

Chapter 5. 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 was dealt with in [Chapter 4](#).

We begin this section by re-emphasising the point with which we began this report. The Central Banking Act was based on international best practice to restore stability to the Bank of PNG. While this was an improvement on what went before, the central banking function would work better if the Act was revised to take into account PNG’s unique circumstances and BPNG’s functions. BPNG has a very different role than the central banks of developed countries. Its policy lending rate is, by its own admission, relatively ineffective ([Chapter 5.2](#)). As [Chapter 3](#) has shown, the Bank plays an important fiscal role. And, as this chapter shows, BPNG also plays an extremely important role in exchange rate setting. These diverse roles mean that a balanced set of objectives, rather than ones focused only on inflation, is essential.

Under the current Act (Section 7), BPNG has three main objectives: price stability; financial stability; and payments efficiency. Subject to these three objectives, Section 7(d) also states that BPNG is to promote macroeconomic stability and economic growth. However, importantly, Section 7(a) also implies (as do Sections 10(1) and Section 11(1)) that the sole objective of monetary policy is price stability.

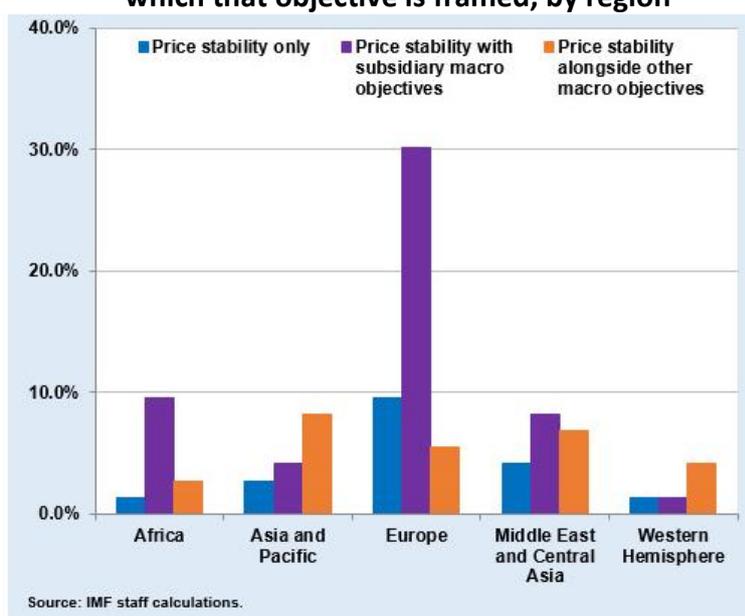
The IMF classifies central bank objectives around the world as “price stability only”, “price stability with subsidiary macro objectives” and “price stability alongside other macro objectives”.⁴¹

Reading Section 7 as a whole one might classify BPNG’s objectives as “price stability with subsidiary macro objectives”, but reading Section 7(a), 10(1) and 11(1), one would classify it as “price stability only”, since price stability is given as the sole objective of monetary policy. While growth is mentioned as a subsidiary objective in Section 7(d), without the tool of monetary policy at its disposal to promote growth, the Bank is reduced to addressing this objective through such worthy but limited initiatives as the promotion of microfinance and digital innovation.

According to IMF research, summarised in the figure below, “price stability only” is not the dominant approach to the setting of objectives in any region. “Price stability with subsidiary macro objectives” is the most common approach in Africa, Europe and the Middle East, but “price stability alongside other macro objectives” is the most common approach in Asia and Pacific, and Western Hemisphere (the Americas). As will become evident, our recommendations would bring PNG into line with the approach most commonly deployed in the Asia-Pacific.

⁴¹ See [here](#). Note that this is in relation to central banks with objectives that feature price stability. 57% of central banks include price stability as an objective, and another 13% have an equivalent objective. A significant number express the objective without reference to price stability but rather, say, monetary stability. See Khan (2017) “Central bank legal frameworks in the aftermath of the global financial crisis”, IMF WP/17/101.

Figure 24. Percentage of central banks with price stability as an objective, by the way in which that objective is framed, by region



Source: [IMF](#).

Several issues have arisen in relation to BPNG’s objectives over the years that make it necessary to revisit them. These issues, addressed sequentially in this chapter, are: exchange rate policy ([Chapter 5.1](#)); the fiscal role of the Central Bank ([Chapter 5.2](#)); whether economic growth has received adequate priority in recent years ([Chapter 5.3](#)); the need to give greater weight to financial development ([Chapter 5.4](#)); and BPNG’s role as the Government’s banker ([Chapter 5.5](#)).

5.1 Exchange rate policy

The exchange rate setting role of BPNG is both important and controversial. In its submission, the Kina Bank stated that “Exchange rate policy is a very contentious issue and is the only monetary policy tool which transmits to the market.” This part of the chapter looks first at who has responsibility for exchange rate policy ([a](#)), and then at currency convertibility ([b](#)), the exchange rate regime ([c](#)), and the issue of overvaluation ([d](#)). The discussion then turns to the costs of these policies ([e](#)) and the reasons for their introduction ([f](#)). Finally, with this analysis behind us, we look at reform options ([g](#)).

(a) Responsibility for exchange rate policy

Exchange rate policy was earlier a government responsibility in PNG. However, Section 58 of the CBA gave this responsibility to BPNG. Section 58 reads:

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 [the bi-annual monetary policy statements] and to achieve the objects of the Central Bank under this Act.

With its reference to the bi-annual monetary policy statements, and to the Act's objectives, Section 58 clearly brings exchange rate policy within the ambit of monetary policy, the exclusive responsibility of BPNG.

International experience shows that it is unusual in high-income countries for exchange rate policy to be set by the central bank (only 4%), but that it is common in low-income countries (43%).⁴² The same IMF survey also notes that "Newer central bank laws increasingly delegate the authority over the exchange rate regime to the central bank" (p.15).

(b) Foreign currency rationing and Kina non-convertibility

As a matter of definition, current account non-convertibility and foreign exchange or currency rationing are the same thing. Current account convertibility means that anyone who wants foreign exchange to import something can get it readily. Rationing means that an importer cannot be guaranteed that they will get the foreign exchange they need to pay for imports. They may have to wait a long time, or they may only get some of what they ask for, or even none.

The IMF first raised the issue of "excess demand in the foreign exchange (FX) market" in its 2014 Article IV report on PNG. Every Article IV report on PNG since has made the same point about exchange rate rationing, that is, a lack of current account convertibility. For example, the most recent (2019) Article IV report on PNG draws attention "to the rationing of FX, which results in undue delays and arrears in current international payments" (Annex p.3).⁴³

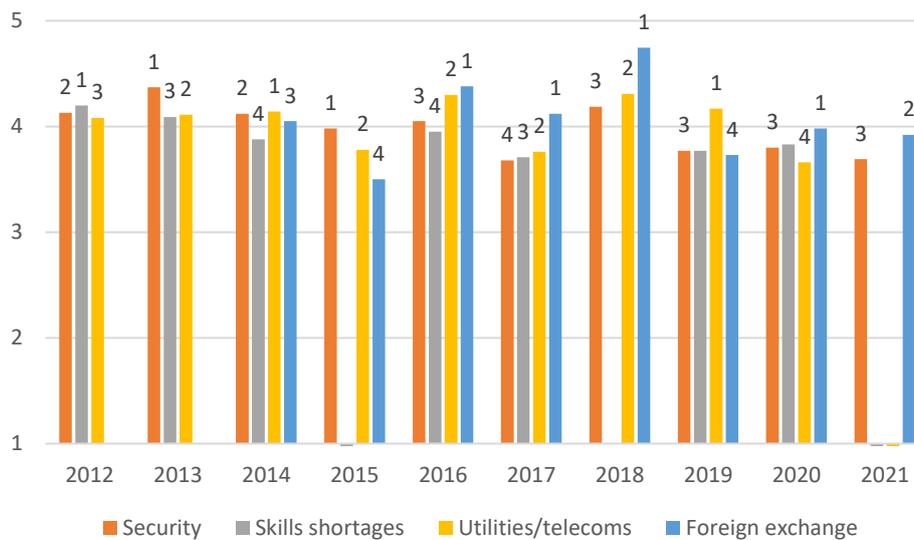
Many other researchers, commentators and organisations have noted the shortage of foreign exchange.

This problem has also been repeatedly stressed by businesses. PNG businesses frequently complain about foreign exchange shortages, and in recent years have often placed this at the top of their list of business constraints. The figure below shows the top constraints listed by business CEOs between 2012 and 2018. Before 2014, foreign exchange was not an issue. But in 2014, it became the third biggest constraint; in 2015, the fourth biggest; and between 2016 and 2018 it was the biggest constraint, more important than security or infrastructure concerns. In 2019, foreign exchange fell to become the fourth biggest constraint, but it went back to being the biggest in 2020. In 2021, it was displaced by COVID-related concerns, and foreign exchange went to second place on the list of business concerns.

⁴² See p. 15 of the IMF 2004 survey [Central bank governance: a survey of boards and management](#).

⁴³ The Article IV is IMF's annual report on member countries. The 2019 Article IV can be found [here](#).

Figure 25. Top four business constraints according to PNG CEOs, 2012 to 2021



Source: Calculated using the annual Business Advantage surveys. Constraints are rated on a scale of 1 to 5, and aggregated over respondents. The four shown are the ones that recur the most over the period. Lack of government capacity was rated as the third most important constraint in 2015 and 2021, and fourth most important in 2018. In 2021, COVID-related restrictions were the biggest constraint. In 2012, access to necessary expertise was the fourth biggest constraint, and in 2013 logistics.

The issue of excess demand for foreign currency has been discussed from time to time in BPNG’s MPSs. Initially, BPNG blamed the banks for using some FX inflows “to provide foreign currency loans (trade finance) and for forward contracts, and other purposes” (March 2017 MPS). In late 2016, BPNG banned trade finance, and introduced other restrictive measures. However, the problem has persisted. The March 2018 MPS noted that “the private sector has reiterated concerns about the accessibility to foreign currency and how it is affecting their business operations.” The September 2018 MPS noted that “demand for foreign currency continues to be greater than supply and consequently there is still a backlog of sell kina orders.”

In the 2019 IMF Article IV, BPNG agreed with the IMF on “the need to restore exchange rate convertibility and to clear the FX orders backlog” (p.11). While BPNG contended that “the true backlog of FX orders is smaller than reported by banks” the admission that the currency was no longer convertible (on the current account) was a significant one.

In its September 2021 MPS, the Bank recently argued that large orders are normally filled within two to three months, while small orders are filled on time, and that therefore there were no outstanding orders (see pp.2 and 4). However, this conclusion is doubtful. First, two to three months is itself a long time, especially if it is after other requirements are met such as obtaining a Tax Clearance Certificate, itself a lengthy process. Second, banks inform us that many importers put in orders with several Authorised Foreign Exchange Dealers (AFEDs) in order to improve their chances of getting foreign exchange. This is a sure sign that there is a problem with convertibility. Third, our consultations with business indicated that foreign exchange availability was still a key concern of business.

It is important to emphasise just what a break with past practices the movement away from current account convertibility is. The March 1975 BPNG Quarterly Economic Bulletin noted “the disadvantages in imposing tight restrictions on the movement of funds, which tend to be self-defeating.”⁴⁴ The hard Kina policy was therefore built on the principle of convertibility: the Kina was to be “freely convertible ... against major world currencies.”⁴⁵ When the currency was floated that policy was retained, at least outside of crisis periods (when the country ran out of foreign exchange reserves). In 1997, two academics wrote: “If exchange rate management is to be judged purely from the standpoint of currency convertibility, Papua New Guinea would have to be awarded relatively high marks, despite the blemish of the 1994 currency crisis.”⁴⁶

It also should be noted that moving away from convertibility is in violation of PNG’s international agreements, since it contravenes Article VIII of the IMF’s Articles of Agreement, which PNG has signed. IMF staff have made these points in their annual Article IV reports every year since 2016. They have also noted the contravention in their annual international report on exchange measures that limit currency convertibility on the current account.⁴⁷

More serious though is the damage that the move away from convertibility has done to the economy and to fiscal discipline. This is discussed in [subsection \(e\)](#).

