BANK OF PAPUA NEW GUINEA

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Quarterly Economic Bulletin

June Quarter 2016

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

1. UPDATE ON DEVELOPMENTS SINCE JUNE 2016

Global economic growth weakened slightly, mainly as a result of lower activity in advanced economies, the Brexit announcement which created uncertainties among the European Union and advanced economies, the on-going rebalancing of the Chinese economy and low international commodity prices which continue to adversely affect commodity exporting countries. Although labour market conditions have improved, global trade and industrial production continue to under-perform. The United States (US) economy continues to grow but at a moderate pace reflecting a pick-up in employment and strong growth in consumer spending. Growth could have been higher if it wasn't for the continued slowdown in the industrial sector driven by lower business investment spending in the energy sector and strengthening of the US dollar affecting investments in export oriented industries. Growth in the Euro Area decelerated as domestic demand and investments in some of the larger economies declined. In the United Kingdom, the uncertainties surrounding the Brexit referendum outcome continue to affect economic activity, while in Japan, weak growth was attributed to lower external demand and investment spending. Emerging markets and developing economies as a group recorded a slight pick-up as growth in India continues to recover strongly aided by the implementation of effective fiscal policy measures and a large improvement in its terms of trade. This is also supported by stable growth in China, reflecting implementation of fiscal policy measures, strong credit growth, robust consumer spending and booming services industry. Based on these developments, the International Monetary Fund (IMF) in its October World Economic Outlook, lowered its global growth forecast to 3.1 percent from its earlier forecast of 3.2 percent made in April 2016. The World Bank's forecasts were relatively lower with its global growth projection of 2.4 percent made in June 2016, compared to its January forecast of 2.9 percent.

The Governor stated that the low international oil prices, although slowly increasing, are benefiting oil importing countries, while oil exporters are being affected in terms of lower export revenue. With PNG being a net oil importer, it will benefit from lower oil prices while, at the same time, experience lower export revenue as an oil exporter. Oil prices rallied by around 50 percent from a 10 year low US$30.00 per barrel in January 2016 to US$45.00 per barrel at the end of September, 2016. The IMF's Monthly Commodity Market Report also stated that for the nine months to September 2016, commodity prices rose by 13.0 percent with much of the increase driven by oil prices followed by metal and agriculture commodity prices. The Governor also noted that while PNG's export prices per barrel of crude oil declined by 7.7 percent over the year to June 2016, this has been compensated by increased production of 17.8 percent. With increasing commodity prices of some of PNG's exports and the weaker kina exchange rate, exporters are encouraged to take advantage of higher prices to increase production.

The Governor noted that inflation picked up slightly in advanced economies but still remained at low levels. In the emerging market and developing economies, headline inflation has been steady as currencies remained broadly stable or appreciated in some cases. He explained that whilst there was some imported inflation as well as the exchange rate pass-through effect from the depreciation of the kina to inflation in PNG, the main cause of inflation came from domestic sources, especially from volatile price movements for seasonal items such as vegetables and betelnut. The underlying or core inflation measures remained relatively low.

In recent months, there have been some good inflows of foreign exchange into the foreign exchange market that cleared some of the back log of import orders and assisted to ease some pressure in the foreign exchange market. The foreign exchange inflows to the market came from the mining sector following the resumption of production at the Ok Tedi mine as well as the recovery in the agriculture sector after the end of the El Nino drought in the first quarter of the year. The Bank of PNG assisted in meeting some of the demand for foreign currency by selling US$395.0 million in the nine months to September, 2016.

Governor Bakani explained that the Authorised Foreign Exchange Dealers (AFED's) have used some of the foreign exchange inflows and funds in the onshore foreign currency accounts to fund trade finance loans, thereby reducing the flows to the spot market. To address this, the Governor issued additional directives at the end September 2016 as follows:

- All the holders of onshore Foreign Currency Accounts (FCAs) are to re-apply to the Central Bank to justify their need for these accounts.
- All domestic lending in foreign currency such as Trade Finance must be approved by the Bank of PNG and repayment made in kina, as stipulated under Regulation 6 of the Exchange Control Regulations.
- Forward contracts have to be settled with forward flows and not from spot inflows.

