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**PORT MORESBY**

17<sup>th</sup> March 2007

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## 2. GENERAL OVERVIEW

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Indicators available to the Bank of PNG reflected continued stability in macroeconomic conditions that resulted in increased activity in 2006. Strong export performance was driven by higher international prices and resulted in a record balance of payments surplus and stable kina exchange rate. The stability in the exchange rate resulted in lower headline inflation outcomes. The Central Bank therefore maintained a neutral monetary policy stance in 2006. Interest rates remained low resulting in increased lending to the private sector. The level of employment increased in 2006 in all sectors of the economy. With the windfall mineral tax revenue in 2006, the Government introduced two supplementary budgets, which redirected funding to priority areas. Since most of these funds would be spent in 2007, the Government should exercise discipline and sound fiscal management, especially in the lead up to the National Elections. The Bank will closely monitor the impact of any excess expenditure on liquidity, exchange rate and inflation.

Over the year to December 2006, the Bank's formal private sector Employment Index increased by 8.6 percent. In the December quarter of 2006 the level of employment increased by 3.7 percent, compared to a decline of 2.1 percent in the September quarter. The increase was broadbased across all sectors and regions, except the Highlands region.

Annual headline inflation was 1.3 percent in 2006, compared to 4.6 percent in 2005. The lower headline inflation was due to significant declines in the prices of seasonal produces and alcoholic drinks during the December quarter. By region, all urban areas, except Goroka, recorded higher prices.

During 2006, the kina continued to strengthen against the US dollar, while it depreciated against the Australian dollar. The kina ended the year at US\$0.3300, from US\$0.3230 at the end of 2005. The kina was worth A\$0.43 at the end of 2006, compared to A\$0.44 at the end of 2005. The daily average kina exchange rate appreciated by 1.4 percent against the US dollar to 32.72 US cents and by 2.4 percent against the Australian dollar to 43.44 cents during 2006. The kina also appreciated against the other major currencies. These

movements resulted in the daily average Trade Weighted Index (TWI) appreciating by 2.23 percent over the year.

Higher international prices for mineral and most agricultural commodities, logs and marine product exports resulted in a 38.0 percent increase in the weighted average kina price of exports in 2006, compared to 2005. There was a 45.8 percent increase in the weighted average kina price of mineral exports, with higher prices of gold, copper and crude oil. For agricultural, logs and marine product exports, the weighted average kina price increased by 3.4 percent. This was accounted for by higher prices of cocoa, palm oil, tea, rubber, logs and marine product exports.

The overall surplus in the balance of payments was K1,942 million in 2006, compared to a surplus of K296 million in 2005. This outcome was due to a net inflow in the capital and financial accounts, which more than offset a decline in the current account surplus.

The current account recorded a lower surplus of K1,238 million in 2006, compared to a surplus of K1,887 million in 2005. This outcome was the result of higher net service and income payments and lower net transfer receipts, which more than offset the higher trade surplus.

The capital account recorded a net inflow of K135 million in 2006, compared to a surplus of K101 million in 2005. This outcome reflected higher transfers by donor agencies through direct project financing.<sup>1</sup>

The financial account recorded a surplus of K627 million in 2006, compared to a deficit of K1,691 million in 2005. The outcome was due to higher net inflows of foreign direct and portfolio investments. These, combined with a net inflow of other investments more than offset increased investments in financial derivative instruments and net loan repayments by the Government and the private sector.

The level of gross foreign exchange reserves at the end of December 2006 was K4,310 (US\$1,450.8) million, sufficient for 8.6 months of total and 11.6 months of non-mineral import covers.

The Bank of PNG maintained a neutral monetary policy stance based on favourable macroeconomic outcomes

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<sup>1</sup> See 'For the Record', on page 35 of the December 2006 QEB.

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and inflation outlook during 2006, with the Kina Facility Rate (KFR) maintained at 6.00 percent. These developments were consistent with the Bank's expectations as stated in the January and July 2006 Monetary Policy Statements.

The Bank continued to utilise Open Market Operation (OMO) instruments in the conduct of monetary policy. Between April and September 2006, there were no Treasury bill auctions as the Central Government retired its maturing domestic debt. The liquidity impact of its maturity was sterilised by the Bank of PNG through the use of Central Bank Bills (CBBs) and Reverse Repurchase Agreements.

The average level of broad money supply (M3\*) increased by 35.4 percent in 2006, compared to an increase of 20.2 percent in 2005. The outcome was due to increases of 54.4 percent and 27.8 percent in average net foreign assets of the depository corporations and net claims on the private sector, respectively. This more than offset a decline of 10.7 percent in average net claims on the Central Government. Net domestic credit outstanding, excluding advances to the Central Government and outstanding loans under the Government's Agricultural export commodity price support scheme increased by 26.6 percent in 2006, compared to an increase of 15.5 percent in 2005. The average level of monetary base (reserve money) grew by 10.5 percent in 2006, compared to an increase of 16.4 percent in 2005. The increase reflected higher deposits of other depository corporations (ODCs) at the Central Bank.

In 2006, 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 K793.9 mil-

lion to K3,035.0 million, compared to an increase of K442.2 million in 2005. The increase was mainly due to growth in private sector credit of K814.7 million, which more than offset a decline of K21.9 million in credit to the public non-financial sector.

Preliminary estimates of the fiscal operations of the National Government showed an overall surplus of K618.7 million in 2006, compared to a surplus of K46.9 million in 2005. The 2006 outcome represents 3.6 percent of nominal GDP and was due to higher tax revenue, resulting from an increase in mineral tax receipts, which more than offset an increase in expenditure.

Total revenue, including foreign grants, during 2006 was K6,436.5 million, 21.1 percent higher than the receipts collected in 2005, and represents 104.5 percent of the 2006 revised budgeted revenue. The increase was attributed to higher collections in most categories of tax and non-tax revenue, except import duties, other indirect tax and foreign grants.

Total expenditure during 2006 was K5,817.8 million, 10.5 percent higher than in 2005, and represents 94.4 percent of the revised budgeted expenditure for 2006. The increase reflected higher recurrent expenditure, which more than offset a decline in development expenditure.

The budget surplus was used to make net overseas loan repayments of K228.1 million and net domestic loan repayments of K390.6 million. Net domestic loan repayments totalling K720.2 million were made to the financial corporations. This more than offset a total financing of K329.6 million from other resident sectors, which reflects the unrepresented cheques issued in 2006.

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## 2. INTERNATIONAL DEVELOPMENTS

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The world economy continued to grow in 2006. The growth was broadbased and led by developments in the industrialised economies and the emerging market economies, especially Brazil, Russia, India and China, which experienced strong demand. The International Monetary Fund's (IMF) World Economic Outlook (WEO) of September 2006 estimated a global real Gross Domestic Product (GDP) growth rate of 5.1 percent in 2006. This rate of growth is expected to fall to 4.9 percent in 2007.

International commodity prices remained high in the fourth quarter of 2006, though the upward momentum of most commodities has slowed down since reaching record levels in May 2006. Between July and October, the price of crude oil slipped by 23 percent from US\$78 a barrel. In November, the low oil prices prompted the Organisation of Petroleum Exporting Countries (OPEC) to cut output targets by 1.2 million barrels per day among its member countries. On December 12th the OPEC pledged to lower production by another 500,000 barrels per day from the first day of February 2007. In December, nickel and zinc reached record highs of around US\$3,450 per tonne and US\$4,345 per tonne, respectively as global inventories of these metals shrank. The price of aluminium rose to around US\$2,810 per tonne, its highest level in six months.

In November, the Finance Ministers and Central Bank Governors from the twenty largest economies (G20) met in Melbourne, Australia. They discussed energy security by allowing foreign investment in major energy exporting nations, creating more transparent markets and improving security of supplies. They agreed that while the outlook for economic growth was positive, above average growth had seen a decline in spare global capacity, which combined with buoyant energy and mineral price had increased the risks to global inflation.

China hosted a quarter of the world's leaders in two separate summits in November, one with African nations and another with the Association of South-East Asian Nations (ASEAN). China pledged to double its aid to the African continent over three years. China also hopes to expand its influence there through its development policy of achieving rapid growth by encouraging a market economy, preserving the role of the State and maintaining an authoritarian one party politi-

cal system. The ASEAN - China summit acknowledged the achievements made in the past 15 years of their dialogue, and reconfirmed their determination to establish an ASEAN - China free trade area by 2010.

With the World Trade Organisation's (WTO) Doha round of trade talks losing momentum and potentially failing after its suspension in July, the Asia Pacific leaders announced in November that they were ready to take the first steps in preparing for a proposed Free-Trade Area of the Asia Pacific (FTAAP). The leaders also stated that their commitment to new offers in the Doha talks would include deeper reductions in trade distorting farm subsidies by industrialised economies, creating new market access in agriculture and making cuts in industrial tariffs.

In the United States (US), real GDP grew by 3.3 percent in 2006, compared to 3.1 percent in 2005. In the last quarter of 2006 real GDP grew by an annualised rate of 3.5 percent, the fastest growth in a year. The major economic development in the US economy has been the slump in the housing market, which had a significant effect on growth in the second and third quarters of 2006. Consumer spending remained high, mainly due to both low unemployment and falling fuel prices.

Industrial production increased by 3.0 percent in 2006, compared to an increase of 2.8 percent in 2005. The Institute of Supply Management's Purchasing Managers' Index (PMI) was 49.5 in November 2006, rising to 51.4 in December 2006, compared to 55.6 in December 2005. An index rating of over 50 indicates an expansion in the manufacturing sector. The slowdown in the index on the previous year's figure reflected the continued slump in the construction and automotive sectors. The unemployment rate was 4.5 percent in December 2006, compared to 4.9 percent in 2005, the lowest rate in five years.

Consumer prices rose by 3.5 percent in 2006, compared to an increase of 3.4 percent in 2005. This reflected a trend of steady rise in consumer prices. Broad money supply increased by 5.4 percent in 2006, compared to an increase of 7.8 percent in 2005. To contain inflation and support economic growth, the US Federal Reserve Board kept the federal funds rate constant at 5.25 percent throughout the last quarter of 2006.

The trade account deficit increased to US\$837.2 billion

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in 2006, from a deficit of US\$782.1 billion in 2005, reflecting increased imports and reduced exports.

In Japan, real GDP grew by 2.3 percent in 2006, compared to 4.2 percent in 2005. Real GDP grew by 4.8 percent in the December quarter of 2006, the fastest in more than two years. The growth in 2006 continued Japan's longest period of economic recovery in post-war history. This growth was originally driven by exports, mainly to China, and then by business investments in capital. Household spending, however, remained sluggish.

Industrial production increased by 4.6 percent in 2006, compared to an increase of 3.8 percent in 2005. Retail sales decreased by 0.2 percent in 2006, compared to an increase of 1.2 percent in 2005. Corporate profitability in the manufacturing sector remained robust in the third quarter of 2006, and rose at a rate of 15.5 percent year on year. With this increase in manufacturing activity the unemployment rate fell to 4.1 percent in December 2006, from 4.4 percent in December 2005.

