BANK OF PAPUA NEW GUINEA

MEDIA RELEASE

24th September 2010

QUARTERLY ECONOMIC BULLETIN
JUNE QUARTER 2010

Mr. Loi M. Bakani, Governor of the Bank of Papua New Guinea (Bank of PNG), today released the June 2010 Quarterly Economic Bulletin (QEB). This statement provides an overview of the economic and financial developments for the June 2010 quarter as well as developments since June 2010.

1. UPDATE ON DEVELOPMENTS SINCE JUNE 2010

The global economic recovery from the recession continued at a moderate pace, although the outlook has weakened somewhat over recent months. Latest data of the US economy has increased concerns about the prospects for a double-dip recession. In the second quarter, revised GDP growth was much lower than expected, housing sales were the weakest on record, capital spending fell and employment growth was weak. In Europe, there was positive growth, largely due to robust GDP growth in Germany. Efforts to address the fiscal problems and strong positive results from bank stress tests have reduced concerns about the debt crisis, which was reflected in lower, although still elevated, risk spreads on government bonds in Spain, Portugal, Ireland and Greece. In Japan, weaker export growth and stagnant private consumption stalled growth in the second quarter. Data out of emerging market economies suggest that growth is still strong but moderating. Most notably, growth in China slowed to 10.3 percent in the second quarter of 2010 from 11.9 percent in the first quarter. Headline inflation generally decreased globally, largely reflecting the pass-through of previous declines in oil and other commodity prices.

Mr. Bakani explained that weaker global growth expectations have contained commodity prices somewhat over recent months, especially crude oil. For Papua New Guinea, export receipts should still be higher this year, with the average prices of gold, copper, palm oil and coffee expected to be higher than in 2009. Since the end of June, international prices of Papua New Guinea's major export commodities showed mixed trends. Gold and oil prices fluctuated but returned to their levels as at the end of June, while copper, palm oil, and coffee prices have increased. The expected commencement of production at the Ramu Nickel-Cobalt project has been delayed due to legal issues, so its anticipated contributions to the trade and current account will also be postponed. Construction work on the LNG project will increase imports, which can offset the surplus in the current account. However, there have been reported delays in some aspects of the construction work, and import growth may not be as high as expected.

Higher export commodity prices should lead to higher corporate taxes for the Government in 2010. This has been the case up to the June quarter with a budget surplus reported for the first six months of 2010. The surplus is expected to be appropriated through a Supplementary Budget for 2010.

In the foreign exchange market, the US dollar appreciated against all major currencies during the June quarter of 2010. This largely reflected investors' decision to invest in the US due to the debt crisis in the Euro zone. 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. Since June, however, some of these flight-to-safety flows have been reversed due to improved economic indicators out of Europe in contrast to weaker economic data out of the US.

After June, the kina appreciated against the US dollar, reaching a high of 37.20 cents on 28th July, and settling at 37.10 cents on 22nd September 2010. Most of the appreciation occurred in the last two weeks of July, when the International Finance Corporation brought in funds for the acquisition of equity in the Bank South Pacific. During the same period, the US dollar has depreciated somewhat against the Australian dollar, due to weaker economic data from the US economy. This, in turn, led the kina to depreciate against the Australian dollar from 42.25 cents at the end of June to 38.80 cents as at 22nd September.

Inflation has increased as shown by the June quarter outcome of the Consumer Price Index (CPI). Consistent with the Bank's Monetary Policy Statement (MPS) released in March 2010, the Bank continues to take a cautious approach in its monthly monetary policy decisions by maintaining the Kina Facility Rate (KFR) at 7.0 percent in the first nine months of 2010.

There have been no changes to the commercial banks' Indicator Lending Rates (ILR) spread, which has been at 10.95-11.95 percent since the end of March 2009. Deposit rates of the commercial banks decreased across all maturities as did the rates for the Central Bank Bills (CBBs). 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 level of gross foreign exchange reserves increased from US$2,580 (K7,168) million at the end of June 2010 to US$2,781.0 (K7,376.6) million as at 22nd September 2010.

2. OVERVIEW OF THE DEVELOPMENTS IN THE JUNE QUARTER OF 2010

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 in export volumes and values, induced by higher international prices of major export commodities; 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 end of the Christmas-new year period, lower oil sales 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 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 increased 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 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, 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 investments and Other investments. The increase in the Direct investment 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 during the quarter, which helped 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 K106.7 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 K2,912.8 million, 12.9 percent higher than the receipts collected in the corresponding period of 2009. This represents 38.9 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 K2,806.1 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 K106.7 million. The surplus and domestic financing of K0.1 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 K48.0 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.