BANK OF PAPUA NEW GUINEA

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Quarterly Economic Bulletin
June Quarter 2018

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

1. UPDATE ON DEVELOPMENTS SINCE JUNE 2018

The momentum in global economic growth continued into the second half of 2018, however, the rising oil prices, higher yields in the United States (US), sentiment shifts resulting from the trade tensions between the US and China, and geo-political and policy uncertainties have and are expected to affect the pace of growth. These factors have had varying impact on the pace of growth across advanced and emerging market economies in recent months. In the US, economic activity continued to strengthen, reflecting strong fiscal stimulus, growing private sector demand and higher imports. In Japan, stronger household consumption, external demand and investment have driven and are expected to drive growth, whilst in the United Kingdom (UK), higher consumption, investment and government spending remain key drivers of growth. In the euro area, the pace of growth continued to fall, mainly reflecting lower household consumption in France and declining domestic demand in Italy due to political uncertainty. In emerging market economies, an improvement in growth expectations, reflecting the upswing of oil and other commodity prices, has helped stem downward pressures related to the strong US dollar, trade tensions and geo-political conflict. In China, growth is maintained, driven by high domestic demand and fixed asset investment, despite regulatory tightening of the financial sector and softening external demand. Growth in India continued to strengthen due to higher consumption and investments following the introduction of the currency exchange initiative in 2016 and goods and services tax in 2017.

Global inflation continued its upward trend in most advanced and emerging market economies, mainly reflecting high fuel prices. Governor Bakani explained that domestic inflation was influenced by the trend in global inflation and pass-through of the depreciation of the kina as reflected in the increase of core inflation measures. While headline inflation remained stable at 4.5 percent in the June quarter, the increases in core inflation measures are indicative of a build-up in inflationary pressures. The Governor reiterated that the Bank will take necessary policy actions to ensure that price stability is maintained should the underlying inflationary pressures translate into increasing headline inflation higher than 5.0 to 6.0 percent.

Governor Bakani mentioned that the latest international commodity price data from the Word Bank published in September, showed mixed results. PNG's export prices for energy commodities were on an upward trend, while its export prices for metals and minerals, and non-energy commodities declined. It was noted that spot prices for liquefied natural gas (LNG) imported into Japan increased by 5.1 percent to US$10.26 per one million British thermal units (btmu), while crude oil West Texas intermediate prices rose by 7.9 percent to US$67.9 per barrel. For metals and minerals, gold prices fell by 1.7 percent to US$1,307.0 per ounce, copper by 1.1 percent to US$6,881 per metric tonne (mt) and silver by 0.6 percent to US$16.6 per ounce. Prices for non-energy commodities mostly fell, with coffee (Arabica) by 1.3 percent to US$2.97 per kg and palm oil by 4.5 percent to US$601.0 per mt.The Governor encourages all exporters to improve production levels to benefit from the high kina value for foreign currency.

The Governor applauded the successful marketing of PNG's debut 10-year sovereign bond that attracted a lot of demand and subsequently the issuance in the international capital markets on the 31st of September 2018 that raised US$500 million at 8.375 percent. As per the 2018 National Budget, this would ease the Government's cash flow and fund key expenditure items, including the retirement of some of the short-term domestic debt. The inflow of the foreign exchange from the bond will assist in meeting some of the outstanding import orders in the domestic foreign exchange market.

The Governor noted that the National Government handed down a record Budget of K16.13 billion on the 13th November 2018, with total revenue and grants of K14.26 billion and a net borrowing of K1.87 billion. The 2019 Budget is framed under the theme: *"Building A Broader Based Economy"* which means broadening the economy by empowering small to medium size enterprises, promoting opportunities for increasing and diversifying private sector investments, and introducing measures to supporting various sectors of the economy, especially manufacturing and agriculture. The 2019 Budget has made provisions for further tax changes in excise and tariff rates to support these sectors and encourage investment, local production, and import replacements. Another good tax initiative is the personal tax relief for two tiers of low income workers. The First Tier is the Tax-Free Threshold of up to K12,500.00 per annum and the Second Tier is the lesser-tax-rate Threshold of K12,501.00 to K20,000.00 per annum. The Government reiterated that in 2019, it will continue to meet its primary commitments to investing in Key Infrastructure Projects, Education, Health, Law and Order, Agriculture, Tourism and SMEs. Also, strengthening the provincial and district levels of Government through improving transparency, accountability and efficient allocation of financial resources will be an important undertaking. The Government will continue to build on the progress made so far to improve fiscal discipline and enhanced governance arrangements through various reforms. These are vital components of building a broad-based and vibrant economy.

