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BANK OF PAPUA NEW GUINEA



**MONETARY POLICY STATEMENT
BY THE GOVERNOR OF
THE BANK OF PAPUA NEW GUINEA,
MR. LOI M. BAKANI**

PORT MORESBY

30th September 2011

Queries on the contents of the Monetary Policy Statement (MPS) should be directed to the Manager, Economics Department on telephone number (675) 3227430 or Manager, Monetary Policy Unit on telephone number (675) 3227278, or both on fax number (675) 3200757. Copies of the Statement can be obtained from the Economics Department and is also available on the Bank's website: <http://www.bankpng.gov.pg>. It will be reproduced in the September 2011 issue of the Quarterly Economic Bulletin (QEB).

Objective of Monetary Policy

The objective of monetary policy in Papua New Guinea (PNG) is to achieve and maintain price stability. This entails low inflation supported by stable interest and exchange rates. The maintenance of price stability leads to:

- Confidence in the kina exchange rate and management of the economy;
- A foundation for stable fiscal operations of the Government;
- Certainty for businesses to plan for long-term investment; and
- A stable macroeconomic environment conducive to economic growth.

Executive Summary

Economic activity in PNG continued to grow in 2011, attributed to the on-going construction of the PNG Liquefied Natural Gas (LNG) project and the spin-off effects to some sectors, higher international commodity prices and increased Government expenditure. The strong domestic demand and high international prices of food and fuel resulted in higher inflation. Most other macroeconomic indicators were broadly in line with the projections made in the March 2011 Monetary Policy Statement (MPS).

The construction phase of the PNG LNG project is contributing to increased growth in the building and construction, commerce and transportation, storage and communication sectors. Increased tax revenue from high international prices of gold, copper, crude oil and some agricultural exports and business activity resulted in higher than budgeted revenue to the Government. The Government subsequently passed a Supplementary Budget of K781.8 million on 21st September 2011. Targeted spending under the Supplementary Budget included free education, health, roads and LNG related commitments. Given these developments, real Gross Domestic Product (GDP) growth for 2011 is expected to be higher than the earlier projection of 9.5 percent.

Annual headline inflation was 9.6 percent in the June quarter of 2011, higher than the Bank's projection for 2011 of 8.5 percent in the March 2011 MPS. The increase reflected higher food and fuel prices and domestic demand. Underlying inflation was around 8.0 percent, indicating inflationary pressure still remains. The Bank therefore tightened monetary policy beginning in June 2011, and revised upwards its inflation projection for 2011 to 9.0 percent from 8.5 percent. High economic growth will continue to contribute to inflation in the medium term.

The expansionary fiscal policy of the Government through increased expenditure and Supplementary Budgets has contributed to an increase in liquidity in the banking system, with the increase in Government deposits, including trust accounts. This has added to domestic demand pressures within the economy and has made monetary policy management more challenging. It is therefore imperative that Government manages fiscal policy responsibly, in order to ensure macroeconomic stability.

To assist the Bank's efforts in achieving and maintaining price stability, the Government should undertake the following measures:

- Prudently manage its fiscal operations and keep within a sound budgetary framework;
- Allow the Bank to manage any unbudgeted windfall revenues on behalf of the Government in an offshore foreign currency account, instead of appropriating them through supplementary budgets;
- Move to establish an offshore Sovereign Wealth Fund (SWF) to manage revenues from the PNG LNG and other mineral projects;
- Appropriate an adequate amount of Treasury bills to the Central Bank in the 2012 National Budget for liquidity management;
- Transfer the trust accounts held at the commercial banks and all new trust accounts to be held at the Central Bank to assist with liquidity management;
- Undertake ongoing maintenance and renovation of existing infrastructure during the construction phase of the PNG LNG project so as not to compete with the private sector and PNG LNG project for the limited productive resources within the country;
- Have a plan to utilize the highly skilled and trained workforce, equipment and machinery used for the construction of the PNG LNG project as and when they become available; and
- Invest in developing a competitive and advanced agriculture sector, from excess revenues to be kept in a Special Purpose Account at the Central Bank.

In addition, the private sector should act responsibly by passing on the benefits of lower import prices as a result of the appreciation of the kina exchange rate and cheaper sources of imports, especially from Asia. Agencies responsible for monitoring prices and competition should ensure proper pass-through of price changes and that competitive markets prevail.

The Bank will continue to undertake financial inclusion initiatives through improvement of the payment and settlement system, financial education, microfinance and mobile phone banking to ensure that the majority of the population can participate in the financial system. These will also enhance competition in the financial sector.

Undertaking the above measures can help minimize the effects of Dutch Disease and reduce inflationary pressures. These would also foster a broad based growth and enable the macroeconomic gains to flow to the wider population.

There is a need for greater coordination between monetary and fiscal policy to achieve price stability during this period of high economic growth and inevitably, inflation. The Government and the Bank should carefully assess the trade-off between high economic growth and inflation in an effort to support domestic economic activity while not letting inflation spiral out of control.

1.0 Monetary Policy Discussions

1.1 Monetary Policy Assessment and Issues

The global economic recovery was slower than anticipated in the first half of 2011, with economic activity slowing down in both advanced and emerging economies, particularly in the former. As a result, the International Monetary Fund (IMF) revised downward the global growth forecast for 2011 to 4.3 percent from 4.5 percent in its June 2011 World Economic Outlook (WEO) Update. The European sovereign debt crisis continued to deepen as bailouts and austerity measures, like increasing taxes and spending cuts failed to stop diminishing investor confidence. Growth in the United States (US) was positive but at a sluggish pace, weighed down by the housing crisis, low employment growth, issues surrounding the Government debt ceiling and downgrading of its sovereign credit rating. Major economies in Asia such as China and India, and Australia continued to grow and inflation has subsequently increased. This, together with the rise in international food and fuel prices, has contributed to a rise in inflation in the PNG economy. The appreciation of the kina exchange rate against the US dollar has partly offset imported inflation. For the rest of 2011, global economic recovery is expected to remain weak.

Economic activity in PNG as measured by real GDP growth is projected to be higher in 2011 than the earlier forecast of 9.5 percent. This is due to higher than expected growth in the building and construction, commerce and transportation, storage and communication sectors. Growth in the other sectors is expected to remain strong with the exception of the petroleum sector. The ongoing construction of the PNG LNG project, higher Government expenditures, continued business investments, as well as higher prices and production of some export commodities will spur this growth. The increase will more than offset further delays in the production of the Ramu Nickel/Cobalt mine in 2011.

Annual headline inflation for the June quarter of 2011 was 9.6 percent, up from 9.0 percent in the March quarter. These inflation outcomes, which were higher than the 8.5 percent projected for 2011 in the March 2011 MPS, were mainly driven by high international food and fuel prices. Turmoil in North Africa and the Middle East added to the increase in oil prices, which were already rising because of growing demand from emerging markets like China and India. Underlying inflation also rose in the last two quarters. There were also strong domestic demand arising from increased economic activities and Government spending. In light of the appreciation of the kina exchange rate, recent moderation of international food and fuel prices, and cheaper sources of imports, especially from Asia, the private sector should act responsibly by passing on the benefits of lower import prices to consumers. Agencies responsible for the monitoring of prices and fair competition should do what they can to ensure proper pass-through of price changes and that competitive markets prevail.

The construction of the PNG LNG project has also generated excessive demand in the housing and property market. This, combined with inelastic supply of real estate and speculative activities, have driven up property prices. The increase in real estate prices are encouraging the public to increase its indebtedness to the financial system by borrowing to invest in the property market. These have the potential to contribute to an 'asset price bubble'. In view of this, relevant Government agencies should introduce adequate reforms to the sector to ensure stability in the financial system.

Annual growth in broad money supply (M3*) and monetary base in August 2011 were 10.6 percent and 50.0 percent, respectively. The increase in broad money supply resulted from increases in private sector credit and net foreign assets of depository corporations, which grew by 9.7 percent and 20.9 percent, respectively. The substantial growth in monetary base was attributed to an increase in currency in circulation, due to increased holdings by the banks and the public, reflecting increased economic activity. Lending grew at a relatively slow pace, as activities associated with the PNG LNG project are funded mainly by the project developers, while other private companies are mainly using their own funds. Over the nine months to September 2011, the Bank issued net new Central Bank Bills (CBB) of K1,170.0 million through its Open Market Operations (OMOs) to diffuse some of the excess liquidity. The Cash Reserve Requirement (CRR) was also increased to 6.0 percent between June and August 2011 which diffused around K300 million. Liquidity continued to remain high during the year, increasing by 19.3 percent over the same period, which exerted downward pressure on domestic interest rates.

