BANK OF PAPUA NEW GUINEA

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QUARTERLY ECONOMIC BULLETIN
MARCH QUARTER 2013

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

1. UPDATE ON DEVELOPMENTS SINCE MARCH 2013

Global economic growth remains weak as Europe is embroiled with deeper-than-expected recession and muted growth in China, Brazil and India. The World Bank in its June 2013 Global Economic Prospect, revised downwards its global growth forecast to 2.2 percent in 2013 from 2.4 percent it made earlier in January 2013. The advanced economies are projected to grow by 1.2 percent, while emerging markets and developing economies are expected to grow by 5.1 percent in 2013, less than 5.5 percent it estimated in January. The austerity measures, including budget controls on spending in European countries have aggravated challenges to economic growth, while outlooks for U.S. and Japan were raised as a result of aggressive stimulus measures. In the U.S. there has been a robust private sector recovery which has not been extinguished by fiscal tightening, while in Japan a dramatic relaxation of macroeconomic policy has sparked an uptick in activity, at least for the short term. Global inflation eased further over recent months and inflationary pressures are expected to remain subdued, in line with the weakness in global demand.

The IMF forecast commodity prices to remain elevated in 2013 from the historical lows of 2011 as a result of supply constraints and a pick-up in global demand. The crude oil prices however continue to be volatile. The international price of crude oil increased to US$96 per barrel in June as a result of modest economic growth and increased in oil consumption by some developed economies. However, there are concerns that crude oil production by the Organization of the Petroleum Exporting Countries (OPEC) is increasing and outstripping demand which could lead to a fall in crude oil prices. Whilst, the IMF's forecast of stable high commodity prices in 2013 may have positive implication for Government revenue, Governor Bakani expressed concern that so far this year, there has been a lower aggregate Government revenue because of lower international commodity prices of our major exports, compared to the corresponding period in 2012. Despite of this, aggregate Government expenditure was higher during the quarter. Mr. Bakani also stated that with Newcrest Mining Ltd writing down the value of its stock by US$1.3 billion, Government revenue could be affected.

With respect to financing of the 2013 National Budget deficit, Governor Bakani has advised the Government that with the high liquidity in the domestic banking system and current low interest rate environment, it would be cheaper and easier to finance the budget deficit domestically instead of the option of external funding that may attract high real cost associated with exchange rate movements and the risk premium attached to low sovereign credit rated countries such as Papua New Guinea. In this regard, he added that the Government has opted for domestic financing over external financing and this is now being implemented.

The winding down of the LNG sector construction project in 2013 is already having an effect on the non-mining private as spin-off business activities are starting to slowdown. This momentum is expected to pick up and would imply that more labour and equipment engaged in the project will be laid off and ready for use elsewhere in the economy. The Governor reiterates that with this buildup of spare capacity from the LNG project, it is important that the Government utilizes the labour and equipment to undertake its development infrastructure projects. With the Government's 2013 Budget stimulus package to increase funding for development projects, this would be a great opportunity for the Government to utilize spare capacity to further develop the economy and partly to offset the impact of the slowdown in activity from the LNG project.

The Governor also mentioned that PNG's economy has already headed towards major structural changes following the commencement of the construction of the LNG project. In the wake of the LNG production in 2014, the country is expected to experience significant growth and revenue receipts in the form of foreign exchange inflows. These inflows will have implications on the kina exchange rate hence, kina appreciating significantly would have potential negative consequences on important economic sectors such as agriculture. He reiterated his view that PNG can avert these risks and, more generally, the potential LNG-generated Dutch Disease effects by putting more resources and effort into developing the agricultural sector. It is important to note that for PNG to have a sustainable economic growth, the Government must heavily invest and develop the agriculture sector including other non-mineral private sectors so that in the long run growth must be underpinned by these sectors rather than developments in the resource sector. It would be a wise decision by the Government to redirect revenues from the resource sector to develop the non-mineral private sector, especially the agriculture sector.

Global inflation has slowed as a result of the stabilization of commodity prices. The IMF projected inflation of 1.7 percent in advanced economies and 5.9 percent in emerging market and developing economies. International food price index has increased to 215.2 points in May from 210 points in January reflecting a general increase in food price levels. The Governor is concern that high import demand could exert further downward pressure on the exchange rate and lead to increase in domestic prices.

Although annual headline inflation increased to 2.8 percent in the March quarter of 2013, compared to 1.6 percent in the December quarter of 2012, it is still considered low. The Bank of PNG is taking a cautious approach, considering factors that could induce inflationary pressures, including the kina depreciation, and maintained the

Kina Facility Rate (KFR) at 6.25 up to June 2013, since the last reduction in March 2013. The upside risk to inflation remains largely associated with the depreciation of the kina exchange rate due to high import demand and the re-introduction and increases in tariffs for some import items in 2013.

