BANK OF PAPUA NEW GUINEA

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Quarterly Economic Bulletin

March Quarter 2016

The Governor of the Bank of Papua New Guinea (Bank of PNG), Mr Loi M. Bakani CMG, today released the March 2016 Quarterly Economic Bulletin (QEB). This statement provides an overview of the economic and financial developments during the March quarter of 2016 as well as key developments since then.

1. UPDATE ON DEVELOPMENTS SINCE MARCH 2016

Global economic growth continued, albeit at a slow and fragile pace. Growth prospects across different economies remain uneven and all regions continued to struggle due to weak global demand and the relatively low commodity prices. In the United States (US), growth projection for 2016 was revised downwards from 2.0 percent to 1.9 percent and this was attributed to a decline in energy sector investment spending, despite resilient consumer spending and improved labour market conditions. The US Federal Reserve also held back its plan to raise the federal funds rate (the fed rate) mainly because of concerns about global economic conditions. In the Euro area, recovery has been moderate and supported by loose monetary policy, low oil prices and a slight increase in government spending. However, weak external demand, renewed domestic uncertainties and broader geopolitical risks continue to weigh heavily on confidence and economic activity. In the United Kingdom (UK), growth weakened amidst the uncertainty surrounding the vote on UK's exit from the European Union (Brexit). The simple majority voting result for UK to exit occurred on 23 June and resulted in a collapse of the financial markets and the pound hitting its lowest exchange rate against the US dollar in over 30 years on 24 June. While the full economic impact of Brexit is unclear, the economy will face a period of prolonged uncertainty. In Japan, growth stagnated, reflecting weaker private consumption which more than offset gains in real income. Exports fell as a result of weak external demand and there were limited benefits from the 2015 yen depreciation. Despite this, labour market conditions continued to improve in Japan. With all these uncertainties surrounding the global economy, both the International Monetary Fund (IMF) and the World Bank (WB) revised downwards their growth forecasts for 2016 from 3.2 percent to 3.1 percent and 2.9 percent to 2.4 percent, respectively.

Governor Bakani noted that although international prices for some commodities have generally recovered from their lows in early 2016, most commodities remain well supplied making significant price increases unlikely. The World Bank expects oil price in 2016 to be around US$41.0 per barrel, which is a downward revision from their earlier forecast of US$51.0 per barrel made in January. The Governor explained that in 2016, revenue from oil and some other major export commodities will be lower than budgeted and encourages the Government to continue to be vigilant to cut non-essential spending and reprioritize expenditure in priority areas. The announcement by the Government to introduce a Supplementary Budget in the current sitting of Parliament is timely and appropriate.

The Governor confirmed the announcement of the Government's borrowing from the international financial market as budgeted for in 2016. He stated that this external financial support would provide budgetary financing and also assist to increase the level of foreign exchange reserves, and relieve the domestic market as the main source of budgetary financing. Given the country's very low external debt level and credible debt servicing track record, the Government has the capacity to source external financing to cover its budgetary needs for the next 2 years, and continue to have the Debt/GDP ratio remain within the limit of the Fiscal Responsibility Act. It is expected that these debt can be serviced from LNG taxes once the accelerated depreciation of the PNG LNG project assets is over after 3 years from now. Apart from this, the development of few major pipeline mineral and LNG projects would provide relief for the Government budget and foreign exchange reserves.

Governor Bakani stated that although the current account turned into surplus since the LNG exports commenced in 2014, the capital account is still in deficit. This implies that the LNG export revenue are retained offshore and has not been coming into the country in the form of taxes to Government. As long as the PNG LNG project is using the accelerated depreciation allowance, which exempts it from payment of taxes on profits, the domestic payments by the project will continue to be for its operating expenditures, dividends and royalties and development levies to landowners and Provincial Governments, paid on the well head value of output. On this note, the Governor assured the landowners and Provincial Governments of the PNG LNG project that the Royalties and Development Levies are safe in the respective trust accounts held at the Central Bank.

