THE NATIONAL RESEARCH INSTITUTE
PAPUA NEW GUINEA

SPOTLIGHT

WHY THE FOREIGN CURRENCY CRISIS IN PNG IS ALMOST ENTIRELY UP TO THE GOVERNMENT TO SORT OUT

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Key Points

- Papua New Guinea is facing foreign currency woes in the wake of the plunge in international commodity prices. The (Central) Bank of Papua New Guinea has been forced to ration currency sales. The restriction of currency trading within a reasonable foreign exchange band is choking the economy.
- Businesses are affected by the foreign exchange liquidity problem. Importers are feeling the pinch as they struggle to fund imports, while others are unable to repatriate their profits abroad.
- The scarcity of the dollar should not be blamed on falling oil prices alone. While the country's foreign currency reserves are quickly becoming depleted, the value of the Kina is also tumbling against the dollar on an almost daily basis. The situation is getting out of hand.
- The government is planning on borrowing from offshore sources to arrest the situation. This might solve the foreign exchange problem to some extent. But the real solution lies in the LNG export sales that are currently not flowing into the PNG economy. If the government allows adequate inflows of mineral, oil and gas export earnings into PNG, the currency crisis will be averted.

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The PNG National Research Institute reaffirms its commitment to respecting the roles of key institutions of the state: the Bank of PNG to manage monetary policy, the Department of Treasury to manage fiscal policy, and the Executive Government to set national economic priorities.

Given the Institute's role as a public policy think tank, we have been keenly observing and monitoring the developments regarding PNG's Foreign Currency reserves and the plight of the PNG Kina. This article has been written to make a contribution and shed light on the issue.

Our main concern is the impact this is having on business. Confidence in the Kina, and more importantly the capacity of businesses to engage in their day to day operations, is paramount.

Introduction

The PNG National Research Institute is concerned about the plight of businesses. Papua New Guinea is heavily involved in trade and investment flows with the rest of the world, but the country does not currently have enough foreign currency. Unfortunately, if the slowdown in global economic condition continues as forecast, the shortage is not likely to ease anytime soon.

The exchange rate influences the flow of goods, services and capital into and out of the country's economy. Since the PNG Government relies heavily on revenues from foreign currency sources, hardly a day has passed without newspaper reports about the repercussions of the twin dwindling of dollars and the country's foreign currency reserves.

Origins of the Problem

Where did the rain start beating upon us? According to the Monetary Policy Statement released by the Governor of the Central Bank (Bank of PNG), Loi Bakani, in March 2016, the PNG Government believes that the low price of international commodities is to blame for the dollar shortage. Since the end of the PNG LNG construction phase, the international crude oil price has been falling, from 109.5 US dollars per barrel in 2003 to 51.6 US dollars per barrel in 2015; and it is expected to fall further to 33.0 US dollars per barrel this year. Other commodity prices have also been falling over the same period, even as gold prices fluctuated.

When it became clear that ExxonMobil will start production from the LNG plant ahead of schedule, the government began to ramp up spending in anticipation of large foreign exchange revenues from the LNG exports flowing into the budget. Because of dwindling commodity prices, tax and dividend payments from the LNG exports have been less than expected. The little revenue that has been generated has been diverted to debt reduction. As a result, there have been widespread public expenditure cuts. Many government departments are not getting the full amount of money that had been allocated to them. A number of church-run institutions that depend on government financial support have threatened to close down their operations due to cash flow problems resulting from cuts in their allocated budgets.

The Blame Game

Opposition politicians, led by Don Polye, blame the foreign currency shortage on poor governance and economic mismanagement by Prime Minister Peter O'Neil's government. They claim that bad policies pursued by the government in the recent past are the reason that the foreign currency squeeze is adversely affecting the country's businesses and the poor. Most impacted by the problem are major importers of crude oil such as Puma Energy, one of PNG's largest multinationals. But the scarcity of foreign exchange also sounds like a reasonable explanation for the recent reports about shortage of drugs in the country's hospitals.

