BANK OF PAPUA NEW GUINEA

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Quarterly Economic Bulletin
September Quarter 2018

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

1. UPDATE ON DEVELOPMENTS SINCE SEPTEMBER 2018

Momentum in global economic growth continued into the third quarter of 2018; albeit at an uneven and slowing pace. Risks related to higher trade costs, the tightening of financial conditions and reverse capital outflows have impacted the pace of growth in both advanced and emerging market economies. In the United States (US), economic activity was driven by higher public spending and a pick-up in private sector investment, while higher domestic demand drove growth in United Kingdom (UK). Meanwhile, economic activity in Japan contracted as a result of natural disasters, while lower export demand hampered growth in the euro area. In emerging market economies, China's pace of growth was at its weakest since the Global Financial Crisis (GFC) despite initial growth expectations. China's growth slowed due to weakening domestic demand and lower production output, while a pick-up in domestic demand is driving higher growth in India. The International Monetary Fund (IMF) in its October 2018 publication of *World Economic Outlook*

(WEO) lowered its global growth forecast by 0.2 percent, to 3.7 percent for 2018, from the last update made in April 2018.

Governor Bakani noted that the latest international commodity price data published by the World Bank in December 2018, showed mixed results for PNG's export prices of energy commodities, metals and minerals and non-energy commodities from its September quarter outcomes. He stated that prices for Liquefied Natural Gas (LNG) imported into Japan increased by 7.5 percent to US$11.7 per one million British thermal units (btmu), while crude oil West Texas Intermediate prices fell by 15.2 percent to US$58.8 per barrel. The prices for metals and mineral increased, with copper prices increasing by 0.8 percent to US$6,164 per metric tonne (mt), gold by 1.3 percent to US$1,229.0 per ounce and silver by 2.7 percent to US$14.6 per ounce. Prices for non-energy commodities mostly fell, except coffee (Arabica), which increased by 6.5 percent to US$2.95 per kg. The Governor reiterated that while commodity prices continue to fluctuate, he urged exporters to increase production levels to benefit from the high kina value from their earnings in foreign currency.

Governor Bakani also noted that in 2018, commodity prices had been affected by rising US interest rates, the appreciation of the US dollar, trade tensions between major economies, commodity specific supply disruptions and financial market pressures in some of the emerging market economies. He stated that there has been a pick-up in export receipts of some of PNG's export commodities as a result of the turn-around in prices especially for crude oil, which averaged around US$65.00 per barrel in 2018, after falling to US$56.5 per barrel in the month of December 2018. With crude oil prices expected to be higher in 2019, the Governor remains confident that there will be adequate foreign exchange inflows to assist the foreign exchange market and Government revenue.

In regard to the domestic foreign exchange market situation, Governor Bakani reported that in 2018 the Bank of PNG supplied US$695.2 (K2,314.0) million into the foreign exchange market to assist in meeting foreign currency orders, compared to US$227.0 (K724) million in 2017. The Central Bank utilized the proceeds from the 3rd tranche of the Credit Suisse loan, the Sovereign Bond, and the World Bank and Asian Development Bank budget support loans to supply foreign exchange in the market. This helped to narrow the imbalance between the supply of and demand for foreign currency. This is on top of the foreign exchange inflows to the Authorized Foreign Exchange Dealers (AFEDs).

Overall, there has been a higher foreign exchange inflow from exports in 2018 than in 2017. Together with the Central Bank intervention, the imbalance has been greatly reduced. Outstanding sell kina orders for critical sectors of the economy were cleared and the length of time taken by AFEDs in serving import orders has been reduced. The total buy foreign currency order in the market has declined to K1.3 billion in January 2019 from K2.5 billion in January 2018. The time taken to serve or clear large orders (>K3mn) has improved from 5 months on average to 3 months on average. Clearance of small orders (<K3mn) is now within 2 months. The volume of backlog of orders has declined from K1.4 billion in January 2018 to K0.4 billion in January 2019. Clearly, there has been significant improvement and relief in the market, especially in the second half of 2018.

The Governor explained that it is important to understand that at any one point in time – that is, in any trading day; supply of foreign currency would not necessarily be exactly equal demand for foreign currency. That is, total orders cannot be fully served because there are always new orders being placed. The key point is that as long as orders get served within a reasonable amount of time and the imbalance is minimal, the market is seen as functioning or normalised.

