



BANK OF PAPUA NEW GUINEA

MEDIA R E L E A S E

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Quarterly Economic Bulletin June Quarter 2015

Mr Loi M. Bakani CMG, Governor of the Bank of Papua New Guinea (Bank of PNG), today released the June 2015 Quarterly Economic Bulletin (QEB). This statement provides an overview of the economic and financial developments during the June quarter of 2015 and some key developments since then.

1. UPDATE ON DEVELOPMENTS SINCE JUNE 2015

In its October *World Economic Outlook (WEO) Update*, the International Monetary Fund (IMF) revised downwards its 2015 global growth forecast to 3.1 percent, 0.2 percentage points lower than its July 2015 forecast. The revision takes into account varying growth prospects across the key countries and main regions. Downside risks have risen as the persistent declining commodity prices resulted in reduced capital flows into the emerging market economies. This is putting downward pressure on their currencies and increasing financial market volatility. Growth in the advanced economies is expected to be driven by a strengthening recovery in the euro area and the return to positive growth in Japan. Growth in the United States (US) is forecast to

be 2.5 percent in 2015 as a result of wage growth, improved labour market conditions, easing financial market conditions, lower fuel prices and a strengthening housing market. The United Kingdom's (UK) growth is revised downwards to 2.4 percent, mainly affected by the drop in manufacturing output. The economic recovery in the euro area is on track, with growth projections for many euro area economies revised upwards and inflation increasing. Growth for Japan is expected to be modest in 2015, with weaker underlying momentum in real wages and consumption. Growth prospects in the emerging markets are expected to weaken in 2015 for a fifth year in a row. This reflects slower growth in oil exporting countries, the slowdown in China, a weaker outlook for exporters of other commodities, including Latin American countries, following declines in other commodity prices.

Governor Bakani noted that the global commodity prices continue to decline and commodity stocks have fallen on account of weaker demand from China. This has implications for export-dependent economies whose currencies depreciate in response to weakening commodity prices. He explained that PNG is going through a similar experience with the kina depreciating in line with declining international commodity prices and, stressed that this is an expected development until such time when the global economic activity strengthens and international commodity prices improve. International commodity prices of PNG's exports such as log and marine products, coffee, copra, palm oil and tea declined in the second quarter of 2015. Key global commodity prices of crude oil, natural gas, agriculture commodities and metals all declined in the first half of 2015.

The Governor noted that the lower commodity prices have affected government revenue and the National Government has undertaken revisions to its expenditure by cutting down on non-priority expenditure items while maintaining expenditures for priority projects in health, education, and transport infrastructure areas. Efforts are also made to raise additional revenue through rigorous tax collection by the Internal Revenue Commission. A Supplementary Budget capturing these revisions will be introduced in the current session of Parliament, and aims to keep the budget deficit close to the original deficit of 4.4 percent of GDP. The Governor stated that it would have been more prudent for the Government to aim for a budget deficit lower than

the original budget given the magnitude of revenue decline and temporary downgrade in country rating by Standard & Poor's rating agency.

Weak global trade is keeping global inflation low throughout the first half of 2015 on account of lower oil and food prices and investment in the emerging and developing economies with no prospect for improvement in the immediate future. However, the risks continue to be the appreciation of US dollar and major currencies due to improved economic activities of the advanced economies. The Governor explained that lower international oil and food prices have fed through to domestic prices offsetting the pressures from the depreciation of the kina. The June quarter headline inflation was 5.7 percent. Headline inflation for 2015 is forecast to be 6.0 percent.

Private sector credit has increased by 3.3 percent over the year to August compared to a decline in July. The Governor emphasised that this growth is encouraging, though it is weaker than the level which PNG has been experiencing over the last couple of years. It is indicative of a slowdown in economic activity, consistent with the latest key economic indicators.

The situation regarding the shortage of foreign currency and the backlog of unfilled foreign currency orders continues to be addressed by the Bank and authorised Foreign Exchange Dealers. The Governor explained that the Bank is monitoring the excess sell kina orders and doing all it can to support the market. The Bank continues to provide temporary relief through its intervention of foreign currency to meet the short-term import needs. It is also ascertaining market participants' compliance with the current regulations and the usage of onshore foreign currency accounts having commissioned an audit on the opening and operations of onshore foreign currency account activities by residents and transactions through the vostro accounts of foreign banks.

The Governor continues to stress that the situation in the foreign exchange market has prevailed for a long period now and some adjustments in the economy should have taken place. This includes importers either reducing imports or seeking alternative source of imports, and exporters taking advantage of the depreciation of kina on their incomes. Such adjustment due are necessary for the foreign exchange

market to return to normalcy. He added that there should not be heavy reliance on the central bank for foreign exchange. Some companies that have funds in their foreign currency accounts should use these funds, and not accumulate them at this time.