(c) The exchange rate regime

In 2014, IMF staff reclassified PNG’s exchange rate regime away from “floating” to “crawl-like”. Then, effective May 2016, it reclassified it to “stabilised”. In August 2017, the IMF once again reclassified the exchange rate regime, this time back to “crawl-like”. That classification has since remained unchanged. However, the last report of the IMF was its 2019 Article IV, and examination of subsequent data shows there has been a subsequent shift back to “stabilised” in November 2020.

The IMF defines an exchange rate regime to be “crawl-like” when (a) it is not floating and (b) the exchange rate remains “within a narrow margin of 2% relative to a statistically identified trend for six months or more”. It is “stabilised” when (a) it is not floating, and (b) moves within 2% of an unchanging trend line.⁴⁸

The first requirement for an exchange rate regime to be stabilised or crawl-like is therefore that the currency not be floating. A floating exchange rate is one in which the exchange rate adjusts so that demand equals supply (with or without intervention from the central bank in terms of foreign exchange reserves). However, as discussed in the previous subsection, PNG’s foreign exchange market has been characterised by rationing since around 2014. By

⁴⁴ Quoted in Garnaut, Baxter and Krueger (1984) *Exchange rate and macroeconomic policy in independent Papua New Guinea*, National Centre for Development Studies (NCDS), ANU, p.10

⁴⁵ Goodman, Lepani and Morawetz (1987) *The economy of Papua New Guinea*, NCDS, ANU, p.53.

⁴⁶ King and Sugden (1997) “[Managing Papua New Guinea’s kina](#)”, *Pacific Economic Bulletin*, vo1.12, no.1, pp.20-29.

⁴⁷ See for example, the [2018 IMF Annual Report on exchange arrangements and exchange restrictions](#).

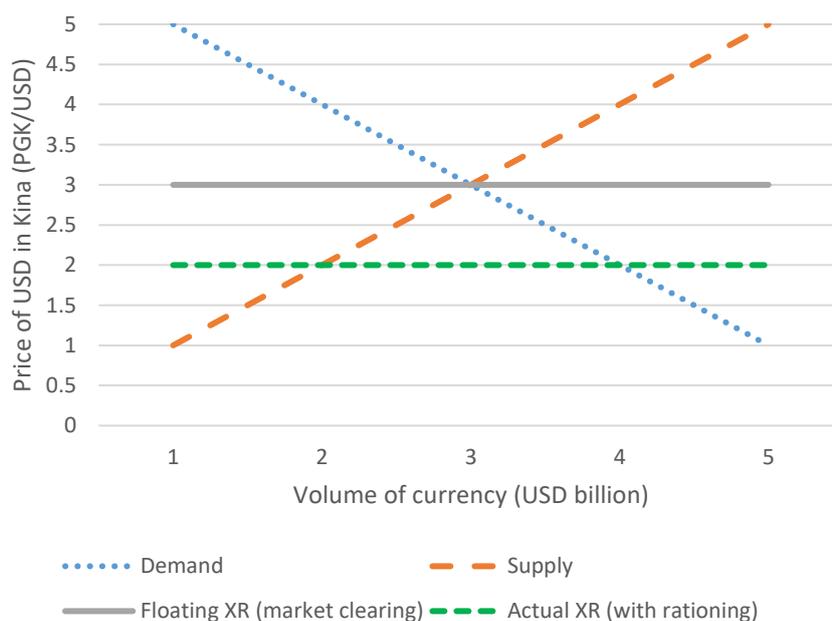
⁴⁸ These definitions can be found in the [2018 IMF Annual Report on exchange arrangements and exchange restrictions](#).

definition, with rationing, demand cannot equal supply as rationing means excess demand. Indeed, if the exchange rate was floated in the current regime, it would collapse given excess demand.

The graph below gives a simple, constructed example of the incompatibility between a floating exchange rate and foreign currency rationing. The two sloping lines show the supply of dollars (upward sloping) and the demand for dollars (downwards sloping). The higher the price for USD expressed in Kina the greater the supply of dollars and the lower the demand. (A higher Kina per USD corresponds to a lower USD per Kina, i.e., a depreciation.)

The market-clearing or floating rate is shown by the grey line, 3 Kina per USD, at which price USD 3 billion of foreign exchange is supplied and USD 3 billion is demanded: the market clears. However, now say that instead of being put at its floating rate the exchange rate is fixed at 2 Kina per USD. Then only USD 2 billion is forthcoming, but at this price, there is demand for USD 4 billion. Therefore, there is excess demand (of USD 2 billion), and the available foreign currency has to be rationed. The simple lesson here is that the floating and rationed exchange rate are different.

Figure 26. An illustrative model of supply of and demand for foreign currency: showing market clearing and rationing regimes



It should be noted that the Kina exchange rate is still market determined, that is, as discussed below, determined in the Interbank Market. However, it is not market clearing: that is, it does not bring about an equality of supply and demand for foreign exchange.

Many other researchers and observers, apart from the IMF, have endorsed the finding that the exchange rate is no longer floating, including BPNG’s own researchers.⁴⁹

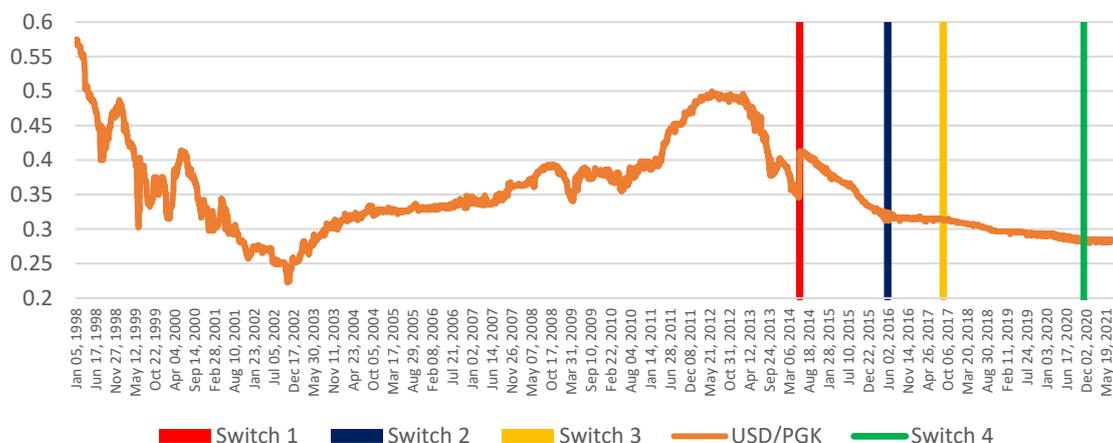
⁴⁹ See the [study](#) by BPNG and Griffith University researchers “Exchange rate volatility and trade in PNG” Griffith-BPNG JPRWP#10, p.20.

An important caveat made by the IMF is that although *de facto* PNG’s exchange rate regime has not been floating since mid-2014, *de jure* it is still floating. Under the IMF’s Articles of Agreement, every country “is required to notify the Fund of the exchange arrangements it intends to apply and to notify the Fund promptly of any changes in its exchange arrangements.”⁵⁰ PNG has not notified the Fund that it has moved away from a floating regime, so that is still regarded by the Fund as the *de jure* regime, even though it no longer reflects the reality of actual exchange rate arrangements on the ground.

The second requirement for an exchange rate to be crawl-like or stabilised is that it follow a smooth trend. This is shown in the five figures below, using daily data from a market website from 1998 onwards. Note that all the five figures, and indeed all the analysis in this section, are based on the USD/Kina or USD/PGK exchange rate. This is because it is the fundamental exchange rate in PNG. All other exchange rates are set with reference to the USD/PGK exchange rate by using “cross country” exchange rates, for example, the AUD/USD exchange rate, and so on.

The first graph shows the entire period from 1998 to September 2021. We can see that ever since the first switch (when the currency suddenly appreciated by 17% and moved away from being floating) the USD/Kina exchange rate has been much smoother. There are, after mid-2014, fewer “ups and downs” or fluctuations. This is a sure sign that the exchange rate has moved away from being floating or market clearing.

Figure 27. USD/PGK from January 1998 to September 2021



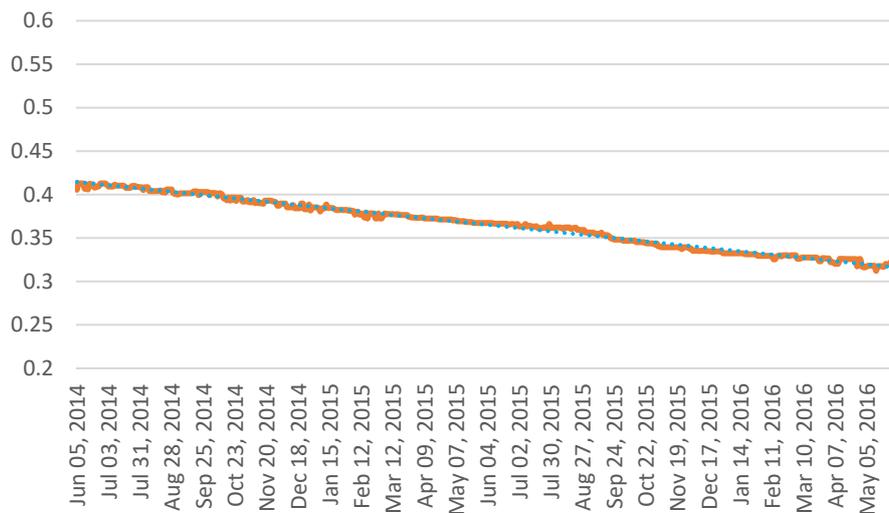
Source: Data for this and subsequent graphs from <https://au.investing.com/currencies/usd-pgk-historical-data>. Note: The switch points are in June 2014, May 2016, August 2017, and November 2020. The data is daily (excluding weekends) from 5 January 1998 to 24 September 2021.

The first “crawl-like” period from June 2014 to May 2016 is one in which the exchange rate depreciated fairly steadily.⁵¹ One can observe from the next graph that over this period the exchange rate moved very tightly around a slowly declining straight trend line. (This period was immediately preceded by the sharp appreciation of the exchange rate at the start of June 2014, which we explain later.)

⁵⁰ This is explained in the [2018 IMF Annual Report on exchange arrangements and exchange restrictions](#), p.43

⁵¹ IMF puts the starting month for this period as April, but in fact it was June.

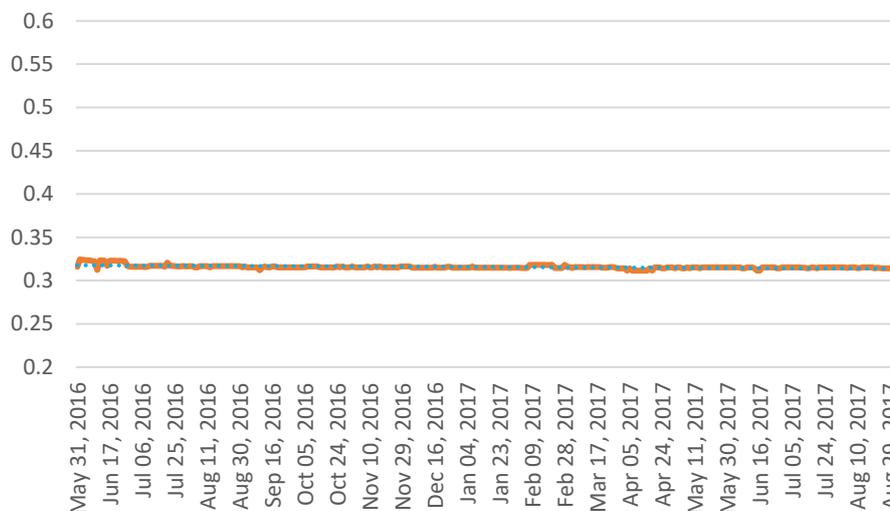
Figure 28. USD/PGK from June 2014 to May 2016 (first crawl-like regime)



Source: <https://au.investing.com/currencies/usd-pgk-historical-data>. Note: Dotted line is a trend line.

In the next “stabilised” period from June 2016 to August 2017, there was almost no depreciation at all. Instead, as the next graph shows, the currency was virtually fixed at about K0.32 to the USD.

