

Monetary Policy Implementation at Different Stages of Market Development

Key Findings and Conclusions

by

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Motivations for the paper

- ***Assess the experience*** with market-based instruments for monetary policy implementation in *shallow markets*
- ***Draw policy implications for Fund operations***, including delivery of technical assistance and coordination between Fund surveillance and operations

Methodology

- ***Review the experience of a dozen countries (or groupings)*** at different stages of market development
- ***Assess what worked and what did not, and why*** by looking at the environment for policy implementation
- ***Grouping of obstacles into three factors:*** macroeconomic, market participation, and institutional conditions

Glossary of Monetary Instruments

- **Rules-based instruments**
 - **Liquid asset ratio (LAR)**
 - **Reserve requirements (RR)**
 - **Standing facilities**
- **Discretionary and market-based (money market operations)**
 - **Open market-type operations**
 - **Open market operations**
 - **Auction techniques**
 - **Fine-tuning operations**

Overarching findings

- ***Difficulties in the transition do not challenge the fundamental shift*** from direct controls to money market operations for the conduct of monetary policy (see Table)
- ***Need for close attention to countries' structural and institutional circumstances*** for designing an action plan to modernize monetary policy conduct

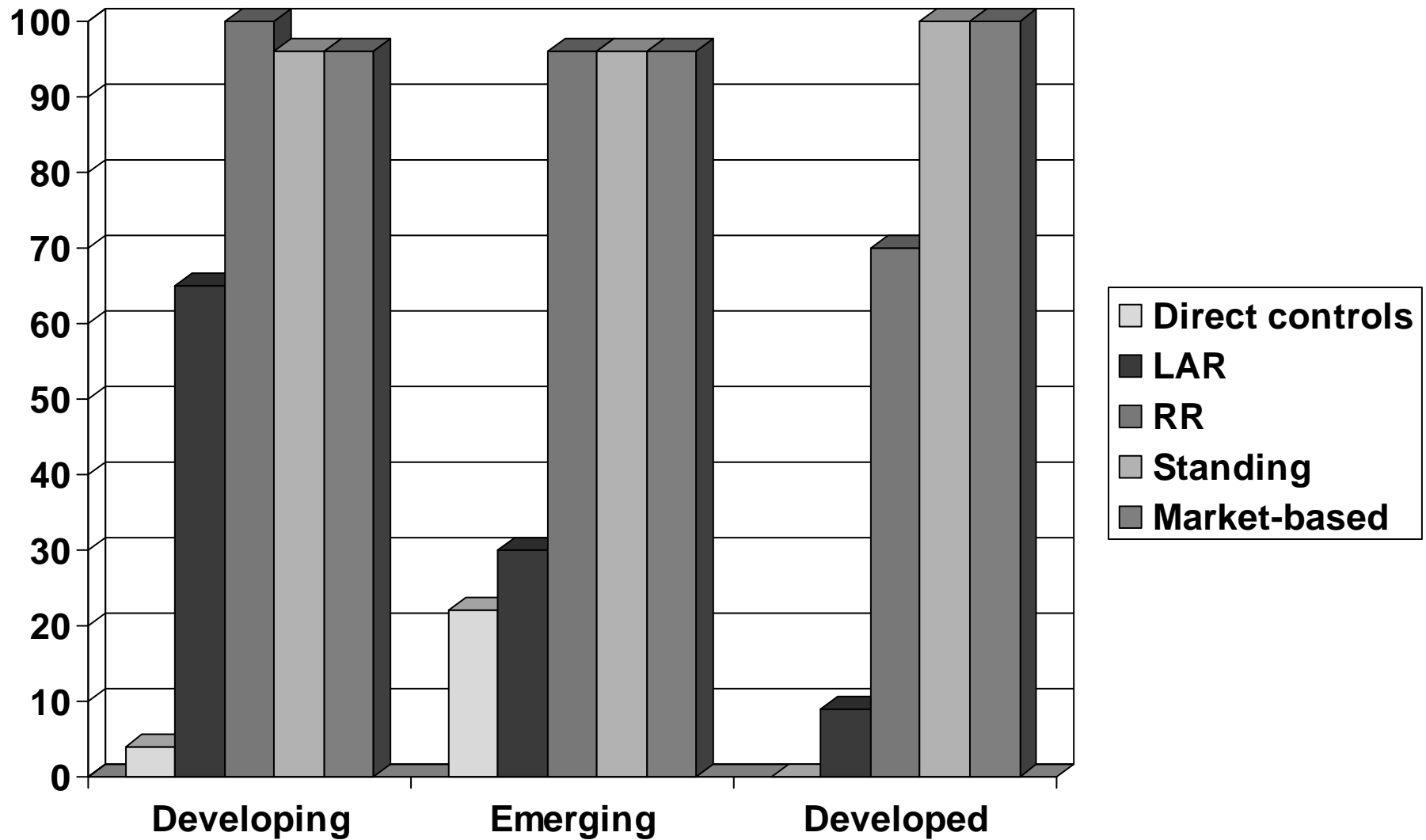
Use of Monetary Instruments in a Sample of Countries (in percent of number of countries in the sample)

