L Wilson Kamit: Central bank independence – the first seven years

Paper presented by Mr L Wilson Kamit, CBE, Governor of the Bank of Papua New Guinea, at the 2008 Waigani Seminar, University of Papua New Guinea, Port Moresby, 14 August 2008.

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Distinguished guests, ladies and gentlemen, may I firstly thank the Organising Committee for the invitation to participate in the 2008 Waigani Seminar.

I propose to discuss our experiences on governance issues at the Bank of Papua New Guinea during the last seven years. The book “Money and Banking in Papua New Guinea” (BPNG, 2nd edition 2007) provides detailed discussion on the country’s development policies, the Central Bank, macroeconomic management and how the economy performed from 1973 to 2005.

My talk is divided into three parts:

1. Background
2. Central bank reforms
3. Our experiences

1. Background

Following the attainment of nationhood in 1975, PNG went through a phase of low but steady economic growth until 1989. The 1990s, often referred to as the “lost decade” was characterized by serious management challenges by successive Governments. The closure of the Bougainville copper mine in 1989, excessive government spending over and above the appropriated amounts and a run down on the foreign exchange reserves led to the balance of payments crisis and the abandonment of the Hard Kina Strategy in 1994. Again, gross fiscal mismanagement and a break-down in good governance combined with the El Niño drought of 1997/98, the Sandline crisis, and the Asian Financial Crisis led to the country facing near-financial collapse at the end of the 1990’s.

The financial system came under stress during this time. Government financing through borrowings from the central bank reached its height. A good portion of the increased government spending was for imports, which led to a high usage of the already low international reserve levels. These had the effect of: limiting the effectiveness of the central bank’s operations; increased money supply; very high level of liquidity and increased interest rates; depreciation of the kina; and high inflation.

Political influence through frequent changes to the Bank’s Governors disrupted monetary policy management. Between 1997 and 1999, we had four Governors, one stayed for only four months.

There was a break-down in governance, serious mismanagement, fraud and outright theft that contributed to the stress within the financial system. The Government-owned commercial bank, controlling fifty percent of the banking business, was mismanaged and on the verge of insolvency. Pyramid (Ponzi or fast-money) schemes were flourishing, supported by people in authority, and a large superannuation fund was close to bankruptcy as a result of corrupt practices by the trustees and management. In all the large superannuation funds, total ignorance and incompetence of management, board and ministerial control on the decision making process, resulted in serious failures. There was lack of confidence in the financial system and the economic management of the country, which also contributed to the depreciation of the kina.

Given all these developments, it was apparent that major reforms were needed to enable the central bank to rectify the problems within the financial system and instil confidence in the economy. Reforms to the financial sector were part of an overall structural reform programme introduced by the Government that included strengthening public expenditure control, enhancing the effectiveness and transparency of development spending, initiating privatisation of and instilling operational discipline in large state enterprises and carrying out comprehensive civil service reforms.

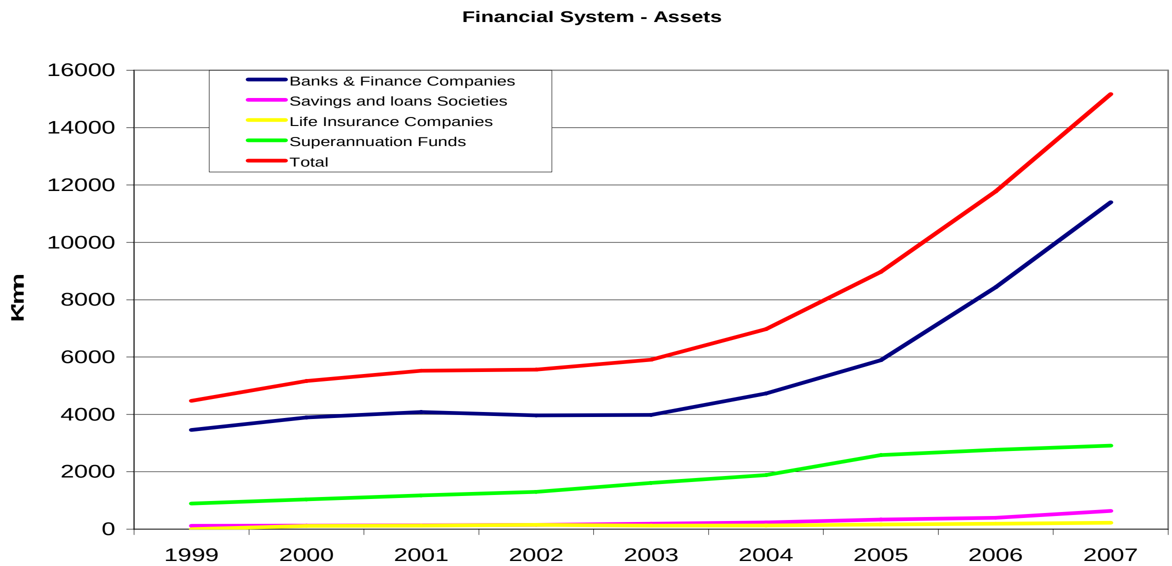
The legislations governing the Central Bank's operations and activities were considerably out of date by the end of the 1990's. The Government therefore decided to revamp the whole financial sector by introducing four new major pieces of legislation. These are the:

