BANK OF PAPUA NEW GUINEA

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QUARTERLY ECONOMIC BULLETIN
SEPTEMBER QUARTER 2011

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

1. UPDATE ON DEVELOPMENTS SINCE SEPTEMBER 2011

A few developments have prompted the International Monetary Fund (IMF) to revise downwards its forecast on economic growth for 2011. Its latest forecast, made in September 2011, is for the global economy to grow by 4.0 percent in 2011, compared to the 4.3 percent projected in June 2011. First, the economic recovery in the advanced economies, especially in the United States, has been slow and sluggish with unemployment still remaining high. Second, the fiscal and financial instability arising from the sovereign debt crisis in the Euro zone and debt burden of Organization for Economic Co-operation and Development (OECD) countries had distinctly increased in the September quarter. Third, Japan's poor recovery from the recession has been compounded by the adverse impact of the earthquake and tsunami disaster. Fourth, the civil unrest in the Middle East and North Africa (MENA) region, and a surge in international oil prices is disrupting trade and business activities and adding to input costs for oil importing countries.

On the other hand, growth in Asia is expected to remain high, mainly due to strong domestic demand. Asia's growth is expected to reach 6.7 percent in 2011, led by China and India with economic growth forecasted at 9.5 percent and 7.8 percent, respectively.

With the envisaged slowdown in economic growth, global demand for primary commodities is expected to decline, prompting the IMF to revise downwards its outlook for global commodity prices. Governor Bakani noted that this can affect the Government's revenue for the last quarter of 2011 and 2012.   As of 12 December 2011, the price of gold fell to US$1,712.90 per ounce after a week high of US$1,739.8 while copper traded at US$7,800.25 per metric tonne as the market reacted to the outcomes of the European Union (EU) summit held in Brussels, Belgium on the Euro debt crises on the 9 December. The outcome of the Organization of the Petroleum Exporting Countries (OPEC) meeting on the 14 December 2011 will also influence oil prices as they consider sanctioning Iran over its nuclear production program besides endorsing a production quarter for Libya. International crude oil traded at US$99.34 per barrel on the 12 December 2011, compared to US$100.2 per barrel in the previous week.

The IMF projects inflation in the advanced economies and some of the emerging economies to ease towards the end of the year as a result of the low global demand. International food prices have continued to ease since September 2011 with the FAO Food Price Index (FFPI) averaging 215 points in November compared to 225 points in September.   These developments will ease global inflation. On this basis, Governor Bakani stated that while Government spending and domestic demand pressures associated with the PNG LNG project can exert upward pressure on inflation, the recent easing in international food prices, the appreciation in the TWI and the drop in fuel related products can have an offsetting effect on inflation for the December quarter.   The Bank therefore took a cautious approach and maintained the Kina Facility Rate (KFR) for the months of October, November and December at 7.75 percent.

The Governor noted with concern that the Treasury Minister's directive for the transfer of funds from trust accounts held at commercial bank to the Bank of BPNG has not been implemented by the Departments concerned. This is one of the main sources of increased liquidity in the banking system, and is making it difficult and costly for conduct of monetary policy by the Bank.

Mr. Bakani also commended the progress made on the legislation process for the establishment of the Sovereign Wealth Fund for better fiscal management of the windfall revenue from the development of the country's mineral resources. He repeated his call for the Government to allow the Central Bank to open and manage an offshore account for any windfall revenue from commodity exports for better liquidity management.

The kina continued to appreciate against the US dollar, supported by high foreign exchange inflows associated with the mineral tax receipts for the Government and the high commodity export earnings. Since September, the kina has appreciated against the US dollar by 4.0 percent while it appreciated against the Australian dollar by 8.0 percent. By the 7th of December 2011, the Kina was trading at 0.4620 against the US dollar and 0.4499 against the Australian dollar.

The level of gross foreign exchange reserves increased from K8,596.6 million (US$3,855.5 million) at the end of September to K9,267.0 million (US$4337.0 million) as at 20th December 2011, attributable to high export prices and continued mineral tax inflows for the Government.

1. OVERVIEW OF THE DEVELOPMENTS IN THE SEPTEMBER QUARTER OF 2011

Economic indicators available to the Bank of Papua New Guinea (the Bank) point to a slow-down in economic growth in the September quarter of 2011, compared to the previous quarter, but on an annual basis, economic activity continued to be strong. The level of employment declined marginally by 0.2 percent in the September quarter of 2011, while it increased by 7.3 percent on an annual basis. High export commodity prices and the subsequent surplus in the current account, continued increase in business activity in some sectors and credit growth in the private sector are all indicative of the robustness in economic growth. The annual headline inflation was 8.4 percent in the September quarter of 2011, lower than the 9.6 percent in the June quarter, attributable to the appreciation of the kina and its offsetting effect on the prices of imports. The kina appreciated against all major currencies in the June quarter and resulted in the daily average Trade Weighted Index (TWI) appreciating by 6.9 percent. In light of the inflation outcome in the June quarter (before the September quarter inflation outcome was released) and continued underlying inflationary pressures , the Bank tightened monetary policy in the September quarter of 2011. The Kina Facility Rate (KFR) was increased by 25 basis points each in July and September to reach 7.75 percent. Operationally, the Bank also increased the commercial banks' Cash Reserve Requirement (CRR) by 100 basis points each in July and August 2011 to 6.0 percent, in support of the tightening stance.

