(Kahunapule Michael Johnson/Flickr)

# Kina devaluation revisited

**By David Lea**

It seems the push to devalue the kina continues unabated. Following earlier arguments for devaluing the kina to be found in the Devpolicy Blog, most recently, the Devpolicy Blog offers a three part series by Martin Davies, a Visiting Fellow at the Development Policy Centre at The Australian National University.

Rather than addressing the varied points made throughout the three part series, I would like to narrow the focus to some of the claims made in the second blog. What is remarkable about this article is the level of certainty with which claims are made. For example, it is estimated that a 20% depreciation of the real exchange rate – a 20% devaluation of the kina requiring a 33% depreciation of the nominal exchange rate (kina relative to the US dollar) – will have some of the following consequences:

- It will improve the trade balance by an amount exceeding USD250 million per annum, increasing forex inflows by the same amount.
- It will increase real agricultural export income by over 30%.
- It will stimulate economic activity in the export and import-competing sectors, providing much needed stimulus to non-resource sector economic activity.

These estimates soon become certainties with the author's statement, "There is no alternative".

One may well wonder how monetary policy and tinkering with the exchange rate is going to produce all these wonderful changes. The confidence that mathematical modelling offers a reliable prediction with regard to human behaviour ignores Weber's argument that belief systems, cultural and political realities, which elude quantification, strongly influence economic activity.

Take the second claim above, that the required change in the exchange rate will increase real agricultural export income by over 30%. Today if you go into any of the major super markets in Port Moresby, you find that half the of the fresh vegetable produce, nearly all of the dairy products, and just about all of the canned goods and medicines, are imported. If the current producers cannot supply the domestic market, where would they find the surplus to satisfy the export market that will then increase export income by 30%?

It is true that for foreign investors exporting commodities a devalued currency will reduce labour costs and some of the value of the monies paid to landowners, but much of the latter, and government royalties, are priced at the market value of the commodity. At the same time political realities will continue to present obstacles to commodity exports; for example, the recent increase to a 55% export tax on the value of roundwood has led to a decrease in exports over the past year.

This projection also ignores the fact that post-independence agriculture declined with the decline of the plantations. Connell (1997) points out that economic nationalism significantly contributed to the decline in expatriate ownership and, accordingly, subsequent productivity of the agricultural sector. One might also underline that conscious political decisions have also contributed to this decline: in the 1970s the government began to grow less reliant on plantation production for income and balance of payments support, and began to rely on revenue from mining, particularly from the huge Bougainville copper mine and subsequently from energy extraction.

It is extremely doubtful that a modification of the exchange rate is going to conjure back into existence a thriving agricultural system based on plantations sufficiently extensive for the export market. It is true that smallholder coffee accounts for 27% of total agricultural export and 6% of GDP, translating to about K450 million, and there has been some expansion, but it is questionable whether devaluation alone will increase production given other factors such as lack of infrastructure.

At the same time Davies brushes over the harm that will be experienced in urban centres when households can no longer afford necessary imports, as a result of a devalued kina.

He writes:

> It [a devaluation] will cause a redistribution of income from urban to rural households; however, some of the falls in urban income will be moderated by

> the increase in non-resource sector activity. This will increase the relative attractiveness of being located in a rural setting relative to an urban one, which could slow urban drift.

These statements fail to acknowledge the chaos that will follow as businesses fold and unemployment explodes in the urban centres, because people on fixed incomes can no longer afford imported necessities, such as medicines. Relocation to thriving non-existent agricultural sectors in rural PNG will not be a viable solution, though the final point would certainly be true – as with the fall of the Roman empire – when urban centres decline and disappear.

Moreover, as Adam Smith observed, the possibility of fostering specialisation, which can produce the surpluses that generate wealth, depends on the size of the market. Market size in turn depends on transportation and communication links that allow for contact between supply chains, as well as suppliers and consumers. In PNG, the road systems are woefully underdeveloped. Roads out of the capital only extend around a 100 kilometres east and 300 west. Most of the rural country can only be reached by airplane. This means that movement of agricultural produce is expensive and extremely inefficient while at the same time communication by internet is expensive, intermittent and often unreliable. This situation ensures that the agricultural market cannot grow and earn 30% more in export income until these issues are addressed – regardless of any supposed stimulus from tweaking the exchange rate.

Finally even if the forex situation improves – and, for example, the Honda and Toyota dealerships in Port Moresby and Lae can access sufficient foreign exchange to bring in more vehicles, which has been problematic lately – how will consumers afford them with their devalued kinas? It is not just luxuries, but also medicines, pharmaceuticals and the range of items necessary for a modern economy such as generators, components for vehicles, aircraft and machinery, that will increase in cost and make urban life and rural development increasingly unsustainable.

I have argued against devaluing the kina previously and I remain unpersuaded by Davies' arguments.

## About the author/s

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