- AFEDs are to separate their Trade Finance and Forward contracts from the Spot market orders.
- Central Bank interventions are not to be used for Trade Finance loans and settlement of Forwards contracts.
- Orders in the spot market should only be for those orders that need to be filled within three business days.
- Spot inflows should only be used to clear spot market orders.

On 8th November 2016, the National Government tabled its 2017 National Budget of K13.3 billion, compared to the 2016 Supplementary Budget of K13.8 billion. The Budget was framed in light of a weak global economic recovery, slight improvements in commodity prices and modest growth in the domestic economy. The Governor noted that the Government's fiscal strategy for 2017 aims to ensure manageable levels of public debt, sustainable deficit and maintain macroeconomic stability. In 2017, the total revenue and expenditure are projected to be slightly lower at K11,473.1 million and K13,349.5 million, respectively. Taking these into consideration and the 2017 National Elections, the Government made adjustments to its expenditure budget, implying that delivery of other essential services will be affected. The reductions are in the Economic, Health, Transport and Law and Justice sectors. The Government will continue to fund its key priority expenditure programs such as the Tuition Fee Free Education, Free Primary Health Care, Infrastructure Projects, Agriculture and Small to Medium Enterprises. It has also made a substantial funding allocation for the 2017 National General Elections of K400 million.

Whilst commending the Government on the 2017 Budget, Governor Bakani continues to remind the Government to be cautious in its spending in light of revenue shortfalls and potential spending spill-overs leading up to and during the National Elections in 2017, as well as being mindful of preparations for the APEC Meeting in 2018. The impact of Government expenditure and large fiscal deficits on import demand, exchange rate and inflation must always be taken into account as important policy considerations. The Central Bank will continue to monitor these developments and will make necessary adjustments to its monetary policy stance if the situation warrants, to assist the Government in ensuring that macroeconomic stability is maintained.

As of 25th October 2016, the level of foreign exchange reserves was K5, 347.9 (US$1,714.0) million, compared to K5,153.2 (US$1,628.4) million at the end of June 2016.

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

Economic indicators available to the Bank of Papua New Guinea (the Bank) show that economic activity improved marginally in the second quarter of 2016. This was attributed to the commencement of mining production and increased production in the agriculture sector following the end of the El-Nino drought in the first quarter of the year. The slowdown in the global economy, and prolonged low international commodity prices continue to adversely affect government revenue and domestic demand. Private sector employment grew for the second consecutive quarter mainly reflecting high seasonal employment in the agriculture sub-sector and the resumption of operations at the Ok Tedi mine. The balance of payments recorded a deficit and resulted in the kina depreciating against all the major currencies. Consequently, the Trade Weighted Index (TWI) depreciated by 6.0 percent. Annual headline inflation was slightly higher at 6.8 per cent in the June quarter of 2016, mainly due to seasonal price movements; however, the underlying inflation measures continue to remain relatively low. The Central Bank therefore maintained its neutral monetary policy stance by keeping the monthly Kina Facility Rate (KFR) at 6.25 percent in the June quarter of 2016.

Data from the Bank's Business Liaison Survey (BLS) show that the total nominal value of sales in the private sector declined by 2.3 percent in the March quarter of 2016, compared to a decline of 4.6 percent in the December quarter of 2015. Excluding the mineral sector, sales declined by 5.5 percent, following a decline of 3.7 percent in the previous quarter. By sector, sales declined in the agriculture/forestry/fisheries, transportation, wholesale, finance business and other services sectors, while it increased in the retail, construction, mineral and manufacturing sectors. By region, sales declined in the Islands, National Capital District (NCD), Morobe and Highlands, while it increased in the Momase and Southern regions. Over the year to March 2016, the total value of sales declined by 17.1 percent, while excluding the mineral sector, sales declined by 13.2 percent.