1. Central Banking Act;
2. Banks and Financial Institutions Act;
3. Superannuation Act; and
4. Life Insurance Act.

The Bank of PNG still administers the Savings and Loan Societies Act 1995 and is in the final stages of replacing it with a modernised legislative framework for this segment of the financial system.

My presentation will concentrate on the Central Banking Act as this relates to "central bank independence" and governance issues relating to the financial system under the Bank's regulatory responsibility.

The Bank of PNG currently has regulatory oversight over 58 licensed financial institutions. There are 4 commercial banks, 9 finance companies, 2 micro-finance institutions and 21 savings & loan societies. There are 14 institutions in the superannuation industry, comprising 7 trustees/authorised superannuation funds, 2 investment managers and 5 fund administrators. Of the 8 in the life insurance industry, 5 are life insurance companies and 3 are brokers. The table and chart below indicates the growth in asset size of the licensed financial institutions since the reforms began in 2000.



2. Central bank reforms

Central to the financial sector reforms were structural reforms at the Bank of PNG, which were considered necessary to achieving stability of the economy in the medium term. Giving the Central Bank more independence and power in the conduct of monetary policy and strengthening financial sector supervision was in line with worldwide trends. The consensus in the 1990s was that central banks contribute positively to economic stability and maintain credibility if they have a sufficient degree of autonomy and are independent of political interference.

When designing our new Central Banking Act, we had the opportunity to access assistance from the International Monetary Fund (IMF) and the World Bank We also looked at the British, Australian, New Zealand, Israel, Hong Kong and Singapore experiences.

Whilst we consulted widely, the new legislation was our own product, using the world's best practises but tailored to PNG's conditions. It is not a mirror image of other legislations and is at the forefront of financial sector legislation.

The Central Banking Act 2000 was enacted by Parliament in April 2000. It had the following features that give greater central bank independence.

1) A clear and focused set of objectives – monetary policy objective of achieving and maintaining price stability which is used by the central banks of all Organization of Economic Co-operation and Development (OECD) countries as the main objective if not the only one.

2) Independent from Government involvement and implementation of central bank's policy and operational functions – the Governor is solely responsible and accountable for monetary policy. The Governor also has sole responsibility for licensing and supervising the financial system, exchange rate management, and exchange control regulations.

3) An independent Governor – The Governor is appointed by the Head of State (Governor General), acting on advice, for a term of between 5 and 7 years, beyond the electoral cycle, and is limited to 2 consecutive terms (not more than 14 years) The removal of a Governor is on the recommendation of the Bank Board.

4) Government financing from the central bank is limited to an overdraft of K112 million for bridging finance purposes only (for short-term cashflow mismatches) and is repayable within 6 months. Access to the facility is at the discretion of the Governor.

5) Independent Board – comprising the Governor who is also the Chairman, the two Deputy Governors and a wide community representation with five ex-officio members (presidents of the PNG Council of Churches, Chamber of Commerce, PNG Trade Union Congress and Institute of Accountants, and Chairman of the Securities Commission). The Minister can appoint 3 members (non ex-officio) to the Board.

