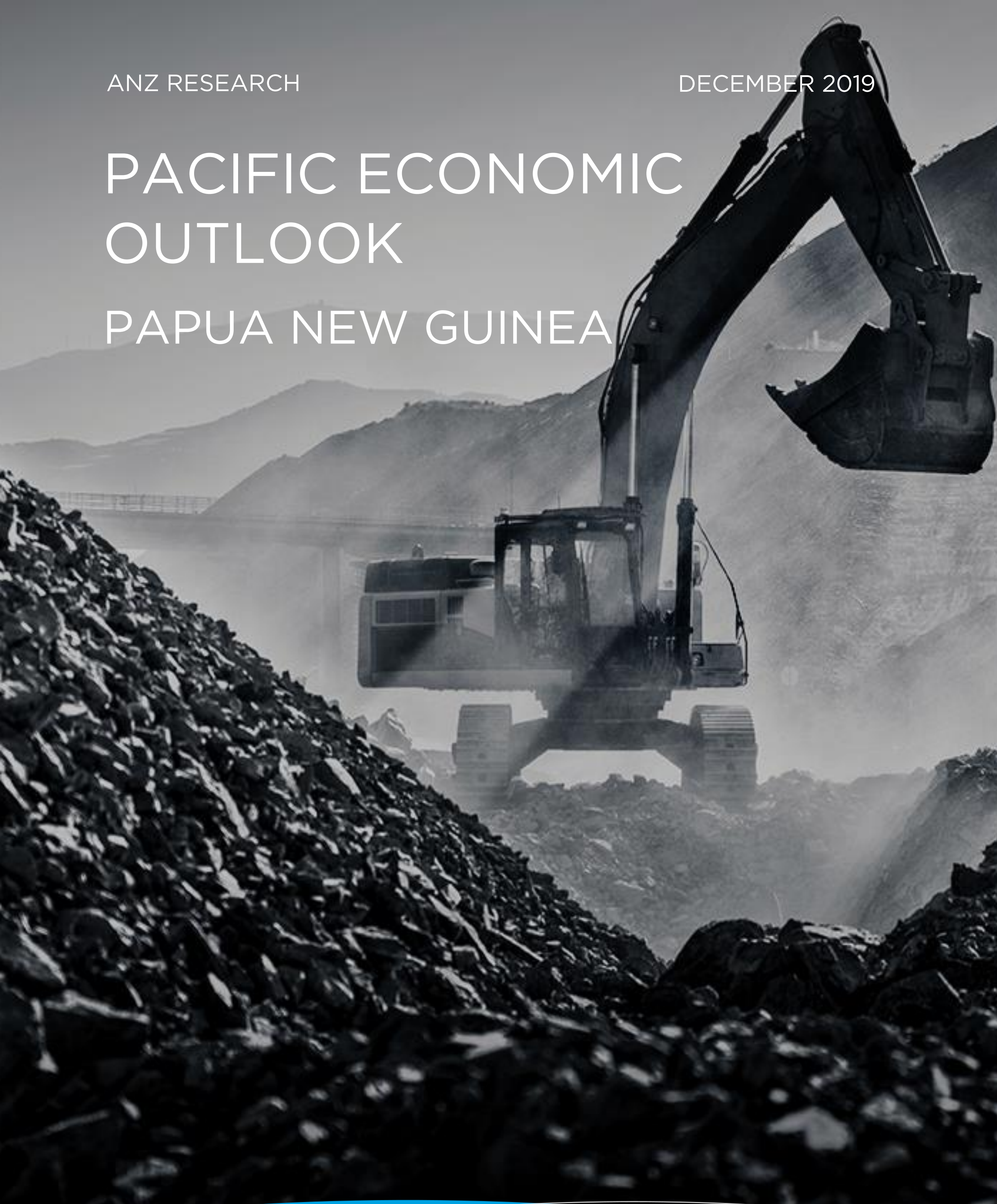
ANZ RESEARCH

DECEMBER 2019

PACIFIC ECONOMIC OUTLOOK

PAPUA NEW GUINEA



Papua New Guinea: at a glance

Economy remains weak

- Strong 2019 GDP is a false dawn
- Headline result driven by rebound in gas exports
- Strip away contribution of gas, economy is probably going backwards

Softer 2020

- Gas projects could not enter into FEED in 2019 as crucial P'nyang agreement still in negotiations
- So, no FID on gas projects in 2020
- Economy stuck in low gear; policy levers not working

Recovery in 2021…

- …if P'nyang can be completed within deadlines
- Allowing FEED, FID and commencement of Papua LNG and PNG LNG expansion by mid-2021

