



BANK OF PAPUA NEW GUINEA

P R E S S R E L E A S E

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QUARTERLY ECONOMIC BULLETIN

SEPTEMBER QUARTER 2007

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

1. DEVELOPMENTS SINCE SEPTEMBER 2007

The Governor reported that the annual headline inflation outcome, as published by the National Statistical Office (NSO), was negative 1.6 percent in the September quarter of 2007, compared to the revised 1.0 percent in the June quarter of 2007. The negative annual headline inflation outcome in the September quarter of 2007 was mainly attributed to a large fall in the prices of seasonal produce (fruit and vegetables and betelnut), as well as for alcoholic drinks and household equipment. Whilst the annual headline inflation declined, the two underlying inflation measures increased with the annual trimmed mean and exclusion-based inflation rates at 3.6 percent and 9.5 percent, respectively. The higher annual underlying inflation outcome was mainly due to the lag effects of the depreciation of the Kina against the Australian dollar in the December quarter of 2006 and increases in inflation from PNG's major trading partners. The divergence between the annual headline and underlying inflation measures is a cause of concern to the Bank of PNG. However, the quarterly Consumer Price Index (CPI) movements of the three inflation measures have converged to around a percent. This is an indication, especially by the quarterly movements of the exclusion-based inflation that inflationary pressures may have eased in the September quarter of 2007.

Since end of September 2007, the daily Kina exchange rate has appreciated against the United States dollar to its highest of US\$0.3545 on the 7th of December 2007, but depreciated to US\$0.3525 on the 27th of December 2007 due to higher demand for foreign exchange. The increase in demand for foreign exchange resulted from the favourable Kina to Australian dollar exchange rate as the Kina appreciated against the Australian dollar since September 2007, from A\$0.3853 to A\$0.4021 on the 27th December 2007. The strengthening of the Kina against the US and Australian dollars are expected to ease inflationary pressures further in the December quarter of 2007.

Whilst the Bank continued to maintain a neutral monetary policy stance, the dealing margins for the Repurchase Agreements (Repos) was reduced to 100 basis points on both sides of the Kina Facility Rate (KFR) to align short-term interest rates with the KFR. One commercial bank lowered its Indicator Lending Rate (ILR) with the spread now at 8.95 - 9.45 percent. Domestic interest rates continued to remain low and stable up to December 2007, consistent with the high level of liquidity in the banking system. Lending to the private sector continued to increase, reflecting the low interest rate environment and the increase in economic activity, but at a lower pace than in 2006.

The level of foreign exchange reserves increased to US\$2,194.3 million on the 27th of December 2007, from US\$1,887.7 million at the end of September 2007. This increase reflected high foreign exchange inflows, mainly from mineral tax receipts received by the Government. Given the slowdown in inflows of foreign exchange the Bank of PNG has supported the market through selling of foreign exchange. This has eased the downward pressure on the Kina exchange rate.

The Governor stated that whilst macroeconomic conditions remained generally favourable, the Bank is concerned about inflationary pressures that will come about as a result of the recent significant increase in the domestic price of fuel in December 2007 and high recurrent expenditure by the Government. Consequently, further inflationary pressure is expected as public enterprises and private companies pass on the high cost of fuel to consumers. Furthermore, the huge fiscal surplus and the build-up in the Government's Trust Accounts combined with increases in monetary aggregates are also causes of concern to price stability. The Bank will continue to closely monitor these developments and, if necessary, adopt an appropriate monetary policy stance in order to maintain price stability.

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

Most economic indicators available to the Bank of PNG (BPNG) point to continued economic growth in the third quarter of 2007. Increased production of some major export commodities, driven by higher international prices, increased Government expenditure supported by large mineral tax inflows, higher import demand and growth in private sector credit are all indicative of this continued growth. Lending to the private sector increased due to low domestic interest rates and increase in business activities. While the annual headline inflation declined in the September quarter of 2007, the annual underlying inflation measures increased mainly reflecting the lag effects of the depreciation of the Kina against the Australian dollar. Given the large fiscal surplus and the build up of deposits in Trust Accounts, the Bank is concerned that if these funds are drawn down at a faster pace it will impact on liquidity and threaten price stability achieved over the last few years.

Data obtained from the Bank of Papua New Guinea's Business Liaison Survey (BLS) showed that the nominal value of sales in the private sector increased by 9.4 percent in the June quarter of 2007, compared to the March quarter of 2007. By sector, the increase in the nominal value of sales was across all sectors, except the building and construction and transportation sectors. By region, all surveyed regions recorded increases in sales. Over the twelve months to June 2007, the nominal value of sales increased by 15.1 percent.

The Bank's Employment Index indicated that employment in the formal private sector, excluding the mineral sector, decreased by 0.5 percent in the September quarter of 2007, compared to an increase of 3.6 percent in the June quarter of 2007. The sectors that recorded declines were the transportation, agriculture/forestry/fisheries and building and construction sectors, while the retail/wholesale, manufacturing and financial/business and other services sectors increased. Over the year to September 2007, the level of employment, excluding the mineral sector, increased by 11.3 percent.

Quarterly headline inflation as measured by the Consumer Price Index (CPI), increased by 0.6 percent in the September quarter of 2007, compared to 0.7 percent in the June quarter of 2007. Quarterly trimmed mean inflation was 1.1 percent and

exclusion-based inflation was 1.2 percent, compared to 1.1 and 1.4 percent, respectively, in the June quarter of 2007. By region, all urban areas recorded higher prices.

