BANK OF PAPUA NEW GUINEA

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Quarterly Economic Bulletin
September Quarter 2017

Mr. Loi M. Bakani, Governor of the Bank of Papua New Guinea (Bank of PNG), today released the September 2017 Quarterly Economic Bulletin (QEB). This statement provides an overview of the economic and financial developments during the September quarter 2017 and some key developments since then.

1. UPDATE ON DEVELOPMENTS SINCE SEPTEMBER 2017

Global economic growth strengthened in 2017, with stronger growth in the euro area, Japan, United States (US) and Canada, and broad growth in the emerging Asian and European economies. In the US, economic activity improved due to more business investments which were partly attributed to the recovery in the energy sector. In Japan, economic growth continues to be supported by increased business spending, buoyant exports, and increased activity in tourism and trade. In contrast, economic activity slowed down in the United Kingdom (UK) amidst uncertainties surrounding the Brexit arrangement. In the emerging market economies, growth is driven by China, reflecting high domestic demand combined with improvement in global demand, while in other emerging market economies such as Brazil and other East Asian economies, higher external demand continued to drive growth. In India, growth slowed as a result of the implementation of the Goods and Services Tax (GST) and currency demonetisation initiative. Based on these developments, the International Monetary Fund (IMF), in its October 2017 World Economic Outlook, raised its global growth forecast to 3.6 percent from its earlier forecast of 3.5 percent made in July 2017.

Governor Bakani stated that up to November 2017, prices for some of Papua New Guinea's export commodities continued to improve. Prices for crude oil, nickel, cocoa and copper increased by 12.4 percent, 6.7 percent, 6.5 percent and 3.8 percent, respectively whilst those for Liquefied Natural Gas (LNG), coffee, gold and tea declined by 3.9 percent, 3.7 percent, 2.4 percent and 0.9 percent, respectively. The Governor added that there was an increase in foreign exchange inflows from export proceeds.

Governor Bakani noted that the National Government's 2018 Budget has a planned expenditure of K14,717.9 million, and a revenue of K12,731.0 million, giving a fiscal deficit of K1,987.2 million or 2.48 percent of Gross Domestic Product (GDP). The deficit will be financed from both external and domestic sources of K1,613.4 million and K373.8 million, respectively. The domestic financing component of the deficit will be from the issuance of Government Treasury Bills and Government Bonds, whilst external financing will be sought from several international organisations, including the World Bank, Asian Development Bank and concessional loans from other development partners. The Government's financing strategy to relieve the domestic market of funding pressures by introducing a financing mix away from the domestic market towards external financing is commendable. These would also provide the much needed foreign currency to support the domestic foreign exchange market.

Following the approval of the 2018 Budget by Parliament, Governor Bakani reiterated that all efforts should be focused on ensuring the external funding of the budget be realised early in 2018. This mainly includes the concessional project funding from the Asian Development Bank (ADB) and the World Bank under the International Development Assistance (IDA)18. He emphasised that PNG should not repeat the past experiences whereby concessional funding from the World Bank under IDA17 was not fully utilised. The Governor also stressed that work should start early in 2018 to realise the drawdown of the remaining balance of the Credit Suisse Syndicate loan and the issuance of the Sovereign Bond as budgeted.

Speaking on inflation, the Governor noted that despite the high levels of global liquidity, global inflation continues to remain low. This is good for PNG and has been reflected in lower annual headline inflation outcomes since September 2016 and for the past three quarters of 2017. However, the Governor notes that despite lower headline inflation outcomes, underlying inflation measures, whilst still low, are slowly increasing as companies start to pass on the effect of the kina depreciation to domestic prices. Given these developments, the Bank of Papua New Guinea (the Bank) will continue to monitor key economic variables to ensure that macroeconomic and price stability is maintained. This remains the primary focus of the Central Bank.

From the end of September to the 31st of December 2017, the average daily kina exchange rate depreciated against all major currencies, except the Australian dollar and the euro. It depreciated against the pound sterling by 3.3 percent to £0.2341, the yen by 1.9 percent to ¥35.1235 and the US dollar by 0.8 percent to US$0.3113. Against the Australian dollar and the euro, it appreciated by 1.8 percent to A$0.4050 and 0.1 percent to €0.2676, respectively. These currency movements resulted in the Trade Weighted Index (TWI) appreciating by 0.04 percent to 30.0082 in the December quarter of 2017.

Good foreign exchange inflows and the Bank's intervention of US$100m under the Government's 100 Day Plan assisted the foreign exchange market in the December quarter of 2017. Inflows from the mining, petroleum, agriculture, forestry, manufacturing, retail and fisheries sectors were used to clear import orders in the spot foreign exchange market. Additionally, the crude oil purchase agreement between Puma Energy Ltd (Puma) and Oil Search Ltd (OSL), in which Puma would purchase fifty percent of crude oil in kina from OSL, is expected to ease the burden on and contribute to the overall improvement in the foreign exchange market. These developments helped ease the demand pressure from the private sector and the Bank to maintain a steady level of foreign reserves.

