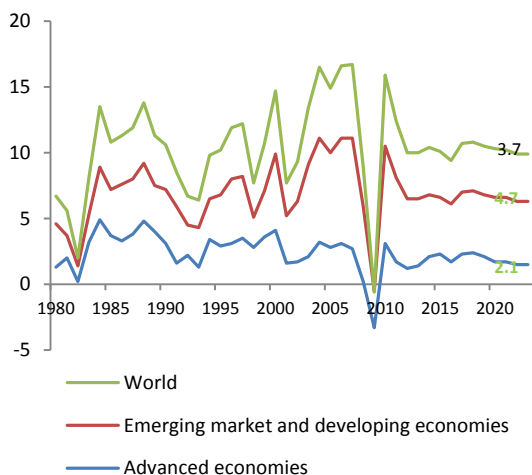


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World Economic Outlook



Source: IMF World Economic Outlook, Oct-18

Highlights

- Storm clouds are brewing for the global economy, as international trade and investment have softened and trade tensions remain elevated. The World Bank expects growth to slow to 2.9% in 2019 from 3.0% in 2018. Although, a truce was reached between the US and China in Dec-18, trade policy uncertainty remains elevated and continues to weigh on confidence.
- The US economy is estimated to have grown by 2.9% in 2018, driven by consumer and government spending. Growth in emerging economies is predicted to remain at 4.2% in 2019. In China, activity remains robust but is decelerating, with the negative impact of trade tensions.
- Commodity prices declined over the year, as indicated by World Bank indices. The *Energy Price Index* declined by 23% over the December quarter and by 7% over the 12-months to Dec-18. Average crude oil prices fell by 28% and 12% to US\$53.96/bbl over the December quarter and 2018 respectively.
- The Pacific Island region economies are expected to grow lower at 1.1% in 2018 [2.9% in 2017] in light of the recent downgrade in PNG economic growth. The Australian Government made some commitment towards the development of the region in the APEC summit in PNG. ADB's PEM for Dec-18 focuses on *Debt Sustainability* in each country.
- Real GDP in PNG was revised to 0.3% in 2018, reflecting the negative impact of the Highlands earthquake on production in the oil and gas, mining and quarrying sectors. In 2019, GDP is expected to rebound to 4.0%. The inflow of sovereign bond proceeds has reduced the FX back-logs and increased international reserves in 4Q-18.



Global Economy

The World Bank in its *Global Economic Prospects [GEP] Jan-19* report, warned that storm clouds

are brewing for the global economy. International trade and investment have softened, while trade tensions remain elevated. The World Bank expects growth to slow to 2.9% in 2019 from 3.0% in 2018.

Growth in advanced economies moderated to 2.2% in 2018, and is expected to slide further to 2.0% in 2019. Despite the truce between the US and China, and Brexit, trade policy uncertainty remains elevated and continues to weigh on confidence. Economic activity is expected to slow, as capacity constraints become more binding and policy accommodation is withdrawn in most advanced economies.

Table 1: Real GDP projections [%]

	2016	2017	2018e	2019F	2020F
World	2.4	3.1	3.0	2.9	2.8
Advanced economies	1.7	2.3	2.2	2.0	1.6
US	1.6	2.2	2.9	2.5	1.7
Euro Area	1.9	2.4	1.9	1.6	1.5
Japan	0.6	1.9	0.8	0.9	0.7
Emerging market & developing economies	3.7	4.3	4.2	4.2	4.5
China	6.7	6.9	6.5	6.2	6.2
India	7.1	6.7	7.3	7.5	7.5
Australia	2.5	2.2	3.2	2.8	3.0
New Zealand	3.6	3.0	3.1	3.0	2.6

Source: World Bank, GEP, Jan-19

GDP growth in United States [US] remains robust at an annualised rate of 3.5% at the end of 3Q-18. This was driven by consumer and government spending. According to Wells Fargo, the Fed tightening in 2018 and Chinese tariffs on American goods have decelerated economic activity with 2019 commencing on a soft footing. GDP is expected to decline to 2.5% in 2019, from 2.9% in 2018.