Annual headline inflation decreased by 1.6 percent in the September quarter of 2007, compared to an increase of 3.3 percent in the September quarter of 2006. The annual trimmed mean inflation was 3.6 percent in the September quarter of 2007, compared to 1.2 percent in the September quarter 2006. Annual exclusion-based inflation was 9.5 percent in the September quarter of 2007, compared to negative 0.8 percent in the September quarter of 2006.

In the September quarter of 2007, the daily average Kina exchange rate appreciated against the US dollar by 2.3 percent, the Australian dollar by 0.4 percent, the Euro by 0.3 percent and the pound sterling by 0.6 percent, while it depreciated by 0.1 percent against the Japanese yen. These movements resulted in the quarterly average Trade Weighted Index (TWI) appreciating by 0.8 percent in the September quarter of 2007.

Higher international prices for most mineral, agricultural and log exports resulted in an 8.0 percent increase in the weighted average kina price of PNG's exports in the September quarter of 2007, compared to the corresponding quarter of 2006. There was a 4.9 percent increase in the weighted average price of mineral exports, with higher kina prices of gold and crude oil, which more than offset the decline in copper export prices. For the agricultural, logs and marine product exports, the weighted average kina price increased by 25.7 percent. This was accounted for by higher kina prices of coffee, cocoa, copra, copra oil, palm oil and log exports.

The overall surplus in the balance of payments for the nine months to September 2007 was K1,227 million, compared to a surplus of K1,536 million in the corresponding period of 2006. This outcome was the result of a lower surplus in the current account combined with a lower net inflow in the capital and financial accounts.

The current account recorded a surplus of K784 million in the nine months to September 2007, compared to a surplus of K1,127 million in the corresponding period of 2006. The lower surplus reflected a decline in trade surplus and higher net

service payments, which more than offset lower net income payments and higher net transfer receipts.

The capital and financial accounts recorded a lower surplus of K411 million in the nine months to September 2007, compared to a surplus of K479 million in the corresponding period of 2006.

The capital account recorded a lower net inflow of K93 million in the nine months to September 2007, compared to K101 million in the corresponding period of 2006. The decline was due to lower capital inflows by donor agencies for project financing.

The financial account recorded a net inflow of K318 million in the nine months to September 2007, compared to a net inflow of K378 in the corresponding period of 2006. This lower outcome was a result of higher net outflow in other investments.

The level of gross foreign exchange reserves at the end of September 2007 was K5,552.2 (US\$1,887.7) million, sufficient for 9.1 months of total and 12.7 months of non-mineral import covers.

The Bank of Papua New Guinea maintained a neutral monetary policy stance during the September quarter of 2007. The Kina Facility Rate (KFR) was kept unchanged at 6.0 percent, while the dealing margin for the Repurchase Agreements (Repo) were maintained at 150 basis points on the buy and sell side of the KFR. The 28-day and 63-day Central Bank Bills (CBBs) rates increased during the same period, reflecting higher issuance of CBBs by the Central Bank to diffuse excess liquidity and realignment of short-term domestic interest rates with the KFR.

The Bank continued to utilise its Open Market Operation (OMO) instruments in the conduct of monetary policy over the September quarter of 2007. The CBBs and Repo facility were mainly used to sterilise excess liquidity, as the Government continued to retire Treasury bills. The Cash Reserve Requirement (CRR) and the Minimum Liquid Assets Ratio (MLAR) of the commercial banks were maintained at 3.0 percent and 25.0 percent, respectively, over the September quarter of 2007.

The average level of broad money supply (M3*) declined marginally by 0.3 percent in the September quarter of 2007, compared to an increase of 8.5 percent in the June

quarter of 2007. The outcome was due to a significant decline in the average net claims on the Government. Net domestic claims outstanding, excluding advances to the Central Government and outstanding loans under the Agricultural export commodity price support schemes, increased by 4.5 percent in the September quarter of 2007, compared to an increase of 10.4 percent in the previous quarter.

Total domestic credit extended by depository corporations (DCs) to the private sector, public non-financial corporations, Provincial and Local level Governments, and other financial corporations increased by K101.2 million to K3,739.6 million in the September quarter of 2007, compared to an increase of K376.8 million in the previous quarter. This was mainly due to an increase of K97.8 million in credit to the private sector and K4.1 million in credit to public non-financial corporations. The annualised growth in domestic credit, excluding Central Government and advances under the price support schemes, increased by 38.2 percent in September 2007.

Preliminary estimates of the fiscal operations of the National Government over the nine months to September 2007 showed an overall surplus of K1,198.5 million, compared to a surplus of K1,086.2 million in the corresponding period of 2006. This represents 6.7 percent of the estimated nominal Gross Domestic Product (GDP). The higher surplus was due to a significant increase in mineral tax receipts, which more than offset the increase in expenditure.

Total revenue, including foreign grants, during the nine months to September 2007 was K4,930.8 million, 15.6 percent higher than the receipts collected in the corresponding period of 2006. This represents 91.0 percent of the budgeted revenue for 2007.

Total expenditure over the nine months to September 2007 was K3,732.3 million, 17.4 percent higher than in the corresponding period of 2006, and represents 68.4 percent of the 2007 budgeted expenditure.

As a result of these developments in revenue and expenditure, the Budget surplus was used to make net overseas loan repayments of K106.3 million, while the balance was used to retire domestic debts and settle cheque floats for 2006 and increase deposits at the Central Bank.