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 June quarter of 2011, compared to a decline of 0.5 percent in the March quarter. Excluding the mineral sector, sales increased by 6.8 percent in the June quarter of 2011, compared to a decline of 4.0 percent in the previous quarter. Sales declined in the agriculture/forestry/fisheries and mineral sectors, which more than offset the increases in the building and construction, wholesale, retail, transportation, manufacturing and financial/business and other services sectors. By region, Southern and Islands recorded declines, while the Highlands, National Capital District (NCD), Morobe and Momase regions recorded increases. Over the twelve months to June 2011, total sales increased by 8.3 percent. Excluding the mineral sector, sales increased by 8.9 percent over the year to September 2011.

The Bank's Employment Index shows that the level of employment in the private sector declined by 0.2 percent in the September quarter of 2011, compared to an increase of 3.0 percent in the previous quarter. Excluding the mineral sector, the level of employment declined marginally in the September quarter, following an increase of 3.2 percent in the June quarter. By sector, the level of employment declined in the transportation, mineral, financial/business and other services and agriculture/forestry/fisheries sectors, while it increased in the manufacturing, retail, wholesale and building and construction sectors. By region, Islands, Momase and NCD recorded declines, while Morobe, Southern and Highlands recorded increases. Over the twelve months to September 2011, the total level of employment increased by 7.3 percent. Excluding the mineral sector, the level of employment increased by 7.5 percent over the year to September 2011.

Quarterly headline inflation, as measured by the Consumer Price Index (CPI) was 0.2 percent in the September quarter of 2011, compared to 2.2 percent in the June quarter. The increases in the ‘Food’, ‘Clothing & footwear’, ‘Household equipment and operations’ and ‘Miscellaneous’ expenditure groups, more than offset the declines in the other expenditure groups. Annual headline inflation was 8.4 percent in the September quarter of 2011, lower than 9.6 percent in the June quarter. The lower outcome was due to the fall in imported prices combined with the strengthening of the kina exchange rate against most of the currencies of PNG’s major trading partners. However, inflationary pressures remained due to increase in domestic demand associated with high Government expenditure, construction of the LNG project and strong private sector activity. The annual underlying inflation as indicated by the exclusion-based inflation rate was 8.4 percent in the September quarter, while the trimmed-mean inflation rate was 6.4 percent in the quarter.

In the September quarter of 2011, the daily average kina exchange rate appreciated against all the major currencies reflecting foreign currency inflows associated with exports and PNG LNG project. It appreciated against the US dollar by 7.0 percent to 0.4465, pound sterling by 8.5 percent to 0.2865, euro by 9.1 percent to 0.3299, Australian dollar by 8.4 percent to 0.4575 and the Japanese yen by 2.7 percent to 34.19, compared to the June quarter. These movements resulted in the daily average TWI appreciating by 6.9 percent to 33.7 over the same period.

Higher international prices for most of PNG’s export commodities, resulted in a 15.2 percent increase in the weighted average kina prices in the September quarter of 2011, compared to the corresponding quarter of 2010. There was a 16.3 percent increase in the weighted average price of mineral exports, with higher prices of gold, copper and crude oil. The weighted average price of non-mineral exports increased by 12.1 percent as a result of higher prices of all the agricultural commodities, with the exception of cocoa, tea, logs and marine products.

There was an overall surplus of K426 million in the balance of payments for the nine months to September 2011, compared to a higher surplus of K524 million in the corresponding period of 2010. This outcome was due to a surplus in the current account, which more than offset a net outflow in the capital and financial accounts.

The current account recorded a surplus of K494 million in the nine months to September 2011, compared to a deficit of K893 million in the corresponding period of 2010. This outcome was attributed to a higher trade surplus, lower net service payments and higher transfer receipts, which more than offset higher net income payments.

The capital and financial accounts recorded a net outflow of K83 million in the nine months to September 2011, compared to a net inflow of K1, 630 million in the corresponding period of 2010.

The capital account recorded a lower net inflow of K63 million in the nine months to September 2011, compared to K83 million in the corresponding period of 2010. The decline reflected lower capital inflows by a donor agency for project financing.

The financial account recorded a net outflow of K146 million in the nine months to September 2011, compared to a net inflow of K1, 547 million in the corresponding period of 2010. This outcome reflected net outflows from foreign direct investments associated with the purchase of shares by a resident mining company, investments in short-term money market and financial derivative instruments by resident entities. These more than offset a net inflow from other investments, resulting from draw downs in foreign currency account balances of mineral companies and commercial banks' net foreign assets.

