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PORT MORESBY
17th September 2008

1. GENERAL OVERVIEW

Economic indicators available to the Bank of Papua New Guinea (the Bank) show that economic activity continued to grow in the first half of 2008. This is evident in: growth in the level of employment; a large surplus in the trade account due to high international prices and increased production of most agricultural and mineral export commodities; higher lending to the private sector; increased Government spending; and increased sales in the private sector. Inflation increased significantly in the June quarter of 2008 as a result of high international fuel and food prices and increased aggregate domestic demand. This, combined with high growth in monetary aggregates and expectations of continued inflationary pressures prompted the Bank to tighten monetary policy in June 2008. The kina appreciated against the US dollar and depreciated against the Australian dollar and resulted in the Trade Weighted Index (TWI) appreciating by 1.3 percent in the June quarter. Any favourable impact on inflation by this exchange rate movement was more than offset by high imported inflation. The Bank is concerned about the inflationary pressures and will take appropriate monetary policy action.

Data obtained from the Bank of PNG's Business Liaison Survey (BLS) show that the total nominal value of sales in the private sector increased by 15.0 percent in the March quarter of 2008, compared to a decline of 1.5 percent in the December quarter of 2007. Excluding the mineral sector, the total nominal value of sales increased by 6.6 percent in the March quarter of 2008. The increase was in all sectors, except the wholesale and transportation sectors. By region, there were increases in the Southern, NCD, Momase and Islands regions, while the Morobe and Highlands regions recorded decreases. Over the twelve months to March 2008, the total nominal value of sales increased by 8.0 percent.

The Bank's Employment Index for the June quarter of 2008 indicate that the total level of employment in the formal private sector increased by 3.3 percent in the June quarter of 2008, compared to an increase of 2.0 percent in the previous quarter. Excluding the mineral sector, the level of employment increased by 3.4 percent in the June quarter of 2008, compared to an increase of 2.9 percent in the previous quarter. All sectors recorded increases in employment levels, except the building and construction sector, which recorded a marginal decline. By region, all regions recorded increases. Over the year to June 2008, the level of employment, excluding the mineral sector, increased by 8.2 percent.

Quarterly headline inflation, as measured by the Consumer Price Index (CPI), increased by 3.7 percent in the June quarter of 2008, compared to an increase of 3.1 percent in the previous quarter. This outcome was due to higher prices in all expenditure groups, except 'Clothing and footwear'. The annual headline inflation was 10.7 percent in the June quarter of 2008, compared to an increase of 7.5 percent in the previous quarter. The higher outcome was mainly attributed to higher international food and fuel prices as well as increases in the prices of seasonal produce. All expenditure groups recorded price increases, with the most notable increases in the 'Rents, council charges, fuel and power' and 'Food' expenditure groups. By region, all surveyed urban areas recorded higher prices in the June quarter and over the year to June 2008. The exclusion-based inflation was 3.7 percent in the June quarter of 2008, compared to 2.8 percent in the previous quarter. Trimmed mean inflation was 3.6 percent in the June quarter of 2008, compared to 3.9 percent in the March quarter of 2008.

In the June quarter of 2008, the daily average kina exchange rate appreciated against the US dollar, pound sterling and Japanese yen, while it depreciated against the euro and Australian dollar. The kina appreciated by 3.1 percent against the US dollar, 3.6 percent against the pound sterling and 2.5 percent against the yen. The kina depreciated by 0.9 percent and 1.0 percent against the Australian dollar and euro, respectively. These movements resulted in the daily average TWI appreciating by 1.3 percent during the June quarter.

Higher international prices for all mineral and most agricultural export commodities resulted in a 25.5 percent increase in the weighted average kina price of Papua New Guinea's exports in the June quarter of 2008, compared to the corresponding quarter of 2007. There was a 25.8 percent increase in the weighted average kina price of mineral exports with higher kina prices of all minerals. For agricultural, log and marine product exports, the weighted average kina price increased by 23.7 percent and was accounted for by higher prices of coffee, cocoa, palm oil, copra, copra oil, rubber and marine products, which more than offset the decline in export prices of tea and logs.

The overall surplus in the balance of payments was K616 million in first six months to June 2008, compared to a lower surplus of K400 million in the corresponding period of 2007. This outcome was due to a higher surplus in the current account, which more than offset a deficit in the capital and financial accounts.

The current account recorded a surplus of K1,149 million in the first six months to June 2008, compared to a surplus of K570 million in the corresponding period of 2007. This outcome was the result of higher trade account surplus and lower net service payments, which more than offset higher net income payments and lower net transfer receipts.

The capital account recorded a net inflow of K18 million in the first six months to June 2008, a decline of 77.8 percent from the corresponding period of 2007, reflecting lower capital transfers.

The financial account recorded a net outflow of K607 million in first six months to June 2008, compared to a net outflow of K297 million in the corresponding period of 2007. This outcome was mainly due to higher net outflow from portfolio investments reflecting investments in short term money market instruments, financial derivative instruments and other investments. The net outflow in other investments is due to a build-up in the net foreign assets of the banking system and foreign currency account balances of resident mineral companies and higher net loan repayments by the Government. These more than offset net inflows from direct investments, reflecting the issuing of new shares abroad by a resident company to raise capital for further expansion.

The level of gross foreign exchange reserves at the end of June 2008 was K6,567.9 (US$2,434.5) million, sufficient for 9.3 months of total and 13.5 months of non-mineral import covers.

The Bank of PNG tightened monetary policy in the June quarter of 2008. To signal this, the Kina Facility Rate (KFR) was increased by 25 basis points to 6.25 percent from 6.00 percent. The dealing margin for the Repurchase Agreements (Repos) was maintained at 100 basis points on both sides of the KFR during the same period. Domestic interest rates for short-term securities showed mixed trends over the quarter.

The Bank continued to utilise its Open Market Operation (OMO) instruments in the conduct of monetary policy over the June quarter of 2008, as both CBBs and Reverse Repos were used to diffuse excess liquidity. As a result, trading in the inter-bank market increased moderately during the same period. 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 2008.

The average level of broad money supply (M3*) increased by 7.0 percent in the June quarter of 2008, compared to an increase of 10.2 percent in the March quarter of 2008. This outcome was due to an increase of 4.7 percent in average net foreign assets of the depository corporations and 11.0 percent increase in average private sector credit, which more than offset a decline of 13.5 percent in average net claims on the Government. Average net domestic claims outstanding, excluding advances to the Central Government and outstanding loans under the Government's agricultural export commodity price support schemes increased by 10.0 percent in the June quarter of 2008, compared to an increase of 11.3 percent in the previous quarter.

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 K393.2 million to K4,912.5 million in the June quarter of 2008. This was mainly due to an increase of K388.4 million in private sector credit and K4.6 million in public non-financial corporations. The annualised growth in domestic credit, excluding the Central Government and advances under the price support schemes was 35.9 percent in the second quarter of 2008.

Preliminary estimates of the fiscal operations of the National Government over the six months to June 2008 showed an overall surplus of K304.4 million, compared to a surplus of K409.2 million in the corresponding period of 2007. This represents 1.5 percent of nominal GDP. The surplus resulted from higher revenue, which more than offset an increase in recurrent expenditure.

Total revenue, including foreign grants, during the first six months of 2008 was K2,502.5 million, K0.9 million higher than the receipts collected in the corresponding period of 2007. This represents 34.8 percent of the budgeted revenue for 2008.

Total expenditure over the six months to June 2008 was K2,198.1 million, 5.1 percent higher than in the corresponding period in 2007, and represents 31.4 percent of the budgeted expenditure for 2008.

As a result of these developments in revenue and expenditure, the Government recorded an overall budget surplus of K304.4 million over the first six months of 2008. The surplus was used to make overseas loan repayments totalling K108.8 million and net negative financing to domestic sources of K195.6 million. The overseas loan repayments comprised of K33.0 million to concessionary, K8.3 million to commercial and K67.5 million to extraordinary sources.

2. INTERNATIONAL DEVELOPMENTS

The world economy continued to grow but at a slower pace in the first half of 2008. The July 2008 World Economic Outlook Update of the International Monetary Fund (IMF) estimated that global economic growth decelerated in the first quarter of 2008 and revised its GDP projections for 2008. Global growth is projected to moderate from 5.0 percent in 2007 to 4.1 percent in 2008. Growth in the advanced economies is expected to fall from 2.7 percent in 2007 to 1.7 percent in 2008. Emerging and developing economies are expected to continue to experience robust growth; with growth rates falling from 8.0 percent in 2007 to 6.9 percent in 2008. The growth in emerging and developing economies is being sustained by productivity gains and the high prices of their natural resource exports though the growth is being threatened by inflation.

The financial market crisis continued into the June quarter. Financial institutions in the United States (US), United Kingdom (UK) and Euro zone, as well as other financially integrated economies, continued to be under considerable stress. Central banks in these economies continued to offer new financing arrangements to provide liquidity to the troubled financial markets. The prolonged effect of the sub-prime housing market collapse and the ensuing financial crisis has prompted the Federal Reserve Bank of US and other major central banks to reconsider the way that they manage asset bubbles. These central banks are considering interest rate increases and/or enhanced regulatory powers to contain future bubbles in asset prices.

Soaring food prices, which have contributed to economic and political woes, showed signs of stabilizing in the June quarter. The United Nation's Food and Agriculture Organisation food price index, which is considered a good indicator of global food inflation, fell for the first time in 15 months in April to 218.2 from 218.4 in March. Experts warned that food prices could continue to rise due to their use in bio-fuels and bad weather.

The price of US light sweet crude oil hit an all time record high of close to USD$144 per barrel on 30th June. Concerns over global supplies as a result of geopolitical tensions between Iran and the West and the crisis in Nigeria pushed oil prices to this new high. In all, the prices of oil have increased by around 40 percent over the year to June 2008 due to the weak US dollar, surging demand and concerns about supply disruptions in the Middle East and Africa. The president of the Organisation of Petroleum Exporting Countries (OPEC), Chakib Khelil, had however stated that the cartel is producing enough oil and that the organization had stocks and extra capacity to spare.

In April, the IMF and World Bank met in Washington D.C. for their annual spring meeting. At the top of the agenda was the global impact of the credit crunch and the uneven progress towards the achievement of human development goals.

In the US, real GDP grew by 1.8 percent over the year to June 2008, the same as in the corresponding period in 2007. The below trend growth rate was due to the continued impact of the US sub-prime mortgage market. Consumer demand has been affected by falling share and house prices and higher food and fuel prices. Growth was supported by a strong export sector which benefited from the weak US dollar. The latest IMF forecast is for growth of 1.3 percent in 2008.

Industrial production increased by 0.3 percent over the year to June 2008, compared to an increase of 1.4 percent over the year to June 2007. The Institute of Supply Management's Purchasing Managers Index was 49.6 and 50.2 in May and June 2008, respectively. An index below 50 indicates contraction while an index above 50 indicates expansion in the manufacturing industry. Retail sales increased by 0.4 percent over the year to June 2008, compared to an increase of 3.7 percent over the year to June 2007, reflecting low consumer demand and increased unemployment. The unemployment rate was 5.7 percent in June 2008, compared to 4.5 percent in June 2007.

Consumer prices rose by 5.0 percent over the year to June 2008, compared to an increase of 2.7 percent over the same period in 2007. This outcome was mainly due to high energy and food prices. Broad money supply increased by 6.1 percent over the year to June 2008, the same as in the corresponding period in 2007. The Federal Reserve kept the Federal Funds Rate unchanged at 2.00 percent in the June quarter of 2008 despite the high inflation rate and in light of the low economic growth.

The trade deficit was US$836.3 billion over the year to June 2008, compared to a deficit of US$823.4 billion over the same period in 2007. The strong export sector, due to the weak US dollar did little to lower the trade deficit.

In Japan, real GDP grew by 1.0 percent over the year to June 2008, compared to 2.3 percent over the year to June 2007. The lower growth was due to low capital investment and lower exports to the US, which have been the main sources of economic growth since 2003. The latest IMF forecast is for growth of 1.5 percent in 2008.

Industrial production remained steady over the year to June 2008, compared to increasing by 1.0 percent over the same period in 2007. Retail sales increased by 1.3 percent over the year to June 2008, compared to a decline of 0.5 percent over the corresponding period in 2007. The unemployment rate was 4.1 percent in June 2008, compared to 3.7 percent in June 2007.

Consumer prices increased by 2.0 percent over the year to June 2008, compared to a decline of 0.2 percent over the year to June 2007. The higher inflation outcome was mainly driven by increases in fuel and food prices and not higher domestic demand. Broad money supply increased by 2.3 percent over the year to June 2008, compared to an increase of 1.8 percent over the same period in 2007. Despite the higher inflation outcome, the Bank of Japan maintained its call rate at 0.50 percent during the June quarter of 2008.

The current account surplus was US$207.3 billion over the year to June 2008, compared to US$192.6 billion over the year to June 2007. The lower surplus was due to a slow down in exports to the US.

In the Euro area, real GDP grew by 1.5 percent over the year to June 2008, compared to 2.5 percent over the year to June 2007. The lower growth was a result of the financial market crisis which has affected investor and consumer confidence, and a fall in trade with the US. The latest IMF forecast is for growth of 1.7 percent in 2008.

Industrial production fell by 0.5 percent over the year to June 2008, compared to an increase of 2.3 percent over the year to June 2007. This reflected low exports and low consumer spending. Retail sales declined by 0.3 percent over the year to June 2008, compared to an increase of 0.9 percent over the year to June 2007. The unemployment rate was 7.3 percent in June 2008, compared to 6.9 percent over the year to June 2007.

Consumer prices in the Euro area increased by 4.0 percent over the year to June 2008, compared to an increase of 1.9 percent over the year to June 2007. Broad money supply increased by 9.5 percent over the year to June 2008, compared to an increase of 10.9 percent over the year to June 2007. The Eureopean Central Bank maintained its monetary policy stance with the Euro Refinancing Rate at 4.00 percent during the June quarter of 2008.

The current account of the euro zone was in deficit by US$31.5 billion over the year to June 2008, compared to a surplus of US$3.6 billion over the same period in 2007.

In Germany, real GDP grew by 1.7 percent over the year to June 2008, compared to 2.5 percent in the corresponding period in 2007, reflecting a slowdown in economic activity. The latest IMF forecast is for growth of 1.8 percent in 2008.

Industrial production increased by 1.6 percent over the year to June 2008, compared to an increase of 4.9 percent over the year to June 2007. Retail sales declined by 3.9 percent over the year to June 2008, compared to a decline of 0.8 percent over the year to June 2007 reflecting a fall in consumer's purchasing power due to high food and fuel prices. The unemployment rate in Germany was 7.8 percent in June 2008, compared to 9.1 percent in June 2007.

Consumer prices increased by 3.3 percent over the year to June 2008, compared to an increase of 1.8 percent over the year to June 2007.

The current account surplus was US$273.5 billion over the year to June 2008, compared to US$182.2 billion over the corresponding period in 2007.

In the UK, real GDP grew by 1.6 percent over the year to June 2008, compared to 3.0 percent over the same period in 2007. House prices continued to lose value and the banking sector crisis has shown no sign of ending. The latest IMF forecast is for GDP to grow by 1.8 percent in 2008.

Industrial production declined by 1.6 percent over the year to June 2008, compared to an increase of 0.8 percent over the same period in 2007. Retail sales increased by 2.7 percent over the year to June 2008, compared to an increase of 3.4 percent over the corresponding period in 2007. The unemployment rate was 5.4 percent in June 2008, the same as in June 2007.

Consumer prices increased by 4.4 percent over the year to June 2008, compared to an increase of 2.4 percent over the year to June 2007. Broad money supply increased by 11.4 percent over the year to June 2008, compared to an increase of 12.9 percent over the corresponding period in 2007. The Bank of England reduced its official Bank Rate to 5.00 percent from 5.25 percent in April 2008.

The trade deficit was US$186.4 billion over the year to June 2008, compared to US$155.8 billion over the year to June 2007.

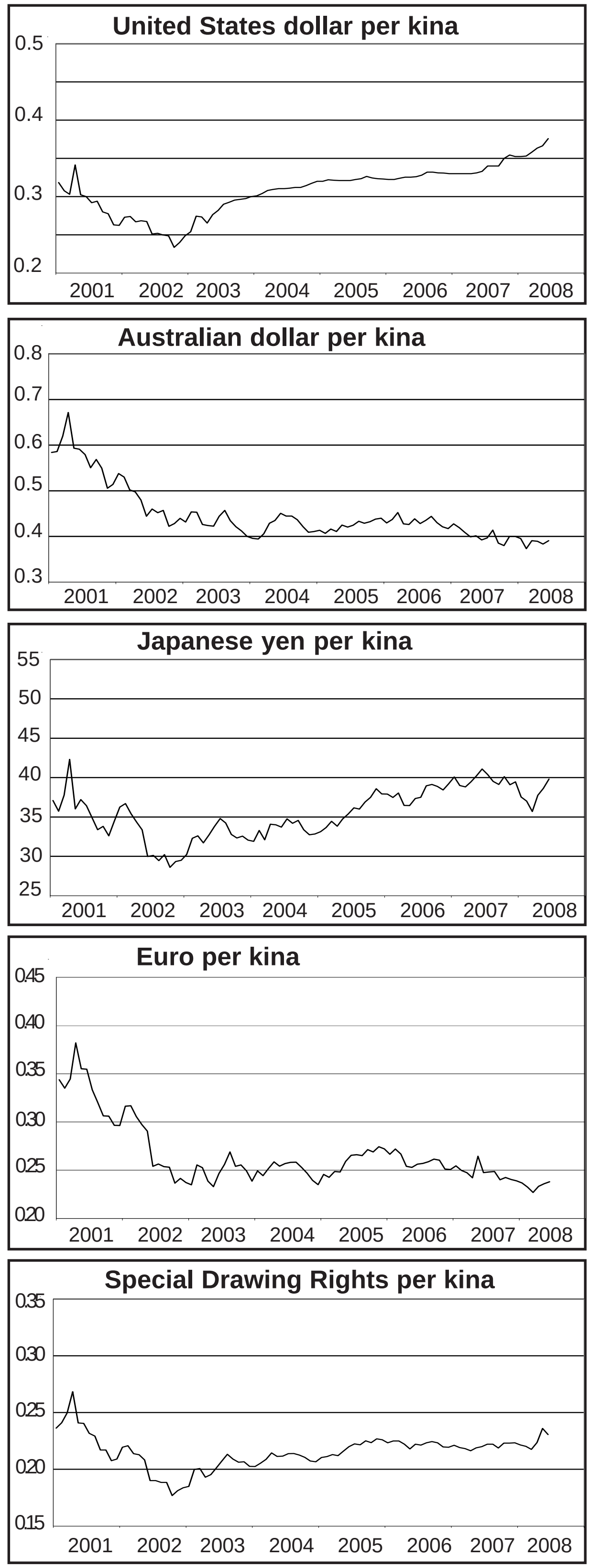
In Australia, real GDP grew by 2.0 percent over the year to June 2008, compared to an increase of 4.3 percent over the year to June 2007. While high commodity prices have supported economic growth, they have also appreciated the Australian dollar which has made manufactured exports uncompetitive in the international market. Rising inflation and the global financial crisis and its impact on the Australian financial sector have also had a large detrimental effect on Australia's economic growth. The latest IMF forecast is for GDP to grow by 2.8 percent in 2008.

Industrial production declined by 0.5 percent over the year to June 2008, compared to an increase of 2.3 percent over the same period in 2007. Retail sales increased by 2.2 percent over the year to June 2008, compared to an increase of 4.3 percent over the year to June 2007, reflecting a decline in consumer demand. The unemployment rate was 4.2 percent in June 2008, compared to 4.3 percent in June 2007.