The daily kina exchange rate depreciated against the US dollar, euro and Australian dollar, while it appreciated against the yen and pound sterling. As of 12th June 2013, it depreciated by 2.8 percent against the euro to 0.3566, 1.2 percent against the US and Australian dollars to 0.4645 and 0.4625 respectively. The kina appreciated by 12.2 percent against the Japanese yen to 46.088, and against the pound sterling by 2.2 percent to 0.3030. The depreciation of the kina exchange rate against the euro, US and Australian dollars were mainly attributed to high import demand and hence higher demand for foreign exchange and lower foreign exchange inflows. The appreciation against the yen and pound sterling mainly reflected cross currency movements.

The level of gross foreign exchange reserves declined to K6,898.5 (US$3,180.2) million as of 01st July 2013, from K7,914.0 (US$3,739.4) million at the end of March 2013. The decline is due to the intervention in the foreign exchange market by the Bank of PNG to ease the pace of depreciation of the kina.

2. OVERVIEW OF THE DEVELOPMENTS IN THE MARCH QUARTER OF 2013

Economic indicators available to the Bank of Papua New Guinea (the Bank) show that economic activity remained strong in the first quarter of 2013 but is leveling off as the construction phase of the PNG-LNG project had reached its peak in 2012. High Government spending, growth in commercial banks' credit to the private sector, increase in long term private sector investments, and growth in the non-mineral private sector contributed to this growth. With the winding down of the construction phase of the PNG-LNG project, there are signs that the spin-off effects to the non-mineral private sector is starting to ease. The balance of payments recorded a deficit in the March quarter of 2013, mainly reflecting a decline in the international prices of PNG's major export commodities. The kina exchange rate depreciated against the United States (US) and Australian dollars in the March quarter of 2013, while the Trade Weighted Index (TWI) appreciated by 0.1 percent, reflecting the strength of the kina against other currencies. Annual headline inflation was 2.8 percent in the March quarter of 2013, compared to 1.6 percent in the December quarter of 2012. Given the lower inflation environment and the need to support economic activity, the Bank further eased its monetary policy stance in March 2013.

Data from the Bank's Business Liaison Survey (BLS) show that the total nominal value of sales in the private sector decreased by 1.0 percent in the December quarter of 2012, compared to a decline of 0.4 percent in the September quarter. Excluding the mineral sector, sales grew by 5.2 percent in the quarter, after increasing by 3.1 percent in the September quarter. Sales decreased in the mineral and financial/business and other services sectors, while there were increases in the agriculture/forestry/fisheries, retail, wholesale, transportation, manufacturing, and building and construction sectors. By region, Southern and Island regions experienced decreases, while the Highlands, National Capital District (NCD), Morobe and Momase recorded increases. In 2012, total value of sales declined by 6.8 percent, while excluding the mineral sector, sales increased by 9.5 percent.

The Bank's Employment Index shows that the total level of employment in the private sector increased by 1.8 percent in the March quarter of 2013, compared to an increase of 0.6 percent in the December quarter of 2012. The level of employment increased in the mineral, building and construction, manufacturing, retail, financial/business and other services, and wholesale sectors, while it declined in the agriculture/forestry/fisheries and transportation sectors. Excluding the mineral sector, the level of employment increased by 0.7 percent. Employment increased in all regions, except the Islands region. Over the year to March 2013, the total level of employment increased by 7.2 percent, while excluding the mineral sector, it increased by 5.7 percent.

Quarterly headline inflation, as measured by the Consumer Price Index (CPI), was 1.6 percent in the March quarter of 2013, compared to an increase of 0.8 percent in the December quarter of 2012. There were increases in the 'Drinks, tobacco and betelnut', 'Clothing and footwear', 'Household equipment and operations' and 'Rents, council charges, fuel/power' and 'Transport and communication' expenditure groups, which more than offset decreases in the ‘Food’ and ‘Miscellaneous’ expenditure groups. By region, all urban areas recorded CPI increases in the March quarter of 2013. The annual headline inflation rate was 2.8 percent in the March quarter of 2013, compared to an increase of 1.6 percent in the December quarter of 2012. This outcome was attributed to the depreciation of the kina since the second half of 2012, and the re-introduction and increase in tariffs on some imported items. The annual exclusion-based inflation declined by 0.4 percent in the March quarter, compared to a decline of 1.9 percent in the previous quarter, while the annual trimmed mean inflation was 0.6 percent in the March quarter of 2013, compared to an increase of 0.6 percent in the December quarter of 2012.

The daily average kina exchange rate depreciated against the Euro, US and Australian dollars, while it appreciated against the pound sterling and Japanese yen in the March quarter of 2013. The kina depreciated against the euro by 2.8 percent to 0.3582, US dollar by 1.2 percent to 0.4724 and the Australian dollar by 1.2 percent to 0.4548. The kina appreciated against the pound sterling by 2.2 percent to 0.3043 and yen by 12.2 percent to 43.55. These movements resulted in the appreciation of the daily average Trade Weighted Index (TWI) by 0.1 percent to 37.70, compared to the December quarter of 2012.