The Governor added that the budget deficit of K1.87 billion will be financed from external grants (or donor funding) and concessional borrowing of K943.1 million and K816.9 million, respectively. Additional external financing will come from the ADB Budget Support Tranche 2 of US$100 (K320.0) million, World Bank Budget Support Tranche 2 of US$50.0 (K155.0) million and US$200.0 (K640.0) million from the proceeds of the Sovereign Bond issued in 2018. The Budget estimated a net external borrowing of K2,496.1 in 2019, with an external gross new borrowing of K2,931.9 million and loan repayment of K435.8 million. This implies a financing gap of K1,000.0 (US$300.0) million which will be sourced through a commercial offering overseas in the first half of 2019. The Bank notes that these inflows of foreign exchange will further support the foreign exchange market and bring more stability in the kina exchange rate and inflation. With the Government's intention to restructure and mature its domestic debt, more kina liquidity is expected to be injected into the economy. This liquidity injection will be in addition to the excess liquidity already in the banking system and may lead to an increase in the demand for money, which will end up in the foreign exchange market in terms of more import orders. The Bank will continue to monitor these developments and will take appropriate measures to ensure that its price stability objective is maintained.

In the September quarter of 2018, the average daily kina exchange rate appreciated against all major currencies except the US dollar. It appreciated against the pound sterling by 2.9 percent to £0.2318, Australian dollar by 2.0 percent to A$0.4130, euro by 1.0 percent to €0.2598 and the yen by 0.6 percent to ¥33.6768. Against the US dollar, the kina depreciated by 1.5 percent to US$0.3020. These currency movements resulted in the Trade Weighted Index (TWI) increasing by 1.9 percent to 29.78 in the quarter.

Governor Bakani noted that as at the 26th November 2018, the level of foreign exchange reserves increased to K7,401.9 (US$2,235.4) million, reflecting the inflow of the sovereign bond money raised from the international financial capital markets. This compares to K5,469.5 (US$1,720.1) million as at 2nd January 2018.

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

Economic indicators available to the Bank of Papua New Guinea (the Bank) point to a pick-up in economic activity in the June quarter 2018, after a decline in the pace of growth in the March quarter of 2018. A higher surplus in the current account, reflecting improved export commodity prices, higher private sector lending, and increased Government development expenditure in the quarter are supportive of the growth. Over the quarter, the average daily kina exchange rate appreciated against all major currencies except the US dollar and the Japanese yen. These movements resulted in the Trade Weighted Index (TWI) increasing by 1.2 percent to 29.23. Annual headline inflation was stable at 4.5 percent in the June quarter, the same as in the March quarter. Considering the overall downward trend in headline inflation from a quarterly average of 6.7 percent in 2016 to 5.4 percent in 2017, and 4.5 percent so far in 2018, and the Bank's expectation of headline inflation to be around 5.0 percent in 2018, the Bank maintained a neutral stance of monetary policy by keeping the monthly Kina Facility Rate (KFR) at 6.25 percent throughout the June quarter of 2018.

Data from the Bank's Business Liaison Survey (BLS) show that the total nominal value of sales in the formal private sector declined by 10.4 percent in the March quarter of 2018, compared to an increase of 9.4 percent in the December quarter of 2017. Excluding the mineral sector, sales declined by 11.9 percent in the quarter, compared to an increase of 13.4 percent in the previous quarter. By sector, sales declined in all the sectors, except the wholesale sector. By region, sales declined in all the regions except the Momase (excluding Morobe) and Islands regions. Over the year to March 2018, total sales declined by 15.6 percent, compared to an increase of 33.6 percent over the corresponding period of 2017. Excluding the mineral sector, sales declined by 12.4 percent over the year to March 2018, compared to an increase of 37.3 percent over the corresponding period of 2017.

