

## **Loi M Bakani: The State of the economy and monetary policy**

Address by Mr Loi M Bakani, Governor of the Bank of Papua New Guinea, to the National Development Forum, Port Moresby, 18 August 2010.

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Thank you Chairman, Mr Brown Bai.

Honourable Paul Tiensten, M.P. Minister for National Planning and Rural Development, Leader of the Opposition, Sir Mekere Morauta KBE, Deputy Opposition Leader Hon. Bart Philemon MP, Acting Chief Secretary Mr Manasupe Zurenuoc, Heads of Government Departments and State Agencies, members of the Consultative Implementation Monitoring Council, my fellow colleagues on the Panel, Mr. Simon Tosali Secretary Department of Treasury, Mr. Joseph Lelang Secretary Department of National Planning, Monitoring and Rural Development, and Mr. Henry Parakei, Secretary Department of Transport, distinguished participants.

Papua New Guinea is enjoying the fourth year of relatively high economic activity as measured by the real growth in Gross Domestic Product (GDP). The average annual growth in GDP for the four years 2007 to 2010, is estimated at 6.7 percent which translates to a per capita growth of 4.3 percent per annum. To put it in another way, at the end of 2010 our people will be 18.3 percent better off from where they were at the beginning of 2007. This trend is likely to continue for the next three years, during the construction period of the Liquefied Natural Gas (LNG) project. Even more important than the overall growth in GDP is the estimated non-mineral sectors growth of 7.2 percent per annum. This translates to a per capita growth of 4.7 percent, the highest and longest period of growth on record since independence. It is estimated that at the end of 2010 the great majority of our people, those in the non-mineral sectors will be 20% better off from where they were at the beginning of 2007.

Despite the Global financial Crisis and meltdown in 2008 and the slow recovery from it in 2009 and 2010, the Papua New Guinea economy continued to grow and performs exceptionally well. We managed to avoid all the financial problems and at the same time have the best and longest stretch of growth in economic activity from the time of independence.

The country is enjoying a mineral boom through the increase in international commodity prices, which resulted in large Government surpluses up to 2008, and high accumulation of funds in trust accounts, that reached a peak of above K5 billion. Of this amount more than K4 billion was deposited with the commercial banks, while the rest was deposited at the Bank of Papua New Guinea. The budget deficits in 2008 and 2009, coupled with the fast draw downs of funds from the trust accounts, resulted in the balances declining to below K1 billion in August 2010.

To those of us dealing with the Sovereign Wealth Fund (SWF) there was an opportunity to commence it during the recent mineral boom. Establishing a SWF to manage large windfall revenues from high commodity prices is talked about for some years. The decision to park the surplus revenue in trust accounts was not a good solution. I have no doubt that a SWF would have managed the surpluses in a much better way. As a consequence, we now have one more bad experience of the management of excess revenue from mineral resources, on top of the Mineral Resources Stabilization Fund.

The recovery in commodity prices in 2009 and 2010 might entail a further opportunity to establish the SWF earlier than the production stage of the LNG project in 2014.

The monetary aspects of the developments in the period were very large inflows of foreign exchange as mineral and petroleum taxes. These flows increased the foreign exchange

reserves from around US\$ 500 million in 2005 to a historical high of above US\$ 2.8 billion in August 2010. The Bank of Papua New Guinea paid the Government Kina for the tax receipts it received in foreign currency. Through this process the infusion of liquidity into the financial system increased. The Government instead of re-depositing the Kina in trust accounts with the Bank of Papua New Guinea, decided to deposit most of it with the commercial banks, at a very substantial cost to the Government and the people of Papua New Guinea.

To avoid the huge amount of liquidity from impacting on the exchange rate and inflation, the Central Bank had to defuse it by issuing Central Bank Bills (CBB). The amount of CBB's outstanding as of today exceeds K4 Billion. In the previous years the CBB's were issued at a relatively high interest rate of 6 percent to 8 percent, but this has declined in 2010 to below 3 percent, mainly due to excess liquidity in the financial system. This way the commercial banks managed to arbitrage between the Government Trust Accounts and the CBB's, and earn a relatively high income on those deposits.

