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Dilemma before Papua New Guinea

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Anything in excess is considered unhealthy. This is true for human beings and economies.

Excess intake of sugar, fat or protein leads to health complications just as lack of them leads to poor nutrition.

Large inflows of foreign exchange lead to appreciation of exchange rate in countries with flexible exchange rates, such as Australia. In case of countries with fixed exchange rates, such as Fiji, large inflows of foreign exchange lead to rise in money supply and inflation.

Both hurt export competiveness.

Appreciation of exchange rate, although it makes imports cheaper, renders exports no longer attractive. Inflation makes exports unattractive, as they become pricier to the rest of the world.

The dilemma

The dilemma, before Papua New Guinea (PNG), which has a flexible exchange rate regime, arises from a classic case, known as "Dutch disease."

PNG is the resource rich country amongst Pacific island nations. Aside from relatively large land area (463,000 sq km) with a population of 7 million and GDP of US$13 billion, compared to Fiji (194,000 sq.km), and population of 850,000 with GDP of US$ 3.8 billion, PNG's mineral and non-mineral resources are considerable.

PNG's exports are more diversified and dominated by minerals: oil, gold, copper ore. Others are agricultural: logs, palm oil, coffee, cocoa, crayfish and prawns.

When world prices for oil and other minerals were rising, the mineral exporting countries all over the world and in our region, Australia and PNG were doing well. Commodity price boom brought prosperity. When world recession set in 2008, following the global financial crisis in USA, China however continued to grow. That helped Australia and PNG to do well with their mineral exports to China.

In addition to mineral export earnings, PNG has been attracting foreign direct investments. One of them is the liquefied natural gas project (LNG) for US$ 19 billion, which is nearing completion. The spin-off effects of construction include increases in non-mining private sector investments, especially in real estate. These have been bidding the prices of non-tradeables such as labour, water and electricity and in the process they reduce the profitability of investment in traditional, non-mineral exports, which include agriculture.

Dutch disease

The term owes its origin to the Dutch economic crisis of the 1960s, consequent to the discovery and exploitation of North Sea natural gas. Rising foreign exchange inflows push up the value of domestic currency and the resultant appreciation makes the country's traditional exports less price competitive to overseas consumers. Further, currency appreciation encourages large cheap imports, killing domestic industries. It even leads to de-industrialisation as they would shift to other countries with lower costs of inputs, including labour.

Re-balancing

Early this week, releasing the central bank's latest Economic Bulletin, Governor Loi Bakani expressed his concerns about the effects of Dutch Disease and the likely impact of winding up of the construction phase. Referring to the latter, he cautioned since labour and equipment engaged in the project would be laid off, the government should utilise the labour and equipment for its development infrastructure projects.

As regards the effects of Dutch disease, the central bank Governor urged government to invest the gains into developing the agricultural sector. The foreign exchange reserves at the end of March 2013 were US$ 3.7 billion, equivalent to 10.9 months of total imports of the country.

He said: "To have a sustainable economic growth, the Government must heavily invest and develop the agriculture sector including other non-mineral private sectors so that in the long run growth must be underpinned by these sectors rather than developments in the mineral resource sector."

If the re-balancing does not take place, high import demand for consumption goods could exert downward pressure on the exchange rate and lead to increase in domestic prices. Governor Bakani warned in clear terms: "The current problem, however, is not of the Kina appreciating but of it depreciating, pushing up prices of imported goods."

So, that is the dilemma before the nation: to re-invest valuable foreign exchange in non-mineral sectors, including agriculture and rural projects raising rural incomes and reducing unemployment and migration to urban areas or fritter them away on consumption imports?

Governor Bakani did not indicate a third option, which would be up in his sleeves:

The central bank can purchase foreign exchange by selling kina and mop up the surplus kina by open market sales of securities. Known as sterilized intervention, it may leave the money supply unchanged. There will be no change in exchange rate as well.

The first option is the best option: re-balancing.

That is the buzzword everywhere!