BANK OF PAPUA NEW GUINEA

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QUARTERLY ECONOMIC BULLETIN
DECEMBER QUARTER 2011

Mr. Loi M. Bakani, Governor of the Bank of Papua New Guinea (Bank of PNG), today released the December 2011 Quarterly Economic Bulletin (QEB). This statement provides an overview of the economic and financial developments for the December 2011 quarter and the developments since December 2011.

1. UPDATE ON DEVELOPMENTS SINCE DECEMBER 2011

Global economic recovery remained relatively sluggish in 2011, reflecting weak investment activity and consumer demand, and high unemployment rate in advanced economies. The International Monetary Fund (IMF) estimated the global economy to have grown by 3.8 percent in 2011, with real GDP growth of 1.6 percent in the advanced economies and 6.2 percent in emerging and developing economies.

As global economic activity is envisaged to slow down further in 2012, the IMF revised downward its forecast for 2012 to 3.3 percent from 4.0 percent made earlier in its September 2011 World Economic Outlook (WEO) publication, reflecting weak growth in the euro area. The IMF forecast is for GDP to grow by 1.2 percent in advanced economies, and emerging and developing economies to grow by 5.4 percent in 2012. The down side risks to these forecasts include further deterioration in the debt crisis in the euro area and its impact on other countries, lack of progress of fiscal consolidation in US and Japan, and unstable real estate and credit markets due to lack of confidence and lower expectation in emerging economies. These, combined with oil supply shocks due to geopolitical tensions in the Middle East and North Africa, could lead to a fall in demand and global output.

Governor Bakani noted that global demand for primary commodities is expected to decline in 2012 and in the medium term, in response to a weak global demand and improvement in supply conditions. However, oil price is expected to remain elevated as a result of supply constraints associated with the geopolitical tensions in the Middle East and North Africa. This is likely to affect Papua New Guinea's Budget revenue forecast in 2012 and the medium term. As of 23rd March 2012, the prices of gold fell to US$1,654.10 per ounce after a high of US$1,718.28 at the beginning of the month, while the price of oil continue to remain volatile and traded at US$105 per barrel.

The IMF projects inflation in the advanced economies and some of the emerging economies to ease further towards the end of 2012 as a result of the low global demand and expectations for low inflation. According to the FAO Food Price Index (FFPI), international food prices have started to pick up again to an average point of 215.3 in February 2012, after dropping to its lowest level of 210.8 points in December 2011.

Governor Bakani stated that inflationary pressures in the domestic economy will come mainly from domestic demand pressures associated with high inflows and spin-off activities relating to the construction of the LNG project and increased Government spending. The upside risks to domestic inflation will stem from: the volatility in import prices; a fall in prices of export commodities; depreciation of the kina exchange rate; and higher than budgeted government expenditure. The Governor cautioned the Government must be disciplined in its spending, particularly during the National Election period, to keep within the 2012 budget.

The Governor added that the main issue that the Central Bank is confronted with is the increasing level of liquidity in the banking system in recent years, caused by the foreign exchange reserve build-up related largely to dollar-denominated mineral tax earnings, high export earnings and inflows related to the PNG Liquefied Natural Gas (LNG) project and other private foreign direct investments. This is compounded by the fast drawdown of trust accounts held at the Central Bank. Whilst the high liquidity levels do not appear to influence inflation via the credit channel despite strong economic growth, it is still a threat to price stability and soundness of the financial system.

Mr. Bakani is concerned that the Central Bank is incurring an increase in the cost of monetary policy management by issuing Central Bank Bills (CBBs) to sterilize some of the excess liquidity. Efforts made to transfer some of the trust account funds to the Central Bank and opening of all new trust accounts with the Bank of PNG have not been really successful as the Government continues to hold high trust account balances with commercial banks.

The kina continued to appreciate against most of the major currencies on the back of the strength of the US dollar as investors look to it as a safe asset in light of the Euro debt crisis and weak global economic conditions. The kina's appreciation was supported by high foreign exchange inflows associated with the LNG project, mineral tax receipts, and high commodity export earnings. Up to April 20th 2012, the kina appreciated against the US dollar by 3.6 percent to 0.4836, and against the Australian dollar by 1.7 percent to 0.4670. The Governor stated that while the kina appreciation is a positive development to curb inflation, it has the potential to adversely affect the export sector. In this regard, the Central Bank has been actively involved in the foreign exchange market to ensure stability in the movement of the kina exchange rate.

The level of gross foreign exchange reserves as at 30th April 2012 was K9,074.9 (US$4,442.2) million, compared to K9,226.4 (US$4,340.1) million as at end of December 2011. The increase in the US dollar value is due to the latest payment of mineral tax for the Government while the decline in the kina value reflects the appreciation of the kina against the US dollar.