Growth in emerging economies is predicted to remain at 4.2% in 2019. In China, activity remains robust but is decelerating, due to the negative impact of trade tensions. In an attempt to mitigate the impact of the trade dispute with the US, the Chinese government has gradually eased fiscal and monetary policies. While the growth forecast for 2018 remains unchanged at 6.5%, slower demand growth and intensifying trade conflict with the US have lowered the growth forecast for 2019 to 6.2%.

The biggest risk to the near-term global economic outlook is the negotiations around trade policy. In Sep-18, the US levied 10% tariffs on an additional US\$200bn worth of Chinese imports. During a meeting in Dec-18, President Donald Trump and President Xi Jinping agreed to delay the planned increases in tariffs for another 90 days [lapses on 1-Mar-19] to negotiate their trade disputes. A fully fledged trade war will impact economic growth in China and the global economy.

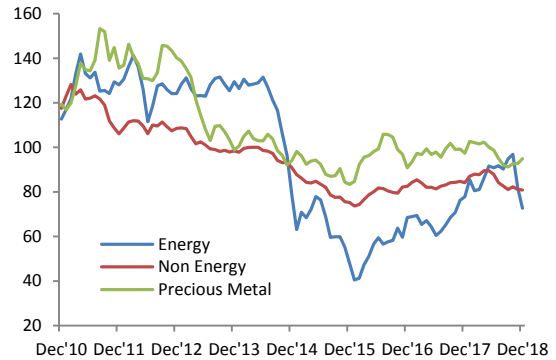


Commodities

Commodity prices declined in the December quarter, compared to a mixed outcome in 3Q-18. The

World Bank's *Energy Price Index* declined by 23% over the December quarter and by 7% over the 12-months to Dec-18. *Non-Energy* and *Precious Metals Indices* declined by 4% and 3% respectively over the year.

Figure 1: World Bank Commodity Indices



Source: World Bank [Pink Sheet], BSP

The plunge in energy prices was led by crude oil prices [average], which fell to US\$54/bbl at the end of Dec-18, from US\$75/bbl in Sept-18. Concerns about elevated global oil production and a slowing global growth outlook drove crude oil prices to their lowest level in the year. The US protectionist approach and Fed interest rate tightening has impacted commodity markets. Over the year, crude oil price declined by 12%.

Natural gas prices [Japan] rose by 35% over 2018 to US\$11.7 mmbtu, attributed to the boost in demand given colder-than-normal weather. Increasing exports of liquefied natural gas, particularly from Qatar and the US, will raise global supply and support an expected price moderation in 2019.

The *Non-Energy Index* declined by 4% in 2018, due to concerns around trade negotiations and the slow-down in Chinese economy. Agriculture prices have fallen by 2% in 2018. Commodity prices at the end of 2018 were lower than expected, hence will negatively impact on commodity producing countries, such as PNG.



Pacific Overview

The Pacific region's growth is expected to decline to less than 1.0% in 2019, in light of the recent PNG economic growth downgrade [see PNG commentary].

The Australian government made some commitments in the APEC summit in Nov-18, (1) Setting up of a US\$2bn Australian Infrastructure Financing Facility for the Pacific to provide funds for concessional infrastructure development, and (2) the MOU between Australia, Japan and US to support for infrastructure investment in the Indo Pacific. These facilities will support infrastructure development in the region.

ADB's PEM [Dec-18] focuses on *Debt Sustainability*. ADB's assessment of the debt profile each country is covered in their respective sections.



Papua New Guinea

Real GDP in 2018 was revised to 0.3% in the 2019 Budget, from 1.0% projected in the MYEFO'18.

The downgrade was due to the negative impact of the Highlands earthquake on production in the oil and gas, mining and quarrying sectors. In 2019, economic growth is expected to rebound to 4.0%.

