Papua New Guinea Kina update

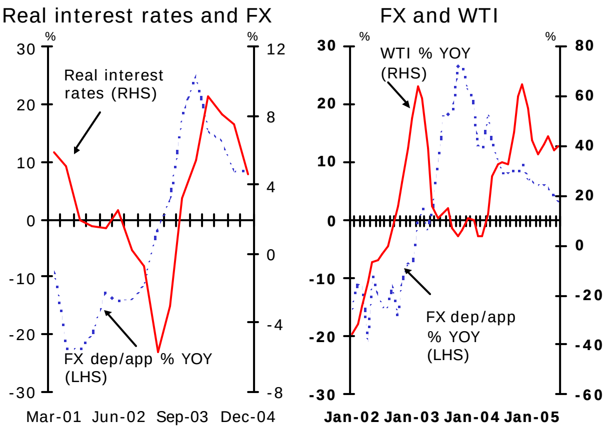
Steady as she goes

- The kina continues to benefit from strong commodity exports and improved macroeconomic management.
- Our forecast calls for a mild depreciation of the kina in the medium term from PGK0.3210/USD currently to PGK0.315/USD at end-2005 and PGK0.300/USD at end-2006.
- The kina is expected to appreciate against the Australian dollar from PGK0.43/AUD currently to PGK0.48/AUD at end-2005, but to then weaken to PGK0.46/AUD by end 2006.
- The risk to the forecast is for a stronger kina in the event of higher export volumes; a ramp-up of the ECP with Australia; and/or a rapid commencement of construction on the Queensland gas pipeline.

The kina has traded in stable range between PGK0.30/USD and PGK0.33/USD for well over a year, and is currently at the strong side of that range at PGK0.3210/USD. Our expectation is for the range to remain roughly in place as the factors that have supported the currency – particularly positive terms of trade and increased stability and efficiency in monetary policy – remain in place. The risk of a rapid reversal in any of these factors seems relatively remote.

However we do expect the kina to weaken mildly within its trading range to PGK0.315/USD by the end of this year. This is in keeping with our broader expectation that the US dollar strength will continue and that currencies of commodity exporting countries may weaken as commodity prices moderate. We expect this trend to continue in 2006 (end-2006 forecast PGK0.300/USD).

Chart 1: Impact of real interest rates and commodity prices on the kina



Source: Bank of Papua New Guinea, Bloomberg

Monetary policy playing greater role

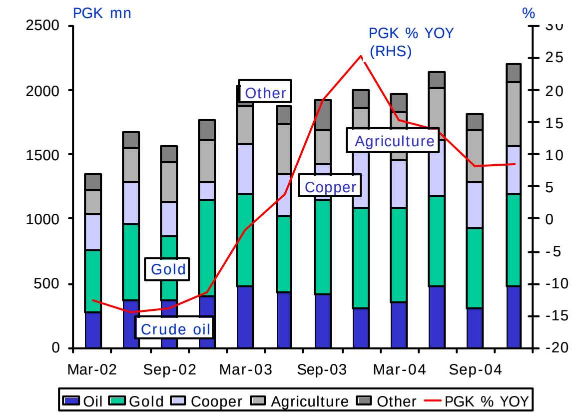
Chart 1 highlights the impact that an improved monetary policy framework has had on the exchange rate. Since passage of the Central Banking Act in 2000 that gave BPNG the explicit mandate to achieve and maintain price stability, nominal interest rates have declined from more than 15% to 7%; CPI has fallen from over 15% in 2000 to just 1.9% YOY for the June quarter. The left-hand chart in Chart 1 shows how the kina strengthened while real interest rates declined in 2001 and 2002, as both trends reflected declining inflation expectations.

The kina began responding to real interest rates in mid-2003, and now tracks trends in real interest rates with a small lag.

Commodity exports – not prices – are key

Conventional wisdom in PNG will often attribute a strong kina performance to high commodity prices. However, it is important to differentiate between high global commodity prices generally and PNG's export performance in particular. The right-hard chart in Chart 1, for example, shows that the rate of nominal appreciation of the kina declined throughout 2004 despite rapidly rising commodity prices as represented by the WTI spot price. The kina's pace of appreciation hit its high of more than 20% YOY in October 2003, which did not coincide with peaks in oil price increases in February 2003 (64% YOY) and again in November 2004 (65% YOY).

Chart 2: Export performance and the kina



Sources: Bank of PNG

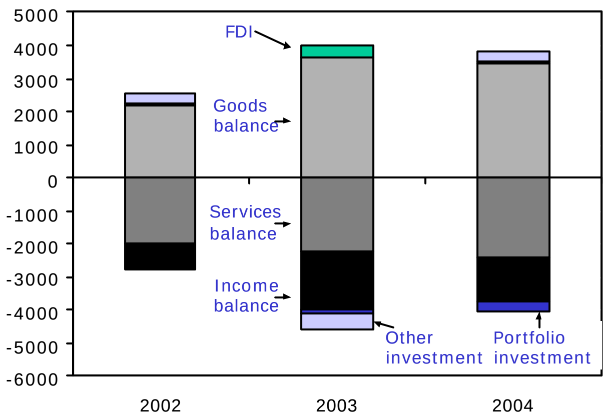
Chart 2 shows that the reason the kina did not respond to higher commodity prices in 2004 was due to a 6.4% YOY decline in export volumes. This brought about a 5% YOY fall in the value of all exports, despite a 13.3% YOY increase in PNG's index of export prices. The fact that the value of the kina fluctuates with real export performance versus expected performance based on commodity spot prices underscores the influence of real supply and demand for foreign currency in the local foreign exchange market. This is the result of restrictions in the capital account that require purchases of real or financial assets for foreign exchange transactions to occur.

