

# BPNG: drastic policy measures needed

by Jeffrey Yabom

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Jeffrey Yabom speaking at the 2023 PNG Update  
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*This is an edited extract from a **keynote speech** delivered by the Assistant Governor of the Bank of Papua New Guinea on behalf of the Governor at the **2023 PNG Update**.*

Economic diversification can only be realised through cohesive policy reforms to address the inherent structural challenges, such as removing market impediments, strengthening institutions and governance, and improving public infrastructure. Against this backdrop, I want to highlight the main contributions of the Bank of PNG through financial sector development towards economic diversification.

Financial sector development plays a pivotal role in effectively mobilising savings and creating investment opportunities, which leads to capital accumulation and technological progress. Over the years, the Bank of PNG has been delivering policy initiatives and financial infrastructures to address market inefficiencies in the financial sector. The notable contributions are financial inclusion, modernisation of the national payments system, and the current development of the secondary market for government securities. These measures aim to bring the unbanked population into the formal banking system to access financial products and services that can help them to hedge against business cycle risks – that is, during economic downturns, people can use their savings or borrow to smoothen their consumption levels.

I want to admit that the bank has also faced numerous challenges that have limited its ability to effectively achieve its mandated objectives of price stability and supporting growth and employment in the non-mineral sector. The main issues are lack of monetary policy transmission, and persistent imbalance in the foreign exchange (FX) market that have been affecting economic activities in recent years.

You will notice that the interest rate margin between lending and deposit rates has remained high around 7–8% for quite some time, implying that banks make more money from deposits without remunerating the depositors well. Our policy efforts to

address this interest rate spread have been hindered by excessive liquidity in the banking system mainly driven by successive fiscal deficit spending. The spillover of this liquidity into imports in turn contributed to the persistently high demand for foreign currency more than offsetting its corresponding supply in the FX market. Since the economy is fully reliant on imports for consumer durables and intermediate inputs, the situation in the FX market bears heavily on domestic economic activities.

One point that I want to stress is, with the Project Development Agreement in place, the surplus trade balance arising mainly from the LNG exports has yet to translate into consistent foreign currency inflows. This has left the economy at the mercy of foreign currency inflows mainly from exports of agricultural commodities. That exemplifies the need for economic diversification driven by both export oriented and import substitution activities to provide lasting solutions to the FX issues we currently face.

Meanwhile, the FX market has been running on a life support from Bank of PNG FX intervention. However, this life support is becoming unsustainable and drastic policy measures need to be undertaken as soon as possible to put the economy back to the path of macroeconomic stability.

I will now turn to broadly touch on the two major reforms undertaken with respect to the central bank. First, by the government in 2021 to modernise the central bank to reflect the changes in economic developments and adapt to international best practice. After two decades, the government amended the Central Banking Act 2001 with the aim to realign the bank's operations to international best practices of the present era. The main amendments included dual objectives of monetary policy (promote price stability, and growth and employment in the non-mineral sector), granting of full policy decision-making power to the Board, and an increase in direct financing of government budget. Generally, the reforms undertaken were good to ensure dilution of power vested to the Governor, improve transparency and good governance, and improve the efficacy of policy design and implementation.

The second phase of the reforms focused on the regulatory and supervisory roles of the central bank. The review of the functions of the central bank in this area as well as the financial sector are important to ensure the stability and development of the financial sector, and providing efficient services to the public. While the bank fully supports these important reforms, it is also important to mention that maintaining central bank independence is paramount.

While the change had positive benefits, it created new challenges with regards to the efficiency of policy decision-making processes, and direct government financing.

The second phase of the review, which is in its final stage, also attempts to address some issues in the first amendment, to empower the central bank to perform its functions effectively.

The second reform is the current IMF [International Monetary Fund] program which the government entered into in March 2023, mainly for budget support rather than the conventional arrangement for balance of payment crisis purposes. The program has stringent conditions in the form of structural benchmarks and quantitative targets that the government and the Bank of PNG must meet to qualify for each tranche of funds to be realised. A total of US\$918 million is expected to fund the reforms.

The important reform on the part of the government is to move into budget consolidation in the medium term to achieve a balanced budget and reduce budget deficits. On the part of the central bank, the program requires critical reforms to the monetary and exchange rate policy frameworks.

The monetary policy reform focuses on linking the policy rate to the market interest rates to improve the transmission of monetary policy to domestic interest rates, including the lending and deposit rates. For instance, if the central bank reduces its policy interest rate, that should influence other market rates to decline to make borrowing cheaper for firms and households. The transmission of policy is important to support the broader objectives and policies of the government including the diversification of the economy by influencing the borrowing cost of credit.

With regards to the exchange rate framework, the program requires the bank to adopt an exchange rate arrangement that can restore flexibility in the exchange rate to address currency overvaluation. The expected depreciation of the kina determined by the market fundamentals of supply and demand will allow the exchange rate to fall from its current overvalued level to its market equilibrium level over time. This will try to restore both internal and external balance.

Such a depreciation of the exchange rate to bring about the balance and support growth in the export industries including the agriculture, fisheries and forestry sector – that is, eliminating overvaluation – should make PNG's exports more competitive, which should support economic diversification efforts. The weaker kina will, of course, have inflationary impact, however this process will be measured and carefully implemented to ensure that inflationary impact is contained – as imports become expensive and expenditure switching should lead to expansion in domestic output.

History shows that we must harness our comparative advantages and invest in the

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right sectors that will set the course for economic diversification to take place. Indeed there are challenges, but I believe that now is the opportunity to forge the pathway to take us from where we are to greater stability and prosperity.

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[Read the full speech](#).*

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