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Recent Monetary Developments in Papua New Guinea

A Correspondent

Papua New Guinea entered 1986 with a depressing sense of crisis in its monetary affairs. Where else in the world could large deposits earn real interest rates of 20 per cent? Yet there was no balance of payments crisis or budget blow-out and bank deposits had grown healthily for three years. The usual factors which erode liquidy were absent.

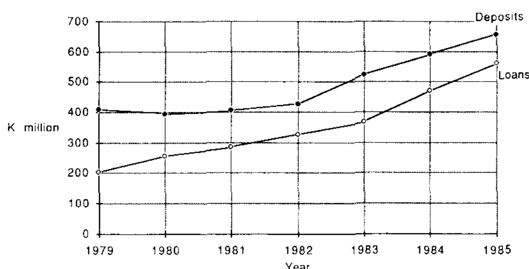
In commodity export dependent economies like Papua New Guinea the monetary managers worry most about balance of trade cycles and unexpected sharp downturns in domestic liquidity. Severe downturns in liquidity can leave Papua New Guinea banks with bullish lending commitments but a shrinking deposit base. The resulting scramble for deposits can be very unseemly for the bankers but rewarding for large depositors.

The last monetary crunch in Papua New Guinea was in 1980-81. Gold export prices fell and oil import prices doubled. A classic balance of payments contraction set in. The weakening deposit base was further eroded by capital flight as confidence in the government's economic management fell.

The current monetary crunch has none of these symptoms. In 1985 average export prices rose over 18 per cent largely as a result of the soaring coffee price; the balance of trade was in surplus; and bank deposits grew 11 per cent. Accustomed to watching these indicators, the monetary authorities failed to address a growing problem which exhibited none of the classic symptoms.

The immediate cause of the current crisis is a boom in lending. Loans grew by more than 50 per cent between December 1984 and December 1985, more than twice as fast as deposits (see Figure 1). The quick sharp effect on bank liquidity is shown in Figure 2.

Figure 1 Commercial banks: Deposits and loans (kina million and percentage change)



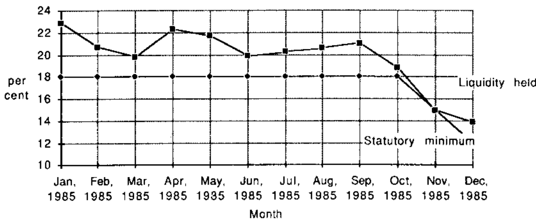
The origins of the lending boom occurred in 1983 with the starting up of two new banks (bringing the total number of full banks to six) and the fight by the older banks to maintain market shares.

By 1985, the Bank of Papua New Guinea (the Central Bank) had almost completely deregulated monetary policy. Interest controls had been lifted and sectoral guidelines had been withdrawn. The Central Bank maintained an annual lending ceiling which, however, applied to the banks **collectively.** The ceiling was set to constrain non-seasonal lending to grow by no more than 9.5 per cent in 1985. Two-thirds of the ceiling was taken up by March 1985. By September 1985 lending growth was double the 'permissible' rate.

The Central Bank did not set out clear policies towards the banks. The lending ceiling was set but not enforced. The commercial banks were also allowed extensive access to the Central Bank's special discount facility, which was designed only as a back-stop for seasonal liquidity pressures. Yet the Central Bank stood firm on maintaining the statutory minimum liquidity ratio at 18 per cent.

The commercial banks continued to compete for loan business some of which was merely the refinancing in kina of off-shore debts. Their liquid asset holdings were quickly reduced to the statutory minimum (see Figure 2). When it became apparent that the Central Bank would not lower the minimum liquid asset ratios, the scramble for deposits accelerated. Large deposit rates were on their way to a peak of 27 per cent (over 20 per cent in real terms). Loan interest rates were sure to follow.

Figure 2 Commercial banks: Liquid asset holdings in 1985 (per cent)



Was the Central Bank lulled by the classic indicators into tolerating the breach of the lending ceiling or was it unable to exert its authority? There may be elements of truth in both views.

Some misleading views were being propagated which diverted attention. One view said that bank lending was not the problem — rather that the government's own domestic borrowing was poaching deposits. However, in the 9 months to September 1985 bank deposits rose K59.6 million (19.7 per cent) while net public borrowing rose K34.1 million. More significantly, three-quarters of the increased government borrowings was taken up by the commercial banks as part of their liquid asset portfolios, and by the Central Bank, thus providing the base for a large part of the increase in bank deposits.

Whatever the influence of the various forces in this interplay the outcome was that a foreseeable monetary crisis was permitted to build up throughout 1985.