In 2011, broad money supply is expected to increase by 14.6 percent, higher than the 9.6 percent projected in the March 2011 MPS. The upward revision is due to an increase in net foreign assets of the banking system as a result of high international commodity prices. Monetary base and private sector credit are projected to grow by 48.7 percent and 14.5 percent, respectively, both also higher than earlier forecast. The high growth in monetary base is attributed to increases in currency in circulation and deposits of Other Depository Corporations (ODC) at the Central Bank. The Bank considers the projected growth in monetary aggregates sufficient to support economic growth, but is also mindful of the inflationary impact of growth in private sector credit associated with the high growth in economic activity.

¹ 'Asset price bubble' is characterized by a steep increase in the price of an asset, including property, which creates expectations of future increases, thus generating further increases beyond the genuine value of the asset.

Preliminary estimates of the Government's fiscal operations over the seven months to July 2011 showed an overall deficit of K15.8 million, or 0.1 percent of nominal GDP, compared to a surplus of K207.4 million in the corresponding period of 2010. In its Mid Year Economic and Fiscal Outcome (MYEFO) report, the Government revised upward the mining and petroleum tax revenues as a result of higher international commodity prices. This would result in additional revenue of K606.8 million in 2011. In line with its balanced budget strategy the Government has passed a Supplementary Budget of K781.8 million on 21st September 2011, comprising the additional revenue, a re-appropriation of K116.0 million from the 2011 development budget for projects that were not implemented, and K59.0 million from other sources. The Government has appropriated a total of K648.5 million in trust accounts for specific activities, including free education (K300.0 million), health (K109.5 million), roads (K158.0 million) and outstanding commitments for the PNG LNG project (K40.0 million). The Government should continue to maintain, improve, and strengthen existing transportation and social sector infrastructure to improve health, education, and law and order. However, it must be careful not to compete with the PNG LNG project for the limited production resources within the country, which would drive up prices and add to inflation. In addition, Government should help develop the traditional sectors like agriculture, which would reduce their costs and mitigate their exposure to adverse price and exchange rate movements and the effects of *Dutch Disease*.

The placement of Government deposits at commercial banks has been one of the major sources of domestic liquidity. Total Government deposits, including trust accounts, at commercial banks was around K2.7 billion at end of August 2011. Between December 2010 and first half of 2011, a total of K617.3 million was deposited into trust accounts at the Central Bank from the 2010 Supplementary Budget. Despite the undertaking by the Government to maintain the funds at the Central Bank, subsidiary accounts were created at the commercial banks and the funds transferred into them. As at 23rd September 2011, a balance of only K90.0 million remained at the Central Bank. From the 2011 National Budget, a total of K723.2 million was to be placed in trust accounts. Of this, K240.2 million was to be parked at the Central Bank but only K60.2 million was deposited up to 23rd September 2011. The Central Bank had to issue CBBs at a substantial cost to partially diffuse the liquidity in the banking system. Excessive liquidity has adverse implications on broader macroeconomic conditions including inflation. As such, the Government should bear greater responsibility in assisting the Central Bank to manage liquidity effectively. These measures include maintaining all trust accounts and other deposits at the Central Bank, reducing deposits at the commercial banks by improving the capacity of implementing agencies to draw down the funds, and appropriate an adequate amount of Treasury bills for the Central Bank to trade for liquidity management purposes.

The Government should establish the offshore SWF to manage revenues from the PNG LNG and other mineral projects. Prior to the establishment of the SWF, the Government should allow the Central Bank to open and manage an offshore account for any windfall revenue from commodity exports. Any appropriation of windfall revenue through Supplementary Budgets will continue to pose concerns for spending, liquidity, the exchange rate and inflation. This calls for greater cooperation between the Government and the Central Bank, especially during this period of high economic growth, and inevitably, inflation. Therefore, the Bank reiterates the need for closer coordination between the Treasury and Finance Departments and the Bank in the conduct of fiscal and monetary policies to achieve price stability.

The construction of the PNG LNG project is contributing to strong growth in some of the sectors, mainly building and construction, commerce, transportation and manufacturing. The high foreign exchange inflows from the LNG related activities and international commodity prices contributed to the appreciation of the kina. The high commodity prices offset the adverse impact of appreciation of the kina on the agriculture/forestry/fisheries sector. To minimize the effects of Dutch Disease stemming from the development of the PNG LNG project, the Government has to invest in developing a competitive and advanced agriculture sector. This is the most efficient and effective way to deal with the Dutch Disease where there are alternative sources of income generation with a wider base of exports. Given the projected revenue and tax inflows, Government would have the resources to invest in the social sector and develop the agriculture sector. A Special Purpose Account (that is budgeted for) should be set up at the Central Bank in which all the excess revenues can be deposited to be used for these purposes.

In this period of high economic growth, aggregate domestic demand will increase and exert upward pressure on inflation. In this regard, the PNG economy would continue to experience high inflation. It will require a joint effort by the Government and the Bank to carefully assess the trade-off between high economic growth and inflation in an effort to support domestic economic activity while not letting inflation spiral out of control.

2 Dutch Disease refers to an economic condition where a resource boom leads to an appreciation of the real exchange rate, which in turn depresses outputs in the traditional tradable sector. The real exchange rate appreciation can occur in two ways. First, a surge in exports from the booming sector leads to an appreciation of the nominal exchange rate, resulting in a rise in the domestic prices of tradable and a consequent reduction in the export of traditional tradable, non-tradable being unaffected. Second, the increase in income from the resource boom may lead to an increase in demand for domestic non-traded goods and a consequent increase in their prices.

1.2 Monetary Policy Stance

Inflation increased in the first half of 2011, mainly driven by high international food and fuel prices, and domestic demand arising from increased economic activities. Because of these, and the prospect of continued inflationary pressures, the Central Bank tightened monetary policy by increasing the Kina Facility Rate (KFR) by 25 basis points each in June, July, and September 2011 to 7.75 percent. The Bank also increased the CRR for commercial banks by 100 basis points each in July and August to 6.0 percent in support of the tight stance.

Economic activity is projected to grow strongly in 2011, due to the ongoing construction of the PNG LNG project, higher Government expenditures, continued business investments, as well as higher prices and production of some export commodities. This strong economic growth would generate domestic demand pressures adding to inflationary pressures.

In 2011, broad money supply is expected to increase by 14.6 percent. Monetary base and private sector credit are projected to grow by 48.7 percent and 14.5 percent, respectively. The projected growth in monetary aggregates will continue to support economic growth. However, the Bank is mindful of the inflationary impact of growth in private sector credit.

The Bank projects headline inflation to be around 9.0 percent in 2011. The upside risks to this projection include:

- Any significant increase in Government expenditure;
- Higher than expected imported inflation from higher food and fuel prices;
- Higher domestic demand pressures arising from the ongoing construction of the PNG LNG project and associated activities;
- Higher inflation expectations by firms; and
- The effects of adverse weather conditions on domestic food production.

In light of the strong domestic economic growth and associated demand pressures in 2011, combined with high international food and fuel prices, the Bank will continue to assess the trade-off between high economic growth and inflation, and maintain a tight monetary policy to ensure inflation does not spiral out of control.

1.3 Conduct of Monetary Policy

Monetary policy will be conducted within the reserve money framework. The MPS provides the overall monetary policy stance, while the monthly KFR remains the instrument for signaling this stance or any changes through an announcement by the Governor. Following the announcement, Open Market Operations will be conducted to support the Bank's monetary policy stance. The OMOs involve Repurchase Agreement (Repo) transactions with commercial banks and the auction of CBBs to ODCs and Treasury bills to the general public.

The Bank has also used one of its direct instruments in 2011, increasing the CRR, to assist in liquidity management.