Upswing from 2022

- We are hopeful that the P'nyang terms will be completed soon
- Setting up a strong next decade for PNG
- Failure to reach a timely agreement could put this upturn at risk

'Honest' budget

- First budget of Marape-Steven government tabled
- Treasurer seeking to understand true state of government finances
- Government keen to pay all outstanding bills

FX normalcy delayed

- Foreign exchange market remains undersupplied
- Improved liquidity from the central bank helping reduce the stock of outstanding payments
- Foreign direct investment will restore balance from H2 of 2021 subject to progress on gas projects

No economic recovery or a balanced FX market until the second half of 2021

- Early in the year, we said that PNG's long-awaited economic recovery will come through in late 2020. However, that's now not possible.
- The time taken to endorse the Papua LNG Gas Agreement and failure to complete the P'nyang Gas Agreement by the end of November mean the economic recovery is further delayed.
- If the P'nyang Gas Agreement can be completed within agreed deadlines, we believe the recovery will take a foot-hold from the second half of 2021, 12 months later than initially envisaged. Obviously, a longer project dialogue will push the recovery out further with a risk that extended negotiations could derail the economic upturn.
- We don't expect the FX market to be in balance until late 2021. An Australian USD300m loan for budget support is helping but it is not enough. PNG still has PGK2bn of profit repatriation yet to be placed on the order book.
- Large flows associated with the next round of mega-projects provide the best hope of the FX market returning to normalcy. This is another reason why P'nyang agreement and the associated terms for additional gas development at the Kutubu fields should be finalised sooner rather than later.
- GDP for 2019 will be impressive, but don't get carried away. It's all coming from a rebound in gas production following the earthquake-induced disruptions in 2018. Take out the contribution of gas (ie production, taxes, royalties, dividends and consumables), and the PNG economy is probably in recession.

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Economic outlook

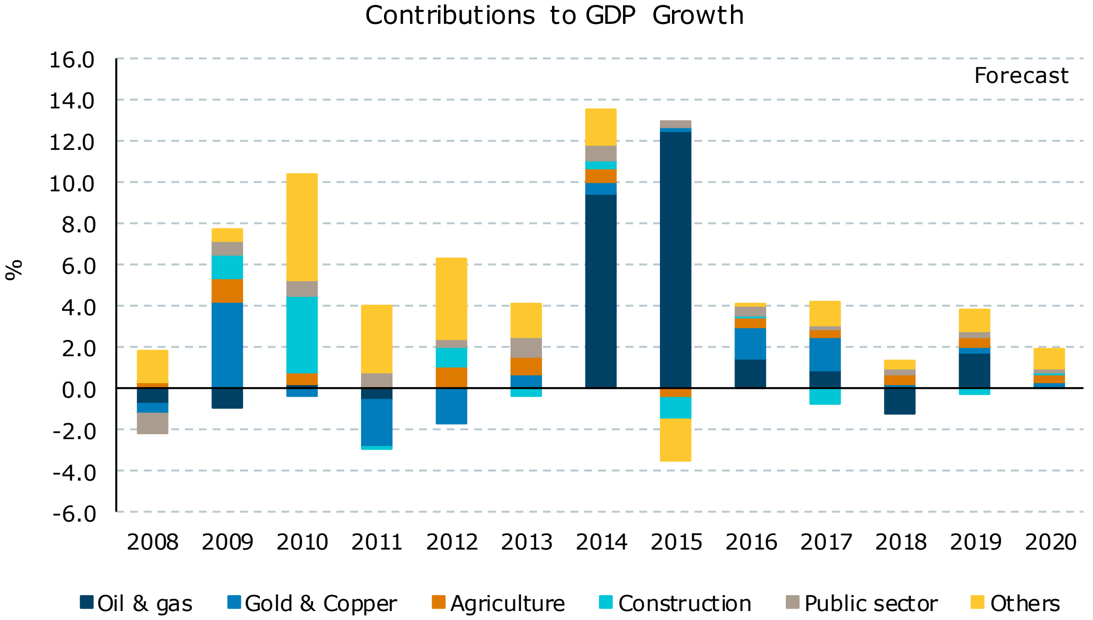
Don’t be misled by a strong GDP for 2019, the economy remains weak

We are forecasting PNG’s economy to grow by an impressive 3.8% in 2019. This will be driven by a rebound in oil and gas production following earthquake-induced disruptions in 2018 (Figure 1). We expect gas output, which makes up 25% of GDP, to lift by 15.8% to around 8.5mt this year from 7.5mt in 2018. However, to many observers, the PNG economy feels more like it is in a recession. Take out the contribution of gas (ie production, taxes, royalties, dividends and consumables) and it probably is.

