BANK OF PAPUA NEW GUINEA

MEDIA RELEASE

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QUARTERLY ECONOMIC BULLETIN
MARCH QUARTER 2011

Mr. Loi M. Bakani, Governor of the Bank of Papua New Guinea (Bank of PNG), today released the March 2011 Quarterly Economic Bulletin (QEB). This statement provides an overview of the economic and financial developments for the March 2011 quarter and the developments since March 2011.

1. UPDATE ON DEVELOPMENTS SINCE MARCH 2011

The global economy continued to grow but at varying paces across different regions. Strong growth continues in Asia, led by China and India while Japan is slowly recovering from the devastation caused by earthquake and tsunami in March 2011. The outlook for global growth has remained positive over recent months and is projected by the IMF to be 4.4 percent in 2011. The growth in the US economy has continued moderately, with further improvement in the labor market, consumer spending supported by business investment, manufacturing and exports. However, the construction and housing market remained subdued, due to a weak demand, foreclosures and distressed property market. Headline inflation increased due to a surge in prices of crude oil, food and other commodities; however underlying inflation and long run inflation remain stable. In

Europe, the recovery is continuing and growth prospects remain positive, largely due to strong GDP growth in Germany, France and Spain, supported by the export sector. General business conditions picked up and labour market improved. The European Central Bank increased its policy rate by 25 basis points in April 2011. However, growth in some Euro member countries remain very weak due to public and private sector debt problems and considerable financial stress remain, while tighter fiscal control is in place in some of the other countries. The pick up in headline inflation in the first quarter of 2011, largely reflecting the pass-through of increased oil, food and other commodity prices, is expected to continue in the remainder of 2011. In view of inflationary concerns, a number of Central Banks, except the US Federal Reserve, have started to increase their official interest rates.

Governor Bakani explained that the increase in global demand for primary commodities has led to high international prices. Up to June 2011, international prices of Papua New Guinea’s major export commodities have increased. Gold, copper and oil prices have increased further since March 2011, and the prices of non-mineral commodities also remained high. This will assist the trade balance while also contributing to a good flow of revenue for the Government’s budget. On the other hand, increased global demand and the rise in food and oil prices have led to an increase in imported inflation for the PNG economy. Together with high aggregate demand, this has led to an increase in domestic inflation.

Annual headline inflation as indicated by the Consumer Price Index (CPI) increased by 9.0 percent in the first quarter of 2011. Inflationary pressures, stemming from higher imported inflation and domestic demand, are expected to continue. In view of these developments, the Bank signaled a tightening stance on its monetary policy by increasing the monthly Kina Facility Rate (KFR) by 25 basis points to 7.25 percent in June 2011.

The Governor stated that the Bank is still concerned that a significant proportion of trust account funds are still held at the commercial banks in spite of the directive issued late last year by the Finance and Treasury Minister for all new trust accounts to be held at the Central Bank. This is contributing to the high level of liquidity in the banking system and the high interest cost for the Central Bank in the conduct of monetary policy. This is because the commercial banks use these funds to invest in Treasury bills and Central Bank Bills (CBBs) and arbitrage on interest rates at a cost to the nation. Efforts are now being made to hold all new trust accounts at the Central Bank, in line with the Treasury Minister's directive.

Since April 2011, the US dollar continued to depreciate against the major currencies on the back of expectations of rising interest rates in the UK and Euro, and a strong commodity-backed Australian dollar, while appreciating modestly against the yen. With the high inflow of foreign exchange, associated with the mineral tax receipts for the Government and high commodity export earnings, the kina continued to appreciate against the US and Australian dollars since 21st April 2011. It reached a high of 43.30 cents against the US dollar and 41.54 cents against the Australian dollar on the 27th of June 2011.

The level of gross foreign exchange reserves increased from K7982.9 million (US$ 3,190.4 million) at the end of March 2011, to K8,441.4 million (US$3,697.3 million) as at 28th of June 2011. The increase is also attributed to the high mineral tax receipts made in foreign exchange.

2. OVERVIEW OF THE DEVELOPMENTS IN THE MARCH QUARTER OF 2011

The economy continued to perform strongly in the first quarter of 2011. This was supported by growth in business sales, private sector employment, private sector credit and higher prices and production of most agricultural and mineral export commodities. With the increase in economic activity, associated with the construction phase of the Liquefied Natural Gas (LNG) project, a general pick-up in activity in the private sector, and increased Government spending, aggregate domestic demand rose. Combined with high international food and fuel prices, this led to an increase in inflation. The annual headline inflation increased by 9.0 percent in the March quarter of 2011, compared to 7.2 percent in the December quarter of 2010. The kina continued to appreciate against the US dollar, while depreciating against other major currencies, particularly the Australian dollar, resulting in a marginal decline in the Trade Weighted Exchange Rate Index (TWI). Before the inflation outcomes for the first quarter of 2011 became available, the Bank of Papua New Guinea (the Bank) maintained a cautious approach to its Monetary Policy stance by keeping the KFR at 7.0 percent throughout the March quarter.