Consumer prices increased by 0.3 percent in 2006, compared to a decrease of 0.1 percent in 2005. Broad money supply increased by 0.8 percent in 2006, compared to 2.0 percent in 2005. The Bank of Japan decided in December to maintain its call rate at 0.25 percent, unchanged since July 2006.

The current account surplus was US\$170.4 billion in 2006, compared to a surplus of US\$164.0 billion in 2005. The slowing US economy has adversely impacted on Japanese exports, with Japan reliant on domestic demand to generate growth.

In the Euro area, real GDP grew by 3.3 percent in 2006, compared to 1.7 percent in 2005. Consumer prices rose by 1.9 percent in 2006, compared to 2.4 percent in 2005. Broad money supply increased by 9.7 percent in 2006, compared to 7.3 percent in 2005. The European Central Bank raised interest rates six times in 2006. The last rise, in December, took the Euro Financing rate to 3.5 percent, the highest in five years. Industrial production and retail sales rose by 4.0 percent and 2.1 percent respectively in 2006, compared to 2005. In 2006, the current account deficit was US\$20.2 billion, or 0.1 percent of GDP.

In Germany, real GDP grew by 2.6 percent in 2006, compared to 1.0 percent in 2005. The higher growth rate reflected the expansion of German companies in

the global market through cutting costs, investing abroad and holding down wages.

Industrial production increased by 5.5 percent in 2006, compared to 3.4 percent in 2005. Retail sales fell by 0.2 percent in 2006, compared to a decline of 0.9 percent in 2005. The growth in economic activity resulted in higher employment, with the unemployment rate falling to 9.5 percent in December 2006, from 11.2 percent in December 2005.

Consumer prices rose by 1.6 percent in 2006, compared to an increase of 2.1 percent in 2005.

The current account surplus was US\$129.4 billion in 2006, compared to US\$112.8 billion in 2005, reflecting increased exports.

In the United Kingdom (UK), real GDP grew by 3.0 percent in 2006, compared to 1.7 percent in 2005, mainly due to buoyant domestic demand.

Industrial production increased by 0.5 percent in 2006, compared to a decline of 2.7 percent in 2005. Retail sales rose by 3.7 percent in 2006, compared to a rise of 4.0 percent in 2005. The unemployment rate was 5.5 percent in December 2006, compared to 5.1 percent in December 2005. Strong labour force growth, driven by high immigration and rising participation, outstripped employment growth and pushed the unemployment rate higher.

Consumer prices rose by 3.0 percent in 2006, compared to an increase of 2.0 percent in 2005. Broad money supply increased by 12.8 percent in 2006, compared to 12.6 percent in 2005. In November the Bank of England raised its base rate by a quarter of a percentage point to 5.0 percent. In the fourth quarter of 2006 inflation reached its highest level for a decade, fuelling fears that the Bank of England will increase interest rates in 2007.

The trade deficit was US\$155.3 billion in 2006, compared to a deficit of US\$119.1 billion in 2005.

In Australia, real GDP grew by 2.5 percent in 2006, compared to 2.7 percent in 2005. Business investment, the main driver of the economy, has slowed, alongside declining public investment and inventories. Domestic consumption and exports however, remained strong.

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Industrial production increased by 0.9 percent over the year to September 2006, compared to an increase of 1.3 percent over the same period in 2005. The lower increase was associated with the downturn in housing construction with lower demand for building materials, the drought and the strong Australian dollar. Retail sales increased by 4.2 percent in 2006, compared to an increase of 1.9 percent in 2005. The unemployment rate fell from 5.1 percent in December 2005 to 4.6 percent in December 2006, its lowest level in 30 years. Skill shortages however, remained a major constraint on growth.

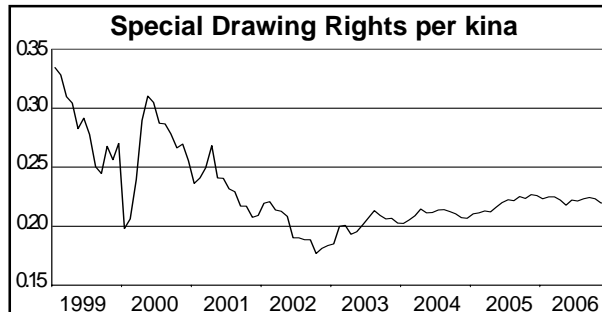
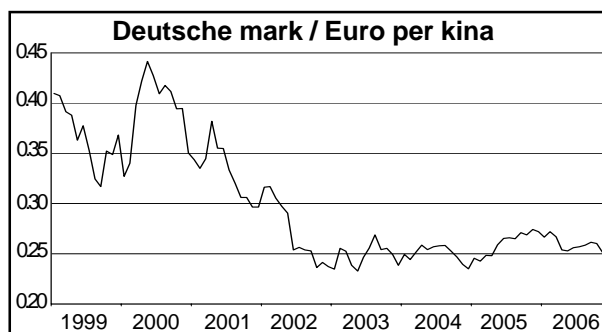
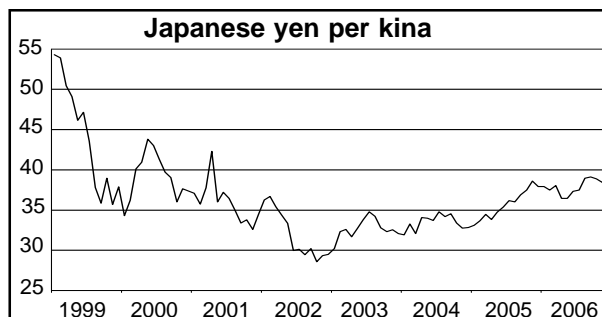
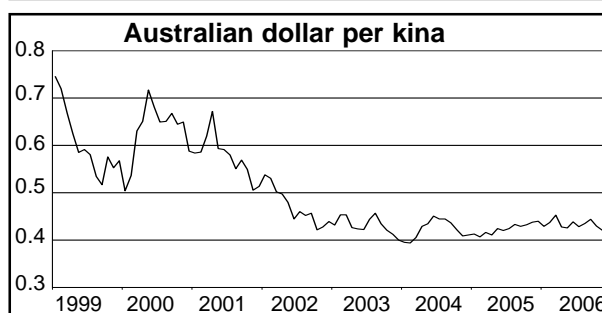
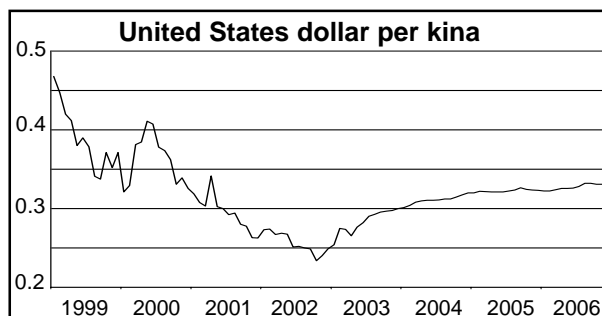
Consumer prices increased by 3.3 percent in 2006, compared to 2.8 percent in 2005. This rate is over the Reserve Bank of Australia's (RBA) inflation target range of 2.0 to 3.0 percent. As a result, the RBA raised interest rates three times in 2006, the last being in November when the cash rate was increased by 25 basis points to 6.25 percent, its highest level in six years.

The trade deficit was US\$9.4 billion in 2006, compared to a deficit of US\$13.6 billion in 2005. The deficit was at its lowest level in 30 months and reflected the high export demand and prices of minerals.

In 2006, the US dollar appreciated against the Japanese yen, and depreciated against the pound sterling, the euro and the Australian dollar. The general weakness in the US dollars provided evidence which suggested that the housing bust may have been affecting the broader economy through reduced consumer confidence.

During 2006, the kina continued to strengthen against the US dollar, while depreciating against the Australian dollar. The kina ended the year against the US dollar at 33.00 cents, from 32.3 cents at the end of 2005. The kina was worth 41.71 Australian cents at the end of 2006, compared to 44.00 cents at the end of 2005. The daily average kina exchange rate appreciated during 2006 by 1.4 percent against the US dollar to 32.72 US cents, by 2.4 percent against the Australian dollar to 43.44 cents, by 7.2 percent against the Japanese yen to 38.06 yen, by 0.3 percent against the pound sterling to 17.78 pence and by 0.5 percent against the Euro to 26.06 cents. These movements resulted in the daily average Trade Weighted Index appreciating by 2.2 percent over 2006.

## EXCHANGE RATES



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### 3. EMPLOYMENT

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According to the Bank's Employment Index, the level of employment in the formal private sector, excluding the mineral sector increased by 3.7 percent in the December quarter of 2006, compared to a decline of 2.1 percent in the September quarter of 2006. Employment levels increased in all sectors and in all regions, except the Highlands region. Over the year to December 2006, the level of employment excluding the mineral sector increased by 8.6 percent, compared to 4.6 percent over the year to September 2006.

In the agriculture/forestry/fisheries sector, the level of employment increased by 3.6 percent in the December quarter of 2006, compared to a decline of 6.0 percent in the September quarter of 2006. The increase was across all sub-sectors. In the agriculture sub-sector, the increase was mainly associated with the harvesting at new palm oil estates. In the forestry sub-sector, the increase reflected the expansion of operations into new logging sites. In the fisheries sub-sector, the increase was associated with the commencement of a new tuna loining operation in Lae and increased production by another fishing company in Madang. Over the year to December 2006, the level of employment increased by 9.4 percent.

In the building and construction sector, the level of employment increased by 2.0 percent in the December quarter of 2006, compared to a decline of 2.3 percent in the September quarter of 2006. The increase was broadbased and included mining related construction projects, as well as roads, buildings and fencing projects which involved the hiring of casual staff. Over the year to December 2006, the level of employment increased by 23.7 percent.

In the manufacturing sector, the level of employment increased by 2.9 percent in the December quarter of 2006, compared to a decline of 2.1 percent in the September quarter of 2006. The increase was due to higher production, expansion of operations by some small to medium size companies and the acquisition by a fuel company. A few companies also engaged students on vacation employment during the festive season as a result of higher demand. Over the year to December 2006, the level of employment increased by 4.5 percent.

In the retail/wholesale sector, the level of employment

increased by 8.9 percent in the December quarter of 2006, compared to a decline of 0.8 percent in the September quarter of 2006. The increase was broadbased reflecting higher seasonal demand and expansion of operations following the opening of a large retail shop and a new branch at a mine site by a major machinery supplier. Casual staffs were also recruited to cater for higher demand during the festive season. Over the year to December 2006, the level of employment increased by 7.6 percent.

In the transportation sector, the level of employment increased by 1.5 percent in the December quarter of 2006, compared to an increase of 4.0 percent in the September quarter of 2006. The increase was mainly due to higher casual employment by an airline company to cater for travel during the festive season. A land transportation company recruited students for on-the-job training, while another hired additional staff due to a new contract to transport goods. Over the year to December 2006, the level of employment increased by 7.0 percent.

