BANK OF PAPUA NEW GUINEA

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QUARTERLY ECONOMIC BULLETIN
SEPTEMBER QUARTER 2010

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

1. UPDATE ON DEVELOPMENTS SINCE SEPTEMBER 2010

The global economic recovery slowed down in the second half of 2010, although growth in Gross Domestic Product (GDP) picked up moderately in the US and Japan in the third quarter. Annual GDP growth in the US increased from 3.0 percent in the second quarter to 3.2 percent in the third quarter, 2010. However, the unemployment rate increased to 9.8 percent in November and, in light of weak growth prospects and continued low inflation, the US Federal Reserve announced plans to initiate a second round of quantitative easing. In Japan, annual GDP growth increased by 2.7 percent in the third quarter, due to strong private consumption and capital investment, from 1.2 percent in the June quarter. In Europe, economic growth slowed between the second and third quarters, with a notable weakening in Germany in the third quarter after an exceptional second quarter. The fiscal problems in Greece, Ireland, and Spain continued into the third quarter, with budgets cuts because of sovereign debt concerns. In November, Ireland held negotiations with the EU and IMF to create a bailout package of 85 billion euros to strengthen its public finances and recapitalize the banking system. The Irish bailout did not allay market concerns about Spanish and Portuguese debt, which were reflected in high bond yields. Data out of emerging market economies suggest that growth slowed markedly in the third quarter after an unsustainably high rate of real GDP growth in the second quarter. Real GDP growth in China slowed from 10.3 percent over the year to the second quarter to 9.6 percent in the third quarter. Headline inflation generally increased globally due to higher food and energy prices.

Mr. Bakani explained that continued high demand from China, the weaker US dollar, search by investors for hard investment assets in the face of low interest rates, and quantitative easing by central banks have underpinned higher commodity prices in recent months. The US dollar prices for all of Papua New Guinea's major exports, including gold, copper, oil, coffee, palm oil, and cocoa, have increased in recent months. Although the stronger Kina against the US dollar will partially offset the gain from the higher US dollar prices, export receipts will increase this year.

A higher than budgeted revenue from increased tax revenue, as a result of high export commodity prices, led the Government to pass a Supplementary Budget for 2010 in November for an additional appropriation of K653.3 million. This is expected to result in a balance budget for 2010. The Central Bank is concerned that if this leads to increased spending in the last two months of the year, it will add to the already high liquidity level in the banking system, which would exert upward pressure on domestic prices of goods and services (inflation). If these additional funds are deposited in trust accounts with commercial banks, they will have the same effect of increase in the level of liquidity. On the other hand, if they are deposited in trust accounts at the Central bank, as directed by the Treasury and Finance Minister, their effects on liquidity levels can be better managed. It is therefore crucial that the Treasury and Finance Departments adhere to the directive from the Treasurer for all trust accounts to be established at the Central Bank.

The 2011 National Budget, passed by the Parliament in November 2011, has both total revenue and expenditure at K9,328.1 million, implying a balanced budget for the year. There are a few positive measures outlined in the budget. These include: a provision for payment by the Government of its liability with the Superannuation Fund for civil servants; the establishment of a Sovereign Wealth Fund that will have three components- Stabilization Fund, Future Savings Fund, and Infrastructure Fund; the establishment of trust accounts with the Central Bank; and the continuation of the Medium Term Debt Strategy (MTDS). The establishment of a Sovereign Wealth Fund is crucial for a disciplined management of the expected revenue windfall from the LNG project and other mineral projects and for macroeconomic stability. The continuation of the MTDS is important for prudent management of debt to achieve a sustainable level of total debt (both domestic and foreign) in the long run.

On the down side, a big increase in expenditure will add to the already high liquidity level in the banking system and exert more upward pressure on inflation. A closer working relationship between the Treasury Department and the Bank of PNG in the coordination and implementation of fiscal and monetary policies is therefore absolutely necessary for macroeconomic stability.

With the LNG project and the associated increase in demands on domestic resources, some sectors such as the construction and transportation are stretched to near-full capacity. Thus, the Government has to be selective and prioritize new construction and maintenance projects, and concentrate its efforts on maintaining and improving the current infrastructure that have deteriorated to an unusable state in some areas.

In the foreign exchange market, the US dollar continued to depreciate against major currencies in the September quarter and beyond. This largely reflected the US dollar weakness due to the slow recovery and prospects for further quantitative easing. Since September, the US dollar has continued to depreciate, although it has regained some strength over the past month due to debt concerns in Europe. Since September, the kina has appreciated against the US dollar, reaching a high of 38.15 cents on 24th October, and settling at 37.90 cents on 13th December. The kina has been depreciating against the Australian dollar since early September, and has decreased from 38.79 cents at the end of September to 38.46 cents as at 13th December. In November, for the first time since the floating of the Kina, one Kina bought less Australian dollar than the US dollar when the Australian dollar reached just over a US dollar.

