BANK OF PAPUA NEW GUINEA

MEDIA RELEASE

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Quarterly Economic Bulletin
March Quarter 2017

Mr Loi M. Bakani, Governor of the Bank of Papua New Guinea (Bank of PNG), today released the March 2017 Quarterly Economic Bulletin (QEB). This statement provides an overview of the economic and financial developments during the March quarter 2017 and some key developments since then.

1. UPDATE ON DEVELOPMENTS SINCE MARCH 2017

Global growth is expected to strengthen in 2017, reflecting improvements in manufacturing and trade mainly from the advanced economies. In the United States (US), growth is projected to improve reflecting fiscal policy easing and improved confidence. The outlook for the Euro area and Japan is also expected to improve based on the cyclical recovery in global manufacturing and trade. Growth in the emerging market and developing economies are, however, revised downwards as a result of weaker outlook in several large economies, especially in Latin America and the Middle East reflecting continued adjustment due to the decline in terms of trade and cuts in oil production. In India and China, growth is expected to continue reflecting strong fiscal expansionary policies. The latest forecast by the International Monetary Fund (IMF) in its April 2017 World Economic Outlook projected growth to increase to 3.5 per cent in 2017 from its earlier projection of 3.4 per cent made in January 2017 update.

The Governor noted that international crude oil prices declined by 2.0 percent from US$50.91 per barrel in March to US$49.91 per barrel in May 2017. He explained that the price decline reflected oversupply of crude oil by the US and other non-Organization of the Petroleum Exporting Countries (OPEC), which more than offset cuts in production by OPEC. He further stated that while PNG's crude oil production declined in the March quarter, this was offset by increased crude oil price to K123.00 per barrel from K106.00 per barrel over the same period in 2016, and resulted in increased oil export receipts of K303.3 million in the quarter. Meanwhile, export prices of several commodities such as rubber, copra oil, copra, palm oil and coffee also increased by 132.0 percent, 83.6 percent, 71.6 percent, 37.7 percent and 3.6 percent, respectively. With improved prices for some of PNG's export commodities, the Governor renewed the call for PNG exporters to take advantage of this and increase production levels.

Speaking on inflation, Governor Bakani stated that PNG's headline inflation is primarily driven by volatile price movements of items such as betelnut and fruits and vegetables, which are subject to seasonality and supply constraints. In contrast, he explained that the core or underlying inflation measures, which display less volatility and measure trend inflation, continue to remain low at around 2.0 percent. Notwithstanding this, the Governor warns that global headline inflation is beginning to trend upwards underpinned by rising price pressures in advanced economies due to rising commodity prices and global demand. He explained that higher foreign inflation can be passed on to domestic prices through imported prices of goods and services. He stressed however, that this should not be of immediate concern as the Kina exchange rate has been stable. The March quarter inflation outcome was 6.0 percent, compared to 6.5 percent in the December quarter of 2016.

In light of the Government's tight cash-flow position, Governor Bakani explained that the Central Bank has selectively applied "Quantitative Easing" program to assist the Government cashflow by buying Government Securities (Treasury bills and Bonds) when the auctions were undersubscribed. The formal arrangement, referred to as the *Slack Arrangement,* was entered into by the Treasury Department and BPNG through exchange of letters in September 2014, and was selectively applied up to 2016, when this arrangement lapsed.

This arrangement known as "Quantitative Easing" is not uncommon and is applied in such situations to assist Government funding needs. Many countries apply it at different times and in different magnitudes. The application of this measure is often referred to as "Printing Money" by central bank which could lead to an increase in money supply and generate inflation.

Governor Bakani clarified that it would not be prudent for the Bank of PNG to allow inflation to increase when it is mandated to ensure price stability as the objective of monetary policy. In this regard, the Bank has actively sterilised this liquidity generated by the Slack Arrangement through selling of Central Bank bills to the market. To date, the Bank has issued Central Bank bills equal to the amount of Government Securities it acquired under the Slack Arrangement. Consequently, inflation rate continue to remain stable around 6.0 percent.

In addition, Governor Bakani mentioned that the Bank is offering these Government Securities to the public to purchase under a Tap Facility. The returns on these securities are attractive and provide investors with another investment avenue to diversify their investment portfolio. He encouraged the public to participate and share in the benefit of attractive returns. The Governor also clarified that the Tap Facility is another way in which the Bank is diffusing liquidity from the banking system as part of its monetary policy operations. This helps to reduce money supply and stabilise inflationary pressures.

The Governor stated that government expenditure is projected to be K13, 349.5 billion in 2017 against projected revenue of K11, 473.1 million, which means a budget deficit of K1, 876.0 million or 2.5 percent of GDP. The hosting of the Asia Pacific Economic Corporation (APEC) 2018 meeting in Port Moresby is a major priority area identified by the Government in the 2017 National Budget; however, with the lower 2017 revenue projection, funding of the budget will remain a challenge for the new Government. This calls for a supplementary budget to be introduced in 2017 to address the decline in revenue.

