L Wilson Kamit: Central bank initiatives - liberalisation of foreign exchange control

Address by Mr L Wilson Kamit, CBE, Governor of the Bank of Papua New Guinea, at the Annual Papua New Guinea Mining Conference, Sydney, 6-7 December 2004.

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Honorable Ministers Bart Philemon, Sam Akoitai, Puka Temu and Sir Moi Avei, Government and industry representatives, distinguished participants, ladies and gentlemen; I want to thank the organizers for inviting me to address this conference.

The subject of my presentation under the topic of Central Bank Initiatives is, “Liberalization of Foreign Exchange Control”. It is now more than eighteen months that we at the Bank of PNG have been deliberating on the subject. It took me until mid November to decide what we should do. I am sure that many of you are asking; why did it take so long?

In the last ten years the Central Bank has had two traumatic experiences:

In September and early October 1994, Papua New Guinea was facing a classical balance of payments crisis. The level of foreign exchange reserves at that time was at minus US$ 164 million, and was declining at a fast pace. As you all know a country may default on its domestic debt, but it can become bankrupt on its foreign debt, and at that time PNG was faced with this situation.

In October 1994, three options were presented to the Government to deal with the crisis:

1. A further devaluation of 25.0 to 30.0 percent, after the devaluation of 12.0 percent on the 12th of September 1994, and retaining the fixed exchange rate regime. The experience in other countries showed that such measures did not solve the problem.
2. Using exchange controls to ban foreign currency transactions and rationing of foreign currency by the Central Bank.
3. The floating of the Kina against the other currencies.

On the 10th of October 1994, the then Prime Minister, Sir Julius Chan who was also the Acting Minister for Finance decided to choose the best of three very tough options, and that was to float the kina.

The Sandline saga, the El Nino drought, the Asian Financial crisis and the loss of confidence by the public on the management of the economy, brought us to the verge of a second balance of payments crisis towards the end of 1998 and early 1999.

In both cases the Bank of PNG used the exchange control regulations to assist in cushioning these shocks, and building up the depleted level of foreign exchange reserves.

It is important to note that the first crisis was all our own doing. The foreign currency inflows from the mining and petroleum exports were at their peak, at hundreds of millions of United States dollars per annum. The Government of the day decided that we could afford a highly expansionary fiscal regime. The planned budget deficit for 1993 was at 5.0 to 6.0 percent of gross domestic product (GDP). It was obvious that it was far from being sustainable even in the short term, when the tax flows from mining and petroleum exports were expected to be high. In the medium to longer term it was a recipe for disaster. The public reacted as expected, by loosing confidence in the kina.

In 1997 and 1998, the Government of the day did nothing to mitigate the economic impact of these shocks. To maintain some resemblance of stability, the Central Bank used the foreign exchange reserves to support the exchange rate. In spite of heavy intervention in the foreign exchange market, the value of the Kina declined at a fast rate, from around US$ 0.70 in 1997 to $0.34 in less than 2 years to 1999. As was the experience in other countries, currency devaluations do not stop the outflow of foreign currency; on the contrary it accelerates it. The Central Bank did not have the independence to rein in the monetary expansion, resulting mainly from a high budget deficit and to be able to stop the pressure on the kina.

In 1994, it was agreed that a floating exchange rate is inconsistent with foreign exchange controls. The recommendations were to retain the foreign exchange regulations until the reserves are built up to a comfortable level that can withstand any adverse impact of liberalization of foreign exchange control.

In 2000, upon the enactment of the new Central Bank Act (CBA), the subject was revisited. It was concluded that the foreign exchange controls should stay in place as they are, at least until the Central Bank has developed appropriate monetary instruments to achieve the objective of price stability.

The election driven 2002 budget, and the large built in fiscal deficit, were the first time the Central Bank could test the instruments it developed, mainly the use of interest rates, to counter-act an expansionary fiscal policy and try to maintain price stability. The other question that we needed an answer to was; will the public believe that the Bank of PNG is going to use its independence to achieve the objective of price stability.