The Somare government was defeated in November 1985. The new government appointed Sir Julius Chan as Finance Minister, a man with a well-earned reputation from a previous tenure in the portfolio.

When the new government took over, the banks had no free reserves and interest rates on large deposits were skyrocketing. Lending interest rates were already at 8-9 per cent in real terms and set to rise. There is an acute political sensitivity in Papua New Guinea to lending interest rates because most nationally-owned businesses are highly geared.

Almost immediately, the Central Bank's last line of defence was demolished. The statutory minimum liquidity ratio was rapidly reduced to 12 per cent. A stream of other measures followed:

1. The much abused special discount facility was abolished in November 1985 but effectively reinstated in February 1986.
2. The lender of last resort rate was raised from 12 per cent to 13 per cent in November 1985, but reduced to 12 per cent a month later and not quoted at all by March 1986.
3. In December 1985, banks were encouraged to assist customers to borrow off-shore but a two-year moratorium on principal repayments was introduced. In January 1986, banks themselves were permitted to accept exchange rate liabilities if the finance was matched with export contracts. By February the bank's ability to lend in foreign currency was restricted to only K20 million.
4. Banks were told that indicative loan interest rates of 14 per cent would be 'appropriate'.
5. In February 1986 companies with majority foreign ownership were told they could not increase or renew loans over K50,000 unless express permission were given by the Central Bank. Such approval would limit domestic borrowing to twice non-resident shareholders' funds.

6. The March 1986 Budget cut back public domestic borrowing.

In three months of thrust and reverse thrust, the Chan measures rewrote three years of deregulation. Such an anarchistic period of intervention can only be explained one way. The government's sole objective has been to lower interest rates on loans to citizen borrowers. As Australian politicians have already discovered — deregulation is fine so long as interest rates are falling.

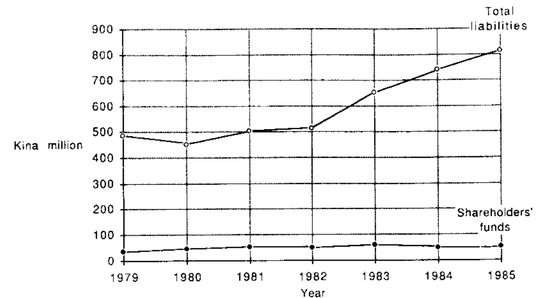
Previously, the concern of monetary policy was to ensure a reasonably steady supply of loanable funds notwithstanding the liquidity cycles induced by balance of trade fluctuations. Free interest rates would assist this. The Chan measures opted to fix the price (interest rates) and obtain the available funds by squeezing out non-citizen borrowers. Hence the encouragement to borrow off-shore, the stated preference for citizen borrowers and, finally, when interest rates continued to climb, the explicit restrictions on non-citizen borrowings. The latter measure was intrusive and particularly damaging for companies needing increased working capital to service the coffee boom.

Nonetheless loan interest rates remained over 15 per cent much to the disquiet of the government. In April the Finance Minister was reported as saying that banks could be 'punished' if loan interest rates exceeded the 'appropriate' level, i.e. 14 per cent. Deregulation seemed a long time ago.

These events have longer-term implications. First the capital adequacy of the commercial banks as a whole has declined sharply up to 1985 (see Figure 3). Continued official pressure to reduce loan interest rates will worsen their position.

Second, the move to off-shore borrowing has occurred out of cycle. Normally substitution of foreign for local borrowing should be encouraged in times of balance of payments weakness. Net repayments may then occur when the external position strengthens. Presently Papua New Guinea's external position is healthy but likely to turn down quickly once coffee prices fall. Repayment on the recent loans is not permitted for two years and hence may start during, and exacerbate, a future period of external weakness.

Figure 3 Commercial banks: Capital ratio, 1979-85



Third, monetary management is in disarray. Non-compliance with the collective lending ceiling in 1985 was a crucial policy failure. To be a more effective tool, the ceiling may have to be split into quotas for each bank. But that would negate the entry of the new banks to increase competition. Interest rate controls will also diminish competition.

