

# ECONOMIC & MARKET INSIGHTS



JUNE QUARTER 2016

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## Highlights

- The global economy appears to have shaken-off the effect of the Brexit referendum especially on international stock markets, with most analysts turning their attention to economic conditions which appear to be weak. The International Monetary Fund (IMF) projects global growth to reach 3.1% this year.
- The Brexit outcome for 'leave' has increased uncertainty in the financial markets and global economic efforts especially in the Euro area. Economic impact on UK is expected to be negative in the near term with 'recession' being the consensus.
- Commodity prices have risen over the first six months. The IMF Commodity Price Index is up by 10.7% over the year to June 2016. Crude oil, metal and agriculture prices continued to ascend over the half year.
- Asian Development Bank (ADB) projects economic growth of 3.9% in the Pacific region. Stronger prospects from smaller economies will support growth with PNG and Fiji facing economic challenges. The tourism industry continued to realise gains during the year.
- The Government of Fiji has passed its 2016/2017 budget, which focuses mainly on Government's plans relating to the expenditure to finance recovery and rehabilitation works arising from the damage caused by Tropical Cyclone Winston. Solomon Islands projects a slight increase from 2015 estimates. Samoa and Tonga achieved higher growth as low oil prices helped boost activity.
- As PNG enters the new normal, economic challenges remain daunting. Tough times call for tough decisions with the National Government seeking offshore funding recently to fund its budget shortfalls. Business sentiment continued to be cautiously optimistic in the near term with most citing foreign exchange shortages as a business impediment. The outcome of the vote-of-no-confidence and the release of the MYEFO 2016 will be something to watch in the coming weeks.

## UK's relative strength

	UK	EU
Land mass	5%	95%
Population	13%	87%
Median age	40.5	42.5
GDP	15%	85%
GDP per capita (euros)	33,842	26,604
Government fiscal balance (share of GDP)	-2.80%	-2.00%
Gross government debt (share)	88%	87%
Foreign direct investment	28%	72%

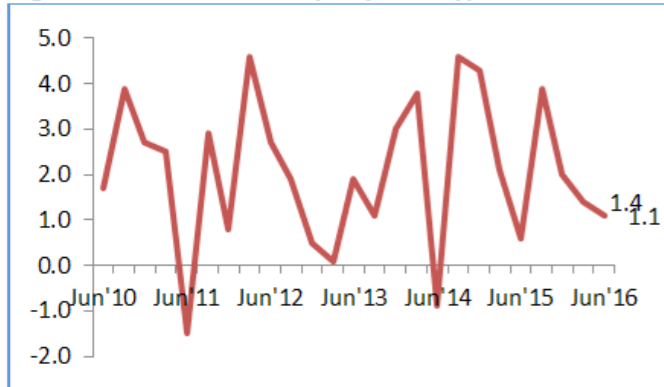
Source: Blackrock Investment Institute, BSP

**Global Economy**

The global economy regained its footing after the UK's referendum result and its negative impact on stock market performance around the world. In its recent update of its World Economic Outlook, the IMF warned that the global economy could be stuck in a "slow growth trap" and pointed to Brexit as one of the key downside risks for the global economy. Most analysts are starting to put the Brexit result behind them, while concentrating on economic activity which appears to be weak at the moment.

Several advanced economies have recorded improved conditions over the past year, but conditions have become more difficult for a number of emerging market economies. The US economy looks pretty solid as analysts expect June quarter GDP to hover around 2% annualised from 1.1% in the previous quarter. Economic activity indicators were positive, with an increase in the June manufacturing conditions ISM index, growth in consumer spending for the second month in a row in May, and a rise in consumer confidence, amongst others.

