INDEPENDENT ADVISORY GROUP

Review of the Central Banking Act 2000
Phase One Report

25 October 2021

Letter of Transmittal

Independent Advisory Group
On Review of Central Banking Act 2000
c/- Treasury Haus, Waigani, NCD, Papua New Guinea.

25th October 2021

Honourable Ian Ling - Stuckey CMG MP
Minister for Treasury,
Treasury Haus,
WAIGANI, NCD,
Papua New Guinea.

Dear Minister,

PHASE I REPORT
Independent Advisory Group on Review of Central Banking Act 2000

Greetings!

We have the honour to submit to you our Phase I Report which addresses our Terms of Reference you issued on 13th May 2021 covering the issues of governance, accountability and transparency; government financing; crisis management; the Bank's objectives; and issues for the second phase of our work. We have presented for your consideration thirty-one recommendations covering these core areas.

We particularly recognise three strategic considerations –

- International best practice has changed, and PNG needs to change with it;
- The experience of the last twenty years shows that we need to take account of Papua New Guinea's unique circumstances and economic structure; and
- A holistic view is required given the Bank's role in setting monetary policy, exchange rate policy, government financing and banking, and financial regulation.

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 what has worked and what has not, both in PNG and internationally – to transform that vision to reality.

The Bank of Papua New Guinea is a critical institution for the Papua New Guinea economy. The Central Banking Act 2000 transformed Bank of PNG'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.

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Robert IGARA CMG	**Sir Wilson KAMIT CBE Kt**	**Professor Stephen HOWES**
Chair	**Member**	**Member**

Independent Advisory Group (IAG) members

Mr Robert Igara, IAG Chair, is Chancellor at the University of Papua New Guinea, and was Chief Secretary when the Central Banking Act was introduced in 2000.

Sir Wilson Kamit was Governor of the Bank of Papua New Guinea from 1999 to 2009.

Dr Stephen Howes is Professor of Economics at The Australian National University and Director of the Development Policy Centre.

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Abbreviations

AFEDs	Authorised Foreign Exchange Dealers
ANU	The Australian National University
BIS	Bank for International Settlements
BPNG	Bank of Papua New Guinea
BSP	Bank of South Pacific
CBA	Central Banking Act 2000
CBBs	Central Bank Bills
CRR	Cash Reserve Requirement
DDA	District Development Authorities
DOT	Department of Treasury
DSIP	District Services Improvement Program
FASU	Financial Analysis and Supervision Unit
FX	Foreign Exchange
GDP	Gross Domestic Product
GNI	Gross National Income
IAG	Independent Advisory Group
ICCC	Independent Consumer and Competition Commission
IMF	International Monetary Fund
IS	Inscribed Stock
KFR	Kina Facility Rate
LNG	Liquid Natural Gas
MPC	Monetary Policy Committee
MPS	Monetary Policy Statement
NEC	National Executive Council
NRI	National Research Institute
NZ	New Zealand
ODC	Other Depository Corporations
PGK	Papua New Guinean Kina
PNG	Papua New Guinea
QE	Quantitative Easing
QEB	Quarterly Economic Bulletin
RBNZ	Reserve Bank of New Zealand
RER	Real Exchange Rate
SOE	State-Owned Enterprise
T-Bills	Treasury Bills
TAF	Temporary Advance Facility
TISA	Teacher’s Savings and Loan Societies
TOR	Terms of Reference
UPNG	University of Papua New Guinea
USD	United States Dollar

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.

Chapter 1. Introduction

The Independent Advisory Group (IAG) welcomes the opportunity to review the Central Banking Act (CBA). We work from the position that the Central Banking Act of 2000 was an important reform, but that 20 years on we should learn from experience to see how the Act can be improved, and the independence, accountability, transparency and effectiveness of the Bank of Papua New Guinea strengthened.

In particular, we note that the Central Banking Act 2000 was written based on "best practice" with the aim of restoring stability to the Bank of PNG and with reference to developed countries' experience. While this certainly led to real improvements, three changes that have since occurred guide the outlook of the IAG.

First, international best practice has changed, and Papua New Guinea needs to change with it. In particular, the international trend in central bank governance is towards separation of governance and management responsibilities, enhancing accountability and transparency, and towards collegial rather than individual decision making.

Second, the experience of the last twenty years shows that we need to take into account PNG's unique circumstances and economic structure. Papua New Guinea's conditions are very different from those of a developed country, and the central banking legislation needs to be made "fit for purpose" for PNG. Only by combining both international and PNG-specific lessons will we able to forge institutions that are both robust, appropriate and relevant to current and future challenges.

Third, a holistic view is required. The Bank of Papua New Guinea is a critical organisation for PNG's economy. Not only does it set monetary policy as conventionally defined in other countries, but it also has a key role to play with regards to the exchange rate policy, government financing and banking and, of course, financial sector regulation. While we defer consideration of financial sector regulation to the second phase of this review, we consider all its other roles in this phase.

The 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 and Professor Stephen Howes, Director, Development Policy Centre, Australian National University are the other two members.

The IAG wrote an Issues Paper (attached as Annex 2) that was released on 30 August 2021, published it on its website (https://pngcentralbankactiag.org/) and circulated it to interested stakeholders. The IAG earlier circulated a draft version of the Issues Paper to Treasury and BPNG on July 21. Treasury's response was received on 20 September and BPNG's on 22 September. Written responses to the published Issues Paper were received from: Bank of South Pacific (BSP), Kina Bank, Brian Gomez, Dr Eugene Ezebilo (National Research Institute), the Reserve Bank of Australia, and the International Monetary Fund (IMF). Consultations were held with: Treasury, the Treasurer and the Treasurer's Office, the BPNG Governor and senior management, BPNG board members, BSP, Kina, Reserve Bank of New Zealand (RBNZ), the New Zealand Treasury, the IMF, Teacher's Savings and Loan Societies (TISA), the Business

Council of PNG, and Credit Corporation. We have also benefited from a report prepared by Deloitte for BPNG on BPNG governance.[1]

We discussed our draft report with the Treasurer's Office and with the Bank of Papua New Guinea. We received written comments on the draft report from the Treasury, BPNG and the IMF. We thank all who provided advice, comments and feedback to the IAG.

The IAG was assisted in its deliberations by a Secretariat in the Treasury, and by a team of economists from the University of Papua New Guinea (UPNG) and The Australian National University (ANU). We would like to sincerely thank Dek Joe Sum (ANU and UPNG); as well as: Sioni Ioa, Ephraim Feto, Josephine Varpin, William Hamilton, Tim Robinson (Treasury); Dr Misty Boiloloi and Paul Flanagan (Treasurer's Office); Maholopa Laveil, Jollanda Matthew and Kelly Samof (UPNG); and Rubayat Chowdhury, Rohan Fox and Thomas Wangi (ANU).

The views expressed in this report are only of the Independent Advisory Group.

1.1 Original terms of reference (TOR)

The terms of reference for the IAG's review were set out by the Treasurer on 13 May 2021, are attached as Annex 1, and are summarised below.

1. **Objectives**

Review whether the objectives of the Central Banking Act 2000 give adequate priority to the growth and development of PNG, and in managing national economic crises (Section 7).

2. **Governance**

Review the current economic in particular monetary policy governance and management mandate of the central bank, including whether the Board or another similar body should have responsibility under the Act for determining monetary policy (sections 7-14, focusing on section 10).

3. **Financing**

Review the current arrangements around advances and financing to the government by the Central Bank, including a review of the TAF and options around quantitative easing options during a declared emergency (focus on Section 55).

4. **Accountability and transparency**

Review the institutional governance and management of the Central Bank whether there is a need for strengthened accountability and transparency, and management performance and terms, in line with international norms (sections 15-36, and sections 42-50 with potentially new sections).

[1] The IMF has prepared a "Safeguards Assessment" for BPNG, which includes recommended changes to the CBA. BPNG has shared with us the IMF's recommendations for changes to the CBA, but is not allowed by the IMF to share with the IAG (or, oddly, with Treasury) the IMF report, including the rationale for such changes.

5. Other issues

Recommend from the findings and conclusions under TOR 1-4 critical strategic issues requiring in-depth analysis and development – this will form the basis of the TOR for the second stage of the review and cover broader issues covering regulation of the financial system, actions to encourage competition, and follow-on work in light of the recent Financial Sector Reform review.

1.2 Terms of reference as addressed by the IAG and report structure

Crisis management is covered by two TOR items, 1 and 3. Under 1, the IAG is asked to review whether BPNG objectives need to be extended to cover crisis management. Under 3, the IAG is asked to examine quantitative easing options during a crisis. For clarity, it is proposed to combine these as a single, separate item relating to crisis management. TOR items 2 (governance) and 4 (accountability and transparency) are closely related, and it is also proposed to address these together. We also think it is best to consider the objectives of the Bank at the end of the report, after all relevant information has been considered, rather than at the beginning.

Thus the revised presentation of the Terms of Reference, in the order in which we deal with the various topics in the report, is:

- Governance, accountability and transparency
- Financing
- Crisis management
- Objectives
- Second-phase issues

There is no change in substance between the original and these proposed TOR. The changes are only for the sake of clarity. The report is structured as follows:

Executive Summary
Chapter 1: Introduction
Chapter 2: Governance, accountability and transparency
Chapter 3: Financing
Chapter 4: Managing national economic crises
Chapter 5: Objectives
Chapter 6: Second phase issues
Chapter 7: Recommendations

The report has a strong focus on monetary policy, with financial sector policy reserved for the second phase of our work. Monetary policy can be defined either narrowly (to cover instruments such as reserve requirements, open market operations, and policy rates) or broadly (as equivalent to macroeconomic policy, and including exchange rate policy). In PNG, exchange rate policy is the responsibility of BPNG, and Section 58 requires it to be set through the Bank's Monetary Policy Statements. In this report, therefore, we define monetary policy in the broader sense of referring to the macroeconomic policies for which BPNG is responsible.

Chapter 2. Governance, accountability and transparency

Under this heading, we "[r]eview the current economic in particular monetary policy governance and management mandate of the central bank, including whether the Board or another similar body should have responsibility under the Act for determining monetary policy (sections 7-14, focusing on section 10)." We also "[r]eview the institutional governance and management of the Central Bank whether there is a need for strengthened accountability and transparency, and management performance and terms, in line with international norms (sections 15-36, and sections 42-50 with potentially new sections)." These items are reviewed together because of their substantial overlap.

Sound governance, robust accountability and strong transparency are desiderata for all public-sector entities, especially a central bank. Looking at BPNG, critical weaknesses have emerged that require addressing. The biggest governance problem arises from the vesting of significant power and authority in a single office and therefore person, the Governor. Consequently, an individual-based rather than a collegial-based approach has been taken to decision making, which is out of line with international practice, and has weakened oversight and accountability. Shifting to a more collegial approach, while not undermining the authority of the Governor, is the biggest change we recommend. A number of other reforms are also put forward to strengthen BPNG independence and improve governance, accountability and transparency.

We begin by examining the role of the Governor (Chapter 2.1). We recommend the creation of a Monetary Policy Committee (MPC). Chapter 2.2 looks at some relevant international MPC models, and Chapter 2.3 examines detailed design options for PNG. We then examine the role of the Board (Chapter 2.4), the role of Government (Chapter 2.5), issues relating to accountability and transparency (Chapter 2.6), and, finally, management performance (Chapter 2.7).

2.1 The role of the Governor

Under the current legislation, the Governor is responsible for monetary policy and financial sector regulation. The latter topic is postponed to the second phase of the review, and the focus of this section is on monetary policy. We consider alternative arrangements in subsection (a) and argue in favour of a Monetary Policy Committee, an argument which is further developed in Chapters 2.2 and 2.3). Subsection (b) looks at the role of the Governor as the Chair of the Board, (c) at the term of the Governor, and (d) at the term of the Deputy Governors.

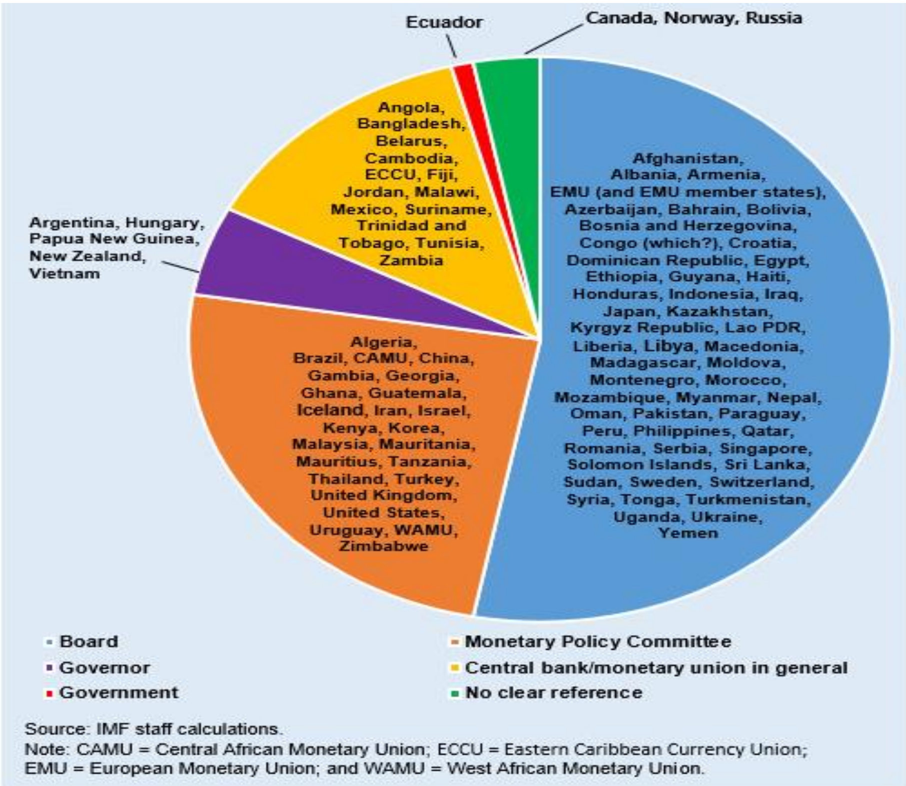
(a) Responsibility for monetary policy

Section 10 of the CBA clearly vests responsibility for monetary policy with the Governor, saying that "[i]t is the duty of the Governor to formulate and implement monetary policy". Section 26 on the functions of the BPNG Board states that "the Board of the Central Bank is responsible for determining the policies of the Central Bank, other than the formulation and implementation of monetary policy and the regulation of the financial system which shall be the responsibility of the Governor.” Section 16(2) also gives untrammelled authority to the Governor with regards to the Central Bank within the constraints of the Act:

> The Governor has the authority to exercise the Central Bank’s powers for the purposes of achieving the objectives and functions of this Act and implementing the policies of the Central Bank.

BPNG is unusual in this regard. According to the IMF (see Figure 1 below), only four other countries give responsibility for monetary policy to their central bank governor: Argentina, Hungary, Vietnam and New Zealand. New Zealand has recently changed its approach, and has now transferred powers from the Governor to a Monetary Policy Committee. That leaves only three countries – Argentina, Hungary, Vietnam – none of which is an appropriate role model for PNG.

Figure 1. Responsibility for monetary policy determination by central bank entity



Source: IMF.

The Bank for International Settlements (BIS) 2009 survey of central bank governance (*Issues in the governance of central banks*) notes that “an increase in the delegation of power to the central bank has often been accompanied by a move to group decision making.” (p.2)

The BIS Survey goes on to note that: “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.” (p.3)

Having a more collective approach would be of benefit to BPNG since it would, again to quote from BIS, "permit a wider range of perspectives to be brought to bear, which adds to the legitimacy and credibility of the central bank decisions…." (p.3)

Given some of the BPNG decisions over recent years – whether relating to transparency (Chapter 2.6), deficit financing (Chapter 3.2) or exchange rate policy (Chapter 5.1) – such an increase in "legitimacy and credibility" would be welcome, and indeed is needed. A more contestable process would give greater confidence that the decisions taken by BPNG are appropriate, and have been arrived at through a robust process in which proper analysis, valid criticisms and alternative points of view have been given due weight.

Although BPNG does have a Monetary Policy Committee (MPC), it is constituted entirely by Bank staff, who report to the Governor. The IMF in its 2004 survey (*Central bank governance: a survey of boards and management*) recommends that any MPC should have external members: "Monetary policy committees, for instance, may be used as an avenue to include external members to ensure a balanced view." (p.40)

Consideration should be given to BPNG moving towards a more collegial approach to monetary policy determination since, based on global experience, this would enhance its independence and integrity and the quality of its decisions. Under any such model, although the concentration of power in the Governor would be reduced, s/he would still have significant leadership and responsibility in decisions on monetary policy.

There are two options: one is that monetary policy should be the responsibility of the Board; the other that it would become the responsibility of a specialised MPC (on which BPNG staff and/or management as well as external members would be included).

There are several reasons why we favour the MPC model.

- First, the Board as a whole might lack the technical expertise required.

- Second, giving the responsibility to an MPC would leave the Board to focus on its oversight role. Indeed, with this option, the Governor would no longer need to be chair of the Board, making it easier for the Board to play that oversight role (as discussed further below in Chapter 2.4).

- Third, the MPC model builds on BPNG's own approach: there already is an MPC; the challenge now is to strengthen it.

- Fourth and finally, the MPC model is consistent with recent global trends. While, as can be seen from the figure above, the majority of countries still entrust monetary policy to the Board, as a recent IMF report notes:

> Following the example of the Bank of England, there has been a recent trend, as part of a broader endeavour to increase autonomy, to shift monetary policy formulation away to a specialized committee that is fully vested with the

power to take monetary policy decisions.[2]

While we favour the MPC option, detailed questions arise as to the design of the MPC. Many questions have to be answered, regarding membership, modes of operation, and so on. While we draw on global experience, Malaysia and New Zealand are particularly attractive options for PNG to consider. New Zealand is an example of a country that has very recently moved from a model in which the Governor has responsibility for monetary policy to one in which that responsibility is shifted to an MPC; and Malaysia is an example of a country that has moved from an internal to a legislated MPC. These two models are considered further in the next section (Chapter 2.2) before the detailed design issues are thrashed out in Chapter 2.3. In the remainder of this section, we consider other aspects relating to the role of the Governor.

While consideration of detailed design is deferred until subsequent sections, we want to clarify at the outset that the Governor would provide leadership in monetary policy as Chair of the MPC. The idea of the MPC is thus not to displace the Governor from his or her key role, but rather to introduce contestability and collegiality as another element to balance that leadership role.

Note also that similar issues arise in relation to financial stability and development, where similar arguments could be mounted that a more collegial approach would be healthy. However, such consideration is deferred until the second phase of this review.

(b) Role of Governor as Chair of the Board

The Governor is (effectively) the Chair of the Board. Section 32(2) of the CBA states that "At a meeting of the Board, the Governor, or in his absence a Deputy Governor designated by the Governor shall preside." Given that the Board is not responsible for either monetary policy or financial regulation (as per Section 26), the BPNG Board is a "supervisory Board" in the words of the 2004 IMF survey (p.23). The IMF recommends that in such a case the Governor should not be the Board chair (p.26). We consider this issue further in Chapter 2.4, where we consider the role of the Board.

(c) Term of appointment

The 2009 BIS Survey shows international practice in relation to the terms of the central bank governors (see the table below, extracted from it). Two-thirds of countries surveyed have a five-to-six-year term for their central bank governor. The BPNG Governor term is for five-to-seven years (Section 15(1)(b)), but in practice the Governor has been appointed since the passage of the CBA for seven-year terms. This is on the long side. A longer term promotes independence, but may undermine accountability, given the undesirability of removing a Governor. An advantage of a seven-year term in the PNG context is that it is not the same as the electoral cycle of five years.

[2] Bossu and Rossi (2019) "The role of board oversight in central bank governance: key legal design issues", IMF Working Paper 19/293, p.32.

Table 1. Length of term and reappointment of central bank governors

	3–4 years	5–6 years	7–8 years	Not specified	Life tenure
Length of term	6	64	17	13	0
Reappointment not limited	0	45	11	0	0

Source: BIS analysis of central bank laws.

Source: Table 5 from the 2009 BIS Survey.

The BPNG Governor cannot be appointed for more than two terms, and therefore for more than 14 years (Section 15(1)(c and d)).

Consideration should be given to a shorter term. 14 years is a very long time. It provides stability, but may lead to complacency. We suggest consideration be given to replace seven by six years as the maximum for a single term, and 12 years as the maximum. We also suggest that no minimum tenure is required for the second term, since this will give added flexibility – e.g., if it is thought that a Deputy Governor will take over (the most common succession pathway), and bearing in mind the term limits we propose to introduce for the position of Deputy Governor (see below).

(d) Deputy Governor

Under current arrangements, at least one and up to two Deputy Governors can be appointed by the Governor for an unlimited number of five-year terms. The Deputy Governor(s) currently serve on the Board, and the (internal) Monetary Policy Committee. Consideration should be given to a term limit, for example, two terms. Having longer than a two term limit might mean inadequate refreshing of the Bank's senior leadership. We also propose that the appointment of the Deputy Governors become a Board responsibility. This would ensure shared responsibility and internal contestability in decision-making.

2.2 The Monetary Policy Committee (MPC): different models

This section highlights international experience with MPCs, drawing on the Malaysian and New Zealand experience. It also highlights relevant experience in PNG from the Independent Consumer and Competition Commission. Drawing on the above models, the best model for PNG can be selected.

(a) Malaysian MPC

Malaysia has had an MPC since 2002. It began as an internal committee but was given legislative foundations in the Central Bank of Malaysia Act 2009.[3] This Act gives the MPC "responsibility for formulating the monetary policy and the policies for the conduct of monetary policy operations" (Section 23(1)). Under the Malaysian model, a Governance Committee of the Central Bank Board has responsibility for nominating members for the MPC. MPC members may be Board members, Bank staff, or outsiders. They are appointed for a

[3] See overview here.

term of three years, with eligibility for reappointment. The Governor and three Deputy Governors are automatically members (the Governor is the chair), and there are at most another seven members on the MPC (so at most 11). Currently, there are two external members (prior to 2015 there were none), and a total of seven members. When nominating someone, the Governance Committee must be satisfied "that the person has the expertise and experience relevant to the responsibility and functions of the Monetary Policy Committee and be a person of probity, competence and sound judgment" (Section 23(5)). In 2012, the Monetary Policy Committee Code of Ethics and Conflict of Interests (Code) and an internal Framework for the Appointment of External Members for the Monetary Policy Committee (Framework) were put in place.

Malaysia's MPC meets at least six times a year. Each meeting lasts for two days. Decisions are made by consensus. Following each meeting, the MPC issues a statement on "the decision made at the meeting and the rationale for such decision."[4]

(b) New Zealand MPC

New Zealand's MPC was established in 2018 and is responsible for formulating monetary policy.[5] It meets at least four times a year. Decisions are made by majority if needed (though so far no votes have been required). Records of each meeting are published. The Bank must also publish four reports on monetary policy every year; they must be approved by the MPC. In practice the quarterly statements and reports are combined.[6] The MPC has five to seven members, including the Governor and two-to-three Bank officers (internal members), and two-to-three non-Bank officers (external members). Internal members must be a majority: currently there are four internal and three external members. Board members cannot be on the MPC. The Board must approve a code of conduct for the MPC, and the relevant Minister and MPC must agree on a charter. There is a Treasury observer on the MPC who is not a voting member. S/he has the same rights to attend and speak at meetings as members. Their role is to support decision making (for example, by sharing information on fiscal policy), and facilitate the coordination of fiscal and monetary policy. Internal members are appointed for up to two terms of up to five years each. External members are appointed for up to two terms of up to four years each. Members are appointed by the Minister on the basis of their knowledge and skills, and not to represent a particular sector. In practice, the MPC meets over five days, and the report and statement are produced at the end of the week of meetings.[7]

(c) PNG Independent Consumer and Competition Commission (ICCC)

As the Kina Bank submission noted, the PNG Independent Consumer and Competition Commission Act 2002 established a Commission with a Commissioner and two part-time Associate Commissioners. One of the Associate Commissioners is required to (a) "have

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[4] Recent statements can be found here.

[5] New Zealand's MPC was created through the RBNZ (Monetary Policy) Amendment Act 2018. As discussed in Chapter 2.4, the RBNZ Act has subsequently been amended to strengthen the Bank's Board. All of the New Zealand examples discussed in this report come from the most recent (2021) Act.

[6] For a recent example, see here.

[7] For more background, see here.

international experience in the operation and administration of an economic regulatory regime" and (b) "shall not be a resident of Papua New Guinea" (Section 11(3)). Such a precedent could be considered for the MPC.

2.3 MPC design issues

In setting out design recommendations for the MPC, we look to international experience (as per the previous section), but also try to build on PNG experience, including by building on the existing (internal) MPC and biannual Monetary Policy Statement (MPS). We try to keep arrangements manageable, bearing in mind the small size of the PNG economy.

Design issues are divided between the following topics: (a) MPC role; (b) MPC membership; (c) meeting arrangements; (d) reporting requirements; and (e) codes. A table in each subsection summarises the New Zealand and Malaysian arrangements as well as our recommendation for PNG.

(a) MPC role

The MPC would be responsible for formulating monetary policy. Beyond that, as per both the Malaysian and New Zealand legislation, the MPC would be responsible for deciding or establishing the approach by which the policy would be pursued. While the MPC would not be responsible for implementation of monetary policy, it should, we argue, oversee that implementation to ensure there is no gap between policy and implementation. This is important because, given the limited effectiveness of monetary policy in PNG, it is easy for such a gap to arise.

Table 2. MPC role: NZ and Malaysian models, and recommendations for PNG

Issue	NZ	Malaysia	Recommendation for PNG
Role	To formulate monetary policy including deciding the approach by which objectives to be achieved.	To formulate monetary policy, and establish general principles, guidelines, terms and conditions for monetary policy operations.	To formulate monetary policy, and oversee its implementation.

(b) MPC membership

A critical set of issues pertain to MPC membership.

The first concerns the size of the MPC. In New Zealand, it is five to seven (currently seven); in Malaysia, up to 11 (currently seven). Bearing in mind the small size of the PNG economy, we recommend a smaller MPC, with four members.

International practice is clear that the Governor should chair the MPC. We recommend that one of the Deputy Governors would also be a member of the MPC. In the Governor's absence, that Deputy Governor would chair.

Should there be a predominance of internal members, as there is in New Zealand and Malaysia? In fact, looking more broadly at international examples, one can find a wide range of approaches. As the table below shows, in some cases there is a majority of internal members, some where there is a majority of external, and some where there is a balance.

Table 3. MPC membership around the world: total, internal and external

Country	Total members	Internal members	External members	Notes
Gambia	8	6	2	Assuming 2 DGs.
Ghana	7	5	2	
Greece	6	3	3	Externals based on Governor's recommendation.
India	6	3	3	
Kenya	8	4	4	At least 2 of external members to be female.
Korea	7	3	4	1 external recommended by Governor.
Malaysia	7	5	2	Numbers reflect current status; max. membership 11; at least 4 internal members.
Mauritania	7	2	5	2 externals proposed by Governor.
Mauritius	8	3	5	
Mongolia	7	3	4	
New Zealand	5-7	3-4	2-3	Internal members must be a majority.
Poland	10	1	9	
Tanzania	4	3	1	External is Board member; assuming 2 DGs
Thailand	7	3	4	4 externals appointed by Board.
Turkey	5	3	2	1 external a Board member.
UK	9	5	4	

Source: IMF Central Bank Legislation Database. Note: External members appointed by government unless specified.

We recommend a balanced approach, with two internal members and two external. We would recommend that decision making be by consensus if possible, but by vote if necessary, with disagreements being recorded, and the Chair having the deciding vote. This would ensure that Bank management, and the Governor in particular, could not be overruled, while maximising contestability.

The two internal members would be the Governor and the Deputy Governor responsible for monetary policy. The two external members would be nominated by the Board. As per the ICCC model (2.2(c)), and reflecting the small size of the PNG economy, one of the two external members would be an international expert, non-resident in PNG.

The two external members would be selected on the basis of their knowledge, skills and character. Their selection would not be representational. There would, as for the Board, be bars on conflict of interest (e.g., a bar on MPs, supervised entities, public officers). (In general, restrictions on MPC membership, guarantees of independence and conditions for removal should parallel those of the Board.) There would be no citizenship requirement, and as mentioned one would be non-residential, and selected as an international expert, on the basis of their knowledge of central banking in developing countries. In New Zealand, MPC members cannot be Board members, but in Malaysia they can. As the Board would provide oversight of the MPC, we recommend against any external MPC member being appointed to the Board.

We would suggest, as per the New Zealand model, a maximum of two four-year terms for the external members.

We recommend that, as per the New Zealand model, there be a Treasury observer, nominated by the Treasury Secretary, who has the same right to attend and speak as any other MPC member, but who has no right to vote (or to have their view incorporated in any consensus decision). As per the New Zealand model, the function of the Treasury observer is to facilitate the coordination of and information sharing in relation to monetary and fiscal policy.

Table 4. MPC membership: NZ and Malaysian models, and recommendations for PNG

Issue	NZ	Malaysia	Recommendation for PNG	Comments
Total membership size	5-7 (currently 7)	Up to 11 (currently 7)	4	Bearing in mind small size of PNG economy.
Chaired by?	Governor (Deputy in Governor's absence).	Governor (Deputy in Governor's absence).	Governor (Deputy in Governor's absence).	
Internal members have majority?	Yes	Yes	Balanced (with Chair having the deciding vote).	Maximum contestability without prospect of management being overruled.
Other *ex officio*	Deputy Governor (1)	Deputy Governor (3)	Deputy Governor (1)	
Other internal members	1-2	Up to 3, but may also be external members; currently 1.	None	Consistent with our balanced model.
External members required?	2-3	Up to 3, but may also be internal members; currently 2.	2	Consistent with our balanced model.
International external member required	No	No	Yes	Recommend applying the ICCC rule.
External members appointed by?	Minister; and gazetted.	Minister on the advice of the Board (on the recommendation of the Governance Committee).	Board (on the recommendation of the Governance Committee).	Board selection would reduce risk of political interference.
Basis of selection	Knowledge and skills; not representational; cannot be Board member.	Expertise and experience; probity, competence and sound judgement. Cannot be MP, director of supervised entity, convicted of criminal offence, bankrupt, public officer. Must be Malaysian citizen. May be a Board member	Knowledge, skills and character; not representational; bars on conflict of interest (e.g. bar on MPs, supervised entities, public officers). May be a Board member. No citizenship requirement.	Bearing in mind small size of PNG economy.

Issue	NZ	Malaysia	Recommendation for PNG	Comments
Removal of members	Minister; only under specified conditions (e.g. 3 or more meetings missed; guilty of misconduct).	Board or Minister if (a) serious misconduct, (b) unsound mind, (C) disqualified due to conflict of interest.	For external members, Board, only on specified grounds. For Governor and Deputy Governor, using grounds and process already legislated.	
Term of non-*ex-officio* members	Internal: 2 terms of up to 5 years each. External: 2 terms of up to 4 years each.	3 years with reappointment.	2 terms of up to 4 years each.	MPC term of *ex officio* members is as per their term.
Treasury observer (non-voting)	Yes	No	Yes	Treasury observer would increase communication.

(c) Meeting arrangements

We now turn to meeting arrangements. We recommend that the MPC tie its meetings to the biannual Monetary Policy Statement (MPS), and therefore convene at least twice per year, with additional meetings to be held if an MPC member deems it necessary, and members to be kept informed on a regular basis. Note that convenings related to the MPS would typically involve more than a single meeting. In New Zealand, each convening involves a week of meetings. While the meeting schedule would not be set out in the legislation (rather in the MPC charter – see subsection (e) below), the New Zealand meeting schedule, shown below, is a useful guide.

Table 5. New Zealand MPS meeting schedule

Monday	Tuesday	Wednesday	Thursday	Friday		Monday	Wednesday
Staff present recent developments, issues, and risks.	Staff present outlook and strategy	MPC discuss risks and external messages	MPC discuss strategy and tactics	MPC decide on strategy and tactics		MPC finalise risks and external messages	MPC decide level and direction of policy instrument MPS release
Information - pooling (Staff as presenters)		MPC deliberations (Staff as advisers)		MPC decisions (Staff not present)			

Source: RBNZ.

The same Reserve Bank of New Zealand document usefully notes:

> This internal decision timetable may be changed as needed to accommodate the availability of MPC members, public holidays, and other relevant factors. MPS release dates and times are fixed (except in extreme circumstances) and published on the RBNZ website at least a year in advance.

This process and timetable uphold the decision-making and communication requirements of the MPC which are specified in the MPC charter. In particular, the charter requires the MPC to produce a summary record of meetings after each policy review, and for this to be accompanied by a Monetary Policy Statement (MPS) on a quarterly basis. The production of these two documents has been incorporated into the process timetable.

The MPS contains the MPC's views on the economic outlook and risk environment. As background to the policy decision, the MPS is drafted after the information-pooling phase and finalised two days before the policy announcement. The first chapter of the MPS, which is the same as the media release, contains the policy decision and MPC's view on the key current risks that need to be emphasised. This chapter is inserted on the day of the announcement.

The summary record of meeting is a record of the decision meetings. It captures the diversity of views that were presented during the discussion. Along with the media release, this summary is finalised on the day of the policy decision.

We have already mentioned that decision making should be by consensus if possible, and by vote if necessary, with disagreements being recorded.

There would be a quorum of three, which would ensure at least one internal and one external member.

Virtual meetings would be allowed, and there would be provision for additional meetings to be held by unanimous resolution.

Table 6. MPC meeting arrangements: NZ and Malaysian models, and recommendations for PNG

Issue	NZ	Malaysia	Recommendation for PNG	Comments
Minimum number of times convened	4 per year; may also make decisions by unanimous resolution.	6 per year; written resolutions not allowed if not discussed at meeting.	Twice per year; may also make decisions by unanimous resolution.	Bearing in mind small size of PNG economy; building on existing twice-yearly MPS.
Decision making by vote or consensus	By vote if necessary; normally by consensus; chair has casting vote.	By consensus.	By consensus if possible; by vote if necessary (with Chair having deciding vote); differences of opinion between voting members to be recorded.	
Quorum provisions	At least 2 internal and 1 external, including Governor or Deputy Governor.	Two-thirds, including Governor or Deputy Governor.	3 (so at least 1 internal and 1 external).	

Issue	NZ	Malaysia	Recommendation for PNG	Comments
Virtual meetings allowed?	Yes	Yes	Yes	

(d) Reporting requirements

The main reporting mechanism for the MPC would be the bi-annual Monetary Policy Statement (MPS). The MPS would be issued after each convening (series of meetings), and would include a meeting report, noting any disagreements. Having the meetings spread over several days allows a report to be produced at the end of the series of meetings, without putting pressure on the MPC to reach agreement immediately and to minimise differences that need to be worked through.

New Zealand also requires a five-yearly report which must "review and assess the formulation and implementation of monetary policy". This would be a good opportunity for longer-term reflection and for addressing issues that might get summary treatment or be neglected altogether in the six-monthly reports. In the New Zealand case, this is a responsibility of the Bank, which is obliged to consult with the MPC on a draft, but, given the expertise required, we recommend that this report be a responsibility of the MPC.

Table 7. MPC reporting arrangements: NZ and Malaysian models, and recommendations for PNG

Issue	NZ	Malaysia	Recommendation for PNG	Comments
MPC publications (to Minister and published)	MPS (approach and reasons) including report of meeting; quarterly.	MPS; six times a year.	MPS including report of meeting; normally half-yearly.	Building on current model.
When is MPS to be produced?	Day after a week of meetings.	Immediately after two-day meeting.	End of series of meetings.	
5-yearly report?	Yes; written by Bank; MPC to comment.	No	Yes, prepared by MPC.	Good opportunity for longer-term reflection.

(e) Codes

Guidance is needed on how the MPC should operate, how any conflicts of interest are to be handled, and what the more detailed transparency requirements should be. Both New Zealand and Malaysia have a code of conduct for their MPCs. New Zealand has a charter as well. We recommend a single charter, which would cover such things as expectations regarding conduct of MPC members (including management of conflict of interest), detailed meeting and reporting requirements, confidentiality requirements, and so on.

Table 8. MPC codes: NZ and Malaysian models, and recommendations for PNG

Issue	NZ	Malaysia	Recommendation for PNG
Code of conduct	Must be approved by Board, be published and cover: conflict of interest, confidentiality, participation and preparation, other minimum ethical standards.	Conflict of Interests Code and Framework for the Appointment of External Members for the Monetary Policy Committee approved by Board.	Single charter to be approved by Board and published.
Charter	Detailing reporting, transparency and decision-making procedures; must be agreed by Minister and MPC.		

2.4 The Board

This part of the chapter considers (a) the responsibilities of the Board, (b) its committees, (c) its membership, (d) its Chair, and (e) its meetings and reports on those meetings, and (f) Treasury observer status.

(a) Responsibilities

The Central Bank Board is given a fairly prescribed role under the CBA. Its responsibilities are:

- To "determin[e] the policies of the Central Bank, other than the formulation and implementation of monetary policy and the regulation of the financial system which shall be the responsibility of the Governor" (Section 26(1)).
- To recommend to the Minister that the Governor be removed from office if in the Board's reasonable opinion "the Governor is guilty of conduct prejudicial to the performance of his duties" (Section 23(1)).
- To review a decision by the Governor to terminate the Deputy Governor if the latter requests it (Section 24(3)).
- To meet at least every three months (Section 32(1)).
- To appoint committees of one or more members and may delegate any of its functions and powers, except this power of delegation, to such committees (Section 34(1)).
- To recommend an increase in BPNG's capital to the Minister (Section 41(2)).
- To recommend transfers from Bank reserves to the Minister (Section 42(2)).
- To determine the net profit at the end of the year and in consultation with the minister determine the amount to be placed into reserves (Section 49(2)).

- To determine if a loss has occurred leading to a significant reduction in reserve funds, in which case the Minister must pay an amount determined by the Board as required to avoid such a reduction (Section 50(2)).

What is missing here is any responsibility for providing oversight. The Board should be responsible not just for policies but for providing oversight in relation to those policies.

The importance of oversight in relation to central banking is increasingly being realised. A recent IMF report concludes that "Central bank laws should systematically set up Oversight Boards, as these bodies are key to the good governance of central banks."[8]

New Zealand presents a good example. The latest revisions to the legislation governing the Reserve Bank of New Zealand involve the strengthening of the role of its board. The NZ Reserve Bank Board, whose role had been, under earlier legislation, to "keep under constant review the performance of the Bank" is now (under the Reserve Bank of New Zealand Act 2021) "the governing body of the Bank" and the Governor, no longer the Board Chair, is described as the Bank's chief executive.

Strengthening the BPNG Board is not a radical proposition. Rather, it involves providing the Board with authorities and responsibilities that are standard for a corporate board. Many of these can be found in the Malaysian central banking legislation, which we draw on in the passages below:

- A general statement is needed that the Board is also responsible for oversight of the policies it sets, and of management.
    - For example, in the case of Malaysia, the Board is responsible (a) "for the general administration of the affairs and business of the Bank and the approval of the budget and operating plan of the Bank;" and (b) for "oversight of the management of the Bank and keep[ing] under constant review the performance of the Bank in giving effect to its objects, carrying out its functions and the use of the resources of the Bank" (Section 14(2)).

- Bank management should be accountable to the Board.
    - As per the Malaysian legislation, "The Governor and Deputy Governors shall be accountable to the Board for their acts and decisions" (Section 15(10)).

- The Board should have oversight of the integrity of the accounts, accounting policies, and financial statements of the Bank, the effectiveness of the internal control system, the performance of the internal audit function, compliance with legal and regulatory functions, and the management of risks (Section 21(4)).

- The Board should also have a role in appointments: in relation to the Deputy Governor (see Chapter 2.1(d)), the Monetary Policy Committee (see Chapter 2.3(b)), and the Board's own membership (see Chapter 2.4(c), and Section 21(3) of

[8] Bossu and Rossi (2019) "The role of Board oversight in Central Bank governance: key legal design issues", IMF Working Paper, WP/19/293, p.62.

the Malaysian legislation.)

- In Chapter 2.7, we note the rapid increase in BPNG operational costs. We recommend that the Board should approve the BPNG budget, and deliver the same to the Minister (compare Section 14(2) and 21(3) of the Malaysian legislation).

- The current legislation gives BPNG responsibility for the appointment of its auditor. In accordance with good corporate practice, it should be the Board who appoints the auditor. BPNG is exempt from the 1989 Audit Act, and thus entitled to appoint its own auditor, with the Auditor General only having the option to undertake an audit rather than the obligation to undertake an annual audit (see Section 47(8) of the CBA and Section 3(3) of the 1989 Audit Act).

- The Board should approve the Annual Report including the audited financial statements, and transmit these to the Minister (as per Section 13(1) of the Malaysian legislation).

- The Board should have access to Bank information.
    - As per the Malaysian legislation, "The Board may require the Bank to produce any book or document and shall have access to any information which is necessary or relevant for the carrying out of its functions under this Act" (Section 14(4)).

- The Board should be able to issue bylaws.
    - As per the Malaysian legislation, "For the purposes of carrying out its functions under this Act, the Board may issue by-laws as are necessary and expedient in relation to the administration, affairs and business of the Bank or in respect of any other matters as set out in this Act" (Section 14(5)).

