BANK OF PAPUA NEW GUINEA

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Quarterly Economic Bulletin

September Quarter 2014

Mr Loi M. Bakani, Governor of the Bank of Papua New Guinea (Bank of PNG), released the September 2014 Quarterly Economic Bulletin (QEB) today. This statement provides an overview of the economic and financial developments during the September quarter 2014 and some key developments since then.

1. UPDATE ON DEVELOPMENTS SINCE SEPTEMBER 2014

The International Monetary Fund (IMF) in its October 2014 *World Economic Outlook* report stated that global economic activity remains weak but it varies among economies. In the United States (US), growth in the second half of the year is stronger, with improved housing activity and non-residential investment, as well as better employment data. In the United Kingdom (UK), growth is supported by strong housing prices, business investment, and improved demand. While employment has grown in the UK, labour productivity has been low indicating some slack in the labour market. Germany and Spain also experienced strong growth while activity was weak in France and Italy. In Asia, Japan's growth has been weak, owing to a consumption tax hike in April and weaker currency during the second half of 2014. However, Japan's export is picking up as a result of a stronger economic performance in the US. China's economy is showing signs of weakness as industrial production, retail sales and property prices declined while India's economy is exhibiting strong growth with improved manufacturing and mining sectors and a robust performance in the capital goods sectors. Based on these latest developments and prospects, the IMF forecast global growth in 2015 to be around 3.8 percent, up from 3.3 percent in 2014.

Key global commodity prices are forecast by the IMF to remain stable in 2015 due to increased global demand. However, the weak growth of some large economies in Europe and Asia will be a downside risk to this projection. International crude oil prices in particular have been declining for some time now, due to increased supply in the market relative to demand.

The Governor pointed out that whilst the fall in oil prices will feed through to lower domestic fuel prices and domestic inflation, can adversely affect oil export revenue and taxes paid to Government in 2015. The 2015 National Budget assumes a price of US$89.7 per barrel while the current price is below US$50.00 per barrel. The Governor added that the fall in the price is significant and urge the Government to closely monitor the trend and its impact on the Budget revenue. He also urge distributors of fuel in PNG to pass on the price decline to industries and consumers. Fuel is an important input for many industries, and the lower fuel prices can have consequent decline in prices of other goods and services that rely on fuel.

Global inflation is projected to increase slightly in 2015 with inflation in advanced economies forecast to be 1.8 percent from 1.6 percent in 2014. In the US, inflation is also expected to increase to 2.1 percent from 2.0 percent in 2014 while Japan's inflation is projected to decline to 2.0 percent from 2.7 percent in 2014. The Euro Area however is currently experiencing low inflation with little prospect for increasing in 2015. The Governor stated that the rise in global inflation will translate into higher imported inflation, which could lead to increase in domestic prices of goods and services. With the September 2014 annual headline inflation outcome of 5.3 percent, the Governor cautioned that the economy is experiencing a build-up of inflationary expectations, mainly driven by the depreciation of the kina. However, the expected reduction in fuel prices should minimise this expectation.

The 2015 National Budget approved by Parliament contained a record expenditure of K16.2 billion, against a revenue projection of K13.9 billion. This is expected to yield a budget deficit of K2.3 billion or 4.4 percent of GDP, down from 5.9 percent in 2014. Some of the key issues on the Budget include:

- An increase of K1.3 billion revenue forecast which is expected to be largely raised from an increase of 15.3 percent in tax revenue from the 2014 revised estimate.

The Governor mentioned that a large portion of the revenue increase is expected to come from the mining and petroleum taxes in addition to the K0.5 billion in LNG dividends. Given the significant decline in oil and gas prices, the tax revenue target may not be achieved if some portions of the gas sales are not locked in forward contracts. The Governor encourages the Government to closely monitor developments in the international prices of these important export commodities, and be prepared to make prompt adjustments to its planned expenditures. Those non-priority recurrent expenditures should be deferred or cut, while priority areas of education, health, infrastructure, law and order and agriculture should continue to be supported.

- An increase in interest payments of 50.4 percent to K1.1 billion in 2015 from K751.0 million in the 2014 revised budget. This is a significant increase in interest cost to Government.