In the June quarter of 2015, the average daily kina exchange rate declined against most currencies. As of 30th September, it had depreciated against the pound sterling by 4.1 percent to 0.2299, the US dollar by 2.9 percent to 0.3488, the Japanese yen by 2.2 percent to 41.81 and euro by 2.6 percent to 0.3103. It appreciated against the Australian dollar by 4.0 percent to 0.4971. These movements resulted in the depreciation of the daily average trade weighted index by 0.96 percent to 35.72.

The level of gross foreign exchange reserves at the end of June 2015 was K5, 592.3 (US\$2,059.5) million, sufficient for 9.8 months of total and 15.2 months of non-mineral import covers. The latest level of gross foreign exchange reserves as at 26th October 2015 was K5,798.0 (US\$2,023.5) million.

2. OVERVIEW OF THE DEVELOPMENTS IN THE JUNE QUARTER OF 2015

Governor Bakani mentioned that economic indicators available to the Bank of Papua New Guinea (the Bank) show signs of weakening growth in economic activity in the second quarter of 2015, reflecting both domestic and international developments. Employment growth in the second quarter was lower than a year ago, although there was some improvement due to seasonal factors. International commodity prices remained depressed, affecting exports from both mineral and non-mineral sectors of the economy. The effect of the low international commodity prices more than offset the effect of the kina depreciation on kina prices of Papua New Guinea's exports, and resulted in the annual weighted average kina price of all exports declining in the June quarter. Annual headline inflation eased to 5.7 percent in June 2015 from 6.1 percent in the March quarter, accounted for by low foreign inflation and international oil prices, despite the depreciation of the kina. The Bank continued to take a cautious approach by keeping the Kina Facility Rate, the policy signalling rate, at 6.25 percent.

Data from the Bank's Business Liaison Survey (BLS) show that the total nominal value of sales in the private sector declined by 7.6 percent in the March quarter of 2015, compared to an increase of 0.5 percent in the December quarter of 2014. Excluding the mineral sector, sales declined by 5.1 percent, following a decline of 0.8 percent in the previous quarter. By sector, sales declined in the wholesale, manufacturing, retail, mineral and the transportation sectors, while they increased in the agriculture/forestry/ fisheries, financial/ business and other services, and the construction sector. By region, sales declined in the Southern, Momase, Highlands and Morobe, whilst they increased in NCD and the Islands. Over the year to March 2015, the total value of sales increased by 3.7 percent, while excluding the mineral sector, sales declined by 5.7 percent.

The Bank's Employment Index shows that the total level of employment in the private sector increased by 1.5 percent in the second quarter of 2015, compared to 1.3 percent in the March quarter. Excluding the mineral sector, the level of employment increased by 1.4 percent, reflecting a seasonal increase in the agriculture/forestry/fisheries sector and some improvement in the retail sector. The level of employment in all other sectors of the economy declined in the quarter. By region, the level of employment increased in the Islands and the Southern regions, which more than offset declines in Morobe, Highlands, NCD and Momase. Over the year to June 2015, the total level of employment declined by 1.1 percent, while excluding the mineral sector, it declined by 1.4 percent.

The Governor noted that quarterly headline inflation, as measured by the Consumer Price Index (CPI), increased by 1.1 percent in the June quarter of 2015, compared to an increase of 1.5 percent in the March quarter. Most expenditure groups recorded price increases which more than offset declines in the 'Transportation', 'Health' and the 'Miscellaneous' expenditure groups. There was no change in the 'Communication' and 'Education' expenditure groups. Prices rose in all urban centres, except for Goroka/Mt Hagen/Madang. The annual headline inflation to June 2015 was 5.7 percent, compared to 6.1 percent in the March quarter.

During the June quarter of 2015, the average daily kina exchange rate depreciated against all the major currencies. It depreciated against the pound sterling by 3.9

percent to 0.2410, US dollar by 2.9 percent to 0.3692, the Australian dollar by 1.7 percent to 0.4746, the yen by 1.1 percent to 44.7723, and the euro by 0.9 percent to 0.3341. These movements resulted in the depreciation of the daily average trade weighted index by 1.7 percent to 35.67.

The weighted average kina price of Papua New Guinea's exports, excluding LNG, declined by 13.7 percent in the June quarter of 2015, compared to the corresponding quarter of 2014. There was a decline of 13.3 percent in the weighted average kina price of mineral exports with lower kina prices mainly for crude oil, nickel and condensate. For agricultural, logs and marine product exports, the weighted average kina price declined by 15.2 percent due to lower prices for coffee, copra, palm oil, tea, rubber, logs and marine products. Excluding logs, the weighted average kina price of agricultural and marine product exports declined by 16.8 percent in the June quarter of 2015, compared to the corresponding quarter of 2014. The lower kina export prices stemmed from lower international commodity prices for most commodities.

The Governor mentioned that there was an overall deficit of K388 million in the balance of payments for the first six months of 2015, compared to a deficit of K16 million in the corresponding period of 2014. There was a significant deficit in the capital and financial account, which more than offset a surplus in the current account.