The Governor takes note of the increase in employment for the second consecutive quarter as an important indicator of economic growth. The Bank's Employment Index shows that the level of employment in the private sector increased by 1.7 percent in the June quarter of 2016, following a lower outcome of 1.4 percent in the March quarter of 2016. Excluding the mineral sector, the level of employment increased by 2.3 percent, with increases in the agriculture/forestry/fisheries and transportation sector which more than offset declines in the manufacturing, wholesale, construction, financial/business and other services sectors, retail and the mineral sectors. By region, employment levels increased in the Highlands and Southern regions while the Islands, Momase, NCD and Morobe regions recorded declines. Over the year to June 2016, the total level of employment declined by 4.4 percent, while excluding the mineral sector, it fell by 4.6 percent.

Quarterly headline inflation, as measured by the Consumer Price Index (CPI), increased by 1.4 percent in the June quarter of 2016, compared to an increase of 1.6 percent in the March quarter. Most expenditure groups recorded increases, which more than offset declines in the 'Health', 'Miscellaneous' and 'Housing' expenditure groups. The 'Communication', 'Education' and 'Household Equipment' expenditure groups recorded no change. By urban centres, prices rose in all centres, with the highest increase recorded in Lae, followed by Port Moresby and Goroka/Hagen/Madang with similar increases, and Alotau/Kimbe/Rabaul with the least increase. The annual headline inflation to June 2016 was 6.8 percent, compared to 6.5 percent in the March quarter.

During the June quarter of 2016, the average daily kina exchange rate depreciated against all major currencies. It depreciated against the Japanese yen by 9.7 percent to 34.2774, the Australian dollar by 6.6 percent to 0.4257, the euro by 5.7 percent to 0.2811, the pound sterling by 3.6 percent to 0.2212 and the US dollar by 3.5 percent to 0.3173. These movements resulted in the depreciation of the daily average Trade Weighted Index (TWI) by 6.0 per cent to 30.7280. The slowing global economy, lower trade and international commodity prices which persisted during the quarter continues to hamper the kina's performance.

The weighted average kina price of Papua New Guinea's export commodities, excluding LNG increased by 3.0 percent in the June quarter of 2016, from the corresponding quarter of 2015. There was an increase of 4.3 percent in the weighted average kina price of mineral exports with higher kina prices for gold and cobalt. For agricultural, logs and marine product exports, the weighted average kina price declined by 1.9 percent, due to lower kina prices for coffee, palm oil and rubber. Excluding logs, the weighted average kina price of agricultural and marine product exports declined by 6.5 percent in the June quarter of 2016, from the corresponding quarter of 2015. The higher kina export prices were due to higher international commodity prices for some commodities combined with the effect of depreciation of the Kina against the US dollar.

The overall deficit in the balance of payments was K73 million in the first six months of 2016, compared to a deficit of K388 million in the corresponding period of 2015. This was due to a deficit in the capital and financial account, more than offsetting a surplus in the current account.

The current account recorded a surplus of K6,634 million in the first six months of 2016, compared to a surplus of K6,690 million in the corresponding period of 2015. The outcome in the current account was due to a surplus in trade balance and net transfer receipts.

The capital account recorded a net inflow of K10 million in the first six months of 2016, the same as in the corresponding period of 2015, reflecting transfers by donor agencies for project financing.

The financial account recorded a net outflow of K6,717 million in the first six months of 2016, compared to a net outflow of K7,072 million in the corresponding period of 2015. The outcome was due to net outflows in other investments reflecting build-up in net foreign assets of the domestic banking system and foreign currency account balances of mining, oil and LNG companies under the various project Development Agreements. This more than offset Government loan drawdowns.

The level of gross foreign exchange reserves at the end of June 2016 was K5,153.2 (US$1,628.4) million, sufficient for 9.8 months of total and 15.4 months of non-mineral import covers.

