

ECONOMIC & MARKET INSIGHT

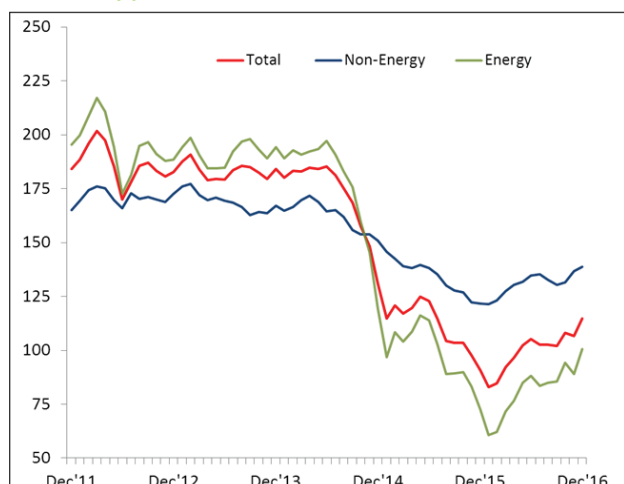


DECEMBER QUARTER 2016

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Commodity prices



Source: International Monetary Fund (IMF), BSP

Highlights

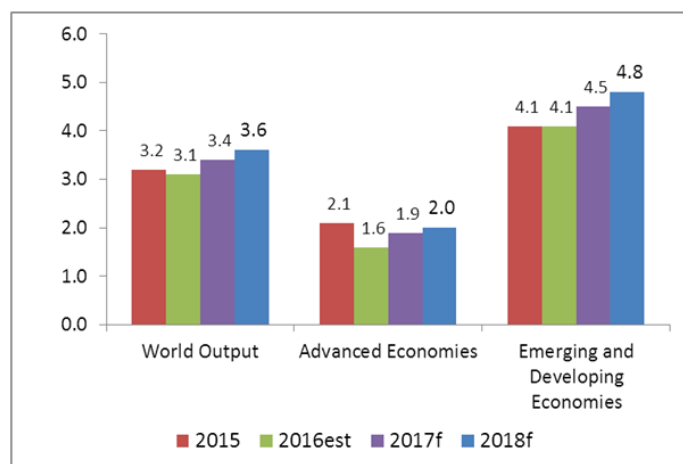
- The global economy grew modestly, despite concerns and the uncertainties surrounding developments during the year. IMF estimated growth of around 3% in 2016 with 3.4% projected for 2017. The lacklustre growth was due to lower growth in US and other advanced economies.
- Advanced economies growth for 2016 was estimated at 1.6%, with 2017 and 2018 upgraded to 1.9% and 2.0% respectively. Growth in emerging and developing economies is projected to strengthen to 4.5% in 2017, compared to 4.1% in 2016. There are some risks around projections as the world is uncertain about the new Trump's administration's policies.
- Commodity prices rose over the December quarter and the year, driven by an increase in oil prices. OPEC members' agreement to cut oil production in 2017 was the main stimulus. It remains to be seen if upward trending oil prices can be maintained, given compliance requirements and the non-effectiveness of OPEC in the price game with the rise of shale oil production.
- The Pacific economies have recorded growth of 2.7% in 2016 and are expected to grow by 3.3% in 2017. The lower than expected growth was due to lower growth in PNG and a decline in tourist arrivals in some countries. The region has experienced significant transformation over the last 20-years, spurred by the development of the Asian region.
- The PNG economic growth for 2016 was estimated at 2.0% with projections at 4.3% in 2017. Agriculture and non-mining sectors are expected to support modest growth. Foreign exchanges are expected to remain, with businesses continuing to have it on their worry list.
- The 2017 National Budget was passed by Parliament in November 2016. Total expenditure and revenue is projected at K11.4bn and K12.7bn respectively, leaving a net deficit of K2.1bn. Fiscal challenges will continue as the government prioritises 2017 National Election and 2018 APEC expenditures. The recent increase in commodity prices is a welcome development.

