

20th June 2007

QUARTERLY ECONOMIC BULLETIN

MARCH QUARTER 2007

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

1. UPDATE ON DEVELOPMENTS SINCE MARCH 2007

The Governor reported that the annual headline inflation outcome was 4.5 percent in March 2007, compared to 1.3 percent in the December quarter 2006. Whilst the headline inflation was within the Bank's forecast for 2007 as stated in its January 2007 Monetary Policy Statement, the underlying inflation measures were above the forecast, with trimmed mean at 6.0 percent and exclusion at 6.9 percent. The higher underlying inflation outcomes were mainly due to the depreciation of the kina against the Australian dollar, increase in foreign inflation of PNG's main trading partners and the lagged effect of fuel price increases as companies started to pass-on the cost to consumers. Further depreciation in the kina against the Australian dollar in April and May implies that underlying inflationary pressures are building up and that inflation could reach a higher level in the June quarter.

Since the end of March 2007, the kina exchange rate appreciated to US\$0.3320 from US\$0.3300, while it depreciated against the Australian dollar from A\$0.4089 to A\$0.3968 as at 15th June 2007.

Domestic interest rates continue to remain low and stable, consistent with the high level of liquidity. Lending to the private sector continue to increase reflecting the low interest rate environment and increase in economic activity.

The level of foreign exchange reserves increased to US\$1,582.4 million on the 15th of June 2007 from US\$1,400.6 million at the end of March 2007, reflecting high foreign exchange inflows mainly from mineral exports.

The Governor stated that whilst macroeconomic conditions have generally remained favourable, the Bank of PNG continue to urge the Government to maintain sound and prudent fiscal management during the National Election period. The Bank of PNG is concerned about the increase in Government spending in the face of the current unfavourable external developments, which is already impacting adversely on prices. It is to the best interest of the nation that the Government maintains macroeconomic stability during this election period. The Bank, on its part, will do all it can to maintain price stability, and will closely monitor the impact of excess liquidity on interest rates, exchange rate and inflation. If the Bank considers that there is a threat to price stability, it will make appropriate changes to its stance of monetary policy.

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

Indicators available to the Bank of PNG showed that economic activity increased in the first quarter of 2007, supported by stable macroeconomic conditions. Formal private sector employment was higher in almost all sectors of the economy. Credit to the private sector continue to grow in the first quarter of 2007 as a result of more business investments while the Government recorded a budget surplus reflecting strong corporate profits and high income tax revenues. General imports increased in the March quarter, compared to the corresponding quarter of 2006. Whilst the export volumes of most of PNG's major commodities declined, these were offset by increases in their prices, reflecting higher international prices. Inflation increase partly as a result of the depreciation of the kina against major currencies. The Bank of PNG maintained a neutral stance of monetary policy over the quarter but is concerned about the high liquidity levels, growth in monetary aggregates, further

depreciation in the exchange rate and, increase in election related Government expenditures and their potential impact on inflation.

The Bank's Employment Index showed that the level of employment in the formal private sector, excluding the mineral sector increased by 4.1 percent in the March quarter of 2007, compared to an increase of 3.7 percent in the December quarter of 2006. Employment levels increased in all regions and sectors, except for the financial/business and other services sectors. Over the year to March 2007, the level of employment, excluding the mineral sector increased by 9.9 percent, compared to 8.6 percent over the year to December 2006.

The headline inflation rate was 0.1 percent in the March quarter of 2007, compared to 0.3 percent in the December quarter of 2006. The increase was due to higher prices in the 'Food', 'Rents, Council charges, Fuel/Power', 'Transport and Communication' and the 'Miscellaneous' expenditure groups. By region, all urban areas, except Lae and Rabaul, recorded higher prices. The annual headline inflation rate was 4.5 percent in the March quarter of 2007, compared to 1.3 percent in the December quarter of 2006.

The exclusion-based inflation measure was 5.3 percent in the March quarter of 2007, compared to 1.8 percent in the December quarter of 2006. Annual exclusion-based inflation was 6.9 percent in March 2007, compared to 2.9 percent in December 2006. Trimmed mean inflation was 5.6 percent in the March quarter of 2007, compared to a decline of 0.7 percent in the December quarter of 2006. Annual trimmed mean inflation was 6.0 percent in March 2007, compared to 0.4 percent in December 2006.

