INDEPENDENT ADVISORY GROUP

# Review of the Central Banking Act 2000
# Phase One Report

25 October 2021

# Executive Summary

The Independent Advisory Group (IAG) was established by the Treasurer, the Hon. Ian Ling-Stuckey. Mr Robert Igara, former Chief Secretary is the Chair. Sir Wilson Kamit, former Governor of the Bank of Papua New Guinea (BPNG) and Professor Stephen Howes, Director, Development Policy Centre, Australian National University (ANU) are the other two members.

We address the various topics contained in the terms of reference provided to us through seven chapters. Chapter 1 provides an introduction; Chapter 2 deals with the issues of governance, accountability and transparency; Chapter 3 with government financing; Chapter 4 with crisis management; Chapter 5 with the Bank's objectives; Chapter 6 with issues for the second phase of our work; and Chapter 7 with recommendations.

Rather than summarise each chapter or topic of our report, this executive summary unifies the report by bringing the various strands in our work together under five themes. These are: learning from experience; strengthening Bank independence; delivering accountability; reducing discretion; and matching objectives with functions.

The passage below covers some of our most important recommendations for changes to the 2000 Central Banking Act (CBA), and shows how they fit together. All thirty-one of our recommendations are detailed in the report's final chapter.

### 1. Learning from experience

We have based our report both on international experience and on detailed analysis of monetary policy making and governance in PNG over the last decade. BPNG has done well in some regards: inflation has been kept relatively low and stable; the payments system has been improved. In other respects, however, there have been some significant problems and negatives that we must learn from, and make changes to avoid in the future:

- The controversial "slack arrangement" has exposed a loophole with regard to the very important Section 55 of the CBA, a loophole that has allowed virtually unlimited deficit financing, an outcome that was certainly never intended. This loophole needs to be closed.

- The prolonged rationing of foreign currency that emerged in 2014 following BPNG's sudden 17% appreciation of the exchange rate and which has plagued the economy ever since has undermined economic growth and encouraged fiscal profligacy. PNG needs to return to its traditional policy of currency convertibility as soon as possible.

- The illegal payments of dividends in the period 2011 to 2015 raise serious questions of governance, both for the Government and for the Bank. This episode points to the need for a strong Board able to uphold the Bank's rights granted to it under the Central Banking Act.

- BPNG waited too long before shifting to an accommodative policy stance, which it did only in the second half of 2019, even though it had been clear for several years that the economy was struggling, with employment falling nearly every year since 2013.

- The financial sector has been stable but has become more concentrated over time. PNG badly needs more competition in the financial sector, and new entrants to push down interest rates, and expand financial sector credit and access to the many who need it and can make good use of it.

We address the financial sector in detail in the second phase of our work, but the other issues listed above provide an important basis for our recommendations in this report, both on specific policy issues and on more general governance reforms. As Winston Churchill said, unless we learn the lessons of the past, we are condemned to repeat it.

## 2. Strengthening Bank independence

The 2000 Central Banking Act was a masterstroke. It ended years of political interference in the running of BPNG by securing the tenure of the Governor and the Board. Gone immediately were the days when the job of BPNG Governor was a revolving door.

One of our aims is to preserve and strengthen that independence. We propose preserving it by keeping in place key features of the existing Act, such as the requirement that the tenure of the Governor and of Board members be protected. This is what distinguishes BPNG from other state-owned enterprises, some of which do indeed suffer from the curse of instability and political interference.

BPNG's independence needs to be not just preserved but strengthened, especially in the light of the illegal dividend payments episode, noted above (see Chapter 2.5(a) for details). As set out in length in Chapter 2 on governance, tighter restrictions need to be placed on who can become a Board member. The Board should be chosen on merit not on the basis of representation, and tight limits should be placed on ministerial discretion. And we should cast the net further, aiming for not only domestic but international representation. A more merit-based, stronger Board will be in a better position to protect BPNG independence.

## 3. Delivering accountability

PNG's Central Banking Act is unusual in the amount of power it vests in one person, the Governor. At last count, there are only three other central banks in the whole world that concentrate as much power in one person as PNG's CBA does. Indeed, just as important as the global trend to central banking independence has been that to collegiality. In the words of the Bank of International Settlements, the central banking club: "Collegial decision-making is a hallmark of modern central banking that both augments the independence of the decision-making process and enhances the quality of decision. In the vast majority of the world's central banks, board or committees are responsible for making policy decisions."

BPNG already has a Monetary Policy Committee (MPC), but it is entirely internal to Bank management. We propose in Chapter 2 that the MPC be strengthened by giving it a legislative mandate to formulate monetary policy and oversee its implementation, and that it be opened to external, including international, members to allow for contestability. The Governor would chair the MPC, and so would retain his or her leadership role on monetary policy, but the collaborative scrutiny that an MPC would provide would greatly enhance accountability.

Our recommendations also give a greater role to BPNG's Board, to give it greater oversight of the Bank, as other countries have done, again to strengthen accountability. In particular, we recommend separating the role of Board Chair and Bank Governor, to promote oversight and avoid conflict of interest.

