BANK OF PAPUA NEW GUINEA

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QUARTERLY ECONOMIC BULLETIN
SEPTEMBER QUARTER 2013

Mr Loi M. Bakani, Governor of the Bank of Papua New Guinea (Bank of PNG), released the September 2013 Quarterly Economic Bulletin (QEB) today. This statement provides an overview of the economic and financial developments during the September quarter 2013 and some key developments since then.

1. UPDATE ON DEVELOPMENTS SINCE SEPTEMBER 2013

Global economic growth continued at a moderate pace up to November with mixed performances in most advanced economies as the momentum slowed, due to weak global demand, political and fiscal uncertainties in the US and Euro zone. Labour markets in major economies continued to be weak while inflation remained subdued as a result of weak global demand. The International Monetary Fund (IMF) in its October World Economic Outlook revised downwards its 2013 global growth forecast to 2.9 percent from its July's forecast of 3.1 percent. This took into account the expected tapering of quantitative easing in the US, which might result in an increase of long term yields for bonds in the US and further exacerbate the weakening of the emerging market economies and the expectation that China might not react with fiscal stimulus as its growth rate has been downgraded from the target of 7.5 percent. The advanced economies are projected to grow by 1.2 percent, while the emerging market and developing economies are expected to grow by 4.5 percent.

The IMF forecast commodity prices to remain flat throughout 2013. The international prices of crude oil fell for the first time since April 2013 to USD$105.5 per barrel in October and further to USD$100 per barrel in November amid improved supply conditions, easing of geopolitical risks in the Middle East and lower global demand. With the prolonged low international commodity prices, the Governor expressed concerns of its adverse impact on the revenue forecast of the Government as well as the low level of foreign exchange inflows.

The Bank's balance of payments data show that export volumes of most of PNG's commodities have declined, attributed to the lower commodity prices, aging trees for coffee, poor road conditions and lack of market accessibility, compounded with natural causes such as the cocoa pod borer. On the other hand, import demand has been very strong this year, mainly from the retail, construction, petroleum, manufacturing and finance/business sectors. These factors have contributed to the continued depreciation of the kina throughout the year.

The daily exchange rate depreciated against most major currencies. As of 20th December, the kina depreciated against pound sterling by 9.7 percent, the Australian dollar by 7.4 percent, euro by 8.2 percent, yen by 4.9 percent and the US dollar by 5.7 percent. The depreciation against the major currencies is attributed to high import demand and lower foreign exchange inflows.

The Bank of PNG continued to support the foreign exchange market during 2013. As a result, the level of gross foreign exchange reserves declined to

K6,841.4 million (USD$2,859.7 million) as of 20th December 2013, from K7,213.8 million (USD$3,037.0 million) at the end of September 2013.

To address the downward trend of the kina exchange rate, the Central Bank introduced several measures on liquidity management and foreign exchange market operations followed by additional ones in December.

These measures resulted in the official inter-bank market exchange rate stabilizing at around USD0.41 and the subsequent in-house commercial bank trading rate at some margin below that, since October. Consequently, the Central Bank's intervention in the foreign exchange market has eased and the international reserve level has stabilized at around USD2.8 billion, which is sufficient for around 8 months of total and 13 months of non-mineral import cover. This is a very comfortable level by international convention.

Annual Inflation in PNG was 3.5 percent in the September quarter of 2013, up from 3.2 percent in the June quarter. The Bank's own assessment of its retail price index gives a similar result for the month of October. The Bank is cautiously monitoring sources of these inflationary pressures in light of high Government spending and the effects of kina depreciation on domestic prices.

In November, the Government announced a K15.0 billion budget for 2014, which represents PNG's largest ever budget. It is an expansionary budget aimed at stimulating economic activity to offset the adverse impacts of the slow-down of the construction phase of the LNG project, and low commodity prices. Mr Bakani commends the Government's commitment to support inclusive and sustainable growth; however, he emphasizes that capacity constraints continue to be of grave concern and must be addressed if the implementation of the budget is to be effective and efficient. The experience in 2013 has shown that many strategic projects earmarked for implementation were delayed mainly due to capacity constraints. In addition, a number of projects that were implemented lack quality and are sub-standard, while others were incomplete and require further funding or have not commenced due to disbursement requirements not being met. These are very serious issues that the Government has to address because of their implications on economic growth as well as Government's capacity to repay debts in the future.

It is planned that the K2.3 billion budget deficit will be financed mostly from domestic sources (70 percent), while funding from the external sources will make up the difference. The Governor acknowledges the Government's commitment to manage its borrowing prudently to avoid unnecessary costs and to ensure adherence to the Medium Term Debt Strategy. He also urges the Government to fast track the drawdown of outstanding concessional loans from donor agencies to implement projects that were already earmarked for implementation.