Consumer prices rose by 4.5 percent over the year to June 2008, compared to an increase of 2.1 percent over the year to June 2007. The increase was mainly associated with high international fuel and food prices. Broad money supply increased by 17.9 percent over the year to June 2008, compared to an increase of 16.0 percent over the year to June 2007. Given the high inflationary pressures, the Reserve Bank of Australia maintained a tight monetary policy stance by holding its Cash Rate at a high of 7.25 percent during the second quarter of 2008.

The trade deficit was US$18.4 billion over the year to June 2008, compared to US$10.9 billion over the same period in 2007.

EXCHANGE RATES



During the June quarter of 2008, the daily average US dollar exchange rate depreciated against the major currencies except the pound sterling. The daily average US dollar exchange rate depreciated by 4.1 percent against the Australian dollar, 4.1 percent against the euro and 0.6 percent against the Japanese yen, while it appreciated by 0.4 percent against the pound sterling. The depreciation of the US dollar against most of the major currencies was due to the continued weakening of the US economy.

In the June quarter of 2008, the daily average kina exchange rate appreciated against the US dollar, pound sterling and Japanese yen, while it depreciated against the euro and Australian dollar. The daily average kina exchange rate appreciated by 3.1 percent against the US dollar, 3.6 percent against the pound sterling and 2.5 percent against the yen. The daily average kina exchange rate depreciated by 0.9 percent and 1.0 percent against the Australian dollar and euro, respectively, during the June quarter. These movements resulted in the daily average TWI appreciating by 1.3 percent during the June quarter.

3. DOMESTIC ECONOMIC DEVELOPMENT

DOMESTIC ECONOMIC ACTIVITY

Data obtained from the Bank's BLS indicate that business sales in the formal private sector grew strongly in the March quarter of 2008, compared to the December quarter of 2007. The nominal value of sales increased by 15.0 percent in the March quarter of 2008, compared to a decline of 1.5 percent in the December quarter of 2007. Excluding the mineral sector, the nominal value of sales increased by 6.6 percent during the same quarter. The increase was in all sectors, except the wholesale and transportation sectors. By region, there were increases in the Southern, NCD, Momase and Islands regions, while the Morobe and Highlands regions recorded decreases. Over the twelve months to March 2008, the total nominal value of sales increased by 8.0 percent. Excluding the mineral sector, annual sales increased by 26.4 percent.

In the agriculture/forestry/fisheries sector, the nominal value of sales increased by 20.2 percent in the March quarter of 2008, compared to an increase of 1.5 percent in the December quarter of 2007. The increase was mainly due to higher production and prices of most agricultural commodities and increase in logging activities and shipment during the period. Over the twelve months to March 2008, the total nominal value of sales increased by 12.3 percent.

In the manufacturing sector, the nominal value of sales increased by 12.7 percent in the March quarter of 2008, compared to a decrease of 7.9 percent in the previous quarter. The increase was mainly a result of higher production of consumer goods supported by higher consumer demand. In addition, there was a major free-freight promotion by a manufacturing company, which resulted in higher sales revenue. Over the twelve months to March 2008, the total nominal value of sales increased by 38.8 percent.

In the mineral sector, the nominal value of sales increased by 28.1 percent in the March quarter of 2008, compared to a decline of 2.3 percent in the December quarter of 2007. The increase in revenue was mainly the result of higher production of gold and copper supported by favourable international prices, combined with higher ore grades at Ok Tedi and increased shipment as a result of higher water levels. Over the twelve months to March 2008, the total nominal value of sales declined by 19.5 percent.

In the building and construction sector[1], the nominal value of sales increased by 12.5 percent in the March quarter of 2008, compared to a decrease of 8.8 percent in the December quarter of 2007. The increase was associated with the commencement of new building projects in NCD, Kokopo, Lae, Kiunga and Hidden valley. In addition, the on-going road maintenance work along the Magi and Highlands highways and construction of some feeder roads in the Western Highlands and Chimbu provinces contributed to the increase.

In the retail sector, the nominal value of sales increased by 4.6 percent, while in the wholesale sector it declined by 1.4 percent in the March quarter of 2008. During the December quarter, the value of sales in the retail and wholesale sectors increased by 2.2 and 6.5 percent, respectively. The increase in the retail sector was mainly driven by higher consumer demand and increased sales to the mining and construction com-

[1] Annual growth in the nominal value of sales for the building and construction sector is not provided due to data inconsistencies.

panies. The decrease in the wholesale sector was mainly associated with low seasonal demand following the Christmas festive season. Over the twelve months to March 2008, the nominal value of sales in the retail and wholesale sectors increased by 20.5 percent and 24.9 percent, respectively.

In the transportation sector, the nominal value of sales declined by 5.5 percent in the March quarter of 2008, compared to an increase of 3.3 percent in the December quarter of 2007. The decrease was mainly associated with lower passenger travel and haulage of cargo. The breakdown of ships belonging to a major sea transport company also contributed to the loss in activity and revenue. Over the twelve months to March 2008, the total nominal value of sales increased by 12.3 percent.

In the financial/business and other services sector, the nominal value of sales increased by 2.2 percent in the March quarter of 2008, compared to an increase of 3.5 percent in the December quarter of 2007. The increase was mainly driven by new contracts awarded to a major security company and increased activity by commercial banks associated with higher lending and investments. Over the twelve months to March 2008, the total nominal value of sales increased by 28.7 percent.

In the Southern region, the nominal value of sales increased by 45.8 percent in the March quarter of 2008, compared to a decline of 9.3 percent in the December quarter of 2007. The increase was mainly in the mineral sector and the agriculture and forestry sub-sectors. In the mineral sector, the increase was associated with the higher international prices and production of copper. In the agriculture sub-sector, the increase was due to higher production and price of palm oil, while in the forestry sub-sector, it was mainly due to increased sales of forestry products and, to some extent, increase in logging activity. Over the twelve months to March 2008, the total nominal value of sales increased by 4.9 percent.

In the Momase region (excluding Morobe), the nominal value of sales increased significantly by 31.2 percent in the March quarter of 2008, compared to a decline of 5.9 percent in the previous quarter. The increase was mainly in the wholesale and manufacturing sectors. The increase in the wholesale sector was due to strong growth in orders from the mining companies, while the growth in the manufacturing sector was associated with higher prices and production of retail items. Over the twelve months to March 2008, the total nominal value of sales increased by 84.0 percent.

In the Islands region, the nominal value of sales increased by 9.3 percent in the March quarter of 2008, compared to an increase of 6.1 percent in the previous quarter. The increase was in the manufacturing and mineral sectors and the agriculture sub-sector. The increase in the manufacturing sector was driven by higher prices and production of coconut oil, while the increase in the mining sector was associated with higher production and prices of gold. In the agriculture sub-sector, the increase was mainly due to the higher production and price of palm oil. Over the twelve months to March 2008, the total nominal value of sales decreased by 34.9 percent.

In NCD, the nominal value of sales increased by 7.9 percent in the March quarter of 2008, compared to a decrease of 5.4 percent in the previous quarter. The increase was in the retail, manufacturing and financial/ business and other services sectors. In the retail sector, the increase was mainly associated with the expansion of activities and increased sales to mining and construction companies. The increase in the manufacturing sector was due to higher production supported by favourable prices and increased demand, while in the financial/business and other services sector, the increase was attributed to the awarding of new contracts to a major security firm and increased lending and investment by commercial banks. Over the twelve months to March 2008, the total nominal value of sales increased by 23.8 percent.

In the Highlands region, the nominal value of sales decreased by 4.1 percent in the March quarter of 2008, compared to an increase of 7.8 percent in the December quarter of 2007. The decrease was mainly in the wholesale, agriculture and mineral sectors. The decrease in the wholesale and agriculture sectors were associated with lower production of coffee. The decrease in the mineral sector was due to a drilling company scaling down its operations. Over the twelve months to March 2008, the total nominal value of sales increased by 23.7 percent.

In Morobe, the nominal value of sales declined by 12.0 percent in the March quarter of 2008, compared to an increase of 13.3 percent in the December quarter of 2007. The decrease was in the manufacturing, wholesale and transportation sectors. In the manufacturing and wholesale sectors, the declines were due to lower demand following the festive season. In the transportation sector, the decrease was associated with falls in passenger travel and cargo haulage by sea. Over the twelve months to March 2008, the total nominal value of sales increased by 8.3 percent.

EMPLOYMENT

The Bank's Employment Index for the June quarter of 2008 indicated that the level of employment in the formal private sector, excluding the mineral sector, increased by 3.4 percent, compared to an increase of 2.9 percent in the March quarter of 2008. All sectors recorded increases in employment levels, except the building and construction sector. By region, all regions recorded increases. Over the year to June 2008, the level of employment excluding the mineral sector, increased by 8.2 percent.

In the agriculture/forestry/fisheries sector, the level of employment increased by 3.8 percent in the June quarter of 2008, compared to an increase of 5.2 percent in the previous quarter. The increase was across all the sub-sectors. In the agriculture sub-sector, the increase was due to the harvesting and planting of palm oil and the beginning of the coffee harvest season in the Highlands region. In the forestry sub-sector, the increase in employment was associated with higher log harvests, while in the fisheries sub-sector, the growth was due to additional shift schedules as a result of higher demand and harvest for fish. Over the year to June 2008, the level of employment increased by 6.1 percent.

In the building and construction sector, the level of employment declined slightly by 0.7 percent in the June quarter of 2008, compared to an increase of 12.3 percent in the March quarter. The decline was mainly due to the completion of road projects in NCD and Mount Hagen and scaling down of drilling operations for mineral companies. The completion of building projects in the Morobe, NCD and Eastern Highlands provinces also contributed to the decline. Over the year to June 2008, the level of employment increased by 4.2 percent.

In the transportation sector, the level of employment increased by 4.5 percent in the June quarter of 2008, compared to an increase of 4.0 percent in the March quarter. The increase was a result of higher cargo haulage and passenger travel by both air and sea transportation. Over the year to June 2008, the level of employment increased by 4.3 percent.

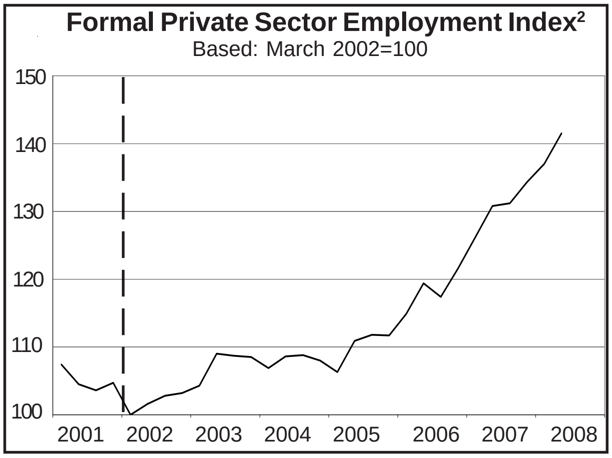
In the manufacturing sector, the level of employment increased by 1.2 percent in the June quarter of 2008, the same as in the previous quarter. The increase was associated with higher demand across a range of manufactured products such as food, beverages, fuel and other associated products. Over the year to June 2008, the level of employment increased by 10.3 percent.

In the retail and wholesale sectors, the level of employment increased by 4.1 percent and 4.3 percent in the June quarter of 2008, compared to an increase of 0.5 percent and a decline of 5.2 percent in the March quarter, respectively. The increase reflected higher consumer demand as well as expansion of operations by a few companies to new locations. The beginning of the coffee season in the Highlands and cocoa flush in the New Guinea Islands region also contributed to the increase. Over the year to June 2008, the level of employment in the retail and wholesale sectors increased by 9.1 percent and 4.7 percent, respectively.

In the financial/business and other services sector, the level of employment increased by 4.2 percent in the June quarter of 2008, compared to an increase of 0.1 percent in the March quarter. The increase was mainly due to the awarding of new contracts and employment of new security guards by security companies. Over the year to June 2008, the level of employment increased by 11.5 percent.

By region, all regions recorded increases in the level of employment. In Morobe, the level of employment increased by 9.0 percent in the June quarter of 2008, compared to a decline of 5.5 percent in the March quarter. Higher employment levels were recorded in the manufacturing, retail, wholesale, and transportation sectors and the fisheries sub-sector. In the manufacturing, retail and wholesale sectors, the increase was due to higher demand, while in the transportation sector, the increase reflected higher haulage of cargo. In the fisheries sub-sector, the increase was due to additional shift schedules as a result of higher demand and harvest of fish. Over the year to June 2008, the level of employment grew by 14.0 percent.

In the Momase region (excluding Morobe), the level of employment increased by 5.0 percent in the June quarter of 2008, compared to an increase of 10.6 percent in the previous quarter. Higher employment



levels were recorded in the manufacturing, transportation, retail and wholesale sectors and the forestry sub-sector. In the manufacturing sector, the increase was associated with higher demand for cigarette and tobacco, while in the transportation sector, the increase was due to higher passenger travel by air. In the retail and wholesale sectors, the increase was due to higher demand and expansion of operations, while in the forestry sub-sector, the increase was due to higher logging activities. Over the year to June 2008, the level of employment grew by 16.4 percent.

In the Southern region (excluding NCD), the level of employment increased by 2.8 percent in the June quarter of 2008, compared to an increase of 0.2 percent in the March quarter. Higher employment levels were recorded in the transportation, wholesale and retail sectors and the agriculture sub-sector. The increase in the transportation sector was due to higher passenger travel by air transportation, while the increase in the retail and wholesale sectors was due to higher income and demand for consumer goods. The growth in the agriculture sub-sector was due to an increase in palm oil harvests. Over the year to June 2008, the level of employment declined by 1.3 percent.

In NCD, the level of employment grew by 2.4 percent in the June quarter of 2008, compared to an increase of 0.2 percent in the March quarter. Higher employment levels were recorded in the manufacturing, wholesale, retail, transportation and financial/business and other services sectors. In the manufacturing sector, the increase was due to higher demand for food, beverages and fuel products. In the wholesale and retail sectors, the increase in employment was due to higher demand for consumer goods, while in the financial/business and other services sector, the increase was associated with the awarding of new contracts to security companies. Over the year to June 2008, the level of employment grew by 9.5 percent.

In the Highlands region, the level of employment increased by 2.4 percent in the June quarter of 2008, compared to an increase of 9.3 percent in the March quarter. Higher employment levels were recorded in the wholesale, retail and transportation sectors and the agriculture sub sector. In the retail and wholesale sectors, the increase was due to higher demand reflecting the start of the coffee season. In the transportation sector, the increase was associated with higher passenger travel. The increase in the agriculture sub-sector reflected the beginning of the coffee season. Over the year to June 2008, the level of employment fell by 1.9 percent.

In the Islands region (including the Autonomous Region of Bougainville) the level of employment increased by 0.3 percent in the June quarter of 2008, compared to an increase of 2.4 percent in the March quarter. Higher employment levels were recorded in the retail, wholesale and transportation sectors and the agriculture sub-sector. The increase in the retail and wholesale sectors was due to increased demand reflecting higher production and prices of cocoa, while the increase in the transportation sector reflected higher passenger travel and haulage of cargo by both sea and air transportation. The increase in the agriculture sub-sector was due to higher production and prices of cocoa. Over the year to June 2008, the level of employment grew by 11.2 percent.

CONSUMER PRICE INDEX

Quarterly headline inflation, as measured by the Consumer Price Index (CPI), increased by 3.7 percent in the June quarter of 2008, compared to an increase of 3.1 percent in the March quarter. This outcome was due to higher prices in all expenditure groups, except the 'Clothing and footwear' group. The annual headline inflation was 10.7 percent in the June quarter of 2008, compared to an increase of 7.5 percent in the March quarter. The outcome was mainly attributed to higher international food and fuel prices as well as increase in the prices of seasonal produce. As a result, all ex-

[2] 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.

penditure groups indicated price increases, mainly in the 'Rents, council charges, fuel and power' and 'Food' expenditure groups. By region, all urban areas recorded higher prices in the June quarter and over the year to June 2008.

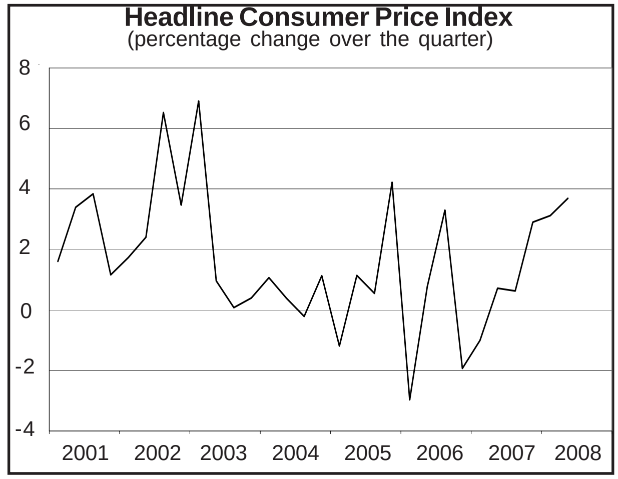
The CPI for the 'Food' expenditure group increased by 6.2 percent in the June quarter of 2008, compared to an increase of 4.6 percent in the March quarter, and contributed 2.5 percentage points to the overall movement in the CPI. A significant increase in the cereals, and fruit and vegetables sub-groups accounted for most of the CPI growth.

The CPI for the 'Drinks, tobacco and betelnut' expenditure group increased by 2.2 percent in the June quarter of 2008, compared to an increase of 2.9 percent in the March quarter. Betelnut and soft drinks dominated the increases with 18.9 percent and 7.3 percent, respectively. However, these increases were partly offset by a decline in cigarettes & tobacco prices by 2.2 percent. This expenditure group contributed 0.4 percentage points to the overall movement in the CPI.

Prices in the 'Clothing and footwear' expenditure group declined by 4.5 percent in the June quarter of 2008, compared to an increase of 2.0 percent in the March quarter. This was attributed to huge mid-year clearance sales to make way for new stocks in the second part of the year, cheap goods from Asia and direct competition from the second-hand clothing outlets. This expenditure group contributed negative 0.3 percentage points to the overall movement in the CPI.

The 'Rents, council charges, fuel and power' expenditure group recorded the highest quarterly CPI increase of 7.3 percent in the June quarter of 2008, compared to an increase of 5.1 percent in the March quarter. The increase reflected the effects of high international oil prices, which impacted on the domestic prices of kerosene and electricity. This expenditure group contributed 0.5 percentage points to the overall movement in the CPI.

In the 'Household equipment and operations' expenditure group, the CPI increased by 1.6 percent in the June quarter of 2008, compared to an increase of 1.0 percent in the March quarter The increase was in the non-durable goods, such as laundry soap/powder and insecticides combined with a marginal increase in durable goods, such as cutleries. This expenditure group contributed only 0.1 percentage points to the



overall movement in the CPI.

In the 'Transport and communication' expenditure group, prices increased by 2.3 percent in the June quarter of 2008, compared to an increase of 1.3 percent in the March quarter. The outcome was due to the increase in the airline and public motor vehicle fares by 6.7 percent and motor vehicle operations by 3.3 percent reflecting higher fuel prices. This expenditure group contributed 0.3 percentage points to the overall movement of the CPI.

The Miscellaneous' expenditure group recorded a marginal price increase of 0.2 percent in the June quarter of 2008, compared to an increase of 0.3 percent in the March quarter. This outcome was due to marginal increases in items for body care , medicine and health care, and writing and drawing materials. There were no changes in education fees which usually is evident during the first quarter. Due to its small weighting, this expenditure group's contribution to the overall CPI growth was negligible.

