

Loi M Bakani: Papua New Guinea's semi annual Monetary Policy Statement (MPS)

Address by Mr Loi M Bakani, Governor of the Bank of Papua New Guinea, to the Port Moresby Chamber of Commerce and Industry, Port Moresby, 31 March 2010.

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Mr. David Conn, CEO of Port Moresby Chamber of Commerce and Industry, members of the Port Moresby Chamber of Commerce & Industry, distinguished guests ladies and gentlemen. I'm most grateful and honored to be invited by the Port Moresby Chamber of Commerce and Industry to make this presentation at today's breakfast, to coincide with the release of the first Monetary Policy Statement (MPS) for 2010.

The Bank of Papua New Guinea was the first public institution that decided to subject itself to transparency and openness by including in the Central Banking Act 2000, the requirement to publish its semi annual MPS. The Act states in clause 10, and I quote: "The Governor shall within one month of the coming into effect of this Act, and every six months thereafter, issue a policy statement setting out the monetary policy of the Central Bank to achieve and maintain price stability for the following six months" end of quote.

Monetary Policy is the central objective of the Bank of Papua New Guinea. The Central Banking Act 2000 added the Regulation of the Financial System and the Promotion of an Efficient National and International Payment Systems, as the second and third most important objectives. These three main objectives and functions are fully vested and under the control and responsibility of the Governor. The Act continues and states, I quote: "Subject to the above, to promote macro-economic stability and economic growth" end of quote. This implies that if the objectives of monetary policy, a prudently managed stable financial system and low cost efficient payments system are achieved, and subject to other policies of Government complementing these conditions, macroeconomic stability and sound economic growth can be achieved. The outcome in the last five years is a testimony to the achievement of these objectives.

I want to state that, we can be very pleased with the fact that our regulatory regime proved itself to its full extent during the recent world wide financial meltdown. The credit goes first and foremost to the boards and management of the banks and financial institutions that were not carried away with the easy phantom profits the new instruments were presenting. I am sure that they will agree that the Central Bank through the financial regulation and prudential standards it issued and insisted on implementing has had its share in preventing the disaster.

I move now to this morning's breakfast presentation on the first MPS for 2010. While you can read what's in the MPS in today's newspapers, my presentation will deal with two main subjects:

1. What is defined as Price Stability by the Bank of Papua New Guinea; and
2. What effect might the Liquefied Natural Gas (LNG) project have on the economy in general and on monetary developments in particular?

The Bank of Papua New Guinea defines Price Stability as a non volatile single digit or low level of inflation supported by stable levels of interest and exchange rates. The term "non volatile" is a very important part of the definition. The objective is, to create a conducive environment for investment and growth in economic activity by the private sector. For the private sector to plan ahead, it must have some certainty of what will be the price of inputs during the period of investment and the selling price of the outputs. An entrepreneur knows that there is risk involved in future flows from any investment. What Central Banks are trying to achieve is a stable macro-economic environment that will reduce the risk of price volatility.

The risk of producing a salable product that has a market, at a competitive price rests with the entrepreneur.

Based on this paradigm it is clear that we do not want a negative inflation. Expectation of negative inflation will reduce investment, entrepreneurs will delay activity to benefit from the lower future costs. Reduction in investment and activity and its multiplier effects will result in a decline in economic activity and negative growth.

The most important decision the Governor has to take is what level of inflation will define price stability. As you already understand it will depend on the level of expected economic activity and growth. It is clear that there is a trade off between the two, i.e. inflation and economic growth.

I want to clearly express to you my definition of price stability. At the level of average real economic growth of 5.25% realized in the four years 2006–2009, the acceptable level of inflation as defined by the Central Bank and even in Government budget documents is 5.0% to 6.0%. The actual average inflation outcome for the same period was 5.265%. This is within the range that I clearly define as a period of price stability. Looking at each year you will see that the range of annual inflation rates varied from 2.4% in 2006 to 11.2% in 2008. You will all agree that once it was realized that inflation is on the rise during 2007 and 2008, the Bank of Papua New Guinea took steps to contain it and it declined to 5.7% in 2009.