2.0 Developments and Expectations

2.1 International Developments

The global economic recovery slowed during the first half of 2011, with varying paces of growth in the advanced and emerging economies. The slowdown in advanced economies has been more pronounced, as a result of disruptions in Japan due to the earthquake and rising public debt levels in the major Organization for Economic Co-operation and Development (OECD) countries. Economic recovery in the US remained weak, with concerns about the sustainability of the increasing US fiscal deficit. In the Euro-zone, the high public debt levels in the periphery countries continue to undermine growth prospects. Economic activity among emerging economies have also slowed but remained relatively strong on the back of buoyant domestic demand and employment. Accordingly, the IMF revised downwards its global growth forecast in the WEO Update for June 2011, from 4.5 percent to 4.3 percent. Advanced economies are projected to grow by 2.2 percent and emerging and developing economies by 6.6 percent.

In the US, real GDP increased at an annualized rate of 1.6 percent during the second quarter of 2011, compared to a revised 0.4 percent growth in the first quarter. In the June quarter, growth was supported by high business investment, government spending and exports, which more than offset a large decline in consumer spending. Concerns over default with the rising US fiscal deficit was averted when Congress approved the new debt ceiling of US\$14.3 trillion in August 2011, the highest in US history. This is conditional on spending cuts over the coming years. Despite this, Standard & Poors downgraded the US sovereign credit rating. Japan's economy fell into recession during the second quarter, with real GDP declining by 1.0 percent following a contraction of 0.9 percent during the first quarter. The contraction was mainly attributed to weaker exports. The Euro-zone's second quarter real GDP grew at an annual rate of 1.7 percent, down from 2.5 percent in the first quarter. The decline in growth mainly reflected a slowdown in Germany combined with a fall in consumer and business confidence as a result of austerity measures, including spending cuts and increasing taxes, implemented by peripheral Euro-zone member countries. The United Kingdom (UK) economy experienced stagnant growth in the June quarter of 0.7 percent whilst the Australian economy remained resilient with growth of 1.1 percent, supported by its resource boom. GDP in China increased by 9.5 percent in the June quarter compared to 9.7 percent in the previous quarter, while in India it increased by 7.7 percent.

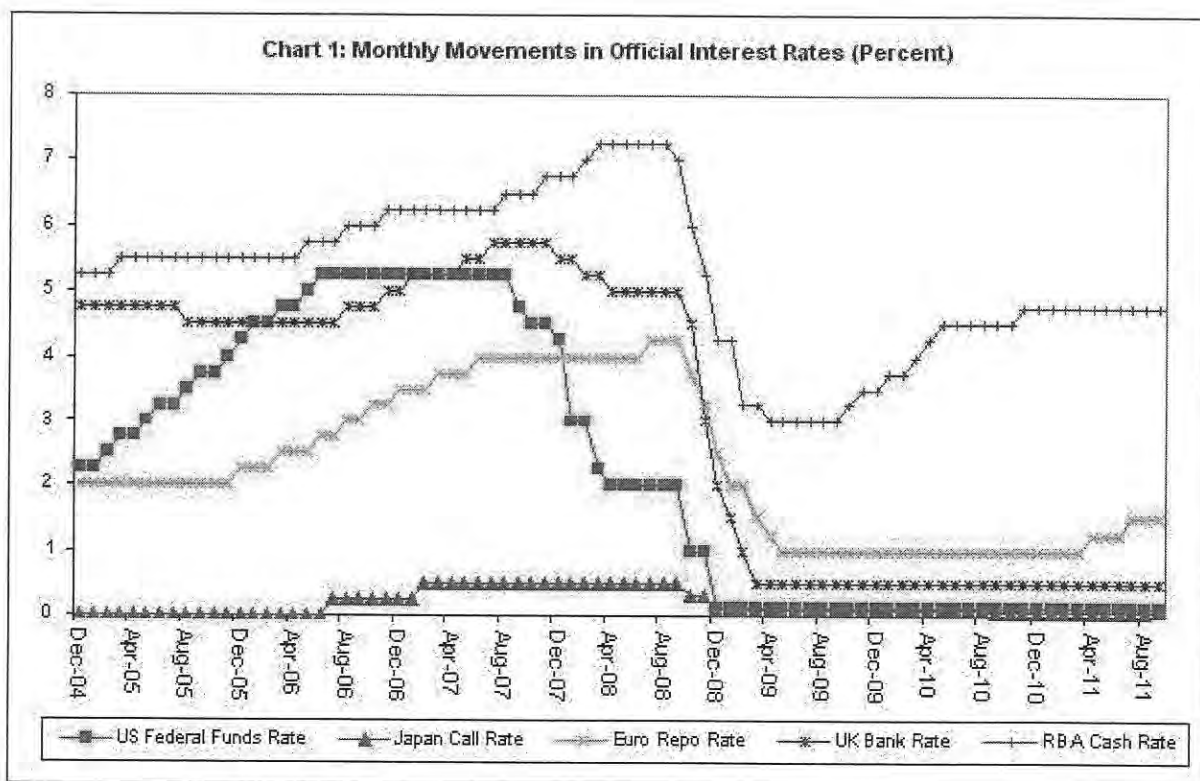
Unemployment rates remained high among advanced economies, reflecting their weak recovery. The unemployment rate in the US was 9.1 percent in July compared to 9.0 percent in January 2011. In Japan, the unemployment rate increased to 4.6 percent in June from 4.5 percent in the previous month. The unemployment rates for the Euro-zone and the UK remained high at 9.9 percent and 7.9 percent respectively in June. The unemployment rate for Australia increased to 5.3 percent in August 2011.

Globally, inflation increased as a result of higher prices of food, mineral and energy products. Annual headline inflation in the US was 3.6 percent in June, the highest since October 2008. Inflation in the Euro-zone was 2.5 percent in July from 2.7 percent in the previous month, while over the same period UK inflation was 4.4 percent from 4.2 percent. Australian inflation was 3.6 percent in the second quarter compared to 3.3 percent in the previous quarter. In China, inflation was 6.5 percent in July from 6.4 percent in the previous month.

Despite higher inflation, most Central Banks in advanced economies did not tighten monetary policy, with the exception of the European Central Bank (ECB). The ECB increased its policy rate by 25 basis points to 1.5 percent in July, after a similar increase in April as inflation remained above its target of 2.0 percent. Other major central banks continued to maintain their accommodative monetary policy stance reflecting weaknesses in their domestic economies. The US Federal Reserve, Bank of Japan, Bank of England and the Reserve Bank of Australia kept their policy interest rates unchanged at 0.25 percent, 0.1 percent, 0.5 percent and 4.75 percent respectively. In contrast, a number of central banks in emerging economies, including China, India and Brazil increased their benchmark interest rates.

Financial market volatility increased during the third quarter of 2011, mainly due to the European debt crisis, uncertainties over the US debt ceiling and the subsequent downgrading of the US credit rating. Investors' uncertainty has led to increased safe-haven investments, such as gold which reached an historical high of US\$1,900.2 per fine ounce as at 5th September 2011. Despite the downgrade of US credit rating, appetite for US government securities remained strong leading to prices on US government bond increasing sharply to around the levels reached during the Global Financial Crisis. In contrast, global stock markets have fallen sharply.

From January to August 2011, the US dollar has generally depreciated against the other major currencies. Apart from the general weakness of the US dollar, expectations of further tightening of monetary policy in the Euro-zone and UK have supported the euro and pound sterling, respectively. The Australian dollar continued to be strong, due to high commodity prices, having reached a high of 1.1061 against the US dollar at the end of July 2011. The Japanese yen was supported by the repatriation of funds by Japanese firms following Japan's earthquake in March 2011. Over the year to August 19th 2011, the Australian dollar appreciated by 2.0 percent to 1.0418 US dollar, the yen by 5.6 percent to 76.82 US dollar, the Euro by 5.7 percent to 1.4381 US dollar and the pound sterling by 8.0 percent to 1.6344 US dollar.



Source: Various Central Banks' websites

2.2 Domestic Economic Condition

Economic activity in PNG as measured by real GDP growth is projected to be higher in 2011 than the earlier forecast. This is due to higher than expected growth in the building and construction, commerce and transportation, storage and communication sectors. Growth in the other sectors is expected to remain strong except the petroleum sector. The ongoing construction of the PNG LNG project, higher Government infrastructure and consumption expenditures, continued business investments, as well as higher prices and production of some export commodities will spur this growth. The increase will more than offset further delays in the production of the Ramu Nickel/Cobalt mine from 2011 to 2012/2013.