I am very pleased that the Minister for Finance and Treasury the Honourable Mr. Peter O'Neill CMG M.P. decided that all future trust accounts will be held with the Central Bank.

As all of you are aware the Primary Objective of the Central Bank is "Price Stability". In previous public statements, I clearly defined it as stable inflation rate below the two digit level. Let me make it very clear, we do not target a specific level of inflation, as we do not follow an "inflation targeting" objective. We want inflation to be stable and predictable, so that investors, the business community, and households have some certainty in planning for the future.

In 2008 the annual inflation increased to 11.2%. It was above the acceptable two digit range. The Bank of Papua New Guinea took all the necessary actions, and used the available instruments and tools it has, to reduce it to within the acceptable level. As a result inflation declined to 5.7% in 2009, and is around this level in the first two quarters of 2010.

One of the factors impacting on inflation is domestic demand and the utilization of the local productive resources. During the construction stage of the LNG project, the domestic productive capacities will be utilized to their fullest extent, in the areas of development and construction of infrastructure projects. I recommend to the Government to reframe its development plans to avoid competing on the very limited productive resources within the economy, especially in the earth moving and construction industries. The LNG project developers are building the "infrastructure corridor" from the Southern Highlands to Port Moresby. They are implementing the largest ever infrastructure project in the country, involving roads, pipeline, power, telecommunication, etc... This development will use up all the existing earth moving and construction capacities within the country.

The Government should therefore concentrate on maintenance work on the existing infrastructure of transport, health centers, schools-colleges and plan ahead for the utilization of the highly trained and experienced work force that will be released from the LNG project, at the end of construction phase.

In the infrastructure areas the Government should concentrate its effort in areas that the LNG developers are not extensively using their resources on, such as, electricity, power generation and telecommunication.

The Government should direct its development budget and implementation capacities to the other priority areas of education, health, law and order, environment and conservation and specifically the agriculture sector. The need to invest in the agriculture sector, that is generating the productive income and the source of livelihood for the great majority of our people, will ensure that the phenomena we define as the "Dutch Disease" will be avoided. The time is too short to go into a full analysis of the "Dutch Disease" phenomena. We at the Central Bank will do our best to ensure that the exchange rate is not pricing the traditional exports of Papua New Guinea uncompetitive in the international commodity markets.

It is of paramount importance to commence the planning of the shift in the priorities now, to ensure that the 2011 budget reflects them.

I am convinced that by proper planning and thoughtful utilization of our implementation capacities, we will avoid the overstretching of the nation's productive resources and capacities. This way we will avoid unwarranted domestic price increases and the import of competing machinery, equipment and labour that, will depart the day the construction of the LNG project is completed. Such a scenario will result in the loss of all the knowhow that could be accumulated for the future use and benefit of the nation's development.

The three to four years of the construction stage of the LNG project will be hard to manage. I am however confident that with close cooperation and coordination with the Government specifically the Departments of Treasury, Finance and National Planning and Monitoring the Bank of Papua New Guinea can achieve the objective of price stability as I defined it.

We are also pursuing vigorously some other objectives such as a modern Payments Systems that will provide a safer, efficient and cost-effective payment and settlement system in the future.

Financial inclusion of the rural majority through financial literacy, micro banking, technological innovation through the use of mobile phone banking.

All of it without compromising the objective of a stable prudently managed financial system that is customer and service oriented and will withstand future shocks as it did in 2008.

If the Government can continue its focus on developing and improving infrastructures and basic social service in the rural areas, people can take advantage of these new financial and payments innovations to improve their livelihood and living conditions. They can also realize the benefits from the LNG project and the improved macroeconomic developments in the economy. If this is sustained into the future, the objectives of the Government's Vision 2050 can be realized.

To do justice to all the roles that are placed under the Bank of Papua New Guinea's mandate, we will continue to protect the Contributor's Savings in the long term Savings Schemes in the Superannuation and Life Insurance industries.

I wish to thank the organizers for inviting me to address the forum and I look forward to the day's presentations.

Thank you.