Monetary policy in Papua New Guinea: a critical analysis

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In 1990, 1994 and again in 1998 Papua New Guinea has had a number of serious fiscal and monetary crises. In 1998 interest rates have exceeded 20 per cent and the exchange rate depreciated significantly. Despite high GDP growth during the 1990s, employment has not risen and investment in sustainable productive activities has been virtually non-existent, except for the oil and gas industries. Human development indicators have fallen, showing that the country has not been able to translate the windfall gains from mineral and petroleum wealth into solid, sustainable development.

This paper takes a critical look at monetary policy in 1998 and makes some suggestions about the lessons that can be learnt to lessen the impact of future crises.

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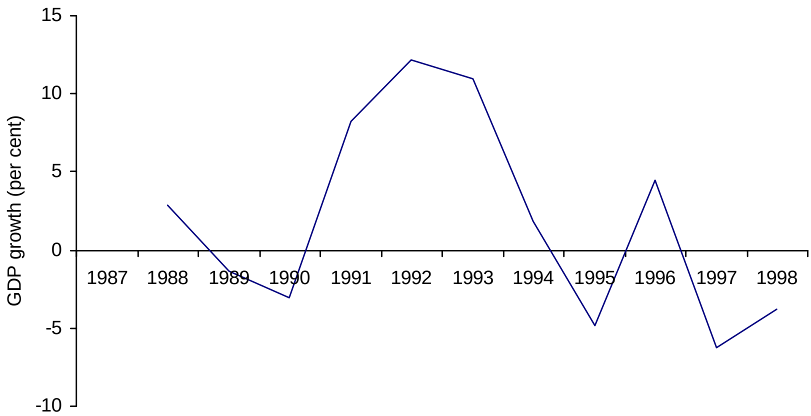
Papua New Guinea's GDP growth has been erratic throughout the 1990s following the shock to the economy of the shut-down of the Bougainville mine in 1989, recovery, then the large fiscal blowout in 1994 resulting in corrective measures that produced a severe slackening of the economy.

The major reason for the sudden turnaround in the Papua New Guinea economy in 1997 was the severe drought associated with the El Niño effect, which also affected other countries in the region. Exports of agricultural products and minerals almost came to a halt due to lack of water for processing and transportation, and imports of rice almost doubled as relief supplies were provided to nearly 1 million people.[1]

Oil production fell and the price of oil declined along with the price of other minerals. Log exports halved as a result of the problems in the Asian economies. Booming agricultural commodity prices in the first half of 1998 have offset these losses. The 1994 devaluation and the rapid depreciation of the kina in early 1998 have given prices in kina terms strong support.

In 1994 the government pushed up interest rates and reduced the money

Figure 1 **Real GDP growth, 1987–98** (per cent)



Note: The 1998 budget estimate was for 6.8 per cent GDP growth but later estimates have revised that downward and the outcome will be negative growth.
Source: Bank of Papua New Guinea, 1997. *Quarterly Economic Bulletin*, December, Port Moresby; Lasaro, I., 1998. *1998 Budget Speech*, Government of Papua New Guinea, Port Moresby; Papua New Guinea, Department of Treasury and Corporate Affairs, 1998. *Economic Monitor*, July, Port Moresby.

supply through lifting the liquid asset reserve ratio to over 30 per cent. In 1998 the 180-day Treasury Bill rate peaked at 23.65 per cent in early May, before falling to 19.25 per cent in early June. It then resumed its upward spiral to reach over 22 per cent at the end of June (Bank of Papua New Guinea *Announcements of Government Treasury Bill Rates*) before gradually falling from the end of August due to the government's new economic package[2] (see Figure 2).

This package was introduced on 29 July 1998 and

- introduced a 10 per cent interest-free cash reserve to be held by commercial banks with the Bank of Papua New Guinea and replacing the present minimum liquid asset reserve
- issued 10 licences for foreign exchange bureaus
- reduced the period that exporters could hold foreign exchange receipts off-shore from 3 to 2 months
- improved the operation of the banking system
- made a number of administrative changes to the bureaucracy and the Bank of Papua New Guinea.

