WESTPAC PNG

Kina adjustment to continue

9 June 2023

Executive Summary

- The IMF notes that they estimate the Kina is overvalued by more than 13 percent in 2022 compared to just 2.1 percent in 2021.
- The IMF has stated that a gradual return to kina convertibility, and the adoption of a market-determined exchange rate, needs to be carefully planned to avoid any excess market volatility.
- The groundwork must be laid to ensure that the market, and supporting institutions, are ready for kina convertibility.
- In response to recent IMF pressure, it's understood the BPNG will present a plan for reverting the kina to convertibility before August this year.
- Estimates of just how overvalued the kina is ranges from a low of 13% (IMF) to a high of 30% (Davis).
- We expect to see the BPNG increase kina convertibility in 2023 associated with a gradual, managed deprecation of the currency. This will see the kina moderating to 0.2757 by the end of 2023 then continue to this trend through 2024 to a low of 0.2640 by the end of the year. We are not expecting to see a resources led recovery of the kina until the second half of 2025.

Evolution of a PNG FX Dilemma

The introduction of FX rationing.

In the face of a depreciating Kina the Bank of PNG (BPNG) decided to limit, or ration, FX transactions by limiting the ability of locals to access foreign currency; by restricting the ability of PNG nationals to sell Kina supported the value of currency but the counterfactual was the creation of excess supply of Kina on the domestic market. This excess Kina had to find a home, some was invested in domestic production to offset imports that could no longer be access but a lot more found a home with domestic banks which invested the excess in Treasury Bills thus supressing interest rates.

Since 2014 BPNG's FX allocation is based on administrative criteria instead of price (participants have no incentive to deviate from the official rate) and forward transactions are forbidden. In addition, the BPNG imposed a trading margin on FX buy-sell spreads offered by authorised dealers effectively impeded the exchange rate from adjusting to a market-clearing level supporting an overvaluation of the currency. This lack of market clearing resulted in major FX rationing with firms unable to access FX to fund imports, repatriate dividends or the purchase of offshore assets.

Despite significant FX shortages no "parallel" FX market has developed.

What is somewhat unique in PNG, compared to other markets where there have been significant FX shortages, is that no parallel FX market developed to soak up excess Kina. It is believed that this may have been due to small FX orders, affecting the largest number of customers but not necessary the largest value demanded, as well as critical commodity importers (fuel and fuel) being fulfilled first while dividend repatriation and offshore asset purchases were the lowest priority.

In the BPNG's March Monetary Policy Statement the Bank suggested that 'compliance and other behavioural issues' was worth K1.486 billion (US$422 million) in outstanding FX orders. However, Westpac has estimated that from our view of the market the size of orders to the six authorised FX dealers is around K2 billion more than the current market can provide.

There would be significant pent-up demand for FX.

It is also very difficult to estimate just how much pent-up demand there is for FX. As FX rationing continued longer than many expected/hoped many would have given up hope of accessing FX and would have made other plans. These plans may include local firms may look towards import substitution for inputs used by investing excess kina into producing those inputs domestically, foreign firms may look to re-invest dividends that can't be remitted now into expanding locally and remitting those dividends when FX becomes more available.

As such, if the market was allowed to clear we may then see this pent-up demand for FX released back into the market and so we can't be sure just how much the demand FX there could be in a market that is truly competitive.

It has also been noted that due to FX shortages, some exporters hold export receipts offshore. Permissible under multiple resource sector Project Development Agreements (PDAs), this allows exporting firms to repatriate only a small fraction of FX revenue to pay local costs while keeping a larger share of FX revenue offshore. By exempting these companies from surrendering export dollars means that a large share of FX revenue never enters the domestic market.

PDAs allow large international firms to maintain FX needed to run their PNG based activities. However, BPNG Acting Governor Elizabeth Genia has warned that these exemptions and concessions, combined with the ongoing underperformance of the non-mineral export sector in generating sufficient FX, has exacerbated the FX shortage. If the Kina is to be more convertible then the significance of PDAs have to be reduced shifting the focus to production sharing arrangements which should result in a more equitable regime.

But it is far from clear that cancelling PDAs is a feasible solution. PDAs do not fall under the BPNG remit so the Bank doesn't have the ability to alter them. Nor can we be certain that cancelling PDAs will increase the inflow of FX; as noted earlier cancelling PDAs could increase the backlog of FX orders if their cancellation boosts expectations that orders will be filled resulting in a significantly greater than expected number of orders being placed.

We also note that tax and dividend payments from the PNG LNG project are expected to increase once tax holidays expire and borrowings are repaid starting in 2024. BPNG has highlighted that historically, the sources of PNG's international reserves were mainly from mineral taxes. However, the recent increases in FX inflows were dominated by increased Government's external borrowings since 2018 and a substantial inflow of Liquified Natural Gas tax in 2022 due to high global commodity prices. The recently accumulated reserve is pre-committed to meet the future demand for external public debt servicing.

A convertible kina could also increase FX inflows.