In the financial/business and other services sector, the level of employment increased by 0.7 percent in the December quarter of 2006, compared to an increase of 2.1 percent in the September quarter of 2006, and was broadbased across all sub-sectors. In the hotel and catering sub-sector, the increase was associated with the expansion of hotel facilities, hiring of casual employees by a catering company and higher guest turnover by a hotel during the festive season. In the finance and insurance sub-sector, the increase was due to higher business activity and casual employees. In the other services sub-sector, the growth was associated with higher demand for private health care services and a new contract awarded to a security company. Over the year to December 2006, the level of employment grew by 9.4 percent.

By region, the level of employment increased in all regions except the Highlands region. In the Islands region, employment grew by 10.3 percent in the December quarter of 2006, compared to a decline of 3.0 percent in the September quarter of 2006. Higher employment was recorded in the agriculture/forestry/fisheries, building and construction, retail/wholesale and financial/business and other services sectors. In the agriculture/forestry/fisheries sector, the increase was due to favourable weather conditions which enabled a logging company to operate at full scale, hiring of casual employees to clear land for a new palm oil site

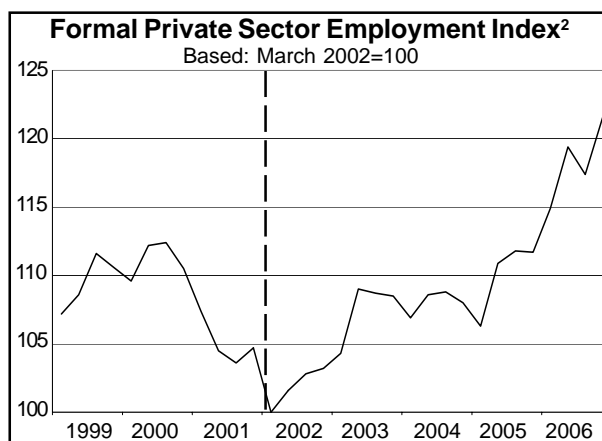
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and harvesting of timber in a new logging area. Higher production in other cash crops also resulted in hiring of additional workers. In the building and construction sector, the growth in employment was mainly associated with construction activity at the Simberi gold mine, while the increase in the retail/wholesale sector was due to casual employees to cater for festive season demand. Higher employment in the financial/business and other services sector was associated with the expansion of a hotel's facilities and higher guest turnover by another. Over the year to December 2006, the level of employment grew by 15.8 percent.

In the Momase region (excluding Morobe), the level of employment increased by 6.5 percent in the December quarter of 2006, compared to 0.5 percent in the September quarter of 2006. Higher employment was recorded in the agriculture/forestry/fisheries and financial/business and other services sector. In the agriculture/forestry/fisheries sector, the growth was mainly a result of higher production associated with tuna loining operations by a fishing company. In the financial/business and other services sector, the increase was due to the recruitment of guards for a new contract awarded to a security company. Over the year to December 2006, the level of employment grew by 7.4 percent.

In Morobe, the level of employment increased by 4.7 percent in the December quarter of 2006, compared to 1.3 percent in the September quarter of 2006. Higher employment was recorded in the building and construction and agriculture/forestry/fisheries sectors. The growth in the building and construction sector was associated with a fencing project at the Nadzab airport and road maintenance work in Lae. In the agriculture/forestry/fisheries sector, the increase was due to the commencement of a new tuna loining operation associated with the establishment of a new tuna cannery in Lae. Over the year to December 2006, the level of employment grew by 9.4 percent.

In NCD, the level of employment increased by 2.5 percent in the December quarter of 2006, compared to a decline of 0.9 percent in the September quarter of 2006. Higher employment was recorded in the manufacturing, wholesale/retail, transportation and financial/business and other services sectors. The growth



in the manufacturing sector was associated with the acquisition of a petroleum company by another major petroleum company, while another manufacturing company recruited additional staff to enhance its marketing activities. The increase in the retail/wholesale sector was due to retail companies opening new shops and branches, diversification of their business operations and gaining access to new markets. In addition, small to medium size retail/wholesale companies hired casual employees during the festive season. In the transportation sector, the growth reflected the recruitment of casual employees by an airline company to cater for the festive season. Higher employment in the financial/business and other services sector reflected two finance/insurance companies and a private hospital taking additional staff as a result of increased business activity. Over the year to December 2006, the level of employment grew by 6.6 percent.

In the Southern region, the level of employment increased by 0.4 percent in the December quarter of 2006, compared to 0.7 percent in the September quarter of 2006. Higher employment was in the retail/wholesale and building and construction sectors. The growth in the retail/wholesale sector was due to the expansion of operations by a major retail company in Alotau. The increase in the building and construction sector reflected contract work done by companies in and around the Ok Tedi mining area. The construction of a road project and hospital building also contributed to this outcome. Over the year to December 2006, the level of employment grew by 8.8 percent.

<sup>2</sup> The dotted vertical line indicates a break in series from 2002. See 'For the Record' in the March 2003 QEB on page 31 and the September 2005 QEB on page 29.



In the Highlands region, the level of employment decreased by 4.1 percent in the December quarter of 2006, compared to a decline of 7.2 percent in the September quarter of 2006. Lower employment was recorded in the retail/wholesale and agriculture sectors, which more than offset increases in the other sectors. In the agriculture sector, the decline was associated with the end of the coffee harvest season. In the retail/wholesale sector, a retail company downsized its operation due to a lack of business activity, especially in the Southern Highlands province. Over the year to December 2006, the level of employment increased by 6.2 percent.

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#### 4. CONSUMER PRICE INDEX

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The headline inflation rate, as measured by the Consumer Price Index (CPI), was 0.3 percent in the December quarter of 2006, compared to 3.3 percent in the September quarter of 2006. The increase was due to higher prices in the 'Transport and Communication', 'Clothing and footwear', and the 'Miscellaneous' expenditure groups. By region, all urban areas, except Goroka and Madang, recorded higher prices. The annual headline inflation rate was 1.3 percent in the December quarter of 2006.

The CPI for the 'Transport and Communication' expenditure group increased by 20.6 percent, compared to negative 0.3 percent in the September quarter of 2006. This group recorded the highest inflation in the December quarter of 2006 and the highest ever recorded inflation for the group since the CPI survey began in 1975. The higher inflation outcome reflected increased prices for motor vehicles in Lae and higher airfares. The group contributed 2.7 percentage points to the overall movement in the CPI.

The CPI for the 'Clothing and Footwear' expenditure group increased by 8.4 percent in the December quarter of 2006, compared to negative 2.8 percent in the September quarter of 2006. The increase was particularly due to higher prices for women and girls clothing, especially dresses and skirts. The increase of 29.1 percent for this expenditure sub-group is the highest recorded increase in a decade. A marginal increase was also recorded for men's and boy's clothing. The group contributed 0.5 percentage points to the overall movement in the CPI.

The CPI for the 'Miscellaneous' expenditure group increased by 2.1 percent in the December quarter of 2006, compared to negative 1.7 percent in the September quarter of 2006. The increase reflected higher prices for entertainment goods, medicine and health care. The group contributed 0.2 percentage points to the overall movement in the CPI.

The CPI for the 'Rents, council charges, fuel and power' expenditure group declined by 10.7 percent in the December quarter of 2006, compared to 4.5 percent in the September quarter of 2006. The decline was due to lower prices for council charges and fuel. The group contributed negative 0.8 percentage points to the overall movement in the CPI.

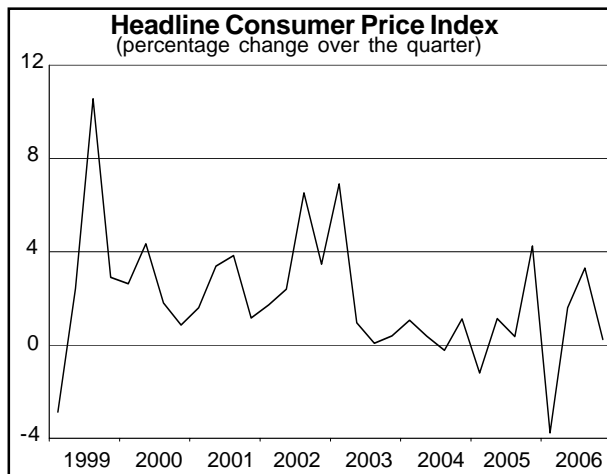
The CPI for the 'Food' expenditure group declined by 6.6 percent in the December quarter of 2006, compared to an increase of 5.6 percent in the September quarter. The decline was mainly driven by falling fruit and vegetables prices in addition to marginal declines in the prices for cereals, meat and fish. This group contributed negative 2.7 percentage points to the overall movement in the CPI.

The CPI for the 'Household, equipment and operations' expenditure group declined by 2.9 percent in the December quarter of 2006 after increasing by 0.9 percent in the September quarter. The group contributed negative 0.2 percentage points to the overall movement in the CPI.

The CPI for the 'Drinks, tobacco and betelnut' expenditure group declined by 2.7 percent in the December quarter of 2006, compared to an increase of 4.3 percent in the September quarter of 2006. The decline was mainly due to falling betelnut prices which contributed negative 1.0 percentage points to the overall movement of the CPI and a decline in prices for alcoholic drinks. A different product specification used by the National Statistical Office to compute changes in tobacco prices also contributed to the decline. The group contributed negative 0.5 percentage points to the overall movement in the CPI.

By urban areas, all surveyed centres, except Goroka and Madang, recorded increases in the December quarter of 2006. In Lae, prices increased by 4.4 percent in the December quarter of 2006, compared to an increase of 4.0 percent in the September quarter. In Port Moresby, prices increased by 3.1 percent in the December quarter of 2006 following an increase of 2.9

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percent in the September quarter. In Rabaul, prices increased by 0.5 percent in the December quarter of 2006 following a decline of 0.1 percent in the September quarter. Goroka and Madang recorded deflation during the December quarter. Prices in Goroka and Madang declined by 14.1 percent and 2.9 percent respectively in the December quarter of 2006, following increases of 8.6 and 0.9 percent, respectively in the September quarter.

In Lae, higher prices for fruits and vegetables, motor vehicles, cigarettes and marginal increases in other food items and in the 'Rents, council charges, fuel and power' expenditure group contributed to the increase. Inflation movements in Lae contributed 1.0 percentage points to the overall movement in the CPI. In Port Moresby, higher prices in the 'transport and communication' and 'household equipment and operations' expenditure groups led to the increase in inflation and contributed 1.3 percentage points to the overall movement in the CPI. The increase in Rabaul was attributed to higher prices for betelnut and fruit and vegetables and contributed 0.1 percentage points to the overall movement in the CPI. In Goroka, lower prices for betelnut, fruit and vegetables and in the 'rents, council charges, fuel and power' expenditure group contributed to the decline. In Madang, lower prices in most of the expenditure groups led to the decline. Goroka and Madang contributed negative 1.7 and negative 0.3 percentage points respectively to the overall movement in the CPI.