The developments in 2002, and even more so in 2003, was a clear vote of confidence in the actions and the instruments the Central Bank employed to maintain price stability. The Bank succeeded in managing a relatively smooth moderate decline in the exchange rate until October 2002.

The turnaround in macroeconomic management was the introduction of a supplementary budget by the Somare Government in September 2002, which successfully reduced the budget deficit to sustainable levels. The 2003 Budget was a further step in fiscal responsibility by reducing the budget deficit to below 2.0 percent of GDP. In early 2003, the public realized that the Government is willing to take the hard decisions to maintain a highly responsible fiscal stance, complemented by major increases in the prices of Papua New Guinea's internationally traded commodities, the path to stable prices, low inflation and interest rates was set.

Based on the highly responsible fiscal stance of the Government, a steady appreciation of the kina and the increase in the foreign exchange reserves ensured in late 2003 and early 2004. Then I asked the Bank of PNG staff and advisors to prepare for the liberalization of foreign exchange controls. The Bank of PNG considers that the main preconditions for liberalization of the controls were sufficiently achieved, mainly the stable macroeconomic environment shown by: low inflation levels to those similar to the industrial nations, reduction in the budget deficit to sustainable levels, significantly high level of foreign exchange reserves, sustainable current account deficit, a stable and competitive exchange rate regime and flexible use of indirect instruments for monetary policy. In addition, the financial sector has the capacity to ensure bank soundness and prudent management of interest rate risk.

After the passing of the 2005 budget, which maintains the continued responsible fiscal stance of the previous three budgets, there is nothing preventing the Bank of PNG from finalizing the exchange control liberalization that was started in 1994, by floating of the kina.

I'm pleased to announce today that effective from **January 2005**, for all practical purposes, many of the requirements for foreign exchange control approvals will be replaced with EXEMPTIONS and reporting obligations by authorized dealers will be tightened. To be more precise, let me give you some details:

1. All remaining trade and services transactions (such as limits on remittances) or what we define as Current Account transactions will be liberalized;
2. There will be no timing, such as 3 months retention period, for the repatriation of export proceeds. We will closely monitor the inflows reported by the authorized dealers reports for our balance of payments statistics.
3. Foreign currency inflows, loan or equity will be freed up. The recipients will be requested to report on the inflows and their terms for balance of payments statistical purposes.
4. There will be no currency clauses in mining and petroleum agreements. The existing agreements are in place, but for practical purposes they can be seen as non-existent.
5. There will be no restrictions on capital outflows. The lenders and equity investors will be required to report on transactions for balance of payments statistical purposes.

These changes basically mean that the Bank of PNG will no longer be required to review, analyse and grant exchange control approvals in all circumstances, but will rely on detailed reporting and impose severe administrative penalties to ensure compliance with reporting requirements by licensed financial institutions.

There are many other details being worked on by the Bank staff and our lawyers. A new set of Foreign Exchange Control Notices will be published and gazetted. The new rules will be simple and easily understood by all those that transact foreign exchange.

The liberalization of foreign exchange controls is one more step towards encouraging foreign investment in Papua New Guinea. We need investment in all sectors of the economy to increase and diversify economic activity, and improve the standard of living of our people. A stable macro economic environment, the outcome of a highly responsible fiscal policy that resulted in low inflation, low interest rates and a stable exchange rate are necessary but not sufficient conditions to achieve high sustainable long-term economic growth.

For this to materialize we need to have substantive improvements in the physical infrastructure and efficient low cost utilities. The Government is in the process of privatizing the utilities, and investing in infrastructure. This will strengthen the role of the private sector to be the engine that drives investment and economic growth.

Given the very stable economic conditions in PNG now and in the medium term and a stable and strong financial system, the Bank of PNG is taking this bold initiative to remove the impediments to allow the free flow of funds between the rest of the world and PNG consistent with the Government's investment policy. The country needs this change, and we at the Central Bank are ready to do all we can in the areas of our responsibility to provide an enabling environment for foreign private sector investment. I therefore invite you to do business and invest in Papua New Guinea. If you already have a business in our country you are encouraged to expand it.

Thank you all.