# The path to kina convertibility in PNG: part three

By Martin Davies
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This blog series looks at the overvaluation of the real exchange rate in Papua New Guinea (PNG), and the need for currency depreciation to tackle the foreign exchange (forex) backlog and forex rationing in PNG. This third blog concludes the series by looking at accompanying policy reforms. We divide the policy recommendations into *very important* and *less important*.

The first of the *very important* policy recommendations is that, for future policy-setting, there needs to be more flexibility in the nominal exchange rate to allow adjustment in the real exchange rate when PNG experiences large shocks to its terms of trade, which happen frequently. In response to a negative terms of trade shock the nominal exchange rate should be allowed to depreciate more; in response to a positive terms of trade shock it will appreciate.

Second, given the tight links between the fiscal balance and the current account balance in PNG, the large fiscal deficits of the past eight years have contributed significantly to the structural imbalance in the forex market. A fiscal rule, in addition to the Medium Term Debt Management Strategy, could be implemented to guide allocation of non-renewable resource wealth over time to ensure intergenerational equity. Such a rule would support achieving and sustaining currency convertibility.

Third, precipitous falls in the government take, as have occurred in the past nine years in PNG, require difficult adjustments for the economy, and provide a challenge for policymakers. A fall in the government take requires a depreciation to ensure internal and external balance, and leads to difficulties for government in managing expenditures relative to revenues. More stability in government take from resource projects is desirable. This requires the government to frontload the revenue streams of new resource projects relative to current arrangements. This could be achieved through greater use of royalties and less generous tax exemptions.

Of *lesser importance*, once convertibility of the kina has been re-established, we recommend that the Bank of Papua New Guinea (BPNG) establishes an interbank market and conducts trading of forex through a daily auction. This will have clear benefits in terms of the efficient allocation of forex to the market. Such an arrangement is not feasible in the current circumstances, with BPNG setting both the price (nominal exchange rate) and quantity of forex in the market. Currently, the BPNG allocates forex to the domestic banks on the basis of their share of domestic banking activity.

A second less important recommendation is that steps be taken to improve foreign access to PNG's Treasury bond market. A prerequisite for this is a convertible currency. Given the successful sovereign bond issue in 2018, there is clearly an international appetite for PNG bonds. This will assist the government in managing the variation in revenues relative to expenditures caused by volatility in resources taxation revenues.

And finally, a few things not to do. Investment of forex reserves in an actively managed portfolio is not appropriate given the need for reserves to be kept in a form which is liquid and readily usable. Investment of some fraction of reserves in highly liquid assets, such as US Treasury bonds, could be considered.

The conversion of a significant proportion of PNG's forex reserves to gold (a gold bullion bank) should not be undertaken. This option increases the risk, and resource and transaction costs, involved in managing and using PNG's forex reserves.

The forex shortage will not be solved through stricter enforcement of the surrender requirement on resident exporters. The surrender requirement is difficult to enforce, and stricter enforcement will be costly and ineffective, encouraging domestic exporters to look for new ways to avoid it

*This the third and final blog in a series on #Kina convertibility. You can read the first blog here and second blog here.*

*Read the full report, which includes a guide for less technically minded readers, here.*

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