



Bank of PNG

Presentation at the National Research Institute

**Topic: *LNG Impact and Implications on
Monetary Policy***

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Format of Presentation

- Monetary Policy and Issues
- Exchange Rate Issues
- Management of foreign Reserves
- Experience with outsourcing of foreign reserves



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Monetary policy objective

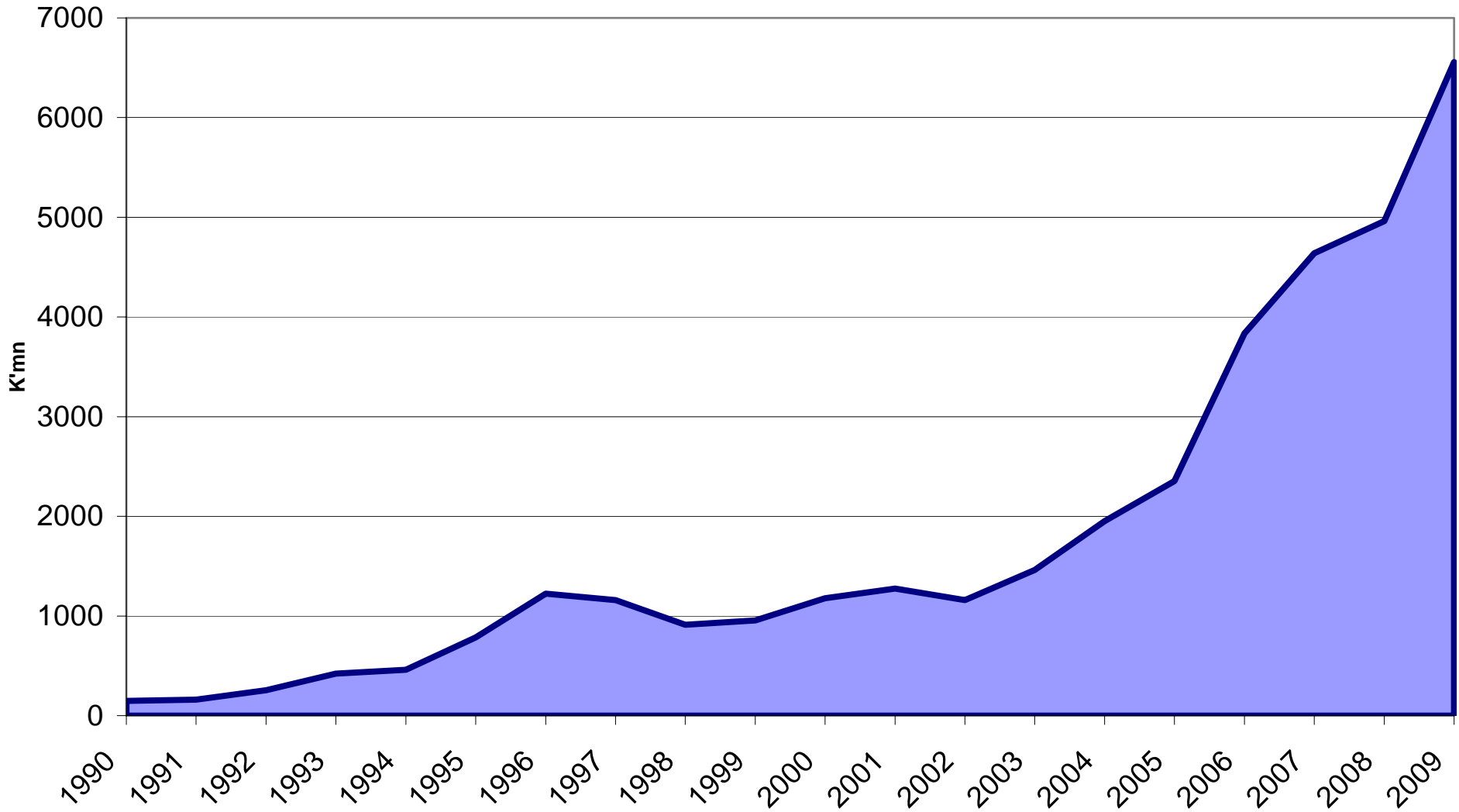
The objective of monetary policy in PNG is to achieve and maintain price stability. We define price stability to entail low inflation supported by stable interest and exchange rates. The maintenance of price stability leads to:

- Confidence in the Kina exchange rate and management of the economy;
- A foundation for stable fiscal operations of the government;
- Certainty for businesses to plan for long-term investment; and
- A stable macroeconomic environment conducive to economic growth.