Global Economy

Investors were concerned about the Chinese slow pace of growth and Fed's interest rate rise in the beginning of the year. During the year, political events took the media by frenzy with Brexit in June and election of Donald Trump as US President in November. Many commentators expected a hard landing; however the global economy was okay though volatile at times.

IMF estimated global growth at 3% (annualized) and projects 2017 growth to pick up to 3.4%. The lackluster growth was due to weaker growth in major global economies, with US growing by 1.6% in 2016 - below expectations of 2.4%. The US economy is expected to expand by 2.2% in 2017. Strong private consumption is seen to be complemented by a recovery in gross fixed capital formation. However, there is some uncertainty on the policy stance of the United States under the Trump administration.

Table 1: IMF Global Economic Outlook



Source: International Monetary Fund, BSP.

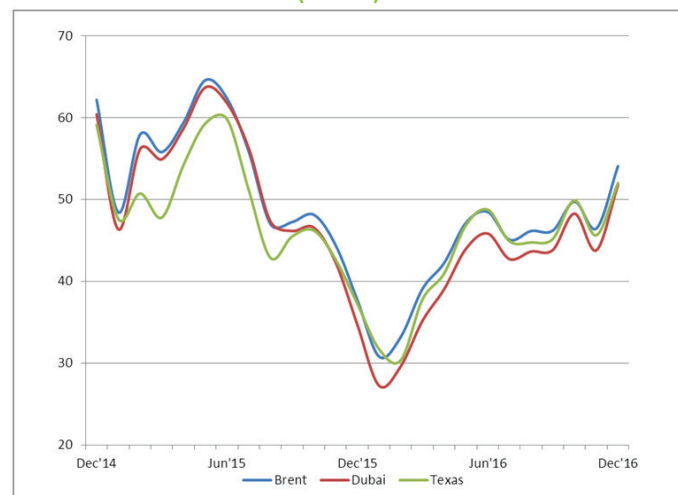
The financial market reaction to the Brexit outcome has been short-lived, however the increase in economic, political, and institutional uncertainty appear to remain as events unfold. The victory of Donald Trump as US President was a surprise to many.

With Trump as the US President, the established political order and conventions that brought prosperity and stability to world affairs since the end of the World War II are challenged and are set to change. China did not experience a hard landing as expected with growth of 6.7% in 2016. 2017 growth was revised up to 6.5% (+0.3% from October forecast) on expectations of continued policy support. In Australia, economic expansion is projected at 2.8% in 2017, the same rate as in 2016. New Zealand's economic growth is seen to reach 2.9% in 2017 from an estimated 2.8% in 2016. Major risks to these forecasts include financial volatility due to higher United States (US) interest rates, weaker growth in China, and slower global trade.

Commodities

IMF Commodity Price Index rose by 12.3% and 26.4% over the December quarter and year respectively. The upsurge was due to the increase in oil prices, reflecting an agreement among major producers to trim supply. Brent Crude oil price added \$7.88 or 17.1% to \$54.07 ending December from \$46.19 in September 2016. Over the year, it has increased by 43.3%.

Table 1: Oil Price Movement ('14-'16)



Source: International Monetary Fund, BSP.

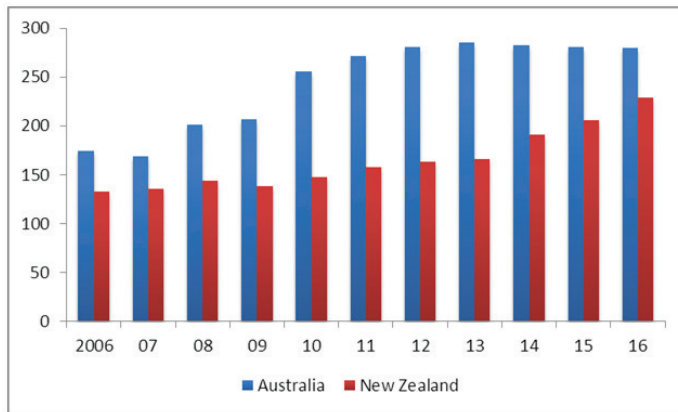
The Organisation of Petroleum Exporting Countries (OPEC) agreed to reduce crude oil output to 32.5 million barrels per day (mbd) following their meeting on 30 November. While Saudi Arabia, Iraq, UAE and Kuwait bear the brunt of the cuts, Iran, Nigeria and Libya has been exempted. OPEC and non-OPEC meeting on 10 December have seen commitment on additional cuts by Russia and Saudi Arabia. An effective date was set as January 2017, however the International Energy Association (IEA) reported that the first 6-months is a probation period, hence it is 'far too soon to see what level of compliance has been achieved.' The actual impact of the agreement will depend on the degree of compliance by OPEC countries. This suggests that the market will have tightened and prices stabilised but not at a sufficiently high level to allow another bonanza for high cost producers.

