BANK OF PAPUA NEW GUINEA

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Quarterly Economic Bulletin

September Quarter 2016

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

1. UPDATE ON DEVELOPMENTS SINCE SEPTEMBER 2016

In its October World Economic Outlook (WEO), the International Monetary Fund (IMF) reported that global growth slightly weakened in 2016. In the United States (US), growth slowed down as a result of weak export performance attributed to the appreciation of the US dollar, while industrial output declined despite strong consumption and employment growth. Meanwhile, the markets' reaction to the election of Donald Trump as US President was initially mixed. Sentiments stabilized after he softened his hard-line stance on various policy statements he made during the election campaign. In the Euro area, growth was weak on the account of weak investment and domestic demand in the larger Euro area economies such as Spain, Italy and France. Following the initial uncertainty surrounding the Brexit vote, growth in the United Kingdom (UK) stabilized after the Bank of England implemented several stimulus packages to stimulate growth and foster investor confidence. In Japan, despite a weaker yen and significant fiscal stimulus, growth continued to slow because of weak global demand. Growth in the emerging market economies, although mixed, was mainly driven by China and India. China showed signs of improvement due to policy realignment while improvement in India's terms of trade, combined with its effective implementation of fiscal policies, more than offset weaknesses in Brazil and other emerging market economies. Based on these developments, the IMF in its October WEO lowered its global growth forecast to 3.1 percent from its earlier forecast of 3.2 percent made in April 2016.

The Governor noted that the International Monetary Fund commodity price index increased by 4.1 percent, with metal prices increasing by 13.9 percent, agriculture commodities by 2.0 percent and crude oil by 0.4 percent between September and November 2016. There have been similar price increases for some of the commodities throughout 2016. Relating this development to the domestic foreign exchange market, Governor Bakani explained that there have been some good inflows of foreign exchange in recent months. Total inflows for the year was US$4,417.7 (K13,870.7) million. On top of this, the Central Bank intervened with US$410.6 (K1,353.2) million. Total outflows for the year was US$4,721.9 (K14,823.5) million. The amount of foreign exchange inflow together with the Central Bank's intervention should have cleared a lot of the back log of import payment orders.

The foreign exchange inflows came from the mining sector following the resumption of production at the Ok Tedi mine, the recovery in the agriculture export sector after the end of the El Nino drought in the first quarter of the year, and from other sectors such as finance & business, and forestry. Generally, total outstanding sell orders in the spot market have declined.

The good inflows have resulted in the relative stability of the kina exchange rate at US$0.3160 in June 2016 to US$0.3150 as at 30th December 2016. The Governor reiterated the call for exporters to utilize the benefit of the low kina exchange rate to increase production and exports in efforts to raise needed foreign exchange. Given the substantial depreciation of the kina exchange rate of around 37 percent since April 2012 to December 2016, the Bank does not believe any further large depreciation of the kina would clear the foreign exchange market, but rather increase inflationary pressures. Mr. Bakani emphasized that while any further depreciation of the kina would be beneficial to few exporters, the effects on prices for consumer items would be harmful for the whole population. This is already evident with the annual inflation rate to September 2016 of 6.8 percent, compared to 6.5 percent in March 2016.

Governor Bakani explained that the Authorised Foreign Exchange Dealers (AFEDs) had used some of the foreign exchange inflows in the spot market and funds in the onshore foreign currency accounts to fund trade finance loans. This has resulted in orders in the spot market not being cleared quickly. The Bank of PNG noted the following non-compliance with Exchange Control Regulations:

- Trade Finance loans offered by AFEDs to their clients were not approved by the Central Bank;
- Contracts made in foreign currency by two resident entities were not approved by the Central Bank;
- Settlements of these contracts in foreign currency by two resident entities were not made in kina; and
- Opening of FCAs by AFED's for residents were not based on proper guidelines.

To address these issues and improve the functioning of the foreign exchange market, the Governor issued a set of Directives at the end September 2016 and subsequent ones in October and November as follows.

- All 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 transactions. 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 Forward 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.
- Remittances abroad from the FCAs have to be approved by the Central Bank until decisions on the maintenance of otherwise of the FCAs are completed.

The assessment of onshore FCAs has been completed and the commercial banks are being notified whether or not their clients will continue to maintain these accounts. The processing of applications by the Central Bank for offshore remittances from the FCAs also ceased after the decisions on the maintenance on the FCAs are conveyed to the AFEDs. AFEDs can then process applications for remittances.

In regard to the fiscal operations of the National Government, Mr Bakani explained that both revenue and expenditure have been lower than budgeted for 2016, with the decline in revenue more substantial due to low commodity prices and low tax collections. The Government is commended for its timely action in introducing a supplementary budget in August 2016 to address the budgetary situation and tighten up on expenditure. The planned external financing through a debut sovereign bond of US$500 million did not eventuate while only the first tranche (US$200 million) of the Credit Suisse loan was obtained, with the balance of US$300 million expected in January 2017. Because of the limited external financing of the budget deficit, most of the financing was through the issuance of Government securities. The market appetite for these securities was limited, especially in the second half of the year. Therefore, the Central Bank had to assist the Government by picking up some of the under-subscriptions at the auctions. For monetary policy purpose and to promote the development of the secondary market for Government securities, the Bank of PNG plans to on-sell these securities through the TAP facility, starting in January/February 2017.

