THE NATIONAL RESEARCH INSTITUTE
PAPUA NEW GUINEA

SPOTLIGHT

DOES FOREIGN EXCHANGE SHORTAGE AFFECT BALANCE OF PAYMENTS IN PAPUA NEW GUINEA?

Thomas Wangi

Volume 17, Issue 9
www.pngnri.org

Key Points

- Foreign exchange shortage has been a chronic issue in Papua New Guinea since 2014, when high commodity prices and resources boom ended.
- Economic agents cannot freely convert Kina into foreign currency to pay for imports, repatriate profits and dividends, and service external debts.
- Foreign exchange shortage affects the current account in favour of exports and capital and financial accounts in favour of inflows, which has partly painted a positive impression on balance of payments in recent years.
- To address foreign exchange shortage, the government may have to support private sector to diversify and expand export volumes, negotiate with project developers to keep their operational bank accounts onshore, and improve earnings from resource projects through increased shareholdings and tax incentive reviews.

inquire
inform
influence

June 2024

THE NATIONAL RESEARCH INSTITUTE
PAPUA NEW GUINEA

SPOTLIGHT
June 2024

DOES FOREIGN EXCHANGE SHORTAGE AFFECT BALANCE OF PAYMENTS IN PAPUA NEW GUINEA?

By Thomas Wangi

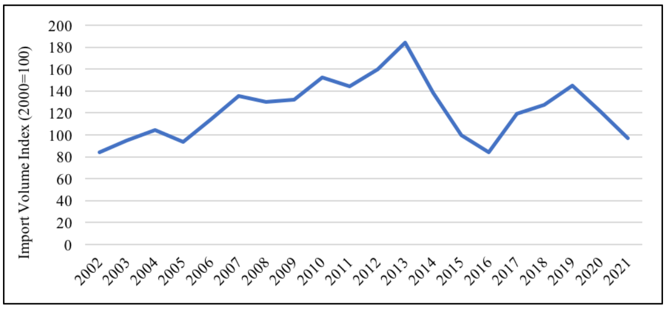
Papua New Guinea (PNG) is a small open economy that relies heavily on the mineral, petroleum and agriculture sectors (BPNG, 2020). These sectors contribute meaningfully to gross domestic product, export earnings, and formal employment. Export earnings directly influence the balance of payments (BOP) position. BOP summarises economic transactions of the local economy with the rest of the world over a period of time. It is an important indicator of a country's economic health. A positive BOP implies that the country is exporting more goods, services, and capital than it is importing. A negative BOP implies that a country is spending more on imports than it is earning from exports and other sources. PNG has recorded both BOP surplus and deficit since political independence.

The volumes of international transactions of PNG are partly subjected to the movements of the Kina exchange rate and stock of foreign exchange reserves. Most countries maintain currency reserves to import goods, manage exchange rates, pay external debts, and make international transactions or investments. In PNG, the chronic foreign exchange shortage issue has restricted the inflow of imports and outflow of profits and dividends (Davies and Schröder, 2022). In addition, this article specifically discusses how foreign exchange shortage may have influenced BOP positions in recent years. It then examines imports, foreign exchange reserves, and BOP figures. The article ends with some policy recommendations on how to improve foreign exchange shortage and BOP position.

Foreign exchange shortage and imports

The foreign exchange shortage issue has become obvious since the end of high commodity prices in 2014 (Davies and Schröder, 2022). In PNG, foreign exchange reserves are denominated mainly in United States (US) dollars. The shortage has occurred because the local economy has a low supply of US dollars and other foreign currencies such as Australian and New Zealand dollars in its reserves to effectively conduct international trade. Hence, economic agents such as importers, investors and the government cannot freely convert Kina into foreign currency to pay for imports, repatriate profits and dividends, and service external debts, respectively. The issue of foreign exchange shortage has done immense damage to the local economy by creating unemployment, and to its international reputation by violating international agreements (IAG, 2021). More specifically, the shortage has limited the ability of the local economy to facilitate imports and attract foreign investments, which has led to a reduction in economic growth and employment.

