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QUARTERLY ECONOMIC BULLETIN
JUNE QUARTER 2007

Mr. L. Wilson Kamit, CBE, Governor of the Bank of Papua New Guinea (Bank of PNG), today released the June 2007 Quarterly Economic Bulletin (QEB). This press statement covers financial and economic developments since June 2007 and an overview of developments in the June quarter, as contained in the June 2007 QEB.

1. UPDATE ON DEVELOPMENTS SINCE JUNE 2007

The Governor reported that the annual headline inflation outcome, as published by the National Statistical Office (NSO), was 1.0 percent in the June quarter of 2007, the same as the revised 1.0 percent in the March quarter of 2007. The low annual headline inflation outcome in the June quarter of 2007 can mainly be attributed to the large fall in the price of fruits and vegetables and betelnut in the first half of 2007. Whilst the headline and trimmed mean inflation outcomes were below the Bank's forecasts as stated in the July 2007 Monetary Policy Statement, the exclusion-based inflation outcome of 8.0 percent was within the Bank's forecast. The higher underlying inflation outcome was mainly due to the depreciation of the kina against the Australian dollar, increases in inflation from PNG's major trading partners and the lagged effect of domestic fuel price increases.

Since June 2007, the daily kina exchange rate has appreciated against the United States dollar to US\$0.34 as of the 20th September 2007. The kina has also appreciated against the Australian dollar since June 2007, to A\$0.39 as of the 20th September 2007.

Domestic interest rates continued to remain low and stable up to September 2007, consistent with the high level of liquidity in the banking system. Lending to the private sector continued to increase, reflecting the low interest rate environment and the increase in economic activity.

The level of foreign exchange reserves increased to US\$1, 870.8 million on the 12th September 2007, from US\$1, 579.6 million at the end of June 2007. This increase reflected high foreign exchange inflows mainly from mineral tax receipts received by the Government.

The Governor stated that whilst macro-economic conditions remained generally favourable, the Bank is concerned about underlying inflationary pressures, as indicated by the high exclusion based inflation outcome in the June quarter of 2007. The Governor also highlighted that the appreciation of the kina against the Australian dollar since the end of June represents a favourable outcome that will reduce the underlying inflationary pressures. He concluded that, "...with the upside risks to inflation remaining strong, the Government is urged to maintain prudent fiscal management and the Bank to closely monitor macro-economic developments over the rest of the year." The Governor reiterated that, "...the Bank is committed to maintaining price stability and will change its neutral monetary policy stance if price stability is threatened."

2. OVERVIEW OF THE DEVELOPMENTS IN THE JUNE QUARTER OF 2007

Economic indicators available to the Bank of Papua New Guinea (BPNG) showed that economic activity continued to grow in the first half of 2007. The growth reflected the high international commodity prices, increased government expenditure and lending to the private sector by commercial banks. As a result of the continued high international export prices, there were surpluses in the Government's fiscal operations and the balance of payments. Employment continued to increase in all sectors and in most regions. Lending to all sectors also increased as a result of low interest rates and confidence by the private sector. The headline inflation rate remained low, although there are signs of underlying inflationary pressures

stemming from the past depreciation of the kina against the Australian dollar. In view of the fiscal surpluses, the Government should fast track the implementation of major development policies contained in the Medium Term Development Strategy as well as removing impediments to investments in order to broaden the economic base and sustain higher economic growth.

Data obtained from the Bank of Papua New Guinea's Business Liaison Survey (BLS), in conjunction with other economic indicators available to the Bank, showed that economic activity increased in the first quarter of 2007. Total nominal value of sales of the private sector increased by 14.9 percent in the March quarter of 2007, compared to the December quarter of 2006. The increase was evident across all sectors, except the manufacturing, retail and transportation sectors. By region, the increase was recorded in the Southern and Island regions. Over the year to March 2007, nominal sales increased by 28.8 percent.

According to the Bank's Employment Index, the level of employment in the formal private sector, excluding the mineral sector, increased by 3.6 percent in the June quarter of 2007, compared to an increase of 4.1 percent in the March quarter of 2007. The level of employment increased in all industries and regions, except National Capital District (NCD). Over the year to June 2007, the level of employment excluding the mineral sector increased by 9.5 percent, compared to 9.9 percent over the year to March 2007.

The annual headline inflation rate was 1.0 percent in the June quarter of 2007, the same as the revised outcome for the March quarter of 2007. This outcome was due to increased prices in all expenditure groups, except the 'Drinks, tobacco and betelnut' and 'Household equipment and operations' groups. By region, all urban areas except Port Moresby, recorded higher prices.

Annual exclusion-based inflation was 8.0 percent in the June quarter of 2007, compared to the revised 6.0 percent in the March quarter of 2007. The annual trimmed mean inflation was 2.9 percent, compared to the revised 2.5 percent in the March quarter of 2007. The high inflationary pressures as indicated by the exclusion-based measure mainly reflected the lagged effect of the depreciation of the kina against the Australian dollar.

In the June quarter of 2007, the daily average kina exchange rate appreciated against the US dollar and Japanese yen while it depreciated against the Australian dollar, Euro and British pound sterling. The average kina exchange rate appreciated against the US dollar and the yen by 1.9 percent and 7.4 percent, respectively. The kina depreciated by 8.4 percent against the Australian dollar, 5.0 percent against the Euro and 6.3 percent against the pound sterling. These movements resulted in the quarterly average Trade Weighted Index (TWI) depreciating by 4.3 percent in the June quarter.