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Chart 1: Liquid Assets of the Banking System

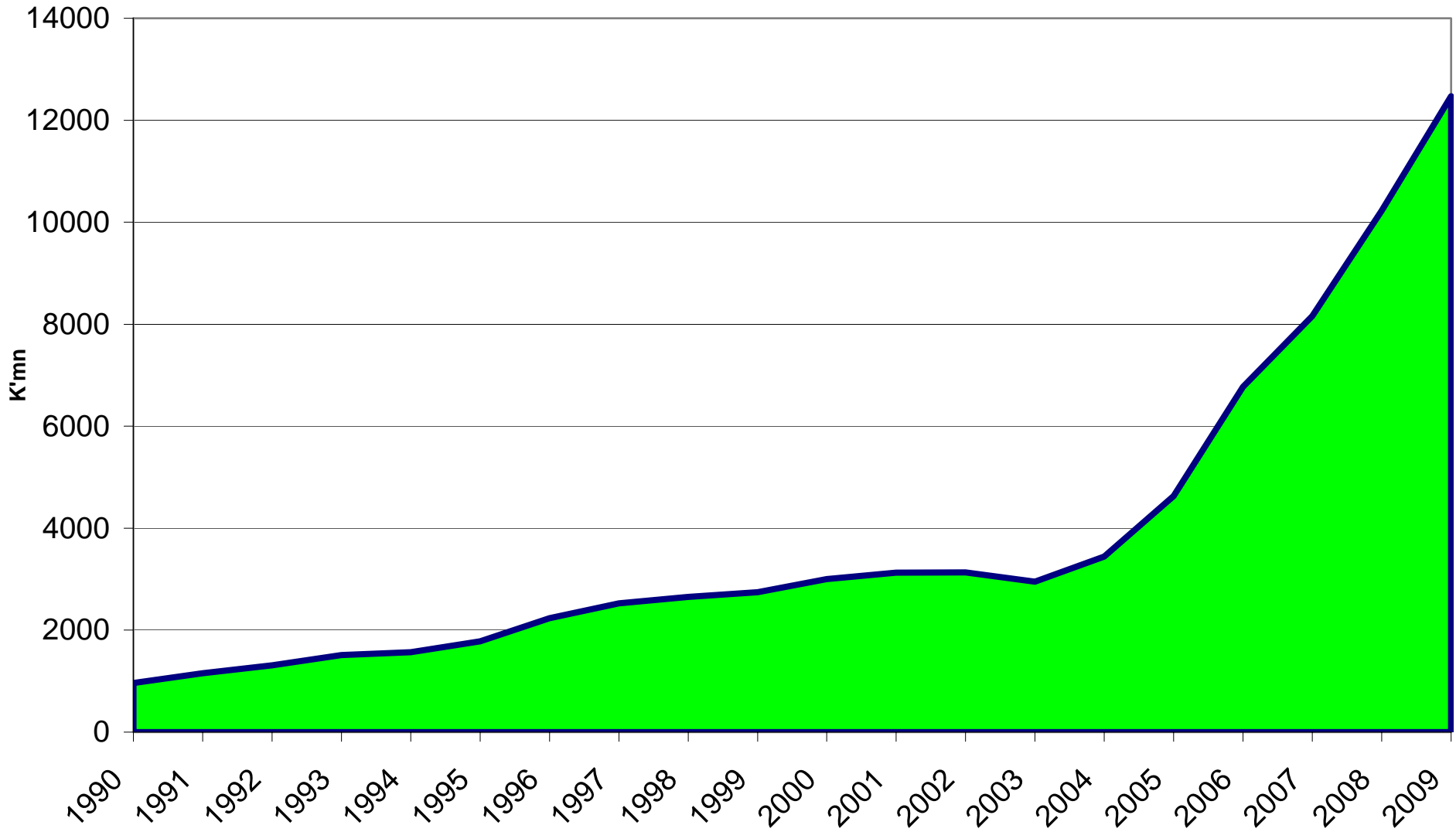


Source: Bank of PNG



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Chart 