



## Capacity Building Seminar

### Monetary Policy in Transition *The Case for a Two-Pillar Monetary Regime*

October 23-24, 2014

Bali, Indonesia

## LECTURE 2 THE CONCEPTUAL FRAMEWORK

**Bernard J. Laurens**  
Monetary and Capital Markets Department  
International Monetary Fund

## BACKGROUND

- ✘ Background: inflation in single digits and financial deepening
- ✘ Countries moving to flexible monetary policy frameworks with greater role to:
  - + Policy interest rates
  - + Inflation objectives
  - + Forward-looking assessments based on high frequency indicators
- ✘ Some countries (i.e., middle income) have adopted formal IT
- ✘ Others are developing “composite regimes”:
  - + Greater flexibility vis-à-vis monetary targets to accommodate changing money demand and need to develop interest rate transmission channel
  - + Strengthened use of policy rates to signal policy stance,
  - + Implicit inflation targets

## WHAT IS IT ALL ABOUT?

- ✘ Introduction elements of forward-looking monetary policy
- ✘ Audience: transitioning countries, i.e., countries...
  - + Less developed financial markets and analytical capacity at the central bank,
  - + Having achieved a degree of financial stability and inflation moderation...
- ✘ For such countries
  - + Reliance on conventional monetary targeting may be challenged by evolving economic structures...
  - + ...yet adopting an IT regime to anchor inflation expectations may not be desirable or feasible.

## TWO-PILLAR FRAMEWORK

- ✘ An appropriate framework is anywhere on continuum from adherence to a money rule to formal IT.
- ✘ The framework should:
  - + Retain a role for money
  - + Include elements of forward-looking analysis
  - + Include operating procedures that enhance interest rate transmission
- ✘ The options depend on:
  - + Conformity with best practices for effective monetary policy
  - + Status of the transmission channels.

## BUILDING BLOCKS: GENERAL CONSIDERATIONS

- ✘ Institutional
  - + Legal framework for the central bank
  - + The 3 pillars of modern central bank governance
- ✘ Macro-financial
  - + *Ensure macroeconomic stability*: coordination of monetary, fiscal, and foreign exchange policy
  - + *Promote financial stability*: critical for an effective interest rate channel of transmission
- ✘ Technical and organizational
  - + Under the direct control of the central bank...
  - + ... buy capacity building can be a long term exercise

## INSTITUTIONAL BUILDING BLOCK

Specifications	Rationale - Comments	Responsibility
Price stability in law as primary objective of the CB.	Prevent developmental objectives from undermining ability to achieve price stability.	Parliament. Requires consensus in society.
De facto & de jure CB independence & matching level of transparency/accountability.	Independence, transparency and accountability are pillars of CB governance, regardless of the monetary regime in place.	Parliament. Requires consensus in society.

## MACRO-FINANCIAL BUILDING BLOCK

Specifications	Rationale - Comments	Responsibility
Clear separation between monetary and fiscal policy.	Curtail fiscal dominance to contain uncertainties in monetary policy conduct.	CB and MOF
Ability to articulate the role of the exchange rate in the monetary strategy.	Clear objectives and strategy for official intervention consistent with the monetary regime.	Central bank.
Stable, sound and deep financial sector.	CB manages liquidity at aggregate level (allocation among banks via interbank market).	CB, financial regulator and MOF.