The increase in the building and construction sector is driven by the pick up in construction of the PNG LNG project as well as high private and public sectors' investments on infrastructure and buildings. The pick up in the commerce sector was due to increased Government spending and higher consumer demand associated with increase in commodity prices. The expansion in the transportation, storage and communication sector is driven by increased activity in all transportation sub-sectors, associated with higher passenger travel, cargo haulage, and storage and communication services. The growth in the agriculture/forestry/fisheries sector is mainly in the agriculture and fisheries sub-sectors, reflecting high prices and production of some agricultural commodities and fisheries products. In the mineral sector, the growth reflects increased production at existing mines, while the petroleum sector is expected to decline as reserves continued to be depleted.

For the medium term, the Bank projects that economic growth will continue in 2012 and 2013. This growth is expected to take into account a full year of production by Ramu Nickel/Cobalt mine and increased production of gold at the Lihir, Hidden Valley and Simberi mines. In addition, higher domestic demand associated with increased government expenditure, private sector investment and high prices of export commodities will support overall growth over this period, as the LNG construction phase winds down in 2013.

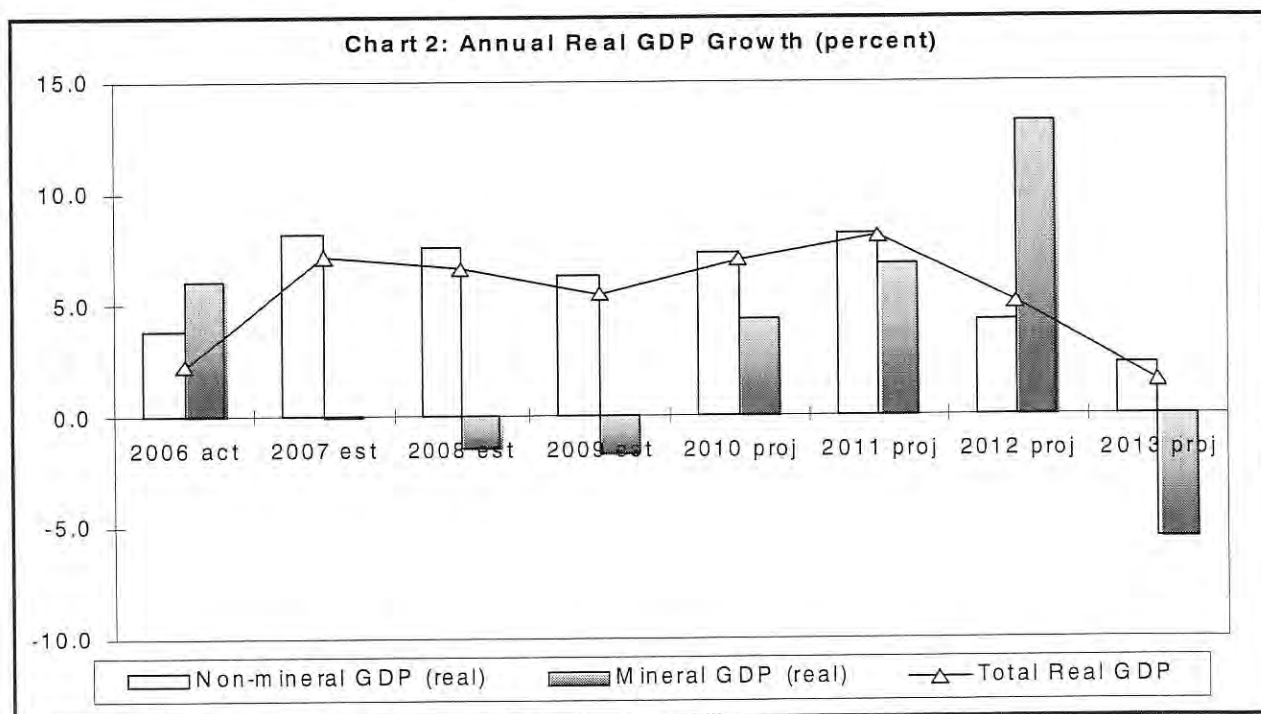
The main downside risks to these projections include:

- any delays and disruptions to the Ramu Nickel/Cobalt and PNG LNG Projects;
- a further slowdown in the world economic growth;
- any declines in international commodity price;
- higher than expected inflation due to high international food and fuel prices; and
- adverse weather conditions and natural disasters.

Data from the Bank's Employment Survey indicate that the annual level of employment in the formal private sector increased by 7.1 percent in the June quarter of 2011, compared to an increase of 5.3 percent in the March quarter of 2011 and 1.1 percent in the December quarter of 2010. The continued growth in employment was mainly associated with the PNG LNG project and strong growth in private sector activity. Employment increased in the retail, wholesale, transportation, agriculture/forestry/fisheries, financial/business and other services, mineral and manufacturing sectors, while it declined in the building and construction sector, reflecting the completion of a number of road and building projects. By region, the level of employment increased in all regions. Excluding the mineral sector, the annual level of employment grew by 6.7 percent in the June quarter of 2011, following an increase of 4.7 percent in the previous quarter.

Data from the Bank's Business Liaison Survey (BLS)³ show that the total nominal value of sales in the private sector increased by 19.9 percent over the twelve months to March 2011, following an increase of 18.1 percent over the twelve months to December 2010. The increase in sales was mainly associated with the construction of the PNG LNG project, increased Government expenditure and strong growth in private sector activity. The increase was recorded in the transportation, retail, manufacturing, building and construction, agriculture/forestry/fisheries, wholesale, financial/business and other services and mineral sectors. Excluding the mineral sector, annual sales increased by 18.4 percent.

³ Not all companies engaged in the LNG project are included in the Bank of PNG quarterly surveys.



