

## **Leonard Wilson Kamit: Sustaining macroeconomic stability**

Presentation by Mr Leonard Wilson Kamit, Governor of the Bank of Papua New Guinea, to the Rural Industries Council, Port Moresby, 22 February 2006.

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### **Introduction**

Thank you Chairman Mr Brown Bai for the invitation to this meeting of the Rural Industries Council (RIC). I want to share my thoughts on financial sector reforms, which commenced in 2000, and how this development changed economic management of the country. I am convinced that sustained macroeconomic stability will lay the necessary foundation for growth in the medium to long run. I present a snap shot of necessary institutional reforms that create an enabling environment to promote sustained macroeconomic stability and growth.

### **Financial Sector Reforms**

I am of the view that most significant reform process in Papua New Guinea was the financial sector in 2000. It involved the Government introducing the new Central Banking Act (CBA) 2000, the Banks and Financial Institutions Act (BFIA) 2000, and the Superannuation and Life Insurance Acts.

Under the Central Banking Act 2000, the Central Bank has three important objectives and functions, which are the responsibility for monetary policy formulation and implementation, financial system supervision and oversight of the payments system. The Act also made significant changes to the relationship between the Central Bank and Government, eliminating political influence, introducing price stability as the objective of monetary policy, and provided greater independence to the Central Bank in the management and conduct of its affairs.

The Central Banking Act 2000 made price stability as the main objective of monetary policy. Consistent with the Act, the Monetary Policy Statement (MPS) is released semi-annually in January and July. In order to respond quickly to monetary shocks, the Kina Facility Rate (KFR) is announced on the first Monday of each month, which provides a clear direction or signal to the market on the Bank's monetary policy stance. The announcement is strengthened through operational instruments, which are market orientated and used commonly by many central banks around the world. These instruments include Treasury bills, short term Inscribed stocks, Repurchase Agreements, and Central Bank Bills.

A sound and healthy financial and efficient payments system is a necessary conduit for monetary policy implementation for facilitating business activity. The Bank has also introduced stringent supervision of banks, finance companies and other financial institutions such as savings and loan societies, superannuation funds and life insurance companies. This is to ensure prudent management of depositor's funds, members' contributions, and premiums on life insurance policies held with these financial institutions. In this regard, the Bank employs best international practices on prudential supervision methods to ensure financial system stability. A greater part of the standards introduced was focused on good governance practices and the assessment of Fit & Proper persons for Directors and Management of these financial institutions.

To date, the reforms have vastly improved the conditions and outlook of the financial sector landscape of the country. In the banking sector, there is marked improvements in asset quality with non-performing loans as a percent of total assets declining from 2.3 percent in 2000 to 1.4 percent in September 2005. Return on assets of the banking system, which was negative 1.1 percent reversed sharply to over 6.0 percent at the end of September 2005. In addition, the banking system remains liquid at 15.5 percent of total deposits, compared to 4.0 percent in 2002. These indicators reflect that the banking system is financially sound and provides a strong foundation for sustained macroeconomic conditions.

In the Superannuation industry, the positive results over the last few years speak for themselves compared to the bad experiences some 6-7 years ago where contributors lost a lot of their savings. The tale is different today. Prudent and good management are enabling contributors to benefit from their funds. The declaration of huge profits by POSF and Nasfund are clear testimony of these reforms. Similarly, improvements are continuing to be instilled in the Life Insurance industry.

The Bank recognizes the importance of the Savings and Loans movements in ensuring the economic and social well being of the members who participate in it. This can only be realized in a sustainable way if the operators of the societies continue to ensure that these institutions are managed in a prudent manner and supported by strong governance. Improved management of the societies combined with stringent level of supervision by the Bank of PNG has enabled the industry to record improvement in its overall performance. Between June 2004 and September 2005 total assets increased by over 50 percent to K312 million.

The rugged geographical terrain of the country makes access to financial service difficult for the semi-formal, informal and the rural population. Financial institutions themselves face these difficulties in reaching out. In our endeavours to bring out financial services to these sectors the Bank of Papua New Guinea in collaboration with the Asian Development Bank, the National Government and AusAid established the "Wau Microbank" under the micro finance project. The pilot project is slowly growing into a viable complementary player in the development of the financial system. In addition, the PNG Sustainable Development Program Company obtained a banking licence from the Central Bank to operate the PNG Micro Finance Limited in 2004, and has operations in NCD and Western Province. The micro-finance industry development is a meaningful way of mobilizing savings and servicing a large section of the community that do not enjoy financial facilities. The Government has also introduced the District Treasury Roll-out Program, which will further complement the provision of financial services in the rural parts of PNG. This entails the provision of treasury, banking and post office services from one outlet mainly at local and district levels.