In 1998 the exchange rate has fallen from K0.69 to the US$ and K0.96 to the A$ in September 1997 to as low as K0.39 against the US$ and K0.63 against the A$ (see Figure 3). Rates at the time of writing are US$0.44 and A$0.75 (*Post-Courier*, 11 September 1998) and appear to have stabilised after the introduction of new economic measures and intervention by the Bank of Papua New Guinea.

Inflation in Papua New Guinea has been reasonably well contained but is coming under pressure due to the depreciation of the currency. The figures for the March quarter of 1998 show a 3 per cent increase for the quarter and an 8 per cent annual increase (Figure 4). The government has not officially revised its budget prediction of 11 per cent, but

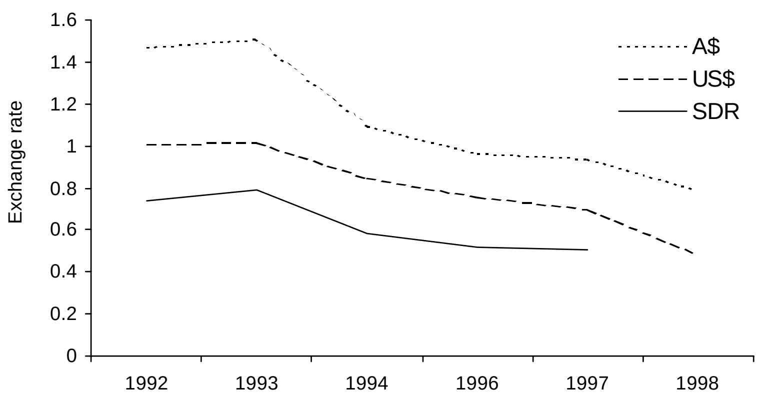
Figure 2 **Papua New Guinea: interest rates, 1989–98** (per cent)

Source: Bank of Papua New Guinea, 1997. *Quarterly Economic Bulletin,* December, Port Moresby; Bank of Papua New Guinea, Announcement of *Treasury Bill Results*, Port Moresby (various issues).

inflation is expected to go much higher as the effects of rice, tinned fish and tinned meat price increases flow through.[3] The government has also allowed a further significant increase in airfares which will have a generally adverse impact because of Papua New Guinea's heavy reliance on air transport.

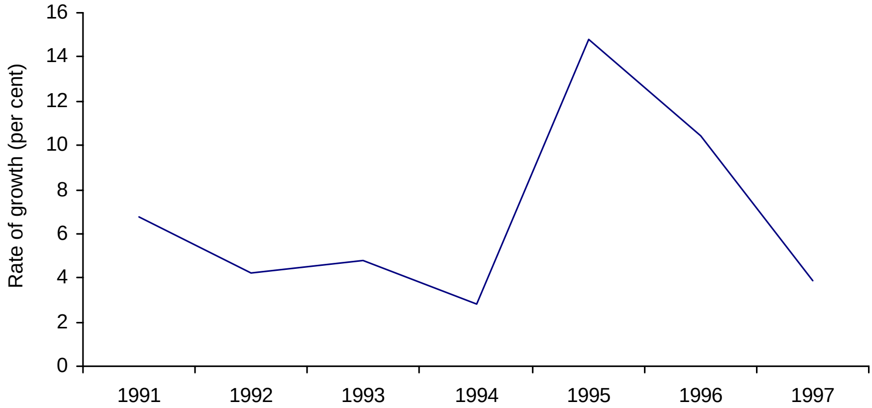
Previous anecdotal evidence suggested that the price of local food at the markets had risen as a result of the increase in the cost of imported foods, goods and services. However, recent anecdotal evidence is that markets are now full of cheap vegetables in Lae and the Highlands.[4] The quick reaction from producers is

Figure 3 **Papua New Guinea: exchange rates, 1992–98**



Source: Bank of Papua New Guinea, 1997. *Quarterly Economic Bulletin*, December, Port Moresby.