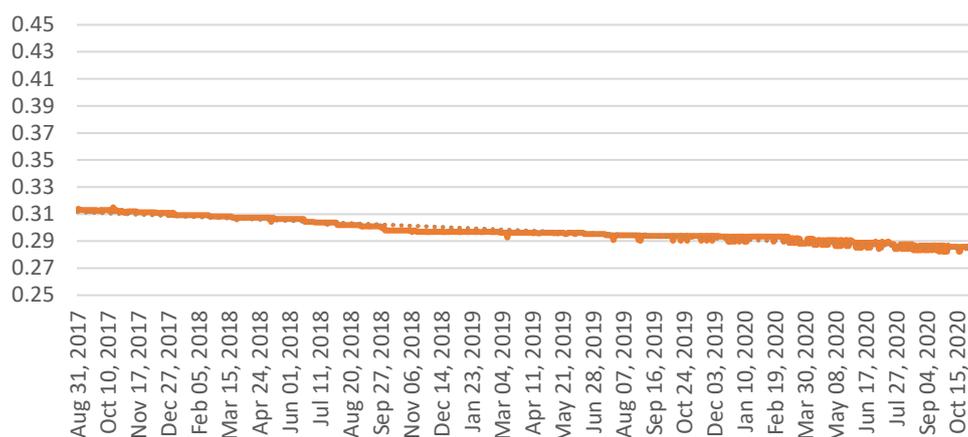
Figure 29. USD/PGK from June 2016 to August 2017 (first stabilised regime)



Source: <https://au.investing.com/currencies/usd-pgk-historical-data>. Note: Dotted line is a trend line.

Then in the third post-floating period, from September 2017 to November 2019, the currency started to fall slowly again, though much more slowly than in the first post-floating period. In that first period (June 2014-Mary 2016), the Kina fell at an annualised rate of 6.7%; between September 2017 and November 2020 it fell at an annualised rate of only 1.2%.

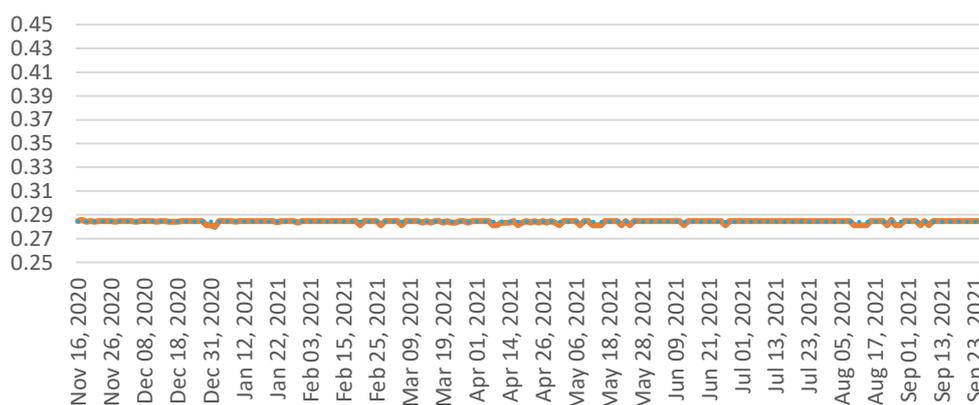
Figure 30. USD/PGK from September 2017 to November 2020 (second crawl-like regime)



Source: <https://au.investing.com/currencies/usd-pgk-historical-data>. Note: Dotted line is a trend line.

Finally, in the fourth period, from November 2020 to the current time, the Kina has stabilised again, this time at K0.285 to the USD.

Figure 31. USD/PGK from November 2020 to September 2021 (second stabilised regime)



Source: <https://au.investing.com/currencies/usd-pgk-historical-data>. Note: Dotted line is a trend line.

In all four periods, one can see that the exchange rate adjustments were very smooth and predictable, the only difference being that they were adjustments around a downward trend in the first and third period, and adjustments around a stationary trend in the second and fourth.⁵²

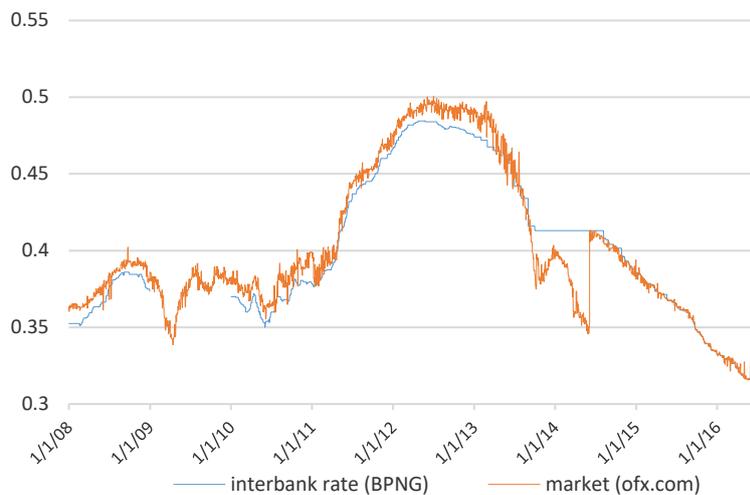
How actually is the exchange rate now set in PNG? And why has it been through the different phases shown above? Crucial to the way the foreign exchange market now works in PNG are the trading bands introduced by BPNG into the foreign exchange market on 4 June 2014.⁵³ Since then Authorised Foreign Exchange Dealers (AFEDs) have been required to always sell within 150 basis points of the interbank rate. This makes the interbank rate the determinant

⁵² The coefficient of determination (R^2) for a trend regression in the first and third periods is 99% and 94% respectively; that is, almost all the variation in the exchange rate over time in these two periods is due to the trend. For the second period, it is only 30%, and in the last it is only 1%. This is because the trend in this period is so close to zero; a zero trend would produce a zero R^2 .

⁵³ As per [this](#) press release.

of the market rate. Earlier the two could have and did at times diverge, but since mid-2014, as the figure below shows, such divergence has not occurred.

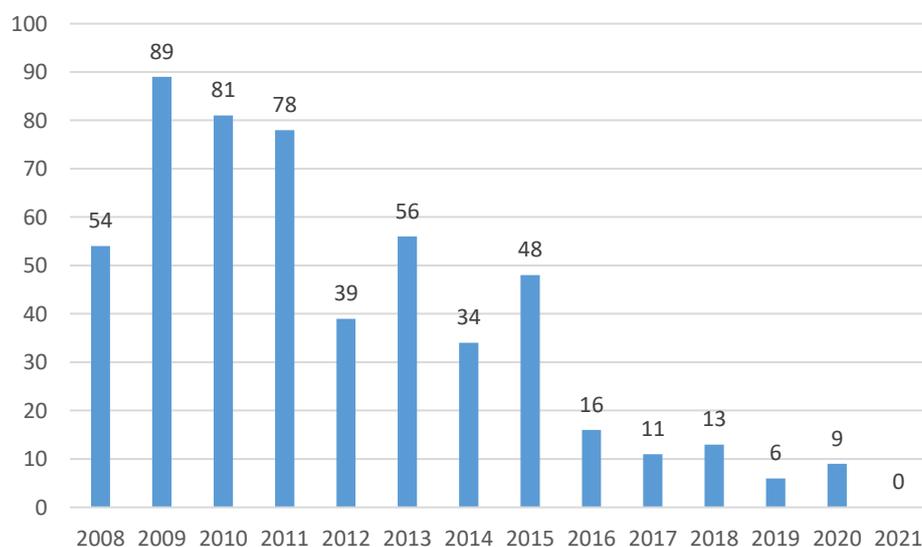
Figure 32. The interbank rate and the market USD/PGK rate, 2008 to 2016



Source: Daily data from BPNG and ofx.com. The overlap between the two lines continues post 2016 to the current day. Data on the interbank rate is missing around 2009. The interbank rate is also known as the mid-rate, and is published on the BPNG website.

So, at least from mid-2014 onwards, to explain the market USD/PGK rate we need to explain the interbank rate. BPNG publishes the daily interbank rate on its website. Analysis of this data is useful to understand PNG’s changing exchange rate regime. If the exchange rate was floating, we would expect the interbank rate to change frequently, in response to both temporary and ongoing changes in demand and supply. As the graph below shows, in the past the daily interbank rate did change frequently, with as many as 89 changes in 2011 for example. However, in more recent years the changes in the interbank rate have been few and far between with fewer than 20 changes each year from 2016 to 2018, fewer than 10 changes in each of 2019 and 2020, and no changes at all in the first 9 months of 2021.

Figure 33. Number of changes per year in the USD/PGK interbank rate, 2008 to 2021



Source: Calculated from BPNG daily exchange rate data; 2021 nine months only.

How is the interbank rate set, and why has the Kina become so inflexible?

The Interbank Market participants are BPNG and the six Authorised Foreign Exchange Dealers (AFEDs).⁵⁴ It is a one-way market, in the sense that BPNG is the only supplier of dollars to the market, and the AFEDs the only buyers.

AFEDs make bids for dollars in the Interbank Market on a daily basis, and are free to submit any bid price they want. However, bids are not responded to; rather, they accumulate, and every month or so BPNG intervenes with foreign exchange from its reserves (average of \$85 million per month for the first nine months of 2021) and indicates how much of that allocation is to go to the different AFEDs. The allocation is made at BPNG's discretion.⁵⁵ In practice, allocations are related to market share. Based on data for 2021 on average BSP gets about 45% of the total intervention amount. BPNG releases this allocation at the latest bid price made.⁵⁶

Only a small share of outstanding orders is matched by the interventions, about 20% based on 2021 data. However, as mentioned in the previous section, importers may place orders for foreign exchange with more than one AFED because they know how difficult it is to get foreign exchange.

The fact that AFEDs set the exchange rate via their bid price seems to be what BPNG means when it refers to the exchange rate regime as (still) floating.⁵⁷ As mentioned earlier, it is true that the exchange rate is market determined (that is, determined by the Interbank Market), but the Kina is not floating because (a) as discussed in the previous subsection, rationing and floating are inconsistent and (b) a float, even a managed float, would result in a lot more volatility. It is nevertheless important to understand why AFEDs do not bid down the Kina more in the Interbank Market.⁵⁸

The first point to note is that there is no benefit to be gained by an AFED from putting in a higher bid price for dollars in the Interbank Market. The bid price does not influence the volume of dollars a dealer will get from BPNG. Therefore, a higher bid price just means the same volume of dollars but at a higher price for the dealer's customers.

What about outside of the Interbank Market? Foreign exchange supplied by BPNG pays for less than 20% of PNG's imports of goods and services. Why don't banks offer a higher price

⁵⁴ ANZ, BSP, Westpac, Kina Bank, First Investment Finance and Moni Plus.

⁵⁵ BPNG's operational guidelines for the Interbank Market states that "[t]he allocation of intervention proceeds will be at BPNG's discretion."

⁵⁶ If the bid price changes between central bank interventions, then AFEDs are allowed to, and do, change their earlier bid prices, so that, by the time of the next intervention, there is only ever at most one bid price since the last intervention.

⁵⁷ When the IMF first said that the exchange rate was not floating, BPNG responded that "The authorities [ie BPNG] emphasized that the USD/Kina rate was market determined" (2015 Article IV, p.11). In PNG's IMF Staff Monitored Program, agreed to in 2020, the PNG Government agreed to "a progressive restoration of kina convertibility and a fully market-determined exchange rate" (2019 Article IV, p. 41). As we clarify, the exchange rate in PNG is market determined, but is not floating.

⁵⁸ Bidding down the Kina (against the dollar) and bidding up the dollar (against the Kina) and paying a higher price for dollars (in Kina) are all equivalent.

to get more dollars from exporters? Here the trading bands introduced in June 2014 play a crucial role. Because of the bands, all AFEDs have to pay the same (interbank) Kina price for dollars to exporters: they are not allowed to “steal” exporters from other AFEDs with the offer of a better price. Thus the only incentive for AFEDs to bid higher for dollars in the Interbank Market (and thus be able to bid higher for dollars from exporters) is that a depreciated Kina should lead to higher dollars in total, for all dealers, from exporters. However, this is an uncertain and longer-term gain compared to the short-term and certain cost of having to charge their customers more for dollars if they bid a higher price in the Interbank Market.

Two other factors further reduce the incentives of AFEDs to bid higher for dollars. One is that some banks borrow in dollars to meet the foreign exchange needs of their customers. They need in the future to recoup those dollars from the Central Bank. If they do this at a lower exchange rate, they will make a Kina loss on that transaction. Another factor is that it is widely reported that BPNG leans on banks from time to time not to bid down the Kina.