**Figure 1: US GDP Growth (% , quarterly)**



Source: US Bureau of Economic Analysis, BSP

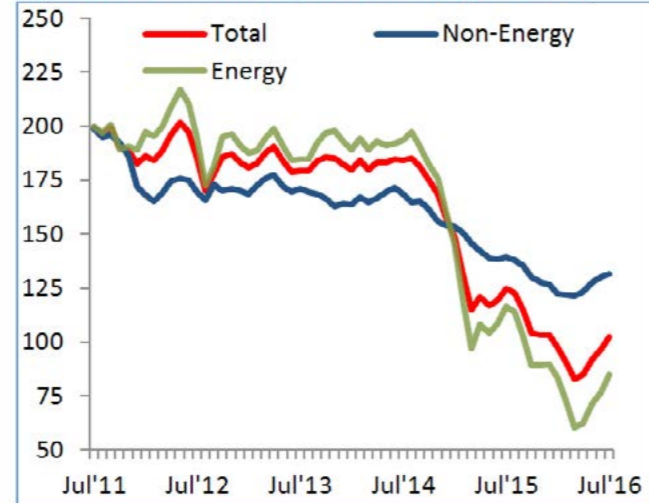
While recovery in the euro area is gradually gaining ground, domestic and external risks abound, with the recent Brexit outcome not abating the situation. Economic impact on UK is expected to be negative in the near term with 'recession' being common among analysts. This will likely slow growth in the euro area and dampen recovery efforts by the global economies. In Japan, Prime Minister Shinzo Abe postponed plans for another increase in the consumption tax, which would have lifted the unpopular tax to 10% from the 8% currently applied. Turning back to our neighbor, Australia, recent data suggest overall economic growth is continuing, despite a large decline in business investment.

In emerging market and developing economies, China's growth rate has moderated further, though recent actions by Chinese policymakers are supporting the near-term outlook. The Chinese economy is expected to grow moderately between 6.5%-7.0% in 2016. Turning to India, the projected 7.6% growth for 2016 will be challenging to achieve with the government slow on reforms and early retirement of the Governor for Reserve Bank of India.

**Commodities**

Commodity prices surged 16% over the quarter, driven by a continued increase in oil prices. Fuel prices rose 21.4% over the quarter, however lower by 23.1% compared to the previous corresponding period. Non-fuel prices rose 5.6% in the June quarter.

**Figure 2: IMF Commodity Price Indices (2005=100)**



Source: IMF commodity market monthly, June 2016.

Crude oil prices rose by 24.1% to \$48.48/bbl, during the June quarter. The increase in oil prices was primarily influenced by supply outages in Nigeria and Canada as well as a steady decline in US oil production. According to International Energy Agency (IEA), there are some signs of a 'balancing act' with oil demand growing stronger and unexpected supply cuts in non-OPEC countries. Meanwhile, metal prices have decreased by 2.1% over the quarter due to excess supply and moderation in Chinese demand.

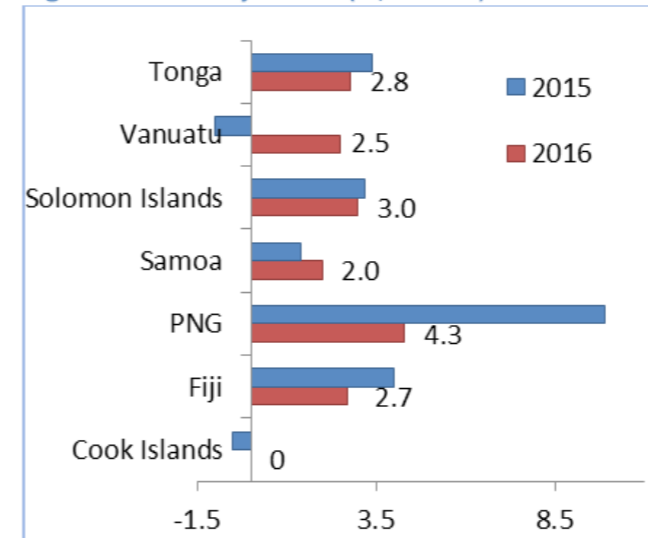
According to BPNG Monthly Economic review for May, most of PNG export commodity prices increased over the month, except for nickel, rubber, copper and palm oil. In 2015, mineral exports including LNG and Condensate were K19.4b, accounting for 83.9% of total merchandise exports, followed by agriculture, marine and other non-mineral exports accounting for 10.9%. Though, export volumes have increased, weighted average price for exports in PGK have declined by 10.2% in 2015, from 2014. We expect commodity prices to improve slightly, but not to the levels seen pre-2014.

**Pacific Overview**

According to ADB Pacific Economic Monitor, July, Pacific region is forecast to grow by 3.9% in 2016. Prospects for smaller economies have slightly improved reflecting stronger than expected performance in tourism, fisheries, and construction.

Tourism in the Pacific region continued to be positive. ADB reported that tourist departures from NZ and Australia to major South Pacific destinations were up by 21.4% (y-o-y) and 1.7% (y-o-y) respectively, over the year to April 2016. Cook Islands, Samoa, and Tonga saw double-digit growth in the number of visitors from New Zealand.