The inflow of the proceeds from the US\$500m sovereign bond has increased the international reserves to US\$2.5bn at the end of 2018. Bank of PNG continued to assist in supplying foreign currency to meet some of the outstanding 'sell-kina' orders in the foreign exchange market. Meanwhile, there is appears to be some public confusion around the 2019 Budget tax measures, based on recent newspaper articles.

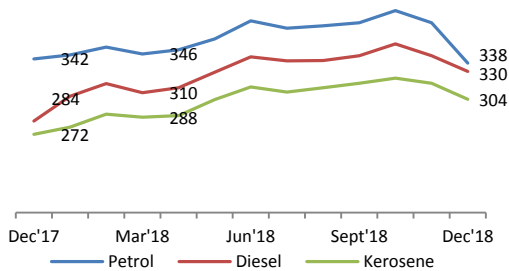


Consumer Price Index

Headline Inflation increased by 4.8% in the 3Q-18, compared to 4.5% in the June quarter. The

Bank of PNG has lowered its inflation projection for this year to 4.5% compared to 5.0% projected in the Mar-18 MPS. According to the 2019 Budget, inflation is projected to increase to around 5.4% in 2019 as the economy stabilises after the APEC lift in 2018 and greater stability in the Kina.

Figure 2: Fuel Prices in POM [toea, average]



Source: ICCS, BSP

Available anecdotal indicator such as the average indicative retail price [IPP] of fuel in Port Moresby was mixed in 2018. *Independent Consumer & Competition Commission [ICCC]* announcement for Jan-19 shows that fuel price declined on average. The fall was mainly attributed to the decrease in IPP and the domestic sea freight rates for the first quarter of 2019.

Over the year, fuel price movements were mixed; with petrol declining slightly by 1.1% to K3.38 while diesel and Kerosene increased by 21.1% and 17.2% to K3.30 and K3.04 respectively.



PNG Exchange Rate

Over the December quarter, the PGK/USD depreciated by 0.7% to 0.297. Against the AUD, the Kina strengthened by 1.8% to 0.4208, reflecting broader based weakness in the AUD. The AUD/USD finished off 2018 around 8 cents lower closing at 0.7049 after a tough year of trading. Market consensus is for PGK to continue to depreciate in 2019.

Foreign exchange market turnover increased by 31.2% over the December quarter and by 17.1% in 2018. Similarly, Bank of PNG intervention increased over the December quarter (148.7%) and in 2018 (218.6%).

Figure 3: Exchange rate movement [daily]



Source: BSP

Much needed relief was given to the market through the conversion of sovereign bond and concessional loan drawdowns. The number of outstanding foreign currency orders significantly reduced by 50% in the second half of 2018.

BSP expects foreign reserves to be around K6.6bn [US\$2.0bn] at the end of 2019, sufficient for 6 months of total import cover and 11 months of non-mineral cover. The level of gross foreign exchange reserves was K8.2bn (US\$2.4bn) at the end of 2018.



Fiscal Position

The 2019 National budget follows on the theme of *reviewing priorities, refocusing energy and reinforcing strengths* in 2018.

Total revenue is estimated to have increased by 16.3% to K13.4bn in 2018, and projected to increase to K14.2bn in 2019 on the back of tax compliance and the SOE dividend policy. Total expenditure is projected to increase to K16.1bn (+5.5%) as the government continues to invest in priority areas.

Table 2: 2019 Budget summary

National Budget Summary						
	2016	2017	2018	2018	2019	2020
	Actual	Actual	Budget	Revised	Project	Projection
Revenue (K'm)	10,486	11,525	12,731	13,400	14,267	14,631
Expenditure (K'm)	13,572	13,320	14,718	15,298	16,134	16,190
Net Deficit (K'm)	3,087	1,795	1,987	1,897	1,867	1,559
Deficit as % of GDP	4.6	2.4	2.5	2.3	2.1	1.6
Debt (K'm)	21,944	25,558	25,808	25,455	27,322	28,881
Debt as a % of GDP	32.4	31.2	32.2	30.9	30.8	30.3
GDP growth rate (%)	2.0	3.0	2.4	0.3	4.0	3.2
Inflation (%)	6.7	5.4	6.9	5.6	5.4	5.5

