BANK OF PAPUA NEW GUINEA

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QUARTERLY ECONOMIC BULLETIN
JUNE QUARTER 2012

Mr. Loi M. Bakani, Governor of the Bank of Papua New Guinea (Bank of PNG), today released the June 2012 Quarterly Economic Bulletin (QEB). This statement provides an overview of the economic and financial developments for the June 2012 quarter and the developments since June 2012.

1. UPDATE ON DEVELOPMENTS SINCE JUNE 2012

The global economic growth continued to remain weak with persistent downside risks as Europe is still grappling with the sovereign debt crisis and growth in major emerging economies are lower than expected. As a result, the International Monetary Fund (IMF) in its July 2012 World Economic Outlook (WEO) Update, revised downwards its global output projection to 3.5 percent in 2012, compared to 3.6 percent previously. Growth in advanced economies is expected to remain low at 1.4 percent in 2012, reflecting the spill-over effects of the Euro debt crisis, with low demand and high unemployment levels. In the United States, economic growth is projected to be 2.0 percent, as growth momentum slowed, associated with subdued domestic demand and activity. In the emerging and developing economies, growth is expected to increase by 5.6 percent, compared to a growth of 6.2 percent in 2011, reflecting the weak external environment and decline in domestic demand in China, India and Brazil. Growth in 2012 is dependent on sufficient policy actions to improve the financial conditions in Europe and elsewhere, and introduction of accommodative fiscal and monetary policies in some emerging and advanced economies, which will allow for growth to strengthen.

Governor Bakani mentioned that all agricultural and mineral commodity prices continued to decline in the second quarter of 2012, including the international price of crude oil to around U$86 per barrel mark reflecting weak global demand, and above-quota production by the Organization of Petroleum Exporting Countries (OPEC). This trend is expected to continue for the rest of 2012, depending largely on the recovery of Europe and the growth in China and some advanced economies. Although commodity prices rebounded in the first quarter of 2012, it remained below the end-2011 levels. As of 21st September 2012, the price of gold was US$1,736.74 per ounce after a high of US$1,741.63 at the beginning of the year, while the price of crude oil continue to remain volatile, trading at an average of US$86 per barrel. Prices of agricultural export commodities are expected to remain low in 2012, compared to 2011. If prices of export commodities continue to decline and remain relatively low, together with the strengthening of the kina, it is likely to impact adversely on the export income and Government revenue, and lead to further shortfalls in the National Budget. Given these developments, the Governor warned that if Government spending is not curtailed in the second half of 2012, there will be serious consequences on the budget outcome for the year.

Inflation in advanced economies eased in the second quarter of 2012 and is expected to ease further due to declining commodity prices, fall in global demand and improved supply conditions. On the back of these developments, the IMF projected inflation in the advanced and emerging and developing economies to be at 1.8 percent and 6.5 percent, respectively. International food prices have declined as indicated by the Food and Agriculture Organisation (FAO) Food Price Index (FFPI), showing a significant drop in the index points to 213.0 points in August 2012, compared to 231.0 points in August 2011. Crude oil prices declined, although it continued to remain volatile. Governor Bakani mentioned that the low commodity prices and low inflation levels overseas will have favorable impact on the domestic inflation.

Given the low inflation outcome in the June quarter of 2012, the Bank of PNG eased its monetary policy stance by reducing the Kina Facility Rate (KFR) by 100 basis points, from 7.75 percent to 6.75 percent in September 2012. In the second half of 2012, the upside risks to inflation will arise from the high import prices, strengthening of export commodity prices, depreciation in the kina exchange rate as well as domestic demand pressures associated with the construction of the PNG LNG project, continued private sector investments and increased Government spending.

The kina exchange rate depreciated against the US dollar, Australian dollar, Japanese yen and the pound sterling, while it appreciated against the euro. As at the end of September 2012, the kina depreciated against the US dollar by 0.5 percent to 0.4805, Australian dollar by 3.4 percent to 0.4593, Japanese yen by 2.5 percent to 37.23, pound sterling by 0.1 percent to 0.2955, while it appreciated against the euro by 2.4 percent to 0.3717. The depreciation of the kina exchange rate against the US and Australian dollar was associated with lower foreign exchange inflows and appreciation of the US Dollar due to safe haven investments in US dollar denominated assets, as well as cross currency movements.

The level of gross foreign exchange reserves decreased from K8,662.4 (US$4,149.8) million at the end of June 2012 to K8,382.6 (US$4,069.8) million as at end of September 2012.

2. OVERVIEW OF THE DEVELOPMENTS IN THE JUNE QUARTER OF 2012

Economic indicators available to the Bank of Papua New Guinea (the Bank) continued to show strong growth in the economy in the June quarter of 2012, driven mainly by business activities associated with the construction of the PNG LNG project, high private sector investments and Government spending. Persistent growth in both employment and private sector credit are indicative of this growth. Continued strong domestic demand pressures associated with high economic growth was expected to lead to higher inflation outcomes. However, the actual inflation outcome of 1.4 percent in the June quarter is lower than expected as a result of lower import prices, supported by the pass-through of past appreciation of the exchange rate, tuition fee-free education policy, lower prices of betel nut and the extension of the Government's Tariff Reduction Program commencing in 2012. The kina appreciated against all major currencies in the June quarter and resulted in the daily average Trade Weighted Index (TWI) appreciating by 10.7 percent. In light of the inflation outcomes in the March quarter and continued underlying inflationary pressures, the bank maintained its tight monetary policy stance by keeping its official rate, the Kina Facility Rate (KFR) unchanged at 7.75 percent in the June quarter of 2012.

