

## Annex 2: Central Banking Act Review Issues Paper (released 30 August 2021)

*This Issues Paper has been prepared to assist the Independent Advisory Group (IAG) established to review the Central Banking Act (CBA) as well as those who have an interest in the Review to understand its Terms of Reference, to canvas the issues which face it, and to provide an initial scan of options in terms of recommendations. Any findings are initial rather than definitive. The Paper is written by but is not intended to commit the IAG in any way to any particular finding or recommendation, but rather to generate feedback and comments.*

### **Introduction**

The Independent Advisory Group welcomes the opportunity to review the Central Banking Act (CBA). We work from the position that the Central Banking Act of 2000 has served PNG well, but that 20 years on we should learn from experience to see how the Act can be improved, and the independence, accountability, transparency and effectiveness of the Bank of Papua New Guinea be strengthened.

### **Terms of Reference (TOR)**

#### **1. Objectives**

*Review whether the objectives of the Central Banking Act 2000 give adequate priority to the growth and development of PNG, and in managing national economic crisis (Section 7);*

#### **2. Governance**

*Review the current economic in particular monetary policy governance and management mandate of the central bank, including whether the Board or another similar body should have responsibility under the Act for determining monetary policy (sections 7-14, focusing on section 10).*

#### **3. Financing**

*Review the current arrangements around advances and financing to the government by the Central Bank, including a review of the TAF and options around quantitative easing options during a declared emergency (focus on Section 55)*

#### **4. Accountability and transparency**

*Review the institutional governance and management of the Central Bank whether there is a need for strengthened accountability and transparency, and management performance and terms, in line with international norms (sections 15-36, and sections 42-50 with potentially new sections).*

#### **5. Other issues**

*Recommend from the findings and conclusions under TOR 1-4 critical strategic issues requiring in-depth analysis and development—this will form the basis of the TOR for the second stage of the review and cover broader issues covering regulation of the financial system, actions to*

*encourage competition, and follow-on work in light of the recent Financial Sector Reform review.*

### **Comments on the Terms of Reference**

Crisis management is covered by two TOR items, 1 and 3. Under 1, the IAG is asked to review whether BPNG objectives need to be extended to cover crisis management. Under 3, the IAG is asked to examine quantitative easing (QE) options during a crisis. For clarity, it is proposed to combine these as a single, separate item relating to crisis management. TOR items 2 (governance) and 4 (accountability and transparency) are closely related, and it is proposed to address these sequentially.

Thus the proposed revised presentation of the Terms of Reference is:

1. Objectives
2. Governance
3. Accountability and transparency
4. Financing
5. Crisis management (objectives and financing)
6. Second-phase issues

Note there is no change in substance between the original and these proposed TOR. The changes are just for the sake of clarity. There is an additional TOR because the crisis management components of other TOR items are separated out and presented on their own.

The rest of this Issues Paper goes through the above six items, one by one.

#### **1. Objectives**

*Under this heading we review “whether the objectives of the Central Banking Act 2000 give adequate priority to the growth and development of PNG” The issue of objectives relating to crisis management is dealt with in section 5.*

#### **Background**

Under the Act (Section 7), BPNG has three main objectives: price stability; financial stability; and payments efficiency. Subject to these three objectives, Section 7 also states that BPNG is to promote economic growth. Section 7 also states (and Sections 10 (1) and Section 11(1) repeat) that the sole objective of monetary policy is price stability, giving this objective a clear primacy.

This articulation of BPNG objectives is consistent with the most common, though not universal, global practice, which is for Central Banks to give priority to price stability. Nevertheless, several issues have arisen in relation to BPNG’s objectives over the years.