I am still very concerned about fast money scams. Hard working Papua New Guineans have lost funds to con-artists who operate these scams. The Bank of PNG continues to warn the public about these scams and individuals must avoid risking their savings. I also call on your rural industries members to support the Bank in warning people about these illegal scams.

The Bank of PNG is also supportive of the Government's initiatives to promote export driven economic growth strategy through removal of impediments to trade and investment. In recognition of this initiative, the Bank liberalized the foreign exchange control regime by freeing up controls in all but (4) areas which are:-

- Opening of foreign currency or kina accounts offshore by residents;
- Approval for capital transaction contracts;
- Gold export licenses; and
- Approval for dealing in foreign exchange.

To date, consistent with the Banks expectation, the liberalization has had limited impact on the balance of payment position of the country. This is the result of an close and on-going dialogue and communication between the stakeholders and the Bank of Papua New Guinea.

## **Macroeconomic Review**

What has been the end result of this massive financial sector reform? The end result is that it has helped to achieve macroeconomic stability that is necessary for inducing sustainable economic growth. The stability in macroeconomic environment is reflected by the following:

- Decline in inflation from double digit levels to an annual headline inflation of 4.6 percent in December 2005;
- Stable exchange rate;
- Historically high levels of international reserves of over US\$760 million that is sufficient for around 8 months of non mineral and 6 months of total import cover;
- Sound fiscal management by the Government was fully supported by high mineral tax receipts and saving from the reduction in interest expenditure. This led to a fiscal surplus of 0.3 percent of GDP in 2005;
- Efficiency gains from Financial Sector Reforms leading to high profitability and improved asset quality of the financial institutions; and
- Confidence in the Government's management of the economy by the public.

Consistent with the macroeconomic stability, the Bank of PNG progressively eased monetary policy, reducing the Kina Facility Rate (KFR) from around 16.0 percent in 2002 to 6.0 percent in February 2006. As a result of the lower interest rate environment private sector credit grew significant in 2005 by over 20 percent. Unlike in the past, where private sector borrowing stagnated because of continued increased funding of the fiscal deficit of the National Government, the increase in private sector borrowing is also the result of improved fiscal management and new loan products offered by the commercial banks.

I released the Semi-Annual Monetary Policy Statement (MPS) on 31 January 2006. The MPS sets the broad parameters for monetary policy for the six months of 2006 and the medium term. The monetary policy for 2006 and the medium term were framed against a background of sound macroeconomic fundamentals, which we expect will be sustained into the medium term.

## **Going Forward**

Going forward, much still needs to be done. The financial sector reforms have not only led to the development of a sound and healthy financial system but also created a stable macroeconomic environment. However, Papua New Guinea should not be complacent with these outcomes but continue to work towards building a more efficient and competitive financial system that accommodates domestic and global challenges. The reforms of the financial sector is still on-going and the following reforms are currently being undertaken by the Bank:

- A Taskforce has reviewed the Superannuation and Life Insurance industries to determine areas where parts of these new legislations could be more stakeholder/member friendly. The Report has been finalized and is waiting to be formally presented to the Treasurer and myself;
- Undertaking a review on the legal framework for Micro-Finance Institutions and a review to the Savings & Loan Societies Act 1995 with the view of separating registry functions from prudential supervision.
- In June 2006 the Bank will undertake a review of the liberalization with the aim of fully liberalizing the remaining exchange controls. I intend to immediately allow holders of onshore foreign currency accounts to settle obligations in foreign currency. This arrangement is intended to minimize foreign exchange transaction costs.
- The Bank decided to licence financial institutions as authorised foreign exchange dealers under the Banks and Financial Institutions Act to promote competition.
- The Bank has commenced a major review of the payments system in Papua New Guinea. Review of the payments system is necessary for a sound and efficient system that will reduce costs to businesses and improve monetary policy transmission. The review will cover different forms of payments, clearing-house, and currency banknotes and coin distribution and withdrawal methods. Papua New Guinea is a predominantly cash economy and I want to see our people use clean banknotes and bright coins. I want to devise more efficient methods of withdrawing dirty and torn banknotes.

In conclusion, these reforms are intended to sustain macroeconomic and price stability over the medium to longer term. With the stable macroeconomic environment, the private sector and members of the Rural Industries Council should use this opportunity to enhance their activities and contribute towards generating economic growth.

Thank you for listening.