We anticipate the economy will remain soft in 2020, largely due to ongoing weakness in construction, in particular mining investment. We don’t expect gas output to be higher, despite the LNG plant consistently achieving higher annual production rates since 2014. Scheduled turbine maintenance will limit the upside to the 8.5mt expected this year.

Non-mining business investment remains subdued. With weak demand and weak profits, it doesn’t make sense for businesses to invest, especially when many still have excess capacity. Low confidence – due to delays in accessing foreign currency and uncertainty surrounding the next round of mega-resource projects – is not encouraging firms to invest.

Figure 1. Oil & gas exports: key determinants of recent growth



Source: National Statistics Office, ANZ Research

Policy levers not working – monetary policy is of limited effect

After keeping the policy rate at 6.25% since March 2013, the Bank of Papua New Guinea (PNG’s central bank) cut the official policy rate – the Kina Facility Rate – twice in 2019. It reduced the policy rate by 25bp in July and 50bp in August, taking the official rate to 5.5%.

We don’t believe the reduction in rates will be able to stimulate demand, as the relationship between commercial bank lending rates and policy rates is very weak. Large surplus liquidity in the banking system prevents smooth transmission of policy rates to market rates. Hence, changing policy rates has limited, if any, impact on domestic demand.

Fiscal policy is up against a debt limit

With monetary policy having limited influence on demand, all the heavy-lifting is left to the government. However, the debt barrier provides little wriggle room to run a counter-cyclical fiscal program. Debt to GDP is at 42% versus a legal limit of 45%.

No FID in 2020, further delaying the long-awaited economic recovery

At the beginning of the year, we expected both the Papua LNG and the PNG LNG Expansion (P’nyang) project to be in preliminary engineering works by late 2019 before commencing construction late next year. However, the crucial P’nyang Gas Agreement hasn’t been finalised.

Economic outlook

The target date for the P'nyang Gas Agreement was the end of November, but that didn't materialise. If the negotiations can be completed within agreed deadlines, we believe a recovery will come in the second half of 2021 – a year later than anticipated. Obviously, a longer project dialogue will push the recovery out further, with a risk that extended negotiations could derail the economic upturn (see box article below).

Note that while the previously signed Papua LNG agreement was given a delayed green light by the Marape-Steven government, work on Papua LNG will not ramp up until the P'nyang terms are agreed to by the government. That is because elements of the Total-led Papua LNG and ExxonMobil-led P'nyang development are integrated, with the synergy delivering material capital and operating-cost savings, especially for the brownfield downstream development.

A return to balanced foreign currency market is also some way off

The stock of outstanding foreign currency payments, albeit declining, is still significant at PGK1.4bn. The recent USD300m loan from Australia will allow the central bank to provide more US dollars to the market, further lowering the overdue import invoices. But this won't be enough. Nearly PGK2bn of capital repatriation is yet to be placed on the order book.

We believe flows associated with works on new gas discoveries will be substantial and present the best chance of returning the FX market to normalcy. So, the longer these projects take to start, the longer the FX market will be undersupplied. A structural shift to a lower currency is an option for rebalancing the market, but the central bank seems reluctant to do this, given the inflationary impact associated with a faster depreciating currency.

New treasurer does 'soul-searching', but little antidote in the 2020 budget

The Treasurer, Ian Ling-Stuckey, announced the Marape-Steven government's first budget on 28 November. In tabling the budget, he emphasised the need to understand the true state of government finances before providing a plan to settle all outstanding government payments and restructuring government debt. The 2020 Budget predicts revenue of PGK14,095m, expenditure of PGK18,727m (of which PGK1,050 relates to unpaid bills from previous years) yielding a deficit of PGK4,631m – the largest in the country's history.

The desire for honest budgeting and accounting for government arrears is admirable, but a clear plan for economic recovery, jobs and a strategy to return the budget to surplus is critical. Given concerns about debt levels, we believe a medium-term plan to return to surplus in order to pay down debt would have been a positive step.

Plan for a broad-based economy once LNG investment is under way

The 2020 budget has allocated PGK200m for small-to-medium enterprise development, mostly in the agriculture sector. Money has also been allocated for the coffee and cocoa industry, fresh produce development and marketing, coconut downstream processing and marketing, oil palm smallholder roads, tourism sector development and livestock industry development. However, the funds are in the PGK5–10m range.

PNG has huge potential in its agriculture, tourism and manufacturing sectors. However, unlocking that requires infrastructure investment of several billion kina. That will be more feasible from the middle of the next decade, when the new gas capacity comes online.

