



BANK OF PAPUA NEW GUINEA

MEDIA RELEASE

20th June 2008

QUARTERLY ECONOMIC BULLETIN **MARCH QUARTER OF 2008**

Mr. L. Wilson Kamit, CBE, Governor of the Bank of Papua New Guinea (Bank of PNG), today released the March 2008 Quarterly Economic Bulletin (QEB). This statement presents an overview of the financial and economic developments during the March quarter of 2008, as well as developments since March 2008.

1. DEVELOPMENTS SINCE MARCH 2008

The Governor reported that the annual headline inflation rate as measured by the Consumer Price Index (CPI), released by the National Statistical Office, was 7.5 percent over the year to March 2008, compared to 3.2 percent over the year to December 2007. This is the highest annual increase since the December quarter of 2003. The increase was in all expenditure groups in the CPI basket. Most prevalent of these rises were the increases in the 'Food' and the 'Rents, council charges and fuel/power' expenditure groups, reflecting the increases in international fuel and food prices, and higher prices of domestic seasonal produces. As a result of the concerns over the impact of inflationary pressures on price stability, the Bank of PNG increased the

monetary policy signalling rate, the Kina Facility Rate (KFR), from 6.00 percent to 6.25 percent, in June 2008. This increase in the KFR signals the tightening stance of monetary policy, and will be closely reviewed by the Bank.

The crisis in the credit markets that started in 2007 has continued beyond the March quarter, giving more impetus to expectations of lower economic activity in the United States (US) and other major economies. Meanwhile, inflation rates in the major industrialised economies have increased, driven mainly by higher food and energy prices. This has led to most Central Banks in the major industrialised economies accepting a trade-off between lower economic activity and increased inflation by maintaining their key policy interest rates. Light crude oil prices in the US hit a new high of US\$138.89 a barrel on the 16th of June 2008, continuing the upward trend in energy prices. Prices for corn hit a new high of US\$8 a bushel in June 2008 after the US, who exports 54 percent of the world's corn, experienced severe flooding in certain farm areas.

The kina has appreciated against the US dollar from US\$0.358 at the end of March 2008 to US\$0.3705 as at 18th June 2008. The appreciation of the kina against the US dollar reflects the continued weakness of the US dollar against all major currencies, combined with the Bank's intervention to support the foreign exchange market with supply of foreign currency. The Federal Reserve cut the Federal Funds Rate to 2.00 percent from 2.25 percent in April, which further weakened the US dollar. The kina depreciated against the Australian dollar from A\$0.3907 at the end of March 2008 to a low of A\$0.3785 on the 22nd of May 2008 before bouncing back to A\$0.3915 on 18th June 2008.

The commercial bank's Indicator Lending Rate (ILR) spread remained unchanged from the end of 2007, between 8.95 percent and 9.45 percent. Domestic interest rates have remained low and stable up to mid June, consistent with the high levels of liquidity in the banking system. Lending to the private sector continued to increase due to the low interest rate environment and higher economic activity.

The level of foreign exchange reserves increased from K5,805.0 (US\$2,075.4) million at the end of March 2008 to K6,261.4 (US\$2,351.1) million as of the 18th June 2008. The increase in the level of foreign exchange reserves was due to significant mineral tax revenue inflows.

The Governor added that on one hand economic growth of the domestic economy has continued at least into the first quarter of 2008, as indicated by the employment growth, large surplus in the trade account, increased volume of some of the major exports, and continued credit growth in the private sector. On the other hand inflation has increased. The Bank of PNG is mindful that the inflationary pressures are likely to continue for the rest of this year and is taking appropriate steps on its monetary policy stance.

2. OVERVIEW OF THE DEVELOPMENTS IN THE MARCH QUARTER OF 2008

Economic indicators available to the Bank of PNG (the Bank) showed that growth of the domestic economy continued into the first quarter of 2008. Higher employment in almost all sectors, a large surplus in the trade account, driven by continued high export commodity prices and

increased volume of some of the major exports and continued credit growth in the private sector under the low interest rate environment are indicative of the growth. Foreign exchange inflows and the depreciation of the US dollar against the other major currencies in light of the weakened US economy led to the kina appreciating against the US dollar over the quarter. However, the strengthening of the Australian dollar against the US dollar resulted in the kina depreciating against the Australian dollar. The rate of inflation, as measured by the CPI, increased in the March quarter of 2008. This was due to high imported inflation, the feed through of high fuel prices and increase in the prices of seasonal produce.

Over the twelve months to December 2007, the total nominal value of sales in the formal private sector, excluding the mineral sector, increased by 17.5 percent. All sectors and regions recorded increases in sales. Data obtained from the Bank's Business Liaison Survey (BLS) showed that the total nominal value of sales in the formal private sector declined by 1.5 percent in the December quarter of 2007, compared to the September quarter of 2007.