- Other working arrangements of the Board, consistent with the legislation, would be set out in a Board Charter that would be approved by the Board in consultation with the Minister.

(b) Committees

Currently, the BPNG Board is entitled but not required to establish committees. According to the BPNG Annual Report, there is a Board Audit and Governance Committee, and there is a Board Remuneration and Succession Planning Committee.

While the Board should have some flexibility to organise itself as it sees fit, it is common practice for Central Banks to have legislated committees. We recommend for PNG a modified form of the Malaysian Central Bank committee structure, with an Audit and Risk Committee, a Governance Committee, and a Budget and Investment Committee with responsibilities as follows.

(i) Audit and Risk Committee

a. Assist the Board in its oversight of the
   i. integrity of the accounts and financial statements of the Bank
   ii. effectiveness of the internal control system of the Bank
   iii. performance of the internal audit function of the Bank
   iv. compliance by the Bank with legal and regulatory requirements
   v. review and management of risks.
b. Appoint the auditor and review the audited accounts.

(ii) Governance Committee

a. Recommend external members of the Monetary Policy Committee, and of the Board and Board subcommittees.
b. Assist the Board in reviewing and finalising the Annual Report.
c. Assist the Board
   i. review and approve corporate strategies of the Bank
   ii. review the Bank's performance against benchmarks
   iii. review performance and assist with appointment of the Governor and Deputy Governors
   iv. oversee the promotion of and compliance with ethical and respectful behaviour among Bank staff, and the provision of safeguards to whistleblowers.

(iii) Budget and Investment Committee

a. Examine and recommend to the Board the budget and operating plan of the Bank for approval.
b. Assist the Board in overseeing the implementation of the budget and operating plan.
c. Assist the Board in its oversight of the Bank's investments.

Regarding membership and meeting schedule, we recommend the following for these three Committees:

- Membership of at least three; and quorum of two-thirds.
- Meetings at least four times a year.
- Decisions via consensus, with disagreements to be recorded.
- Board to appoint Chairs (from external Board members).
- At least two external members on each Committee.

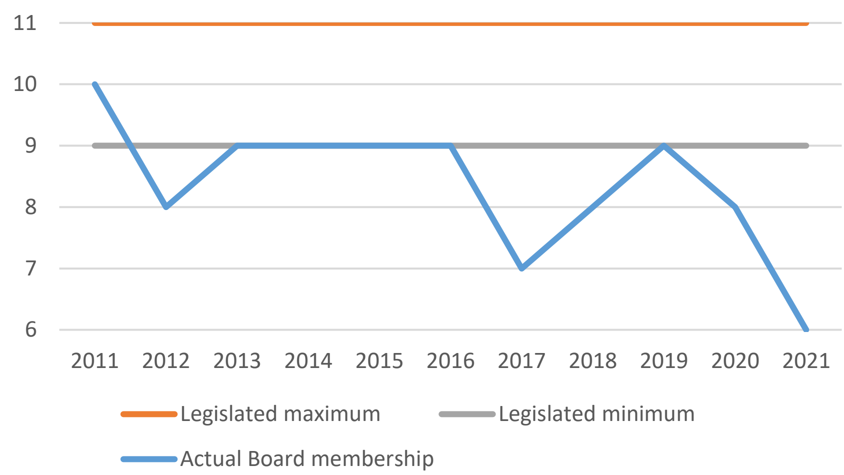
It can also be argued that the Board should have a Financial Sector Policy Committee – again, however, this is deferred to the second phase of the review. The Board would continue to be free to set up other subcommittees.

The Monetary Policy Committee is a Committee of the Bank, not of the Board. We outlined several important roles in the previous section on the MPC that the Board would need to play in regards to it. For example, the Board would select the MPC's external members, and it would approve the MPC's charter. The Board should not, however, be in a position to overturn the decisions of the MPC. That would be too messy and undermine the Governor's authority. However, the current situation where the Board is completely sidelined in relation to BPNG's core function of monetary policy is not satisfactory either. The most recent New Zealand legislation sets out a good middle path. In the New Zealand legislation, the Board's role is to "regularly review the performance of the MPC" (Section 95(1)). Thus there would be a report on monetary policy and its implementation at every Board meeting. While Board members could not direct a different approach, they could certainly ask questions.

(c) Board membership

The PNG CBA establishes a Board with a maximum of eleven members, and requires that there be at least nine. Analysis over the last decade shows that in several years the minimum has not been achieved – see the figure below. As of late September 2021, according to its website, BPNG only has six members, which is three below the legislated minimum, and is the minimum needed for quorum (Section 32(3)). For a variety of reasons, two of the *ex officio* positions were vacant (Securities Commission, Chamber of Commerce), and only one of the three NEC nominees was in place.

Figure 2. BPNG Board size, 2011 to 2020



Source: BPNG Annual Reports.

How large does the Board need to be? A smaller Board would be more efficient and effective. We suggest a maximum of eight, with no more than two internal positions.

Currently, the BPNG Board includes up to three BPNG managers (the Governor, and up to two Deputies), five *ex officio* positions (representatives of the church, business, trade unions, Institute of Accountants, and Securities Commission), and up to three appointees of the Head of State (National Executive Council appointees). These NEC appointees have a three-year term limit; the *ex officio* representatives have no term limit: and, as discussed earlier, the Governor currently has a 14-year term limit, and the Deputy Governors can have any number of five-year terms.

A strength of the BPNG Board, especially compared to others in PNG, is its stability with an average tenure of just over four years over the last decade. Once a Board member has been appointed, there are only very limited conditions under which he or she can be removed. This is a key protection against political interference, which should remain in place.

The advantage of *ex officio* positions is that they reduce the discretion in appointment of Board members. The disadvantage is that such an arrangement might lead to members with little expertise and very long tenures. Some BPNG Board members have had a tenure of 10 years.

In general, we recommend the abolition of the *ex officio* positions. However, one exception we would make given PNG's small size is to consider requesting the Governors of central banks of neighbouring countries, such as Malaysia, New Zealand, Indonesia, Australia or Singapore, to nominate a Board member: a retired senior staff or Board member, or a national expert of the country concerned. (Current staff and Board members would not be allowed due to potential or perceived conflicts of interest.) Term limits should be placed on these *ex officio* positions, for example, two appointments of five years.

NEC appointees are appointed for a three-year term, and may be reappointed any number of times. We recommend this be extended to five years, to reduce the likelihood of vacant positions, but limited to two terms. (From 2017, there have been either only one or two NEC nominees on the Board, out of the maximum of three.) The Act currently requires NEC nominees to have "generally recognised standing and professional experience in monetary and banking matters" (Section 27(2)(c)). Given that the Board is not actually responsible for monetary policy, this could be replaced by "generally recognised standing and relevant professional experience."

To limit ministerial discretion, we recommend that two of the NEC appointees be made on the basis of Board recommendation, without discretion, and that the other two be made in consultation with the Board.

To promote gender equity, we recommend that at least two Board members be women.

Members coming on the Board through this revamping should have staggered initial terms so that no more than one or two Board members need to be appointed at any one time. With a reduction in total board size, the quorum could also be reduced from six to five.

In summary, we recommend total membership of eight:

- two internal members (Governor and one Deputy Governor, selected by the Governor),
- two nominees of neighbouring Central Bank governors,
- two nominees on the recommendation of the Board, and
- two nominees in consultation with the Board.

Overall, these reforms would make for a stronger, more effective and more independent Board, with more of an emphasis on expertise, and less of an emphasis on representation.

While Board members are required to declare any conflict of interest, more rigorous provisions would further safeguard the Bank's independence. It would be sensible to: (a) explicitly state that members of the Board shall not be subject to the direction or control of any person including the Government; and (b) clarify that any officers of entities regulated by BPNG and any government employees should not be Board members.

We also recommend a time limit of 30 days for Board and MPC membership for nominations should vacancies arise.

(d) Board chair

As discussed earlier (Chapter 2.1(b)), the Governor should not be the Chair of the Board due to conflict of interest risks. We recommend that the Board select a Chair and Deputy Chair from among external, resident members. We recommend that the term of the Chair and Deputy Chair be four years. The role of the Chair would be set out in the Board Charter mentioned earlier.

(e) Board meetings

The BPNG Board is required to meet at least every three months. According to Treasury, the requirement (under Section 26(2)) that the Governor "submit every three months to the Minister a report on the proceedings and resolutions of the Board and the steps taken, if any, in consequence thereof" has not been complied with for some time.

We recommend that the Chair and the Governor should have joint responsibility under Section 26(2) of submitting the report after each Board meeting on proceedings and resolutions to the Minister.

We also recommend a summary of every Board meeting be made public.

(f) Treasury Board observer status

As we discuss in the next section, the information flow between the Bank and the Government has often been less than satisfactory. While we would not support Treasury or Treasurer representation on the Bank Board, we see no reason why Treasury should not be given (non-voting) observer status, as it would have on the Monetary Policy Committee (see Chapter 2.3(b)). This would provide a regular communication channel where all else failed. It would ensure that the Bank Board and management were aware of Government concerns without being obliged to act on them.

2.5 The role of Government

The first subsection (a) sets out some of the issues that have arisen over the last decade concerning the relationship between the Bank and the Government. The second (b) looks at how the information flow between the two entities can be improved. The third (c) examines better dispute resolution mechanisms.

(a) Disputes and disagreements between the Government and the Bank

A number of disagreements have arisen between the Central Bank and the Government over a variety of issues. The increase in the Temporary Advance Facility (TAF) is one, though here the Government exercised its primacy via amending the CBA, which is its democratic right. A better example of the kind of issue we have in mind concerns the issue of foreign exchange shortages. The Treasurer has placed on the public record for some time his belief that such shortages are hurting business (see Chapter 5.1 for further discussion of this issue). This is both a reasonable belief and a reasonable concern for a Treasurer to raise. But where has been the dialogue between the Treasurer and BPNG regarding the resolution of this issue, let alone the agreement on how it would be resolved? As far as we can tell there has been no such dialogue or agreement (beyond perhaps the short-term fix of arranging for more foreign loans).

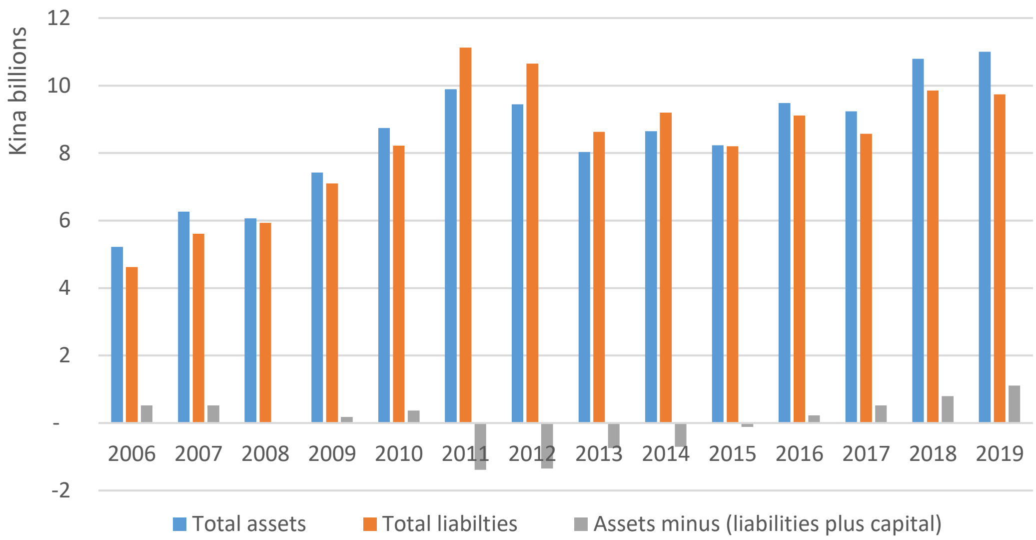
Close coordination is also important. The Bank plays a particularly significant role in relation to the International Monetary Fund, which writes important reports about the PNG economy, and from which the PNG Government borrows. Any such loan is between the IMF and the Government, but BPNG plays a crucial role, not only as the entity to whom the loan funds are provided, but also as part of the negotiating team. Since, given BPNG independence, the Government cannot direct the Bank, close communication and teamwork are vital. The feedback from Treasury and the Treasurer's office indicates that this has not always been the case.

Disagreements between the Bank and the Government have not only related to matters of policy. BPNG is, in a broad sense, a state-owned enterprise, and financial disagreements can arise from time to time between the Bank and its owner, the Government. The CBA states that net operating profits of the Bank shall be divided between Bank reserves and payments to Government (dividends) based on the determination of "the Minister in consultation with the Board" (Section 49(2)).[9] Section 49(3) is clear that "no amount shall be paid" to Government "where, in the opinion of the Central Bank, the assets of the Central Bank are, or after the payment would be, less than the sum of its liabilities and paid-up capital."

This combination of clauses caused problems for the Bank between 2011 and 2015 when, as the graph below shows, its assets fell short of the sum of its liabilities and paid-up capital. This shortfall was due to a number of reasons including: currency appreciation, which made its foreign reserves less valuable in Kina; excess liquidity, which led to more commercial bank deposits at BPNG, a growing liability; and an increasing number of Central Bank Bills (CBBs) to mop up liquidity, another growing liability.

[9] Section 50(1) states that profits arising from revaluations are not available for distribution.

Figure 3. Bank assets and liabilities, 2006 to 2020



Source: BPNG annual reports.

In 2010, the Bank made an operating profit of K22 million. The Board recommended retaining the profit, but in September 2011 the NEC directed that amount to be paid as dividends (BPNG 2011 Annual Report, p.78). BPNG paid this amount. However, the Auditor General, in the 2011 Annual Report, ruled that this contravened the CBA because, in 2011, assets fell short of liabilities.

In 2010 assets exceeded liabilities. However, Section 49(3) states that no amount should be paid to the Government where assets "after the payment would be" less than liabilities. Certainly, assets were less than liabilities at the end of 2011. Moreover, the Act requires the judgement about assets and liabilities to be made by the Central Bank. Presumably the Bank's judgement was that in September 2011 as in December 2011 liabilities exceeded assets.

In 2011 the Bank made an operating loss, and in 2012 it made a small operating profit of K24 million, which it retained. In 2013, however, the Bank made a much larger operating profit of K103 million. This led to an even clearer contravention of the Act as detailed below.

Because assets once again fell short of liabilities (plus paid-up capital), under Section 49(3) BPNG should not have paid a dividend to the Government. However, the Bank was directed by the NEC in December 2013 to pay the dividend of K102.9 million. It paid this amount in December 2014 (BPNG 2014 Annual Report, p.13).

Why did the Board approve this dividend payment? After all the law is clear, and Section 49(3) would have provided a clear defence to any refusal to pay dividends. The reason is given by another clause under which, if the Bank incurs a loss leading to a significant reduction in its reserve funds, the Government is obliged to pay to the Bank such amount as the Board considers necessary to avoid such a reduction (Section 50(2)). The Government is also authorised to issue non-interest notes (promissory notes) for an amount not exceeding such payment (Section 50(4)). The Bank had been requesting such a promissory note since 2011, which was the first year in which the Bank's liabilities exceeded its assets (see the 2011 Annual Report and Figure 3 above).

Finally, the Government issued a promissory note for K1.12 billion on 10 December 2014. The BPNG 2014 Annual Report outlines the clear link between these two, stating that:

> In consultation with the Minister, the Bank paid a dividend of K102 million to the Government in December 2014 out of the retained profits from the 2013 financial year, in exchange for a promissory note issued pursuant to section 50 of the CBA. (p.13)

Once again, the Auditor General in his letter accompanying the 2014 Annual Report dated June 16 2015 noted that this payment "was in contravention of Section 49(3)" of the CBA.

In 2014, the Bank again made a sizeable operating profit (K90 million) and in 2015 it paid that amount as dividends to the Government. Again, under Section 50(3) it should not have, since in 2015, although assets exceeded liabilities, they fell short of liabilities plus paid-up capital. There was, however, no objection this time from the Auditor General, perhaps because assets exceeded liabilities.

Since 2016, BPNG assets have exceeded liabilities and paid-up capital, and BPNG has continued to pay dividends.

The three dividend payments in 2011, 2014 and 2015 raise important issues of governance. Neither the Bank Board nor the Government has complied with the law:

- Payment of the promissory note does not change an illegal dividend payment into a legal one.
- The promissory note itself may not under the Act exceed the Government's payment to the Bank out of the consolidated revenue fund, and no payment seems to have been made.[10]
- The payment and/or promissory note that should have been made in 2011 was not made till 2014.

The appropriateness of the financial arrangements set out in Section 50 is a complex matter which we will address in the second phase of our review. Also in that phase we will need to address the recent disagreements that have arisen between BPNG and the Auditor General regarding the valuation of its holdings of government securities, and the implications for its valuation of assets and for its income.[11]

In terms of broader lessons, this episode reveals evidence of critical weaknesses in governance – in the capacity and leadership of the Bank Board and management, and in the behaviour of Government – in complying with the CBA 2000, and in managing the Bank-Government relationship. It is clear that the Bank Board needs to be strengthened to better manage its relationship with Government. The measures we have proposed in the previous section (Chapter 2.4) will deliver a stronger board, with greater technical skills and

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[10] The 2013 BPNG Annual Report mentioned that the Bank was requested "payment from Consolidated Revenue combined with the issue of a promissory Note to the Bank." In the end they just got the latter.
[11] See the 2019 Part IV Report of the Auditor General, pp.6-7.

international representation, and collectively able to engage constructively with Government whilst maintaining the Bank's independence and integrity.

(b) Information sharing

There are several information sharing provisions under the Central Banking Act. Section 12 requires the Governor to advise the Minister of the effect on monetary policy of any government policy, actual or proposed. Section 13 requires the Governor to report to the Minister where there are adverse conditions that may threaten monetary stability, monetary policy or economic development. Section 14 requires the Bank and Treasury to "keep each other fully informed of all matters" of mutual concern. Section 26(2) requires the Governor to submit a report on each Board meeting to the Minister. Section 44(1) requires Annual Reports to be submitted to the Treasurer. Under Section 8, the Bank shall advise the Minister as soon as practicable where it considers that a regulated body is in financial difficulty.

The Bank and Treasury shared with us very different views on the level of information sharing on practice. According to BPNG:

> There is always understanding, co-operation and collaboration between BPNG and DOT [Department of Treasury].

However, according to Treasury:

> On Treasury-BPNG cooperation, there is already a provision in the Act (Section 14) requiring each part to keep each other informed on all matters that concern the Bank and Department jointly. This generally has not occurred in practice.

According to Treasury, a high-level Treasury-BPNG Committee was established, but only met once.

We have several recommendations to improve the information flow. First, as discussed earlier, both the MPC and the Board would have a non-voting Treasury observer. This would definitely improve information flows, as the observer would be obliged to convey information from Treasury and would better understand BPNG thinking.

Second, the role of Department of Treasury should be more centrally acknowledged within the Act. At the moment, it is only mentioned once, in Section 14, as referenced above (this is the section that requires that the Bank and Treasury keep each other informed). As per the New Zealand model, we propose that Treasury be recognised as "assist[ing] the Minister to carry out the Minister's role (Section 77(2))" in relation to the Central Banking Act. This would give the Treasury greater legal standing to interact with the Bank, which is important since obviously there are limits to what the Treasurer as an individual can do.

Third, we want a more constructive working relationship between not just the Treasury and the Bank but also the Treasurer and the Bank. To this end, we recommend adopting the Malaysian obligation that the Bank be proactive in keeping the Minister informed. The relevant section is as follows:

> The Bank shall keep the Minister informed of policies relating to its principal objects (Section 72(1)).

Fourth, if the Minister feels s/he is not getting the information s/he needs, s/he should be able to request it. As per the New Zealand legislation, the Bank should be obliged to supply to the Minister any reports or other information related to the performance of its duties that the Minister requests, within a time period and in a manner reasonably required by the Minister. (Section 193 and 194).[12]

(c) Dispute management

There are three possible ways to handle disagreements. The first gives pre-eminence to the Central Bank. Under this option, the Bank has the last word. As long as it stays within the legislation defining its responsibilities and authorities, there is nothing the Government can do.

The second option gives *ex ante* pre-eminence to the Government. Under this option, the Government gets to spell out in more detail than in the legislation what the Bank should do. Operational responsibility is still left with the Bank, but objectives are articulated by the Government of the day, in more detail than by the legislation.

The third gives *ex post* pre-eminence to the Government. Under this option, the Government intervenes only if it finds itself in disagreement with the Bank. If so, a mediation procedure is put in place, but with the Government ultimately having the last word.

In terms of real-world examples, PNG's current legislation is an example of the first option. PNG's Central Banking Act gives pre-eminence to BPNG. Say that the Government thought that the Bank was not doing enough to control inflation. There is in fact nothing it could do.[13]

New Zealand gives us an example of the second, *ex ante* Government pre-eminence option. In New Zealand, the relevant minister is required to issue a remit to the MPC. The remit may provide targets for specific objectives (e.g. a specific inflation rate that the Bank should target) or a "framework for weighting the economic objectives", that is, for resolving trade-offs. The remit can also define "any matters in connection with an economic objective" and may set down "a requirement for the MPC to have regard to one or more matters in connection with seeking to achieve an economic objective" (see Section 119 of the Reserve Bank of New Zealand Act 2021). In fact, in New Zealand, Cabinet may even instruct the MPC to ignore the objectives set out in the Act, and pursue other objectives (Section 121).

Malaysia gives an example of the third, *ex post* government pre-eminence option. In Malaysia, if there is a disagreement between the Minister and the Bank "relating to its principal objects"

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[12] In the New Zealand legislation, this is a requirement in relation to the Board, but we feel it would be more usefully expressed in relation to the Bank as a whole. Also, the wording has changed with the most recent (2021) amendments. This (simpler) wording and reference comes from the amendments of 2018.

[13] Dismissing the Governor is not a practical option; in practice, dismissal would occur only following improbity.

they must try to reach agreement (Section 72(2)).[14] If they cannot, the Bank must submit a statement to the Minister, and the Minister must take that statement to Cabinet, who can then direct the Bank. The Bank must then implement Cabinet's decision, but may table any objections in parliament.

Finally, Australia presents an interesting case. It has legislative provisions for almost exactly the same *ex post* dispute resolution mechanism as Malaysia. It also has a non-legislated practice of producing joint "Statements on the Conduct of Monetary Policy" by the Treasurer and the Governor, about every three years. This "has recorded the common understanding" between the Governor and the Treasurer "on key aspects of Australia's monetary and central banking policy framework since 1996." Such a practice gives both sides equal importance, since agreement is needed to reach the document.[15]

Each of these three options has pros and cons. The problem with the first (Bank pre-eminence) is the democratic deficit. Moreover, if the Government feels the Central Bank is not implementing its policy properly, a sub-optimal outcome may result; for example, the government might interfere with or diminish the Bank's independence, perhaps by legislation.

The problem with the second (Government *ex ante* pre-eminence) is that, in an economy such as PNG's, which is prone to shocks, and where the effectiveness of monetary policies is in any case limited, it may be unhelpful or even counterproductive to articulate objectives beyond the extent to which they are laid out in the legislation. For example, inflation can spike if there is a depreciation. Even if the government wanted to provide an inflation target, given the limited effectiveness of monetary policy (see Section 3.2), there is no guarantee that the Bank would be able to hit the target.

That leaves the third option (Government *ex post* pre-eminence) which is the one we put forward. It is very important to note that this only gives the Government the right, after a pre-ordained and transparent process is undertaken, to order the Bank to change its policies, and only then in accordance with the legislation.

We also invite the Treasurer and the Governor to consider a joint statement, such as is produced every three to five years in Australia. As in the Australian case, such a requirement should not be a legislative mandate (since it might open the door to political interference, and it might over-burden the system), but consideration of such a joint statement could help produce a more cooperative attitude between these two critical arms of state.

We do not see this option as opening the door to political interference. We find it highly unlikely that the Cabinet would decide to "take on" the Bank through the dispute resolution mechanism, and in any case the Cabinet's decisions and the Bank's response would both be constrained by legislation. As far as we are aware, the dispute resolution mechanism available to the Central Bank and Government in both Malaysia and in Australia has been used in neither country.

[14] The "principal objects" of the Malaysian Central Bank are "to promote monetary stability and financial stability conducive to the sustainable growth of the Malaysian economy" (Section 5(1)).
[15] The most recent such statement was issued in September 2016.

2.6 Accountability and transparency

According to the 2009 BIS Survey quoted earlier (*Issues in the governance of central banks*), "[t]he key issue is to strike the right balance between protecting the independence of the central bank and preserving its accountability" (p.135).

BPNG is required (under Section 44) to submit to the Minister an annual report within six months of the end of the financial year (along with audited financial statements, the auditor's report, and a statement on projected income and expenditure for the next financial year). The section also requires that this report be tabled in Parliament and be referred to an appropriate parliamentary committee. The 2019 annual report was only added to the website in September 2021. The 2020 annual report and financial statement is not yet on the website (though it is more than six months after the end of the last financial year). The Bank needs to be more prompt in completing and publishing its annual reports. Ideally, such reports would be considered by a parliamentary committee. At a minimum, however, they should be available for public scrutiny.

Transparency promotes accountability. There is a growing trend among central banks towards transparency, with an increasing number publishing their monetary policy strategy, their macroeconomic forecast and model, and meeting minutes. In 2020, the IMF released its updated Central Bank Transparency Code.

The Bank does regularly issue forecasts for GDP, balance of payments and inflation. This is a positive. They are included as part of the six-monthly policy statements. There has been little discussion in these statements of changes to exchange rate policy (Chapter 5.1) or purchases of government securities (Chapter 3.2).

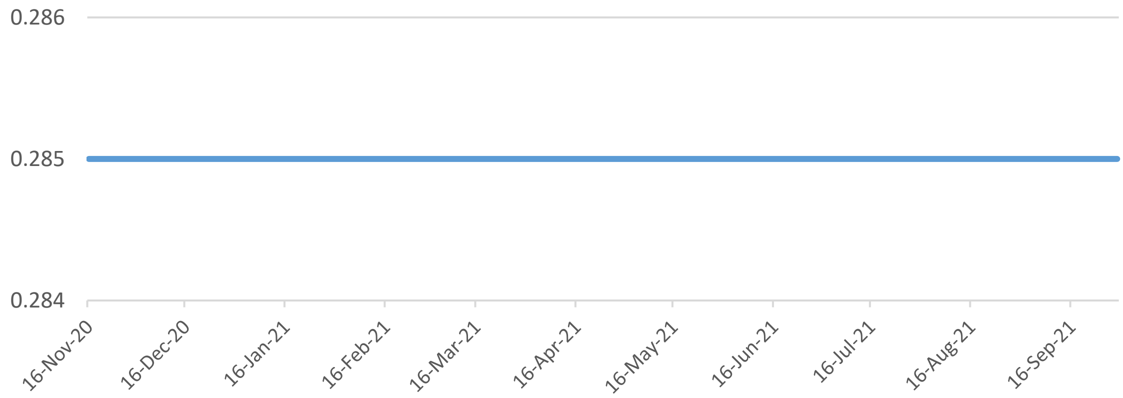
The BPNG website is a potential platform for transparency, and an invaluable source of data, but much information is out of date.[16] As of late September 2021, statistical information in the Quarterly Economic Bulletin (QEB) tables was only updated to December 2020, nine months ago; data on Treasury Bill (T-Bill) and Inscribed Stock (IS) auctions are also only up to 2020; the last Quarterly Economic Bulletin is December 2020; and the last Monthly Economic Review is for June. (Monthly reviews for March-June were all issued in September.) While COVID-19 might cause some delays in some data, there is no excuse for first quarter BPNG data to be missing from the website as of the third quarter of 2021. Moreover, with COVID-19 there is even more need for timely data.

Some of the Bank's policy statements have suffered from a lack of transparency. For example, the MPSs should contain a statement on Bank purchases of government securities over the period, but generally do not. Sometimes, the MPSs have even been misleading. For example, in its September 2021 MPS, the Bank stated that "the floating exchange rate regime introduced in 1994 remains in place". As we discuss in Chapter 5.1, in PNG the exchange rate is set in the Interbank Market. The USD/Kina daily exchange rate on the Interbank Market is

[16] This was also commented on by one of the submissions we received. Mr Brian Gomez, a former PNG adviser and journalist, wrote that "At this current time, BPNG's most recently quarterly bulletin is for the December quarter of 2020. It was released on August 10 this year. By contrast the Reserve Bank of Fiji at this time has published its quarterly report for the June quarter of 2021, as have Malaysia, Philippines and other countries."

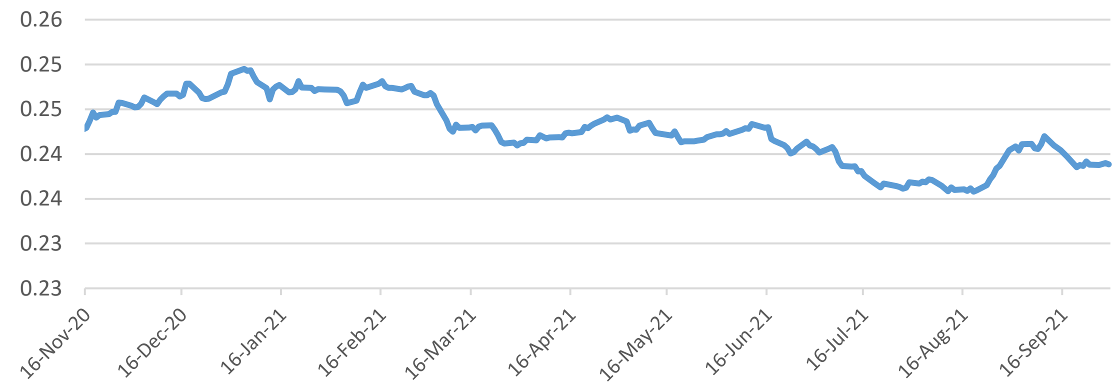
published by BPNG. It is unchanged since November 2020. An exchange rate that doesn't change for such a long time clearly cannot be floating. A floating exchange rate is one that moves up and down. The graphs below compare the USD/Kina interbank exchange rate and the USD/Malaysian Ringgit interbank exchange rates, the latter but not the former being a floating rate.

Figure 4. The USD/Kina interbank exchange rate from November 2020 to September 2021: not floating



Source: https://www.bankpng.gov.pg/historical-exchange-rates/

Figure 5. The USD/Malaysian Ringgit interbank exchange rate from November 2020 to September 2021: an example of a floating exchange rate



Source: https://www.bnm.gov.my/exchange-rates

Such statements by the Central Bank undermine its credibility.

We also received feedback from stakeholders not only for more information, but for more engagement, and for respectful dialogue. Ongoing, persistent disconnects between the private sector and the Bank about the seriousness of foreign exchange shortages could have been avoided by more regular exchanges of views.

Greater emphasis on collegial decision making (see Chapter 2.1) should itself lead to more engagement, accountability and transparency, as it will mean that Bank decisions will be more contestable. In addition, we propose the following legislative requirements:

- A statement be released after every MPC meeting and Board meeting (as discussed earlier).

- BPNG be required to release economic information in a comprehensive and timely manner.
- BPNG be required to release its annual and financial report on the website within six months of the completion of the relevant year.
- BPNG be required to engage in stakeholder dialogue.

2.7 Management performance

The Bank's staff costs have doubled after inflation between 2010 and 2019, and total costs have more than doubled after inflation over the same period. The BPNG Act has provision for a performance (not policy) audit (Section 48), but one has not been undertaken. Calling for a performance audit would itself be a vote of no confidence in the Bank, and would be a drastic measure. It is not, therefore, realistic to rely on this as a measure or threat to ensure performance. Overall, in the opinion of the IAG, better management performance will be obtained with stronger governance, in particular with a stronger Board and a Board that is more focused on oversight (as we recommend in Chapter 2.4).

Other issues concern the Bank's asset management and its financial performance more generally. Given time constraints, these would need to be the object of investigations in our second phase.

Chapter 3. Financing

Under this heading, we "[r]eview the current arrangements around advances and financing to the government by the Central Bank, including a review of the TAF … (focus on Section 55)" ["Options around quantitative easing options during a declared emergency" are discussed under item 5 below.]

We first review the Temporary Advance Facility (TAF) (Chapter 3.1). We then assess recent trends in BPNG purchases of government securities, including the so-called "slack arrangement" (Chapter 3.2) and consider reforms in this area (Chapter 3.3). We note that a loophole has emerged over the last decade which has led to excessive central bank deficit financing, and propose a pragmatic, conservative approach to close it.

3.1 Temporary Advance Facility

The Temporary Advance Facility (TAF) is established under Sections 55(2) and (4) of the CBA to provide short-term advances to the Government. In 2020, the Government amended the CBA to increase the TAF cap from K300 million to 12% of revenue and grants (including aid), averaged over the last three years (currently about K1.7 billion).[17] The Act was also amended to give the Government 12 months to repay the TAF, up from six.

The amended Section 55(2) reads:

> (2) The Central Bank may grant temporary advances to the Government in respect of temporary deficiencies of revenue due to cash flow mismatches at an interest rate or rates no less favourable than the prevailing rates payable by the Government on Treasury Bills or notes, or securities issues by the Government.
>
> (4) Subject to Subsection (6),[18] the total amount of advances under Subsection (2)
>
> (a) shall not at any time exceed 12 percent of the annual average total revenue and grants receipts (including donor grants but not including once off asset sales or their equivalent) averaged over the previous three years to the year in which advances are sought.
>
> (b) shall be repaid to the Central Bank as soon as practicable, but in any case, not later than twelve months from the date of the advance.

Section 55(3) was removed in 2020. This had authorised BPNG only to grant advances "where the granting of such an advance to the Government is not inconsistent with the monetary policy stance outlined in policy statements of the Central Bank." The amendments also removed the TAF from the prohibition of Central Bank deficit financing (Section 55(9)).

[17] Prior to this amendment, the cap had always been expressed in nominal terms, but had been revised upwards from its initial value of K100 million.

[18] Subsection (6) refers to advances outstanding at the time of the 2000 Act and is no longer relevant.

BPNG was unhappy with the amendments, arguing that it was not consulted, and that the 12-month payment period is too long.

The earlier TAF limit was low by international standards, and the reform may help the Government solve its serious cash flow problems at the start of the year. The current limit is obviously higher by international standards, but reasonable. In Malaysia, temporary financing is limited to 12.5% of estimated revenue in the current year (Section 71(3)),[19] and the amount must be paid by three months after the end of the fiscal year in which it is extended.

BPNG has also argued that the increase in the TAF would worsen the problem of excess liquidity (discussed below), and “pose[d] a challenge to monetary policy management” (March 2021 MPS p.3). It therefore sold government securities in the second half of 2020 to “diffuse part of the liquidity injected through the TAF” (p.3). Whether or not the liquidity concerns were justified, it was odd for BPNG to sell these securities before it had observed how much the Government would use the TAF. According to Figure 6 below, the TAF has hardly been used in recent years, including in 2020. We lack full data for 2021, but we understand that there has been some limited use of the TAF this year.

The Government has a legitimate need to smooth cash flow, and PNG has a well-known problem of back-end loaded expenditure. Spending more earlier in the year would improve spending effectiveness. From this perspective, we endorse the increase in the TAF, and agree that the provision of the Facility by the Central Bank, given its short-term and capped nature, does not need to be dependent on an assessment of monetary policy conditions.

As mentioned above, advances have to be paid back within 12 months (earlier six months). The purpose of the TAF is to smooth cash flow. It is envisaged that it would be utilised early in the year and repaid at the end of the year. The Malaysia model is that the temporary advances have to be paid back not more than three months into the next fiscal year. Another alternative would be to require that the TAF be paid back within the fiscal year.

Neither alternative would be markedly different in practice from the 12-month rule currently in place. However, it is important to send a clear signal that the TAF is not a deficit financing mechanism but, as per Section 55(2), an advance “in respect of temporary deficiencies of revenue due to cashflow mismatches”. Therefore, we propose that the TAF provisions be amended to enforce repayment within the fiscal year.

The current legislation states that the TAF advance is to be paid back with interest “at an interest rate or rates no less favourable than the prevailing rates payable by the Government on Treasury Bills or notes, or securities issued by the Government.” For clarity, we recommend that “no less” be replaced by “no more and no less” and “prevailing rates” be replaced by “prevailing comparable rates”.

The Malaysian legislation states that “if after that date [i.e. that date on which repayment is due] any such financing remains outstanding, the power of the Bank to extend further

[19] This includes other government securities purchased by the Central Bank, excluding those acquired in the course of monetary policy operations (Section 71(3)).

financing in any subsequent financial year shall not be exercisable unless and until the outstanding financing has been repaid" (Section 71(2)). This is a useful discipline, and we recommend a similar clause be added to the PNG legislation.

The 2020 amendments defined revenue excluding privatisation receipts but including aid. We would argue that both should be excluded. Much aid is spent off budget, and there are few if any problems with cash flow when it comes to aid.

Finally, the 2020 amendments leave it as a matter of discretion for BPNG whether it will provide the TAF.

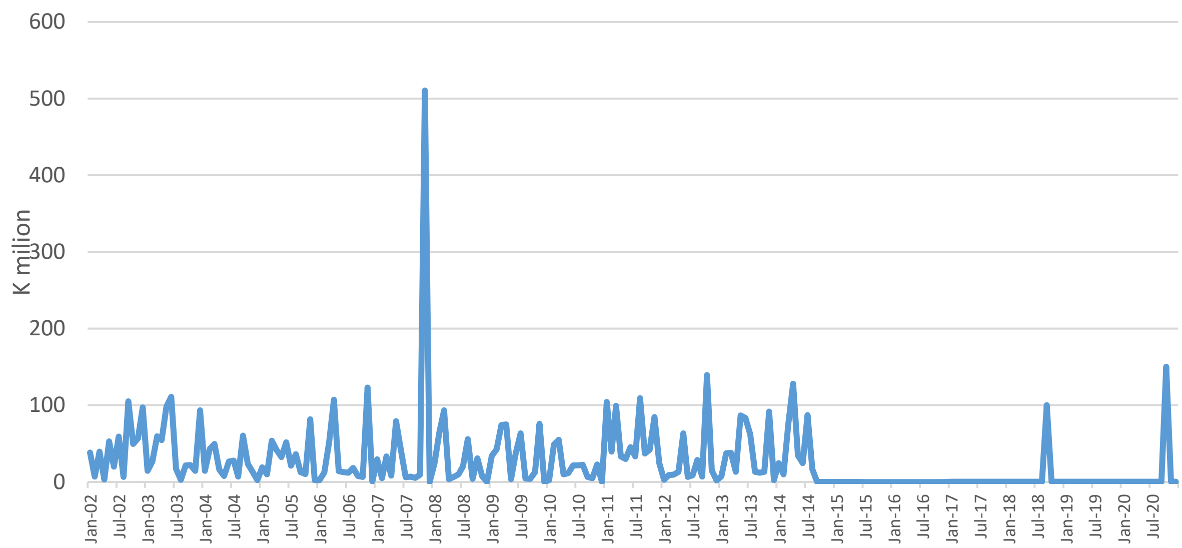
In Chapter 5.5, we argue that providing good banking services should be one of the objectives of the Central Bank. The provision of the TAF is (unlike financing) a banking service that BPNG provides to the Government. In addition to this new objective, good relations between the Central Bank and the Treasurer and Treasury, and regular meetings, as proposed by various mechanisms in the previous chapter, should further reinforce a sense of collaboration in relation to the TAF, among other areas of mutual interest.

There nevertheless remain two risks: one that the Central Bank might refuse to issue the TAF without justification; and, two, that the Government will ask for it unreasonably, for example, very late in the year, and not because of a temporary cashflow mismatch. In general, as set out in the Executive Summary, we aim in this report to reduce the scope for discretion. We propose that in Section 55(2) 'may' be replaced by 'will'. This still leaves room for the Governor to exercise judgement as to whether there is a temporary cashflow mismatch, but provides no other grounds on which the Governor could refuse a compliant request for an overdraft.

It is one thing to amend the legislation underpinning the TAF. It is another thing for the Government to use it, and another thing still to resolve its cash-flow problems. In these paragraphs, we outline some of the underlying problems regarding TAF usage and budget cash-flow.

Utilisation of the TAF has been very low in recent years, as the graph below shows. It is not clear how advances could have reached K500 million in late 2007, but it is also evident that from 2015 the TAF has hardly ever been used (up to the end of 2020). This is surprising since the PNG government has had well-publicised cash flow problems since the end of the resource boom. One possible explanation for this is that, as discussed in the next part of this chapter, since 2015 BPNG has been buying large volumes of T-Bills and these may have become a substitute for the TAF.

