BANK OF PAPUA NEW GUINEA

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Quarterly Economic Bulletin

December Quarter 2016

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

1. UPDATE ON DEVELOPMENTS SINCE DECEMBER 2016

Global economic activity improved in the first quarter of 2017, particularly in advanced economies with increased trading and production in some sectors, including manufacturing. Increased stability in the global financial markets supported the growth. With commodity prices rebounding from their early 2016 lows, there is some relief to commodity exporters. In the US, activity was strong in the manufacturing and service sectors. In the United Kingdom (UK), growth remained robust, as government and consumer spending picked up strongly, while growth in Japan and the Euro area are mainly driven by exports. Growth has been mixed in the emerging markets and developing economies. In China, growth gained momentum as a result of fiscal policy expansion, while India is showing some slow down. With these developments, the International Monetary Fund (IMF), in its April 2017 *World Economic Outlook (WEO)* revised upward its 2017 growth forecast to 3.5 percent from its earlier forecast of 3.4 percent made in January this year.

The Governor noted that international prices of some of the export commodities improved during the March quarter of 2017. Agricultural commodity prices increased by 1.0 percent in the first quarter of the year. For Papua New Guinea's exports, prices for cocoa, copra oil, cobalt, gold and LNG increased in the quarter. This has led to an improvement in foreign exchange inflows. The IMF reported that crude oil prices are expected to rise to an average of US$55.0 per barrel in 2017 from an average of US$43.0 per barrel in 2016.

Governor Bakani stated that some Authorised Foreign Exchange Dealers have offered trade finance kina loans to their clients for working capital after the Central Bank Directives in November 2016 stopped trade finance loans denominated in foreign currency. This entailed increased usage of foreign currency from the spot market and cost to the client. Mr Bakani therefore issued another Directive on 19th of April 2017 stopping trade finance loans in any currency, including kina, that involves usage of foreign currency from the spot market. This is to allow the spot market to function better in serving the normal spot orders.

Whilst some export commodity prices improved, they continued to be relatively low and affect Government revenue and expenditure. Therefore, the Governor reiterates that the Government must control and prioritise its spending especially before and after the National elections to maintain fiscal prudency and debt sustainability. The Governor also reiterated his call for all revenue raising Government agencies to improve on their efforts in revenue collections in 2017.

Mr Bakani reported that the annual headline inflation from March 2016 to March 2017, as released by the National Statistical Office, was 6.0 percent compared to 6.6 percent in the twelve months December 2016. The main contributors to this increase were the "Alcohol Beverages, Tobacco and Betelnut" expenditure group with 24.1 percent price increase over the twelve months, followed by "Housing" with 8.0 percent, "Household Equipment" with 4.1 percent, and "Food and Non-Alcoholic Beverages" with 3.5 percent. The quarterly price increase was 1.1 percent in the

March quarter 2017, compared to 1.8 percent in the December quarter 2016, with the main influences from the “Alcohol beverages, Tobacco and Betelnut” with 2.8 percent price increase, “Housing” with 1.3 percent, and “Food and Non-Alcoholic Beverages” with 1.2 percent.

The Governor also announced that a new Tap Facility for Treasury Bills and Treasury Bonds is now available as of 21st of April 2017. Corporate clients, households, and individuals can buy these Government securities from the Central Bank for relatively good returns. This will assist in liquidity management as well as promote a savings culture amongst Papua New Guineans. The minimum purchase amount is K5,000.00 and in multiples of K1,000.00 thereafter.

The level of gross foreign exchange reserves at the end of March 2017 was US$1,737.9 (K5,439.3) million, sufficient for 8.5 months cover for total imports, and 14.4 months for non-mineral imports. As at 17th May 2017, the level of gross foreign exchange reserves was US$1,694.8 (K5,304.6) million.

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

Economic indicators available to the Bank of Papua New Guinea (the Bank) show that the economy grew at a slower pace in 2016. The recommencement of production and export by the Ok Tedi and Porgera mines from the drought-induced temporary closures in 2015, and a recovery in agriculture production and export, following the end of the El Nino drought, as well as increased production at Lihir and Ramu mines were largely behind the growth. This, together with lower imports, resulted in the balance of payments recording an overall surplus in 2016, from the deficit in 2015. However, the improvement in the balance of payments was not sufficient to generate an increase in Government revenue as some international commodity prices were still relatively low. With lower tax and non-tax revenue, total Government revenue was lower than budgeted, and with the expenditure level almost as budgeted, a budget deficit was realised for 2016. The improvement in the external sector especially from non-LNG exports resulted in improved foreign exchange inflows especially in the second half of 2016. This contributed to the stability of the kina against the US dollar in the December quarter of 2016, after some depreciation in the first three quarters of the year. Against the other major currencies the kina depreciated over the year. As a result, the annual Trade Weighted Index (TWI) declined by 11.4 percent to 31.9 in 2016. Annual headline inflation was 6.6 percent in 2016, while the underlying inflation measures remained low at around 2.0 percent. The Central Bank maintained its neutral stance of monetary policy by keeping the monthly Kina Facility Rate (KFR) at 6.25 percent throughout 2016.