But we can also see situations where more convertible kina could increase the inflows of FX. There may also be a significant stock of forex being held outside PNG waiting to be converted into kina when the market price and conditions are right. This may include foreign investors with an interest in investing in PNG but are withholding trades to avoid a capital loss that would result from kina depreciation. These accumulated stock imbalances, both in terms of significantly greater than expected demand for FX and kina are significant features of the current PNG FX market and must be resolved for convertibility to be re-established.

Why Does This Matter?

A stronger currency lowers the price of imports thus reducing inflationary pressure on households as well as making capital imports for infrastructure projects cheaper; so is it not a good thing? A stronger currency also means that PNG exports, particularly non-resources exports, will be much more expensive compared to global competitors thus suppressing local prices and exporters incomes.

In addition, by the BPNG protecting its FX reserves by rationing the markets access to FX has resulted in significant import compression. That is imports have been significantly less than they other would have been, reducing not just the variety and availability of good for domestic consumption but also reduces growth and investment diminishing productivity capacity thus limiting future growth and even export opportunities. Since 2014 as imports collapsed formal sector employment has contracted. This is a significant welfare cost PNG households and business have to bare supporting the BPNG's current FX regime.

A stronger currency will have to be supported by more USD reserves to keep the rates artificially high. IMF baseline envisages that reserves will decline from 11 months of imports in 2022 to just above 6 months in 2024 as a result of: (i) increased provision of FX to the market by the BPNG in 2023, and (ii) the removal of FX restrictions and administrative barriers to reduce FX backlogs, with a peak impact expected in 2024.The reserve path remains consistently above the US$2 billion (5.2 month) floor suggested by the reserve adequacy metrics.

A key element of the BPNG management of the exchange rate is that the kina has been largely stable against the US dollar, resulting in nominal effective appreciation against key trading partners, contributing to the kina overvaluation. Given the stabilized exchange rate with the US dollar, ongoing monetary policy tightening by the US Federal Reserve may lead to a difficult policy trade-off in case of an adverse current account shock.

A stronger currency also narrows margins for exporters. That added to the volatility in prices of agricultural products, exporters in this space may receive even less PGK in export proceeds when global commodity prices are lower. This will dampen PNGs ambition to shift away from dependence on mining and natural resource exports. There is also an offset in the imported inputs into agricultural goods, such as fertilizers and pesticides, which will become less costly. Nevertheless, the opportunity cost of a stronger rate is for overall less returns on export revenues when converted back to PGK.

A lower exchange rate would also increase the attractiveness, for investors, in the five mega projects (Pogera, Wafi-Golpu, Papua LNG, P'nyang and Pacsca) estimated at around USD30 billion by PM during his speech in the "Back-to-Businsess" breakfast hosted by PNG business council.

So, What is the Solution?

A solution can be seen in a review of the recent history of the Kina FX market. Overtime, the BPNG has allowed some nominal depreciation of the Kina but it has resisted a full adjustment of the real, inflation adjusted, exchange rate and has managed the resulting shortage by rationing FX. So, despite PNG running a significant current account surplus the initial outflows related to the initial LNG capital investment added to the declining government share of the resources sector income and the deterioration of government's budget balance due, in part, to significant increase in public salary bill all of which resulted in a significant increase in the demand for FX.

As a result of the rationing of FX the interbank FX market is broken. Currently, the BPNG allocates FX to the various intermediaries on the basis of their order books with priority given to critical industries (particularly fuel and food). And while the Bank has increased the monthly supply of FX it is being done so administratively rather than on price so we seeing the prices adjust to clear the market. The key solution is to shift this from an administrative process to a price setting process. The BPNG could reform the market by introducing an auction where FX is allocated on the basis of price while still taking a more managed approach to the exchange rate. The IMF has noted that it does not require the convertibility of the Kina in the form of a floating exchange rate per se but that it would like to see some movement in the exchange rate.

The IMF also provided a hint in how some of this movement could be created via a reduction in the BPNG's reserve of foreign currencies. As at the end of March it was estimated that PNG's gross foreign reserves were US$4bn, more than double what the IMF Staff Assessment suggest is a comfortable level.

How far could the currency fall if the currency was an open floating market? The IMF estimate the currency to be overvalued by 13.4%. Earlier research by Martin Davis suggests that the kina could be overvalued by between 20& to 30%. As such, if the kina was allowed a full float it is clear that, at least for the near term, there could be a very significant and destabilising devaluation.

As such we would expect that BPNG would adopt a more managed regime allowing for a modest devaluation of the kina over time. This would test the market to see just how much pent-up demand there is for FX as well as encouraging offshore interests in PNG to step into the market.

We do note that new Papua LNG project, which is set provide PGK18bn in new spending during its construction phase (equivalent of 27% of GDP in 2022) as well as a 60% boost to the value of PNG exports when it comes on-line in 2028, present significant upside risk for FX inflows of FX and thus a meaningful upside risk for the kina. But we have to get to those projects first and as we don't know just how much pent-up demand there is for FX we don't know how long it will take for the FX inflows to clear the market. In addition, as long as the surge in LNG investment was not creating a domestic inflationary problem, that a stronger currency would help to offset, the BPNG could offset some of the strength by selling kina to further build up its FX reserves.