During the December quarter of 2018, the average daily kina exchange rate depreciated against the US dollar by 1.5 percent to US$0.2973, the Japanese yen by 0.4 percent to ¥33.5496, the pound sterling by 0.3 percent to 0.2301. Against the Australian dollar and the euro, the kina appreciated by 0.4 percent to A$0.4146 and by 0.3 percent to €0.2605, respectively. These currency movements resulted in the Trade Weighted Index (TWI) depreciating by 0.55 percent to 29.61 in the December quarter of 2018.

The Governor stated that the level of foreign exchange reserves as at the 31st December 2018, improved to K7,602.84 (US$2,296.00) million, compared to

K5,482.70 (US$1, 666.74) million at the end of September 2018. As of 24th January 2019, the foreign exchange reserve level was K7, 487.48 (US$2,261.22) million.

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

Economic indicators available to the Bank point to a lower pace of economic growth in the September quarter of 2018. Although there was a marginal decline in the level of employment in the formal private sector in the quarter, continued higher surplus in the current account, supported by improved export commodity prices, higher private sector lending, and increased Government spending in the quarter are indicative of the economy-wide growth. During the quarter, the average daily kina exchange rate appreciated against all major currencies, with the exception of the US dollar. These movements resulted in the Trade Weighted Index (TWI) increasing by 1.9 percent to 29.78. Annual headline inflation increased to 4.8 percent in the September quarter, from 4.5 percent in the June quarter. Considering that annual headline inflation has come down from a high of 6.8 percent in the September quarter of 2016 to 4.5 percent in the March and June quarters 2018, and there is stability in other key macroeconomic indicators, the Bank of Papua New Guinea maintained a neutral stance of monetary policy by keeping the monthly Kina Facility Rate (KFR) at 6.25 percent throughout the September 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 increased by 4.2 percent in the June quarter of 2018, compared to a decline of 13.2 percent in the March quarter of 2018. Excluding the mineral sector, sales increased by 1.4 percent in the June quarter, compared to a decline of 12.4 percent in the previous quarter. By sector, sales increased in the agriculture/forestry/fishing, wholesale and mineral sectors, while it declined in the construction, manufacturing, financial/business/other services, transportation and retail sectors. By region, sales increased in the Southern (excluding NCD), Islands and Morobe regions, while it declined in the Highlands, Momase (excluding Morobe) and NCD regions. Over the year to June 2018, total sales declined by 2.1 percent, compared to a decline of 3.7 percent over the corresponding period in 2017. Excluding the mineral sector, sales declined by 4.1

percent over the year to the June 2018, compared to an increase of 5.2 percent over the corresponding period in 2017.

The Bank's Employment Index shows that the level of employment in the formal private sector declined by 0.2 percent in the September quarter of 2018, compared to an increase of 0.2 percent in the June quarter of 2018. Excluding the mineral sector, the level of employment fell by 0.3 percent in the quarter, compared to a decline of 0.1 percent in June quarter. By sector, the level of employment decreased in the agriculture/forestry/fishery, wholesale, manufacturing, and retail sectors, which more than offset increases in the financial/business and other services, transportation, construction and mineral sectors. By region, the level of employment declined in Islands, Morobe and Southern regions, while it increased in NCD, Momase and the Highlands regions. Over the year to September 2018, the total level of employment fell by 2.0 percent, compared to a decline of 3.9 percent in the corresponding period of 2017. Excluding the mineral sector, it declined by 2.3 percent, over the year to September 2018, compared to a decline of 5.3 percent over the corresponding period in 2017.

Quarterly headline inflation, as measured by the Consumer Price Index (CPI), increased by 1.1 percent in the September quarter of 2018, compared to an increase of 1.3 percent in the June quarter. All expenditure groups recorded price increases except for the 'Education' and 'Communication' expenditure groups, which recorded no change. By urban centre, prices increased in all the surveyed centres. Over the twelve months to September 2018, annual headline inflation was 4.8 percent, compared to the increase of 4.5 percent over the twelve months to June 2018.

In the September quarter of 2018, the US dollar appreciated against all major currencies. It appreciated against the pound sterling by 4.3 percent, the Australian dollar by 3.4 percent, the euro by 2.4 percent and the yen by 2.1 percent. With Gross Domestic Product (GDP), wages and inflation remaining strong, the Fed raised the Fed Fund's rate by 25 basis points, which helped strengthen the US dollar against all the other major currencies.

The weighted average kina price of PNG's export commodities, excluding LNG, increased by 7.2 percent in the September quarter of 2018, compared to the corresponding quarter of 2017. There was an increase of 13.0 percent in the weighted average price of mineral exports, reflecting higher kina prices for all mineral export commodities, with the exception of cobalt. For agricultural, logs and marine product exports, the weighted average kina price decreased by 10.2 percent due to lower prices of copra, copra oil, palm oil, rubber and marine products. Excluding log exports, the weighted average kina price of agricultural and marine product exports decreased by 13.7 percent in the quarter, compared to the corresponding quarter of 2017. The lower kina export price reflected a decline in international prices for some of PNG's export commodities.