According to IMF, shale production is expected to rebound strongly with future prices hovering around \$55. Future curves are almost flat around the 2017-2018 horizons just below \$55, implying an increase in shale production. There is consensus that commodity prices continue to remain below pre-2014 levels.

Pacific Overview

The Pacific Island Countries (PIC's) have experienced significant transformation over the last 2 decades spurred by growth in the Asian region. Beside its tourist attraction, the region is endowed with natural resources that continue to be demanded globally. ADB reported that PIC exports have increased by 169% over the last 2 decades reaching \$9.6bn in 2013. Foreign direct investments have also surged during this period. Challenges in tourism infrastructure, private sector development, trade liberalization and human capital still remain in varying degrees amongst the economies.

Average economic growth in the Pacific is projected at 2.7% in 2016 and 3.3% in 2017, the lowest since the global financial and economic crisis. The lower than expected growth was due to declining resource-related revenues from PNG and Timor-Leste, aggravated by decline in tourism arrivals in some PIC's.

Table 2: Tourist Departures to Pacific Destinations ('000, January- August)

Source: Asia Development Bank, BSP

Tourism in the region fell by 0.5% or 1,400 fewer trips over the 8 months of 2016 - lower than the 4.4% global growth. Tourist departures from New Zealand to major South Pacific destinations increased by 11.2% (y-o-y) in the first 8 months of 2016, supported by rising household incomes from recent robust economic performance. Tourism to Fiji continued, while Cook Islands, Samoa, and Tonga destinations showed solid growth. Vanuatu saw a recovery in Australian tourism after Qantas and Virgin Australia flights resumed in June; however it was a different story for NZ visitors.

Growth in the Cook Islands, Samoa, and Tonga in 2016 (ended 30 June 2016) was above projections driven by the unexpectedly strong tourism. Samoa received an additional strong boost from fisheries, and Tonga benefitted from recovery in agriculture and stimulus from construction on major infrastructure projects.

Papua New Guinea

PNG's economic growth was lower than expected at 2% (est.) in 2016, compared to earlier projection of 4.3%. Growth continued to be positive, albeit lower than recent years. Lower growth was once again driven by lower commodity prices and its impact on government revenue.

PNG is a price taker hence, cannot influence the international prices of its main exports. However, it can make timely policy adjustments to smooth out or take advantage of the volatilities of the commodity prices.

The 2017 National Budget was passed by Parliament in November 2016. Total expenditure and revenue is projected at K11.5bn and K13.3bn respectively, leaving a net deficit of K1.8bn. Tax revenue is expected to increase by 9% to K9.2bn (12.2% of GDP) non-tax revenue of K1.2bn (1.7% of GDP). Grants will decrease significantly to K1.0bn, due mainly to reduced cash flow from Sovereign Wealth Fund (SWF). A supplementary budget should be released around February 2017.

The foreign exchange shortage still remained on businesses 'worry list' despite some improvements after the resumption of OTML in March 2016. Though, commodity prices have recovered over the year, BSP expects the kina to remain stable reflecting low commodity prices, the continuation of fiscal deficit, low inflows and the strength of the US\$.

Consumer Price Index

General prices of goods and services have increased in 2016, with 2017 Budget noting inflation at 6.6%, compared to projection of 5.7%. This is slightly higher than the 6.4% recorded at the end of 2015.

According to the National Statistics Office, prices of most domestic goods and services continued to remain high especially alcoholic beverages, tobacco and betel-nut, fruits and vegetables, medical services and housing rents amongst others.