	Developing Countries	Emerging Countries	Developed Countries
Credit & interest rate controls	4	22	0
Liquid asset ratio (LAR)	65	30	9
Reserve requirements	100	96	70
Open-ended/standing facilities	96	96	100
Discretionary & market-based	96	96	100

Sources: MFD, Information System for Instruments of Monetary Policy database. Data based on practices as of end-2001 in central banks from 23 developing, 23 emerging, and 23 developed countries.

Use of Monetary Instruments in a Sample of Countries

(in percent of number of countries in the sample)



“Initial conditions” **for Effective Monetary Policy**

- **Macroeconomic conditions**
 - Stable macro framework
 - Supportive fiscal policy (sterilization costs)
- **Market infrastructure**
 - Competitive financial system
 - Adequate supervisory framework
- **Institutional framework**
 - Operational autonomy of central bank
 - Adequate operational capacity at the central bank

Fiscal Dominance: A Multi Faceted Problem

- Direct government borrowing from the central bank
- Lack of fiscal discipline which undermines investor confidence
- Lack of resources at the CB to conduct monetary policy
- Quasi fiscal operations by the CB with no compensation from the government

What Can Be Done?

- Sound institutional framework
 - Clear objective for monetary policy
 - Limits to CB credit to the government
- CB transparency and communication
 - Explain to the public the objectives of the CB
 - IMF Code of Transparency
 - Accountability

Financial Strength of the Central Bank

- Neutralize the expansionary effect of losses on reserve money
- Appropriate arrangements to cover CB losses
- Look at the balance of the consolidated public sector (central bank + government)
 - Generate surplus in government budget to cover CB losses

Dealing with Liquidity Surplus

- Is it easier for the central bank to operate on asset side of its balance sheet?
- How to create a liquidity shortage?
- What should be the mix of market-based and rules-based instruments?
- Should reserve requirements be remunerated?

Establishing Efficient Money Markets

- What is minimum number of participants for the interbank market to work?
- How to overcome reluctance to trade on the interbank market?
- Need for greater central bank involvement than in mature markets?

Strengthening Financial Market Infrastructure

- Legal infrastructure
 - Primary objective for central bank
 - Central bank's autonomy and accountability
- Operational infrastructure
 - Liquidity forecasting framework
 - Payment systems