**Figure 3: GDP Projections (% , annual)**



Source: IMF WEO, ADB outlook, BSP

Exports from Pacific countries to Australia rose over the four months reflecting increased commodity exports from PNG. The region is also negotiating a trade and cooperation agreement with Australia and New Zealand (PACER+). PNG's Minister, Richard Maru stated that, PNG will not enter PACER+ deal citing vulnerability of the manufacturing industry and the likely loss in income and employment.

**Papua New Guinea**

PNG's ranking on the World Bank's survey of "Doing Business 2016" dropped four places to 145. The country's ranking also declined under the World Bank's "Starting a Business" assessment, falling from last year's 128 to 138 this year. Rankings are based on a country's current regulations to support businesses from start up to closing down including business registration, access to electricity, property registration and business taxes, among others.

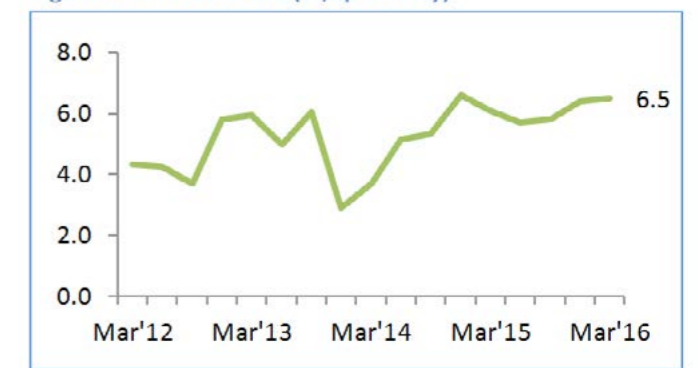
The NEC has approved plans to sell down 4.4% of national government equity in the PNG LNG Project to a beneficiary group that includes five provincial governments and landowners. The National newspaper reported that the Landowners have secured funding. Meantime, the Parliament will hold vote-of-no-confidence on 22nd of July.

Domestic economic indicators point to a 'new normal' with fiscal challenges remaining at forefront. Economic growth is projected to average 2.9% in 2016-2018, which is lower than the last two-decades, however higher than regional peers. Inflation rose marginally, PGK remain volatile and fiscal challenges are mounting.

**Consumer Price Index**

According to National Statistics Office (NSO), headline inflation increased by 10 basis points to 6.5% in March 2016 from 6.4% in the previous quarter. This was due to the pass-through impact of the depreciating Kina and the moderating domestic demand.

**Figure 4: Inflation rate (% , quarterly)**



Source: Bank of PNG, BSP

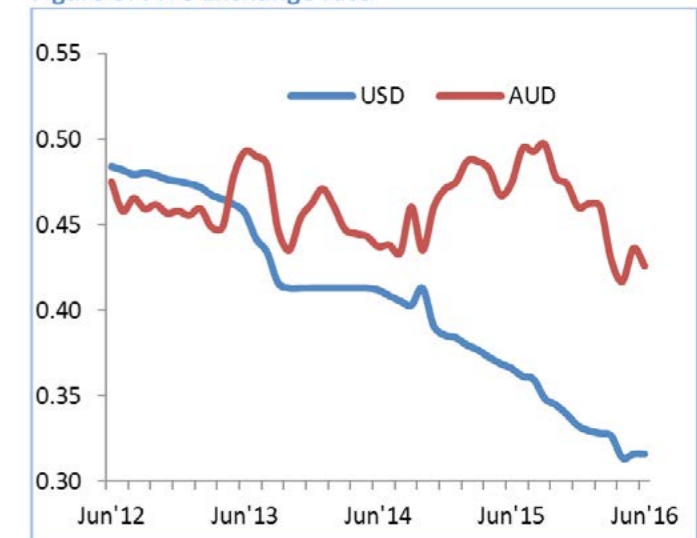
Domestic demand has moderated lately, with inflation driven by increases in alcohol, tobacco and betelnut prices. One of the underlying theorems in economics is that consumers behave rationally; hence we would expect a decline in 'discretionary' spending given the tough economic conditions. This appears not to be the case in PNG.

Bank of PNG projects annual headline inflation of 6.5% in 2016, while trimmed-mean and the exclusion-based underlying measures expected at 4.5% and 4.0% respectively. The lower economic growth and other developments are non-inflationary; hence the Bank will maintain its neutral stance over the next 6-months.

