OVERVIEW OF MONETARY AND EXCHANGE RATE POLICY REGIMES

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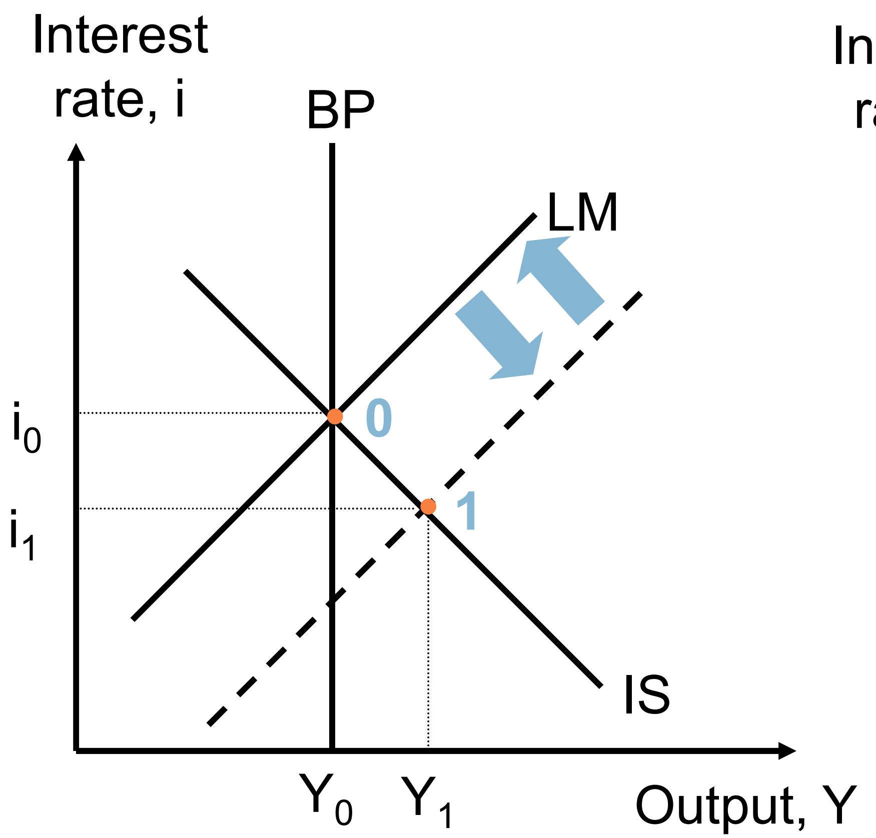
Overview

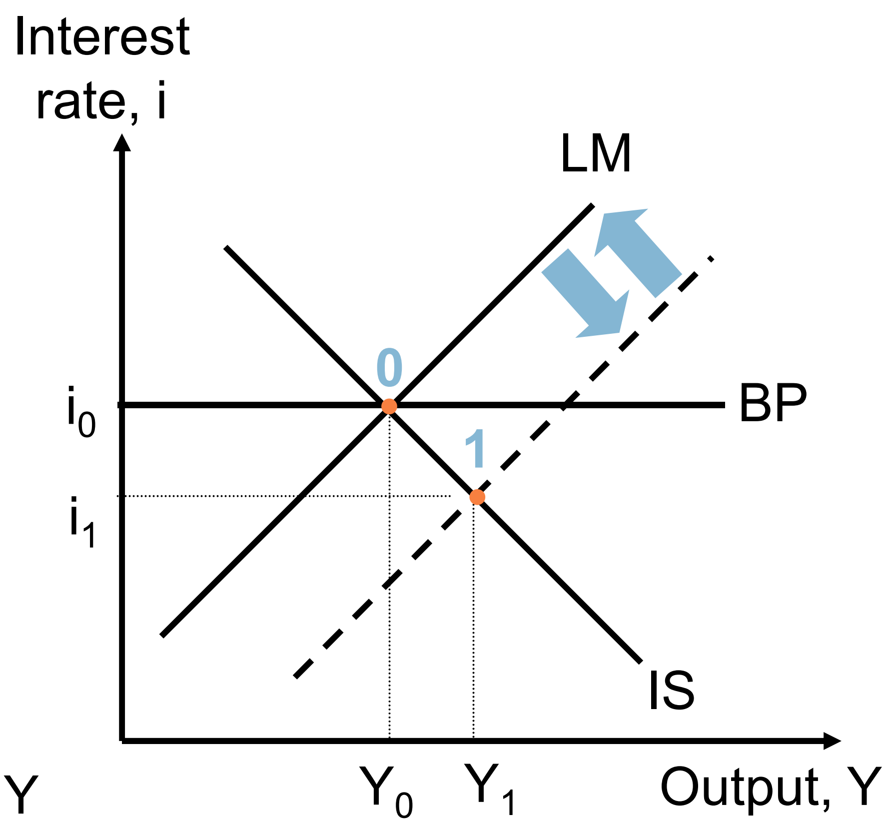
I. Introduction
II. Central Bank Objectives
III. Implementing Monetary Policy
IV. Fundamental Policy Trade-Offs
V. Designing a Monetary and Exchange Policy Regime for Myanmar

