BANK OF PAPUA NEW GUINEA

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QUARTERLY ECONOMIC BULLETIN
SEPTEMBER QUARTER 2012

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

1. UPDATE ON DEVELOPMENTS SINCE SEPTEMBER 2012

Global economic activity remained weak due to lower growth in the major advanced economies, partly attributed to the European sovereign debt crisis, which continue to derail progress, especially in the euro zone economies. As a result, the International Monetary Fund (IMF) in its October 2012 *World Economic Outlook* (WEO) revised downward its forecast for global growth to 3.3 percent in 2012, from its July forecast of 3.5 percent. Output in advanced economies is expected to remain sluggish, while some emerging and developing economies continue to experience moderate to strong growth. In the Euro area, growth is projected to decline by 0.1 percent while the United States (US) and Japan are expected to grow by 2.0 percent and 2.6 percent, respectively. In Asia, growth is expected to weaken as activity in China continues to slow down due to weak global demand and tightening in credit conditions. The lower growth in India reflects low business confidence and lags in the implementation of structural reforms.

Governor Bakani stated that agricultural and mineral commodity prices continue to decline since the third quarter of 2012, while the price for crude oil remain volatile. The international price of crude oil fell to US$87.00 per barrel for the first time in three months in November as a result of a contraction in the US manufacturing sector. The Organization of Petroleum Exporting Countries (OPEC) expect crude oil prices to increase in the first quarter of 2013 as some member states (Nigeria, Angola and Iran) would not be able to meet their production quota. As of 4th December 2012, crude oil traded at US$88.85 per barrel declining from US$103.86 at end of June 2012, while gold prices traded at US$1,717.38 per ounce, an increase from US$1,599 per ounce. The Governor mentioned that the slowdown in global economy and lower commodity prices are major concerns due to their implications on National Government's budget for 2013, and the kina exchange rate. Any depreciation of the kina will yield domestic inflationary pressures.

Global inflation continues to ease due to weak global demand and low commodity prices partly attributed to the ongoing debt crisis in Europe. The growth momentum in a number of emerging market economies like Brazil, China and India have slowed down reflecting weak domestic demand due to capacity constraints and policy tightening as well as the weak external environment. In light of these developments, the IMF projected inflation in advanced and developing economies to be at 1.9 percent and 6.1 percent, respectively. International food prices remained flat at 213 points in July and August 2012, increasing slightly to 215 points in September before dropping back to 213 points in October.

In regard to the 2013 National Budget, Governor Bakani stated that the K2.6 billion fiscal deficit is relatively large in historical terms and 8 percent inflation projected for 2013; pose major challenges for the Bank. The design, formulation and implementation of monetary policy will have to carefully asses and evaluate what measures and instruments to be used, to ensure that price stability is maintained and inflation rate is at a manageable level. The deficit financing in itself is an accepted strategy to achieve higher economic growth, in periods of declining private sector domestic demand, as is the case following the scaling down of the construction of the PNG LNG project. The Government has to ensure that it spends productively and efficiently on income generating activities, so that the growth in GDP absorbs the inflationary impact of deficit financing. A major concern would be the lack of capacity to spend efficiently and effectively, at the national, provincial and district levels. The funds that will be disbursed are significant and if there is lack of capacity to implement the development budget then there is the possibility of funds not properly used for its intended purpose.

Given the very high level of liquidity in the financial system, the Bank is of the view that the deficit financing and the need for the Government to raise domestic funding, will have no c*rowding out* effect on the private sector. The Bank will monitor these developments closely and assess their impact over the course of 2013. The Governor emphasizes that coordination between the Department of Treasury and the Bank commences immediately to agree on the funding of the deficit, both the instruments to be used and the timing of the placements.

Given the low inflation outcome in the September quarter of 2012, the Bank of PNG continued to maintain its monetary policy stance by maintaining the Kina Facility Rate (KFR) at 6.75 percent in November and December 2012. However, the Bank is mindful of the upside risks associated with low commodity prices and high Government deficit and their implications on the kina exchange rate as well as the impact of new tariffs on certain imports in 2013.

The kina depreciated against the US dollar, Australian dollar, the pound sterling and the euro, while it appreciated against the Japanese yen. From the end of September 2012 to 21st December, the kina depreciated against the US dollar by 0.94 percent to 0.4760, Australian dollar by 0.85 percent to 0.4554, and euro by 3.0 percent to 0.3605 and, pound sterling by 0.95 percent to 0.293, while it appreciated against the Japanese yen by 7.4 percent to 39.99 and euro by 2.4 percent to 0.3717. The depreciation of the kina exchange rate against the US and Australian dollars was associated with lower foreign exchange inflows and increased demand for foreign currency in the domestic foreign exchange market.

The level of gross foreign exchange reserves stabilized around the US$4.0 billion mark. As at 24th December 2012 it was K8,333.5 (US$4,008.4) million compared to K8,382.6 (US$4,069.8) million as at end of September 2012.