The level of gross foreign exchange reserves as at the end of June 2017 was K5,345.0 (US$1,707.7) million, sufficient for 6.0 months of total and 9.2 months of non-mineral import covers. As at the 24th August 2017, the total level of gross foreign exchange reserves was slightly higher at K5,572.8 (US$1,780.5) million.

2. OVERVIEW OF THE DEVELOPMENTS IN THE MARCH QUARTER OF 2017

Economic indicators available to the Bank of Papua New Guinea (the Bank) indicate that economic activity continued to grow at a low pace in the March quarter of 2017. An increase in production and export of some commodities, in both the mineral and non-mineral sectors, is indicative of the low growth. The increase in exports, partially induced by improvement in some of the export prices, and lower imports resulted in the balance of payments surplus in the March quarter. This resulted in improvement in foreign exchange inflows that provided some relief in the domestic foreign exchange market and stability in the kina exchange rate. With the kina stabilising against the major currencies, the Trade Weighted Index (TWI) appreciated by 0.6 per cent. Partly as a result of this, the annual inflation outcome was lower at 6.0 percent, compared to the previous quarters. Taking this into consideration as well as the continued low underlying inflation outcomes at around 2.0 percent, the Bank maintained the neutral stance of monetary policy by keeping its monetary policy signalling rate, the Kina Facility Rate (KFR), at 6.25 percent throughout the March quarter of 2017.

Data from the Bank's Business Liaison Survey (BLS) show that the total nominal value of sales in the private sector increased by 13.0 percent in the December quarter of 2016, compared to a decline of 0.1 percent in the September quarter of 2016. Excluding the mineral sector, sales increased by 3.3 percent in the December quarter, following an increase of 3.0 percent in the previous quarter. By sector, sales increased in the agriculture/forestry/fisheries, mineral, wholesale, retail, manufacturing and the financial/business and other services sectors, while it declined in the transportation and construction sectors. By region, all regions recorded an increase except for the Highlands region. Over the year to December 2016, sales increased by 30.9 percent, while excluding the mineral sector, it increased by 18.4 percent.

The Bank's Employment Index shows that the level of employment in the private sector decreased by 0.7 percent in the March quarter of 2017, compared to a decline of 2.4 percent in the December quarter of 2016. Excluding the mineral sector, the level of employment fell by 1.2 percent. By sector, the employment level declined in the construction, transportation, retail and wholesale sectors, which more than offset increases in the mineral, manufacturing, financial/business and other services and agriculture/forestry/fisheries sectors. By region, the level of employment declined in NCD, Morobe and Southern, while it increased in the Islands, Momase and Highlands regions. Over the year to March 2017, the total level of employment declined by 1.7 percent, while excluding the mineral sector, it declined by 2.5 percent.

Quarterly headline inflation, as measured by the Consumer Price Index (CPI), increased by 1.1 percent in the March quarter of 2017, compared to an increase of 1.8 percent in the December quarter of 2016. There were price increases for all expenditure groups except for the ‘Miscellaneous’, ‘Education’ and ‘Communication’ expenditure groups with no price changes. By urban centre, prices increased in all the surveyed centres. The annual headline inflation was 6.0 percent in the March quarter of 2017, compared to 6.6 percent in the December quarter of 2016.

During the March quarter of 2017, the daily average kina exchange rate depreciated against the US and Australian dollar, while it appreciated against the yen, pound sterling and the euro. It depreciated against the Australian dollar by 1.2 percent to 0.4157 and the US dollar by 0.1 percent to 0.3150. The kina appreciated against the yen by 3.9 percent to 35.8071, the euro by 0.7 percent to 0.2943, while the pound sterling remained unchanged at 0.2541.These currency movements resulted in the Trade Weighted Index (TWI) appreciating by 0.6 percent to 31.16 in the March quarter of 2017 from 30.79 in the December quarter of 2016.

The weighted average kina price of Papua New Guinea's exports, excluding LNG, increased by 15.4 percent in the March quarter of 2017, compared to the corresponding quarter of 2016. There was an increase of 17.2 percent in the weighted average kina price of mineral exports, reflecting higher kina prices for gold, copper, crude oil, nickel, cobalt and condensate. For the agricultural, logs and marine product exports, excluding refined petroleum product exports, the weighted average kina price increased by 9.3 percent, due to higher kina prices of coffee, copra, copra oil, palm oil, rubber and logs. The weighted average kina price of agricultural and marine product exports increased by 11.6 percent in the March quarter of 2017, compared to the corresponding quarter of 2016. The higher kina export prices reflected some improvements in international commodity prices, combined with the price effect of the kina depreciation against the US dollar.