2: Total Deposits of the Banking System

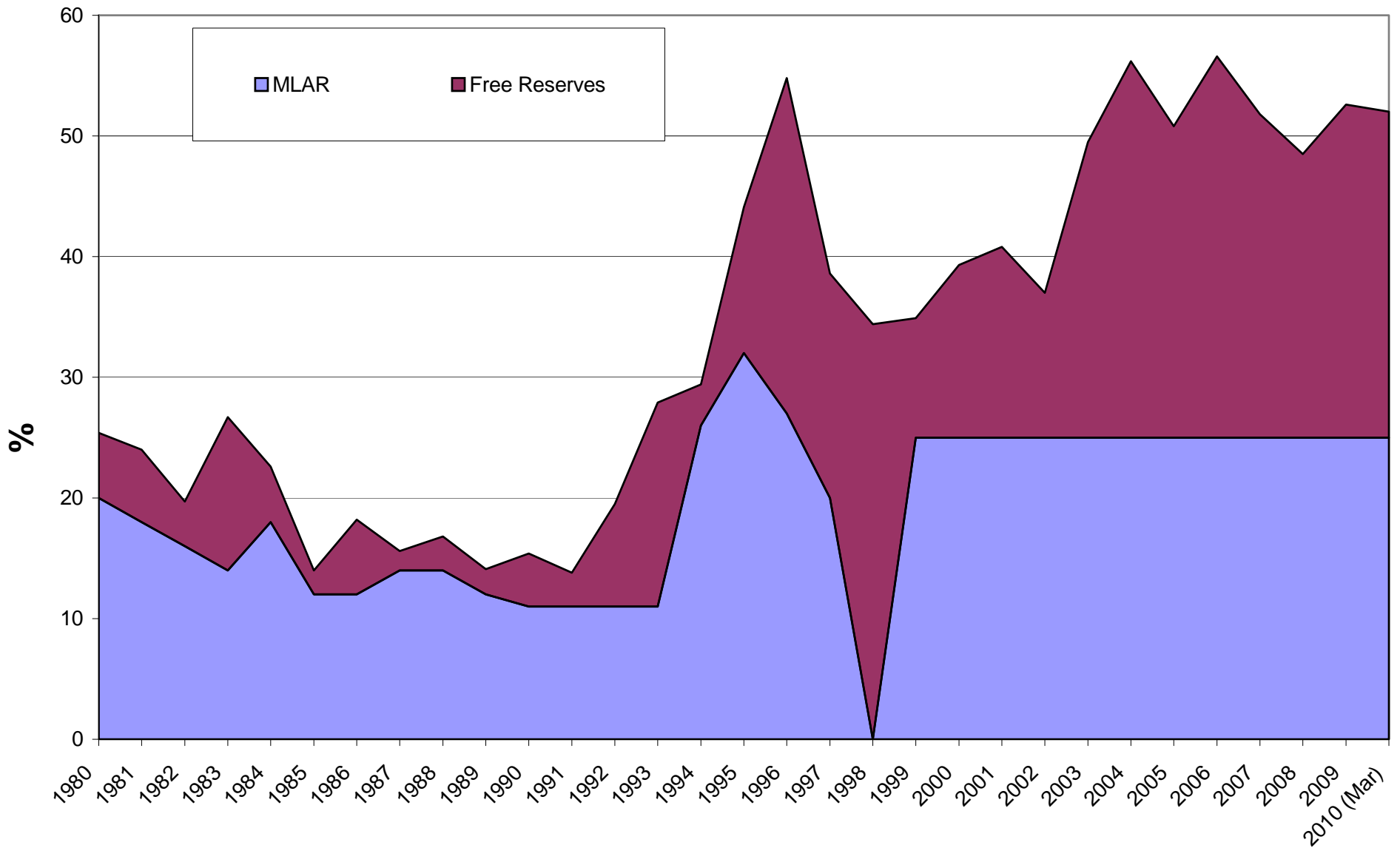


Source: Bank of PNG



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Chart 3: MLAR and Free Reserves