## 5. EXPORT COMMODITIES REVIEW

The total value of merchandise exports was K12,617 million in 2006, an increase of 24.1 percent from 2005. There were increases in the values of cocoa, palm oil, tea, rubber, logs, marine products, gold, copper and crude oil exports. The value of agricultural, marine products and other non-mineral exports, excluding forestry and refined petroleum product exports was K1,416.2 million and accounted for 11.2 percent of total merchandise exports in 2006, compared to 15.2 percent of total merchandise exports in 2005. Forestry product exports were K520.3 million and accounted for 4.1 percent of total merchandise exports in 2006, compared to 4.7 percent in 2005. Refined petroleum product exports were K263.9 million and accounted for 2.1 percent of total merchandise exports in 2006, compared to 4.9 percent in 2005. Mineral export receipts, excluding crude oil were K7,499.3 million and accounted for 59.0 percent of total merchandise exports in 2006, compared to 52.8 percent in 2005. Crude oil exports totalled K2,967.3 million and accounted for 23.5 percent of total merchandise exports in 2006, compared to 22.5 percent in 2005.

The weighted average kina price of Papua New Guinea's exports increased by 38.0 percent in 2006, relative to 2005. There was an increase of 45.8 percent in the weighted average kina price of mineral exports, with higher prices of gold, copper and crude oil exports. For agricultural, logs and marine product exports, the weighted average kina price increased by 3.4 percent. This was attributed to higher prices of cocoa, palm oil, tea, rubber, logs and marine product exports, which more than offset the declines in the prices of coffee, copra and copra oil. The higher kina prices of some of the agricultural export commodities reflected higher international prices, while the decline in others reflected lower international prices combined with the appreciation of the kina in 2006, compared to 2005. Excluding logs, the weighted average price of agricultural and marine product exports increased by 3.2 percent in 2006, compared to 2005.

### Mineral Exports

Total mineral export receipts were K10,416.6 million in 2006, an increase of 36.1 percent from 2005. The increase was due to higher kina prices of gold, copper and crude oil, which more than offset declines in the export volumes of gold and copper.

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Gold export volumes were 55.8 tonnes in 2006, a decline of 20.9 percent from 2005. The decline was due to lower production of high grade ore and shipment from the Lihir, Ok Tedi, Porgera and Tolukuma mines, which more than offset increased production from the Kainantu mine. The average free on board (f.o.b.) price received for Papua New Guinea's gold exports was K55.0 million per tonne in 2006, an increase of 36.8 percent from 2005. The outcome is mainly attributed to higher international prices resulting from increased demand. The average gold price at the London Metal Exchange was US\$603 per fine ounce in 2006, an increase of 36.1 percent from 2005. The increase was due to higher demand from investors for gold-based investments as a safe-haven investment after increased volatility of prices in the equity markets and the uncertainty surrounding the US dollar. The higher export price more than offset the decline in export volume resulting in export receipts of K3,069.4 million in 2006, an increase of 8.3 percent from 2005.

Copper export volumes were 216.7 thousand tonnes in 2006, a decline of 4.2 percent from 2005. The decline was due to lower production and shipment of copper ore from the Ok Tedi mine as a result of reduced water levels at the Fly river. The average f.o.b. price of Papua New Guinea's copper exports was K19,979 per tonne in 2006, an increase of 80.9 percent from 2005. The increase in international prices was due to lower stock levels at the London Metal Exchange, combined with higher demand from China and India, two of the major copper consuming countries in Asia. The increase in export price more than offset the decline in export volume resulting in export receipts of K4,329.5 million in 2006, an increase of 73.3 percent from 2005.

Crude oil export volumes in 2006 were 14,405.1 thousand barrels, an increase of 8.3 percent from 2005. The increase reflected higher extraction rates and production from the Kutubu, Moran and South East Mananda oil projects, which more than offset declines from the Gobe Main and South East Gobe oil projects. The average export price of crude oil in 2006 was K206 per barrel, an increase of 19.8 percent from 2005. The higher international prices resulted from cuts to the production quota by the Organisation of Petroleum Exporting Countries (OPEC), the on-going crisis in Iraq, lower North American oil stocks and increased demand in Asia, especially from China and India. The combined increases in export price and volume resulted in export receipts of K2,967.3 million in 2006, an increase of 30.0 percent from 2005.

Export receipts of refined petroleum products from the Napanapa Oil Refinery in 2006 were K263.9 million, a decline of 46.9 percent from 2005. The significant decline reflected lower production following a shut down of the refinery to revamp operational efficiencies of the products produced.

### **Agriculture, Logs and Fisheries Exports**

Export prices of most agricultural commodities increased in 2006, compared to 2005. Cocoa prices increased by 3.3 percent, palm oil by 4.3 percent, tea by 9.7 percent, rubber by 44.2 percent, logs by 3.7 percent and marine products by 29.2 percent. Coffee prices declined by 1.4 percent, copra by 15.8 percent and copra oil by 15.5 percent. The average export price of logs was K185 per cubic metre in 2006, an increase of 3.7 percent from 2005. The increase in export prices of cocoa, palm oil, tea, rubber, logs and marine products more than offset the declines in the prices of coffee, copra and copra oil. This resulted in a 3.4 percent increase in the weighted average price of agricultural, forestry and marine product exports. Excluding logs, the weighted average price of agricultural and marine product exports increased by 3.2 percent in 2006, compared to 2005.

The volume of coffee exported was 52,300 tonnes in 2006, a decline of 27.5 percent from 2005. The decline was mainly associated with the biennial production cycle with 2006 as the off year, combined with prolonged wet season and bad road conditions. The average export price of coffee was K6,444 per tonne in 2006, a decline of 1.4 percent from 2005. The decline was mainly due to lower international prices reflecting an increase in world supply resulting mainly from higher production from Brazil and other major producing nations. The combined declines in export price and volume resulted in export receipts of K337.0 million in 2006, which is lower by 28.5 percent from the 2005 receipts.

The volume of cocoa exported was 44,000 tonnes in 2006, a marginal decline of 0.5 percent from 2005. Lower production and exports from the major cocoa producing regions was mainly due to unfavourable rain and wind conditions during the flowering period that impeded production, combined with infrastructure and logistic problems in getting cocoa produce to the market. The average export price of cocoa was K4,645 per tonne in 2006, an increase of 3.3 percent from 2005. The increase was due to higher international

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prices resulting from lower supply in the world market caused by declines in production from the Ivory Coast and other countries in Asia and Latin America. The increase in export price more than offset the decline in export volume resulting in export receipts of K204.4 million in 2006, an increase of 2.9 percent from 2005.

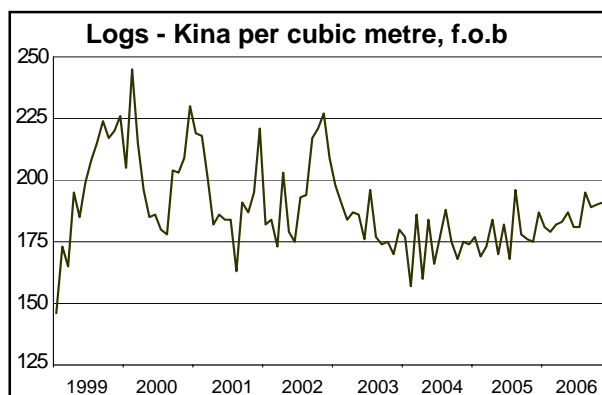
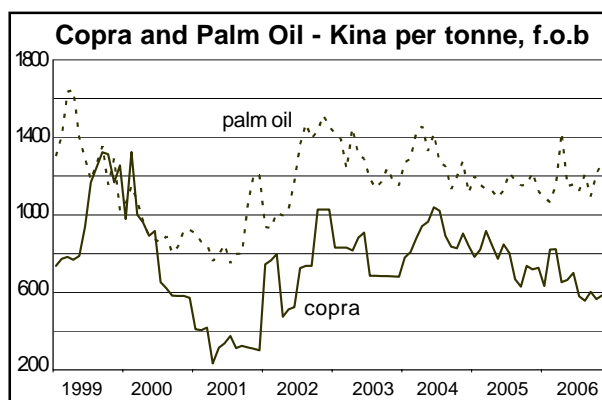
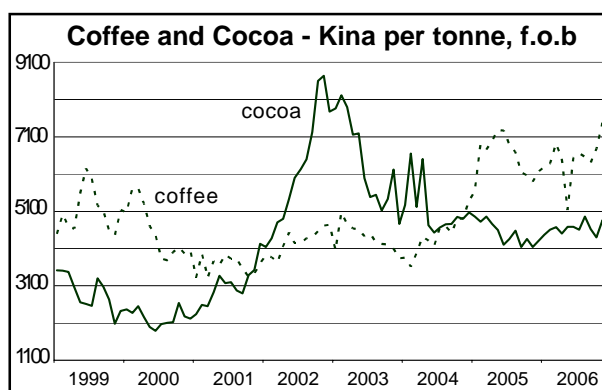
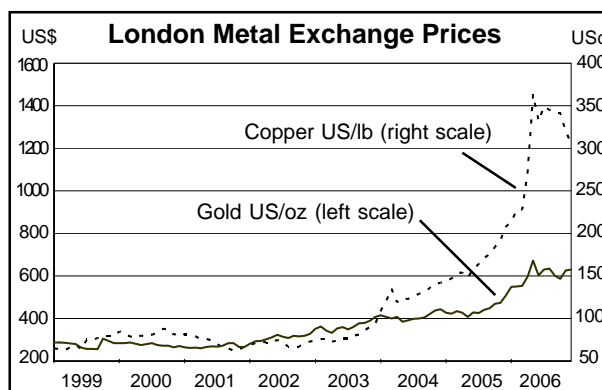
The volume of copra exported was 12,700 tonnes in 2006, a decline of 43.0 percent from 2005. The decline was attributed to lower production and exports from the major copra producing regions as a result of declines in international prices, lack of good infrastructure and rainy conditions. The average export price of copra was K654 per tonne in 2006, a decline of 15.8 percent from 2005. The decline was due to lower international prices caused by higher production from the Philippines and Indonesia, two of the world's major copra producers. The combined declines in export price and volume resulted in export receipts of K8.3 million in 2006, a decline of 52.0 percent from 2005.

The volume of copra oil exported was 41,500 tonnes in 2006, a decline of 23.7 percent from 2005. The decline was mainly due to lower quantities of copra purchased by the two domestic mills for processing and exporting. The average export price of copra oil was K1,455 per tonne in 2006, a decline of 15.5 percent from 2005. The decline was due to lower international prices as a result of higher copra production from the Philippines and Indonesia, combined with an increase in supply of other edible oils in the world market. The combined declines in export price and volume resulted in export receipts of K60.4 million in 2006, a decline of 35.5 percent from 2005.