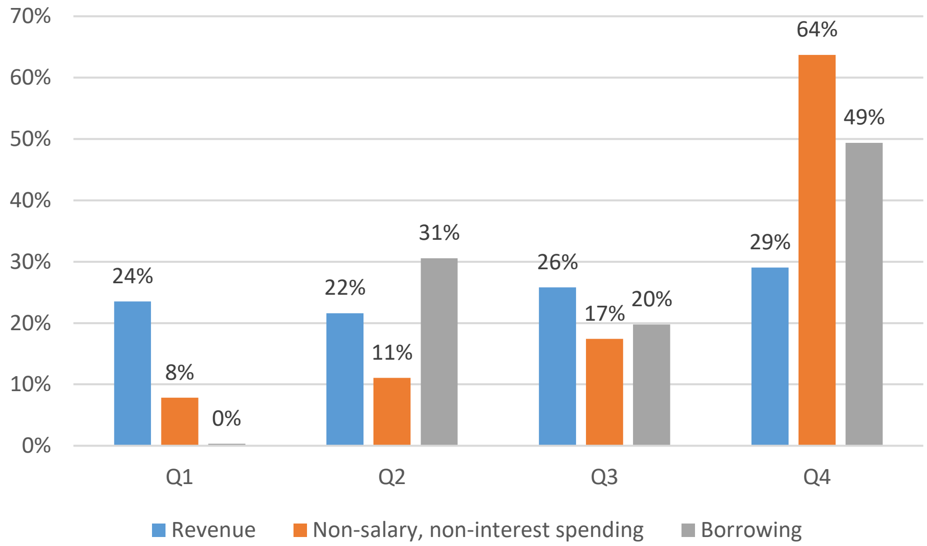
Figure 6. TAF advances from BPNG to Government, 2002 to 2020



Source: BPNG QEB Table 2.3. Notes: Data to December 2020. Balance at the end of each month

Spending remains very uneven. BPNG data for 2020 suggests that almost two-thirds of non-salary, non-interest government expenditure in this year was in the last quarter, and only 8% in the first quarter. Revenue was quite evenly spread over the year but, at least last year, borrowing, which has become increasingly important relative to revenue, was also back-end loaded. Uncertainty about borrowing prospects (especially overseas borrowing, which is very lumpy) would have led to spending hesitancy, but provides some justification for the TAF, since the borrowing was, at least in 2020, so back-end loaded.

Figure 7. Revenue and spending by quarter in 2020



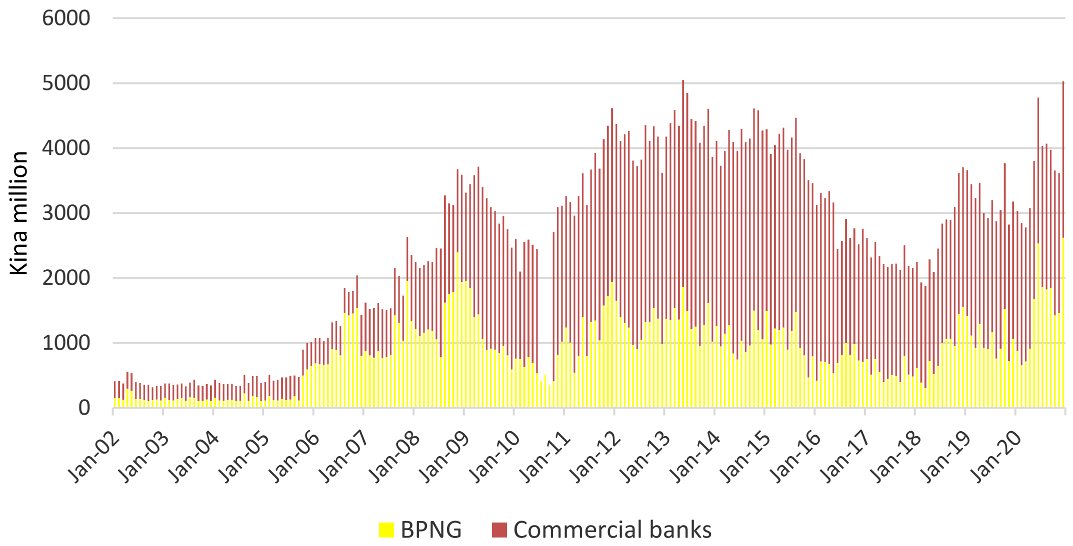
Source: Calculated from BPNG QEB Table 7.1. Note: It is assumed that salary and interest spending are smoothly spread over the four quarters.

Spending is allocated to the quarter in which cheques are issued. Most cheques are issued in the last quarter (the 64% figure in 2020 in the graph above), but a significant amount of non-salary, non-interest spending may not be cashed until the completion of the first half of the following year (say, 15-20%). This means that actual on-the-ground spending is smoother than the above graph suggests, since in the first and even in the second quarter actual spending will be a mix of this year's and last year's budgeted expenditure. However, this is hardly an improvement. First, issuing cheques several months before they are cashed, and in a hurry to meet end-of-year deadlines, is a recipe for corruption and mismanagement. Second, the stock of uncashed cheques becomes another claim on the next year's revenue and another drag on spending that year's budget. If departments have to acquit their last year's funds before they receive this year's, and it takes several months to do that, then this will also lead to an end-of-year spending rush.

Yet another piece of this complex puzzle can be seen in the next graph which shows government deposits at both BPNG and the commercial banks. Despite a tight budgetary position and the accumulation of arrears, since 2008 these deposits have hardly ever fallen below K2 billion, and the most recent data puts them at K5 billion. Since January 2011, deposits at the Central Bank have varied between K300 million and K2.6 billion. These deposits are government funds not yet spent (though they may have been committed or even counted as spent if they correspond to cheques written). K2.6 billion in BPNG deposits (at the end of December 2020) would seem excessive.

Deposits at the commercial banks have varied between K1.5 billion and K3.4 billion. Deposits at the commercial banks used to reflect trust account balances. However, these have fallen to only about K250 million according to the latest Final Budget Outcome. What contributes to the K2.4 billion of central government deposits at commercial banks requires further investigation.

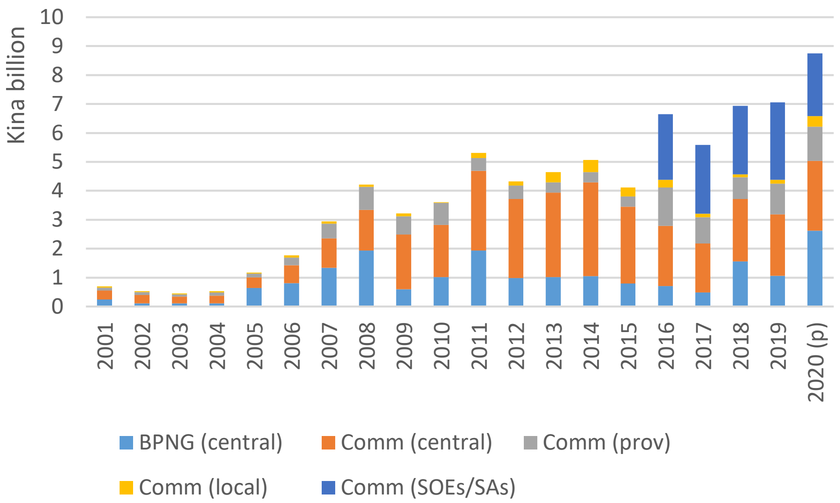
Figure 8. Central government deposits at BPNG and at commercial banks, 2002 to 2020



Source: BPNG QEB Table 2.2. Commercial bank deposit data monthly, but missing for July to September 2010.

Finally, we can bring in provincial, local and SOE/Statutory Authority deposits. The latter category presumably includes District Services Improvement Program (DSIP) funding, which goes to District Development Authorities (DDAs). Once these deposits are included, the total value of government deposits in the banking system – including both BPNG and the commercial banks – is K8.7 billion. Getting these deposit levels down might be difficult but would both help deal with the problem of excess liquidity and provide a one-off debt-free boost to spending.

Figure 9. All government deposits at BPNG and at commercial banks, 2001 to 2020



Source: BPNG QEB Tables 2.2 and 3.8. Notes: 'Comm' stands for commercial bank deposits of different type, central government ('central'), provincial government ('prov'), local government ('local') or 'SOEs/SAs'. SOEs are state owned enterprises, and SAs are Statutory Authorities (including DDAs which receive DSIP funding). The SOE/SA category was only introduced in 2016.

While these problems run deep, a plan must be made both to reduce government deposits and to smoothen government spending, and thereby increase its productivity.

3.2 Deficit financing and the slack arrangement

The TAF facility is intended not for deficit financing but cash flow management. Rules governing BPNG lending to the Government are provided by Sections 55(8) and (9). These two clauses read as follows:

> (8) The Central Bank may, for purposes of monetary policy management, purchase treasury bills or notes or securities issued by the Government at market-determined yields and such treasury bills, notes or securities will be excluded for the purposes of determining aggregated outstanding advances pursuant to Subsection (4).
>
> (9) Excluding the temporary advances available in accordance with Subsection (2) and (4), the Central Bank shall not grant advances to the Government in respect of, or for the purpose of funding, a Government fiscal deficit.[20]

Together, these two clauses imply that whether purchases of government debt by BPNG are allowed depends on the purpose of that purchase: yes, if it is for monetary policy

[20] Note that Section 55(9) was also revised in 2020. Earlier, the clause contained the words "Notwithstanding anything to the contrary contained in this section" instead of "Excluding the temporary advances available in accordance with Subsection (2) and (4)". Subsections (2) and (4) relate to the TAF.

management (Subsection 8); no, if it is for the purpose of funding a deficit (Subsection 9).

There are two problems with this set-up. First, it is very difficult in general to verify a purpose, and to distinguish between a genuine purpose and a rationalisation. Second, the differences between monetary policy and deficit financing can be blurred, especially, as we will see below, in PNG.

These problems have led to confusion, loopholes and a lack of transparency. Policy measures have been advanced that have had the effect of providing substantial, and in fact unlimited, assistance to the Government to finance its deficit.

In its September 2014 Monetary Policy Statement, BPNG announced that because the "issuance of Government securities led to a sharp increase in domestic interest rates … the Treasury Department agreed for the Bank to take up under-subscriptions at the Treasury bill and Inscribed stocks auctions to on-sell to the public for monetary policy purposes" (p.10). This became known as the "slack arrangement".

The original slack arrangement ran to March 2015, at which point it was suspended.[21] In 2015, the IMF advised BPNG "to refrain from providing any direct financing to the government." BPNG in response "reiterated its intention to avoid any direct financing of the government budget deficit" (IMF 2015 Article IV, p.11).

In fact, however, the slack arrangement was re-introduced in July 2015. BPNG has informed the IAG that the slack arrangement ended in 2018. In 2020, as part of its Staff Monitored Program with the IMF, BPNG and the Government agreed not to make further use of the slack arrangement.[22] We are informed that in 2021 BPNG has recommenced the practice of purchasing undersubscribed government securities;[23] whether BPNG will hold these beyond the end of the year remains to be seen.

As is evident from these quotes, there are two types of government securities in PNG: Treasury Bills (or T-Bills), and Inscribed Stock (IS or bonds). The latter have a longer maturity.

It is not clear if all purchases since 2014 by BPNG of T-Bills and Inscribed Stocks have been through the slack arrangement, or if BPNG has also been purchasing these securities from banks and other holders. In its annual reports, the Bank talks about the slack arrangement only with reference to T-Bills, but in the September 2014 and September 2017 MPS announcements it is clear that this arrangement also covered Inscribed Stock.

The slack arrangement was carried out with a low profile. While monthly figures on BPNG holdings of government securities can be found in the BPNG monthly statistics, such statistics receive little attention, and are often published with considerable delay. (At the end of

[21] Suspension was announced in the BPNG March 2015 MER (p.2).

[22] One condition of the SMP is "Halt BPNG financing of the public sector. BPNG additional net lending to the government under the 'slack' arrangement will be limited to zero (Quantitative Target)."

[23] The September 2021 MPS states that "between the end of December 2020 and June 2021, there was a net injection of K431.5 million through trade in Government securities", which presumably refers to the purchase of government securities by BPNG.

September 2021, the latest monthly figures were for December 2020.) Moreover, no distinction is made in these statistics between government securities purchased from government and those purchased from third parties.

We could not find reference to the slack arrangement in annual government budget documents.

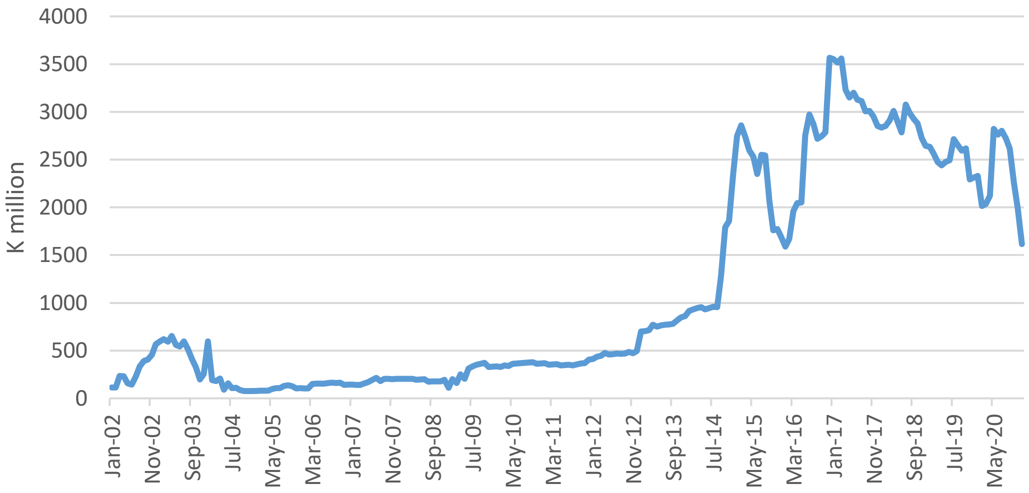
BPNG mentioned the slack arrangement only twice in its six-monthly MPSs, once, as mentioned above, in September 2014, and then again in September 2017 when it said:

> In light of the Government's tight cash-flow and domestic financiers reaching their limit on sovereign exposure, the Central Bank had to assist the Government by buying Government Securities (Treasury bills and bonds) when the auctions were undersubscribed. The formal arrangement, referred to as the Slack Arrangement, was entered into by the Treasury Department and the Bank from September 2014 to March 2015. Thereafter, this arrangement continued through exchange of letters up to 2016. The Bank has actively sterilised this liquidity generated by the Slack Arrangement through on-selling of the Government securities and CBBs to the market. As at the end of August, the Bank's holding of securities (Treasury bills and bonds) under the Slack Arrangement was K1.600 billion. (pp.11-12)

This was the only time at which BPNG revealed the extent of its engagement in deficit financing. The figure of K1.6 billion is equal to the increase in BPNG holdings of government securities between August 2016 and September 2014. This suggests that all purchases of government securities over this period were direct from Government, under the slack arrangement.

In any case, the holdings by BPNG of government securities (T-Bills and Inscribed Stock) have increased massively since the slack arrangement was introduced, as the figure below shows.

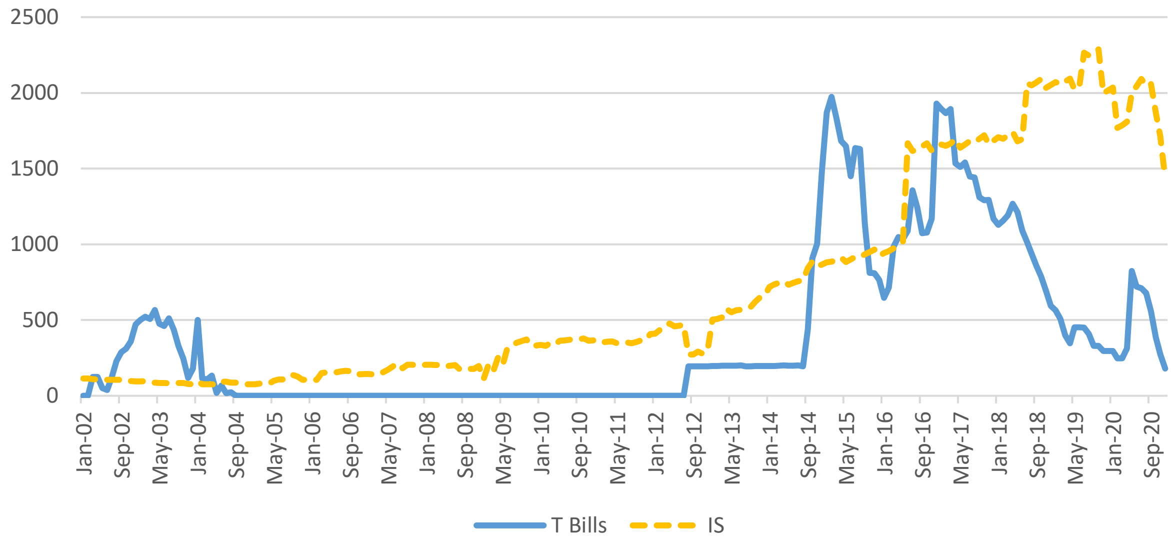
Figure 10. BPNG holdings of government securities, 2002 to 2020



Source: BPNG QEB Table 2.3.

The next figure shows T-Bills and Inscribed Stock separately. BPNG holdings of T-Bills went from K193 million in August 2014 to K1,974 million in February 2015, an increase of K1,780 million in just six months. BPNG holdings of Inscribed Stock went from K762 million in August 2014 to K1,625 in August 2016, an increase in K862 million in two years.

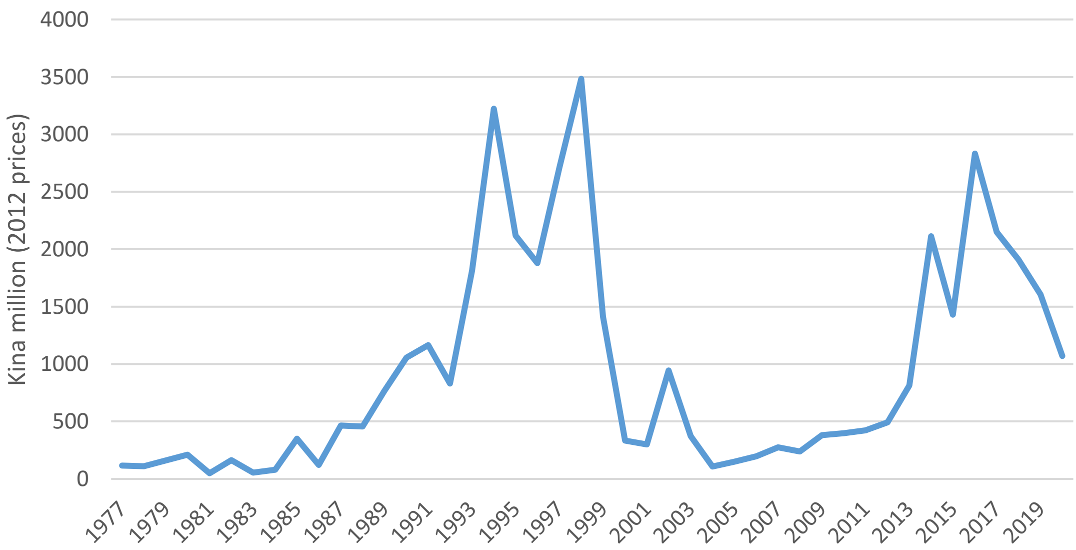
Figure 11. BPNG holdings of T-Bills and Inscribed Stock, 2002 to 2020



Source: BPNG QEB Table 2.3.

The figure below shows a longer time perspective. One of the main motivations of the central banking reforms of 2000 was to bring an end to excessive Central Bank financing of the deficit. However, adjusted for inflation, BPNG government debt holdings around 2016 were close to the levels seen in the crisis years of the mid and late 1990s. In fact, in 2016, 90% of domestic borrowing undertaken by Treasury was from the Central Bank.

Figure 12. BPNG holdings of government debt (securities), adjusted for inflation, 1977 to 2020



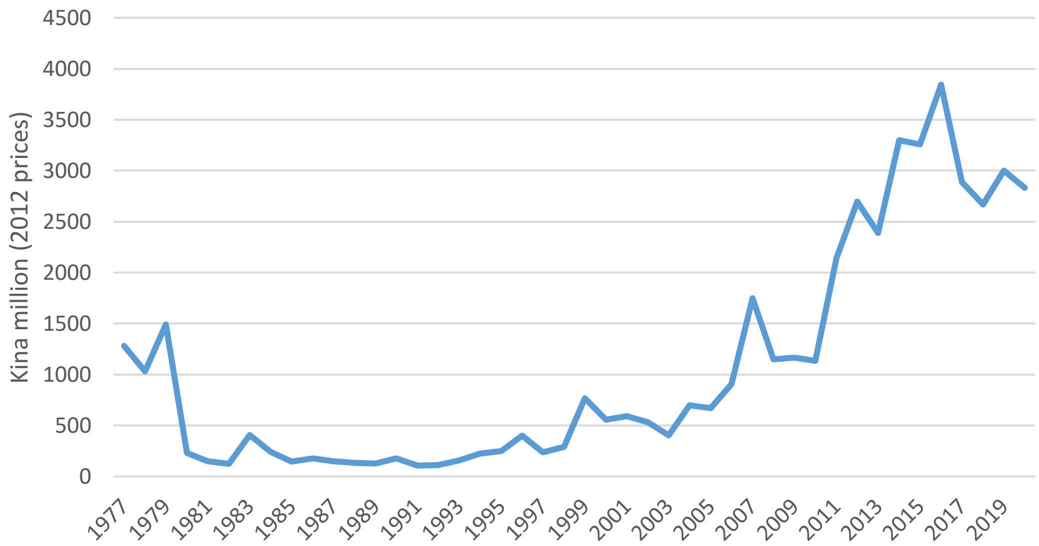
Source: PNG Economic Database.

Why did BPNG engage in such an ambitious program of purchases of government securities from 2014 onwards? The written rationales, mentioned above, refer to the need "to address the sharp increase in the interest rates of domestic Government securities" (BPNG 2015 Annual Report, p.32) and "to assist the Government" given "tight cash-flow and domestic financiers reaching their limit on sovereign exposure" (September 2017 MPS, pp. 11-12).

These rationales require further investigation. Section 55(8) requires that the purchase of bonds be justified with respect to monetary policy management, so we need to examine the issue from this perspective, as we do in the next few paragraphs.

It is well known that commercial banks hold deposits at BPNG way in excess of the Cash Reserve Requirement (CRR). The growth in commercial bank deposits at BPNG is one of the major monetary developments of the last decade or so. As the graph below shows, apart from the first few years after independence, commercial bank deposits at BPNG were less than K500 million (in 2012 prices) until in the early 2000s. Then with the resource boom, deposits poured into the commercial banks. Unable to find enough loans to utilise them, banks started depositing them with the Central Bank and these deposits skyrocketed reaching almost K4 billion in 2016 (in 2012 prices; K5 billion in current prices). Since then, with the economic slow-down, deposits have fallen, but at around K3 billion (in 2012 prices; K4 billion in current prices) they are still at an historic high.

Figure 13. Commercial bank deposits and cash at BPNG adjusted for inflation, 1977 to 2020



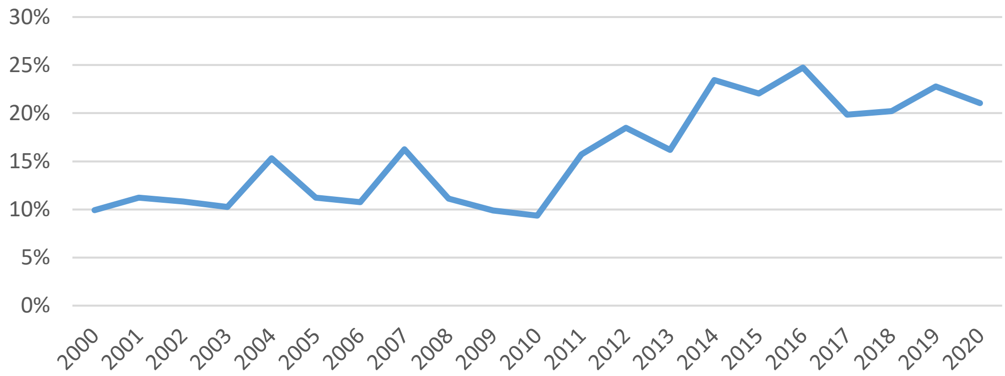
Source: PNG Economic Database.

This excess liquidity, as it is known – the placing by commercial banks of deposits with the Central Bank significantly above the CRR – is a barrier to effective monetary policy in PNG, and a major goal of monetary policy has long been to reduce excess liquidity. For example, in its response to the 2015 IMF Article IV, BPNG "acknowledged that excess liquidity inhibits the monetary transmission mechanism" (p.11). The March 2019 MPS talked about the need "to manage excess liquidity in the banking system and improve the transmission of monetary policy" (p.9). [24]

[24] A BPNG research paper from 2019 noted that "Excess liquidity has been a salient feature of the PNG banking system for over a decade. This has largely [negatively] impacted the effectiveness of the monetary policy

In 2003, BPNG introduced CBBs (Central Bank Bills) to mop up excess liquidity. This worked well for a while and, until about 2010, commercial bank liquidity – that is the ratio of commercial bank deposits at BPNG to total commercial bank deposits – was contained in most years to about 10%. However, this ratio grew rapidly after 2010 to as high as 25% and even now is above 20%. For about a decade, the CRR has not been binding. Banks obtain no interest either on CRR deposits or other deposits with BPNG.

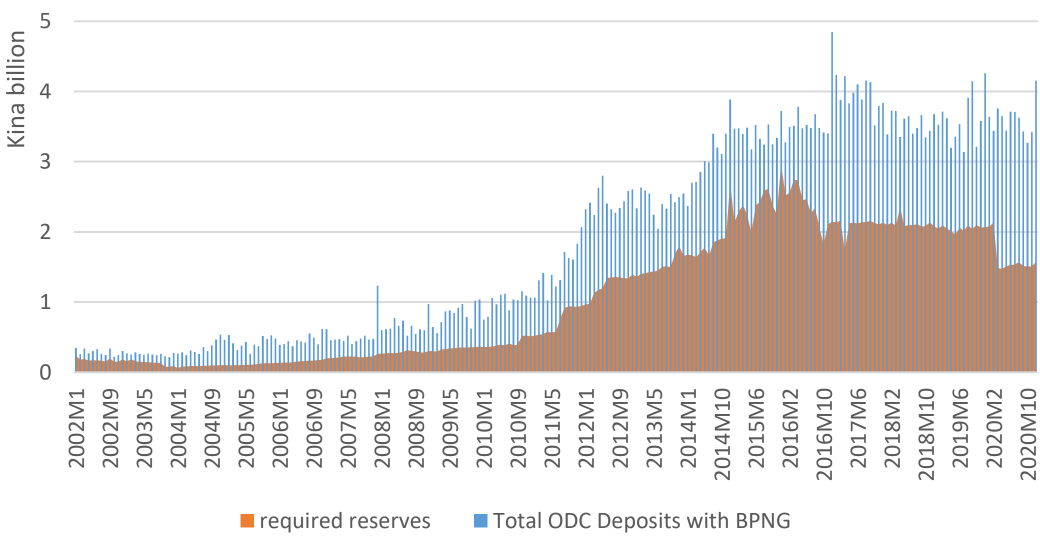
Figure 14. Ratio of commercial bank deposits at BPNG to total commercial bank deposits, 2000 to 2020



Source: PNG Economic Database.

While banks need to hold some deposits in excess of the CRR for operational reasons, their actual deposits at BPNG are much higher. This figure shows the extent to which the deposits of the banks at BPNG exceed the minimum required, with actual deposits twice the level of the required amount.

Figure 15. ODC actual and required deposits with BPNG, 2002 to 2020

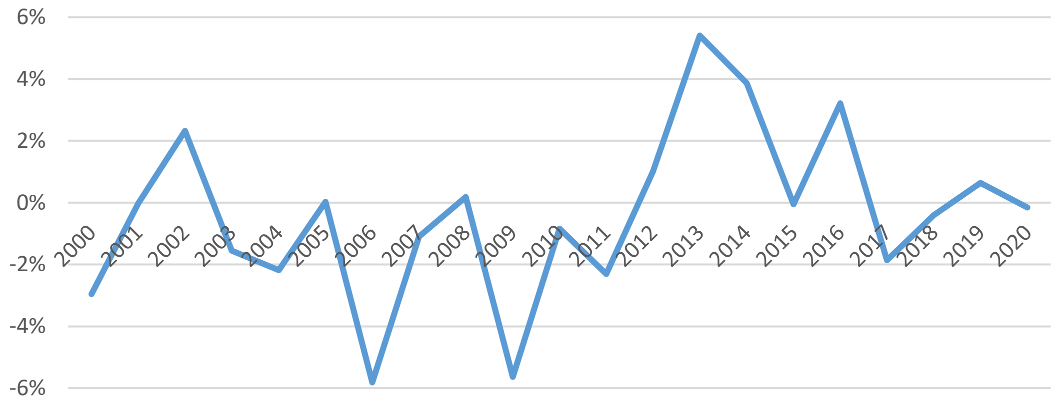


Source: BPNG QEB Tables 3.3 and 3.4. ODCs are Other Depository Corporations which include commercial banks and non-banking financial institutions such as microfinance banks and savings and loan societies.

transmission mechanism in PNG." See Tumsok (2019) "Estimating excess liquidity demand for Papua New Guinea".

Purchasing by the Central Bank of government securities likely worsened this problem of excess liquidity. Let us assume that if BPNG didn't purchase the government debt, then the commercial banks and other entities would have, using their idle deposits. We can then define BPNG liquidity injections as its net purchase of government securities minus its net sale of CBBs. From the graph below, which shows these liquidity injections as a percentage of GDP, we can see such injections are either zero or negative between 2000 and 2010, which is consistent with the Bank trying to mop up excess liquidity. However, after 2010, these injections become large and positive for a few years, 5.4% of GDP in 2013, 3.9% in 2014 and 3.2% in 2016 (all years of high BPNG purchases of government securities). Note from Figure 13 that this is the period in which excess liquidity got a lot worse.

Figure 16. BPNG liquidity injections as % of GDP, 2000 to 2020



Source: PNG Economic Database. Note: Negative injections are withdrawals. Injections are defined as net purchases by BPNG of government securities minus net sales of CBBs.

In fact, as we discuss below, it may not be entirely realistic to assume that financial sector institutions would have stepped in and bought all the securities that the Bank did, but as long as they would have bought some we can conclude that BPNG policy of purchasing government securities would have worsened the problem of excess liquidity, and so, in relation to this key goal of monetary policy management, made no sense.[25]

But could in fact these purchases have had a justification, on some other grounds, in particular fiscal grounds? BPNG itself, as noted earlier, cited reducing interest rates and assisting the Government finance its deficit as rationales for the slack arrangement.[26] 2014 – when the slack arrangement was introduced – was a year in which PNG ran its highest deficit ever (to that point in time) and 2015 was a year of acute fiscal stress for PNG in which expenditure, budgeted to increase, had to be cut by 11%. In this context, it would not be surprising if the slack arrangement was introduced for fiscal reasons, specifically to enable additional borrowing.

[25] In its comments to the IAG, BPNG noted that "The arrangement was fully sterilised through the issuance of Central Bank Bills to financial institutions and the Tap Facility offered to the public." However, the analysis shows this isn't the case as the net purchases of government securities far exceeded sales of CBBs. Moreover, given the concern with excess liquidity, it would have made more sense for the Bank to have issued CBBs and not purchased government bonds.

[26] BPNG also mentioned cash flow problems as a rationale for the slack arrangement but given that from November 2014 the Government stopped using the TAF it is hard to give that rationale much weight (see Figure 6).

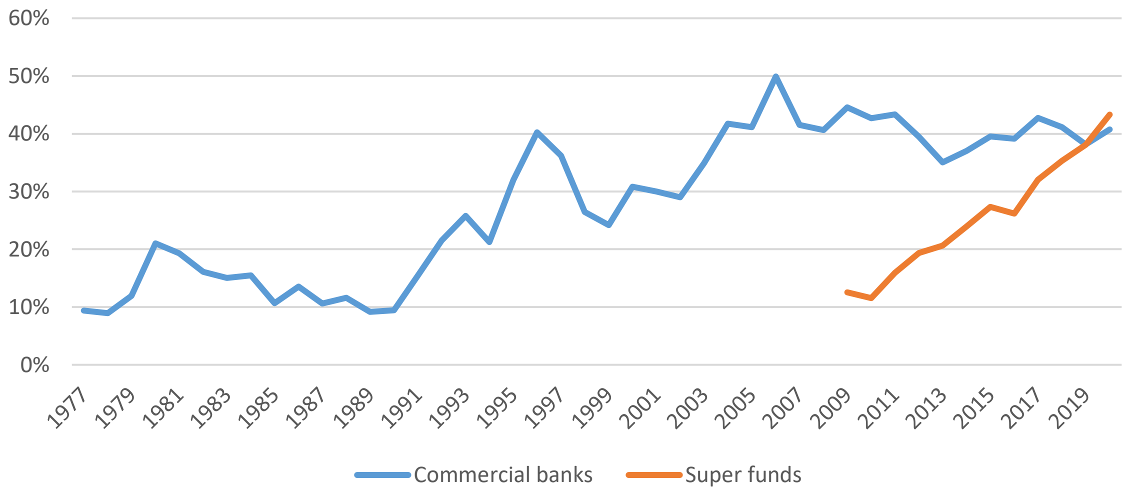
This would be consistent with the September 2017 MPS justification and its reference to BPNG "assist[ing] the Government by buying Government Securities." It is also consistent with the comments BPNG made in its submission to the IAG, namely that:

> The slack arrangement between the Government and BPNG was entered into in 2016 as a result of the challenges brought about by the El Nino drought and low international commodity prices, resulting in low Government revenue and economic growth.

Single borrower exposure limits are a significant challenge to deficit financing in PNG. Prudential single borrower limits issued by BPNG in 2011 do not apply to government debt.[27] However, any financial institution will be wary about loaning too much to a single borrower, and will have limits in place to manage the risk. In the course of our consultations, banks informed us that they do indeed have limits on how much they will lend to the Government, but that they are not necessarily expressed as a single number.

Let us consider loans from banks to the Central Government, to SOEs and to BPNG together – whether through actual loans or T-Bills, Inscribed Stock or CBBs. The figure below shows that the holdings by commercial banks of government debt thus defined rose to about 40% of their total assets over the 2000s and have stayed there ever since. From Figure 17, it looks like banks are reluctant to invest more than 40% of their assets in the government sector. The graph also shows that the superannuation sector has massively increased its exposure to government paper and now has over 40% of its assets in government debt holdings. This sector also limits its exposure to government at around 40%.[28]

Figure 17. Commercial bank and superannuation fund holdings of government debt as a percentage of total assets, 1977 to 2020



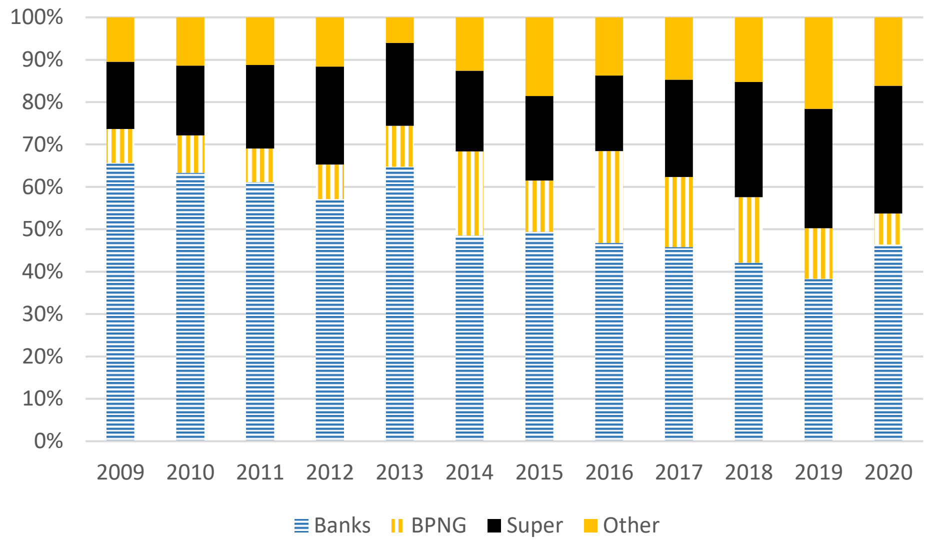
Source: BPNG quarterly statistics.

[27] See BPNG Prudential Standard 1/2011 "Single borrower and large exposure limits".

[28] According to the 2015 World Bank report, "Review of the PNG government bond and capital market development", the maximum bound on government paper holdings is 38.5% for Nambawan (the public service super fund) and 38% for Nasfund (pp. 37 and 38). It is possible that these bounds have subsequently been increased.

Consistent with the argument that commercial banks have been at their limit for carrying government debt for some time, the Government has diversified away from the banks for the funding of their deficit. Up to 2013, commercial banks held two-thirds of government domestic debt. As the figure below shows, now they hold only about 40%. Superannuation funds in particular now have a much bigger share of government debt.

Figure 18. Holders of domestic PNG government debt, 2009 to 2020



Source: BPNG quarterly statistics. Note: T-Bills and Inscribed Stocks only.

Given all this, it is reasonable to conclude that the heavy BPNG purchases of government debt from around 2013 to 2016 helped governments run higher deficits than it would have been able to otherwise, since it would have taken time for the Government to diversify its borrowing away from the banks. It would also have helped reduce interest costs – since to attract other commercial players, the Government would have had to offer higher interest rates.

To summarise, the slack arrangement, even if it worsened the problem of excess liquidity, could have been justified under Section 55(8) if "monetary policy management" is defined to include pursuit of the goal of lowering the interest rate on government securities. However, the slack arrangement definitely helped the Government fund its deficit, and from this point of view was illegal under Section 55(9).

The bottom line is that the slack arrangement confirms the ambiguity of the current legislation and the need for reform. Either deficit financing should be banned altogether, or it should be allowed within limits, but the current wording of Section 55 which allows it to happen without limits is clearly unsatisfactory, as it defeats the original purpose of the legislation.

We pursue the issue of amendments to Section 55 in the next section, where we propose a pragmatic, conservative solution. We conclude this section with two remarks.

First, we note that the slack arrangement also brings home the need for greater contestability and transparency. A properly constituted MPC certainly would have helped clarify the grounds on which the slack arrangement was occurring, and whether it was justified given that it would likely worsen the problem of excess liquidity. More transparency also would have helped. Regular and timely reporting by the Bank of its purchases of T-Bills and Inscribed Stock, both from the Government and from third parties, should be included in the biannual Monetary Policy Statements and in the Bank's monthly reviews.

Second, for completeness we tie this analysis back to the earlier discussion in Chapter 2.5 of BPNG's own financial position. As noted there, between 2011 and 2014 the Bank's liabilities exceeded its assets (due to appreciation of the Kina, its foreign exchange reserves were no longer as valuable in Kina). Over time, the Bank reduced its CBBs (a liability) with its "Debt securities issued" falling from K3.2 billion in 2013 to K1.6 billion in 2015. And it increased its "GoPNG securities" (an asset) from K0.9 billion in 2013 to K2.4 billion in 2014 and K2.2 billion in 2015. BPNG's reduction in the stock of its own bonds (CBBs) and purchase of government bonds certainly helped its balance sheet. However, under the legislation there is no provision for the Bank to buy government bonds in order to boost its balance sheet, and there is certainly no evidence that that is what actually drove BPNG government bond purchases.

3.3 Recommendations for revising Section 55

From the preceding section, we can see that the way that Section 55 is currently written is ambiguous, and can lead, and indeed has led, to uncertainty not only over whether BPNG purchases of government bonds are sensible but even over whether they are legal. Moreover, the section places no cap on the purchases of such bonds, and in some years they have grown rapidly and seemingly without limit, undermining one of the main intentions of the legislation.

Revisions are needed to Section 55. A different approach is needed to the role of the Central Bank in deficit funding, one that is less focused on intentions, which cannot be observed, and one that gives appropriate weight to competing considerations.

We must start by acknowledging that it is risky to require or even allow a central bank to have a deficit-financing role. PNG and international experience have shown that this can lead to political interference, and to high inflation. This is the traditional argument against giving the central bank a deficit-financing role, and it is a powerful one. But it not the only consideration.

The other consideration that has to be taken into account is that the PNG financial sector is not competitive, and is shallow. There are very few market players, and large banks and superannuation funds know that the deficit cannot be financed without them, meaning that the banks and superannuation funds can exercise monopsony power. Their significant leverage helps explains why interest rates on government bonds are high even though they are low-risk (the Government has never defaulted on an interest payment). Exposure limits further reduce the competitiveness of the PNG market since they further reduce the ability of players to take on government debt. This again pushes up interest rates to entice other players to come in and buy the debt (e.g. superannuation funds). Last year, to finance its COVID-19 bond, the PNG Government offered a 12% interest rate on a 10-year bond. In Australia, the interest rate on government 10-year bonds in currently 1.3%. In Malaysia it is 2.4%, in Singapore 1.4%, in Fiji 5.3%.

As the World Bank comments in a 2015 report on PNG's bond market:[29]

> The PNG institutional investor base exhibits minimal competition, especially amongst commercial banks where there are only three players. The government as an issuer is very dependent on a few investors and their preferences. This poses potential funding and refunding risks for government debt… (p.39)

In such a non-competitive market, BPNG has a legitimate role to play in reducing the market power of the big financiers, and thereby reducing interest rates.

Weighing up these two competing considerations is key to resolving this financing issue. One extreme approach would be to ban all deficit funding by BPNG. Another equally extreme would be to put no limits on it. Neither of these two represents an appropriate balance. An intermediate position is needed, whereby some deficit funding is allowed but within limits.