- **Exchange rate policy.** Although exchange rate policy has traditionally been a government responsibility in PNG (and most other countries),<sup>1</sup> Section 58 of the CBA can be read as vesting responsibility for exchange rate policy formulation with BPNG.<sup>2</sup> Since 2015, IMF staff have reclassified PNG's exchange rate regime away from "floating" to a "crawl", or "fixed" (for different periods). IMF staff have also in recent years found PNG to be maintaining restrictive exchange measures and multiple currency practices which limit currency convertibility on the current account, and are inconsistent with the IMF Articles of Agreements (to which PNG has subscribed).<sup>3</sup> The IMF has argued that foreign exchange rationing has increased unemployment in PNG and led to shortages of intermediate imports.<sup>4</sup> PNG businesses frequently complain about exchange rate shortages. The Bank's goal of price stability makes it unsuitable for it to set exchange rate policy as this goal will always bias decisions against depreciation (which are inevitably inflationary).
- **Little attention to the economic growth objective.** In recent years, inflation has been moderate in PNG, and growth has been very low. Since 2013, formal sector employment has been declining and per capita non-mineral GDP growth has been negative. Despite the fact that subject to price stability BPNG should promote economic growth, there has been no mention of low growth in BPNG statements and no discussion of the need for stimulatory policies until the onset of COVID.
- **Financial stability.** The PNG financial sector is stable, but its duopolistic or monopolistic nature is not supportive of development. Some have argued that the regulatory barriers to entry have been set too high. The question arises as to whether BPNG's objective in favour of financial stability is at the expense of financial and therefore economic development.<sup>5</sup>

## Options

BPNG's objectives could be left the same, with the focus on inflation. This would be consistent with the practice across most banks.

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<sup>1</sup> See p. 15 of the IMF 2004 survey [\*Central bank governance: a survey of boards and management\*](#).

<sup>2</sup> Section 58 states that "The official value of the monetary unit in terms of other currencies may be determined by the Governor acting on, and in accordance with, policy statements issued pursuant to Section 11 and to achieve the objects of the Central Bank under this Act."

<sup>3</sup> See for example, the [\*2018 IMF Annual Report on Exchange Arrangements and Exchange Restrictions\*](#).

<sup>4</sup> See p.25 of the 2018 IMF Policy Paper "[\*Review of the Fund's policy on Multiple Currency Practices: initial considerations\*](#)" The exact language used is that PNG maintains "exchange restrictions subject to IMF approval under Article VIII, Section 2(a), of the IMF's Articles of Agreement."

<sup>5</sup> BPNG is also charged under the Banks and Financial Institutions Act 2000 with promoting "the general stability and effective working of the financial system in PNG" (Section 5(1)). The Financial Analysis and Supervision Unit (FASU) within BPNG is charged with monitoring and enforcing compliance with The Money Laundering and Counter Terrorism Act 2015. According to Section 61(2), "FASU shall be an operationally independent unit with the functions as specified under this Act and can institute proceedings on behalf of the Bank of Papua New Guinea for the purpose of this Act." Issues relating to the financial sector beyond overall BPNG governance and objectives are likely to be further investigated in the second stage of the Committee's work.

Alternatively, its objectives could be changed to give a more balanced approach. For example, the US Federal Reserve has the objectives of maximizing employment, stabilizing prices, and moderating long-term interest rates. Such a rearticulation of objectives would lead to a recalibration of strategy, both monetary and perhaps financial.

Who has responsibility for setting exchange rate policy needs to be agreed on, and the parameters within which that responsibility is exercised clarified. If the focus on price stability is retained, certainly exchange rate policy should not rest with BPNG. If more balanced objectives are adopted, then BPNG could retain responsibility for exchange rate policy, within agreed and perhaps legislated constraints, such as to reflect PNG's long-standing commitment to current-account convertibility.

It is not sufficient to clarify who is responsible for exchange rate policy. It also needs to clarify what the policy should be. In particular, the government needs to decide whether it is content to retain a regime of foreign exchange rationing or wishes to return to compliance with the IMF Articles of Association and good economic practice and ensure convertibility on the current account. It also needs to be formally acknowledged that PNG's current exchange rate regime is not floating, and, assuming the government remains committed to a floating regime, a plan should be articulated to return to it.

## **2. Governance**

*Review the current economic in particular monetary policy governance and management mandate of the central bank, including whether the Board or another similar body should have responsibility under the Act for determining monetary policy (sections 7-14, focusing on section 10).*

### **Background**

Section 10 of the CB Act clearly vests responsibility for monetary policy formulation and implementation with the Governor. Section 26 on the functions of the BPNG Board states that formulation and implementation of monetary policy and the regulation of the financial system is not a Board responsibility, but the Governor's responsibility. BPNG is unusual. IMF staff research cited in the TOR for this review shows that only three other countries give responsibility for monetary policy to the central bank governor: Argentina, Hungary and Vietnam. None are appropriate role models.