Figure 2: Inflation rate (% , quarterly)

Source: Bank of PNG, BSP

Inflation is expected to increase to 7.0% with the continued depreciation in the PGK among major trading partners and volatile movements in the prices of seasonal items. The 2017 National Election and 2018 APEC related spending is expected to boost income and spending in the economy. This will likely put some upward pressure on inflation, exacerbated by the weak fundamentals.

PNG Exchange Rate

Foreign exchange shortages continued throughout 2016 and would likely to remain a challenge in 2017. The government's plan to issue a sovereign bond and Bank of PNG's talk of seeking temporary IFC facility did not come to fruition, though there was a \$210m loan from Credit Suisse in August. Negotiations are still underway regarding the sovereign bond issue and second tranche of Credit Suisse loan.

Over the year, PGK depreciated by 5.3% to 0.315 against USD and by 4.4% against AUD to 0.4363. The last few weeks of the year were characterized by a strengthening US dollar on the back of expectations of an expansionary fiscal policy by the incoming Trump administration.

Over a 6 week period from mid- December, the dollar rallied nearly 7%. In turn, this took considerable pressure off kina crosses. For example, PGK/JPY rallied from 32.56 to 35.56, an increase of nearly 10%. Figure 3 shows some strength in November, though the general trend is sideways.

Figure 3: PGK/AUD movement in 2016



Source: BSP

Market turnover increased from 2015 to 2016 by nearly K3.0bn (+10.8%). The weaker exchange rate explains roughly half those gains. The rest is accounted for by OTML resuming production and a strong agricultural season. Bank of PNG intervention was K1.352bn, dramatically lower than 2015 when the market was supported to the tune of K2.298bn. Strong year end inflows kept the central bank out of the foreign exchange market in December. PGK is a commodity currency; hence commodity price movement will have significant implication on the PGK. Improvement in commodity prices will support in PGK, however unlikely to pre-2014 levels.

Fiscal Position

The government has passed the 2017 National Budget at a time when global commodity prices and economy remained low and weak. Expenditure is planned at K13.3b against revenue projections of K11.5b. The resulting budget deficit will be financed by domestic and external borrowing. In 2017, total debt is projected to reach 28.8% of GDP (Figure 3). Key priorities include; tuition free education; free primary health care; infrastructure projects; agriculture and small to medium enterprises (SME), with the highest priority given to the funding of the National General Elections and 2018 APEC Summit. The latter two priority areas were allocated K2.7bn or 20% of total projected expenditure.

Table 3: 2015-2017 Budget

	2015 Actual	2016 Budget	2016 MYEFO	2017 Budget
Revenue (K'm)	10,776	12,650	10,764	11,473
Expenditure (K'm)	13,789	14,763	14,763	13,350
Balance	-	-	-	-
	3,012	2,112	3,999	1,876
Deficit (as % of GDP)	4.9%	-3.8%	-5.9%	-2.5%
Debt/GDP ratio	29.1%	35.8%	32.2%	28.8%

Source: 2017 Budget, BSP

The largest revenue item is income from profits and capital gains estimated at K5.8bn. Personal income tax collections are expected to be K3bn, Company Income Tax of K2.4bn and K154m in Mining and Petroleum Tax. Government's plan to tax employee housing benefits is likely to be reviewed following

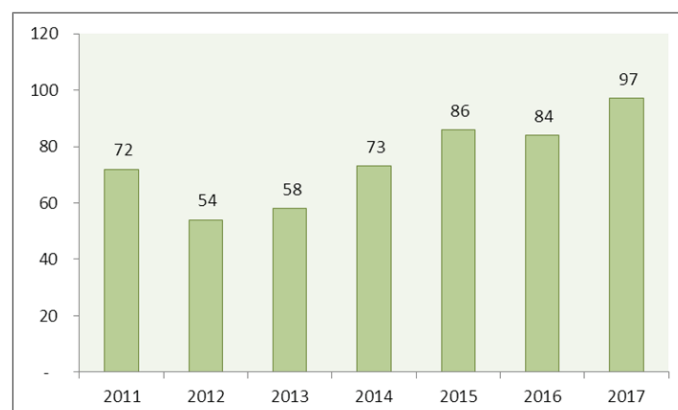
feedback from the formal sector. The supplementary budget will likely include this, amongst other revisions.