Mr Bakani reported that the domestic economy continues to grow but at a slower pace, reflecting the winding down of the construction phase of the PNG LNG project and lower export commodity prices. The growth is driven by activities in the non-mineral private sector, supported by an increase in credit extended by commercial banks to the private sector, and an increase in Government expenditures.

Indications are that real GDP growth is lower than last year but moderate at around 5.0 percent, which is still strong when compared to other developing economies. And with annual inflation low at 3.5 percent and within the Bank's forecast for the year, this is a commendable achievement.

2. OVERVIEW OF THE DEVELOPMENTS IN THE SEPTEMBER QUARTER OF 2013

Economic indicators available to the Bank of PNG show that the slow pace of economic growth continued in the third quarter of 2013. While lower international commodity prices and the winding down of the construction phrase of the LNG project are the factors behind the easing in activity, growth in the non-mineral private sector activity, supported by an increase growth in credit extended by commercial banks, and increased recurrent and development expenditure have contributed to sustained growth. With the balance of payments recording a deficit in the quarter, the kina continued to depreciate against most currencies of its main trading partners, and resulted in the Trade Weighted Index (TWI) depreciating by 8.1 percent. The annual headline inflation was higher at 3.5 percent in the September quarter of 2013, compared to 3.2 percent in the June quarter while the underlying measures remained very low at 0.8 percent for the trimmed mean and negative 0.3 percent for the exclusion based. In view of the low inflation outcomes and to support economic growth, the Bank maintained its neutral stance of monetary policy by maintaining the Kina Facility Rate (KFR) at 6.25 percent throughout the quarter.

Data from the Bank's Business Liaison Survey show that the total nominal value of sales in the private sector increased by 9.9 percent in the June quarter of 2013, compared to a decline of 8.6 percent in the March quarter of 2013. Excluding the mineral sector, sales increased by 8.4 percent in the June quarter, compared to a decline of 11.6 percent in the previous quarter. Sales increased in all the sectors as well as in all the regions. Over the twelve months to June 2013, total nominal value of sales decreased by 0.9 percent, while excluding the mineral sector, sales increased by 3.5 percent.

The Bank's Employment Index shows that the total private sector employment level declined by 3.1 percent in the September quarter of 2013, compared to an increase of 2.4 percent in the previous quarter. Excluding the mineral sector, the level of employment declined by 2.9 percent. The level of employment declined in the mineral, building and construction, agriculture/forestry/fisheries, financial/business and other services sectors, which more than offset the increase in other sectors. Employment declined in the Islands, NCD and Momase regions, while it increased in the Southern, Morobe and Highlands. Over the year to September 2013, the level of employment increased by 1.6 percent, while excluding the mineral sector, it declined by 1.3 percent.

Headline inflation, as measured by the Consumer Price Index (CPI), was 1.2 percent in the September quarter of 2013, compared to no change in the June quarter. There were increases in the 'Food', 'Rents, council charges fuel/power', 'Drinks, tobacco, and betelnut', and 'Transport and communication' expenditure groups, which more than offset decreases in other expenditure groups. The annual headline inflation was 3.5 percent in the September quarter of 2013, compared to an increase of 3.2 percent in the June quarter of 2013. All surveyed urban centres recorded price increases in the September quarter. The annual exclusion based inflation declined by 0.3 percent in the September quarter, compared to a decline of 0.6 percent in the June quarter. The annual trimmed mean inflation was 0.8 percent in the quarter, compared to 0.7 percent in the previous quarter.

In the September quarter of 2013, the daily average kina exchange rate depreciated against the euro by 6.7 percent to 0.3311, US dollar by 5.4 percent to 0.4385, pound sterling by 6.1 percent to 0.2831 and the Japanese yen by 5.2 percent to 43.39. It appreciated against the Australian dollar by 2.4 percent to 0.4790. These movements resulted in the depreciation of the daily average TWI by 8.1 percent to 34.83, compared to the June quarter of 2013.

The weighted average kina price of Papua New Guinea's exports declined by 2.8 percent in the September quarter of 2013, compared to the corresponding quarter of 2012. There was a 1.7 percent decline in the weighted average price of mineral exports, mainly due to lower gold prices. For the agricultural, logs and marine product exports, excluding refined petroleum product exports, the weighted average kina price declined by 7.4 percent. Lower kina export prices of all agricultural exports, with the exception of tea, copra and logs contributed to this decline. Excluding logs, the weighted average kina price of agricultural and marine product exports declined by 10.7 percent in the September quarter of 2013, compared to the corresponding period of 2012.