Data from the Bank's Business Liaison Survey (BLS) show that the total nominal value of sales in the private sector increased by 8.3 percent in the December quarter of 2010, compared to an increase of 8.8 percent in the September quarter. Excluding the mineral sector, sales increased by 1.1 percent in the December quarter, following an increase of 5.0 percent in the previous quarter. Sales increased in all the sectors, except the agriculture/forestry/fisheries and manufacturing sectors. By region, all regions recorded increases, except the National Capital District (NCD). In 2010, the total value of sales increased by 18.4 percent, compared to the previous year.

The Bank's Employment Index shows that the level of employment in the formal private sector increased by 4.9 percent in the March quarter of 2011, after increasing by 2.1 percent in the December quarter of 2010. Excluding the mineral sector, the level of employment picked up by 5.1 percent in the same quarter, following an increase of 2.0 percent in the previous quarter. By sector, employment increased in the transportation, agriculture, forestry and fisheries, mineral, retail, manufacturing and financial/business and other services sectors, while it fell in the building and construction and wholesale sectors. By region, the level of employment picked up in all the regions, except Momase. Over the year to March 2011, the total level of employment increased by 8.1 percent, compared to the corresponding period in 2010, while excluding the mineral sector, the level of employment rose by 7.7 percent over the year to March 2011.

Quarterly headline inflation, as measured by the CPI, was 3.1 percent in the March quarter of 2011, compared to 2.7 percent in the December quarter of 2010. The increase was broad-based across all expenditure groups, with the largest increase coming from ‘Drinks, tobacco and betelnut’ expenditure group. Annual headline inflation was 9.0 percent in the March quarter, higher than the 7.2 percent in the December quarter of 2010. The annual underlying inflation as indicated by the exclusion-based and trimmed-mean measures were 6.6 percent and 6.8 percent, respectively, in the March quarter of 2011. The increase in annual inflation was attributed to the pass-through of higher international prices of food and fuel, as well as higher prices of betelnut, fruits and vegetables and clothing and footwear. All the surveyed centres recorded price increases in the March quarter and over the year to March 2011.

In the March quarter of 2011, the daily average kina exchange rate appreciated against the US dollar, pound sterling and euro, while it depreciated against the Australian dollar and Japanese yen. It appreciated against the US dollar by 2.9 percent to 0.3895, pound sterling by 5.0 percent to 0.2419, and euro by 11.2 percent to 0.2753. It depreciated against the Australian dollar by 6.9 percent to 0.3770 and Japanese yen by 5.6 percent to 32.2400. These movements resulted in the daily average TWI depreciating marginally by 0.1 percent in the March quarter of 2011 to 30.92, from 30.95 in the December quarter of 2010.

Higher international prices of mineral products and most agricultural exports resulted in a 23.5 percent increase in the weighted average kina price of exports in the March quarter of 2011, compared to the corresponding quarter of 2010. There was a 21.5 percent increase in the weighted average kina price of mineral exports, with higher prices of all mineral exports. The weighted average kina price of agricultural, logs and marine product exports increased by 31.1 percent and was attributed to higher kina prices of cocoa, coffee, copra, copra oil, palm oil, rubber and marine products.

There was an overall deficit in the balance of payments of K187 million for the three months to March 2011, compared to a deficit of K299 million in the corresponding period of 2010. This outcome was due to a deficit in the capital and financial accounts, which more than offset a surplus in the current account.

The current account recorded a surplus of K356 million in the March quarter of 2011, compared to a deficit of K877 million in the corresponding quarter of 2010. The outcome was attributed to higher trade surplus and net transfer receipts, combined with lower net service and income payments.

The capital account recorded a surplus of K26 million in the March quarter of 2011, compared to a surplus of K24 million in the same quarter in 2010, reflecting higher transfers by donor agencies through direct project financing.

The financial account recorded a deficit of K590 million in the March quarter of 2011, compared to a surplus of K606 million in the corresponding quarter of 2010. This was due to net outflows from foreign direct investments, associated with the purchase of shares by a resident mineral company and investments in financial derivatives, combined with net loan repayments by the Government. This more than offset a net inflow from portfolio investments, reflecting the sale of short term money market instruments and from other investments. The net inflow in other investments reflected a drawdown in the net foreign assets of the commercial banks and foreign currency account balances of resident mineral companies.

The level of gross foreign exchange reserves at the end of March 2011 was K7,982.9 (US$3,190.4) million, compared to K6,803.3 (US$2,372.0) million, at the end of March 2010, sufficient for 9.9 months of total and 12.4 months of non-mineral import covers.