Governor Bakani continues to echo the message for the Government to increase its efforts to grow the traditional sectors, mainly agriculture, to reduce its dependency on the mineral sector and sustain the economy over the long term. Given the efforts already to invest in infrastructure, this should open the rural areas to domestic and international markets, and introduce advance cultivation technologies. It is very encouraging to learn that the Government has reached agreement to develop few major integrated agriculture ventures in different provinces. In addition, the emphasis on development of the SME and tourism sectors is encouraging. These sectors are expected to be the main source of employment and income generation for the population.

On the domestic foreign exchange market, Mr. Bakani confirmed that there have been some good foreign currency inflows stemming from resumption of operation of the Ok Tedi mine, combined with increased coffee, cocoa and palm oil exports. This has resulted in the stability of the kina exchange rate at US$0.3160 from June to late July 2016. The Bank's analysis showed that over the recent months in particular, the foreign exchange inflows in the spot market together with the Central Bank's interventions were sufficient to clear most of the trade related demand for foreign exchange. The Governor noted that in spite of this, most of the spot foreign exchange inflows were used by commercial banks for other purposes, and not all were used to clear outstanding orders. As a result, the volume of outstanding orders for foreign currency remained high. The Bank is continuously assessing the various practices of the commercial banks and outstanding orders to determine the level of genuine import orders, and make the foreign exchange market operate more smoothly and efficiently.

The Governor reiterated the call for exporters to utilize the benefit of the low kina exchange rate to increase production and exports in efforts to raise needed foreign exchange. Given the substantial depreciation of the kina exchange rate of around 36 percent since April 2012 to August 2016, the Bank does not believe any further large depreciation of the kina would clear the foreign exchange market, but rather increase inflationary pressures. Mr Bakani emphasized that while any further depreciation of the kina would be beneficial to few exporters, the effects on prices for consumer items would be harmful for the whole population. This is already evident with the annual inflation rate to June 2016 of 6.8 percent, compared to 6.5 percent in March 2016.

The level of gross foreign exchange reserves on 29th July 2016 was K5,057.1 (US$1,620.8) million, which represents 11.5 months of total and 18.3 months of non-mineral import covers. As of 23rd August 2016, the level of foreign exchange reserves was K5,457.2 (US$1,749.0) million.

2. OVERVIEW OF THE DEVELOPMENTS IN THE MARCH QUARTER OF 2016

Economic indicators available to the Bank of Papua New Guinea (the Bank) show that domestic economic activity continued to grow at a slow pace in the March quarter of 2016, amidst low international commodity prices and the continued closure of Ok Tedi mine for most of the quarter. An increase in the level of total private sector employment in the quarter, following a decline in the second half of 2015, and a surplus in the overall balance of payments in the quarter, in contrast to a deficit in the corresponding quarter of 2015, are indicative of the growth. The end of the El Nino drought provided some relief and contributed to the growth through increased production and export of a few export commodities as well as increased subsistence production. The kina depreciated against all the major currencies with the exception of the British pound, resulting in the Trade Weighted Index (TWI) declining by 4.3 percent. The annual headline inflation was 6.5 percent in the quarter, compared to 6.4 percent in the previous quarter. The Bank considered this inflation outcome as manageable and therefore maintained its neutral stance of monetary policy by keeping the monthly KFR at 6.25 percent throughout the March quarter.

Data from the Bank's Business Liaison Survey (BLS) show that the total nominal value of sales in the private sector declined by 2.9 percent in the December quarter of 2015, compared to a decline of 10.3 percent in the September quarter. Excluding the mineral sector, sales declined by 3.1 percent, following a decline of 3.0 percent in the previous quarter. By sector, sales declined in the manufacturing, retail, wholesale and mineral sectors, while it increased in the agriculture/forestry/fisheries, finance/business and other services, transportation and construction sectors. By region, sales declined in the Momase, Southern, Highlands and Morobe regions while it increased in the NCD and the Islands region. In 2015, the total value of sales decreased by 14.9 percent, while excluding the mineral sector, it declined by 4.4 percent.