Data from the Bank's Business Liaison Survey (BLS) showed that the total nominal value of sales in the private sector fell by 2.9 percent in the March quarter of 2012, compared to a growth of 3.1 percent in the December quarter of 2011. Excluding the mineral sector, sales declined by 0.1 percent in the March quarter of 2012, compared to a fall of 1.4 percent in the previous quarter. Sales declined in the building and construction, transportation, agriculture/forestry/fisheries, mineral and retail sectors, while the manufacturing, wholesale and financial/business/other services sectors recorded increases. By region, Southern, Morobe and Momase recorded declines while NCD, Highlands and Islands recorded increases. Over the twelve months to March 2012, total sales declined by 7.7 percent.

The Bank's Employment Index show that the level of employment in the formal private sector increased by 3.0 percent in the June quarter of 2012, compared to an increase of 1.0 percent in the previous quarter. Excluding the mineral sector, the level of employment increased by 2.9 percent. The level of employment increased in all sectors, except the manufacturing, building and construction, and financial/business/other services sectors. By region, the level of employment picked up in all regions except the Islands region. Over the year to June 2012, the total level of employment increased by 5.1 percent, compared to the corresponding period in 2011. Excluding the mineral sector, the level of employment increased by 4.9 percent over the year to June 2012.

Quarterly headline inflation, as measured by the Consumer Price Index (CPI), declined by 0.4 percent in the June quarter of 2012, compared to an increase of 0.3 percent in the March quarter of 2012. A decline in the 'Drinks, tobacco, and

Betelnut' expenditure group, more than offset increases in the other expenditure groups. Annual headline inflation was 1.4 percent in the June quarter of 2012, compared to 4.0 percent in March quarter, mainly attributed to lower import prices, supported by the pass-through of previous appreciation of the exchange rate, tuition fee-free education policy, lower prices of betelnut and the extension of the Government's Tariff Reduction Program commencing in 2012. The annual underlying inflation as indicated by the exclusion-based inflation was 0.2 percent, while the annual trimmed mean inflation was 3.4 percent in the June quarter. By region, all urban areas recorded price increases in the June quarter, except Rabaul and Port Moresby.

In the June quarter of 2012, the daily average kina exchange rate appreciated against all the major foreign currencies. It appreciated against the US dollar by 1.5 percent to 0.4802, Australian dollar by 5.8 percent to 0.4796, euro by 3.7 percent to 0.3772, pound sterling by 0.8 percent to 0.3045, and the Japanese yen by 2.4 percent to 38.28. These movements resulted in the appreciation of the daily average TWI by 10.7 percent to 37.31 in the June quarter of 2012, compared to 33.69 in the March quarter of 2012.

The weighted average kina price of Papua New Guinea's exports was 18.0 percent lower in the June quarter of 2012, compared to the corresponding quarter of 2011. There were lower kina prices of gold, copper and crude oil exports, which resulted in a 15.9 percent decline in the weighted average price of all mineral exports. For the agricultural, logs and marine product exports, excluding refined petroleum products, the weighted average price declined by 24.4 percent due to lower kina export prices of agriculture and log exports, which more than offset an increase in the price of marine products.

The balance of payments recorded an overall deficit of K604 million in the first six months of 2012, compared to a surplus of K354 million in the corresponding period of 2011. This outcome was the result of a deficit in the current account, which more than offset a surplus in the capital and financial accounts.

The current account recorded a deficit of K1,361 million in the first six months of 2012, compared to a surplus of K330 million in the corresponding period of 2011. The deficit in the current account was due to a net service and income payments, which more than offset a surplus in the trade account and net transfer receipts.

The trade account recorded a surplus of K1,445 million in the first six months of 2012, a decrease of 60.2 percent from the corresponding period of 2011. The lower surplus was due to a decline in the value of merchandise exports, which more than offset a decrease in the value of merchandise imports. The value of merchandise exports in the first six months of 2012 was K5,769 million, a decline of 34.6 percent from the corresponding period of 2011. The decrease was attributed to lower values of all export commodities, with the exception of refined petroleum and marine product exports.

The surplus in the capital and financial account is due to net inflows from capital transfers, direct and portfolio investments reflecting capital transfers by donors, equity inflows and drawdown from investments in short term money market instruments, respectively. There were also net inflows in other investments reflecting drawdown in net foreign assets of the domestic banking system and foreign currency account balances of mineral companies. These more than offset net outflows in financial derivative instruments. During the first six months of 2012, the appreciation of the kina against the currencies of Papua New Guinea's major trading partners, resulted in a reduction in the kina value of balance of payments transactions.

