BANK OF PAPUA NEW GUINEA

MEDIA RELEASE

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Quarterly Economic Bulletin

December Quarter 2014

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

1. UPDATE ON DEVELOPMENTS SINCE DECEMBER 2014

The International Monetary Fund, *in its April 2015 World Economic Outlook*, maintained its 2015 global growth forecast at 3.5 percent, on the account of stronger growth in advanced economies but weaker growth in emerging markets, reflecting more subdued prospects for some large emerging market economies and oil exporters.

In the United States, economic growth was resilient but at a slower pace in the first quarter of 2015 due to weaker industrial output, a stronger US dollar and harsh winter conditions. In the United Kingdom, growth slowed reflecting a sharp fall in oil and gas production, while the Euro area showed signs of recovery reflecting lower oil prices, lower interest rates and weak euro. Despite the ongoing quantitative easing measures, Japan's growth remains weak mainly due to the effect of the consumption tax hike in 2014. Weak global trade and falling prices of some of China's industrial metals continue to hamper China's growth as its industrial and manufacturing output fell despite gains from lower oil prices.

Key global commodity prices of crude oil, natural gas, agricultural commodities and metals declined in the first quarter of 2015. For oil, the sharp decline was due to the expansion of oil output in the US, receding concerns on supply disruptions, and OPEC's decision to maintain supply levels. The decline in prices for the other commodities followed the appreciation of the US dollar against a broad group of currencies in the second half of 2014. As a result of the decline in international oil prices, the domestic prices of fuel (diesel, petrol and kerosene) declined significantly in the December quarter 2014 and March quarter of 2015. The Governor urges business houses and providers of public utilities to pass on the benefits of lower fuel prices onto prices of goods and services that use fuel as an intermediate input. On the other hand, low oil prices will lead to a fall in export revenue for PNG's oil exports. Subsequently, this will have a major negative impact on Government's revenue in 2015, as the National Budget factored in a price per barrel of US$89.7, which is much lower than the current international price of about US$60.00 per barrel. Governor Bakani added that the Government will have to review the 2015 National Budget parameters and prudently manage expenditure consistent with lower revenue.

Global inflation is expected to be low in 2015 on account of low oil prices, low investment and productivity in a number of advanced and emerging market economies as a result of weak global trade. However, the up-side risk to low global inflation outcome in 2015 would come from the appreciating US dollar.

The Governor acknowledges the Government's increased focus on developing the non-mineral export sectors of the economy. Investment in the non-mineral sectors will assist in providing employment opportunities, increase the revenue base of the economy, and reduce the risk of Dutch Disease. Investment in the agriculture sector will improve production of export commodities such as coffee, cocoa, tea and copra that are constrained by poor extension services, limited financial resources, poor access to market and lack of managerial skills. Had the non-mineral mineral sector been more developed, the economy would be in a better stead to withstand the effects of the lower oil and other commodity prices.

The Governor noted that the Budget outcome for 2014 of a deficit of K2,992.0 million or 7.3 percent of GDP is notably higher than the 5.9 percent expected in the revised 2014 budget. He added that for 2015 Budget, the lower than expected tax from the mineral sector should be factored in with necessary adjustments to expenditure, and the Government should spend within the remit of its available revenues and focus on priority development projects.

The new Organic Law on Sovereign Wealth Fund (SWF) was presented to Parliament in February 2015, and is expected to pass the final reading later in 2015. The Governor noted that a few important amendments must be incorporated and to ensure its consistency with the Kumul Act before the Law goes for the final reading. The Government should maintain its commitment to have the SWF operational in 2016 to prudently manage revenue inflows from LNG and other mineral projects in a sustainable manner. This will assist the country mitigate the effects of the Dutch Disease phenomenon.

The Governor reiterated that the shortage of foreign currency liquidity in the domestic market continues to dictate the movement of the kina exchange rate. Despite some good inflows, the demand for foreign currency, including outstanding orders, far exceeds the supply. He urged the private sector to be prudent in managing their demand for foreign currency and make necessary adjustments to curtail demand. The Governor also urged exporters to increase production and exports to take advantage of the lower kina and bring in foreign exchange proceeds to assist the market.

On 05th of March 2015, the Governor issued Exchange Control Directives in line with the Foreign Exchange Control Manual. The Directives covered: the use of vostro accounts by foreign banks; onshore foreign currency accounts; and offshore foreign currency accounts. The Governor stated that these directives were aimed at ensuring prudent conduct of these accounts and compliance to the Foreign Exchange and Gold Regulation. After a review and audit of these accounts, any unauthorised accounts would be closed and foreign currency balances converted to kina. He emphasised that foreign banks may have abused their vostro accounts by conducting unauthorised banking business in PNG, while holders of foreign currency accounts could be hoarding foreign currencies. The unauthorised use of these accounts have also contributed to the decline in liquidity in the foreign exchange market.