Figure 4 **Papua New Guinea: inflation growth, 1991–97** (per cent)



Source: Bank of Papua New Guinea, *Quarterly Economic Bulletin*, (various issues) Port Moresby.

interesting, demonstrating how well information flows in the PNG economy.

Fresh food prices

There is conflicting evidence about the cost of fruit and vegetables. The March quarter consumer price index (CPI) shows a 3.8 per cent increase in fruit and vegetables for the quarter and a 27.4 per cent increase between March 1997 and March 1998, by far the largest increase in any expenditure item in the food section of the index (National Statistical Office 1998). Independent advice from the Fresh Produce Development Corporation indicates a decline in the price of vegetables of around 12.3 per cent for the March quarter.[5] More research is necessary to ascertain why these results differ, but the CPI figure supports the earlier anecdotal evidence.

The classical role of monetary policy

According to economic theory, government could now be expected as a result of recent experiences to take measures that lessen or reverse these effects. The initial shock came from the drought. There was a drastic reduction in income and foreign exchange. Imports continued at the same level, reserves began to fall and the exchange rate started to move down.

It has been reported that at this stage a number of large traders became nervous and decided to bet against the currency, placing large orders offshore for merchandise to substantially increase their stocks within Papua New Guinea. This increased the pressure on the exchange rate. The authorities saw this as an increase in demand and moved to increase interest rates to dampen demand, which they saw spilling over into imports. This view has been maintained (until recently), justifying a high level of intervention in the money market, and forcing interest rates higher.

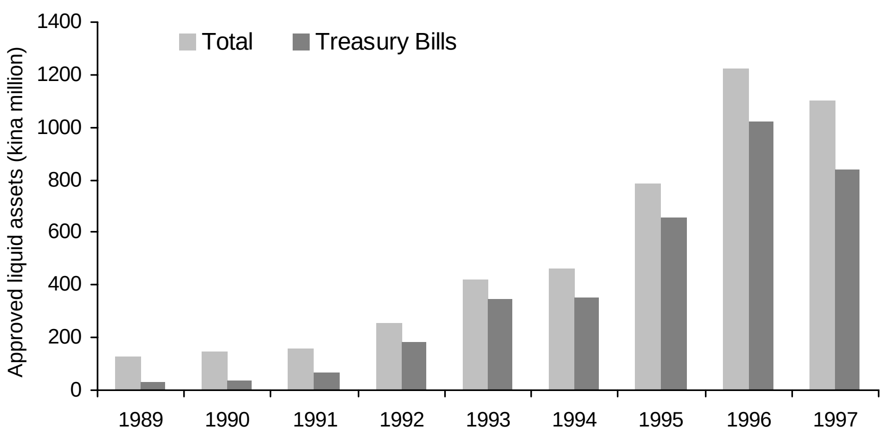
However, interest rates were already under pressure from other sources, especially from the commercial banks which were locking their surplus liquidity into Treasury Bills. When there was a sudden demand for foreign currency from commercial bank customers, or any other requirement for cash, short-term rates were forced up to attract the domestic currency required to meet short-term requirements (including foreign exchange) which put upward pressure on Treasury Bills. The failure to establish a secondary Treasury Bill market or any other form of secondary market to release these short-term pressures resulted in interest rates continuing to rise, despite high levels of liquidity in the banking system.

It has been reported that the Bank of Papua New Guinea has refused to accept bids which were below the rate that it wished to defend.[6] If this is so, the market has been prevented from operating to reduce rates.

The Treasury Bill rate spilled over into commercial rates, which were increasing despite the high levels of liquidity. Commercial interest rates rose to nearly 30 per cent. There was very little demand for loans. However, the increase in commercial rates adversely affected borrowers who already had loans. It also made the creation of employment and economic growth almost impossible. Interestingly, for some of this period, Bank of Papua New Guinea rates remained significantly higher than commercial rates. Thus, commercial banks were able to maintain their overall spread by taking advantage of the higher Treasury Bill rates.