Why is the P'nyang Gas Agreement important for PNG?

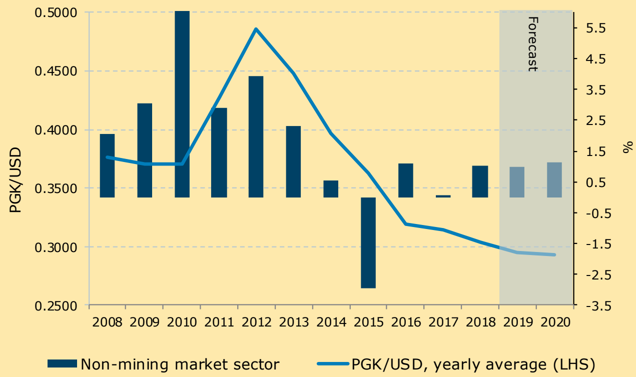
There is nothing unusual about the current weakness

Since the completion of the PNG LNG project in 2014, PNG's economy has struggled. Headline GDP, driven by exports, has been impressive; but underneath those strong numbers is very weak domestic demand. That's not totally out of step with PNG's past economic performance.

PNG is a narrow commodity-based economy, and mining investment is the principal driver of growth. When there are new discoveries or when commodity prices are high enough to underwrite exploration and brownfield expansions, economic growth is strong. Post construction boom, increased capacity allows mineral exports to take over as the driver of growth. But once export capacity is reached, growth slows to population growth of around 2% per year.

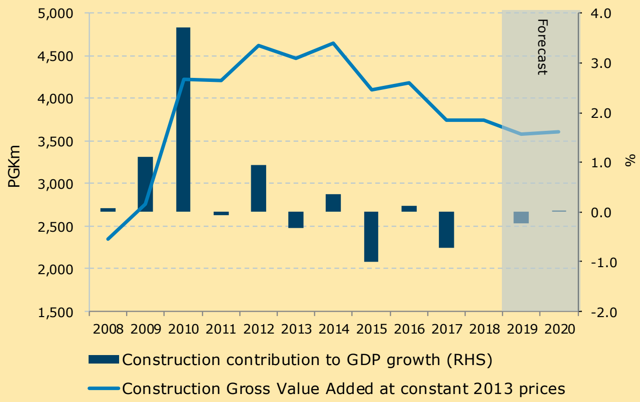
PNG does not have a mature non-mining economy that can take the baton from mining investment and become the driver of growth. Kina-sensitive industries, such as tourism and manufacturing, have great potential, but they are not sufficiently developed (Figure 2). Without mining investment, the economy gets stuck in low gear waiting for the tailwinds from the next phase of construction (Figure 3).

Figure 2. Weak non-mining economy



Source: National Statistic Office, ANZ Research

Figure 3. Construction contribution to GDP



Source: National Statistics Office, ANZ Research

The good news is that the next mining investment phase is coming

After bumping around the bottom of the cycle for a number of years, economic recovery is not far away. The O'Neill government originally signed the Papua LNG Gas Agreement in April this year, and the Marape-Steven government endorsed it in September. However, early engineering works will not start until the P'nyang Gas Agreement (currently under negotiation) is completed. The downstream processing elements of the ExxonMobil-led PNG LNG expansion (P'nyang) and the Total-led Papua LNG can be integrated. Hence, the fiscal terms of both projects need to be finalised before work can commence. Once these projects are online, PNG's gas exports will double to 16mtpa.

Failure to reach the P'nyang agreement could derail recovery

The government is working hard to secure a larger share of PNG's growing gas revenue and ensure landowners, provincial governments, the state and future generations of Papua New Guineans get a more equitable share of its gas reserves. Pushing against that is the pressure on the venture partners to secure shareholder returns.

Why is the P'nyang Gas Agreement important for PNG?

Mining capital is not a limitless pool, and PNG – notwithstanding its unique value proposition including rich gas – is competing against discoveries in Mozambique, Guyana, Brazil and the United States. Hence the need to strike the right balance between national and investor interest in negotiating the P'nyang agreement.

However, timely completion of the P'nyang agreement is needed to prevent Papua LNG and PNG LNG Expansion being indefinitely on hold. Long delays could see these projects miss the production deadline of 2024 when the market is undersupplied.

That would be a body blow to the country and could do irreversible damage to the economy. At the least, it will derail the economic recovery and be a major setback for PNG because the higher standard of living that accompanies stronger economic performance will be lost.