In summary, while various factors are in play, it is fundamentally the reliance of rationing combined with trading bands that has changed PNG’s foreign exchange market from a floating to a very stable non-floating regime by drastically weakening the incentives on AFEDs to pay a higher price for dollars.

Why did the exchange rate appreciate by 17% in June 2014, and why has the exchange rate regime been through four different phases since then? We cannot be certain of this, but we can put forward some plausible explanations:

- From late 2013 to June 2014, the interbank and market rate increasingly diverged (Figure 32). Over this period, AFEDs did not bid the dollar down in the Interbank Market due to informal guidance from BPNG, but made massive profits by selling these dollars at a much higher market rate. Then, due to the introduction of the trading bands in June 2014, the USD/PGK market rate was suddenly forced up (appreciated) by 17% on 5 June (Figure 32) to the interbank rate.⁵⁹ The pre-appreciation market exchange rate was more or less market clearing, but with the appreciation, demand for dollars went up, and this is when rationing began, and the backlog of orders started to build.⁶⁰ The earlier informal guidance from BPNG that the dollar should not be bid up in the Interbank Market (which had caused the long period of stationarity in the interbank rate) was then lifted. Dealers thought that a lower exchange rate would once again clear the market, and they gradually put in higher bids for dollars.
- When, a couple of years later, the exchange rate approached 30 cents per Kina, the Central Bank expressed its concerns to the banks about instability and excessive depreciation, and that level became a threshold that, it was viewed, should not be crossed and so banks stopped pushing down the Kina. This second phase went from

⁵⁹ The alternative was for the interbank rate to depreciate suddenly to the market rate, but that would have violated informal BPNG guidance.

⁶⁰ The first reports of rationing started to emerge in late 2014: see for example [this Business Advantage article](#) from October 2014 where the Chief Executive of the Manufacturers Council of PNG talks about “absurd” limits on foreign exchange for importers.

mid-2016 to late-2017.

- 2016 was the first year in which foreign exchange became the top concern of business, and it remained the top concern in 2017 and 2018 (Figure 25). Eventually, the voices of business could not be ignored, and in late-2017, depreciation came to be acceptable again, and it resumed, albeit at a much lower pace. The 30 cents barrier was finally broken around mid-2019.
- This gradual depreciation continued into the COVID-19 era, when bidding up the dollar came to be seen as inappropriate when the banks were under pressure to provide economic relief. Hence the most recent period of stationarity since November last year (see also Figure 4).

The problem with the trading bands is not their introduction, but their use combined with rationing. Consider an alternative scenario of trading bands without rationing. Then AFEDs would be able to fully meet their demand for dollars, and if that demand increased, they would bid a higher price for dollars, and supply would respond (either from exporters or the Central Bank). The Kina would be floating and would move more often.

Consider finally the case in which there was a surge of dollars into PNG. Rationing would end and, if the surge was large enough, there would be upward pressure on the Kina in the face of excess supply of dollars as banks sought to pass on the benefits from a stronger Kina to their customers. (This would be especially the case if BPNG started responding to bids for dollars or if some of the AFEDs started trading dollars through the Interbank Market.) In other words, the foreign exchange market in PNG, as now constituted (in which BPNG only acts as a price-taker), will respond to upward pressure on the Kina, but resist downward pressure. As we discuss in (f), this is exactly what we would expect given BPNG's price stability legislative mandate.

(d) Overvaluation

Just because the exchange rate is not floating does not mean that it is overvalued. However, IMF staff and many other organisations and researchers have also found that, in fact, the Kina exchange rate is overvalued. This is a frequent comment in the annual IMF Article IV reports on PNG, and has also been confirmed by various academic studies. The IMF started recommending currency depreciation for PNG in its 2014 Article IV assessment. In its 2017 and 2019 reports, it specifically described the Kina as overvalued. The World Bank, ADB and commercial banks have all called for a devaluation, as has the Business Council of Papua New Guinea.⁶¹ A recent study by Dr Martin Davies concluded that “the current real exchange rate is overvalued by between 20 and 30 percent” (p.4).⁶² An earlier academic study found that “the kina should depreciate by about 20% to close the gap between the actual and equilibrium

⁶¹ See [Business Advantage](#), 6 October 2015, [Business Advantage](#), 1 April 2020, and [Business Advantage](#), 7 September 2020.

⁶² See Davies (2021) “The path to kina convertibility: study of the foreign exchange market of Papua New Guinea”, Institute of National Affairs (INA) Discussion Paper no. 120.

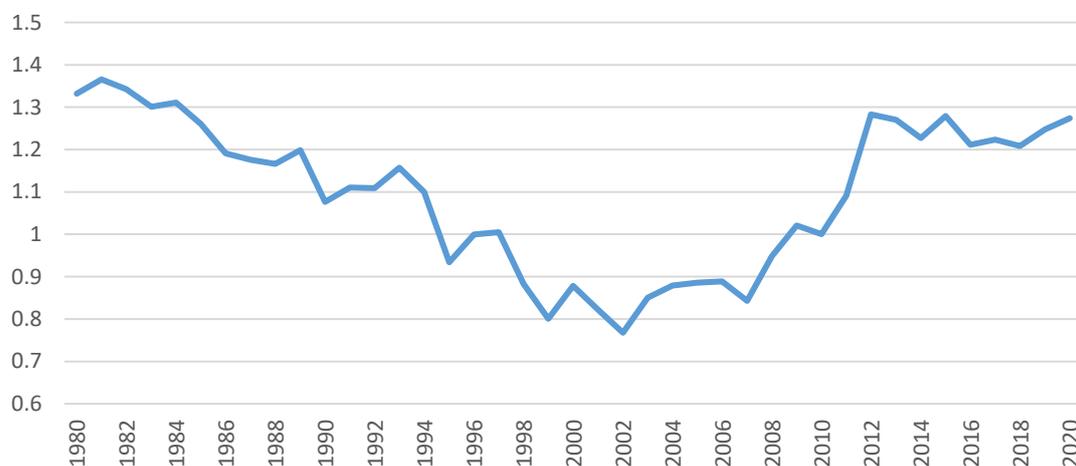
value of the RER [real exchange rate].”⁶³

The surest evidence that the exchange rate is overvalued is the excess demand for foreign currency. The very fact of rationing means that the Kina needs to depreciate to clear the market.⁶⁴

But there is a lot of other evidence as well.

One sign of the Kina’s overvaluation is the fact that the real exchange rate is at the same level as it was during the boom, even though the boom is over, and therefore one would expect a real exchange rate depreciation. The figure below shows the real exchange rate for PNG. The real exchange rate fell over the 1980s and 1990s but recovered with the resource boom. However, although the resource boom ended in 2014, the real exchange rate has not devalued in real terms.

Figure 34. PNG real exchange rate (2010=1), 1980 to 2020



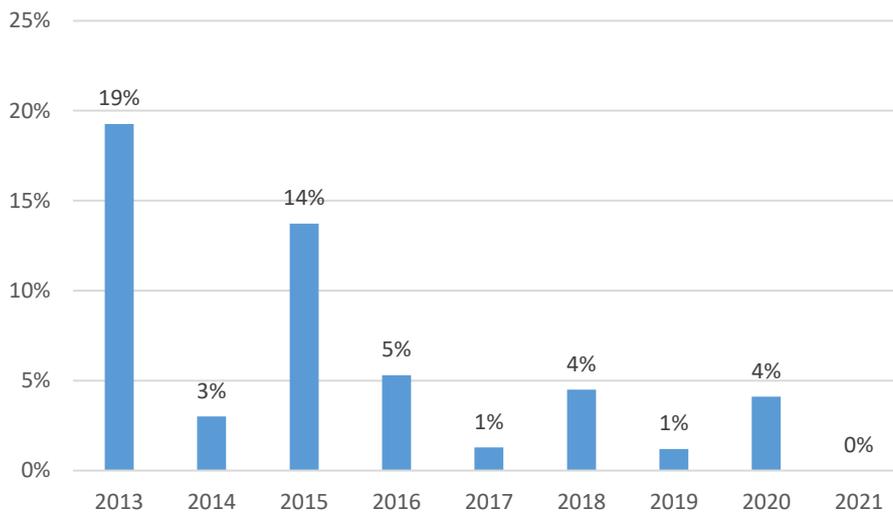
Source: World Development Indicators. The index is set equal to unity in 2010, and shows changes in the value of the Kina relative to a trade-weighted average of several foreign currencies, adjusted for relative movements in inflation.

As shown in the next figure, although there was significant nominal depreciation in 2013 and 2015, in other years depreciation has been very modest. Given that inflation is higher in PNG than its trading partners, and depreciation of the currencies of other trading partners relative to the USD, PNG’s modest nominal depreciation in most years has not been enough to bring about a real depreciation.

⁶³ See Fox and Schroeder (2017) “After Papua New Guinea’ resource boom: is the kina overvalued”, *Asia and the Pacific Policy Studies*, Vol. 5, No. 1, pp. 65-76.

⁶⁴ The alternative would be to release more foreign exchange reserves, but this is unlikely to be sustainable.

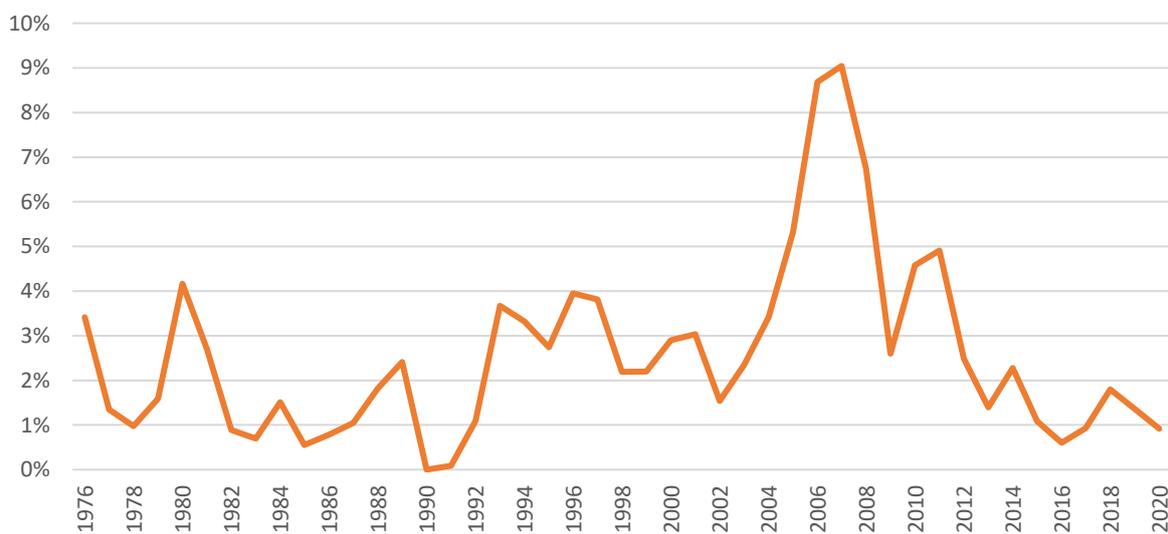
Figure 35. Annual USD per PGK depreciations, 2013 to 2021



Source: Calculated comparing the first daily rate in each year and the last daily rate in the same year from USD/PGK exchange rate data provided by <https://au.investing.com/currencies/usd-pgk-historical-data>. 2021 is up to the end of September and actually shows a tiny appreciation using this method; to avoid confusion, this is replaced by zero.

Confirmation that the exchange rate is overvalued also comes from looking at the resource revenue take, that is, the revenue that flows to the government budget from resource-sector projects. This is a major source of foreign exchange for the broader PNG economy. This peaked during the resource boom but has since fallen away to just 1-2% of GDP. Given the lack of foreign exchange now coming in from resource projects, we would certainly expect a real depreciation.⁶⁵

Figure 36. Government’s resource take as a percentage of GDP, 1976 to 2020



Source: [PNG Economic Database](#).

⁶⁵ This point is confirmed in the econometric analysis of Davies (2021) “The path to kina convertibility: study of the foreign exchange market of Papua New Guinea”, INA Discussion Paper No. 120.