Perversely, there continues to be an increase in bank lending levels with the Bank of Papua New Guinea reporting an increase in lending of K22.9 million in the fortnight ending 19 June 1998 and K12 million in July 1998 (Bank of Papua New Guinea (c): Table 1.1). The Bank could not

Figure 5 **Papua New Guinea: total approved liquid assets, 1989–97** (kina million)



Source: Bank of Papua New Guinea, 1997. *Quarterly Economic Bulletin,* December, Port Moresby.

identify what sectors this lending has gone to but felt that it was for businesses taking up unused loan facilities that they had kept on standby. Private sector credit rose by K357 million in the 12 months to the end of May 1998. One bank was reputedly responsible for much of that lending. The Bank of Papua New Guinea has only recently requested information about this lending which may have played a large part in the exchange rate problems.

There has been an increase in the level of invisibles in foreign payments and it is possible that there has been significant foreign exchange leakage from those bank loans. It has also been suggested that some businesses are being forced to finance stocks with overdraft monies due to the increases in kina costs. It depends on whether margins are sufficiently robust to be able to afford this type of financing. If they are not, it will be unsustainable and some business closures could be expected.

Very quickly the situation got out of control. At that stage the government was involved in the money market because it was still afraid of an inflationary push in demand flowing on to increased imports. It was a major seller in the Treasury Bill auctions. The very rapid decline in the exchange rate passed through to higher prices for imported foods and other consumer goods, thus consumer demand was unlikely to expand. Papua New Guinea is heavily dependent on imports and consumers were adjusting to their kina being able to buy less goods, that is, a declining real income.

In December 1997 K293 million of bank deposits were held by central, provincial and local-level government. It is likely that at least another K300 million was held by statutory authorities such as the National Provident Fund, Public Officers' Superannuation Fund, Harbours Board, utilities, and so on,[7] making up nearly half of total bank liquidity. These bodies would not have a high propensity to import. So who did the government think was likely to create the demand for foreign currency that would put further pressure on the currency? It could only have been speculators who were already forcing rates up through the foreign exchange market. Government intervention in the money market, to the extent that it has pushed up interest rates, could be argued to have been unnecessary and detrimental. It may also have added to the feelings of uncertainty due to non-economic reasons such as law and order problems, infrastructure problems, lack of middle-level managerial staff, corruption and land tenure problems which existed before the recent crisis. This uncertainty has led both foreign and PNG business people to invest their money offshore rather than in Papua New Guinea. Perceptions in Papua New Guinea are that an investment has to earn a return of at least 20 per cent or the money will be invested in Port Moresby real estate or overseas.[8]

It is possible that the increase in interest rates added to the uncertainty and perversely encouraged capital flight as people moved to repatriate capital at whatever short-term cost. The failure of oil revenues from increased production at Gobe and Moran fields to come back onshore quickly may be partially due to this factor; however, it may also be due to reported difficulties in obtaining foreign exchange when it is needed to settle offshore bills, interest payments and so on.

A response to higher interest rates in larger countries would have attracted capital outflow. By comparison, rates in Australia are around 5 per cent.[9] If interest rates were the only factor at work, capital should be flowing from Australia and elsewhere to Papua New Guinea and working to stabilise both interest and exchange rates in Papua New Guinea.

Obviously, currency speculators are more sophisticated and interest rates have been discounted against real and expected exchange rates as well as foreign currency availability. Exporters have also decided to hold receipts off-shore as long as possible because of the uncertainty in the currency market.

One possible reason for the lack of capital inflow is that Papua New Guinea is a small country and has a currency that few people have heard about. Therefore, it doesn’t attract the attention of large overseas currency speculators. Another likely reason is that Papua New Guinea is no longer an attractive place to invest for a number of reasons discussed elsewhere (Duncan and Lawson 1997; Garnaut 1998; Manning, *Post-Courier* 12 June 1998; Papua New Guinea Chamber of Mines and Petroleum, *Bulletin*, various issues). If the government’s reason for pushing interest rates higher was to attract foreign investment, it was doomed to failure.[10]

Components of the exchange rate

There are two elements of Papua New Guinea’s total foreign reserves that are not included in the supply of foreign exchange made available in the market place. They are Australian grant funds and receipts of the state-owned Mineral Resources Development Corporation from sales of its share of mineral and petroleum products.