The next question I want to answer is what if economic growth accelerates and inflation rate rise to two digit levels, as was the case in China and India prior to the last Depression in World economic activity. Some of you might be asking was it a recession or a depression. If we go by the standard definition of two quarters negative growth that defines a recession, and any period of negative growths longer than that defines a depression, then to the best of my judgment the world is just coming out of a depression.

My response is that we should accept the fact that the economic environment will be different and inflationary pressures will be substantial. At higher levels of economic growth, we should accept a higher range of inflation rates. We will have to live with a high inflation environment. But the policy challenge is not to allow the rate of inflation to spiral out of control and become entrenched in double digit figures. We should do all we can to keep it within ranges of single digit mark. But at an average annual economic growth rate of around 9.0% and above, the range of price stability has to be redefined. In a country like Papua New Guinea, in which domestic supplies in all areas are very scarce and those available are in very short supply; just look at professional, skilled and semi skilled labor, housing, building materials, manufactured goods, etc... the high annual economic growth rates will exhaust domestic supplies and exert inflationary pressures to unprecedented levels. In such a case the questions the Governor will face are:

- (1) Do we dampen demand by implementing a very tight monetary policy of high interest rates; or
- (2) Set a higher range of inflation rates for price stability.

Based on the experience of other countries, in such a case, my intention is to define price stability at inflation rates around the 8.0% mark. But I will be quiet reluctant to have a double digit level of inflation, for the main reason that I want to be sure inflation is not going out of control. Even this higher mark is achievable only if the Government and the Central Bank will cooperate and coordinate all their activities, to ensure that fiscal operations are not imposing any further pressures on the scarce domestic resources and monetary policy management does not become difficult and expensive as experienced in 2008 and 2009.

Some examples of cooperation and coordination relate to maintaining a balanced budget inclusive of draw downs from trust accounts. Historical experience in the 1980's and 1990's and early 2000's show that Government deficits have a very immediate impact on inflation.

Depositing all trust accounts with the Central Bank, creating the Sovereign Wealth Fund that should act as Stabilization and a Future Generation Fund will insulate large foreign currency inflows in offshore managed accounts. These should prevent those flows from impacting on the domestic liquidity, which have been a source for monetary inflation that the Central Bank had to defuse at a very high cost to the public purse by selling Central Bank Bills (CBB's). I would like to commend the Government for deciding to establish a Stabilization Fund, Future Fund and Infrastructure Fund from the windfall revenue comprising taxes and dividends that will come from the LNG project. A joint working group has been set up comprising Treasury and BPNG staff and will submit its recommendation on an appropriate model or framework for these Funds to the National Executive Council (NEC) at the end of June 2010.

During the construction phase of the LNG project, there is a need for Government to review all development projects and budget and implement only the most immediately needed ones, to ensure that no further pressures are placed on the very limited domestic resources. The Government has to be conscious not to crowd out the private sector, which will implement very large infrastructure and development projects in the next four years, during which the LNG project is constructed. In 2010, we have allowed for broad money to grow by 21%, which we consider sufficient to meet the borrowing needs of the private sector to support economic growth. If the Government will receive any windfall revenue from high mineral taxes and dividends as a result of increasing commodity export prices, it should allow the Central Bank to insulate them by keeping the funds in offshore foreign currency accounts, instead of depositing them in trust accounts domestically. This would reduce the impact of these funds on domestic liquidity, the exchange rate and inflation.

On the second question of how the LNG project will impact on the Papua New Guinea economy this issue has been continuously discussed in many forums, and only one or two studies have been undertaken on it. I will only touch on some of the areas of the project's impact, mainly those that influence the areas the Bank of Papua New Guinea is responsible for.