Sources: 2019 Budget documents

Key themes and our analysis are;

- **Restructure Government debt** – shift in debt financing to external sources [~42% in 19 vs. 35% in 18]. The recent US\$500m sovereign bond and planned ADB and World Bank [each US\$300m over 3 years] and US\$300m commercial bank loan is in line with this strategy. Though Debt to GDP ratio is within target, exchange rate risks and interest payments [~K1.8bn or 13.4% of revenue in 2018] have increased, with repayment expected to be challenging.
- **Focusing on revenue collection** – smart taxing by IRC and Customs in line with the *Medium Term Revenue Strategy [MTRS]*. Enforcement of the *Public Monies Management Regularization [PMMR] Act 2017* and 50% minimum dividend payment from SOEs supports this.
- **Maintaining expenditure and fiscal discipline** – the government plans to overhaul the payroll process to ensure personnel emoluments remain at around 6% of GDP. Value for money infrastructure projects are critical as well.
- **Clearing foreign exchange imbalance** – though we see a reduction in outstanding orders, FX shortages will still remain a challenge for businesses in 2019. Despite the BOP surplus, international reserves will continue to remain around US\$2.0bn.

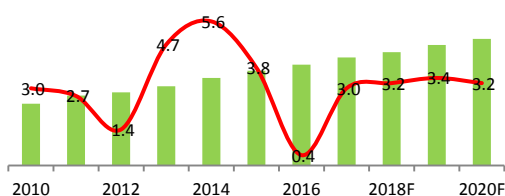
The personal income tax threshold for low income earners increased from K10,000 to K12,500 as announced in the 2019 budget. This will lead to a tax saving of K710 per annum for resident taxpayers and K160 for non-resident earning K20,000. There were numerous customs and exercise measures which are intended to support the domestic industry.



Fiji

The Fijian economy is expected to achieve its ninth [9] consecutive year of expansion with GDP growth of 3.2% expected in 2018. This was despite the impact of three [3] tropical cyclones; Cyclone Evan [Dec-12], Cyclone Winston [Feb-16] and Cyclone Josie and Ken [Apr-18]. The Fijian people and economy continued to be resilient and optimistic of the future.

Figure 4: GDP growth [% , annual]



Source: RBF, BSP

The IMF mission [17-Dec-18] noted that, sustaining strong growth will depend on rebuilding fiscal policy buffers and boosting private sector development.

The RBF released its *Financial Stability Review [FSR]* for Oct-18. The financial system remains sound as indicated by stable capital to risk weighted assets. BSP Fiji Country Manager, Haroon Ali stated that, “system liquidity has fallen from FJD600m in Jan-18 to FJD300m in Jan-19. Lending rates have come under pressure as deposit rates rise.” The corporate sector continued to report subdued credit growth and a gradual increase in non-performing loans- similar to the household sector.

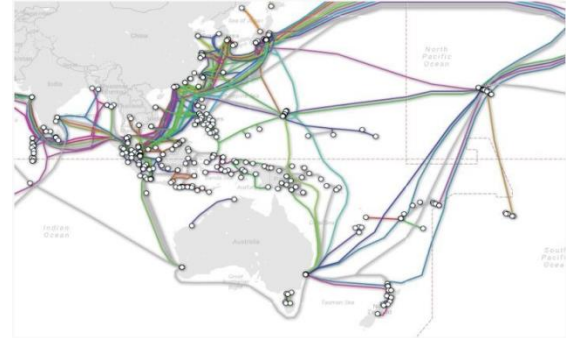
In politics, the Prime Minister, Voreqe Bainimarama’s party, FijiFirst won narrowly in the 2018 National Election.



Solomon Islands

GDP growth is expected to drop marginally to 3.4% in 2019, compared to 3.5% in 2018 and 3.0% in 2017. One of the most important infrastructure investments in 2019 will be the construction of the undersea telecommunications cable. The project which is majority funded by Australia, aims to improve internet connectivity and reduce reliance on expensive satellite communications.