The Bank's Employment Index shows that the level of employment in the private sector increased by 1.6 percent in the March quarter of 2016, following a decline of 3.5 percent in the December quarter of 2015. Excluding the mineral sector, the level of employment increased by 1.5 percent, with increases in all sectors except the construction and retail sectors. By region, employment increased in the Highlands, Southern, Morobe and Islands regions, while it declined in the NCD and Momase regions. Over the year to March 2016, the total level of employment declined by 3.1 percent, while excluding the mineral sector, it declined by 3.8 percent.

The Governor noted that the quarterly headline inflation, as measured by the Consumer Price Index (CPI), increased by 1.6 percent in the March quarter of 2016, compared to an increase of 1.9 percent in the December quarter of 2015. There were price increases in the 'Alcoholic beverages, tobacco and betelnut', 'Health', 'Household equipment', 'Transport', 'Clothing and foot wear', 'Recreation', 'Miscellaneous', 'Restaurants and hotels', 'Food and non-alcoholic beverages' and 'Communication' expenditure groups. The 'Education' expenditure group recorded no change, while the 'Housing' expenditure group recorded a decline. Prices increased in all urban centres. The annual headline inflation to March 2016 was 6.5 percent, compared to 6.4 percent in the December quarter of 2015.

During the March quarter of 2016, the average daily kina exchange rate depreciated against all major currencies except the British pound. It depreciated against the US dollar by 3.2 percent 0.3185, the Australian dollar by 3.4 percent 0.4556, the Japanese yen by 8.0 percent to 37.9480, and the euro by 3.9 percent to 0.2804. It appreciated against the pound sterling by 2.5 percent to 0.2219. The slowing global economy, lower trade and international commodity prices as well as domestic conditions continue to hamper the kina’s performance. These movements resulted in the average daily Trade Weighted Index (TWI) declined by 4.3 percent to 32.7.

Governor Bakani mentioned that the weighted average kina price of Papua New Guinea's exports in the March quarter of 2016 declined by 15.9 percent, compared to the corresponding quarter of 2015. There was an 18.8 percent decline in the weighted average kina price of mineral exports, accounted for by lower gold, copper, crude oil, nickel, cobalt and condensate prices. For the agricultural, logs and marine product exports, excluding refined petroleum product exports, the weighted average kina price declined by 3.3 percent with lower kina prices of coffee, copra oil, palm oil, rubber and marine products. Excluding logs, the weighted average kina price of agricultural and marine product exports declined by 5.6 percent in the March quarter of 2016, compared to the corresponding quarter of 2015. The decline in kina export prices stemmed from lower international commodity prices.

The balance of payments recorded an overall surplus of K366 million in the March quarter of 2016, compared to a deficit of K210 million in the corresponding period of 2015. A surplus in the current account more than offset a deficit in the capital and financial account.

The surplus in the current account was due to higher trade surplus and net transfer receipts, which more than offset net service and income payments.

The deficit in the capital and financial account came from the other investments, reflecting a build-up in the foreign currency account balances of resident mineral companies, which more than offset net Government loan drawdowns.

The level of gross foreign exchange reserves at the end of March 2016 was K5,592.8 (US$1,806.9) million, sufficient for 11.5 months of total and 18.3 months of non-mineral import covers.

The Central Bank maintained its neutral stance of monetary policy in the March quarter of 2016 by keeping the monthly KFR at 6.25 percent. The annual headline inflation to March 2016 of 6.5 percent was within the Bank's expectations and considered manageable. During the quarter, the Bank utilised its Open Market Operation instruments in the conduct of monetary policy to manage liquidity. There was a net Central Bank Bill (CBB) issuance of K239.3 million by the Bank during the quarter. Lower than expected Government revenue affected its cash flow and resulted in increased issuance of its securities. The Government made a net issuance of K632.5 million in Treasury bills, while there was a net retirement of K220.4 million in Treasury bonds (previously referred to as Inscribed stocks). The Cash Reserve Requirement (CRR) for the commercial banks was maintained at 10.0 percent during the quarter.

