Monetary policy under the financial and economic programs

A brief note on the conduct of monetary policy for macroeconomic stability, 1994–2000*

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This paper explains how the central bank conducted monetary policy with the objective of achieving price and exchange rate stability in Papua New Guinea between 1994 and 2000, the period of the financial, economic and structural adjustment programs. In this context, sustaining macroeconomic stability is taken to mean achieving and maintaining low inflation and a competitive kina exchange rate. The discussion is brief, and some matters will not be discussed, as the paper is not intended to be highly technical.

Generally, monetary policy ‘sets the framework within which the commercial banks carry out deposit taking and lending operations’ (Dahanayake 1982:147). Thus, monetary policy should provide a stable economic environment conducive to providing sufficient liquidity for the economy.

The objective of monetary policy in Papua New Guinea has been to ensure there is sufficient liquidity1 to support growth of economic activity in the private sector, excluding mining and petroleum, that is sustainable in the medium term. A longer-term objective is achieving and maintaining a sound and efficient financial system.

Prior to 1993, the intermediate target of monetary policy was the growth in credit to the private sector, excluding the mining and petroleum sectors. This was based on the existence of a predictable relationship between the
nominal GDP of the private sector and the level of credit. That is, the level of credit available in the private sector is thought to influence eventual level of economic growth.

At the time the central bank, the Bank of Papua New Guinea, used a number of instruments to achieve its aims—the Minimum Liquid Asset Ratio (MLAR)\(^2\) the Exchange Settlement Account (ESA)\(^3\) and the Discount Facility. Trade in government securities played only a minor part. These can be classified as direct instruments of monetary policy.

Starting in 1993, the Bank of Papua New Guinea (BPNG) shifted from using direct instruments to using indirect instruments of monetary control. Foreign exchange liberalisation, changes to the tax system in 1993 and the high liquidity in the economy were beginning to have major implications for monetary aggregates and the conduct of monetary policy, as they weakened the relationship between the level of credit and the nominal non-mining GDP. The foreign exchange liberalisation increased the susceptibility of the economy to external shocks, introduced further potential volatility for monetary aggregates and reduced the effectiveness of monetary instruments. As a result, the BPNG moved to money supply (M3) as the intermediate target variable and used trade of treasury bills as the indirect monetary instrument to achieve this target. The indirect instrument affects the supply of money through changes in the stock of reserve money (monetary base),\(^4\) the money multiplier, or both. A change in the provision of reserve money through open market operations affects the liquidity position of commercial banks and through it the supply of money and credit. A change in the interest rates of government securities can affect money market conditions and lead to changes in lending and deposit rates of commercial banks. It could also affect the currency/deposit ratio and excess reserve ratio, thus altering the money multiplier and the money supply.

The macro ‘provocations’ for SAP and the monetary measures/reactions

From the macro point of view, three major developments contributed towards the necessity of having the financial and economic program that complemented and supported the Structural Adjustment Program (SAP). First, between the late 1980s and 1994, there were large increases in recurrent national government spendings, financed mostly from the domestic financial system. This resulted in large increases in net credit to the government,
resulting in large increases in money supply. Second, non-mining private investment, especially in the primary sector, stagnated because the kina was overvalued. This made Papua New Guinea prices less competitive and the increased government borrowings crowded out private sector investment. Third, there had been a build-up in foreign debt service, compounded by ‘unwise’ government spending, which led to a depleting level of international reserves.

The government, through the Treasury and the Central Bank, responded to this by

- successfully negotiating with the IMF for a ‘stand-by arrangement’ on 14 July 1994 worth SDR (special drawing rights) 71.48 million for balance of payments support
- floating the Kina in October, after a devaluation in September
- enforcing tight controls on Government expenditure.

As a consequence of the tightening of controls over government spending, the government budget deficit was reduced from 10 per cent of GDP in July to 2.3 per cent in December 1994. Tighter government spending was aimed at in the immediate ensuing years. These form the core of fiscal and monetary measures in pursuit of

...macroeconomic stability through vigorous fiscal and monetary policies in support of a low inflation environment and a competitive exchange rate (World Bank and Government of Papua New Guinea 1995)

At the central bank, the MLAR was increased from 11 per cent to 26 per cent in October–November 1994 to tighten liquidity. Activity in treasury bill auction became strong. Another new instrument, the ‘kina auction facility’, was introduced in 1995 basically to assist in liquidity management, along with t-bills. The change to the use of indirect instruments and open market operations in the conduct of monetary management after 1993 was necessitated by the 1994 financial crisis.