There is not all good news with a depreciating kina. It is likely that a kina depreciation will see PNGs debt servicing bill increase over time, in PGK terms, even if there has been no increase it the government's borrowing requirements. This has been a reason why the government has been hesitant on depreciating the rate apart from the risk of imported inflation overshooting. Recognising this the IMF has restricted PNG from obtaining too many new external loans by placing a USD1,405 million ceiling on new loans contracted in 2023 and going forward. This should reduce some burden on debt servicing and the incurrence of new offshore loan arrears, hence a depreciation will not have such a detrimental effect on loan servicing going forward.

As such, expect to that the BPNG will increasingly allow kina convertibility through the rest of the year with a gradual, managed deprecation of the currency. This will see the kina ease back to 0.2757 by the end of 2023 then continue to moderate through 2024 to a low of 0.2640 by the end of the year. We are not expecting to see a resources led recovery of the kina until the second half of 2025.

Economic & Financial Statistics/Forecasts

Foreign Exchange Forecasts

Kina	Jun-23	Sept-23	Dec-23	Mar-24	Jun-24	Sept-24	Dec-24
PGK/USD	0.2817	0.2787	0.2757	0.2727	0.2697	0.2667	0.2640
PGK/AUD	0.4083	0.3871	0.3726	0.3637	0.3549	0.3510	0.3429
PGK/NZD	0.4402	0.4223	0.4116	0.4041	0.3996	0.3952	0.3882
PGK/GBP	0.2254	0.2230	0.2188	0.2165	0.2124	0.2084	0.2047
PGK/JPY	37.190	36.237	35.295	34.639	33.988	33.343	32.736
PGK/SGD	0.3719	0.3666	0.3612	0.3573	0.3534	0.3481	0.3445

Source: Westpac Economics

Interest Rate Forecast

Australia	Latest	Jun-23	Sept-23	Dec-23	Mar-24	Jun-24	Sept-24	Dec-24
Cash	4.10	4.10	4.35	4.35	4.10	3.85	3.60	3.35
10 Year Bond	3.64	3.40	3.30	3.20	3.00	2.80	2.70	2.50
US								
Fed Funds	5.125	5.125	5.125	4.875	4.375	3.875	3.375	2.875
US 10 Year Bond	3.61	3.50	3.40	3.30	3.10	2.90	2.80	2.60
New Zealand								
Cash	5.50	5.50	5.75	5.75	5.75	5.75	5.25	4.75
10 Year Bond	4.30	4.20	4.15	4.10	3.95	3.80	3.75	3.70

Source: Westpac Economics

Economic Statistics

PNG	2019	2020	2021	2022f	2023f	2024f	2025f
Money Supply (%)	4.4	7.0	11.8	14.8	10.1	8.0	8.8
Private Sector Credit (%)	4.0	4.3	0.4	6.9	5.7	6.5	6.3
Current Account (K millions)	18,522.2	17,281.4	20,151.0	31,746.6	28,921.4	26,633.8	29,275.4
Gross International Reserves (K millions)	7,880.0	9,437.9	11,544.9	14,298.4	13,406.2	13,666.1	14,005.5
Total Import Cover (months)	*5.0*	7.4	9.8	11.2	10.5	10.6	10.8
Non-mineral Import Cover (months)	*8.2*	11.8	18.7	22.1	19.1	19.0	18.9
Headline Inflation	2.7	5.1	5.7	6.3	5.5	5.0	4.5
Fiscal Surplus/Deficit (K Million)	-4,172.1	-6,501.50	-7,955.50	-5,984.70	-4,984.90	-3,968.70	-3,462.40
Deficit % of GDP	-5.0	-8	-8.5	-5.6	-4.4	-3.3	-2.7

Source: Bank of PNG, International Monetary Fund and National Statistics Office

Global & Trading Partner Growth Forecast

	2019	2020e	2021f	2022f	2023f	2024f
World Economy	2.8	–3.1	6.0	3.4	2.8	3.0
US	2.2	–3.4	5.7	2.1	1.6	1.1
Eurozone	1.3	–6.4	5.2	3.5	0.8	1.4
Australia	2.0	-2.1	4.9	3.7	1.6	1.7
New Zealand	2.9	–2.1	5.6	2.4	1.1	0.8
Japan	0.3	–4.5	1.7	1.1	1.3	1.0
China	6.0	2.2	8.1	3.0	5.2	4.5
India	4.2	–6.6	8.7	6.8	5.9	6.3

Source: International Monetary Fund, World Economic Outlook

For queries; contact

Justin Smirk
Senior Economist
jsmirk@westpac.com.au
Ph: +61 2 9178 2065

Jonathan Prince
Treasurer, Westpac PNG
jprince@westpac.com.au
+675 322 0784