Figure 1: Import volume index: 2002 to 2021



Source: World Bank

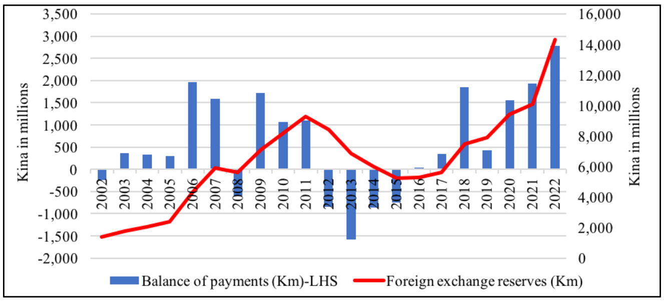
The Central Bank of PNG (BPNG) has managed the shortage by rationing foreign exchange reserves, which has become a hindrance to private sector business activities in the local economy (Davies and Schröder, 2022). Specifically, the rationing has generated a large backlog of foreign exchange orders, which implies that economic agents such as importers are waiting in the queue to access foreign currency. According to Figure 1, the rationing of foreign currency had drastically reduced the volume of imports between 2013 and 2016. Firms were importing fewer goods and services than their normal orders. However, active Central Bank interventions in the foreign exchange market improved the stock of foreign reserves and reduced the backlog. Consequently, volume of imports improved up to 2019. Thereafter, it had deteriorated partly due to the outbreak of coronavirus pandemic and high demand for foreign reserves by the government to service its external debts. PNG, as an import-dependent country, needs imports to grow the economy and promote living standards of the people. No economy in the world has grown without imports (IAG, 2021). The current International Monetary

Fund (IMF) program and positive developments in the mineral and petroleum sectors have improved capital inflows to finance imports, but the foreign exchange shortage remains a concern to businesses and individuals in the country.

Balance of payments

Figure 2 shows that PNG experienced a notable surge in foreign exchange inflows between 2002 and 2012 mainly due to strong commodity prices and resources boom. Foreign direct investment was the main source of capital inflows, mostly associated with large-scale mining and petroleum projects. From 2006 onwards, portfolio investment had improved due to drawdown from investments in short-term money market instruments (Irau, 2009). In addition, improvements in the balances of current, capital, and financial accounts helped PNG to enjoy healthy BOP positions for most of the years between 2002 and 2022 (see Figure 2). These accounts are the main components of BOP, each reflecting different types of transactions. For instance, trade in goods and services is reflected in the current account while foreign direct investment is reflected in the financial account. However, from 2012 to 2015, the economy recorded consecutive BOP deficits due to high import demand, fall in prices of export commodities, completion of construction phase of the liquefied natural gas project, and servicing of external loans. The foreign exchange reserves reached critical low levels between 2015 and 2017. Thereafter, positive net inflows were supported by dividend and tax payments to the government from mineral and petroleum exports and official offshore borrowings.

Figure 2: Balance of payments and foreign exchange reserves: 2002 to 2022



Source: Quarterly Economic Bulletin, BPNG

Note: Km denotes Kina in millions and LHS refers to left hand side

In the March 2024 monetary policy statement, BPNG (2024) estimates overall BOP surplus for 2023. In 2024, BPNG has projected the overall BOP to be deficit, which will likely be driven by high net outflows in the financial account. The stock of foreign reserves is expected to decline in 2024 due to selling of currencies in the foreign exchange market and servicing of external debt. However, there is sufficient gross foreign reserves for 10.0 months of total and 17.9 months of non-mineral import covers (BPNG, 2024). To strengthen the BOP position and the foreign reserves stock from 2024 onwards, under the current IMF program, BPNG has been executing the roadmap to adopt a flexible exchange rate regime (IMF, 2023). This proposed policy intervention is expected to cause a Kina exchange rate depreciation, which may encourage more exports and foreign investments. The expected capital inflows from these activities may address the chronic foreign exchange shortage in the economy.

How foreign exchange shortage affects balance of payments?

The recent biannual monetary policy statements of the Central Bank have stated that the overall BOP surpluses are driven by surpluses in the current account, which more than offset deficits in the capital and financial accounts (BPNG, 2023). The surpluses in the current account are driven mainly by high commodity prices and increased production of major export commodities. This implies that with the support of better prices and improved production, the domestic economy receives additional capital inflows in the form of revenues to exporters, dividends to investors, and taxes to the government. The positive net inflows improve the overall BOP position. Furthermore, the surpluses indicate that PNG has exported more goods and services than it has imported in recent years.