It is assumed that these foreign exchange inflows are excluded to try and insulate the country from ‘Dutch disease’[11] effects and to build up total reserves after the very low levels of 1994. The rationale for exclusion of any foreign exchange components during an exchange crisis caused by natural disasters is hard to fathom.

It is unlikely that inclusion of these two elements would have a lasting effect on the exchange rate. They might cause the kina to appreciate slightly in the short term. However, after the initial effect of having more currency available, adjustments would again be made according to the underlying forces in the economy which determine the demand for the kina and for foreign currency.

Another aspect of the foreign exchange crisis has been the failure of the government to draw down on aid and loan moneys that have already been agreed and which are increasing interest costs. This, combined with the failure to access IMF and World Bank funds, has meant that several hundred million dollars have not flowed into Papua New Guinea. This is not a new problem—K300 million made available by the World Bank for the reconstruction of East New Britain after the 1994 volcano was reallocated from existing loan approvals.

If Papua New Guinea had adopted a true floating exchange rate and had utilised all available sources of foreign capital available to it, the exchange rate may have settled at a higher rate than its current level.

Components of the interest rate

The interest rate has been forced up by three factors: competition for foreign reserves, government and Bank of Papua New Guinea intervention, and problems in the domestic banking system. This is despite the fact that there are more than adequate liquid reserves and that they have fallen only marginally since 1997.[12] In a perfect market such liquidity would force banks to compete for lending opportunities and this would force interest rates down. The conundrum is that this has not happened in Papua New Guinea, pointing to the fact that information flows and alternative investment opportunities have not developed sufficiently to create the necessary competition to push interest rates in the same direction as liquidity levels. The introduction of new banks into Papua New Guinea in the early 1980s to provide competition did not solve this problem and therefore the solution has to be found elsewhere.

The government and the Bank of Papua New Guinea have intervened for different reasons. The government has intervened when it has been short of cash to meet its commitments. Unfortunately it is not easy to determine when the government is selling Treasury Bills, any more than the real financial position of the government is visible at any one time. If there are short-term cash flow problems there is a good reason for government to go into the marketplace, but it is important to distinguish between legitimate financial problems and bad cash management. Officially, the fiscal regime has kept expenditure within revenue constraints. However, there is doubt that actual expenditures have been kept under good control and there have been periodic government decisions that make such controls harder to impose.[13]

It has also intervened to dampen demand, which it saw as spilling over to imports. There are no official statistics available, however it appears that import duty receipts are running significantly below budget and that this trend has increased during the year.[14] If this is so the volume of imports must be significantly down because of the increased costs due to the falling exchange rate. This suggests that the exchange rate has already affected the level of imports and the assumption about a demand overhang is false.

The failure of the domestic banking system has been that there are no alternative money sources to the Treasury Bills, or if there are, they are not working properly. There is virtually no secondary money market whereby short-term liquidity requirements could be satisfied. This is for two reasons. First, the commercial banks are quite happy to watch Treasury Bill rates rise. Money on deposit with the Bank of Papua New Guinea at rates above 20 per cent earns an income that any manager would be proud to take to the board. Moreover, it is risk-free.

The average spread between borrowing and lending rates of the commercial banks from 1994 to 1997 was 5.8 per cent. In May 1998 the spread had increased to 9.23 per cent which shows that the banks have been able to take advantage of the high Treasury Bill rates to increase profitability (Bank of Papua New Guinea 1998b, 1998c). When interest rates are high the banks will tend to buy Treasury Bills rather than lend for commercial or productive purposes. It is also unlikely that there will be projects seeking funding at these high rates of interest.

Another reason that the secondary bill market has not emerged to dampen interest rates is that the stamp duty payable on any transaction in Treasury Bills is 1.5 per cent, which acts as a disincentive to trade in bills. It is a short-sighted tax because if it discourages trading in bills it is detrimental to the rest of the economy, and it does not raise significant revenue. It would therefore make sense to remove the stamp duty in order to encourage the bill market.