In the December quarter of 2014, the daily average kina exchange rate appreciated against all the major currencies, except for the US dollar. As of 28th May 2015, the kina appreciated against the euro by 6.9 percent, the Australian dollar by 3.6 percent, and the Japanese yen by 1.1 percent, while it depreciated against the US dollar by 6.6 percent and pound sterling by 3.8 percent.

The level of gross foreign exchange reserves declined to K5,538.1 (US$2,062.9) million as at 27th of May 2015, from K5,980.7 (US$2,342.1) million at the end of December 2014. The decline is due to intervention in the foreign exchange market by the Bank of PNG to assist the market with liquidity and ease the pace of depreciation of the kina. The level is sufficient for 7.9 months of total and 12.4 months of non-mineral import covers.

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

Economic indicators available to the Bank of Papua New Guinea (the Bank) show a strong growth in the domestic economy in 2014, mainly reflecting the commencement of LNG production and export. This was supported by improvement in international prices of most of PNG's export commodities in 2014 and economic activity in some sectors of the non-mineral private sector, although at a slower pace. The construction of infrastructure projects, including transportation, health and education facilities in various regions and the sporting facilities in the National

Capital District for the 2015 Pacific Games contributed to economic activity in the non-mineral private sector. With higher export volume and value of LNG than earlier expected, the balance of payments recorded a lower deficit in 2014 than in 2013. In the December quarter, the Trade Weighted Index (TWI) strengthened by 2.0 percent, reflecting the appreciation of the kina against the Australian dollar. Annual inflation was 6.6 percent in 2014, compared to 2.9 percent in 2013, mainly attributed to a weak kina. The Bank of PNG considered inflation to be at a manageable level and therefore, maintained its stance of policy by keeping the Kina Facility Rate (KFR) at 6.25 percent throughout 2014.

Data from the Bank's Business Liaison Survey (BLS) show that the total nominal value of sales in the private sector declined by 3.5 percent in the September quarter of 2014, compared to an increase of 15.4 percent in the June quarter. Excluding the mineral sector, sales declined by 5.4 percent, following an increase of 5.9 percent in the previous quarter. Sales declined in the financial/business and other services sector, agriculture/forestry/fisheries, manufacturing and the wholesale sectors, while they increased in the mineral, transportation, construction and retail sectors. By region, sales declined in NCD, Islands and the Southern regions, while it increased in Morobe, Momase (excluding Morobe) and the Highlands regions. Over the twelve months to September 2014, the total nominal sales increased by 16.7 percent, while excluding the mineral sector, sales increased by 4.3 percent.

The Bank's Employment Index shows that the level of employment in the private sector declined by 2.5 percent in the December quarter of 2014, compared to a decline of 0.8 percent in the previous quarter. Excluding the mineral sector, employment fell by 2.8 percent, with declines in manufacturing, construction and the agriculture/forestry/fisheries sectors - only the transportation and mineral sectors recorded marginal increases. By region, the level of employment declined in most regions, except for the Islands. In 2014, the total level of employment declined by 3.4 percent, while excluding the mineral sector, it declined by 2.9 percent.

Quarterly headline inflation, as measured by the Consumer Price Index (CPI) increased by 1.4 percent in the December quarter of 2014, compared to an increase of 1.6 percent in the September quarter. Price increases were recorded in the

'Health', 'Clothing and Footwear', 'Housing', 'Household Equipment', 'Alcoholic Beverages, Tobacco and Betelnut', 'Food and Non-Alcoholic Beverages', 'Recreation', and 'Miscellaneous' expenditure groups. Annual headline inflation to December 2014 quarter was 6.6 percent compared to 2.9 percent in December 2013. By urban centre, consumer prices increased in all centres, with the exception of Alotau/Kimbe/Rabaul.

In the December quarter, the daily average kina exchange rate appreciated against all major currencies except the US dollar. It appreciated against the Japanese yen by 6.4 percent to 45.032, the Australian dollar by 4.6 percent to 0.4605, euro by 2.6 percent to 0.3152 and pound sterling by 2.0 percent to 0.2487. It depreciated against the US dollar by 3.3 percent to 0.3937. These movements in the currencies resulted in the TWI increasing by 3.0 percent to 35.47 in the December quarter from 34.75 in the September quarter. In 2014, the daily average kina exchange rate depreciated against all the major currencies. It depreciated against the pound sterling by 13.7 percent to 0.2468, the euro by 9.1 percent to 0.3062, the US dollar by 9.0 percent to 0.4066, the Australian dollar by 2.4 percent to 0.4510 and the Japanese yen by 1.3 percent to 42.9984.

Higher international prices for some of PNG's export commodities excluding LNG prices resulted in an increase of 2.8 percent in the weighted average kina prices in 2014, compared to 2013. There was a 15.1 percent increase in the weighted average price of non-mineral exports as a result of higher kina prices for all agricultural commodities, with the exception of rubber and marine products. The weighted average price of mineral exports declined by 0.4 percent mainly due to lower kina prices for gold and cobalt.

