



BANK OF PAPUA NEW GUINEA

MEDIA RELEASE

21st October, 2011

QUARTERLY ECONOMIC BULLETIN JUNE QUARTER 2011

Mr. Loi M. Bakani, Governor of the Bank of Papua New Guinea (Bank of PNG), today released the June 2011 Quarterly Economic Bulletin (QEB). This statement provides an overview of the economic and financial developments for the June quarter, 2011 and the developments since June 2011.

1. UPDATE ON DEVELOPMENTS SINCE JUNE 2011

The global economy is projected to grow moderately at an annual rate of 4.3 percent in 2011, reflecting a slowdown in major economies. This is a slight downward revision of 0.1 percent from the 4.4 percent forecast made in April by the International Monetary Fund (IMF) for 2011. The marginal downward revision is due to the sluggish growth in the US economy, weak growth in Eurozone countries, some of which are in sovereign debt crisis, unrest in oil producing economies, and bad weather and supply chain disruptions following the tsunami and earthquake disasters in Japan. The Asia region appears to be holding up better. Strong growth is expected to continue in Asia, led by China and India while Japan is expected to slowly recover. For the second six months of 2011, growth in the US economy is expected to be supported by modest gains in the

labor market, consumer spending, business investment particularly in equipment and software, manufacturing and exports. However, the construction activity and housing market continue to remain weak due to a distressed property market. Meanwhile, inflation is rising but is expected to end the year below the Federal Fund's target of 2.0 percent.

Although, headline inflation has increased in many economies, it is expected to moderate as prices of crude oil, food and other commodities have already started to subside. Global prices for food eased in August 2011 but remained significantly higher than the levels in August 2010. Prices for some specific commodities such as rice, maize and wheat remained volatile. Similarly, price levels for a number of major commodities are higher than the levels in August 2010. The Food and Agriculture Organisation's (FAO) Food Price Index (FFPI) averaged 203.3 points in August 2011, and 30.0 percent higher than in August 2010. A strong rise in international prices of sugar, rice and meat contributed to much of the increase in the FFPI in August 2011.

The underlying inflation and long run inflation are expected to remain stable. In Europe, the recovery is expected to continue and growth prospects remain positive, largely due to strong GDP growth in Germany, France and Spain. This is mainly supported by growth in exports and improvement in general business conditions and the labour market. However, growth in some Euro member countries is expected to remain very weak due to public and private sector debt problems and considerable financial stress. In view of inflationary concerns, a number of Central Banks including the European Central Bank and emerging market economies have raised their official interest rates except the US, Japan, UK and Australia.

Governor Bakani noted that the increase in global demand for primary commodities has resulted in high international prices of PNG's major export commodities. However, since the end of June 2011, international prices of Papua

New Guinea's major export commodities have fluctuated, especially for gold and copper. As at 26th September 2011, the prices of gold was USD\$1,809.10 per ounce after recording a weekly low of US\$1,639.80 per ounce while copper plummeted to US\$8,005.25 per metric tonne on the announcement by the Federal Reserve that the US economy faced significant downside risks due to Europe's on-going debt crises. International oil price subsided to US\$87.96 per barrel from US\$92.89 per barrel at end of June 2011.

The inflation outcomes for the third quarter of 2011 were released by the National Statistical Office in the week ending 21st October 2011. This is a marked improvement in the time taken for the release of inflation outcomes after a quarter ends. The annual headline inflation as measured by the Consumer Price Index (CPI) increased by 8.4 percent in the third quarter of 2011, compared to 9.6 percent in the second quarter of 2011. Although, inflation is expected to subside due to declines in the prices of food and oil, inflationary pressures remain high due to the increase in domestic economic activity. In view of these developments, the Bank tightened monetary policy by increasing the monthly Kina Facility Rate (KFR) by 25 basis points each in June, July and September to 7.75 percent. To support this stance, the cash reserve requirement (CRR) was increased by 100 basis points each in July and August from 4.0 percent to 6.0 percent.

The Governor is concerned that Government deposits, including the trust accounts held with the commercial banks has been one significant source of increased liquidity in the banking system. The Central bank is incurring an increase in the cost of monetary policy management by issuing Central Bank Bills (CBB) to diffuse some of the excess liquidity. Efforts are now being made to transfer the trust accounts funds to the Central Bank in line with the Treasurer's directive, including the opening of all new trust accounts with the Bank of PNG.

