



BANK OF PAPUA NEW GUINEA

MEDIA RELEASE

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Quarterly Economic Bulletin

March Quarter 2015

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

1. UPDATE ON DEVELOPMENTS SINCE MARCH 2015

Global economic activity continues to grow at a slow pace in the first half of 2015, underpinned by supportive - though less accommodative - monetary conditions, a slower pace of fiscal consolidation and lower oil prices. In particular, growth has been strengthening in the United States, after some temporary weakness caused by adverse winter conditions at the beginning of the year, and the United Kingdom, while in Japan it remains tepid. Economic recovery in Europe is gradually becoming more broadly based, supported by the monetary stimulus measures, currency depreciation and low energy prices. The outlook for advanced economies is positive for the remainder of the year, although in Europe it relies on a timely agreement with Greece over financing arrangements.

Emerging market economies continue to experience weak growth. China introduced stimulus measures to support economic activity, with particular focus on boosting household demand and increasing consumption, whilst Russia is still experiencing the effects of the economic sanctions and the fall in oil prices.

The growth divergence between regions is expected to widen in 2015 due to the differing impacts of the recent decline in the prices of oil and other commodities. In particular, oil-importing countries stand to benefit from the lower oil prices in the form of reduced budgetary, balance of payment, and inflationary pressures. In contrast, oil-exporting economies could experience contraction in economic activity and revenue losses, which may require macroeconomic policy adjustments. Ultimately, the impact of lower oil prices depends on country specific factors such as fiscal buffers and cyclical position. The Governor acknowledges the Government's efforts in making adjustments to the 2015 Budget and stresses the need to continue with the policy and structural reforms for improvements to budget implementation and monitoring.

Following the collapse of the international crude oil prices in 2014 from around US\$107 per barrel to around US\$45 per barrel, it is now trading around US\$60 per barrel. According to the Consumer Price Index (CPI) released by National Statistics Office (NSO) for the March quarter 2015, the prices of fuels declined with diesel and petrol declining by 14.8 percent and 12.5 percent, respectively. While the business houses and general consumers of fuels were the beneficiaries, business houses did not pass on the lower prices onto the prices of other goods and services. Such non-transmission or delays in the transmission of lower fuel prices to prices of other goods and services was complicated by the increases in fuel prices in the subsequent months announced by the ICCC. Mr Bakani suggested the ICCC may have to review its process of effecting changes in fuel prices to ensure some adjustments to prices of other goods and service are made by business houses before further announcements on fuel prices are made.

The strong appreciation of the US dollar has led to a major realignment in exchange rates since mid-2014, with some economies experiencing the depreciation of their currencies in excess of 15.0 percent. These currency movements have been driven

by a gradual tightening of monetary policy in the United States, but easing in the Euro area and Japan. The Governor noted that this partly explains the downward pressure on the kina, which depreciated against the US dollar by 3.4 percent in the first quarter of the year. Over the year to 19th June 2015, the daily average kina exchange rate depreciated by 11.0 percent against the US dollar. The Governor added that the depreciation in the exchange rate was also due to shortage of foreign currency liquidity in the domestic market reflecting lower foreign exchange inflows. The Governor urges producers and exporters to take advantage of the weaker kina and increase production and exports. He also advises the Government to prioritise its expenditure and companies to do likewise to reduce and/or defer some of their import needs that are less priority to assist the current situation. Mr Bakani stressed that the current foreign exchange market and exchange rate movements have various implications for the Government, business houses and consumers, and all sectors of the economy should take ownership of the situation and undertake appropriate and necessary adjustments to their operations.

Global inflation remains low largely as a result of the low energy and food prices. However, with the effect of low prices diminishing, the expectation of a recovery in commodity prices and a pick-up in global activity, inflation is projected to accelerate towards the end of the year and into 2016. Inflation trends will differ widely across countries with lower inflation expectations in advanced economies, while additional pressures from exchange rate depreciation is expected to exert inflationary pressures in emerging and developing economies.

Following the issuance of the Foreign Exchange Control Directives on 5th March 2015 by the Bank to ensure a smooth functioning of the foreign exchange market and instill order, a few companies have complied and closed some of their unauthorised offshore foreign currency accounts. This followed instructions given to holders of unapproved offshore foreign currency accounts to close them and remit funds to PNG. The Bank is also undertaking a verification exercise on remittances of export proceeds by exporters of non-mineral commodities. An audit on the opening and operations of domestic foreign currency accounts and Vostro Accounts, and transactions in these accounts, including transfers, by domestic Authorised Foreign Exchange dealers has commenced and is continuing.

The level of gross foreign exchange reserves declined to K5,628.1 (US\$2,085.2) million as at 18th of June 2015, from K5,729.0 (US\$2,164.4) million at the end of March 2015. The decline is due to intervention by the Bank in selling foreign currency to the foreign exchange market. The level is sufficient for 8.9 months of total and 13.5 months of non-mineral import covers.