Source: 2011 National Budget

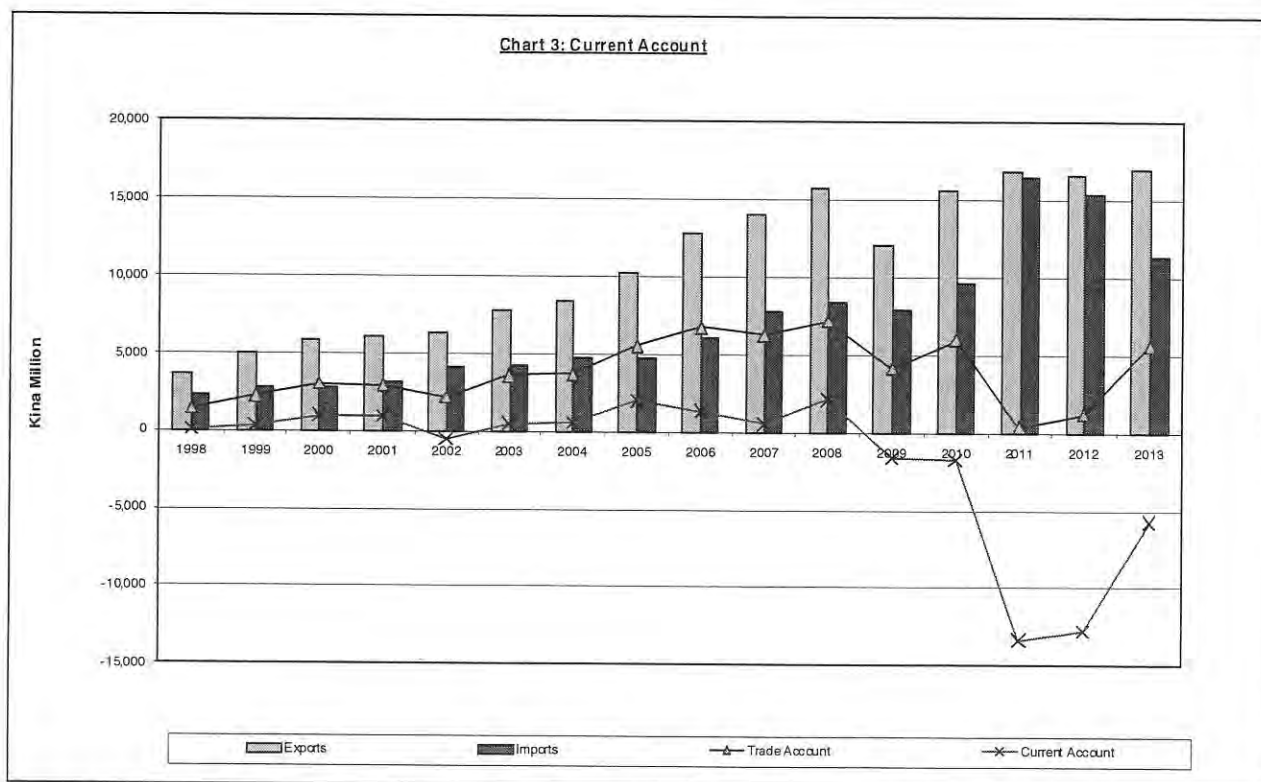
2.3 Balance of Payments

Preliminary balance of payments data for the first six months of 2011 showed an overall surplus of K359 million, compared to a higher surplus of K471 million in the same period of 2010. This outcome was due to a surplus in the current account, which more than offset a deficit in the capital and financial accounts (see Chart 3). The surplus in the current account was due to a higher trade balance and lower net service payments, which more than offset higher net income payments and lower net transfer receipts. The deficit in the capital and financial accounts was due to lower transfers by donor agencies for project financing and net outflows mainly from foreign direct investments. Net outflows from foreign direct investments were associated with the purchase of shares by a resident mineral company, purchase of short-term money market instruments, investments in financial derivative instruments through hedge arrangements, combined with higher net loan repayments by the Government. These more than offset net inflows from draw downs in net foreign assets of the banking system.

The level of gross foreign exchange reserves at the end of June 2011 was US\$3,738.6 (K8,485.9) million, sufficient for 10.5 months of total and 14.6 months of non-mineral import covers. As at 26th September 2011, the level of gross foreign exchange reserves was US\$3,815.9 (K8,479.8) million.

The World Bank's June 2011 price forecasts indicate that international prices for all of PNG's non-mineral export commodities will be lower in 2011, compared to 2010, except for coffee, palm oil and copra oil. According to the mineral companies in PNG, the prices of all mineral exports are expected to increase over the same period.

⁴ Balance of payments data does not include transactions by some of the new major projects, including PNG LNG and Ramu Nickel/Cobalt.



Source: Bank of PNG

The export volumes of all of PNG's major non-mineral commodities are projected to increase in 2011, compared to 2010, except for cocoa, palm oil and tea. The projected higher production in 2011 and into the medium term is associated with higher international prices resulting from increased global demand, mainly from Asia. The volume of gold exports is expected to increase in 2011, compared to 2010, while copper and oil export volumes are projected to decline over the same period. The increase in gold exports is due to on-going expansion of the Lihir mine combined with mining of higher ore grades from the existing mines. Copper volumes are expected to decline in 2011 as a result of disruptions in production, which will recover over the medium term. In the petroleum sector, the decline in exports is associated with the natural decline in production from existing oilfields. The Ramu Nickel/Cobalt project is expected to commence production in 2012/2013.

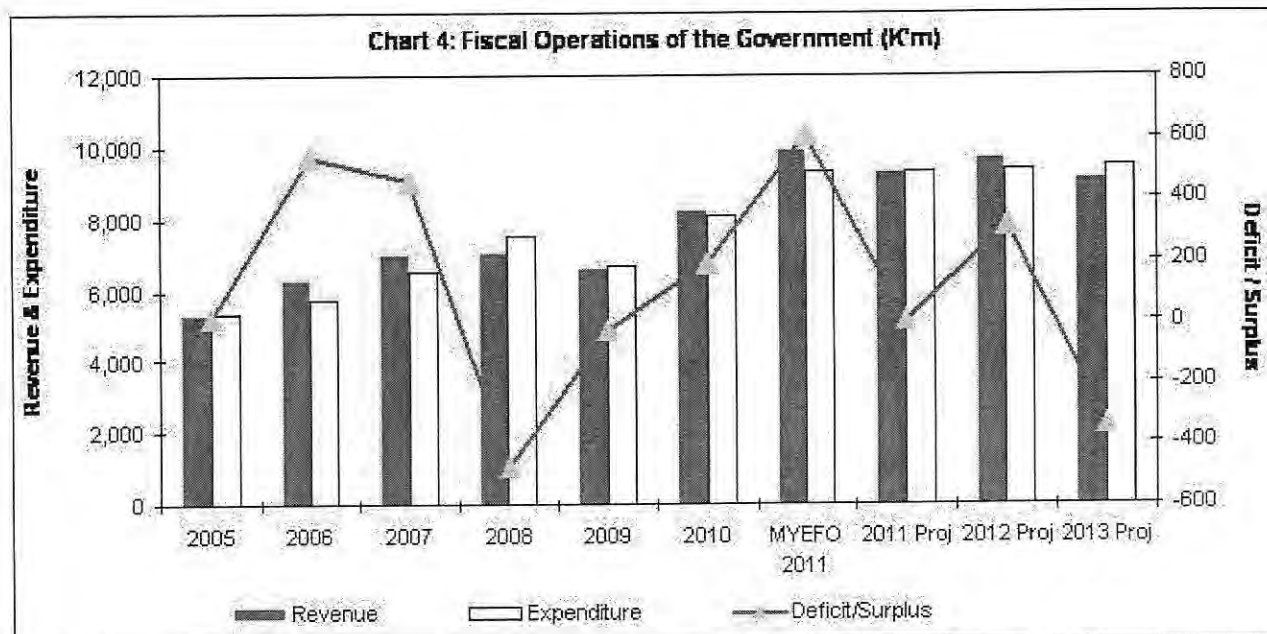
The main assumptions underlying the balance of payments projections for 2011 and the medium term are:

- relatively stable kina exchange rate;
- ongoing construction of the PNG LNG project and the production to commence in 2014;
- further delay in commencement of production at Ramu Nickel/Cobalt mine; and
- decline in international commodity prices stemming from the slow recovery of the global economy.

The current account is projected to record a significantly higher deficit in 2011, mainly due to increased imports, service and income payments associated with the PNG LNG project. This will be more than offset by a surplus in the financial account reflecting inflows mainly associated with the injection of equity funds and the drawdown of loan funds for financing of the PNG LNG project by the project partners. Most of the payments relating to the PNG LNG project will be spent offshore and may not affect the domestic foreign exchange market. As a result, the overall balance of payments is projected to be in surplus by K825 million in 2011, compared to a surplus of K1,066 million in 2010. At the end of 2011, the gross foreign exchange reserves are projected to be around US\$4,002.7 (K8,994.8) million, sufficient for 6.5 months of total and 17.7 months of non-mineral import covers. Gross reserves are projected to be higher into the medium term due to increased inflows associated mainly with high international prices of PNG's export commodities (See Appendix - Table 2).

2.4 Fiscal Operations of the National Government

Preliminary estimates of the Government's fiscal operations over the seven months to July 2011 showed an overall deficit of K15.8 million, or 0.1 percent of nominal GDP, compared to a surplus of K207.4 million in the corresponding period of 2010. Total revenue, including foreign grants, decreased by 0.2 percent in the seven months to July 2011, compared to the corresponding period in 2010, and represents 40.1 percent of the 2011 budget. The decline in revenue mainly reflected lower non-tax receipts, which more than offset higher tax receipts. Total expenditure increased by 6.1 percent over the seven months to July 2011, compared to the corresponding period in 2010, and represented 40.3 percent of the budget. The increase in recurrent expenditure is attributed to higher spending by National Departments and Provincial Governments, combined with higher interest payments on domestic debt. The decrease in development expenditure was due to lower expenditure by National Departments. The budget deficit of K15.8 million and net external loan repayments totalling K18.0 million was financed mainly by the domestic sector. The net financing by domestic sources of K913.1 million comprised of net drawdown totaling K205.6 million of Government deposits at the Central Bank, K648.7 million in net borrowing from ODCs, and K58.8 million in net borrowing from Other Financial Corporations. This more than offset K879.3 million in cheques presented for payment.