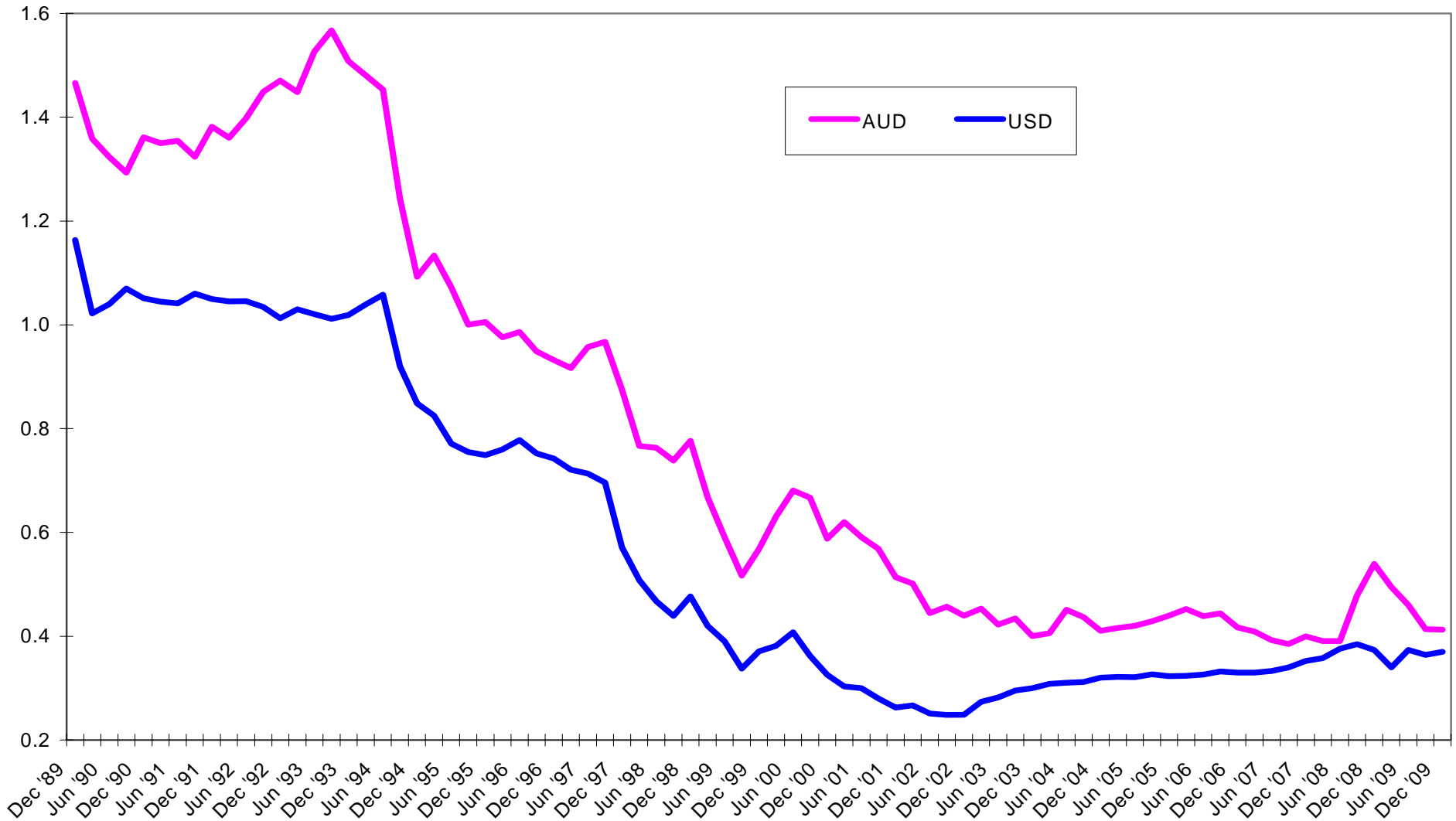
Source: Bank of PNG



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Exchange rate