The focus of monetary policy between 1994 and 2000 was that of liquidity tightening, through the application of the Treasury bill auction and the kina auction facility. It effectively meant that, if there was any excessive government spending, its adverse impact on macroeconomic stability was left to the Central Bank to correct through its monetary policy. Procedurally, any excessive weekly spending of the government that may render inflationary pressures and downward pressure on the kina exchange rate in terms of foreign currency is curtailed by the absorption of excessive liquidity in the banking system through the use of treasury bill auction and
kina auctions, especially when the increase in government spending is financed domestically.

**The weekly routine at the Central Bank for liquidity management aimed at stability in exchange rate movements and inflation**

Each week, BPNG staff assess and project the liquidity level in the banking system. Among other things, one of the major considerations is the government’s expected revenue and expenditure and the resulting net impact on liquidity, and the maturity of treasury bills.

**Kina auction**

The Kina auction occurs on Mondays. It can be regarded as a short-term liquidity management tool. Factors that are taken into account for the projection of liquidity for the week include net government spending, inter-bank trading as manifested in the ESA accounts, maturity of T-bills, developments in the exchange rate in the past week or two and developments that will impact on exchange rate (for example, exports and imports), interest rates and monetary aggregates. The bottom line is that if it is projected that there will be a net increase in liquidity then it can exert downward pressure on the exchange rate, among other considerations. Hence, for macroeconomic stability in terms of smoothing of exchange rate fluctuations and inflationary concerns, the BPNG buys the perceived excess liquidity from the commercial banks, for which it pays interest after a week. In other words, the commercial banks pay an interest-earning deposit at the Central Bank. In this way, there is less liquidity or notional average liquidity in the banking system and, therefore, fewer adverse pressures on the exchange rate and inflation rate. If it is projected that liquidity will decline during the week, then the bank will sell the considered shortfall to the commercial banks.

In the short history of the facility, it has been most weighted on the buy or absorption side.

**Treasury bill auction**

For the T-bill auction, the vast amount of information prepared for the kina auction is used to support the decision about the amount to be offered for T-bill purchase during the week. If it is considered that selling and renewing/rolling over matured T-bills would help limit liquidity then the Central
Bank offers an appropriate amount for the purpose. T-bills of four different maturity terms—28 day, 63 day, 91 day and 182 day bills—are released.

The two tools are complementary and supportive of each other in management of liquidity for macroeconomic stability.

A personal experience of discussions with the International Monetary Fund

At the Bank of Papua New Guinea, staff would prepare projections of inflation, balance of payments and gross domestic product for the next one or two years from all available information and data, including from international sources. These, among other necessary materials, form some of the basis of the BPNG’s predictions of how the economy might fare in the coming year. IMF staff also make their own assessment of the economic outlook. BPNG staff, together with Treasury staff, would then present their projections and explain the basis for them. Agreement and disagreement on certain parts or aspects of the projections are usually put forward and discussed between the parties. Without going into the technicalities, the bottom line is that this assessment, considering all necessary information, including fiscal figures, is made to establish what level of support, especially balance of payments support, the economy needs. Once the level of assistance needed has been agreed upon, IMF staff would present Papua New Guinea’s case to the IMF Washington office for consideration and approval.

A typical point of disagreement is the projected rate of inflation. The IMF usually projected a higher inflation rate than the BPNG. This is a typical case of more restraint on money growth, upon considering, among other things, what a possible further blow-out in the budget might do. BPNG, on the other hand, while being mindful of inflationary and exchange rate concerns, were also concerned about a growth in money supply that is necessary to support a projected growth in GDP.

Independence of the central bank

The Central Banking Act, 2000 gives the Bank of Papua New Guinea more independence in its functions as banker and financial agent to the government and regulator of the financial sector in pursuance of its objective of formulating and implementing monetary policy towards achieving and maintaining price stability among others.
Before the new Act came into being, there were instances where the statutory limit on government borrowing under the Temporary Advance Facility (TAF) was violated. This added an extra burden to the Central Bank’s attempt at liquidity management. Under the new Act, this will not be allowed to happen: ‘the total amount of advances under Subsection (2) shall not at any time exceed K100 [million] (or such other adjusted amount as agreed by the Governor and National Executive Council…’ (Section 55 Subsection 4 (a)) and this ‘shall be repaid to the Central Bank as soon as practicable, but in any case, not later than six months from the date of the advance’ (Section 55 Subsection 4 (b)).

The above, plus other stated means, make the governor more independent in determining and conducting monetary policy. Others include

- semi-annual monetary policy statements
- official monthly signalling of the monetary policy stance of the BPNG through the announcement of the kina facility rate
- advising the Minister of any adverse fiscal developments which would be detrimental to price stability
- indirectly conducting monetary policy by allowing either the interest rate to rise or the exchange rate to depreciate, thus increasing the government’s debt servicing and forcing it to budget more prudently.

All these will make the central bank become more independent and effective in its conduct of monetary policy.