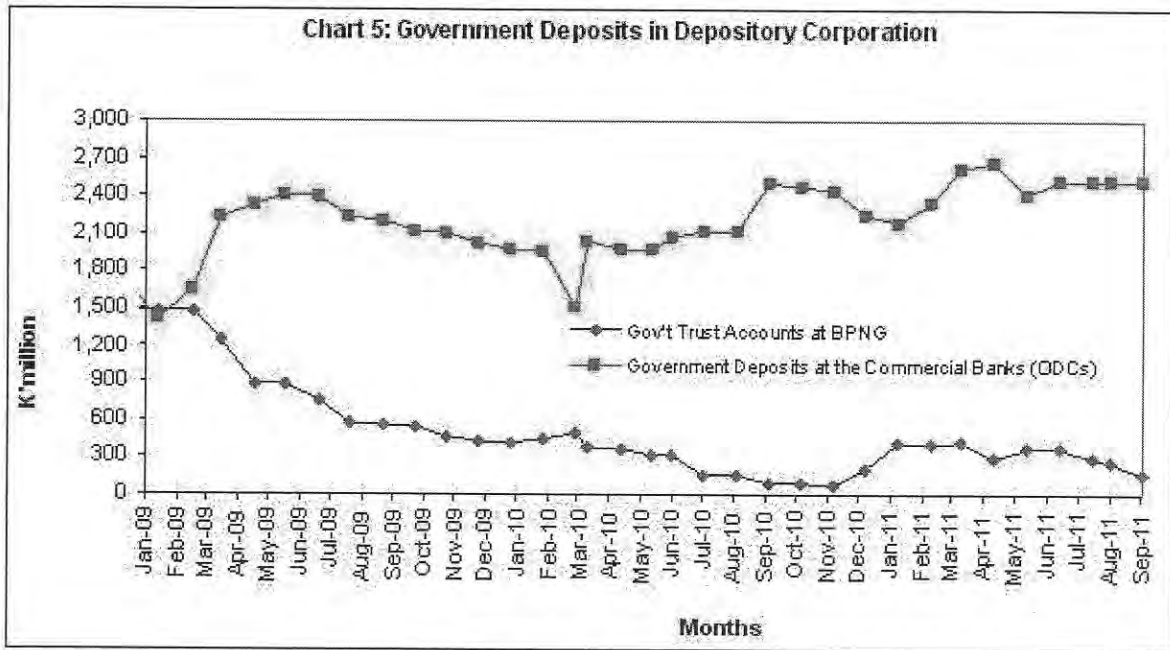


Source: Department of Treasury

The total amount of Government deposits at the depository corporations increased by K820.2 million to K4,082.8 million at the end of August 2011, compared to K3,262.4 million in December 2010. At the Central Bank, the amount of Government trust account funds has decreased to K155.3 million as at week ending 23rd September 2011, from K212.8 million at the end of December 2010 (see chart 5).

Total public debt increased by K101.4 million to K6,690.1 million in the June quarter of 2011, compared to K6,579.7 million in the December quarter of 2010. This outcome was attributed to higher new issuance of Government securities, both Treasury bills and Inscribed stocks, which more than offset a decline in external loans.

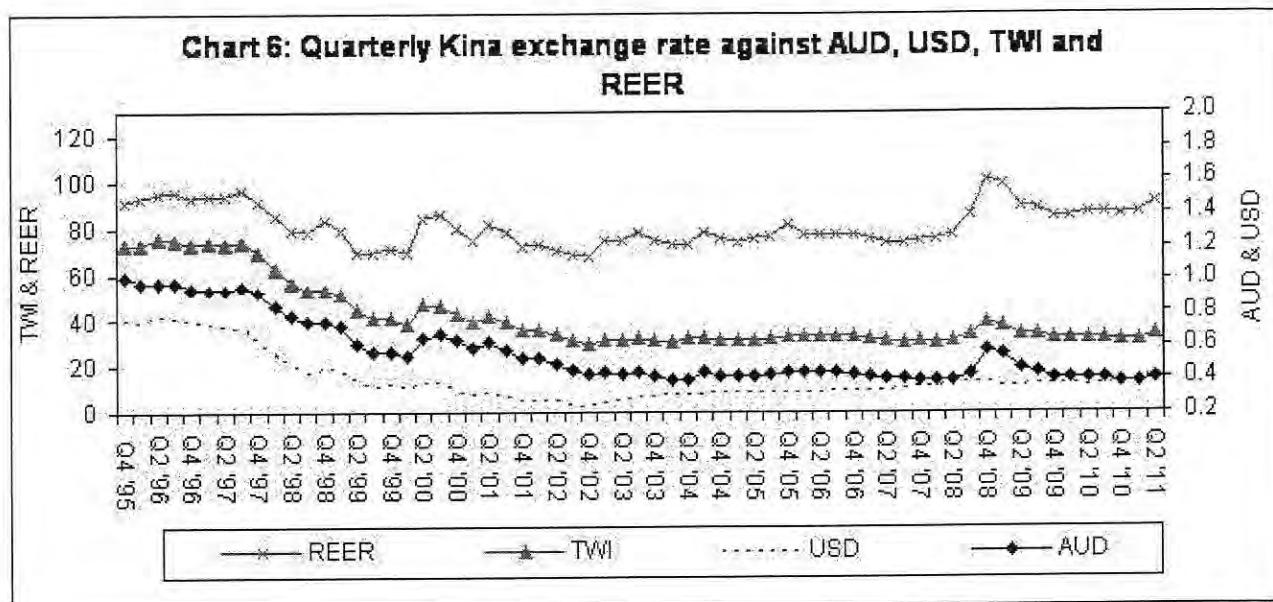
In the MYEFO report, the Government projected a surplus of K606.8 million or 2.0 percent of the GDP, higher than the balanced budget projected for 2011. This outcome was mainly due to higher than anticipated revenue, especially mineral taxes owing to higher international commodity prices. In line with its balanced budget strategy the Government has passed a Supplementary Budget of K781.8 million on 21st September 2011, comprising the additional revenue, a re-appropriation of K116.0 million from the 2011 development budget for projects that were not implemented, and K59.0 million from other sources. The Government has appropriated a total of K648.5 million in trust accounts for specific activities, including free education (K300.0 million), health (K109.5 million), roads (K158.0 million) and outstanding commitments for the PNG LNG project (K40.0 million).



Source: Bank of PNG

2.5 Exchange Rate

The daily average kina exchange rate appreciated against the US dollar by 10.9 percent to US\$0.4078 and depreciated against the Australian dollar by 5.4 percent to A\$0.3920 during the nine months to 23rd September 2011. The appreciation of the kina against the US dollar reflected higher export receipts, as well as a weakened US dollar, whilst the depreciation against the Australian dollar was attributed to cross currency movements, as the Australian dollar strengthened against most major currencies due to increased demand for its exports supported by higher commodity prices and favourable interest rate differentials. As a result, the Trade Weighted Index (TWI) appreciated by 8.5 percent during the same period. The Real Effective Exchange Rate (REER) also appreciated by 4.7 percent during the June quarter of 2011 (see Chart 6).



Note: The REER uses IMF's revised CPI indices rebased to 2005, as contained in the June 2009 release of the International Financial Statistics (IFS), in contrast to the previous series with 2000 as the base year.

Source: Bank of PNG and IMF

2.6 Inflation

Annual headline inflation increased to 9.6 percent in the June quarter of 2011, from 9.0 percent in the March quarter of 2011 and 7.2 percent in the December quarter of 2010. The latest inflation outcomes have exceeded the Bank's annual forecast of 8.5 percent as outlined in the March 2011 MPS. These were mainly due to an increase in imported fuel and food prices, strong economic growth associated with the PNG LNG project and high Government expenditure. The increase in the June quarter was recorded in the 'Drinks, tobacco and betelnut', 'Rent, Council charges, and fuel/power', 'Clothing and footwear', 'Transport and communication', 'Food', and 'Household equipment and operations' expenditure group, whilst the 'Miscellaneous' group recorded a decrease. All urban areas reported increases in inflation.