The Bank's Employment Index showed that the level of employment in the formal private sector increased by 2.0 percent in the March quarter of 2008, compared to a revised increase of 2.4 percent in the December quarter of 2007. Excluding the mineral sector, it increased by 2.9 percent, compared to a revised 2.2 percent in the December quarter of 2007. All sectors recorded increases in employment levels, except the wholesale and mineral sectors. All regions recorded growth in employment levels, except Morobe. Over the year to March 2008, the

level of employment in the formal private sector, excluding the mineral sector, increased by 8.4 percent.

Quarterly headline inflation, was 3.1 percent in the March quarter of 2008, compared to 2.9 percent in the December quarter of 2007. Over the year to March 2008, the headline inflation rate was 7.5 percent, compared to 3.2 percent over the year to December 2007. The higher outcome was due to price increases in all expenditure groups, mainly in the 'Food' and 'Rents, council charges, fuel and power' groups. Trimmed mean inflation was 3.9 percent in the March quarter of 2008, compared to 2.3 percent in the December quarter of 2007. Exclusion-based inflation was 2.8 percent in the March quarter of 2008, compared to 2.1 percent in the December quarter of 2007.

In the March quarter of 2008, the daily average kina exchange rate appreciated slightly against the US dollar and the pound sterling, while it depreciated against the euro, Australian dollar and Japanese yen. The average kina exchange rate appreciated by 0.3 percent against the US dollar and 1.2 percent against the pound sterling, while it depreciated by 5.6 percent against the Japanese yen, 1.6 percent against the euro and 2.4 percent against the Australian dollar. These movements resulted in the daily average Trade Weighted Index (TWI) depreciating by 2.5 percent during the March quarter.

Higher international prices of all mineral and most agricultural exports resulted in a 27.4 percent increase in the weighted average kina price of Papua New Guinea's exports in the March quarter of 2008, compared to the corresponding quarter in 2007. There was a 28.7 percent increase in the weighted average price of mineral exports, with higher kina prices of

all minerals. For the agricultural, logs and marine product exports, the weighted average price increased by 22.3 percent and was attributed to higher kina prices of coffee, cocoa, palm oil, copra, copra oil, and marine products.

The overall deficit in the balance of payments was K114 million in the March quarter of 2008, compared to a deficit of K106 million in the corresponding period in 2007. This outcome was due to a deficit in the capital and financial accounts, which more than offset a surplus in the current account.

The current account recorded a surplus of K269 million in the March quarter of 2008, compared to a deficit of K294 million in the corresponding period in 2007. This outcome was mainly attributed to a higher trade surplus and lower net service payments, which more than offset higher net income payments and lower net transfer receipts.

The capital and financial accounts recorded a net outflow of K356 million in the March quarter of 2008, compared to a net inflow of K169 million in the corresponding period in 2007. This outcome was mainly associated with a net outflow in the financial account reflecting equity withdrawal from direct investments, higher portfolio investments, the 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 March 2008 was K5,805.0 (US\$2,075.4) million, sufficient for 9.0 months of total and 13.1 months of non-mineral import covers.

The Bank of PNG continued to maintain a neutral monetary policy stance during the March quarter of 2008, with the Kina Facility Rate (KFR) remaining unchanged at 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. The Central Bank Bill (CBB) rates increased over the March quarter of 2008, while other domestic interest rates showed mixed trends.

The Bank continued to utilise its Open Market Operation (OMO) instruments in the conduct of monetary policy over the March quarter of 2008, utilising the CBB and Repo Facility to manage liquidity. Trading in the inter-bank market remained low due to the high level of liquidity in the banking system. The Cash Reserve Requirement (CRR) and the Minimum Liquid Assets Ratio (MLAR) of commercial banks were maintained at 3.0 percent and 25.0 percent, respectively, over the March quarter of 2008.

The average level of broad money supply (M3*) increased by 10.2 percent in the March quarter of 2008, compared to an increase of 8.3 percent in the December quarter of 2007. The outcome was due to an increase of K535.3 million in average net claims on the Government, 11.4 percent increase in average private sector credit and 3.3 percent increase in average net foreign assets of the depository corporations. 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 11.3 percent in the March quarter of 2008, compared to an increase of 6.1 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 K468.6 million to K4,517.8 million, compared to an increase of K307.4 million in the previous quarter. This was mainly due to an increase of K465.6 million in private sector credit. The annualised growth in domestic credit, excluding Central Government and advances under the agricultural commodity price support schemes, was 33.9 percent in the first quarter of 2008.

Preliminary estimates of the fiscal operations of the National Government over the three months to March 2008 showed an overall deficit of K116.8 million, compared to a deficit of K34.8 million in the corresponding period in 2007. This represents 0.6 percent of nominal GDP. The deficit reflected higher recurrent expenditure, combined with lower revenue.

Total revenue, including grants, during the March quarter of 2008 was K699.5 million, 29.1 percent lower than the receipts collected in the corresponding period of 2007. This represents 9.7 percent of the budgeted revenue.

Total expenditure over the three months to March 2008 was K816.3 million, 20.1 percent lower than in the corresponding period in 2007, and represents 11.7 percent of the budgeted expenditure for 2008.

The deficit, combined with net external loan repayments of K55.4 million was financed domestically with a net of K172.2 million, mainly through the drawdown of deposits with commercial banks and the Central Bank.