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

Economic indicators available to the Bank of Papua New Guinea (the Bank) show that domestic economic activity continued to grow in the September quarter of 2012, compared to the previous quarter. Continued increase in the level of employment in the private sector and in lending to the private sector, although at a slower pace, are indicative of this growth. However, the lower international commodity prices for Papua New Guinea's (PNG) exports have resulted in an overall balance of payments deficit for the nine months to September 2012. The Trade Weighted Index (TWI) depreciated in the September quarter by 1.8 percent as the kina depreciated against the US dollar and the Australian dollar. Inflation continued to remain low with an annual outcome of 2.0 percent in the September quarter, 2012. The lower outcome is attributed to lower international food and fuel prices as well as the lag effects of past appreciation of the kina exchange rate. With the low inflation, the Bank eased monetary policy by reducing the KFR (Kina Facility Rate) from 7.75 percent to 6.75 percent in September quarter of 2012.

Data from the Bank's Business Liaison Survey1 (BLS) show that the total nominal value of sales in the private sector fell by 2.8 percent in the June quarter of 2012, compared to a decline of 2.9 percent in the March quarter. Excluding the mineral sector, sales increased by 2.4 percent in the June quarter of 2012, compared to a fall of 1.0 percent in the previous quarter. Sales declined in the mineral, wholesale, manufacturing, transportation, agriculture/forestry/fisheries and financial/business and other services sectors, while the building and construction and retail sectors recorded increases. By region, Southern and National Capital District (NCD) recorded declines, while Momase, Islands, Morobe and Highlands experienced increases. Over the twelve months to June 2012, total sales declined by 2.8 percent.

The Bank's Employment Index show that the total level of employment in the private sector increased by 1.6 percent in the September quarter of 2012, compared to an increase of 3.0 percent in the previous quarter. Excluding the mineral sector, the level of employment increased by 1.5 percent. The level of employment increased in all sectors, except the transportation and financial/business and other services sectors. By region, there were increases in all regions, except the Southern region. Over the year to September 2012, the total level of employment increased by 7.0 percent, while excluding the mineral sector, the level of employment increased by 6.6 percent.

Quarterly headline inflation as measured by the Consumer Price Index (CPI) was 0.8 percent in the September quarter of 2012, compared to a decline of 0.4 percent in the June quarter. There were increases in the 'Food', 'Drinks, tobacco and betelnut', and 'Miscellaneous' expenditure groups, which more than offset decreases in the other expenditure groups. The annual headline inflation rate was 2.0 percent in the September quarter of 2012, compared to 8.4 percent in the September quarter of 2011. This lower outcome was attributed to the past appreciation of the kina, tuition free education policy of the government and extension of the tariff reduction program. By region, all urban areas recorded increases in the September quarter. The annual exclusion-based inflation declined by 0.8 percent in the September quarter of 2012, compared to an increase of 0.2 percent in the previous quarter. The annual trimmed mean inflation was 2.2 percent in the quarter, compared to 3.4 percent in the previous quarter.

In the September quarter of 2012, the daily average kina exchange rate depreciated against all the major trading partners' currencies except the euro, which it appreciated against by 2.4 percent to 0.3850. It depreciated against the US dollar by 0.5 percent to 0.4813, the Australian dollar by 3.4 percent to 0.4632, the pound sterling by 0.1 percent to 0.3057 and the Japanese yen by 2.5 percent to 37.8284. These movements resulted in a depreciation of the daily average TWI exchange rate by 1.8 percent to 38.06 in the September quarter of 2012, from 38.74 in the June quarter.

The weighted average price of Papua New Guinea's exports was 16.2 percent lower in the September quarter of 2012, compared to the corresponding quarter of 2011. There was a 14.7 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, excluding refined petroleum product exports, the weighted average price declined by 21.2 percent due to lower kina export prices of logs and all agricultural exports, with the exception of tea and marine products.

The balance of payments recorded an overall deficit of K868 million for the nine months to September 2012, compared to a surplus of K427 million in the corresponding period of 2011. This outcome was due to a deficit in the current account, which more than offset net inflows in the capital and financial accounts.

The deficit in the current account was attributed to lower trade surplus, higher net service and net income payments, and lower net transfer receipts. The net inflow in capital and financial account was due to inflows from foreign direct, portfolio and other investments. These more than offset net outflows from investments in financial derivatives instruments.

The capital account recorded a lower net inflow of K25 million in the nine months to September 2012, compared to K63 million in the corresponding period of 2011. The decline reflected lower transfers by donor agencies for project financing. The financial account recorded a net inflow of K2,020 million in the nine months to September 2012, compared to a net inflow of K391 million in the corresponding period of 2011. This outcome was a result of higher net inflow from foreign direct investments and portfolio investments reflecting equity inflows and draw down from investments in short-term money market instruments by resident entities

The level of gross foreign exchange reserves at the end of September 2012 was K8,399.60 (US$4,042.1) million, sufficient for 10.5 months of total and 15.3 months of non-mineral import cover.

