BANK OF PAPUA NEW GUINEA

MEDIA RELEASE

22nd May 2019

Quarterly Economic Bulletin
December Quarter 2018

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

1. UPDATE ON DEVELOPMENTS SINCE DECEMBER 2018

Weakness in global growth is expected to continue into the first quarter of 2019 due to tighter credit conditions, further escalation of United States (US)–China trade tensions, disruption in the auto manufacturing industry in Germany, monetary policy tightening in some of the emerging economies and major advanced economies, and slowing global demand. In the US and Japan, growth is expected to be driven by expansionary fiscal stimulus, while growth in other advanced economies are expected to slow. In the euro area, demand weakened due to fall in industrial production in Germany and Italy, and social unrest in France. In the United Kingdom (UK), growth continues to be affected by uncertainties surrounding the Brexit. For emerging economies, India's growth continues to recover, driven by strong investment and consumption spending, and supported by an expansionary monetary policy. Growth in China exceeded expectations in the first quarter of 2019, mainly driven by higher industrial production, strong consumer spending and increased fixed asset investment. The International Monetary Fund (IMF) in its April publication of World Economic Outlook (WEO) 2019, lowered its growth forecast to 3.3 percent from 3.5 percent in its January 2019 Update.

The latest international commodity price data published by the World Bank in April 2019, show improvements for most of PNG export commodity prices of energy, metals and non-energy commodities, compared to actual outcomes in December 2018. Governor Bakani stated that price for Liquefied Natural Gas (LNG) based on imports to Japan increased by 0.7 percent to US$11.87 per one million British thermal units (btmu), while price of crude oil by West Texas Intermediate fell by 6.6 percent to US$54.9 per barrel. The prices of most metals and mineral increased, with price of silver increasing by 6.8 percent to US$15.6 per ounce, gold by 6.1 percent to US$1,304.0 per ounce and copper by 1.8 percent to US$6,226 per metric tonne (mt). For non-energy commodities, prices increased for palm oil by 5.8 percent to US$578 per metric tonne and coffee (Arabica) by 2.8 percent to US$2.24 per kg, while cocoa fell by 5.1 percent to US$2.95 per kg.

Governor Bakani encouraged the export sector to take advantage of some of the high commodity prices and increase production levels, especially for the agricultural export commodities. This also includes boosting local production for domestic consumption and replacing similar imported items. He noted the importance of a sustainable export sector as the main source of foreign exchange and reiterated that every support is needed from the private sector, growers and the Government to expand this sector. Without the right policies and support from all stakeholders to grow this sector, the on-going issues confronting the foreign exchange market in terms of lower foreign exchange inflows and build-up of import orders will continue to persist. This will put pressure on the exchange rate and domestic inflation. While the Central Bank can intervene to support the market, its capacity to do so continuously is limited by its accumulated level of foreign exchange reserves. Large investment projects such as the Papua LNG and Wafi Gold projects are expected to increase foreign exchange inflows in the near future like many of these major projects in the past, however, these inflows are not sustainable in the long-run. Therefore, growing the non-mineral export sector is critical for long term sustainable and inclusive growth because the majority of our people are engaged in this sector, especially the agriculture sector.

During the March quarter of 2019, the average daily kina exchange rate depreciated against the Japanese yen by 2.6 percent to ¥32.6844, pound sterling by 0.3 percent to 0.2301 and the US dollar by 0.2 percent to US$0.2968. Against the Australian dollar and euro, it appreciated by 0.6 percent to A$0.4170 and 0.3 percent to €0.2613, respectively. These currency movements resulted in the Trade Weighted Index (TWI) depreciating by 1.0 percent to 29.44 in the March quarter of 2019.

Governor Bakani stated that the level of foreign exchange reserves as at the 29th March 2019, fell to K6,899.70 (US$2,080.26) million, compared to K7,402.70 (US$2, 235.60) million at the end of December 2018. As of 30th April 2019, the foreign exchange reserve level further declined to K6,847.01 (US$2,060.95) million, reflecting continued intervention by the Central Bank into the foreign exchange market.