Higher international prices for mineral, most agricultural commodities and log exports resulted in a 12.8 percent increase in the weighted average kina price of Papua New Guinea's exports in the June quarter of 2007, compared to the corresponding quarter of 2006. There was a 9.9 percent increase in the weighted average kina price of mineral exports, with higher prices for gold, copper and crude oil. For the agricultural, forestry and marine product exports, the weighted average kina price increased by 41.2 percent and was attributed to higher kina export prices of coffee, cocoa, palm oil, copra oil, copra, rubber and logs, which more than offset declines in export prices of tea and marine products.

The overall surplus in the balance of payments was K400 million for the first six months of 2007, compared to a higher surplus of K675 million in the corresponding period of 2006. This outcome was the result of a lower surplus in the current account, which more than offset an improvement in the capital and financial accounts.

The current account recorded a surplus of K304 million in the first six months of 2007, compared to a surplus of K1,059 million in the corresponding period of 2006. This outcome was the result of a lower trade account surplus, combined with higher net service payments, which more than offset lower net income payments and higher net transfer receipts.

The capital account recorded a net inflow of K81 million in the first six months of 2007, an increase of 17.4 percent from the corresponding period of 2006, reflecting higher capital inflows.

The financial account recorded a surplus of K21 million in the first six months of 2007, compared to a deficit of K382 million in the corresponding period of 2006. This outcome was due to a higher net inflow in direct investments, reflecting sale of shares in the Lihir mine, provision of equity capital for the Frieda River project and the placement of shares by a mineral company to raise capital. These net inflows more than offset higher net outflows for portfolio investments, reflecting purchase of short-term money market instruments and a build-up in both net foreign assets of commercial banks and foreign currency account balances of resident mineral companies.

The level of gross foreign exchange reserves at the end of June quarter 2007 was K4,725.4 (US\$1,579.6) million, sufficient for 7.6 months of total and 10.4 months of non-mineral import covers.

The Bank of Papua New Guinea maintained a neutral monetary policy stance during the June quarter of 2007. The Kina Facility Rate (KFR) was kept unchanged at 6.00 percent, while the dealing margin for the Repurchase Agreements (Repo) was retained at 150 basis points on the buy and sell side of the KFR. The Central Bank Bill (CBB) rates increased over the June quarter reflecting higher issuance of CBBs to sterilise excess liquidity and realign short-term interest rates to the KFR. Domestic interest rates for loans and deposits depicted mixed trends over the quarter.

The Bank utilised its Open Market Operation (OMO) instruments in the conduct of monetary policy over the June quarter of 2007. The Central Bank issued additional CBBs and utilised Reverse Repos to sterilise excess liquidity as a result of the Government retiring Treasury bills. 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, over the June quarter of 2007.

The average level of broad money supply (M3*) increased by 8.5 percent in the June quarter of 2007, compared to a revised increase of 7.5 percent in the March quarter of 2007. This outcome was due to increases of 13.2 percent in average net foreign assets of the depository corporations (DCs) and 10.2 percent in average net private sector credit, which more than offset a decline of 8.4 percent in average net claims on the Central Government. The average level of monetary base increased by 6.0 percent in the June quarter of 2007, compared to 6.6 percent in the March quarter.

Total domestic credit extended by DCs to the private sector, public non-financial corporations, Provincial and Local Level Governments, and other financial corporations, increased by K376.8 million to K3,638.4 million in the June quarter of 2007, compared to a revised increase of K225.2 million in the March quarter of 2007. Growth in lending to the private sector totaling K376.2 million was mainly to the agriculture, other business, retail, building and construction, and transport and communication sectors. The annualised growth in domestic credit, excluding Central Government and advances under the Agricultural export commodity price support scheme was 31.1 percent over the six months of 2007.

Preliminary estimates of the fiscal operations of the National Government over the six months to June 2007 showed an overall surplus of K420.6 million, compared to a surplus of K363.0 million in the corresponding period of 2006. This represents 2.4 percent of nominal GDP. The surplus resulted from higher revenue, which more than offset an increase in development and recurrent expenditures.

Total revenue, including foreign grants, during the first six months of 2007 was K2,744.2 million, 20.3 percent higher than the receipts collected in the corresponding period of 2006. This represents 50.6 percent of the budgeted revenue for 2007. The increase was attributed to higher tax receipts and foreign grants, which more than offset lower non-tax receipts.

Total expenditures over the six months to June 2007 was K2,323.6 million, 21.1 percent higher than in the corresponding period of 2006, and represents 42.6 percent of the budgeted expenditure for 2007. The increase was due to higher development and recurrent expenditures.

The budget surplus was used to make net overseas loan repayments of K72.1 million and net negative domestic financing of K348.5 million. The net overseas loan repayments comprised of K40.3 million to concessionary, K7.8 million to commercial and K24.0 million to extraordinary sources. Negative domestic financing of K322.8 million was related to the settlement of cheques issued in 2006 to other resident sectors, combined with a net repayment of K25.7 million to the financial corporations sector reflecting an increase in Government deposits with Depository Corporations.