I Introduction—Conventional Academic Approach to Monetary Policy Analysis

Fixed exchange rates



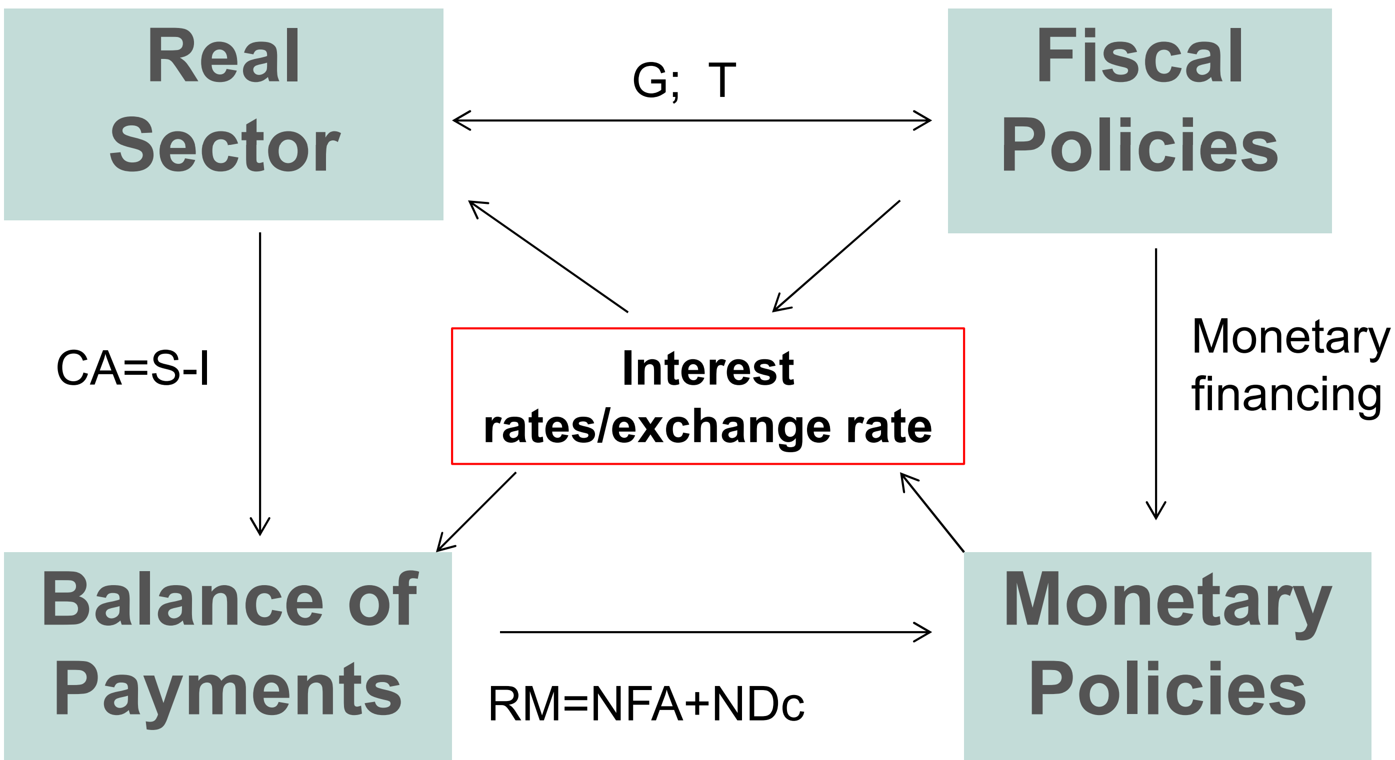
No capital mobility



Perfect capital mobility

Introduction—Taking a Step Back: Distinguishing Between Different Macroeconomic Sectors