The Governor also reiterated the point he made in the September Monetary Policy Statement (MPS) regarding the management of windfall revenue for the Government. The Government should establish a Sovereign Wealth Fund to manage revenues from the PNG LNG and other mineral projects. Prior to the establishment of the SWF, the Government should allow the Central Bank to open and manage an offshore account for any windfall revenue from commodity exports. Any appropriation of windfall revenue through Supplementary Budgets will continue to pose concerns for spending, liquidity, the exchange rate and inflation. This calls for greater cooperation between the Government and the Central Bank, especially during this period of high economic growth, and inevitably, inflation in order to achieve price stability.

Since April 2011, the US dollar continued to depreciate against the major currencies on the back of expectations of rising interest rates in the UK and Euro, and a strong commodity-backed Australian dollar, while appreciating modestly against the yen. With the high inflow of foreign exchange associated with high commodity prices and construction phase of the LNG project, the kina appreciated against the US and Australian dollars since 21st April 2011. The daily average kina exchange rate movements against pound sterling and Japanese yen remain mixed as of August 2011. Since June 2011, the kina exchange rate appreciated against the US dollar by 3.17 percent averaging 0.4428 and the Australian dollar by 4.0 percent averaging 0.4216 by August 2011. These movements resulted in the daily average Trade Weighted Index (TWI) appreciating by 2.7 percent since June quarter to 34.21 by August 2011.

The high foreign exchange inflows from the LNG project related activities and international commodity prices have led to the strengthening of the kina exchange rate and an improvement in terms of trade between PNG and its main trading partners. The appreciation of the kina also helped minimized the impact of high international fuel and food prices, and imported inflation. This has contributed to the lower inflation outcome for the September quarter of 2011. The

latest Bank forecast, as contained in the Bank's MPS, is for an annual headline inflation of 9.0 percent for 2011. However, if the current inflation trend continues and international food prices stabilize, the inflation outcome for 2011 may turn out to be lower than forecasted. While the appreciation of the Kina has the effect of reducing export revenue and producers income in Kina terms, this is more than offset by the positive effect of high commodity prices. Thus, there is a net gain in revenue for exporters and the Government.

Governor Bakani further reiterated that the construction of the PNG LNG project is contributing to strong growth in some of the sectors, mainly building and construction, commerce, transportation and manufacturing. The high foreign exchange inflows from the LNG related activities and international commodity prices contributed to the appreciation of the kina. The positive effect of high commodity prices has offset the adverse impact of appreciation of the kina on export revenue in the agriculture/forestry/fisheries sector. To minimize the effects of *Dutch Disease* stemming from the development of the PNG LNG project, the Government has to develop a competitive and advanced agriculture sector as well as other non-LNG sectors. This is the most efficient and effective way to deal with the Dutch Disease where there are alternative sources of income generation with a wider base of exports. Given the projected revenue and tax inflows, the Government would have the resources to invest in the social sector and develop the agriculture sector.

The level of gross foreign exchange reserves increased from K8,441.4 (US\$3,697.3) million at the end of June 2011, to K8,785.1 (US\$3,997.2) million as at 19th October, 2011. The increase was mainly attributed to high commodity prices and mineral exports, and mineral tax receipts by the Government.

2. OVERVIEW OF THE DEVELOPMENTS IN THE JUNE QUARTER OF 2011

Governor Bakani stated that economic indicators available to the Bank of PNG (the Bank) show that domestic economic activity continued to grow in the June quarter of 2011. Higher prices and production of export commodities, the continued construction phase of the PNG LNG Project and its spin-off effects to some sectors, an increase in Government expenditure, and a continued but lower pace of credit growth in the private sector have all contributed to the growth in economic activity and an increase in employment. The consequent increase in aggregate demand, combined with the increase in international food and fuel prices, has subsequently led to an increase in inflation. The annual headline inflation was 9.6 percent in the June quarter of 2011, compared to 9.0 percent in the March quarter. The kina appreciated against all the major currencies, which resulted in the Trade Weighted Index (TWI) appreciating by 3.8 percent in the June quarter. With the rise in the inflation and indications of continued inflationary pressure, the Bank tightened monetary policy by increasing the Kina Facility Rate (KFR) by 25 basis points each in June, July and September to 7.75 percent. This was operationally supported by an increase in the Cash Reserve Requirement (CRR) for the commercial banks by 100 basis points each in July and August to 6.0 percent.