In terms of expenditure, there was a trend shift in projected allocations with provinces, community & culture, and administration receiving 52% while health, transport and other sectors allocations' was lower than last year. Financing the budget will be a challenge with domestic investors reaching their exposure limits. Besides the Credit Suisse funding, the government is continuing its negotiation on the sovereign bond. Total public debt is estimated to increase to K21.6bn at the end of 2017 with interest expense comprising 10% of expenditure. It will be critical for the government to quantify the risks and benefits of the available funding options in ensuring PNG's debt to GDP ratio remains below the legislative limit of 30%.

Fiji

This year saw one of the devastating cyclones (Cyclone Winston) which killed 44 people and damaged and destroyed 30,369 houses, 495 schools and 88 health clinics and medical facilities.. The Fiji government's disaster recovery estimated the value of disaster effects (excluding environment) being \$1.99b which will cost around \$1.96b to achieve overall recovery, reconstruction and resilience in affected sectors.. Given its significant economic impact, growth projections for 2016 was lowered to 2.0% from 3.5% in the beginning of the year. The recent downward revision reflected the larger-than-expected negative impact of both Winston and Zena in February and April this year. Growth is expected to recover to 3.6% in 2017.

Figure 4: Ease of Doing Business ranking



Source: Doing business reports for Fiji (various issues)

The agriculture sector was hard hit with a total value of damage and production losses in agriculture amounts to F\$542 million, of which F\$80.3m is attributable to damage and F\$460.7m is attributable to loss. Sugar industry saw an annual reduction in production as sugarcane and sugar production fell by 25% and 37% respectively. The industry also faces the challenges of diversifying markets and improving productivity as it prepares for the loss of Fiji's preferential access to the EU market on 30 September 2017. Agricultural sector contributes to 7.9% of Fiji's GDP (2016-17 National Budget).

The Reserve Bank of Fiji (RBF) has announced World Bank's Ease of Doing Business ranking. Looking at Fiji's Doing Business performance over the past 7 years (figure 4 above), the overall

ease of doing business ranking improved significantly from 2011 to 2012, before deteriorating between 2013 and 2015, and thereafter improving slightly in 2016. In particular, the lower ranking in 2013 was attributed to certain regulatory requirements made compulsory for companies.

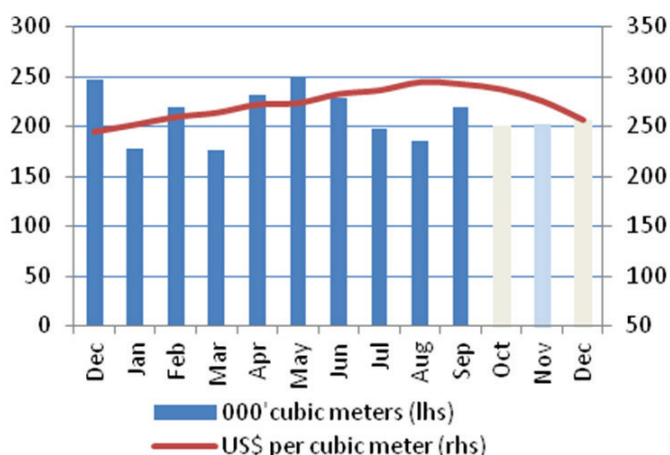
The year-end inflation forecast for 2016 is expected to be around 4 - 5%. The impacts from recent Tropical Depression (TD04F) is expected to keep inflation rates high for December 16. Overall, the high inflation throughout the year was attributed to higher prices for alcoholic beverages, tobacco & narcotics; health; and furnishing, household equipment and routine household maintenance categories. Inflation is expected to fall to around 2.5% in 2017, notwithstanding any unexpected shocks.

Solomon Islands

Despite a dull outlook in the beginning of the year, economic growth has been revised slightly upwards to 3.2% vs. 2.9% as the year winds down. In our September publication we noted that, surprise increases in the primary sector particularly in forestry and to some extent agriculture and fisheries sectors contributed to the slight upward revision. Preliminary data in the eleven months to November 2016 remains positive.