## TECHNICAL AND ORGANIZATION BUILDING BLOCK (1/2)

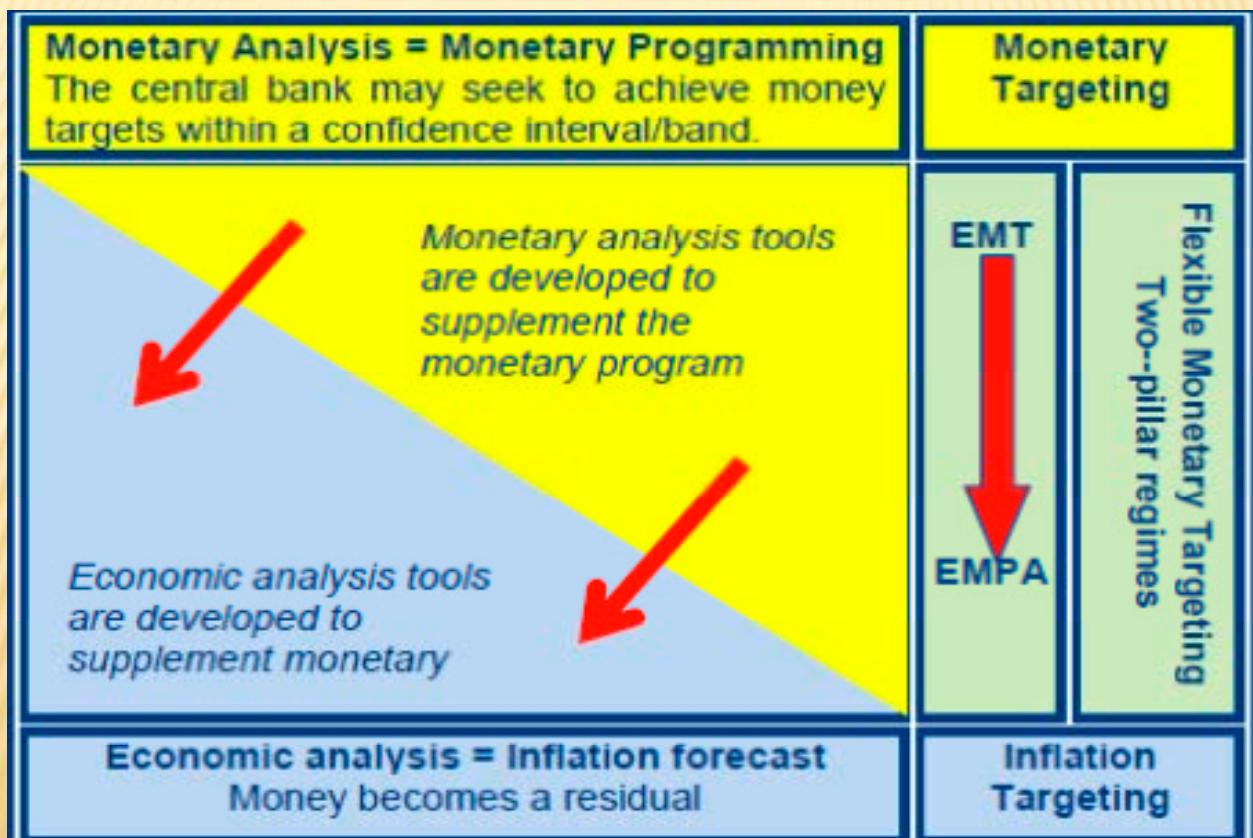
Specifications	Rationale - Comments	Responsibility
Effective liquidity forecasting framework.	CB ensures stable liquidity conditions in money market	Central bank
A set of monetary instruments in line with the level of money market development.	Undertake effective monetary operations, allowing the CB to steer effectively ST market rates.	Central bank
Adequate statistical data.	Provide the CB with the necessary data to support analytical work and macro-modeling.	CB and Statistics office

## TECHNICAL AND ORGANIZATION BUILDING BLOCK (2/2)

Specifications	Rationale/Comments
Tools to communicate effectively policy stance.	Anchor inflation expectations through a transparent communication policy.
Proven CB analytical capacities to support understanding of the transmission channels	Ability to assess role of money, interest rates, and the ER.
Decision-making process and organization to support monetary policy conduct.	Monetary policy decisions made via formal structure taking account of all relevant information.

*PS: all specifications are CB responsibility.*

## TWO-PILLAR FRAMEWORK



## **ENHANCED MONETARY TARGETING (EMT)**

- ✘ Broad money is retained as intermediate target.
- ✘ Monetary operations are calibrated to support the interest rate transmission channel: reserve money targets are loosely followed.
- ✘ Periodic reviews of the broad monetary program that incorporates inputs from enhanced monetary analysis as well as some elements of economic analysis allow assessing the need for adjusting the monetary policy stance.

## **ENHANCED MONETARY POLICY ANALYSIS (EMPA)**

- ✘ Monetary policy analysis centered on an inflation forecast takes center stage,
- ✘ Monetary analysis evolves towards cross-checking economic analysis.
- ✘ This approach is relevant for central banks with a robust model-based analytical capacity.