THE NATIONAL RESEARCH INSTITUTE
PAPUA NEW GUINEA

SPOTLIGHT

WHAT WILL HAPPEN TO INFLATION WHEN PNG ADOPTS THE IMF'S PROPOSED EXCHANGE RATE POLICY?

Thomas Wangi

Volume 16, Issue13
www.pngnri.org

Key Points

- The International Monetary Fund (IMF) has approved US$918 million loan to Papua New Guinea (PNG) Government for a period of 38 months.
- The IMF has proposed several policy reforms as conditions for the loan and one of them is for the Bank of PNG (the Central Bank) to introduce a flexible exchange rate system.
- Under the proposed exchange rate regime, the Kina is expected to depreciate, which may subsequently ease foreign exchange shortage but cause imported inflation.
- Monetary policy cannot appropriately address imported inflation while fiscal policy may relieve inflationary pressure but at a cost to the government.

inquire
inform
influence

August 2023

THE NATIONAL RESEARCH INSTITUTE
PAPUA NEW GUINEA

SPOTLIGHT
August 2023

WHAT WILL HAPPEN TO INFLATION WHEN PNG ADOPTS THE IMF'S PROPOSED EXCHANGE RATE POLICY?

Thomas Wangi

The IMF approved PNG Government's request for US$918 million loan under the Extended Credit Facility and the Extended Fund Facility program on 22 March 2023. The program aims to protect the domestic economy against shocks and promote inclusive growth over a period of 38 months. Specifically, the program focuses on three policy reforms: (i) strengthen debt sustainability through sustained fiscal consolidation; (ii) improve operational framework of the Central Bank to reduce excess liquidity, remove exchange rate restriction and alleviate foreign exchange shortage; and (iii) enhance governance and operationalise the anti-corruption framework. Under the loan arrangement, the IMF has proposed to relevant government agencies to implement these policy reforms starting at the end of June 2023.

This paper focuses on the second policy reform, specifically the exchange rate restriction and foreign exchange shortage. IMF (2023) stated that the Kina is overvalued in real terms under the current foreign exchange rate regime. Particularly, the Kina exchange rate exceeds the price the open market is willing to pay. The overvaluation has led to foreign exchange shortage and consequent rationing. In order to address the backlog of foreign exchange orders, the IMF has proposed to the Central Bank to remove the trading band of the Kina and adopt a flexible exchange rate regime. This proposed policy intervention is expected to cause an exchange rate depreciation due to weak demand for Kina in the foreign exchange market. The depreciation may address foreign exchange shortage through increased exports and foreign investments but can also generate high prices for imported goods and services.

Exchange rate policies: 1975 to present

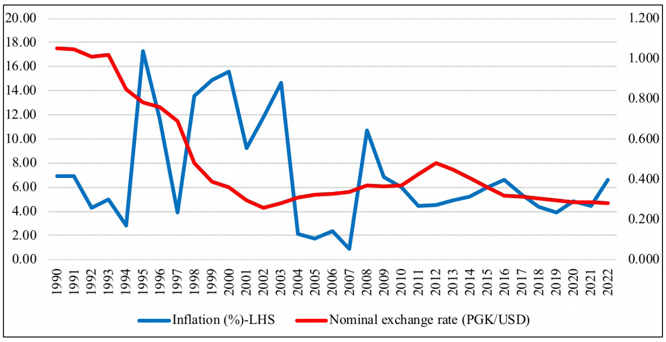
PNG has adopted three exchange rate systems since political independence: (i) fixed regime (1975-1993), (ii) managed float regime (1994-2013), and (iii) crawl-like regime (2014-present). Under the fixed regime, the Central Bank pegged the nominal Kina exchange rate to a basket of major currencies. Under this regime, the nominal value of a Kina was equivalent to or above a US dollar while the inflation rate was maintained below 10.00 percent (see Figure 1). However, the hard Kina policy caused some economic instabilities such as overvalued real exchange rate, low export growth, shortage of foreign reserves and rising foreign public debt (Tumsok et al., 2019). These issues forced the government through the Central Bank to float the Kina in 1994, in which the exchange rate was determined by the market forces. More specifically, the regime was known as managed float because the Central Bank regularly intervened in the foreign exchange market to support the Kina.