By urban areas, prices increased in all surveyed centers in the June quarter of 2008. Lae recorded the highest increase of 6.5 percent in the June quarter of 2008, compared to an increase of 3.0 percent in the March quarter of 2008. In Port Moresby, prices increased by 2.3 percent in the June quarter of 2008, compared to an increase of 3.9 percent in the March quarter of 2008. In Goroka, prices increased by 4.3 percent in the June quarter of 2008, compared to an increase of 1.7 percent in the March quarter of 2008. In Madang, prices increased by 2.4 percent in the June quarter of 2008, compared to an increase of 2.2

percent in the March quarter of 2008. In Rabaul, prices increased by 4.6 percent in the June quarter of 2008, compared to an increase of 2.5 percent in the March quarter of 2008.

In Lae, there were higher prices in all expenditure groups, except the 'Clothing and footwear' expenditure group. 'Rents, council charges, fuel and power', 'Food', and 'Drinks, tobacco and betelnut' expenditure groups recorded huge price increases. In Port Moresby, price increases were in the 'Rents, council charges, fuel and power' and 'Food' expenditure groups. In Goroka, prices increased in the 'Food' and 'Rents, council charges, fuel and power' expenditure groups. In Madang, price increases were recorded in the 'Rents, council charges, fuel and power', 'Food', and 'Transport and communication' expenditure groups. In Rabaul, there were higher prices in the 'Rents, council charges, fuel and power', 'Food' and 'Transport and communication' expenditure groups.

The exclusion-based inflation measure was 3.7 percent in the June quarter of 2008, compared to 2.8 percent in the March quarter. Trimmed mean inflation was 3.6 percent in the June quarter of 2008, compared to 3.9 percent in the March quarter. The annual exclusion-based and trimmed-mean inflation outcomes were 10.2 and 11.4 percent, respectively.

4. EXPORT COMMODITIES REVIEW

The total value of merchandise exports in the June quarter of 2008 was K4,331 million, 5.4 percent higher than in the corresponding quarter of 2007. Higher export values were recorded for coffee, cocoa, palm oil, copra, copra oil, rubber, gold, crude oil, refined petroleum products and other mineral exports, while there were declines in the export values of tea, logs, marine products and copper exports. Mineral export receipts, excluding crude oil, were K2,330.0 million and accounted for 53.8 percent of total merchandise exports in the June quarter of 2008, compared to K2,468.7 million or 60.1 percent in the corresponding quarter of 2007. Crude oil exports totalled K1,064.6 million and accounted for 24.6 percent of total merchandise exports in the June quarter of 2008, compared to K882.3 million or 21.5 percent in the corresponding quarter of 2007.

The value of agricultural, marine product, and other non-mineral export, excluding forestry and refined petroleum product exports was K684.9 million and accounted for 15.8 percent of total merchandise exports in the June quarter of 2008, compared to K506.3 million or 12.3 percent in the corresponding quarter of 2007. Forestry product exports were K146.4 million and accounted for 3.4 percent of total merchandise exports in the June quarter of 2008, compared to K167.1 million or 4.1 percent in the corresponding quarter of 2007. Refined petroleum product exports were K105.1 million and accounted for 2.4 percent of total merchandise exports in the June quarter of 2008, compared to K83.6 million or 2.0 percent in the corresponding quarter of 2007.

The weighted average price of Papua New Guinea's exports was 25.5 percent higher in the June quarter of 2008, compared to the corresponding quarter of 2007. There was a 25.8 percent increase in the weighted average price of mineral exports, with higher kina prices for all mineral exports. For the agricultural, logs and marine product exports, excluding refined petroleum product exports, the weighted average price increased by 23.7 percent, and was accounted for by higher prices of all export commodities, with the exception of tea and logs. Excluding logs, the weighted average price of agricultural and marine product exports increased by 34.1 percent in the June quarter of 2008, compared to the corresponding period of 2007. The higher kina export prices reflected increases in international prices.

Mineral Exports

Total mineral export receipts were K3,394.6 million in the June quarter of 2008, compared to K3,351.0 million in the corresponding quarter of 2007. This outcome was due to a combined increase in export receipts of gold and crude oil, which more than offset a decline in copper export receipts resulting from a decline in export volumes.

The volume of gold exported in the June quarter of 2008 was 15.7 tonnes, an increase of 3.3 percent from the corresponding quarter of 2007. This outcome was due to a significant increase in production from the Lihir mine resulting from the expansion of the production capacity of its processing plant, higher production from the Porgera mine and increased shipment of ore grades from the Ok Tedi mine. The average free on board (f.o.b.) price received for Papua New Guinea's gold exports was K79.2 million per tonne during the

June quarter of 2008, an increase of 29.0 percent from the corresponding period of 2007. The average gold price at the London Metal Exchange increased by 34.2 percent to US$896 per fine ounce in the June quarter of 2008, compared to the corresponding quarter of 2007. The increase was due to higher international prices as a result of lower production, especially in South Africa and Australia, caused by operational and labour problems and higher demand for gold based investments in response to increased volatility of prices in the equity markets. The combined increase in export price and volume resulted in a 33.3 percent increase in export receipts to K1,243.2 million in the June quarter of 2008, from the corresponding quarter of 2007.

Copper export volumes declined by 34.9 percent to 46.2 thousand tonnes in the June quarter of 2008, compared to the corresponding quarter of 2007. The decline was due to lower shipment of copper ore and concentrate despite higher production, as compared to the higher shipment in the corresponding period of 2007. The higher shipment in June quarter of 2007 was mainly due to the clearing of backlog of shipment for 2006, due to low water levels. The average f.o.b. price of Papua New Guinea's copper exports increased by 8.7 percent to K23,152 per tonne in the June quarter of 2008, compared to K21,308 per tonne in the corresponding quarter of 2007. This outcome was mainly due to higher international prices resulting from lower production in Australia and Chile, combined with increased demand from Europe, China and the United States. The decline in export volume more than offset the increase in export price resulting in a 29.3 percent decline in export receipts to K1,069.6 million in the June quarter of 2008, compared to the corresponding quarter of 2007.

Crude oil export volumes declined by 16.6 percent to 3,343.4 thousand barrels in the June quarter of 2008, compared to the corresponding quarter of 2007. The decline reflected lower extraction rates and production from the Kutubu, Moran and Gobe oil fields due to the natural decline of reserves, combined with the shut down of major production facilities for maintenance at Kutubu and Moran. The average export price of crude oil increased by 44.5 percent to K318 per barrel in the June quarter of 2008, compared to the corresponding quarter of 2007, due to higher international prices. The increase in international oil prices was due to cuts to production quotas by the Organisation of Petroleum Exporting Countries (OPEC), combined with supply disruptions in Nigeria by the militants. The increase in export price more than offset the decline in export volume resulting in an increase in export receipts by 20.744.5 percent to K1,064.6 million in the June quarter of 2008, compared to the corresponding quarter of 2007.

Export receipts of refined petroleum products from the Napanapa Oil Refinery increased by 25.7 percent to K105.1 million in the June quarter of 2008, compared to the corresponding period in 2007. The increase was due to high international price and increase in export volume.

Agriculture, Logs and Fisheries Exports

Export prices of most agricultural export commodities increased in the June quarter of 2008, compared to the corresponding quarter of 2007. Coffee prices increased by 14.1 percent, cocoa by 21.4 percent, palm oil by 48.5 percent, copra by 91.3 percent, copra oil by 62.0 percent and rubber by 12.1 percent, while tea prices declined by 4.0 percent. The average export price of logs declined by 10.1 percent to K186 per cubic meter in the June quarter of 2008, compared to the corresponding quarter of 2007. The average export price of marine products increased by 3.6 percent in the June quarter of 2008, from the corresponding period in 2007. The net effect of these price movements was a 23.7 percent increase in the weighted average price of agricultural, log and marine product exports.

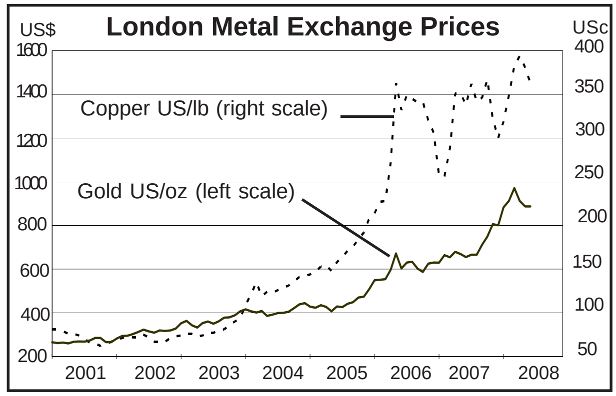
The volume of coffee exported increased by 63.0 percent to 17,600 tonnes in the June quarter of 2008, compared to the corresponding quarter of 2007. The increase was due to higher production attributed to favourable weather conditions, continued recovery of coffee trees after rehabilitation and export of stocks from previous periods. The average export price of coffee increased by 14.1 percent to K8,199 per tonne in the June quarter of 2008, compared to the corresponding quarter of 2007. The increase was due to higher international prices reflecting a decline in world supply, following lower production from Brazil as a result of unfavourable wet weather conditions and speculative buying linked to the weak US dollar. The combined increase in export volume and price resulted in an 86.0 percent increase in export receipts to K144.3 million in the June quarter of 2008, compared to the corresponding period of 2007.

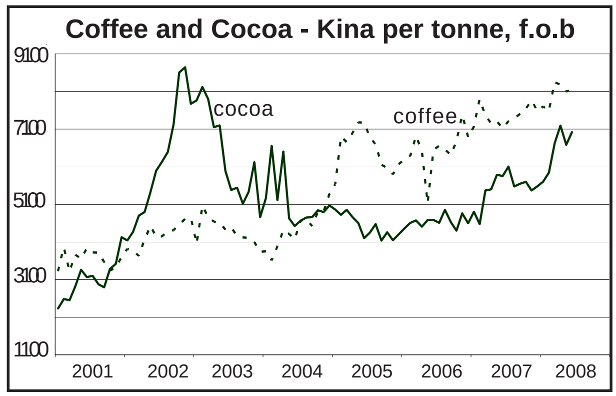
The volume of cocoa exported increased by 4.4 percent to 11,900 tonnes in the June quarter of 2008, compared to the corresponding quarter of 2007. This outcome was due to favourable weather conditions in the cocoa producing regions, higher production from the Autonomous Region of Bougainville and carried over stocks from the previous period. The average export price of cocoa increased by 21.4 percent to K7,017 per tonne in the June quarter of 2008, compared to the corresponding period of 2007. This outcome was due to higher international prices resulting from the lower supply in the world market, due to declines in production from the Ivory Coast and Indonesia caused by unfavourable weather conditions.The combined increase in export volume and price resulted in a 26.7 percent increase in export receipts to K83.5 million in the June quarter of 2008, compared to the corresponding period of 2007.

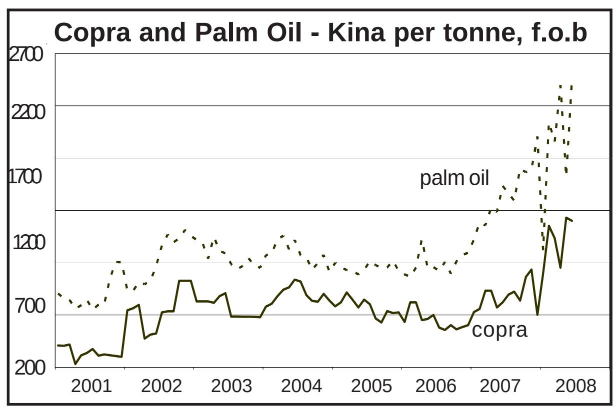
The volume of copra exported increased by 23.1 percent to 4,800 tonnes in the June quarter of 2008, compared to the corresponding quarter of 2007. The outcome was due to increase production in the major copra producing regions, especially in the Autonomous Region of Bougainville, and favourable weather conditions. The average export price for copra increased by 91.3 percent to K1,521 per tonne in the June quarter of 2008, compared to the corresponding quarter of 2007. This outcome was due to higher international prices resulting from lower production from the Philippines due to aging coconut trees and unfavourable weather conditions. The combined increase in export volume and price resulted in a 135.5 percent increase in export receipts to K7.3 million in the June quarter of 2008, compared to the corresponding period of 2007.

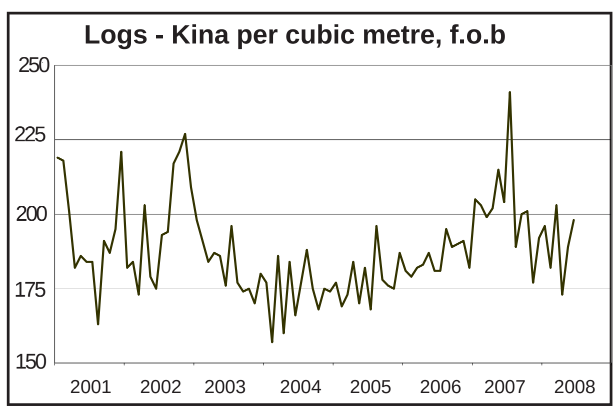
The volume of copra oil exported increased by 5.6 percent to 15,000 tonnes in the June quarter of 2008, compared to the corresponding period of 2007. The increase was primarily due to higher volume of copra sold to the domestic copra mills, resulting from the availability of sea transportation to copra producers in other producing regions. The average export price of copra oil increased by 62.0 percent to K3,753 per tonne in the June quarter of 2008, compared to the corresponding period of 2007. The increase reflected higher international prices mainly due to lower production of copra from the Philippines and higher demand from the emerging economies for bio-fuel products. The combined increase in export volume and price resulted in a 71.1 percent increase in export receipts to K56.3 million in the June quarter of 2008, compared

EXPORT COMMODITY PRICES









to the corresponding period of 2007.

The volume of palm oil exported increased by 11.0 percent to 112,300 tonnes in the June quarter of 2008, compared to the corresponding period of 2007. The increase was due to the harvesting from matured palm oil trees in the new estates and the lag effect of palm oil peak harvesting period in the first half of the year. The average export price of palm oil increased by 48.5 percent to K2,694 per tonne in the June quarter of 2008, compared to the corresponding quarter of 2007. The increase was mainly attributed to lower production from Malaysia, combined with a higher demand for edible oils in the world market. The combined increase in export volume and export price resulted in a 64.8 percent increase in export receipts to K302.5 million in the June quarter of 2008, compared to the corresponding period of 2007.

The volume of tea exported declined by 5.9 percent to 1,600 tonnes in the June quarter of 2008, compared to the corresponding quarter of 2007. The decline was due to transportation problems associated with the closure of the Highlands Highway. The average export price of tea declined by 4.0 percent to K2,938 per tonne in the June quarter of 2008, compared to the corresponding period of 2007. This outcome was mainly due to the appreciation of the kina against the Australian dollar despite higher international price. The combined decline in export volume and price resulted in a 9.6 percent decline in export receipts to K4.7 million in the June quarter of 2008, from the corresponding period of 2007.

The volume of rubber exported increased by 30.0 percent to 1,300 tonnes in the June quarter of 2008, compared to the corresponding period of 2007. This outcome was attributed to favourable weather conditions and increased small-scale production in the major producing regions. The average export price increased by 12.1 percent to K6,615 per tonne in the June quarter of 2008, compared to the corresponding period of 2007. The increase was due to higher international prices following strong demand from China and India, combined with lower supply from Vietnam and Malaysia, two of the major producers in the world market. The combined increase in the export volume and price resulted in a 45.8 percent increase in export receipts to K8.6 million in the June quarter of 2008, from the corresponding period of 2007.

The volume of logs exported declined by 11.1 percent to 689.0 thousand cubic meters in the June quarter of 2008, compared to the corresponding period of 2007. This was attributed to the lower production and shipment from major logging projects resulting from unfavourable weather conditions. The average export price of logs declined by 10.1 percent to K186 per cubic meter in the June quarter of 2008, compared to the corresponding period of 2007. This outcome was due to lower international prices reflecting the oversupply of logs to the Asian markets, especially China. The decline in export volume and price resulted in a 20.0 percent decline in export receipts to K128.1 million in the June quarter of 2008, from the corresponding period of 2007.

The volume of marine products exported declined by 83.0 percent to 1,700 tonnes in the June quarter of 2008, compared to the corresponding period of 2007. The average export price of marine products increased by 3.6 percent to K7,118 million in the June quarter of 2008, from the corresponding period of 2007. The decline was attributed to lower export volume, which more than offset an increase in export price.

5. BALANCE OF PAYMENTS

The overall surplus in the balance of payments for the first six months of 2008 was K616 million, compared to a lower surplus of K400 million in the corresponding period of 2007. This outcome was the result of a higher surplus in the current account, which more that offset a deficit in the capital and financial accounts.

The surplus in the current account was due to a higher trade account surplus and lower net service payments, which more than offset higher net income payments and lower net transfer receipts. The surplus in the capital account reflected a net inflow of capital transfers, combined with the receipt of funds by a mineral company for trading of carbon credits. The deficit in the financial account is due to a higher net outflow from portfolio investments reflecting investments in short term money market instruments, investments in financial derivative instruments and other investments. The net outflow in other investments is due to a build-up in the net foreign assets of the banking system and foreign currency account balances of resident mineral companies and higher net loan repayments by the government. These more than offset the net inflows from direct investments reflecting the issuing of new shares abroad by a resident company to raise capital for further expansion. During the first six months of 2008, the kina depreciated against the currencies of Papua New Guinea's major trading partners with the exception of the US dollar, Hong Kong dollar and British pound sterling, compared to the corresponding period in 2007.

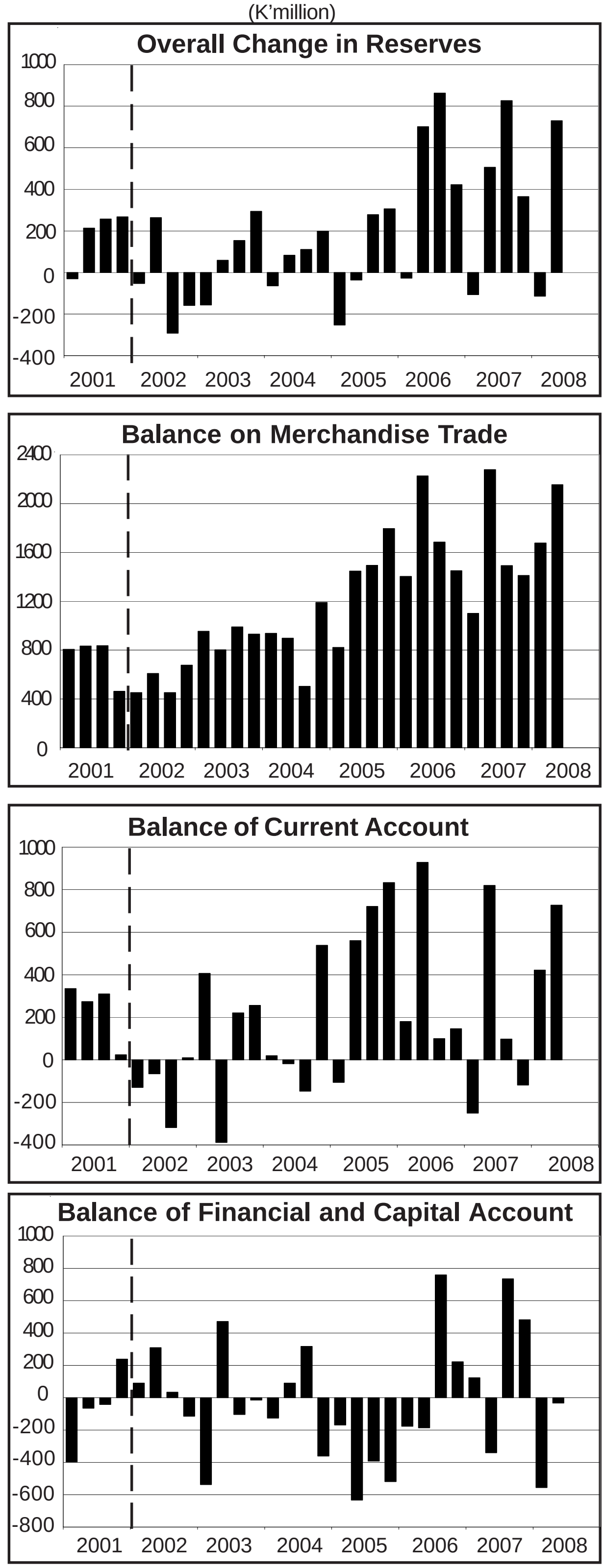
The trade account recorded a surplus of K3,832 million in the first six months of 2008, an increase of 13.4 percent from the corresponding period of 2007. The higher surplus was due to an increase in the value of merchandise exports, which more than offset the increase in the value of merchandise imports. The value of merchandise exports in the first six months of 2008 was K8,083 million, an increase of 12.8 percent from the corresponding period of 2007. The increase was attributed to higher values of gold, crude oil, coffee, cocoa, palm oil, copra, copra oil, rubber, and other exports receipts.

