PNG September Monetary Policy Statement: a quick assessment

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PNG's six-monthly Monetary Policy Statement (MPS) was released today in the national papers. As usual, it has good news and not so good news. Overall, however, it is a realistic assessment of the challenges facing the PNG economy, and indicates the central bank is playing an important role as an independent commentator on elements of the PNG economy. However, more work needs to be done on the exchange rate.

The good news is that GDP growth is still strong at the aggregate level (although now "less than 9 per cent" which is a worrying statement on the health of the non-resource sector of the economy), inflation remains low (6 per cent), foreign reserves remain at healthy levels (more on this below), the Kina continues its adjustment towards market levels (although too slowly), overall credit growth is reasonable (although too low for private sector credit at only 3.9 per cent so less than inflation), and there is positive commentary on issues ranging from the structure of the economy (more emphasis on agriculture), resource tax policy (no more concessions) and the need for fiscal adjustment.

The major announcement is formal recognition that PNG's balance of payments will be negative in 2015. In March, the estimated surplus for 2015 was K1,168 million, and as argued in an earlier blog, this was unrealistic. It is now forecast as a deficit of K505 million – a much more realistic figure especially given foreign exchange earnings from the sale of a Provincial Government's share in Oil Palm plantations. Despite a near full year production of the PNG LNG project, and extensive foreign exchange rationing, PNG's external position is going backwards. This is worrying, but the first step in addressing the problem is at least acknowledging that there is a problem.

The justification for the slow pattern of depreciation of the Kina against the US dollar receives considerable attention. Highlighting the reality that "the supply of foreign currency has been lower than the demand, which contributed to the depreciation of the kina" promotes understanding of the drivers for depreciation. This is important as a lower Kina is sometimes regarded as a weakness in PNG – and policy changes are more likely to be sustained if there is public support. However, there are still significant problems with how the issue is being presented and addressed. There is still no reason given for why the Kina/US dollar market based exchange rate jumped 17 per cent in June 2014 (which hurt rural exporters). The depreciation over the last 15 months has nearly returned the Kina to previous market levels against the US dollar. But there have been two significant changes since then. First, PNG's international commodity prices have fallen sharply – and a major depreciation would be expected in such circumstances. Second, the US dollar has strengthened relative to other currencies. This means that a primary focus on the US dollar exchange rate can be misleading.

Relative to the market based exchange rates on 1 June 2014, the Kina has appreciated against the

Australian dollar by 34 per cent, against the Indonesian Rupiah by 27 per cent, against the Malaysian Ringgit by 40 per cent, and against the Indian Rupee by 12 per cent. Such large appreciations, combined with the fall in oil prices, are a major factor for why imported inflation is so low and why inflation in PNG is so reasonable. However, this also means the PNG economy is now much less competitive relative to its neighbours. Without returning to a more competitive position, there will be continuing pressures on PNG's balance of payments and foreign exchange reserves. Too much weight has been applied to using quantitative restrictions through foreign exchange controls to maintain PNG foreign exchange reserve levels around the USD 2 billion mark. When small PNG businesses can no longer open foreign exchange accounts (due to the Vostro account review which is now being audited but has not yet been completed), this ultimately also hurts sustainable growth. There is a need for a faster rate of depreciation of the Kina – related to actual market-based exchange rates – and based on a broader set of currencies than just the US dollar. Imported inflation pressures will need to be managed, but the current low levels of inflation are actually an opportunity to accelerate a move down in the Kina. The key issue is the speed of external adjustment – not its direction.

A second issue is more of a curiosity. PNG faces a major fiscal challenge in adjusting to K2.5 billion lower revenues forecast in the MYEFO (and this will be an on-going drop in revenues across the medium-term). The MPS indicates that the budget deficit at the end of June was K942 million. The MPS indicates that there has been net new issuance of government securities to cover this deficit of K2,010.7 million in the six months to September. Part of this was implicitly financed by the central bank backing out of its own Central Bank Bills (CCB). But overall, it does indeed appear that the previous announcement that the central bank will no longer purchase under-subscriptions in government securities is being maintained – and stopping the effective printing of money is a real key to ensuring PNG addresses its economic challenges and avoids a potential crisis.

Overall, apart from needing to do more on the exchange rate and greater acknowledgement of how foreign exchange restrictions are hurting local businesses, this is a good statement. We look forward to improved policy statements on the fiscal front including a 2016 Budget Strategy, a Supplementary Budget and an appropriately forward looking 2016 Budget.

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