**PNG Exchange Rate**

PNG Kina depreciated against the USD and AUD by 0.8% and 3.2% to US\$0.3160 and AU\$0.4259 over the June quarter. Over the six months, PGK has lost 5% against USD and 7.5% against AUD. The decline was due to the lag-on impact of the fall in commodity prices and cross-currency movements. The Australian dollar has depreciated by 3.0% against the USD over the quarter.

**Figure 5: PNG Exchange rate**



Source: Bank of PNG, BSP

The months of May and June were much improved in terms of foreign currency inflows. Inflows were supported by a rebound in commodity prices, the resumption of full production at OTML and improved yields in the agricultural sector, notably cocoa and coffee. Reflecting this improved dynamic the exchange

rate has exhibited more stability. Indeed the BPNG reference rate has only dropped 5 points since the beginning of May, with no change since 13 May. Consequently, BSP has revised its outlook for the exchange rate. We expect this new found stability to be extended in the second half of 2016. BSP also notes that conversations continue between Treasury, BPNG and offshore investors to secure further US\$ funding, whether that be a bilateral loan or a sovereign bond issue. If talks result in a successful capital raising, then this would be a significant circuit breaker in terms of the core foreign exchange shortage.

**Fiscal Position**

The National Government faces mounting challenges in managing its budget. It was reported by press that the National Government secured a K1.5b unsecured syndicated loan arranged by Credit Suisse AG. According to the Treasurer, Patrick Pruaitch, the loan will be used “to meet the expenses of financing and much needed works and services of the State, including essential infrastructure and development projects” (The National). Though the terms and conditions of the loan are yet to be made public, it is a testament to the challenges faced by the State to fund its development budget in light of continued subdued commodity prices.

ADB PNG Country Economist, Yurendra Basnett observed that cash-flow management is getting more difficult for the government as commercial banks reach their exposure limits on government debt. Demand for government securities has declined especially on new issuance as indicated by under-subscriptions in the recent past. Government’s financing costs will likely increase; with 2016 Budget projecting domestic debt alone to reach 3.0b and fiscal deficit likely to be more than the K2b projected. Factoring the costs of offshore financing costs will be challenging for the government, exacerbated by the depreciating Kina.

**Fiji**

The economy is forecast to grow by 2.4% in 2016 driven by the transport and storage sector; financial and insurance activities; accommodation and food services; wholesale and retail trade; construction and the public administration and defence sectors. According to 2016/2017 Budget, total revenue is forecast at \$3,175.3m with a total budgeted expenditure of \$3,643.3m. This provides a net fiscal deficit of \$468.0m, equivalent to 4.7% of GDP.

Figure 7: 2016/2017 Budget Estimates

	2016 Budget (\$m)	2016/2017 Budget (\$m)	2017/2018 Target (\$m)T	2018/2019 Target (\$m)
Revenue	3,128.7	3,175.3	3,073.1	3,221.7
Expenditure	3,414.5	3,643.3	3,437.1	3,549.3
Net Deficit	(285.8)	(468.0)	(364.0)	(327.6)
GDP (current price)	9,691.1	9,866.8	10,401.3	10,920.7
Debt	4,659.9	4,969.3	5,344.4	5,661.0
Debt as a % of GDP	48.1%	50.4%	51.3%	51.8%
Growth rate	2.4%	2.8%	3.6%	3.2%
Inflation	1.6%	2.0%	2.0%	2.5%

Source: 2016/2017 Budget Supplementary, BSP

The government debt is projected to be 50.4% of GDP in 2016/2017, compared to 48.1% estimated in 2016 budget. The underlying government debt policy is to maintain debt at a sustainable level, with debt falling as a share of GDP over recent years due to Fiji’s strong economic performance.

Headline inflation rose to 5.2% in May reflective of supply shortages and temporary price hikes in agricultural products. The temporary supply shortage following the climatic events in February and early April was the main cause. Inflation is forecasted at 2.0% in 2017 and 2018. Imported inflation from low global fuel prices continues to keep inflationary pressures subdued.

**Solomon Islands**

Medium term prospects remain positive with economic growth rate expected to average 3.15% over 2016-2018. Central Bank of Solomon Islands (CBSI) is expected to maintain an accommodative monetary policy stance over the next six months. This will complement the expansionary policy of the government which aims at growing the economy and addressing the development needs of the country.