The Bank for International Settlements (BIS) 2009 survey of central bank governance ([Issues in the governance of central banks](#)) notes that "an increase in the delegation of power to the central bank has often been accompanied by a move to group decision making." (p.2).

The BIS Survey goes on to note that: "Collegial decision-making is a hallmark of modern central banking that both augments the independence of the decision-making process and enhances the quality of decision. In the vast majority of the world's central banks, board or committees are responsible for making policy decisions." (p.3)

Having a more collective approach would be of benefit to BPNG since it would, again to quote

from BIS, “permit a wider range of perspectives to be brought to bear, which adds to the legitimacy and credibility of the central bank decisions....” (p.3)

Given the criticism of some of the BPNG decisions over recent years – whether relating to exchange rate policy already discussed or deficit financing discussed below – such an increase in legitimacy and credibility would be welcome. Setting aside the issue of whether these decisions were the right one, a more contestable process would give greater confidence that these decisions were indeed the right ones and that all valid criticisms and alternative points of view had been given due weight.

Although BPNG does have a Monetary Policy Committee (MPC), it is constituted entirely by Bank staff, who report to the Governor. The IMF in its 2004 survey ([Central bank governance: a survey of boards and management](#)) recommends that any MPC should have external members: “Monetary policy committees, for instance, may be used as an avenue to include external members to ensure a balanced view.” (p.40)

### **Options**

Consideration should be given to BPNG moving towards a more collective approach to monetary policy determination since, based on global experience, this would enhance both its independence and the quality of its decisions. Under any such model, although the concentration of power in the Governor would be reduced, s/he would still be the most powerful decision maker on monetary policy.

Analysis should be undertaken of the suitability of this model for the PNG context,

Further consideration would need be given as to whether monetary policy should be the responsibility of the Board or of a specialized MPC (on which BPNG staff and management would be included, but would not dominate).

In both cases, careful consideration would need to be given to composition of and appointment protocols for the Board/MPC to ensure independence, contestability and effectiveness. This is discussed further in the next section.

### **3. Accountability and transparency**

*Review the institutional governance and management of the Central Bank whether there is a need for strengthened accountability and transparency, and management performance and terms, in line with international norms (sections 15-36, and sections 42-50 with potentially new sections).*

#### **Background**

This item covers a range of items, including (a) management performance and terms, (b) accountability and (c) transparency.

### **(a) Management performance and terms**

The [2009 BIS Survey](#) discussed earlier shows international practice in relation to the terms of the central bank governors (see the table below, extracted from it). Two-thirds of countries surveyed have a 5-6 year term for their central bank governor. The BPNG Governor term is for seven years, which is on the long side. A longer term promotes independence, but may undermine accountability, given the difficulties (and undesirability) of removing a Governor. An advantage of the seven-year term in the PNG context is that it is not the same as the electoral cycle of five years.

Length of term and reappointment of central bank governors Per cent of 47 central banks					
	3–4 years	5–6 years	7–8 years	Not specified	Life tenure
Length of term	6	64	17	13	0
Reappointment not limited	0	45	11	0	0

Source: BIS analysis of central bank laws.

Source: Table 5 from the [2009 BIS Survey](#)

Regarding management performance, the Committee could examine the operational budget of BPNG. The Bank's staff costs have doubled after inflation between 2010 and 2019, and total costs have more than doubled over the same period. Further research is required to establish the extent to which such increases are justified. The BPNG Act has provision for a performance (not policy) audit (Section 48), but one has not been undertaken.