Chart 4: Kina against US Dollar and Australian Dollar



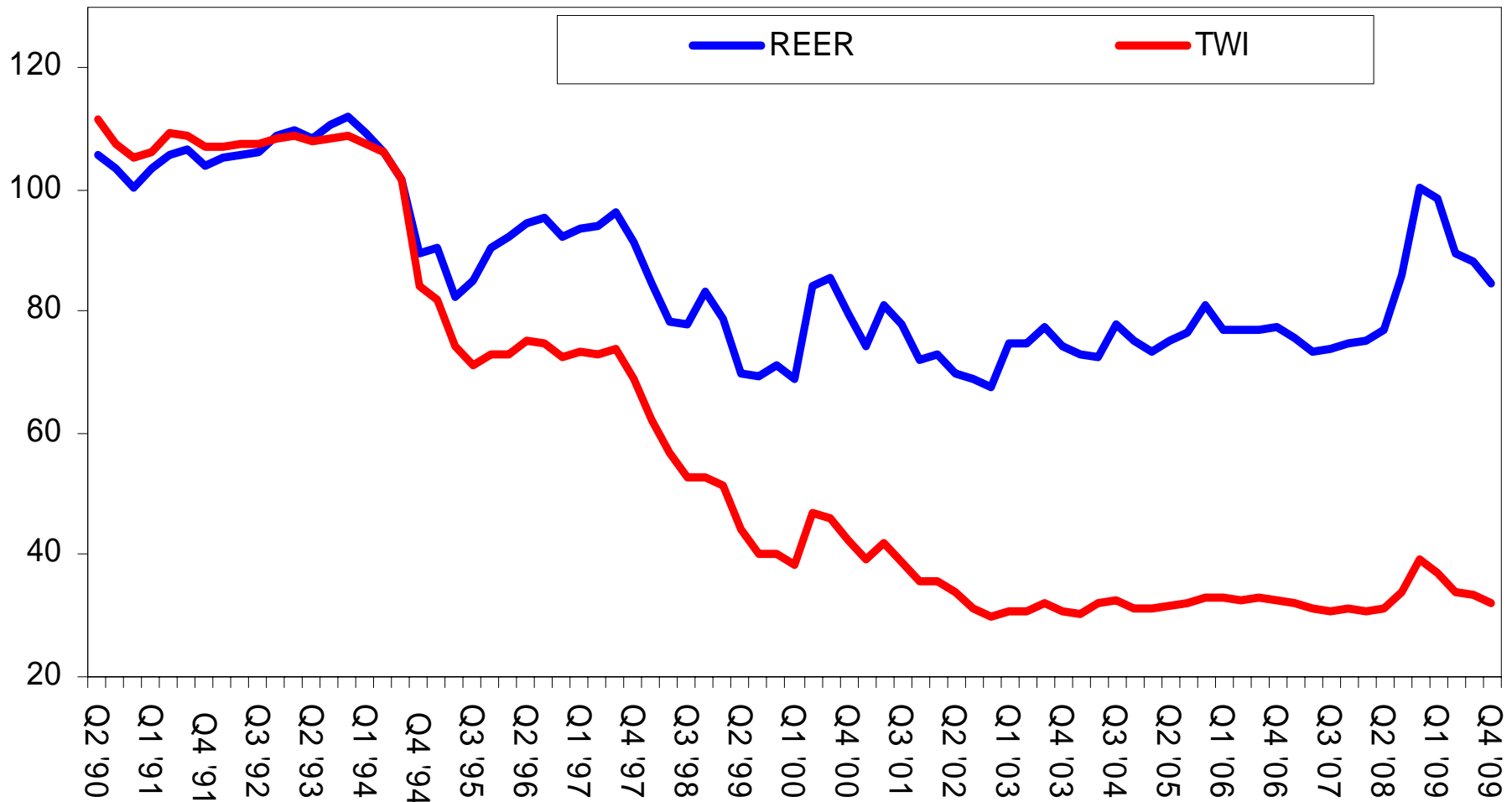
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Exchange rate