The volume of palm oil exported was 362,300 tonnes in 2006, an increase of 4.8 percent from 2005. The outcome was due to higher production following the harvesting from new estates combined with increased shipments from the major palm oil producing regions. The average export price of palm oil was K1,181 per tonne in 2006, an increase of 4.3 percent from 2005. The increase reflected higher international prices due to lower production from Malaysia and Indonesia, two of the world's major producers. The combined increases in export price and volume resulted in export receipts of K427.9 million in 2006, an increase of 9.3 percent from 2005.

The volume of tea exported was 6,600 tonnes in 2006, a decline of 4.3 percent from 2005. Lower production was mainly associated with rainy conditions that

## EXPORT COMMODITY PRICES



affected the major tea producing areas. In addition, labour dispute in one of the tea estates also affected production however, it was negligible compared to the effect of bad weather condition. The average export price of tea was K3,212 per tonne in 2006, an increase of 9.7 percent from 2005. The increase in export price more than offset the decline in export volume resulting in export receipts of K21.2 million in 2006, an increase of 5.0 percent from 2005.

The volume of rubber exported was 4,400 tonnes in 2006, a decline of 8.3 percent from 2005. The decline was mainly attributed to unfavourable weather conditions in the rubber producing regions combined with deteriorating road conditions. The average export price was K5,409 per tonne in 2006, an increase of 44.2 percent from 2005. The increase was due to higher international prices as a result of lower supply in the world market. The increase in export price more than offset the decline in export volume resulting in export receipts of K23.8 million in 2006, an increase of 32.2 percent from 2005.

The volume of logs exported was 2,653 thousand cubic metres in 2006, an increase of 16.9 percent from 2005. The increase was associated with higher production and shipment of logs reflecting the re-opening of dormant logging sites and commencement of new projects following the lifting of embargo on new logging projects. The average export price of logs was K185 per cubic metre in 2006, an increase of 3.7 percent from 2005. The increase was due to higher international prices, reflecting lower supply of tropical hardwoods in the world market. The combined increase in export price and volume resulted in export receipts of K491.0 million in 2006, an increase of 21.3 percent from 2005.

The value of marine product exports was K89.1 million in 2006, an increase of 28.4 percent from 2005. This was a result of an increase in export price which more than offset the marginal decline in export volume.

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## 6. BALANCE OF PAYMENTS

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The overall surplus in the balance of payments was K1,942 million in 2006, compared to a surplus of K296 million in 2005. This outcome was due to a net inflow

in the capital and financial accounts, which more than offset a lower surplus in the current account. The net inflow in the capital and financial accounts reflected capital transfer<sup>3</sup> receipts, combined with a draw down in portfolio, other investment assets and an increase in foreign direct investment inflows. The decline in the current account surplus was due to a higher net service and income payments and lower net transfer receipts, which more than offset a surplus in the trade account. In 2006, the kina appreciated against all the currencies of Papua New Guinea's major trading partners, compared to 2005. This resulted in a decline in the kina value of some balance of payments transactions.

The trade account recorded a surplus of K6,631 million in 2006, an increase of 22.0 percent from 2005. The higher surplus was due to an increase in the value of merchandise exports, which more than offset an increase in the value of merchandise imports. The value of merchandise exports in 2006 was K12,617 million, an increase of 24.1 percent from 2005. The increase was attributed to higher values of copper, crude oil, gold, cocoa, palm oil, tea, rubber, logs and marine product exports.

The value of merchandise imports was K5,986 million in 2006, an increase of 26.5 percent compared to 2005. The increase was due to higher imports by all sectors. General imports increased by 28.1 percent to K4,423 million in 2006, compared to 2005, reflecting increased aggregate demand in the economy. Imports by the mining sector increased by 12.5 percent to K1,076 million in 2006, compared to 2005. The increase was due to higher capital expenditures undertaken by the Ok Tedi and Lihir mines. Petroleum sector imports increased by 52.2 percent to K487 million in 2006, compared to 2005. The outcome reflected higher capital expenditures associated with the Kutubu oil project, on-going work at the Moran oil project and construction of the Juha gas fields.

The deficit in the services account was K3,566 million in 2006, an increase of 32.9 percent compared to 2005. This outcome was due to payments of transportation costs and insurance associated with higher imports, education, other financial, computer and information, communication, other business, construction, refining and smelting and other services, combined with lower service receipts by resident companies.

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<sup>3</sup> Refer to footnote on page 2.

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The deficit in the income account was K2,423 million in 2006, an increase of 45.1 percent from 2005. This outcome was due to higher payments of dividend, interest and compensation of employees, which more than offset higher income receipts.

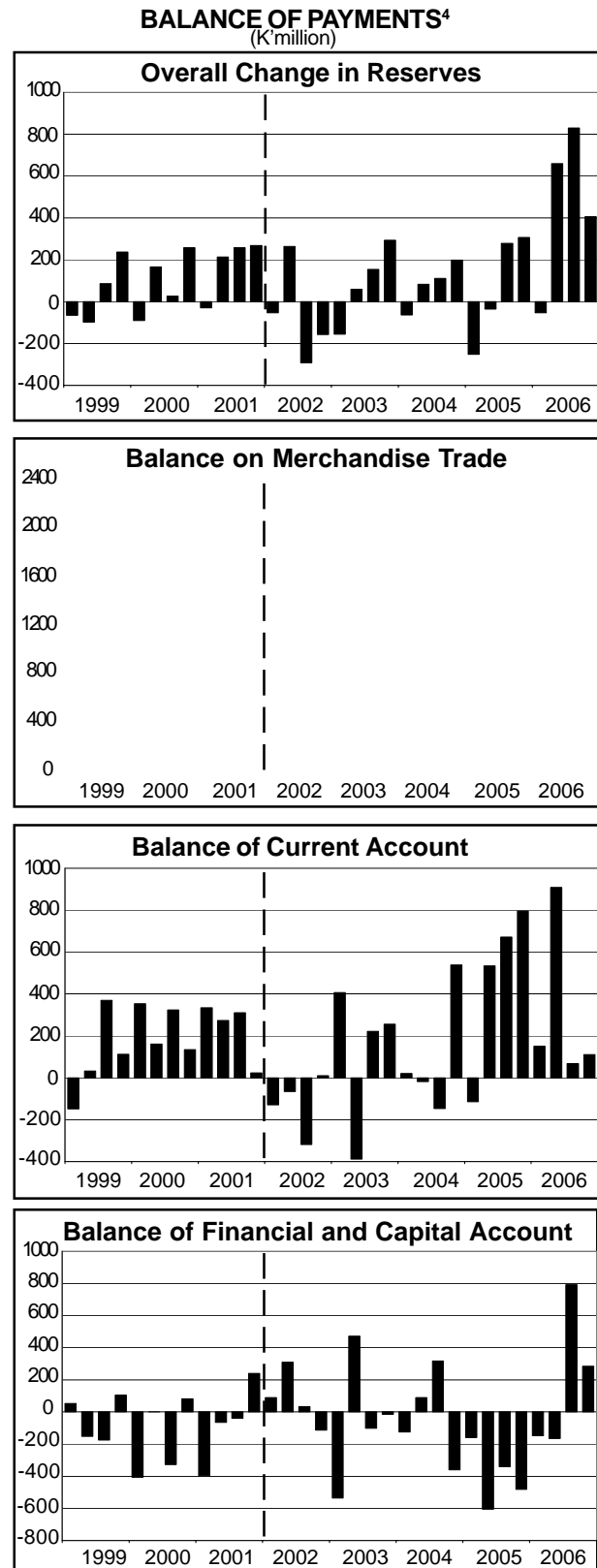
The surplus in the transfers account was K596 million in 2006, a decline of 25.8 percent from 2005. This outcome was due to increased payments of superannuation contributions, family maintenance, tax and licensing fees and gifts and grants, combined with lower transfer receipts.

As a result of these developments in the trade, services, income and transfers accounts, the current account recorded a surplus of K1,238 million in 2006, compared to a surplus of K1,887 million in 2005.

The capital account recorded a net inflow of K135 million in 2006, compared to K101 million in 2005. This outcome reflected higher transfers by donor agencies through direct project financing for the acquisition of fixed assets.

The financial account recorded a net inflow of K627 million in 2006, compared to a net outflow of K1,691 million in 2005. This outcome was due to net inflows of foreign direct investment, portfolio and other investments totalling K662 million. The increase in foreign direct investment inflows reflected share placements by a mineral company to raise capital for exploration activities and operational expenses, while net inflow in portfolio investment assets was due to a draw down of short-term money market instruments. In addition, there was a net inflow in other investments reflecting a draw down in foreign currency account balances of mineral companies and a decline in net foreign assets of the banking system. These more than offset increased investments in financial derivative instruments and higher net loan repayments by the Government and private sector. The Government made a net loan repayment of K303 million in 2006, compared to K293 million in 2005. This included a prepayment of K100.7 million for ADB loans.

As a result of these developments, the capital and financial accounts balance recorded a surplus of K762 million in 2006, compared to a deficit of K1,590 million in 2005.



<sup>4</sup> The dotted vertical lines indicate a break in series from 2002. See 'For the Record' in the March 2002 QEB on page 29.

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In the December quarter of 2006, the balance of payments recorded an overall surplus of K406 million, compared to a surplus of K306 million in the corresponding quarter of 2005. This outcome was due to a net inflow in the capital and financial accounts, which more than offset a deterioration in the current account.

The value of merchandise exports was K2,973 million in the December quarter of 2006, an increase of 3.2 percent from the corresponding quarter of 2005. The increase was due to higher export values of copper, gold, palm oil, tea, rubber, logs and marine products. Agricultural, forestry, marine products and other non-mineral exports, excluding refined petroleum products were K427.3 million and accounted for 14.4 percent of total merchandise exports in the December quarter of 2006, compared to 19.1 percent in the corresponding quarter of 2005. Refined petroleum product exports totalled K62.7 million in the December quarter of 2006 and accounted for 2.1 percent of total merchandise exports, compared to 2.2 percent in the corresponding quarter of 2005. Mineral exports totalled K2,483.0 million or 83.5 percent of total merchandise exports in the December quarter of 2006, compared to 78.7 percent in the corresponding quarter of 2005.

The value of merchandise imports was K1,578 million in the December quarter of 2006, an increase of 40.6 percent from the corresponding quarter of 2005. This outcome reflected higher imports in all sectors. General imports increased by 42.2 percent to K1,145 million in the December quarter of 2006, compared to the corresponding quarter of 2005. Mining sector imports increased by 8.3 percent to K286 million in the December quarter of 2006, compared to the corresponding quarter of 2005. This outcome was due to higher capital expenditures by the Ok Tedi and Lihir mines. Imports by the petroleum sector increased significantly by 177.4 percent to K147 million in the December quarter of 2006, compared to the corresponding quarter of 2005. This outcome was due to higher capital expenditure by the Kutubu oil project, work on consolidating parts of the Moran project overlapping into other petroleum licensed areas and construction of the Juha well.