Given that PNG has been faced with trade surpluses in recent years, it is likely to experience an increase in its foreign reserves and an appreciation of the Kina. However, the country's foreign reserves are not sufficient to meet the demand for import payments and other international transactions (IMF, 2023). Specifically, the shortage of foreign exchange has restricted the abilities of importers to buy foreign goods and services, investors to repatriate profits and dividends to offshore bank accounts, and government to service its external debt repayments. This implies that businesses are importing fewer goods and services than their normal volumes, and foreign investors are transferring less profits and dividends than anticipated. Hence, the shortage has impacted the current account in favour of exports, and capital and financial accounts in favour of inflows, which has partly painted a positive impression on BOP positions in recent years.

Policy suggestions

The foreign exchange shortage has restricted the international trade and capital flows of the country. It has directly affected the BOP position, and therefore, requires appropriate policy interventions. Firstly, the domestic export capacity is small and dominated by the mining, petroleum and gas sectors. Other sectors, especially agriculture and manufacturing, require strong government support to improve export production and meet minimum export requirements. In addition, the current IMF reform on the Kina exchange rate is expected to make exports competitive. High export volumes may generate more capital inflows for the local economy, which can ease foreign exchange shortage issue. Secondly, the government has allowed mining, petroleum and gas companies to keep their foreign exchange earnings in offshore bank accounts through project development agreements. The government has also managed its share of resource revenues from approved foreign currency accounts. These practices have limited the inflow of foreign exchange reserves. For future resource project agreements, the government may have to negotiate with resource developers to keep their operational accounts onshore. Thirdly, the government receipts from resource projects have been low because of various factors such as limited shareholding participations, several tax incentives, and fluctuations in commodity prices. To improve resource revenue inflows, the government may have to negotiate for greater share of ownership and review tax incentives especially for future resource projects.

Conclusion

The position of BOP signals the status of foreign reserves and exchange rate. A trade surplus implies an increase in foreign reserves and an appreciation of the domestic currency. In PNG, despite the trade surpluses recorded in recent years, the country has experienced severe foreign exchange shortage since the end of high commodity prices and resources boom. Specifically, there has been a mismatch between supply of and demand for foreign currency in the foreign exchange market. Hence, economic agents such as importers and investors cannot freely convert Kina into foreign currency to pay for imports, and repatriate profits and dividends. The shortage has interrupted capital outflows but inflows such as export receipts and aid have easily entered the economy. Such movements have generated net inflows which may paint a positive impression on BOP positions in recent years. Therefore, it is essential to improve the stock of foreign exchange reserves by supporting private sector to expand production and exports, negotiating with project developers in the mineral and petroleum sectors to keep their operational bank account onshore, and improving government receipts from resource projects through increased shareholdings and tax incentive reviews.

References

Bank of Papua New Guinea. (2020-2024). Monetary Policy Statement, Port Moresby. https://www.bankpng.gov.pg/monetary-policy/bi-annual-statements/. (Accessed 04/2024)

Bank of Papua New Guinea. (2001-2022). Quarterly Economic Bulletin, Bank of Papua New Guinea, Port Moresby. https://www.bankpng.gov.pg/statistics/quarterly-economic-bulletin-statistical-tables/. (Accessed 04/2024)

Davies, M. H. and Schröder, M. (2022). *The path to Kina convertibility: an analysis of Papua New Guinea's Foreign Exchange Market*, ADB Working Paper, No. 663, Manila.

International Monetary Fund. (2023). *Request for an agreement under the Extended Credit Facility and an Extended Agreement under the Extended Fund Facility,* IMF Country Report, No. 23/126, Washington.

Independent Advisory Group. (2021). *Review of the Central Banking Act 2000*, Phase One Report, Port Moresby.

Irau, T. (2009). *Capital flows and their implications for central bank policies in Papua New Guinea*, Working Paper, Bank of Papua New Guinea.

About the Author

Dr Thomas Wangi is a Senior Research Fellow under the Sustainable Land Development Research Program at the PNG National Research Institute. He holds a PhD in Economics from the Australian National University, a Master of Economics from James Cook University, Australia, an Honours in Economics and a Bachelor of Economics from the University of Papua New Guinea. His research interests include macroeconomic policy, economic development, land economics and policy impact analysis.