The overall deficit in the balance of payments was K861 million in 2014, compared to a deficit of K1,574 million in 2013. This outcome was due to a higher surplus in the current account, more than offsetting a deficit in the capital and financial account.
The current account recorded a surplus of K7,083 million in 2014, compared to a deficit of K7,746 million in 2013. 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 K5.0 million in 2014, compared to a net inflow of K35 million in 2013 reflecting lower transfers by donor agencies for project financing.

The financial account recorded a net outflow of K8,004 million in 2014, compared to a net inflow of K6,155 million in 2013. The outcome was due to higher net outflows in direct investments reflecting equity outflows. This combined with outflows in other investments reflecting build-up in foreign currency account balances of mining, oil and gas companies, and in net foreign assets of the banking system. These more than offset net inflows from portfolio investments reflecting drawdown from investments in short term money market instruments.

The level of gross foreign exchange reserves at the end of December 2014 was K5,980.7 (US$2,342.1) million, sufficient for 8.0 months of total and 11.6 months of non-mineral import covers.

The Central Bank continued its neutral stance of monetary policy by maintaining the Kina Facility Rate (KFR) at 6.25 percent during the December quarter of 2014. This was in view of the moderate inflation outcomes for the first three quarters of 2014, which were below the Bank's inflation forecast for 2014. The neutral stance was also intended to encourage credit to the private sector and support economic activity following the completion of the construction of the LNG project. Domestic interest rates generally trended upwards over the December quarter of 2014, with short-term rates for securities increasing for most maturities. There was a net CBB issuance of K252.0 million during the quarter, while the Government's financing needs resulted in a net issuance of K716.2 million in Treasury bills and K314.5 million in Inscribed stocks.

The average level of broad money supply (M3*) increased by 1.9 percent in the December quarter of 2014, compared to an increase of 0.7 percent in the previous quarter. This outcome was influenced by an increase in average net claims on the Central Government reflecting increased issuances of securities and drawdown of Government deposits, combined with an increase in average private sector credit of 2.9 percent. The average net domestic claims outstanding, excluding net claims on the Central Government, increased by 9.9 percent in the December quarter of 2014, following an increase of 12.5 percent in the September quarter. The average level of monetary base (reserve money) increased by 7.9 percent in the December quarter of 2014, following an increase of 9.2 percent in the previous quarter. This reflected higher commercial banks' deposits at the Central Bank and currency in circulation.

The Net Foreign Assets (NFA) of the financial corporations, comprising depository corporations (DCs) and other financial corporations (OFCs), decreased by 3.0 percent to K8,167.8 million in the December quarter of 2014, compared to a decline of 12.3 percent in the September quarter. This resulted from a decline in net foreign asset of DCs, which more than offset the increase from OFCs. Net claims on the Central Government increased by K545.6 million to K6,570.4 million in the December quarter of 2014, compared to an increase of K634.2 million in the previous quarter. This resulted from increased issuance of securities by the Government to fund its budget.

In the December quarter of 2014, total domestic credit extended by financial corporations to the private sector, public non-financial corporations, Provincial and Local level Governments, and other financial corporations, increased by K796.8 million to K14,325.5 million, compared to an increase of K394.4 million in the previous quarter. This was due to increases of K354.8 million and K442.0 million in credit to the private sector and public non-financial corporations, respectively. The annual growth in domestic credit, excluding Central Government, was 17.0 percent in 2014, compared to 15.8 percent in 2013.

Preliminary estimates of the fiscal operations of the National Government in 2014 show an overall deficit of K2,992.0 million, compared to a deficit of K2,672.4 million in 2013. This represents 7.3 percent of nominal GDP.

Total revenue, including foreign grants, was K11,497.8 million in 2014, 16.9 percent higher than the receipts collected in 2013. This represents 90.9 percent of the revised budgeted revenue for 2014. The increase in revenue was primarily due to higher tax and non-tax receipts, which more than offset lower foreign grants.

Total expenditure was K14,489.8 million in 2014, 15.9 percent higher than in 2013 and represents 96.1 percent of the revised budgeted appropriation for 2014. This outcome reflects a higher recurrent expenditure, which more than offset a decline in the development expenditure.

As a result of these developments in revenue and expenditure, there was a budget deficit of K2,992.0 million. The budget deficit was financed by external and domestic sources with K421.8 million and K2,570.2 million, respectively. External financing was all from concessionary borrowing of K421.8 million. The domestic financing comprised of net purchases of Government securities totalling K1,869.0 million by OFCs and K1,649.7 million by the Central Bank. These, more than offset K37.4 million retirement of Government securities to ODCS and K911.1 million in cheque floats not presented for encashment.

Total public (Government) debt outstanding at the end of 2014 was K15,355.5 million, K3,735.6 million higher than in 2013. Both domestic and external debts increased over the year. The increase in domestic debt was due to higher net issuance of Treasury bills and Inscribed stocks, while the increase in external debt was mainly influenced by higher net borrowings, combined with the depreciation of the kina. This has resulted in the debt to nominal GDP ratio increasing to 38.8 percent in 2014, compared to 32.7 percent in 2013.