BANK OF PAPUA NEW GUINEA

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QUARTERLY ECONOMIC BULLETIN
DECEMBER QUARTER 2009

Mr. Loi M. Bakani, Governor of the Bank of Papua New Guinea (Bank of PNG), today released the December 2009 Quarterly Economic Bulletin (QEB). This statement provides an overview of the economic and financial developments for the December 2009 quarter as well as developments since December 2009.

1. UPDATE ON DEVELOPMENTS SINCE DECEMBER 2009

The economic recovery from the world recession, beginning in the second half of 2009, gained some momentum in the first quarter of 2010, especially in major economies. The recovery was supported by improved confidence in major financial markets and a rebound in global trade, reflecting a pick-up in global demand and a consequent increase in commodity prices. Coordinated and accommodative fiscal and monetary policies were also behind the recovery. Economic activity in key advanced economies is expected to rebound in 2010, supported by high business investment and increase in consumer demand. Higher growth in emerging and developing economies, especially in China, India and some Latin American countries, are expected to contribute to the world GDP growth. However, major challenges still lie ahead as countries deal with high unemployment rates, high public debt, low net household assets and weak housing activity. The expected increase in commodity prices in 2010 should help improve the trade account of the Papua New Guinea economy.

In the foreign exchange market, the US dollar strengthened against the Japanese yen, pound sterling and euro but weakened against the Australian dollar from end of 2009 to 9th April 2010. The US dollar strengthened against the euro mainly as a result of a downturn in economic activity in the euro area, combined with high public debt for some of the euro zone member countries. The weakness in the pound sterling was mainly associated with the plunge in equity markets and high fiscal deficit, while the appreciation against the yen was mainly due to capital movements to the US, reflecting an improvement in US economic conditions. The strengthening of the Australian dollar against the US dollar was due to an increase in domestic interest rates, improved commodity prices and strong economic outlook in Australia.

Between the end of December 2009 and 9th April 2010, the daily average kina exchange rate depreciated against the Australian dollar and the Japanese yen, remained stable against the US dollar, while it appreciated against the euro and British pound. It depreciated against the Australian dollar by 13.1 percent to A$0.4043 and by 1.8 percent against the yen to 33.37, while it remained relatively stable at U$0.3600 against the US dollar. Against the pound sterling, it appreciated by 1.1 percent to 0.2355 sterling and by 1.7 percent to 0.2657 euro. These movements resulted in the daily average TWI depreciating by 7.0 percent to 31.78 over this period.

An easing in the annual headline inflation from 10.2 percent in March quarter to 5.3 percent in the September quarter 2009, prompted the Bank of PNG to ease monetary policy for the month of December 2009. The policy signaling interest rate, the Kina Facility Rate (KFR) was reduced by 1.0 percent to 7.0 percent. Since then, the KFR rate has been kept unchanged to April 2010 in view of inflationary pressures. The Bank projects inflation to be around 8.0 percent in

2010. The upside risks to inflation could come from a weaker kina, increased economic activity and thus increased domestic demand pressures associated with the commencement of construction for the LNG project, high imported inflation, increased wage pressures and excessive Government spending. The Central Bank will closely monitor these developments and adjust its monetary policy stance where necessary to contain inflation.

In 2009, the Bank continuously warned the Government about the impact of its fast drawdown of trust accounts on total liquidity, interest rates, inflation, and cost of monetary policy management. The fast drawdown occurred in spite of an understanding between the Bank and the Government to move trust account funds from commercial banks to the Central Bank for prudent macroeconomic policy management. Consequently, total liquidity in the banking system increased significantly by K1,596.3 million over the twelve months to end December 2009 and the Bank had to issue new Central Bank Bills totaling K1,567 million at an interest rate cost of K90 million, to diffuse excess liquidity. Reflecting the high liquidity, the 28 day Central Bank Bill (CBB) rate has declined to a range of 4.0 to 5.0 percent in the first quarter of 2010 from 6.0 to 6.5 percent in the December quarter of 2009. Credit to the private sector continued to grow, but at a slower pace.

The level of gross foreign exchange reserves decreased to K6,448.3 (U$ 2,424.6) million as at 16th April 2010, from K6,553.1 (U$2,457.4) million as at the end of December 2009. This is mainly due to the selling of foreign currency by BPNG to meet the demand for it and support the exchange rate.