Chart 5: Quarterly Kina exchange rate against TWI and REER



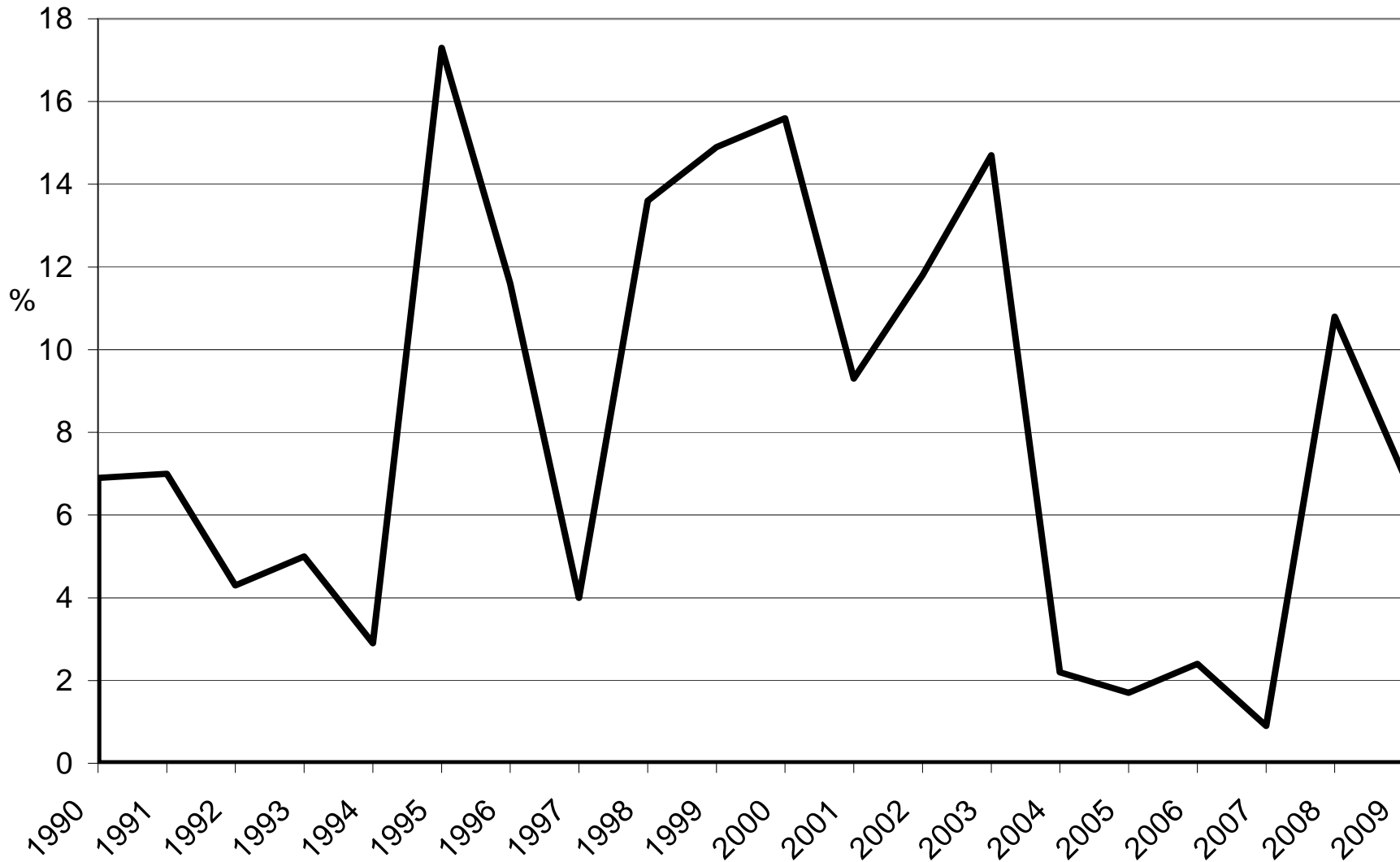
Source: Bank of PNG



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Inflation

Chart 6: Consumer Price Index (CPI)



Source: NSO