Another possible solution is to widen the market for Treasury Bills or encourage some other form of bond market for public investment. This would provide competition for the banks, forcing them to reduce the spread between borrowing and lending rates. It would also lead to a reduction in bank liquidity as depositors withdrew funds to buy Bills or bonds. This would reduce competition by the commercial banks in the official market and provide a further constraint on interest rates.

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Provision of information

Any visitor to Papua New Guinea remarks on how open the press is and how easy it is to obtain information. Unfortunately, this is not the case within government and especially with regard to information about the economy. The main reason is that the government is not at all clear about what is happening in the economy. For example, predictions of GDP growth, interest rates and exchange rates in the Treasurer's Budget speech (Lasaro 1998) have been heavily discounted and GDP growth has now been revised downward from 6.7 per cent at the time of the Budget to -3.8 per cent in July (Papua New Guinea, Department of Treasury and Corporate Affairs 1998: Table 1).

It is not clear that the government knows what its cash position is. The Department of Finance reports a shortfall in revenue, while the Internal Revenue Commission is reported to have received more money than it budgeted for in the first half of the year. The private sector and the National Economic Summit have requested government to carry out an independent audit of its financial position. There can be no debate and no openess if the government doesn't know the factors at work in the economy and the public doesn't believe what the government is saying.

Assumptions about the effects of certain policy decisions need to be rigorously debated and challenged. What are the components of demand? Is it necessary to mop up liquidity or has that already happened as a result of the depreciation of the kina? How does the government expect to stimulate growth when interest rates are so high and government is under-performing in recurrent expenditure, development expenditure and income collection (Manning, *Post-Courier*, 26 June 1998; Papua New Guinea, Department of Treasury and Corporate Affairs 1998).

Government should report its interventions in the money market and explain its reasons for doing so. If it is for cash-flow reasons or for other macro-management reasons, these need to be explained and justified.

The prescriptions of the International Monetary Fund and World Bank need to be more open to debate. It has been stated that the IMF wanted interest rates to increase to 35 per cent and additional taxes of K80 million to be raised. This would have further strangled an economy already in recession.

Brogan et al. (1998) have drawn attention to the need for greater transparency about the economy and for institutions such as the Auditor-General and the Parliamentary Public Accounts Committee to be given more 'teeth' and support from within the parliament as well as from the general public. This will go a long way toward exposing some of the assumptions behind certain government decisions and encourage debate, perhaps leading to improvement in the formation of its assumptions.

Recommendations for policy

Assumptions about the PNG economy, particularly those relating to the import overhang, led to faulty government policies. With IMF encouragement, interest rates have been pushed up and the exchange rate has been allowed to fall. This has resulted in further stagnation in an economy that has a history of poor employment creation. Official inflation rates for the 1998 June quarter are not yet available but the dramatic increase in prices for rice, canned meat and canned fish have drastically reduced the standard of living of urban populations, especially in Port Moresby, without access to gardens or good markets.

IMF prescriptions, based on assumptions that Papua New Guinea will react in the same way as much larger economies, need to be carefully examined. It is probable that the remedies to PNG's problems will be different to the classical policy prescriptions of demand and exchange rate management because of incorrect assumptions about import overhangs and liquidity levels.