The value of merchandise imports increased by 12.2 percent to K4,251 million in the first six months of 2008, compared to the corresponding period of 2007. The increase was due to higher imports across all sectors. Imports by the mining sector increased by 32.8 percent to K968 million in the first half of 2008, compared to the corresponding period of 2007. The increase reflected higher capital expenditure undertaken by all mines except the Tolukuma and Kainantu gold mines. Petroleum sector imports increased by 22.9 percent to K365 million in first six months of 2008, compared to the corresponding period of 2007. The increase was due to higher capital expenditure, resulting from continued drilling, exploration and evaluation on all existing oil fields. General imports increased by 5.7 percent to K2,918 million in the first six months of 2008, compared to the corresponding period of 2007.

The deficit in the services account was K1,825 million in the first half of 2008, a decline of 23.8 percent from the corresponding period of 2007. The lower deficit was due to declines in payments for travel, education, other financial, computer and information, communication, other business, government services n.i.e, construction, refining and smelting and other services.

The deficit in the income account was K1,024 million in the first half of 2008, an increase of 5.7 percent from the corresponding period of 2007. The outcome was mainly due to higher dividend payments and lower

BALANCE OF PAYMENTS[3]
(K'million)



[3] The dotted vertical lines indicate a break in series from 2002. See 'For the Record' in the March 2002 QEB on page 29.

interest receipts by resident entities.

The surplus in the transfers account was K166 million in the first half of 2008, a decline of 70.1 percent from the corresponding period of 2007. This outcome was due to lower receipts from gifts and grants and licensing fees, combined with higher payments for family maintenance.

As a result of these developments in the trade, services, income and transfers accounts, the current account recorded a surplus of K1,149 million in the first six months of 2008, compared to a surplus of K570 million in the corresponding period of 2007.

The capital account recorded a net inflow of K18 million in the first six months of 2008, a decline of 77.8 percent from the corresponding period of 2007. This reflected lower capital transfers by donor agencies for project financing.

The financial account recorded a net outflow of K607 million in the first six months of 2008, compared to a net outflow of K297 million in the corresponding period of 2007. This outcome reflected a higher net outflow from portfolio investments due to investments in short term money market instruments, investments in financial derivative instruments and other investments. The net outflow in other investments was due to a build-up in the net foreign assets of the banking system and foreign currency account balances of resident mineral companies and higher net loan repayments by the government. These more than offset net inflows from direct investments reflecting the issuing of new shares abroad by a resident company to raise capital for further expansion.

In the June quarter of 2008, the balance of payments recorded an overall surplus of K730 million, compared to a surplus of K506 million in the corresponding quarter of 2007.

The value of merchandise exports increased by 5.4 percent to K4,331 million in the June quarter of 2008, compared to the corresponding quarter of 2007. The increase was due to higher values of gold, crude oil, coffee, cocoa, palm oil, copra, copra oil, rubber, refined petroleum products, and other export receipts.

The value of merchandise imports increased by 18.9 percent to K2,176 million in the June quarter of 2008, compared to the corresponding quarter of 2007, with increases in all sectors. Imports by the mining sector were K474 million in the June quarter of 2008, an increase of 50.0 percent from the corresponding quarter of 2007. This was due to higher capital expenditures by all the mines, with the exception of the Tolukuma and Kainantu gold mines. Petroleum sector imports were K195 million in the June quarter of 2008, an increase of 16.8 percent from the corresponding quarter of 2007. This was due to higher capital expenditure, resulting from continued drilling, exploration and evaluation on all existing oil fields. General imports were K1,507 million in the June quarter of 2008, an increase of 11.9 percent from the corresponding quarter of 2007.

The deficit in the services account was K842 million in the June quarter of 2008, a decline of 23.7 percent from the corresponding quarter of 2007. The lower deficit was due to declines in payments for education, other financial, other business, government services n.i.e, construction, refining and smelting and other services.

The deficit in the income account was K676 million in the June quarter of 2008, an increase of 6.1 percent from the corresponding quarter of 2007. This outcome was due to higher dividend payments and lower interest receipts by resident entities.

The surplus in the transfers account was K90 million in the June quarter of 2008, compared to a higher surplus of K283 million in the corresponding period in 2007. This outcome was due to lower receipts for superannuation funds, gifts and grants and licensing fees, combined with higher payments for family maintenance.

As a result of these developments in the trade, services, income and transfers accounts, the current account recorded a surplus of K727 million in the June quarter of 2008, compared to a surplus of K820 million in the corresponding quarter of 2007.

The capital account recorded a net inflow of K4 million induring the June quarter of 2008, a decline of 90.2 percent from the corresponding period of 2007. This outcome was due to lower capital transfers by donor agencies for project financing.

The financial account recorded a net outflow of K37 million in the June quarter of 2008, compared to a net outflow of K381 million in the corresponding period of 2007. This outcome was due to net outflows from investments in financial derivative instruments and other investments due to a build-up in the net foreign assets of the banking system and foreign currency account balances of resident mineral companies and higher net loan repayments by the government. These more than offset net inflows from foreign direct investments and portfolio investments reflecting sale of short term money market instruments.

The level of gross foreign exchange reserves at the end of the June quarter of 2008 was K6,567.9 (US$2,434.5) million, sufficient for 9.3 months of total and 13.5 months of non-mineral import covers.

6. MONETARY DEVELOPMENTS

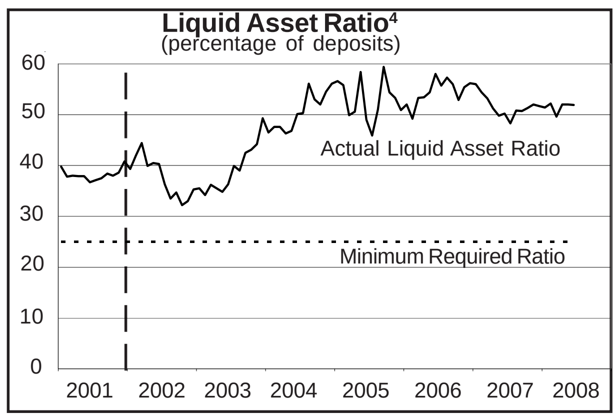
INTEREST RATES AND LIQUIDITY

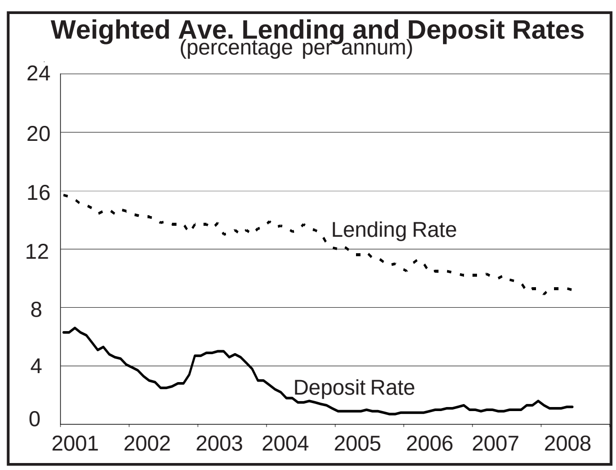
The Bank of Papua New Guinea tightened monetary policy in the June quarter of 2008. As a result, the KFR was increased by 25 basis points to 6.25 percent from 6.00 percent, for the first time since September 2005. The dealing margin for the Repurchase Agreements (Repos) was maintained at 100 basis points on both sides of the KFR during the same period.

Interest rates for short-term securities showed mixed trends during the June quarter of 2008, with the 28-day Central Bank Bill (CBB) rate decreasing from 5.49 percent to 5.45 percent and the 63-day CBB rate increasing from 5.44 percent to 5.49 percent. The 91-day CBB introduced in May 2008 increased from 5.24 percent to 5.54 percent at the end of June 2008. The CBB rates, whilst depicting mixed trends traded above 5.0 percent reflecting higher issuance by the Central Bank to diffuse excess liquidity and align short-term domestic interest rates with the KFR. There were no Treasury bill auctions during the period reflecting the Government's surplus cash flow position. The weighted average rates quoted by commercial banks on wholesale term deposits (K500,000 and above) showed mixed trends; the 30-day and 60-day deposit rates increased, whilst the 90-day and 180-day rates declined during the June quarter of 2008. The 30-day rate increased from 3.81 percent to 4.08 percent and the 60-day rate from 3.53 percent to 3.61 percent, whilst the 90-day and 180-day rates declined from 3.83 percent to 3.30 percent and 4.10 percent to 3.96 percent, respectively. The weighted average interest rate on total deposits paid by commercial banks increased from 1.1 percent to 1.2 percent, whilst the weighted average interest rate on total loans decreased marginally from 9.3 percent to 9.2 percent. The commercial banks Indicator Lending Rates (ILR) spread increased to 8.95 - 9.70 percent from 8.95 - 9.45 percent due to an increase made by one commercial bank during the period.

The Bank continued to utilise Open Market Operation (OMO) instruments in the conduct of monetary policy over the June quarter of 2008, as both CBBs and Reverse Repos were used to diffuse excess liquidity. As a result, trading in the inter-bank market increased moderately during the same period. 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 the June quarter of 2008.

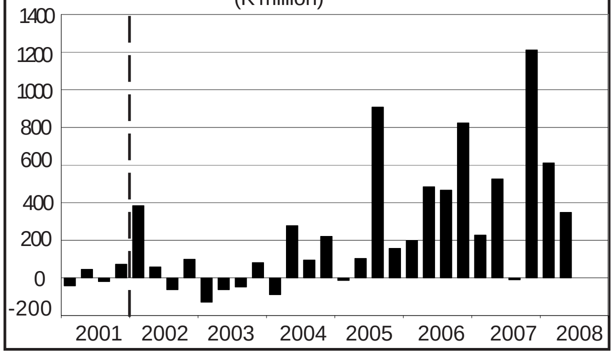
Average liquid assets held by other depository corporations (ODCs) increased by 7.2 percent in the June quarter of 2008, compared to an increase of 10.4



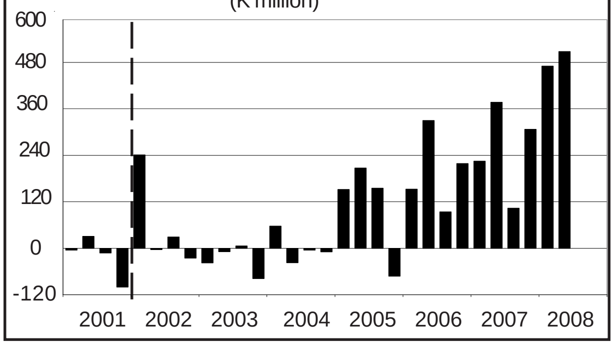


[4] The dotted vertical lines indicate a break in series from 2002. See 'For the Record' in the June 2006 QEB on page 44.

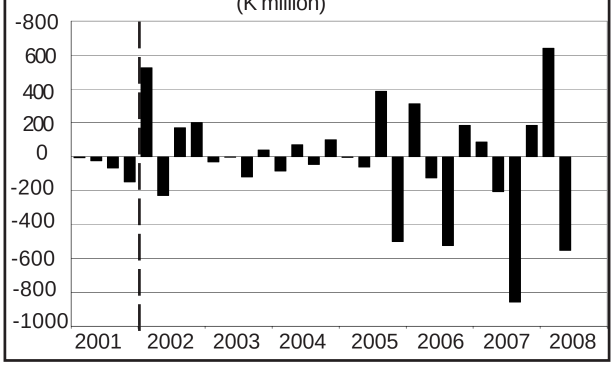
Change in Total Money Supply[5]
(K'million)



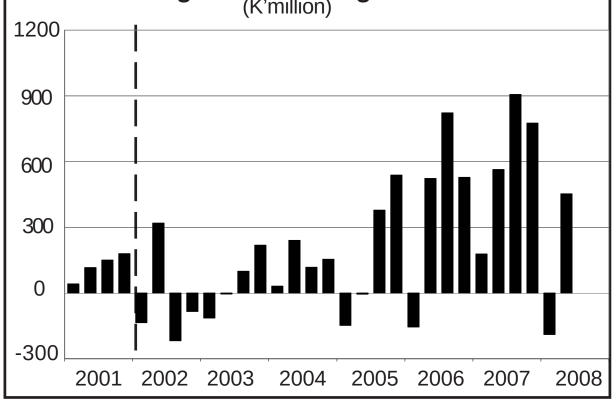
Change in Domestic Claims[5] (Excl. Central Gov't)
(K'million)



Change in Net Claims to Government[5]
(K'million)



Change in Net Foreign Assets[5]
(K'million)



percent in the previous quarter. The increase reflected higher holdings of CBBs, and deposits held at the Central Bank, which more than offset the decline in holdings of Treasury bills, Inscribed stocks of maturity of less than one year and currency.

MONEY SUPPLY

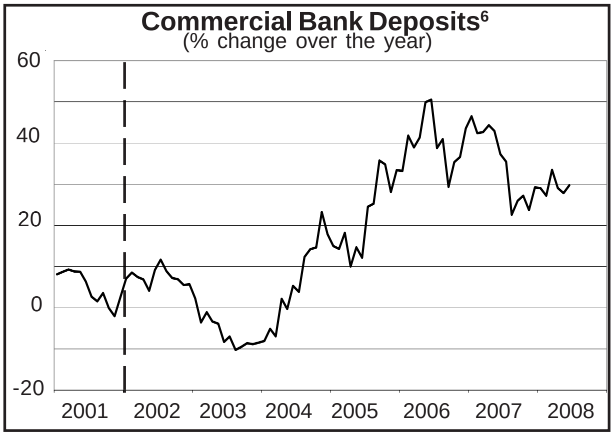
The average level of broad money supply (M3*) increased by 7.0 percent in the June quarter of 2008, compared to an increase of 10.2 percent in the March quarter of 2008. This outcome was due to an increase of 4.7 percent in average net foreign assets of the depository corporations and 11.0 percent increase in average private sector credit, which more than offset a decline of 13.5 percent in average net claims on the Government. Average net domestic claims outstanding, excluding advances to the Central Government and outstanding loans under the Government's Agricultural Export Commodity Support Scheme increased by 10.0 percent in the June quarter of 2008, compared to an increase of 11.3 percent in the previous quarter. The average level of monetary base (reserve money) increased by 12.4 percent in the June quarter of 2008, compared to a decline of 9.2 percent in the March quarter of 2008. This reflected higher deposits of ODCs at the Central Bank and increase of currency in circulation.

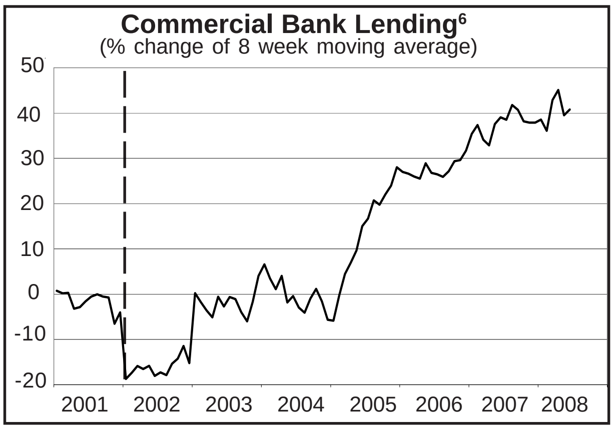
The decline in average net claims on the Government in the June quarter of 2008 resulted mainly from the decline in the purchase of Government securities by ODCs as the Government retired maturing Treasury bills due to its favourable cash flow position. This more than offset the decrease in Government deposits at the Central Bank.

The average level of narrow money supply (M1*) increased by 11.5 percent in the June quarter of 2008, compared to an increase of 7.5 percent in the March quarter of 2008. This was due to an increase in transferable deposits and currency in circulation. The average level of quasi money increased by 1.4 percent in the June quarter of 2008, compared to an increase of 13.9 percent in the previous quarter, due to an increase in average savings deposits.

The average level of deposits of the ODCs increased by 5.6 percent in the June quarter of 2008 to K10,103.1 million from K9,563.6 million in the March quarter of 2008, due to increases in both transferable and other

[5] Break in series. Refer to footnote on page 19.





deposits, excluding Central Government deposits, which declined.

LENDING

During the June quarter of 2008, 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 K393.2 million to K4,912.5 million, compared to an increase of K470.1 million in the previous quarter. This was mainly due to an increase of K388.4 million in private sector credit and K4.6 million in public non-financial corporations. Credit to the private sector was broad-based with lending to the agriculture, forestry and fisheries, manufacturing, transport and communication, wholesale and retail trade, building and construction, mining and quarrying and other business services sectors, as well as the household sector for personal loans and advances for housing. There were no repayments under the price support schemes. The annualised growth in domestic credit, excluding the Central Government and advances under the price support schemes was 35.9 percent in the second quarter of 2008.

7. PUBLIC FINANCE

Preliminary estimates of the fiscal operations of the National Government over the six months to June 2008 showed an overall surplus of K304.4 million, compared to a surplus of K409.2 million in the corresponding period of 2007. This represents 1.5 percent of nominal GDP. The surplus resulted from higher revenue, which more than offset an increase in recurrent expenditure.

Total revenue, excluding foreign grants, during the first six months of 2008 was K2,502.5 million, K0.9 million higher than the receipts collected in the corresponding period of 2007. This represents 34.8 percent of the budgeted revenue for 2008. The increase was attributed to higher tax and non-tax receipts combined with an increase in infrastructure tax credits.

Total tax revenue amounted to K2,381.5 million, 5.7 percent higher than the receipts collected during the same period in 2007, and represents 43.2 percent of the budgeted tax receipts for 2008. Direct tax receipts totalled K1,738.2 million, 10.0 percent higher than the receipts collected over the corresponding period in 2007, and represents 42.0 percent of the budgeted amount. The increase was due to higher collections in personal income, company income and other direct taxes. The increase in personal and corporate income tax receipts mainly reflect the recording of deferred payments from the March quarter of 2008. The higher company tax is due to the improved profitability of companies mainly arising from the high international prices of export commodities and increased domestic demand. Other direct taxes increased as a result of higher receipts from sundry items including dividend withholding tax.