2. OVERVIEW OF THE DEVELOPMENTS IN THE DECEMBER QUARTER OF 2011

Economic indicators available to the Bank of Papua New Guinea (the Bank) show that economic growth continued to be strong in 2011, following the high growth in 2010. This was driven by the construction phase of the PNG LNG project and its spillover effects to the other sectors of the economy such as building and construction and transportation, high export commodity prices, and increased Government expenditure. Growth in employment, an increase in business activity in the non-mineral private sector, and continued but lower growth in private sector credit are all indicative of this growth. Inflation moderated in 2011 with an annual headline inflation of 6.9 percent compared to 7.2 percent in 2010. This was attributed to lower and stable prices of food and fuel and the appreciation of the kina over the year, especially against the US dollar. The kina appreciated against all major currencies in the December quarter and resulted in the daily average Trade Weighted Index (TWI) appreciating by 6.4 percent. Although inflation eased in the second half of the year, domestic demand pressures associated with the strong economic growth remained high in 2011. The Bank therefore took a cautious approach by maintaining the Kina Facility Rate (KFR) at 7.75 percent in the December quarter, after the increases from 7.0 percent between June and September.

Data from the Bank's Business Liaison Survey (BLS) show that the total nominal value of sales in the private sector declined by 0.2 percent in the September quarter of 2011, compared to a decline of 7.6 percent in the June quarter. Excluding the mineral sector, sales increased by 3.4 percent in the September quarter of 2011, compared to an increase of 6.8 percent in the June quarter. Sales declined in the mineral, manufacturing and retail sectors, which more than offset increases in the agriculture/forestry/fisheries, building and construction, wholesale, transportation, and financial/business/other services sectors. By region, NCD, Highlands, Islands and Momase recorded declines, while the Morobe and Southern regions experienced increases. Over the twelve months to September 2011, total sales declined marginally by 0.6 percent.

The Bank's Employment Index shows that the level of employment in the private sector increased marginally by 0.2 percent in the December quarter of 2011, compared to a decline of 0.2 percent in the previous quarter. Excluding the mineral sector, the level of employment declined by 0.1 percent in the December quarter, following a decline of 0.03 percent in the September quarter. By sector, the level of employment declined in the agriculture/forestry/fisheries and manufacturing sectors, while it increased in the financial/business/other services, mineral, wholesale, retail, and building and construction sectors. By region, Islands and Highlands recorded declines, while Momase, Morobe, NCD and Southern experienced increases. In 2011, the total level of employment increased by 6.2 percent. Excluding the mineral sector, the level of employment increased by 6.2 percent in 2011 as the change in the mineral sector was negligible.

Quarterly headline inflation as measured by the Consumer Price Index (CPI), was 1.2 percent in the December quarter of 2011, compared to 0.2 percent in the previous quarter. There were increases in the 'Transport and Communication', 'Household equipment and operations', 'Drinks, tobacco and betel nut', 'Clothing and footwear' and 'Miscellaneous' expenditure groups, while 'Food' and 'Rent, council charges, fuel and power' expenditure groups recorded declines. All surveyed urban areas recorded price increases in the December quarter of 2011, except for Rabaul. Annual headline inflation was 6.9 percent in the December quarter of 2011, lower than the 8.4 percent in the September quarter. The lower outcome was due to a fall in imported prices of food and fuel, combined with the appreciation of the kina against the currencies of Papua New Guinea's (PNG) major trading partners. The annual underlying inflation as measured by the exclusion-based and trimmed-mean inflation rate was 7.7 percent and 6.5 percent respectively in 2011.

In the December quarter of 2011, the daily average kina exchange rate appreciated against all the major currencies, reflecting continued high foreign exchange inflows. . It appreciated against the US dollar by 3.5 percent to 0.4665, pound sterling by 6.1 percent to 0.2914, euro by 8.6 percent to 0.3605, Australian dollar by 7.5 percent to 0.4591 and the Japanese yen by 2.9 percent to 36.17, compared to the September quarter. These movements resulted in the daily average Trade Weighted Index (TWI) appreciating by 6.4 percent to 37.3 over the quarter.

Higher international prices of PNG's mineral and most agricultural exports resulted in a 14.0 percent increase in the weighted average kina price of exports in 2011, compared to 2010. There was a 13.9 percent increase in the weighted average price of mineral exports, with higher kina prices of gold, copper and crude oil. For agricultural, logs and marine product exports, the weighted average kina price increased by 14.4 percent. This was accounted for by higher prices of coffee, palm oil, copra, copra oil, rubber and marine products.

The balance of payments recorded an overall surplus of K1, 096 million in 2011, compared to a surplus of K1,065 million in 2010. This outcome was due to a surplus in the capital and financial accounts, which more than offset a deficit in the current account. The financial account recorded a net inflow of K1, 087 million in 2011, compared to a net inflow of K2,934 million in 2010, a result of net inflows from portfolio and other investments. The capital account recorded a net inflow of K73 million in 2011, compared to K101 million in 2010, reflecting lower transfers by donor agencies for project financing.