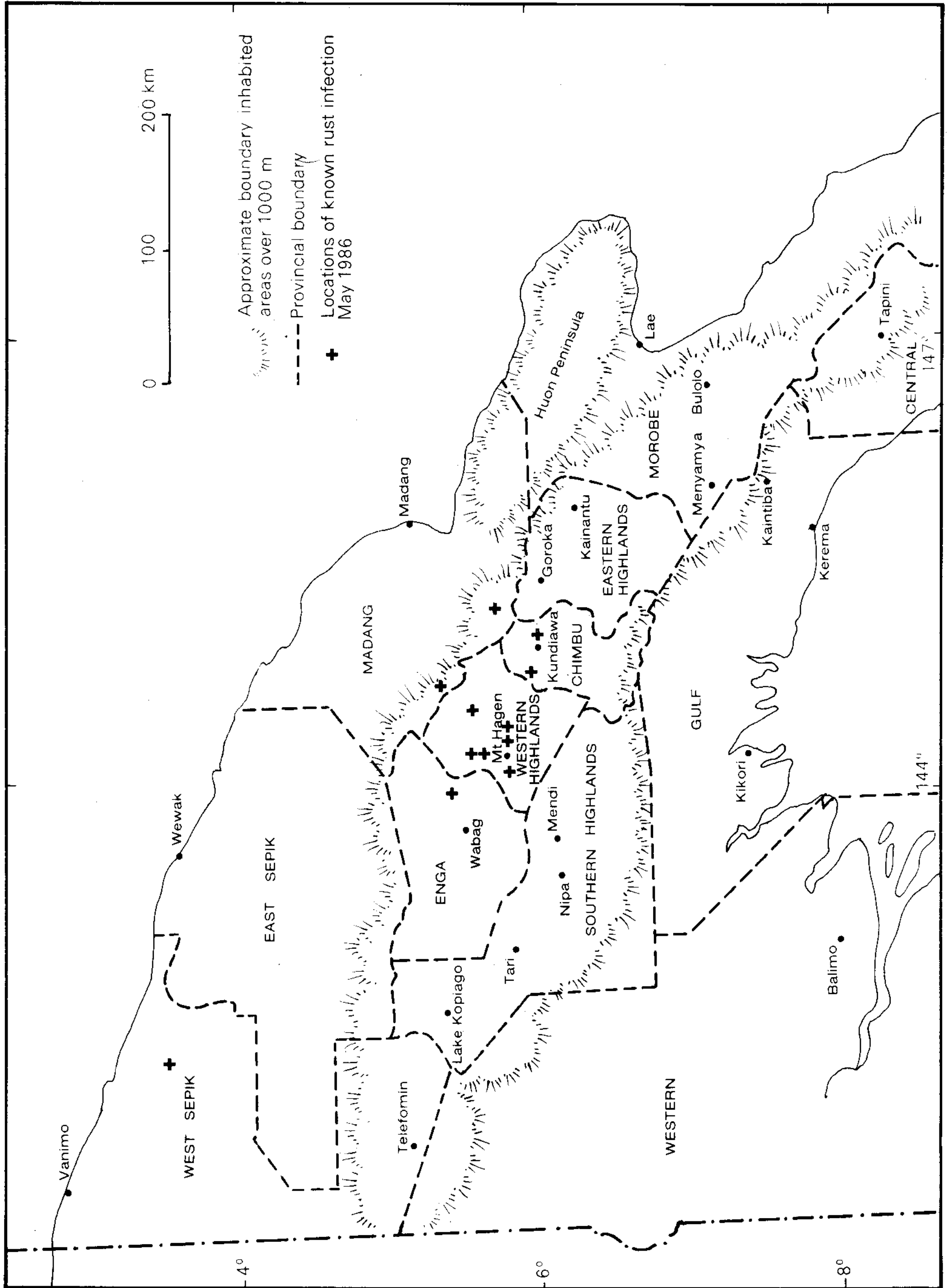
The dilemma for the Central Bank is that the tougher the monetary controls demands at a political level the harder it is for the new banks to achieve a viable market share. The formula emerging seems to be in character:

(i) keep anti-competitive controls in place, and

(ii) make room for the new banks by reducing the PNGBC's market share.

In March the Finance Minister announced that the private banks could compete with the PNGBC for government accounts. Later he told the PNGBC Board that the government would not be happy if the PNGBC's market share fell below 50 per cent.

The march of deregulation in Papua New Guinea monetary affairs has stopped. Interventionism is the fashion. The last words belong to Sir Julius Chan, still talking down interest rates in May 1986: 'As sure as the sun rises and sets, we will intervene.'


0
100
200 km
Approximate boundary inhabited areas over 1000 m
Provincial boundary
Locations of known rust infection May 1986
Vanimo
Wewak
Madang
Lae
Huon Peninsula
Bulolo
Tapini
Menyamya
Kaintiba
Kerema
Kainantu
Goroka
Kundiawa
Mt Hagen
Wabag
Mendi
Nipa
Tari
Lake Kopiago
Telefomin
Kikori
Balimo
WEST SEPIK
EAST SEPIK
MADANG
MOROBE
EASTERN HIGHLANDS
CHIMBU
WESTERN HIGHLANDS
ENGA
SOUTHERN HIGHLANDS
GULF
WESTERN
CENTRAL
4°
6°
8°
144°
147°