Indirect tax receipts was K643.3 million, 4.6 percent lower than in the corresponding period in 2007, and represents 46.8 percent of the budgeted tax receipts for 2008. Most categories of indirect tax receipts declined. The Goods and Services tax (GST) decreased as a result of lower collections from some provinces, combined with refunds of overdue claims to a large company. The decline in other indirect tax

[6] Refer to footnote on page 19.

receipts was a result of lower collection of arrears for the phased out mining levy. The lower export tax receipts reflected lower log exports. Excise duties increased as a result of higher volumes of domestically produced and imported items combined with higher international oil prices, while the increase in import duty was attributed to higher import demand.

Total non-tax revenue amounted to K104.4 million, K72.3 million higher than in the corresponding period of 2007, and represents 21.4 percent of the budgeted amount. The increase mainly reflected higher dividend payments related to the improved profitability of companies and increased collection of Departmental revenue. Infrastructure tax credit totalled K16.6 million, K9.3 million higher than in the corresponding period in 2007, due to higher utilisation by mineral companies on infrastructure development. Foreign grants to June 2007 were not recorded due to non-reporting by donor agencies mainly the Australian Government through its agency AusAID.

Total expenditure over the six months to June 2008 was K2,198.1 million, 5.1 percent higher than in the corresponding period in 2007, and represents 31.4 percent of the budgeted expenditure for 2007. The increase was due to higher recurrent expenditure, which more than offset lower development expenditure.

Recurrent expenditure for the first half of 2008 was K1,765.6 million, 18.3 percent higher than in the corresponding period in 2007, and represents 48.6 percent of the 2008 budgeted appropriation. Of this total, K1,113.4 million relates to National Departmental expenditure, 31.6 percent higher than the amount spent in the corresponding period in 2007, and represents 49.2 percent of the budgeted appropriation. The increase reflects higher personal emoluments, education subsidies, payments for departmental goods and services and court orders. Provincial Government recurrent expenditure was K422.3 million, 25.0 percent higher than in the corresponding period in 2007, and represents 54.3 percent of the budgeted amount. The increase was due to higher spending for personal emoluments, goods and services and conditional grants, including grants to the Autonomous Bougainville Government (ABG). Interest payments totalled K99.1 million, 49.7 percent lower than the amount paid in the corresponding period in 2007. This outcome reflected lower holdings of Treasury bills and the reduction in interest payments on foreign loans as a result of the appreciation of the kina exchange rate against the US dollar.

Total development expenditure for the first six months of 2008 was K395.5 million, 32.6 percent lower than in the corresponding period in 2007, and represents 21.0 percent of the budgeted expenditure for 2008. The decrease reflected the non-reporting of foreign grants mainly by AusAID, which more than offset increases in counterpart funding for projects by the Government and higher utilisation of infrastructure tax credit by mineral companies.

As a result of these developments in revenue and expenditure, the Government recorded an overall budget surplus of K304.4 million over the first six months of 2008. The surplus was used to make overseas loan repayments totalling K108.8 million and net negative financing to domestic sources of K195.6 million. The overseas loan repayments comprised of K33.0 million to concessionary, K8.3 million to commercial and K67.5 million to extraordinary sources. Net negative financing to domestic sources totalling K276.1 million represented the settlement of cheque floats to other resident sectors, which more than offset K80.5 million in net Government deposit with the financial corporations sector.

PAPUA NEW GUINEA'S TOTAL EXTERNAL EXPOSURE

Papua New Guinea's total external exposure is given by the stock of public and private sector external debt and foreign equity holdings in resident business enterprises.

This article reviews Papua New Guinea's total external exposure for the period 2005 to 2007. Historically, inflows of loans and equity capital for public and private sector investments have financed the balance of payments gaps as a result of low level of domestic savings. Papua New Guinea's balance of payments from 2005 to 2007 is presented in Table 1, and it shows that in 2005 there was a net capital outflow which reflected debt service payments by the mineral[1] sector. From 2006 to 2007, there were net capital inflows reflecting a significant increase in drawdown of loans by the mineral and manufacturing sectors. Over the same period, the current account recorded surpluses.

Between 2005 and 2007, Papua New Guinea's total external exposure as a percent of nominal Gross Domestic Product (GDP) continued to trend downwards from 64.2 percent in 2005 to 59.6 percent in 2007. This trend can be attributed mainly to a steady decline in the public external debt outstanding, combined with increase in nominal GDP. As a percentage of nominal GDP, total external debt outstanding declined from 41.3 percent in 2005 to 37.1 percent in 2007, while total foreign equity holdings declined marginally from 22.8 percent in 2005 to 22.6 percent in 2007. At the end of 2007, 74.8 percent of Papua New Guinea's external debt was denominated in US dollars (60.4 percent) and Japanese Yen (14.3 percent). Between 2005 and 2007, the kina appreciated by 4.7 percent and 11.8 percent against the US dollar and Japanese yen respectively, while it decreciated by 4.8 percent against the Australian dollar. The kina value of total external exposure increased, during this period, as a result of an increase in private sector external debt and total foreign equity holdings, which more than offset the decline in public sector external debt.

Papua New Guinea's total foreign exposure was K11,063 million in 2007, 12.4 percent higher than in 2005. This outcome was due to an increase in total private sector external debt and foreign equity holdings, which more than offset the decline in total public debt outstanding. The increase in private sector exter-

Table 1: **Balance of Payments (a) (K'million)**

	2001	2002	2003	2004	2005	2006	2007 (p)
Export of Goods and Services (b)	7,135	7,123	8,671 r	9,093 r	11,229 r	13,816	15,148
Import of Goods and Services	6,236	7,731	7,323 r	7,920 r	8,353 r	10,603	13,206
Current Account Balance (c) (d)	899	-607	-351 r	-233 r	1,206 r	751	1,942
Capital & Financial Account	-264	320	-183	-313 r	-1,714 r	618	1,001
Foreign Exchange Reserve Level	1,672	1,377 r	1,743 r	2,072 r	2,368 r	4,326	5,919
Months of Total Import Cover	6.1	5.0 r	4.9 r	5.6 r	6.0 r	8.5	9.1

Source: Bank of Papua New Guinea.

(a) The BOP format changed in 2002 to conform with the new IMF reporting format (BPM5), refer to "For the Record Note" in the March 2003 QEB for detailed explanations to the changes in the reporting format.
(b) The revisions for 2003 to 2006 refer to footnote (i) & (j) in Table 8.1 (S39) on Balance of Payments.
(c) Excludes transfer account transactions. Beginning in 2002, it includes transactions in the Income Account, due to changes in the reporting. Prior to 2002, all Income Account transactions were recorded under Services Account. Refer to footnote (a).
(d) Break in the series in 2006 highlights the exclusion of Income and Transfer accounts from export and import calculations which conforms with the method of calculation of debt-ratios used and the indictors employed in the calculation process. See "For the Record", June 2007 QEB for detailed explanation.

[1] Mineral sector includes the petroleum sector.

Table 2:	External Debt Outstanding and Foreign Equity Holdings (K'million) (a)						
	2001	**2002**	**2003**	**2004**	**2005**	**2006**	**2007 (p)**
External Debt							
Official Sector	**5,294.0**	**5,777.4**	**4,901.0**	**4,409.5**	**3,855.7**	**3,617.9**	**3,145.7**
Commercial	116.0	224.0	184.0	170.0	133.0	123.9	107.6
Concessional	5,178.0	5,553.4	4,717.0	4,239.5	3,722.7	3,494.0	3,038.1
Private Sector	**2,970.0**	**3,050.0**	**2,380.0**	**2,138.0**	**2,485.0**	**2,986.4**	**3,733.0**
Mineral (b)	1,768.0	1,824.0	1,383.0	1,161.0	1,559.0	2,130.4	2,907.9
Other	1,085.0	1,124.0	930.0	923.0	842.0	840.0	818.9
Commercial Stat. Authorities.	117.0	102.0	67.0	53.0	84.0	16.0	6.2
Total Debt Outstanding	**8,264.0**	**8,827.4**	**7,281.0**	**6,547.2**	**6,340.7**	**6,604.3**	**6,878.7**
As a % of GDP	**79.5**	**76.3**	**57.0**	**47.8**	**41.3**	**38.7**	**37.1**
As a % of Export of Goods and Services (c)	**115.8**	**123.9**	**83.4**	**73.1**	**56.7**	**47.8**	**45.4**
Foreign Equity Holdings							
Private Sector							
Mineral (a)	2,142.0	2,241.0	2,176.0	2,236.0	2,231.7 r	3,001.5	3,080.0
Other	740.0	755.0	800.0	916.0	1,077.8 r	1,088.4	1,104.0
Total Foreign Equity Holdings	**2,882.0**	**2,996.0**	**2,976.0**	**3,153.0**	**3,309.5 r**	**4,089.9**	**4,184.0**
As a % of GDP (Nominal terms)	**27.7**	**25.9**	**23.3**	**23.0**	**21.6 r**	**24.0**	**22.6**
Total External Exposure	**11,146.0**	**11,823.4**	**10,257.0**	**9,699.0**	**9,650.2 r**	**10,694.2**	**11,062.7**
As a % of GDP (Nominal terms)	**107.2**	**102.2**	**80.4**	**70.8**	**62.9 r**	**62.7**	**59.6**
GDP (Nominal Terms)	**10,396.3**	**11,568.6**	**12,765.0**	**13,692.0**	**15,339.2**	**17,050.8**	**18,550.9**

Source: Bank of Papua New Guinea, National Statistics Office & Department of Treasury.

(a) Figures from 1999-2003 are based on the old CS-DRMS database. Figures for 2004-2007 are from the upgraded databse system
(b) Includes petroleum and Mineral Resources Development Company Pty Ltd (MRDC).
(c) See Footnote (d) in Table 1.

nal debt was mainly due to loan drawdowns by the mineral, manufacturing and agriculture companies. From 2005 and 2007, the public sector external debt outstanding declined annually due to high net loan repayments combined with the appreciation of the kina against the US dollar and the yen.

Between 2005 and 2007, total foreign equity increased due to significant investments in the mineral, manufacturing and agricultural sectors.

Composition of External Debt Outstanding

As presented in Table 2, Papua New Guinea's total external debt outstanding increased by 8.5 percent to K6,879 million in 2007, from K6,341 million in 2005. Total external debt outstanding as a percentage of nominal GDP declined from 41.3 percent in 2005 to 37.1 percent in 2007. This outcome was largely due to a decline in public sector debt combined with an increase in nominal GDP over the period.

The Government's external debt outstanding declined by 18.4 percent to K3,146 million in 2007 from 2005, and comprised 45.7 percent of total external debt in 2007 compared to 60.8 percent in 2005. Concessionary loans comprised 96.6 percent of total public external debt in 2007 with commercial loans making up the balance.

The decline in the stock of debt between 2005 and 2007 was due to higher repayments and the appreciation of the kina against the US dollar (4.7 percent) and the Japanese yen (11.8 percent).

The declining trend in the composition of public debt outstanding indicates that the Government, in line with its Medium Term Debt Strategy, intends to reduce the share of public external debt to total public debt. This would be facilitated by retiring public sector external debt and substituting it with financing from the domestic sector through increased issuance of longer dated Inscribed stocks.

The total stock of private sector external debt outstanding increased by 50.2 percent to K3,733 million in 2007, from K2,485 million in 2005. The increase was due to higher drawdown of loans by the mining, petroleum, manufacturing and agriculture sectors. The private sector debt outstanding, excluding mineral and commercial statutory authorities', declined by 2.7 percent from 2005 to K819 million in 2007. This was due to higher repayments by the manufacturing sector.

The increase in private sector external debt outstanding from 2005 to 2006 was mainly from the mineral

Table 3:	Maturity Structure of Government External Debt Outstanding: 2001 - 2007 (K'million)													
Maturity	**2001**	**%**	**2002**	**%**	**2003**	**%**	**2004**	**%**	**2005**	**%**	**2006**	**%**	**2007 (p)**	**%**
1 to 5 years	2	0	41	1	42	1	20	0	9	0	0	0	0	0
6 to 10 years	406	8	433	7	429	9	235	5	102	3	33	1	31	1
11 to 15 years	291	6	494	9	435	9	424	10	366	9	286	8	252	8
Over 15 years	4,595	87	4,809	83	3,995	82	3,731	85	3,379	88	3299	91	2863	91
Total	**5,294**	**100**	**5,777**	**100**	**4,901**	**100**	**4,410**	**100**	**3,856**	**100**	**3,618**	**100**	**3,146**	**100**

Source: Financial Evaluation Division, Department of Treasury.

sector. This reflected loan drawdowns for the construction and extension of the geothermal power plant at the Lihir Gold mine, capital expenditure work at the Highlands Kainantu gold mine and equity participation in the oil and gas projects. The increase in 2007 reflected significant loan drawdowns by Lihir Gold Limited, Morobe Consolidated Goldfields, Simberi Gold Limited and Barrick Goldfields Limited in the mineral sector.

Maturity Structure of Government External Debt Outstanding

Table 3 presents the maturity structure of Government's external debt, classified by date of maturity from drawdown. At the end of 2007, 1 percent and 8 percent of debt stock had original maturities between 6 to 10, and 11 to 15 years respectively. The remaining 91 percent of debt had maturities over 15 years which are loans provided by multilateral agencies under structural adjustment programs (SAP) and for other development projects.

Maturity Structure of Private External Debt Outstanding

As presented in Table 4, the maturity structure of the private sector debt, classified by date of maturity from drawdown, shows that 80.0 percent of the total stock had original maturities between 1 to 10 years. These are mainly commercial debt associated with the min-

Table 4:	Maturity Structure of Private External Debt Outstanding: 2001-2007 (K'million) (a)													
Maturity	**2001**	**%**	**2002**	**%**	**2003**	**%**	**2004**	**%**	**2005**	**%**	**2006**	**%**	**2007 (p)**	**%**
1 to 5 years	957	32	966	32	135	6	790	37	342 r	14	314	11	1,022	27
6 to 10 years	489	16	532	17	1,010	42	433	20	1,172 r	47	1,817	61	1,978	53
11 to 15 years	778	26	753	25	672	28	607	28	577 r	23	564	19	482	13
Over 15 years	746	25	799	26	563	24	307	14	394 r	16	291	10	251	7
Total	**2,970**	**100**	**3,050**	**100**	**2,380**	**100**	**2,138**	**100**	**2,485**	**100**	**2,986**	**100**	**3,733**	**100**

Source: Bank of Papua New Guinea.
(a) See footnote (a) in Table 2

Table 5:	External Debt Service by Category of Borrower (K'million) (a)						
	2001	2002	2003	2004	2005	2006	2007 (p)
Official Sector	**542**	**549**	**610**	**567**	**465**	**478**	**614**
Principal	356	364	446	435	354	364	501
Commercial	45	34	45	27	17	16	16
Concessional	311	330	401	408	336	348	485
Interest (b)	186	185	164	133	112	114	113
Commercial	7	6	4	3	2	2	2
Concessional	179	179	160	130	109	112	111
Private Sector	**1,093**	**468**	**1,145**	**377**	**663**	**1,034**	**1,923**
Principal	973	376	1,039	316	577	935	1,799
Mineral (c)	905	278	936	217	499	496	568
Other (d)	20	57	63	81	23	430	1,222
Commercial Stat. Authorities (e)	48	41	40	18	55	9	9
Interest (b)	120	92	106	61	86	99	124
Mineral (c)	92	54	64	33	48	83	83
Other	23	32	39	26	36	16	41
Commercial Stat. Authorities (e)	5	6	3	2	2	0	0
Total Debt Service	**1,635**	**1,017**	**1,755**	**945**	**1,129**	**1,512**	**2,536**
Principal	**1,329**	**740**	**1,485**	**750**	**931**	**1,299**	**2,299**
Interest	**306**	**277**	**270**	**194**	**198**	**213**	**237**
Total Debt Servicing/Export of Goods and Sevices (%) (f)	**22.9**	**14.3**	**20.1**	**10.6**	**10.1**	**10.9**	**16.7**
Interest Payments/Export of Goods and Sevices (%) (f)	**4.3**	**3.9**	**3.1**	**2.2**	**1.8**	**1.5**	**1.6**

Source: Bank of Papua New Guinea & Department of Treasury.
(a) See foot note (a) in Table 2
(b) From 1999 onwards Other fees and charges are not included.
(c) Includes petroleum and MRDC.
(d) The significant increase in 2007 was due to debt service by the manufacturing sector.
(e) Includes Bank of Papua New Guinea's debt service.
(f) See Footnote (d) in Table 1.

eral sector. The remaining 20.0 percent with over 10 years to maturity mainly constitutes inter-company debt, contracted between resident companies and their foreign affiliates.

External Debt Service

Table 5 shows that Papua New Guinea's external debt service payments, comprising of principle and interest, increased by 124.6 percent from 2005 to K2,536 million in 2007. Much of the increase was attributed to the mineral sector, whose debt service obligations have first call on export receipts. The external debt service of the mineral sector and other private sector companies, excluding the commercial and statutory authorities, accounted for a large portion relative to the total external debt service of the private sector. The Government's external debt service increased between 2005 and 2007, mainly due to the repayments of some loans whose grace periods have ended combined with increased loan repayments by the Government. In 2007, K297 million was paid by the Government on those loans considered to be expensive.

Debt Service to Exports Ratio[2]

The ratio of debt service to exports is defined as the ratio of debt service to the value of exports of goods and services. This ratio is used as an indicator of a country's ability to meet external debt obligations from its export earnings.

As shown in Chart 1, Papua New Guinea's debt service to exports ratio showed an increasing trend since 2005, and was around 16.7 percent by the end of 2007. This outcome was due to a significant increase of 124.7 percent in debt service payments to K2,536 million, mainly by the mineral and manufacturing sectors. The ratio was higher compared to that of the African and other developing economies. The overall increase in Papua New Guinea's debt service to exports ratio indicates that the country's ability to meet its external debt obligations has declined.

[2] Refer to 'For the Record' in the June 2007 Quarterly Economic Bulletin for detailed explanation.

Debt to Exports Ratio[3]

The debt to exports ratio is defined as the ratio of total outstanding debt to the value of exports of goods and services for the economy. This ratio is used as a measure of sustainability and as an indicator of a country's ability to meet its future external debt obligations from its export earnings.

Between 2005 and 2007, Papua New Guinea's ratio of external debt outstanding to exports of goods and services continued to trend downwards, as shown in Chart 2, and was lower than the ratios of other Latin America, Africa and other developing countries. The decline was due to high debt service payments and the appreciation of the kina against the US dollar and the Japanese yen, the main currencies in which loans are denominated. The decline in Papua New Guinea's ratio of external debt to export receipts of goods and services from 56.7 percent in 2005 to 45.4 percent in 2007 resulted mainly from a significant increase in the value of goods and services exported during this period. The decline in the country's debt to exports ratio indicates an improvement in the country's ability to meet its external debt obligations.

Debt to GDP Ratio[4]

This ratio is defined as total outstanding external debt to nominal GDP. It is an indication of the country's ability to service external debt by switching resources from production of domestic goods to the production of exports.

The ratio of Papua New Guinea's external debt outstanding to nominal GDP, as shown in Chart 3, indicates that while it declined between 2005 and 2007, it was still higher than the average of Africa, Latin America and other developing countries. The decline was due to higher debt repayments by the public and private sectors, appreciation of the kina against the US dollar and significant increase in the nominal GDP. The decline in the debt to GDP ratio indicated an improvement in the country's ability to meet its future external debt obligations.