The surplus in the current account was due to a higher trade surplus, combined with lower service payments and higher transfer receipts. The deficit in the capital and financial account mainly reflected the build-up in the net foreign assets of the domestic banking system, foreign currency account balances of resident mineral sector companies, and net Government and private sector loan repayments.

The level of gross foreign exchange reserves at the end of June 2015 was K5,592.3 (US\$2,059.5) million, sufficient for 9.8 months of total and 15.2 months of non-mineral import covers.

The Governor stated that the Central Bank considered the inflation outcomes in the first two quarters as manageable and therefore maintained its neutral stance of monetary policy by keeping the Kina Facility Rate at 6.25 percent during the June quarter of 2015. It will continue to monitor the impact of Government spending, developments in the foreign exchange market, and inflation and stands ready to change its monetary policy stance should conditions warrant doing so.

The average level of broad money supply (M3*) increased by 1.2 percent in the June quarter of 2015, compared to an increase of 1.9 percent in the March quarter of 2015. This outcome was mainly influenced by an increase in average net claims on the Central Government, reflecting increased issuance of securities for budget financing. The average net domestic claims outstanding, excluding net claims on the Central Government, increased by 0.6 percent in the June quarter of 2015, following an increase of 3.0 percent in the March quarter of 2015. The average level of monetary base (reserve money) decreased by 1.7 percent in the June quarter of 2015, following a decline of 1.1 percent in the previous quarter. This reflected declines in commercial banks' deposits at the Central Bank and currency in circulation.

The average level of deposits in other depository corporations (ODCs) increased by 1.7 percent to K20,273.9 million in the June quarter of 2015, from K19,930.7 million in the previous quarter. This reflected an increase in deposits of the private sector, Government and public nonfinancial corporations.

The net foreign assets (NFA) of financial corporations, comprising depository corporations (DCs) and other financial corporations (OFCs), increased by 2.3 percent to K8,446.6 million in the June quarter of 2015, compared to an increase of 0.9 percent in the March quarter of 2015. This was mainly due to gains from short term investments overseas and revaluation gains from the depreciation of the kina. The NFA of the Central Bank declined, reflecting its interventions (sale of US dollar) in the foreign exchange market to assist in meeting the high demand for foreign currency by importers, which continued to put downward pressure on the kina exchange rate. The intervention also eased the pace of the exchange rate depreciation. Net claims on the Central Government increased by K650.9 million to

K7,943.9 million in the June quarter of 2015, compared to an increase of K553.8 million in the previous quarter. This resulted from increased issuance of securities for financing of the budget deficit.

In the June quarter of 2015, total domestic credit extended by financial corporations to the private sector, public non-financial corporations and 'Provincial and Local level Governments' increased by K274.2 million to K14,710.4 million, compared to an increase of K4.3 million in the previous quarter. This was mainly due to an increase of K328.1 million in credit to the private sector, while claims on public non-financial corporations declined by K53.1 million. The increase in credit to the private sector reflected advances by the ODCs to the manufacturing, construction, transport and communications, government, mining and quarrying and the real estate, renting and business service sectors, for purposes that include business expansion. The annualised growth in domestic credit, excluding Central Government, was 12.0 percent in the June quarter of 2015, lower than 15.1 percent recorded in the March quarter.

The Governor noted that the preliminary estimates of the fiscal operations of the National Government over the six months to June 2015 showed an overall deficit of K942.0 million, compared to a deficit of K563.6 million in the corresponding period of 2014. This represents 1.8 percent of nominal GDP, and reflected lower revenue and higher expenditure.

Total revenue, including foreign grants, during the June quarter of 2015 was K4,434.9 million, 6.1 percent lower than in the corresponding period of 2014. This represents 31.8 percent of the budgeted revenue for 2015. The decrease in revenue mainly reflected lower direct and indirect tax receipts, more than offsetting increases in non-tax receipts and foreign grant inflows.

Total expenditure over the six months to June 2015 was K5,376.9 million, 1.7 percent higher than in the corresponding period of 2014 and represents 33.2 percent of the budgeted appropriation for 2015. This outcome reflected higher recurrent and development expenditures, especially on the 2015 Pacific Games sporting facilities and major road infrastructure projects.

The budget deficit of K942.0 million was financed from net external sources of K121.6 million and domestic financing of K820.4 million. External loan financing comprised of K143.9 million from concessional sources, which more than offset repayment of K22.3 million to extraordinary sources. The domestic financing comprised of net purchases of Government securities totalling K575.6 million and K369.4 million by the ODCs and OFCs, respectively, combined with K159.8 million in cheques presented for encashment. These more than offset K284.3 million in net Government deposits at the Central Bank.

Total public (Government) debt outstanding in the June quarter of 2015 was K17,243.7 million, K1,888.1 million higher than in the December quarter of 2014. Both domestic and external loans increased. The increase in domestic debt resulted from net new issuance of Treasury bills and Inscribed stock, while the increase in external debt mainly reflected the drawdown of concessional loans.

The total amount of Government deposits in the depository corporations decreased to K4,075.3 million in June 2015, from K4,165.9 million in the March quarter of 2015.