As with the Central Banking Act, the new Banks and Financial Institutions Act (BFIA) was enacted in 2000 which broadened and improved the regulation, supervision and control of the banks and finance companies, introducing international best practises. The Bank also assumed regulatory oversight of the life insurance and superannuation industries. With the exception of the general insurance industry, the National Development Bank, the Port Moresby Stock Exchange and a Unit Trust, the Bank of PNG is now basically overseeing the whole financial system.

3. Our experiences

Granting greater independence to central banks is now seen as important to ensuring sound monetary policy management and implementation. Our experiences show that legislation changes were crucial to guaranteeing central bank independence. This however had to be undertaken within the context of an overall reform package for the whole finance industry. Piece-meal legislative changes, on their own, are not effective. There has to be political will to ensure these changes take place. The Central Bank independence was reaffirmed in a public announcement by the Treasurer in November 2007. This was done to dispel comments that the independence of the central bank should be curtailed or diluted.

Formulation and conduct of monetary policy for price stability

In carrying out its responsibilities under increased independence, the Central Bank has to perform and be more accountable and transparent to the Parliament and the public.

Before 2000, monetary policy was formulated for a year horizon and announced in the first quarter of each year. The objective of monetary policy was broadly stated as that of providing sufficient liquidity for the non-mineral private sector to grow at a sustainable rate. Monetary policy was accommodative of fiscal operations of the Government and preoccupied with financing fiscal deficits, especially in the 1990s. The formal process involved the Governor presenting the monetary policy stance to the Bank Board for its approval. Then it is forwarded to the Finance Minister for his endorsement. There can arise a conflict of interest between fiscal and monetary policy, and issue governance and integrity of monetary policy.

From July 2000, under the *Central Banking Act 2000*, debt management and monetary policy per se were clearly separated with a clear and specific objective for the latter – that of achieving and maintaining price stability. The Bank can formulate monetary policy for any term it decides. For transparency purposes it must report to the public on a six-monthly basis a Monetary Policy Statement (MPS), which involves a review of the monetary policy stance and if necessary a change in the stance is made. Under the Act the Governor has the authority and mandate to decide on and implement the monetary policy stance without having to go to the Board and the Treasury Minister for their approval as was the case previously.

Price stability entails low inflation, low interest rates and stable exchange rate. Our own research (Sampson, Nindim, Marambini and Yabom, 2005)[1] shows there is a strong link between exchange rate movements and inflation. Given this link, the Bank ensures that volatility in the exchange rate is smoothened out through its intervention in the foreign exchange market on either side of the market, while not trying to determine the long term trend of kina exchange rate nor targeting a specific rate. Stability in the exchange rate, together with other factors such as prudent fiscal management, can then lead to stability in price and other macroeconomic conditions.

Complementing the MPS is the monthly announcement of the monetary policy stance through the key short-term policy interest rate – the Kina Facility Rate (KFR), introduced in February 2001.

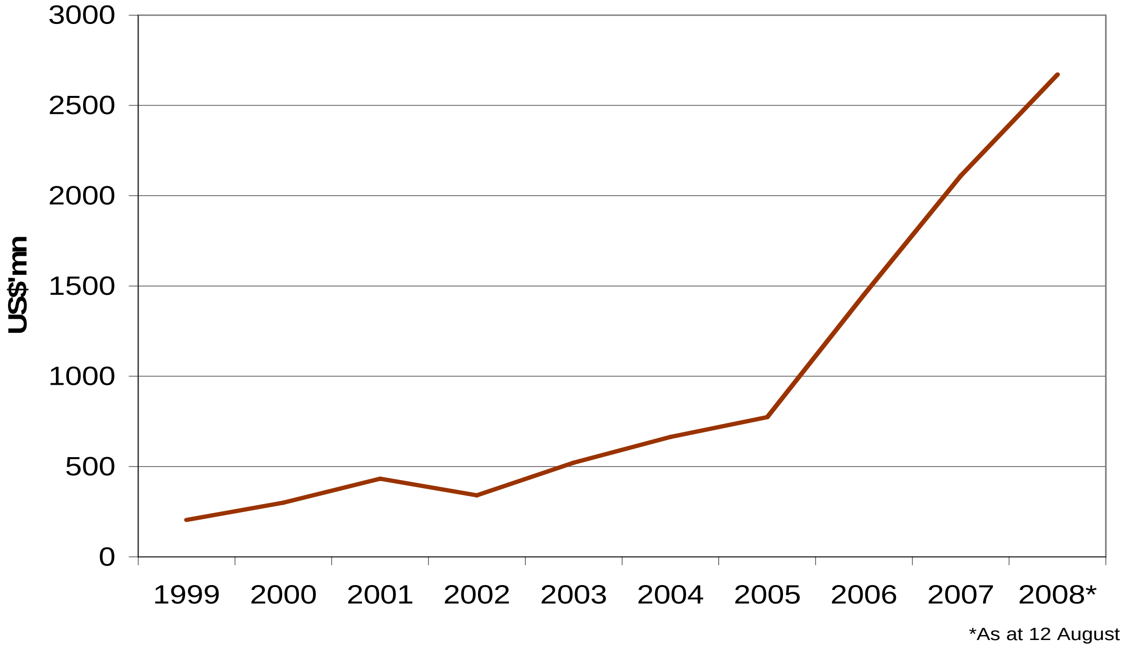
For effective management of monetary policy the Bank has introduced new instruments such as Central Bank Bills and Repurchase Agreements, and put in place new prudential requirements and standards for supervision of the financial system. Operational arrangements have been implemented for a transparent and market-related relationship with the Government, including an Agency Agreement for our role as banker to the Government and agent for trade in government securities and the registry function.

