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Research Update:

Papua New Guinea 'B+' FC Rating Affirmed; LC Rating Lowered To 'B+' On Revised Methodology; Outlook Stable

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Overview

- Standard & Poor's affirmed its foreign currency long-term rating on Papua New Guinea (PNG) at 'B+' and its short-term ratings at 'B'. The transfer & convertibility assessment (T&C) remains 'BB'.
- We lowered our local currency long-term rating on PNG to 'B+' from 'BB-', based on our recently-revised sovereign rating methodology.
- The new methodology puts more weight on the development of local currency debt markets, which are shallow in PNG. This factor, in combination with very limited monetary flexibility, requires an equalization of the local and foreign currency ratings.
- The outlook is stable, which in our view, balances PNG's improved economic prospects with the challenges it faces in overcoming weak political and institutional settings, as well as infrastructure shortcomings.

Rating Action

On Aug. 22, 2011, Standard & Poor's Ratings Services affirmed the foreign currency long-term rating on Papua New Guinea (PNG) at 'B+', and the short-term ratings at 'B'. We also lowered the local currency long-term sovereign credit rating on PNG to 'B+' from 'BB-'. The long-term rating outlook is stable. The T&C assessment remains 'BB'.

Rationale

Constraining the ratings on PNG is our opinion of the vulnerabilities associated with the country's high dependence on its minerals sector, combined with the country's fragmented political structure, public policy development, and service delivery. In addition, there is a lack of transparency in the activities of statutory authorities, trust accounts, and other government-owned or government-controlled entities contributing to PNG's off-balance-sheet liabilities. Further constraining the ratings are the infrastructure shortcomings and security risks that impede investment required to diversify the economy. However, the government's moderate fiscal flexibility and the strong potential of the minerals and allied sectors to boost economic growth support the ratings.

In our opinion, PNG's economy is likely to continue to benefit from favorable commodity prices, a government commitment to development, and a financial

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system that has no significant links to global wholesale funding markets. We expect the economy to expand by 4.2% in 2011 on a per capita basis, following growth of 4.6% in 2010. High gold, copper, and oil prices and the construction of a liquefied natural gas (LNG) plant are supporting significant activity in non-mining (mainly transport, storage, and communication) sectors. The direct and indirect effects of LNG-related construction activity and public spending will likely add to the challenges PNG faces in lowering persistently high CPI inflation. We expect consumer prices to rise by more than 7% in each of the next two years, in part reflecting substantial inflows of capital into the country and emerging capacity constraints in labor and product markets that are associated with the LNG project construction. The banking system is largely insulated from global markets, reflecting its predominantly domestic funding base and limited exposure to global wholesale funding markets. Key downside risks to PNG's outlook could arise from possible delays in completing the LNG project, a weakening in prices and demand for PNG's resources exports, and a house-price correction in the main centers of Port Moresby and Lae.

Off-budget borrowings and expenditure undermine PNG's efforts to consolidate its fiscal policy, and illustrate ongoing weaknesses in governance and transparency. An easing in constraints in off-budget trust account spending led to a deficit of 9.7% in 2009, but there has since been some progress in containing spending. We estimate the fiscal accounts to be broadly balanced in 2010 and 2011. However, there is uncertainty on this due to the difficulty in tracking the spending of windfall mining revenues from earlier years from off-balance-sheet trust accounts; the government's aim of balancing its budget in 2011 does not include spending from the accounts. While the government's medium-term fiscal strategy targets spending from the trust accounts at less than 4% of GDP, an election due in 2012 raises risks of further unrestrained spending that may add to demand and inflationary pressures. While the government has borrowed US$1.1 billion (12% of GDP) commercially off-budget to fund its equity in the LNG project--and assuming our base case for the fiscal and external accounts holds--we expect the government to be able to carry such debt at current rating levels so long as the project comes on line as presently planned.

Large current account deficits, related to the LNG investment, are partly financed by foreign direct investment (FDI) and will likely be temporary. We expect the current account deficits to average over 20% of GDP in 2010 and 2011, reflecting LNG construction-related goods and services imports and income deficits (due to income payments to foreign employees and dividend payments to non-residents from high mining profits). The FDI flows have supported the accumulation of reserves to 3.6 months of current account payments in 2010, versus 2.3 months in 2005. PNG's external position remains moderate despite the additional borrowings associated with the LNG project--with narrow net external debt of 16% of current account receipts (CAR) estimated for 2011, while the country's net external liability position is 74% of CAR.

The country's political and institutional frameworks remain weak, which pose a key challenge as PNG effectively manages the large windfall gains from the LNG project. A new Prime Minister and ministerial lineup following the retirement of Michael Somare should improve political certainty in the near term--albeit the political settings following general elections due in 2012 remain highly uncertain. The continued use of off-budget borrowings and expenditure in 2010—outside of parliamentary approval and oversight— is symptomatic of the weak transparency and governance. We also note that previous gains in political stability have not led to an appreciably better security environment or improved infrastructure, which are vital to boosting non-mineral investment. The quality of public services remains poor. We also observe that PNG has made little improvement in literacy and other human-development indicators. In addition, information risk is a rating constraint. Although understandable for a country at this stage of development, significant off-budget transactions appear to be rising, and there are long lags and important gaps in coverage for the national income accounts, the international investment position, the fiscal accounts, and the monetary survey.

We have equalized the local currency rating with the foreign currency rating because monetary policy options, which underpin a sovereign's greater flexibility in its own currency, are constrained by PNG's high inflation, relatively undeveloped domestic debt markets, and credibility issues related in part to transparency shortfalls. Our T&C assessment is two notches above the sovereign foreign currency rating to reflect our opinion that the likelihood of the sovereign restricting access to foreign exchange needed by PNG-based non-sovereign issuers for debt service is moderately less than the likelihood of the sovereign defaulting on its foreign currency obligations. While there are some foreign exchange restrictions, the foreign exchange regime is fairly open, and economic policies are outward-oriented with regard to resource development.

Outlook

The stable outlook balances PNG's improved economic prospects with the challenges it faces in overcoming weak political and institutional settings, as well as infrastructure shortcomings, to raise the prospects of the largely disenfranchised population through minerals sector revenue.

We would lower the ratings if a weakening in global economic conditions reduces demand and prices for PNG's minerals exports, and in turn, worsens the country's external position and government finances. Any material delay in the LNG project under construction would present some short-term risk of a lower rating due to the liabilities associated with the commercial borrowings to fund the government's equity interest and completion guarantees to the creditor and landowners.

Upside potential to the sovereign rating could arise from the beneficial impact of the LNG project on PNG's economic prospects, government finances, and external position. However, any such upgrade would likely occur closer to around when the project starts earning revenue (estimated to be 2014), given the project completion risks.

Related Criteria And Research

- Sovereign Government Rating Methodology And Assumptions, June 30, 2011

Ratings List

Downgraded; Ratings Affirmed

	To	From
Papua New Guinea (Independent State of)		
Sovereign Credit Rating		
Local Currency	B+/Stable/B	BB-/Stable/B

Ratings Affirmed

Papua New Guinea (Independent State of)	
Sovereign Credit Rating	
Foreign Currency	B+/Stable/B
Transfer & Convertibility Assessment	
Local Currency	BB
Papua New Guinea (Independent State of)	
Short-Term Debt (1 issue)	B

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