Data from the Bank's Business Liaison Survey (BLS) show that the total nominal value of sales in the private sector declined by 2.0 percent in the September quarter of 2016, compared to an increase of 20.8 percent in the June quarter. Excluding the mineral sector, sales fell by 1.0 percent in the quarter, compared to an increase of 20.3 percent in the June quarter. By sector, sales declined in the retail, construction, wholesale and mineral sectors, while it increased in the transportation, agriculture/forestry/fisheries, financial/business and other services and manufacturing sectors. By region, sales declined in the Southern (excluding NCD), Islands and Morobe while it increased in the Highlands, NCD and Momase (excluding Morobe) regions. Over the year to September 2016, sales increased by 10.4 percent, while excluding the mineral sector, it increased by 10.1 percent.

The Bank's Employment Index shows that the level of employment in the private sector declined by 1.7 percent in the December quarter of 2016, compared to a decline of 0.7 percent in the September quarter. Excluding the mineral sector, the level of employment declined by 2.0 percent, compared to a decline of 0.8 percent in the previous quarter. By sector, employment declined in the wholesale, agriculture/forestry/fisheries, construction and transportation sectors, while it increased in the retail, mineral, manufacturing and financial/business and other services sectors. By region, the level of employment declined in Morobe, Highlands, Momase (excluding Morobe), Islands, Southern (excluding NCD) and NCD. Over the twelve months to December, the total level of employment increased by 1.0 percent, while excluding the mineral sector, it increased by 0.7 percent.

Quarterly headline inflation, as measured by the Consumer Price Index (CPI), increased by 1.8 percent in the December quarter of 2016, compared to an increase of 1.7 per cent in the September quarter. All expenditure groups recorded increases except for the 'Restaurants and hotels' expenditure group which declined. There were no price changes for the 'Education' and 'Communication' expenditure groups. By urban centre, prices increased in all the surveyed centres.

In the December quarter, the daily average kina exchange rate appreciated against all the major currencies except the US dollar. It appreciated against the yen by 6.6 percent to 34.4671, the pound sterling by 5.9 percent to 0.2541, the euro by 3.3 percent to 0.2922, and the Australian dollar by 1.0 percent to 0.3153. It depreciated against the US dollar by 0.1 per cent to 0.3153. These movements in the currencies resulted in the TWI appreciating by 2.6 percent to 30.97 in the December quarter from 30.19 in the September quarter of 2016. In 2016, the average daily kina exchange rate depreciated against all major currencies except the pound sterling. It depreciated against the US dollar by 7.2 percent to 0.3153, the Australian dollar by 10.8 percent to 0.4207, the yen by 16.4 percent to 34.4671, and the Euro by 5.8 percent to 0.2922. The kina strengthened against the pound sterling by 13.5 percent to 0.2541. The movements in average daily kina exchange rates resulted in the daily average TWI declining by 13.5 percent to 30.97 in the quarter.

The weighted average kina price of Papua New Guinea's exports, excluding LNG, increased by 7.2 percent in 2016, from 2015. There was an increase of 7.4 percent in the weighted average kina price of mineral exports, reflecting higher kina prices for gold and cobalt. For agricultural, logs and marine product exports, the weighted average kina price increased by 6.8 percent, due to higher kina prices of all the exports, except for rubber and marine products. Excluding logs, the weighted average kina price of agricultural and marine product exports increased by 5.4 percent in 2016. The higher kina export price reflected some improvements in international commodity prices combined with the price effect of the kina's depreciation against the US dollar.

The overall balance of payments position was in a surplus of K30 million in 2016, compared to a deficit of K753 million in 2015. A surplus in the current account more than offset a deficit in the capital and financial account.

The current account recorded a surplus of K16,790 million in 2016, compared to a surplus of K12,153 million in 2015. 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 K16,782 million in 2016, compared to a deficit of K12,832 million in 2015. The outcome was due to outflows in direct, portfolio and other investments reflecting equity outflow from liquidation of investments onshore, investments in short-term money market instruments offshpre and a build-up in foreign currency accounts of mineral companies, respectively.

