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High cost of "protecting" the kina

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Papua New Guinea (PNG), the largest island country in our region with rich endowments of resources, mineral and non-mineral, and super export earning capacities, which recorded the highest annual growth rates last three year (5.5% in 2013, 8.5% in 2014 and 11.0% in 2015) is in difficulties. The latest credit ratings of PNG by both Standard & Poor's and Moody's are negative.

Asian Development Bank (ADB)'s annual economic publication, *Asian Development Outlook 2016* released on Thursday, March 30 confirms PNG faces serious fiscal challenges. These challenges stem from weak commodity prices and shortfalls in mineral sector revenues. ADB predicts PNG's growth rate in 2016 would be only 4.3 percent—less than half of last year's rate of 11%, and it would fall to 2.4% in 2017. Since PNG economy dominates the South Pacific region, the region's growth rate would also fall to 3.8% in 2016, down from 7.0% in 2015.

Can one blame it exclusively on the prevailing worldwide, poor commodity prices and the continuing declining trend in oil and gas prices? Alternatively, is it, as the Opposition in PNG's Parliament claimed, because of poor government's economic policies with overly optimistic forecasts of oil and gas prices, and unrealistic expenditure cuts in education and health sectors?

Declining foreign reserves

Central Bank's foreign reserves are decreasing.

They decreased to $US1.8 billion in March this year, from about US$ 2.0 billion last September. It is expected to decline further to US$1.7 billion by mid April. The reason is not just the rise in imports or decline in export earnings. It is also because of measures taken by Bank of PNG (BPNG) to arrest the rapid depreciation of the currency, the kina.

The kina's value in terms of US dollar is falling. The exchange rate is rising.

If the exchange rate is defined as units of kina (K) per US$, we will note the price of US dollar is going up in terms of kina. According to IMF, the period average rate per US$ was K2.08 in 2012; K2.24 in 2013; K2.46 in 2014; and K2.87 in 2015. As of March 31, one US dollar is K3.03.

If US dollar goes up in value in terms of kina, the kina is seen depreciating. We use the term depreciation, as PNG has a floating exchange rate regime unlike Fiji's fixed exchange rate regime. A downward change in the value of the domestic currency under a fixed exchange rate regime is referred to as devaluation.

A study by Jonathan Pryke of Lowy Institute shows that the value of the kina has fallen in terms of US dollar: from US$0.46 in May 12 to US$0.35 in May 15. A recent prediction by Rohan Fox, a lecturer at the University of PNG is, the kina will soon be worth only US$ 0.28. Correspondingly, dollar would be K3.57.

Protecting the kina

The central bank, which enjoys autonomy under the Bank of PNG (BPNG) Act 2000 has been "protecting the kina". It has been selling foreign exchange and buying upkina for boosting its value, a process known as intervention under the country's floating exchange rate regime.

Jonathan Pryke reminds us that the 15 most natural resource dependent countries, which have floating exchange rates, including PNG, have been experiencing depreciation of their currencies by around 15 percent. If the country's currency continues depreciating, it will harm consumers in the country, since imports will become more and more expensive. Though depreciation will be an incentive to exporters, especially in the rural sector, which produces agricultural output, immediate impact on domestic inflation is likely to be severe as borne out by past experiences. Further current drought conditions will only compound the problem.

Boosting the value of kina or arresting the further depreciation of currency needs reserves. BPNG needs foreign reserves, not only because of the "measures to protect the kina" but also because of its obligations to clear the backlogs of demand for foreign reserves from importers. It is reported that BPNG would be seeking at least a loan of K793 million ($US250 million) from the World Bank and International Finance Corporation to clear the foreign currency backlog, estimated to be as high as K3 billion.

Fixed Vs Floating exchange rates

That brings us to discuss the advantages of a fixed exchange rate regime. Fiji's foreign exchange earnings from agricultural exports and tourism are seasonal and marked by fluctuations throughout the year. They are not as steady as expenditures on imports of food and fuel and machinery. When there are swings in foreign exchange earnings largely associated with seasonal patterns in agricultural exports and tourism, the exchange rate under a pure float would be seriously affected. Frequent, sudden changes in exchange rate would adversely affect foreign trade and business activities. Experiences show that for highly trade-dependent open economies with less diversified production and export structures, a completely fixed exchange rate was most appropriate.

A fixed exchange rate regime has served Fiji well. It is also to the credit of the authorities to have been resisting the pressures from IMF each year for switching on to a flexible rate regime.

PNG adopted the flexible exchange rate regime in 1994 soon after its 12 percent devaluation of the kina. Not only seasonality but also cyclical flows in trade and exchange earnings have been affecting PNG ever since then. PNG is not fully committed to a floating exchange rate regime. The half-hearted floating exchange rate regime has been more managed by official interventions by central bank, effectiveness of which is often limited by the availability of foreign reserves. It is not a pure float, but a “dirty float.”

A return to fixed exchange rate regime, a shield to cyclical disturbances is a possibility?

Worth considering!

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