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

Economic indicators available to the Bank of Papua New Guinea (the Bank) show that growth in economic activity improved slightly in the first quarter of 2015, though it remained weaker than a year ago. There were positive signs of strengthening activity in some non-mineral sectors, whilst the strong growth in the mineral sector continued to be driven by the production of LNG. After declining in the second half of 2014, there was a return to positive growth in employment in the first quarter led by the agriculture/forestry/ fisheries and the manufacturing sectors. This is expected to be reflected early in 2015 in the non-mineral sector sales, which declined in the last quarter of 2014 due to poor commodity prices. However, total sales in 2014 were up from 2013, driven by the commencement of LNG production. In the March quarter of 2015, the weighted average kina price of Papua New Guinea's exports declined by 35.5 percent from the corresponding quarter in 2014. Despite this, the total value of exports was 85.9 percent higher, largely attributed to the export of LNG and related products. The annualized growth of private sector credit was weak at 0.5 percent. A fiscal deficit was recorded during the quarter reflecting lower revenue collection. The annual headline inflation was 6.1 percent in the first quarter of 2015. The Bank continued to take a cautious approach in its monetary policy stance by maintaining the Kina Facility Rate at 6.25 percent.

Data from the Bank's Business Liaison Survey show that the total nominal value of sales in the private sector increased by 0.6 percent in the December quarter of 2014, compared to a decline of 3.2 percent in the September quarter. Excluding the mineral sector, sales declined by 0.6 percent, following a decline of 5.4 percent in the previous quarter. By sector, sales increased in the financial/ business and other services, manufacturing and mineral sectors, while the retail, construction,

transportation, wholesale and the agriculture/forestry/fisheries sectors recorded declines. By region, sales increased in the Highlands, NCD and the Islands regions, whilst they decreased in Morobe, Southern and Momase. In 2014, the total value of sales increased by 4.3 percent, while excluding the mineral sector, sales declined by 7.0 percent.

The Bank's Employment Index shows that the total level of employment in the private sector increased by 1.0 percent in the March quarter of 2015, compared to a decline of 3.0 percent in the December quarter of 2014. Excluding the mineral sector, the level of employment increased by 1.1 percent reflecting growth in the agriculture/forestry/ fisheries, manufacturing, and the financial/ business and other services sectors. The transportation, construction, mineral, retail and the wholesale sectors recorded marginal declines. By region, the level of employment increased in all regions, except for Morobe and the Highlands. Over the year to March 2015, the total level of employment declined by 2.8 percent, while excluding the mineral sector, it declined by 2.7 percent.

Quarterly headline inflation, as measured by the Consumer Price Index, increased by 1.5 percent in the March quarter of 2015, compared to the increase of 1.4 percent in the December quarter of 2014. There were increases in the 'Health', 'Alcoholic Beverages, Tobacco and Betelnut', 'Housing', 'Household Equipment', 'Clothing and Footwear', 'Food and Non-Alcoholic Beverages', 'Restaurants and Hotels' and 'Communications' expenditure groups. The 'Education' expenditure group recorded no change, while the 'Recreation', 'Transport' and 'Miscellaneous' expenditure groups recorded declines. Prices increased in all urban centres, except for Goroka/Mt Hagen/Rabaul. The annual headline inflation to March 2015 was 6.1 percent, compared to 6.6 percent over the year to December 2014. The annual underlying inflation was 5.3 percent for the exclusion-based measure and 4.8 percent for the trimmed-mean measure.

During the March quarter of 2015, the average daily kina exchange rate appreciated against all the major currencies, except for the US dollar. It appreciated against the euro by 7.0 percent to 0.3371, the Australian dollar by 4.9 percent to 0.4829, the pound sterling by 0.9 percent to 0.2509 and the Japanese yen by 0.5 percent to

45.2778. It depreciated against the US dollar by 3.4 percent to 0.3802. These movements resulted in the appreciation of the daily average trade weighted index by 1.9 percent to 36.3.

The weighted average kina price of Papua New Guinea's exports declined by 35.5 percent in the March quarter of 2015, compared to an increase of 1.9 percent in the corresponding period of 2014. There was a decline of 40.7 percent in the weighted average kina price of mineral exports with lower prices for gold, copper, crude oil and cobalt. For agricultural, logs and marine product exports the weighted average kina price declined by 6.0 percent due to lower prices for palm oil, tea, rubber and marine products. Excluding logs, the weighted average kina price of agricultural and marine product exports declined by 10.5 percent in the quarter, compared to the corresponding quarter of 2014. The lower kina export prices reflected weak international commodity prices.

The balance of payments recorded an overall deficit of K210.0 million in the March quarter of 2015, compared to a deficit of K182.0 million in the corresponding period of 2014. The deficit was due to a net outflow in the capital and financial account, which more than offset a surplus in the current account.