Overseas aid not a major factor for kina

The government of PNG continues to receive strong support from development agencies – particularly AusAID – as well as multilateral development banks. Foreign grants averaged PGK645 mn in the four years to 2005, or roughly 18% of total central government receipts.

However, ODA support plays a neutral role in the balance of payments as seen in Chart 3. Net official flows are recorded in the "other investment" category, which is very small relative to flows in the current account on trade, services and income. Net official flows were negative for 2002 through 2004.

Chart 3: ODA's minor role in BOP



Source: Bank of PNG

Concerns have been raised since June that ODA funding to PNG would decline sharply following the Supreme Court's decision in May that the immunity granted to the Australian Assisting Police acting under the Enhanced Cooperation Package is unconstitutional. The ECP, modelled on the perceived success of the RAMSI program in the Solomon Islands, provides a total of A$800 million over a five year period to improve law and order as well as public sector management in PNG. While it is true that the ECP is for now on hold until such time as the governments can negotiate a solution to this legal obstacle, the suspension of the ECP does not represent a cut off in aid from Australia.

The Australian government remains strongly committed to its aid program in PNG, which has for many years been the largest recipient of Australian ODA funding. For FY2005/2006, AusAID estimates total aid at A$492 million, or 33% of its total programmed aid for this fiscal year. As such, the roughly A$160 average annual disbursement under the ECP represents about 32% of the planned ODA to PNG from the Australian government this fiscal year.

Indeed the main risk to a slowdown in aid funding lies within the PNG government, where receipts of foreign grants to the central government have lagged the budgeted amounts due to delays in program implementation. For example, in 2004 the government was anticipating PGK850 mn in foreign grant receipts, but recorded only PGK480 mn. The Treasury has indicated it anticipates roughly A$300 mn in aid annually from Australia going forward. However it is also important to note that JICA, the Japan International Cooperation Agency, is also expected to be a major contributor to PNG in the next few years.

Gas pipeline developing favourably

Although unlikely to affect the value of the kina through 2005 and much of 2006, the ongoing progress on the PNG-Queensland gas pipeline is a long-term positive the kina, and potentially for the PNG economy.

In June, project developers signed an agreement with Alcan's aluminium refinery in the Northern Territory to a long-term purchasing contract for the pipeline. More importantly, early in July Australian Gas Light announced that it had agreed to a A$4.5 bn Gas Supply Agreement to buy 1,500 petajoules of gas over 20 years starting in 2009. AGL also signed a conditional agreement of US$300 mn to acquire a 10% equity stake in the upstream PNG gas project. The agreements are subject to the project reaching financial close in 2006, but the confidence of project developers of reaching this deadline is rising given these important contracts.

The project is a joint venture between ExxonMobil, Oil Search, Nippon Oil and MRDC targeting gas sales only. If financial close is reached next year, construction on the project would begin in 2007 – which would already provide a boon to PNG's economy in terms of increasing foreign direct investment and employment.

Gradual capital account liberalisation

Another important long term development that could impact upon the kina is the gradual liberalisation of PNG's capital account. Most recently, the authorities announced that onshore residents and businesses would no longer need Central Bank approval to hold foreign currency deposits in onshore accounts.

The impact of this announcement on the kina was negligible, as a number of currency regulations remain in place. Particularly, all foreign exchange transactions still require the underlying purchase of an asset (real or financial); and all onshore financial transactions must be undertaken in kina.

However, over time, should the authorities continue to liberalise the capital account, the role of sentiment in driving the value of the currency would increase relative to the fundamental demand-and-supply balance now in place.

Economic and political outlook positive

The table below highlights our forecasts for key economic indicators for the PNG economy. We expect economic growth to remain positive, and for inflation, interest rates and the currency to remain steady. The positive outlook can be largely attributed to the government's improved fiscal management, which has helped to stabilise the economy and allowed the central bank to retain a neutral monetary policy.

The 2005 budget assumes real GDP growth of 2.9% and inflation of 2.6% at year-end – assumptions that seem broadly realistic. Given that June CPI was only 1.9%, inflation could surprise on the downside and give BPNG room to further cut interest rates. The investment in infrastructure development as planned in the 2005 budget would also help set the stage for rising and sustainable growth in 2006 and beyond. Progress toward financial close on the gas pipeline will be a major positive for the economy and the external accounts in the next few years, although the government will need to work toward diversifying the economy to avoid increasing vulnerabilities to downturns in commodity prices.

Finally, our forecasts assume that the Somare government remains in power through the end of its term in 2007. The threat of no confidence motions appears to have waned with little momentum toward any no confidence motions being put forward. Should the absence of no confidence motions remain in place through August 2006, the Somare government will have reached the 12-month grace period before the August 2007 (scheduled) elections during which no confidence motions cannot be called. Another 18-month grace period follows the subsequent election, potentially allowing for two and a half years of relative political stability.

PNG forecast table

	2004	2005f	2006f
Real GDP growth (%)	2.6	2.9	2.5
Inflation (yr av, %)	1.9	1.8	2.0
Fiscal balance (% GDP)	1.7	-1.2	-0.8
Public sector debt / GDP	55	53	50
Current account balance (% GDP)	2.3	1.8	0.4
Exchange rate (eop)			
PGK per USD	.327	.315	.300
PGK per AUD	0.42	0.48	.046
Interest rate (Kina Facility Rate) (eop)	7.00	6.5	6.25

Sources: BPNG, ANZ Bank

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Research can also be viewed on our website:
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