Chart 1: Debt Service to Exports Ratio

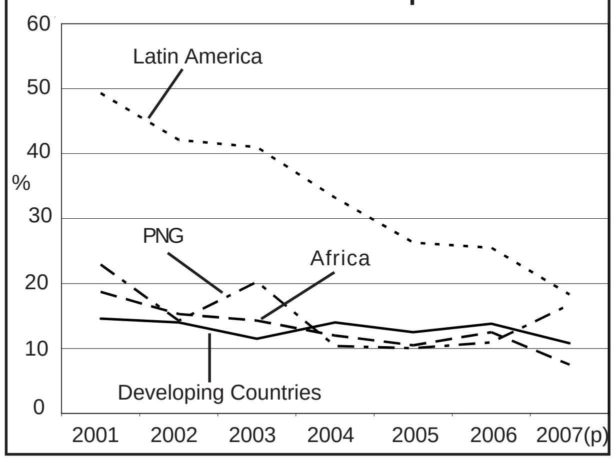


Chart 2: Debt to Exports Ratio

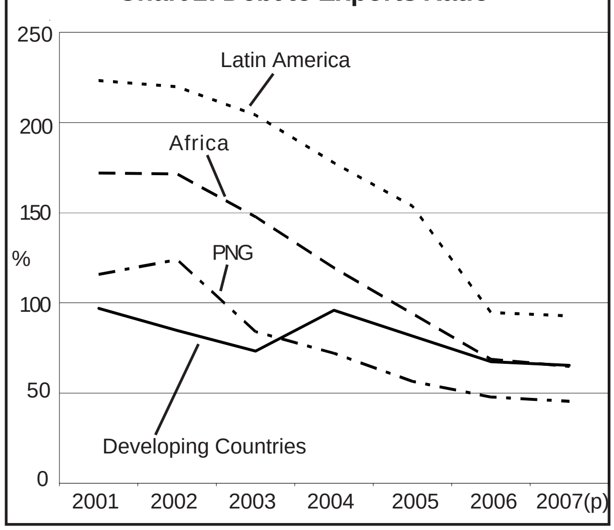
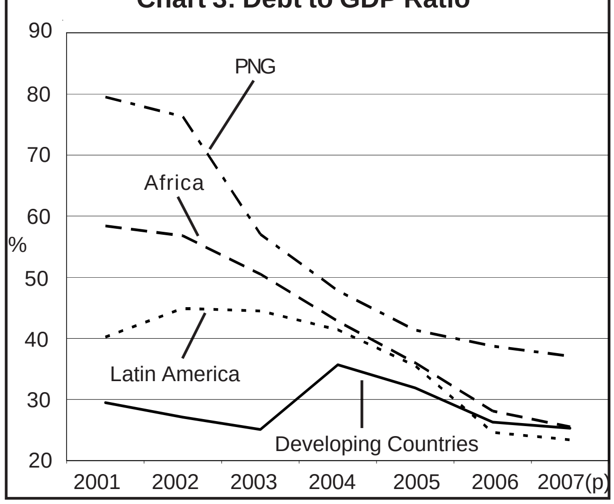


Chart 3: Debt to GDP Ratio



[3 & 4] Refer to footnote on page 38.

Table 6:	Foreign Equity Holdings by Country of Origin (K'million) (a)							
Country	**2001**	**2002**	**2003**	**2004**	**2,005**		**2,006**	**2007 (p)**
Australia	1,657	1,615	1,612	1,658	1,671	r	2,280	2,305
United States	112	112	48	48	48		48	48
United Kingdom	169	158	158	156	181	r	181	206
Japan	107	115	115	107	107		107	107
Canada	42	42	42	42	43		43	98
Singapore	20	142	142	155	162	r	162	162
Hong Kong	45	49	52	66	66		70	70
South Korea	64	64	64	64	41		41	24
Malaysia	126	126	170	170	170		170	170
Bahamas	189	189	189	189	189		189	189
Bermuda	66	66	66	66	66		66	66
Others	285	318	318	431	565	r	734	740
Total Foreign Equity	**2,882**	**2,996**	**2,976**	**3,152**	**3,309**		**4,090**	**4,183**
As a % of GDP (nominal)	**27.7**	**25.9**	**23.3**	**23.0**	**21.6**		**24.0**	**22.6**
Gross Domestic Product (GDP) (a)	10,396	11,569	12,765	13,692	15,339		17,051	18,551

Source: Bank of Papua New Guinea.
(a) See footnote (a) in Table 2
(b) GDP figures are from various budget documents published by Department of Treasury.

Foreign Equity Investment in Papua New Guinea

As presented in Table 6, foreign equity investment in Papua New Guinea increased by 19.4 percent from 2005 to K4,183 million in 2007. The ratio, as a percentage of nominal GDP, increased from 22.8 percent in 2005 to 24.0 percent in 2006 reflecting an increase in the value of equity investments in the mineral, banking/insurance/finance, retail and other sectors. The increase in foreign equity in 2007 was due to investments in the agricultural, mineral, and banking/insurance/finance sectors.

By country of origin, equity investments from Australia, Japan, the United Kingdom (UK), Singapore, Bahamas and Malaysia together accounted for 71.3 percent in 2005, and increased to 75.0 percent in 2007. Investments from Australia, UK, Canada and

Table 7:	Foreign Equity Holdings by Economic Sector (K'million) (a)							
Economic Sector	**2001**	**2002**	**2003**	**2004**	**2005**		**2006**	**2007 (p)**
Agriculture	191	194	194	194	194		194	219
Mineral (b)	2,142	2,241	2,176	2,237	2,232	r	3,002	3,080
Transportation	7	7	5	5	5		5	5
Manufacturing	88	100	144	214	379	r	382	382
Fisheries	52	52	52	52	52		52	52
Bank/Insurance/Finance	122	113	113	115	131	r	131	137
Retail	32	32	32	32	31		38	38
Forestry	112	125	128	152	130		130	130
Hotel/Restraurant	10	10	10	10	10		10	10
Other	126	122	122	141	146	r	147	131
Total Foreign Equity	**2,882**	**2,996**	**2,976**	**3,152**	**3,310**		**4,090**	**4,184**

Source: Bank of Papua New Guinea.
(a) See footnote (a) in Table 2
(b) Includes petroleum.

Hong Kong increased, while the investments from the USA, Japan, Singapore, Malaysia, Bermuda and Bahamas remained stable over the same period.

Table 7 shows that the mineral sector accounted for 68.7 percent and 73.6 percent of the total foreign equity in 2005 and 2007, respectively, reflecting the dominance of this sector in the economy. Equity in the non-mineral private sector increased by 0.6 percent to K1,104 million in 2007 from 2005, reflecting marginal growth in investments.

Net Equity Flows

As shown in Tables 8 and 9, Papua New Guinea displayed a consistent trend of net equity inflows from 2005 to 2007. This was due to an increase in investments in the agriculture, mineral, banking/insurance/finance and retail sectors.

Table 8: Equity Inflows by Country of Origin (K'million) (a)

Country	2001	2002	2003	2004	2005	2006	2007 (p)
Australia	-	100	-	59	2	609	27
United Kingdom	-	-	-	10	-	-	25
Fiji	-	-	-	-	-	1	0
Japan				40			
Germany	-	-	-	-	-	-	-
Canada	-	-	-	-	1	-	55
Singapore	-	122	-	13	-	-	-
Hong Kong (PRC)	-	4	3	15	-	3	-
Taiwan (PRC)				13			
Malaysia	-	-	44	-	-	-	-
Others	8	44	-	78	154	168	1
Inflows/Transfers (b)	**8**	**270**	**47**	**228**	**157**	**781**	**108**

(a) See footnote (a) in Table 2

(b) The large inflows in 2002, 2004, 2005, 2006 and 2007 were for the agriculture, manufacturing, fisheries, mineral and manufacturing sectors, respectively.

Table 9: Equity Withdrawals /Transfers by Country of Destination (K'million) (a)

Country	2001	2002	2003	2004	2005	2006	2007 (P)
Australia	-	142	3	-	-	-	2
Canada							1
Japan				48			
Korea, Republic of							17
United Kingdom	-	6		3	-	-	-
United States			65				
Others	-	2	-		-	-	1
Withdrawals/ Transfers (b)	**0**	**150**	**68**	**51**	**0**	**0**	**20**
Net Flows	**8**	**120**	**-20**	**177**	**157**	**781**	**88**

Source: Bank of Papua New Guinea.

(a) See footnote (a) in Table 2

(b) Transfers to other non-residents are treated as withdrawals.

Dividend Payments

Dividends reflect the cash return to shareholders and are an indicator of the profitability of an enterprise. As shown in Tables 10 and 11, dividend payments increased by 20.3 percent to K1,604 million in 2007, from 2005. The increase in dividend payments, between 2005 and 2006, reflected higher payments mainly by the mineral, fisheries, transport and bank/insurance/finance sectors. In 2007, dividend payments declined as a result of lower payments by the mineral, fisheries, transport and bank/insurance/finance sectors, compared to 2006. The consistently high annual dividend payments made to Australia and Singapore between 2005 and 2007 reflects the high shareholding of mineral companies by the two countries and their dominance of equity investment in Papua New Guinea (see Table 6).

Table 10: Dividend Payments by Country of Destination (K'million) (a)

Country	2001	2002	2003	2004	2005	2006	2007 (p)
Australia	237	146	490	506	449	411 r	333
United States	6	123	219	26	16	4	0
United Kingdom	0	1	0	0	0	0	0
Japan	0	0	1	3	3	2	0
France	0	0	0	0	5	2	0
New Zealand	1	8	2	10	12	12	11
Korea	3	0	12	17	18	13	13
Philippines	0	0	0	0	2	11	2
Hong Kong	1	1	3	3	0	0	3
Italy	0	0	0	0	0	64	0
Canada	24	18	0	0	0	0	0
Singapore	19	3	32	29	774	1295	1070
Malaysia	22	23	24	26	36	17	26
Others	4	2	1	29	17	116	147
Total	**317**	**325**	**785**	**650**	**1,333**	**1,947**	**1,604**

Source: Bank of Papua New Guinea.
(a) See footnote (a) in Table 2

Table 11: Dividend Payments by Economic Sector (K'million) (a)

Economic Sector	2001	2002	2003	2004	2005	2006	2007 (p)
Mineral(b)	203	166	587	318	1,026	1,663	1,363
Agriculture	11	10	21	18	33	0	0
Transport	1	0	17	10	9	12	2
Dredging Construction	0	2	2	1	0	4	3
Engineering Construction	0	2	0	2	0	0	3
Fisheries	0	0	0	0	2	11	2
Manufacturing	56	38	73	106	72	71	80
Bank/Ins/Finance	22	42	55	136	108	116	54
Retail	3	28	4	8	16	14	31
Electricity,Gas and Water	3	0	12	17	18	13	13
Others (c)	18	35	13	33	48	42	53
Total	**317**	**324**	**785**	**650**	**1,333**	**1,947**	**1,604**

Source: Bank of Papua New Guinea.
(a) See footnote (a) in Table 2
(b) Includes petroleum.
(c) Includes dividends from the remaining sectors and from unspecified sectors.

MONETARY POLICY STATEMENT (MPS) JULY 2008

Executive Summary

Based on the high inflation outcome in the March quarter of 2008 and expectations that inflation will be higher for the year, the Bank of Papua New Guinea (Bank) tightened its monetary policy stance in June 2008 by increasing the Kina Facility Rate (KFR) to 6.25 percent from 6.0 percent. Annual headline inflation was 7.5 percent in the March quarter. The outcome was due to higher imported inflation resulting from increases in international oil and food prices and depreciation of the kina against the Australian dollar. Domestic factors including faster growth in monetary aggregates, higher Government spending emanating from the 2006 and 2007 Supplementary Budgets, the second round effect of fuel price increases on goods and services and higher aggregate demand also contributed to the outcome.

Whilst external sources of inflation such as international oil and food prices are beyond the authorities' control, prudent management of fiscal and monetary policies is important to help contain domestic demand. On its part, the Bank issued additional Central Bank Bills (CBBs) to absorb excess liquidity and prevent interest rates from falling and also intervened in the foreign exchange market to allow the kina to appreciate against the US dollar in the first half of 2008. But these were not enough to contain the inflation that is largely driven by external sources.

Inflationary pressures are expected to remain strong throughout the remainder of 2008. The Bank will pursue a tightening monetary policy stance in 2008.

This stance is based on the following expectations for 2008:

- Inflation of around 9.0 percent;
- Credit growth to the private sector to continue; and
- Real Gross Domestic Product (GDP) growth rate to be 7.6 percent.

The upside risks to the inflation expectation will arise from: further increases in international oil and food prices, higher imported inflation from PNG's major trading partner countries, depreciation of the kina exchange rate against the currencies of PNG's major trading partner countries, higher growth in monetary aggregates, increases in wages, further increases in Government expenditure and fast drawdown of trust account funds, increase in aggregate demand, and other unforeseen external and domestic shocks.

The return to price stability requires close coordination between the Government and the Bank. In this respect, the Bank will assess these developments and their potential effects on restoring price stability, and make appropriate adjustments to the stance of monetary policy in 2008 and over the medium term.

1.0 Monetary Policy Discussions

1.1 Monetary Policy Assessment and Issues

The high inflation outcome for the March[1] quarter of 2008 and expectations of continued inflationary pressures prompted the Bank of Papua New Guinea to tighten monetary policy after maintaining a neutral stance since September 2005. Hence, the KFR was increased by 25 basis points to 6.25 percent in June 2008.

Annual headline inflation was 7.5 percent in the March quarter. The outcome was due to higher imported inflation resulting from increases in international oil and food prices (*see Box 1*) and depreciation of the kina against the Australian dollar. Domestic factors including the fast growth in monetary aggregates, higher Government spending from the 2006 and 2007 Supplementary Budgets, second round effect of fuel price increases on goods and services and higher aggregate demand also contributed to the outcome. Inflationary pressures are expected to remain strong throughout 2008.

The kina depreciated against the Australian dollar by 2.3 percent to A$0.3906 at the end of June 2008 from December 2007. This added to inflationary pressures as Australia is a major source of PNG's imports. However, against the US dollar, the kina appreciated by 6.7 percent to US$0.3760, which reflected increased foreign exchange inflows and Central Bank intervention to help dampen inflationary pressures.

Interest rates remained low due to the high level of liquidity in the banking system. The low interest rate environment combined with a fiscal surplus and improved business confidence led to the continuation of the strong growth in lending to the private sector by other depository corporations (ODCs)[2]. The increase in lending enabled the private sector to continue to expand business activity and increase employment in the first half of 2008. This contributed to the increase in domestic demand and inflationary pressures.

Despite the low interest rate environment compared to Papua New Guinea's substitute financial markets and the liberalisation of the capital account in September 2007, there was no significant capital outflow and downward pressure exerted on the exchange rate. This is due to the low level of portfolio investment and the shallowness of the domestic capital market. As an alternative form of investment, the growth in the domestic capital market was reflected by the high turnover at the Port Moresby Stock Exchange (POMSoX) in the first half of 2008.

Annual growth in broad money supply (M3*) and the monetary base were 27.5 percent and 33.2 percent, respectively, over the year to June 2008. The growth in broad money supply was accounted for by an increase in the net foreign assets of the Central Bank and net claims on the private sector by ODCs. To diffuse excess liquidity from the banking system and address concerns of inflationary pressures, the Bank issued new CBBs totalling K1.4 billion over the first six months of 2008. Since its introduction in September 2005, the level of CBBs outstanding reached K4.0 billion as at 25th July 2008.

Preliminary estimates of the Government's fiscal operations recorded a surplus of K317 million during the five months to May 2008. However, recurrent expenditure increased by 31.5 percent in the first five months of 2008 compared to the corresponding period in 2007, due to frontloading of warrants in January 2008. While the Bank endorses the achievement of fiscal surpluses by the Government, the fast pace of increases in recurrent expenditure and drawdown of trust account funds, can contribute to aggregate demand and inflationary pressure.

Excluding foreign grants, there was a marginal increase in development expenditure, reflecting the ongoing capacity constraints of implementing agencies. It is important that the Government addresses this problem to enhance service delivery and ensure sustained economic growth.

The growth in the monetary aggregates and recurrent expenditure has contributed to the higher than expected inflation outcome and forced the Bank to tighten monetary policy. The Bank will closely monitor the changes in the monetary aggregates and recurrent expenditure and continue its close coordination with the Government, where necessary, to restore price

[1] March quarter inflation outcomes became available in May 2008.

[2] As of June 2006, the Bank adopted the new International Monetary Fund (IMF) reporting format for Monetary and Financial Statistics, which extended the coverage to include financial institutions other than the Central Bank and commercial banks. Refer to the June 2006 Quarterly Economic Bulletin (QEB) for details.

stability which will assist in enabling continued economic growth.

1.2 Monetary Policy Stance

Based on the high inflation outcome in the March quarter of 2008 and expectations that inflation will be higher for the year, the Bank will pursue a tightening monetary policy stance in 2008.

This stance is based on the following expectations for 2008:

- Inflation of around 9.0 percent;
- Credit growth to the private sector to continue; and
- Real GDP growth rate to be 7.6 percent.

The Bank expects broad money supply to grow by 20.7 percent and the monetary base by 16.3 percent in 2008. The increase in broad money supply is mainly due to the projected growth in the net foreign assets of the Central Bank and private sector credit. If private sector credit is directed to expanding productive capacity it will reduce inflationary pressures in the long run. A tightening monetary policy stance will raise the cost of borrowing and reduce aggregate demand through lower lending growth in 2008.

The Bank expects the Government to prudently manage its fiscal operations in 2008 by avoiding excessive recurrent expenditure, effectively spending on the priority areas of health, education, law and order and physical infrastructure and continuing to repay debt in line with the Medium Term Debt Strategy. Efforts should be made to improve implementation capacity for development expenditure so that economic growth is sustained in the medium term. The fast tracking of public sector reforms and removal of other impediments to trade and investment consistent with the medium term development, fiscal and debt strategies are also necessary to support economic growth.

The upside risks to the inflation expectation will arise from:

- Further increases in international oil and food prices;
- Higher imported inflation from PNG's major trading partner countries;
- Depreciation of the kina exchange rate against the currencies of PNG's major trading partner countries;
- Higher growth in monetary aggregates;
- Increases in wages;
- Further increases in Government expenditure and fast drawdown of trust account funds;
- Increase in aggregate demand; and
- Other unforeseen external and domestic shocks.

The Bank will assess these developments and their potential effects to restoring price stability, and make appropriate adjustments to the stance of monetary policy in 2008 and over the medium term.

1.3 Conduct of Monetary Policy

Monetary policy will be conducted within the reserve money framework. The Monetary Policy Statement (MPS) provides the overall monetary policy framework, while the monthly KFR remains the instrument for signalling the Bank's monetary policy stance through an announcement by the Governor. Following the announcement, Open Market Operations (OMOs) will be conducted to support the Bank's monetary policy stance. The OMOs involves Repurchase Agreement (Repo) transactions with commercial banks and the auction of CBB to licensed ODCs and Treasury bills to the general public.

The Bank is committed to adopting appropriate monetary policy management strategies that will help to restore price stability.