Figure 5: Proposed Undersea Cable between PNG-SI



Key Facts

Background: The 4,000-plus kilometer fiber optic cable will connect Honiara, with Port Moresby and Sydney. It will also include domestic networks connecting Honiara with Auki, Taro and Noro in SI.

Sponsors: Majority AUSAID funded [A\$91.1m] with PNG and SI Governments contributing one third [A\$45.5m].

Project Costs: A\$136.6m

Contractor: VOCUS

Timeframe: 2018-2019

Expected benefits: Greater speeds and bandwidth (10 terabits per second on each fibre). It will be 200 times faster than the existing cables - reduce the cost of internet to the consumer.

Source: BSP

On the fiscal budget, the preliminary estimates show a deficit of SB\$159m in Sept-18, against a deficit of SB\$65m in Jun-18. ADB analysis show that debt level started to rise in 2017, but remains well below the government’s nominal ceiling of 35% of GDP. Recognizing the infrastructure need, the government is investing in several projects with debt financing.

The Solomon Islands is expected to hold its national elections in Mar-19, the first since the departure of the Regional Assistance Mission to Solomon Islands (RAMSI) in Jun-17. In anticipation, the government has passed the electoral Bill 2018 and other regulatory and administrative changes.

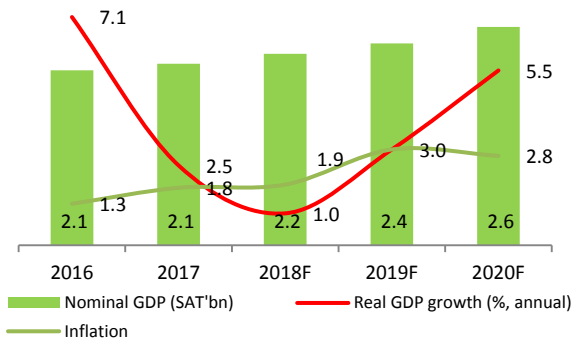


Samoa

GDP growth of 1.0% is forecasted for 2018, from 2.5% in 2017. The decline is due to the closure of

Yazaki plant and reducing fishing, agriculture and financial services output. Yazaka is a manufacturing plant for automobile wires that employs more than 700 people and generates WST1.04m in total annual revenue. Its impact on the economy will be significant.

Figure 6: GDP growth and inflation [%, annual]



Source: CBS, BSP

The ADB analysis shows that between 2009 and 2015, Samoa has funded large constructions through foreign loans. As a result, debt to GDP rose from 32% in 2009 to 56% in 2015. ADB notes that, consolidation efforts in the last three fiscal years have reversed the trend [50.3% at Jun-18]. It will be challenging to maintain this trend in light of the private and public sector infrastructure and construction projects relating to the Pacific Games 2019.

The Pacific Central Bank Governors meeting, themed “Strengthening Collaboration” was held in Samoa on 14 and 15 Nov-18. Discussions were held on the FinTech innovations, AML/CTL Compliance, and remittance issues with the aim to foster collaboration and cooperation to mitigate risks and meet the challenges posed.

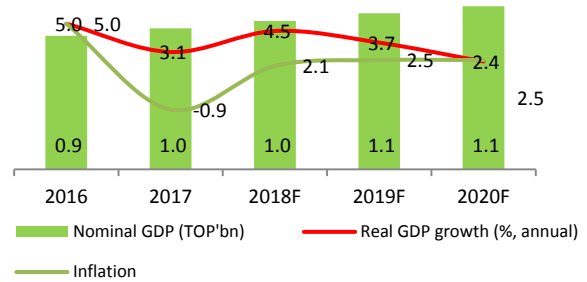


Tonga

The ADB forecast GDP growth of 0.4% in 2018, before rebounding to 1.9% in 2019. This is much

lower than the National Reserve Bank of Tonga [NRBT] projection of 4.5% in 2018 and 3.7% in 2019 (see Figure 7). Despite the wide variance in projections, growth was impacted by the Tropical Cyclone Gita in Feb-18, which cost the economy an estimated US\$164.3m, equivalent to 38% of Tonga’s GDP in 2017.