The Bank of Papua New Guinea eased monetary policy by reducing the KFR from 7.75 percent to 6.75 percent in the September quarter of 2012, following low inflation outcomes up to the June quarter of 2012. The low inflation outcome was attributed to low imported inflation supported by the lag pass-through effect of the appreciation of the kina. The Bank continued to utilise its Open Market Operation (OMO) instruments in the conduct of monetary policy in the September quarter of 2012. There was a net reduction of K536.0 million in CBBs during the quarter as holders retired their bills. The Government made a net issuance of K402.5 million Treasury bills and K138.0 million Inscribed stocks during the quarter, which assisted the Bank in its liquidity management. The Cash Reserve Requirement (CRR) for the commercial banks was maintained at 8.0 percent in the September quarter of 2012.

The average level of broad money supply (M3*) increased by 0.3 percent in the September quarter of 2012, compared to an increase of 2.8 percent in the June quarter. This outcome was influenced by an increase in average net claims on the Central Government following net issuance of securities and drawdown of Government deposits. Average net domestic claims outstanding, excluding net claims on the Central Government, increased by 4.7 percent in the September quarter of 2012, following an increase of 2.5 percent in the June quarter. The average level of monetary base (reserve money) declined by 7.6 percent in the September quarter of 2012, compared to a growth of 10.6 percent in the June quarter. This reflected a decline in commercial bank's deposits at the Central Bank, which more than offset an increase in currency in circulation. The average level of deposits in ODCs decreased by 0.5 percent to K17,846.6 million in the September quarter of 2012 from K17,926.7 million. This reflected declines in transferable and Central Government deposits.

The net foreign assets of financial corporations, declined by 3.0 percent to K9,876.6 million in the September quarter of 2012, compared to a decline of 1.3 percent in the June quarter. This resulted from declines in net foreign assets of the Central Bank and other financial corporations (OFCs). Net claims on the Central Government decreased by K2.5 million to K1,816.1 million in the September quarter of 2012, compared to an increase of K693.6 million in the previous quarter. This resulted from an increase in Government deposits and maturing of Government securities by ODCs.

In the September quarter of 2012, total domestic credit extended by financial corporations to the private sector, public non-financial corporations, Provincial and Local Governments, and OFCs, increased by K329.8 million to K10,008.7 million, compared to an increase of K153.2 million in the June quarter of 2012. This was mainly due to increases of K210.3 million and K171.8 million in credit to the private sector and public non-financial corporations, respectively. The growth in private sector credit reflected advances by the ODCs to the manufacturing, commerce, transport and communication and other business services sectors, as well as the household sector for housing advances. The annualised growth in domestic credit, excluding Central Government was 11.8 percent in the September quarter of 2012.

Preliminary estimates of the fiscal operations of the National Government over the nine months to September 2012 showed an overall surplus of K233.1 million, compared to a surplus of K366.3 million in the corresponding period of 2011. This represents 0.7 percent of nominal GDP and reflected higher revenue, which more than offset an increase in expenditure.

Total revenue, including foreign grants, over the nine months to September 2012 was K6,629.6 million, 23.3 percent higher than the receipts collected in the corresponding period of 2011. This represents 65.3 percent of the revised budgeted revenue for 2012. The increase in revenue reflected higher receipts in most categories of both tax and non-tax revenue, combined with higher foreign grants.

Total expenditure over the nine months to September 2012 was K6,396.5 million, 27.7 percent higher than in the corresponding period of 2011. This represents 60.6 percent of the revised budgeted appropriation for 2012 and resulted from both higher development and recurrent expenditures.

The budget surplus of K233.1 million and net external borrowing of K24.7 million was offset by net negative financing to domestic sources totalling K257.8 million. The external borrowing of K69.1 million was from concessional sources, while loan repayments of K8.0 million and K36.4 million were made to commercial and extraordinary sources, respectively. The net negative financing to domestic sources mainly comprised of K2,151.7 million worth of cheques presented for payment by other resident sectors. This more than offset Government deposits placed at the Central Bank totalling K865.5 million and purchases of Government securities totalling K691.8 million and K336.6 million by ODCs and OFCs, respectively.

Total public (Government) debt outstanding at the end of the September quarter of 2012 was K8,202.2 million, K487.1 million higher than in the June quarter of 2012 and resulted from increases in both domestic debt and external loans. The increase in domestic debt resulted from net new issuance of Treasury bills and Inscribed stocks, while the increase in external debt mainly reflected the drawdown of concessional loans. This resulted in the debt to nominal GDP ratio increasing to 25.1 percent from 23.6 percent between the two quarters.

The total amount of Government deposits in the depository corporations increased by K292.0 million to K4,251.1 million in September 2012, compared to K3,959.1 million in June 2012. Government trust accounts held at the Central Bank increased by K230.5 million to K457.1 million between the end of September 2012 and June 2012, reflecting placements by the Government mainly for the 2015 South Pacific Games and infrastructure development grants.