**Conclusion**

This paper has outlined the BPNG’s approaches to achieving macroeconomic stability, in terms of inflation and exchange rate. Under the financial program and the structural adjustment program, the BPNG has managed liquidity by increasing its open market operations through treasury bill and kina auctions. Between 1994 and 2000, it absorbed excess liquidity most of the time, thus causing interest rates to increase significantly. This was considered necessary to smooth out the potentially large depreciation in the kina exchange rate and the inflation rate. But this has been at the cost of investment growth because interest rates rose so high. For instance, the interest rate on the 182-day bill reached a high of 28.03 per cent in August 1999 (Bank of Papua New Guinea 2001). National accounts figures for investment show that real investment has declined (Table 1).
Monetary policy, 1994–2000

It could be argued that monetary policy between 1994 and 2000, while trying to smooth out the potentially big changes in inflation and the exchange rate, became highly focused on changes in government spending and the way in which the government budget deficit is financed. Thus monetary policy was overburdened with government debt management, and not enough attention was paid to monetary policy for investment growth. But this may have been necessary given the turmoil in the economy and the change to a floating exchange rate regime.

One might ask why it is, with all that effort expended in stabilising inflation and the exchange rate, that the kina’s foreign currency value has gone down substantially and the inflation rate has risen so high that ordinary and well-off Papua New Guineans are really feeling the pinch. One possible response to that question is that it could have been far worse, had it not been for the BPNG’s efforts in liquidity absorption and management. The Central Banking Act, 2000 will go a long way towards making the BPNG effective in achieving the objectives of its monetary policy. The Act should not be tampered with or amended to suit political intentions.

If there are any lessons to be learnt here, they are that governments must be wise in their spending and that this spending must be on constructive areas like infrastructure development because huge consumption and recurrent expenditures definitely contributed to the macro ‘provocations’ of the programs. Monetary policy should be focused on limiting inflation and should not be dragged into government debt management.

Although this brief paper has not thrown any analytical light on this area, it is perhaps not out of line to say that the hard kina policy of the

Table 1 Employment and investment, 1994–2000 (per cent)

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<th>Year</th>
<th>CPI</th>
<th>Employment</th>
<th>Real investment</th>
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<tr>
<td>1994</td>
<td>2.9</td>
<td>7.3</td>
<td>6.2</td>
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<tr>
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<td>17.3</td>
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<td>1996</td>
<td>11.6</td>
<td>7.5</td>
<td>-7.9</td>
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<tr>
<td>1997</td>
<td>4.0</td>
<td>-0.2</td>
<td>-14.7</td>
</tr>
<tr>
<td>1998</td>
<td>13.6</td>
<td>-2.3</td>
<td>-5.2</td>
</tr>
<tr>
<td>1999</td>
<td>14.9</td>
<td>2.6</td>
<td>-16.2</td>
</tr>
<tr>
<td>2000</td>
<td>15.6</td>
<td>1.5</td>
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independence year is difficult to sustain in the long term should any new government contemplate it. The floating exchange rate regime is proving costly to ordinary Papua New Guineans in terms of the cost of living. It would be neither popular nor sensible from a political and independent state sovereignty point of view for Papua New Guinea to adopt the Australian dollar. Intuitively, this may be more feasible and sustainable than having it tied to a basket of currencies where the US dollar is given a high weighting. Papua New Guinea can thus feel safe if the Australian dollar fares well against the US dollar, however that manifests itself, whether appreciating or depreciating from different agents’ viewpoints. We can go down with the Aussie dollar or up with the Aussie dollar. There will be a sense of safety while maintaining a reasonable foreign currency value, which can be competitive as well.

References


International Monetary Fund and Government of Papua New Guinea, 1995. Staff Report for the 1995 Article IV Consultation and Request for a Stand-By Arrangement. Southeast Asia and Pacific Department and Policy Development and Review Department, International Monetary Fund, Washington, DC.


Notes

* Views, definitions and explanations expressed here reflect the understanding of the author and do not necessarily reflect the official stance of the Bank of PNG. Any errors in these therefore are those of the author.
Papua New Guinea’s liquid assets consist of its currency, bankers’ deposits with the central bank, treasury bills and inscribed stocks with remaining terms to maturity of less than three years.

The level of liquid assets that commercial banks are required to hold as a percentage of total deposits and other prescribed liabilities.

This is an inter-bank trading account.

Monetary base is defined as the liquid assets of the commercial banks plus currency in circulation.

Under the floating exchange rate system, the value of the kina against the US dollar (and the thus the cross rates against other key currencies) is now set by the activity of commercial and retail buyers and sellers of foreign exchange rather than fixed by the Bank of PNG.

In 1999, MLAR was replaced by a new facility or policy instrument called Cash Reserve Requirement (CRR).

The TAF allows for temporary advances to the government to cover temporary deficiencies resulting from mismatches in revenue and expenditures.