Monetary stability or more devaluation?

Ross Garnaut

Currency instability, periodic inconvertibility, higher inflation and interest rates—all products of the currency crisis—all damage incentives to investment, growth and performance of the real economy. Nominal devaluation may lead to long-term improvement in competitiveness but large improvements require other steps as well: removal of protection, improved efficiency and reduction of the costs of law and order, public administration, public utilities and other infrastructure, and improvements in the quality of the workforce. The currency depreciation will only be a step on the long path to development if it is supported by a return to disciplined expenditure and monetary stability.

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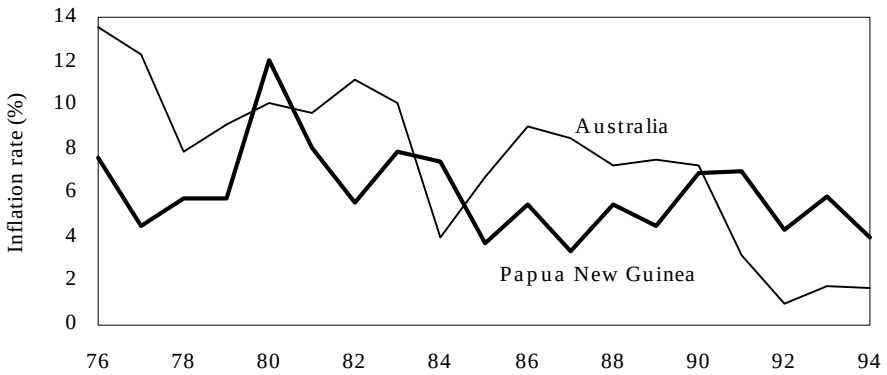
A good start

For 1½ decades after independence, Papua New Guinea maintained a convertible currency that mostly held its value against major world currencies, and a rate of inflation that was low by international and certainly Australian standards (Figures 1 and 2). Low inflation was associated with relatively low interest rates.

Low inflation and interest rates and high confidence in the financial system were built around a 'hard currency strategy'. The principle element of the strategy was commitment to constraining domestic expenditure within the economy's means, and in particular to avoid large budget deficits and unsustainable levels of foreign borrowing. This supported the convertibility of the kina at rates of exchange that were consistent with low inflation in an open economy.

On two occasions—in 1983 and 1990—there were substantial 'one-off' devaluations of the Papua New Guinea kina against other currencies in response to large shocks, within the framework of the 'hard kina strategy'. Papua New Guinea's cautious approach to fiscal management passed a most severe test in the immediate aftermath of closure of the Bougainville mine—the kina was devalued and expenditure was adjusted downward in line with sharply diminished means.

Figure 1 **Inflation in Papua New Guinea and Australia, 1976–94**

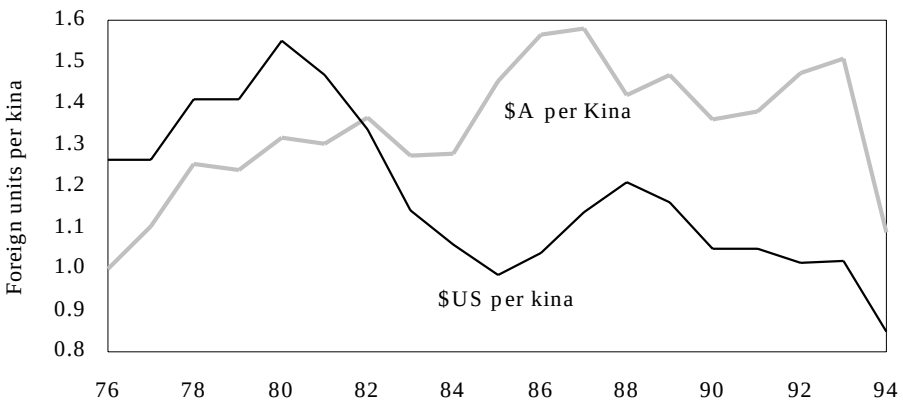


Source: Asia Pacific Economics Group, *Asia Pacific Profiles 1995*, The Australian National University, Canberra:286.

Fiscal crisis

This approach to monetary management was abandoned in the first half of the 1990s. Fiscal discipline broke down. In the late 1980s it became more common for expenditure to exceed budgeted levels—from the early 1990s by a large amount. Budgeted expenditure grew more rapidly and entered risky territory. Exceptionally low agricultural export prices prompted costly subsidies and large tax cuts in the 1993 Budget greatly diminished the revenue base.

Figure 2 **Foreign exchange value of the kina, 1976–94** (foreign units per kina)



Source: International Economic Databank, The Australian National University, Canberra.

Resource rents misunderstood

It is at first surprising that these severe budgetary problems emerged just after a time when a resource boom had fuelled strong growth and contributed greatly to revenue flows to the government.

There is, in fact, a sense in which the resources boom is a cause of the budget problem. After 1½ decades of unusual fiscal frugality—in which per capita real government expenditure fell—a new atmosphere of fiscal comfort had supported increases in real expenditure. The earlier frugality culminated in traumatic adjustment to loss of revenue from the Bougainville mine but the prospects of large revenues from new resource projects lifted the sense of crisis once the initial adjustment decisions had been taken.