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

Economic indicators available to the Bank of Papua New Guinea (the Bank) point to a slowdown in economic activity in 2018, mainly due to a significant decline in the production and export volumes of LNG and crude oil reflecting the impact of the earthquake in February, which resulted in the temporary shutdown of the gas and oil processing facilities. However, there was a moderate growth in the non-mineral sector due to higher production in some of the agricultural export commodities and increased activity in the construction, commerce and, accommodation and food service sectors partly reflecting the hosting of the Asia-Pacific Economic Cooperation (APEC) Meetings. The increases in international prices of all mineral export commodities combined with some increases in the volumes of a number of major non-mineral exports more than offset the declines in mineral export volumes and prices of non-mineral commodities, and resulted in a large balance of payments surplus for 2018. Increased foreign exchange inflows combined with external budget financing including the sovereign bond helped reduce the backlog of import orders in the market and assisted business activity in the non-mineral sector. In 2018, the average daily kina exchange rate depreciated against the US dollar, while it appreciated against other major currencies, including the Australian dollar. The movements of these currencies resulted in a decline in the Trade Weighted Index (TWI) by 3.6 percent to 29.40. The annual headline inflation was 4.3 percent in the December quarter of 2018, compared to 4.7 percent in the December quarter of 2017. Although the headline inflation trended downward, the underlying measures increased indicating a pickup in inflationary pressures. The Bank therefore, maintained the monthly Kina Facility Rate (KFR) at 6.25 percent in the December 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 0.1 percent in the September quarter of 2018, compared to an increase of 4.8 percent in the June quarter of 2018. Excluding the mineral sector, sales increased by 4.7 percent in the September quarter, compared to an increase of 2.6 percent in the previous quarter. By sector, sales increased in the manufacturing, transportation, agriculture/forestry/fisheries and financial/business/other services sectors, while it declined in the construction, retail, mineral and wholesale sectors. By region, sales increased in the Highlands and National Capital District (NCD) regions, while it declined in the Momase, Islands, Southern and Morobe regions. Over the year to September 2018, total sales declined by 0.4 percent, compared to a decline of 4.7 percent over the corresponding period in 2017. Excluding the mineral sector, sales increased by 6.7 percent over the year to September 2018, compared to a decline of 2.8 percent over the corresponding period in 2017.

The Bank’s Employment Index shows that the level of employment in the formal private sector increased by 1.5 percent in the December quarter of 2018, compared to a decline of 0.2 percent in the September quarter of 2018. Excluding the mineral sector, the level of employment fell by 0.8 percent. By sector, employment increased in the mineral, construction, retail and financial/business and other services sectors, which more than offset decreases in the transportation, agriculture/forestry/fisheries, wholesale and manufacturing sectors. By region, employment increased in the

Highlands, NCD, Southern and Momase regions, while it decreased in the Islands, and Morobe regions. In 2018, total employment level increased by 1.8 percent, compared to a decline of 3.8 percent in 2017. Excluding the mineral sector, the level of employment declined by 0.9 percent in 2018, following a decline of 4.8 percent in 2017.

Quarterly headline inflation, as measured by the Consumer Price Index (CPI), increased by 0.8 percent in the December quarter of 2018, compared to an increase of 1.1 percent in the September quarter. All expenditure groups recorded price increases except for the ‘Transport’ expenditure group which declined, while the ‘Education’ and ‘Communication’ expenditure groups recorded no price change. By urban centre, prices increased in all the surveyed centres. Annual headline inflation was 4.3 percent in 2018, compared to 4.7 percent in 2017. Annual underlying inflation, measured as trimmed mean and exclusion-based, were 4.0 percent and 5.5 percent, respectively in 2018.

In the December quarter of 2018, the average daily kina exchange rate depreciated against the US dollar and the Japanese yen while it appreciated against the Australian dollar and the euro. The kina depreciated slightly against the US dollar by 1.5 percent to US$0.2973 and 0.4 percent against the yen to ¥33.5496, while it appreciated against the Australian dollar by 0.4 percent to AU$0.4146 and the euro by 0.3 percent to €0.2605. The movements of these currencies resulted in the fall of the TWI by 0.3 percent to 29.70 in the December quarter of 2018. In 2018, the kina exchange rate appreciated against the Australian dollar, pound sterling, euro and Japanese Yen by 5.5 percent, 4.2 percent, 3.7 percent and 0.26 percent, respectively. Against the US dollar, it depreciated by 3.7 percent. As a result, the TWI depreciated by 3.6 percent to 29.40.

The weighted average kina price of Papua New Guinea's export commodities, excluding Liquefied Natural Gas (LNG), increased by 10.5 percent in 2018, from 2017. There was an increase of 15.9 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 decreased by 6.8 percent due to lower prices of all non-mineral commodities, with the exception of cocoa and log prices. Excluding log exports, the weighted average kina price of agricultural and marine exports decreased by 9.6 percent in 2018, from 2017. Lower international prices accounted for the decline.