The Governor maintains that real interest rates are positive and there is no need for further increase in interest rates on Government securities. But in a market with few players and limits being placed on exposures to Government debts, this may be a constrain on the Government's ability to raise domestic financing, which could exert upward pressure on domestic interest rates and cost to the Government. He explained that higher debt service is not productive as it diverts financial resources away from productive investments and developments. Despite of concerns and limits on exposure to Government debt, the Government has a clean record of not defaulting on any of its debts in the past and to date.

- The Governor also pointed out that the Government deficit financing strategy relies on an asset sale of K2.5 billion. This represents the 4.27 percent sale of PNG LNG equity to landowners. It is therefore crucial that the Government should act quickly with arrangements to raise this financing for the Budget.

In terms of the capacity of the domestic banking system to finance the 2015 budget deficit, Governor Bakani pointed out that total liquidity in the system is K8.9 billion. This liquidity is held in different forms of liquid instruments, including cash and securities issued by the Government and Bank of PNG. The Bank of PNG has K1 billion in Central Bank Bills that are held by licensed financial institutions. The level of liquidity in the financial system is more than adequate to finance the budget deficit and also available for borrowing by the public.

In regard to claims that the Government has run out of funds or has cash-flow problems to meet 2014 expenditure commitments, the Governor explained that by the end of December 2014 the Government had a positive cash-flow position, sufficient to meet its commitments. The problem regarding the processing of payment through cheques (like for teachers leave entitlements) was not due to insufficient funds. Rather, it may be due to procedural error in processing the cheques in the new National Payments System - the Kina Automated Transfer System (KATS). The Governor stressed that the KATS is very reliable in ensuring compliance to clearing and settlement payment processes, and urge the cheque issuing departments to exercise diligence and care in the execution of the payments under the new payments system.

Furthermore, the Governor stressed an important point regarding the exchange rate regime. The regime remains a floating exchange rate regime and not a pegged exchange rate as some commentators and sectors of the business community have portrayed in relation to the introduction of the exchange rate trading band. The only changes effected by the introduction of the exchange rate trading band, is to reduce the exorbitantly high margins of foreign exchange trading by the authorised dealers to 75 basis points, above and below the interbank market rate, and it has nothing to do with the exchange rate regime. This change provides a transparent direction to price foreign exchange inflows above the interbank rate, and below for outward payments. Since the introduction of the trading band on the 4th of June, the Kina has depreciated by 6.6 percent from US$0.4130 to US$0.3855, indicating that the foreign exchange interbank market is functioning as in a floating exchange rate regime. Governor stressed that there has been inflows of foreign currency but they were not sufficient to meet the high demand. The Bank of PNG has and will continue to act responsibly and ensure an orderly movement in the kina exchange rate.

Governor emphasised that commentators should observe the trend in the Kina exchange rate over longer time horizon rather than focus and draw conclusions on a one year development. The kina has depreciated by 20.4 percent from its high of US$0.4845 at the peak of its appreciation in 2012. The sharp depreciation of the kina therefore would have benefitted and encouraged the exporters to increase production and exports. More depreciation is good only if there is a supply response of the agricultural export commodities, otherwise it will be inflationary. In PNG, there are structural constrains such as transportation, production capacity and market accessibility to address the supply response, not only commodity prices.

The level of gross foreign exchange reserves was K6,011.1 (US$2,347.3) million as of 31st December 2014. This level is sufficient for 8.2 months of total import cover and 11.3 months of non-mineral import cover, which are still very comfortable compared to the IMF's conventional measure of 5 months import cover. The decline in reserves level from end of 2013 was due to intervention in the foreign exchange market by the Bank of PNG to assist in meeting the demand for foreign currency and to service the Government's foreign currency needs.

2. OVERVIEW OF THE DEVELOPMENTS IN THE SEPTEMBER QUARTER OF 2014

Economic indicators available to the Bank of Papua New Guinea (the Bank) show that economic activity picked up in the June quarter, following a slow pace of growth in the first quarter, and continued into the September quarter of 2014. This was attributable to increased activity in the non-mineral private sector, reflective of increased Government spending on infrastructure and other priority areas under its expansionary fiscal policy. The total level of employment increased by 0.2 percent in the September quarter, mainly reflecting growth in the non-mineral private sector. The weighted average kina price of Papua New Guinea's exports increased by 8.6 percent in the September quarter of 2014, compared to the corresponding quarter of 2013. However, declines in export volumes of most of the major export commodities resulted in lower export receipts. This, combined with high import demand, resulted in the kina depreciating against all major currencies. Consequently, the Trade Weighted Index (TWI) depreciated by 0.7 percent in the quarter. With the lag effect of the depreciation of the kina and a pick-up in imported inflation, the annual headline inflation in the September quarter of 2014 increased by 5.3 percent. The Bank continued to take a cautious approach in its monetary policy stance by maintaining the Kina Facility Rate at 6.25 percent throughout the quarter.

