Introduction to Monetary Policy

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Outline

I. Central Bank Objectives

II. Monetary Policy Frameworks

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Central Bank Objectives: Inflation

“...it was clearly understood that my task was to get inflation above zero and below 2%.”

Don Brash, former RBNZ Governor
Central Bank Objectives: Foreign Exchange Stability

Avoiding large, sudden foreign exchange outflows!

- Shortage of foreign exchange can lead to loss of confidence in domestic currency
- Exchange rate needs to be competitive
Central Bank Objectives: Financial System Stability

Keeping the banking system solvent!

Well-functioning credit and payment system
## Central Bank Objectives & Functions

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Central Bank Objectives: Historical Experience in Myanmar

Annual CPI Inflation Rates (1996-2013)
Central Bank Objectives: CBM Law

Objectives specified in CBM law

CBM Law, Chapter II:

• The aim of the Central Bank shall be to maintain and preserve domestic price stability

• The Central Bank shall, in accordance with its aim, also endeavor to attain the following objectives:

  ✓ To promote monetary stability
  ✓ To enhance financial system stability
  ✓ To develop efficient payments and settlement system
  ✓ To support the general economic policy of the Government conducive to sustained economic development
Outline

I. Central Bank Objectives

II. Monetary Policy Frameworks
Monetary Policy Frameworks

Central challenge for monetary policy frameworks:
Long gaps between policy decision and ultimate objective!
Role of Targets

As a result of the long transmission lag between central bank instrument and ultimate objective, operating and intermediate targets are needed.

**Target**: proximate goals, not objectives in and of themselves; work directly toward achieving the long-term objectives of policy.
Operating Targets

**Operating target:** tactical goals that the central bank can influence in the short run

- Reserve money/ monetary base: The central bank can control the size of its own balance sheet
- Short-term interest rates (e.g., interbank rate (“federal funds”) in the U.S.)
Intermediate Targets

Providing a Link to the Ultimate Objective

• Criteria for intermediate targets
  – Consistent with ultimate goals
  – Can be accurately measured
  – Timely
  – Can be influenced by the central bank
Intermediate Targets as Nominal Anchor

• A ‘nominal anchor’ is an intermediate target that helps to pin down inflationary expectations

• The choice of an intermediate target defines the monetary policy framework
  – Exchange rate anchor
  – Monetary aggregate target
  – Inflation targeting
Classification of Monetary Frameworks

Exchange Rate Regimes

- **Dollarization** or currency union
- **Currency board**
- **Peg**
  - Fixed
    - Horizontal bands
  - **Crawling peg**
    - Without bands
    - With bands
  - **Floating**
    - Managed
    - Independent
Exchange Rate Regime in Myanmar: Historical Perspective

- Official rate was very stable between 1950 and 2011—but it was set by government with no relationship to economic developments.

- In 2012, official rate was allowed to float and brought in line with market rate.
Exchange Rate Regime Myanmar: 2013

- April 2012: CBM started daily foreign currency auctions to determine exchange rate
- **De jure**: effective April 2, 2012, the de jure exchange rate arrangement was reclassified to a managed float from a conventional peg
- **De facto**: due to multiple exchange rates, de facto regime is classified as other managed arrangement
Monetary Targeting Regime

Policy Decision → Monetary Operations

Reserve Money → Broad Money

Broad Money on track? → Inflation
Monetary Framework in Myanmar

Historically close link between broad money and prices:

![Graph showing the relationship between broad money and CPI indices from 2001 to 2012. The graph depicts a steady upward trend for both indices, with the CPI (2005=100) and broad money (2005=100) indices starting from low values in 2001 and rising consistently.]
Monetary Framework in Myanmar

Historically, reserve money and broad money are also closely linked:

This opens possibility for central bank to influence prices via its control over reserve money and the broad money-price linkage.
Monetary Framework in Myanmar

More recently, there is still a close link between reserve money growth and inflation:

![Chart showing Reserve Money & Headline CPI (Y-o-Y Change in %)]
Make a convincing case that inflation forecast is on track
Thank You!

In the next lecture, you are going to hear more about reserve money and the CBM balance sheet.