The balance of payments recorded a surplus of K1,849 million in 2018, compared to a surplus of K350 million in 2017. 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 K20,047 million in 2018, compared to a surplus of K17,050 million in 2017. This was accounted for by a higher trade account surplus and net transfer receipts, which more than offset net service and income payments.

The capital and financial account recorded a deficit of K18,196 million in 2018, compared to a deficit of K16,697 million in 2017. This was due to higher net outflows reflecting equity withdrawals and build-up in offshore foreign currency account balances of mining, oil and LNG companies covered under the Project Development Agreements.

The level of gross foreign exchange reserves at the end of December 2018 was K7,457.1 (US$2,214.8) million, sufficient for 6.7 months of total and 14.8 months of non-mineral import covers.

While taking into consideration the downward trend in annual headline inflation for the first three quarters of 2018, the underlying inflation measures indicated an increase in inflationary pressures, and therefore, the Bank maintained the monthly Kina Facility Rate (KFR) at 6.25 percent throughout the December quarter of 2018. The dealing margins for the Repurchase Agreement (Repos) were also maintained at 100 basis points on both sides of the KFR.

The Bank utilised its Open Market Operation (OMO) instruments in the conduct of monetary policy to manage liquidity. Liquidity continued to be high, but unevenly distributed among the banks which led to an increase in borrowing through the interbank market and the Repo Facility during the quarter. There was a net Central

Bank Bill (CBB) retirement of K7.6 million, while the Government retired a net K697.1 million and K117.9 million in Treasury bills and Treasury bonds, respectively, in the December quarter of 2018. 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*) decreased by 1.9 percent in the December quarter of 2018, following a decrease of 1.7 percent in the September quarter. This outcome was due to a decline in Net Domestic Assets (NDA), which more than offset an increase in Net Foreign Assets (NFA) of the banking system. Average net domestic claims outstanding, excluding net claims on the Central Government, decreased by 0.1 percent in the December quarter, compared to an increase of 3.0 percent in the previous quarter. This was driven by a decline in average net claims on public non-financial corporations and other financial corporations. In 2018, the average level of broad money supply declined by 3.3 percent, compared to an increase of 6.8 percent in 2017.

The NFA of the financial corporations, comprising depository corporations (DCs) and other financial corporations (OFCs), increased by 18.0 percent to K8,695.1 million in the December quarter of 2018, compared to an increase of 3.1 percent in the previous quarter. There were increases in the NFA of the Central Bank and other depository corporations (ODCs), which more than offset a decrease at OFCs. The increase at the Central Bank reflected inflows from mineral tax receipts and Government's external financing for Budget support. The decrease at OFCs reflected decline in foreign investments.

Net claims on the Central Government by financial corporations decreased by K1,391.2 million to K11,578.3 million in the December quarter of 2018, compared to an increase of K439.6 million in the previous quarter. The retirement of Government securities using part of the proceeds from the sovereign bond issued in September 2018 accounted for the decrease.

In the December quarter of 2018, total domestic credit extended by financial corporations to the private sector, public non-financial corporations and, Provincial and Local level Governments decreased by K218.0 million to K17,435.7 million, compared to an increase of K440.2 million in the previous quarter. This was accounted for by a decrease of K136.5 million in credit extended to the private sector and K81.4 million to the public non-financial corporations. The decline in credit to the private sector was broad-based, with notable decreases in net loan repayments by the ‘agriculture, forestry and fisheries’, 'building and construction', ‘metals and other mining’, ‘wholesale trade’ and 'hotels and restaurants' sectors.

The fiscal position of the National Government in 2018 show a deficit of K2,048.4 million, compared to the deficit of K1,794.7 million in 2017. This represents 2.5 percent of nominal GDP.

Total revenue, including foreign grants in 2018 was K14,085.8 million, 22.2 percent higher than in 2017 and represents 105.1 percent of the revised amount in the 2018 Supplementary Budget. The increase reflects both higher tax and non-tax receipts and donor grants.

Total expenditure was K16,134.1 million in 2018, 21.1 percent higher than in 2017 and represents 105.5 percent of the 2018 revised amount. This outcome reflects increases in both the recurrent and development expenditures.

The deficit was mainly financed from external sources of K3,596.3 million, which also accounted for a net repayment of K1,547.9 million on domestic debt.

Total public (Government) debt outstanding as at the end of December 2018 was K25,606.6 million, an increase of K2,048.4 million from 2017, reflecting an increase in external debt.

Total Government deposits at depository corporations increased by K1,524.2 million to K3,708.9 million in 2018, compared to 2017. The increase in Government deposits reflected drawdowns from external financing and higher tax revenues.