Under the floating regime, the nominal exchange rate depreciated significantly, averaging 23.62 percent in the first five years of operation. In 2002, the nominal value of Kina against US dollar dropped drastically to an all-time low of 0.257. However, the subsequent depreciations in the real exchange rate were largely offset by rising domestic inflation ignited by high imported prices. Moreover, following the floating of Kina, inflation reached an all-time high of 17.28 percent in 1995. However, the floating regime supported the export sector, balance of payments and international reserve inflows. During this regime, high commodity prices and construction of the liquefied natural gas project contributed highly to economic growth and appreciation of the Kina exchange rate. From 2012 onwards, the fall in commodity prices had harmful impacts on export revenues, foreign reserve inflows, balance of payments and exchange rate. Hence, the Central Bank intervened in the foreign exchange market to address the foreign reserve shortage and depreciation of the Kina.

In 2014, the Central Bank introduced an exchange rate trading band in the foreign exchange market to stabilise the Kina against the major currencies. Under this regime, which is currently being applied, the exchange rate dealers are restricted to trade within the trading band. The IMF has classified the current exchange rate regime as a de facto crawl-like arrangement. This means the Kina is neither floated nor fixed, instead it makes limited movements within the trading band. Consequently, nominal exchange rate remained generally flat up to 2022 while inflation was fluctuating below 6.00 percent (see Figure 1). However, the real exchange rate was overvalued by at least 13.00 percent (Fox and Schröder, 2018). This implies that the true value of the Kina is not reflected in the trading of actual goods and services between PNG and its trading partners. The overvaluation of the Kina has made foreign investment less attractive, impeded export growth in the non-resource sector and caused foreign exchange shortage. These issues have become a concern to external commentators and PNG's development partners.

Hence, the IMF has proposed to the Central Bank to remove the trading band by the end of August 2023 and move towards a flexible exchange rate system.

Figure 1: Nominal exchange rate and inflation movements, 1990 to 2022



Source: Bank of PNG; Note: LHS= left hand side, PGK=PNG Kina, USD=United States dollar

Foreign exchange shortage

The overvalued Kina becomes expensive to buy in the foreign exchange market. This may discourage foreign investors and exporters to freely transfer their funds to PNG. They are willing to transfer funds when the exchange rate depreciates so that they can buy more Kina. Hence, the overvaluation has contributed partly to persistent foreign exchange shortage in the domestic market. Other contributing factors are reported in Odhuno et al. (2016). Consequently, the Central Bank has been rationing the foreign exchange reserves, which has become a hindrance to private sector business activities. Furthermore, the rationing has generated a large backlog of foreign exchange orders. However, the recent rise in commodity prices and active Central Bank interventions have improved the stock of foreign reserves and reduced the backlog of foreign exchange orders. Despite these positive developments, the foreign exchange shortage remains a concern in PNG.

Proposed exchange rate policy reform

Under the current IMF loan arrangement, one of the measures aims to restore Kina convertibility by removing the exchange rate restriction and moving towards a more flexible exchange rate system. IMF (2023) stated that this reform may result in a market clearing exchange rate that can effectively eliminate Kina overvaluation and improve foreign exchange shortage. Several papers such as Fox and Schröder (2018), Davies and Schröder (2022) and IMF (2022) established that the real Kina exchange rate is overvalued and suggested a flexible exchange rate regime. Given the current economic conditions such as a low volume of non-resource sector exports and an underdeveloped capital market, the Kina is expected to depreciate under the proposed regime. A low exchange rate is expected to encourage more investments in the resource and non-resource sectors since investment becomes cheap in real Kina terms. As such, foreign investors and exporters may transfer their funds to the domestic economy. Furthermore, the depreciation of the Kina is expected to stimulate domestic exports as they become competitive in the market and generate foreign reserves for the local economy in the long run. Thus, the improved foreign reserves will support private sector businesses to order their imports and transfer their profits to offshore bank accounts in a timely manner.

The key aim of the exchange rate reform is to boost competitiveness of the non-resource exports. However, the IMF (2023) paper has not indicated clearly which industries in the non-resource sector are ready to support the proposed policy. That is identifying the businesses that are prepared to export more goods and services and bring foreign reserves to PNG. Moreover, it can be noted that the improvements in the foreign exchange market during the floating regime, similar to the proposed exchange rate policy, were supported not only by the depreciation of Kina but also high commodity prices and resources boom. Although the PNG economy being highly import-dependent, recent papers such as Fox and Schröder (2018), Davies and Schröder (2022) and IMF (2022) have not stated clearly how the depreciation of Kina will affect business costs, import prices and external debt servicing costs.

