BANK OF PAPUA NEW GUINEA

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Quarterly Economic Bulletin
March Quarter 2018

Mr. Loi M. Bakani CMG, Governor of the Bank of Papua New Guinea (Bank of PNG), today released the March 2018 Quarterly Economic Bulletin (QEB). This statement provides an overview of the economic and financial developments during the March quarter of 2018 and some key developments since then.

1. UPDATE ON DEVELOPMENTS SINCE MARCH 2018

Global economic growth is expected to remain strong in 2018 maintaining the momentum from 2017, despite the effect of the protectionist trade policies of the US and China on trade and investment, and tightening of financial conditions as major central banks remove policy accommodation to deal with inflation. Growth in the United States (US) has shown improvements in the second quarter attributed to strong gains in personal income and higher personal consumption, fixed investment and an expansionary fiscal policy. In the euro area, growth is expected to be supported by higher final consumption and increase in investments. In the United Kingdom (UK), growth is expected to continue mainly driven by the service sector, whilst growth in Japan is expected to moderate. Emerging market economies continue to recover as commodity prices continue to improve, which is expected to strengthen consumer demand and investment. China's growth remains solid with continuing rebalancing despite a slowdown in investment, while higher exports and a pickup in investment are driving growth in India.

Global inflation is expected to increase in advanced economies in 2018 mainly attributed to higher oil prices. In response to the pickup in inflation, advanced economies are moving away from monetary policy accommodation which seems to be having some tightening effect on global financing conditions. The feed through effect of global inflation combined with the depreciation of the kina exchange rate, have impacted domestic core inflation measures which started to increase. The Governor mentioned that headline inflation in PNG continues to be driven by lower prices of seasonal items, resulting in the downward trend. However, he noted that the Bank is mindful of the increase in underlying measures as they are indicative of a build-up in inflationary pressures. The Bank of PNG's monthly Retail Price Index (RPI) for May 2018 also show this increasing trend in the underlying inflation measures. The Governor mentioned that the Bank will continue to closely monitor these developments to ensure that price stability is maintained.

Governor Bakani noted that international commodity price data from the Word Bank published in April, showed a broad-based improvement in the prices of major export commodities driven by both global demand and supply constraints. Price indices of energy, non-energy and precious metals increased by 19.8 percent, 4.1 percent and 2.8 percent, respectively. Higher energy prices reflected an increase in Liquefied Natural Gas (LNG) by 13.4 percent and crude oil prices by 10.0 percent, whilst the increase in non-energy price index was a result of higher prices for coffee, cocoa, logs and rubber. The increase in the precious metal price indices was attributed to higher prices for gold by 4.0 percent and silver by 2.0 percent. Given favourable prices of some export commodities, Papua New Guinea (PNG) exporters should take full advantage of price improvements and increase production.

With improvements in the international commodity prices and the recommencement of production of two major mines and the LNG project following the earthquake in February 2018, foreign exchange inflows have improved significantly. In July, foreign exchange inflows had reached the levels of 2017 mainly reflecting higher production by OK Tedi and Porgera mines and the LNG project, coupled with the commencement of corporate tax payments to the Government by the operator of PNG LNG project. In addition, the final drawdown of US$190 million of the Credit Suisse Syndicate Loan in June 2018 also assisted in providing the necessary foreign exchange. Other inflows expected in the coming years include the Budget support loans from the Asian Development Bank (ADB) and the World Bank. The first component of ADB loan of US$100 million is being drawn down in August, while the US$150 million of the World Bank loan is expected to be drawn down after the approval by the World Bank Board. Out of the Credit Suisse loan, a total of US$143.8 million was used by BPNG to intervene in the foreign exchange market. The Bank plans to utilise future inflows to support and clear import orders.

The Governor urges the cooperation of the private sector for firms to act responsibly, including the foreign exchange dealers, in ensuring that only current import orders are brought to the market and companies to refrain from front-loading future import orders. The Bank anticipates that foreign exchange inflows will continue to improve to reduce this imbalance and current import orders should be met at a reasonable timeframe.

Between the March and June quarters of 2018, the average daily kina exchange rate appreciated against all major currencies except the US dollar and the Japanese yen, which remained unchanged. It appreciated against the Australian dollar by 3.1 percent to A$0.4050, euro by 2.4 percent to €0.2573 and the pound sterling by 1.6 percent to £0.2254. The US dollar depreciated by 0.7 percent to US$0.3066, while the yen remained unchanged at ¥33.4677. These currency movements resulted in the Trade Weighted Index (TWI) appreciating by 1.18 percent to 29.23 over the June quarter of 2018.

As at the end of June 2018, the level of foreign exchange reserves was K5,598.9 (US$1,730.1) million, compared to K5,564.6 (US$1,713.9) million at the end of March 2018.