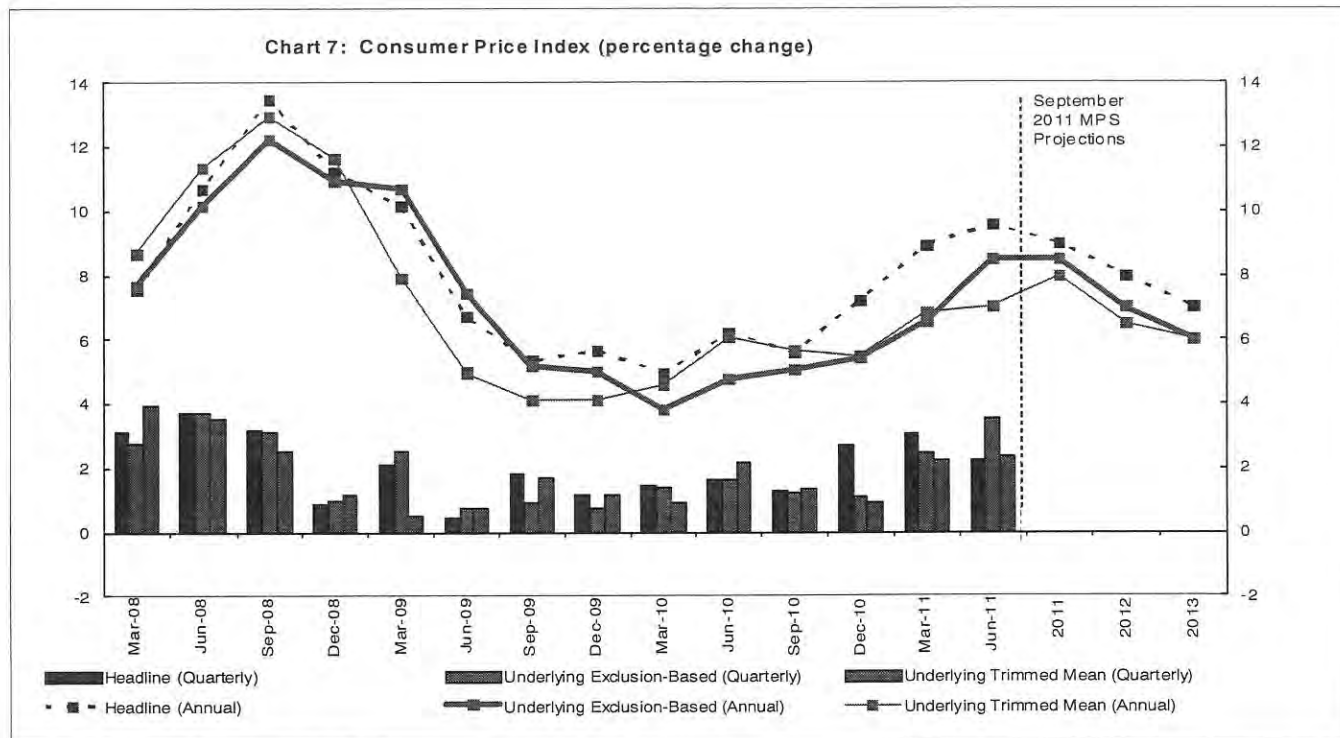
The annual exclusion-based inflation rate was 8.5 percent in the June quarter of 2011, compared to 6.6 percent in the March quarter, while the annual trimmed-mean inflation was 7.0 percent in the June quarter of 2011, compared to 6.8 percent in the March quarter.

The Bank revised upwards its annual inflation projections for 2011, with headline inflation to be around 9.0 percent, and trimmed-mean and the exclusion-based inflation at around 8.5 and 8.0 percent, respectively. These upward revisions are based on the following factors:

- An increase in Government spending;
- Expected higher imported inflation from PNG's major trading partners, especially through higher food and fuel prices;
- Higher domestic demand pressures arising from the ongoing construction of the PNG LNG project and associated activities; and
- Higher inflation expectations by firms.

For the medium term, headline inflation is projected to be around 8.0 percent in 2012 and 7.0 percent in 2013. These projections are based on the expectation that the kina will remain stable against the US dollar, and that volatility in international food and fuel prices is expected to moderate in the medium term. The LNG construction activity which is one of the main factors driving the domestic inflationary pressures is expected to wind down in 2013. Furthermore, the supply capacity of the economy is expected to increase in the medium term, which could also ease inflationary pressures.

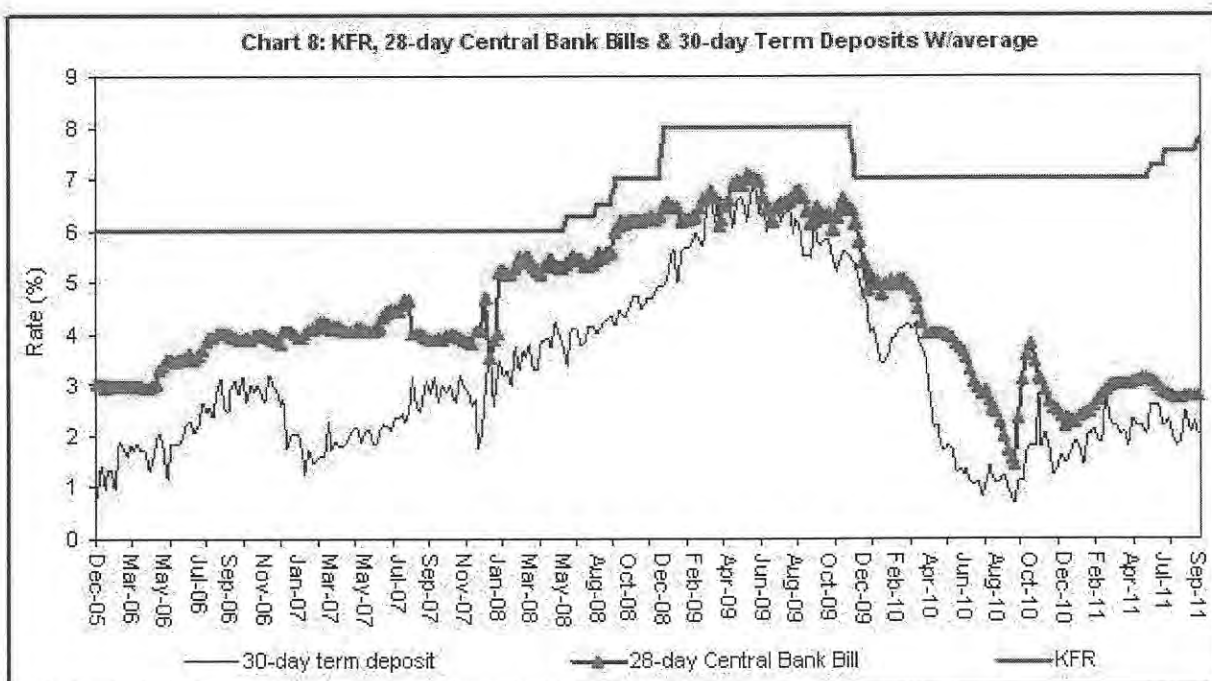
The upside risks to these projections include the depreciation of the kina, any excessive Government spending in the lead up to the National Elections in 2012, higher than expected international fuel and food prices, and higher inflation in PNG's main trading partners.



Source: NSO and Bank of PNG.

2.7 Monetary and Financial Market Developments

In light of high inflation outcomes and expectations, the Bank began tightening monetary policy in June 2011. The KFR was progressively increased by 25 basis points each in June, July and September 2011 to reach 7.75 percent. The Bank also increased commercial banks' CRR by 100 basis points each in July and August 2011, to 6.0 percent to support the tightening stance. The trading margin for the Repo was maintained at 100 basis points on both sides of the KFR.