The balance of payments recorded an overall deficit of K1,260 million for the nine months to September 2013, compared to a deficit of K868 million in the corresponding period of 2012. A deficit in the current account, more than offset a surplus in the capital and financial account. The deficit in the current account was attributed to a lower trade surplus and higher net service payments. The surplus in capital and financial account was mainly due to inflows from capital transfers and other investments, which more than offset higher net outflows from portfolio investments.

The level of gross foreign exchange reserves at the end of September 2013 was K7,242.72 (US$3,037.0) million, sufficient for 8.4 months of total and 13.0 months of non-mineral import cover.

The Bank maintained a neutral stance of monetary policy by keeping the Kina Facility Rate unchanged at 6.25 percent over the September quarter of 2013, following low inflation outcomes in the first two quarters of 2013.

Domestic interest rates moved upwards between the end of June and September 2013. The Bank continued to utilise its Open Market Operation (OMO) instruments in the conduct of monetary policy in the September quarter of 2013. There was a net retirement totaling K466.2 million in Central Bank Bills during the quarter. The Government also made a net retirement of K120.5 million in Treasury bills, while issuing a total of K266.0 million of Inscribed stock during the quarter. The Cash Reserve Requirement for the commercial banks was maintained at 8.0 percent in the September quarter of 2013.

The average level of broad money supply (M3*) increased by 2.4 percent in the September quarter, compared to an increase of 4.1 percent in the June quarter of 2013. This was mainly influenced by an increase in average net claims on the Central Government as a result of increased issuances of securities and drawdown of Government deposits, combined with an increase of 4.7 percent in average credit to the private sector. Average net domestic claims outstanding, excluding net claims on the Central Government, increased by 3.1 percent in the September quarter of 2013, following an increase of 3.8 percent in the June quarter.

The net foreign assets of financial corporations, comprising depository corporations (DCs) and other financial corporations (OFCs), increased by 12.7 percent to K10,738.2 million in the September quarter of 2013, compared to a decline of 2.9 percent in the June quarter of 2013. This resulted from increases in net foreign assets of the Central Bank, other depository corporations (ODCs) and OFCs. Net claims on the Central Government increased by K929.2 million to K3,947.2 million in the September quarter of 2013, compared to an increase of K441.8 million in the previous quarter. This was due to issuance of Government securities for budget financing.

In the September quarter of 2013, total domestic credit extended by financial corporations to the private sector, public non-financial corporations, Provincial and Local level Governments, and other financial corporations, increased by K204.3 million to K11,949.4 million, compared to an increase of K720.3 million in the June quarter of 2013.

Preliminary estimates of the fiscal operations of the National Government over the nine months to September 2013 show an overall deficit of K495.5 million, compared to a surplus of K233.1 million in the corresponding period of 2012. This represents 1.4 percent of nominal GDP.

Total revenue, including foreign grants, over the nine months to September 2013 was K6,542.3 million, 1.3 percent lower than the receipts collected in the corresponding period of 2012. This represents 62.4 percent of the budgeted revenue for 2013. The decrease in revenue was mainly attributed to lower foreign grants, which more than offset an increase in tax and non-tax receipts.

Total expenditure over the nine months to September 2013 was K7,037.8 million, 10.0 percent higher than in the corresponding period of 2012. This represents 54.0 percent of the budgeted appropriation for 2013. The increase was attributed to both higher recurrent and development expenditures.

The deficit along with net external loan repayments of K123.9 million was financed from domestic sources totaling K619.4 million. The domestic financing comprised of K1,717.3 million and K113.2 million in financing by ODCs and OFCs, respectively. These more than offset K83.4 million in Government deposits at the Central Bank and K1,127.7 million in cheque floats not presented for encashment.

Total public debt outstanding at the end of the September quarter of 2013 was K10,985.8 million, K415.8 million higher than in the June quarter of

2013. Both domestic and external loans increased. The increase in domestic debt resulted from net new issuance of Treasury bills and Inscribed stocks, while the increase in external debt was due to the effect of the depreciation of kina against major currencies combined with drawdown of concessional loans. This resulted in the debt to (nominal) GDP ratio increasing to 30.8 percent from 27.9 percent between the two quarters.

The total amount of Government deposits in the DCs decreased by K768.1 million to K4,253.1 million in September 2013, compared to K5,021.2 million in June 2013. Government trust accounts held at the Central Bank increased by K28.0 million to K175.8 million between the end of September and June 2013.