On 22 June, CBSI granted an interim licence to Bred Bank to establish its banking infrastructure and open for business within 12 months. Bred (Vanuatu) Limited is part of the second largest banking group in France, ‘Banque Populaire’, which also has outlets in New Caledonia, Tahiti and Fiji. Competition in the local market has increased with the inclusion of Bred Bank, bringing commercial banks to 4 in Solomon Islands.

Headline inflation rose to 4.4% in April from 3.9% in the previous month. This reflected an increase in domestic inflation associated mainly with increases in local food prices and transport and communication categories. Imported inflation fell to 2.5% from 2.7% in the previous month. Inflation is projected to remain within the 3%-5% range in 2016.

The government recorded a deficit of \$136m in May compared to a deficit of \$133m in April. Revenue and expenditure fell by 5% and 2% to \$196m and \$332m, respectively. Tax revenue fell by 7% to \$184m due to lower collections on income and profits and GST. On the debt front, Government debt stock continued to fall, particularly following a large one-off advance repayment of domestic debt made in the final quarter of 2015.

**Samoa**

According to IMF, Samoa achieved higher growth as low oil prices helped boost activity in the transport and energy sectors, and as implementation of public infrastructure projects improved. GDP grew by 1.7% in 2015 compared to 1.2% in 2014.

The government continued its expansionary policy designed to recover from Cyclone Evan, while the Central Bank of Samoa (CBS) embraced an easing monetary policy. In line with this, CBS official interest rate continued to fall, ending June 2016 at 0.15% compared to 0.18% in June 2014. Likewise, commercial banks’ average lending rates dropped 98 basis points from 10.28% to 9.30% at the end of June 2016.

Annual average headline inflation rate stabilized at 0.3% in March 2016, compared to 1.2% in the corresponding month of 2015. International reserves dropped to a level of around 4.8 months of imports in 2015/16, which is comfortably within the benchmark of four (4) months of import cover.

CBS statistics shows that, lending into professional and business services has overtaken building, construction and installation as the main economic sector in Samoa. Over the year to April 2016, commercial bank lending into the professional and business services increased by 4% while agriculture, forestry and fisheries segment lending grew by 3%.

**Tonga**

The Tongan economy was strong over the six months, supported by the expansion in the primary sector, construction, trade, tourism and credit growth. Low consumer demand during the month of April has contributed to a decrease in domestic food prices. Growth is expected to stay around 2.5–3.0% over the medium term, supported mainly by construction activities related to the preparation for the Pacific Games (PG).

Headline inflation slipped back to a deflation of 0.9% in April, driven mainly by increase in Kava-Tonga prices, though we noted continued shortage of Kava supplies. Domestic food prices have increased as well by 5.9% as a result of higher prices recorded for talo tarua, swamp taro, cassava, yams (early & late), pele leaves, carrots, ripe bananas, watermelon, pineapple, coconuts (brown & green) and stringed fish.

The number of international arrivals rose by 482 (8.1%) passengers in April, reflecting the commencement of Fiji Airways’ direct route from Fiji to Vava’u and also the introduction of the Air New Zealand Boeing 777 in April. This coincides with an increase in travel receipts of \$2.1m (43.8%).

Balance of Overseas Exchange Transactions (OET) as of April 2016 was surplus of \$5.5m, following a deficit of \$11.2m in the previous month. Improvement in the balances of the current and financial accounts to surpluses in April, contributed to the overall surplus. Official foreign reserves remained comfortable at \$322.9m at the end of April, equivalent to 9.0 months of import cover.

The Foreign Exchange Levy was effective on 1 June 2016, with all incoming and outgoing funds to be charged 0.5 sentiti. Most foreign exchange dealers will be impacted by the Levy.

**Cook Islands**

Cook Islands launched its new National Sustainable Development Plan (NSDP) 2016-2020 on 16th June. The document builds upon the successes of the previous plans, with 16 ‘national development goals’ covering welfare, culture, economy and population among others.

Cook Islands Finance Minister, Mark Brown welcomed the decision by the ADB to develop a contingent credit line to finance post disaster recovery in the Pacific Small Island Development States. In his address in the 49th Asian Development meeting

in Frankfurt, he stated that, “Pacific DMCs need innovative financing mechanisms that suit [their] needs and yet be flexible enough to account for inherent vulnerabilities, such as susceptibility to adverse climatic events and global economic shocks.”.