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Managing foreign reserves

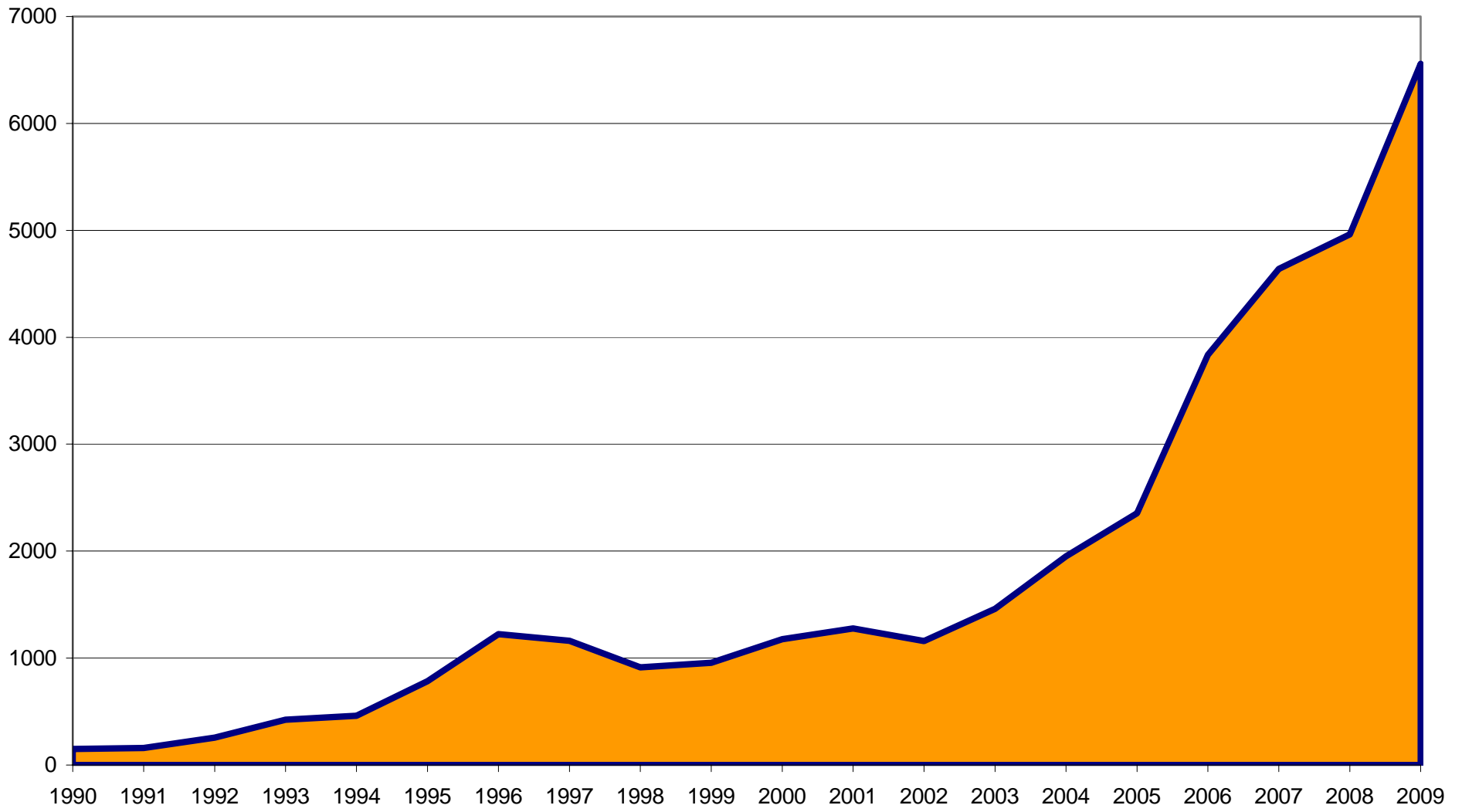
Central Banking Act 2000, Section 8 (1) (d) mandates the Bank of Papua New Guinea to manage the gold, foreign exchange and other international reserves of Papua New Guinea.

