BANK OF PAPUA NEW GUINEA

MEDIA RELEASE

12th May 2016

Quarterly Economic Bulletin

December Quarter 2015

Mr Loi M. Bakani CMG, Governor of the Bank of Papua New Guinea (Bank of PNG), today released the December 2015 Quarterly Economic Bulletin (QEB). This statement provides an overview of the economic and financial developments during the December quarter of 2015 and some key developments since then.

1. UPDATE ON DEVELOPMENTS SINCE DECEMBER 2015

Global economic recovery has weakened further in light of increasing financial turbulence from renewed global market asset volatility. Economic activities in advanced economies and financial stresses in several large emerging market economies have not improved since the end of 2015. The large emerging market economies such as Brazil and Russia are in recession, others face tight financial conditions, while oil exporting economies face weaker terms of trade from low global trade and falling commodity prices. In the United States, growth was slow and this was attributed to weaker demand, lower exports, lower energy sector output and non-residential investment despite improvement in the labour market conditions. In the United Kingdom (UK), growth weakened as demand for services and manufacturing output dropped. Growth was stronger in the Euro area, attributable to stronger domestic demand from across the union with increased industrial and manufacturing output and government spending from Germany and Spain. Growth in China was slightly stronger than forecast, reflecting robust domestic consumption and strong contribution from the services sector, which more than offset recent weaknesses in the manufacturing sector. Growth in Japan was significantly lower as a result of declining private consumption. As a result of these developments, the International Monetary Fund (IMF) in its 2016 April World Economic Outlook (WEO) revised downwards its 2016 growth forecast to 3.2 percent from its early forecast of 3.4 percent made in January.

The Governor noted that poor growth prospects from China and other emerging market economies combined with abundant supply are putting downward pressure on the prices of most commodities. The IMF's Primary Commodities Price Index show a decline by 19.0 percent since August 2015. The prices of oil, natural gas and metal, among others, have declined notably by 39 percent, 22 percent and 9.0 percent, respectively. The Governor explained that in spite of strong global demand; excess oil supply is pushing inventories in the Organization for Economic Co-operation and Development (OECD) member countries to record-high levels, resulting in falling oil prices while warm winter conditions also contributed to the decline in the price of natural gas. The declining metal prices are attributed to the slowdown and a shift away from commodity based investment in China. In line with these developments, the kina prices of Papua New Guinea's exports may decline and thus, the export earnings. The Governor reiterated that given the continued low commodity prices, and the uncertainty of a turnaround in commodity prices in the near future, the Government's revenue target may have to be revised or introduce other revenue measures.

International food prices have declined by 4.0 percent with declines in most food items. The IMF projects food prices to decline further by 6.0 percent in 2016 owing to oversupply, with expected high level of stock and lower demand. The Governor mentioned that the feed through from lower international prices of fuel and food is good for the economy in the face of the depreciating kina. He urge companies to pass on the benefits of lower prices to consumers.

The Governor noted that cheques worth more than K400.0 million issued in 2015 were presented during the first quarter of 2016. This is a significant expenditure from 2015 and therefore, may add to the pressures in the Government cash flow management in 2016. He emphasised the need for the Government to make necessary adjustments to its expenditure if there are mismatches in revenue and expenditure and pursue external funding of the budget to ease pressure on domestic sources.

Governor Bakani acknowledged the release of the nominal GDP figures for 2006 to 2013 by the National Statistics Office (NSO) in March 2016. During this period, the average nominal GDP growth was around 9.4 percent, reflective of the high commodity prices in most years between 2002 and 2011 and of major development projects, including the construction of the PNG LNG project. Over this period, nominal GDP increased from K25.4 billion in 2006 to K47.5 billion in 2013. Based on the new GDP figures, the GDP per capita has increased from 2006 level of K4,024 to K6,204 in 2013. The Bank and the Treasury Department have recalculated the nominal GDP for 2014 and 2015, which is expected to be released soon by the Government.