2.0 Developments and Expectations

2.1 International Developments

Global economic growth is expected to weaken in 2008. According to the International Monetary Fund's (IMF) World Economic Outlook (WEO) Update of July 2008, global real GDP growth is projected to be 4.1 percent in 2008, compared to 5.0 percent in 2007. The lower growth is mainly driven by the slowdown in the US economy and its contagion effect on the rest of the world. It is expected that in advanced economies, growth rates will be 1.7 percent and 1.4 percent in 2008 and 2009 respectively, compared to 2.7 percent in 2007. Emerging and developing economies are also expected to slow marginally to 6.9 percent and 6.7 percent, in 2008 and 2009 respectively, from 8.0

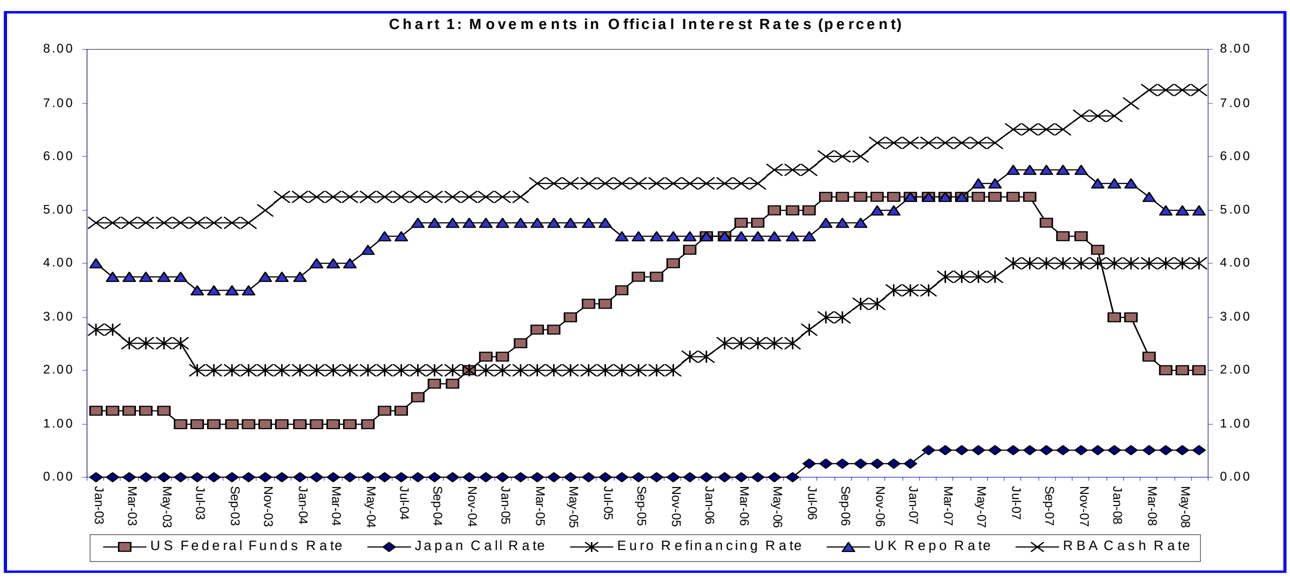
percent in 2007.

In the US, economic growth slowed rapidly in the first quarter of 2008 reflecting the ongoing sub-prime mortgage crisis and rising oil prices. In 2008, the US economy is expected to grow at a much lower rate of 1.3 percent, down from 2.2 percent in 2007. The impact of the slow down in the US economy on other advanced economies[3], through the financial market turmoil and reduced trade, is significant. In the Euro area, economic growth is expected to decelerate to 1.7 percent from 2.6 percent in 2007, reflecting a fall in demand caused by reduced trade, high oil prices and financial market turbulence. The Japanese economy is projected to slow to 1.5 percent from 2.1 percent in 2007, mainly due to the slump in housing investment, the dampening impact of the appreciation of the yen against the US dollar on export growth, and rising oil and food prices. For emerging and developing economies, economic growth is expected to decelerate but remain robust at 6.9 percent in 2008, compared to 8.0 percent in 2007, driven mainly by developing Asia.

Crude oil prices rose to record highs above US$140 per barrel in June 2008 on the back of geopolitical tensions, capacity constraints and volatile world financial markets. Oil prices are expected to remain high for the remainder of the year. Similarly, gold prices continue to remain strong at around US$900 an ounce after reaching a historic high of US$1,007 per ounce in March this year. Except for tea, all other commodities experienced price booms, largely due to supply constraints and strong demand from emerging and developing economies.

The risks to the global economic outlook include further volatility in financial markets due to the slow down in the US, further increases in international oil, food and other commodity prices, strong inflationary pressures and trade imbalances.

Global inflationary pressures will continue throughout 2008. This will be due to the high international prices of commodities, especially base metals, food and energy, reflecting robust demand from emerging and developing economies, particularly China and India. Annual inflation in the March quarter of 2008 was 3.9 percent in the US, 3.6 percent in the Euro area, 1.2 percent in Japan and 4.2 percent in Australia. In the emerging and developing economies, China and India recorded inflation of 11.1 percent and 8.8 percent, respectively, over the same period. Despite increased inflationary pressures, the major central banks' approach to monetary policy over the first half of 2008 differed. The US Federal Reserve and Bank of England reduced their official interest rates to 2.0 and 5.0 percent, respectively, in April 2008 due to concerns over the significant slowdown in economic growth. However, the Reserve Bank of Australia raised its Official Cash Rate in February to 7.00 percent and in March 2008 to 7.25 percent to contain inflationary pressures, while the European Central Bank and Bank of Japan kept their policy rates unchanged at 4.0 and 0.5 percent, respectively, although concerns over increased inflationary pressures remained.



[3] Includes the Euro area, United Kingdom (UK) and Japan.

Global financial markets have been under considerable stress since the last quarter of 2007 due to tight credit and liquidity conditions emanating from the mortgage crisis in the US. The performance of financial markets were also affected by the attitude of investors to bear risk, difficulties in valuing complex financial products, uncertainties about the exposures of major financial institutions to credit losses, and concerns about the weaker outlook for the global economy. During the first half of 2008, the major central banks made a concerted effort to address liquidity constraints by providing access to funds to minimise disruptions to their financial markets. This included expanding access to central banks lending facilities and the range of collaterals offered to financial institutions.

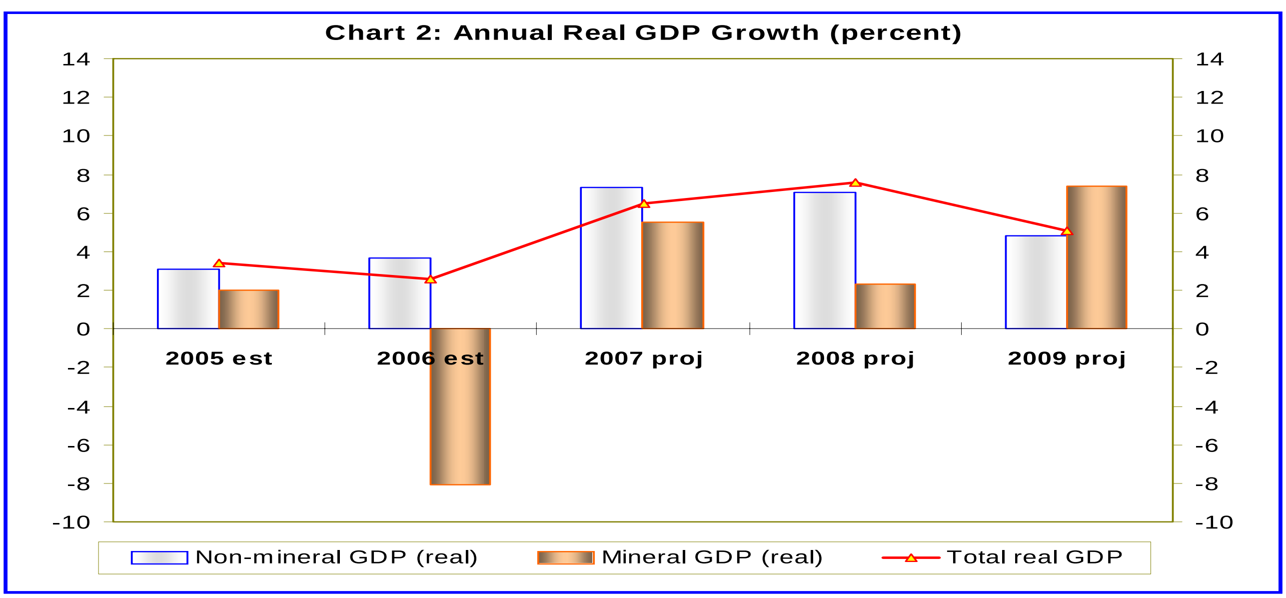
In the foreign exchange markets, the US dollar depreciated against most major currencies in the first half of 2008 reflecting the mortgage crisis in the US. Government bond markets, which started the year on a strong note on the back of the turmoil in financial markets, have now weakened due to rising global inflation and inflation expectations.

2.2 Domestic Economic Conditions

Preliminary data from the Bank's Business Liaison Survey (BLS) indicates that nominal value of sales by the private sector grew by 17.1 percent in the March quarter of 2008, compared to the December quarter of 2007. Excluding the mineral sector, economic activity increased by 6.9 percent in the March quarter of 2008, with higher sales across all sectors except the wholesale, retail and transportation sectors. Over the twelve months to March 2008, the value of sales increased by 26.7 percent.

The Bank's Employment Index indicates that the total level of employment in the formal private sector continued to increase on a quarterly basis throughout 2007 and the first quarter of 2008. The level of employment in the March quarter of 2008 grew by 8.5 percent compared to the December quarter of 2007. Excluding the mineral sector, employment levels increased by 2.9 percent. The growth in March 2008 was across all sectors except the wholesale/retail and mineral sectors. Over the twelve months to March 2008, employment increased by 8.4 percent.

The Bank's Business Sentiment Survey (BSS)[4] indicates that business confidence is high and economic activity will continue to increase for the rest of 2008. Profits and employment are expected to increase further in the second half of 2008, compared to the first six months of 2008. Although, there is a positive outlook for the remainder of 2008, companies are concerned about high inflation and its associated costs of doing business. Consequently, companies have passed on some of the increasing costs to customers in the first half of 2008 with further increases expected in the second half of 2008.



Source: Department of Treasury

[4] The BSS is a qualitative survey conducted biannually with company executives on their business outlook.

The Bank estimated that real GDP in 2007 grew by more than the Government's estimate of 6.5 percent, with robust growth in all sectors of the economy, except the mineral sector (*see Chart 2*). There were strong growth in the manufacturing, construction and commerce sectors and the transport, communication and finance sub-sectors. In 2008, the Bank forecast real GDP growth to be in line with the Government's projection of 7.6 percent. All sectors are projected to grow in 2008, especially in the agriculture, construction, manufacturing and commerce sectors and the finance sub-sector. The notable increase in the construction sector and its spill-over effects to the other sectors is attributed to the construction of the Ramu Nickel/Cobalt and the Hidden Valley mines. The growth in the other sectors is mainly due to higher production and prices of all mineral and most agricultural export commodities. Higher Government expenditure and continued growth in private sector credit are also expected to contribute to this growth.

In 2009, the Bank projects real GDP growth to be higher than the Government's projection of 5.1 percent with growth expected in all sectors of the economy. Growth in the construction and mineral sectors is associated with the ongoing construction of the Ramu Nickel/Cobalt and the Hidden Valley mines and the commencement of production by these two mines in late 2009. In addition, Government initiatives to rehabilitate and develop infrastructure, remove other impediments to trade and investment, and continue with public sector reforms are also expected to contribute positively to the growth. The major risks to this outlook would stem from higher inflation, fluctuations in production and prices of export commodities, as well as the global demand for these commodities.

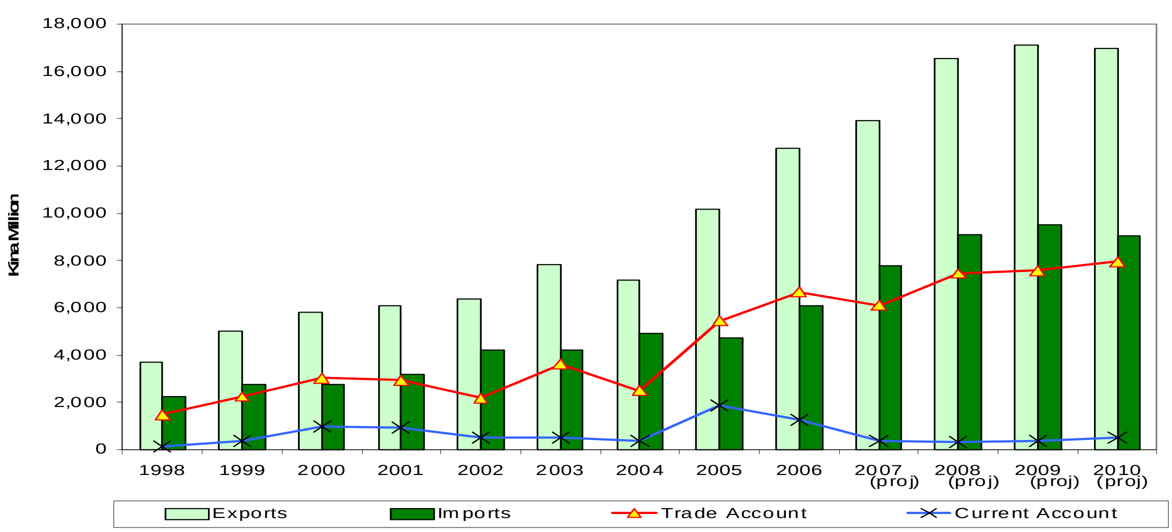
2.3 Balance of Payments

Preliminary balance of payments data for the five months to May 2008 showed an overall surplus of K649.5 million, compared to a surplus of K356.9 million in the corresponding period of 2007. This outcome was due to combined surpluses in the current and capital and financial accounts. The surplus in the current account was attributed to higher trade account balance and lower net income payments which more than offset higher net service and transfer payments. The surplus in the capital and financial account was mainly due to a higher net inflow from investments in short term money market instruments and a drawdown in the net foreign assets of the banking system, which more than offset a build up in foreign currency account balances of the mineral companies and higher loan repayments by the Government.

The level of gross foreign exchange reserves at the end of May 2008 was US$2,347.7 (K6,568.9) million, sufficient for 10.3 months of total and 15.2 months of non-mineral import covers. As at 29th July 2008, the level of gross foreign exchange reserves was US$2,421.2 (K6,264.4) million.

The May 2008 World Bank price projections indicated

Chart 3: Current Account



Source: Bank of PNG

that most international prices of PNG's non-mineral exports will be higher in 2008, compared to 2007. According to the mineral companies, prices of all mineral exports are expected to increase in 2008.

The export volumes of PNG's major commodities are projected to increase in 2008 (*see Chart 3*). The projected increases are mainly due to supply responses to higher international prices for most non-mineral commodities and improved road infrastructure associated with the Government's medium term objective of increasing agricultural output through the National Agricultural Development Plan (NADP). The non-mineral export volumes are projected to continue to increase in the medium term. In the mineral sector, the projected increase is due to mining of higher ore grades from existing mines, upgrading of the processing plant at Lihir to boost production and increased exploration activities. The Ramu Nickel/Cobalt project is expected to commence production in the second half of 2009. In the petroleum sector, production is projected to decline over the medium term and is associated with the natural declines of reserves in the existing oilfields.

The Bank assumes a stable exchange rate in its balance of payments projections for 2008 and the medium term. The Liquefied Natural Gas (LNG) project was not included in the projections.

Accordingly, the overall surplus in the balance of payments is projected to be K2,086.7 million in 2008, compared to a surplus of K1,593.8 million in 2007. At the end of 2008, it is projected that gross foreign exchange reserves will be around US$2,784.5 (K7,385.9) million, sufficient for 9.8 months of total and 16.9 months of non-mineral import covers. The gross foreign exchange reserves are projected to increase further over the medium term (*see Appendix - Table 2*).

2.4 Fiscal Operations of the National Government

Preliminary estimates of the fiscal operations of the National Government over the five months to May 2008 showed an overall budget surplus of K317.0 million, compared to a surplus of K510.5 million in the corresponding period of 2007. This represents 1.6 percent of nominal GDP[5] and reflected higher revenue, which more than offset an increase in expenditure. The budget surplus was used to make net repayments of overseas loans totalling K102.1 million and net settlement of cheques totalling K214.9 million to other resident sectors.

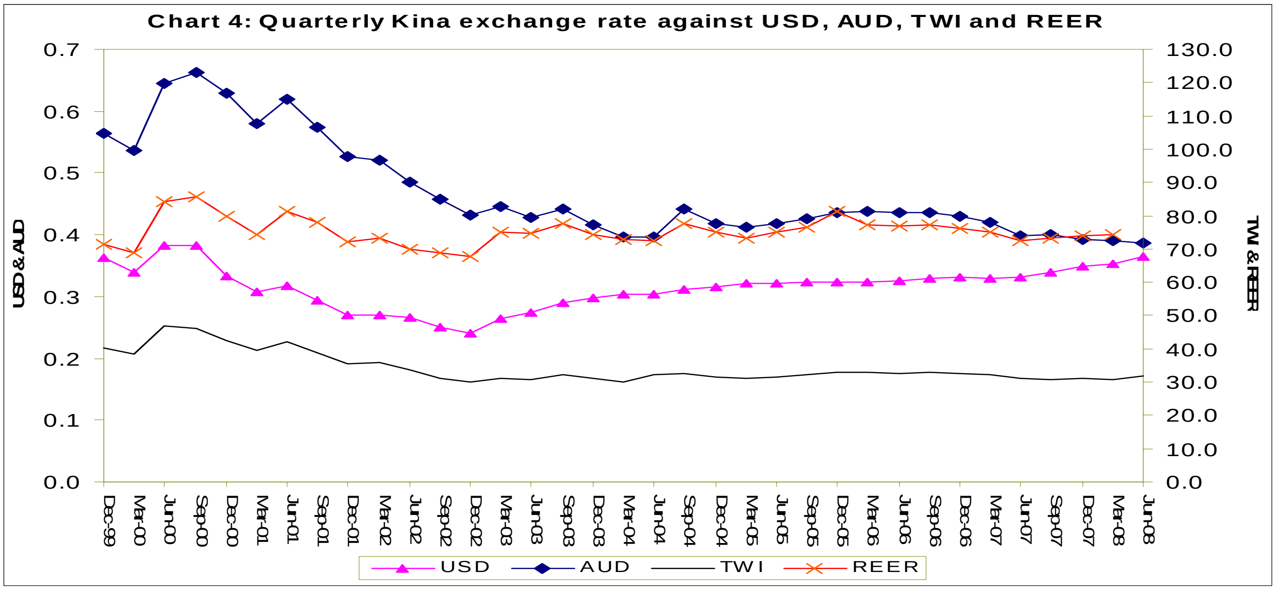
Total revenue, excluding foreign grants, represented 29.6 percent of the 2008 Budget while total expenditure represented 25.9 percent over the five months to May 2008. However, recurrent expenditure increased by 31.5 percent in May 2008, compared to May 2007 and represented 40.0 percent of the budgeted appropriations. This reflected the frontloading of warrants to National Departments and Provincial Governments in January 2008. Development expenditure, excluding foreign grants, increased by 0.2 percent during the same period and represented 17.6 percent of the budget. This reflects the ongoing capacity constraints of implementing agencies. Despite this, the Government fully drew down funds under the District Services Improvement Program (DSIP) totalling K356 million from the Central Bank, by July 2008.

Total debt to nominal GDP ratio declined to 31.9 percent from 33.6 percent between the end of December 2007 and June 2008 reflecting the higher growth in GDP combined with net retirement of domestic loans. Total domestic debt declined by 2.6 percent to K3,085.5 million, mainly resulting from the net retirement of Treasury bills and Inscribed stocks totalling K50.8 million and K33.2 million, respectively. Foreign debt increased by 4.6 percent to K3,214.0 million reflecting Government drawdown of external loans.

2.5 Exchange Rate

The kina strengthened against the US dollar, while it weakened against the Australian dollar during the first half of 2008. The kina appreciated against the US dollar by 6.7 percent to US$0.3760 at the end of June 2008 from US$0.3525 in December 2007, due to foreign exchange inflows mainly from the mineral, communication and agriculture/forestry/fisheries sectors, and Central Bank intervention. The kina depreciated against the Australian dollar by 2.3 percent to A$0.3906 from A$0.3999 during the same period reflecting cross currency movements as the US dollar weakened against the Australian dollar due to interest rate differentials and high commodity prices. As a result, the Trade Weighted Index (TWI) depreciated by 0.6 percent during the same period. The Real Effective Exchange Rate (REER) appreciated by 0.4 percent during the March quarter of 2008 reflecting the high domestic inflation (*see Chart 4*).