Inflation has slowed slightly as shown by the September quarter outcome of the Consumer Price Index (CPI). Consistent with the Bank’s Monetary Policy Statement (MPS) released in September 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 through the twelve months of 2010. In October, the Bank increased the Cash Reserve Ratio from 3.0 percent to 4.0 percent to offset increased liquidity. This had an immediate effect on interest rates for the Central Bank Bills (CBBs) and deposits, which increased but were still below the KFR and inflation rates. Due to the continued high level of Government spending and foreign exchange inflows, the liquidity level remained high, prompting the Central Bank to increase its issuance of CBB in October and November 2010.

The level of gross foreign exchange reserves increased from US$2,912 (K7,683) million at the end of September 2010 to US$3047.0 (K7,924.7) million as at 16th December 2010.

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

Economic indicators available to the Bank of Papua New Guinea show that the economy continues to grow but at a slower pace in the September quarter of 2010. While the value of most export commodities increased as a result of high international prices, there was a decline in the volume of many of the mineral and agriculture/forestry/fisheries exports. Government spending and credit extended to the private sector continued to grow, with the latter at a slow pace. Employment level in the private sector declined in the quarter but increased on a yearly basis. The rate of inflation eased in the September quarter compared to the previous quarter but underlying inflationary pressure still persist and is associated with increased domestic activity and demand emanating from the construction phase of the PNG LNG project. The Bank of Papua New Guinea therefore continued to take a cautious approach in its monetary policy by maintaining the policy signaling rate, the monthly Kina facility rate (KFR) at 7.0 percent throughout the September quarter of 2010.

Data from the Bank's Business Liaison Survey (BLS) show that the total nominal value of sales in the private sector increased by 2.3 percent in the June quarter of 2010, following a decrease of 2.0 percent in the March quarter. Excluding the mineral sector, sales picked up significantly by 16.1 percent in the June quarter, after dropping by 1.2 percent in the previous quarter. By sector, there were increases in all sectors, except the agriculture/forestry/fisheries and mineral sectors. By region, sales picked up in National Capital District (NCD), Momase, Highlands, Islands and Morobe regions, while the Southern region recorded a decline. Over the twelve months to June 2010, total sales increased by 15.3 percent.

The Bank's Employment Index shows that the level of employment in the formal private sector decreased by 0.4 percent in the September quarter of 2010, following an increase of 1.3 percent in the previous quarter. Excluding the mineral sector, the level of employment declined by 0.8 percent in the September quarter of 2010, after increasing by 1.2 percent in the previous quarter. By sector, employment dropped in the agriculture/forestry/ fisheries, transportation and, building and construction sectors, while the mineral, manufacturing, wholesale, retail and financial/business and other services sectors recorded increases. While it is visible that there are increased activities and employment in the transportation, and building and construction sectors, some of these changes are not captured in the Bank's employment survey as some of the companies undertaking these work are new and not covered under the survey. By region, employment fell in all regions, except the NCD and Morobe. Over the year to September 2010, the total level of employment increased by 0.5 percent, while excluding the mineral sector, there was no change.

Quarterly headline inflation, as measured by the Consumer Price Index (CPI), was 1.3 percent in the September quarter of 2010, compared to 1.6 percent in the June quarter. There were increases in all the expenditure groups except the 'Rents, council charges, fuel and power'. Annual headline inflation was 5.6 percent in the quarter, down from 6.2 percent in the June quarter. The annual rate of inflation was driven by increases in all expenditure groups except the 'Household, equipments and operations' and 'Miscellaneous' expenditure groups. By region, all urban areas recorded price increases in the quarter and over the year to the September quarter of 2010 with Lae recording the highest quarterly increase while Rabaul recorded the lowest. Annual trimmed-mean inflation was 5.7 percent in the quarter, slightly less that 5.8 percent in the previous quarter, while annual exclusion-based inflation was 5.1 percent, compared to 4.8 percent in the June quarter.

Over the September quarter of 2010, the daily average kina exchange rate appreciated against the US dollar, Pound sterling and the euro while it depreciated against the Australian dollar and Japanese yen. It appreciated against the US dollar by 1.9 percent to 0.3667, against the Pound sterling by 10.1 percent to 0.2656, and against the Euro by 0.7 percent to 0.2844, while it depreciated against the Australian dollar by 0.2 percent to 0.4071 and against the Japanese yen by 5.0 percent to 31.50. These movements resulted in the daily average Trade weighted Index (TWI) depreciating by 0.3 percent in the September quarter of 2010 to 31.8, down from 31.9 in the June quarter.