Data from the Bank's Business Liaison Survey (BLS) show that the total nominal value of sales in the private sector declined by 0.5 percent in the March quarter of 2011, compared to an increase of 8.3 percent in the December quarter of 2010. Excluding the mineral sector, sales decreased by 4.0 percent in the March quarter of 2011, following an increase of 1.1 percent in the December quarter of 2010. Sales declined in the transportation, retail and manufacturing sectors while it increased in the building and construction, mineral, agriculture/forestry/fisheries, wholesale and, financial/business and other services sectors. By region, NCD and Morobe recorded declines, while there

were increases in the Highlands, Islands, Southern and Momase regions. Over the twelve months to March 2011, total sales increased by 19.9 percent.

The Bank's Employment Index shows that the level of employment in the formal private sector increased by 3.0 percent in the June quarter of 2011, after increasing by 3.1 percent in the previous quarter. Excluding the mineral sector, the level of employment picked up by 3.2 percent in the same quarter, following an increase of 3.1 percent in the previous quarter. By sector, the level of employment increased in the transportation, wholesale, agriculture/forestry/fisheries, financial/business and other services, mineral and manufacturing sectors, while it declined in the building and construction and retail sectors. By region, the level of employment picked up in all the regions. Over the year to June 2011, the total level of employment increased by 7.1 percent, compared to the corresponding period in 2010. Excluding the mineral sector, the level of employment increased by 6.7 percent over the year to June 2011.

The Governor mentioned that quarterly headline inflation, as measured by the Consumer Price Index (CPI), was 2.2 percent in the June quarter of 2011, compared to 3.1 percent in the March quarter. There were increases in most expenditure groups, with the highest price increases recorded in the 'Rents, Council charges, fuel and power', and 'Household Equipment and Operations' expenditure groups. Annual headline inflation was 9.6 percent in the June quarter, higher than the 9.0 percent in the March quarter, mainly reflecting higher international food and fuel prices, combined with strong economic growth. The annual underlying inflation as indicated by the exclusion-based inflation rate was 8.5 percent in the June quarter, while the annual trimmed-mean inflation was 7.0 percent in the June quarter. All the surveyed urban areas recorded price increases in the June quarter of 2011.

In the June quarter of 2011, the daily average kina exchange rate appreciated against all the major currencies. It appreciated against the US dollar by 7.9

percent to 0.4130, the Australian dollar by 2.0 percent to 0.3888, the pound sterling by 5.9 percent to 0.2533 and the Japanese yen by 6.9 percent to 33.6925. These movements resulted in the daily average TWI appreciating by 3.8 percent in the June quarter to 32.08, up from 30.96 in the March quarter.

Higher international prices of all minerals and most agricultural exports resulted in a 19.6 percent increase in the weighted average price of exports in the June quarter of 2011, compared to the corresponding quarter of 2010. There was an 18.5 percent increase in the weighted average price of mineral exports, with higher kina prices of all the exports. The weighted average price of agricultural, logs and marine product exports excluding refined petroleum products increased by 24.2 percent and was attributed to higher kina prices of coffee, copra, copra oil, palm oil and rubber. This more than offset the decline in the prices of log and marine product exports.

The Governor noted that the overall surplus in the balance of payments for the first six months of 2011 was K359 million, compared to a higher surplus of K471 million in the corresponding period of 2010. This outcome was the result of a surplus in the current account, which more than offset a deficit in the capital and financial accounts.

The current account recorded a surplus of K846 million in the first six months of 2011, compared to a deficit of K657 million in the corresponding period of 2010. The surplus in the current account was due to a higher trade balance 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 K54 million in the first six months of 2011, a decline of 33.3 percent from the corresponding period of 2010. This reflected lower transfers by donor agencies for project financing.

The financial account recorded a net outflow of K570 million in the first six months of 2011, compared to net inflows of K1,158 million in the corresponding period of 2010. This outcome reflected net outflows mainly from foreign direct investments associated with the purchase of shares by a resident mineral company, purchase of short-term money market instruments, investments in financial derivative instruments through hedge arrangements, combined with higher net loan repayments by the Government. These more than offset net inflows from draw downs in net foreign assets of the banking system.

The level of gross foreign exchange reserves at the end of June 2011 was K8,485.9 (US\$3,738.6) million, sufficient for 10.5 months of total and 14.6 months of non-mineral import covers.

Governor Bakani mentioned that the Bank of Papua New Guinea tightened its monetary policy stance in June 2011, by increasing the Kina Facility Rate (KFR) to 7.25 percent from 7.00 percent, in response to the high inflation outcomes and expected inflationary pressures arising from strong domestic demand. The dealing margin for the Repurchase Agreements (Repos) was maintained at 100 basis points on both sides of the KFR during the quarter. Domestic interest rates for short-term securities and wholesale deposits showed mixed trends across all maturities during the quarter, compared to the March quarter of 2011.