Australian aid grants fall

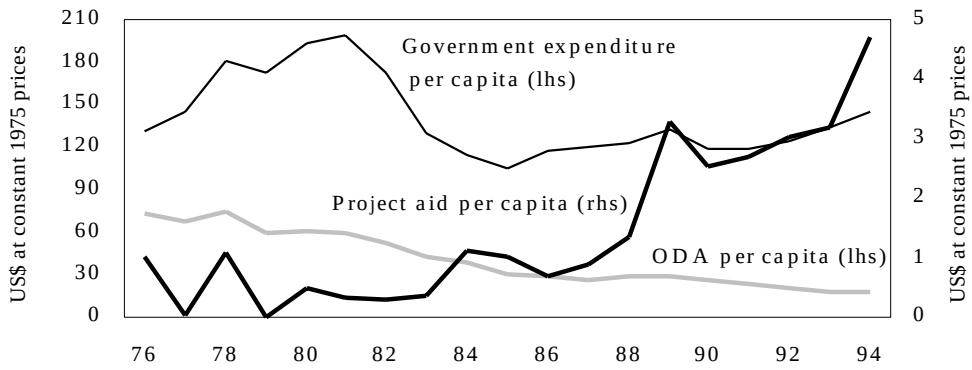
Australian aid disbursements and the Bougainville mine were the backbone of the modern sector at the time of independence. Apart from the mine, other modern sector activities depended heavily on aid for the provision of services and infrastructure and on aid-financed public expenditure for a market.

There has been a dramatic reduction in the level of Australian aid since independence: in constant prices from US$101 per capita or 69.8 per cent of total government expenditure in 1975, to US$19 per capita or 12.9 per cent of total government expenditure in 1994 (Figure 3). Australian aid nevertheless remains very important to the economy and large by international standards.

Australian untied cash grants are falling rapidly. Functions which were once supported by these aid resource flows remain with the public sector. The necessity to remove old functions and to retrench staff attached to those functions is not well understood.

The task of adjusting to decline in such an important part of the economic base has been considerable, but was met responsibly

Figure 3 **Real per capita expenditure and Australian grant aid (budget plus project aid), 1975–94**



Note: US$ values of expenditures (made in kina) affected by exchange rate movements.
Source: Asia Pacific Economics Group, *Asia Pacific Profiles 1995*, The Australian National University, Canberra:290.

through the 1970s and most of the 1980s. Further adjustment is required because since 1993, an increasing proportion of Australian aid has taken the form of funding projects, rather than untied cash grants to the Papua New Guinea Treasury. This shift was a response to Australian official perceptions that Papua New Guinea public expenditure was poorly focused and applied, and that projects with a major direct input of Australian management and skills would be more effective for development. In any case, it was widely accepted that, two decades after independence, aid to Papua New Guinea would gradually be placed on a basis that was more like other aid relationships.

If within a constant total level of Australian aid a portion is shifted from untied cash grants to direct funded projects, direct spending by the Papua New Guinea government must be reduced commensurately. Programs formerly funded from the Papua New Guinea budget must be contracted or terminated as project aid increases in scale. Otherwise the reduction of untied cash grants will emerge as an increased budget deficit.

Failure to understand the relationship between the shift to project aid and the budget deficit has exacerbated recent budgetary problems. The modest scale of the shift so far (projects represented US$59.8 million or 25.2 per cent of Australian aid in the 1994 financial year) means that the effects have been modest also. This issue will become rapidly more important to economic stability in the late 1990s.

Devaluation and the real economy

Currency instability, periodic inconvertibility, higher inflation and interest rates—all products of the currency crisis—all damage incentives to investment, growth and performance of the real economy.

There may be a countervailing benefit if the nominal devaluation leads to long-term improvement in *competitiveness*—if domestic costs in kina do not rise to match the lower international value of the kina. In Papua New Guinea, many costs—of imported goods and services, professional and skilled labour, and the many goods and services produced from them—will become more expensive, more or less proportionately to the kina's fall. The main gain in competitiveness will come from the more rapid fall in *real wages* for low-skill urban workers. Urban real wages were falling anyway following the elimination of the urban minimum wage in 1992, but the fall can be expected to proceed more rapidly in the post-devaluation inflation.

The final reduction in the *real* exchange rate and therefore improvement in competitiveness is likely to be modest. But it will help the expansion of the export and import-competing industries necessary for strengthening employment while restoring balance in external payments.

Large improvements in competitiveness of export production would require other steps as well: removal of protection, which raises living and business costs (in line with the Papua New Guinea Prime Minister's commitment at the 1994 APEC Leaders' Meeting to establish free trade by 2020), improvement in efficiency and reduction of costs of law and order, public administration, public utilities and other infrastructure, and improvements in the quality of the workforce through education and training.

All of this takes time. Development is a long and painful process. There is no magic wand—certainly not soft money.

But there is a path ahead to development, if Papua New Guineans choose to take it. And the currency depreciation,

supported by a return to disciplined expenditure and monetary stability, can represent a step on that path.

Restoring stability

To restore stability following the adjustment, Papua New Guinea will need to return to earlier approaches to monetary management. The kina, now devalued by about 26 per cent since mid-1994 against the Australian dollar, has effectively been fixed by the monetary authorities against a basket of trading-partner currencies. It is possible that this rate could be held if fiscal discipline were restored—that is if the 1995 Budget sticks. In this case, increases in consumer prices, probably having risen by a total of 10 per cent in the six months to March 1995, will stabilise around international levels in 1996.

The alternative to fiscal discipline is more convertibility and creditworthiness scares and another cycle of devaluation and chronic high inflation. The more this continues, the more costly it will be. All of the gains from depreciation can be had the first time around, without adding to the costs.