[5] GDP refers to the 2008 National Budget estimate.



Source: Bank of PNG

Between the end of June and 29th July 2008 the kina appreciated against the US and Australian dollars by 55 and 77 basis points to US$0.3815 and A$0.3983, respectively.

2.6 Inflation

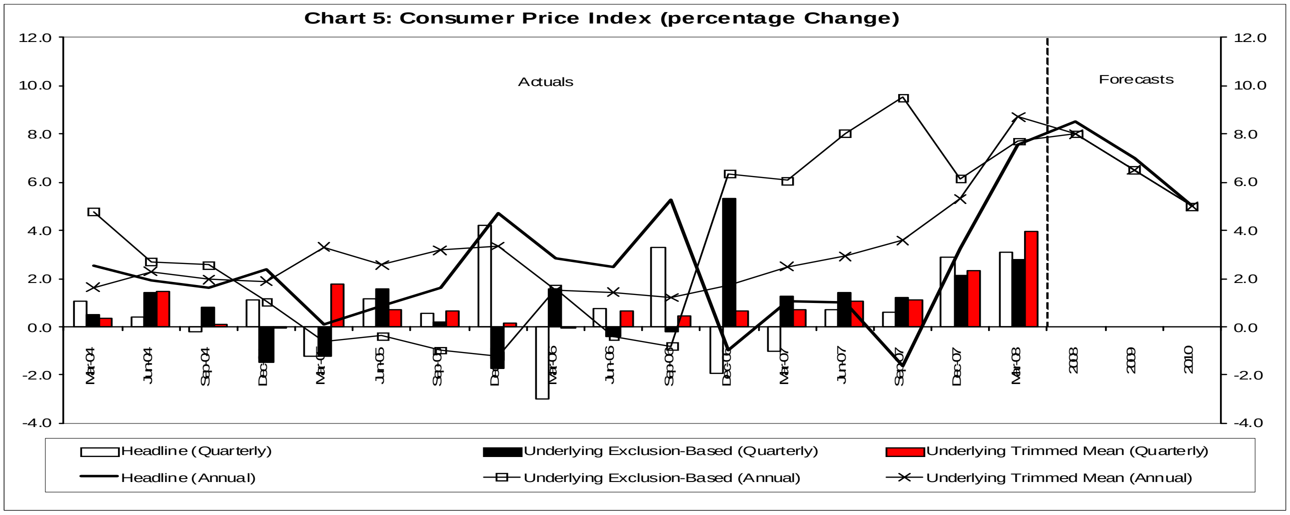
Annual headline inflation was 7.5 percent in the March quarter of 2008, compared to 3.2 percent in the December quarter of 2007. This is the highest annual increase since December quarter 2003. There were increases in all expenditure groups particularly from the 'food' and 'rents, council charges, fuel and power' groups, reflecting high international fuel and food prices, and increased prices of domestically produced fruits and vegetables.

Annual exclusion-based inflation was 7.7 percent in the March quarter of 2008, compared to 6.1 percent in the December quarter of 2007. Annual trimmed-mean inflation was 8.7 percent in the March quarter of 2008, compared to 5.3 percent in the December quarter of 2007 (*see Chart 5*). The higher underlying inflation outcomes were driven mainly by the increase in imported inflation associated with the high international oil and food prices and the feed-through of domestic fuel prices to goods and services and the depreciation of the kina against the Australian dollar. Quarterly inflation outcomes for the core measures have also been increasing significantly since the September quarter of 2007.

In 2008, annual headline inflation is projected to be around 9.0 percent, while exclusion-based and trimmed-mean inflation are both projected to be around 8.0 percent. The upward revision from the projections made in the January 2008 MPS reflects the realised inflation in the March quarter, expected increase in both international and domestic cost pressures stemming from the high oil and food prices, feed-through of fuel price increases to the prices of domestic goods and services, increase in prices of public utilities and demand for higher wages. On the other hand, the demand pull inflationary pressures would come from increased aggregate demand reflecting higher commodity prices and increase in government expenditure and private sector credit.

For the medium-term, headline inflation is expected to ease to around 5.0 percent, higher than the projections made in the January 2008 MPS (*see Appendix - Table 2*). The decline in medium-term inflation projections are based on the assumption that international oil and food prices will subside and inflation outcomes in PNG's main trading partner countries will ease.

The risks to these projections would stem from: further increases in international oil, food and other commodity prices; higher inflation outcomes in PNG's main trading partner countries; depreciation of the kina exchange rate; and the impact of other domestic factors such as a significant growth in government expenditure and increases in wages and monetary aggregates.



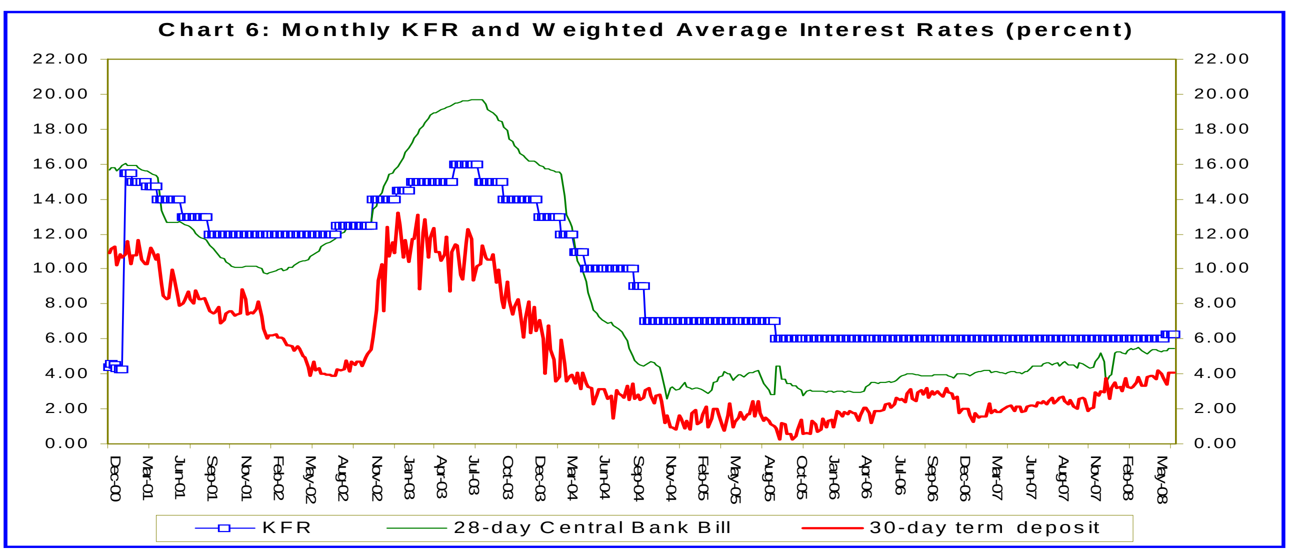
Source: Bank of PNG & National Statistical Office (NSO)

2.7 Monetary and Financial Market Developments

The high inflation outcome for the March quarter and expectations of continued inflationary pressures prompted the Bank of Papua New Guinea to tighten monetary policy after maintaining a neutral stance since September 2005. As a result, the KFR was increased by 25 basis points to 6.25 percent in June 2008 (*see Chart 6*). The trading margin for the Repo was maintained at 100 basis points on both sides of the KFR in the first half of 2008.

The Bank issued CBBs totalling K1,447.7 million to diffuse excess liquidity in the banking system in the first half of 2008. As a result, interest rates for short-term securities depicted an upward trend. The CBB and Treasury bill rates all traded above 5.00 percent.

The Indicator Lending Rates (ILR) spread remained unchanged at 8.95 – 9.45 percent during the first half of 2008. Following the increase in the KFR, one commercial bank announced an increase in its ILR from 9.45 percent to 9.70 percent in July 2008. The weighted average interest rate on total deposits declined from 1.58 percent in December 2007 to 1.20 percent in June 2008, while the weighted average lending rate on total loans declined from 9.25 percent to 9.17 percent. As a result, the spread between the weighted average lending and deposit rates widened (*see Chart 7*).



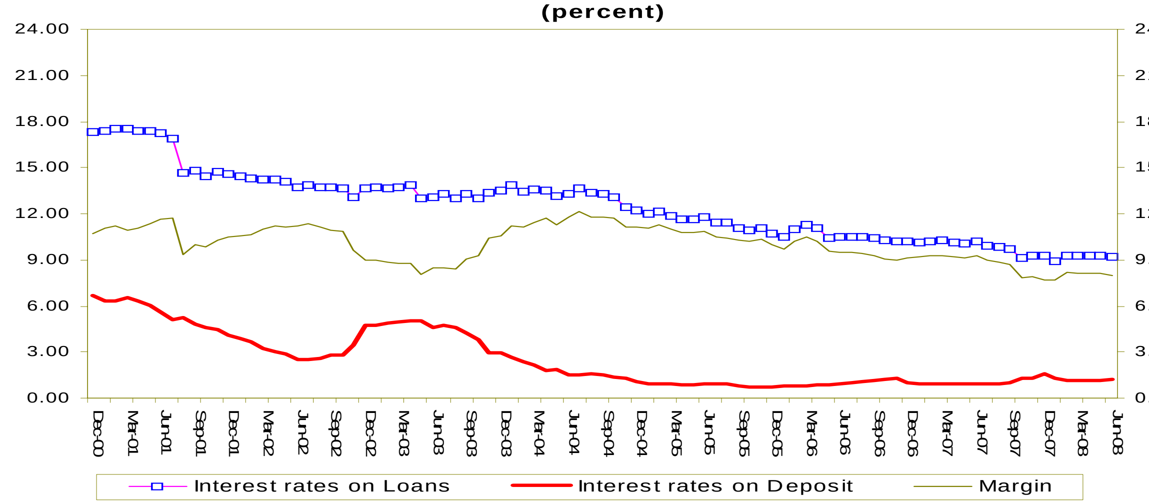
Source: Bank of PNG

Total liquidity of the banking system increased by 12.1 percent to K5,163.6 million between end of December 2007 and June 2008, mainly due to mineral sector inflows and higher Government expenditure. As a result, the Bank continued to utilise OMOs to diffuse the excess liquidity.

Lending extended by ODCs to the private sector increased by 35.3 percent over the year to June 2008. The growth in private sector credit was broad based across all sectors due to the low inment and improved business confidence. Net claims on the Government declined by 68.1 percent over the year to June 2008, due to increased deposits and retirement of debt held by the depository corporations (DCs).

The level of broad money supply (M3*) increased by 27.5 percent over the year to June 2008 as a result of the growth in net foreign assets of the DCs combined with an increase in private sector credit. This more than offset the decline in net credit to the Government. The growth in net foreign assets is primarily accounted for by increased mineral tax receipts driven by high commodity prices. The monetary base increased by 33.2 percent during the same period due to higher commercial banks deposits at the Central Bank and currency in circulation (*see Appendix-Table 1*).

Chart 7: Monthly Weighted Average Lending & Deposit rates and Margins (percent)



Source: Bank of PNG

Box 1: Causes of high international food and fuel prices and their pass-through to inflation in the domestic economy

High international fuel and food prices have contributed strongly to rising global inflation over the last couple of years and especially in 2008.[1] These high prices have largely been due to imbalances between supply and demand.

Causes

The high growth rates of emerging and developing economies such as China and India have fueled the increased demand for fuel, base metals and food products. The nature of growth in these economies is commodity-intensive with fuel for production, base metals for manufacturing and construction and food for consumption. Demand has grown tremendously, but due to supply constraints, prices have risen sharply.

Global demand for oil has caught up with supply after a long period of spare capacity. The supply response to this increased demand has been slow due to geo-political factors, high investment costs, technological, geological and policy constraints, which include OPECs reluctance to increase supply. The geo-political factors due to instability in the Middle East, the nationalisation of oil assets in Venezuela and the tension in Nigeria have all contributed to the shortfall in oil supply.

Financial market developments, such as reduction in key central banks' policy interest rates have fuelled speculation and the depreciation of the U.S. dollar allowing investors to switch away from money market instruments to commodity futures. These have contributed to upward price pressure over the last year.

Similarly for agricultural crops, supply levels have not kept up with rising demand in recent years. In addition, unfavourable weather conditions in the major wheat, rice and corn producing countries in 2007 caused lower harvests and led to rising prices. Rising bio-fuel production, induced by higher oil prices and generous policy support, has resulted in reduction in food supply and caused their prices to rise. Substitution effect has also led to higher demand and prices for other food crops. Moreover, there have been adoptions of trade policies to raise domestic food supplies and lower domestic prices. This has resulted in lower exports from major food producers, putting upward pressure on world prices. These factors have not only pushed up corn, rice and other food prices but also, to a lesser extent, meat and poultry products.

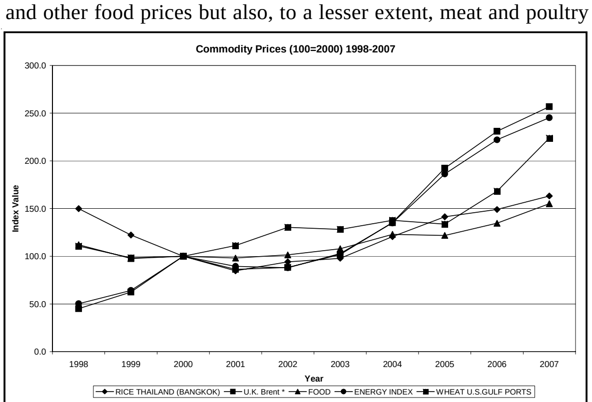
Pass-through to inflation in the PNG Economy

Papua New Guinea is a small open economy and is vulnerable to financial and economic developments in the rest of the world. Food and fuel products constitute an important share of PNG's consumption basket. High international prices of oil mean that prices of imported fuel and refined fuel products from the domestic oil refinery will increase as they are priced at import parity price ex-Singapore. As a result, the prices of fuel products such as petrol at the pump-stations will rise. This is referred to as the first round effect of oil price increase and is due to an external shock over which PNG has no control. The first round effect has both imported inflation and exchange rate components.

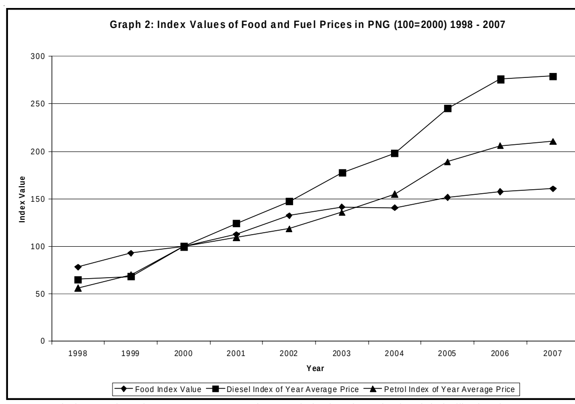
The second round effect of the oil price rise is realised when the buyers of the fuel products face a rise in the cost of their operations and have to increase the prices of their goods and services for consumers. For example, when farmers take their goods to the market during a period of oil price increases they have to pay more for transportation freight and passenger fare. The farmers are then forced to increase their prices at the market place to make up for the extra costs that are incurred. Similarly, because of the higher prices employees will demand higher wages which increases the cost of production and demand leading to further increase in prices.

International food price movements impact on prices for the imported food products directly such as flour and rice imports. When the retailer is charged higher prices by the supplier it must at some point pass these higher prices onto the consumer. In addition, bakery products for example, become more expensive during these times as flour is a major ingredient in the production process.

Graphs 1 and 2 show that prices of food and oil based products on international markets and markets in PNG have followed a similar trend since 1998. Food and oil based products, that are susceptible to high international food and fuel prices constitute a large portion of the weighting to sub-groups and groups that have a large weight in the CPI basket. For example, the 'cereals' sub-group, which consists of commodities whose prices are subject to movements in international prices for rice and flour contribute 10.0 percent to the total CPI outcome. As a result, increasing international food and fuel prices can contribute to CPI inflation.



Source: IMF



Source: Bank of PNG, Independent Consumer & Competetion Commission (ICCC) & National Statistical Office (NSO)

[1] In Papua New Guinea's case, high prices for the country's export commodities, which have been experienced recently, also contributed to inflationary outcomes through their strengthening effect on domestic demand.

Appendix

Table 1: Monetary and Credit Aggregates (annual % change)

INDICATOR	2005 (actual)	2006 (actual)	2007 (actual)	JUN 2008 (actual)	JAN 2008 MPS (proj)	2008 (proj)	2009 (proj)	2010 (proj)
Broad Money Supply	30.7	39.0	27.3	27.5	38.3	20.7	24.4	16.4
Monetary Base	3.0	21.7	61.8	33.2	15.0	16.3	15.5	15.2
Claims on the Private Sector	25.2	36.8	30.8	35.3	22.3	28.5	23.1	24.0
Net Claims on Gov't	-24.7	-11.6	-83.5	-68.1	115.5	-9.5	-22.2	-0.2
Net Foreign Assets	33.5	58.2	51.7	35.8	26.6	17.2	14.2	6.9

Source: Bank of PNG

Table 2: Summary of Other Macroeconomic Indicators

INDICATOR	2005 (actual)	2006 (actual)	2007 (actual)	MAR 2008 (actual)	JAN 2008 MPS (proj)	2008 (proj)	2009 (proj)	2010 (proj)
CONSUMER PRICE INDEX (annual % changes)								
Headline	4.6	1.3	3.2	7.5	3.5	9.0	7.0	5.0
Trimmed mean	3.3	0.4	6.0	8.7	4.0	8.0	6.5	5.0
Exclusion based	-1.4	2.9	6.0	7.7	6.0	8.0	6.5	5.0
BALANCE OF PAYMENTS (kina millions)*								
Current account	1,887	1,255	366	417	-853.7	338	377	522
Financial account	-1,590	719	1,183	283	2,520.4	1,749	802	113
Overall balance	296	1,958	1,592	649	1,843.6	2,087	1,179	778
Gross Int. Reserves	2,368	4,326	5,919	6,568.9	7,763.0	7,386	8,565	9,200
IMPORT COVER (months)*								
Total	6.0	8.5	9.1	10.3	12.7	9.8	10.8	12.2
Non-mineral	8.2	11.5	13.0	15.2	21.2	16.9	18.0	18.1
EXPORT PRICE*								
Crude oil (US$/barrel)	55.0	67.3	73	100.8	60.8	117.1	101.1	108.5
Gold (US$/ounce)	403	554.7	671	840.7	538.1	890.4	865.1	832.6
Copper (USc/pound)	161.6	296.6	320	346.5	225.0	323.0	331.2	317.6
FISCAL OPERATIONS OF THE GOVERNMENT*								
Surplus/Deficit (K'm)	7.6	535.8	454.5	317.0	202.3	202.3	273.5	121.8
% of GDP (nominal)	0.1	3.1	2.4	1.6	1.0	1.0	1.3	0.6
REAL GROSS DOMESTIC PRODUCT (annual % growth)**								
Total GDP	3.4	2.6	6.5	--	6.6	7.6	5.1	4.2
Non-mineral GDP	3.1	3.7	7.3	--	6.5	7.1	4.8	4.0

Source: Bank of PNG, NSO and Department of Treasury

* *Actuals to May 2008 while GDP ratios reflect projections in the 2008 Budget*
** *GDP projections are from Treasury Department*