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Global uncertainties and PNG's falling kina

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Each year, October is the month for the second of the two biannual growth assessments by International Monetary Fund (IMF).

In its *World Economic Outlook* released this week, IMF has lowered its April growth forecast for America to 1.6 percent for 2013, which is lower by 0.1 percentage point.

The revision is due to the uncertain outcome of the ongoing budget wrangle between the US legislature and the government and the much dreaded debt default by mid-October in the event of failure to increase the government's borrowing ceiling. Debt default would result in rise in domestic interest rates, pushing the American economy into recession again.

Consequently, the world growth rates were also revised downward. They are 2.9 percent for 2013 and 3.4 percent in 2014, both being 0.2 percentage point less than the previous forecasts.

For the Pacific islands, the IMF has the following growth rate forecasts for 2013: Fiji: 3.0; Papua New Guinea (PNG): 5.4; Samoa: 0.1; Solomon Islands: 3.9; Tonga: 0.9; and Vanuatu: 3.3.

ADB's warning

The Asian Development Bank (ADB)'s forecasts released this week in its Asian Development Outlook (ADO) update are not very different. However, its warning against running fiscal deficits and the accompanying current account deficits is timely.

The ADO update specifically cautions that exchange rates be flexible, balancing inflation and corporate external debt. The report warns that defending unrealistic exchange rates risks depleting foreign exchange reserves.

The warning is applicable more to those countries, which have flexible exchange rates. In our region, PNG is the only country with a flexible exchange rate regime, under which exchange rates are determined by daily interaction of market forces of supply and demand for kina.

Fiji, Samoa, Solomon Islands, Tonga and Vanuatu have fixed exchange rate regimes. Their central banks anchor their policies around a fixed nominal exchange rate within an allowable band. Certainly, they have to keep a watch on fiscal deficits which often spill over into trade deficits, as they do not enjoy regular capital inflows unlike emerging economies in Asia.

If the trade and current account deficits are not sustainable, countries under fixed exchange rate regimes are forced to the dreaded, extreme remedy: devaluation of the kind which Fiji had to resort to in 2009. The inflationary implications are serious as most of the items of consumption are import dependent.

PNG's kina under stress

In July, the kina was about Aus$ 0.4855. It went down to Aus$ 0.4076 in early October. The fall in value was 16 percent. During the same period, the kina depreciated by about 14 percent against the American dollar, as it fell from US$ 0.4438 to US$ 0.3830.

The causes behind the fall in kina are different from those, which were behind the depreciation of currencies of emerging economies such as Brazil, India and Mexico. Fall in their currencies was due to reversal of capital inflows, especially the short term hot money, in search of higher returns. After the US central bank chairman in late May announced that additions to money supply at the rate of US$ 85 billion a month would be scaled back, investors pulled their funds out, as they expected rise in US interest rates. The capital outflows were moderated only after subsequent announcements that the easy money policy would be continued for a while until the US economic recovery signs were more firm.

Rising current account deficit

The reason behind kina depreciation is more conventional: emergence of current account deficit. It is no longer 2.7 billion kina as estimated earlier. It has been revised to a close 7 billion kina. The sharp rise in current account deficit is due to decrease in PNG's exports and rise in imports. The demand for foreign currency to pay for imports exceeds supply of foreign currency from exports, resulting in a fall in value of kina.

Any further depreciation can be averted only if PNG attracts greater capital inflows than usual, now that the construction phase of the liquefied natural gas project (LNG) is nearly over.

The latest monetary policy statement by the central bank recognizes that a weakening kina would be inflationary, as imports would cost more. However, there could be some positive outcomes. Kina depreciation would make PNG's exports more attractive and imports more expensive, thus eventually leading to some improvement in current account position.

PNG has a far more diversified export base. It has a wide range of exports: mineral and non-mineral, including coffee and tea, unlike other island countries. Further, in the medium term, once the LNG project takes off, there will be record current account surpluses.

As of now, it looks that the central bank may not use its large foreign reserves to intervene in the market to reverse the depreciation.

It would rather wait and watch.