Higher international prices for all mineral and agricultural exports resulted in a 22.6 percent increase in the weighted average kina prices of exports in the September quarter of 2010, compared to the corresponding quarter of 2009. There was a 22.3 percent increase in the weighted average price of mineral exports, with higher kina prices of gold, copper and crude oil. The weighted average price of agricultural, logs and marine product exports increased by 24.0 percent and was accounted for by higher kina prices of all the agricultural commodities and logs.

There was an overall surplus of K583 million in the balance of payments for the nine months to September 2010, compared to a higher surplus of K1,338 million in the corresponding period of 2009. This outcome was due to net inflows in the capital and financial accounts, which more than offset the deficit in the current account.

The current account recorded a deficit of K427 million in the nine months to September 2010, compared to a deficit of K859 million in the corresponding period of 2009. The outcome was attributed to increase in net service payments, which more than offset trade surplus, transfer receipts and lower net income payments.

The capital and financial accounts recorded a net inflow of K1,007 million in the nine months to September 2010, compared to K2,183 million in the corresponding period of 2009.

The capital account recorded a net inflow of K83 million in the nine months to September 2010, compared to K58 million in the corresponding period of 2009. The increase reflected higher capital inflows by donor agencies for project financing.

The financial account recorded a net inflow of K924 million in the nine months to September 2010, compared to a net inflow of K2,125 million in the corresponding period of 2009. This outcome reflected net inflow from direct and other investments. The net inflow from direct investment reflected equity inflows from non-residents while the net inflow from other investments is associated with the draw downs in foreign currency account balances of mineral companies and commercial banks' net foreign assets. These more than offset net outflows from investments in short term money market and financial derivative instruments, and higher net loan repayments by the Government.

The level of gross foreign exchange reserves at the end of September 2010 was K7,628.9 (US$2,802.9) million, sufficient for 10.5 months of total and 14.3 months of non-mineral import cover.

The Bank continued to utilise its Open Market Operation (OMO) instruments, mainly Central Bank Bills (CBB) in the conduct of monetary policy over the September quarter of 2010. In addition, Government Treasury bill and Inscribed stock auctions were conducted during the quarter. The commercial banks also utilised the interbank market to meet their liquidity needs, though with less frequency given the high level of liquidity. 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.

The average level of broad money supply (M3*) increased by 0.6 percent in the September quarter of 2010, compared to a revised increase of 6.3 percent in the

June quarter. This outcome was mainly due to an increase of 3.8 percent in average net private sector credit and an increase of 1.2 percent in average net foreign assets of depository corporations. Average domestic claims outstanding, excluding advances to the Central Government increased by 3.5 percent in the September quarter of 2010, compared to a revised increase of 5.2 percent in the June quarter. The average level of monetary base (reserve money) declined by 0.9 percent in the September quarter of 2010, compared to a revised increase of 15.1 percent in the June quarter.

During the September quarter of 2010, total domestic credit extended by depository corporations to the private sector, public non-financial corporations, Provincial and Local Governments, and other financial corporations, increased by K145.2 million to K6,868.9 million, compared to a revised increase of K345.7 million in the June quarter of 2010. This was mainly due to an increase of K170.4 million to the private sector and K4.6 million to other financial corporations, which more than offset a decline of K27.8 million in loans extended to other non financial corporations.

Preliminary estimates of the fiscal operations of the National Government over the nine months to September 2010 show an overall surplus of K709.7 million, compared to a surplus of K531.6 million in the corresponding period of 2009. This represents 2.8 percent of nominal GDP.

Total revenue, including foreign grants, during the nine months to September 2010 was K5,063.8 million, 25.7 percent higher than the receipts collected in the corresponding period of 2009. This represents 67.6 percent of the budgeted revenue. The increase in revenue mainly reflected higher tax revenue and foreign grants, which more than offset lower non-tax receipts. Total expenditure during the nine months to September 2010 was K4,354.1 million, 24.5 percent higher than in the corresponding period of 2009 and represents 58.1 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 K709.7 million over the nine months to September 2010. The surplus was used to make a net external loan repayment of K139.7 million and a net negative domestic financing of K570.0 million. The net negative domestic finance comprised of K866.7 million in repayments to other depository corporations and increased Government deposits at other depository corporations and K70.8 million in cheques presented for payment.

Total public (Government) debt declined by K494.5 million to K6,475.3 million in the September quarter of 2010, compared to K6,969.8 million in the June quarter of 2010, resulting in the total debt to nominal GDP ratio decreasing to 26.0 percent from 28.0 percent between the two quarters. Both the external and domestic debts declined during the quarter.