Central Bank of Solomon Islands (CBSI) production index fell by 14% to 101 points in November following a 30% increase in the previous month. Over the year to November, it has increased by 23 points indicating that domestic activities improved over the course of 2016. Driving this positive outturn were higher outputs in logs, fish catch and copra which more than offset the decline in palm oil and cocoa.

Figure 5: Log exports and prices (annual)



Source: Central Bank of Solomon Islands, IMF, BSP

Log production as measured by export volumes was up by 24% to 220,000m³ over the year to September 2016. The month of November saw a significant decline in log exports, suggesting that annual production will be slightly above 2015 production levels. The international price of log (hardwood) increased by 5% to US\$256 over 2016.

Turning to inflation, headline inflation eased further to minus 2.8% in November from 2.9% in June. The fall was underpinned by the declines in imported and domestic inflation rates. The reduction in imported inflation was driven primarily by falls in

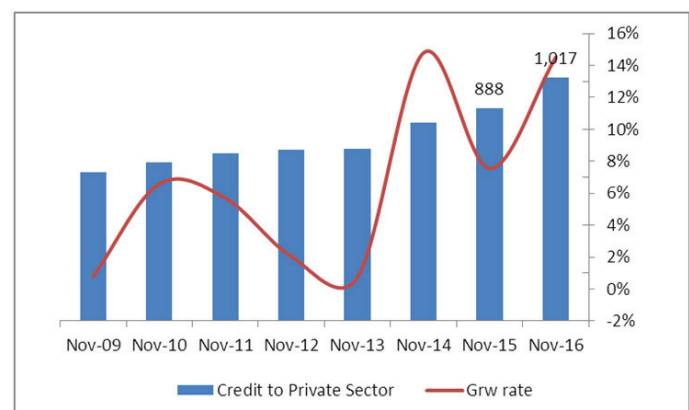
most categories in the imported CPI basket offsetting increases in housing and recreational categories. ADB projects inflation of around 3.3% in 2016 before rising significantly to 4.5% in 2017. The government recorded a deficit of \$75m in November compared to a deficit of \$80m in the previous month. Revenue and expenditure fell by 2% and 3% to \$214m and \$290m, respectively. The decline in total expenditure more than outweighed the fall in revenue during the month. Deficit to GDP ratio was projected to be around 1.29% in 2016 before moderating to 0.57%. Government's debt trended downward this month as a result of an \$11m one off advanced repayment for servicing of mostly foreign loans.

Samoa

Economic growth in Samoa is estimated to be substantially higher at 5%-6% in 2016. This was driven by upgrade of the main international airport, investment in hotels and the start of deep-sea fishing operations. These have stimulated transport, tourism, construction and electricity and water supply.

The ongoing road widening and airport extension projects and the grand opening of Sheraton-Aggie Greys Hotel and Taumeasina Hotel is expected to boost spin offs. Bank credit to the private sector continued to register growth, with 12-month growth of 15% to \$1.017bn as at November 2016 (Figure 6). According to the Central Bank of Samoa (CBS) statistics, the increase was due to increases in 'other activities' and building, construction and installation industries. Professional and business services also contributed to the growth. Despite that, lending rates and liquidity in the industry declined.

Figure 6: Private Sector Lending



Source: Central Bank of Samoa, BSP

Annual average headline inflation rate increased to 5.0% (est.) in 2016 from 4.0% in 2015. Imported inflation has trended downwards, however domestic prices rose steadily during the year led by taro prices. The increase in import costs was lower than anticipated, hence the modest increase between 2015 and 2016. The inflation projection for 2017 is revised up to 1.9%.

Economic growth in 2017 is projected to be lower, due mainly to the closure of Yazaki Samoa. The closure of the manufacturing plant will have an impact on employment and export processing services, amongst other economic activities.

¹It is a manufacturing plant for automobile wires and contributes 5% to GDP.