The level of gross foreign exchange reserves at the end of June 2012 was K8,662.4 (US$4,149.8) million, sufficient for 10.8 months of total and 15.6 months of non-mineral import covers.

The Bank of Papua New Guinea maintained its tight stance of monetary policy by keeping the KFR at 7.75 percent in the June quarter of 2012, in light of the inflation outcome in the March quarter of 2012 and potential inflationary pressures stemming from increased domestic demand. To support the tight stance of monetary policy, the Cash Reserve Requirement (CRR) was increased from 7.0 percent to 8.0 percent in the quarter. The dealing margin for the Repurchase Agreements (Repos) was maintained at 100 basis points on either sides of the KFR. Interest rates for short-term securities continued to decrease across all maturities between the end of March and June 2012, reflecting the persistently high liquidity levels.

The Bank continued to utilise its Open Market Operation (OMO) instruments in the conduct of monetary policy in the June quarter of 2012. Given the high level of liquidity in the banking system, there was a net issuance of Central Bank Bills (CBBs) totaling K39.2 million during the period. The Government made a net Treasury bill issuance of K128.4 million and Inscribed stock of K172.0 million during the quarter, which helped diffuse some of the excess liquidity.

The average level of broad money supply (M3*) increased by 2.8 percent in the June quarter, compared to an increase of 3.1 percent in March quarter of 2012, attributed to an increase in average net claims on the Central Government following increased issuance of securities and drawdown of Government deposits. Average net domestic claims outstanding, excluding net claims on the Central Government increased by 2.7 percent in the June quarter, following an increase of 2.1 percent in the March quarter of 2012. The average level of monetary base (reserve money) grew by 10.6 percent in the June quarter of 2012, compared to an increase of 16.0 percent in the March quarter of 2012.

The average level of deposits at the other depository corporations (ODCs) increased by 2.8 percent, to K17,917.4 million in the quarter, from K17,421.7 million in the March quarter of 2012. This reflected increases in transferable and Central Government deposits.

The net foreign asset of the financial corporations fell by 1.3 percent in the June quarter of 2012, compared to a decline of 5.4 percent in the March quarter, due to lower net foreign assets of the Central Bank and other financial corporations (OFCs). Net claims on Central Government increased by K694.8 million in the June quarter of 2012, compared to an increase of K965.4 million in the previous quarter. This resulted from drawdown in Government trust accounts and increase in holdings of Government securities by ODCs.

Total domestic credit extended by financial corporations to the private sector, public non-financial corporations, Provincial and Local Level Governments, and OFCs increased by K211.6 million to K9,630.0 million in the June quarter of 2012,compared to an increase of K362.3 million in the March quarter. This was mainly due to an increase of K164.1 million in credit to the private sector. The growth in private sector credit reflected advances by the ODCs to the manufacturing, transport and communication and other business services sectors, as well as to the household sector for housing advances.

Preliminary estimates of the fiscal operations of the National Government over the six months to June 2012 show an overall deficit of K156.3 million, compared to a deficit of K173.5 million in the corresponding period of 2011, which represent 0.5 percent of nominal GDP. The deficit reflects higher expenditure, which more than offset an increase in revenue.

Total revenue, including foreign grants, over the six months to June 2012 was K4,016.5 million, 27.2 percent higher than the receipts collected in the corresponding period of 2011. This represents 38.0 percent of the budgeted revenue for 2012. The increase in revenue reflected higher collections of both tax and non-tax receipts, which more than offset a decline in foreign grants during the period.

Total expenditure over the six months to June 2012, was K4,172.8 million, 25.3 percent higher than in the corresponding period in 2011. This represents 39.5 percent of the budgeted appropriation for 2012 and reflected both higher recurrent and development expenditure.

The budget deficit of K156.3 million was financed from external and domestic sources with K84.4 million and K71.9 million, respectively. External borrowing of K92.4 million was from concessional sources, which more than offset loan repayments of K8.0 million to extraordinary sources. Domestic financing comprised of net drawdown of Government deposits at the Central Bank totalling K1,091.1 million combined with net purchases of Government securities totalling K439.5 million and K278.5 million by ODCs and OFCs, respectively. These more than offset K1,737.2 million mostly in cheques presented for payment by other resident sectors.

Total public (Government) debt outstanding at the end of the June quarter of 2012 was K7,715.1 million, K476.7 million higher than in the March quarter of 2012, with increases in both domestic and external debts. The increase in domestic debt resulted from net new issuance of Treasury bills and Inscribed stocks, while the increase in external debt mainly reflected the drawdown of concessional loans. This resulted in the debt to GDP ratio increasing to 25.9 percent in the June quarter of 2012, from 24.3 percent in the March quarter of 2012.

The total amount of Government deposits in the depository corporations decreased by K465.5 million to K3,957.8 million in June 2012, compared to K4,423.3 million in March 2012. Government trust accounts held at the Central Bank decreased by K255.7 million to K226.6 million between the end of March 2012 and June 2012, mainly reflecting drawdowns for the state's equity contribution to the PNG LNG project and other major expenditure items.