2. OVER VIEW OF THE DEVELOPMENTS IN THE DECEMBER QUARTER OF 2009

Economic indicators available to the Bank of Papua New Guinea show that the domestic economy grew at a lower pace in 2009, compared to 2008. Lower global demand, as result of the world recession, led to significant falls in the international prices of most primary commodities. This adversely affected exports of PNG's major commodities, with significant falls in both volumes and prices, resulting in lower export earnings for the mineral and the agriculture/forestry/fisheries sectors. Consequently, the current account recorded a large deficit. However, significant inflows in the capital and financial accounts more than offset the current account deficit, yielding an overall balance of payments surplus. After a low pace in the first half of the year, growth in the private sector activity picked up in the second half of 2009, with significant growth in the building and construction, financial/business and other services, retail and transportation sectors. This was also supported by an increase in private sector lending from the commercial banks under a low interest rate environment. Increased spending by the Government also contributed to the growth in the economy.

Evidence of growth also came from the increase in quarterly aggregate employment and business sales for the December and September quarters of 2009, respectively. Annual headline inflation rate eased to 5.7 percent in 2009 from 11.2 percent in 2008, mainly reflecting lower international prices of fuel and food, low foreign inflation, and the appreciation of the kina, especially against the Australian dollar. The Trade Weighted Exchange Rate Index (TWI) appreciated by 1.3 percent during the year. Given the high inflation in the early part of 2009, the Bank maintained a tight stance of monetary policy throughout the year until December when the policy signaling rate, the monthly Kina Facility Rate (KFR), was reduced from 8.0 percent to 7.0 percent. The reduction follows the easing in inflation rate.

Data from the Bank's Business Liaison Survey (BLS) show that the total nominal value of sales in the private sector increased by 3.4 percent in the September quarter of 2009, compared to an increase of 9.1 percent in the June quarter. Excluding the mineral sector, sales increased by 11.5 percent in the September quarter, following an increase of 4.9 percent in the previous quarter. By sector, all sectors recorded increases, except the mineral and transportation sectors. By region, all regions recorded increases, except the Islands and Highlands regions. Over the twelve months to September 2009, total sales declined by 15.8 percent.

The Bank's Employment Index show that the level of employment in the formal private sector increased by 0.7 percent in the December quarter of 2009, compared to an increase of 0.6 percent in the September quarter. The change in employment level in the mineral sector was negligible so that when excluding the mineral sector, the level of employment increased by 0.7 percent in the December quarter of 2009, compared to an increase of 0.6 percent in the previous quarter. By sector, the level of employment increased in all sectors, except the financial/business and other services sector. By region, all regions recorded increases, except the Momase and the Highlands regions. Over the year to December 2009, the level of employment increased by 4.2 percent, compared to 3.8 percent over the year to September 2009. Excluding the mineral sector, the level of employment increased by 5.0 percent over the year to December 2009, compared to 4.0 percent over the year to September.

Quarterly headline inflation, as measured by the Consumer Price Index (CPI), was 1.2 percent in the December quarter of 2009, compared to 1.8 percent in the September quarter. The increases were in all expenditure groups, except the 'household equipment & operations expenditure' group, with the largest increases recorded in the 'Rents, council charges, fuel and power' and 'Transport and communication' expenditure groups, which mainly reflected an increase in fuel prices. By region, all urban areas recorded increases, except Lae. The quarterly exclusion-based and trimmed-mean inflation recorded increases of 0.8 percent and 1.2 percent, respectively, in the December quarter of 2009, compared to an increase of 0.9 and 1.4 percent, respectively, in the previous quarter.

Over 2009, the daily average kina exchange rate appreciated against all major currencies, except the US dollar and Japanese yen. It appreciated against the Australian dollar by 4.54 percent to A$0.4652, pound sterling by 15.08 percent to 0.2331 sterling, euro by 3.25 percent to 0.2613 euro, while it depreciated against the US dollar by 1.9 percent to US$0.3639 and Japanese yen by 11.26 percent to 34.00 yen. These movements resulted in the daily average TWI appreciating by 1.3 percent during the year.