2. OVERVIEW OF THE DEVELOPMENTS IN THE MARCH QUARTER OF 2018

Economic indicators available to the Bank of Papua New Guinea point to a decline in economic activity in the March quarter of 2018, mainly due to the temporary shutdown of the LNG production facilities and two major mines, following the 7.5 magnitude earthquake in February 2018. Economic activity in the non-mineral private sector was subdued in the quarter despite improvement in private sector lending and prices of some export commodities, and higher Government expenditure. The loss of LNG and gold production resulted in lower export values and led to a lower trade surplus in the quarter. During the quarter, the kina depreciated against all major currencies, resulting in the TWI declining by 3.7 percent from 30.0 to 28.9. The price effect of the depreciation of the kina was more than offset by declines in prices of seasonal items, resulting in the easing of quarterly headline inflation to 1.0 percent in the March quarter of 2018, from 1.3 percent in the previous quarter. On an annual basis, headline inflation eased to 4.5 percent in March quarter, compared to 6.0 percent in the March quarter of 2017. In consideration of the downward trend in annual headline inflation from a quarterly average of 6.7 percent in 2016 to a quarterly average of 5.4 percent in 2017, and the Bank's expectation of headline inflation to be around 5.0 percent in 2018, the Bank maintained a neutral monetary policy stance by keeping the Kina Facility Rate (KFR) at 6.25 percent throughout the first quarter of 2018.

Governor Bakani noted that data from the Bank's Business Liaison Survey (BLS) show that the total nominal value of sales in the formal private sector increased by 5.6 percent in the December quarter of 2017, compared to a decline of 1.1 percent in the September quarter of 2017. Excluding the mineral sector, sales increased by 6.5 percent in the December quarter, compared to a decline of 4.9 percent in the previous quarter. By sector, sales increased in all sectors. By region, sales increased in all the regions except the Southern region, which excludes the National Capital District (NCD). Over the year to December 2017, total sales declined by 10.9 percent, compared to an increase of 30.9 percent in the corresponding period of 2016. Excluding the mineral sector, sales declined by 5.1 percent, compared to an increase of 25.1 percent in the corresponding period of 2016.

The Bank's Employment Index shows that the level of employment in the formal private sector increased by 0.3 percent in the March quarter of 2018, compared to a decline of 2.3 percent in the December quarter of 2017. Excluding mineral sector, the level of employment increased by 0.2 percent. By sector, the level of employment increased in the wholesale, agriculture/forestry/fishery, mineral, construction and financial/business and other services sectors, while it declined in the manufacturing, transportation and retail sectors. By region, the level of employment increased in all regions, except Morobe and NCD. Over the year to March 2018, total employment declined by 4.6 percent, compared to an increase of 0.1 percent in the corresponding period of 2017. Excluding the mineral sector, employment declined by 5.5 percent over the year to March 2018, compared to a decline of 0.4 percent in the corresponding period of 2017.

The Governor mentioned that quarterly headline inflation, as measured by the Consumer Price Index (CPI), increased by 1.0 percent in the March quarter of 2018, compared to an increase of 1.3 percent in the December quarter of 2017. There were price increases for all expenditure groups, except for the 'Alcoholic Beverages, Tobacco and Betelnut' expenditure group, which recorded a decline. By urban centre, prices increased in all the surveyed centres. Annual headline inflation was 4.5 percent over the year to March 2018, compared to 4.7 percent over the year to December 2017.

During the March quarter of 2018, the daily average kina exchange rate depreciated against all the major currencies. It depreciated against the euro by 6.1 percent to €0.2513, pound sterling by 5.3 percent to £0.2218, yen by 4.7 percent to ¥33.4613, Australian dollar by 3.0 percent to A$0.3928 and the US dollar by 0.8 percent to US$0.3088.

The Governor noted that the weighted average kina price of Papua New Guinea's exports, excluding LNG, increased by 17.4 percent in the March quarter of 2018, compared to the corresponding quarter of 2017. There was an increase of 22.2 percent in the weighted average kina price of mineral exports. For agricultural, logs and marine product exports, the weighted average kina price increased by 1.8 percent, due to higher kina prices for logs and marine products. Excluding logs, the weighted average kina price of agricultural and marine product exports increased by 1.4 percent in the March quarter of 2018, compared to the corresponding quarter of 2017. The higher kina export price reflected improvements in international commodity prices, combined with the price effect of the depreciation of the kina against the US dollar.

The balance of payments recorded an overall deficit of K177 million in the March quarter of 2018, compared to a surplus of K369 million in the corresponding period of 2017. A deficit in the capital and financial account more than offset a surplus in the current account.

The current account recorded a higher surplus of K4,397 million in the quarter, compared to K4,316 million in the corresponding quarter of 2017. This was due to a higher trade surplus and transfer receipts, combined with lower service and income payments.