The outcome in the current account was due to higher trade surplus, combined with lower service payments and higher transfer receipts. The deficit in the capital and financial account was mainly due to net outflows in other investments, reflecting a build-up in the net foreign assets of the domestic banking sector, foreign currency account balances of resident mineral sector companies and net Government loan repayments.

The level of gross foreign exchange reserves at the end of March 2015 was US\$2,168.4 (K5,770.4) million, sufficient for 9.0 months of total and 13.9 months of non-mineral import covers.

The Central Bank maintained its neutral stance of monetary policy by keeping the monthly Kina Facility Rate (KFR) at 6.25 percent throughout the March quarter of 2015. Although inflation progressively increased in each quarter of 2014, reaching

6.6 percent in the December quarter, the outcomes were considered to be manageable. In addition, the Bank took into account its expectation of lower inflation in 2015.

Domestic interest rates generally declined over the March quarter of 2015, with rates for short-term securities decreasing for all maturity terms. 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 K400.4 million in Treasury bills and K79.0 million in Inscribed stocks.

The average level of broad money supply (M3*) increased by 1.9 percent in the March quarter of 2015, compared to an increase of 2.6 percent in the December quarter of 2014. This outcome was influenced by an increase in average net claims on the Central Government. The average net domestic claims outstanding, excluding net claims on the Central Government, increased by 3.0 percent in the March quarter of 2015, following an increase of 5.1 percent in the December quarter of 2014.

The average level of monetary base (reserve money) decreased by 1.1 percent in the March quarter of 2015, after it increased by 7.9 percent in the previous quarter. This reflected declines in commercial banks' deposits at the Central Bank and currency in circulation.

The average level of deposits in other depository corporations (ODCs) increased by 0.8 percent to K19,930.7 million in the March quarter of 2015, from K19,763.5 million in the previous quarter. This mainly reflected increase in deposits of the private sector, ODCs and public nonfinancial corporations.

The net foreign assets of the financial corporations, which comprise depository corporations (DCs) and other financial corporations (OFCs), increased by 0.1 percent to K8,241.4 million in the March quarter of 2015, compared to a decline of 2.3 percent in the December quarter of 2014. This resulted from an increase in the net foreign assets of ODCs, reflecting foreign exchange inflows from a public asset sale. In spite of the increase, the high demand for foreign currency continued to exert downward pressure on the kina. The Central Bank intervened in the foreign

exchange market to assist in meeting the demand for foreign currency. Net claims on the Central Government increased by K538.3 million to K7,293.0 million in the March quarter of 2015, compared to an increase of K729.8 million in the previous quarter. This resulted from increased issuance of securities by the Government to finance the 2015 Budget.

In the March quarter of 2015, 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 K16.4 million to K14,448.2 million. This compares to an increase of K903.1 million in the previous quarter and was due to an increase of K82.0 million in credit to the private sector, which more than offset a decline of K66.6 million from the public non-financial corporations. The growth in credit to the private sector reflected advances by the ODCs to the 'transport and communication', 'building and construction', 'mining and quarrying', 'hotels and restaurants' and 'real estate, renting and business services' sectors, as well as the household sector for personal loans. The annualised growth in domestic credit, excluding Central Government, was 0.5 percent in the March quarter of 2015.

Preliminary estimates of the fiscal operations of the National Government over the three months to March 2015 showed an overall deficit of K405.1 million, compared to a surplus of K105.2 million in the corresponding period of 2014. This represents 0.8 percent of nominal GDP and reflected lower revenue.

Total revenue, including foreign grants, during the March quarter of 2015 was K1,400.5 million, 30.1 percent lower than the receipts collected in the corresponding period of 2014. This represents 10.1 percent of the budgeted revenue for 2015. The decrease in revenue mainly reflected lower collections in both direct and indirect taxes and non-tax receipts, which more than offset a slight increase in foreign grants.

Total expenditure for the first three months to March 2015 was K1,805.6 million, 4.9 percent lower than in the corresponding period of 2014 and represents 11.2 percent of the budget appropriation for 2015. This outcome reflected lower recurrent expenditure, which more than offset an increase in development expenditure.

As a result of the developments in revenue and expenditure, the Government recorded a budget deficit of K405.1 million. The deficit and net external loan repayments of K63.3 million were financed from domestic sources with K468.4 million. External loan repayments comprised of K32.9 million, K16.3 million and K14.1 million to concessional, commercial and extraordinary sources, respectively. Domestic financing comprised net purchases of Government securities totalling K223.7 million, K285.4 million and K210.4 million by the Central Bank, ODCs and OFCs, respectively. These more than offset K251.1 million payments by other resident sectors, mainly cheques presented for encashment.

Total public (Government) debt outstanding in the March quarter of 2015 was K16,145.2 million, K789.7 million higher than in the December quarter of 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 mainly reflected the depreciation of the kina.

The total amount of Government deposits in the depository corporations decreased by K172.4 million to K4,165.9 million in March 2015, compared to K4,338.3 million in December 2014.