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# Monetary Policy Implementation at Different Stages of Market Development

By a Staff Team Led by Bernard J. Laurens

INTERNATIONAL MONETARY FUND
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# Preface

The single most salient trend in the practice of monetary policy over the last two decades has been a move toward reliance on money market operations for monetary policy implementation. Nowadays, central bankers around the world agree on the economic benefits of market-based monetary instruments. The move has taken place in an environment where financial markets have become more integrated domestically and internationally. It also reflects the belief that allowing market forces to allocate financial resources brings about increased economic efficiency and growth. However, small economies, or countries with undeveloped financial markets, have found that a lack of competition in financial markets has complicated reliance on money market operations, at times forcing them to rely on direct instruments or moral suasion. In some larger countries, the process has been gradual and at times full of difficulties. Drawing on a variety of country experiences, this paper analyzes the reasons for these difficulties and proposes a stylized sequencing of reforms that enables an introduction of money market operations tailored to each country's particular circumstances.

The material in this paper was prepared in response to questions raised by some Executive Directors regarding the use of market-based monetary instruments in small economies or in countries with undeveloped financial markets and was discussed at an IMF Executive Board seminar on November 17, 2004. It was prepared under the direction of Hervé Ferhani (Senior Advisor, Monetary and Financial Systems Department) by a staff team led by Bernard J. Laurens that included Marco Arnone, Alina Carare, George Iden, Kentaro Iwatsubo, Rodolfo Maino, Obert Nyawata, Andrea Schaechter, and Stephen Swaray. Patricia Mendoza and Galina Menchikova provided outstanding secretarial support. Linda Griffin Kean edited the manuscript and coordinated production.

The paper has benefited from the comments of IMF Executive Directors and colleagues in the Monetary and Financial Systems Department (MFD) and in other departments in the IMF. This paper should not be reported as representing views or policies of the International Monetary Fund. The views expressed in the paper are those of the authors and should not be attributed to the IMF, its Executive Board, or its management.

Stefan Ingves
*Director*
Monetary and Financial Systems Department

# Glossary of Monetary Instruments

The instruments are ordered starting with those that can be used in shallow money markets and ending with those that are effective only in developed money markets. Some of the instruments, i.e., reserve requirements and standing facilities, may be used at all stages of money market development.

- **Rules-based instruments**: Monetary instruments based on the regulatory power of the central bank. These include:
  - **Liquid asset ratios (LARs):** Requirements for a bank to hold minimum amounts of specified liquid assets, typically as a percentage of the bank's liabilities.
  - **Reserve requirements (RRs):** Requirements for a bank to hold minimum balances with the central bank, typically as a percentage of its liabilities. When averaging provisions are allowed, banks can fulfill reserve requirements on the basis of average reserve holdings during the maintenance period.
  - **Standing facilities:** Monetary instruments used at the initiative of banks and bearing a pre-specified interest rate which allow banks to borrow from the central bank (refinance standing facility) or deposit funds with the central bank (deposit standing facility).

- **Money market operations:** Monetary instruments used at the discretion of the central bank and bearing an interest rate linked to money market conditions. These are meant to influence the underlying demand and supply conditions for central bank money. They include:
  - **Open market–type operations:** Market-based monetary operations based on auction techniques regulated by the central bank. OMO-type operations involve (1) lending/borrowing with underlying assets as collateral, (2) primary market issuance of central bank securities or government securities for monetary policy purposes, and (3) acceptance of fixed-term deposits.
  - **Open market operations (OMOs):** Market-based monetary operations conducted by the central bank as a participant in the money market. OMOs involve (1) buying/selling assets outright on the secondary market and (2) buying/selling assets under a repurchase agreement in the repo market or through foreign exchange swaps.
  - **Auction techniques:** Used by central banks in their money market operations, these include: (1) volume tenders, with banks bidding only for volumes supplied by the central bank at a preset interest rate; and (2) interest rate tenders, with banks bidding for both the amount and the rate; the central bank charges the rates offered (multiple-rate auction) or the cutoff rate (uniform-rate auction).
  - **Fine-tuning operation:** An irregular money market operation executed mainly to deal with unexpected liquidity fluctuations in the market.

# Part I

# A Framework for Sequencing Reforms

# I Overview

Central bankers around the world generally agree on the benefits for the economy of using market-based instruments to implement monetary policy. Following a trend initiated in the 1970s in industrial countries, central banks in most developing countries and emerging market economies have attempted to regulate overall liquidity conditions in the economy through financial operations in the domestic money markets. The objective of these central banks has been to influence the underlying demand and supply conditions for central bank money. The move was the parallel in the monetary area of the trend toward enhancing the role of price signals in the economy in general. It aimed at improving domestic savings mobilization and strengthening their market allocation.

The process was not without difficulties in those countries that did not succeed in developing their money markets. A survey of country experiences shows that failure to establish a clear separation between money creation and government funding needs often limited the effectiveness of money market operations, as did limited market participation and the lack of an effective framework to determine the timing and size of the central bank's money market operations.

The experience of countries at different stages of money market development shows that the timing and speed of moving toward reliance on money market operations to conduct monetary policy must be tailored to each country's particular circumstances. A stylized sequencing can be mapped into a four-stage process:

- Stage zero refers to the situation of post-conflict countries. Financial reforms involve reestablishing key functions in those areas where a central bank typically has responsibilities.
- Stage one in the process involves developing financial intermediation. Monetary policy relies on rules-based instruments—that is, instruments based on the regulatory power of the central bank, such as reserve requirements or deposit or refinance facilities available to the banks on demand, under certain preset conditions.
- Stage two involves fostering interbank market development. Money market operations can be introduced at this stage, but rules-based instruments retain an important role. Countries with limited market participation—for instance due to the small size of their economy—may not progress beyond stage two.
- Stage three involves the diversification of markets. At the end of stage three, liquidity management can fully rely on money market instruments.

This paper supports the close integration of the work of the International Monetary Fund's area departments (i.e., surveillance or use of resources) with the Fund's technical assistance in monetary policy design and implementation. This integration is particularly relevant for countries in transition to market-based frameworks for the implementation of monetary policy.