Data from the Bank's Business Liaison Survey (BLS) show that the total nominal value of sales in the private sector increased by 17.4 percent in the June quarter of 2014, compared to a decline of 7.1 percent in the March quarter. Excluding the mineral sector, sales increased by 2.1 percent, following a decline of 6.4 percent in the previous quarter. Sales increased in the mineral, agriculture/forestry/fisheries, manufacturing, wholesale, construction and transportation sectors while it declined in the retail and financial/business and other services sectors. By region, sales increased in all regions. Over the twelve months to June 2014, total nominal sales increased by 23.4 percent, while excluding the mineral sector, it increased by 15.9 percent.

The Bank's Employment Index shows that the total level of employment in the private sector increased by 0.2 percent in the September quarter of 2014, compared to an increase of 0.1 percent in the June quarter. Excluding the mineral sector, employment increased by 0.3 percent, with increases in the construction, retail and transportation sectors. By region, employment increased in the Highlands, Morobe and Islands regions, while it declined in NCD and Momase. Over the twelve months to September 2014, the total level of employment increased by 1.5 percent, while excluding the mineral sector, it increased by 3.0 percent.

Quarterly headline inflation, as measured by the Consumer Price Index (CPI), was 1.6 percent in the September quarter of 2014, compared to an increase of 1.5 percent in the June quarter. Price increases were recorded in the 'Household Equipment', 'Miscellaneous', 'Health' , 'Clothing and Footwear' , 'Recreation', 'Transport', 'Alcoholic Beverages, Tobacco and Betelnut' , 'Restaurants and Hotels', 'Food and Non-Alcoholic Beverages' and 'Housing' expenditure groups. Prices in all centres increased, with Port Moresby having the highest increase, followed by Alotau/Kimbe/Rabaul, Lae and Goroka/Hagen/Madang. The annual exclusion based inflation increased by 5.0 percent in the September quarter, compared to a decline of 1.1 percent in the same period in 2013. The annual trimmed mean inflation was 5.4 percent in the quarter, compared to 0.2 percent in the same period in 2013.

During the September quarter of 2014, the average daily kina exchange rate depreciated against all major currencies except the Japanese yen and the euro. The kina depreciated against the US dollar by 1.4 percent to 0.4072, pound sterling by 0.6 percent to 0.2438 and Australian dollar by 0.5 percent to 0.4403, while it appreciated against the Japanese yen by 0.2 percent to 42.3262 and the euro by 2.1 percent to 0.3037. These movements resulted in the depreciation of the daily average TWI by 0.7 percent to 34.75, compared to the June quarter of 2014.

The weighted average kina price of Papua New Guinea's exports increased by 8.6 percent in the September quarter of 2014, compared to the corresponding quarter of 2013. There was a 6.2 percent increase in the weighted average price of mineral exports, with higher kina prices of gold, copper, crude oil and nickel. For the agricultural, logs and marine product exports, the weighted average price increased by 15.7 percent, with higher kina prices for most agricultural commodities, logs and marine products. Excluding logs, the weighted average price of agricultural and marine product exports increased by 16.2 percent in the quarter, compared to the corresponding quarter of 2013. The higher kina export prices reflected higher international prices for most commodities, combined with the depreciation of the kina against USD.

The balance of payments recorded an overall deficit of K436 million for the nine months to September 2014, compared to a deficit of K1,173 million in the corresponding period of 2013. A deficit in the current account more than offset a surplus in the capital and financial account.

The deficit in the current account was lower than in the corresponding period of 2013 and was due to a higher trade surplus and lower net service and income payments

The surplus in the capital and financial account was mainly due to inflows from portfolio investment reflecting drawdown from investments in short term money market instruments. This more than offset higher net outflows from direct and other investments reflecting equity outflow and build up in foreign currency account balances of mineral companies, respectively.