The deficit in the services account was K908 million in the December quarter of 2006, an increase of 35.5 percent from the corresponding quarter of 2005. This outcome was due to payments for transportation and insurance associated with higher imports, travel, education, insurance, other financial, computer and infor-

mation, cultural and recreational, communication, other business and construction services, combined with lower service receipts by resident companies.

The deficit in the income account was K417 million in the December quarter of 2006, an increase of 3.0 percent compared to the corresponding quarter of 2005. This outcome was due to higher compensation of employees and dividend payments, which more than offset higher income receipts.

The surplus in the transfers account was K41 million in the December quarter of 2006, compared to K112 million in the corresponding quarter of 2005. The significant decline was due to lower family maintenance, tax, licensing fees and gifts and grant receipts, combined with higher transfer payments.

As a result of these developments in the trade, services, income and transfers accounts, the current account recorded a surplus of K111 million in the December quarter of 2006, compared to a higher surplus of K795 million in the corresponding quarter of 2005.

The capital account recorded a net inflow of K34 million in the December quarter of 2006, compared to K33 million in 2005. This outcome reflected capital transfers by donor agencies for projects.

The financial account recorded a net inflow of K250 million in the December quarter of 2006, compared to a net outflow of K515 million in the corresponding period of 2005. The outcome was due to a net inflow of portfolio investment totalling K262 million from investments in short-term money market instruments, and a lower net outflow for other investments reflecting a decline in net foreign assets of the banking system.

As a result of these developments, the capital and financial accounts balance recorded a surplus of K284 million in the December quarter of 2006, compared to a deficit of K482 million in the corresponding quarter of 2005.

The level of gross foreign exchange reserves at the end of December 2006 was K4,310 (US\$1,450.8) million, sufficient for 8.6 months of total and 11.6 months of non-mineral import covers.

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## 7. MONETARY DEVELOPMENTS

### INTEREST RATES AND LIQUIDITY

The Bank of Papua New Guinea maintained a neutral monetary policy stance based on favourable macroeconomic outcomes and inflation outlook during 2006. Consistent with the Bank's expectations as stated in the January and July 2006 MPSs, the KFR was maintained at 6.00 percent in 2006. The dealing margin for the Repurchase Agreements (Repos) was reduced by 1.00 percent in aggregate to 150 basis points on both sides of the KFR to realign domestic interest rates to the KFR. The Central Bank Bill (CBB) rates showed an increasing trend with the 28-day rate increasing from 2.99 percent to 4.02 percent over the year to December 2006. In May 2006, the 63-day CBB was introduced and sold at 3.67 percent and by the end of 2006 the rate increased to 4.04 percent. Government Treasury bill rates declined with the 91-day rate declining from 3.84 percent in December 2005 to 2.97 percent in April 2006 when it was last offered. The 182-day Treasury bill rate declined from 4.91 percent to 3.30 percent and the 364-day rate fell from 5.69 percent to 4.49 percent over the year to December 2006. The weighted average deposit rates quoted by commercial banks on wholesale deposits (K500,000 and above) showed increasing trends across all maturities in 2006. The 30-day rate increased from 0.82 percent to 2.02 percent, 60 days from 0.95 percent to 1.19 percent, the 90-day rate from 1.45 percent to 1.50 percent and the 180-day rate from 2.18 percent to 4.11 percent. The weighted average interest rate on total deposits paid by commercial banks increased from 0.8 percent to 1.0 percent, whilst the weighted average interest rate on total loans declined from 10.7 percent to 10.2 percent. The commercial banks maintained their Indicator Lending Rates (ILR) within the spread of 9.45 to 10.70 percent.

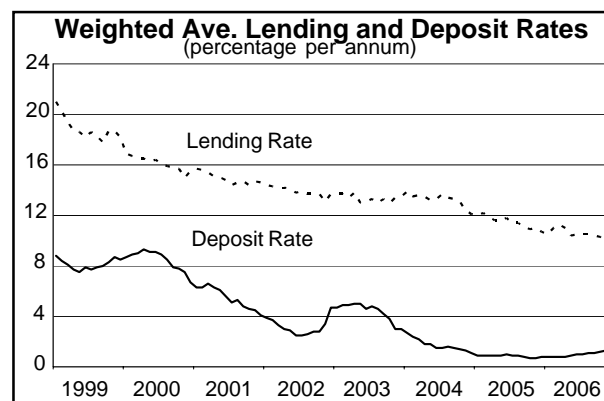
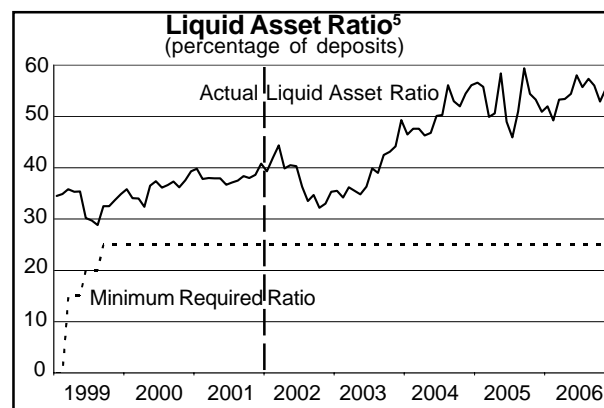
The Bank continued to utilise Open Market Operation (OMO) instruments in the conduct of monetary policy over the year to December 2006. Between May and September 2006, there were no Treasury bill auctions as the Government retired its maturing bills. The liquidity impact of the maturities was sterilised by the Central Bank through the use of CBBs and Reverse Repos. Trading in the inter-bank market remained low

in 2006 due to the high level of liquidity in the banking system. 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, in 2006.

Average liquid assets held by other depository corporations (ODCs) increased by 43.5 percent in 2006, compared to an increase of 26.2 percent in the previous year. The increase reflected higher holdings of currency, CBBs, Treasury bills and Inscribed stock, which more than offset a decline in deposits held at the Central Bank.

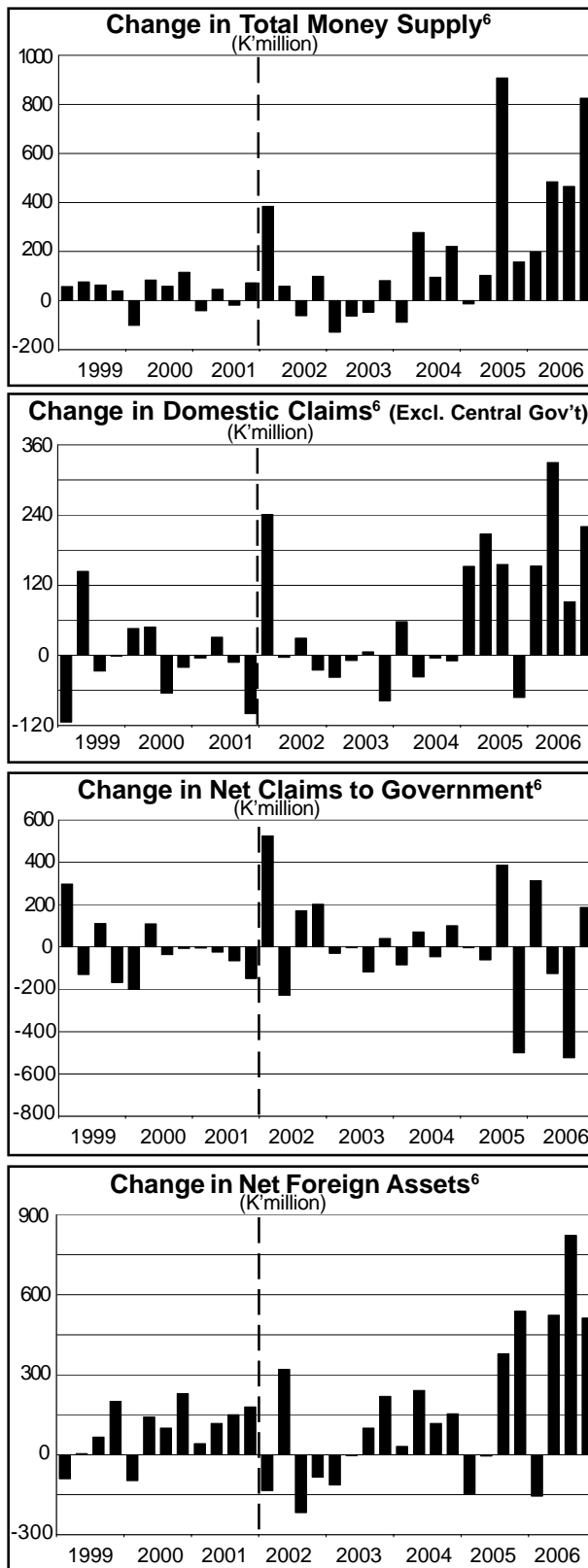
### MONEY SUPPLY

The average level of broad money supply (M3\*) increased by 35.4 percent in 2006, compared to an increase of 20.2 percent in 2005. The outcome was due to increases of 54.4 percent in average net foreign assets of the depository corporations and 27.8 percent in average net claims on the private sector, which more



<sup>5</sup> The dotted vertical lines indicate a break in series from 2002. See 'For the Record' in the June 2006 QEB on page 44.





than offset a decline of 10.7 percent in average net claims on the Central Government. Net domestic credit outstanding, excluding advances to the Central Government and outstanding loans under the Government's Agricultural export commodity price support schemes increased by 26.6 percent in 2006, compared to an increase of 15.5 percent in 2005. The average level of monetary base (reserve money) grew by 10.5 percent in 2006, compared to an increase of 16.4 percent in 2005. The increase reflected deposits of ODCs at the Central Bank and an increase in currency in circulation. The decline in average net credit to Government in 2006 resulted mainly from increased Government deposits at the Central Bank, which more than offset an increase in purchase of Government securities by ODCs.

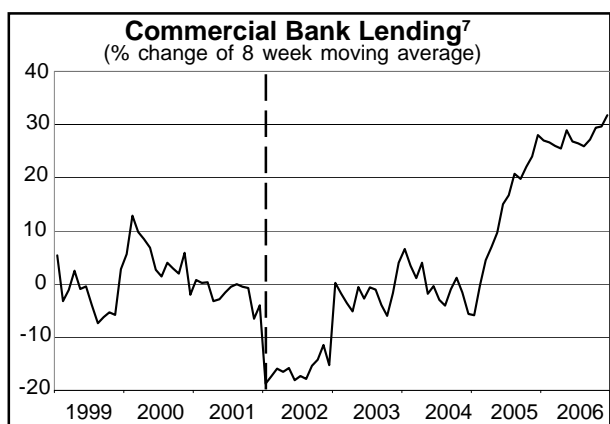
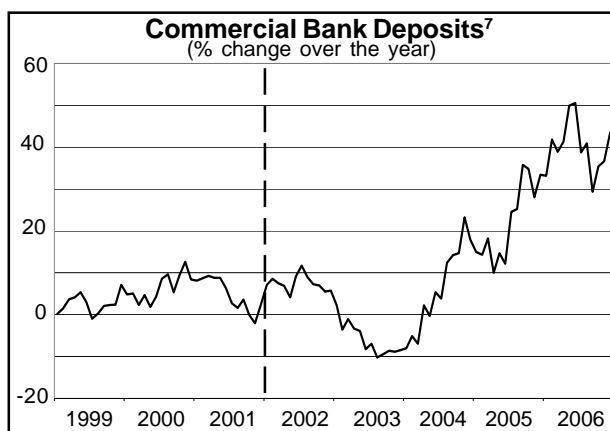
The average level of narrow money supply (M1\*) increased by 27.0 percent in 2006, compared to an increase of 34.2 percent in 2005. There were increases in both currency in circulation and demand (transferable) deposits. The average level of quasi money increased by 47.7 percent in 2006, compared to an increase of 4.3 percent in 2005, mainly due to an increase in average savings deposits.