As of 31st December 2017, the level of foreign exchange reserves was K5,463.3 (US$1,718.3) million, compared to K5,573.2 (US$1,769.5) million at the end of September 2017.

2. OVERVIEW OF THE DEVELOPMENTS IN THE SEPTEMBER QUARTER OF 2017

Economic indicators available to the Bank of Papua New Guinea (the Bank) point to a slight improvement in domestic economic activity in the September quarter of 2017. Higher international commodity prices and exports of some commodities, higher Government expenditure and a marginal increase in private sector lending supported this growth. The improvement in commodity prices and exports resulted in a higher balance of payments surplus for the nine months to September 2017, compared to the corresponding period of 2016. The resulting increase in inflows of foreign exchange was minimal as a significant portion of the LNG and mineral export receipts are kept in offshore foreign currency accounts. The kina depreciated against all major currencies, except the Japanese yen. As a result, the TWI decreased by 2.85 percent to 29.99 in the September quarter of 2017. Prices of seasonal items fell and resulted in annual headline inflation easing further to 5.1 percent in September quarter from 5.8 percent in June quarter 2017. The Central Bank therefore, continued to maintain a neutral monetary policy by keeping the monthly Kina Facility Rate (KFR) at 6.25 percent over the September quarter of 2017.

Data from the Bank's Business Liaison Survey (BLS) show that the total nominal value of sales in the private sector increased by 3.3 percent in the June quarter of 2017, compared to a decline of 2.0 percent in the March quarter of 2017. Excluding the mineral sector, sales fell by 4.1 percent, compared an increase of 1.5 percent in the previous quarter. By sector, sales increased in the mineral and financial/business and other services sectors, while it declined in the rest of the sectors. By region, sales increased in the Islands, Highlands, Morobe and Momase (excluding Morobe) regions while it declined in the Southern (excluding NCD) region and NCD. Over the year to June 2017, total sales increased by 14.2 percent, compared to an increase of 1.1 percent in the corresponding period of 2016, while excluding the mineral sector, sales increased by 9.5 percent, compared to an increase of 7.9 percent in the corresponding period of 2016.

The Bank's Employment Index shows that the total level of employment in the formal private sector declined by 0.7 percent in the September quarter of 2017, compared to a decline of 1.3 percent in the June quarter of 2017. Excluding the mineral sector, the level of employment fell by 1.2 percent in the quarter, compared to a decline of 1.5 percent in the June quarter. By sector, employment decreased in the construction, manufacturing, agriculture/forestry/fisheries, transportation, retail and financial/business and other services sectors, which more than offset increases in the mining and wholesale sectors. By region, employment declined in the Southern, NCD and Islands regions, while it increased in the Highlands, Morobe and Momase regions. Over the year to September 2017, the total level of employment declined by 3.2 percent, compared to a decline of 1.0 percent over the corresponding period of 2016. Excluding the mineral sector, employment declined by 4.5 percent, compared to a decline of 1.3 percent in the corresponding period of 2016.

Quarterly headline inflation, as measured by the Consumer Price Index (CPI), increased by 1.0 percent in the September quarter of 2017, compared to an increase of 1.2 percent in the June quarter. All expenditure groups recorded price increases except for the 'Transport', Communication' and 'Education' expenditure groups, all of which recorded no change. By urban centre, prices increased in all the surveyed centres. Annual headline inflation was 5.1 percent over the year to September quarter 2017, compared to 5.8 percent over the year to June quarter of 2017.

In the September quarter of 2017, the US dollar depreciated against the euro by 7.2 percent, the Australian dollar by 5.8 percent and the British pound sterling by 3.4 percent, while it appreciated against the Japanese yen by 18.2 percent. The US dollar weakened due to improved economic conditions in the euro area and Australia, and slower growth in the US. During the September quarter of 2017, the average daily kina exchange rate depreciated against all major currencies, except the yen. It depreciated against the euro by 6.6 percent to €0.2674, the Australian dollar by 5.1 percent to A$0.3967, the pound sterling by 2.0 percent to £0.2421 and the US dollar by 0.2 percent to US$0.3139. It appreciated against the yen by 2.4

percent to ¥35.7993. These currency movements resulted in the TWI depreciating by 2.85 percent to 29.99 in the September quarter of 2017.

The weighted average kina price of Papua New Guinea's export commodities, excluding LNG, increased by 21.5 percent in the September quarter of 2017, compared to the corresponding quarter of 2016. There was an increase of 13.8 percent in the weighted average price of mineral exports, reflecting higher kina prices for all mineral commodities. For agricultural, logs and marine product exports, the weighted average kina price increased by 8.3 percent, due to higher prices of all agricultural commodities, except for cocoa, coffee and palm oil. Excluding logs, the weighted average kina price of agricultural and marine product exports increased by 8.7 percent in the September quarter, from the corresponding quarter of 2016. The increase in kina export prices reflected improved international prices for some of PNG's export commodities, combined with the price effect of the kina's depreciation against the US dollar.