The weighted average price of Papua New Guinea’s exports in the March quarter of 2013 declined by 4.3 percent, compared to the corresponding quarter of 2012. There was a 2.3 percent decline in the weighted average price of mineral exports, with lower kina prices of all mineral exports. For the agricultural, logs and marine product exports, the weighted average kina price declined by 12.3 percent and was attributed to lower kina prices of coffee, copra, copra oil, palm oil and rubber. Excluding logs, the weighted average price of agricultural and marine product exports declined by 17.0 percent in the March quarter of 2013, compared to the corresponding quarter in 2012.

The balance of payments recorded an overall deficit of K431 million in the March quarter of 2013, compared to a deficit of K452 million in the corresponding period of 2012. The outcome was due to a deficit in the current account, which more than offset a surplus in the capital and financial accounts. The deficit in the current account was due to higher net service, income and transfer payments, which more than offset a higher trade surplus. The surplus in the capital and financial accounts was due to net inflows of equity from foreign direct investments, sale of short term money market instruments and drawdown of net foreign assets of the domestic banking system and foreign currency account balances of mineral companies.

The level of gross foreign exchange reserves at the end of March 2013 was K7,914.0 US$3,739.4 million, sufficient for 10.9 months of total and 17.0 months of non-mineral import covers.

The Bank further eased monetary policy by reducing the Kina Facility Rate (KFR) by 50 basis points to 6.25 percent in March 2013, in response to low inflation outcomes throughout 2012 and to support lending to the private sector and economic activity. The dealing margin for the Repurchase Agreements (Repos) was maintained at 100 basis points from the KFR. Interest rates for short-term securities decreased across all maturities between the end of December 2012 and March 2013 due to high level of liquidity in the banking system. The Government made a net issuance of K1,290.7 million in Treasury bills and K290.0 million in Inscribed stock during the quarter, which assisted the Bank in its liquidity management. Subsequently, there was a net retirement of K869.7 million in Central Bank Bills (CBBs) during the quarter.

The average level of broad money supply (M3*) increased by 1.3 percent in the March quarter of 2013, compared to an increase of 2.1 percent in the December quarter of 2012. This outcome was partly influenced by an increase of 2.8 percent in average private sector credit. Average net domestic claims outstanding, excluding net claims on the Central Government increased by 4.2 percent in the March quarter of 2013, following an increase of 4.3 percent in the December quarter of 2012.

The average level of deposits in ODCs increased by 2.8 percent to K18,595.6 million in the March quarter of 2013 from K18,089.0 million in the December quarter of 2012.

The net foreign assets of the financial corporations, comprising depository corporations and other financial corporations (OFCs), decreased by 5.9 percent to

K9,797.5 million in the March quarter of 2013, compared to an increase of 4.6 percent in the December quarter of 2012.

In the March 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 K433.5 million to K11,003.7 million, compared to an increase of K506.9 million in the December quarter of 2012.

Preliminary estimates of the fiscal operations of the National Government over the three months to March 2013 show an overall deficit of K327.1 million, compared to a deficit of K76.5 million in the corresponding quarter of 2012. This represents 0.9 percent of nominal GDP.

In the March quarter, total revenue, including foreign grants, was K1,344.5 million, 11.0 percent lower than in the corresponding period of 2012. This represents 12.8 percent of the budgeted revenue for 2013. The decrease in revenue reflected lower collection in tax and non-tax receipts combined with lower foreign grants. Total expenditure was K1,671.6 million, 5.4 percent higher than in the corresponding period of 2012 and represents 12.8 percent of the budget appropriation for 2013. This outcome reflected higher recurrent and development expenditure.

The budget deficit of K327.1 million and net external loan repayment of K34.5 million was financed domestically. External loan repayments comprised of K20.4 million to concessionary sources and K14.1 million to extraordinary financing sources. Domestic financing of K361.6 million comprised of a net issuance of Government securities totalling K955.2 million to other depository corporations and K32.9 million to other financial corporations. These more than offset Government deposits of K471.2 million at the Central Bank and settlement of cheques totalling K155.3 million by other resident sectors.

Total public (Government) debt outstanding in the March quarter of 2013 was K9,472.2 million, K1,630.4 million higher than in the December quarter of 2012. Both domestic and external debt increased. The increase in domestic debt resulted from net issuance of Treasury bills and Inscribed stocks, while the increase in external debt partly reflected the depreciation of the kina. This resulted in the debt to nominal GDP ratio increasing to 26.6 percent in the March quarter of 2013, compared to 24.0 percent in the December quarter of 2012.

The total amount of Government deposits in the depository corporations increased by K1,008.9 million to K4,775.6 million in March 2013, compared to K3,766.7 million in December 2012. Government trust accounts held at the Central Bank decreased by K50.8 million to K341.5 million between the March quarter of 2013 and December quarter of 2012.