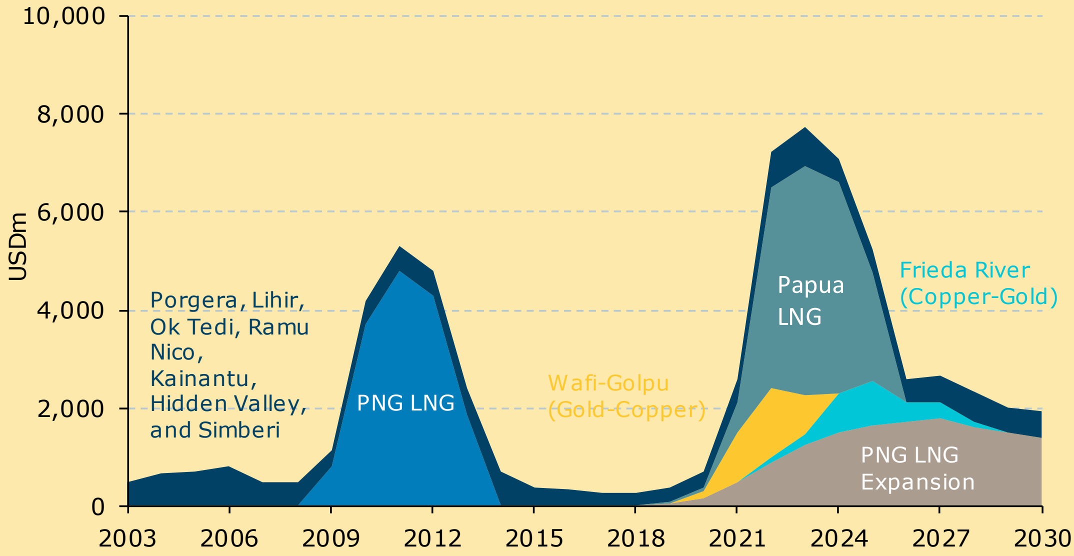
We remain optimistic about the next decade, for now

The Wafi-Golpu gold/copper greenfield development could start in late 2020, if the state can resolve how it will share the benefits with the Morobe Provincial Government by Q1 2020 and there is some clarity on the application of the proposed new Mining Act. Further, we expect the gas projects to commence by late 2021, assuming an agreement can be finalised within agreed deadlines. These combined with the Sepik Development Project (which takes in the Frieda River copper/gold project) plus asset renewals and brownfield extensions will push activity higher for a number of years (Figure 4).

The gas and mining investment in the next decade, in our view, will almost certainly surpass the 1990s resources boom underwritten by the copper and gold expansion at Ok Tedi, the Kutubu oil project and Porgera gold mine.

Accordingly, we are calling the next resource investment cycle a 'super cycle'. The volume of construction work will be further boosted by projects under the national electrification program and road investment funded by a stronger fiscal position (the state's original PNG LNG debt will be repaid by the middle of next decade).

Figure 4. PNG's resource construction wave



Source: ANZ Research

Commodity price forecasts

Contract LNG prices, although moderating, are expected to outperform the spot price by some margin (Figure 5 and 6). This augurs well for PNG LNG as the majority of its production (7.9 out of 8.5mtpa) are sold under long- and medium-term contracts. Gold, copper and nickel – PNG's key mineral exports – are expected to do well in 2020.

Surging supply continues to weigh on LNG prices

Demand for LNG remains robust. We estimate imports will increase by 17mt this year (+5.5% y/y). However, the LNG market has hit a roadblock, as capacity expansions throughout Asia and North America overwhelm the market. We expect LNG supply to hit 371mt in 2019, a rise of 32mt or 13.1% from 2018. That has seen about 15mt a year of supply struggle to find a home, a big reason behind the downward pressure on spot LNG prices we have seen this year.

The spot price, as measured by the Japanese/Korea Marker current month future, is trading around USD5.9/mmbtu. This compares with JCC-linked oil prices of around USD10/mmbtu (Figure 6).

Meanwhile, inventories remain high. In Japan, the market has exited summer with high inventory levels (around 4.5mt, about 1mt higher than the same period last year). In South Korea, inventories are reaching saturation, with storage around 80% of capacity in October.

The only light at the end of the tunnel is the impact of the International Maritime Organisation 2020 rules on shipping fuel. The ban on dirty fuels could lead to fuel-switching, with LNG an attractive option for vessels. Low LNG prices make the option even more enticing. All considered, we see little relief from low LNG prices over the coming year.