Between 2012 and March 2016, the daily average kina exchange rate had depreciated against the US dollar and the Australian dollar by 31.5 percent and 1.7 percent, respectively. Governor Bakani reaffirmed the stance taken by the Central Bank that the exchange rate is a floating one. Thus, the depreciation of the kina since 2012 is a clear reflection of the supply and demand situation in the foreign exchange market. The Central Bank continued to support the foreign exchange market by supplying foreign currency to meet some of the import demand by the private sector. The Bank has to balance the foreign currency need of the Government, private sector demand and ensure that it continues to hold adequate level of foreign exchange reserves for the country.

The Governor also clarified that despite the current account recording a big surplus mainly due to the exports of LNG, this has not resulted in significant inflow of foreign exchange and Government tax revenues. The revenue flows from the LNG exports are held in offshore accounts for debt services by the LNG project. In addition, the Government tax revenue from LNG has been low due to accelerated depreciation of the project assets as stipulated in the Development Agreement of the project.

Meanwhile, the Bank and the Government are seeking external sources of financing to support the foreign exchange market and budgetary financing. Governor Bakani continued to emphasise the need for exporters to take advantage of the kina depreciation to increase production and exports that would bring in the much needed foreign exchange. At the same time, consumers and importers should adjust their consumption patterns and sourcing of imports by buying locally produced goods. This can reduce demand for foreign exchange and also encourage the development of our local industries. In the longer term, the Government is refocussing on diversifying the economy to other sectors like agriculture, tourism and SME, which would reduce its reliance on the non-renewable sectors.

The level of gross foreign exchange reserves at the end of April 2016 was K5, 499.1 (US$1,773.5) million, sufficient for around 10.0 months of total and 15.0 months of non-mineral import covers.

2. OVERVIEW OF THE DEVELOPMENTS IN THE DECEMBER QUARTER OF 2015

Economic indicators available to the Bank of Papua New Guinea (the Bank) show that domestic economic activity continued to grow in 2015, but at a lower pace than in 2014. The first full year of LNG production was behind this growth. There were offsetting factors that contributed to the low growth. These include the temporary closures of the Ok Tedi and Porgera mines, and the Napa Napa oil refinery, lower domestic food production associated with the El Nino drought and low export commodity prices. The low international commodity prices and the El Niño drought adversely affected production for most of PNG's mineral and agricultural exports, which in turn reduced overall domestic demand and Government revenue. The kina depreciated against most of the major currencies in 2015, while it appreciated against the Australian dollar. The Trade Weighted Index (TWI) increased marginally by 0.5 percent to 35.47 in 2015. Inflation was 6.4 percent in 2015, compared to 6.6 percent in 2014, mainly attributed to the depreciation of the kina. The inflation outcomes were considered to be manageable and therefore the Bank maintained a neutral stance of monetary policy by keeping the monthly Kina Facility Rate (KFR) at 6.25 percent throughout 2015.

Data from the Bank's Business Liaison Survey (BLS) show that the total nominal value of sales in the private sector decreased by 14.4 percent in the September quarter of 2015, compared to an increase of 6.2 percent in the June quarter of 2015. Excluding the mineral sector, sales declined by 6.7 percent, following an increase of 5.3 percent in the previous quarter. By sector, sales declined in the mineral, agriculture/forestry/fisheries, retail, manufacturing, wholesale, finance/business and other services sectors, while it increased in the construction and transportation sectors. By region, sales declined in the Southern, Islands, Momase, and NCD while it increased in Morobe and the Highlands regions. Over the year to September 2015, sales declined by 16.0 percent.

The Bank's Employment Index shows that the level of employment in the private sector declined by 3.8 percent in the December quarter of 2015, following a drop of 3.7 percent in the September quarter of 2015. Excluding the mineral sector, the level of employment decreased by 4.2 percent, with declines across all sectors. By region, employment declined in all regions. Over the twelve months to December 2015, the total level of employment fell by 3.7 percent, while excluding the mineral sector, it declined by 4.2 percent.