The Bank's Employment Index shows that the level of employment in the formal private sector increased by 0.2 percent in the June quarter of 2018, compared to an increase of 0.3 percent in the March quarter of 2018. Excluding the mineral sector, the level of employment fell by 0.1 percent. By sector, the level of employment increased in the manufacturing, mineral and financial/business and other services sectors, which more than offset declines in the wholesale, construction, retail, agriculture/forestry/fishing and transportation sectors. By region, the level of employment increased in the Highlands, Islands and NCD, while it declined in the Southern, Momase and Morobe regions. Over the year to June 2018, the total level of employment fell by 3.2 percent, compared to a decline of 3.2 percent over the corresponding period of 2017. Excluding the mineral sector, it declined by 4.1 percent, compared to a decline of 4.1 percent over the corresponding period of 2017.

Quarterly headline inflation, as measured by the Consumer Price Index (CPI), increased by 1.3 percent in the June quarter of 2018, compared to the 1.0 percent increase in the March quarter of 2018. All expenditure groups recorded price increases except for the 'Education' expenditure group which remained constant. By urban centre, prices increased in all the surveyed centres. Annual headline inflation was 4.5 percent over year to the June quarter of 2018, same as over the year to the March quarter of 2018.

During the June quarter of 2018, the average daily kina exchange rate appreciated against all major currencies except the US dollar, while it remained stable against the yen. The kina appreciated against the Australian dollar by 3.1 percent to A$0.4049, euro by 2.4 percent to €0.2572 and the pound sterling by 1.6 percent to £0.2254. Against the US dollar, the kina depreciated by 0.7 percent to US$0.3067, while it remained stable against the yen at ¥33.4600. These currency movements resulted in the TWI increasing by 1.2 percent to 29.23 in the June quarter of 2018.

The weighted average kina price of PNG's exports, excluding LNG, increased by 16.2 percent in the June quarter of 2018, compared to the corresponding quarter of 2017. There was an increase of 17.4 percent in the weighted average price of mineral exports, reflecting higher kina prices for all mineral export commodities. For agricultural, logs and marine product exports, the weighted average kina price increased by 11.2 percent due to higher prices of cocoa, copra and marine products. Excluding log exports, the weighted average kina price of agricultural and marine product exports increased by 18.3 percent in the quarter, compared to the corresponding quarter of 2017. The higher kina export price reflected an increase in international prices for most of PNG's export commodities, combined with the price effect of the depreciation of the kina against the US dollar.

With a surplus in the current account more than offsetting a deficit in the capital and financial account, the balance of payments recorded an overall surplus of K98 million for the first six months of 2018, compared to a surplus of K141 million in the corresponding period of 2017.

The current account recorded a surplus of K9,300.0 million in the first six months of 2018, compared to a surplus of K8,856.0 million in the corresponding period of 2017. The surplus in the current account was due to a trade surplus and higher net transfer receipts, combined with lower net service and income payments.

The capital and financial account recorded a deficit of K9,196.0 million in the first six months of 2018, compared to K8,711.0 million in the corresponding period of 2017. This outcome was attributed to direct and other investments, reflecting equity withdrawals and build-up in offshore foreign currency account balances of mineral companies including the LNG project. These more than offset net inflows from Government loan drawdowns.

The level of gross foreign exchange reserves at the end of June 2018 was K5,706.4 (US$1,730.1) million, equivalent to 4.8 months of total and 8.3 months of non-mineral import covers.

The Bank of Papua New Guinea continued to maintain a neutral stance of policy by keeping the monthly Kina Facility Rate (KFR) at 6.25 percent throughout the June quarter of 2018. Annual headline inflation was 4.5 percent in the June quarter of 2018, same as in the previous quarter, which is considered manageable, while the outcomes for other key macroeconomic indicators were relatively stable and in line with the Bank's annual projections for 2018. The dealing margins for the Repurchase Agreement (Repos) were also maintained at 100 basis points on both the buy and sell sides of the KFR.