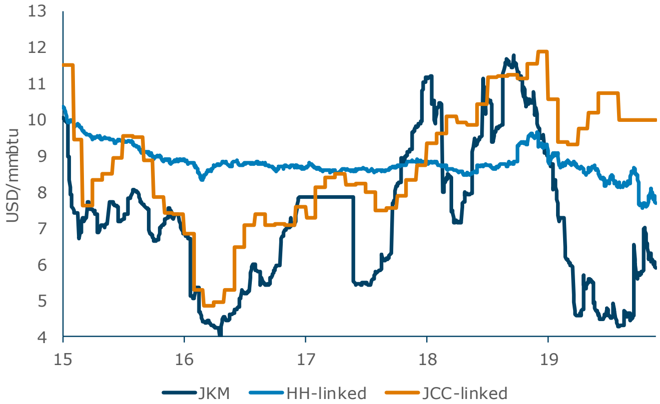
Better news for gold, copper and nickel

We believe a weaker USD should support gold. And an inflexion point in equity markets looks imminent. So, a rollover in funds from equity to defensive assets is largely expected, and gold and other precious metals should benefit from this shift.

In terms of the industrials complex, copper demand has been softer than expected this year amid disappointing industrial activity. However, some stabilisation in the macro backdrop next year should see it recovering. We expect copper to trade above USD6,000/t in 2020.

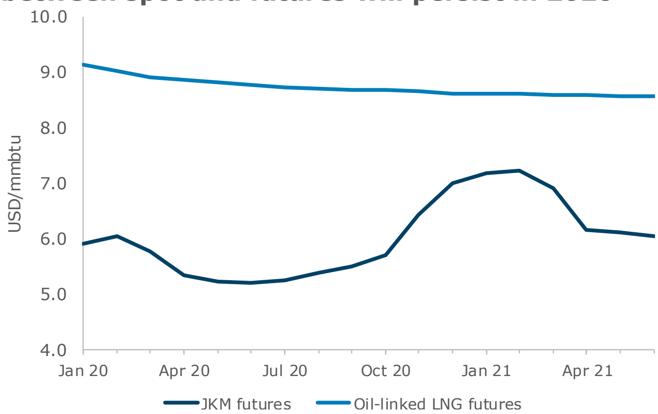
A ban on nickel ore exports from Indonesia rattled the market this year. With the implementation date being brought forward to 1 January 2020, importers have been heavily restocking, which should limit the impact. Chinese NPI producers are cutting their production capacity, due to margin pressure and domestic environmental regulations. These supply challenges along with demand recovery should keep market undersupplied by 180kt next year. Electric vehicles are the long-term supportive story for the metal. We see prices trending higher towards USD15,500/t.

Figure 5. Spot LNG price well below the oil-linked price



Source: Bloomberg, ANZ Research

Figure 6. Futures signal that the high spread between spot and futures will persist in 2020



Source: Bloomberg, ANZ Research

Kina forecasts

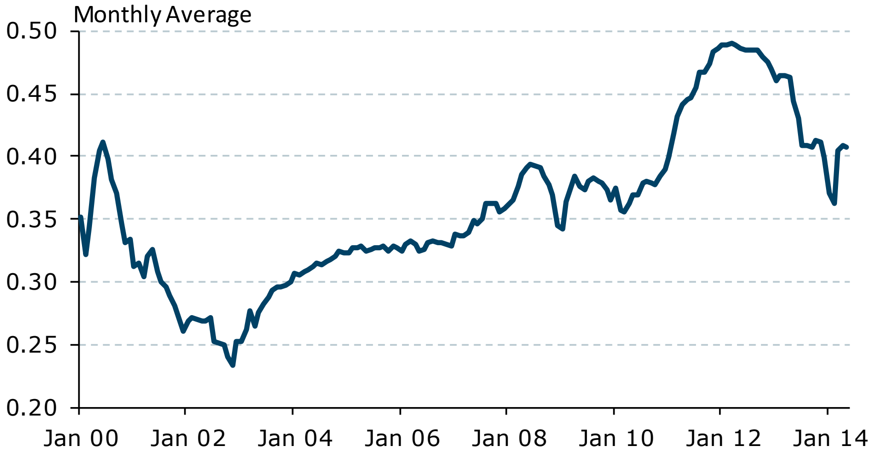
PGK/USD to continue to drift lower

PNG's foreign exchange market remains undersupplied. Demand for foreign currency, in particular US dollars, exceeds available supply. Accordingly, the kina has been depreciating against the US dollar since 2014 when PNG first faced a scarcity of foreign currency. We expect this trend to continue for at least another year.

Foreign direct investment holds key to restoring normalcy

Foreign direct investment has an important influence on the kina. Indeed, a ramp-up in PNG LNG construction over 2011 and 2012 brought US dollars into the country. This saw the kina appreciate by 27.4% to a high of USD0.4867 in Q3 2012 from USD0.3842 Q1 2011 (Figure 7). This occurred despite commodity prices (kina's other underlying driver) falling during this period, having peaked in early 2011.