The level of gross foreign exchange reserves at the end of September 2011 was K8, 596.6 (US$3,855.5) million, sufficient for 10.4 months of total and 14.9 months of non-mineral import cover.

The Bank of Papua New Guinea tightened monetary policy in the September quarter of 2011, by increasing the KFR twice by 25 basis points each in July and August to 7.75 percent from 7.25 percent in the June quarter. This was in response to high inflation outcomes and expectations arising from strong domestic demand associated with LNG related activities, Government spending and high international commodity prices. The dealing margin for the Repurchase Agreements (Repos) was maintained at 100 basis points on both sides of the KFR during the quarter.

To support the tightening stance of monetary policy and assist diffuse excess liquidity, the CRR of the commercial banks was increased twice by 100 basis points each in July and August to 6.0 percent. Domestic interest rates for short-term securities and wholesale deposits showed mixed trends. Interest rates declined for Central Bank Bills (CBB) and Treasury bill, while large term deposit rates increased between end of June and September 2011.

The Bank continued to use its Open Market Operation (OMO) instruments in the conduct of monetary policy over the September quarter of 2011. There was limited Treasury bills auction during the quarter due to the Government's positive cash flow position. Liquidity in the banking system remained high and was partly diffused through the issuance of CBBs. There was active trading in the inter-bank market as a result of the uneven distribution of liquidity in the banking system.

The average level of broad money supply (M3*) increased by 4.1 percent in the September quarter of 2011, compared to an increase of 7.8 percent in the June quarter. This outcome was due to an increase of 6.7 percent in average net foreign assets of depository corporations and an increase of 1.4 percent in average net private sector credit. Average net domestic claims outstanding, excluding net claims on the Central Government, increased by 1.1 percent in the September quarter of 2011, compared to an increase of 2.5 percent in the June quarter. The average level of monetary base (reserve money) grew by 17.6 percent in the September quarter of 2011, compared to an increase of 3.5 percent in the June quarter.

The net foreign assets of the financial corporations (FCs) declined by 1.0 percent in the September quarter of 2011, compared to an increase of 1.2 percent in the June quarter, following an increase in holdings by depository corporations (DCs) and other financial corporations (OFCs). Net claims on the Central Government declined by 43.8 percent in the September quarter of 2011, compared to an increase of 7.7 percent in the previous quarter. This was due to an increase in Central Government deposits, mainly in trust accounts.

In the September 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 K346.9 million to K9,195.6 million, compared to an increase of K187.1 million in the June quarter of 2011. This was mainly due to an increase of K290.2 million to public non-financial corporations and K56.6 million in private sector credit. The growth in private sector credit reflected advances to the manufacturing, transport and communication, agriculture, Government and other business services sectors, as well as the household sector for housing advances. The increase in lending is partly attributed to demand associated with the construction of the PNG LNG project. The annualized growth in domestic credit, excluding Central Government was 15.8 percent in September 2011.

Preliminary estimates of the fiscal operations of the National Government over the nine months to September 2011 showed an overall surplus of K366.3 million, compared to a surplus of K709.6 million in the corresponding period of 2010. This represents 1.3 percent of nominal GDP. The surplus reflected higher revenue, which more than offset an increase in expenditure.

Total revenue, including foreign grants, over the nine months to September 2011 was K5, 376.4 million, 6.2 percent higher than the receipts collected in the corresponding period of 2010. This represents 57.6 percent of the budgeted revenue for 2011. The increase in revenue mainly reflected higher tax revenue, which more than offset lower non-tax receipts and foreign grants. Total expenditure over the nine months to September 2011 was K5, 010.1 million, 15.1 percent higher than in the corresponding period of 2010 and represents 53.7 percent of the budget appropriation for 2011. This outcome reflected increases in recurrent expenditure, which more than offset a decline in development expenditure.

As a result of the developments in revenue and expenditure, the Government recorded an overall budget surplus of K366.3 million in the nine months to September 2011. The surplus was used to make a net external loan repayment of K129.9 million and net negative financing to domestic sources of K236.4 million. The external loan repayments comprised of K120.6 million to concessionary and K9.3 million to commercial sources. The negative financing to domestic sources comprised of a net Government deposit totalling K323.4 million at the depository corporations, combined with K19.2 million in settlement of cheques. This more than offset financing by the OFCs totalling K106.2 million.

Total public (Government) debt outstanding at the end of September quarter of 2011 was K6,639.8 million, K50.3 million lower than in the June quarter. The outcome reflected declines in domestic and external debts. The decrease in external debt reflected loan repayments combined with the appreciation of the kina, while the decline in domestic debt resulted from a net retirement of Government securities, mainly Treasury bills.

The total amount of Government deposits in the depository corporations increased by K514.1 million to K3, 838.6 million in September 2011, compared to K3,324.5 million in the June quarter of 2011. The balance of Government trust accounts held at the Central Bank decreased by a net of K132.1 million to K245.2 million between the end of June and September 2011.