Papua New Guinea has a history of investments in mineral and petroleum projects. I went back to study what can be deduced about the impact they have had on economic growth, inflation, foreign exchange flows and employment. In the decade 1981 to 1991 five major projects were constructed, Ok Tedi, Misima, Hides Gas, Porgera and Kutubu, all at a total cost of US\$ 6.0 billion. They commenced production in the years 1984 to 1992. The information about their impact was distorted by the second oil crisis in the early 80's, and the Bougainville uprising in 1989. In spite of those events the lesson we can draw is that economic activity as measured by GDP increased from around 4% to 5% before reaching 11% to 12% during the period of construction of the mining projects, and to 17% when the Kutubu petroleum project was constructed.

The construction of these projects has had a very moderate impact on inflation, if at all. It increased to 11.7% in 1980 mainly as a result of the second oil crisis. For the period of construction of these projects, inflation rate averaged 5.5% with some outliers in 1982 and 1983 at 6.9% and 8.5% and in early 1990's by around 7.0%, respectively. Most of the projects in the 80's and 90's were in remote areas in the Star Mountains, Misima Island, Southern Highlands, and Enga and these areas are not measured in the Urban Based CPI we are using. The lessons learnt are limited.

The LNG project is two and a half times larger at around US\$15 billion to be spent in four years. But what is expected is that PNG will experience a period of heightened economic activity with GDP growth increasing, combined with inflation rate moving up to a new level. This is expected to occur during the construction phase of the LNG project. The MPS makes mention of some of these impact based on a study we carried out jointly with the Monash University. The project is important but we have to be careful not to exaggerate its benefits. The GDP may increase significantly (expected to be around 50%) but what matters most are the expenditures on domestic factors of production for the construction and set-up phase.

Upon the production phase, the main means through which to spread the benefits of the project throughout PNG over time is the Government's fiscal policy. The best fiscal strategy is to save some of the windfall revenue gain in a SWF for the future while consuming only a part of it. Under this strategy the effects of the *Dutch Disease* can be minimized. This fiscal strategy will also make it easier for the management of monetary policy in addressing inflationary concerns. This is in contrast to spending more than it receives or spending all that it gets where the effects of the Dutch Disease will be exacerbated. Some sectors such as building and construction, transportation, manufacturing and services will benefit from the project, especially in the short run during the construction phase. While others will not, particularly the traditional agricultural exports sector as it will be adversely affected by the *Dutch Disease* effect (due to appreciation of kina exchange rate). Let me emphasize that these findings are based on preliminary information and data, and they can be updated once all the information and the data will be provided by the project developers.

So the Bank of Papua New Guinea will have to assess the developments and take the necessary steps to ensure that inflation is not getting out of control.

The system used to fund projects will assist in containing some of the inflationary pressures. The major developers or Engineering, Procurement and Construction (EPC) contractors use off-shore finance to fund the project. We expect most of these financing transactions to be undertaken between offshore accounts as allowed for under the 2008 Exemption Regulation, where they are exempted from seeking approval from BPNG for opening of foreign currency accounts offshore. But other sub-contractors will still be required under the Central Banking (Gold & Foreign Exchange) Act to submit their requirements to the Bank of Papua New Guinea to determine their eligibility under the 2008 Exemption Regulation. Some of the labor, materials and supplies will be purchased in the domestic markets. To purchase them the developer or contractor has to exchange foreign currency for Kina. The result is that the supply of foreign exchange increases which has a revaluation effect on the exchange rate. As a result imported inflation declines. This will mitigate some of the unprecedented very high demand pressures on domestic resources, and inflation. This together with prudent management of the budget and trust accounts can minimize the effect of Dutch disease in PNG.

The analysis leads me to the conclusion that the Bank of Papua New Guinea is going to face untested turbulent times. Once all the information will become available, we will design the policy framework for ensuring that price stability is maintained.

The challenges faced by the Government and the Bank of Papua New Guinea are huge. I am sure that we can live up to them and secure a stable macro economic environment conducive to a country wide long term economic growth.

Thank you all for listening and have fun on a Fools Day.