Lower kina prices of most of the mineral and agricultural export commodities reflected lower international prices in the first nine months of 2009, which more than offset the depreciation of the kina against the US dollar in 2009. The weighted average kina price of Papua New Guinea's exports declined by 14.4 percent in 2009, relative to 2008. There was a decline of 14.5 percent in the weighted average kina price of mineral exports, with lower kina prices of copper and crude oil exports. For agricultural, logs and marine product exports, the weighted average kina price decline by 13.8 percent. This was accounted for by lower prices of coffee, cocoa, palm oil, copra, copra oil and rubber exports.

There was an overall surplus in the balance of payments of K1, 728 million in 2009, compared to a deficit of K598 million in 2008. This outcome was due to a surplus in the capital and financial accounts, which more than offset a deficit in the current account.

The trade account recorded a surplus of K4, 158 million in 2009, a decline of 42.2 per cent from 2008. The lower surplus was due to a significant decline in the value of merchandise exports, reflecting the decline in international prices and the consequent lower export volumes. This more than offset a decline in the value of merchandise imports.

The capital account recorded a net inflow of K74 million in 2009, compared to K67 million in 2008, reflecting higher transfers by donor agencies through direct project financing for capital projects such as roads and buildings (regarded in balance of payments as acquisition of fixed assets).

The financial account recorded a net inflow of K2, 989 million in 2009, compared to a net outflow of K2,863 million in 2008. This outcome was due to net inflows from direct investments, mainly from share placements by a resident mineral company to raise capital for on-going operation and capital related expenditure, drawdown from investments in short-term money market and financial derivative instruments, and from other investments.

The level of gross foreign exchange reserves at the end of December 2009 was K6,553.1 (US$2,457.4) million, sufficient for 10.1 months of total and 15.3 months of non-mineral import covers.

The Bank of Papua New Guinea eased its monetary policy stance in the month of December 2009, prompted by lower inflation outcome, by reducing the Kina Facility Rate (KFR) from 8.00 percent to 7.00 percent. The dealing margin for the Repurchase Agreements (Repos) was maintained at 100 basis points on both sides of the KFR. Domestic interest rates for short-term securities decreased across all maturities to December 2009 reflecting excess liquidity in the banking system.

There was a decline in Treasury bill auction in 2009 due to the Government's positive cash flow position, prompting the Central Bank to diffuse excess liquidity mainly through issuance of additional CBBs and occasional use of Reverse Repos. Trading in the inter-bank market was low in 2009 due to the high level of liquidity in the banking system.

The average level of broad money supply (M3*) increased by 11.0 percent in 2009, compared to an increase of 26.4 percent in 2008. This outcome was due to an increase of 23.2 percent in average net private sector credit, an increase of

4.5 percent in average net foreign assets of depository corporations, and an increase of 20.8 percent in average net credit to public non financial corporations. Net domestic claims outstanding, excluding advances to the Central Government and outstanding loans under the Government's Agricultural export commodity support schemes increased by 17.5 percent in 2009, compared to an increase of 39.2 percent in 2008.

In 2009, 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 K946.0 million to K6,562.0 million, compared to an increase of K1,566.7 million in 2008. This was due to an increase in private sector credit of K954.4 million, advanced to most sectors, including building and construction, transport and communication, commerce, hotels and restaurants, real estate and other business sectors.

Preliminary estimates of the fiscal operations of the National Government for 2009 show an overall deficit of K36.3 million in 2009, compared to a deficit of K478.5 million in 2008. This represents 0.2 percent of nominal GDP. The deficit could have been higher if the K521 million drawdown from trust accounts was not recorded again as revenue.

Total revenue, including foreign grants, was K6,651.3 million in 2009, 6.0 percent lower than in 2008. This represents 100.2 percent of the revised Budget. The decline in revenue mainly reflected lower direct tax receipts, especially company tax, associated with lower international commodity prices, which more than offset an increase in non-tax revenue.

Total expenditure in 2009 was K6,687.6 million, 11.4 percent lower than in 2008 and represented 99.4 percent of the revised Budget. This outcome was due to lower capital expenditure, mainly accounted for by no additional priority expenditure in 2009, which more than offset an increase in recurrent expenditure.

A significant increase in personnel emoluments and interest payments contributed to the higher recurrent expenditure.

The deficit, combined with net external loan repayments totaling K110.1 million were financed by K146.5 million from domestic sources, mainly through the issuance of domestic Government securities.