While the blame game might be just another political theatre, especially with the impending general election next year, the value of the Kina continues to tumble against the dollar almost on a daily basis. The Kina depreciated against the dollar from US$0.385 in December 2014 to UD$0.332 in December 2015 – a 13.7 percent depreciation. By 30 March 2016 the Kina was selling for US$0.324. Meanwhile, the central bank is running-down the country's foreign currency reserves, both to supply the much needed foreign exchange and to prop up the Kina. Despite this, the stock of available foreign exchange currency is still insufficient to satisfy demand.

To bridge the gap, the Government is scheming to substitute inflows from sovereign (LNG) wealth (which are in fact not flowing) with sovereign debt. It is understood that the Government is negotiating a soft loan with the International Finance Corporation, the commercial arm of the World Bank Group, while also planning on borrowing from other offshore sources. Indeed, borrowing from offshore to finance the deficit might solve the foreign exchange problem to some extent. With these additional debt burdens, however, the situation is clearly becoming unsustainable. If the Government are planning on using the LNG money to pay off foreign debts, this will ultimately reduce the net offshore borrowing, instead of increasing it.

How to Move Forward

Papua New Guineans are looking for solutions to fix the country's foreign currency problem, and are asking who should do it. People quite rightly believe there are solutions out there. After all, PNG is not the first country to fall into a foreign currency shortage quagmire. The more extreme example in the recent past is Zimbabwe, who abandoned her currency for the US dollar. Nigeria, Africa's largest oil-rich economy, is currently looking for solutions to her dwindling foreign exchange occasioned by the fall in world oil prices. While there is no single correct answer to the choice of appropriate exchange rate policy, the case for PNG is probably quite unique.

First, unlike many other countries where parallel exchange rate markets thrive, the option of devaluing the Kina makes little sense. There is virtually no parallel exchange rate market in PNG. PNG is also unique because there are only a handful of players in the country's foreign exchange market, so allowing the exchange rate to be determined by market forces – known in economics and finance circles as floating the exchange rate – is unlikely to work. The BPNG has therefore been sceptical, and arguably rightly so, about these popular exchange rate policy choices. There are other policy choices that the bank has also always ruled out.

How then should the current foreign currency quagmire be fixed, and who should do it? Given the current circumstances of the country, the answer probably lies in the fact that PNG is resource-rich and most of the country's foreign exchange is earned by the government. There is therefore a good reason to believe that the government can fix the problem, without blaming it for starting or exacerbating the current foreign exchange crisis.

The government has often provided reasons why sufficient export revenues are not coming into PNG. The main one is that it signed agreements allowing mining, petroleum and gas companies to keep their foreign exchange earnings in offshore foreign currency accounts. The question must be asked: Is it too difficult to renegotiate these deals? Could the government require these 'most favoured companies' to repatriate surpluses, after servicing offshore loan commitments, to PNG, rather than keeping the balance in offshore foreign currency accounts?

After all, BPNG banned all other resident companies and individuals not operating under any 'confidential' project development agreements from opening domestic and offshore foreign currency accounts. And those who already have offshore accounts are required to repatriate their money from abroad to help ease the country's foreign currency squeeze.

But the need to repatriate money held abroad should not be limited to private companies and individuals. The Government is also managing its share of the mineral, oil and gas export revenue proceeds offshore while the country's Sovereign Wealth Fund is yet to be fully operationalised. It would seem therefore that the country's low dollar reserves should not be blamed entirely on the falling oil prices because PNG is not receiving the LNG gas export revenue in full.

PNG's foreign exchange reserves at the end of 2015 were US$1.9 billion (K5.2 billion), which was sufficient to cover a year's worth of imports. This is higher than the 3 months reserve that the IMF considers advisable. It therefore seems logical that BPNG should not continue to sell foreign exchange from the country's reserve holdings when there are near nil foreign exchange inflows which the Government has control of. The current foreign currency crisis in PNG is therefore almost entirely up to the Government to sort out – by allowing adequate inflows of mineral, oil and gas export earnings into PNG.

The writers are based at the National Research Institute in Port Moresby and hold the following portfolios at the Institute: Dr Francis Odhuno is a Senior Research Fellow and the Economic Policy Research Program leader; Dr Charles Yala is the Director; Dr David Ayres is Senior Deputy Director of Research and Knowledge Management; while Dr Osborne Sanida is Deputy Director for Corporate Services. We thank Dr Theo Levantis and Prof. Satish Chand for their insightful comments.