**BANK OF PAPUA NEW GUINEA**

**MEDIA RELEASE**

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# Quarterly Economic Bulletin

# December Quarter 2013

Mr Loi M. Bakani, Governor of the Bank of Papua New Guinea (Bank of PNG), released the December 2013 Quarterly Economic Bulletin (QEB) today. This statement provides an overview of the economic and financial developments during the December quarter of 2013 and some key developments since then.

## 1. UPDATE ON DEVELOPMENTS SINCE DECEMBER 2013

Global economic activity continues to strengthen mainly driven by improvement in the financial market conditions and consumer spending in advanced economies. In emerging market economies, growth is due to strong exports although domestic demand remains weak as a result of tight financial conditions and high interest rates. The International Monetary Fund (IMF) in its January 2014 World Economic Outlook (WEO) Update revised its global growth forecast for 2014 upwards to 3.7 percent, from the 3.6 percent made in October 2013. The revision took into account positive economic outlook for the advanced economies in 2014 which are expected to grow by 2.2 percent in 2014. In the US, economic growth is expected to soften in the first quarter of 2014 mainly as a result of the unusual cold weather but to pick up for the remainder of the year as domestic demand strengthens and supported by Federal Government spending. The euro area economy is expected to continue to recover in 2014 as confidence improves and, financial market fragmentation and fiscal consolidation eases. Growth is mainly export driven and pick-up in economic activity will be modest in economies under stress as debt related issues and high unemployment continue to constrain domestic demand. In Japan, planned fiscal consolidation combined with the implementation of a higher consumption tax rate that takes effect on 1st April 2014 is projected to affect growth. The emerging market and developing economies are expected to grow by around 5.1 percent in 2014, with improved prospects in all regions.

Global inflation is projected to be marginally higher in 2014, mainly reflecting the recovery in the advanced economies which is offset by low prices projected for food and energy. In 2014, the IMF projected inflation of 1.8 percent in advanced economies and 5.7 percent in emerging market and developing economies. The World Bank forecast international food prices to remain low in 2014 given record harvest in wheat, maze and rice, increasing availability of supply and stronger global stocks. Low imported price of imports, especially food, is good for PNG.

On the other hand, PNG's export commodity prices are expected to decline. Crude oil is expected to trade at US$103/bbl in 2014, which is below the 2013 price level. Gold and copper prices are also expected to trade lower. Agriculture prices are expected to drop by 2.7 percent in 2014. The Governor cautioned that the fall in international commodity prices does not augment well for PNG's export sector as reduction in foreign exchange revenue can exert downward pressure on the exchange rate, as well as Government revenue. However, the fall in the kina exchange rate should benefit the exporters and so the producers are encouraged to take advantage of it.

Inflation increased in 2013 with an annual outcome of 4.7 percent in 2013, with expectations of inflationary pressures in 2014. This would mainly stem from low export commodity prices and high import demand associated with the Government's fiscal stimulus. As a result, the Bank through its Monetary Policy continued its cautious stance of monetary policy by maintaining its Kina Facility Rate (KFR) at 6.25 percent in the first quarter of 2014.

The daily kina exchange rate depreciated against the US dollar, pound sterling and Euro, while it appreciated against the Australian dollar and Japanese yen in the first quarter of 2014. As of 31$^{st}$ March, the kina depreciated against the US dollar by 0.1 percent to 0.4130, sterling by 2.2 percent to 0.2496 and euro by 0.7 percent to 0.3015. It appreciated against the Australian dollar by 3.3 percent to 0.4610 and yen by 2.3 percent to 42.4724.

The level of gross foreign exchange reserves declined to K6, 653.9 (US$2,781.3) million as of 31$^{st}$ March 2014, from K7, 213.8 (US$3,037.0) million at the end of December 2013. The decline is due to intervention in the foreign exchange market by the Bank of PNG to ease the pace of the depreciation of the kina.

## 2. OVERVIEW OF THE DEVELOPMENTS IN THE DECEMBER QUARTER OF 2013

Economic indicators available to the Bank of Papua New Guinea (the Bank) show that growth in economic activity slowed in 2013, compared to 2012.The adverse effects of the winding down of the construction phase of the LNG project and lower international commodity prices and production for most of PNG's mineral and agricultural exports were more than offset by the continued growth in the private sector, supported by higher growth in credit by commercial banks, and increased recurrent and development Government expenditure to yield a moderate overall growth. Part of the increase in private sector and Government activity came from the construction of sporting facilities in preparation of the 2015 Pacific Games. With lower exports and strong import demand, the latter reflecting both the private and public demand, the balance of payments recorded a deficit. Consistent with the developments in the external sector, the kina depreciated against most of the major currencies, including the US dollar and Australian dollar over the year. In the December quarter of 2013, the Trade Weighted Index (TWI) depreciated by 6.1 percent mainly reflecting the depreciation of kina against most trading partners' currencies. Inflation was 4.7 percent in 2013, compared to 1.6 percent in 2012, attributed to high import duty and excise tax rates, higher betelnut prices and some lagged effect of the kina depreciation. With persisting inflationary pressures, the Bank of PNG maintained its stance of monetary policy by keeping the Kina Facility Rate (KFR) at 6.25 percent in the December quarter of 2013.