Governor Bakani urges all revenue raising Government agencies to improve on their efforts in revenue collections in 2017. He also iterated his call for Government Departments and agencies to live within their means while maintaining critical services for the public.

The level of foreign exchange reserves as of 30th December 2016, was K5,266.9 (US$1,685.4) million, compared to K5,467.5 (US$1,725.1) million at the end of September 2016.

OVERVIEW OF THE DEVELOPMENTS IN THE SEPTEMBER QUARTER OF 2016

Economic indicators available to the Bank of Papua New Guinea (the Bank) point to a slowdown in business activity in the September quarter of 2016. Prices for most agricultural exports improved while for key mineral, petroleum and gas commodities, prices continued to be low. Government revenue and expenditure for the nine months to September were lower than budgeted. With the improvement in prices of some of the export commodities, and good production of a few commodities, and lower actual import payments, the balance of payments recorded a surplus for the nine months to September 2016, compared to a deficit for the corresponding period of 2015. The lower than budgeted government expenditure and lower import payments affected business activity and led to a marginal decline in the level of employment in the private sector, following positive growth in the previous two quarters. With some improvements in the foreign exchange inflows from the agriculture and mining industry, the kina exchange rate stabilized against the US dollar and some other key currencies over the quarter, while it depreciated against Japanese yen. The Trade Weighted Index (TWI) declined by 1.7 percent to 30.19 in the quarter. Annual headline inflation was 6.8 percent in the September quarter of 2016, mainly driven by volatile prices of seasonal items. However, the underlying inflation measures continue to remain low. The Central Bank continued to take a cautious approach by maintaining its neutral stance of monetary policy and keeping the Kina Facility Rate (KFR) at 6.25 percent over the September quarter of 2016.

Data from the Bank's Business Liaison Survey (BLS) show that the total nominal value of sales in the private sector increased by 15.7 percent in the June quarter of 2016, compared to a decline of 4.0 percent in the March quarter. Excluding the mineral sector, sales increased by 10.6 percent following a decline of 7.5 percent in the previous quarter. By sector, sales increased in the agriculture/forestry/fisheries, construction, manufacturing, mineral, wholesale and retail sectors, while it declined in the finance/business and other services, and transportation sectors. By region, sales increased in the Southern, Momase, Islands and Morobe while it declined in the Highlands and NCD. Over the year to June 2016, sales declined by 3.2 percent, while excluding the mineral sector, it declined by 0.8 percent.

The Bank's Employment Index shows that the level of employment in the private sector marginally declined by 0.7 percent in the September quarter of 2016, compared to an increase of 2.1 percent in the June quarter. Excluding the mineral sector, the level of employment declined by 1.0 percent, compared to an increase of 2.3 percent in the previous quarter. By sector, employment declined in the transportation, agriculture/forestry/fisheries, manufacturing, and financial/business and other services sectors, while it increased in the mineral, construction, wholesale and retail sectors. By region, employment declined in the Southern, Highlands, Morobe and NCD, while it increased in Momase. There was no change in the Islands region. Over the twelve months to September, the total level of employment declined by 1.0 percent, while excluding the mineral sector, it declined by 1.5 percent.

Quarterly headline inflation, as measured by the Consumer Price Index (CPI), increased by 1.7 percent in the September quarter of 2016, compared to an increase of 1.4 percent in the June quarter of 2016. Most expenditure groups recorded increases, which more than offset declines in the 'Transport' and 'Miscellaneous' expenditure groups. There were no changes for the 'Communication', 'Education' and 'Clothing and Footwear' expenditure groups. By urban centre, prices increased in all the centres. The annual headline inflation to September 2016 was 6.8 percent, the same as in the June quarter, and compared to 6.5 percent in the March quarter.

During the September quarter of 2016, the average daily kina exchange rate depreciated against the yen by 0.1 percent to 34.2366 and appreciated against the pound sterling by 0.1 percent to 0.2214. It remained unchanged against the Australian dollar, Euro and the US dollar at 0.4257, 0.2811, and 0.3172, respectively. These movements resulted in the daily average TWI declining by 1.7 percent to 30.19 in the quarter.

The weighted average kina price of Papua New Guinea's export commodities, excluding LNG, increased by 10.0 percent in the September quarter of 2016, compared to the corresponding quarter of 2015. There was a decline of 11.6 percent in the weighted average kina price of mineral exports, with lower kina prices for copper and crude oil. For agricultural, logs and marine product exports, the weighted average kina price increased by 5.6 percent, due to higher kina prices of all agricultural commodities, except for rubber and marine products. Excluding logs, the weighted average kina price of agricultural and marine product exports increased by 5.9 percent in the September quarter, from the corresponding quarter of 2015. The overall increase in kina export price stemmed from higher international prices for some of PNG's export commodities.