The level of gross foreign exchange reserves at the end of December 2016 was K5, 257.5 (US$1,656.1) million, sufficient for 7.2 months of total and 12.6 months of non-mineral import covers.

The Central Bank was mindful that annual headline inflation slowly crept up, averaging 6.7 percent over the first three quarters of 2016, and was monitoring the developments closely so as to change its monetary policy stance if it was necessary. For the December quarter of 2016, annual headline inflation was lower marginally at 6.6 percent. Considering also that the underlying inflation has been low at around 2.0 percent, the Bank maintained its neutral stance of monetary policy by keeping the policy signalling rate, the Kina Facility Rate (KFR), at 6.25 percent. The Bank utilised its Open Market Operation (OMO) instruments as normal in the conduct of monetary policy to manage liquidity in the December quarter of 2016. There was a net CBB retirement of K245.2 million during the quarter, while the Government made a net issuance of K1,050.9 million in Treasury bills and K168.8 million in Treasury bonds.

The average level of broad money supply (M3*) increased by 2.3 percent in the December quarter of 2016, compared to an increase of 5.1 percent in the September quarter of 2016. This outcome was mainly due to increases in average net credit to the private sector, Central government and other financial corporations (OFCs). The average net domestic claims outstanding, excluding net claims on the Central Government, increased by 3.5 percent in the December quarter of 2016, following an increase of 1.7 percent in the September quarter. The average level of monetary base (reserve money) increased by 8.2 percent in the quarter, following an increase of 0.2 percent in the September quarter. This growth was mainly attributed to significant increases in commercial banks' deposits held at the Central bank, following the retirement of CBBs by banks during the quarter. The net foreign assets

(NFA) of the financial corporations, comprising depository corporations (DCs) and OFCs, decreased by 8.3 percent to K6,395.2 million in the December quarter of 2016, compared to an increase of 2.4 percent in the September quarter. There were declines in the NFA of both the Central Bank and ODCs. The decline in NFA of the Central Bank reflected external public debt repayments and interventions in the foreign exchange market. The decrease in NFA of ODCs was mainly due to a fall in their foreign assets.

Net claims on the Central Government increased by K757.7 million to K12,111.9 million in the December quarter of 2016, compared to an increase of K1,135.4 million in the previous quarter. This resulted from the increased issuance of Government securities for budget financing.

In the December quarter of 2016, total domestic credit extended by financial corporations to the private sector, public non-financial corporations and 'Provincial and Local level Governments' increased by K365.0 million to K16,875.1 million, compared to an increase of K339.7 million in the previous quarter. This was influenced by an increase of K399.8 million in credit to the private sector, which more than offset a decline of K34.5 million in credit to the non-financial corporations. The increase in credit to the private sector came from advances by ODCs to the 'retail', 'hotels and restaurants', 'transport, storage and communication', 'building and construction' and 'agriculture/forestry/ fisheries' sectors, as well as to the household sector for housing loans. The annual growth in domestic credit, excluding Central Government, was 5.6 percent in 2016, lower than 10.7 percent recorded in 2015.

The National Government recorded an overall budget deficit of K3,086.9 million in its fiscal operations for 2016, compared to a deficit of K2,532.6 million in 2015. This represents 4.6 percent of nominal GDP.

Total revenue, including foreign grants in 2016 was K10,485.5 million, 4.4 percent lower than in 2015. This represents 89.5 percent of the revised budgeted revenue for 2016.

Total expenditure in 2016 was K13,572.4 million, 0.6 percent higher than in 2015 and represents 98.1 percent of the 2016 revised budget. Recurrent expenditure increased while development expenditure declined in 2016, compared to 2015.

As a result of these developments in revenue and expenditure, the Government recorded a budget deficit of K3,086.9 million. The deficit was financed from both external and domestic sources amounting to K1,448.9 million and K1,638.0 million, respectively. External borrowing comprised concessional loans of K803.6 million and commercial loans of K686.8 million, which more than offset repayments of K41.5 million to extraordinary sources. Domestic financing comprised of net purchases of Government securities by the Central Bank, ODCs, OFCs and public non-financial corporations of K1,750.0 million, K198.7 million, K114.4 million and K96.7 million, respectively. These more than offset encashment of presented cheques totalling K521.8 million.

Total public (Government) debt outstanding in 2016 was K21,944.0 million, which is K3,472.3 million higher than in 2015. Both the external and domestic debt increased. The increase in external debt reflected loan drawdowns on both concessional and commercial loans. The increase in domestic debt was attributed to net issuance of Government securities.

The total amount of Government deposits in the depository corporations decreased by K695.3 million to K2,792.8 million in December 2016, compared to December 2015. This reflects withdrawals associated with project implementation.