Data from the Bank's Business Liaison Survey (BLS) show that the total nominal value of sales in the private sector increased by 0.3 percent in the September quarter of 2013, compared to an increase of 9.9 percent in the June quarter. Excluding the mineral sector, sales increased by 4.6 percent in the September quarter, after increasing by 8.4 percent in the June quarter of 2013. Sales increased in all sectors except the mineral and manufacturing sectors. By region, Highlands, Momase and Islands regions recorded increases while Southern, National Capital District (NCD) and Morobe regions recorded declines. Over the twelve months to September 2013, total value of sales declined by 0.2 percent.

The Bank's Employment Index shows that private sector employment increased by 1.5 percent in the December quarter of 2013, compared to a decline of 3.1 percent in the previous quarter. Excluding the mineral sector, employment increased by 1.9 percent, driven primarily by the building and construction sector. Employment increased in all regions except the Highlands and Momase regions. In 2013, the total level of employment increased by 2.5 percent, whilst in the non-mineral sector, it remained stagnant.

Quarterly headline inflation, as measured by the Consumer Price Index (CPI), was 1.9 percent in the December quarter of 2013, compared to an increase of 1.2 percent in the September quarter. There were increases in the 'Transport and communication', 'Rents, council charges fuel/power', 'Drinks, tobacco, and betelnut', and 'Clothing and footwear' expenditure groups, while the 'Household equipment & operations' expenditure group declined. The annual headline inflation was 4.7 percent in the December quarter of 2013, compared to 1.6 percent in the December quarter of 2012. All urban areas recorded price increases except Madang in the December quarter. The annual exclusion based inflation increased by 5.9 percent in 2013, following a decline of 5.2 percent in 2012, while the annual trimmed-mean inflation increased by 1.8 percent in 2013, compared to an increase of 1.1 percent in 2012.

In the December quarter of 2013, the daily average kina exchange rate depreciated against all the major trading partners' currencies. It depreciated against the US dollar by 5.7 percent to 0.4137, Australian dollar by 6.9 percent to 0.4461, pound sterling by 9.8 percent to 0.2552, Japanese yen by 4.3 percent to 41.5048 and euro dollar by 8.3 percent to 0.3037. These movements in the currencies resulted in the Trade Weighted Index (TWI) depreciating by 6.1 percent to 35.24 in the December quarter of 2013 from 37.55 in the September quarter. In 2013, the daily average kina exchange rate depreciated against all the major currencies except yen. It depreciated by 6.9 percent against the US dollar to 0.4469, Australian dollar by 0.4 percent to 0.4619, pound sterling by 5.6 percent to 0.2861. Against the TWI, it depreciated by 7.0 percent to 35.93.

Lower international prices for some of PNG's export commodities resulted in a 12.2 percent decline in the weighted average kina prices in 2013, compared to 2012. There was a 13.6 percent decline in the weighted average kina price of mineral exports, with lower prices of all exports except crude oil. The weighted average price of non-mineral exports declined by 5.9 percent as a result of lower kina prices for all agricultural commodities, logs and marine products with the exception of tea.

The overall deficit in the balance of payments was K1,685 million in 2013, compared to a surplus of K850 million in 2012. This outcome was due to a deficit in the current account, which more than offset a surplus in the capital and financial account.

The current account recorded a deficit of K7,402 in 2013, compared to a deficit of K7,493 in 2012. The outcome was due to lower trade surplus and higher services and income payments, which more than offset higher transfer receipts.

The capital account recorded a net inflow of K35 million in 2013, compared to K32 million in 2012, reflecting lower transfers by donor agencies through direct project financing. The financial account recorded a net inflow of K5,747 million in 2013, compared to a net inflow of K3,938 million in 2012. The outcome was due to higher net inflows from direct and other investments, reflecting equity inflows and drawdown of loans by the Government and from foreign currency account balances of the mineral companies. These combined with loan drawdown for the PNG LNG project to fund the final phase of construction.

The level of gross foreign exchange reserves at the end of December 2013 was K6,841.8 (US$2,854.7) million, sufficient for 7.2 months of total and 10.6 months of non-mineral import covers.