It is useful, as always, to review international experience. The IMF has produced two valuable reports on the subject. In 2012, the IMF reviewed international experience with the provision of central bank credit to government.[30] This review found that 51 countries prohibit all credit, 47 allow short-term advances, and 40 allow longer-term credit. When we look at developing countries, however, only 17 have a full ban on credit, 53 allow advances, and another 22 allow longer-term credit. Where central bank financing is allowed, it is normally for the exclusive benefit of the central government, and within legislated limits: "there is consensus that central banks should only be allowed to provide a limited amount of credit to the government to avoid undermining their operational autonomy" (p. 14).

We can agree with this IMF report that "As a first best, central banks should not finance government expenditure." However, it is also obvious that a financial market environment such as PNG's does not admit first-best solutions. The solution adopted by many countries, as revealed by the survey, to allow government financing within limits is an appropriate second-best response.

This second-best argument is further elaborated by another useful 1993 report from the IMF.[31] This report argues, correctly, that:

> When, as in many developing countries, banking and financial markets are thin, inefficient, and lack flexibility, and, particularly, when no market for treasury bills or for any other government paper exists, some of the provisions of the ideal model for the direct financial relations between the government and the central bank may be inappropriate. (p.12) [The "ideal model" is defined by the report as the one seen in developed countries where the central bank has no deficit financing role.]

The report concludes that, in such circumstances, "some limited access to direct central bank

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[29] World Bank (2015) "Review of the PNG government bond and capital market development", August.

[30] Jacome et al (2012), "Central bank credit to the government: what can we learn from international practices", IMF Working Paper 12/16, January.

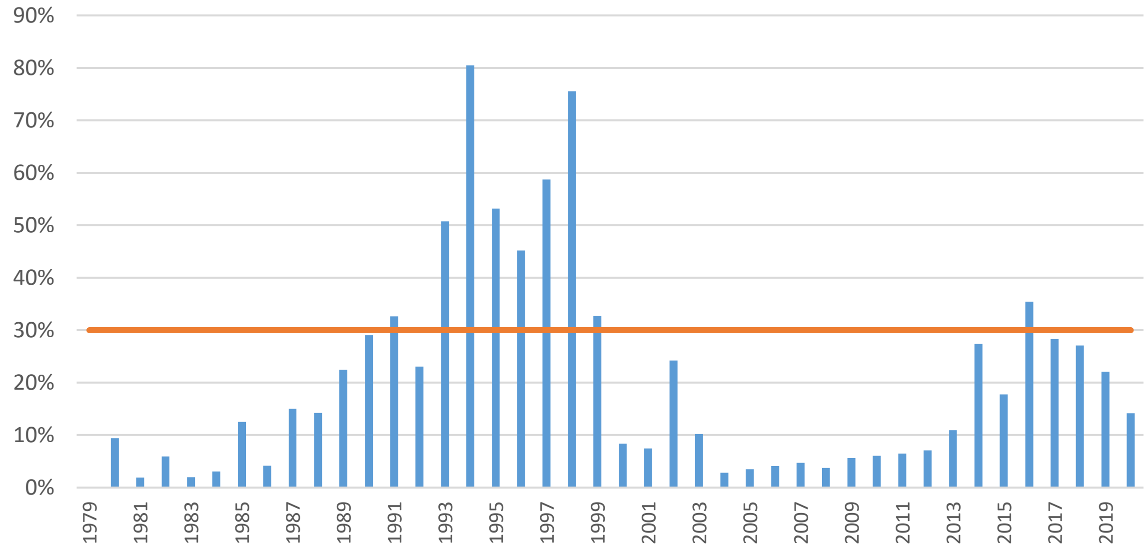
[31] Cottarelli (1993) "Limiting central bank credit to the government: theory and practice", IMF, Occasional Paper 110, December.

credit may be unavoidable" (p.12), and recommends a ceiling defined in terms of a percentage of government revenue (p.15).

The Fijian example is pertinent. In Fiji's central banking law, there is a limit for central bank holdings of government securities and advances of 30% of government revenue (excluding aid, averaged over the last three years).

The graph below illustrates how this limit would work in the PNG context. A 30% limit would have ruled out the extent of central bank financing in the 1990s, and the extent of financing seen in 2016. We consider what the actual limit should be below. Here we just want to establish the basic proposition to allow some, but limited, financing of the deficit by the central bank.

Figure 19. BPNG holding of government securities as a percentage of revenue (excluding aid) over the previous three years, versus a 30% threshold, 1979 to 2020



Source: PNG Economic Database.

The Fijian legislation does not distinguish between primary and secondary purchases. This is appropriate for PNG because in PNG there is no secondary market,[32] and may not be one for a long time.[33] As should be clear from the previous section, whether BPNG purchases securities from the Government or from banks, this can, in the presence of an exposure limit and non-competitive markets, enable higher deficits and lower interest rates.[34]

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[32] The World Bank 2015 report referenced earlier notes that currently "there is no secondary market activity" (p.16). BPNG purchases and sales of government paper do not themselves constitute a secondary market.

[33] One of BPNG's aims is to establish a secondary market for government securities, through its Central Securities Depository (CSD) project. This project commenced in 2019, but is not yet complete. Even if this platform is established, however, there is no guarantee that market players will use it. The 2015 World Bank report notes that: "The development of a secondary market for government securities is a considerable challenge for most emerging, developing, and even developed markets" (p.42) and that in PNG "[t]he limited number of intermediaries, three banks, and the non-existent service of secondary market-making functions greatly undermine any potential secondary transactions" (p.43).

[34] Primary purchases: BPNG buy securities from the Government, leading to a higher deficit. Secondary purchases: BPNG buys government securities from banks, giving banks the headroom to buy more government securities, again leading to a higher deficit.

Discretion would be left with the Central Bank as to how close it wants to be to the legislated limit (as long as it does not exceed it). It should not be at the limit all the time or the Bank would leave itself no room to offset market power. Leaving BPNG with this discretion is important to respect central bank independence. It also recognises that the Central Bank needs independence to buy and sell government securities to implement monetary policy. It would be up to the Monetary Policy Committee of the Bank to decide what its holdings of government securities should be. Its decision as to how much government debt to buy is a matter of monetary policy, but the rationale or justification may be monetary or fiscal. The Bank can be trusted to make the right judgement if it has the right objectives, and the balanced objectives we propose in Chapter 5 will give BPNG the incentive to want to help the government finance its deficit, and to balance that against its price stability objectives.

Interest rates would be set by the market as per current arrangements. The language of Section 55(2) could be used, revised as proposed in Chapter 3.1.

Given that there is no secondary market in PNG, one could argue that all BPNG purchases should be direct from the Government. This would have the value of reducing discretion. Because of the lack of a secondary market, different securities bought in and released to the market have different yields. If BPNG is able to buy government securities directly from banks, there is a risk the banks will sell lower-interest rate securities to BPNG, and then buy higher-interest securities from the Government. However, if BPNG cannot buy from and sell to banks, then a secondary market might never develop. There should at a minimum be a requirement that BPNG demonstrate that it is conducting its sale and purchase of government securities with a view to minimising the cost to it of those purchases.

Two further questions remain: (a) Would the limit include the TAF?; and (b) What should the limit be? On the first question, the TAF is intended to be only for cashflow management and not for deficit financing, and we have proposed in Chapter 3.1 that the legislation be clarified to reflect this. Therefore, the TAF should be excluded from that limit.

What then should be the limit? There is no "right" answer. Looking at the graph above, we could use the Fijian limit of 30%. Other countries have lower limits, but note that the limit we propose would apply to all purchases of securities not just those directly from the Government.[35] A limit of 20% would send the message that BPNG's purchases of government securities in the last decade were too high, and that a more conservative approach is now being taken. Whereas the 30% limit was only exceeded once in the last decade (2016), a 20% limit was exceeded five times. A 20% limit would allow BPNG currently to hold K2.3 billion of Central Government debt, up from its currently level of K1.6 billion. A higher limit could be considered during emergencies (see Chapter 4.2).

To recap, the lesson that we need to learn from the slack arrangement is not that such arrangements are necessarily bad and should be eliminated altogether. To the contrary, the experience suggests that, in the PNG context, such arrangements may be desirable or even

[35] Jacome et al (2012) write: "In practice, most countries limit credit, overdrafts, or advances to 10–20 percent of government revenues in the previous fiscal year" ("Central bank credit to the government: what can we learn from international practices", IMF Working Paper 12/16, January. p.20). From the IMF Central Bank Legislative Database, Laos has a limit of 25% of ordinary revenue for the last three years.

necessary. But, (a) ambiguity around their use should be eliminated, and (b) limits around their use should be imposed.

There are several advantages of an approach like the Fijian one. The first is that it is clear. The central bank's motive for action – which is difficult to ascertain and impossible to verify – does not need to be assessed. The second is that it closes the current loophole whereby no limit is placed on the extent to which BPNG can finance the government deficit. The third is that it suits the realities of the PNG market environment.

We conclude this section with consideration of other non-legislative measures that could be taken to lower government interest rates. Obviously, the long-term solution is more competition. It is ironic that in 2020 PNG depositors got 1.1% on a one-year commercial bank term deposit (BPNG QEB Table 6.3), but the banks themselves got 7.2% on a 365-day T-bill. One solution is to give savers more direct access to government paper. BPNG has been trying this through its Tap Facility, which aims to encourage investment by individuals, in amounts of K5,000 or more. By the end of 2019, cumulative sales of K797 million had been achieved. This represents annual sales of some K440 million, about 6% of the deficit. While the Tap is a positive, the amounts involved are small, and it cannot be used to put downward pressure on interest rates.

Another approach would be to improve the way in which government bonds are auctioned to attract more players, including foreign investors. The current set-up leaves much to be desired. The World Bank 2015 report[36] referenced throughout this section commented that:

> … investors expressed frustration and concerns with the uncertainty created in the market over the issuance announcement procedures, auctions cancelled on occasions, and the relative short time to react to the issuance announcements, particularly with T-Bills. (p.32)

It also noted that:

> The primary market remains manual and physical where registered bidders, primarily commercial banks place bids, usually through e-mail, without accompanying payment instructions, while other non-registered bidders submit physical cheques at the central bank along with the bidding documents. *This current manual and cumbersome process will not attract non-resident investors.* (p.30)

The report noted that "BPNG has evaluated and is currently testing the Bloomberg Automated Auction System for the government securities and central bank bills primary market." This system has still not been introduced.

The Central Bank is the Government's banker and financial agent, and auctioning government debt is a joint responsibility of the Treasury and BPNG. As of late September 2021, the most recent Treasury Bill and Inscribed Stock auction plans and results on the BPNG website date from 2020, in some cases August 2020, more than a year ago. The Treasury website has Treasury Bond announcements for April to June 2021 and before that the most recent is July

[36] World Bank (2015) "Review of the PNG government bond and capital market development", August.

2019. This can only be described as woeful.

A joint approach by BPNG and Treasury to overhaul government bond auction arrangements does not require legislation but needs to be implemented urgently with the aim of introducing new buyers of such bonds, including overseas buyers.[37]

One of our recommendations in the chapter on objectives is that it should be explicitly stated that one of BPNG's objectives is to provide efficient and effective banking services to the Government (see Chapter 5.5). With this objective in place, it is hoped that the Bank will increase efforts to improve auction arrangements, which will lead to lower interest rates. Of course, it goes without saying that Treasury too must make additional efforts, and that only by collaboration can improved auction arrangements be put in place.

Even with such reforms, however, we anticipate that the market for government bonds will remain both highly concentrated and shallow and that there will for many years to come be policy grounds to allow the Central Bank to be active – within prescribed limits – as a buyer of government bonds.

The approach set out in this chapter is a pragmatic, conservative one, based on common-sense. To recap the main arguments, in PNG any purchase by the Central Bank of government debt, whether from the Government or another entity, will potentially help the Government finance the deficit given shallow domestic capital markets and single exposure limits. If we want to stop BPNG from helping the Government finance the deficit, then we must stop it ever purchasing government bonds. That would be extreme: few central banks are subject to such a bar. A better approach would be to allow BPNG to buy government securities but only up to a limit. We take a conservative approach, as we think that the fiscal support provided by BPNG to the Government in recent years has been excessive, and we wish to limit it more tightly. We therefore propose a limit on BPNG holdings of government securities of 20% of revenue minus aid, averaged over the last three years.

[37] Though note that overseas buyers will be deterred by the lack of assurance that they will be able to repatriate their investments upon maturing. This underlies the importance of addressing Kina convertibility, the subject of Chapter 5.1.

Chapter 4. Managing national economic crises

Under this heading, we "[r]eview whether the objectives of the Central Banking Act 2000 give adequate priority to … managing national economic crisis (Section 7)" as well as "options around quantitative easing (QE) options during a declared emergency (focus on Section 55)."

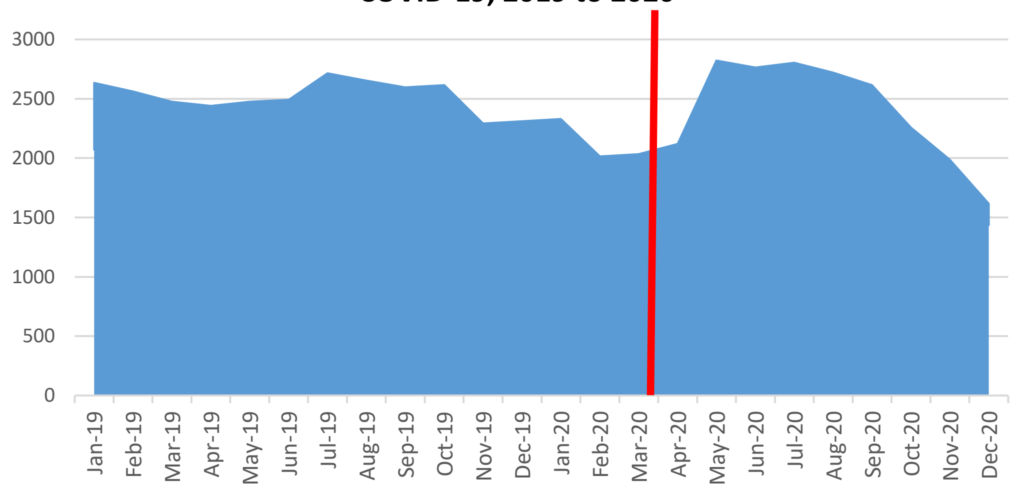
For ease of handling, we have rearranged the TOR to bring together the two items related to crisis management – objectives and QE. (QE or asset purchase programs involve the purchase of government securities.[38])

In Chapter 4.1, we assess BPNG's response to COVID-19, and in Chapter 4.2 we assess what legislative changes are needed for future crises.

4.1 BPNG response to COVID-19

With the onset of the COVID-19 pandemic, BPNG announced on 30 March 2020 that it would engage in the purchase of government securities (or QE) to inject liquidity. It did initially, but then, as the graph below shows, a few months later started selling government securities. As the figure also shows, the Bank in fact held less government debt at the end of 2020 than it did at the start of the pandemic. As discussed in Chapter 3.1, the sale of securities in the second half of the year was due to the Bank's concerns that the increase in the TAF would increase liquidity. However, again as discussed there, in fact Treasury has made little use of the TAF, at least up to the end of 2020. Moreover, other decisions made by BPNG in response to COVID-19 were designed to inject liquidity: not only the QE program, but a reduction in the Cash Reserve Requirement from 10% to 7%, and a cut in the Kina Facility Rate (KFR) from 5% to 3%.

Figure 20. Central bank holdings of government debt (Kina millions): before and during COVID-19, 2019 to 2020

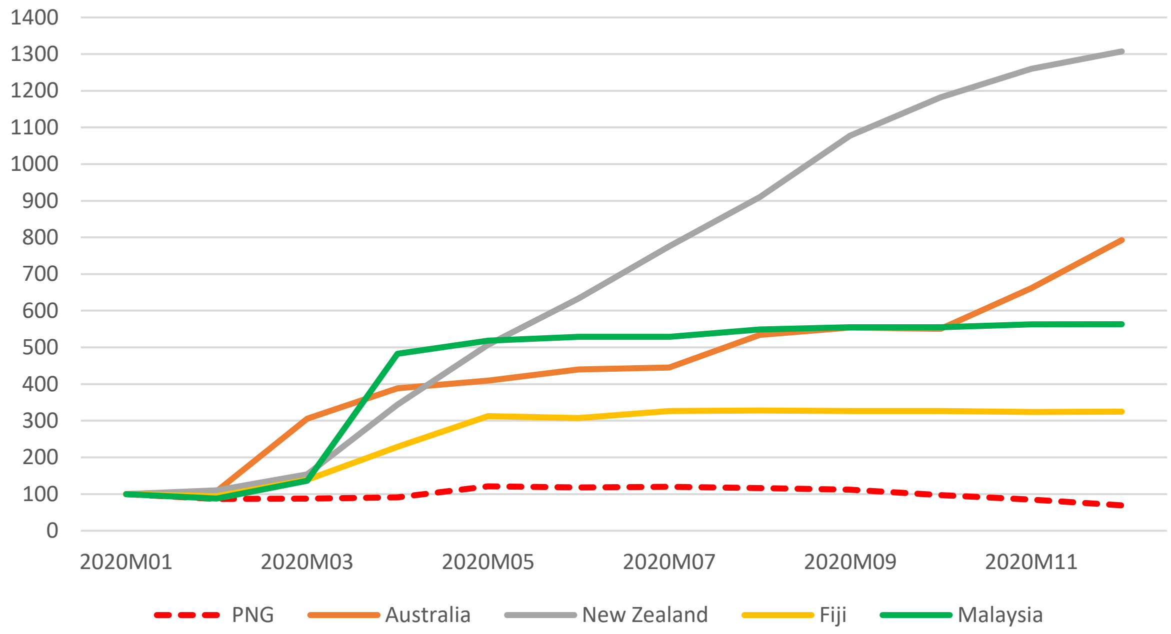


Source: QEB Table 2.3. Notes: The thick line marks the onset of the COVID-19 pandemic. Government debt includes Inscribed Stock and Treasury Bills.

[38] https://www.bankofengland.co.uk/faq/inflation-and-interest-rates

The September 2021 MPS reports purchases of government bonds of K431.5 million between December 2020 and June 2021, suggesting that the sale in the second half of 2020 was partly reversed. No explanation is provided. In any case, these purchases do not change the conclusion that, as shown in the next figure, the lack of sustained QE in PNG makes the country stand out in an international context when many other central banks increased their government bond holdings over the course of last year.

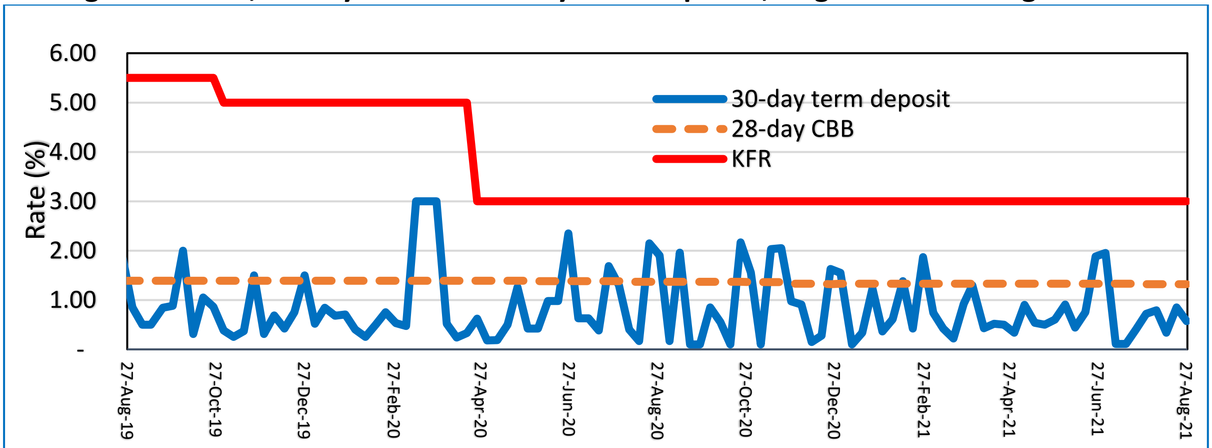
Figure 21. Central bank holdings of government securities in 2020 (Jan 2020=100)



Source: BPNG and IMF.

The June 2021 BPNG Monthly Economic Report shows that, despite the reduction in the Kina Facility Rate, the CBB and 30-day term deposit rates have not changed. This is in line with the general understanding that transmission of the KFR to bank rates is weak in PNG due to excess liquidity (as discussed in Chapters 3.2 and 5.2).

Figure 22. KFR, 28-day CBB and 30-day term deposits, August 2019 to August 2021



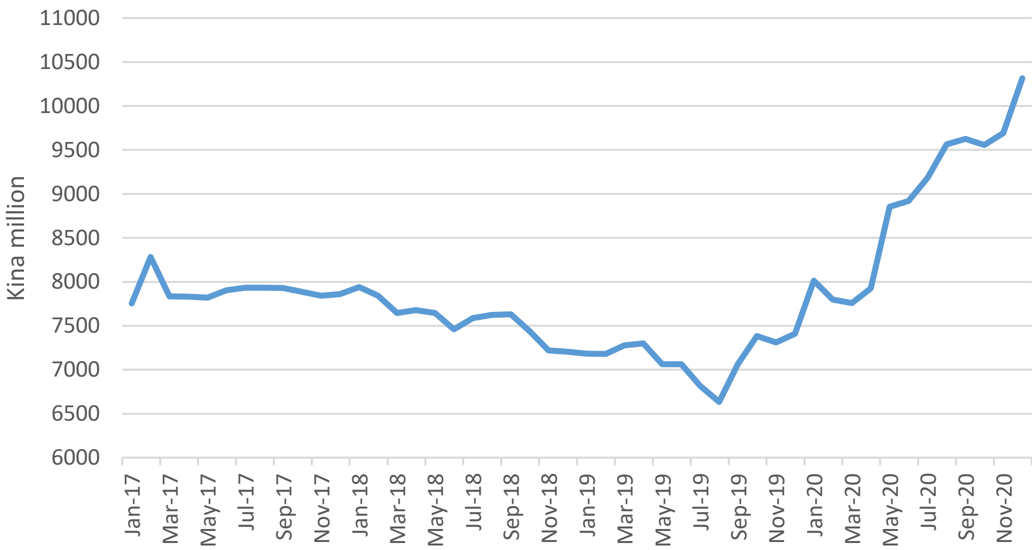
Source: BPNG Monthly Economic Review, June 2021. Note: The 30-day term deposit rate is volatile as it is a weighted average of wholesale and retail deposits, and the weights change over time.

Consistent with the finding in Chapter 3.2 that BPNG decisions have a strong fiscal impact, BSP notes in its annual report that the lowering of the Cash Reserve Requirement enabled it to invest in the Government's COVID-19 bonds (see BSP 2021 Annual Report, p.12). This supports our earlier argument that banks are at or near their single-borrower exposure limits. Although they have excess liquidity, they are constrained from investing their excess deposits in bonds (even though this would be very profitable for them) because of those limits. Deposits needed to meet the CRR requirement are not counted in the asset base, the denominator used to calculate the single-borrower limit. Therefore, reducing the CRR means increasing the single-borrower denominator, and therefore enables more lending to government.

The next graph shows that after three years (2017, 2018 and 2019) in which commercial banks have had holdings of government securities of K8 billion or below, in 2020, they increased those holdings to K10 billion. In May alone – just a month after BPNG reduced the CRR – the commercial banks increased their holdings of government securities by K0.9 billion. Over the course of the year, commercial bank holdings of government debt increased by K2.9 billion, which was the net increase in government domestic debt holdings over the course of the year.[39]

Not all of this increase would have been due to the reduction of the CRR, but it would have helped. Negative domestic borrowing in 2018 (when PNG secured a large commercial foreign loan) also helped create room for additional domestic lending to government in 2020.

Figure 23. Commercial bank holdings of government securities, 2017 to 2020



Source: BPNG QEB Table 3.7

[39] As mentioned, there was an unexpected decline in holdings by BPNG of central government debt by K0.7 billion over the year. Superannuation fund holdings also increased by K1.3 billion, and other sources decreased holdings by K0.6 billion.

4.2 Legislative options

There are no crisis provisions in the CBA 2000. A few countries do include crisis provisions in their central bank legislation. For example, Section 19 of the Bank of England Act 1998 gives reserve powers to the UK Treasury over monetary policy "in extreme economic circumstances".

Section 19 of the PNG CBA 2000 requires the Governor to report to the Minister when conditions exist that "may be likely to affect adversely the achievement of the financial and economic policies of the Government." The Treasurer informs us that no such report was received in relation to COVID-19.

Many central banks have been very active in response to COVID-19 without the activation of emergency clauses, or the takeover of their powers by the government. However, some countries did amend legislation in response to the pandemic to support bond purchases (Indonesia and Brazil) and/or to increase the limit on such purchases.[40]

Recommending legislative provisions for monetary policy in PNG in the event of an emergency requires an understanding of how the PNG Constitution deals with emergencies, the subject of Part X of the Constitution. This provides for the declaration of emergencies by the National Executive Council (NEC). Emergencies can cover wars (or the imminent dangers of wars), natural disasters, including infectious disease outbreaks, and acts by persons that threaten life. Once an emergency has been declared, emergency regulations and then an Emergency Act can be put in place. An example of an Emergency Act is the Emergency Act 1979 imposed in response to unrest in the Highlands. The Emergency (General Provisions) (COVID-19) Act 2020 was passed in response to the current pandemic. The Emergency Law typically gives extraordinary powers to a designated Controller. Subject to some basic constitutional protections, the Emergency Law can amend any other law as required.

Many emergencies would not warrant overriding the provisions of the Central Banking Act. The range of measures undertaken by BPNG during the COVID-19 pandemic have been those undertaken by many banks: reduction in policy lending rate; reduction in the Cash Reserve Requirement; QE (though not sustained); and short-term credit facility for the second-tier financial institutions. This indicates that BPNG already has many of the powers it needs to respond to an emergency.

At the same time, it could be reasonably argued that during an emergency, BPNG should be able to play more of a role in relation to government financing. The Government already has the power to amend or suspend any part of the CBA through an Emergency Law. It is better though to attempt to provide some guidance to Government that it can use in an emergency. We propose therefore that the CBA be revised to foreshadow temporary increases in the Bank's financing role (as envisaged in Chapter 3.3) through an Emergency Act following a national emergency, if declared for the whole of Papua New Guinea.

One strength of current BPNG arrangements is that, with the concentration of powers in one

[40] See the IMF and BIS COVID-19 central bank response databases.

person, decisions can be made quickly in an emergency (by the Governor or by the Deputy Governor in the absence of the former). A Monetary Policy Committee might not be so nimble. The Reserve Bank of New Zealand Act that set up that country's MPC foreshadowed this problem, and laid down emergency procedures for the MPC, which we recommend also be adopted by PNG. These involve the Governor being satisfied that emergency circumstances exist, that urgent action is necessary, and that other members are unable to participate in the required decision making in a timely manner.

Chapter 5. Objectives

Under this heading we review "whether the objectives of the Central Banking Act 2000 give adequate priority to the growth and development of PNG". The issue of objectives relating to crisis management was dealt with in Chapter 4.

We begin this section by re-emphasising the point with which we began this report. The Central Banking Act was based on international best practice to restore stability to the Bank of PNG. While this was an improvement on what went before, the central banking function would work better if the Act was revised to take into account PNG's unique circumstances and BPNG's functions. BPNG has a very different role than the central banks of developed countries. Its policy lending rate is, by its own admission, relatively ineffective (Chapter 5.2). As Chapter 3 has shown, the Bank plays an important fiscal role. And, as this chapter shows, BPNG also plays an extremely important role in exchange rate setting. These diverse roles mean that a balanced set of objectives, rather than ones focused only on inflation, is essential.

Under the current Act (Section 7), BPNG has three main objectives: price stability; financial stability; and payments efficiency. Subject to these three objectives, Section 7(d) also states that BPNG is to promote macroeconomic stability and economic growth. However, importantly, Section 7(a) also implies (as do Sections 10(1) and Section 11(1)) that the sole objective of monetary policy is price stability.

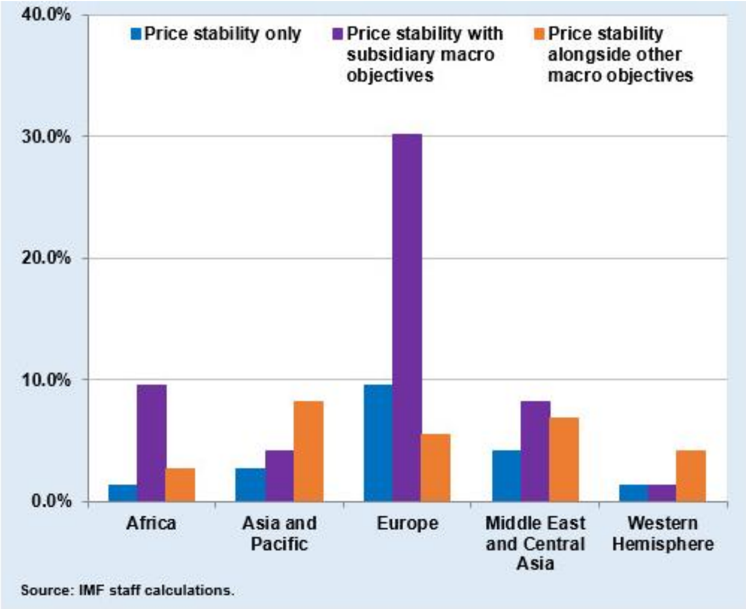
The IMF classifies central bank objectives around the world as "price stability only", "price stability with subsidiary macro objectives" and "price stability alongside other macro objectives".[41]

Reading Section 7 as a whole one might classify BPNG's objectives as "price stability with subsidiary macro objectives", but reading Section 7(a), 10(1) and 11(1), one would classify it as "price stability only", since price stability is given as the sole objective of monetary policy. While growth is mentioned as a subsidiary objective in Section 7(d), without the tool of monetary policy at its disposal to promote growth, the Bank is reduced to addressing this objective through such worthy but limited initiatives as the promotion of microfinance and digital innovation.

According to IMF research, summarised in the figure below, "price stability only" is not the dominant approach to the setting of objectives in any region. "Price stability with subsidiary macro objectives" is the most common approach in Africa, Europe and the Middle East, but "price stability alongside other macro objectives" is the most common approach in Asia and Pacific, and Western Hemisphere (the Americas). As will become evident, our recommendations would bring PNG into line with the approach most commonly deployed in the Asia-Pacific.

[41] See here. Note that this is in relation to central banks with objectives that feature price stability. 57% of central banks include price stability as an objective, and another 13% have an equivalent objective. A significant number express the objective without reference to price stability but rather, say, monetary stability. See Khan (2017) "Central bank legal frameworks in the aftermath of the global financial crisis", IMF WP/17/101.

Figure 24. Percentage of central banks with price stability as an objective, by the way in which that objective is framed, by region



Source: IMF.

Several issues have arisen in relation to BPNG's objectives over the years that make it necessary to revisit them. These issues, addressed sequentially in this chapter, are: exchange rate policy (Chapter 5.1); the fiscal role of the Central Bank (Chapter 5.2); whether economic growth has received adequate priority in recent years (Chapter 5.3); the need to give greater weight to financial development (Chapter 5.4); and BPNG's role as the Government's banker (Chapter 5.5).

5.1 Exchange rate policy

The exchange rate setting role of BPNG is both important and controversial. In its submission, the Kina Bank stated that "Exchange rate policy is a very contentious issue and is the only monetary policy tool which transmits to the market." This part of the chapter looks first at who has responsibility for exchange rate policy (a), and then at currency convertibility (b), the exchange rate regime (c), and the issue of overvaluation (d). The discussion then turns to the costs of these policies (e) and the reasons for their introduction (f). Finally, with this analysis behind us, we look at reform options (g).

(a) Responsibility for exchange rate policy

Exchange rate policy was earlier a government responsibility in PNG. However, Section 58 of the CBA gave this responsibility to BPNG. Section 58 reads:

> The official value of the monetary unit in terms of other currencies may be determined by the Governor acting on, and in accordance with, policy statements issued pursuant to Section 11 [the bi-annual monetary policy statements] and to achieve the objects of the Central Bank under this Act.

With its reference to the bi-annual monetary policy statements, and to the Act's objectives, Section 58 clearly brings exchange rate policy within the ambit of monetary policy, the exclusive responsibility of BPNG.

International experience shows that it is unusual in high-income countries for exchange rate policy to be set by the central bank (only 4%), but that it is common in low-income countries (43%).[42] The same IMF survey also notes that "Newer central bank laws increasingly delegate the authority over the exchange rate regime to the central bank" (p.15).

(b) Foreign currency rationing and Kina non-convertibility

As a matter of definition, current account non-convertibility and foreign exchange or currency rationing are the same thing. Current account convertibility means that anyone who wants foreign exchange to import something can get it readily. Rationing means that an importer cannot be guaranteed that they will get the foreign exchange they need to pay for imports. They may have to wait a long time, or they may only get some of what they ask for, or even none.

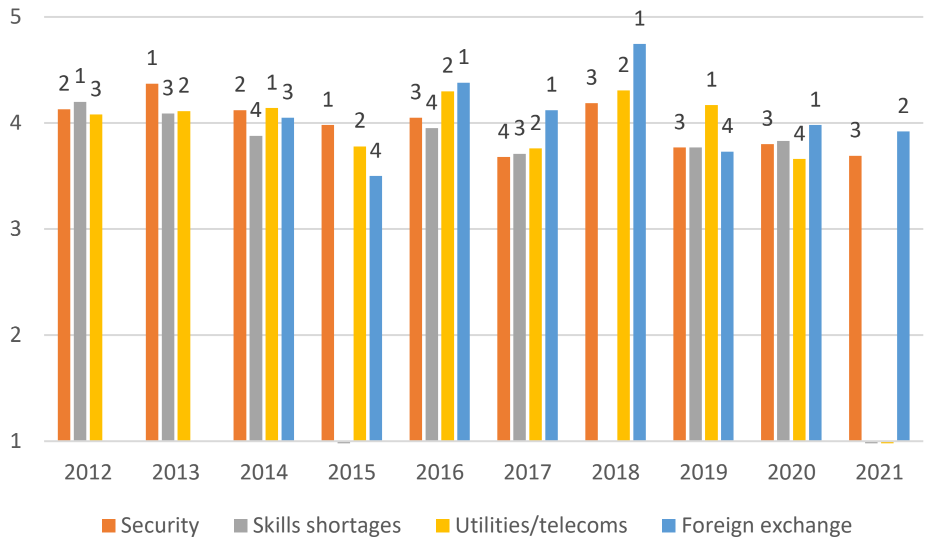
The IMF first raised the issue of "excess demand in the foreign exchange (FX) market" in its 2014 Article IV report on PNG. Every Article IV report on PNG since has made the same point about exchange rate rationing, that is, a lack of current account convertibility. For example, the most recent (2019) Article IV report on PNG draws attention "to the rationing of FX, which results in undue delays and arrears in current international payments" (Annex p.3).[43]

Many other researchers, commentators and organisations have noted the shortage of foreign exchange.

This problem has also been repeatedly stressed by businesses. PNG businesses frequently complain about foreign exchange shortages, and in recent years have often placed this at the top of their list of business constraints. The figure below shows the top constraints listed by business CEOs between 2012 and 2018. Before 2014, foreign exchange was not an issue. But in 2014, it became the third biggest constraint; in 2015, the fourth biggest; and between 2016 and 2018 it was the biggest constraint, more important than security or infrastructure concerns. In 2019, foreign exchange fell to become the fourth biggest constraint, but it went back to being the biggest in 2020. In 2021, it was displaced by COVID-related concerns, and foreign exchange went to second place on the list of business concerns.

[42] See p. 15 of the IMF 2004 survey *Central bank governance: a survey of boards and management*.
[43] The Article IV is IMF's annual report on member countries. The 2019 Article IV can be found here.

Figure 25. Top four business constraints according to PNG CEOs, 2012 to 2021



Source: Calculated using the annual Business Advantage surveys. Constraints are rated on a scale of 1 to 5, and aggregated over respondents. The four shown are the ones that recur the most over the period. Lack of government capacity was rated as the third most important constraint in 2015 and 2021, and fourth most important in 2018. In 2021, COVID-related restrictions were the biggest constraint. In 2012, access to necessary expertise was the fourth biggest constraint, and in 2013 logistics.

The issue of excess demand for foreign currency has been discussed from time to time in BPNG's MPSs. Initially, BPNG blamed the banks for using some FX inflows "to provide foreign currency loans (trade finance) and for forward contracts, and other purposes" (March 2017 MPS). In late 2016, BPNG banned trade finance, and introduced other restrictive measures. However, the problem has persisted. The March 2018 MPS noted that "the private sector has reiterated concerns about the accessibility to foreign currency and how it is affecting their business operations." The September 2018 MPS noted that "demand for foreign currency continues to be greater than supply and consequently there is still a backlog of sell kina orders."

In the 2019 IMF Article IV, BPNG agreed with the IMF on "the need to restore exchange rate convertibility and to clear the FX orders backlog" (p.11). While BPNG contended that "the true backlog of FX orders is smaller than reported by banks" the admission that the currency was no longer convertible (on the current account) was a significant one.

In its September 2021 MPS, the Bank recently argued that large orders are normally filled within two to three months, while small orders are filled on time, and that therefore there were no outstanding orders (see pp.2 and 4). However, this conclusion is doubtful. First, two to three months is itself a long time, especially if it is after other requirements are met such as obtaining a Tax Clearance Certificate, itself a lengthy process. Second, banks inform us that many importers put in orders with several Authorised Foreign Exchange Dealers (AFEDs) in order to improve their chances of getting foreign exchange. This is a sure sign that there is a problem with convertibility. Third, our consultations with business indicated that foreign exchange availability was still a key concern of business.

It is important to emphasise just what a break with past practices the movement away from current account convertibility is. The March 1975 BPNG Quarterly Economic Bulletin noted "the disadvantages in imposing tight restrictions on the movement of funds, which tend to be self-defeating."[44] The hard Kina policy was therefore built on the principle of convertibility: the Kina was to be "freely convertible … against major world currencies."[45] When the currency was floated that policy was retained, at least outside of crisis periods (when the country ran out of foreign exchange reserves). In 1997, two academics wrote: "If exchange rate management is to be judged purely from the standpoint of currency convertibility, Papua New Guinea would have to be awarded relatively high marks, despite the blemish of the 1994 currency crisis."[46]

It also should be noted that moving away from convertibility is in violation of PNG's international agreements, since it contravenes Article VIII of the IMF's Articles of Agreement, which PNG has signed. IMF staff have made these points in their annual Article IV reports every year since 2016. They have also noted the contravention in their annual international report on exchange measures that limit currency convertibility on the current account.[47]

More serious though is the damage that the move away from convertibility has done to the economy and to fiscal discipline. This is discussed in subsection (e).

(c) The exchange rate regime

In 2014, IMF staff reclassified PNG's exchange rate regime away from "floating" to "crawl-like". Then, effective May 2016, it reclassified it to "stabilised". In August 2017, the IMF once again reclassified the exchange rate regime, this time back to "crawl-like". That classification has since remained unchanged. However, the last report of the IMF was its 2019 Article IV, and examination of subsequent data shows there has been a subsequent shift back to "stabilised" in November 2020.

The IMF defines an exchange rate regime to be "crawl-like" when (a) it is not floating and (b) the exchange rate remains "within a narrow margin of 2% relative to a statistically identified trend for six months or more". It is "stabilised" when (a) it is not floating, and (b) moves within 2% of an unchanging trend line. [48]

The first requirement for an exchange rate regime to be stabilised or crawl-like is therefore that the currency not be floating. A floating exchange rate is one in which the exchange rate adjusts so that demand equals supply (with or without intervention from the central bank in terms of foreign exchange reserves). However, as discussed in the previous subsection, PNG's foreign exchange market has been characterised by rationing since around 2014. By

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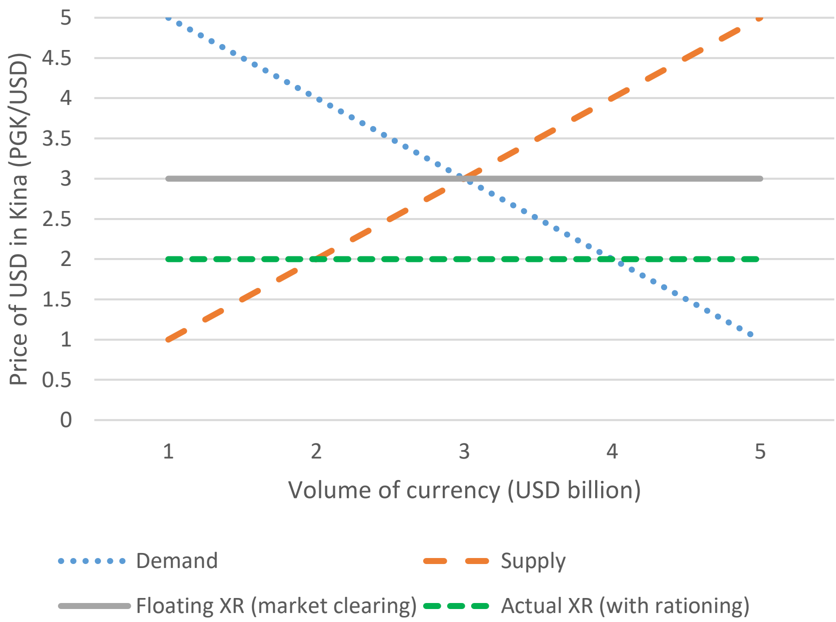
[44] Quoted in Garnaut, Baxter and Krueger (1984) *Exchange rate and macroeconomic policy in independent Papua New Guinea*, National Centre for Development Studies (NCDS), ANU, p.10
[45] Goodman, Lepani and Morawetz (1987) *The economy of Papua New Guinea*, NCDS, ANU, p.53.
[46] King and Sugden (1997) "Managing Papua New Guinea's kina", *Pacific Economic Bulletin, vo1.12, no.1, pp.20-29.*
[47] See for example, the *2018 IMF Annual Report on exchange arrangements and exchange restrictions*.
[48] These definitions can be found in the *2018 IMF Annual Report on exchange arrangements and exchange restrictions*.

definition, with rationing, demand cannot equal supply as rationing means excess demand. Indeed, if the exchange rate was floated in the current regime, it would collapse given excess demand.