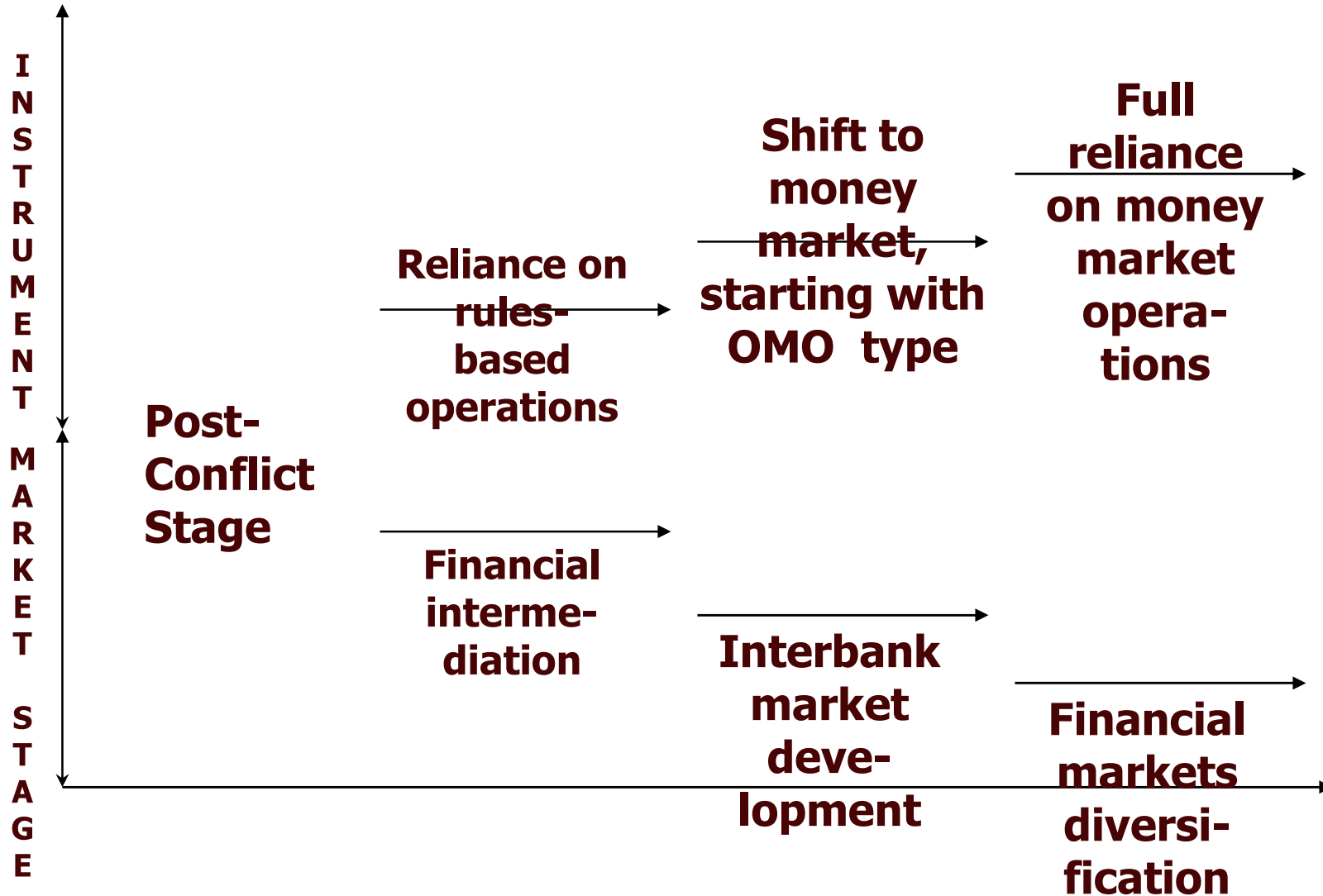
Policy Implications

- Need for sound relationship between CB and government
- Need for strong prudential supervision of financial institutions
- Need for efficient financial market infrastructure
- Advantageous to have phased implementation

Sequencing of reforms

- ***One size does not fit all***: some countries may not be able to rely on full-fledged open market operations
- ***Mix of rules-based instruments and money market operations*** has to be tailored to the level of money market development (see stylized chart)

Stylized Representation of Sequencing



Post Conflict Stage

- Establish key central bank functions
 - Adopt key pieces of legislation
 - Establish payment systems
 - Undertaken currency reform
- Establish commercial banking system
- Monetary policy = currency

Financial Intermediation Stage

- Enhance role of banks in financial intermediation: savings mobilization
- Address structural impediments to bank lending
- Develop role of banks in payment systems
- Separate money creation and government funding
- Reliance on rules-based instruments

Interbank Market Development Stage

- Monetary policy = systemic liquidity management
- Monetary framework: quantities
- Monetary instruments: mix of rules-based and market-based
- Condition: functioning interbank market

Financial Market Diversification Stage

- Monetary framework: prices (interest rate)
- Wider range of options to choose from to structure money market operations
- Reliance on rules-based can be retained: safety valve

The Case of Small Countries

- Some small countries were able to develop effective market-based frameworks
- Countries may not go beyond Stage two
 - Functioning interbank market allows overall liquidity management
 - Monetary policy “anchored” on balance sheet of central bank
- Possible mix of instruments
 - Reserve requirements
 - Standing facilities
 - Money market operations in the interbank market

Implications for Fund operations

- ***Strong case for integration of Fund operations***, including technical assistance, surveillance (FSAP) and use of resources
- ***Next step: develop a menu of options*** for monetary policy conduct that takes into account the underlying impediments to market development