- Inflows of foreign exchange mainly come from mineral taxes and dividends, royalties, donor financing and concessional loan draw downs.
- The foreign reserves are used to meet the Government's foreign debt obligations, foreign exchange intervention and the Bank's obligations to international financial institutions, if any.



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Chart 7: International Reserves (K'mn, current prices)



Source: Bank of PNG



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Main reasons for holding foreign exchange reserves are as follows:

- Intervene in the foreign exchange market in pursuit of Monetary Policy and Exchange Rate policy objectives
- Investment Portfolio
- Service the Government's foreign debt obligations
- Support the domestic economy from external shocks



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BPNG's Investment objectives

- To meet its mandated responsibilities
- Understand and control the risks faced in managing the foreign exchange reserves.
- Therefore, primary objective - to preserve the capital value of the foreign exchange reserves by maximising Liquidity, minimising Credit and Interest Rate risks and to earn an acceptable rate of return on the assets. Return is maximised after the first two objectives of liquidity requirements, and credit and interest rate risks are met.



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Foreign Assets

- **A High Degree of Liquidity**
- **Low Level of Credit Risk** - invest only in “AAA” and “AA” rated credit, and only in Sovereign, International Agencies and selected corporate bonds such as major Banks. There are limits on maximum holding of any private credit issued security.
- **Positive Return** - subject to the above constraints, return is maximised on the investments.

The Central Bank’s foreign exchange reserves are held in liquid foreign currency assets in cash, money market instruments, and long term bonds.



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Risk management

- The Bank of PNG, like many other central banks is faced with three external risks that it cannot negate; credit, interest rate and exchange rate risks. Of the three risks, the major risk is the exchange rate.
- An Investment Committee periodically reviews the Bank's investment performance against their benchmarks and recommends adjustments, if needed.



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Outsourcing of foreign reserves

- Between 2006 and 2007, BPNG's foreign exchange reserves increased from US\$780 million to US\$2.1 billion due to strong exports and government taxes from the mineral and petroleum sector.
- There was a need to build the level of foreign exchange reserves as part of its macroeconomic and price stability objectives.
- Decided in December 2007 to outsource part of the foreign exchange reserves to be managed by external fund managers.



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Outsourcing of foreign reserves

- Following a tendering process, four fund managers and a custodian were selected.
- Outsourcing began on 24th April 2008 when US\$200 million each was outsourced to Schroders and Clariden Leu Asset Management, a total of US\$400 million.
- The remaining balance of US\$400 million was transferred to the other two fund managers, Sinopia and Deutsche Bank on 30th June 2008.



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Investment Mandate

- Investment mandate for the external fund managers was similar to the in-house mandate.
- The fund managers have the added flexibility of investing up to 10 percent of their portfolios in triple A rated corporate bonds and having a higher modified duration (a measure of interest rate risk) of 5 years, compared with 2.5 years for the in-house managed funds.



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Results so far

- Review done in December 2009.
- All fund managers complemented BPNG's Investment Management Agreement (IMA) risk management framework in withstanding the effect of the global financial crisis.
- Since inception, the outsourced funds have steadily increased from US\$800 million to US\$853.3 million as at December 2009. This represents a 9.7 % rate of return and compared with 6.3 % for the Citigroup's World Government Bond Index 1-3 year USD Hedged Benchmark.



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Thank you