The graph below gives a simple, constructed example of the incompatibility between a floating exchange rate and foreign currency rationing. The two sloping lines show the supply of dollars (upward sloping) and the demand for dollars (downwards sloping). The higher the price for USD expressed in Kina the greater the supply of dollars and the lower the demand. (A higher Kina per USD corresponds to a lower USD per Kina, i.e., a depreciation.)

The market-clearing or floating rate is shown by the grey line, 3 Kina per USD, at which price USD 3 billion of foreign exchange is supplied and USD 3 billion is demanded: the market clears. However, now say that instead of being put at its floating rate the exchange rate is fixed at 2 Kina per USD. Then only USD 2 billion is forthcoming, but at this price, there is demand for USD 4 billion. Therefore, there is excess demand (of USD 2 billion), and the available foreign currency has to be rationed. The simple lesson here is that the floating and rationed exchange rate are different.

Figure 26. An illustrative model of supply of and demand for foreign currency: showing market clearing and rationing regimes



It should be noted that the Kina exchange rate is still market determined, that is, as discussed below, determined in the Interbank Market. However, it is not market clearing: that is, it does not bring about an equality of supply and demand for foreign exchange.

Many other researchers and observers, apart from the IMF, have endorsed the finding that the exchange rate is no longer floating, including BPNG's own researchers.[49]

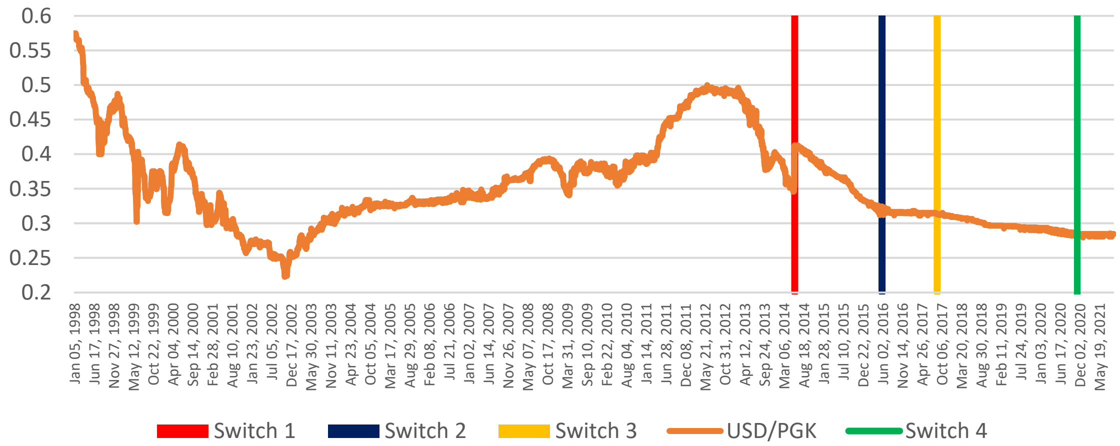
[49] See the study by BPNG and Griffith University researchers "Exchange rate volatility and trade in PNG" Griffith-BPNG JPRWP#10, p.20.

An important caveat made by the IMF is that although *de facto* PNG's exchange rate regime has not been floating since mid-2014, *de jure* it is still floating. Under the IMF's Articles of Agreement, every country "is required to notify the Fund of the exchange arrangements it intends to apply and to notify the Fund promptly of any changes in its exchange arrangements."[50] PNG has not notified the Fund that it has moved away from a floating regime, so that is still regarded by the Fund as the *de jure* regime, even though it no longer reflects the reality of actual exchange rate arrangements on the ground.

The second requirement for an exchange rate to be crawl-like or stabilised is that it follow a smooth trend. This is shown in the five figures below, using daily data from a market website from 1998 onwards. Note that all the five figures, and indeed all the analysis in this section, are based on the USD/Kina or USD/PGK exchange rate. This is because it is the fundamental exchange rate in PNG. All other exchange rates are set with reference to the USD/PGK exchange rate by using "cross country" exchange rates, for example, the AUD/USD exchange rate, and so on.

The first graph shows the entire period from 1998 to September 2021. We can see that ever since the first switch (when the currency suddenly appreciated by 17% and moved away from being floating) the USD/Kina exchange rate has been much smoother. There are, after mid-2014, fewer "ups and downs" or fluctuations. This is a sure sign that the exchange rate has moved away from being floating or market clearing.

Figure 27. USD/PGK from January 1998 to September 2021



Source: Data for this and subsequent graphs from https://au.investing.com/currencies/usd-pgk-historical-data.
Note: The switch points are in June 2014, May 2016, August 2017, and November 2020. The data is daily (excluding weekends) from 5 January 1998 to 24 September 2021.

The first "crawl-like" period from June 2014 to May 2016 is one in which the exchange rate depreciated fairly steadily.[51] One can observe from the next graph that over this period the exchange rate moved very tightly around a slowly declining straight trend line. (This period was immediately preceded by the sharp appreciation of the exchange rate at the start of June 2014, which we explain later.)

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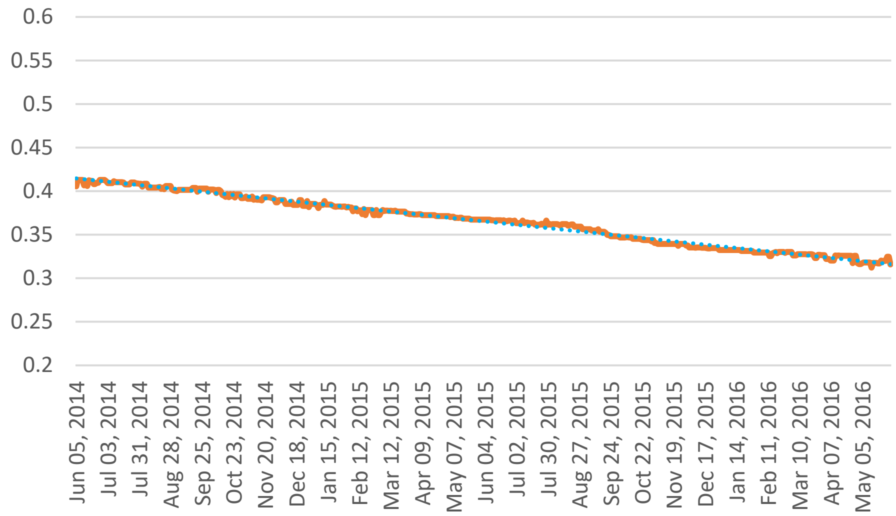
[50] This is explained in the *2018 IMF Annual Report on exchange arrangements and exchange restrictions*, p.43

[51] IMF puts the starting month for this period as April, but in fact it was June.

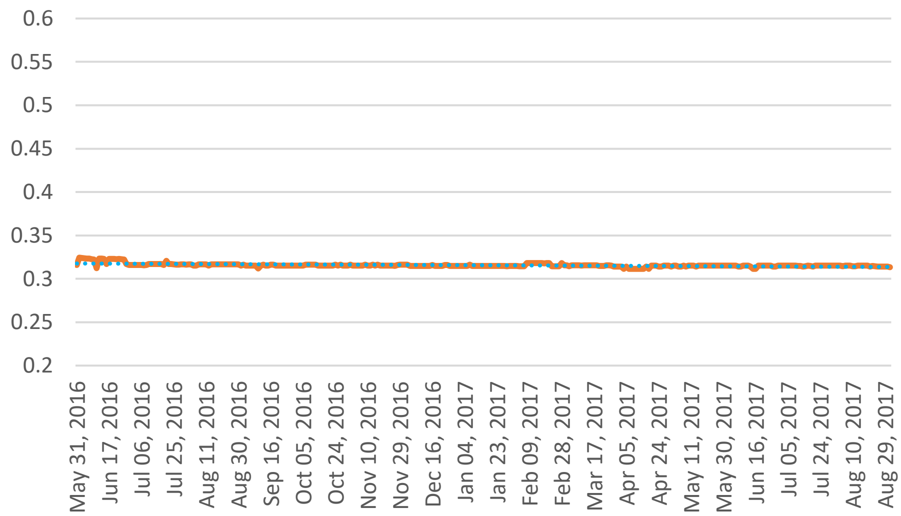
Figure 28. USD/PGK from June 2014 to May 2016 (first crawl-like regime)



Source: https://au.investing.com/currencies/usd-pgk-historical-data. Note: Dotted line is a trend line.

In the next "stabilised" period from June 2016 to August 2017, there was almost no depreciation at all. Instead, as the next graph shows, the currency was virtually fixed at about K0.32 to the USD.

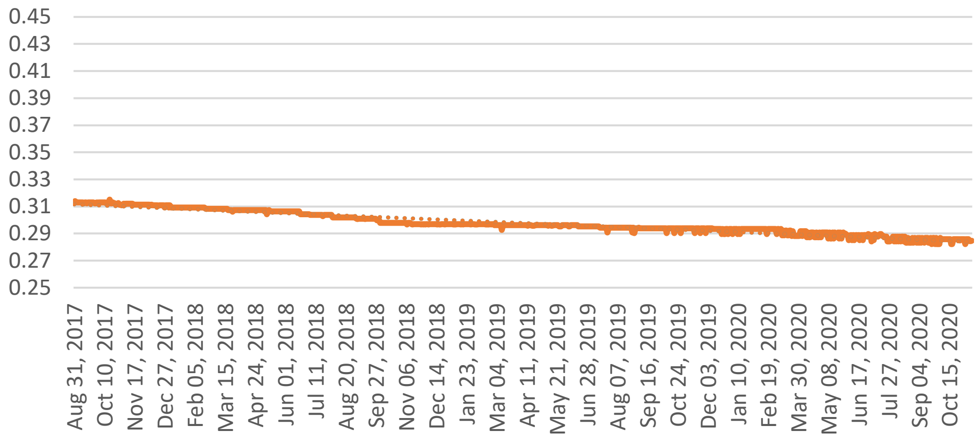
Figure 29. USD/PGK from June 2016 to August 2017 (first stabilised regime)



Source: https://au.investing.com/currencies/usd-pgk-historical-data. Note: Dotted line is a trend line.

Then in the third post-floating period, from September 2017 to November 2019, the currency started to fall slowly again, though much more slowly than in the first post-floating period. In that first period (June 2014-Mary 2016), the Kina fell at an annualised rate of 6.7%; between September 2017 and November 2020 it fell at an annualised rate of only 1.2%.

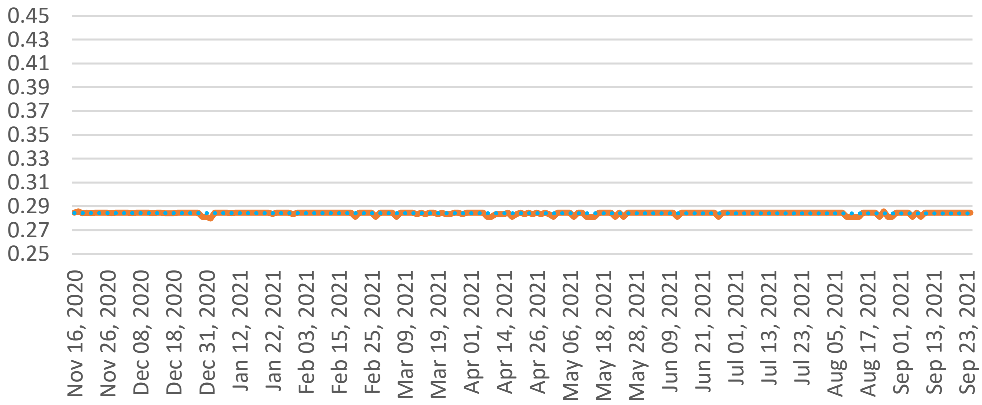
Figure 30. USD/PGK from September 2017 to November 2020 (second crawl-like regime)



Source: https://au.investing.com/currencies/usd-pgk-historical-data. Note: Dotted line is a trend line.

Finally, in the fourth period, from November 2020 to the current time, the Kina has stabilised again, this time at K0.285 to the USD.

Figure 31. USD/PGK from November 2020 to September 2021 (second stabilised regime)



Source: https://au.investing.com/currencies/usd-pgk-historical-data. Note: Dotted line is a trend line.

In all four periods, one can see that the exchange rate adjustments were very smooth and predictable, the only difference being that they were adjustments around a downward trend in the first and third period, and adjustments around a stationary trend in the second and fourth.[52]

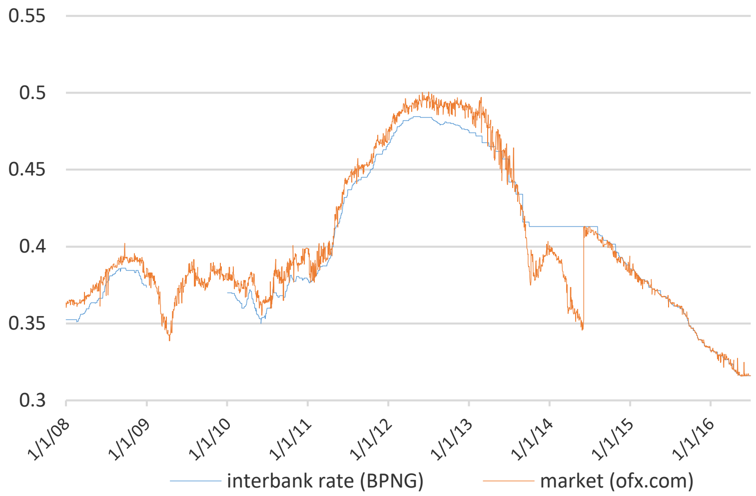
How actually is the exchange rate now set in PNG? And why has it been through the different phases shown above? Crucial to the way the foreign exchange market now works in PNG are the trading bands introduced by BPNG into the foreign exchange market on 4 June 2014.[53] Since then Authorised Foreign Exchange Dealers (AFEDs) have been required to always sell within 150 basis points of the interbank rate. This makes the interbank rate the determinant

[52] The coefficient of determination (R^2) for a trend regression in the first and third periods is 99% and 94% respectively; that is, almost all the variation in the exchange rate over time in these two periods is due to the trend. For the second period, it is only 30%, and in the last it is only 1%. This is because the trend in this period is so close to zero; a zero trend would produce a zero R^2.

[53] As per this press release.

of the market rate. Earlier the two could have and did at times diverge, but since mid-2014, as the figure below shows, such divergence has not occurred.

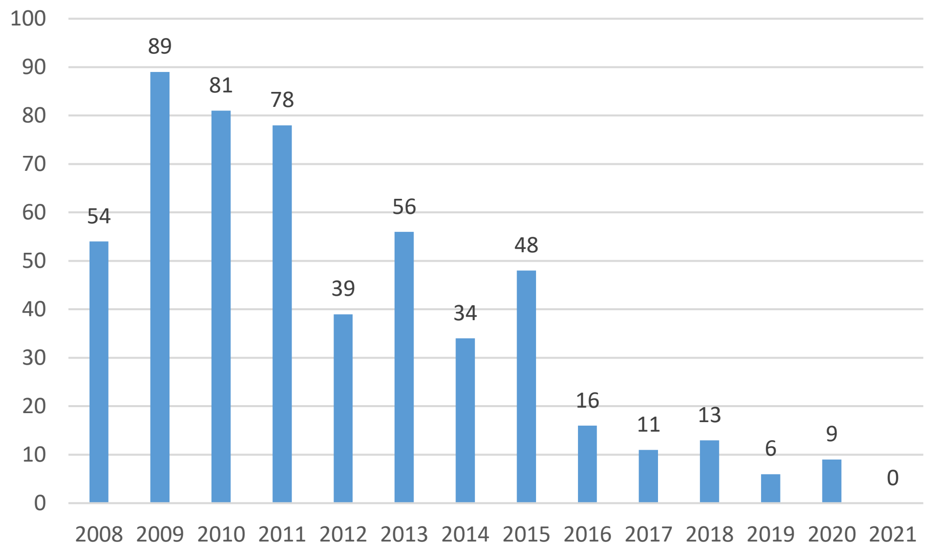
Figure 32. The interbank rate and the market USD/PGK rate, 2008 to 2016



Source: Daily data from BPNG and ofx.com. The overlap between the two lines continues post 2016 to the current day. Data on the interbank rate is missing around 2009. The interbank rate is also known as the mid-rate, and is published on the BPNG website.

So, at least from mid-2014 onwards, to explain the market USD/PGK rate we need to explain the interbank rate. BPNG publishes the daily interbank rate on its website. Analysis of this data is useful to understand PNG's changing exchange rate regime. If the exchange rate was floating, we would expect the interbank rate to change frequently, in response to both temporary and ongoing changes in demand and supply. As the graph below shows, in the past the daily interbank rate did change frequently, with as many as 89 changes in 2011 for example. However, in more recent years the changes in the interbank rate have been few and far between with fewer than 20 changes each year from 2016 to 2018, fewer than 10 changes in each of 2019 and 2020, and no changes at all in the first 9 months of 2021.

Figure 33. Number of changes per year in the USD/PGK interbank rate, 2008 to 2021



Source: Calculated from BPNG daily exchange rate data; 2021 nine months only.

How is the interbank rate set, and why has the Kina become so inflexible?

The Interbank Market participants are BPNG and the six Authorised Foreign Exchange Dealers (AFEDs).[54] It is a one-way market, in the sense that BPNG is the only supplier of dollars to the market, and the AFEDs the only buyers.

AFEDs make bids for dollars in the Interbank Market on a daily basis, and are free to submit any bid price they want. However, bids are not responded to; rather, they accumulate, and every month or so BPNG intervenes with foreign exchange from its reserves (average of $85 million per month for the first nine months of 2021) and indicates how much of that allocation is to go to the different AFEDs. The allocation is made at BPNG's discretion.[55] In practice, allocations are related to market share. Based on data for 2021 on average BSP gets about 45% of the total intervention amount. BPNG releases this allocation at the latest bid price made.[56]

Only a small share of outstanding orders is matched by the interventions, about 20% based on 2021 data. However, as mentioned in the previous section, importers may place orders for foreign exchange with more than one AFED because they know how difficult it is to get foreign exchange.

The fact that AFEDs set the exchange rate via their bid price seems to be what BPNG means when it refers to the exchange rate regime as (still) floating.[57] As mentioned earlier, it is true that the exchange rate is market determined (that is, determined by the Interbank Market), but the Kina is not floating because (a) as discussed in the previous subsection, rationing and floating are inconsistent and (b) a float, even a managed float, would result in a lot more volatility. It is nevertheless important to understand why AFEDs do not bid down the Kina more in the Interbank Market.[58]

The first point to note is that there is no benefit to be gained by an AFED from putting in a higher bid price for dollars in the Interbank Market. The bid price does not influence the volume of dollars a dealer will get from BPNG. Therefore, a higher bid price just means the same volume of dollars but at a higher price for the dealer's customers.

What about outside of the Interbank Market? Foreign exchange supplied by BPNG pays for less than 20% of PNG's imports of goods and services. Why don't banks offer a higher price

[54] ANZ, BSP, Westpac, Kina Bank, First Investment Finance and Moni Plus.

[55] BPNG's operational guidelines for the Interbank Market states that "[t]he allocation of intervention proceeds will be at BPNG's discretion."

[56] If the bid price changes between central bank interventions, then AFEDs are allowed to, and do, change their earlier bid prices, so that, by the time of the next intervention, there is only ever at most one bid price since the last intervention.

[57] When the IMF first said that the exchange rate was not floating, BPNG responded that "The authorities [ie BPNG] emphasized that the USD/Kina rate was market determined" (2015 Article IV, p.11). In PNG's IMF Staff Monitored Program, agreed to in 2020, the PNG Government agreed to "a progressive restoration of kina convertibility and a fully market-determined exchange rate" (2019 Article IV, p. 41). As we clarify, the exchange rate in PNG is market determined, but is not floating.

[58] Bidding down the Kina (against the dollar) and bidding up the dollar (against the Kina) and paying a higher price for dollars (in Kina) are all equivalent.

to get more dollars from exporters? Here the trading bands introduced in June 2014 play a crucial role. Because of the bands, all AFEDs have to pay the same (interbank) Kina price for dollars to exporters: they are not allowed to "steal" exporters from other AFEDs with the offer of a better price. Thus the only incentive for AFEDs to bid higher for dollars in the Interbank Market (and thus be able to bid higher for dollars from exporters) is that a depreciated Kina should lead to higher dollars in total, for all dealers, from exporters. However, this is an uncertain and longer-term gain compared to the short-term and certain cost of having to charge their customers more for dollars if they bid a higher price in the Interbank Market.

Two other factors further reduce the incentives of AFEDs to bid higher for dollars. One is that some banks borrow in dollars to meet the foreign exchange needs of their customers. They need in the future to recoup those dollars from the Central Bank. If they do this at a lower exchange rate, they will make a Kina loss on that transaction. Another factor is that it is widely reported that BPNG leans on banks from time to time not to bid down the Kina.

In summary, while various factors are in play, it is fundamentally the reliance of rationing combined with trading bands that has changed PNG's foreign exchange market from a floating to a very stable non-floating regime by drastically weaking the incentives on AFEDs to pay a higher price for dollars.

Why did the exchange rate appreciate by 17% in June 2014, and why has the exchange rate regime been through four different phases since then? We cannot be certain of this, but we can put forward some plausible explanations:

- From late 2013 to June 2014, the interbank and market rate increasingly diverged (Figure 32). Over this period, AFEDs did not bid the dollar down in the Interbank Market due to informal guidance from BPNG, but made massive profits by selling these dollars at a much higher market rate. Then, due to the introduction of the trading bands in June 2014, the USD/PGK market rate was suddenly forced up (appreciated) by 17% on 5 June (Figure 32) to the interbank rate.[59] The pre-appreciation market exchange rate was more or less market clearing, but with the appreciation, demand for dollars went up, and this is when rationing began, and the backlog of orders started to build.[60] The earlier informal guidance from BPNG that the dollar should not be bid up in the Interbank Market (which had caused the long period of stationarity in the interbank rate) was then lifted. Dealers thought that a lower exchange rate would once again clear the market, and they gradually put in higher bids for dollars.

- When, a couple of years later, the exchange rate approached 30 cents per Kina, the Central Bank expressed its concerns to the banks about instability and excessive depreciation, and that level became a threshold that, it was viewed, should not be crossed and so banks stopped pushing down the Kina. This second phase went from

[59] The alternative was for the interbank rate to depreciate suddenly to the market rate, but that would have violated informal BPNG guidance.

[60] The first reports of rationing started to emerge in late 2014: see for example this Business Advantage article from October 2014 where the Chief Executive of the Manufacturers Council of PNG talks about "absurd" limits on foreign exchange for importers.

mid-2016 to late-2017.

- 2016 was the first year in which foreign exchange became the top concern of business, and it remained the top concern in 2017 and 2018 (Figure 25). Eventually, the voices of business could not be ignored, and in late-2017, depreciation came to be acceptable again, and it resumed, albeit at a much lower pace. The 30 cents barrier was finally broken around mid-2019.

- This gradual depreciation continued into the COVID-19 era, when bidding up the dollar came to be seen as inappropriate when the banks were under pressure to provide economic relief. Hence the most recent period of stationarity since November last year (see also Figure 4).

The problem with the trading bands is not their introduction, but their use combined with rationing. Consider an alternative scenario of trading bands without rationing. Then AFEDs would be able to fully meet their demand for dollars, and if that demand increased, they would bid a higher price for dollars, and supply would respond (either from exporters or the Central Bank). The Kina would be floating and would move more often.

Consider finally the case in which there was a surge of dollars into PNG. Rationing would end and, if the surge was large enough, there would be upward pressure on the Kina in the face of excess supply of dollars as banks sought to pass on the benefits from a stronger Kina to their customers. (This would be especially the case if BPNG started responding to bids for dollars or if some of the AFEDs started trading dollars through the Interbank Market.) In other words, the foreign exchange market in PNG, as now constituted (in which BPNG only acts as a price-taker), will respond to upward pressure on the Kina, but resist downward pressure. As we discuss in (f), this is exactly what we would expect given BPNG's price stability legislative mandate.

(d) Overvaluation

Just because the exchange rate is not floating does not mean that it is overvalued. However, IMF staff and many other organisations and researchers have also found that ,in fact, the Kina exchange rate is overvalued. This is a frequent comment in the annual IMF Article IV reports on PNG, and has also been confirmed by various academic studies. The IMF started recommending currency depreciation for PNG in its 2014 Article IV assessment. In its 2017 and 2019 reports, it specifically described the Kina as overvalued. The World Bank, ADB and commercial banks have all called for a devaluation, as has the Business Council of Papua New Guinea.[61] A recent study by Dr Martin Davies concluded that "the current real exchange rate is overvalued by between 20 and 30 percent" (p.4).[62] An earlier academic study found that "the kina should depreciate by about 20% to close the gap between the actual and equilibrium

[61] See Business Advantage, 6 October 2015, Business Advantage, 1 April 2020, and Business Advantage, 7 September 2020.

[62] See Davies (2021) "The path to kina convertibility: study of the foreign exchange market of Papua New Guinea", Institute of National Affairs (INA) Discussion Paper no. 120.

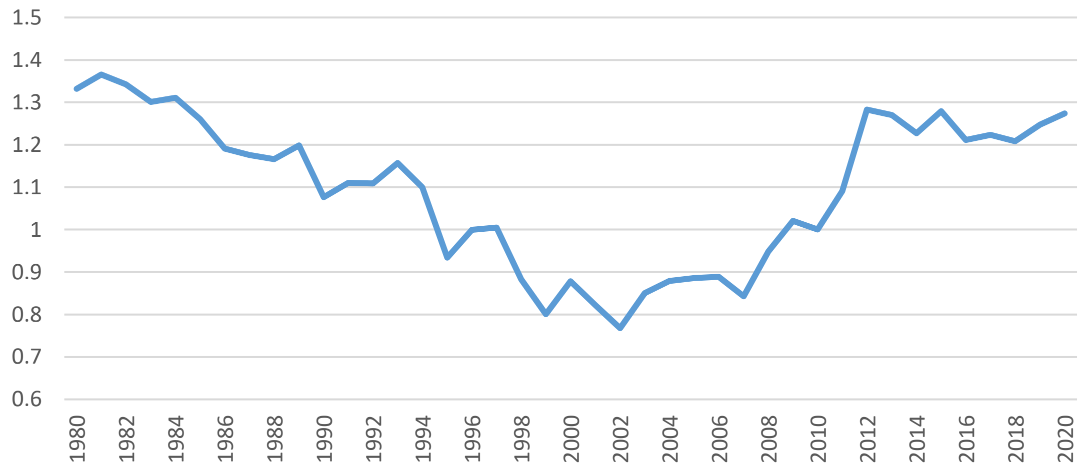
value of the RER [real exchange rate].”[63]

The surest evidence that the exchange rate is overvalued is the excess demand for foreign currency. The very fact of rationing means that the Kina needs to depreciate to clear the market.[64]

But there is a lot of other evidence as well.

One sign of the Kina’s overvaluation is the fact that the real exchange rate is at the same level as it was during the boom, even though the boom is over, and therefore one would expect a real exchange rate depreciation. The figure below shows the real exchange rate for PNG. The real exchange rate fell over the 1980s and 1990s but recovered with the resource boom. However, although the resource boom ended in 2014, the real exchange rate has not devalued in real terms.

Figure 34. PNG real exchange rate (2010=1), 1980 to 2020

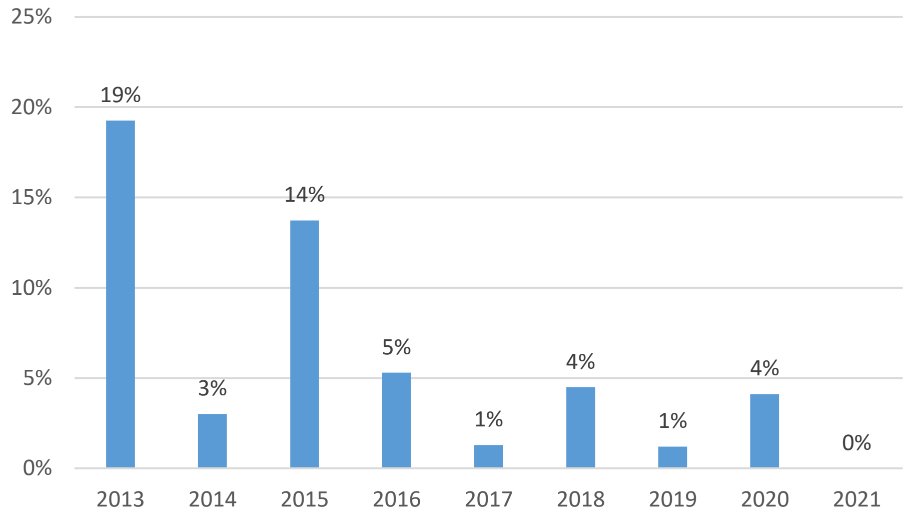


Source: World Development Indicators. The index is set equal to unity in 2010, and shows changes in the value of the Kina relative to a trade-weighted average of several foreign currencies, adjusted for relative movements in inflation.

As shown in the next figure, although there was significant nominal depreciation in 2013 and 2015, in other years depreciation has been very modest. Given that inflation is higher in PNG than its trading partners, and depreciation of the currencies of other trading partners relative to the USD, PNG’s modest nominal depreciation in most years has not been enough to bring about a real depreciation.

[63] See Fox and Schroeder (2017) “After Papua New Guinea’ resource boom: is the kina overvalued”, *Asia and the Pacific Policy Studies,* Vol. 5, No. 1, pp. 65-76.
[64] The alternative would be to release more foreign exchange reserves, but this is unlikely to be sustainable.

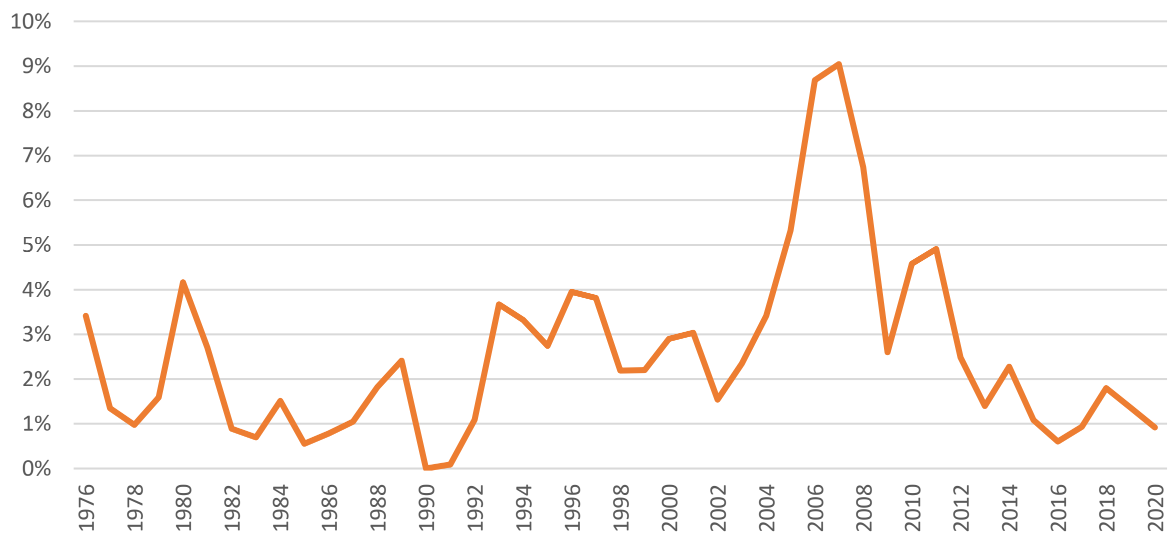
Figure 35. Annual USD per PGK depreciations, 2013 to 2021



Source: Calculated comparing the first daily rate in each year and the last daily rate in the same year from USD/PGK exchange rate data provided by https://au.investing.com/currencies/usd-pgk-historical-data. 2021 is up to the end of September and actually shows a tiny appreciation using this method; to avoid confusion, this is replaced by zero.

Confirmation that the exchange rate is overvalued also comes from looking at the resource revenue take, that is, the revenue that flows to the government budget from resource-sector projects. This is a major source of foreign exchange for the broader PNG economy. This peaked during the resource boom but has since fallen away to just 1-2% of GDP. Given the lack of foreign exchange now coming in from resource projects, we would certainly expect a real depreciation.[65]

Figure 36. Government's resource take as a percentage of GDP, 1976 to 2020



Source: PNG Economic Database.

[65] This point is confirmed in the econometric analysis of Davies (2021) "The path to kina convertibility: study of the foreign exchange market of Papua New Guinea", INA Discussion Paper No. 120.

In the 2019 IMF Article IV, BPNG agreed that the exchange rate was overvalued, though it contended that "the overvaluation of the kina is towards the lower end of the range estimated by IMF staff" (p.11).[66]

(e) Impacts of current policies

The fact that businesses have since 2014 regarded foreign exchange shortages as their most or one of their most important constraints points to the costs of current policy settings.

Just to give one example of the concerns of business, in October 2019 City Pharmacy MD Mahesh Patel was quoted as saying that "the issue of shortage of US dollars has been an ongoing issue over the years … Patel said CPL and business houses were experiencing constant delays with uncertainty on the availability of US dollars affecting trade … Patel said a shortage of US dollars meant constant delays in shipments, which meant lost sales and a loss of credibility with the suppliers."

It is not only importers who struggle to get dollars. Investors find it difficult to get dollars to repatriate profits (make dividend payments to foreign owners). For example, the bankruptcy (Administrator's) report for the Australian airline Virgin, that used to fly to PNG, noted that the company has US$7.75 million "trapped [in PNG] due to a shortage of Australian dollars in Papua New Guinea. As a result, these funds are not expected to be released from Papua New Guinea."

In general, the policy of non-convertibility has damaged PNG's reputation as an investment-friendly country. As one 2021 US government report advising US businesses considering investing in PNG commented:

> … [A] lack of available foreign exchange makes such conversions, transfers, and repatriations time consuming. … While there are no legal time limitations on remittances, foreign companies have waited many months for large transfers or performed transfers in small increments over time due to a shortage of foreign exchange.

The IMF has argued that foreign exchange rationing has increased unemployment in PNG and led to shortages of intermediate imports.[67] Academic commentators have agreed that rationing is bad for economic growth. Dr Martin Davies in his recent Institute of National Affairs study[68] concluded that:

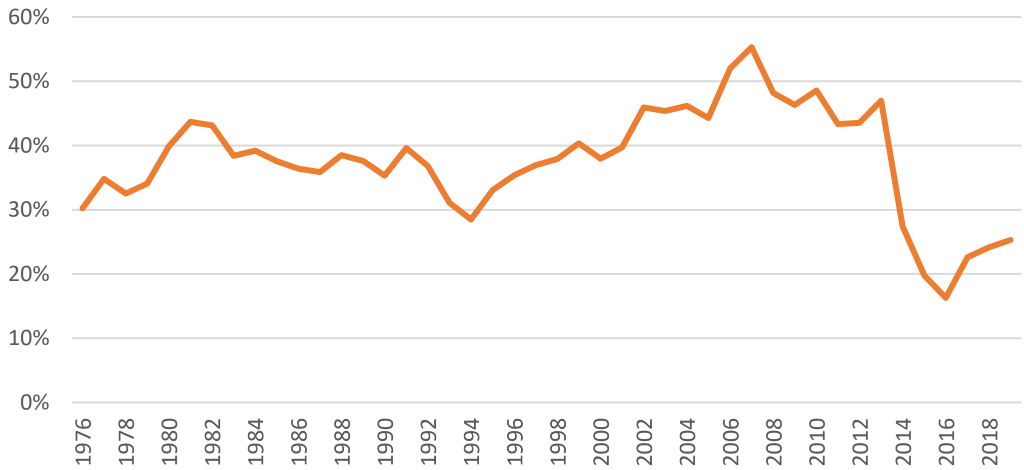
> The rationing of foreign exchange has led to import compression. This reduces the growth of the economy through reduced investment which diminishes productive capacity, and increases costs which reduces current and future export opportunities. It also reduces the variety and availability of goods for domestic consumers which has

[66] The overvaluation range estimated in 2019 by the IMF was 11-18%.
[67] See p.25 of the 2018 IMF Policy Paper "Review of the Fund's policy on Multiple Currency Practices: initial considerations"
[68] Davies (2021) "The path to kina convertibility: study of the foreign exchange market of Papua New Guinea", INA Discussion Paper No. 120.

a welfare cost to households. Given this, returning the Kina to full convertibility is of the highest priority. (2021, p.2)

The issue of import compression is an important one. It is often said that PNG is an import-dependent country, but PNG's ratio of imports to GDP is in fact at its lowest ever level. Every country needs to import to grow and promote living standards, but import compression due to foreign exchange rationing has prevented this in recent years.

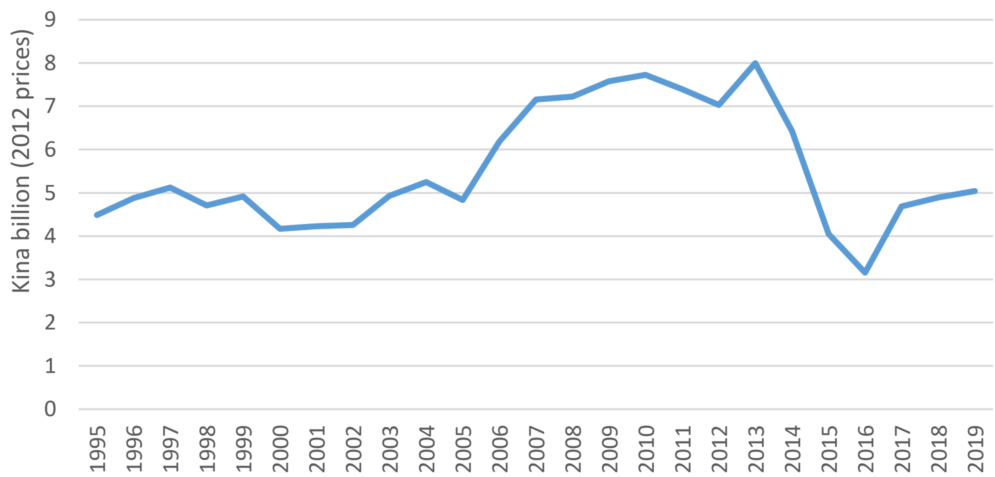
Figure 37. Ratio of imports (goods and services) to GDP, 1976 to 2019



Source: PNG Economic Database.

The next figure removes resource imports and services, and shows only the imports of non-resource goods, such as imported food, and equipment for manufacturing and construction. It shows that, adjusting for inflation, these imports are back at pre-boom levels, that is the levels seen in the 1990s. Given the population and economic growth since the 1990s, this is not what one would expect and certainly would have a negative impact on growth.

Figure 38. Non-resource goods imports (adjusted for inflation), 1995 to 2019



Source: PNG Economic Database and BPNG QEB.

Rationing is also damaging because of the discretion it introduces into official decision making, and therefore the lobbying that it encourages. Because there is not enough foreign exchange to clear the market, officials have to decide who gets what, and importers lobby to get to the front of the queue.

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.