The Bank utilised its OMO instruments in the conduct of monetary policy to manage liquidity. Liquidity continued to be high and unevenly distributed in the banking system hence, borrowing by commercial banks under the interbank and Repo facilities were resorted to during the quarter. There was a net CBB retirement of K203.0 million, while the Government retired a net of K89.6 million in Treasury bills and issued K310.9 million in Treasury bonds in the June quarter. The CRR on commercial banks' total deposits and prescribed liabilities was maintained at 10.0 percent.

The average level of broad money supply (M3*) decreased by 1.1 percent in the June quarter of 2018, compared to an increase of 0.1 percent in the March quarter. There was a decrease in NFA, which more than offset an increase in domestic assets. The net domestic claims outstanding, excluding net claims on the Central Government, increased by 2.0 percent in the June quarter, compared to an increase of 1.6 percent in the previous quarter.

The average level of monetary base (reserve money) decreased by 0.9 percent during the June quarter, compared to a decrease of 2.4 percent in the March quarter of 2018. This reflected a decline in commercial banks' deposits held at the Central Bank.

The NFA of the financial corporations, comprising Depository Corporations (DCs) and Other Financial Corporations (OFCs), increased by 2.5 percent to K7,147.6 million in the June quarter, compared to a decrease of 4.0 percent in the previous quarter.

There were increases in the NFA of the Central Bank and OFCs, which more than offset a decline at Other Depository Corporations (ODCs). The increase at the Central Bank reflected inflows from Government's commercial and concessional loan drawdowns and mineral sector tax receipts, while the increase at OFCs reflected inflows of foreign investments. The decrease in the ODCs reflected a fall in holdings of foreign assets.

Net claims on the Central Government by financial corporations declined by K505.0 million to K12,528.2 million in the June quarter, compared to a decrease of K118.3 million in the previous quarter of 2018. This mainly resulted from an increase in Government deposits, which more than offset a net increase in holdings of Government securities, particularly the purchase of Treasury bills by ODCs.

In the June 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 K195.1 million to K17,162.0 million, compared to an increase of K296.2 million in the previous quarter. This was influenced by increases of K280.1 million of credit extended to the private sector, which more than offset the decrease K84.9 million to public non-financial corporations. The increase in credit to the private sector was broad-based, with notable increases to the 'transport and communication' sector, followed by 'real estate, renting and business services', and 'hotels and restaurants'. The increase in lending reflected a pick-up in activities in some of the sectors associated with the hosting of the Asia-Pacific Economic Cooperation (APEC) meetings in 2018.

Preliminary estimates of the fiscal operations of the National Government over the six months to June 2018 show a deficit of K324.9 million, compared to the deficit of K784.4 million in the corresponding period of 2017. This represents 0.4 percent of nominal GDP.

Total revenue, including foreign grants for the six months to June 2018 was K5,555.3 million, 25.0 percent higher than in the corresponding six months of 2017 and represents 43.8 percent of the 2018 budgeted amount. The increase reflects both higher tax and non-tax receipts.

Total expenditure over the six months to June 2018 was K5,878.2 million, 12.5 percent higher than in the corresponding period of 2017 and represents 39.9 percent of the 2018 budgeted amount. Both the recurrent and development expenditures increased during the first half of 2018.

The deficit was mainly financed from domestic sources of K617.1 million, which more than offset a net repayment of K292.2 million to external sources. Net domestic financing comprised K80.1 million, K215.0 million and K420.7 million from the Central Bank, OFCs and other resident sectors, respectively. These, more than offset net retirement of Government securities by ODCs of K98.7 million. Net external loan repayments comprised K542.6 million and K22.6 million to concessional and extraordinary sources, respectively, which more than offset a borrowing of K273.0 million from commercial sources.

Total public (Government) debt outstanding as at the end of June 2018 was K 24,371.2 million, an increase of K890.6 million from March 2018, reflecting increases in both domestic and external debt levels during the quarter. The increase in external debt reflected a net borrowing of commercial loans whilst the increase in domestic debt was attributed to a net purchase of Government securities, particularly Treasury bonds.

Total Government deposits at depository corporations increased by K574.3 million to K2,476.6 million at the end of June 2018, compared to the level at the end March 2018. The increase in Government deposits reflected drawdowns from external loans and tax revenues.