The balance of payments recorded an overall surplus of K369 million in the March quarter of 2017, compared to a surplus of K366 million in the corresponding period of 2016. A surplus in the current account more than offset a deficit in the capital and financial account.

The current account recorded a surplus of K4,661 million in the March quarter of 2017, compared to K3,299 million in the corresponding period of 2016. This was due to a higher surplus in the trade account and net transfer receipts, combined with lower service and income payments.

The capital and financial account recorded a deficit of K4,297 million in the March quarter of 2017, compared to K2,945 million in the corresponding period of 2016. The outcome was due to net outflows in portfolio and other investments reflecting purchase of equity by resident entities and a build-up in foreign currency account balances of mining and petroleum companies, respectively.

The level of gross foreign exchange reserves at the end of March 2017 was K5,626 (US$1,798) million, sufficient for 6.9 months of total and 11.5 months of non-mineral import covers.

Annual headline inflation slowly increased over the first three quarters in 2016, averaging 6.7 percent, before ending the year at 6.6 percent in the December quarter. It further eased to 6.0 percent in the March quarter of 2017. Considering this and also that underlying inflation has been low at 2.0 to 3.0 percent in the same period, the Bank maintained a neutral stance of monetary policy by keeping the policy signalling rate, the KFR, at 6.25 percent. The Bank utilised its Open Market Operation (OMO) instruments in the conduct of monetary policy to manage liquidity. There was a net Central Bank Bill (CBB) retirement of K179.5 million during the quarter. The Government made a net issuance of K249.6 million in Treasury bills and retired K188.2million in Treasury bonds (previously referred to as Inscribed stock) during the same period. 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 1.9 percent in the March quarter of 2017, compared to an increase of 2.3 percent in the December quarter of 2016. This was due to increases in average net foreign assets, net claims on Central Government and credit to other financial corporations (OFCs). The average net domestic claims outstanding, excluding net claims on the Central Government, decreased by 1.7 percent in the March quarter of 2017, compared to an increase of 4.2 percent in the December quarter of 2016.

The net foreign assets (NFA) of the financial corporations, comprising depository corporations (DCs) and OFCs, increased by 15.7 percent to K7,399.8 million in the March quarter of 2017, compared to a decline of 8.1 percent in the previous quarter. There were increases in the NFA of both the Central Bank and ODCs. The increase in the NFA of the Central Bank mainly reflected the second tranche of the Credit Suisse syndicated loan of US$110 million in January 2017, while the increase in the ODCs reflected foreign exchange inflows by both the mineral and non-mineral export sectors during the period.

In the March quarter of 2017, total domestic credit extended by financial corporations to the private sector, public non-financial corporations and 'Provincial and Local level Governments' decreased by K577.2 million to K16,305.5 million, compared to an increase of K378.1 million in the previous quarter. This was influenced by decreases of K580.9 million and K3.8 million in credit to the private sector and public non-financial corporations, respectively. The decrease in credit to the private sector resulted from loan repayments mainly by the ‘agriculture, forestry and fisheries’, ‘finance’, ‘building and construction’ and the ‘household’ sectors. Excluding the Central Government, there was an annualised decline in domestic credit of 43.0 percent.

Preliminary estimates of the fiscal operations of the National Government over the three months to March 2017 show a deficit of K39.9 million, compared to the deficit of K113.8 million in the corresponding period of 2016. This represents 0.1 percent of nominal GDP.

Total revenue, including foreign grants, for the March quarter 2017 was K2,029.6 million, 27.8 percent higher than in the corresponding period of 2016. This represents 17.7 percent of the total budgeted revenue for 2017. The increase in revenue reflected higher tax receipts and foreign grants, which more than offset a decline in non-tax receipts.

The deficit of K39.9 million was mainly financed from external sources totalling K378.7 million, and K35.2 million from the domestic financial corporations sector, both of which also accounted for net borrowing by the public non-financial corporations of K45.2 million and the encashment of presented cheques from the previous year totalling K328.8 million. External financing comprised a net concessional borrowing of K23.9 million and commercial loans of K354.8 million. Net domestic financing comprised of net purchase of Government securities by the ODCs and PFCs of K131.1 million and K145.3 million, respectively. These more than offset net repayment of Government securities by Central Bank and public non-financial corporations of K241.2 million and K45.2 million, respectively.

Total public (Government) debt outstanding as at March 2017 was K22,452.1 million, an increase of K508.2 million from December 2016. Both the external and domestic debt levels increased. The increase in external debt reflected loan drawdowns on both concessional and commercial loans. The increase in domestic debt was attributed to the net issuance of Government securities.

The total amount of Government deposits at depository corporations decreased by K155.6 million to K2,637.7 million in March 2017, compared to December 2016. The decline was due to drawdowns by the Government to fund projects such as the new court house at Waigani, as well as payment for education subsidy.