According to Ministry of Finance & Economic Management (MFEM) annual headline inflation fell by 0.1%, while underlying inflation increased by 2.0% in March quarter 2016. Fuel prices and international travels fell by 8.3% and 2.3% consecutively making the largest downward contribution over the quarter.

**Vanuatu**

Vanuatu’s economy continued to recover from last year’s Cyclone Pam with growth expected to pick up to 2.5% in 2016 and 3.8% in 2017. Downside risks include; safety of the runway at the Port Vila international airport, severe El Niño conditions harming agriculture, and political uncertainties.

Annual inflation was 2.0% in the March quarter 2016, compared to 1.4% in the previous quarter. The increase was attributed to a 3.6% increase in food, followed by transport (+5.2%), education (+4.7%), clothing and footwear (+3.4%), household supplies (+0.9%) and recreation (+2.0%). These more than offset the decline in housing and utilities and miscellaneous prices which showed declines of 1.8% and 2.3% respectively.

Vanuatu’s trade deficit was VT3,395m, which was VT3,415m lower than the previous month, however higher by VT1,871m over the year. This resulted from export earnings of VT439m and imports of VT3,834m in March 2016.

Lending growth has moderated somewhat, with domestic credit increasing by 1.5%, owing mainly to increases in loans to public non-financial corporations, other non-financial corporations and other resident sectors. However, this level was still down by 6.9% compared to a year ago.

MARKET RATES

FOREIGN EXCHANGE			
	APRIL	MAY	JUNE
PGK/USD	0.3175	0.3160	0.3160
FJD/USD	0.4821	0.4599	0.4810
SBD/USD	0.1273	0.1240	0.1264
WST/USD	0.3918	0.3821	0.3926
TOP/USD	0.4537	0.4411	0.4541
NZD/USD	0.6959	0.6695	0.7114
VUV/USD	0.0092	0.0089	0.0090

COMMODITIES			
	APRIL	MAY	JUNE
Oil (US\$ per barrel WTI)	47	50	48
Gold (US\$ per ounce)	1,293	1,218	1,288
Copper (US\$ per metric ton)	5,050	4,671	4,845
Nickel (US\$ per metric ton)	9,445	8,435	9,445
Palm Oil (MYR per metric ton)	2,562	2,597	2,353
Coffee (US\$ per LB)	123	123	146
Cocoa (US\$ per metric ton)	3,232	3,026	2,963
Sugar (US\$ per LB)	16	17	21
Lumber (US\$ per 1,000 feet)	307	312	308

MACRO DATA

Real GDP Growth (% annual)				
	2014	2015	2016f	2017f
PNG	13.3	9.9	4.3	2.4
Fiji	5.3	4.5	2.4	3.1
Solomon Islands	1.0	2.9	3.0	3.1
Samoa	1.2	1.7	2.0	0.5
Tonga	2.0	3.4	2.8	2.7
Cook Islands	-1.2	-0.5	0.0	0.2
Vanuatu	2.3	-1.0	2.5	3.8

Inflation (%)				
	2014	2015	2016f	2017f
PNG	5.2	6.4	6.5	7.5
Fiji	0.6	1.4	3.0	3.0
Solomon Islands	5.2	-0.3	4.4	5.7
Samoa	-1.2	1.9	2.0	2.0
Tonga	2.1	-0.7	-0.3	0.5
Cook Islands	1.6	3.0	1.8	2.0
Vanuatu	1.1	1.4	1.9	2.4

Fiscal Balance (% of GDP)				
	2014	2015	2016f	2017f
PNG	-6.9	-5.0	-3.8	-2.3
Fiji	-4.1	-2.5	-2.9	-2.5
Solomon Islands	-1.3	-3.5	3.0	na
Samoa	-4.8	-4.2	-3.9	na
Tonga	-0.2	-0.1	-0.2	na
Cook Islands	-5.4	-7.4	-6.1	na
Vanuatu	1.0	-1.5	-9.8	-10.8

Foreign Exchange Reserves (USD m)				
	2014	2015	2016f	2017f
PNG	2,296	1,920	1,920	3,373
Fiji	913	872	780	na
Solomon Islands	530	550	550	na
Samoa	155	156	160	na
Tonga	138	140	140	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, ADB, 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

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