The Bank continued to utilise its Open Market Operation (OMO) instruments in the conduct of monetary policy over the June quarter of 2011. There was limited Treasury bill auction during the quarter due to the Government's positive cash-flow position, while Inscribed stock auctions were conducted according to the issuance schedule. As a result, high liquidity was mainly diffused through net issuance of the CBBs. The level of liquidity in the banking system was high, and unevenly distributed. As a result, trading in the inter-bank market was active during the period as banks borrowed to maintain positive Exchange Settlement

Balance (ESA) balances. The Cash Reserve Requirement (CRR) of the commercial banks was maintained at 4.0 percent over the June quarter.

The average level of broad money supply (M3*) increased by 7.7 percent in the June quarter, compared to an increase of 2.2 percent in the March quarter of 2011. This outcome was due to an increase of 3.1 percent in average net foreign assets of depository corporations and an increase of 2.2 percent in average net private sector credit. Average net domestic claims outstanding, excluding net claims on the Central Government increased by 2.4 percent in the June quarter of 2011, compared to an increase of 2.8 percent in the March quarter of 2011. The average level of monetary base (reserve money) grew by 3.5 percent in the June quarter, compared to an increase of 8.7 percent in the March quarter of 2011.

The net foreign assets of the financial corporations increased by 1.6 percent in the June quarter, compared to a decline of 3.4 percent in the March quarter of 2011, following an increase in holdings by ODCs and OFCs. Net claims on the Central Government increased by 8.4 percent in the June quarter of 2011 compared to an increase of 36.0 percent in the previous quarter. This was influenced by increase in Treasury bills and Inscribe stock holdings by the ODCs.

In the June quarter of 2011, total domestic credit extended by financial corporations to the private sector, public non-financial corporations, Provincial and Local Governments, and other financial corporations, increased by K165.5 million to K8,827.1 million, compared to an increase of K188.4 million in the March quarter of 2011. This was mainly due to an increase of K238.1 million in private sector credit, which more than offset a decline of K72.5 million in advances to public non-financial corporations. The growth in private sector credit reflected advances to the transport and communication, building and construction, mining and quarrying, commerce and hotels and restaurants in other business services sectors.

Preliminary estimates of the fiscal operations of the National Government over the six months to June 2011 showed an overall deficit of K173.5 million, compared to a surplus of K106.7 million in the corresponding period of 2010. This represents 0.6 percent of nominal GDP. The deficit reflected higher expenditure, which more than offset an increase in revenue.

Total revenue, including foreign grants, during the first six months to June 2011 was K3,158.2 million, 8.4 percent higher than the receipts collected in the corresponding period of 2010. This represents 33.9 percent of the budgeted revenue for 2011. The increase in revenue mainly reflected higher tax and non-tax receipts combined with higher foreign grants. Total expenditure for the first six months to June 2011 was K3,331.7 million, 18.7 percent higher than in the corresponding period of 2010, and represents 35.7 percent of the budget appropriation for 2011. This outcome mainly reflected higher recurrent expenditure.

The budget deficit of K173.5 million and net repayment of K66.5 million was financed by the domestic sector. The net external loan repayments comprised of K23.2 million to concessionary, K5.4 million to commercial and K37.9 million to exceptional financing sources. The net financing by domestic sources comprised of K77.5 million and K58.8 million in net issuance of Government securities to ODCs and OFCs, respectively. These combined with a net drawdown of Government deposits totaling K205.6 million, mainly from trust account funds at the Central Bank, more than offset K101.9 million in other domestic financing representing cheques presented for payment.

Total public (Government) debt outstanding at the end of the June quarter of 2011 was K6,690.1 million, K110.4 million higher than in the December quarter of 2010. The increase reflected higher domestic debt, which more than offset lower external debt. The increase in domestic debt resulted from net new

issuance of Inscribed stocks and Treasury bills, while the decline in external debt reflected lower drawdown of loans, combined with the appreciation of the kina against most of the major borrowing currencies.

The total amount of Government deposits in the depository corporations increased by K53.5 million to K3,315.9 million in the June quarter of 2011, compared to K2,243.6 million in the December quarter of 2010. The balance of trust account funds held at the Central Bank increased by a net of K164.5 million to K377.3 million in the June quarter of 2011, compared to K212.8 million in the December quarter of 2010.