Figure 7: GDP growth and inflation [%, annual]



Source: 2018/19 Budget, BSP

The IMF–World Bank 2017 Debt Sustainability Analysis indicated that reconstruction costs attributed to disasters had significantly contributed to the accumulation of external debt. The external debt distress rating increased from moderate to high risk due to worsened external debt dynamics in the medium term.

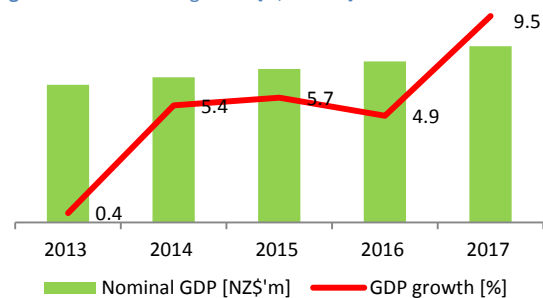


Cook Islands

GDP growth for 2017 was revised upwards to 9.5%, compared to 3.2% in the previous estimates. At

constant 2016 prices, total GDP for 2017 recorded a value of NZ\$487.5m. The Minister of Finance & Economic Management [MFEM] announced that the base year for the GDP calculation was 2016, compared to 2006 in the prior calculations. Tourism and donor support will continue to underpin economic growth. Figure 8 presents historical GDP growth rates using 2016 as the base year.

Figure 8: Revised GDP growth [%, annual]



Source: MFEM, BSP

Some progress has been made between the UK and Cook Islands regarding the issue of overseas development assistance from the Economic Co-operation and Development [OECD]. The OECD’s rule does not allow high income countries to seek ODA if high income is maintained for three [3] years. Due to negotiations, any country experiencing economic shocks caused by crises or natural disasters can still apply for OECD assistance. The decision by OECD on whether to graduate Cook Islands to a ‘developed nation status’ will be made in 2019.

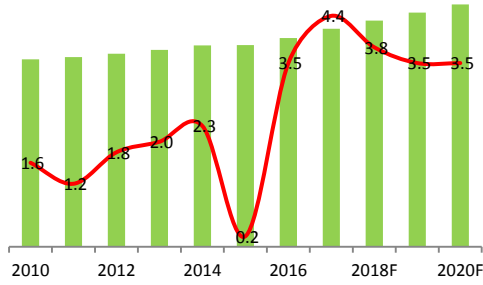


Vanuatu

Economic growth averaged 2.1% over the last seven [7] years despite the impact of Cyclone Pam

[Mar-15] and Cyclone Gita [Feb-18]. Tourism and remittance are the main drivers of growth. GDP growth is projected to moderate from 3.8% in 2018 to 3.5% in 2019.

Figure 9: GDP growth [% , annual]



Source: VNSO, BSP

Visitor arrivals by air increased by 5% to 11,426 over the 12-months to Sep-18, with most visitors arriving for holiday purposes. Infrastructure and airport upgrades will support tourism growth.

Inflation showed an increase of 1.7% in the 3Q-18, from 2.3% in the 2Q-18. Official foreign reserves at 10.5 months remained above the threshold level of 4 months of import cover at the end of Jun-18, which are sufficient buffers for imports and external obligations.

