other financial corporations (OFCs), form FC1 was issued in June 2009 where reporting of monetary and financial statistics commenced. As a result, the Bank has a more comprehensive set of data on monetary and financial statistics for PNG for monetary policy formulation and dissemination.

Importance of changes to the QEB

The first reforms undertaken in the June 2006 saw ODCs coverage increase and as a result a more accurate measure in the compilation of monetary aggregates (see for the record June 2006 *QEB*). In this *QEB* issue, the changes and refinements undertaken has resulted in a more comprehensive coverage with the reporting of the OFCs where the Bank is now able to compile the financial corporations survey (FCS). This means that the Bank now has a more accurate measure of credit aggregate extended by the financial sector (both banking and non-banking) and its financial position against the rest of the other economic sectors and non-residents. Hence, the health of the financial sector can now be reported on and closely monitored. This has also seen a further improvement in data quality which is paramount for the Central Bank to make sound policies.

Changes to Monetary Tables

The required changes involved are the inclusion of new tables on the OFCs and the clear separation and distinction of financial instrument classification and sectorisation by the ODCs as reported in the call report form FC1.

Following are the major changes undertaken:

- The inclusion of OFC survey and aggregate tables and sub-sectoral balance sheets of the superannuation funds, life insurance companies and brokers, investment managers and fund administrators;
  The inclusion of the financial corporation survey;
- A break-in series for data reported by the ODCs in existing tables from March 2008 namely the finance companies, merchant banks, savings & loans societies, and microfinance companies in the calculation of monetary aggregates;
- The inclusion of monthly data by the savings & loans societies previously reported quarterly; and
- Reclassification and valuation of instruments and sectors consistent with *MFSM 2000.*

Coverage and Output

The data coverage has improved significantly from previous publications. For the ODCs, the Microfinance companies sector now includes the Nationwide microbank, while the savings and loans societies in this publication has around

90 percent coverage in the new monthly FC1 reports. The Bank is currently working on collecting data on the remaining savings & loans societies. For the OFCs, all licensed superannuation funds, life insurance companies, investment managers and fund administrators are now covered with partial coverage of the insurance brokers which are yet to fully comply. Ideally, the Bank would like to further expand the coverage to include those institutions outside its supervision such as the general insurance industry. The new data source and tables will be refined and updated in up-coming publications during this transition period as the bank moves to cover those remaining financial institutions currently not captured and corrections made to reporting errors by reporting financial institutions.

Definitions of concepts, Acronyms and Financial Instruments

1. 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.

2. 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.

3. Other Financial Corporations (OFCs): The OFC sub-sector is made up of the insurance corporations, superannuation (pension) funds, other financial intermediaries and financial auxiliaries such as insurance brokers, investment managers and fund administrators.

4. 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.

5. 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.

6. 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.

7. 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.

8. 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 the economy, including the external sector.

9. Public nonfinancial corporations: Public nonfinancial corporations are resident nonfinancial 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).

10. 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.

11. 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.

12. 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

13. 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.

14. 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.

i.) *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.

ii.) *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.

iii.) *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.

FOR THE RECORD

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 2008, the KFR announcements by the Bank were;

2008	07 January	Maintained at 6.00 %
	04 February	Maintained at 6.00 %
	03 March	Maintained at 6.00 %
	07 April	Maintained at 6.00 %
	05 May	Maintained at 6.00 %
	02 June	Maintained at 6.00 %
	10 June	Raised to 6.25 %
	07 July	Maintained at 6.25 %
	04 August	Raised to 6.50 %
	01 September	Raised to 7.00 %
	06 October	Maintained at 7.00 %
	03 November	Maintained at 7.00 %
	01 December	Raised to 8.00 %
2009	05 January	Maintained at 8.00 %
	02 February	Maintained at 8.00 %
	02 March	Maintained at 8.00 %
	06 April	Maintained at 8.00 %
	04 May	Maintained at 8.00 %
	01 June	Maintained at 8.00 %
	06 July	Maintained at 8.00 %
	03 August	Maintained at 8.00 %
	07 September	Maintained at 8.00 %
	05 October	Maintained at 8.00 %
	02 November	Maintained at 8.00 %
	07 December	Reduced to 7.00 %
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 %

For details of the KFR, see Table 6.3 (S34) of the QEB.
KFR announcements prior to January 2007 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 Bill (CBB) [1]

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.

Current Transfers Account

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

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.

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.

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

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.
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.
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.
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.
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.
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 [2]	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 for 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.

[2] 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.

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
Sep 1999	The 1999 Supplementary Budget
Dec 1999	The 2000 National Budget
Jun 2000	Semi-annual Monetary Policy Statement, July 2000
Dec 2000	The 2001 National Budget
Dec 2000	Semi-annual Monetary Policy Statement, January 2001
Jun 2001	Semi-annual Monetary Policy Statement, July 2001
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

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

LIST OF TABLES