Monetary Policy and Central Banking

Central banks have a crucial role to ensure economic and financial stability. They conduct monetary policy to achieve low and stable inflation. In the wake of the global financial crisis, central banks have expanded their toolkits to deal with risks to financial stability, and to manage volatile exchange rates. Central banks need clear policy frameworks to help achieve their objectives. Operational frameworks tailored to country circumstances enhance the effectiveness of central bank policy. The IMF supports countries around the world by providing policy advice and technical assistance.

Monetary policy

A key role of central banks is to conduct monetary policy to achieve price stability (low and stable inflation), and help manage economic fluctuations. The policy frameworks within which central banks operate have been subject to major changes over recent decades.

Since the late 1980s, inflation targeting has emerged as the leading framework within which monetary policy is conducted. Many central banks, for example in Canada, the euro area, the United Kingdom, and New Zealand have introduced an explicit inflation target. More recently, many low-income countries are also transitioning from targeting a monetary aggregate (a measure of the volume of money in circulation) to an inflation targeting framework.

Operationally, central banks conduct monetary policy by adjusting the supply of money, generally through open market operations. For instance, the central bank may purchase government debt from commercial banks and thereby increase the money supply (monetary easing). The purpose of open market operations is to steer short term interest rates, which is expected to then influence longer term rates and overall economic activity. In many countries, especially low-income countries, the transmission mechanism from changes in money supply to interest rates are not as effective. Prior to moving from monetary to inflation targeting, countries need to first develop a framework to enable the central bank to target short-term interest rates.

Following the global financial crisis, advanced economy central banks eased monetary policy by lowering interest rates until rates came close to the zero lower bound, which limited conventional monetary options. With the danger of deflation rising, central banks undertook unconventional monetary policies, including buying bonds (especially in the U.S., U.K., and Japan) with the aim of further lowering long term rates and loosening monetary conditions.

Foreign exchange regimes and policies

The choice of a monetary framework is closely linked to the choice of an exchange rate regime. A country that has a fixed exchange rate will have no scope for an independent monetary policy compared with one that has a more flexible exchange rate regime. Although some countries may have a flexible exchange rate they still try to manage its level, which could involve a trade-off with the objective of price stability. A fully flexible exchange rate regime supports an effective inflation-targeting framework.
Macroprudential policy

The crisis has shown that countries need to contain risks to the financial system as a whole with dedicated financial policies. Many central banks that also have a mandate to promote financial stability have upgraded their financial stability frameworks, including by establishing macroprudential policy frameworks. Macroprudential policy needs a strong institutional framework to work effectively. Central banks are well placed to conduct macroprudential policy as they have the capacity to analyze systemic risk. In addition, they are often relatively independent and autonomous agencies. In many countries, legislators have assigned the macroprudential mandate to the central bank or to a dedicated committee within the central bank. Regardless of the choice of the model used to implement macroprudential policy, the institutional set up should be strong enough to counter opposition from the financial industry and political pressures, and establish the legitimacy and accountability of macroprudential policy. It needs to ensure policymakers are given clear objectives and the necessary legal powers, and foster cooperation on the part of other supervisory and regulatory agencies.

How the IMF supports effective central bank frameworks

The IMF promotes effective central bank frameworks through:

- **Multilateral surveillance** and policy papers to help improve global outcomes. For example, by providing policy advice on how to avoid potential side effects from the implementation and exit of unconventional monetary policy.

- Regular dialogue as part of bilateral surveillance (Article IV consultation). The IMF provides policy advice to countries on monetary policy action to achieve low and stable inflation, as well as on establishing an effective monetary policy and macroprudential policy frameworks.

- **The Financial Sector Assessment Program**, which provides member countries with an evaluation of their financial system, and in-depth advice on policy frameworks to contain and manage financial stability risks, including the macroprudential policy framework.

- Country programs supported by an IMF arrangement often include measures to strengthen monetary policy and central banking issues.

- **Technical assistance** helps countries develop more effective institutions, legal frameworks, develop capacity through training, and provides advice on various central bank policies. Topics include monetary policy frameworks, exchange rate regimes, transitioning from monetary aggregate targeting to inflation targeting, improving central bank operations (such as open market operations, foreign exchange market), and macroprudential policy implementation.