The legislative reforms in 2000, prudent management of fiscal and monetary policies in the 2000s, increased foreign exchange reserves and the stability in exchange rate – driven largely by the high international commodity prices, have enabled the Central Bank to achieve

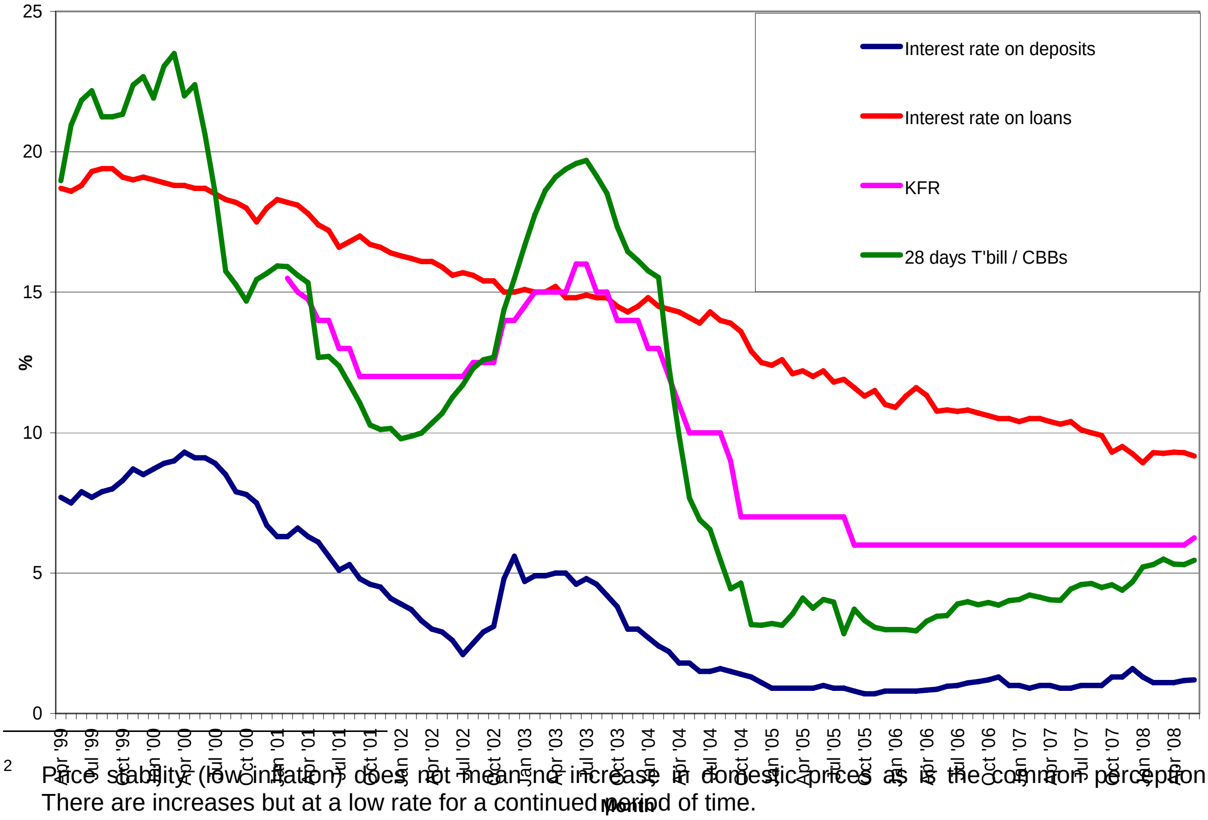
[1] Refer to BPNG Working Paper BPNGWP 2006/02 "Exchange Rate Pass-Through in Papua New Guinea".