Tonga

Tongan's economy continued to grow modestly between 2.5%-3.0%. Activities are being supported by a couple of one-off events including donor-sponsored construction activities and preparation for the upcoming Pacific Games in 2019. 2016 economic growth is projected at 2.7%.

Agriculture export volumes rose over the year to October 2016, reaching a 4-year high. This reflects the commencement of the squash season. The secondary sector remained strong as well, supported by rises in individual housing loans and business loans for the construction and manufacturing sectors.

The Tonga Strategic Development Framework (TSDF) 2015 – 2025 launched last year sets a national vision for a “more progressive Tonga supporting a higher quality of life for all”.

The primary sector is projected to experience steady growth and is expected to increase in the future given the recent establishment of the country's first Fisheries and Agricultural Sector Plans outlining the priority investments planned for implementation in the coming years.

Annual inflation increased by 7% as at the end of September 2016. The significant rise stems from the new customs duties on imported food products as well as domestic prices being at very low levels last year. Upward inflationary pressure is expected in the near term due to amendments made to custom duty and excise tax effective on 1st July 2016.

Cook Islands

Economic growth in Cook Islands was above expectations. According to ADB Outlook, 2015 economic growth was estimated at 4.8%. Construction, restaurant & accommodation and finance industries were the main drivers.

ADB estimates shows that the economy has sustained this rate of growth in 2016, outpacing earlier expectations of stagnation. This resulted from higher visitor arrivals, which rose by 11% in the year, partly aided by the launch of a new Jetstar Airways service between Auckland and Rarotonga in March 2016.

In the financial industry, commercial bank lending was down by 2.0% to NZ\$292.4m in September compared to June 2016. All categories recorded decrease in borrowings except public administration (+100%), wholesale & retail (+8.9%) and others which was up by 8.2% over the quarter. Despite the decline in lending, Interest rates have been relatively stable.

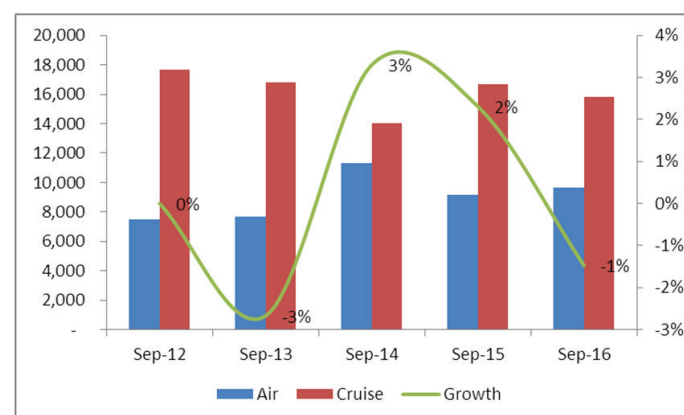
Annual inflation was 0.9% at the end of December 2016, compared to 0.72% in the previous year. The fall was driven by decrease in international airfares, motor fuel & oil and rents and mortgages. Tobacco and alcohol was up. Underlying CPI decreased by 0.3% over the same period.

Vanuatu

Vanuatu's economy continued to recover from the impacts of Cyclone Pam in March. Growth is projected to reach 4.0% in 2016 and 4.5% in 2017. Growth is predominately related to the infrastructure projects having started in and around Port Vila. Tourism has held up better than expected despite the temporary cancellation of international air services by major regional carriers.

Cruise ship or day visitors is the most common type of tourism in Vanuatu, with 15,825 visitors arriving in 9 cruise ships in September. 9,672 visitor arrived by air, which was a 5% increase over 12-months. Most visitors arrived for holiday purposes. The upgrade to airport facilities should boost tourism sector.

Table 3: 2015-2017 Budget



Source: 2017 Budget, BSP

Merchandise exports were mixed, with copra and cocoa exports up by more than 50%, while coconut oil and beef were down over the year to September 2016. Copra exports stood at 9,114 tonnes, representing an increase of 51% or 3,082 tonnes over September quarter 2015.

In monetary terms, copra exports increased by 30% or VT108m when compared to VT361m in September quarter 2015. According to National Statistics Office of Vanuatu, domestic export earnings (excluding re-exports) for September 2016 increased by 57% or VT109m to VT302m, compared to September 2015.