Although increasing to 6.8 percent for the twelve months to June 2016, the Central Bank still considers the annual headline inflation outcome to be still manageable and therefore maintained its neutral monetary policy stance over the June quarter of 2016 by keeping the monthly KFR at 6.25 percent. During the quarter, the Bank utilised its Open Market Operation instruments in the conduct of monetary policy to manage liquidity. There was a net CBB retirement of K549.6 million. The Government made a net issuance of K288.5 million in Treasury bills, while issuing a net of K208.4 million in Treasury bonds (previously Inscribed stocks). The Government had to meet its financing requirements through increased issuance of securities because of lower revenue from tax and export receipts. 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 1.7 percent in the June quarter of 2016, compared to an increase of 2.6 percent in the March quarter of 2016. This outcome was mainly influenced by increases in average net credit to the

Central Government, private sector, other financial and public non-financial corporations. The average net domestic claims outstanding, excluding net claims on the Central Government, increased by 1.0 percent in the June quarter of 2016, compared to an increase of 2.0 percent in the March quarter of 2016. The average level of monetary base (reserve money) increased by 4.8 percent in the June quarter of 2016, following a decline of 1.7 percent in the previous quarter. This was due to increases in both currency in circulation and commercial banks' deposits at the Central Bank.

The average level of deposits in other depository corporations (ODCs) increased by 0.5 percent to K21, 816.7 million in the June quarter of 2016, from K21, 710.7 million in the previous quarter. In the financial corporations, comprising depository corporations (DCs) and other financial corporations (OFCs), net foreign assets (NFA) decreased by 18.1 percent to K5, 864.7 million in the June quarter of 2016, following a decline of 2.2 percent in the March quarter of 2016. This resulted from declines in the NFA of both ODCs and the Central Bank. The decline at ODCs was due to low foreign exchange inflows as a result of low international commodity prices for PNGs exports, while the decline at the Central Bank reflected intervention in the foreign exchange market.

In the June 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 K1,191.5 million to K14,643.0 million, compared to a decline of K143.4 million in the previous quarter. This was mainly due to a decrease of K1,403.2 million in credit to the private sector, which more than offset an increase of K211.6 million in credit to public non-financial corporations. The decline in credit to the private sector reflected repayments to ODCs by the 'agriculture, fisheries and forestry', manufacturing, finance, 'building and construction' and 'real estate, renting and business services' sectors, while the increase in public non-financial corporations reflected advances to the State Owned Enterprises. The annualised growth in domestic credit, excluding Central Government, recorded a decline of 32.7

percent in the June quarter of 2016, compared to a decline of 1.8 percent in the March quarter of 2016.

Preliminary estimates of the fiscal operations of the National Government over the six months to June 2016 showed an overall deficit of K624.8 million, compared to a deficit of K942.0 million in the corresponding period of 2015. This represents 0.9 percent of nominal GDP.

Total revenue, including foreign grants, over the first six months to June 2016 was K4,160.2 million, 6.2 percent lower than in the corresponding period of 2015. This represents 32.9 percent of the budgeted revenue for 2016. The decrease in revenue mainly reflected lower tax receipts, which more than offset increases in non-tax receipts.

Total expenditure for the first six months to June 2016 was K4,785.0 million, 11.0 percent lower than in the corresponding period of 2015 and represents 32.4 percent of the budgeted appropriation for 2016. This outcome reflected lower development expenditure which more than offset an increase in recurrent expenditure.

The deficit was financed from both external sources totalling K336.6 million and domestic sources totalling K288.2 million. Net external financing comprised net concessional loan drawdown of K440.2 million, which more than offset net loan repayments to commercial sources of K83.9 million and extraordinary sources of K19.7 million. Net domestic financing comprised net purchases of Government securities of K741.5 million by the Central Bank, K1,119.9 million by ODCs, K73.9 million by OFCs and K95.0 million by the Public Non-Financial Corporations. These more than offset K1,742.0 million mainly cheques presented for encashment.

Total public (Government) debt outstanding in the June quarter of 2016 was K19,258.2 million, K294.4 million higher than in the March quarter of 2016. Domestic debt increased by K615.3 million resulting from net issuance of Government securities, while external debt decreased by K320.90 million reflecting repayments of concessional loans.

The total amount of Government deposits in the depository corporations decreased by K777.2 million to K2,505.2 million in June 2016, compared to March 2016. The decline was due to Government drawdown on deposits held in various Trust and Operating accounts because of its tight cash-flow situation.