and maintain price stability (low inflation)[2] in the 2003 to 2007 period. These are shown in the following charts foreign exchange reserves, interest rates, exchange rates and inflation rates.

International Reserves

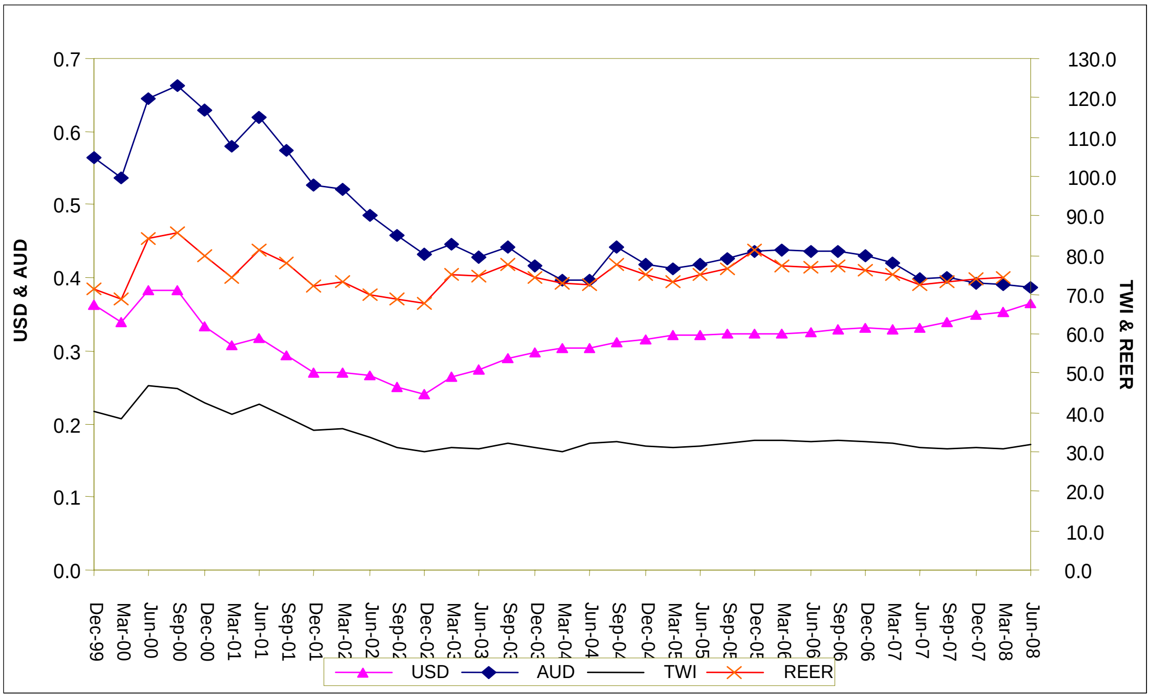


Interest Rates



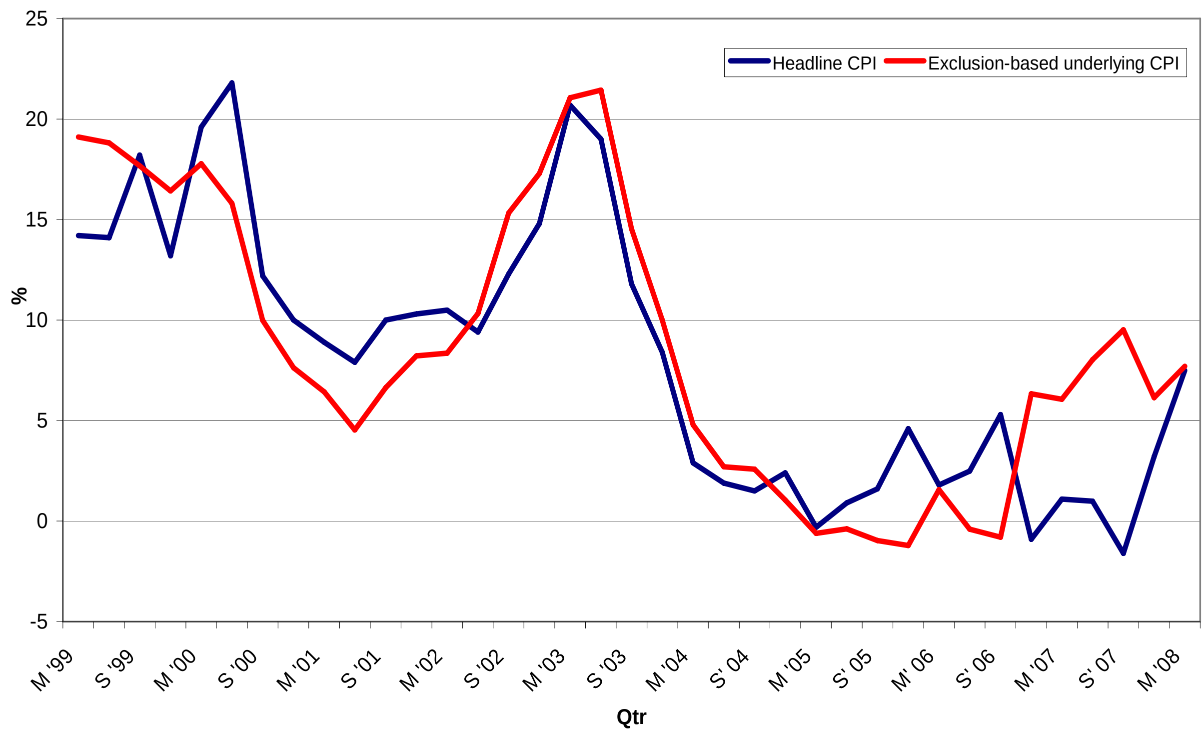
[2] Price stability (low inflation) does not mean no increase in domestic prices as is the common perception. There are increases but at a low rate for a continued period of time.