The Governor noted that the quarterly headline inflation, as measured by the Consumer Price Index (CPI), increased by 1.9 percent in the December quarter of 2015, compared to an increase of 1.7 percent in the September quarter of 2015. There were price increases for the 'Alcoholic Beverages, Tobacco and Betelnut', 'Food and Non-alcoholic Beverages', 'Restaurants and Hotels', 'Health', 'Housing Equipment', 'Transport' and 'Housing' expenditure groups while the 'Miscellaneous', 'Clothing and Footwear', and 'Recreation' expenditure groups recorded declines.

There were no price changes for the 'Education' and 'Communication' expenditure groups. Annual headline inflation to December 2015 was 6.4 percent, compared to 6.6 percent in December 2014. By urban centre, prices increased in all the surveyed centres.

In the December quarter, the daily average kina exchange rate depreciated against all major currencies. It depreciated against the yen by 5.8 percent to 41.2472, the US dollar by 5.2 percent to 0.3398, the Australian dollar by 4.4 percent to 0.4717, the euro by 3.8 percent to 0.3101 and the pound sterling by 3.1 percent to 0.2240. These movements in the currencies resulted in the TWI decreasing by 4.4 percent to 34.14 in the December quarter from 35.72 in the September quarter. This was due to a strengthening of the United States (US) economy. In 2015, the daily kina exchange rate depreciated against the US dollar and the pound sterling, while it appreciated against the other major currencies. It depreciated against the US dollar by 11.0 percent to 0.3617 and the pound sterling by 4.1 percent to 0.2367 while it appreciated against the Australian dollar by 6.6 percent to 0.4807, the euro by 6.4 percent to 0.3258, and the Japanese yen by 1.8 percent to 43.7642. For the year, the TWI appreciated by 0.5 percent to 35.47 from 35.28 in 2014, mainly reflecting the appreciation of the Australian dollar.

Governor Bakani mentioned that the weighted average kina price of Papua New Guinea's exports declined by 10.2 percent in 2015, from 2014. There was a decline of 12.5 percent in the weighted average kina price of mineral exports with lower kina prices for copper, crude oil, nickel and condensate. For agricultural, logs and marine product exports, the weighted average kina price declined by 2.2 percent due to lower prices of some of the major commodities. Excluding logs, the weighted average price of agricultural and marine product exports declined by 5.9 percent in 2015, from 2014. The lower kina export prices stemmed from the lower international commodity prices.

The balance of payments recorded an overall deficit of K607 million in 2015, compared to a deficit of K861 million in 2014. A deficit in the capital and financial account more than offset a surplus in the current account.

The current account recorded a surplus of K13,392 million in 2015, compared to a surplus of K5,963 million in 2014. The outcome was due to a higher trade surplus and net transfer receipts, which more than offset lower net service and income payments.

The capital account recorded a net inflow of K2 million in 2015, compared to a net inflow of K5 million in 2014, reflecting lower transfers by donor agencies for project financing.

The financial account recorded a net outflow of K13,954 million in 2015, compared to a net outflow of K6,799 million in 2014. The outcome reflected a build-up in foreign currency account balances of mining, oil and LNG companies under the various Project Development Agreements. These more than offset inflows from foreign direct and portfolio investments in the form of equity inflows and drawdowns from investments in short term money market instruments, respectively.

The level of gross foreign exchange reserves at the end of December 2015 was K5,226.3 (US$1,865.1) million, sufficient for 10.0 months of total and 15.8 months of non-mineral import covers.

The Governor noted that the headline inflation outcomes of 6.1 percent to 5.8 percent for the first three quarters of 2015 were considered by the Central Bank to be manageable. Considering this and other relevant macroeconomic indicators, including inflationary expectations, the Bank maintained a neutral stance of monetary policy by keeping the monthly KFR at 6.25 percent throughout the December quarter of 2015. During the quarter, the Bank utilised its Open Market Operation (OMO) instruments in the conduct of monetary policy to manage liquidity. There was a net Central Bank Bills (CBB) retirement of K640.9 million during the quarter, while the Government made a net issuance of K78.5 million in Treasury bills and K337.0 million in Inscribed stocks.