The Bank maintained a neutral stance of monetary policy by keeping the KFR unchanged at 6.25 percent over the December quarter of 2013, following low inflation outcomes in 2013. Domestic interest rates moved upwards between the end of September and December 2013. The Bank continued to utilize its Open Market Operation (OMO) instruments in the conduct of monetary policy in the December quarter of 2013. There was a net retirement of Central Bank Bills (CBBs) totaling K435.2 million during the quarter. The Government also made a net retirement of K83.3 million in Treasury bills, while issuing a total of K599.7 million of Inscribed stocks. The Cash Reserve Requirement (CRR) was increased from 8.0 percent to 9.0 percent in the December quarter of 2013. The increase in CRR and issuance of Inscribed stocks assisted in diffusing some of the excess liquidity in the banking system.

The average level of broad money supply (M3*) increased by 1.2 percent in the December quarter of 2013, compared to an increase of 2.6 percent in the September quarter. This outcome was mainly influenced by an increase in average net claims on the Central Government as a result of net issuance of securities and drawdown of Government deposits, combined with an increase in average private sector credit. The average net domestic claims outstanding, excluding net claims on the Central Government, increased by 2.5 percent in the December quarter of 2013, following an increase of 3.1 percent in the September quarter. The average level of monetary base (reserve money) increased by 3.4 percent in the December quarter of 2013, following an increase of 5.2 percent in the previous quarter.

The Net Foreign Assets (NFA) of financial corporations, comprising depository corporations (DCs) and other financial corporations (OFCs), decreased by 12.1 percent to K9,456.1 million in the December quarter of 2013, compared to an increase of 11.8 percent in the September quarter of 2013. This resulted from decreases in the NFAs of the Central Bank, ODCs and OFCs. Net claims on the Central Government increased by K732.3 million to K4,657.2 million in the December quarter of 2013, compared to an increase of K908.4 million in the previous quarter. This was a result of the issuance of Government securities to finance the Budget deficit.

In the December quarter of 2013, total domestic credit extended by financial corporations to the private sector, public non-financial corporations, provincial and local level governments, and other financial corporations, increased by K236.7 million to K12,197.5 million, compared to an increase of K205.9 million in the previous quarter. This was mainly due to an increase of K264.8 million in credit to the private sector. The growth in private sector credit reflected advances by the ODCs to the manufacturing, commerce, 'mining and quarrying', 'hotels and restaurants' and 'real estate, renting and business services' sectors. The annualized growth in domestic credit, excluding Central Government, was 15.3 percent in the December quarter of 2013, compared to 7.2 percent in the previous quarter.

Preliminary estimates of the fiscal operations of the National Government in 2013 showed an overall deficit of K2,497.8 million, compared to a deficit of K1,377.9 million in 2012. This represents 4.2 percent of nominal Gross Domestic Product (GDP) and reflected higher expenditure.

Total revenue, including foreign grants, in 2013 was K9,374.6 million, 2.0 percent lower than the receipts collected in 2012. This represents 89.4 percent of the 2013 revised budgeted revenue. The decrease in revenue resulted from lower excise duties, dividend payments and foreign grants.

Total expenditure was K11,872.4 million in 2013, 8.5 percent higher than in 2012 and represents 89.8 percent of the revised budgeted appropriation for 2013. This resulted from higher expenditures in both the recurrent and development budgets.

The budget deficit of K2,497.8 million in 2013, was financed from net external borrowing from concessional sources of K299.5 million and domestic sources of K2,198.3 million. External borrowing totaled K344.8 million, which more than offset loan repayments of K19.6 million to commercial and K25.7 million to extraordinary sources. Domestic financing comprised of a net issuance of Government securities totaling K2,185.7 million and K264.1 million to ODCs and OFCs, respectively. These more than offset net withdrawals of Government deposits of K65.7 million at the Central Bank and cheques presented for payment by other resident sectors totaling K188.8 million.

Total public (Government) debt outstanding at the end of 2013 was K11,619.9 million, K3,269.7 million higher than in 2012. Both domestic and external debts increased over the period. The increase in domestic debt resulted from higher net issuance of Treasury bills and Inscribed stocks, while the increase in external debt mainly reflected higher net borrowings combined with the depreciation of the kina. This resulted in the debt to nominal GDP ratio increasing to 32.7 percent in 2013, compared to 25.6 percent in 2012.

The total amount of Government deposits in the depository corporations decreased by K299.50 million to K3,946.1 million in December 2013, compared to September 2013. Government trust accounts held at the Central Bank increased by K118.4 million to K294.0 million during the same period.