- Papua New Guinea, like the much more powerful Southeast Asian economies, is powerless to defend its exchange rate against underlying economic forces. Recent interventions seem to have broken the no-confidence cycle and halted the decline in the currency. Attempts are under way to gain access to promised IMF and World Bank funds and to raise commercial funds to meet exchange shortfalls. These may depend on the passage of the value-added tax legislation, a condition of the IMF and Bank commitment.
- Sudden increases in demand for imports need to be carefully analysed to ascertain whether they are short-term speculative increases or longer-term increases in demand which will place sustained pressure on the currency. It is possible that the Bank of Papua New Guinea understood that the increase in demand for imports and credit at the end of 1997 was of a short term and self limiting nature.[15] If this is so, it is hard to understand why interest rates were pushed higher during the start of 1998 and allowed to remain so high for so long. If the IMF was involved in this decision, it demonstrates a failure to understand PNG conditions.
- Government needs to foster debate about its policies and the prescriptions of international agencies which can make wrong assumptions, leading to wrong advice.
- The money market needs to be opened up. A secondary Treasury Bill market should be established. The stamp duty on Bill transactions should be removed to encourage the market to develop. Consideration should be given to placing Treasury Bills and commercial deposits on the same tax-free footing.
- Consideration should also be given to making Treasury Bills or some other form of instrument available to small depositors and government investors to create competition for deposits with the commercial banks.
- Provincial and local-level governments should be encouraged to place surplus funds in interest-bearing deposits rather than cheque accounts. Increased competition in the banking system would see institutions competing for these funds.
- The foreign exchange system needs to be inclusive of all currency coming into the country.
- Greater effort has to be made to improve the capacity to absorb concessional and donor funding to improve development performance as well as bring foreign currency into the country.
- Opening of secondary money markets should lessen pressure on interest rates and downward pressure on the currency.
- By holding official interest rates at a high level, commercial rates have also risen to a level that prohibits borrowing for investment purposes. This means that the only people

being affected by the high rates are those who have already borrowed money at lower levels. This represents a potential problem for an already shrinking economy because it will place a number of businesses in jeopardy.

Notes

1 Transport to and from the Ok Tedi mine is via the Fly River. When the river levels fall too low production is halted. The overall mineral production effect was relieved to some extent by better than expected revenues from the Lihir mine, which came on-stream earlier than expected due to the prolonged dry weather.

2 The package has recognised some of the problems outlined in this paper, particularly high interest rates and falling exchange rates. It appears to have been effective in the short term. It remains to be seen if it will have a long-term impact—this will depend on commercial bank reactions to it. Consideration of longer term developments is outside the scope of this paper.

3 The retail price of rice has more than doubled in the first 6 months of 1998. Recently a 5 per cent reduction was announced as a result of the appreciation of the kina against the US dollar.

4 This is probably due to a twofold effect. During the drought rice sales increased substantially before aid supplies started to arrive, suggesting that people were using savings to feed themselves. The increased food sales could be to replace the depleted cash reserves. A second effect could be the expected reaction to a devaluation where it becomes more attractive to produce food domestically.

5 Fresh Produce Development Corporation, June 1998. This is taken from a simple average of 31 items at Gordons market in December 1997 and March 1998. Different weightings could well alter this observation.

6 Personal communication with a commercial bank executive.

7 Conversations with Bank of Papua New Guinea staff. Deposits held by these bodies are no longer recorded separately in official records so cannot be easily verified.

8 The author interviewed a number of PNG business people in Mt Hagen who freely admitted that they would not invest in their home province and preferred to invest in Australia even though the returns were lower than they could expect in Papua New Guinea.

9 Reserve Bank of Australia, Official Cash Rate 16/06/98.

10 A government advisor stated privately that interest rates could rise above 35 per cent—which is reportedly the level the IMF would like to see—and still not attract capital inflow.

11 Where a country maintains a higher exchange rate because of a windfall gain in foreign currency earnings which distorts against long-term sustainable development in agriculture and other export or import-competing industries.

12 Liquid commercial bank reserves peaked in 1996 at K1,224 million, rising from K129 million in 1989 and falling to K941 million in March 1998 (Bank of Papua New Guinea(b): March 1998)

13 Decisions to give all members of Parliament K10,000 to help their electorates celebrate independence day and to increase their electoral development funds to K500,000 per head do not provide incentives for the public service to restrain its expenditure.

14 Details of revenue shortfall are not

available but the Internal Revenue Commission reported that revenue is down by 8 per cent despite improved collection methods.

[15] Where unusually high levels of stocks exist and interest rates increase, the companies holding stocks tend to be at risk because the higher rates of interest slow demand for their products. The unusually high holdings of motor car stocks in Papua New Guinea could be due to this reason.

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