The average level of broad money supply (M3*) increased by 1.4 percent in the December quarter of 2015, compared to an increase of 0.3 percent in the previous quarter. This outcome was mainly influenced by increases in average net credit to the other financial corporations (OFCs), public non-financial corporations and the private sector. The average net domestic claims outstanding, excluding net claims on the Central Government, increased by 3.4 percent in the December quarter of 2015, following an increase of 4.0 percent in the September quarter of 2015. The average level of monetary base (reserve money) increased by 3.1 percent in the quarter, following an increase of 0.1 percent in the September quarter. This was due to an increase in both currency in circulation and commercial banks' deposits at the Central Bank.

The net foreign assets (NFA) of the financial corporations, comprising depository corporations (DCs) and other financial corporations (OFCs), declined by 2.9 percent to K7,302.5 million in the December quarter of 2015, compared to a decline of 10.9 percent in the September quarter of 2015. This resulted from a decline in the NFA of the Central Bank outweighing an increase in ODCs. The decline in NFA of the Central Bank was due to its interventions in the foreign exchange market. The increase in NFA at ODCs was mainly due to an increase in their foreign assets mainly as a result of revaluation gains following the depreciation of the kina. Net claims on the Central Government increased by K698.8 million to K8,402.9 million in the December quarter of 2015, compared to a decline of K238.7 million in the previous quarter. This resulted from the increased purchase of Government securities.

In the December quarter of 2015, total domestic credit extended by financial corporations to the private sector, public non-financial corporations and 'Provincial and Local level Governments' increased by K506.2 million to K15,858.1 million, compared to an increase of K652.0 million in the previous quarter. This mainly comprised increases of K274.6 million and K232.2 million in credit to the public non-financial corporations and the private sector, respectively. The increase in credit to the public non-financial corporations reflected advances by the ODCs to State Owned Enterprises, while the increase in private sector credit was due to advances to the 'mining and quarrying', 'real estate, renting and business services', 'hotels and restaurants' and wholesale sectors. The annual growth in domestic credit, excluding Central Government, was 9.9 percent in 2015, lower than the 17.8 percent recorded in 2014.

Governor Bakani mentioned that preliminary estimates of the fiscal operations of the National Government in 2015 showed an overall deficit of K2,532.6 million, compared to a deficit of K2,992.2 million in 2014. This represents 5.0 percent of nominal GDP. The Treasury Department has not revised this deficit to GDP ratio following the new GDP data released by the NSO in March 2016. It is expected that the ratio will be well below 5.0 percent.

Total revenue, including foreign grants, in 2015 was K10,963.5 million, 4.7 percent lower than in 2014. This represents 87.9 percent of the revised budgeted revenue for 2015.

Total expenditure in 2015 was K13,496.1 million, 6.9 percent lower than in 2014 and represents 91.1 percent of the revised budgeted appropriation for 2015. This outcome reflects both lower recurrent and development expenditures.

As a result of these developments in revenue and expenditure, the Government recorded a deficit of K2,532.6 million. The budget deficit was financed from both the external and domestic sources amounting to K520.9 million and K2,011.7 million, respectively. Financing from external sources comprised mainly concessional loans of K567.7 million, more than offsetting repayments of K46.8 million to extraordinary sources. Domestic financing comprised of net purchases of Government securities totalling K23.9 million, K1,844.2 million, K503.9 million and K200.0 million by the Central Bank, ODCs, OFCs and Public Non-Financial Corporations. These more than offset K560.3 million cheques presented for encashment.

Total public (Government) debt outstanding in December 2015 was K18,194.5 million, K3,539.0 million higher than in December 2014. Both domestic and external loans increased. The increase in domestic debt resulted from net new issuance of Treasury bills and Inscribed stocks, while the increase in external debt reflected the drawdown of concessional loans, combined with the depreciation of the exchange rate. The debt to GDP ratio for 2014 and 2015 will have to be recalculated and revised based on the new nominal GDP data released by the NSO in March 2016. It is expected that the ratio will be well within the required ratio in the Fiscal Responsibility Act.

The total amount of Government deposits in the depository corporations decreased by K498.1 million to K3,488.1 million in December 2015, compared to K3,986.2 million in the September quarter of 2015.