The average level of broad money supply (M3*) increased by 2.6 percent in the March quarter of 2016, compared to an increase of 1.4 percent in the December quarter of 2015. This outcome was mainly influenced by an increase in net claims on the Central Government following increased issuance of securities and drawdown of Government deposits for budget financing. There were also increases in average net credit to the public non-financial corporations and the private sector to support the growth in the money supply. The average net domestic claims outstanding, excluding net claims on the Central Government, increased by 2.0 percent in the March quarter of 2016, following an increase of 3.5 percent in the December quarter of 2015. The average level of monetary base (reserve money) declined by 1.7 percent in the March quarter of 2016, following an increase of 3.1 percent in the previous quarter. This was due to decreases in both the currency in circulation and commercial banks' deposits at the Central Bank.

The net foreign assets (NFA) of financial corporations, comprising depository corporations (DCs) and other financial corporations (OFCs), declined by 2.7 percent to K7,156.3 million in the March quarter of 2016, compared to a decline of 2.2 percent in the December quarter of 2015. This resulted from a decline in the NFA of ODCs outweighing an increase in the Central Bank's NFA. The decline in NFA at ODCs was due to a fall in their foreign assets as a result of low foreign exchange inflows. The increase in NFA of the Central Bank mainly reflected an increase in the value of its investments abroad due to revaluation gains following the depreciation of the kina exchange rate. Net claims on the Central Government increased by K876.2 million to K9,278.5 million in the March quarter of 2016, compared to an increase of

K699.0 million in the previous quarter. This resulted from the increased net issuance of Government securities, especially Treasury bills for budget financing.

In the March quarter of 2016, total domestic credit extended by financial corporations to the private sector, public non-financial corporations and 'Provincial and Local level Governments' decreased by K143.4 million to K15,834.5 million, compared to an increase of K626.0 million in the previous quarter. This was mainly due to decreases of K83.8 million and K59.6 million in credit to the private sector and public non-financial corporations, respectively. The annualised growth in domestic credit, excluding Central Government, was a decline of 1.4 percent in the March quarter of 2016, compared to an annual outcome of 10.7 percent increase recorded in December 2015.

Governor Bakani mentioned that preliminary estimates of the fiscal operations of the National Government over the three months to March 2016 showed an overall deficit of K113.8 million, compared to a deficit of K405.1 million in the corresponding period of 2015. This represents 0.2 percent of nominal GDP.

Total revenue, excluding foreign grants, during the March quarter of 2016 was K1,588.0 million, 13.4 percent higher than in the corresponding period of 2015. This represents 12.5 percent of the budgeted revenue for 2016. The increase in revenue mainly reflected higher direct, indirect and non-tax receipts.

Total expenditure for the first three months to March 2016 was K1,701.8 million, 5.8 percent lower than in the corresponding period of 2015 and represents 11.5 percent of the budgeted appropriation for 2016. This outcome reflected both lower recurrent and development expenditures.

The deficit of K113.8 million was financed from both external and domestic sources. Net external financing of K72.7 million comprised net concessional borrowing of K80.7 million, which more than offset net loan repayments to extraordinary financing of K8.0 million. Net domestic financing of K41.1 million comprised net purchases of Government securities of K727.3 million by the Central Bank, ODCs and OFCs, which more than offset K686.2 million in cheques presented for encashment.

Total public (Government) debt outstanding in the March quarter of 2016 was K18,777.1 million, K582.6 million higher than in the December quarter of 2015. Both domestic and external loans increased. The increase in domestic debt resulted from net issuance of Treasury bills, while the increase in external debt mainly reflected drawdown from concessional sources.

The total amount of Government deposits in the depository corporations decreased by K205.8 million to K3,282.3 million in March 2016, compared to December 2015, reflecting drawdowns to finance projects and other priority expenditures.