In the March quarter of 2007, the daily average kina exchange rate depreciated against all the major currencies except the yen. The daily average kina exchange rate depreciated by 0.3 percent against the US dollar to 33.00 US cents and by 2.3 percent against the Australian dollar to 42.00 cents. These movements resulted in the quarterly average Trade Weighted Index (TWI) depreciating by 1.3 percent during the March quarter.

Higher international prices for mineral, most agricultural commodities and log exports resulted in a 11.5 percent increase in the weighted average kina price of Papua New Guinea's exports in the March quarter of 2007, compared to the corresponding quarter of 2006. There was a 9.6 percent increase in the weighted average price of mineral exports, with higher kina prices of copper and gold. For the agricultural, forestry and marine product exports, the weighted average kina price increased by 23.3 percent and was attributed to higher kina prices of coffee, cocoa, palm oil, copra oil, tea, rubber and log exports, which more than offset declines in export prices of copra and marine products.

The overall deficit in the balance of payments was K106 million in the March quarter of 2007, compared to a deficit of K27 million in the corresponding period of 2006. This outcome was due to a deficit in the current account, which more than offset a surplus in the capital and financial accounts.

The current account recorded a deficit of K395 million in the March quarter of 2007, compared to a surplus of K151 million in the corresponding period of 2006. This outcome was mainly attributed to a lower trade surplus and higher net service payments, which more than offset lower net income payments and higher net transfer receipts.

The capital account recorded a higher net inflow of K40 million in the March quarter of 2007, an increase of 48.2 percent from the corresponding period of 2006. The increase reflected higher capital transfers by donor agencies through direct project financing.

The financial account recorded a net inflow of K223 million in the March quarter of 2007, compared to a net outflow of K175 million in the corresponding period of 2006. This outcome reflected higher draw down of investments in short-term money market instruments and financial derivative instruments, combined with higher draw down of loans and foreign currency account balances by the mineral companies.

The Bank of Papua New Guinea maintained a neutral monetary policy stance during the March quarter of 2007. The Kina Facility Rate (KFR) was kept unchanged at 6.00 percent and the dealing margin for the Repurchase Agreements (Repos) was maintained at 150 basis points on both sides of the KFR. Central Bank Bill (CBB) rates showed increasing trends reflecting higher issuance of CBBs to sterilise excess liquidity and realign short-term domestic interest rates with the KFR. Domestic interest rates for loans and deposits showed mixed trends during the quarter.

The Bank continued to utilise Open Market Operation (OMO) instruments in the conduct of monetary policy over the March quarter of 2007. The CBBs were mainly used to sterilise excess liquidity, which was complemented by the increased issuance of Treasury bills by the Government. For daily liquidity management purposes, the commercial banks utilised the inter-bank market and Repos with the Bank of PNG to meet their liquidity needs. 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 March quarter of 2007.

The average level of broad money supply (M3*) increased by 7.5 percent in the March quarter of 2007, compared to an increase of 9.4 percent in the December quarter of 2006. The outcome was due to increases of 31.9 percent in average net claims on the Government, 9.3 percent in average private sector credit and 3.4 percent in 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 7.9 percent in the March quarter of 2007, compared to an increase of 7.3 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 K222.3 million to K3,258.7 million, compared to an increase of K218.9 million in the previous quarter. This was mainly due to an increase of K228.1 million in private sector credit, which more than offset declines of K4.5 million in claims on public non-financial corporations and K1.8 million in claims

on Provincial and Local Governments. The annualised growth in domestic credit, excluding Central Government and advances under the price support schemes was 20.0 percent in the first quarter of 2007.

Preliminary estimates of the fiscal operations of the National Government over the three months to March 2007 showed an overall surplus of K231.5 million, compared to a deficit of K70.4 million in the corresponding period of 2006. This represents 1.3 percent of nominal GDP. The surplus resulted from higher revenue combined with lower expenditure.

Total revenue, including grants, during the March quarter of 2007 was K780.9 million, 9.5 percent higher than the receipts collected in the corresponding period of 2006. This represents 14.4 percent of the 2007 budgeted revenue.

Total expenditure over the three months to March 2007 was K549.4 million, 29.9 percent lower than in the corresponding period of 2006, and represents 10.1 percent of the budgeted expenditure for 2007.

As a result of these developments in revenue and expenditure, the Government recorded a surplus of K231.5 million in the first three months of 2007. The surplus was used to make net external loan repayments of K35.1 million and net negative financing of K196.4 million.

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