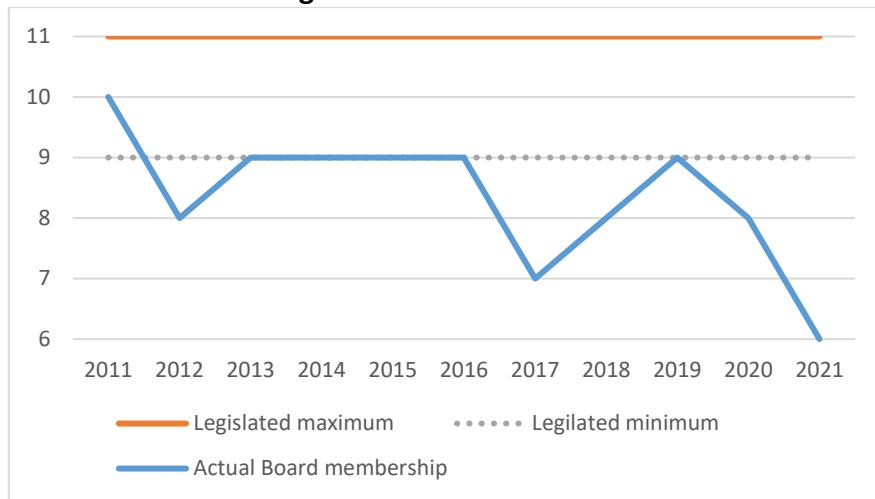
### **(b) Accountability**

According to the 2009 BIS Survey, “[t]he key issue is to strike the right balance between protecting the independence of the central bank and preserving its accountability”. (p.135).

BPNG's most immediate accountability is to its Board. Article 26(1) of the CBA states that the “Board of the Central Bank is responsible for determining the policies of the Central Bank, other than the formulation and implementation of monetary policy and the regulation of the financial system which shall be the responsibility of the Governor.” This makes the Board a “supervisory Board” in the words of the 2004 IMF survey (p.23). The IMF recommends that in such a case the governor should not be the Board chair (p.26).

The PNG CBA establishes a Board with a maximum of eleven members, and requires that there be at least nine. Analysis over the last decade shows that in several years the minimum has not been achieved – see the figure below.

**Figure 1. BPNG Board size**



Source: BPNG Annual Reports.

Further investigation is required as to why the Bank has not had its minimum required membership for significant periods of time. The BPNG Board includes up to three BPNG managers (the Governor, and up to two Deputies), five ex officio positions (representatives of the church, business, trade unions, Institute of Accountants, and Securities Commission), and three appointees of the Head of State (NEC appointees). These NEC appointees have a three-year term limit, the ex officio representatives have no term limit, the Governor has a 14-year limit, and the Deputy Governor can have any number of five-year terms.

The advantage of ex officio positions is that they reduce the discretion in appointment of Board members. The disadvantage is that it might lead to members with little expertise and very long tenures.

Other accountability mechanisms for central banks are quantitative targets, and regular parliamentary reviews. BPNG has neither of these. It is required to submit to the Minister an annual report within six months of the end of the financial year. At the time of writing, the most recent BPNG annual report on the website is 2018, and the most recent financial report 2019.

The IMF in its 2016 Article IV called on BPNG to “stop monetizing the fiscal deficit” (p.13) Given that Article 55 prevents BPNG from funding the fiscal deficit, this reference to the so-called “slack arrangement” between the Government and BPNG raises important issues of accountability. (See Section 4 for further discussion.)

### (c) Transparency

Transparency promotes accountability. There is a growing trend among central banks towards transparency, with a growing number publishing their monetary policy strategy, their macroeconomic forecast and model, and meeting minutes.

BPNG issues a policy statement every six months. The BPNG website is a platform for transparency, but some information is out of date. (At the time of writing, statistical information in the QEB tables is only updated to December 2020, more than six months ago.

Data on Treasury Bill and Inscribed Stock auctions are also only up to 2020.) The Bank issues forecasts for GDP, balance of payments and inflation.

## **Options**

The term for the Governor could be left at seven years, or shortened to five years to bring it into line with more standard international practice.

Terms and appointment protocols for Board members (and any Monetary Policy Committee, if established) should be reviewed. Consideration could be given to appointment of representatives of other Central Banks to the BPNG board.

Concerns about BPNG management performance could be addressed by greater accountability and transparency, and by Board governance reforms including appointments of persons with relevant expertise and experience rather than ex-officio appointments of institution representatives.

A range of measures could be considered to promote accountability and transparency. In addition, greater emphasis on collective decision making (as discussed under the previous TOR item) should itself lead to more accountability and transparency, as it will mean that Bank decisions will be more contestable.

## **4. Financing**

*"Review the current arrangements around advances and financing to the government by the Central Bank, including a review of the TAF ... (focus on Section 55)" [ "Options around quantitative easing options during a declared emergency" are discussed under item 5 below.]*

### **Background**

The Temporary Advance Facility (TAF) is established under Section 55(2) to provide short-term advances to the government. In 2020, the Government amended the BPNG Act to increase the TAF cap from K200 million to 12% of revenue and grants (including aid), averaged over the last three years. The Act was also amended to give the government 12 months to repay the TAF, up from six. The earlier limit was low by international standards, and the reform will help the government solve its serious cash flow problems especially at the start of the year.