In the 2019 IMF Article IV, BPNG agreed that the exchange rate was overvalued, though it contended that “the overvaluation of the kina is towards the lower end of the range estimated by IMF staff” (p.11).⁶⁶

(e) Impacts of current policies

The fact that businesses have since 2014 regarded foreign exchange shortages as their most or one of their most important constraints points to the costs of current policy settings.

Just to give one example of the concerns of business, in October 2019 City Pharmacy MD Mahesh Patel was [quoted](#) as saying that “the issue of shortage of US dollars has been an ongoing issue over the years ... Patel said CPL and business houses were experiencing constant delays with uncertainty on the availability of US dollars affecting trade ... Patel said a shortage of US dollars meant constant delays in shipments, which meant lost sales and a loss of credibility with the suppliers.”

It is not only importers who struggle to get dollars. Investors find it difficult to get dollars to repatriate profits (make dividend payments to foreign owners). For example, the bankruptcy (Administrator’s) report for the Australian airline Virgin, that used to fly to PNG, [noted](#) that the company has US\$7.75 million “trapped [in PNG] due to a shortage of Australian dollars in Papua New Guinea. As a result, these funds are not expected to be released from Papua New Guinea.”

In general, the policy of non-convertibility has damaged PNG’s reputation as an investment-friendly country. As one 2021 US government [report](#) advising US businesses considering investing in PNG commented:

... [A] lack of available foreign exchange makes such conversions, transfers, and repatriations time consuming. ... While there are no legal time limitations on remittances, foreign companies have waited many months for large transfers or performed transfers in small increments over time due to a shortage of foreign exchange.

The IMF has argued that foreign exchange rationing has increased unemployment in PNG and led to shortages of intermediate imports.⁶⁷ Academic commentators have agreed that rationing is bad for economic growth. Dr Martin Davies in his recent Institute of National Affairs study⁶⁸ concluded that:

The rationing of foreign exchange has led to import compression. This reduces the growth of the economy through reduced investment which diminishes productive capacity, and increases costs which reduces current and future export opportunities. It also reduces the variety and availability of goods for domestic consumers which has

⁶⁶ The overvaluation range estimated in 2019 by the IMF was 11-18%.

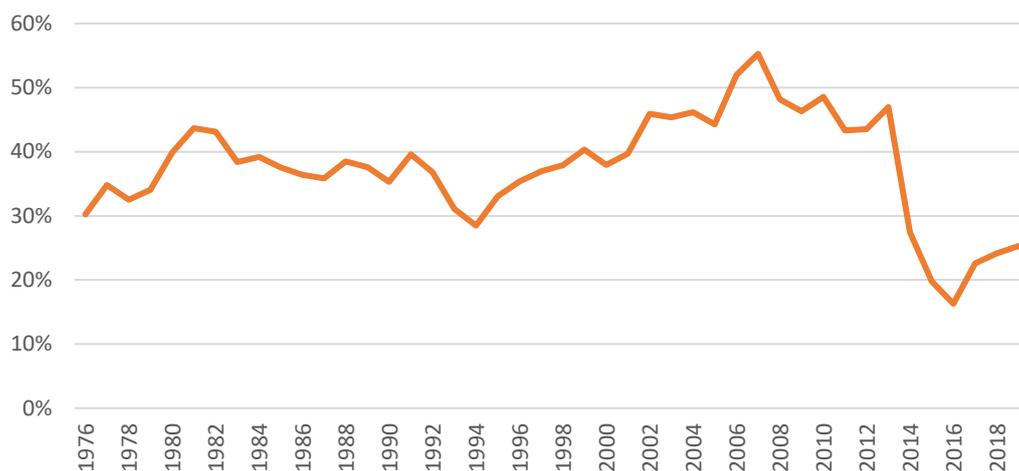
⁶⁷ See p.25 of the 2018 IMF Policy Paper “[Review of the Fund’s policy on Multiple Currency Practices: initial considerations](#)”

⁶⁸ Davies (2021) “The path to kina convertibility: study of the foreign exchange market of Papua New Guinea”, INA Discussion Paper No. 120.

a welfare cost to households. Given this, returning the Kina to full convertibility is of the highest priority. (2021, p.2)

The issue of import compression is an important one. It is often said that PNG is an import-dependent country, but PNG's ratio of imports to GDP is in fact at its lowest ever level. Every country needs to import to grow and promote living standards, but import compression due to foreign exchange rationing has prevented this in recent years.

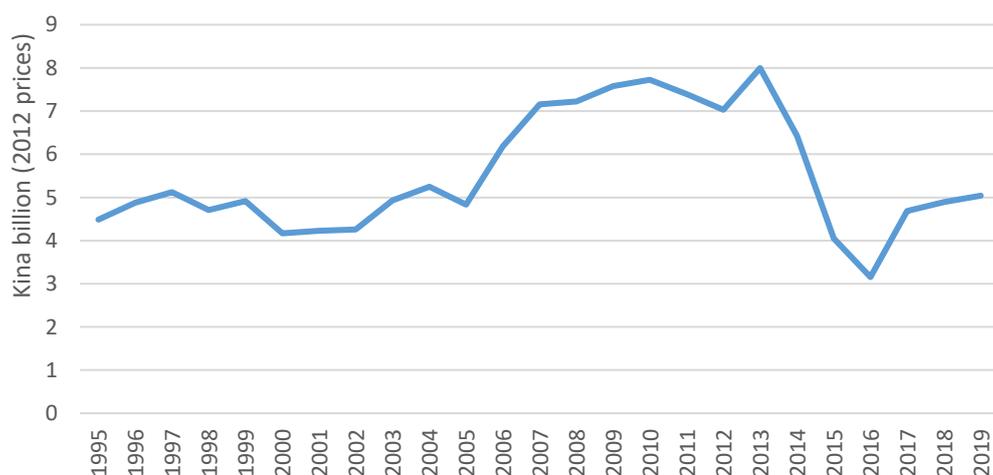
Figure 37. Ratio of imports (goods and services) to GDP, 1976 to 2019



Source: [PNG Economic Database](#).

The next figure removes resource imports and services, and shows only the imports of non-resource goods, such as imported food, and equipment for manufacturing and construction. It shows that, adjusting for inflation, these imports are back at pre-boom levels, that is the levels seen in the 1990s. Given the population and economic growth since the 1990s, this is not what one would expect and certainly would have a negative impact on growth.

Figure 38. Non-resource goods imports (adjusted for inflation), 1995 to 2019



Source: [PNG Economic Database](#) and BPNG QEB.

Rationing is also damaging because of the discretion it introduces into official decision making, and therefore the lobbying that it encourages. Because there is not enough foreign

exchange to clear the market, officials have to decide who gets what, and importers lobby to get to the front of the queue.

In the course of our consultations, we heard stories from businesses having to text the Governor or reach him through an intermediary in order to request the release of foreign exchange to finance vital imports. This is not the sort of economy that will serve PNG well – one where business leaders have to focus on lobbying rather than innovation; and where business success depends on relationships rather than performance.

Another deleterious effect of non-convertibility is on fiscal policy. PNG's hard Kina policy was introduced at independence to enforce fiscal restraint. If large fiscal deficits were run, there would be increased demand for foreign exchange and this would require either devaluation or a reduction in foreign exchange reserves. Devaluation was not allowed under the hard Kina policy, and a reduction in reserves could only be temporary or it would lead to a balance of payments crisis. These were credible threats that restrained fiscal policy.⁶⁹

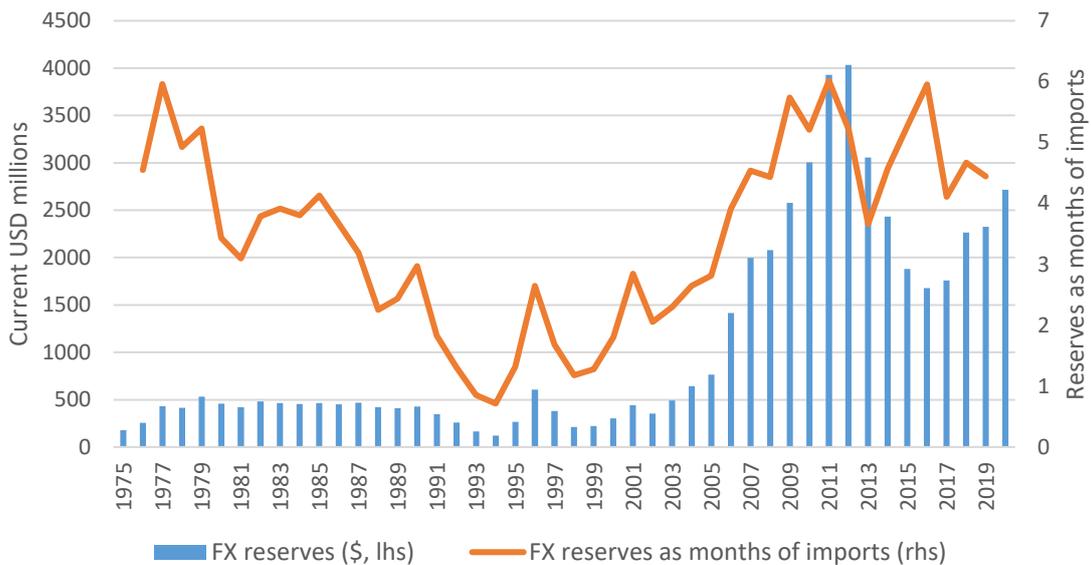
Even when the exchange rate was floated in 1994, the restraining influence of exchange rate policy on fiscal policy was preserved. If there were large deficits, there would be a devaluation, which was unpopular, and/or there would be a depletion of foreign exchange reserves, which was unsustainable.

Now, however, with foreign currency rationing, there is no feedback from the balance of payments to fiscal policy. Governments can run whatever deficits they want, and BPNG will ensure that foreign exchange reserves are protected, and any depreciation limited

We can see from the figure below that foreign exchange reserves, while not as high as they were during the boom, are much higher than in most of the pre-boom era, both in absolute terms, and as months of imports. This shows the priority given by the Central Bank in recent years to protecting reserves.

⁶⁹ In December 1975, Finance Minister Sir Julius Chan said: "...[I]f we try to get out of our problems by running regular budget deficits, then we will be forced to devalue." Quoted in Garnaut, Baxter and Krueger (1984) *Exchange rate and macroeconomic policy in independent Papua New Guinea*, NCDS, ANU, p.11.

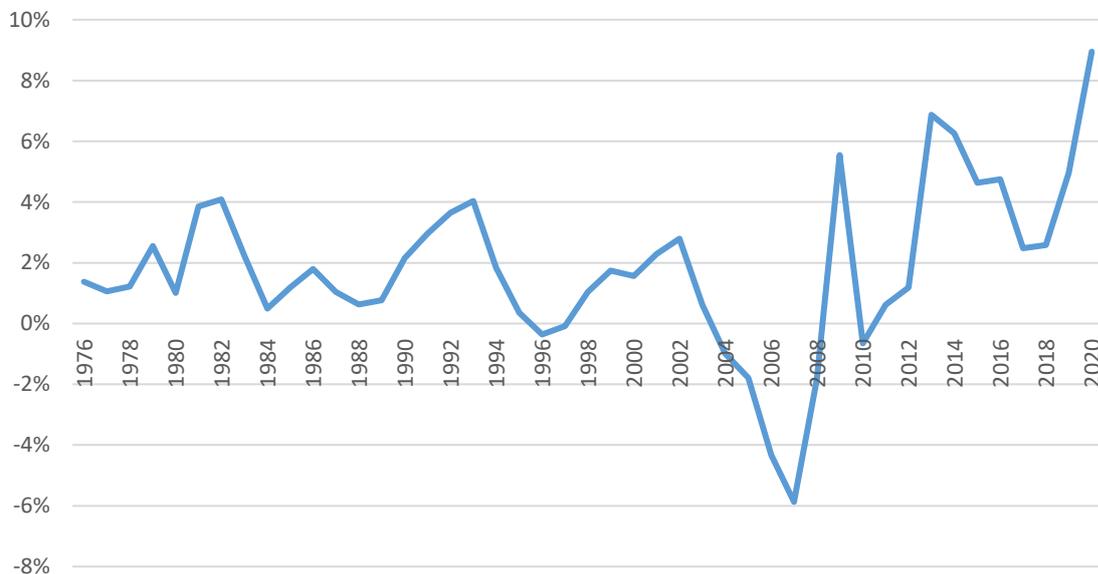
Figure 39. Foreign exchange reserves, 1975 to 2020



Source: [PNG Economic Database](#).