The current account recorded a lower deficit of K114 million in 2011, compared to the deficit of K1,721 million in 2010. The deficit was accounted for by higher net services and income payments, which more than offset a trade surplus and net transfer receipts.

The level of gross foreign exchange reserves at the end of December 2011 was K9, 226.4 (US$4,340.1) million, sufficient for 11.5 months of total and 16.7 months of non-mineral import covers.

Although inflation outcomes eased in the second half of 2011, the Bank of PNG kept the KFR at 7.75 percent in the December quarter of 2011, in light of underlying inflationary pressures and expectations arising from strong domestic demand associated with the PNG LNG project and related activities, combined with high Government spending and international commodity prices. The dealing margin for the Repurchase Agreements (Repos) was maintained at 100 basis points on both sides of the KFR. Domestic Interest rates for short-term securities showed increasing trends across all maturities during the quarter.

The Bank continued to utilise its Open Market Operation (OMO) instruments in the conduct of monetary policy in 2011. There was limited Treasury bill auction during the quarter due to the Government's positive cash flow position. As a result, some of the excess liquidity was diffused through the issuance of Central Bank Bills (CBB). The liquidity in the banking system was unevenly distributed at times, thus prompting trading in the interbank market, as banks borrowed from each other to maintain positive Exchange Settlement Account (ESA) balances.

The average level of broad money supply (M3*) increased by 13.4 percent in 2011, compared to an increase of 17.0 percent in 2010. This outcome was due to an increase of 14.2 percent in average net foreign assets of depository corporations and an increase of 11.8 percent in average net private sector credit. Average net domestic claims outstanding, excluding net claims on the Central Government, increased by 11.4 percent in 2011, compared to an increase of 16.5 percent in the corresponding period. The average level of monetary base (reserve money) grew by 38.4 percent in 2011, compared to an increase of 20.4 percent in the corresponding period.

The average net foreign assets of the financial corporations increased by 10.9 percent in 2011, compared to an increase of 11.4 percent in 2010, following an increase in holdings by other depository corporations (ODC) and other financial corporations (OFC). Average net claims on the Central Government declined by 47.4 percent in 2011, compared to an increase of 34.5 percent in the corresponding period. This was accounted for by an increase in Central Government deposits, mainly in trust accounts.

In 2011, total domestic credit extended by financial corporations to the private sector, public non-financial corporations, Provincial and Local Level Governments, and other financial corporations, increased by K363.3 million to K8,836.5 million, compared to an increase of K1,276.7 million in 2010. This was mainly due to an increase of K441.5 million in net credit to the private sector.

Preliminary estimates of the fiscal operations of the National Government for 2011 show an overall deficit of K85.8 million[1], compared to a surplus of K186.3 million in 2010. The deficit represents 0.3 percent of nominal Gross Domestic Product (GDP), reflecting higher expenditure, which more than offset an increase in revenue.

Total revenue, including foreign grants, was K9, 168.8 million in 2011, 10.8 percent higher than the amount in 2010. This represents 93.2 percent of the revised budget revenue for 2011. The increase in revenue reflected higher tax revenue and foreign grants, which more than offset a decline in non-tax receipts. Total expenditure was K9,254.6 million in 2011, 14.4 percent higher than in 2010 and represents 93.2 percent of the revised budget appropriation for 2011, accounted for by higher recurrent and development expenditures.

As a result of the developments in revenue and expenditure, the Government recorded an overall budget deficit of K85.8 million in 2011. The budget deficit and net external loan repayments of K225.8 million were financed by the domestic sector with K311.6 million. The net external loan repayments comprised of K165.9 million to concessionary, K17.9 million to commercial and K42.0 million to extraordinary financing sources. The domestic financing comprised of K817.8 million in cheque float not yet presented for payment, which more than offset K506.2 million in net negative financing by the financial corporations, mainly reflecting Government deposits at the Central Bank.

Total public (Government) debt outstanding at the end of the December quarter of 2011 was K7,238.4 million, K658.7 million higher than in the December quarter of 2010. The increase reflected higher domestic debt, which more than offset a decline in external debt. The increase in domestic debt was due to new issuance of Treasury bills and Inscribed stocks. The decrease in external debt reflected loan repayments and lower drawdown of loans, combined with the effect of appreciation of the kina.

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1. This was a preliminary figure supplied by the Treasury Department. The Department has since revised the 2011 budget outcome to a deficit of K63.7 million. While the Press Release reports the preliminary fiscal outcome, the revised figure is used in the Public Finance section of the December quarter 2011 issue of the Quarterly Economic Bulletin.

The total amount of Government deposits in the depository corporations increased by K1, 525.6 million to K4, 788.0 million in the December quarter of 2011, compared to K3,262.4 million in the December quarter of 2010.The balance of Government trust accounts held at the Central Bank increased by a net of K516.5 million to K729.4 million between the end of December 2010 and December 2011.