There is a difference between independence and isolation. The feedback we have received indicates that the Bank of Papua New Guinea has isolated itself too much, both from other parts of government, and from private-sector stakeholders. Independence prevents abuse, but isolation undermines accountability. If no one knows what the Bank is doing, how can it be held to account? While BPNG should continue to be independent from the Government, it needs to do more to collaborate with other arms of Government, especially Treasury, and especially in times of crisis, such as the current pandemic. There has been in recent times too little communication between the Government and the Bank, and we propose several measures to improve the two-way flow of information, to resolve disputes, and to promote teamwork – all without in any way undermining Bank independence.

Greater outreach is also required to the private sector. We heard a clear demand from business for the Bank to make itself more available for discussion, to explain itself, and to consider alternative views. The seemingly never-ending disagreement between the private sector and BPNG on the extent – or even the existence – of foreign exchange shortages is the sort of issue that could easily be resolved through dialogue.

Greater collegiality needs to be accompanied by more transparency. The Bank plays a critical and commendable role in collating and publishing economic statistics, but they are released too slowly. We propose the timely release of economic data be mandated, and that both the existing Board and the proposed Monetary Policy Committee release statements to the public after each time they meet.

The raft of governance reforms set out in detail in Chapter 2 to promote collegiality and transparency will deliver accountability without sacrificing independence.

### 4. Reducing discretion

The Bank of Papua New Guinea was made independent by the 2000 Central Banking Act to reduce the scope for discretion arising from political interference. But an unintended consequence of the legislation has been to create new scope for discretion or arbitrary behaviour by the Bank itself.

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.

We propose two new simple, transparent and desirable rules to reduce the scope for discretion, and increase predictability.

First, as discussed in Chapter 3, we want to close the loophole currently present in Section 55 on government financing. We take a conservative, pragmatic approach. Given PNG's shallow capital markets and single-borrower limits, all BPNG purchases of government securities potentially have a fiscal impact, making it easier for the government to finance its deficit. To completely prohibit government financing would therefore mean banning all BPNG dealing in government securities. This is one option, but it would be extreme. Given the lack of competition in PNG's financial markets, the Bank can play a useful, if limited, role in deficit financing by combatting the market power of key private sector financiers. The key word here is 'limited' and we propose a prudent, quantitative and easily measurable legal limit on deficit financing, one that could be temporarily increased in times of national crisis such as COVID-19. Such an approach is in line with relevant international practice and would prevent the excesses of the "slack arrangement" from ever being seen again.

Second, as discussed at length in Chapter 5.1, we want to bring an end to foreign exchange shortages and to foreign currency rationing. The Bank's job of managing the Kina is not an easy one, especially given the volatility of the PNG economy, and the undiversified nature of the foreign exchange market. We think foreign exchange management can certainly be improved, but, as per the existing CBA (Section 58), that should be left to the Bank to fix, not attempted by government fiat or undermined by government interference. Nevertheless, however the Bank manages the Kina, it should be required by law to ensure the currency's convertibility on the current account. The practice of rationing foreign exchange, which BPNG introduced in 2014 and has allowed to continue ever since, is not only in violation of PNG's international agreements. More importantly, this practice has done immense damage to PNG's economy, and to its international reputation, and has encouraged fiscal profligacy by guaranteeing to politicians that no matter how high a fiscal deficit they run they will not risk a balance of payments crisis. Convertibility was for the first 40 years of PNG's independence the bedrock of its economic policy. Unfortunately, it will take time to unwind the damage and it will not be possible to return to convertibility immediately. We propose a grace period of just over a year be given, with a legislatively mandated return to Kina convertibility by 2023.

## 5. Matching objectives with functions

BPNG is a very powerful central bank. Due to the chronic problem of excess liquidity, commercial banks do not need to borrow from the Central Bank, and so its policy lending rate is ineffectual. However, as discussed immediately above, the Bank does have critical roles to play with regards to fiscal and exchange rate policy. It is also responsible for the payments systems that undergird PNG's economy, for providing banking services to government, and for regulating the financial sector.

For any organisation, objectives are critical. This is especially the case for BPNG whose objectives are legislatively enshrined.

As we argue in Chapter 5, BPNG's objectives are too narrowly defined for an organisation with so many roles and so much power. Currently, the sole objective of monetary policy is price stability. This was understandable when the CBA was put in place given the high inflation that the country was then battling. But also at that time the Bank's central role in relation to the exchange rate and fiscal policy was little understood. In particular, a price-stability-only mandate is inappropriate for BPNG given its responsibility for exchange rate policy as it introduces a bias against depreciation given the latter's inflationary impact. We contend that the objectives of the Bank should extend beyond price stability to include broad-based growth.

We propose other changes in the Bank's objectives as well. Financial stability is critical, but not an end in itself. The Bank should also be charged with promoting financial sector development: without sacrificing prudence, new entrants need to be encouraged to disrupt and reverse the current tendency towards a banking monopoly. And the Bank should also have an objective relating to its function as the government's banker to incentivise it to modernise government debt auctions.

### 6. Summary

Our vision is a Central Bank of Papua New Guinea that is both independent and accountable, whose discretion is limited by law, and whose objectives are aligned to its functions. Our recommendations draw on detailed analysis – both of what has worked and what has not, both in PNG and internationally – to transform that vision into reality.

The Bank of Papua New Guinea is a critical institution for the PNG economy. The Central Banking Act 2000 transformed BPNG's performance with positive results for the economy and people of Papua New Guinea. A second round of reforms is now needed, and could have the same transformational impact once again.