On the fiscal side, however, deficits have never been larger. Prior to the last decade, the greatest run of deficits of more than 2% of GDP was in the early 1990s: four years from 1991 to 1994. However, fiscal deficits have been above 2% of GDP every year since 2013 (eight years in total so far), and were above 4% from 2013 to 2016.

Figure 40. Fiscal deficits (% GDP), 1976 to 2020



Source: [PNG Economic Database](#).

A large fiscal deficit can sometimes be justified (many countries are running large deficits during the pandemic), but a long series of large deficits is more difficult to justify. PNG has adopted various limits on the deficit and on debt, but none of these have been adhered to over time. The earlier deterrent on running large deficits (that the country risked a large devaluation and/or running out of foreign exchange) was effective for many years, and when it failed (as in the 1990s) corrective measures were then taken to reduce the deficit. Now,

with the balance of payments risk of running large deficits removed we are seeing something quite different: year after year of large deficits.

BPNG often advises the PNG Government to practice fiscal prudence. For example, the September 2019 MPS comments that “The high deficit is a concern”. It is ironic that BPNG’s own exchange rate policies have the opposite effect, that is, of encouraging fiscal profligacy.

So far, we have focused on the costs of non-convertibility. What about the effects of overvaluation? It is agreed that depreciation will lead to inflation. The strong link between depreciation and inflation in PNG is well established. The most recent study by Dr Martin Davies reports that “the rate of inflation is particularly sensitive to exchange rate movements” and that “The IMF and the BPNG estimate that pass-through is between 30 and 40 percent, and that it is complete in four quarters.”⁷⁰

An exchange rate depreciation would also stimulate the economy (beyond the elimination of foreign exchange rationing). However, the extent of the stimulus is debated. For example, Dr Davies has argued that a 20% real depreciation would “improve the trade balance by an amount exceeding USD250 million per annum, ... increase real agricultural export income by over 30%, ...[and] stimulate economic activity in the export and import-competing sectors, providing much needed stimulus to non-resource sector economic activity.”⁷¹ In its September 2021 MPS, BPNG countered that “a large depreciation may not necessarily lead to the desired supply response in the non-mineral private sector due to structural impediments” (Box 1)⁷²

An exchange rate depreciation would make it more expensive for the government to service its external debt (about 45% of its total debt). Finally, an important cost of the current foreign exchange regime (described in [\(c\)](#) above) is its lack of transparency, for example, the description by BPNG of the regime as floating when clearly it is not. This leads to confusion, and makes it impossible to work out what BPNG’s objectives are with regards to the exchange rate and therefore to macroeconomic policy more generally.

(f) Explaining the changes

Why since 2014 has BPNG (a) moved away from a floating to a non-floating regime and (b) moved away from convertibility on the current account?

⁷⁰ Davies (2021) “The path to kina convertibility: study of the foreign exchange market of Papua New Guinea” INA Discussion Paper No. 120. See also Sampson et al (2006) “Exchange rate pass-through in Papua New Guinea”, *Pacific Economic Bulletin*, vol.21, no. 1, pp.20-37. A [2008 IMF study](#) noted that “inflation historically has had a strong negative correction with foreign exchange rate movements”, and that “movements in headline inflation are mainly explained by tradable goods, which account for 77 percent of the CPI basket.” There is a broader international finding that exchange rate pass through declines once inflation is tamed, but it does not disappear: see Baqueiro et al (2003), “Fear of floating or fear of inflation? The role of exchange rate pass-through in monetary policy in a changing environment”, BIS Papers No. 19, October.

⁷¹ Davies “[The path to Kina convertibility in PNG: part two](#)”, Devpolicy Blog, 2 August 2021

⁷² It is worth noting though that in the 2012 IMF Article IV BPNG commented that “that allowing the exchange rate to appreciate further would hurt traditional exporters”, and in the 2013 IMF Article IV, BPNG commented that “a strong kina would adversely affect external competitiveness.”

Although Section 58 of the CBA requires BPNG to set out its exchange rate policy in its biannual policy statements, it has never done so. It has at times maintained that the exchange rate regime is floating, and at times has commented on the backlog of FX orders.

Explaining the above changes therefore requires some analysis. In late 2013, when the interbank rate became flat for the first time (Figure 32), there was still an expectation that PNG was on the cusp of a boom, with Liquid Natural Gas (LNG) revenues soon to start flowing in, and other resource projects to follow. The expectation by BPNG was that the Kina would appreciate not depreciate. As time went by though, it became evident that nearly all the LNG revenue was heading offshore. Total resource revenue flowing to the budget fell, and future resource projects started to look more uncertain. Presented with a different longer-term scenario, why wasn't there more of an effort by BPNG to depreciate the currency and clear the foreign exchange backlog that by then had built up?

One reason is that any policy that delivers even a modest boost to inflation cannot be contemplated by BPNG given its current legislative mandate which requires it give complete priority in its monetary policy settings (of which the exchange rate is a part) to price stability. As discussed at the start of this chapter, BPNG is only allowed to consider price stability when formulating monetary policy: the Act states this three times. Moreover, Section 58 implies that the value of the Kina in terms of other currencies is to be set in accordance with monetary policy and its objectives, thereby completely subordinating exchange rate policy to the anti-inflation objective attached by the CBA to monetary policy.

As discussed above in [subsection \(e\)](#), if there is one thing we know about depreciation in PNG it is that it will lead to inflation. BPNG has repeatedly been clear about this, writing for example in the 2017 IMF Article IV that it was "concerned about the impact that depreciation would have on the overall rate of inflation" (p.10). More recently, the September 2021 MPS argued against depreciation on the grounds that "a large depreciation will increase the import prices and domestic inflation, which would adversely affect people's welfare" (Box 1).

In summary, the overriding importance BPNG gives, and is required to give, to combatting inflation has made it reluctant to allow a real depreciation of the Kina and helps explain the persistence of the Kina's overvaluation and therefore of the rationing of foreign exchange.

[\(g\) Policy options](#)

There are many steps that BPNG could take to reduce or remove the overvaluation of the Kina and restore the convertibility of the Kina. This is not a matter of technical capacity, or a problem that requires technical assistance for its resolution. A fundamental problem is that foreign exchange is currently allocated by BPNG to dealers with no reference to their willingness to pay. BPNG could simply set a higher price on the dollars it brings to the market to clear the market. It could also release more of its reserves into the market. It could invite exporters onto the Interbank Market, and that would restore the incentives to banks to bid the dollar up. BPNG could replace allocations on the basis of discretion or market share by an

auction, so that dealers who bid more for dollars got more dollars.⁷³

However, these are decisions that, out of respect for its independence, should be left to the Bank. Our interest is in making sure that the Bank has the right objectives in mind when it is designing its exchange rate policy.

Clearly, the Bank's goal of price stability is unsuitable for an entity that sets exchange rate policy. This goal will always bias decisions against depreciation since, as discussed earlier, depreciations are inevitably inflationary. Recently the IMF wrote advocating depreciation of the Kina saying that the "overvaluation could be largely eliminated over the next three years without boosting inflation excessively."⁷⁴ However, even a moderate boost to inflation cannot be contemplated by an entity whose mandate is price stability.

This is particularly the case given the ineffectiveness of the policy rate (the Kina Facility Rate) in controlling inflation due to excess liquidity. This has been well documented and is discussed elsewhere ([Chapters 3.2](#), [4.1](#) and [5.2](#)). Given this, the exchange rate is the only instrument BPNG has to pursue its only monetary policy objective of price stability. This strengthens the bias against depreciation.

The barriers against overvaluing the exchange rate in order to control inflation that are present in other countries are much weaker in PNG. There is no parallel, informal or illegal market in foreign exchange; or, if there is, it is much smaller than in countries with comparable features of rationing and overvaluation. There is no powerful constituency for depreciation. PNG's large companies are either resource companies, or importers. Depreciation would benefit mainly rural producers, who are not politically powerful. Moreover, there is much public opposition to depreciation because of its impact on inflation and because of memories of the chaotic 1990s. In the past, devaluations have come when PNG has faced a balance of payments crisis. But with the current system of rationing, there is no prospect of such a crisis. Indeed, it seems that the current economic policy settings of overvaluation and rationing could be sustained indefinitely.⁷⁵

International research has found patterns of "dread of depreciation",⁷⁶ "fear of

⁷³ As the IMF comments, "The allocation of scarce FX can be done efficiently through a one-sided fixed volume auction, but this requires a willingness to let the exchange rate adjust fully to clear the market. Scarce FX can alternatively be allocated through an interbank FX market, provided the market functions efficiently, but again this requires a willingness to let the exchange rate adjust fully to clear the market." See the article "Evolution of PNG's FX regime" in [IMF PNG Selected Issues](#), November 2015, p.21.

⁷⁴ PNG 2019 Article IV, p.11.

⁷⁵ Even though this is not the international norm. In general, researchers have concluded that "[i]n the face of fundamental forces driving the exchange rate, 'defending' the national currency does not prevent its depreciation and only leads to massive losses of foreign reserves." (See Loayza and Mendez-Ramos (2016). "Should we fear foreign exchange depreciation?", Research Policy Brief, World Bank, October, and the references therein. However, this may not apply to countries with limited capital mobility and very regulated foreign exchange markets where rationing can be applied. In PNG foreign reserves have actually increased of late (Figure 39).

⁷⁶ Dutta and Leon (2002) "Dread of depreciation: measuring real exchange rate interventions", IMF WP/02/63, April.

appreciation”,⁷⁷ and “fear of floating”.⁷⁸ PNG is an example of the first of these three. Of course, there are some external shocks that put upward pressure on the exchange rate and others that put downward pressure on the exchange rate. BPNG was supportive of the floating regime when it led to the appreciation of the Kina (from 2003 to 2012), but moved away from floating after it became clear that this was leading to sustained depreciation. As shown in (c), PNG’s current exchange rate regime is resistant to currency depreciation, but will allow for appreciation in the face of a positive terms of trade shock leading to an inflow of dollars.

The bias against depreciation needs to be removed from PNG’s exchange rate policy settings. Different analysts and policy makers might disagree about how much a depreciation would stimulate PNG’s economy. But all would agree that the issue of depreciation should be considered with regard to its impact on both growth and inflation, and not only with regard to its inflationary impact, which is the only thing allowed to be taken into account in the way BPNG’s objectives are currently articulated.

There are therefore two options. The first, Option A, is to give responsibility for exchange rate policy back to the Government. The second, Option B, is to leave responsibility for exchange rate policy with BPNG but to change its objectives.

We first consider Option A. If there were an obviously superior exchange rate policy the operation of which it was simple to delegate then there would be a case for this option. The Government would then establish exchange rate policy, and BPNG would implement that policy. This is the case in Australia or New Zealand for example. There, the government policy is that the exchange rate should float. There is no question that the RBA could move to another regime.

However, the problem with this proposal (to make exchange rate policy a government responsibility) is that there is no obvious “best” and simple way to manage the Kina that could easily be set by the Government and then implemented by BPNG.

There are two candidate “set and forget” or “pure” exchange rate policies: freely-floating and fully-fixed.

On the former, although PNG shifted in 1994 to a floating exchange rate regime, the small number of market players, the important role of BPNG as a provider of foreign exchange to the market (from resource projects and foreign loans), and the extreme volatility to which the Kina would be subject if freely floated, all mean that a freely floating Kina is unadvisable and perhaps unviable.

It has sometimes been suggested that the Kina should be permanently tied at a fixed rate to another currency. This would be a return to an even harder version of the original hard Kina policy. There is a logic to this proposal. However, we sense no appetite for it, and it can be argued that it would not be suitable for an economy that is as prone to shocks as PNG is, and

⁷⁷ Abstract of Levy-Yeyati and Sturznegger (2007) “Fear of appreciation”, World Bank Policy Research Working Paper No. 4387.

⁷⁸ Calvo and Reinhart (2000) “Fear of floating”, NBER Working Paper 7993.

that it would be difficult to credibly commit to irrevocably fixing the Kina.