The average level of deposits of the ODCs increased by 36.7 percent in 2006 to K5,821.2 million, from K4,256.9 million in 2005, due to increases in both transferable and other deposits including Central Government deposits.

## LENDING

Over the year to December 2006, total domestic credit extended by depository corporations to the private sector, public non-financial corporations, Provincial and Local Level Governments, and other financial corporations, increased by K793.9 million to K3,035.0 million, compared to an increase of K442.2 million in 2005. Growth in credit to the private sector during 2006 increased by K814.7 million, which more than offset a decline of K21.9 million to the public non-financial sector. Credit to the private sector was mainly due to lending to the agriculture, forestry and fisheries, manufacturing, transport and communication, building and construction, mining and quarrying and other sectors, including the household sector for personal loans and advances for housing. There were no repayments under the price support schemes. The annualised

<sup>6</sup> Break in series. Refer to footnote on page 16.



growth in domestic credit, excluding Central Government and advances under the price support schemes was 35.4 percent over the twelve months to December 2006.

Over the first six months of 2006, total domestic credit extended by the depository corporations to the private sector, public non-financial corporations, Provincial and Local Level Governments and other financial corporations increased by K482.5 million to K2,723.6 million. Growth in credit to the private sector and Provincial and Local Level Governments increased by K490.8 million and K0.4 million, respectively, which more than offset a decline of K8.7 million in credit to the public non-financial corporations. The increase in private sector credit was due to lending to the transport and communication, commerce, building and construction, other sectors, coffee, fisheries, forestry and other agriculture sub-sectors and personal advances to the household sector.

Over the second half of 2006, total domestic credit extended by the depository corporations to the private sector, public non-financial corporations, Provincial and Local Level Governments and other financial corporations increased by K311.4 million to K3,035.0 million. Private sector credit increased by K323.8 million, which more than offset a decline of K13.2 million and K0.4 million in credit to public non-financial corporations and other financial corporations, respectively. The growth in credit to the private sector was broadbased with lending to the manufacturing, transport and communication, finance, commerce, building and construction, mining and quarrying, agriculture, forestry and fisheries and household sectors.

## 8. PUBLIC FINANCE

Preliminary estimates of the fiscal operations of the National Government showed an overall surplus of K618.7 million in 2006, compared to a surplus of K46.9 million in 2005. This represents 3.6 percent of nominal GDP and was due to higher tax revenue resulting from an increase in mineral tax receipts, which more than offset an increase in expenditure.

Total revenue, including foreign grants, during 2006 was K6,436.5 million, 21.1 percent higher than the receipts collected in 2005, and represents 104.5 percent of the 2006 revised budgeted revenue. The increase was attributed to higher collections in all categories of tax and non-tax revenue, except the import duties, other indirect tax and foreign grants.

Total tax revenue amounted to K5,012.7 million, 33.1 percent higher than the receipts collected during 2005, and represents 106.1 percent of the revised budgeted tax receipts for 2006. The increase reflected higher collections in both the direct and indirect tax categories.

Direct tax receipts totalled K3,891.2 million, K1,097.2 million more than the receipts collected in 2005, and represents 106.8 percent of the revised budgeted amount. The increase reflected higher collections of personal, company and other direct tax receipts. The growth in personal tax receipts resulted from active collections of overdue salary and wages tax by the

<sup>7</sup> Refer to footnote on page 16.

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Internal Revenue Commission (IRC), combined with increased employment by the private sector. The increase in company tax receipts reflected improved profitability by companies due to higher mineral and agricultural production and prices. Other direct taxes increased due to higher receipts from gaming machine and dividend withholding taxes.

Indirect tax receipts was K1,121.5 million, K148.6 million higher than in 2005, and represents 103.8 percent of the revised budgeted tax receipts. This was attributed to increases in most categories of indirect taxes which more than offset declines in import duties and other indirect taxes. The increase in excise duties was related to an increase in consumption of domestically produced items far outweighing that of imported items. The higher Goods and Services Tax (GST) reflected increased collections in the provinces combined with gross collections on imported items. Import duty collections declined reflecting a 5 percentage points reduction in all tariff rates considered as impediments to investment, while other indirect tax receipts decreased as a result of the gradual phasing out of the mining levy.

Total non-tax revenue amounted to K429.8 million, K166.6 million higher than the amount collected in 2005, and represents 97.1 percent of the revised budgeted amount. The increase mainly reflected higher dividend payments by Government Statutory bodies and the mineral sector. Foreign grants for development projects totalled K994.0 million, K289.1 million lower than in 2005, due to reduced commitments from donor countries attributed to the withdrawal and completion of some large projects.

Total expenditure during 2006 was K5,817.8 million, 10.5 percent higher than in 2005, and represents 94.4 percent of the revised budgeted expenditure for 2006. The increase reflected a higher recurrent expenditure, which more than offset a decline in development expenditure.

Recurrent expenditure in 2006 was K3,684.9 million,

7.9 percent higher than in 2005, and represents 96.4 percent of the revised budgeted appropriation. The increase was due to higher spending by both the National Departments and Provincial Governments. The National Departmental expenditure was K2,344.5 million, K120.9 million higher than in 2005, and represents 96.5 percent of the revised budgeted appropriation. The increase reflected higher education subsidies, payment of court orders, and additional expenditure set aside for the Supplementary Budget. Provincial Government recurrent expenditure was K803.4 million, 22.4 percent higher than the expenditure level during 2005, and represents 106.2 percent of the revised budgeted amount. The increase was due to higher personal emoluments, goods and services grants and conditional grants. Interest payments totalled K307.1 million, K25.7 million lower than the amount paid in 2005, and reflected lower interest rates on Treasury bills combined with the debt switch from short to longer term maturities, and the effect of the appreciation of the kina against the US dollar on foreign debt service.

Total development expenditure in 2006 was K1,482.9 million, 19.8 percent lower than in 2005 and represents 87.9 percent of the revised budgeted expenditure for 2006. The decline was attributed to slow implementation of projects as well as reduced commitments from donor countries as some projects were either completed or withdrawn due to lack of implementation capacity by the implementing agencies.

The surplus was used to make net overseas loan repayments of K228.1 million and net domestic loan repayments of K390.6 million. The net external loan repayments comprised of K16.6 million in commercial and K251.1 million in extraordinary repayments, which more than offset a draw down of K39.6 million in concessionary loans. Net domestic loan repayments totalling K720.2 million were made to financial corporations. This more than offset a total financing of K329.6 million from other resident sectors, which reflects unrepresented cheques issued in 2006.

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## THE 2007 NATIONAL BUDGET

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The National Budget is the principal tool for fiscal policy; one component of a set of policy tools employed by the Government to meet multiple objectives of macroeconomic management. At the macroeconomic level, the importance of the budget lies in its immediate impact on the level of aggregate demand and hence, on the whole economy.

This article reviews the 2007 National Budget which was presented in Parliament on 14th November 2006 with a second Supplementary Budget for 2006 and another for 2007. The 2007 Budget continued to focus on sustaining macroeconomic stability and achieving further economic growth through its implementation in line with the Medium Term Fiscal Strategy (MTFS) and the Medium Term Development Strategy (MTDS). As with previous budget articles the detailed budget data has been rearranged and aggregated. Some misclassification of data may occur as a result of this process but the primary focus here is the broad aggregates and trends.

The fiscal strategy for 2007 and the medium term is set against a backdrop of sound global and domestic economic conditions. To maintain macroeconomic stability, the Government aims to achieve a budget deficit of 0.2 percent of GDP in 2007, which is consistent with its goal of achieving a balanced budget over the medium term. The MTFS for 2007 continues the broad objective of promoting an enabling environment for private sector growth and investment through efficient delivery of public services, low cost structures, appropriate regulatory controls and financial incentives. The high level of international prices for mineral commodities enabled the Government to revise upwards the appropriations for the Development budget by allocating the windfall revenue towards development priorities outlined under the MTDS.

The Government, in adhering to the MTDS, has identified seven Expenditure Priority Areas (EPAs) in which to focus its public investment program. The seven EPAs are: Primary and Preventative Health; HIV/AIDS Prevention; Basic Education; Development Oriented Adult Education; Transport Infrastructure Rehabilitation and Maintenance; Promotion of Income Earning Opportunities; and Law and Justice. The Government aims to align the Development Budget with the MTDS EPAs by increasing its allocation every year.

The 2007 Budget focuses on improving the existing tax regime and continue with the planned tax reductions, including the second round of personal tax reductions and the phasing out of the mining levy. The main revenue measures introduced in the 2007 Budget were: incentives for tourism operators; reforms on forestry revenue sharing arrangements; tax concessions for agricultural related projects under the Green revolution program; excise relief for banana boats and light aircraft fuels; and new funding arrangement for distribution of Goods and Services Tax (GST) revenue for provinces.

The focus of expenditure control measures for 2007 were on increased spending for MTDS priority areas, further improvements to public finance management, continued public sector reforms and removal of impediments to business and investment. The Government's on-going public sector reforms are vital in building the capacity of the institutions of public service delivery and creating a conducive environment for macroeconomic stability and economic growth.

The Government has increased its appropriations under the Development Budget by K64.3 million to K757.5 million in order to partially offset a projected 11.6 percent decline in donor funding in 2007. This is due to uncertainties over PNG's share of donor funds mainly from the European Union (EU), Japan and China. These project support grants from donors continue to form an essential part of on-going development expenditure.

The formulation of the Budget was based on the expectation of favourable economic developments, with a projected real GDP growth rate of 4.5 percent in 2007. Growth is expected from all sectors of the economy except the petroleum sub-sector, due to the natural decline of reserves in existing oil fields and falling global oil prices. The projected growth in the agriculture sector reflects increased production due to higher international prices, expansion of production and tax incentives provided to the sector. The other sectors, including the construction, manufacturing and mining sectors are expected to improve.