KEY CONTACTS

Robin Fleming- Group CEO
rfleming@bsp.com.pg

Peter Beswick - Group GM Corporate
pbeswick@bsp.com.pg

Paul Thornton - Group GM Retail
pthornton@bsp.com.pg

Rohan George – Group GM Treasury
rgeorge@bsp.com.pg

Gheno Minia – GM BSP Capital
gminia@bsp.com.pg

Paul Lee- Bernstein- Head of Strategy
plee-bernstein@bsp.com.pg

Paul Russell-DGM Paramount
PRussell@bsp.com.pg

Christophe Michaud – GM BSP Finance
cmichaud@bsp.com.pg

Michael Nacola - MD, BSP Life, Fiji
MNacola@bsp.com.fj

Daniel Faunt – GM Offshore Branches
dfaunt@bsp.com.pg

Brett Taylor- CM, BSP Finance [PNG]
btaylor@bsp.com.pg

Jotam Sinopane- Analyst
jsinopane@bsp.com.pg

COUNTRY MANAGERS

Haroon Ali - Fiji
hali@bsp.com.fj

David Anderson - Solomon Islands
danderson@bsp.com.sb

Maryann Lameko Vaai - Samoa
mlameko-vaii@bsp.com.pg

Daniel Henson - Tonga
dhenson@bsp.com.pg

David Street - Cook Islands
dstreet@bsp.com.pg

Nik Regenvanu- Vanuatu
nregenvanu@bsp.com.pg

MACRO-DATA

FX DEVELOPMENTS

Real GDP Growth (% annual)

	2016	2017	2018f	2019f
PNG	2.0	2.2	0.3	4.0
Fiji	0.4	3.0	3.2	3.4
Solomon Islands	3.5	3.0	3.5	3.4
Samoa	7.1	2.5	1.0	3.0
Tonga	5.0	3.1	4.5	3.7
Cook Islands	4.9	9.5	3.5	3.0
Vanuatu	3.5	4.4	3.8	3.5

Inflation (%)

	2016	2017	2018f	2019f
PNG	6.6	4.7	5.0	5.0
Fiji	3.9	3.8	3.3	3.0
Solomon Islands	0.5	1.0	1.7	2.0
Samoa	1.3	1.8	1.9	3.0
Tonga	5.0	-0.9	2.1	2.5
Cook Islands	1.6	1.6	1.1	1.3
Vanuatu	0.8	3.1	4.8	3.4

Fiscal Balance (% of GDP)

	2016	2017	2018f	2019f
PNG	-4.6	-2.4	-2.3	-2.1
Fiji	-5.7	-4.9	-4.5	-3.5
Solomon Islands	-4.5	-3.4	1.3	-3.9
Samoa	-0.4	1.3	-1.0	-2.5
Tonga	-1.0	-3.2	-4.8	-7.5
Cook Islands	3.8	1.5	-6.2	-4.1
Vanuatu	-6.1	-7.5	-8.0	-4.3

Sources: **Commodities & FX:** Bloomberg, WB, PNG: 2017 Supplementary 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, IMF, Reserve Bank of Vanuatu, BSP:

FOREIGN EXCHANGE

	OCT	NOV	DEC
PGK/USD	0.3030	0.3010	0.2990
FJD/USD	0.4759	0.4705	0.4682
SBD/USD	0.1251	0.1241	0.1236
WST/USD	0.3962	0.3962	0.3962
TOP/USD	0.4416	0.4377	0.4390
NZD/USD	0.6826	0.4377	0.4390
USD/VUV	111.15	111.15	111.15

COMMODITIES

	OCT	NOV	DEC
Oil (US\$ per barrel WTI)	70.75	56.67	48.95
Gold (US\$ per troy ounce)	1,215	1,221	1,250
Copper (US\$ per metric ton)	6,220	6,196	6,075
Nickel (US\$ per metric ton)	12,315	11,240	10,835
Palm Oil (MYR per metric ton)	2,194	2,248	2,174
Coffee (US\$ per LB)	113.10	101.80	102.45
Cocoa (US\$ per metric ton)	2,220	2,336	2,057
Sugar (US\$ per LB)	11.48	11.42	11.20
Lumber (US\$ per 1,000 feet)	455.40	437.60	344.40

Foreign Exchange Reserves (USD m)

	2016	2017	2018f	2019f
PNG	1,678	1,700	2,400	2,000
Fiji	972	960	1,156	na
Solomon Islands	514	520	542	561
Samoa	113	125	132	na
Tonga	140	na	na	na
Cook Islands	na	na	na	na
Vanuatu	na	na	na	na

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