The PNG Government certainly could try to establish a freely-floating or fully-fixed Kina, and then take back exchange rate policy. If, as seems likely, however, these are ruled out on the grounds discussed above, then there are two plausible exchange rate arrangements for PNG left: a managed float and a non-floating but not-fully-fixed arrangement such as a crawling-peg.

Neither of these two “intermediate regimes” is obviously superior to the other. Importantly, both would require BPNG to intervene in the market using its foreign exchange reserves. If either of these regimes were in place, and Government had responsibility for the exchange rate, it would have to instruct BPNG how much to intervene in the market, and what rate to aim at. This would be impractical, and would undermine BPNG independence.

Therefore, assuming that one of the intermediate regimes will apply, Option A – giving exchange rate policy back to the Government – is inadvisable. This leaves Option B which is to change the objectives of the Central Bank so that it takes both inflation *and* growth into account when it sets exchange rate policy. This is the option we favour.

Looking around the world, we can find useful examples of other central banks that have exchange rate policy responsibility but not a singular focus on price stability. The Philippines presents a good example. The relevant legislation states that the Philippines Central Bank (through its Monetary Board) “shall determine the exchange rate policy of the country.” It also says that the “primary objective” of the Central Bank “is to maintain price stability conducive to a balanced and sustainable growth of the economy. It shall also promote and maintain monetary stability and the convertibility of the peso.”

There are some countries that combine a primary price stability objective and responsibility for exchange rate policy. Kenya and Thailand are two examples. However, both countries have long had floating exchange rates, and both have powerful industries that depend on a competitive exchange rate. These circumstances, which do not apply in the case of PNG, limit the scope for the central banks of these countries to support an overvalued exchange rate, even if they wanted to. These are not relevant examples for PNG.

While we favour Option B and think it is advisable for BPNG to have responsibility for exchange rate policy, we do not think the Bank should be totally unconstrained in its exchange rate setting powers. In particular, we argue that BPNG should set exchange rate policy subject to the constraint that the Kina should be convertible on the current account. Foreign exchange rationing for importers should be abandoned as bad for growth and employment, and bad for fiscal policy. As discussed in [\(e\)](#), foreign exchange rationing undermines PNG’s attractiveness as an investment destination. It makes the imports needed for growth harder to get. It introduces too much discretion, and incentivises firms to lobby. And it gives governments a free pass to run fiscal deficits as large as possible for as long as they want. Moreover, current-account convertibility is a principle well accepted both globally and historically in PNG, where it was the bed rock of macroeconomic policy until its recent abandonment, and where it is a principle that PNG has been signed up to since independence given its subscription to Article VIII of the IMF Articles of Agreement.

Many countries, in their central banking legislation, mandate a requirement of current account convertibility (Box 1). We propose that PNG do the same.

Box 1. Legislative mandates to ensure convertibility

A number of countries around the world require their central bank to ensure convertibility, as the following extracts (direct quotes) obtained from various laws through the IMF Central Bank Legislation Database show:

- **Dominican Republic:** The exchange system shall be based on the unrestricted convertibility of the Dominican currency with respect to other currencies.... Any impediment to free convertibility in existence when this Law enters into force should be removed within one year.
- **Jordan:** The objectives of the Central Bank shall be to maintain monetary stability in the Kingdom and to ensure the convertibility of the Jordan Dinar, and to promote the sustained economic growth in the Kingdom in accordance with the general economic policy of the Government.
- **Kazakhstan:** The National Bank of Kazakhstan shall provide for the maintenance of gold and foreign exchange reserves at a level necessary to ensure the stability and convertibility of the national currency, payments to settle obligations of the Republic of Kazakhstan.
- **Philippines:** The primary objective of the Bangko Sentral is to maintain price stability conducive to a balanced and sustainable growth of the economy. It shall also promote and maintain monetary stability and the convertibility of the peso.
- **Sri Lanka:** In determining its domestic monetary policies the Monetary Board shall especially consider their effects on Sri Lanka's international financial position as evidenced by the relation of domestic to world prices and costs, by the level and composition of exports and imports, by the international balance of payments, and, ultimately, by the ability of the Central Bank to maintain the international stability of the Sri Lanka rupee and its free convertibility for current international transactions.
- **United Arab Emirates:** Endeavor to support the currency, maintain its stability internally and externally, and ensure its free convertibility into foreign currencies.

A requirement of maintaining current account convertibility could be drafted, consistent with the IMF Articles of Agreement which PNG has already signed on to, as a requirement that no restrictions should be imposed on the making of payments and transfers for current international transactions.⁷⁹

Since the Kina is not at the current time convertible on the current account, any such legislation could not be imposed with immediate effect, or it would be immediately violated. A grace period could be established. We would suggest that the requirement be binding by

⁷⁹ See the 2018 IMF paper "[Annual report on exchange arrangements and exchange restrictions](#)", p.26. The exact language used there is that PNG maintains "exchange restrictions subject to IMF approval under Article VIII, Section 2(a), of the IMF's Articles of Agreement." Article VIII2(a) of the IMF requires that "no member shall, without the approval of the Fund, impose restrictions on the making of payments and transfers for current international transactions."

the start of 2023.

It is possible that current-account convertibility might need to be suspended in the event of a balance-of-payments crisis. This could be allowed for in the legislation, subject to the authorisation of the Monetary Policy Committee, and a commitment to return to convertibility as soon as possible.

While enshrining the principle of current account convertibility in legislation is important, it is not a substitute for broadening the objectives of the Bank given its exchange rate mandate. Even without rationing, the Bank will need to decide on the exchange rate regime (likely a managed float or a crawling peg), and it will then need to form judgements on desirable exchange rate adjustments, and this would require judgements to be made about the impact of the exchange rate on both inflation and growth.

In summary, we propose that the BPNG retain responsibility for exchange rate policy, subject to the legislative requirement that the Kina be convertible on the current account, and to a broadening of the Bank's monetary policy objectives.

5.2 BPNG's fiscal role

As argued in the previous section, the objectives of BPNG need to be consistent with its functions and capabilities. As we discussed in [Chapter 3.2](#), monetary policy instruments such as the Kina Facility Rate have for some time had limited or no influence over broader outcomes such as bank lending rates and the inflation rate. BPNG itself is well aware of this. In the 2015 IMF Article IV report, BPNG "acknowledged that excess liquidity inhibits the monetary transmission mechanism" (p.11). PNG's excess liquidity reflects a variety of factors, the most fundamental of which is a lack of lending opportunities relative to funds available. This structural problem is unlikely to be solved any time soon.

At the same time, the various policies of the Bank do have real influence on fiscal outcomes. We have documented this at length in various chapters. In summary:

- [Chapter 3.2](#) showed how, given PNG's shallow capital markets, and single-borrower exposure limits, Bank purchases of government securities have helped the government finance its deficit and put downward pressure on interest rates
- [Chapter 4.1](#) showed how the Bank's reduction in the CRR in 2020 increased bank lending to the government given single-borrower limits.
- [Chapter 5.1](#) showed how Bank exchange rate policy has discouraged fiscal prudence by the introduction of foreign exchange rationing.

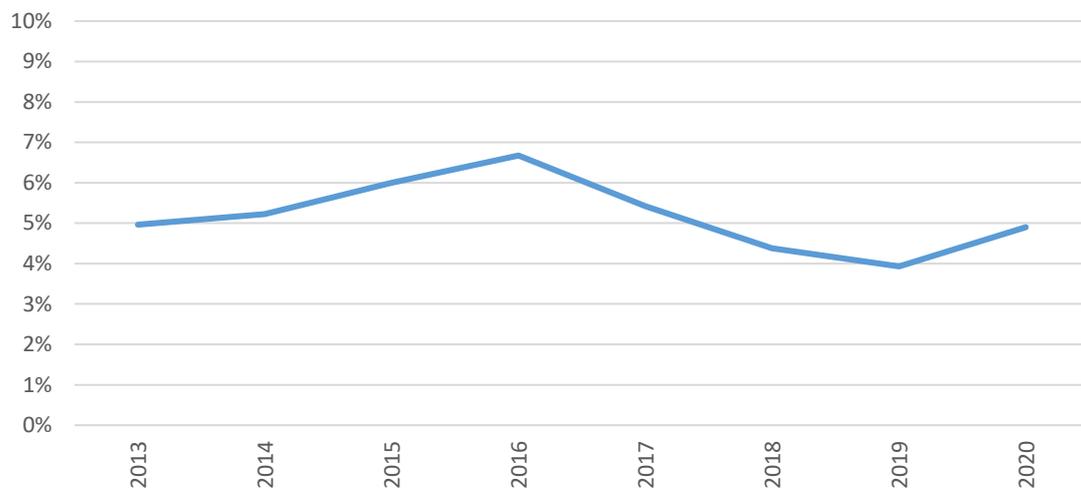
Clearly, in playing a fiscal role, the Bank must be mindful of inflationary risks. However, if controlling inflation was its only objective, or even its prime objective, the Bank would never assist the Government to finance its deficit. As we argue in Chapter 3, the financing role that the Bank plays should be made transparent and limited, but it should not be removed altogether. Given that it will continue to play a financing role, the Bank's objectives need to

be broadened.

5.3 Neglect of economic growth

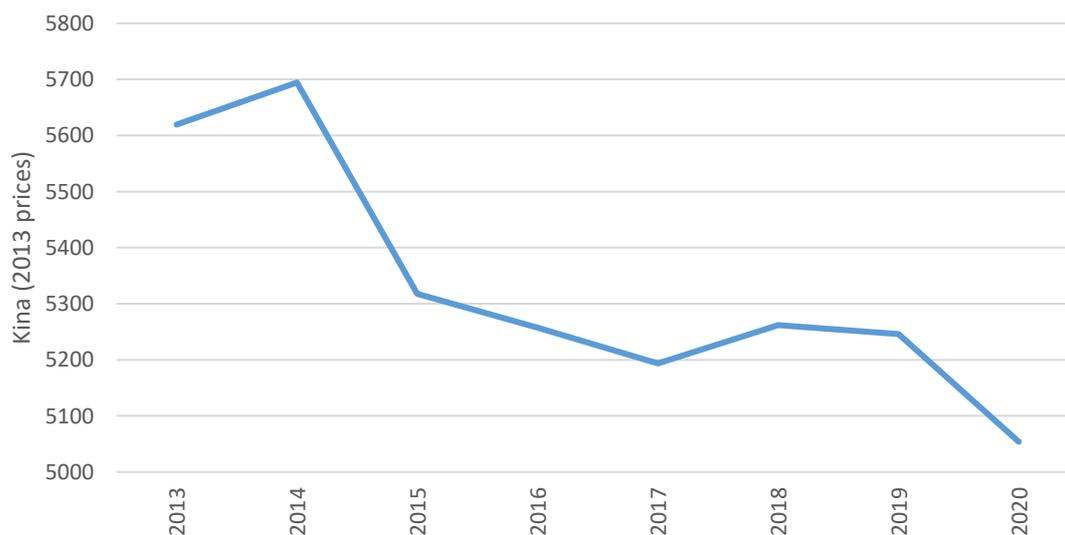
In recent years, inflation has been moderate in PNG (Figure 41). But economic growth has been sluggish in the post-boom or “bust” years. Per capita non-resource GDP growth has been negative, and formal sector employment has fallen every year since 2013 except for 2018 (Figures 42 and 43). The 7% contraction in non-resource GDP per capita between 2013 and 2019 is one of PNG’s biggest ever, and the reduction in formal sector employment by 7.9% over the same period is the biggest ever.