Figure 7. PGK/USD



Source: Bloomberg

Hence, the timing of a balance in the FX market is dependent on the start of the energy projects. At this stage, we think it will be late 2021 before we see normalcy. Until then, the BPNG may consider engaging in regular intervention to help reduce the size of the order book.

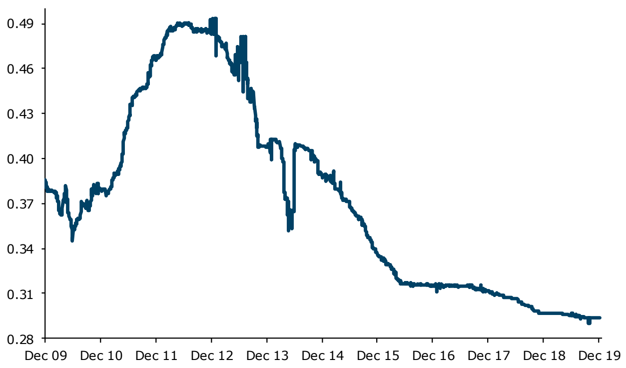
Figure 8. Kina forecasts (quarterly average)

	Sep 19 Actual	Dec 19	Mar 20	Jun 20	Sep 20	Dec 20	Mar 21	Jun 21	Sep 21	Dec 21
PGK/USD	0.2943	0.2939	0.2925	0.2919	0.2914	0.2907	0.2896	0.2904	0.2924	0.3014
PGK/AUD	0.4762	0.4311	0.4366	0.4401	0.4415	0.4405	0.4388	0.4401	0.4430	0.4567
PGK/NZD	0.5026	0.4591	0.4501	0.4537	0.4553	0.4590	0.4597	0.4610	0.4641	0.4784
PGK/EUR	0.2647	0.2657	0.2692	0.2670	0.2649	0.2611	0.2570	0.2555	0.2550	0.2621
PGK/JPY	31.58	31.92	32.27	32.60	32.64	32.56	32.44	32.52	32.75	33.76

Source: Bloomberg, ANZ Research

Kina forecasts

PGK/USD



PGK/NZD

PGK/AUD

PGK/SGD

Source: Bloomberg, ANZ Research

Macro forecasts

GVA by industry	% of GDP 2018	PGKm	Annual per cent change (1)						
		2018e	2014	2015	2016	2017	2018e	2019f	2020f
Agriculture, forestry and fishing	15.4	10,041	3.4	-2.6	2.7	2.4	3.3	**2.9**	**2.7**
Oil and gas extraction	22.2	13,446	299.6	111.8	6.7	4.1	-5.6	**8.1**	**0.2**
Mining and quarrying	10.1	7,415	4.9	2.4	17.4	16.2	1.9	**3.1**	**2.2**
Manufacturing	1.7	1,098	-0.9	-12.9	3.8	3.7	1.5	**2.1**	**1.8**
Construction	6.8	3,739	3.8	-11.7	1.9	-10.6	0.0	**-4.1**	**0.5**
Wholesale and retail trade	8.7	5,481	1.2	-6.0	1.7	1.2	1.0	**2.6**	**3.9**
Transport and storage (warehousing)	2.2	1,448	-13.4	6.4	2.4	1.2	6.5	**4.4**	**2.7**
Finance and insurance	2.6	1,533	-15.4	-16.0	-5.0	-1.6	-1.5	**0.7**	**0.8**
Real estate activities	5.5	3,512	2.6	3.1	4.9	3.5	0.1	**1.7**	**2.1**
Administration and support services	6.4	4,128	1.9	-2.4	0.6	0.5	4.0	**3.5**	**2.9**
Public admin and defence	4.5	2,906	11.6	3.8	1.7	1.9	3.8	**3.1**	**3.0**
Education	2.7	1,725	7.8	3.5	5.7	2.1	3.0	**3.5**	**3.0**
Others (2)	7.2	5,170	3.9	-2.4	4.5	1.8	4.0	**4.1**	**3.9**
Mining (3)	32.3	20,862	73.9	61.2	9.8	7.9	-3.1	**6.3**	**0.9**
Non-mining	64.2	40,782	1.8	-3.7	2.4	0.5	2.4	**2.3**	**2.7**
Total GVA	96.5	61,643	11.9	10.5	4.8	3.0	0.5	**3.7**	**2.1**
Taxes less subsidies on products	3.5	2,385	55.2	-10.1	-11.9	19.5	-8.1	**1.3**	**-3.3**
GDP	**100**	**64,028**	**13.5**	**9.5**	**4.1**	**3.5**	**0.2**	**3.6**	**1.9**