The level of gross foreign exchange reserves at the end of September 2014 was K6,086.6 (US$2,489.3) million, sufficient for 7.4 months of total and 10.6 months of non-mineral import covers.

The Central Bank continued to take a cautious approach and maintained the KFR at 6.25 percent in the September quarter of 2014, in consideration of the low inflation outcomes in the first two quarters of the year. Domestic interest rates, including for short-term securities, continued to increase between the end of June and September 2014. There was a net issuance of K52.8 million of Central Bank Bills (CBBs) in the quarter. To meet its financing needs, the Government made a net issuance of K527.3 million in Treasury bills and K486.0 million in Inscribed stocks.

The average level of broad money supply (M3*) increased slightly by 0.7 percent in the September quarter, compared to an increase of 1.7 percent in the June quarter of 2014. This outcome was mainly influenced by an increase in average net claims on the Central Government as a result of increased issuances of securities and drawdown of Government deposits, combined with an increase of 1.8 percent in average private sector credit. The average net domestic claims outstanding, excluding net claims on the Central Government, increased by 2.6 percent in the September quarter of 2014, following an increase of 5.0 percent in the June quarter.

The average level of deposits in other depository corporations (ODCs) increased by 0.8 percent to K19,433.6 million in the September quarter of 2014 compared to the previous quarter. This mainly reflected an increase in transferable deposits and other deposits of public non-financial corporations.

The net foreign assets of the financial corporations, comprising depository corporations (DCs) and other financial corporations (OFCs), decreased by 12.2 percent to K8,427.4 million in the September quarter of 2014, compared to an increase of 2.5 percent in the June quarter. This resulted from a decline in net foreign assets of the DCs, which more than offset an increase in OFCs. Net claims on the Central Government increased by K535.6 million to K5,926.3 million in the September quarter of 2014, compared to an increase of K329.9 million in the previous quarter. This was a result of issuance of Government securities for budget financing.

In the September quarter of 2014, total domestic credit extended by financial corporations to the private sector, public non-financial corporations, Provincial and Local level Governments, and OFCs increased by K372.1 million to K13,506.5 million, compared to an increase of K590.5 million in the previous quarter. This was due to increases of K269.4 million and K102.8 million in credit to the private sector and public non-financial corporations, respectively. The annualized growth in domestic credit, excluding Central Government, was 11.8 percent in the September quarter of 2014.

Preliminary estimates of the fiscal operations of the National Government over the nine months to September 2014 show an overall deficit of K1,510.1 million, compared to a deficit of K495.5 million in the corresponding period of 2013. This represents 3.8 percent of nominal GDP, and reflected higher expenditure which more than offset an increase in revenue.

Total revenue, including foreign grants, over the nine months to September 2014 was K6,675.9 million, 2.0 percent higher than the receipts collected in the corresponding period of 2013. This represents 52.6 percent of the budgeted revenue for 2014. The increase in revenue was largely attributed to higher collection of direct receipts, which more than offset lower non-tax receipts and foreign grants. Total expenditure in the period was K8,186.0 million, 16.3 percent higher than in the corresponding period of 2013 and represents 54.4 percent of the budgeted appropriation for 2014. This outcome reflected higher recurrent and development expenditures.

As a result of these developments in revenue and expenditure, the Government recorded a deficit of K1,510.1 million. The budget deficit and net external loan repayment of K146.0 million were financed by domestic sources with K1,656.1 million. External loan repayments comprised of K117.6 million, K7.4 million and K21.0 million for concessionary, commercial and extraordinary financing sources, respectively. Domestic financing comprised of a net purchase of Government securities totalling K1,514.9 million and K250.7 million by OFCs and ODCs, combined with a net drawdown of K893.9 million from Government deposits at the Central Bank. These more than offset a K1,003.4 million payments mostly in cheques presented by other resident sectors.

Total public (Government) debt outstanding increased by K798.6 million to K14,651.6 million at the end of September 2014, from the end of June. The domestic debt has increased while the net external debt decreased. The increase in domestic debt resulted from new issuance of Treasury bills and Inscribed stocks, while the decrease in external debt reflected loan repayments.

The total amount of Government deposits in the depository corporations increased by K177.7 million to K4,211.2 million in September 2014, compared to K4,033.5 million in June 2014.