Another deleterious effect of non-convertibility is on fiscal policy. PNG's hard Kina policy was introduced at independence to enforce fiscal restraint. If large fiscal deficits were run, there would be increased demand for foreign exchange and this would require either devaluation or a reduction in foreign exchange reserves. Devaluation was not allowed under the hard Kina policy, and a reduction in reserves could only be temporary or it would lead to a balance of payments crisis. These were credible threats that restrained fiscal policy.[69]

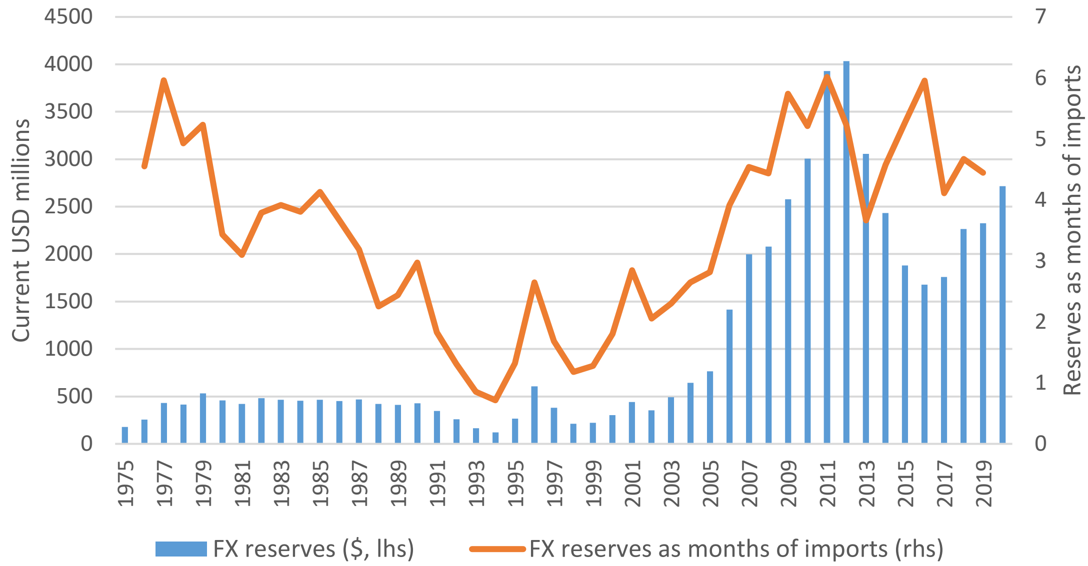
Even when the exchange rate was floated in 1994, the restraining influence of exchange rate policy on fiscal policy was preserved. If there were large deficits, there would be a devaluation, which was unpopular, and/or there would be a depletion of foreign exchange reserves, which was unsustainable.

Now, however, with foreign currency rationing, there is no feedback from the balance of payments to fiscal policy. Governments can run whatever deficits they want, and BPNG will ensure that foreign exchange reserves are protected, and any depreciation limited

We can see from the figure below that foreign exchange reserves, while not as high as they were during the boom, are much higher than in most of the pre-boom era, both in absolute terms, and as months of imports. This shows the priority given by the Central Bank in recent years to protecting reserves.

[69] In December 1975, Finance Minister Sir Julius Chan said: "…[I]f we try to get out of our problems by running regular budget deficits, then we will be forced to devalue." Quoted in Garnaut, Baxter and Krueger (1984) *Exchange rate and macroeconomic policy in independent Papua New Guinea*, NCDS, ANU, p.11.

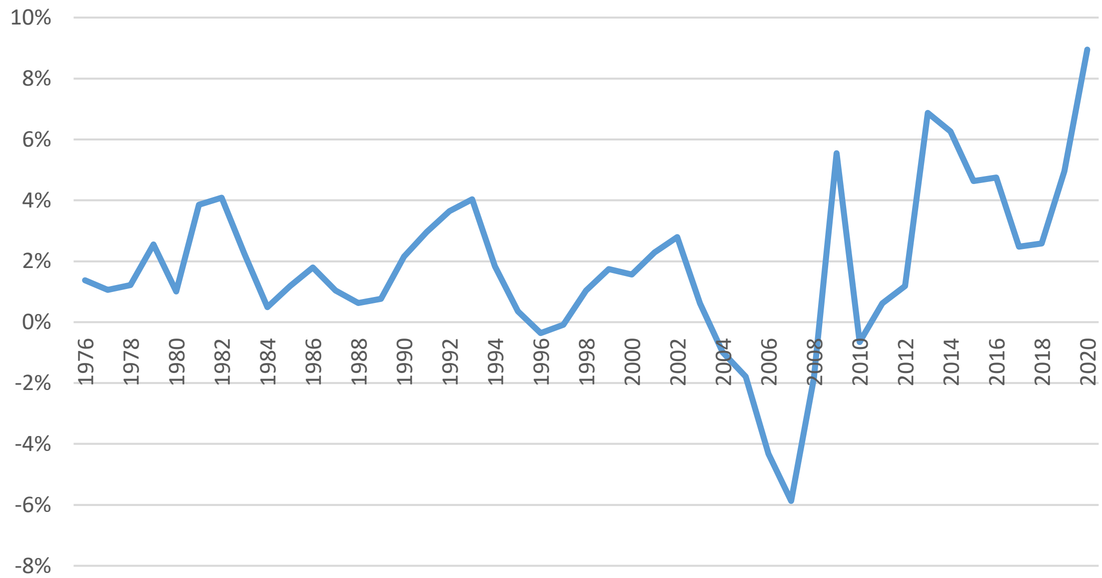
Figure 39. Foreign exchange reserves, 1975 to 2020



Source: PNG Economic Database.

On the fiscal side, however, deficits have never been larger. Prior to the last decade, the greatest run of deficits of more than 2% of GDP was in the early 1990s: four years from 1991 to 1994. However, fiscal deficits have been above 2% of GDP every year since 2013 (eight years in total so far), and were above 4% from 2013 to 2016.

Figure 40. Fiscal deficits (% GDP), 1976 to 2020



Source: PNG Economic Database.

A large fiscal deficit can sometimes be justified (many countries are running large deficits during the pandemic), but a long series of large deficits is more difficult to justify. PNG has adopted various limits on the deficit and on debt, but none of these have been adhered to over time. The earlier deterrent on running large deficits (that the country risked a large devaluation and/or running out of foreign exchange) was effective for many years, and when it failed (as in the 1990s) corrective measures were then taken to reduce the deficit. Now, with the balance of payments risk of running large deficits removed we are seeing something quite different: year after year of large deficits.

BPNG often advises the PNG Government to practice fiscal prudence. For example, the September 2019 MPS comments that "The high deficit is a concern". It is ironic that BPNG's own exchange rate policies have the opposite effect, that is, of encouraging fiscal profligacy.

So far, we have focused on the costs of non-convertibility. What about the effects of overvaluation? It is agreed that depreciation will lead to inflation. The strong link between depreciation and inflation in PNG is well established. The most recent study by Dr Martin Davies reports that "the rate of inflation is particularly sensitive to exchange rate movements" and that "The IMF and the BPNG estimate that pass-through is between 30 and 40 percent, and that it is complete in four quarters."[70]

An exchange rate depreciation would also stimulate the economy (beyond the elimination of foreign exchange rationing). However, the extent of the stimulus is debated. For example, Dr Davies has argued that a 20% real depreciation would "improve the trade balance by an amount exceeding USD250 million per annum, … increase real agricultural export income by over 30%, …[and] stimulate economic activity in the export and import-competing sectors, providing much needed stimulus to non-resource sector economic activity."[71] In its September 2021 MPS, BPNG countered that "a large depreciation may not necessarily lead to the desired supply response in the non-mineral private sector due to structural impediments" (Box 1)[72]

An exchange rate depreciation would make it more expensive for the government to service its external debt (about 45% of its total debt). Finally, an important cost of the current foreign exchange regime (described in (c) above) is its lack of transparency, for example, the description by BPNG of the regime as floating when clearly it is not. This leads to confusion, and makes it impossible to work out what BPNG's objectives are with regards to the exchange rate and therefore to macroeconomic policy more generally.

(f) Explaining the changes

Why since 2014 has BPNG (a) moved away from a floating to a non-floating regime and (b) moved away from convertibility on the current account?

[70] Davies (2021) "The path to kina convertibility: study of the foreign exchange market of Papua New Guinea" INA Discussion Paper No. 120. See also Sampson et al (2006) "Exchange rate pass-through in Papua New Guinea", *Pacific Economic* Bulletin, vol.21, no. 1, pp.20-37. A 2008 IMF study noted that "inflation historically has had a strong negative correction with foreign exchange rate movements", and that "movements in headline inflation are mainly explained by tradable goods, which account for 77 percent of the CPI basket." There is a broader international finding that exchange rate pass through declines once inflation is tamed, but it does not disappear: see Baqueiro et al (2003), "Fear of floating or fear of inflation? The role of exchange rate pass-through in monetary policy in a changing environment", BIS Papers No. 19, October.

[71] Davies "The path to Kina convertibility in PNG: part two", Devpolicy Blog, 2 August 2021

[72] It is worth noting though that in the 2012 IMF Article IV BPNG commented that "that allowing the exchange rate to appreciate further would hurt traditional exporters", and in the 2013 IMF Article IV, BPNG commented that "a strong kina would adversely affect external competitiveness."

Although Section 58 of the CBA requires BPNG to set out its exchange rate policy in its biannual policy statements, it has never done so. It has at times maintained that the exchange rate regime is floating, and at times has commented on the backlog of FX orders.

Explaining the above changes therefore requires some analysis. In late 2013, when the interbank rate become flat for the first time (Figure 32), there was still an expectation that PNG was on the cusp of a boom, with Liquid Natural Gas (LNG) revenues soon to start flowing in, and other resource projects to follow. The expectation by BPNG was that the Kina would appreciate not depreciate. As time went by though, it became evident that nearly all the LNG revenue was heading offshore. Total resource revenue flowing to the budget fell, and future resource projects started to look more uncertain. Presented with a different longer-term scenario, why wasn't there more of an effort by BPNG to depreciate the currency and clear the foreign exchange backlog that by then had built up?

One reason is that any policy that delivers even a modest boost to inflation cannot be contemplated by BPNG given its current legislative mandate which requires it give complete priority in its monetary policy settings (of which the exchange rate is a part) to price stability. As discussed at the start of this chapter, BPNG is only allowed to consider price stability when formulating monetary policy: the Act states this three times. Moreover, Section 58 implies that the value of the Kina in terms of other currencies is to be set in accordance with monetary policy and its objectives, thereby completely subordinating exchange rate policy to the anti-inflation objective attached by the CBA to monetary policy.

As discussed above in subsection (e), if there is one thing we know about depreciation in PNG it is that it will lead to inflation. BPNG has repeatedly been clear about this, writing for example in the 2017 IMF Article IV that it was "concerned about the impact that depreciation would have on the overall rate of inflation" (p.10). More recently, the September 2021 MPS argued against depreciation on the grounds that "a large depreciation will increase the import prices and domestic inflation, which would adversely affect people's welfare" (Box 1).

In summary, the overriding importance BPNG gives, and is required to give, to combatting inflation has made it reluctant to allow a real depreciation of the Kina and helps explain the persistence of the Kina's overvaluation and therefore of the rationing of foreign exchange.

(g) Policy options

There are many steps that BPNG could take to reduce or remove the overvaluation of the Kina and restore the convertibility of the Kina. This is not a matter of technical capacity, or a problem that requires technical assistance for its resolution. A fundamental problem is that foreign exchange is currently allocated by BPNG to dealers with no reference to their willingness to pay. BPNG could simply set a higher price on the dollars it brings to the market to clear the market. It could also release more of its reserves into the market. It could invite exporters onto the Interbank Market, and that would restore the incentives to banks to bid the dollar up. BPNG could replace allocations on the basis of discretion or market share by an auction, so that dealers who bid more for dollars got more dollars.[73]

However, these are decisions that, out of respect for its independence, should be left to the Bank. Our interest is in making sure that the Bank has the right objectives in mind when it is designing its exchange rate policy.

Clearly, the Bank's goal of price stability is unsuitable for an entity that sets exchange rate policy. This goal will always bias decisions against depreciation since, as discussed earlier, depreciations are inevitably inflationary. Recently the IMF wrote advocating depreciation of the Kina saying that the "overvaluation could be largely eliminated over the next three years without boosting inflation excessively."[74] However, even a moderate boost to inflation cannot be contemplated by an entity whose mandate is price stability.

This is particularly the case given the ineffectiveness of the policy rate (the Kina Facility Rate) in controlling inflation due to excess liquidity. This has been well documented and is discussed elsewhere (Chapters 3.2, 4.1 and 5.2). Given this, the exchange rate is the only instrument BPNG has to pursue its only monetary policy objective of price stability. This strengthens the bias against depreciation.

The barriers against overvaluing the exchange rate in order to control inflation that are present in other countries are much weaker in PNG. There is no parallel, informal or illegal market in foreign exchange; or, if there is, it is much smaller than in countries with comparable features of rationing and overvaluation. There is no powerful constituency for depreciation. PNG's large companies are either resource companies, or importers. Depreciation would benefit mainly rural producers, who are not politically powerful. Moreover, there is much public opposition to depreciation because of its impact on inflation and because of memories of the chaotic 1990s. In the past, devaluations have come when PNG has faced a balance of payments crisis. But with the current system of rationing, there is no prospect of such a crisis. Indeed, it seems that the current economic policy settings of overvaluation and rationing could be sustained indefinitely.[75]

International research has found patterns of "dread of depreciation",[76] "fear of

[73] As the IMF comments, "The allocation of scarce FX can be done efficiently through a one-sided fixed volume auction, but this requires a willingness to let the exchange rate adjust fully to clear the market. Scarce FX can alternatively be allocated through an interbank FX market, provided the market functions efficiently, but again this requires a willingness to let the exchange rate adjust fully to clear the market." See the article "Evolution of PNG's FX regime" in *IMF PNG Selected Issues*, November 2015, p.21.
[74] PNG 2019 Article IV, p.11.
[75] Even though this is not the international norm. In general, researchers have concluded that "[i]n the face of fundamental forces driving the exchange rate, 'defending' the national currency does not prevent its depreciation and only leads to massive losses of foreign reserves." (See Loayza and Mendez-Ramos (2016). "Should we fear foreign exchange depreciation?", Research Policy Brief, World Bank, October, and the references therein. However, this may not apply to countries with limited capital mobility and very regulated foreign exchange markets where rationing can be applied. In PNG foreign reserves have actually increased of late (Figure 39).
[76] Dutta and Leon (2002) "Dread of depreciation: measuring real exchange rate interventions", IMF WP/02/63, April.

appreciation",[77] and "fear of floating".[78] PNG is an example of the first of these three. Of course, there are some external shocks that put upward pressure on the exchange rate and others that put downward pressure on the exchange rate. BPNG was supportive of the floating regime when it led to the appreciation of the Kina (from 2003 to 2012), but moved away from floating after it became clear that this was leading to sustained depreciation. As shown in (c), PNG's current exchange rate regime is resistant to currency depreciation, but will allow for appreciation in the face of a positive terms of trade shock leading to an inflow of dollars.

The bias against depreciation needs to be removed from PNG's exchange rate policy settings. Different analysts and policy makers might disagree about how much a depreciation would stimulate PNG's economy. But all would agree that the issue of depreciation should be considered with regard to its impact on both growth and inflation, and not only with regard to its inflationary impact, which is the only thing allowed to be taken into account in the way BPNG's objectives are currently articulated.

There are therefore two options. The first, Option A, is to give responsibility for exchange rate policy back to the Government. The second, Option B, it to leave responsibility for exchange rate policy with BPNG but to change its objectives.

We first consider Option A. If there were an obviously superior exchange rate policy the operation of which it was simple to delegate then there would be a case for this option. The Government would then establish exchange rate policy, and BPNG would implement that policy. This is the case in Australia or New Zealand for example. There, the government policy is that the exchange rate should float. There is no question that the RBA could move to another regime.

However, the problem with this proposal (to make exchange rate policy a government responsibility) is that there is no obvious "best" and simple way to manage the Kina that could easily be set by the Government and then implemented by BPNG.

There are two candidate "set and forget" or "pure" exchange rate policies: freely-floating and fully-fixed.

On the former, although PNG shifted in 1994 to a floating exchange rate regime, the small number of market players, the important role of BPNG as a provider of foreign exchange to the market (from resource projects and foreign loans), and the extreme volatility to which the Kina would be subject if freely floated, all mean that a freely floating Kina is unadvisable and perhaps unviable.

It has sometimes been suggested that the Kina should be permanently tied at a fixed rate to another currency. This would be a return to an even harder version of the original hard Kina policy. There is a logic to this proposal. However, we sense no appetite for it, and it can be argued that it would not be suitable for an economy that is as prone to shocks as PNG is, and

[77] Abstract of Levy-Yeyati and Sturznegger (2007) "Fear of appreciation", World Bank Policy Research Working Paper No. 4387.
[78] Calvo and Reinhart (2000) "Fear of floating", NBER Working Paper 7993.

that it would be difficult to credibly commit to irrevocably fixing the Kina.

The PNG Government certainly could try to establish a freely-floating or fully-fixed Kina, and then take back exchange rate policy. If, as seems likely, however, these are ruled out on the grounds discussed above, then there are two plausible exchange rate arrangements for PNG left: a managed float and a non-floating but not-fully-fixed arrangement such as a crawling-peg.

Neither of these two "intermediate regimes" is obviously superior to the other. Importantly, both would require BPNG to intervene in the market using its foreign exchange reserves. If either of these regimes were in place, and Government had responsibility for the exchange rate, it would have to instruct BPNG how much to intervene in the market, and what rate to aim at. This would be impractical, and would undermine BPNG independence.

Therefore, assuming that one of the intermediate regimes will apply, Option A – giving exchange rate policy back to the Government – is inadvisable. This leaves Option B which is to change the objectives of the Central Bank so that it takes both inflation *and* growth into account when it sets exchange rate policy. This is the option we favour.

Looking around the world, we can find useful examples of other central banks that have exchange rate policy responsibility but not a singular focus on price stability. The Philippines presents a good example. The relevant legislation states that the Philippines Central Bank (through its Monetary Board) "shall determine the exchange rate policy of the country." It also says that the "primary objective" of the Central Bank "is to maintain price stability conducive to a balanced and sustainable growth of the economy. It shall also promote and maintain monetary stability and the convertibility of the peso."

There are some countries that combine a primary price stability objective and responsibility for exchange rate policy. Kenya and Thailand are two examples. However, both countries have long had floating exchange rates, and both have powerful industries that depend on a competitive exchange rate. These circumstances, which do not apply in the case of PNG, limit the scope for the central banks of these countries to support an overvalued exchange rate, even if they wanted to. These are not relevant examples for PNG.

While we favour Option B and think it is advisable for BPNG to have responsibility for exchange rate policy, we do not think the Bank should be totally unconstrained in its exchange rate setting powers. In particular, we argue that BPNG should set exchange rate policy subject to the constraint that the Kina should be convertible on the current account. Foreign exchange rationing for importers should be abandoned as bad for growth and employment, and bad for fiscal policy. As discussed in (e), foreign exchange rationing undermines PNG's attractiveness as an investment destination. It makes the imports needed for growth harder to get. It introduces too much discretion, and incentivises firms to lobby. And it gives governments a free pass to run fiscal deficits as large as possible for as long as they want. Moreover, current-account convertibility is a principle well accepted both globally and historically in PNG, where it was the bed rock of macroeconomic policy until its recent abandonment, and where it is a principle that PNG has been signed up to since independence given its subscription to Article VIII of the IMF Articles of Agreement.

Many countries, in their central banking legislation, mandate a requirement of current account convertibility (Box 1). We propose that PNG do the same.

Box 1. Legislative mandates to ensure convertibility

A number of countries around the world require their central bank to ensure convertibility, as the following extracts (direct quotes) obtained from various laws through the IMF Central Bank Legislation Database show:

- **Dominican Republic**: The exchange system shall be based on the unrestricted convertibility of the Dominican currency with respect to other currencies…. Any impediment to free convertibility in existence when this Law enters into force should be removed within one year.
- **Jordan:** The objectives of the Central Bank shall be to maintain monetary stability in the Kingdom and to ensure the convertibility of the Jordan Dinar, and to promote the sustained economic growth in the Kingdom in accordance with the general economic policy of the Government.
- **Kazahkstan:** The National Bank of Kazakhstan shall provide for the maintenance of gold and foreign exchange reserves at a level necessary to ensure the stability and convertibility of the national currency, payments to settle obligations of the Republic of Kazakhstan.
- **Philippines:** The primary objective of the Bangko Sentral is to maintain price stability conducive to a balanced and sustainable growth of the economy. It shall also promote and maintain monetary stability and the convertibility of the peso.
- **Sri Lanka:** In determining its domestic monetary policies the Monetary Board shall especially consider their effects on Sri Lanka's international financial position as evidenced by the relation of domestic to world prices and costs, by the level and composition of exports and imports, by the international balance of payments, and, ultimately, by the ability of the Central Bank to maintain the international stability of the Sri Lanka rupee and its free convertibility for current international transactions.
- **United Arab Emirates**: Endeavor to support the currency, maintain its stability internally and externally, and ensure its free convertibility into foreign currencies.

A requirement of maintaining current account convertibility could be drafted, consistent with the IMF Articles of Agreement which PNG has already signed on to, as a requirement that no restrictions should be imposed on the making of payments and transfers for current international transactions.[79]

Since the Kina is not at the current time convertible on the current account, any such legislation could not be imposed with immediate effect, or it would be immediately violated. A grace period could be established. We would suggest that the requirement be binding by

[79] See the 2018 IMF paper "Annual report on exchange arrangements and exchange restrictions", p.26. The exact language used there is that PNG maintains "exchange restrictions subject to IMF approval under Article VIII, Section 2(a), of the IMF's Articles of Agreement." Article VIII2(a) of the IMF requires that "no member shall, without the approval of the Fund, impose restrictions on the making of payments and transfers for current international transactions."

the start of 2023.

It is possible that current-account convertibility might need to be suspended in the event of a balance-of-payments crisis. This could be allowed for in the legislation, subject to the authorisation of the Monetary Policy Committee, and a commitment to return to convertibility as soon as possible.

While enshrining the principle of current account convertibility in legislation is important, it is not a substitute for broadening the objectives of the Bank given its exchange rate mandate. Even without rationing, the Bank will need to decide on the exchange rate regime (likely a managed float or a crawling peg), and it will then need to form judgements on desirable exchange rate adjustments, and this would require judgements to be made about the impact of the exchange rate on both inflation and growth.

In summary, we propose that the BPNG retain responsibility for exchange rate policy, subject to the legislative requirement that the Kina be convertible on the current account, and to a broadening of the Bank's monetary policy objectives.

5.2 BPNG's fiscal role

As argued in the previous section, the objectives of BPNG need to be consistent with its functions and capabilities. As we discussed in Chapter 3.2, monetary policy instruments such as the Kina Facility Rate have for some time had limited or no influence over broader outcomes such as bank lending rates and the inflation rate. BPNG itself is well aware of this. In the 2015 IMF Article IV report, BPNG "acknowledged that excess liquidity inhibits the monetary transmission mechanism" (p.11). PNG's excess liquidity reflects a variety of factors, the most fundamental of which is a lack of lending opportunities relative to funds available. This structural problem is unlikely to be solved any time soon.

At the same time, the various policies of the Bank do have real influence on fiscal outcomes. We have documented this at length in various chapters. In summary:

- Chapter 3.2 showed how, given PNG's shallow capital markets, and single-borrower exposure limits, Bank purchases of government securities have helped the government finance its deficit and put downward pressure on interest rates

- Chapter 4.1 showed how the Bank's reduction in the CRR in 2020 increased bank lending to the government given single-borrower limits.

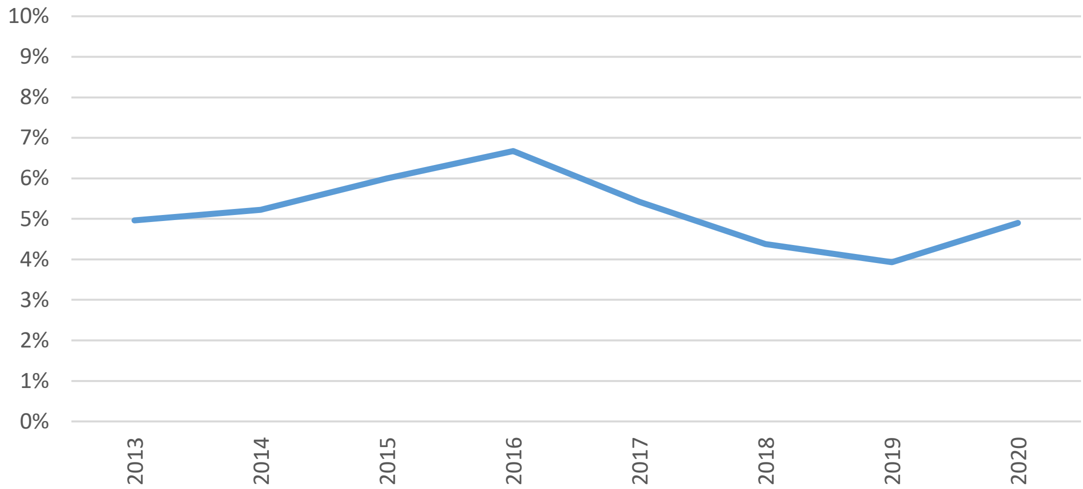
- Chapter 5.1 showed how Bank exchange rate policy has discouraged fiscal prudence by the introduction of foreign exchange rationing.

Clearly, in playing a fiscal role, the Bank must be mindful of inflationary risks. However, if controlling inflation was its only objective, or even its prime objective, the Bank would never assist the Government to finance its deficit. As we argue in Chapter 3, the financing role that the Bank plays should be made transparent and limited, but it should not be removed altogether. Given that it will continue to play a financing role, the Bank's objectives need to be broadened.

5.3 Neglect of economic growth

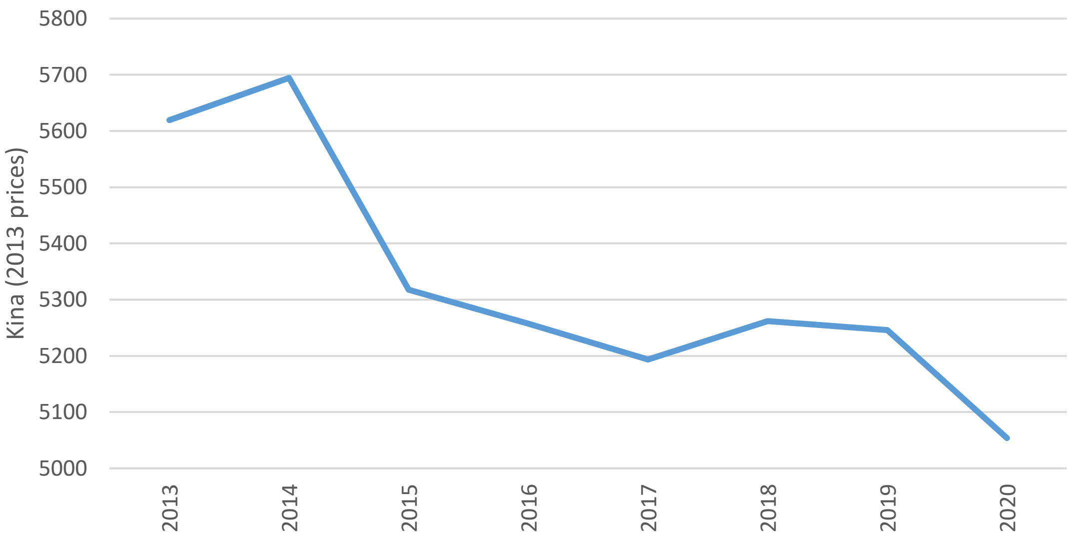
In recent years, inflation has been moderate in PNG (Figure 41). But economic growth has been sluggish in the post-boom or "bust" years. Per capita non-resource GDP growth has been negative, and formal sector employment has fallen every year since 2013 except for 2018 (Figures 42 and 43). The 7% contraction in non-resource GDP per capita between 2013 and 2019 is one of PNG's biggest ever, and the reduction in formal sector employment by 7.9% over the same period is the biggest ever.

Figure 41. CPI inflation, 2013 to 2020



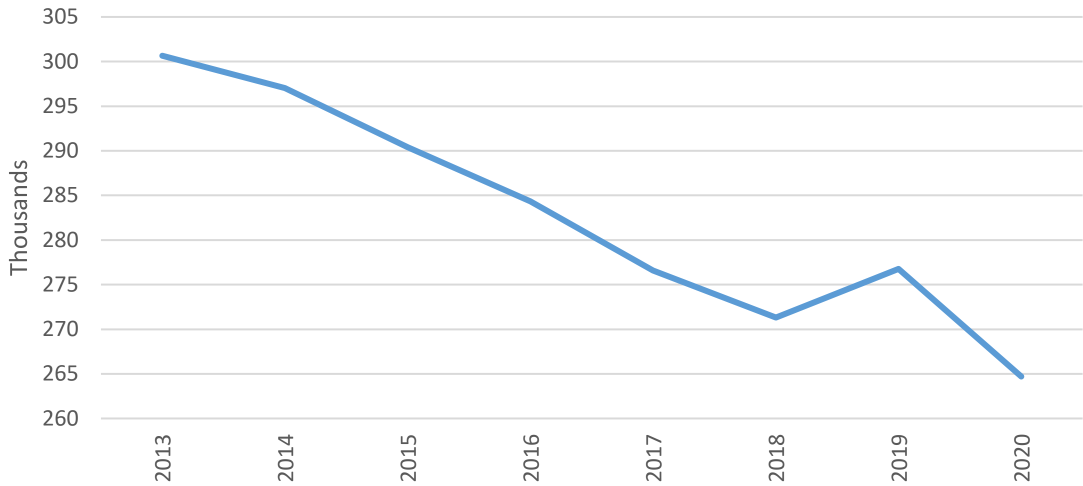
Source: [PNG Economic Database.]()

Figure 42. Non-resource (i.e. non-mineral) GDP per capita, 2013 to 2020



Source: [PNG Economic Database]().

Figure 43. Formal sector employment in PNG (excluding the public service), 2013 to 2020

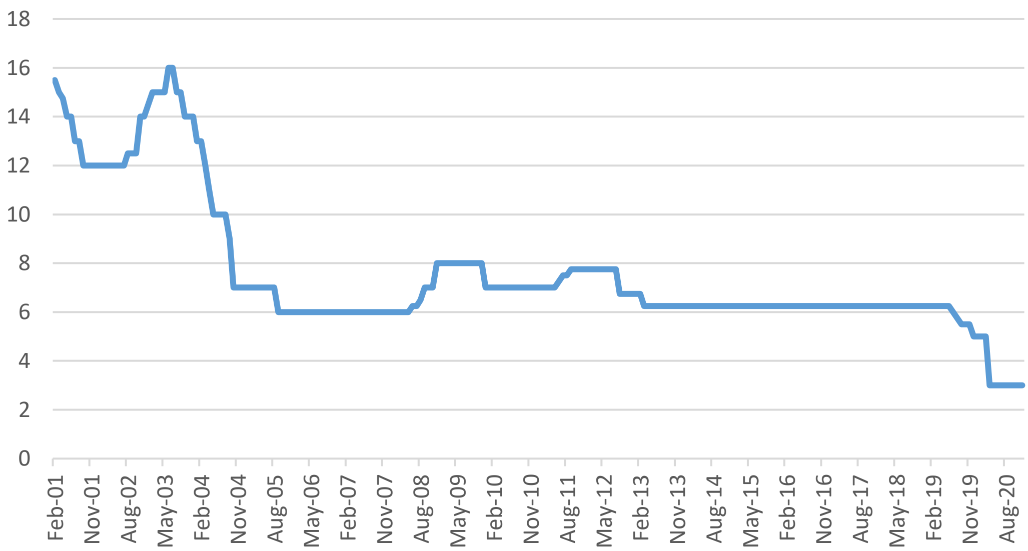


Source: [PNG Economic Database.]()

Little attention has been paid by BPNG to this poor growth performance. While recent growth figures are presented in its Monetary Policy Statements, there has been no mention of sustained low economic and negative employment growth in these statements, and no discussion of the need for stimulatory policies until 2019.

BPNG left the Kina Facility Rate unchanged from March 2013 to June 2019. In early 2013, PNG economy was booming. But the boom finished in 2014 with the completion of the mega PNG LNG project, and non-resource sector growth has been anaemic thereafter, with formal sector employment falling every year except for 2019. However, it was only in September 2019 that the KFR was finally reduced by BPNG, with cuts in both July and August of that year.

Figure 44. The Kina Facility Rate, 2001 to 2020



Source: BPNG QEB Table 6.3.

BPNG often refers to the KFR as its "policy signalling rate". While the effectiveness of changes in the KFR can be questioned (see the discussion above and in Chapter 3.2), by not changing the KFR, BPNG was signalling prior to June 2019 that it did not see the need to stimulate the economy (e.g. by an exchange rate depreciation) despite several years of negative non-resource per capita and formal sector employment growth.

This is confirmed by that fact that, from March 2013 to March 2019, the Bank described its monetary stance as "neutral" (see September 2019 MPS, p. 14). It was only in the September 2019 MPS that BPNG said it had moved to an "easing" policy.

It is understandable that BPNG did not shift to "easing" as early as 2014. Then it was still thought that a resource boom was underway, and indeed that employment and government revenue would grow strongly with the commencement of PNG LNG production. However, by 2015 and 2016 there were plenty of signs and a lot of commentary that the boom was over.

While the Bank should have signalled an "easing" stance much earlier, that it didn't may in part be explained by its legislative mandate, which, as noted, requires it to set monetary policy solely with respect to its impact on price stability.

As reported at the start of this chapter, most countries in the Asia-Pacific give their central bank a broader mandate than BPNG has. Papua New Guinea should, we argue, adopt the most common approach in the region, namely, to place "price stability alongside other macro objectives" (see Figure 24).

It could be argued that there is no point, or indeed that it would be counterproductive to give BPNG a stronger growth mandate, since central banks cannot influence economic growth. However, this would be misguided. First, as noted in Chapter 5.1 the Bank's exchange rate policy role certainly has an impact on growth. Second, as noted in Chapter 5.2, in the PNG context monetary policy can be supportive of economic growth by lowering government borrowing costs through a *limited* deficit financing role.

It should be noted that international guidance from the IMF is in favour of giving primacy to the objective of price stability.[80] We do not question this as general advice, but certainly doubt its applicability to PNG. In fact, the IMF's actual recommendation is for "a focus on the inflation objective with a credibly flexible exchange rate" (p.47). While this is sensible advice as far as it goes, PNG's own experience points to the risk that a primary focus on inflation might lead instead to a prolonged embrace of an overvalued exchange rate, especially when the policy rate cannot be used to meet the inflation goal due to poor monetary policy transmission.[81] Since 2000, BPNG has had price stability not just as its primary goal, but its only goal for monetary policy, and, as we have shown, this has led over time to serious problems with the exchange rate regime being set only with regard to inflation control, and

[80] See the IMF 2015 Staff Report "Evolving monetary policy frameworks in low-income and other developing countries".
[81] In general, making price stability the overriding or primary objective is recommended to counter "inflationary bias" by building central bank credibility. However, this argument assumes that the central bank has instruments (other than the exchange rate) to pursue a price stability objective, and that exchange rate setting is not subordinated to this objective. See Masson et al (1997) "The scope for inflation targeting in developing countries", IMF Working Paper, WP/97/130.

without attention to competitiveness and growth.[82]

Any emphasis on economic growth in BPNG's objectives should be in terms of benefit to the people of Papua New Guinea. An ideal target would be Gross National Income (GNI), which excludes profits repatriated offshore, since they do not directly benefit the PNG people. However, GNI is not measured in PNG. A good proxy is non-mineral or non-resource sector GDP, that is GDP excluding the value-added of the resources sector. Many of the benefits of the resources (mineral) sector flow offshore. Employment within the resources sector is small, and its benefits to PNG are mainly to the extent that the sector generates spillovers to the rest of the economy, for example, through tax revenue. In the absence of GNI data growth in non-resource GDP, rather than GDP as a whole, should be the economic indicator tracked in relation to a growth objective.

A good example of the need to focus on non-resource rather than total GDP is provided by the recent past. Average annual GDP growth from 2014 to 2019 has been 5.8%, which is good. But average annual non-resource GDP growth over the same period has been only 1.6%, very poor. If the focus was on the former, one might conclude that everything was fine, and no stimulus was needed. But the high GDP growth over this period was largely due to the LNG project. The non-resource GDP growth figure is a much better measure of the health of the economy over this period since, as is well known, few benefits from the PNG LNG project have flowed through to the rest of the economy.

To keep the focus on benefits to the people, and bearing in mind data limitations, we argue that the growth objective be cast in terms of employment as well. Employment as a whole cannot be measured in PNG because it is mainly in the informal sector. However, even though the formal sector only employs a minority of the labour force, growth in formal sector employment is a good proxy for the broad health of the economy and for broader employment prospects. This measure also has the advantage of being measured on a quarterly basis and relatively promptly (by BPNG), whereas GDP data is only available annually and with a long lag (the latest GDP data reported by NSO as of September 2021 is 2018).

5.4 Financial stability and development

The PNG financial sector is stable, but its duopolistic or even monopolistic nature is not supportive of development.[83] The interest rate spreads and the profitability of the PNG banking sector are among the highest in the world.[84] BPNG's only duty in this regard is to ensure the stability of the financial system.[85] It bears no responsibility for the development

[82] The IMF recommends a focus on medium-term inflation, and states that temporary increases in inflation do not require a policy response (p.30). However, BPNG clearly (and understandably) interprets its policy mandate in a way that rules out even temporary increases in inflation due to depreciation.

[83] BSP is by far the major bank. Kina is the second, much smaller domestic bank. ANZ has withdrawn from retail banking but still services the business sector; Westpac is seeking to withdraw.

[84] According to the IMF "PNG's banking sector was the fourth most profitable of 177 comparable countries in 2011, measured by return on equity" (IMF PNG 2015 Article IV, p.12). In 2018, the interest rate spread was 8.6%, compared to the East Asia and Pacific average of 5% (Howes et al (2019) "2019 PNG economic survey", *Asia and the Pacific Policy Studies*).

[85] BPNG is also charged under the Banks and Financial Institutions Act 2000 with promoting "the general stability and effective working of the financial system in PNG" (Section 5(1)). The Financial Analysis and

of the sector. While ICCC has to approve mergers, bank licenses can only be issued by BPNG. The current objective encourages BPNG to place the barriers to entry as high as possible. The current system is highly stable.[86] Allowing new entrants can only increase risk. A more balanced approach is needed, giving BPNG a mandate for financial development as well as stability. This is not uncommon. The IMF notes that a central bank's mandate often includes "financial stability, and financial market development".[87]

5.5 BPNG as the Government banker

Under Section 8 of the CBA, one of the functions of the Central Bank is that it may "act as banker and financial agent to the Government". This is an extremely important, if often overlooked, function that BPNG plays, covering the following:

- Financing of government debt is not the role of the Central Bank as the government's banker, but selling government debt is. As discussed in Chapter 3.3, the auctioning of government securities leaves a lot to be desired. This is a joint responsibility of both the Treasury and BPNG.

- BPNG helps the Government raise funds, not only through auctions but externally as well. When the Government wants to borrow money from an international organisation, the Bank has a critical role to play, not only as the recipient for such funds, but also as part of the loan negotiations, especially relating to policy conditions. It is very important that Treasury and BPNG cooperate closely in such operations.

- Helping the Government manage its cash flow through the overdraft facility (the TAF) is another important responsibility BPNG has as the Government's banker.

In theory, the job of securing government debt could be given to another entity. For example, in Australia, the Australian Office of Financial Management issues debt securities on behalf of the Australian government. In practice, however, given the small size of the PNG economy (only about 1% of the size of the Australian economy), BPNG will have to continue to perform multiple functions and manage any resulting conflicts of interest.[88]

What objectives should the Bank consider when carrying out this important job of being banker to the government? The Government, like any bank customer, obviously wants to enjoy responsive and efficient banking services. To date, the banking function has not been performed adequately by BPNG. Treasury performance also needs to be improved. But with

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Supervision Unit (FASU) within BPNG is charged with monitoring and enforcing compliance with The Money Laundering and Counter Terrorism Act 2015. According to Section 61(2), "FASU shall be an operationally independent unit with the functions as specified under this Act and can institute proceedings on behalf of the Bank of Papua New Guinea for the purpose of this Act." Issues relating to the financial sector beyond overall BPNG governance and objectives are likely to be further investigated in the second phase of our work.

[86] An IMF 2011 financial sector stability assessment found that PNG's "banking system is characterized by strong indicators" and that "Indicators point to a generally well capitalized and highly profitable sector overall."

[87] IMF Staff Report (2015) "Evolving monetary policy frameworks in low-income and other developing countries", October, p.47

[88] See Laurens and de la Piedra (1998) "Coordination of monetary and fiscal policies", IMF WP/98/25.

respect to BPNG, which is independent and governed by legislation, the Government needs to send a clear signal through legislation that it expects better.

In Section 7, the Bank's payments function is highlighted via the objective "to promote an efficient national and international payments system." It is widely acknowledged that BPNG has done a good job in pursuing its payments system objective. Likewise, we would suggest, the banking function should be governed by its own objective also articulated in Section 7, that is, as mentioned, to provide efficient and responsive banking services to the Government.

Chapter 6. Second phase issues

The IAG was asked to "[r]ecommend from the findings and conclusions under TOR 1-4 critical strategic issues requiring in-depth analysis and development – this will form the basis of the TOR for the second stage of the review and cover broader issues covering regulation of the financial system, actions to encourage competition, and follow-on work in light of the recent Financial Sector Reform review."