The capital and financial account had a higher deficit of K4,574 million in the quarter, compared to K3,945 million in the corresponding quarter of 2017. The outcome was due to net outflows in portfolio and other short term money market investments, and a build-up in offshore foreign currency account balances of mineral companies. This more than offset net inflows from direct investments reflecting intercompany financing of resident entities.

The level of gross foreign exchange reserves at the end of March 2018 was K5,397.5 (US$1,686.7) million, sufficient to cover 5.1 months of total and 8.9 months of non-mineral imports.

Mr. Bakani indicated that the downward trend in headline inflation was mainly due to lower prices for betelnut and fruit and vegetables. However, underlying inflation measures have been slowly trending upwards since September 2016. Considering the inflation outcomes and improvement in some key macroeconomic indicators, the Bank of Papua New Guinea adopted a cautious approach and maintained a neutral stance of policy by keeping the KFR at 6.25 percent during the March quarter of 2018.

The Bank utilised its Open Market Operation (OMO) instruments in the conduct of monetary policy to manage liquidity, which continued to be high and unevenly distributed in the banking system. There was a net issuance of K112.2 million in Central Bank Bills (CBB) by Bank of PNG, while the Government issued a net of K73.2 million in Treasury bills and retired K112.5 million in Treasury bonds during the quarter. The Cash Reserve Requirement (CRR) on commercial banks' total deposits and prescribed liabilities was maintained at 10.0 percent.

The average level of broad money supply (M3*) increased by 0.1 percent in the March quarter of 2018, compared to a decline of 1.8 percent in the December quarter of 2017. This outcome was due to an increase in average net domestic credit mainly reflecting a turnaround in credit to the private sector. These more than offset a decline in credit to the Central Government and net foreign assets (NFA) of the banking system. The average net domestic claims outstanding, excluding net claims on the Central Government, increased by 1.6 percent in the quarter, compared to an increase of 0.3 percent in the previous quarter.

The NFA of the financial corporations, comprising Depository Corporations (DCs) and Other Financial Corporations (OFCs), decreased by 4.0 percent to K6,975.6 million in the March quarter of 2018, compared to a decrease of 3.4 percent in the previous quarter. The decrease in DCs was from both the Central Bank and Other Depository Corporations (ODCs). The decline at the Central Bank reflected interventions in the foreign exchange market and external debt repayments during the period. For ODCs the decline reflected an increase in liabilities to non-residents while for OFCs it reflected a decline in claims on non-residents.

Net claims on the Central Government by financial corporations declined by K118.3 million to K13,033.2 million in the March quarter of 2018, compared to an increase of K37.3 million in the previous quarter. This reflected a net retirement of Government securities, both Treasury bills and Treasury bonds by ODCs and OFCs.

In the March quarter of 2018, total domestic credit extended by financial corporations to the private sector, public non-financial corporations and 'Provincial and Local level

Governments' increased by K296.2 million to K16,966.9 million, compared to an increase of K168.2 million in the previous quarter. This was influenced by increases of K202.5 million to the private sector and K93.6 million to public non-financial corporations. The increase in credit to the private sector was mainly by ODCs to the 'hotels and restaurants', 'retail', and 'building and construction' sectors, as well as the household sector for housing and personal loans.

Governor Bakani noted that preliminary estimates of the fiscal operations of the National Government over the three months to March 2018 show a deficit of K282.4 million, compared to the deficit of K39.9 million in the corresponding period of 2017. This represents 0.4 percent of nominal Gross Domestic Product (GDP).

Total revenue, including foreign grants, in the March quarter of 2018 was K2,404.8 million, 18.5 percent higher than in the corresponding quarter of 2017 and represents 18.9 percent of the 2018 budgeted amount. The increase reflects higher tax and non-tax receipts. Total expenditure for the quarter was K2,687.2 million, 29.9 percent higher than in the corresponding period of 2017 and represents 18.3 percent of the 2018 budgeted amount. This was driven by high recurrent expenditure, which was partially offset by a decline of 3.6 percent in development expenditure.

The deficit of K282.4 million was financed mainly from domestic sources of K1,411.8 million, more than offsetting net repayments to external sources of K1,129.4 million. Net domestic financing was mainly from other resident sectors totalling K1,608.0 million, which comprises a net purchase of Government securities, by the public and Central Bank and unpresented cheques from the previous year. These more than offset net retirement of Government securities by ODCs and OFCs of K123.2 million and K264.6 million, respectively. Net external repayments comprised K773.4 million and K346.9 million to concessional and commercial sources, respectively and K9.1 million to extraordinary sources.

Total public (Government) debt outstanding as at March 2018 was K23,480.9 million, a decline of K77.3 million from December 2017, with decreases in both the external and domestic debt levels. The decline in domestic and external debt reflected net retirement of Government securities, and net repayments on both concessional and commercial loans, respectively.

The total amount of Government deposits at depository corporations decreased by K281.9 million to K1,902.3 million in March 2018, compared to December 2017.