Will the proposed policy reform be inflationary?

The simple answer is yes. The historical data shows that the exchange rate policy reform implemented in 1994 led to a significant depreciation of the Kina and a sharp rise in inflation (see Figure 1). The IMF's proposed regime is similar to the 1994 reform because the Kina exchange rate will be determined freely by the market forces of supply and demand. In this circumstance, the exchange rate is largely expected to depreciate since the demand for Kina is already low in the foreign exchange market. The immediate impact is that the imports become expensive while exports become cheap. Relating to the former, the economic agents will pass the additional costs of imports to the consumers in the form of increased prices of goods and services. Clearly, another wave of inflation is on the way for PNG. High inflation may subsequently reduce demand for goods and services, worsen welfare of consumers, increase business costs, and discourage new investments and expansion of existing businesses.

Policy suggestions to control inflation

There are several monetary and fiscal policy tools available to control different types of inflation in PNG. Considering the nature of domestic economic conditions, none of the monetary policy tools may effectively address imported inflation in the short and medium terms. For instance, a rise in domestic interest rate may not stimulate foreign capital inflows and improve the Kina exchange rate because PNG's capital market is underdeveloped. Hence, this policy cannot address imported inflation through exchange rate appreciation. However, fiscal policies such as price subsidies and import duty exemptions on selected goods can ease the inflationary pressure but are costly to the government.

Another policy option to consider for long-term inflation control is import substitution, mainly through the agriculture and livestock sector. Under the guide of existing government policies such as Customary Land 2023, Special Economic Zone 2023 and National Food Security 2018-2027, the private sector in partnership with the government can utilise customary land for large-scale agriculture and livestock production. The produce from this sector can replace food imports, reduce imported inflation and protect foreign exchange depletion.

Conclusion

The real Kina exchange rate is overvalued under the current exchange rate system. The overvaluation has created an unattractive environment for foreign investment and made exports less competitive. Consequently, the domestic economy receives low volumes of foreign reserve inflows. Hence, the IMF has proposed to the Central Bank to adopt a flexible exchange rate to address foreign exchange shortage. Under the proposed exchange rate regime, the Kina is expected to depreciate causing high prices for imported goods and services. The high prices will reduce the purchasing power of Kina and significantly affect the welfare of the people. In order to address imported inflation, fiscal policy measures and import substitutions can be considered by relevant authorities. Furthermore, the question of whether this proposed policy reform is appropriate for PNG at a time when inflation is already high requires more discussions before it comes into effect this year.

References

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.

Fox, R. and Schröder, M. (2018). After Papua New Guinea's resource boom: is the Kina overvalued? *Asia & the Pacific Policy Studies*, 5(1), 65-76.

International Monetary Fund. (2022). *Staff Report for the 2022 Article IV Consultation*, IMF Country Report, No. 22/305, Washington.

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.

Odhuno, F., Ayres, D., Sanida, O. and Yala, C. (2016). Why the foreign currency crisis in PNG is almost entirely up to the Government to sort out. *PNG NRI Spotlight,* 9 (1).

Tumsok, M., Su, J., Singh, T. and Sharma, P. (2019). *Exchange rate volatility and trade in Papua New Guinea,* Working Paper, Griffith University.

About the Authors

Thomas Wangi is a Research Fellow with Sustainable Land Development Research Program, PNG National Research Institute and a PhD Candidate (economics) at Crawford School of Public Policy, Australian National University. He holds a Master of Economics from James Cook University, Australia and a Bachelor of Economics (with honours) from the University of Papua New Guinea. His research interests include macroeconomic policy, economic development, land economics and policy impact analysis.

The Papua New Guinea National Research Institute (PNG NRI), PO Box 5854, Boroko, NCD 111, Papua New Guinea. Telephone +675 326 0061; Facsimile +675 326 0213. Website: www.pngnri.org; email: pngnri@pngnri.org

PNG NRI is an independent statutory authority established by an Act of Parliament in 1988 and confirmed by the IASER (Amendment) Act 1993.