Inflation was up by 0.9% in September quarter. Price movement of fruits and vegetables in Port Vila, International airfares, transport and housing utilities drove the increase.

There was price increases observed in both Port Vila and Luganville. The recent increase in commodity prices may be inflationary. Inflation is expected to be around 3% in the medium term.

MARKET RATES

FOREIGN EXCHANGE				
	OCT	NOV	DEC	2018f
PGK/USD	0.3155	0.3150	0.3150	na
FJD/USD	0.4829	0.4788	0.4695	na
SBD/USD	0.1267	0.1250	0.1236	na
WST/USD	0.3943	0.3933	0.3867	na
TOP/USD	0.4556	0.4528	0.4446	na
NZD/USD	0.7151	0.7083	0.6934	na
VUV/USD	108.62	109.47	113.68	na
COMMODITIES				
	OCT	NOV	DEC	
Oil (US\$ per barrel WTI)	46.86	49.44	53.72	
Gold (US\$ per ounce)	1,277.21	1,173.2	1,147.5	
Copper (US\$ per metric ton)	4,583	5,825	5,535	
Nickel (US\$ per metric ton)	10,475	11,250	10,020	
Palm Oil (MYR per metric ton)	2,763	3,043	3,060	
Coffee (US\$ per LB)	164.15	147.50	137.05	
Cocoa (US\$ per metric ton)	2,735	2,387	2,126	
Sugar (US\$ per LB)	21.57	19.81	19.51	
Lumber (US\$ per 1,000 feet)	298.20	329.80	316.60	

MACRO DATA

Real GDP Growth (% annual)				
	2015		2017f	2018f
PNG	9.9	2.0	2.8	2.7
Fiji	3.6	2.0	3.6	3.0
Solomon Islands	2.9	3.2	2.5	3.0
Samoa	1.7	6.4	2.0	2.0
Tonga	3.4	2.7	2.6	2.8
Cook Islands	3.0	4.2	4.0	1.3
Vanuatu	1.3	4.0	4.5	3.8

Inflation (%)				
	2015	2016	2017f	2018f
PNG	6.4	6.6	7.0	6.6
Fiji*	1.4	3.5	4.0	2.0
Solomon Islands	-0.3	3.3	4.5	2.8
Samoa	1.9	0.1	2.0	2.0
Tonga	-0.7	2.0	1.9	3.6
Cook Islands	3.0	0.4	1.6	3.1
Vanuatu	1.4	1.9	2.4	2.4

Fiscal Balance (% of GDP)				
	2015	2016f	2017f	2018f
PNG	-4.9	-3.1	-2.5	-2.3
Fiji	-2.5	-1.6	-4.7	-3.5
Solomon Islands	-2.2	-3.6	-3.9	1.5
Samoa	-3.9	-0.4	-3.5	0.6
Tonga	-0.2	-2.3	-2.5	-1.5
Cook Islands	-4.4	2.3	-3.5	-3.4
Vanuatu	7.2	-10.6	-17.3	-9.2

Foreign Exchange Reserves (USD m)				
	2015	2016f	2017f	2018f
PNG	1,920	1,725	1,620	na
Fiji	872	780	na	na
Solomon Islands	550	550	na	na
Samoa	156	160	na	na
Tonga	140	140	na	na
Cook Islands	na	na	na	na
Vanuatu	na	na	na	na

Economic Data Sources:

Commodities & FX: Bloomberg
 PNG: 2016 Budget, Department of Treasury, Bank of PNG, ADB, BSP
 Fiji: Reserve Bank of Fiji, ADB, IMF, BSP
 Solomon Islands: Central Bank of Solomon Islands, ADB, IMF, BSP
 Samoa: Samoa Bureau of Statistics, ABD, IMF, BSP
 Cook Islands: Financial Supervisory Commission, ADB, IMF, BSP
 Tonga: Tonga Department of Statistics, IMF, ADB, BSP
 Vanuatu: ADB, Reserve Bank of Vanuatu, BSP

* Revised in the MYEFO'16, ** MPS Sept'16,

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