Apart from any follow-on work flowing from our first-phase investigations and recommendations, many additional issues, that have been brought to our attention in the course of our consultations, could be covered in the IAG's second phase or stage of review of the Central Banking Act. These include:

- Regulation of banks and other financial institutions, in particular how to:
    - encourage new, low-risk entrants; and
    - expand the capacity of the domestic financial sector to meet the economy's need for credit drive down borrowing costs, and better meet the needs of small and medium enterprises including through open banking and fintech.
- Regulation of the superannuation and insurance sectors, including the roles of the Office of the Insurance Commissioner and BPNG.[89]
- The governance of the Financial Analysis and Supervision Unit (FASU) within BPNG, as per the Anti Money Laundering and Counter Terrorism Financing Act 2014, and its relationship to the responsibility of BPNG under the Banks and Financial Institutions Act 2000.
- BPNG's financial performance and management, including its financial relations with government and the valuation of its holdings of government bonds.
- Other legislation by which BPNG is governed, including the National Procurement Act, Public Financial Management Act, the Audit Act, and so on.
- The shortage of cash in January 2021, and what lessons, if any, are to be learnt.
- The ways in which more up-to-date "real time" data on the PNG economy can be obtained, through "big data" sources such as tax and superannuation.

[89] Bearing in mind the Superannuation and Life Insurance Review currently underway.

Chapter 7. Recommendations

7.1 Introduction

This chapter contains our recommendations. After this brief introduction, Chapter 7.2 presents them in relation to the issues of governance, accountability and transparency discussed in Chapter 2. Chapter 7.3 presents recommendations in relation to the financing issues discussed in Chapter 3. Chapter 7.4 presents recommendations in relation to crisis management as discussed in Chapter 4. Finally, Chapter 7.5 presents recommendations in relation to objectives as discussed in Chapter 5.

Recommendations are numbered from 1 to 31. Each recommendation contains a summary of that recommendation, its rationale, the relevant report reference for more detail, and the recommended legislative changes. *Suggested new text is placed in italics*.

7.2 Governance, accountability and transparency (Chapter 2)

Recommendation 1: Terms for Governor

Recommendation: We recommend that the maximum for a single term for the Governor be reduced from seven to six, and from 14 to 12 years as the maximum in total. There should be no minimum tenure for the second term (for flexibility in succession).

Rationale: Seven years for a single term and 14 for a total of two terms are on the long side as term limits by international standards and could be reduced to six and 12 without sacrificing stability. Removing the minimum for the second term would increase the flexibility for replacement of the Governor by a Deputy Governor (the most common succession pathway), bearing in mind the term limits we propose for a Deputy Governor.

Report reference: Chapter 2.1(c)

Recommended changes: The relevant clauses of Section 15(1) state that the Governor

> (b) be appointed for such period, of not less than five years and more than seven years, as the Head of State, acting on advice, determines; and
> (c) be eligible for re-appointment for a total maximum of two terms; and
> (d) not serve as Governor in total for more than 14 years.

We recommend clauses (b) and (d) be revised to read:

> *(b) be appointed for such period, of not more than six years, and in the case of the first term not less than five years, as the Head of State, acting on advice, determines; and*
> *(d) not serve as Governor in total for more than 12 years.*

Recommendation 2: Appointment of and term limits for Deputy Governors

Recommendation: The Deputy Governors should be appointed by the Board, and subject to a two-term limit.

Rationale: Deputy Governors form part of the critical leadership team of the Bank and share the responsibilities of the Governor including as members of the Board and the MPC. This collegial approach promotes synergy of expertise and accountability. At the moment Deputy Governors are appointed by the Governor, after consultation with the Minister. Shifting this responsibility to the Board removes political considerations from the appointment process.

There is currently no limit on how long someone can be Deputy Governor. A ten-year limit will promote continued rejuvenation of the Bank leadership.

Report reference: Chapter 2.1(d)

Recommended changes: Section 19(1) currently reads:

> The Governor shall, after consultation with the Minister, by notice in the National Gazette, appoint: (a) a Deputy Governor; or (b) two Deputy Governors, of the Central Bank.

We recommend instead:

> *The Board shall, after consultation with the Governor, by Notice in the National Gazette, appoint: (a) a Deputy Governor; or (b) two Deputy Governors, of the Central Bank*.

Section 20(1) currently reads:

> The Deputy Governor or the Deputy Governors, as the case may be, shall be appointed for a term of five years and may be re-appointed for a further term or terms, each up to five years.

We recommend 'a further term or terms' be replaced by '*a maximum of two terms*'.

There is also a need for transitional arrangements. Section 112(1) of the Act reads:

> The persons who, immediately before the coming into operation of this Act, held the position of Governor and Deputy Governor under the repealed Act, shall, on the coming into operation of this Act, notwithstanding the appointment process set out in this Act, continue to hold office as the Governor and Deputy Governor respectively, and on the same terms and conditions.

This clause is now redundant. We recommend it be replaced by:

> *The persons who, immediately before the coming into operation of the amended*

Section 15(1)(b) and Section 20(1), held the position of Governor and Deputy Governor, shall, on the coming into operation of the amended Section 15(1)(b) and Section 20(1), notwithstanding the appointment process set out in this Act, continue to hold office as the Governor and Deputy Governor respectively, on the same terms and conditions, but subject to the term limits set out in Section 15(1) and Section 20(1), both as amended. If those term limits have been exceeded, those persons shall remain in office until new appointments are made, such appointments to be made as expeditiously as possible.

Recommendation 3: Establishment of a Monetary Policy Committee (MPC)

Recommendation: Responsibility for the formulation of monetary policy and oversight of its implementation should be moved from the Governor and vested in a Monetary Policy Committee chaired by the Governor.

Rationale: This would bring BPNG into line with international best practice, and improve accountability, contestability and transparency.

Report reference: Chapters 2.1, 2.2 and 2.3

Recommended changes: Section 10 currently reads:

> **10. GOVERNOR RESPONSIBLE FOR IMPLEMENTATION OF MONETARY POLICY.**
> (1) It is the duty of the Governor to formulate and implement monetary policy consistent with the carrying out by the Central Bank of its objective of achieving and maintaining price stability.
>
> (2) The Governor has power to do in the country or elsewhere all things necessary or convenient to be done to formulate and implement monetary policy including without limitation and in addition to any other powers conferred by this Act or any other law, power to – [etc]

We propose Section 10 be revised to read:

> ***10. RESPONSIBILITY FOR FORMULATION AND IMPLEMENTATION OF MONETARY POLICY.***
> *(1) The Monetary Policy Committee is hereby created as a Committee of the Bank.*
>
> *(2) It is the duty of the Monetary Policy Committee to formulate monetary policy and oversee its implementation consistent with the carrying out by the Central Bank of its objectives as defined in Section 7(a).*
>
> *(3) The Governor has power to do in the country or elsewhere all things necessary or convenient to be done to implement monetary policy as formulated and overseen by the Monetary Policy Committee, including without limitation and in addition to any other powers conferred by this Act or any other law, power to –* [etc]

Note that Section 10(2) above is also revised to ensure that the objectives of monetary policy are only defined once, to remove possible ambiguity: see Recommendation 30.

Recommendation 4: MPC membership

Recommendation: The Monetary Policy Committee should have a balanced membership of two internal and two external members, with external members selected by the Board, and one an international expert.

Rationale: Our approach keeps the MPC small, and maximises contestability, while ensuring that the Governor, who would chair the MPC, cannot be overruled, by giving him or her the casting vote if needed. MPC external members would be appointed by the Board to ensure independent capacity of the MPC, and, following the ICCC precedent, one external member would be a non-resident international expert.

Report reference: Chapter 2.3(b)

Recommended changes: Prescriptions regarding MPC membership could be set out as a new Section 10A, as follows:

> ***10A. MONETARY POLICY COMMITTEE MEMBERSHIP***
> *(1) The Monetary Policy Committee shall have a membership of four.*
>
> *(2) The membership of the Board will comprise –*
> *(a) The Governor, ex officio, who will be the Chair, and preside over meetings.*
> *(b) The Deputy Governor responsible for monetary policy, ex officio, nominated by the Governor, and who will preside over meetings in the absence of the Chair.*
> *(c) Two persons appointed by the Head of State, acting on advice, by notice in the National Gazette, on the recommendation of the Board, who are not Bank employees or Board members, who are persons of*
> *(i) good moral standing,*
> *(ii) generally recognized standing and professional experience in monetary and banking matters, and*
> *one of whom has international experience in monetary policy and is not a resident of Papua New Guinea*
>
> *(3) The validity of the acts of the Monetary Policy Committee will not be affected by any vacancy in its membership.*
>
> *(4) With respect to the persons in (c) the Board shall, on the basis of the recommendations of the Board Governance Committee, make a recommendation to the Minister, and the Minister shall transmit that recommendation to the National Executive Council to advise the Head of State to appoint the candidate recommended by the Board to the Monetary Policy Committee.*

Section 30 deals with extraordinary vacancies. It should be extended to the MPC, and a time limit imposed for nominating candidates whenever a vacancy arises, of 30 days. Therefore, wherever Section 30 refers to 'the Board' replace it by '*the Board or Monetary Policy Committee'.* Section 30(3) reads:

> (3) When the office of a Member becomes vacant, a person shall be nominated and appointed to fill the vacancy in the same way as the person whose office has become vacant was nominated and appointed.

After 'nominated' add '*within 30 days'.*

Likewise, Sections 35 ("Fees and Expenses of Members") 36 ("Oath and Affirmation of Office"), 45(2)(f) (on details of fees etc.), 83(1)(a) ("Secrecy"), 95(1) and (2) ("Limitation of Actions"), and 102 ("Indemnity") should apply to both Board and MPC members. In Section 35, replace 'members' by '*members of the Board and/or Monetary Policy Committee*'; in Sections 36, 83(1)(a) and 102(1), after 'member of the Board' add '*and/or Monetary Policy Committee'*; in Section 45(2)(f) and 95(1) and (2) replace 'members of the Board' by '*members of the Board and/or Monetary Policy Committee*'.

Recommendation 5: MPC member terms

Recommendation: The two external members should have terms of four years, and a maximum of two terms. The initial terms should be staggered.

Rationale: The proposed term limits follow the New Zealand practice. The staggering of initial terms is to avoid a sudden loss of MPC membership and experience.

Report reference: Chapter 2.3(b)

Recommended changes: Continue new Section 10A as follows:

> *(5) Other than ex officio members, Monetary Policy Committee members will have a term of four years, with a maximum of two terms.*
>
> *(6) Other than ex officio members, the first time members are appointed to the Monetary Policy Committee, one will have a first term of three years, and the other a first term of five years, on the recommendation of the Board.*

Recommendation 6: MPC independence

Recommendation: Restrictions on MPC membership, guarantees of independence and conditions for removal should parallel those of the Board.

Rationale: In general, restrictions on MPC membership, guarantees of independence and conditions for removal should parallel those of the Board.

Report reference: Chapter 2.3(b)

Recommended changes: Section 31(2) places limits on who can be appointed to the BPNG

Board. The same criteria should apply to external MPC members. Section 31(2) currently begins:

> No person shall be appointed, or re-appointed to the office of member of the Board, or hold that office, if that person –

Replace 'member of the Board' by '*member of the Board, or member of the Monetary Policy Committee*'. Under Recommendation 16, we propose additional limitations on who can become an MPC (or Board) member.

Provision needs also to be made for the removal of members. Sections 31(3) and (4) currently read:

> (3) A member of the Board shall be deemed to have resigned from office where that person is prohibited from continuing to hold office under this section and the Minister shall, as soon as possible after the occurrence of such an event, publish the reason for the vacation of the office in the National Gazette.
>
> (4) Where, in the reasonable opinion of the Minister, following consultation with the Governor, a member of the Board is –
> (a) incapable of performing his duties; or
> (b) in breach of his conditions of appointment; or
> (c) guilty of conduct prejudicial to the performance of the duties of his office,
> the Head of State, acting on advice, may remove him from office and replace him under this Act.

In both clauses, replace 'member of the Board' by '*member of the Board, or member of the Monetary Policy Committee*'.

Monetary Policy Committee members should not be subject to outside direction; nor should members of the Board (see Recommendation 16). We recommend a new clause 27(4) that states this, as follows:

> *Members of the Monetary Policy Committee and the Board shall not be subject to the direction or control of any person including the Government.*

Recommendation 7: MPC meetings

Recommendation: The Monetary Policy Committee should convene for at least two series of meetings a year, with more if required. It should make decisions by consensus if possible, and vote if necessary, with the Chair having the deciding vote. It should have a quorum of three, and allowance for remote meetings and meetings by resolution.

Rationale: The MPC should be aligned with the biannual MPS, and so convened at least twice a year, with provision for more meetings if needed. A mechanism is needed for when consensus cannot be reached; our proposal ensures that management cannot be overruled.

Report reference: Chapter 2.3(c)

Recommended changes: Prescriptions regarding MPC meetings could be set out as a new Section 10B, as follows:

10B. MONETARY POLICY COMMITTEE MEETINGS

(1) The Monetary Policy Committee shall meet at least twice a year.

(2) The Monetary Policy Committee shall make decisions by consensus if possible and by vote if necessary.

(3) If a vote is required to reach a decision of the Monetary Policy Committee, and votes are evenly split, then the Chair will have the deciding vote.

(4) A quorum of at least three is required for a meeting.

(5) Meetings can be held virtually.

(6) Additional meetings can be held by unanimous resolution.

(7) Between meetings, Monetary Policy Committee members shall be kept informed of all significant monetary policy implementation decisions.

(8) Monetary Policy Committee members shall have the right to seek information from the Bank, and have that information provided promptly.

(9) If, in the opinion of any Monetary Policy Committee member, a change in monetary policy may be needed between scheduled meetings, then an additional meeting shall be convened prior to that change being made, with emergency procedures as provided for in Section 10C.

(10) Following any meeting of the Monetary Policy Committee, whether in person, virtual or by resolution, a statement shall be published summarising the views of voting members and noting any votes.

Recommendation 8: MPC to issue MPS

Recommendation: The Monetary Policy Committee should issue the biannual Monetary Policy Statement (MPS), which should include a summary of its meeting.

Rationale: The MPS is the bedrock of monetary policy, and therefore must be an MPC responsibility. The MPS can be extended to include a report of the MPC meeting.

Report reference: Chapter 2.3(c) and 2.3(d)

Recommended changes: Section 11(1) currently reads:

> The Governor shall, within one month of the coming into operation of this Act, and every six months thereafter, issue a policy statement setting out the monetary policy of the Central Bank to achieve and maintain price stability for the following six month period.

We recommend this be replaced by:

> *The Monetary Policy Committee shall at least twice a year issue a policy statement setting out the monetary policy of the Central Bank to achieve and maintain its objectives as defined in Section 7(a) for the following six month period.*

Note the reference to Section 7(a) so that objectives are only defined once, for the avoidance of ambiguity and confusion. See Recommendation 30.

Section 11(2) currently reads:

> Without limiting the generality of Subsection (1), a policy statement issued under Subsection (1) shall contain –
> (a) details of action taken in accordance with Section 10(2)[90]; and
> (b) details of advice given in accordance with Section 12[91]; and
> (c) an outline of any circumstances giving rise to the Governor furnishing any report to the Minister in accordance with Section 13[92].

We recommend a new clause be added:

> *(d) a report on the meeting of the Monetary Policy Committee held prior to the issuance of the Monetary Policy Statement, summarising the views of voting members and noting any votes.*

In (2)(a), Section 10(2) needs to be replaced by Section 10(3), as revised under Recommendation 3.

Recommendation 9: MPC to produce five-year statement

Recommendation: The Monetary Policy Committee should produce a five-year statement.

Rationale: A five-yearly report to "review and assess the formulation and implementation of monetary policy", as per the Reserve Bank of New Zealand Act, would be a good opportunity for longer-term reflection and for facing up to issues that might get summary treatment or be neglected altogether in the six-monthly reports.

Report reference: Chapter 2.3(d)

Recommended changes: We recommend a new subsection be added to Section 11 ("Policy

[90] Monetary policy implementation.
[91] Advice concerning the effects of monetary policy.
[92] Special reports on adverse conditions.

Statements”):

(4) The Monetary Policy Committee must review and assess and consequently issue a report on the formulation and implementation of monetary policy every five years, starting the year after which this provision comes into effect.

Recommendation 10: MPC Charter

Recommendation: The Board must publish a charter for the MPC to provide for more detailed rules.

Rationale: More detailed rules would need to be established for the MPC. This can best be done by the Board through an MPC Charter.

Report reference: Chapter 2.3(e)

Recommended changes: We recommend a new subsection be added to Section 11:

(5) The Board shall approve, publish, review and periodically update a charter for the Monetary Policy Committee (MPC), consistent with this Act, which will include:
(a) requirements for summary records of the MPC’s meetings (including the content of the records, when and how those records must be published, and matters relating to the recording of different views and votes);
(b) guidelines or requirements relating to the publication or disclosure by a member of the MPC of any matter relating to the MPC or its functions or powers;
(c) requirements relating to other information that must or may be published by or on behalf of the MPC, including when and how that information must or may be published;
(d) meeting arrangements;
(e) rules for MPC members to manage and avoid conflicts of interest;
(f) rules for MPC members to maintain the confidentiality of information;
(g) rules for MPC members to promote active participation and preparation; and
(h) any other minimum standards of ethical behaviour and requirements for MPC members.

In addition, the existing conflict of interest rules applying to the Board should apply to the MPC. Section 33 reads:

33. DISCLOSURE OF INTEREST
(1) A member of the Board, who has a direct or indirect interest in a matter that is being considered or is proposed to be considered, by the Board, shall disclose the nature of his interest at the first meeting of the Board at which he is present after the relevant facts have come to his knowledge.

(2) A disclosure under Subsection (1) shall be recorded in the minutes of the Board, and after the disclosure the member –

(a) shall not be present during any deliberation or decision of the Board with respect to the matter; and
(b) shall not take part in any deliberation or decision of the Board with respect to the matter; and
(c) shall be disregarded for the purpose of constituting a quorum for any such deliberation or decision.

Throughout, replace 'Board' by '*Board and/or Monetary Policy Committee*'.

Recommendation 11: Additional powers for the Board.

Recommendation: The Board should be given additional responsibilities and powers to enable it to execute its oversight role.

Rationale: The Board's role is fairly limited under the Act. While it should not be given responsibility for monetary policy, the Board does need additional powers to be able to play its oversight role effectively.

Report reference: Chapter 2.4(a)

Recommended changes: Section 26(1) currently reads:

> Subject to this Act, the Board of the Central Bank is responsible for determining the policies of the Central Bank, other than the formulation and implementation of monetary policy and the regulation of the financial system which shall be the responsibility of the Governor.

The words 'which shall be the responsibility of the Governor' should be deleted. Some of these responsibilities will in fact shift to the MPC as defined by the legislation.

Section 26(1) should be redrafted to include additional responsibilities:

> Subject to this Act, the Board of the Central Bank is responsible for
> (a) determining the policies of the Central Bank, other than the formulation and implementation of monetary policy and the regulation of the financial system;
> *(b) the general administration of the affairs and business of the Bank and the approval of the budget and operating plan of the Bank; and*
> *(c) oversight of the management of the Bank and keeping under constant review the performance of the Bank in giving effect to its objectives and carrying out its functions and the use of the resources of the Bank.*

Subsequent clauses would define additional important roles for the Board:

> *(2) The Governor and Deputy Governors shall be accountable to the Board for their acts and decisions.*
>
> *(3) The Board has oversight of the integrity of the accounts and financial statements*

of the Bank, the effectiveness of the internal control system, the performance of the internal audit function, compliance with legal and regulatory functions, and the management of risks.

(4) The Board may require the Bank to produce any book or document and shall have access to any information which is necessary or relevant for the carrying out of its functions under this Act.

(5) For the purposes of carrying out its functions under this Act, the Board may issue by-laws as are necessary and expedient in relation to the administration, affairs and business of the Bank or in respect of any other matters as set out in this Act.

(6) The Board shall, following consultation with the Minister, issue a Board Charter to prescribe its further working arrangements, consistent with this Act.

Recommendation 12: Bank Board to appoint auditor and approve Annual Report

Recommendation: The Bank Board should appoint the auditor and approve the Annual Report including the audited financial statements, which should be transmitted to the Minister and published promptly.

Rationale: Appointing the auditor, and approving the Annual Report are traditional Board prerogatives. The Annual Report should be published promptly.

Report reference: Chapter 2.4(a)

Recommended changes: Section 44(1) currently reads:

> Within six months after the end of each financial year the Central Bank shall deliver to the Minister –
> (a) a report on the operations of the Central Bank during that financial year; and
> (b) audited financial statements for that financial year; and
> (c) the auditor's report on those financial statements; and
> (d) a statement of the projected income and expenditure for the next financial year.

This should be a Board responsibility, and the Annual Report should be published in a timely manner. Therefore, 'Within six months after the end of each financial year the Central Bank shall deliver to the Minister –' should be replaced by '*Within six months after the end of each financial year the Central Bank Board shall deliver to the Minister and cause to be published on the Internet –*'

Section 47(1) reads:

> The Central Bank may, from time to time, appoint one or more persons (whether as individuals or as the members from time to time of any firm or firms), being persons qualified for appointment as auditors of a company under the ***Companies Act* 1997**, to be the auditor or auditors of the Central Bank.

Since this should be a Board responsibility, replace 'The Central Bank' by '*The Central Bank Board*'.

Recommendation 13: Establishment of Audit and Risk Committee, Governance Committee, and Budget and Investment Committee.

Recommendation: There should be three mandatory Board sub-committees, an Audit and Risk Committee, a Governance Committee, and a Budget and Investment Committee.

Rationale: While the Board should have the flexibility and autonomy to establish its own sub-committees, three sub-committees are of sufficient importance for their establishment to be mandated, namely an Audit and Risk Committee, a Governance Committee, and a Budget and Investment Committee.

Report reference: Chapter 2.4(b)

Recommended changes: We recommend the following new subsections be added to Section 34 ("Committees") which empowers the Board to establish Committees and sets out the basic rules under which they are to operate. After the eight existing subsections would come:

> *(9) The Board shall establish an Audit and Risk Committee. The committee will, among other duties:*
> *(a) Assist the Board in its oversight of*
> *(i) the integrity of the accounts and financial statements of the Bank;*
> *(ii) the effectiveness of the internal control system of the Bank;*
> *(iii) the performance of the internal audit function of the Bank;*
> *(iv) the compliance by the Bank with legal and regulatory requirements; and,*
> *(v) the review and management of risks.*
> *(b) Appoint the auditor and review the audited accounts.*
>
> *(10) The Board shall establish a Governance Committee. The committee will, among other duties:*
> *(a) Recommend external members of the Monetary Policy Committee, and of the Board, and Board subcommittees.*
> *(b) Assist the Board in reviewing and finalising the Annual Report.*
> *(c) Assist the Board to –*
> *(i) review and approve Bank corporate strategies;*
> *(ii) review Bank performance against benchmarks;*
> *(iii) review performance and assist with appointment of the Governor and Deputy Governors; and,*
> *(iv) oversee the promotion of and compliance with ethical and respectful behaviour among Bank staff, and the provision of safeguards to whistleblowers.*
>
> *(11) The Board shall establish a Budget and Investment Committee. The committee will, among other duties:*
> *(a) Examine and recommend to the Board the budget and operating plan of the*

Bank for approval.
(b) Assist the Board in overseeing the implementation of the budget and operating plan.
(c) Assist the Board in its oversight of the Bank's investments.

(12) In relation to the committees described in (9), (10) and (11):
(a) There will be a membership of at least three; and quorum of two.
(b) Meetings should be held least four times a year.
(c) Decisions are to be made via consensus, with disagreements to be recorded
(d) The Board shall appoint a chair for each committee from external Board members.
(e) At least two members who are not Bank employees shall sit on each Committee.

(13) All Board Committees can meet virtually.

Recommendation 14: Revamped Board membership

Recommendation: The size of the Board should be reduced to eight (and the quorum to five), with two Bank members, two members nominated by the Board, two nominated by the Minister, and two members nominated by neighbouring Central Bank governors. At least two Board members shall be women.

Rationale: The current Board is unwieldy, and its representative character unsatisfactory. Members should be nominated on the basis of merit, with limited ministerial discretion, and international experience should be sought out.

Report reference: Chapter 2.4(c)

Recommended changes: Section 27 deals with membership of the Board. Section 27(1) currently reads:

> The Board shall consist of not less than nine and not more than 11 members.

We recommend that 'not less than nine and not more than 11 members' be replaced by '*eight*'.

Section 27(2) currently reads:

> The membership of the Board will comprise –
> (a) the Governor, *ex officio*; and
> (b) each Deputy Governor, *ex officio*; and
> (c) up to three persons appointed by the Head of State, acting on advice, by notice in the National Gazette being from among persons of –
> (i) good moral standing; and
> (ii) generally recognized standing and professional experience in monetary and banking matters; and
> (d) the following persons appointed by the Head of State, acting on advice, by

notice in the National Gazette:-

(i) the person who is elected Head of the Papua New Guinea Council of Churches, *ex officio*; and

(ii) the person holding the office of President of the Papua New Guinea Chamber of Commerce, *ex officio*; and

(iii) the person holding the office of President of the Papua New Guinea Trade Union Congress, *ex officio*; and

(iv) the person holding the office of President of the Papua New Guinea Institute of Accountants, *ex officio*; and

(v) the person holding the office of Chairman of the Securities Commission in accordance with the Securities Act 1997, *ex officio*.

We recommend that clauses (b), (c) and (d) be revised, and new clauses added:

(b) one Deputy Governor, selected by the Governor, not the Deputy Governor on the Monetary Policy Committee if there is more than one Deputy Governor.

(c) two persons appointed by the Head of State, acting on advice, in consultation with the Board, by notice in the National Gazette being from among persons of (i) good moral standing; and (ii) generally recognized standing and professional experience; among whom at least one will be a woman;

(d) two persons appointed by the Head of State, acting on advice, on the recommendation of the Board, by notice in the National Gazette being from among persons of (i) good moral standing; and (ii) generally recognized standing and professional experience; among whom at least one will be a woman;

(e) two persons appointed by the Head of State, acting on advice, by notice in the National Gazette being from nominations made by regional Central Bank Governors, which Governors to be selected by the Board on the advice of the Governance Committee, being from among persons of (i) good moral standing; and (ii) generally recognized standing and professional experience; (iii) international experience in central banking; and (iv) not a resident of Papua New Guinea.

(f) With respect to the persons in (d) the Board shall, on the basis of the recommendations of the Board Governance Committee, make a recommendation to the Minister, and the Minister shall transmit that recommendation to the National Executive Council to advise the Head of State to appoint the candidate recommended by the Board.

(g) With respect to the persons in (e) the Board shall, on the basis of the recommendations made by regional Central Bank Governors, make a recommendation to the Minister, and the Minister shall transmit that recommendation to the National Executive Council to advise the Head of State to appoint the candidate recommended by the Board.

(h) With respect to the persons in (e), should a vacancy arise that cannot be filled in a timely manner by nomination of a regional Central Bank Governor, the Bank Board and the Minister shall agree on a person that meets the criteria in category (e) and the Minister shall transmit that recommendation to the National Executive Council to advise the Head of State to appoint the candidate recommended by the Board.

With the Board size reduced to eight, the quorum, currently six, also needs to be reduced.

Section 32(3) currently reads:

> At meetings of the Board the quorum necessary for the transaction of business is six members, one of which must be the presiding member.

We recommend that 'six members, one of which must be the presiding member' be replaced by '*five members, one of which must be the Chair or Deputy Chair*'.

To facilitate the participation of non-resident Board members, virtual meetings need to be allowed for, as for the MPC (see Recommendation 7). Add a new clause Section 32(8):

> *Meetings can be held virtually.*

There is a need for transitional arrangements. Under the Act, Section 112(3) reads:

> The Board of the Central Bank under the repealed Act shall continue as the Board of the Central Bank re-established and continuing under this Act until such time as a new Board is selected in accordance with the provisions of this Act.

This clause is no longer applicable and could be deleted and replaced by:

> *The Board of the Central Bank shall continue until such time as a new Board quorum is selected in accordance and at the earliest possible time with the amended provisions of this Act.*

Recommendation 15: Terms of Board members

Recommendation: Increase the term for external Board members from three to five years, and limit them to two terms.

Rationale: A term of five years is likely to lead to greater continuity and fewer vacant Board positions, which has been a problem in the past. At the same time, a two-term limit would ensure continued Board reform.

Report reference: Chapter 2.4(c)

Recommended changes: Section 28 on the term of office of Board members currently reads:

> **28. TERM OF OFFICE OF MEMBERS OF THE BOARD**
> (1) Members referred to in Section 27(2)(c) shall hold office for a term of three years.
>
> (2) A member may at any time resign from office by notice in writing to the Governor.
>
> (3) A member may be re-appointed to the Board.

In section 28(1), replace 'three' by '*five*' and add '*Section 27(2)(d) and Section 27(2)(e)'* after 'Section 27(2)(c)' (so that this covers off all three groups of external members – see

Recommendation 14). In Section 2(3), add '*no more than once*' after 'Board' (to introduce a maximum of two terms).

A new clauses are needed under Section 28 on the transition (see also Recommendation 14):

> *(4) Other than ex officio members, the first time following the passage of this Amended Act that members are appointed to the Board by the Head of State, acting on advice, one appointed under Section 27(2)(c) will have a first term of two years, and one of five years, one appointed under 27(2)(d) will have a first term of three years, and one of four-and-a half years, and one appointed under 27(2)(e) will have a term of four years, and one of five years, to be decided by the Board Chair.*

Recommendation 16: Board independence

Recommendation: Ensure that members of the Board are independent and not subject to direction or control.

Rationale: It needs to be explicitly stated that employees of entities regulated by BPNG and public servants should not be on the Bank Board or MPC. Board members also should not be subject to direction.

Report reference: Chapter 2.4(c)

Recommended changes: We recommend that the following subsection be added to Section 31(2) which places bars on certain categories of people becoming Board members (and, if Recommendation 6 is adopted, MPC members):

> *(g) is an officer of an entity regulated by BPNG or works for a Government Department or Ministerial Office.*

The Governor also should not be able to direct the Board. Section 32(1) currently reads:

> The Board of the Central Bank shall meet as often as the business of the Central Bank requires at such times and places as the Board determines or as the Governor, or in his absence the Deputy Governor, directs, but in any event not less frequently than once every three months.

Delete 'or as the Governor, or in his absence the Deputy Governor, directs'.

Board members should not be subject to outside direction. See Recommendation 6 in this regard and reference to proposed new clause 27(4).

Recommendation 17: Independent Chair

Recommendation: The Board should select a Chair and Deputy Chair from among the external members. Since the Board exercises an oversight role, the Governor should not be the Chair.

Rationale: As per IMF advice, and to avoid conflicts of interest, since the Board is a supervisory one, the Governor should not be the Board Chair.

Report reference: Chapters 2.1(b) and 2.4(d)

Recommended changes: Section 32 deals with Board meetings, and Section 32(2) currently reads:

> At a meeting of the Board, the Governor, or in his absence a Deputy Governor designated by the Governor shall preside.

We recommend that this clause be replaced by the following:

> *(2a) The Board shall select a Chair and Deputy Chair from among those external members resident in Papua New Guinea.*
>
> *(2b) At a meeting of the Board, the Chair, or in their absence the Deputy Chair shall preside.*

Other roles and responsibilities of the Board Chair would be spelt out in the Board charter (Recommendation 11).

Recommendation 18: Joint reporting by the Governor and the Board Chair

Recommendation: The Governor and the Chair should jointly report to the Minister on Board meetings, summaries of which should be published.

Rationale: Since we have proposed that the roles of Governor and Board Chair be separated, the question arises as to who should report to the Minister on Board meetings. We propose that both should, and that a summary of each Board meeting should be published.

Report reference: Chapter 2.4(e)

Recommended changes: Section 26(2) currently reads:

> The Governor shall submit every three months to the Minister a report on the proceedings and resolutions of the Board and the steps taken, if any, in consequence thereof.

We recommend that 'The Governor shall' be replaced by '*The Board Chair and the Governor shall jointly*'.

In addition, we recommend that the words be added *'A summary report shall be published on the BPNG website within three months.'*

Recommendation 19: Recognition of the authority of the Governor, the Board and the MPC

Recommendation: The authority of the Bank be divided between the Governor, the Board and the Monetary Policy Committee, rather than given only to the former.

Rationale: Section 16(2) currently gives authority to the Governor to exercise the Central Bank's powers. A more collegial, balanced and accountable approach would be to divide those powers between the Governor, the Board, and the Monetary Policy Committee.

Report reference: Chapters 2.1, 2.3 and 2.4

Recommended changes: Section 16(2) gives authority to the Governor under the Act:

> The Governor has the authority to exercise the Central Bank's powers for the purposes of achieving the objectives and functions of this Act and implementing the policies of the Central Bank.

We recommend that 'The Governor has the authority to exercise' be replaced by '*The Governor, the Board and the Monetary Policy Committee have the authority as defined in this Act to exercise*'.

Recommendation 20: Treasury Observer on MPC and Board

Recommendation: There should be a Treasury observer on the Monetary Policy Committee and on the Board.

Rationale: To promote the flow of information between the Bank and the Treasury, we propose that there be a non-voting Treasury observer on the Monetary Policy Committee and on the Bank Board.

Report reference: Chapter 2.5(b)

Recommended changes: Section 14 currently reads:

> **14. LIAISON BETWEEN THE CENTRAL BANK AND THE DEPARTMENT RESPONSIBLE FOR TREASURY MATTERS**
> The Central Bank and the Department responsible for treasury and finance matters shall keep each other fully informed of all matters that concern the Central Bank and the Department jointly.

Since separate departments are now responsible for treasury and finance, delete 'and finance'. Make the above 14 (1) and add a new Section 14(2) for the MPC Observer:

> *There shall be a Departmental Observer on the Monetary Policy Committee.*
>
> *(a) The Secretary to the Department responsible for treasury matters must ensure that the Secretary, a Deputy Secretary or First Assistant Secretary to that Department is nominated to be the Departmental Observer.*

(b) The Departmental Observer has the same rights to attend and speak at a meeting of the Monetary Policy Committee as a member but has no right to vote on any question before the Monetary Policy Committee and is not subject to the duties that apply to members.

(c) The nomination must be made by written notice to the Bank Governor (with a copy to the officer or employee if it is a person other than the Secretary to the Department).

(d) The Departmental Observer must perform that role subject to any conditions that are agreed by the Departmental Secretary and the Governor, including matters relating to confidentiality and avoiding conflicts of interest.

(e) Those conditions remain in effect until the Departmental Secretary and the Governor agree to amend the conditions (regardless of changes to the person who holds any office or role).

(f) The Departmental Secretary may, at any time and entirely at the Secretary's discretion, replace the Departmental Observer by giving written notice to the chairperson.

(g) The function of the Departmental Observer is to —

(i) support decision making by the Monetary Policy Committee (for example, by sharing information on fiscal policy);

(ii) facilitate the co-ordination of monetary and fiscal policy; and

(iii) carry out any other function agreed between the Governor and the Departmental Secretary.

Likewise, add a new Section 14(3) for the Board Departmental Observer:

There shall be a Departmental Board Observer on the Bank Board.

(a) The Secretary to the Department responsible for treasury matters must ensure that the Secretary, a Deputy Secretary or First Assistant Secretary to that Department is nominated to be the Departmental Board Observer.

(b) The Departmental Board Observer has the same rights to attend and speak at a meeting of the Board as a member but has no right to vote on any question before the Board and is not subject to the duties that apply to Board members.

(c) The nomination must be made by written notice to the Bank Governor (with a copy to the officer or employee if it is a person other than the Secretary to the Department).

(d) The Departmental Board Observer must perform that role subject to any conditions that are agreed by the Departmental Secretary and the Governor, including matters relating to confidentiality and avoiding conflicts of interest.

(e) Those conditions remain in effect until the Departmental Secretary and the Governor agree to amend the conditions (regardless of changes to the person who holds any office or role).

(f) The Departmental Secretary may, at any time and entirely at the Secretary's discretion, replace the Departmental Board Observer by giving written notice to the chairperson.

(g) The function of the Departmental Board Observer is to facilitate the flow of information between the Bank and the Department responsible for treasury matters.

Recommendation 21: Additional information sharing provisions

Recommendation: To improve Bank-Government collaboration and information flows, Treasury should be formally recognised as assisting the Treasurer to carry out his or her role in relation to the Bank. The Bank should be under an obligation to keep the Minister informed of its policies, and the Minister should be able to request and receive information from the Bank in a reasonable time period.

Rationale: These are all measures adopted by other jurisdictions to improve the flow of information and collaboration, without threat to Central Bank independence.

Report reference: Chapter 2.5(b)

Recommended changes: Add further clauses to Section 14 on Bank-Treasury relations:

> *(4) The Bank shall keep the Minister informed of policies relating to its objectives.*
>
> *(5) The Bank must supply to the Minister any reports or other information relating to the performance of its duties that the Minister requests.*
>
> *(6) The reports or information must be supplied at the time and in the manner reasonably required by the Minister.*
>
> *(7) The Department responsible for treasury matters shall assist the Minister in carrying out the Minister's role.*

Recommendation 22: Introduction of dispute resolution mechanism

Recommendation: An explicit dispute-resolution mechanism should be introduced.

Rationale: It is not feasible, given data difficulties and the volatility of the PNG economy, for the Government to issue BPNG with an explicit policy charter, say with quantified objectives. What if the Government and BPNG disagree on the relative weights that should be given to the Bank's objectives? A better path is to introduce an explicit dispute-resolution mechanism when disagreements cannot be resolved. We propose the model used in Malaysia and Australia be utilised.

Report reference: Chapter 2.5(c)

Recommended changes: We recommend a new Section 14A along the following lines:[93]

> ***14A ISSUES OF POLICY***
> *(1) In the event of a difference of opinion between the Minister and the Governor relating to the Bank's pursuit of its objectives, the Minister and the Governor shall*

[93] The Malaysian clauses refer to the Board, but in PNG's case we think reference to the Governor is more appropriate.

endeavour to reach an agreement.

(2) If the Minister and the Governor are unable to reach an agreement, the Governor shall furnish to the Minister a statement in relation to the matter in respect of which the difference of opinion has arisen.

(3) The Minister shall then submit a recommendation together with the statement furnished by the Governor under subsection (2) to the National Executive Council.

(4) Acting on the recommendation of the Minister and the statement furnished by the Governor, the National Executive Council may determine the policy to be adopted by the Bank, which must not be inconsistent with anything in this Act.

(5) The Minister shall inform the Governor of the policy as determined under subsection (4) and that the Government accepts responsibility for the policy.

(6) The Bank shall then give effect to the policy as determined under subsection (4).

(7) If the Governor objects to the policy as determined under subsection (4), the Bank may submit its objections and reasons therefor in writing to the Minister who shall cause the same together with the policy as determined under subsection (4) to be immediately published, and to be laid before the Parliament, or, if Parliament is not then sitting, at the sitting of the following meeting of Parliament.

Recommendation 23: Improving transparency

Recommendation: Measures should be introduced to improve transparency and stakeholder discourse.

Rationale: There is a worldwide trend to greater transparency among central banks, which PNG should be part of. The circumstances within Papua New Guinea requires public face-to-face discourse to promote understanding and participation in public policy making and implementation, especially in monetary policy. This also provides the opportunity for BPNG to demonstrate what "advantage… the people of Papua New Guinea" (Section 7) have gained from the Bank's policies and performance.

Report reference: Chapter 2.6

Recommended changes: Several changes to promote transparency have already been included under other reforms including provision for the Bank's annual report to be published promptly on its website (Recommendation 12) and for MPC meeting reports to be included in the MPS (Recommendation 8).

Under Section 11(3), the MPS is to be delivered to the Minister and published in the National Gazette. It currently reads as follows:

The Governor shall –

(a) deliver to the Minister; and
(b) cause to be published in the National Gazette
each policy statement issued under Subsection (1).

In addition, and reflecting current practice and the need for greater stakeholder understanding and engagement, two new clauses should be added before 'each policy statement' relating to publication and engagement, as follows:

(c) cause to be published on the Internet; and
(d) promote informed stakeholder discourse and engagement in relation to

Publication requirements should apply not only to the MPS but also to the five-year statement (Recommendation 9). Therefore also under Section (3) above, after 'Subsection (1)', add '*and Subsection (4)*', which, as per Recommendation 9, requires five-year statements to be produced.

For publication of a summary of each BPNG Board meeting, see Recommendation 18 with reference to Section 26(2).

Finally, the timely release of economic data is an important function of BPNG and should be a legislative requirement. We propose a new Section 26(3):

The Bank is required to publish via the Internet economic data in a comprehensive and timely manner.

7.3 Financing (Chapter 3)

Recommendation 24: Temporary Advance Facility (TAF) clarifications

Recommendation: The Temporary Advance Facility (TAF) should be defined in relation to revenue net of aid; the interest rate that applies to the TAF should be clarified; TAF repayments should be made within the year; compliant TAF requests should be heeded; and a provision should be introduced to ban further TAF allocations if outstanding TAF amounts are not paid on time and in full.

Rationale: While the TAF arrangements have recently been reformed by an amendment to the Central Banking Act in 2020, various matters require clarification to avoid dispute and ensure fiscal discipline.

Report reference: Chapter 3.1

Recommended changes: Section 55(4) reads, after the recent amendment:

(a) shall not at any time exceed 12 percent of the annual average total revenue and grants receipts (including donor grants but not including once off asset sales or their equivalent) averaged over the previous three years to the year in which advances are sought.

> (b) shall be repaid to the Central Bank as soon as practicable, but in any case, not later than twelve months from the date of the advance.