BPNG has argued that the increase in the TAF will worsen the problem of excess liquidity. However, since the TAF is only short-term financing, the validity of this objection is unclear.

Other advances from BPNG to help the Government finance its fiscal deficit are disallowed under Section 55(9). Despite this, as mentioned earlier, BPNG developed the so-called "slack" arrangement by which it purchased T-bills in the primary market, and held them for long periods. The outstanding balance at the end of 2017 was K1.231 million and in 2018 K630 million thereby helping the government to finance its deficit.

Some countries allow some deficit financing, but limit total Bank support to the government. In Fiji, for example, there is a limit for RBF holdings of government securities and advances of 30 percent of government revenue.

BPNG is authorized to purchase treasury bills or securities for the purpose of monetary policy management (Section 55(8)). BPNG does this by purchasing such instruments on the secondary market. PNG financial institutions are at or near their exposure limits in terms of PNG government debt holdings. Therefore, if BPNG buys some of their debt, they are able to purchase more from the government. This eases the financing challenge, and puts downward pressure on interest rates, while still being allowed under the Central Banking Act.

## **Options**

One option is to keep Section 55 as it is. This might be considered appropriate bearing in mind that it has just been amended. Alternatively, expanded (though still limited) support from BPNG to government deficit financing could be allowed, as per the Fiji model.

### **5. Managing national economic crisis**

*“Review whether the objectives of the Central Banking Act 2000 give adequate priority to ... managing national economic crisis (Section 7). Review the current arrangements around advances and financing to the government by the Central Bank, including a review of ... options around quantitative easing (QE) options during a declared emergency (focus on Section 55)”*

## **Background**

For ease of handling, we have rearranged the TOR to bring together the two items related to crisis management – concerning objectives relating to and QE during an emergency. (QE or asset purchase programs involve the purchase of government securities to push down interest rates, stimulate the economy, and/or support government deficit financing. The purchase of such securities could be in the primary or secondary market.)

There are no crisis provisions in the BPNG Act. A few countries do include crisis provisions in their central bank legislation. For example, [Section 19](#) of the Bank of England Act 1998 gives reserve powers to the UK Treasury over monetary policy “in extreme economic circumstances”.

It can be argued that emergency provisions are not needed since, as long as price stability is not threatened, BPNG is mandated to support growth. However, during a crisis one might give more weight to economic growth (or minimizing the economic shock) and less weight to price stability. It should also be noted that the Government may declare a State of Emergency on various grounds, which gives it temporarily enhanced powers.

Many central banks have been very active in response to COVID-19 without the activation of emergency clauses, or the takeover of their powers by the government. However, some countries did amend legislation in response to the pandemic to support bond purchases

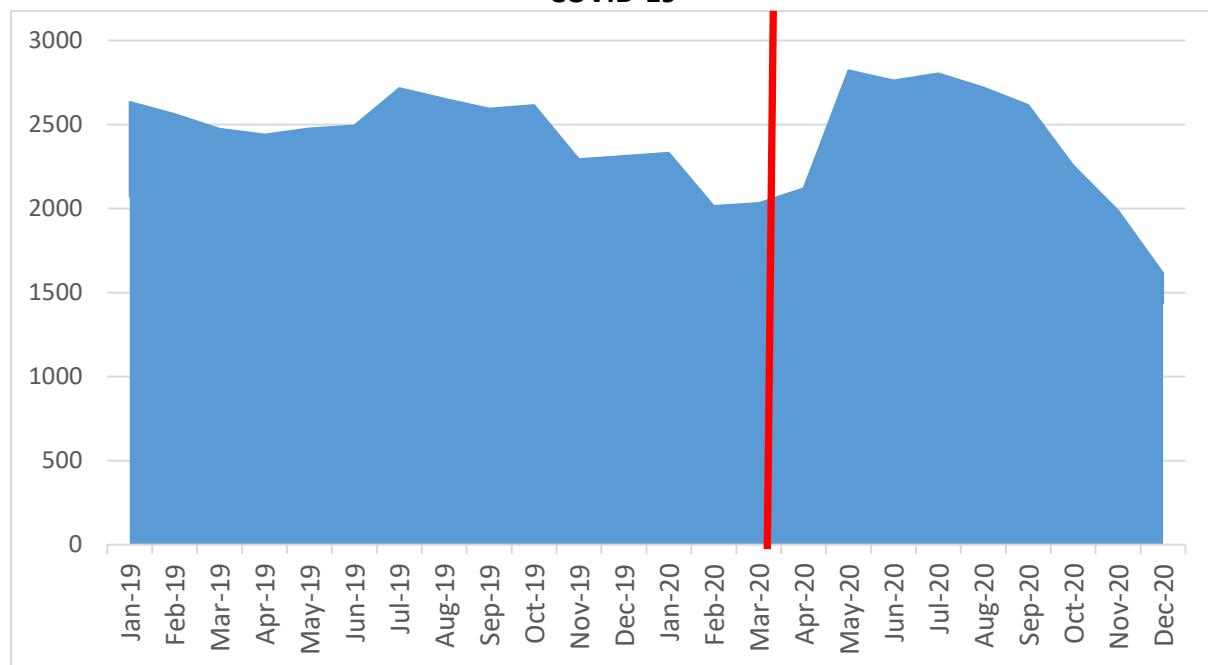
(Indonesia and Brazil) and/or to increase the limit on such purchases. (Both the IMF and BIS have developed COVID central bank response databases. These can be interrogated for further insights.)