(1) Constant 2013 prices
(2) Others include electricity, gas and air-conditioning; water supply and waste management; accommodation and food services; information and communication; professional and scientific; health and social work; and other services
(3) Mining GVA is crude oil and gas extraction plus other mining
e: estimate, f: forecast

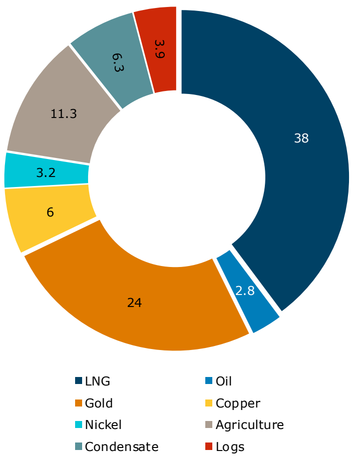
Key financial indicators	2014	2015	2016	2017	2018	2019f	2020f
CPI (Dec on Dec, % change)	6.7	6.4	6.6	4.7	4.3	**4.0**	**4.5**
BPNG Underlying CPI (Dec on Dec, % change)	4.0	2.3	1.9	2.3	4.0	**3.5**	**4.0**
Kina Facility Rate (as at Dec, %)(4)	6.25	6.25	6.25	6.25	6.25	**5.5**	**5.5**
Foreign Reserves (PGKbn)(5)	6.0	5.2	5.3	5.6	7.5	**8.3**	**8.3**
Current Account (PGKbn)	6.0	13.4	16.7	19.7	20.0	**20.1**	**20.3**
- as a % of GDP	11.2	21.6	24.9	26.3	29.0	**26.7**	**23.2**
Government Budget (% of GDP)	-6.3	-4.5	-4.6	-2.4	-2.5	**-2.7**	**-1.6**

(4) Bank of Papua New Guinea policy indicator rate
(5) Bank of Papua New Guinea forecasts as at 30 September 2019
f: forecast

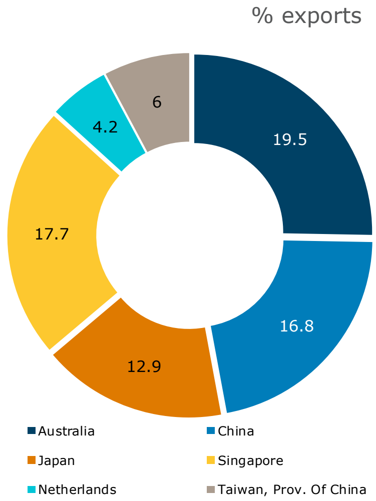
Country profile

Demographics	1990	2000	2010	2016
Population (million)	4.31	5.57	7.11	8.08
Urban population growth (annual %)	3.9	1.3	2.1	2.3
Individuals using the internet (% population)	0.0	0.8	1.3	9.6
Life expectancy at birth, total (years)	59	62	65	65
Global links				
Merchandise trade (% GDP)	74	92	68	45
External debt stocks – total (current prices in USDm)	2,594	2,325	5,987	19,688
Total debt service (% exports of goods, services and primary income)	37.2	12.9	13.3	49.1
Personal remittances received (USDm)	5	7	3	3
Net official development assistance received (USDm)	412.4	275.2	512.4	527.9

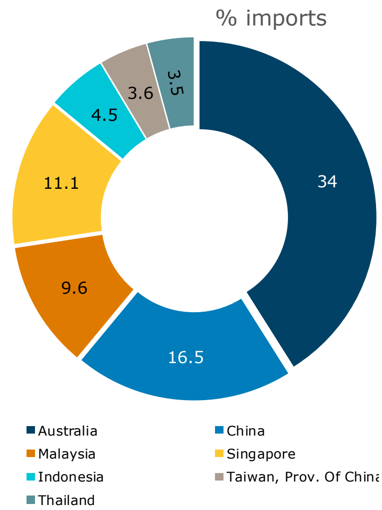
Composition of goods exports, 2018



Destination of goods exports, 2018



Import of goods origins, 2018



Long-term sovereign credit ratings	Rating	Outlook	Date
Moody's	B2	Stable	15 February 2019
Standard & Poor's	B	Stable	23 April 2019

Corruption Perception Index, 2018	Score*
Western Europe & European Union	66
Asia and Pacific average	44
Papua New Guinea	28

*Scoring system: 100 highly clean, 0 highly corrupt
Source: World Bank, Moody's, S&P, International Monetary Fund, Transparency International

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[3 July 2019]

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