The Bank continued to maintain a cautious approach to its monetary policy stance by keeping the monthly KFR at 7.00 percent throughout the March quarter of 2011. This is in view of inflationary pressures arising from high aggregate domestic demand, induced by the construction of the LNG project and high Government spending. The dealing margin for the Repurchase Agreements (Repos) was maintained at 100 basis points on both sides of the KFR during the quarter. Interest rates for short-term securities increased across all maturities between the end of December 2010 and end of March 2011.

The Bank continued to utilise its Open Market Operation (OMO) instruments in the conduct of monetary policy over the March quarter of 2011. Given the high liquidity level in the banking system, the Bank made a net issuance of CBBs totalling K157.2 million, to diffuse liquidity during the period. The Government made a net issuance of K183.5 million in Treasury bills while Inscribed stock auctions were conducted according to the issuance schedule. Trading in the inter-bank market was active during the period, reflecting the uneven distribution of liquidity held amongst the commercial banks. The Cash Reserve Requirement (CRR) of the commercial banks was maintained at 4.0 percent over the March quarter.

The average level of broad money supply (M3*) increased by 2.1 percent in the March quarter of 2011, compared to a decline of 0.2 percent in the December quarter of 2010. This outcome was due to an increase of 3.0 percent in average net private sector credit and 0.9 percent in average net foreign assets of depository corporations. Average net domestic claims outstanding, excluding net claims on the Central Government, increased by 2.9 percent in the March quarter of 2011, compared to an increase of the same rate in the December quarter of 2010.

The net foreign asset of financial corporations declined by 1.3 percent in the March quarter of 2011, compared to an increase of 7.2 percent in the December quarter of 2010. This resulted from a decline in net foreign assets of the Central Bank due to the appreciation of the Kina against most major currencies. Net claims on Central Government increased by 32.8 percent in the March quarter of 2011, compared to a decline of 29.8 percent in the December quarter of 2010. This was influenced by a decline in Government deposits at the Central Bank and advances under the Temporary Advance Facility (TAF).

In the March quarter of 2011, total domestic credit extended by financial corporations to the private sector, public non-financial corporations, Provincial and Local Governments, and other financial corporations, increased by K194.9 million to K8,668.1 million, compared to an increase of K473.0 million in the December quarter of 2010. This comprised an increase of K189.7 million in private sector credit and an increase of K5.2 million to public non-financial corporations. Credit to the private sector comprised lending to the transport and communication, building and construction, mining and quarrying and other business services sectors, in particular real estate and renting, hotels and restaurants as well as advances to the household sector for personal loans. The increase in lending also reflected businesses expanding their capacities to cater for increased demand. The annualised growth in domestic credit, excluding Central Government was 16.5 percent in March 2011.

Preliminary estimates of the fiscal operations of the National Government over the three months to March 2011 show an overall deficit of K77.0 million, compared to a deficit of K193.5 million in the corresponding period of 2010. This represents 0.3 percent of nominal GDP.

Total revenue, including foreign grants, during the March quarter of 2011 was K1,652.2 million, 50.1 percent higher than the receipts collected in the corresponding period of 2010. This represents 17.7 percent of the 2011 budgeted revenue. The increase in revenue mainly reflected higher tax revenue and receipt of foreign grants, which more than offset lower non-tax receipts. Total expenditure for the first three months to March 2011 was K1,729.2 million, 33.6 percent higher than in the corresponding period of 2010 and represents 18.5 percent of the budget appropriation for 2011. This outcome reflected increases in both recurrent and development expenditures.

As a result of these developments in revenue and expenditure, the Government recorded an overall budget deficit of K77.0 million. The deficit of K77.0 million and net external repayment of K66.4 million was financed mainly from the domestic sources. The net external loan repayments comprised of K27.1 million to concessionary, K0.4 million to commercial and K38.9 million to extraordinary financing sources. The net financing by domestic sources comprised of net drawdown totalling K561.4 million of Government deposits, mainly trust account funds at the Central Bank. This more than offset K299.4 million in net deposits at ODCs, K10.9 million in payment of Inscribed stock maturity and K107.6 million in cheques presented for payment.

Total public (Government) debt outstanding at the end of March quarter of 2011 was K6,469.6 million, K28.7 million lower than in the December quarter of 2010. The decrease was due to lower domestic and external debts. The decrease in external debt reflected loan repayments, combined with the appreciation of the kina against most of the major currencies, while the decline in domestic debt resulted from net retirement of Government securities, mainly Inscribed stocks. The balance of Government trust accounts held at the Central Bank increased by a net of K214.2 million to K427.0 million between the end of December 2010 and March 2011. This reflected the new trust accounts established for the 2010 Supplementary Budget.

The total amount of Government deposits in the depository corporations decreased by K116.5 million to K3,145.9 million in March 2011, compared to K3,262.4 million in December 2010.