Exchange Rates



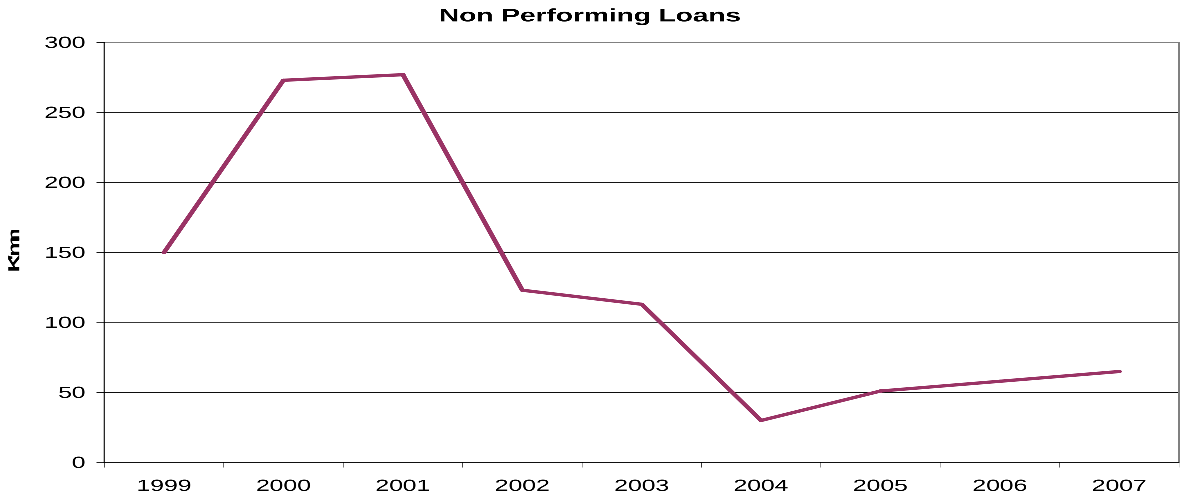
Source: Bank of PNG

Inflation

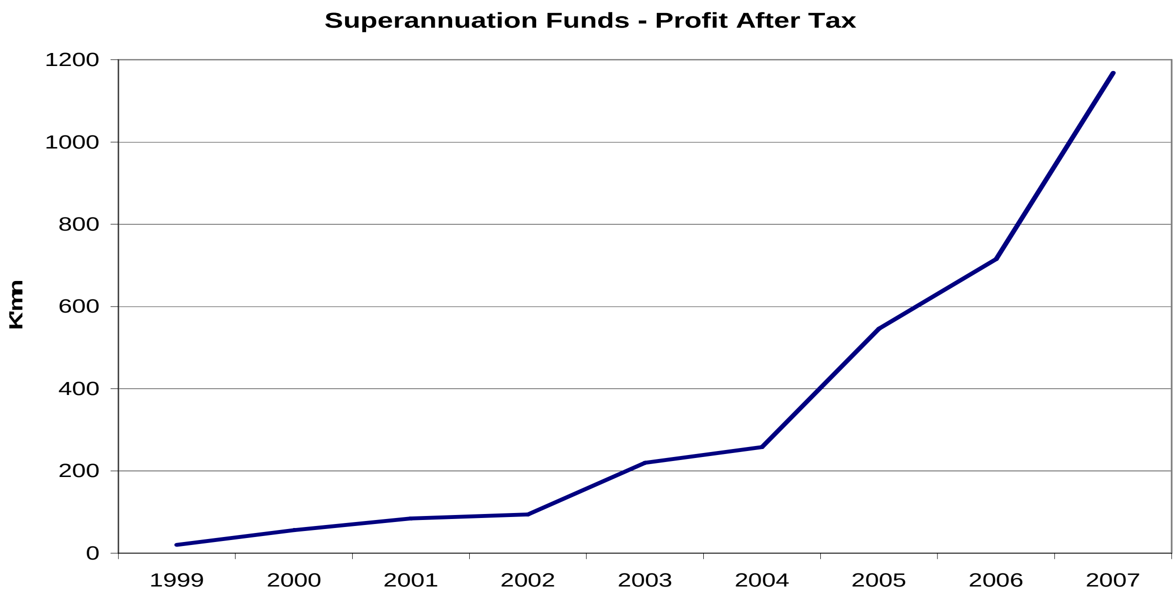


Supervision

With respect to supervision, our independence allowed us to clean up the financial sector. In 2000, we replaced the board and management of the troubled Government-owned PNG Banking Corporation. It was revamped and successfully sold off under the Government's privatisation programme in 2002. The commercial banks were able to perform well following the reforms. The chart below shows the decline in non performing loans (NPLs) since 1999.



The clean up process included closing down 86 dormant savings and loan societies, placed other financial institutions under management, with a view of enabling them to trade themselves back into business, and liquidated a number of financial institutions that have been mismanaged and were beyond rescue. The Superannuation Act also enabled the Bank to effectively supervise the industry as reflected in the chart below, which shows a rapid increase in the profitability of the superannuation industry.



Transparency, public awareness, clear communication and close liaison between the Central Bank and the Government, commercial banks, other financial institutions, the business community and the general public is also an important element of good governance. Regular consultations take place at the senior management and technical levels, explaining changes to policy or operations with the other stakeholders (Government, commercial banks, etc). For this, we must be objective in the advice we give and be professionally and technically competent in the analytical work we do. The success of any changes introduced by the Central Bank depended on the support and cooperation of others within the financial system and the community.

For Papua New Guinea, we had to act at a time of crisis, which is not the most desirable environment to implement such reforms. However, in my judgement, the outcomes were very favourable and the results very positive.

The way ahead

There are several challenges we face at the Central Bank as we move into the new millennium. These are:

- Policy objective – maintaining price stability to assist economic activity.
- Financial inclusion – how to get the un-banked portion of our population into the formal financial system.
- Financial Awareness and literacy – to educate the populace on financial matters and awareness against fast-money scams.
- Financial crime – improving ways of dealing with perpetrators of money schemes, financial fraud and theft, proceeds of crime, etc.
- Statistics – we continue to struggle to get reliable and timely data on other non-banking and financial sectors. Such information as the national accounts is out-dated as well as the inflation basket.