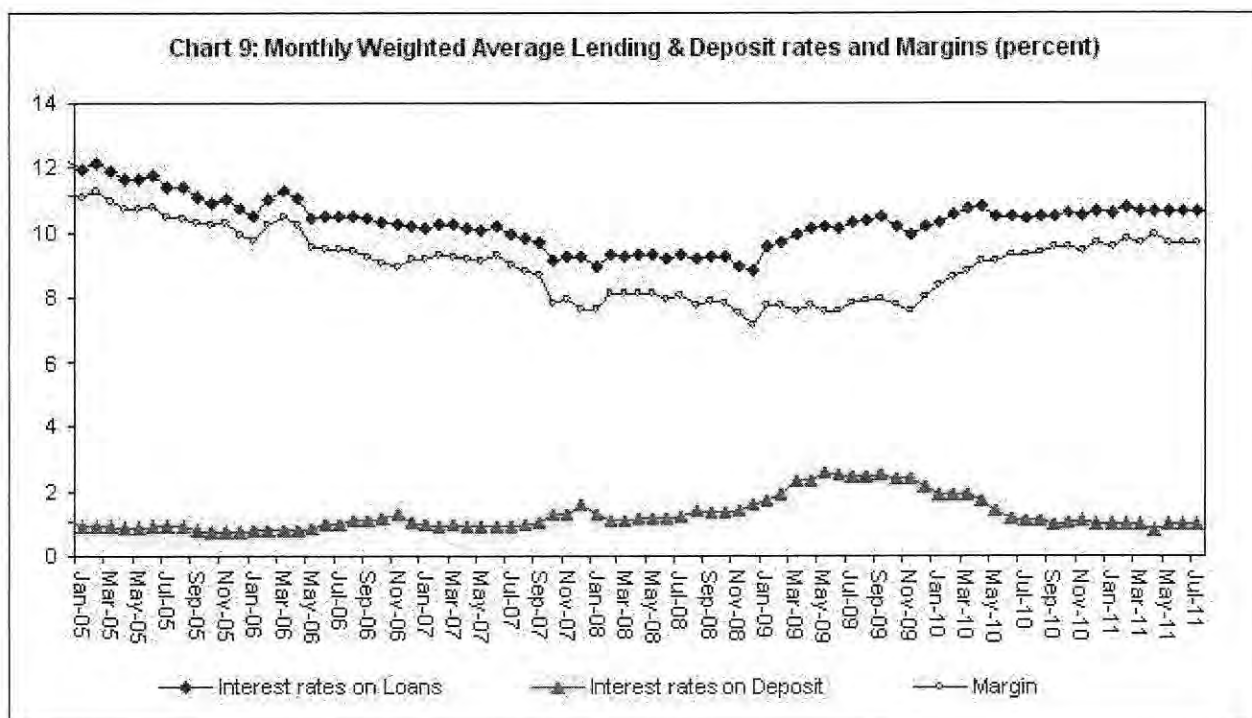
Source: Bank of PNG

The Bank issued net new CBBs totaling K1,170.0 million through its Open Market Operations to diffuse some of the excess liquidity in the banking system between December 2010 and September 2011. The CBB rates increased, with the 28-day bill increasing from 2.35 percent to 2.76 percent. Treasury bill rates also increased during the same period, with the 182-day rate increasing from 3.23 percent to 4.23 percent. All commercial banks increased their Indicator Lending Rates (ILR) in response to the tightening stance of policy, with the range increasing to 11.45 - 12.20 percent in September 2011 from 10.95 - 11.95 percent, which was the range since March 2009. The weighted average interest rate on total deposits remained unchanged at around 1.0 percent between December 2010 and August 2011, while the weighted average lending rate on total loans increased from 10.6 percent to 10.8 percent. As a result, the spread between the weighted average lending and deposit rates widened (see Chart 9).

Total liquidity of the banking system increased by 13.5 percent to K7,670.5 million over the twelve months to August 2011, due to increase in Government deposits including trust account balances and foreign exchange inflows. Lending extended by ODCs to the private sector increased by 9.7 percent over the twelve months to August 2011. The growth in private sector credit was broad based across all sectors, with notable increases in lending to the transport and communication, finance, building and construction, mining and quarrying, and real estate and business services sectors, as well as personal loans. Net claims on the Government decreased by K198.4 million over the twelve months to August 2011, mainly due to the net retirement of Treasury bills and increase in Government deposits with depository corporations.

The level of broad money supply increased by 10.6 percent over the twelve months to August 2011 as a result of growth in private sector credit and increases in net foreign assets of the Central Bank and ODCs. The monetary base increased by 50.0 percent during the same period, mainly reflecting an increase in currency in circulation.

In 2011, broad money supply is expected to increase by 14.6 percent, higher than the 9.6 percent growth projected in the March 2011 MPS. The upward revision is due to an increase in net foreign assets of the banking system as a result of high international commodity prices. Monetary base and private sector credit are projected to grow by 48.7 percent and 14.5 percent, respectively, both higher than the earlier forecasts. The high growth in monetary base is attributed to increases in currency in circulation and deposits of ODCs at the Central Bank. The Bank considers the projected growth in monetary aggregates sufficient to support economic growth, but is also mindful of the inflationary impact of growth in private sector credit associated with the high growth in economic activity (see Appendix-Table 1).



Source: Bank of PNG

Appendix

Table 1: Monetary and Credit Aggregates (annual % changes)

INDICATOR	2008 (actual)	2009 (actual)	2010 (actual)	Mar 2011 MPS	2011 (Actual to Aug)	2011 (proj)	2012 (proj)	2013 (proj)
Broad Money Supply	11.2	21.8	10.2	9.6	10.6	14.6	12.2	10.9
Monetary Base	-12.0	11.9	11.1	9.2	50.0	48.7	21.1	15.6
Claims on the Private Sector	28.0	15.1	18.1	13.2	9.7	14.5	13.6	12.3
Net Claims on Gov't	-174.3	-694.6	-130.2	161.5	-242.1	563.5 ⁵	-18.7	-96.5
Net Foreign Assets	-14.0	27.0	20.2	22.2	20.9	11.2	2.0	3.0

Source: Bank of PNG

Table 2: Summary of Other Macroeconomic Indicators

INDICATOR	2008 (actual)	2009 (actual)	2010 (actual)	Mar 2011 (MPS)	2011 (Actual to June)	2011 (proj)	2012 (proj)	2013 (proj)
CONSUMER PRICE INDEX (annual % changes)								
Headline	11.2	5.7	7.2	8.5	9.6	9.0	8.0	7.0
Trimmed-mean	11.7	4.1	5.5	6.5	7.0	8.0	6.5	6.0
Exclusion- based	11.0	5.0	5.4	7.0	8.5	8.5	7.0	6.0
BALANCE OF PAYMENTS (kina millions)⁶								
Current account	2,145	-1,612	-1,720	-14,566	847	-13,297	-12,755	-5,742
Financial account	-2,861	3,220	2,934	15,902	-569	15,144	12,892	5,890
Overall balance	-598	1,782	1,066	1,412	357	825	220	225
Gross Int. Reserves	5,321	7,104	8,170	9,677	8,526	8,995	9,216	9,440
IMPORT COVER (months)								
Total	7.5	10.8	10.2	6.3	11.0	6.5	7.2	10.0
Non-mineral	10.8	14.8	13.9	17.1	15.3	17.7	16.6	15.8
EXPORT PRICE								
Crude oil (US\$/barrel)*	106.7	59.0	78.8	80.0	117.9	107.2	102.1	98.7
Gold (US\$/ounce)	850.9	968.6	1,187.3	1,265.8	1387.2	1,547.1	1,438.7	1,344.2
Copper (US\$/pound)	327.8	217.6	333.4	350.0	434.7	419.0	431.0	385.9
FISCAL OPERATIONS OF THE GOVERNMENT**								
Surplus/Deficit (K'm)	-478.4	-36.3	257.6	0.0	-15.8	0.0	312.8	-337.4
% of GDP	2.2	0.2	1.0	0.0	0.1	0.0	1.0	1.1
REAL GROSS DOMESTIC PRODUCT (annual % growth) ***								
Total GDP	6.6	5.5	7.1	8.0	--	9.3	5.1	1.6
Non-mineral GDP	7.6	6.3	7.3	8.2	--	8.2	4.3	2.3

* Prices take into account, company hedging and differ from market prices.

** Preliminary fiscal operations up to July 2011. 2011 - 2013 projections are from the 2011 National Budget.

*** GDP figures are from the 2011 National Budget, except for 2011 which is from the July 2011 MYEFO report.

Source: Bank of PNG, NSO and Department of Treasury

⁵ Reflects increased negative net claims on the Government associated with increased deposits at Depository Corporations.⁶ For 2011, imports for the PNG LNG project are included in the annual projections but not in the actuals to June 2011.