Figure 41. CPI inflation, 2013 to 2020



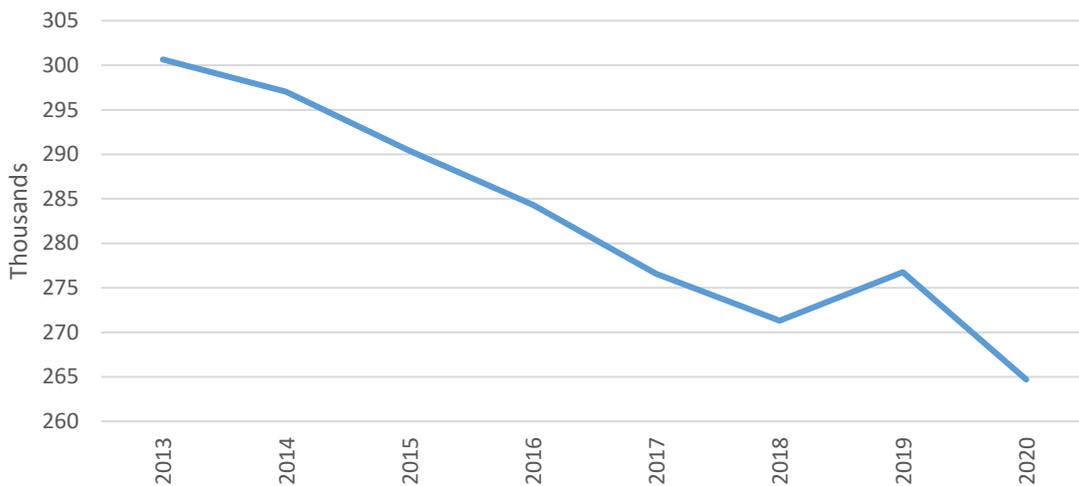
Source: [PNG Economic Database](#).

Figure 42. Non-resource (i.e. non-mineral) GDP per capita, 2013 to 2020



Source: [PNG Economic Database](#).

Figure 43. Formal sector employment in PNG (excluding the public service), 2013 to 2020

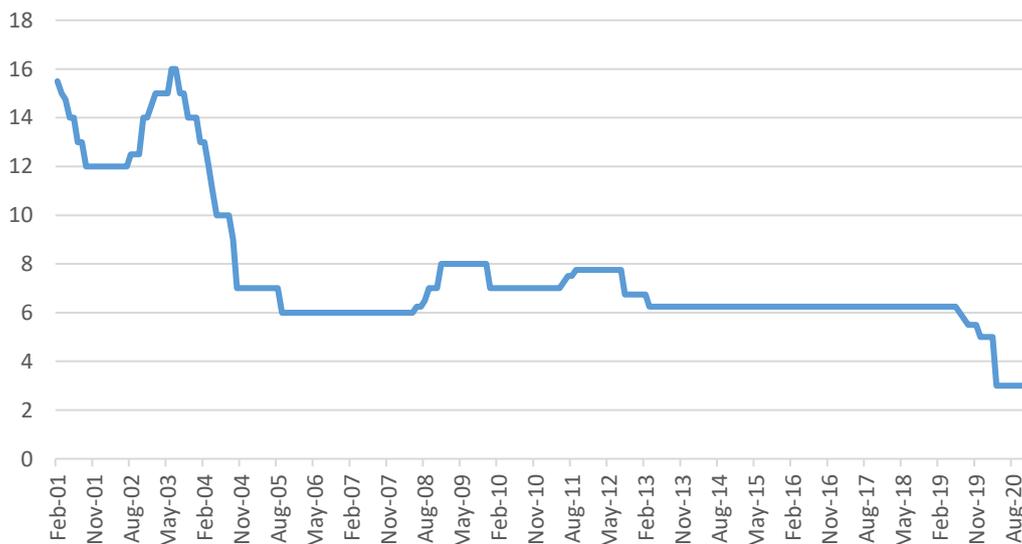


Source: [PNG Economic Database](#).

Little attention has been paid by BPNG to this poor growth performance. While recent growth figures are presented in its Monetary Policy Statements, there has been no mention of sustained low economic and negative employment growth in these statements, and no discussion of the need for stimulatory policies until 2019.

BPNG left the Kina Facility Rate unchanged from March 2013 to June 2019. In early 2013, PNG economy was booming. But the boom finished in 2014 with the completion of the mega PNG LNG project, and non-resource sector growth has been anaemic thereafter, with formal sector employment falling every year except for 2019. However, it was only in September 2019 that the KFR was finally reduced by BPNG, with cuts in both July and August of that year.

Figure 44. The Kina Facility Rate, 2001 to 2020



Source: BPNG QEB Table 6.3.

BPNG often refers to the KFR as its “policy signalling rate”. While the effectiveness of changes in the KFR can be questioned (see the discussion above and in [Chapter 3.2](#)), by not changing the KFR, BPNG was signalling prior to June 2019 that it did not see the need to stimulate the

economy (e.g. by an exchange rate depreciation) despite several years of negative non-resource per capita and formal sector employment growth.

This is confirmed by that fact that, from March 2013 to March 2019, the Bank described its monetary stance as “neutral” (see September 2019 MPS, p. 14). It was only in the September 2019 MPS that BPNG said it had moved to an “easing” policy.

It is understandable that BPNG did not shift to “easing” as early as 2014. Then it was still thought that a resource boom was underway, and indeed that employment and government revenue would grow strongly with the commencement of PNG LNG production. However, by 2015 and 2016 there were plenty of signs and a lot of commentary that the boom was over.

While the Bank should have signalled an “easing” stance much earlier, that it didn’t may in part be explained by its legislative mandate, which, as noted, requires it to set monetary policy solely with respect to its impact on price stability.

As reported at the start of this chapter, most countries in the Asia-Pacific give their central bank a broader mandate than BPNG has. Papua New Guinea should, we argue, adopt the most common approach in the region, namely, to place “price stability alongside other macro objectives” (see Figure 24).

It could be argued that there is no point, or indeed that it would be counterproductive to give BPNG a stronger growth mandate, since central banks cannot influence economic growth. However, this would be misguided. First, as noted in [Chapter 5.1](#) the Bank’s exchange rate policy role certainly has an impact on growth. Second, as noted in [Chapter 5.2](#), in the PNG context monetary policy can be supportive of economic growth by lowering government borrowing costs through a *limited* deficit financing role.

It should be noted that international guidance from the IMF is in favour of giving primacy to the objective of price stability.⁸⁰ We do not question this as general advice, but certainly doubt its applicability to PNG. In fact, the IMF’s actual recommendation is for “a focus on the inflation objective with a credibly flexible exchange rate” (p.47). While this is sensible advice as far as it goes, PNG’s own experience points to the risk that a primary focus on inflation might lead instead to a prolonged embrace of an overvalued exchange rate, especially when the policy rate cannot be used to meet the inflation goal due to poor monetary policy transmission.⁸¹ Since 2000, BPNG has had price stability not just as its primary goal, but its only goal for monetary policy, and, as we have shown, this has led over time to serious problems with the exchange rate regime being set only with regard to inflation control, and

⁸⁰ See the IMF 2015 Staff Report “Evolving monetary policy frameworks in low-income and other developing countries”.

⁸¹ In general, making price stability the overriding or primary objective is recommended to counter “inflationary bias” by building central bank credibility. However, this argument assumes that the central bank has instruments (other than the exchange rate) to pursue a price stability objective, and that exchange rate setting is not subordinated to this objective. See Masson et al (1997) “The scope for inflation targeting in developing countries”, IMF Working Paper, WP/97/130.

without attention to competitiveness and growth.⁸²

Any emphasis on economic growth in BPNG's objectives should be in terms of benefit to the people of Papua New Guinea. An ideal target would be Gross National Income (GNI), which excludes profits repatriated offshore, since they do not directly benefit the PNG people. However, GNI is not measured in PNG. A good proxy is non-mineral or non-resource sector GDP, that is GDP excluding the value-added of the resources sector. Many of the benefits of the resources (mineral) sector flow offshore. Employment within the resources sector is small, and its benefits to PNG are mainly to the extent that the sector generates spillovers to the rest of the economy, for example, through tax revenue. In the absence of GNI data growth in non-resource GDP, rather than GDP as a whole, should be the economic indicator tracked in relation to a growth objective.

A good example of the need to focus on non-resource rather than total GDP is provided by the recent past. Average annual GDP growth from 2014 to 2019 has been 5.8%, which is good. But average annual non-resource GDP growth over the same period has been only 1.6%, very poor. If the focus was on the former, one might conclude that everything was fine, and no stimulus was needed. But the high GDP growth over this period was largely due to the LNG project. The non-resource GDP growth figure is a much better measure of the health of the economy over this period since, as is well known, few benefits from the PNG LNG project have flowed through to the rest of the economy.

To keep the focus on benefits to the people, and bearing in mind data limitations, we argue that the growth objective be cast in terms of employment as well. Employment as a whole cannot be measured in PNG because it is mainly in the informal sector. However, even though the formal sector only employs a minority of the labour force, growth in formal sector employment is a good proxy for the broad health of the economy and for broader employment prospects. This measure also has the advantage of being measured on a quarterly basis and relatively promptly (by BPNG), whereas GDP data is only available annually and with a long lag (the latest GDP data reported by NSO as of September 2021 is 2018).

5.4 Financial stability and development

The PNG financial sector is stable, but its duopolistic or even monopolistic nature is not supportive of development.⁸³ The interest rate spreads and the profitability of the PNG banking sector are among the highest in the world.⁸⁴ BPNG's only duty in this regard is to ensure the stability of the financial system.⁸⁵ It bears no responsibility for the development

⁸² The IMF recommends a focus on medium-term inflation, and states that temporary increases in inflation do not require a policy response (p.30). However, BPNG clearly (and understandably) interprets its policy mandate in a way that rules out even temporary increases in inflation due to depreciation.

⁸³ BSP is by far the major bank. Kina is the second, much smaller domestic bank. ANZ has withdrawn from retail banking but still services the business sector; Westpac is seeking to withdraw.

⁸⁴ According to the IMF "PNG's banking sector was the fourth most profitable of 177 comparable countries in 2011, measured by return on equity" (IMF PNG 2015 Article IV, p.12). In 2018, the interest rate spread was 8.6%, compared to the East Asia and Pacific average of 5% (Howes et al (2019) "[2019 PNG economic survey](#)", *Asia and the Pacific Policy Studies*).

⁸⁵ 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

of the sector. While ICCC has to approve mergers, bank licenses can only be issued by BPNG. The current objective encourages BPNG to place the barriers to entry as high as possible. The current system is highly stable.⁸⁶ Allowing new entrants can only increase risk. A more balanced approach is needed, giving BPNG a mandate for financial development as well as stability. This is not uncommon. The IMF notes that a central bank's mandate often includes "financial stability, and financial market development".⁸⁷

5.5 BPNG as the Government banker

Under Section 8 of the CBA, one of the functions of the Central Bank is that it may "act as banker and financial agent to the Government". This is an extremely important, if often overlooked, function that BPNG plays, covering the following:

- Financing of government debt is not the role of the Central Bank as the government's banker, but selling government debt is. As discussed in [Chapter 3.3](#), the auctioning of government securities leaves a lot to be desired. This is a joint responsibility of both the Treasury and BPNG.
- BPNG helps the Government raise funds, not only through auctions but externally as well. When the Government wants to borrow money from an international organisation, the Bank has a critical role to play, not only as the recipient for such funds, but also as part of the loan negotiations, especially relating to policy conditions. It is very important that Treasury and BPNG cooperate closely in such operations.
- Helping the Government manage its cash flow through the overdraft facility (the TAF) is another important responsibility BPNG has as the Government's banker.

In theory, the job of securing government debt could be given to another entity. For example, in Australia, the Australian Office of Financial Management issues debt securities on behalf of the Australian government. In practice, however, given the small size of the PNG economy (only about 1% of the size of the Australian economy), BPNG will have to continue to perform multiple functions and manage any resulting conflicts of interest.⁸⁸

What objectives should the Bank consider when carrying out this important job of being banker to the government? The Government, like any bank customer, obviously wants to enjoy responsive and efficient banking services. To date, the banking function has not been performed adequately by BPNG. Treasury performance also needs to be improved. But with

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 phase of our work.

⁸⁶ An IMF 2011 [financial sector stability assessment](#) found that PNG's "banking system is characterized by strong indicators" and that "Indicators point to a generally well capitalized and highly profitable sector overall."

⁸⁷ IMF Staff Report (2015) "Evolving monetary policy frameworks in low-income and other developing countries", October, p.47

⁸⁸ See Laurens and de la Piedra (1998) "Coordination of monetary and fiscal policies", IMF WP/98/25.

respect to BPNG, which is independent and governed by legislation, the Government needs to send a clear signal through legislation that it expects better.

In Section 7, the Bank's payments function is highlighted via the objective "to promote an efficient national and international payments system." It is widely acknowledged that BPNG has done a good job in pursuing its payments system objective. Likewise, we would suggest, the banking function should be governed by its own objective also articulated in Section 7, that is, as mentioned, to provide efficient and responsive banking services to the Government.