There was an overall surplus of K240 million in the balance of payments for the nine months to September 2016, compared to a deficit of K394 million in the corresponding period of 2015. A higher surplus in the current account more than offset a deficit in the capital and financial account.

The current account recorded a surplus of K11,520 million for the nine months to September 2016, compared to a surplus of K9,169 million in the corresponding period of 2015. This was due to a higher trade account surplus and net transfer receipts, combined with lower service and income payments.

The capital and financial account recorded a deficit of K11,170.6 million for the nine months to September 2016, compared to a deficit of K10,799.0 million in the corresponding period of 2015. The outcome was due to net outflows in portfolio and other investments reflecting investments in short term money market instruments and build up in net foreign assets of commercial banks, and foreign currency account balances of resident mineral companies, respectively. These more than offset inflows from net Government loan drawdowns.

The level of gross foreign exchange reserves at the end of September 2016 was K5,467.5 (US$1,725.1) million, sufficient for 11.9 months of total and 20.4 months of non-mineral import covers.

The Central Bank maintained its neutral stance of monetary policy by keeping the policy signaling rate, the Kina Facility Rate (KFR) at 6.25 percent during the

September quarter of 2016. The Central Bank is mindful that annual headline inflation has slowly crept up, averaging 6.7 percent over the first three quarters of the year. It will closely monitor this development and may change its monetary policy stance when necessary.

The average level of broad money supply (M3*) increased by 5.1 percent in the September quarter of 2016, compared to an increase of 1.8 percent in the June quarter of 2016. There were increases in average net claims on the Government, and credit to other financial corporations (OFCs), public non-financial corporations from increased lending to state owned enterprises, and to the private sector. The average net domestic claims outstanding, excluding net claims on the Central Government, increased by 1.7 percent in the September quarter of 2016, following an increase of 1.2 percent in the June quarter of 2016. The average level of monetary base (reserve money) increased by 0.2 percent in the quarter, compared to an increase of 4.8 percent in the June quarter. This was mainly influenced by the increase in currency in circulation, offsetting a decline in commercial banks' deposits at the Central Bank

The average level of deposits at other depository corporations (ODCs) increased by 2.7 percent to K22,414.3 million in the quarter, from K21,816.7 million in the June quarter. This reflected increases in deposits of OFCs, public non-financial corporations, and other resident sectors, more than offsetting a decline in Government deposits during the quarter.

The net foreign assets (NFA) of the financial corporations, comprising depository corporations (DCs) and OFCs, increased by 2.4 percent to K6,977.1 million in the September quarter, compared to a decline of 4.8 percent in the June quarter. This resulted from an increase in the NFA of the Central Bank, which more than offset a decline in the NFA of ODCs. The increase at the Central Bank reflected the drawdown of an external commercial loan. This assisted the Central Bank in its interventions to meet some of the import demand in the foreign exchange market.

In the September quarter of 2016, total domestic credit extended by financial corporations to the private sector, public non-financial corporations and 'Provincial and Local level Governments' increased by K339.6 million to K16,510.1 million, compared to an increase of K335.9 million in the previous quarter. This was mainly due to an increase of K219.5 million in credit to the private sector and K119.8 million in credit to the public non-financial corporations. The annualised growth in domestic credit, excluding Central Government, was 7.8 percent in the September quarter of 2016, compared to 7.1 percent in the June quarter.

Preliminary estimates of the fiscal operations of the National Government over the nine months to September 2016 show an overall deficit of K1,356.2 million, compared to a deficit of K1,940.1 million in the corresponding period of 2015. This represents 2.0 percent of nominal GDP.

Total revenue, including foreign grants, over the nine months to September 2016 was K7,623.5 million, 2.2 percent higher than in the corresponding period of 2015. This represents 65.0 percent of the revised budgeted revenue for 2016. The increase in revenue mainly reflected higher tax receipts, which more than offset a decline in non-tax receipts.

Total expenditure over the nine months to September 2016 was K8, 979.7 million, 4.4 percent lower than in the corresponding period of 2015 and represents 64.9 percent of the revised appropriation for 2016. This outcome reflected both lower recurrent and development expenditures.

The budget deficit of K1,356.2 million was financed mainly from domestic sources totalling K1,502.2 million, as there was a net external loan repayment of K146.0 million. Domestic financing comprised net purchase of Government securities totalling K528.4 million by the Central Bank, K1,572.4 million by the ODCs, K81.2 million by OFCs and K96.7 million by Public Non-Financial Corporations. These also accounted for the payments for cheque floats totalling K776.5 million to other sectors.

Total public (Government) debt outstanding in the September quarter of 2016 was K19, 440.7 million, K182.5 million higher than in the June quarter of 2016. Domestic loans increased while external loans decreased. The increase in domestic debt was largely attributed to net new issuance of Government securities, while the decrease in external debt reflected loan repayments.

The total amount of Government deposits at the depository corporations increased by K146.2 million to K2,652.7 million in September 2016, compared to June 2016.