Leonard Wilson Kamit: Monetary and financial sector reforms in Papua New Guinea

Presentation by Mr Leonard Wilson Kamit, Governor of the Bank of Papua New Guinea, on Economic and Policy Update by the Australian National University, Port Moresby, 28 April 2006.

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Introduction

The Director, Asia Pacific School of Economics and Government of the Australian National University, Professor Andrew MacIntyre, distinguished guests, ladies and gentlemen.

I am delighted to be invited to today's session to share my thoughts on the evolution of financial sector reforms in Papua New Guinea, and in particular the benefits from the reforms.

Monetary policy prior to 2000

Prior to 2000, the Minister of Finance significantly influenced Monetary Policy of the Bank of Papua New Guinea. Monetary policy, then, was submitted to the Board of the Central Bank who recommended it to the Minister for Finance for approval. This setting had a major set back because of its conflicting nature. The arrangement allowed for automatic financing of the fiscal deficit through Temporary Advances, which were subsequently converted to Treasury bills at the end of the year. Fiscal deficit when financed by the Central Bank result in the following:

- Increase liquidity levels as new money was injected into the financial system;
- Exert pressure on the exchange rate. This leads to inflationary pressure because in Papua New Guinea changes in inflation rate are closely associated with movements in the exchange rate;
- Deplete the international reserves of the country as the Bank of Papua New Guinea intervenes in the foreign exchange market to support the kina. From 1992-1994, expansionary fiscal policy accompanied by high fiscal deficits of the Government led to complete depletion of the country's international reserves by July 1994 with only half a month of import cover remaining; and
- Negatively impacts on investor confidence and in the Government's management of the economy.

Similarly, when the fiscal deficit is financed by the private sector, the increase in holdings of Government securities crowd out private sector investments, which is vital for generating employment and growth. Commercial banks' primary role as financial intermediaries is to accept deposits and lend for investment, which in the process create economic activity. This process becomes less efficient if commercial banks fail to meet private sector demand for credit.

Financial sector reforms since 2000

The most significant reform process in Papua New Guinea since 2000 was in the financial sector. 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 2002.

Under the Central Banking Act 2000, the Central Bank has three important objectives. These are:

- The responsibility for monetary policy formulation and implementation;
- Financial system regulation and prudential 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 Governor is responsible for monetary policy and financial system supervision whilst the Board of the Bank is responsible for administrative oversight of the Central Bank. The Board of the Central Bank comprises of ex-officio members from the Chamber of Commerce, the Trade Union Congress, the Securities Commission, Council of Churches, the Institute of Accountants and two appointees by the Minister for Treasury.

The Central Banking Act 2000 made price stability the main objective of monetary policy. Consistent with the Act, the Monetary Policy Statement (MPS) is released semiannually taking into account monetary policy views for the year and the medium term. However, as monetary policy shocks are more frequent and for the Bank of Papua New Guinea to respond quickly to shocks, the Kina Facility Rate (KFR) is announced on the first Monday of each month, which provides a clear signal to the market on the Bank's monetary policy stance. This announcement is strengthened through operational instruments such as Treasury bills, Repurchase Agreements and Central Bank Bills, which are also used by many other central banks.

The regulatory and supervisory framework for the financial system has evolved significantly since 2000. With the additional Superannuation and Life Insurance Acts, the main thrust of the policies has been to preserve the soundness and stability of the financial system whilst ensuring that the intermediation process continues to support economic growth. In this regard, the Bank has introduced international *best practices* on prudential 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 addition, a 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 1.1 percent in December 2005. Return on assets of the banking system, which was negative 1.1 percent in 2002 reversed sharply to over 4.2 percent at the end of December 2005. As a result return on equity has improved significantly to 50.5 percent in 2005, making it amongst the highest in the region. These indicators reflect that the banking system is financially sound and provides a strong foundation for sustained macroeconomic growth.

In the Superannuation industry, the reforms have improved the overall performance of the industry. The total assets of the industry, which increased by 6 percent to K992 million in 1999, grew significantly over the years to K2,583 million in 2005. One of the major Superannuation funds, Nasfund, which suffered a contraction in total assets in 1999 to K169 million, from K209 million in 1998 reversed sharply to K753 million in 2005. The rapid growth in total assets over the last few years reflects prudent and good management. As a result profitability of the industry has also increased sharply over the years. Similarly, improvements are continuing to be instilled in the Life Insurance industry, whose total assets have grown steadily from K108 million in 2000 to K126 million in 2004.

In the Savings and Loans societies, the contributors have benefited from improved management and stringent supervision including the *fit and proper* person requirement by the Bank of Papua New Guinea. This has enabled the industry to record improvement in its overall performance. Between 2000 and December 2005 total assets increased by over 139 percent to K312 million. The number of societies contracted during this period from 121 to 20 as the Bank de-licenced and liquidated dormant societies.

Consistent with ensuring stability of the financial system, the rapid growth of fast money scams is a concern to the Bank of Papua New Guinea. In response, the Bank took measures to close their operations, periodically place advertisements in the media about the dangers in investing in such scams. The Bank and law enforcer's actions are limited against fast money scheme operators but we continue to warn the public to take necessary precaution and refrain from taking unnecessary risks through expectations of abnormally high rates of return. The public is urged that if you have paid any money to a fast money scheme operator, go and demand the immediate return of your money.

The rugged geographical terrain of the country makes access to financial services difficult for the semi-formal, informal and the rural population. 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 Micro Finance Limited, which obtained a banking license in 2004, and has operations in NCD, Western and Oro Province. The micro-finance industry development is a meaningful way of mobilizing savings and servicing a large section of the community to whom financial facilities are not readily available.

The Government has also introduced the District Treasury Roll-out Program, which will further complements the provision of financial services in the rural parts of Papua New Guinea. This entails the provision of treasury, banking and post office services from one outlet mainly at local and district levels.

The Bank of Papua New Guinea 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.

In addition, borrowing restrictions on domiciled foreign companies were removed to encourage growth in lending.

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

Macroeconomic outcome

The end result of the financial sector reforms and the other reforms in aggregate have resulted in political and macroeconomic stability. The current Government will serve a full term in office, which is a first of its kind since independence. The reforms have also helped to achieve macroeconomic stability as reflected by the lower annual headline inflation of 4.6 percent in 2005, compared to 21.8 percent in 1998, stable exchange rate at around US$0.3240, high international reserves of US$770 million that is sufficient for 7-11 months of import cover, and a strong growth in private sector credit at an annual rate of over 20 percent. This performance is also reflective of the investors and public's confidence of the management of the economy. In this regard, the private sector must be recognized and commended for the continuous confidence in the economy.

However, the Government needs to be cautious and remain within the Medium Term Development Strategy (MTDS) and the Budgetary framework, because these achievements to date can easily be undone if there is any fiscal slippage in the lead up to the National Elections next year.

Going forward

Papua New Guinea should not be complacent with the current macroeconomic stability 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 of the legal framework for the Savings & Loan Societies and Micro-finance Institutions;
- The Bank continuous with the review of liberalization of foreign exchange controls with the aim of fully liberalizing the remaining controls;

- The Bank encourages licensed non-bank financial institutions as authorized foreign exchange dealers 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. The review will cover different forms of payments, clearing-house, 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.

These financial sector reforms are intended to sustain macroeconomic stability over the medium to longer term, which is necessary for laying the foundation for economic growth. However, these reforms themselves may not be able to achieve the desired outcomes if the Government reneges on delivering the budgetary expectations. This expectation also takes into account the Government's achievement of a balanced budget in the medium term and commitment to deliver priority areas identified in the Medium Term Development Strategy (MTDS).