There was an overall balance of payments surplus of K529 million for the nine months to September 2018, compared to a surplus of K327 million in the corresponding nine months of 2017. A surplus in the current account more than offset a deficit in the capital and financial account.

The current account recorded a surplus of K14,167 million for the nine months to September 2018, compared to a surplus of K13,055 million in the corresponding period of 2017. This was due to a higher trade account surplus and net transfer receipts, which more than offset net service and income payments. The trade surplus was due to high export receipts of LNG, while surplus in the transfer account was due to higher gifts and grants, and tax receipts.

The capital and financial account recorded a deficit of K13,636 million in nine months to September 2018, compared to K12,725 million in the corresponding nine months of 2017. This resulted from outflows of direct and other investments reflecting equity withdrawals and build-up in foreign currency account balances of mining, oil and LNG companies covered which more than offset transfers by donor agencies for project financing.

The level of gross foreign exchange reserves at the end of September 2018 was K5,482.7 (US$1,666.7) million, equivalent for 5.8 months of total and 11.9 months of non-mineral import covers.

Considering that annual headline inflation has come down from a high of 6.8 percent in the September quarter of 2016 to 4.5 percent in the March and June quarters of 2018, and stability in other key macroeconomic indicators, the Bank of Papua New Guinea maintained a neutral stance of monetary policy by keeping the monthly KFR at 6.25 percent throughout the September quarter of 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 Open Market Operation instruments in the conduct of monetary policy to manage liquidity. Liquidity continued to be high albeit uneven distribution between the commercial banks that led to an increase in the banks borrowing through the interbank and the Repo facilities during the quarter. There was a net CBB issuance of K55.2 million, while the Government retired a net of K55.4 million in Treasury bills and issued K265.5 million in Treasury bonds in the September 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 1.7 percent in the September quarter of 2018, the same percentage decline as in the June quarter of 2018. There was a decrease in Net Domestic Assets (NDA), which more than offset an increase in Net Foreign Assets (NFA). The net domestic claims outstanding, excluding net claims on the Central Government, increased by 3.0 percent in the September quarter, compared to an increase of 2.0 percent in the previous quarter. This was driven by an increase in private sector credit, and claims on public nonfinancial corporations.

The NFA of the financial corporations, comprising depository corporations (DCs) and OFCs, increased by 3.1 percent to K7,370.6 million in the September quarter of 2018, compared to an increase of 2.5 percent in the previous quarter. There were increases in the NFA of the Central Bank and OFCs, which more than offset a decline at ODCs. The increase at the Central Bank reflected inflows from Government's commercial and concessional external loan drawdowns as well as mineral sector tax receipts, while the increase at OFCs reflected inflows of foreign investments and export earnings. The decrease in the ODCs NFA reflected an increase in foreign liabilities during the period.

In the September 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 K440.2 million to K17,653.6 million, compared to an increase of K246.6 million in the previous quarter. This was accounted for by an increase of K405.6 million of credit extended to the private sector and K34.6 million to the public non-financial corporations. The increase in credit to the private sector was broad-based, with the increase reflecting activities associated with the hosting of the APEC events in 2018.

Preliminary estimates of the fiscal operations of the National Government for the nine months to September 2018 show a deficit of K1,006.5 million, compared to the deficit of K894.6 million for the corresponding nine months of 2017. This represents 1.2 percent of nominal GDP.

Total tax revenue for the nine months to September was K7,363.3 million, 17.3 percent higher than in the corresponding period of 2017 and represents 76.4 percent of the 2018 budgeted amount. Direct tax receipts totalled K4,574.4 million,16.9 percent higher than in the corresponding period of 2017 and represents 78.1 percent of the 2018 budgeted tax revenue. The increase reflected higher mining and petroleum taxes and other direct taxes.

The deficit of K1,006.5 million was mainly financed from domestic sources of K2,039.4 million while there was a net repayment of K1,032.9 million to external sources. Total public (Government) debt outstanding as at the end of September 2018 was K26,904.6 million, an increase of K2,533.4 million from June 2018.

Total Government deposits at depository corporations increased by K430.0 million to K2,906.6 million at the end of September 2018, from the level at the end June 2018. The increase reflected tax revenue and drawdowns of external loans.