Table 1 summarises fiscal developments from 2003 to 2006 and the Budget indicators for 2007. In 2007, the fiscal burden on the economy, as represented by the appropriations/GDP ratio is expected to improve to 30.5 percent from the 2006 outcome of 33.7 percent. The improvement reflects lower expenditure growth

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Table 1: Budgetary Indicators (K'million)							
	2003	2004	2005	2006			2007
	Actuals			Original Budget	Revised Budget	Preliminary Outcome	Budget
1. Total Internal Revenue & Grants	3,650	4,350	5,313	4,739	6,162	6,437	5,422
2. Appropriations	3,774	4,148	5,266	4,829	6,162	5,818	5,457
3. <i>of which:</i> Additional Priority Expenditure					650	650	450
4. Surplus/(Deficit) =1-2	-124	202	47	-90	0	619	-35
5. Primary Balance	615	578	333	407	432	862	441
6. <i>FINANCING</i>	124	-202	-47	90	0	-619	35
External	-307	-325	-238	-124	-224	-234	-84
Domestic	431	124	191	214	224	-385	119
Asset sales	40	25	0	0	0	0	0
<i>Memorandum Items:</i>							
7. Borrowed Funds	814	1,434	1,602	1,383	1,293	1,007	2,278
8. GDP (Nominal)	12,567	12,652	15,339	15,886	17,269	17,269	17,886
<i>(Ratios to Nominal GDP in %)</i>							
9. Appropriations/GDP	30.0	32.8	34.3	30.4	35.7	33.7	30.5
10. Total Internal Revenue & Grants/GDP	29.0	34.4	34.6	29.8	35.7	37.3	30.3
11. Surplus or Deficit/GDP	-1.0	1.6	0.3	-0.6	0.0	3.6	-0.2
12. Borrowed Funds/GDP	6.5	11.3	10.4	8.7	7.5	5.8	12.7
<i>(Growth rates in %, year on year)</i>							
13. Total Internal Revenue & Grants	13.0	19.2	22.2	-10.8	16.0	21.1	-15.8
14. Appropriations	1.0	9.9	27.0	-8.3	17.0	10.5	-6.2
15. GDP (Nominal)	7.8	0.7	21.2	3.6	12.6	12.6	3.6
16. Headline Inflation (Over the Year)	8.4	2.4	4.6	4.6	5.3	1.3	6.0
The above figures may not correspond to Table 7.1 in the QEB due to some reclassification.							
Source: Bank of Papua New Guinea and 2007 Budget Papers, Volumes 1, Department of Finance and Treasury.							

consistent with the projected decline in total revenue and grants, combined with current expenditure controls and the Government's adherence to the MTFs.

The 2006 preliminary fiscal out-turn showed a surplus of 3.6 percent of nominal GDP, compared to a small deficit and a balanced budget projected in the original and revised budgets, respectively. The budget surplus was used to make net repayments to external and domestic sources.

The projected Budget deficit of K35.0 million for 2007

is 0.2 percent of nominal GDP. A net external loan repayment of K83.7 million is budgeted, comprising of K4.3 million to extraordinary sources, K18.2 million to concessionary sources and K61.2 million to commercial sources. A positive net domestic financing of K118.7 million is projected to be raised, predominantly through the issuance of Inscribed stocks. This trend is consistent with the Government's debt management strategy to switch debt from short term to longer term.

The primary balance (see Table 1) measures the effects of discretionary budgetary policy by excluding

**Table 2: Distribution between Revenue and Financing items in the 2007 Budget (K' million)**

	2003	2004	2005	2006			2007
	Actuals			Original Budget	Revised Budget	Preliminary Outcome	Budget
1. Total Internal Revenue & Grants	3,650	4,350	5,313	4,739	6,162	6,436	5,422
2. Direct Taxes	1,787	2,223	2,794	2,468	3,644	3,891	3,072
3. Indirect Taxes	931	1,031	993	1,050	1,152	1,145	1,144
4. Department Rev. & Services	80	80	78	82	82	116	84
5. Revenue from Assets	160	165	165	145	290	291	243
6. Grants	693	850	1,283	994	994	994	879
Memorandum Item:							
7. Borrowings	814	1,434	1,602	1,383	1,293	1,256	2,278
<i>Ratios (%)</i>							
8. Direct Taxes/Total Revenue	48.9	51.1	52.6	52.1	59.1	60.5	56.7
9. Indirect Taxes/Total Revenue	25.5	23.7	18.7	22.2	18.7	17.8	21.1
10. Dept. Revenue/Total Revenue	2.2	1.8	1.5	1.7	1.3	1.8	1.6
11. Revenue from Assets/Total Revenue	4.4	3.8	3.1	3.1	4.7	4.5	4.5
12. Grants/Total Revenue	19.0	19.5	24.1	21.0	16.1	15.4	16.2
Memorandum Item:							
13. Borrowings/Total Revenue	22.3	33.0	30.2	29.2	21.0	19.5	42.0

Source: see Table 1.

interest payments from the conventional measure of fiscal deficit. This deficit indicates how the fiscal actions of the Government affect its net debt position and is important in assessing the sustainability of fiscal deficit. A surplus in the primary balance in 2007 indicates that the projected deficit is sustainable and implies that the Government's net debt and total public debt to GDP ratio is expected to decline.

Table 2 depicts that the revenue components of the 2007 Budget as a percentage of total revenue increased for most revenue measures, except the direct taxes and Department revenue and services. The total budgeted revenue and grants for 2007 is projected to be 12.0 percent lower, compared to the 2006 revised budget. The decline mainly reflects lower direct tax receipts due to decreases in tax collections from the mineral sector and a decline in grants.

In 2007, total direct taxes are projected to decrease by 15.7 percent and account for 56.7 percent of total

revenue compared to 59.1 percent in the revised Budget for 2006. The decline is largely due to lower mining and petroleum tax receipts depicting an assumed reduction in the international copper price and a moderate reduction in oil production.

Indirect taxes are expected to decrease by 0.7 percent but increase as a ratio of total revenue to 21.1 percent in 2007, compared to the 2006 revised Budget. The decline reflects the continued phased reduction in the mining levy, more than offsetting the growth in Goods and Services Tax (GST) receipts and excise collections. Non-tax revenue is expected to decline by 12.0 percent, compared to the 2006 revised Budget, mainly due to the projected reduction in dividends from the State's share in the Ok Tedi mine following an assumed reduction in the international price of copper.

Total project grants are expected to decline by 11.6 percent in 2007, compared to the 2006 revised Budget. The decline is mainly the result of uncertainties over

	2003	2004	2005	2006			2007
	Actuals			Original Budget	Revised Budget	Preliminary Outcome	Budget
1. Total Appropriation	3,774	4,148	5,266	4,829	6,162	5,818	5,457
2. Current Expend. National Level (a)	2,101	2,130	2,760	2,396	3,068	2,882	2,623
3. Development Expenditure (b)	1,079	1,327	1,849	1,687	1,687	1,483	1,637
4. Provincial Governments (c)	595	691	657	746	757	803	747
5. Additional Priority Expenditure					650	650	450
<i>Ratios (%)</i>							
5. Current Expenditure/Total Appropriation	55.7	51.3	52.4	49.6	49.8	49.5	48.1
6. Dev. Expenditure/Total Appropriation	28.6	32.0	35.1	34.9	27.4	25.5	30.0
7. Provincial Govts/Total Appropriation	15.8	16.7	12.5	15.4	12.3	13.8	13.7
Source: Table 1							
Notes:							
(a) Current Expenditure, National Level includes interest payments and transfers to CSAs.							
(b) Development expenditure includes Australian project grants							
(c) Provincial Government's is recurrent expenditure only.							

PNG's share of donor funds from the EU, Japan and China.

The 2007 National Budget aims to implement the recommendations of the Taxation Review Committee (TRC) with the aim of improving and simplifying tax administration in order to encourage investment and economic growth in the long run. The Government will continue to focus on strengthening tax compliance including improvements in collections of non-tax revenue.

Table 3 shows that the share of recurrent expenditure to total appropriation will decrease to 48.1 percent in 2007, compared to 49.8 percent in the 2006 revised Budget. This trend is consistent with the MTFs which follows a path of deficit reduction towards a balanced budget in the medium term. The share of development expenditure to total appropriation is 30.0 percent in 2007, compared to 27.4 percent in the 2006 revised Budget. The increase reflects the on-going alignment of expenditure from Recurrent to Development Budget to fund the MTDS priority areas. The increase in funding of the Development Budget is to partially cover for the expected shortfall in project grants in 2007.

The 2007 Budget shows that total expenditure is 11.4 percent lower than the 2006 revised Budget. National recurrent expenditure is projected to decrease by 14.5 percent, development expenditure by 3.0 percent, and recurrent Provincial Government spending by 1.3 percent.

During the handing down of the 2007 National Budget, the Government introduced a second Supplementary Budget for 2006 as a result of significant mineral tax revenue inflows reflecting the high international prices for mineral export commodities. To reduce the risk of the windfall revenue being built into the on-going recurrent expenditure, a separate Appropriation Bill was introduced to direct the windfall revenue to priority areas. A total amount of K1.1 billion was appropriated of which K650.0 million was made available for spending in 2006, and K450.0 million in 2007 on top of the 2007 Budget appropriation (see Table 3). This follows from an earlier Supplementary Budget introduced by the Government in August 2006, which allocated K682.5 million of the windfall revenue to priority expenditure areas identified under three broad categories: MTDS priority projects (K445.8 million), outstanding obligations (K172.8 million) and non-MTDS expenditure (K63.9 million).

Achieving the 2007 Budget revenue and expenditure targets is important because of its implications on financing and the level of public debt. The major threat to monetary conditions, the exchange rate and inflation, remains any fiscal slippages in the 2007 Budget in the lead up to the National Elections combined with the impact of the Supplementary Budgets on overall liquidity in 2007. Therefore, the Government's MTDS and MTFS, which encourages prudent management of Government finances to achieve a balanced budget and sustainable debt levels in the medium-term is key to macroeconomic stability. In addition, any changes to the major assumptions in the Budget framework such as declining mineral prices could fuel domestic borrowing and lead to inflationary pressures.

The appropriate fiscal policy that should be adopted must, in addition to being internally consistent and compatible with the broader objectives of the Government, be sustainable. If the budget deficit and a sustainable level of domestic financing are to be achieved in 2007, the Government must refrain from excessive expenditure over-runs and maintain expenditure levels within the parameters of the 2007

Budget.

In light of the Central Bank's neutral stance of monetary policy, fiscal discipline is necessary to complement the gains achieved over the previous years to sustain macroeconomic stability. Moreover, if the targets for Government revenue and external financing fall short of expectations, expenditure levels should be reviewed and cut, rather than reliance on domestic financing to meet budgeted and unbudgeted expenditure levels. Any increase in domestic financing to cover shortfalls in revenue will undermine the macroeconomic stability gained over the last four years. It is also important for the Government to refrain from issuance of new domestic debt when revenue is higher than budgeted or a budget surplus is being experienced. If further windfall in revenue is realised, the surplus revenue should be re-directed to fund priority development expenditures and reduce Government debt. In this context, it is crucial that the structural reforms are continued by the Government and development expenditure priorities are implemented effectively and efficiently, in order to achieve long-term sustainable growth.

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