BANK OF PAPUA NEW GUINEA

SPECICAL FEATURE ARTICLE

Foreign Exchange Market Development and Issues

The domestic foreign exchange (FX) market inflows continue to improve, however the imbalance in the demand for and supply of foreign currency (FC) persist. In 2022, total provisional exports receipts was K49,912.3 million, compared to K36,354.5 million in 2021, while total provisional imports was K15,485.9 million in 2022. Of the total export receipts, K18,684.0 million flowed into the domestic FX market, compared to K21,878.0 million outflows. The total shortfall in the FX market of K4,066.7 million (of which K872.7 million was outstanding orders in the market) was mainly met by Bank of PNG's intervention of K3,089.5 million. Although the supply of FC (inflows + BPNG's intervention) improved, it was insufficient to meet the overall demand. The demand for FC, led by imports, has been high, despite improved supply from the mineral and Agriculture/Fisheries/Forestry sectors (see Figure 1).

Figure 1. Foreign exchange market condition (K'million)

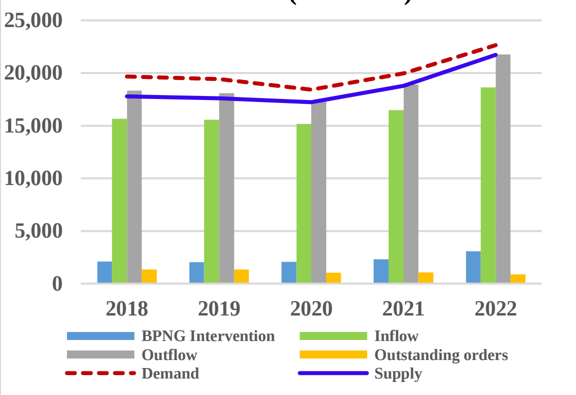
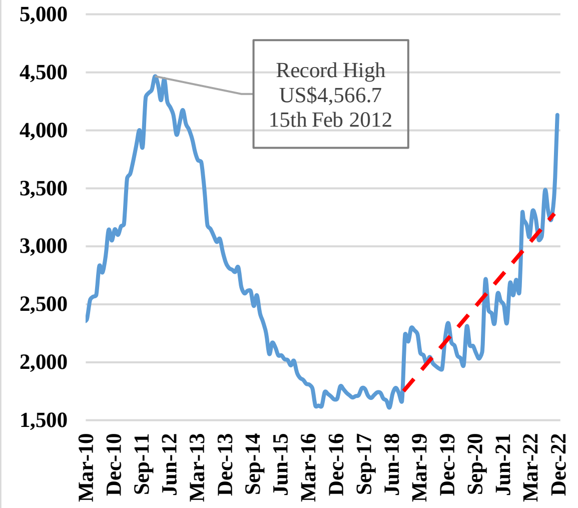


Figure 2. FX Reserves (US$'million)



The demand for FC is broad-based, dominated by the manufacturing and retail sectors. In additon, the substantial increase in the import orders for refined petroleum products has crowded out other orders for FC in the FX market. The Bank noted that frontloading of FC orders by some companies also contributed to the build-up in import orders. These issues, compounded by shortfall in the supply of FCs, led to delays in clearing genuine orders. Furthermore, some of those import orders were lacking full documentation, hence did not meet the compliance requirements for FC transactions. Therefore, Enhanced Due Diligence requirements were issued by the Bank and implemented by the Authorised Foreign Exchange Dealers to assess the orders. This contributed to improved compliance for orders to be served and to support the functioning of the FX market. To complement its regulatory measures, the Bank increased its intervention amount to US$877.2 million in 2022 from US$663.8 million in 2021 and to a US$100.0 million monthly intervention amount for 2023.

Despite these measures, the FX market still faces challenges in clearing demand for FC with the supply of it. This mainly reflects the fundamental structural issue with the Project Development Agreements (PDAs), that allow for export proceeds from mineral sector to be kept offshore. Therefore, the trade surpluses recorded in the Balance of Payments do not fully translate into the domestic FX inflows. In addition, the tax and non-tax concessions of the PDAs have reduced the Government's revenue from the resource projects. This also affects inflows into and the sustainablility of the foreign reserves. Historically, the sources of PNG's international reserves were mainly from mineral taxes. However, the recent increases were dominated by increased Government's external borrowings since 2018 and a substantial inflow of Liquified Natural Gas (LNG) tax in 2022 due to high global commodity prices. Nonetheless, the current level of reserves is still lower than the historical level achieved in 2012 (see Figure 2), and therefore the Bank is very cautious of running down the reserves. The recently accumulated reserve is pre-committed to meet the future demand for external public debt servicing. The external debt repayments of the Government have increased to US$297.6 million in 2022 from US$138.8 million in 2014. As the total Government's external debt increases, so does its external debt servicing obligations. Hence, it would be unsustainable for BPNG to continue its current pace of intervention to support the FX market, if the reopening of the Porgera Gold mine and the developments of the proposed mineral and petroleum projects are delayed, and the non-mineral export sector does not improve further. The risk is that running down of the country's international reserves without the flexibility in the kina exchange rate will have severe macroeconomic consequences, such as on inflation, credit risk, economic activity and growth.

Figure 3. Major FX Reserves Inflows Components (US$'million)

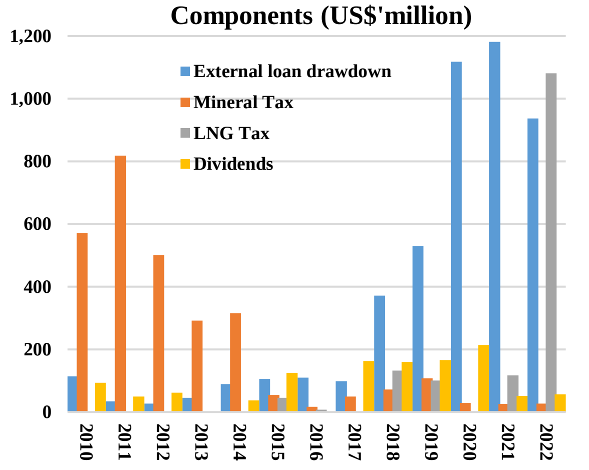
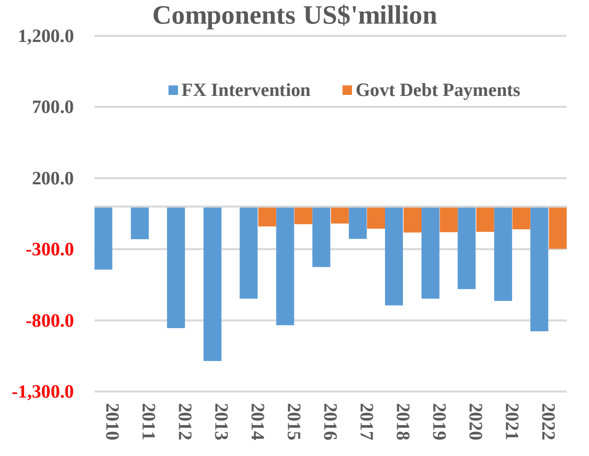


Figure 4. Major FX Reserves Outflows Components US$'million



The ongoing imbalance in the FX market requires immediate and appropriate structural policy reforms to improve the supply of FC into the country. For its part, the Bank will help address the imbalance in the FX market and enhance exchange rate flexibility, supported by the enforcement of compliance requirements and prudent management of scarce international reserves, over the medium term.