We recommend that in (a) 'including donor grants but' be replaced by '*excluding donor grants and*'. We recommend that in (b) 'not later than twelve months from the date of the advance' be replaced by '*no later than the end of the financial year*'.

Section 55(2), as recently amended, states that:

> The Central Bank may grant temporary advances to the Government in respect of temporary deficiencies of revenue due to cash flow mismatches at an interest rate or rates no less favourable than the prevailing rates payable by the Government on Treasury Bills or notes, or securities issues by the Government.

We recommend that 'may' be replaced by '*will*', 'no less' be replaced by '*no more and no less*' and 'prevailing rates' be replaced by '*prevailing comparable rates*'.

We also recommend a clause be added so that if the TAF is not repaid in full and on time then no further TAF will be extended. Noting that clause 55(3) has been recently deleted, this could become a new clause (3):

> *If after that that date on which repayment of advances is due any such financing remains outstanding, the power of the Bank to extend further advances shall not be exercisable unless and until the outstanding financing has been repaid.*

Recommendation 25: Limit on Central Bank holdings of government securities

Recommendation: We propose a limit on BPNG holdings of government securities of 20% of revenue minus aid, averaged over the last three years.

Rationale: The current wording of Section 55 is ambiguous and introduces a loophole for unlimited financing of the government deficit. Rather than banning all Bank purchases of government securities altogether, we propose a transparent and clear limit on such purchases.

Report reference: Chapter 3.3

Recommended changes: Sections 55(8) and (9) currently read:

> (8) The Central Bank may, for purposes of monetary policy management, purchase treasury bills or notes, or securities, issued by the Government at market determined yields and such treasury bills, notes or securities will be excluded for the purposes of determining aggregate outstanding advances pursuant to Subsection (4).
>
> (9) Notwithstanding anything to the contrary contained in this section, the Central Bank shall not grant advances to the Government in respect of, or for the purpose of funding, a Government fiscal deficit.

We recommend that these two subsections be replaced by the following:

> *(8) The Central Bank may, in the pursuit of its objectives, purchase and sell in the most economical way possible treasury bills or notes or securities issued by the Government at market-determined yields. Central Bank holdings of treasury bills, notes or securities excluding the outstanding temporary advance under Section (2) may not exceed 20 percent of revenue (excluding foreign aid, loans and one-off asset sales) averaged over the last three years. After that date on which repayment of securities is due, the power of the Bank to purchase further securities shall not be exercisable unless and until the outstanding financing has been repaid.*

The last sentence punishes the Government in the event of non-repayment.

7.4 Managing national economic crises (Chapter 4)

Recommendation 26: Preparation for emergencies

Recommendation: Include a provision which allows for amendment of the limit on central bank financing through the use of an Emergency Law when a national emergency is declared for the whole of PNG. Also provide for decision making in an emergency.

Rationale: In the time of a national emergency, PNG should have the option of increasing, on a temporary basis, BPNG's capacity to provide financing to the Government. With the proposed creation of the MPC, explicit provisions are needed to authorise decisions in an emergency.

Report reference: Chapter 4.2

Recommended changes: We recommend two new clauses be added to follow Section 55(8), as revised under Recommendation 25 above, namely:

> *(9) If a national emergency is declared for the whole of Papua New Guinea, the limit on Central Bank holdings of government securities defined in (8) above may be increased from 20 percent to 30 percent for the duration of the national emergency if provision for this is made in an Emergency Act subsequent to the declaration of the national emergency.*
>
> *(10) If such an increase is made during a national emergency, the old limit must be adhered to within one year of the ending of the national emergency.*

Procedures are needed for the MPC in the case of an emergency, where very quick decisions are needed. We propose that the arrangements put in place under the Reserve Bank of New Zealand Act be used, as follows, under a new section:

> **10C. MONETARY POLICY COMMITTEE EMERGENCY PROCEDURES**
> *(1) Despite the lack of a quorum, the Chair and other members of the Monetary Policy Committee that are available (if any) may make any decision on behalf of the Monetary*

Policy Committee or perform or exercise any other function, power, or duty of the Monetary Policy Committee if the Chair is satisfied that –

(a) exceptional circumstances exist; and

(b) an urgent action is necessary to prevent, correct, or mitigate harm to the economy; and

(c) despite the use of all reasonable means available, other members of the Monetary Policy Committee have not been able to be contacted on the matter or are unable to fully participate in dealing with the matter; and

(d) action on the matter is required before a quorum will be able to be obtained.

(2) If a decision is made or other thing is done under this clause –

(a) the Chair must make a record of –

(i) the Chair's reasons for being satisfied of the matters referred to in (1); and

(ii) the decision or thing; and

(b) the Chair must, as soon as practicable, provide a copy of that record to –

(i) the Minister; and

(ii) the Board; and

(iii) the members of the Monetary Policy Committee that were not available when the decision was made or the other thing was done.

7.5 Objectives (Chapter 5)

Recommendation 27: Balanced objectives

Recommendation: Bearing in mind the Bank's responsibility for monetary policy extends to the exchange rate regime and the impact of its monetary policy on government financing, render its objectives in a more balanced way.

Rationale: BPNG's responsibility for monetary policy includes its responsibility for both the formulation and implementation of exchange rate policy under Section 58. Implementation of monetary policy also has major implications for government financing. A narrowly defined price stability mandate is unsuitable for a Central Bank with such a wide-ranging role in the economy.

Report reference: Chapters 5.1, 5.2 and 5.3

Recommended changes: Section 7 currently reads:

7. OBJECTIVES OF THE CENTRAL BANK

For the advantage of the people of Papua New Guinea, the objectives of the Central Bank are:

(a) to formulate and implement monetary policy with a view to achieving and maintaining price stability; and

(*b*) to formulate financial regulation and prudential standards to ensure stability of the financial system in Papua New Guinea; and

(*c*) to promote an efficient national and international payments system; and

(*d*) subject to the above, to promote macro-economic stability and economic

> growth in Papua New Guinea.

We propose that clause (d) be dropped and clause (a) be replaced by:

> to formulate and implement monetary policy with a view to achieving and maintaining price stability and *promoting employment and economic growth, especially of the non-mineral non-petroleum sector*; and

Note we use the term '*non-mineral non-petroleum*' rather than '*non-resource*' as this is more widely used in PNG.

Recommendation 28: Financial system development and stability

Recommendation: Require the Bank to promote financial system development as well as stability.

Rationale: PNG's financial system is stable, but underdeveloped. High lending rates and limited credit access are a constraint on growth. As regulator of the financial system, BPNG needs to pay due attention both to the stability of the financial system and its development.

Report reference: Chapter 5.4

Recommended changes: BPNG's objective regarding the financial sector is given in Section 7(b) which currently reads:

> to formulate financial regulation and prudential standards to ensure stability of the financial system in Papua New Guinea

We propose that 'stability' be replaced by '*stability and development*'.

Recommendation 29: Banking services

Recommendation: An objective be added that corresponds to BPNG's role as provider of banking services to the Government.

Rationale: The provision of banking services is an important function that the Bank of Papua New Guinea provides to the Government. Just as in carrying out its payments function, BPNG is required to promote an efficient payments system (Section 7(c)), so in carrying out its banking function, BPNG should be required to provide efficient and responsive banking services.

Report reference: Chapter 5.5

Recommended changes: An additional objective be added to Section 7, that is, a new (d) (since the old (d) would be dropped – see Recommendation 27 above), namely:

> *to provide efficient and responsive banking services to the Government.*

Recommendation 30: Avoidance of confusion regarding objectives

Recommendation: Ensure that the objectives of the Bank are only stated once.
Rationale: Objectives should just be articulated in one place, rather than three as per the current Act to avoid any possible conflict or ambiguity.

Report reference: Chapter 5.

Recommended changes: Amendments to Section 10(1) and Section 11(1) regarding the objectives of monetary policy have already been proposed so that they refer to the objectives as stated in Section 7(a). See Recommendations 3 and 8. No further changes are needed.

Recommendation 31: Current account convertibility

Recommendation: Mandate current account convertibility from 2023 onwards.

Rationale: Current account convertibility – including the ability of importers to get foreign exchange to pay for their imports – was, until 2014, a foundation of PNG economic policy, and is a globally accepted norm. Lack of current account convertibility (foreign exchange rationing) imposes high economic costs and encourages fiscal profligacy. To avoid prolonged deviations from non-convertibility in the future, we recommend that convertibility be legislated for with provisions for its authorised, temporary suspension if there is a balance-of-payments crisis. Since it cannot be introduced immediately, a start date is needed. We propose the start of 2023.

Report reference: Chapter 5.1

Recommended changes: Section 58 currently reads:

> **58. OFFICIAL VALUE OF MONETARY UNIT.**
> The official value of the monetary unit in terms of other currencies may be determined by the Governor acting on, and in accordance with, policy statements issued pursuant to Section 11 and to achieve the objects of the Central Bank under this Act.

We recommend that this clause be retained as Section 58(a), and that a new clause 58(b) be added to ensure that the Kina is convertible on the current account:[94]

> *Starting 1 January 2023, the Central Bank shall not impose, except in case of a balance-of-payments crisis, restrictions on the making of payments and transfers for current international transactions. If, in a balance-of-payments crisis, restrictions on convertibility need to be imposed, the imposition and retention of such restrictions*

[94] This wording reflects that of Article VIII of the IMF Articles of Agreement to which PNG has been subscribed since 1975, Article VIII reads: "Subject to the provisions of Article VII, Section 3(*b*) and Article XIV, Section 2, no member shall, without the approval of the Fund, impose restrictions on the making of payments and transfers for current international transactions." Article VII, Section 3(b) provides for the Fund to declare a currency as scarce, and this provides a justification for the imposition of limitations on the freedom of exchange. Article XIV allows for transitional arrangements for countries that have applied to use them (PNG has not).

must be authorised by the Monetary Policy Committee, if necessary using the emergency procedures of Section 10C, publicised, and kept in place for the shortest time possible.

Annex 1: Terms of Reference

INDEPENDENT STATE OF PAPUA NEW GUINEA

REVIEW OF THE CENTRAL BANKING ACT 2000

The Treasurer, in consultation with the Prime Minister and the Ministerial Economic Committee of the National Executive Council, has decided it is timely to have a review of the Central Banking Act 2000. The objective is to modernise the Central Banking Act 2000 in line with international developments over the last 20 years while continuing to ensure the independence of the central bank in line with international norms.

The review will benefit from the advice of an Independent Advisory Group. An Independent Advisor Group was similarly established by the late Sir Mekere Morauta when looking at the changes that led to the Central Banking Act 2000. The Independent Advisory Group will be chaired by Robert Igara, Chancellor at the University of Papua New Guinea, and formerly Chief Secretary when the Central Banking Act was introduced in 2000. Other members of the Independent Advisory Group will include the former Governor of the Bank of Papua New Guinea from 1999 to 2009, Sir Wilson Kamit. Professor Stephen Howes, Head of the Development Policy Centre at the Australian National University, and a good friend of PNG through its linkages with the University of Papua New Guinea and his support for the Femili group fighting domestic violence, will also be a member of the Group.

The Independent Advisory Group will be supported by a Technical Support Group consisting of equal numbers of Treasury and BPNG staff, support from Justice and Attorney General's and broader support from the IMF. Specific technical assistance will also be sought from bilateral sources.

This will be an important review, so it is vital that there is wide consultation, strong communication and that the review draws on best international practice for countries in similar circumstances to PNG.

Terms of Reference

The review will be in two stages. The first stage is to report in mid-July for possible legislative changes in the August sitting of Parliament, and the second stage to report in early October for the November sitting of Parliament.

The specific Terms of Reference for the first stage of the review focus on the following five elements:

1. Review whether the objectives of the Central Banking Act 2000 give adequate priority to the growth and development of PNG, and in managing national economic crisis (Section 7);
2. Review the current economic in particular monetary policy governance and management mandate of the central bank, including whether the Board or another similar body should have responsibility under the Act for determining monetary policy, (sections 7-14 focusing on section 10);
3. Review the current arrangements around advances and financing to the government by the Central Bank, including a review of the TAF and options around quantitative easing options during a declared emergency (focus on Section 55)
4. Review the institutional governance and management of the Central Bank whether there is a need for strengthened accountability and transparency, and management performance and terms, in line with international norms (sections 15-36, and sections 42-50 with potentially new sections); and
5. Recommend from the findings and conclusions under TOR 1-4 critical strategic issues requiring in-depth analysis and development - this will form the basis of the TOR for the second stage of the review and cover broader issues of regulation of the financial system, actions to encourage competition, and follow-on work in light of the recent Financial Sector Reform review.

The Independent Advisory Group will consult and agree with the Minister for Treasury on the specific expected outcomes and the work schedule under Phase I of the TOR, in particular those recommendations which will require legislation and Parliamentary approval in 2021.

Background

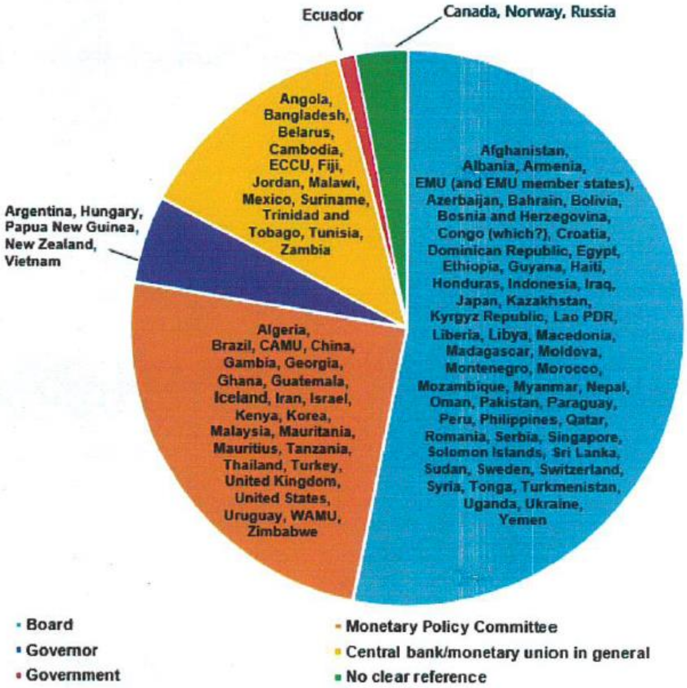
The COVID-19 crisis has highlighted that PNG does not have the same flexibility as many other nations to respond to national emergencies. PNG has fallen behind international best practice in being able to access monetary policy instruments to support a country in a declared emergency. Changes were made in the context of the

2020 Budget to provide greater cash management flexibility within the year and PNG is now benefitting from this reform through early payment of school fees and more support through the development budget - such as for Bougainville - than was previously possible.

However, other monetary options to support the economy in the on-going COVID-19 crisis, with a revenue shortfall of over K2 billion still expected in 2021, are available to other countries but not PNG. The review will be asked to review both the form and level of the Temporary Advance Facility, as well as other Quantitative Easing options including the possibility of direct financing of the budget as is done in many other countries (such as Australia, New Zealand, Singapore, Indonesia and the Philippines).

One very unusual feature of PNG's Central Banking Act is that the Governor is given sole power to determine monetary policy. In 2018, there were only five countries in the world that did this (shown in purple in graph below). Since 2018, New Zealand has moved the power to a Monetary Policy Committee. The majority of countries in the world have their Central Bank Board make monetary policy, followed by a Monetary Policy Committee. The terms of the bank's senior management are also lengthy relative to international norms.

Chart 3
Monetary policy determination



Source: IMF staff calculations.
Note: CAMU = Central African Monetary Union; ECCU = Eastern Caribbean Currency Union; EMU = European Monetary Union; and WAMU = West African Monetary Union.

BPNG's accountability and transparency arrangements are also very limited in comparison to international standards. Specifically and given its unique role which reach beyond Papua New Guinea, and the need to provide assurance to international partners, the governance and audit function require compliance with international best practice and standards. Similarly, there is a wider lack of transparency around the Board and its deliberations, and a lack of account ability on its annual budget. These require a review of the scheme of governance adopted some 20 years ago under the *Central Bank Act 2000*. BPNG has recognised this and is undertaking a corporate governance review, and early result s of that work will be built into this review process but not supercede this higher level review.

There is a broader range of matters that should also be considered by the review - aimed at ensuring the central bank has the appropriate legislation to fulfill its functions especially in light of rapidly changing technologies, as well as challenges around some elements of global financing flows (such as anti-money laundering actions).

Any changes to the Central Banking Act 2000 will be through Parliament. This becomes the ultimate test point to ensure the changes are in the best interests of PNG. As part of this process, the changes will also need to go through the National Executive Committee after vetting by the Central Agencies Co-ordinating Committee as well as the State Solicitor. The Treasurer, as the responsible Minister, will take forward any recommended changes to NEC drawing on the advice of the Independent Advisory Group and its Technical Assistance Group. There will be broad inputs to the review.

Consultation will be an important part of the review. This will include consultation with SMEs, larger firms, exporters and importers, consumer groups as well as key government institutions such as the ICCC on issues such as maintaining both competitiveness and stability in the banking system.

The processes of the review also need to be transparent. A website is proposed to cover the considerations of the review, along with regular updates to the public and Parliament.

Hon Ian Ling-Stuckey, CMG. MP

Minister for Treasury
13 May 2021

Annex 2: Central Banking Act Review Issues Paper (released 30 August 2021)

This Issues Paper has been prepared to assist the Independent Advisory Group (IAG) established to review the Central Banking Act (CBA) as well as those who have an interest in the Review to understand its Terms of Reference, to canvas the issues which face it, and to provide an initial scan of options in terms of recommendations. Any findings are initial rather than definitive. The Paper is written by but is not intended to commit the IAG in any way to any particular finding or recommendation, but rather to generate feedback and comments.

Introduction

The Independent Advisory Group welcomes the opportunity to review the Central Banking Act (CBA). We work from the position that the Central Banking Act of 2000 has served PNG well, but that 20 years on we should learn from experience to see how the Act can be improved, and the independence, accountability, transparency and effectiveness of the Bank of Papua New Guinea be strengthened.

Terms of Reference (TOR)

1. **Objectives**

Review whether the objectives of the Central Banking Act 2000 give adequate priority to the growth and development of PNG, and in managing national economic crisis (Section 7);

2. **Governance**

Review the current economic in particular monetary policy governance and management mandate of the central bank, including whether the Board or another similar body should have responsibility under the Act for determining monetary policy (sections 7-14, focusing on section 10).

3. **Financing**

Review the current arrangements around advances and financing to the government by the Central Bank, including a review of the TAF and options around quantitative easing options during a declared emergency (focus on Section 55)

4. **Accountability and transparency**

Review the institutional governance and management of the Central Bank whether there is a need for strengthened accountability and transparency, and management performance and terms, in line with international norms (sections 15-36, and sections 42-50 with potentially new sections).

5. **Other issues**

Recommend from the findings and conclusions under TOR 1-4 critical strategic issues requiring in-depth analysis and development– this will form the basis of the TOR for the second stage of the review and cover broader issues covering regulation of the financial system, actions to *encourage competition, and follow-on work in light of the recent Financial Sector Reform review.*

<u>Comments on the Terms of Reference</u>

Crisis management is covered by two TOR items, 1 and 3. Under 1, the IAG is asked to review whether BPNG objectives need to be extended to cover crisis management. Under 3, the IAG is asked to examine quantitative easing (QE) options during a crisis. For clarity, it is proposed to combine these as a single, separate item relating to crisis management. TOR items 2 (governance) and 4 (accountability and transparency) are closely related, and it is proposed to address these sequentially.

Thus the proposed revised presentation of the Terms of Reference is:

1. Objectives
2. Governance
3. Accountability and transparency
4. Financing
5. Crisis management (objectives and financing)
6. Second-phase issues

Note there is no change in substance between the original and these proposed TOR. The changes are just for the sake of clarity. There is an additional TOR because the crisis management components of other TOR items are separated out and presented on their own.

The rest of this Issues Paper goes through the above six items, one by one.

<u>1. Objectives</u>

Under this heading we review “whether the objectives of the Central Banking Act 2000 give adequate priority to the growth and development of PNG” The issue of objectives relating to crisis management is dealt with in section 5.

Background

Under the Act (Section 7), BPNG has three main objectives: price stability; financial stability; and payments efficiency. Subject to these three objectives, Section 7 also states that BPNG is to promote economic growth. Section 7 also states (and Sections 10 (1) and Section 11(1) repeat) that the sole objective of monetary policy is price stability, giving this objective a clear primacy.

This articulation of BPNG objectives is consistent with the most common, though not universal, global practice, which is for Central Banks to give priority to price stability. Nevertheless, several issues have arisen in relation to BPNG’s objectives over the years.

- **Exchange rate policy.** Although exchange rate policy has traditionally been a government responsibility in PNG (and most other countries),[1] Section 58 of the CBA can be read as vesting responsibility for exchange rate policy formulation with BPNG.[2] Since 2015, IMF staff have reclassified PNG's exchange rate regime away from "floating" to a "crawl", or "fixed" (for different periods). IMF staff have also in recent years have found PNG to be maintaining restrictive exchange measures and multiple currency practices which limit currency convertibility on the current account, and are inconsistent with the IMF Articles of Agreements (to which PNG has subscribed).[3] The IMF has argued that foreign exchange rationing has increased unemployment in PNG and led to shortages of intermediate imports.[4] PNG businesses frequently complain about exchange rate shortages. The Bank's goal of price stability makes it unsuitable for it to set exchange rate policy as this goal will always bias decisions against depreciation (which are inevitably inflationary).

- **Little attention to the economic growth objective.** In recent years, inflation has been moderate in PNG, and growth has been very low. Since 2013, formal sector employment has been declining and per capita non-mineral GDP growth has been negative. Despite the fact that subject to price stability BPNG should promote economic growth, there has been no mention of low growth in BPNG statements and no discussion of the need for stimulatory policies until the onset of COVID.

- **Financial stability**. The PNG financial sector is stable, but its duopolistic or monopolistic nature is not supportive of development. Some have argued that the regulatory barriers to entry have been set too high. The question arises as to whether BPNG's objective in favour of financial stability is at the expense of financial and therefore economic development.[5]

Options

BPNG's objectives could be left the same, with the focus on inflation. This would be consistent with the practice across most banks.

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[1] See p. 15 of the IMF 2004 survey *Central bank governance: a survey of boards and management*.
[2] Section 58 states that "The official value of the monetary unit in terms of other currencies may be determined by the Governor acting on, and in accordance with, policy statements issued pursuant to Section 11 and to achieve the objects of the Central Bank under this Act."
[3] See for example, the *2018 IMF Annual Report on Exchange Arrangements and Exchange Restrictions*.
[4] See p.25 of the 2018 IMF Policy Paper "Review of the Fund's policy on Multiple Currency Practices: initial considerations" The exact language used is that PNG maintains "exchange restrictions subject to IMF approval under Article VIII, Section 2(a), of the IMF's Articles of Agreement."
[5] BPNG is also charged under the Banks and Financial Institutions Act 2000 with promoting "the general stability and effective working of the financial system in PNG" (Section 5(1)). The Financial Analysis and Supervision Unit (FASU) within BPNG is charged with monitoring and enforcing compliance with The Money Laundering and Counter Terrorism Act 2015. According to Section 61(2), "FASU shall be an operationally independent unit with the functions as specified under this Act and can institute proceedings on behalf of the Bank of Papua New Guinea for the purpose of this Act." Issues relating to the financial sector beyond overall BPNG governance and objectives are likely to be further investigated in the second stage of the Committee's work.

Alternatively, its objectives could be changed to give a more balanced approach. For example, the US Federal Reserve has the objectives of maximizing employment, stabilizing prices, and moderating long-term interest rates. Such a rearticulation of objectives would lead to a recalibration of strategy, both monetary and perhaps financial.

Who has responsibility for setting exchange rate policy needs to be agreed on, and the parameters within which that responsibility is exercised clarified. If the focus on price stability is retained, certainly exchange rate policy should not rest with BPNG. If more balanced objectives are adopted, then BPNG could retain responsibility for exchange rate policy, within agreed and perhaps legislated constraints, such as to reflect PNG's long-standing commitment to current-account convertibility.

it is not sufficient to clarify who is responsible for exchange rate policy. It also needs to clarified what the policy should be. In particular, the government needs to decide whether it is content to retain a regime of foreign exchange rationing or wishes to return to compliance with the IMF Articles of Association and good economic practice and ensure convertibility on the current account. It also needs to be formally acknowledged that PNG's current exchange rate regime is not floating, and, assuming the government remains committed to a floating regime, a plan should be articulated to return to it.

2. Governance

Review the current economic in particular monetary policy governance and management mandate of the central bank, including whether the Board or another similar body should have responsibility under the Act for determining monetary policy (sections 7-14, focusing on section 10).

Background

Section 10 of the CB Act clearly vests responsibility for monetary policy formulation and implementation with the Governor. Section 26 on the functions of the BPNG Board states that formulation and implementation of monetary policy and the regulation of the financial system is not a Board responsibility, but the Governor's responsibility. BPNG is unusual. IMF staff research cited in the TOR for this review shows that only three other countries give responsibility for monetary policy to the central bank governor: Argentina, Hungary and Vietnam. None are appropriate role models.

The Bank for International Settlements (BIS) 2009 survey of central bank governance (*Issues in the governance of central banks*) notes that "an increase in the delegation of power to the central bank has often been accompanied by a move to group decision making." (p.2).

The BIS Survey goes on to note that: "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." (p.3)

Having a more collective approach would be of benefit to BPNG since it would, again to quote from BIS, “permit a wider range of perspectives to be brought to bear, which adds to the legitimacy and credibility of the central bank decisions….” (p.3)

Given the criticism of some of the BPNG decisions over recent years – whether relating to exchange rate policy already discussed or deficit financing discussed below – such an increase in legitimacy and credibility would be welcome. Setting aside the issue of whether these decisions were the right one, a more contestable process would give greater confidence that these decisions were indeed the right ones and that all valid criticisms and alternative points of view had been given due weight.

Although BPNG does have a Monetary Policy Committee (MPC), it is constituted entirely by Bank staff, who report to the Governor. The IMF in its 2004 survey (*Central bank governance: a survey of boards and management*) recommends that any MPC should have external members: “Monetary policy committees, for instance, may be used as an avenue to include external members to ensure a balanced view.” (p.40)

Options

Consideration should be given to BPNG moving towards a more collective approach to monetary policy determination since, based on global experience, this would enhance both its independence and the quality of its decisions. Under any such model, although the concentration of power in the Governor would be reduced, s/he would still be the most powerful decision maker on monetary policy.

Analysis should be undertaken of the suitability of this model for the PNG context,

Further consideration would need be given as to whether monetary policy should be the responsibility of the Board or of a specialized MPC (on which BPNG staff and management would be included, but would not dominate).

In both cases, careful consideration would need to be given to composition of and appointment protocols for the Board/MPC to ensure independence, contestability and effectiveness. This is discussed further in the next section.

3. Accountability and transparency

Review the institutional governance and management of the Central Bank whether there is a need for strengthened accountability and transparency, and management performance and terms, in line with international norms (sections 15-36, and sections 42-50 with potentially new sections).

Background

This item covers a range of items, including (a) management performance and terms, (b) accountability and (c) transparency.

(a) Management performance and terms

The 2009 BIS Survey discussed earlier shows international practice in relation to the terms of the central bank governors (see the table below, extracted from it). Two-thirds of countries surveyed have a 5-6 year term for their central bank governor. The BPNG Governor term is for seven years, which is on the long side. A longer term promotes independence, but may undermine accountability, given the difficulties (and undesirability) of removing a Governor. An advantage of the seven-year term in the PNG context is that it is not the same as the electoral cycle of five years.

Length of term and reappointment of central bank governors
Per cent of 47 central banks

	3–4 years	5–6 years	7–8 years	Not specified	Life tenure
Length of term	6	64	17	13	0
Reappointment not limited	0	45	11	0	0

Source: BIS analysis of central bank laws.

Source: Table 5 from the 2009 BIS Survey

Regarding management performance, the Committee could examine the operational budget of BPNG. The Bank's staff costs have doubled after inflation between 2010 and 2019, and total costs have more than doubled over the same period. Further research is required to establish the extent to which such increases are justified. The BPNG Act has provision for a performance (not policy) audit (Section 48), but one has not been undertaken.

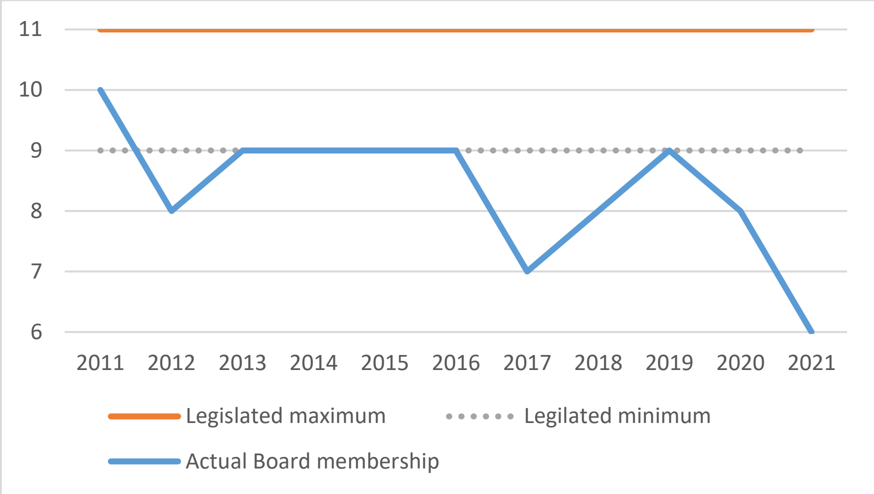
(b) Accountability

According to the 2009 BIS Survey, "[t]he key issue is to strike the right balance between protecting the independence of the central bank and preserving its accountability". (p.135).

BPNG's most immediate accountability is to its Board. Article 26(1) of the CBA states that the "Board of the Central Bank is responsible for determining the policies of the Central Bank, other than the formulation and implementation of monetary policy and the regulation of the financial system which shall be the responsibility of the Governor." This makes the Board a "supervisory Board" in the words of the 2004 IMF survey (p.23). The IMF recommends that in such a case the governor should not be the Board chair (p.26).

The PNG CBA establishes a Board with a maximum of eleven members, and requires that there be at least nine. Analysis over the last decade shows that in several years the minimum has not been achieved – see the figure below.

Figure 1. BPNG Board size



Source: BPNG Annual Reports.

Further investigation is required as to why the Bank has not had its minimum required membership for significant periods of time. The BPNG Board includes up to three BPNG managers (the Governor, and up to two Deputies), five ex officio positions (representatives of the church, business, trade unions, Institute of Accountants, and Securities Commission), and three appointees of the Head of State (NEC appointees). These NEC appointees have a three-year term limit, the ex officio representatives have no term limit, the Governor has a 14-year limit, and the Deputy Governor can have any number of five-year terms.

The advantage of ex officio positions is that they reduce the discretion in appointment of Board members. The disadvantage is that it might lead to members with little expertise and very long tenures.

Other accountability mechanisms for central banks are quantitative targets, and regular parliamentary reviews. BPNG has neither of these. It is required to submit to the Minister an annual report within six months of the end of the financial year. At the time of writing, the most recent BPNG annual report on the website is 2018, and the most recent financial report 2019.

The IMF in its 2016 Article IV called on BPNG to "stop monetizing the fiscal deficit" (p.13) Given that Article 55 prevents BPNG from funding the fiscal deficit, this reference to the so-called "slack arrangement" between the Government and BPNG raises important issues of accountability. (See Section 4 for further discussion.)

(c) Transparency

Transparency promotes accountability. There is a growing trend among central banks towards transparency, with a growing number publishing their monetary policy strategy, their macroeconomic forecast and model, and meeting minutes.

BPNG issues a policy statement every six months. The BPNG website is a platform for transparency, but some information is out of date. (At the time of writing, statistical information in the QEB tables is only updated to December 2020, more than six months ago.

Data on Treasury Bill and Inscribed Stock auctions are also only up to 2020.) The Bank issues forecasts for GDP, balance of payments and inflation.

Options

The term for the Governor could be left at seven years, or shortened to five years to bring it into line with more standard international practice.

Terms and appointment protocols for Board members (and any Monetary Policy Committee, if established) should be reviewed. Consideration could be given to appointment of representatives of other Central Banks to the BPNG board.

Concerns about BPNG management performance could be addressed by greater accountability and transparency, and by Board governance reforms including appointments of persons with relevant expertise and experience rather than ex-officio appointments of institution representatives.

A range of measures could be considered to promote accountability and transparency. In addition, greater emphasis on collective decision making (as discussed under the previous TOR item) should itself lead to more accountability and transparency, as it will mean that Bank decisions will be more contestable.

4. Financing

"Review the current arrangements around advances and financing to the government by the Central Bank, including a review of the TAF … (focus on Section 55)" ["Options around quantitative easing options during a declared emergency" are discussed under item 5 below.]

Background

The Temporary Advance Facility (TAF) is established under Section 55(2) to provide short-term advances to the government. In 2020, the Government amended the BPNG Act to increase the TAF cap from K200 million to 12% of revenue and grants (including aid), averaged over the last three years. The Act was also amended to give the government 12 months to repay the TAF, up from six. The earlier limit was low by international standards, and the reform will help the government solve its serious cash flow problems especially at the start of the year.

BPNG has argued that the increase in the TAF will worsen the problem of excess liquidity. However, since the TAF is only short-term financing, the validity of this objection is unclear.

Other advances from BPNG to help the Government finance its fiscal deficit are disallowed under Section 55(9). Despite this, as mentioned earlier, BPNG developed the so-called "slack" arrangement by which it purchased T-bills in the primary market, and held them for long periods. The outstanding balance at the end of 2017 was K1.231 million and in 2018 K630 million thereby helping the government to finance its deficit.

Some countries allow some deficit financing, but limit total Bank support to the government. In Fiji, for example, there is a limit for RBF holdings of government securities and advances of 30 percent of government revenue.

BPNG is authorized to purchase treasury bills or securities for the purpose of monetary policy management (Section 55(8)). BPNG does this by purchasing such instruments on the secondary market. PNG financial institutions are at or near their exposure limits in terms of PNG government debt holdings. Therefore, if BPNG buys some of their debt, they are able to purchase more from the government. This eases the financing challenge, and puts downward pressure on interest rates, while still being allowed under the Central Banking Act.

Options

One option is to keep Section 55 as it is. This might be considered appropriate bearing in mind that it has just been amended. Alternatively, expanded (though still limited) support from BPNG to government deficit financing could be allowed, as per the Fiji model.

5. Managing national economic crisis

"Review whether the objectives of the Central Banking Act 2000 give adequate priority to … managing national economic crisis (Section 7). Review the current arrangements around advances and financing to the government by the Central Bank, including a review of … options around quantitative easing (QE) options during a declared emergency (focus on Section 55)"

Background

For ease of handling, we have rearranged the TOR to bring together the two items related to crisis management – concerning objectives relating to and QE during an emergency. (QE or asset purchase programs involve the purchase of government securities to push down interest rates, stimulate the economy, and/or support government deficit financing. The purchase of such securities could be in the primary or secondary market.)

There are no crisis provisions in the BPNG Act. A few countries do include crisis provisions in their central bank legislation. For example, Section 19 of the Bank of England Act 1998 gives reserve powers to the UK Treasury over monetary policy "in extreme economic circumstances".

It can be argued that emergency provisions are not needed since, as long as price stability is not threatened, BPNG is mandated to support growth. However, during a crisis one might give more weight to economic growth (or minimizing the economic shock) and less weight to price stability. It should also be noted that the Government may declare a State of Emergency on various grounds, which gives it temporarily enhanced powers.

Many central banks have been very active in response to COVID-19 without the activation of emergency clauses, or the takeover of their powers by the government. However, some countries did amend legislation in response to the pandemic to support bond purchases

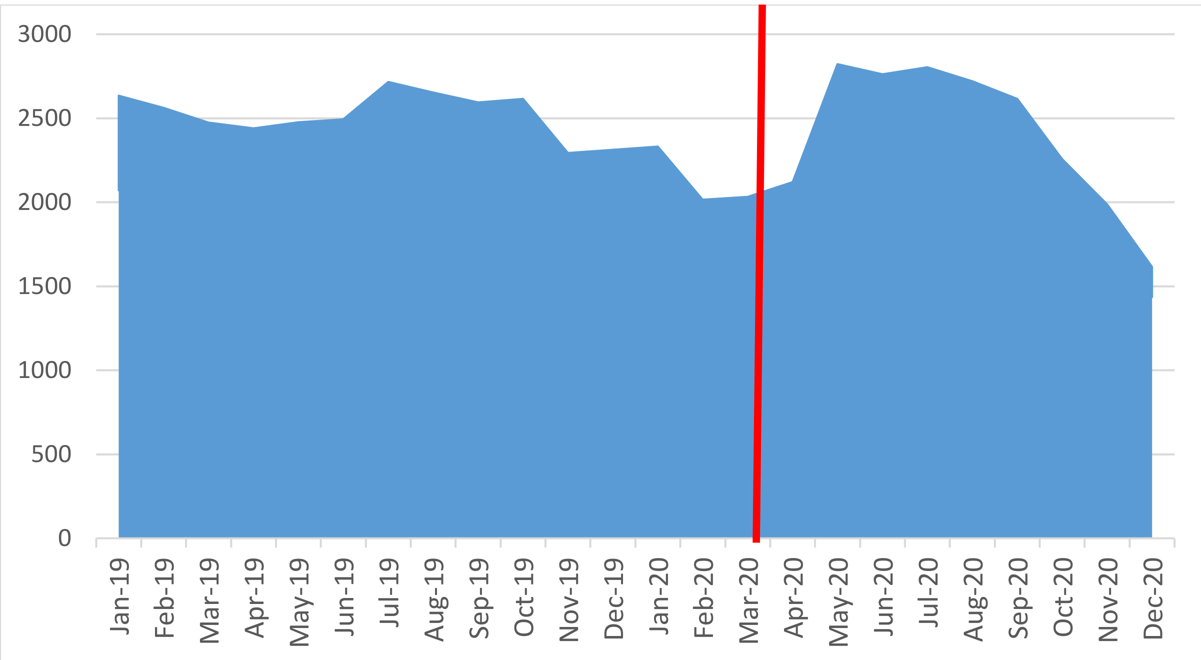
(Indonesia and Brazil) and/or to increase the limit on such purchases. (Both the IMF and BIS have developed COVID central bank response databases. These can be interrogated for further insights.)

Most central banks have restricted their QE to the purchase of government bonds on the secondary market. However, some central banks have extended their support to purchases in the primary market (Indonesia and Philippines).

The IMF's advice is that purchases of government securities by the central bank can be justified in emergencies, but that secondary market purchases are preferred, and that monetary policy objectives and central bank autonomy should not be undermined.

BPNG initially engaged in QE with the onset of the COVID-19 pandemic, but then, as the graph below shows, unwound its position. The latest data shows that it held less government debt at the end of 2020 than it did before the pandemic. This was due to its concerns about the increase in the TAF.[6] However, it appears the government has made limited use of the TAF, and in any case this is a short-term, cash-flow-smoothing instrument. The lack of sustained QE in PNG makes the country stand out in an international context when many other central banks are playing an active role to assist governments at a time of crisis. (Data for 2021 is unavailable on the BPNG website.)

Figure 2. Central bank holdings of government debt (Kina millions): before and during COVID-19



Notes: The thick line marks the onset of the COVID-19 pandemic. Data from BPNG website. Government debt includes inscribed stock and Treasury bills.

[6] The March 2021 MPS indicated that "The Central Bank undertook some trading in the secondary market by on-selling its stock of Government securities to diffuse part of the liquidity injected through the TAF."

Options

With regard to legislative change, there are three options:

- One would be to introduce new clauses relating to objectives and/or functions during a crisis.
- Another would be to revise provisions relating to the financing of deficits, especially purchases of bonds on the primary market, either during a crisis or more generally.
- A option would be not to recommend any legislative changes.

Regardless of whether there is legislative change, further investigations should explore whether, without compromise to BPNG's independence, BPNG and Treasury can better cooperate in the national interest, especially at times of crisis, and what mechanisms could promote such enhanced cooperation.

6. Further issues

Recommend from the findings and conclusions under TOR 1-4 critical strategic issues requiring in-depth analysis and development– this will form the basis of the TOR for the second stage of the review and cover broader issues covering regulation of the financial system, actions to encourage competition, and follow-on work in light of the recent Financial Sector Reform review.

Background

Among the many additional issues that could be covered in the IAG's second stage of work, priority ones for further investigation could include:

- How to encourage new, low-risk entrants into the banking sector.
- How to remove excess liquidity.
- How to expand the capacity of the domestic financial sector to meet the government's borrowing needs (to reduce reliance on offshore borrowing) and how to drive down government borrowing costs.
- The governance of the Financial Analysis and Supervision Unit (FASU) within BPNG, as per the Anti Money Laundering and Counter Terrorism Financing Act 2014, and its relationship to the responsibility of BPNG under the Banks and Financial Institutions Act 2000.
- How to expand capacity of the financial sector to better meet the needs of small and medium enterprises including through "Open Banking/FinTech".

Other issues will no doubt be suggested and added over the course of the Committee's first stage of work.