Most central banks have restricted their QE to the purchase of government bonds on the secondary market. However, some central banks have extended their support to purchases in the primary market (Indonesia and Philippines).

The IMF's advice is that purchases of government securities by the central bank can be justified in emergencies, but that secondary market purchases are preferred, and that monetary policy objectives and central bank autonomy should not be undermined.

BPNG initially engaged in QE with the onset of the COVID-19 pandemic, but then, as the graph below shows, unwound its position. The latest data shows that it held less government debt at the end of 2020 than it did before the pandemic. This was due to its concerns about the increase in the TAF.<sup>6</sup> However, it appears the government has made limited use of the TAF, and in any case this is a short-term, cash-flow-smoothing instrument. The lack of sustained QE in PNG makes the country stand out in an international context when many other central banks are playing an active role to assist governments at a time of crisis. (Data for 2021 is unavailable on the BPNG website.)

**Figure 2. Central bank holdings of government debt (Kina millions): before and during COVID-19**



Notes: The thick line marks the onset of the COVID-19 pandemic. Data from BPNG website. Government debt includes inscribed stock and Treasury bills.

<sup>6</sup> The March 2021 MPS indicated that “The Central Bank undertook some trading in the secondary market by on-selling its stock of Government securities to diffuse part of the liquidity injected through the TAF.”

## **Options**

With regard to legislative change, there are three options:

- One would be to introduce new clauses relating to objectives and/or functions during a crisis.
- Another would be to revise provisions relating to the financing of deficits, especially purchases of bonds on the primary market, either during a crisis or more generally.
- A option would be not to recommend any legislative changes.

Regardless of whether there is legislative change, further investigations should explore whether, without compromise to BPNG's independence, BPNG and Treasury can better cooperate in the national interest, especially at times of crisis, and what mechanisms could promote such enhanced cooperation.

## **6. Further issues**

*Recommend from the findings and conclusions under TOR 1-4 critical strategic issues requiring in-depth analysis and development—this will form the basis of the TOR for the second stage of the review and cover broader issues covering regulation of the financial system, actions to encourage competition, and follow-on work in light of the recent Financial Sector Reform review.*

### **Background**

Among the many additional issues that could be covered in the IAG's second stage of work, priority ones for further investigation could include:

- How to encourage new, low-risk entrants into the banking sector.
- How to remove excess liquidity.
- How to expand the capacity of the domestic financial sector to meet the government's borrowing needs (to reduce reliance on offshore borrowing) and how to drive down government borrowing costs.
- The governance of the Financial Analysis and Supervision Unit (FASU) within BPNG, as per the Anti Money Laundering and Counter Terrorism Financing Act 2014, and its relationship to the responsibility of BPNG under the Banks and Financial Institutions Act 2000.
- How to expand capacity of the financial sector to better meet the needs of small and medium enterprises including through "Open Banking/FinTech".

Other issues will no doubt be suggested and added over the course of the Committee's first stage of work.