There was an overall surplus of K327 million in the balance of payments for the nine months to September 2017, compared to a surplus of K241 million in the corresponding period of 2016. A surplus in the current account more than offset a deficit in the capital and financial account.

The current account recorded a surplus of K13,935 million for the nine months to September 2017, compared to a surplus of K11,229 million in the corresponding period of 2016. This was due to a higher trade account surplus and net transfer receipts, which more than offset service and income payments.

The capital and financial account recorded a deficit of K13,639 million in the nine months to September 2017, compared to a deficit of K10,971 million in the corresponding period of 2016. The outcome was due to net outflows in direct, portfolio and other investments reflecting withdrawal of equity and investments in short term money market instruments, and build up in offshore foreign currency account balances of resident mineral companies under the Project Development Agreement, respectively.

The level of gross foreign exchange reserves at the end of September 2017 was K5,573.2 (US$1,769.5) million, sufficient for 5.6 months of total and 9.0 months of non-mineral import cover.

In determining the stance of policy, the Central Bank considered the continued downward trend in annual headline inflation and the relative stability in other macroeconomic indicators and therefore maintained its neutral stance of monetary policy. As a result, the KFR was maintained at 6.25 percent during the September quarter of 2017.

The Bank utilised its Open Market Operation (OMO) instruments in the conduct of monetary policy to manage liquidity during the September quarter of 2017. Liquidity continued to remain high in the banking system. There was a net Central Bank Bill (CBB) issuance of K137.0 million during the quarter. The Government also made a net issuance of K1.9 million in Treasury bills and K135.9 million in Treasury bonds during the period for budget financing. 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 1.3 percent in the September quarter of 2017, compared to a marginal decline in the June quarter. This outcome was due to increases in average net foreign assets and net domestic claims of 4.4 percent and 0.8 percent, respectively. The average net domestic claims outstanding, excluding net claims on the Central Government, increased by 0.9 percent in the September quarter of 2017, compared to a decrease of 0.4 percent in the June quarter of 2017. The average level of monetary base (reserve money) increased by 0.4 percent during the quarter, following a decline of 1.9 percent in the June quarter of 2017. This reflected an increase in commercial banks' deposits at the Central Bank.

The NFA of the financial corporations, comprising depository corporations (DCs) and other financial corporations (OFCs), increased by 8.5 percent to K7,522.1 million in the September quarter of 2017, compared to a decrease of 6.5 percent in the previous quarter. There were increases in the NFA of both the Central Bank and ODCs. The increase in NFA of the Central Bank reflected foreign exchange inflows related to mineral sector dividend and tax receipts during the quarter. The increase in the ODCs reflected an increase in foreign exchange inflows during the period. Net claims on the Central Government by financial corporations increased by K212.2 million to K13,114.2 million in the September quarter of 2017, compared to an increase of K306.7 million in the previous quarter. This resulted from new issuance of Government securities, particularly Treasury bonds, for budget financing.

In the September quarter of 2017, total domestic credit extended by financial corporations to the private sector, public non-financial corporations and 'Provincial and Local level Governments' increased by K93.7 million to K16,502.5 million, compared to an increase of K98.7 million in the previous quarter. This was influenced by an increase of K109.2 million in credit to the private sector. The increase in credit to the private sector resulted from advances by ODCs to the 'retail trade', 'transport and communication', 'wholesale trade' and 'finance' sectors.

The fiscal operations of the National Government over the nine months to September 2017 show a deficit of K894.6 million, compared to the deficit of K542.5 million in the corresponding period of 2016. This represents 1.2 percent of nominal GDP.

Total tax revenue amounted to K6,278.0 million, 9.4 percent higher than in the same period in 2016 and represents 70.8 percent of the total revised amount for 2017. Direct tax receipts totalled K3,913.1 million, 0.5 percent lower than in 2016 and represents 67.3 percent of the total revised amount. The decline in direct tax reflected lower company tax which more than offset the increase in personal and other direct taxes. The decline in company tax was partly associated with downward variations in provisional tax instalments due to low economic activity, and low mining and petroleum taxes. The increase in personal tax reflected improved lodgements and payments as a result of increased compliance.

The deficit of K894.6 million was financed from domestic sources totalling K1,990.5 million, while there was a net repayment of external loans totalling K1,095.9 million. Total public (Government) debt outstanding as at September 2017 was K23,856.7 million, an increase of K969.9 million from June 2017.

The total amount of Government deposits at depository corporations decreased by K67.9 million to K2,174.4 million in September 2017, compared to June 2017.