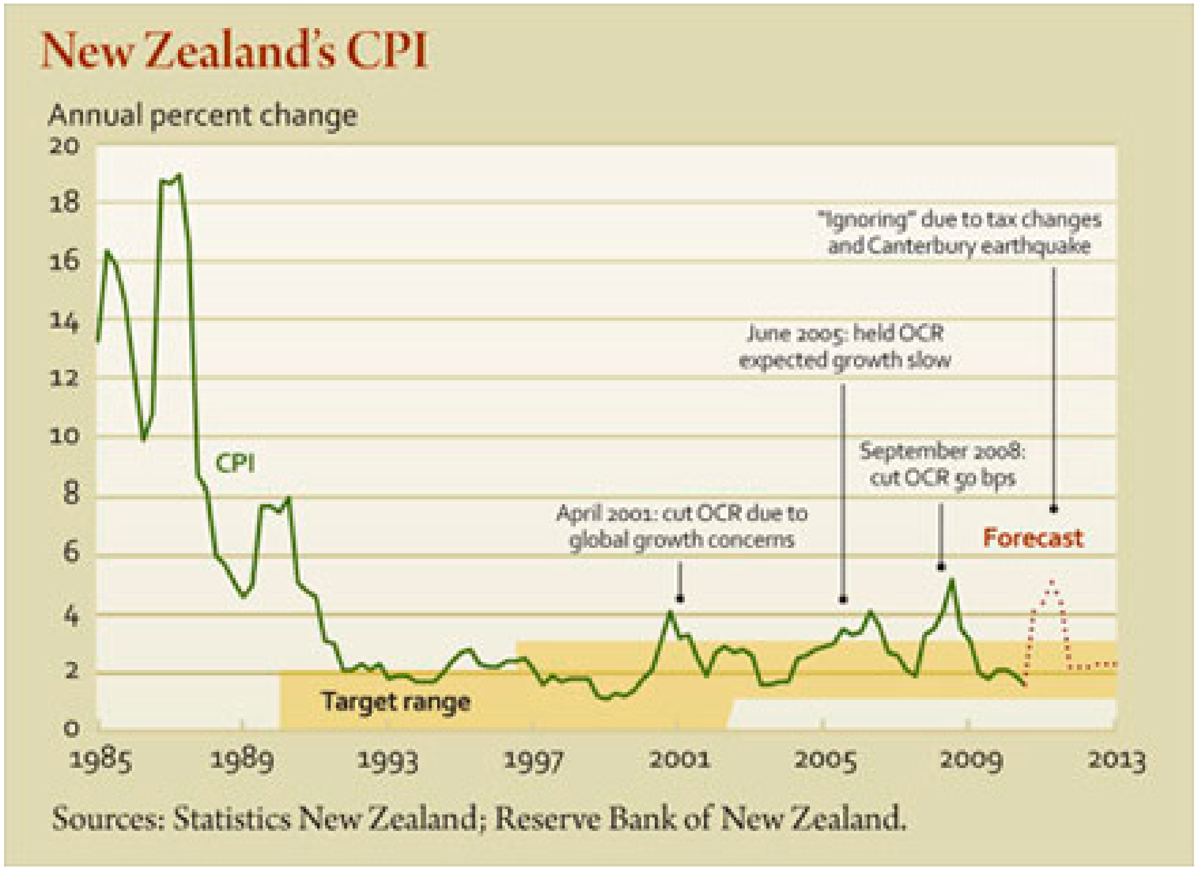
Capturing linkages between sectors



Introduction—Questions We Want to Ask

- What is it a central bank wants to achieve (central bank objectives)?
- How does monetary policy operate and what are the transmission mechanisms?
- What are the fundamental monetary policy trade-offs?
- Taking all this into account, what is the appropriate monetary and exchange rate policy regime for Myanmar?

II 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

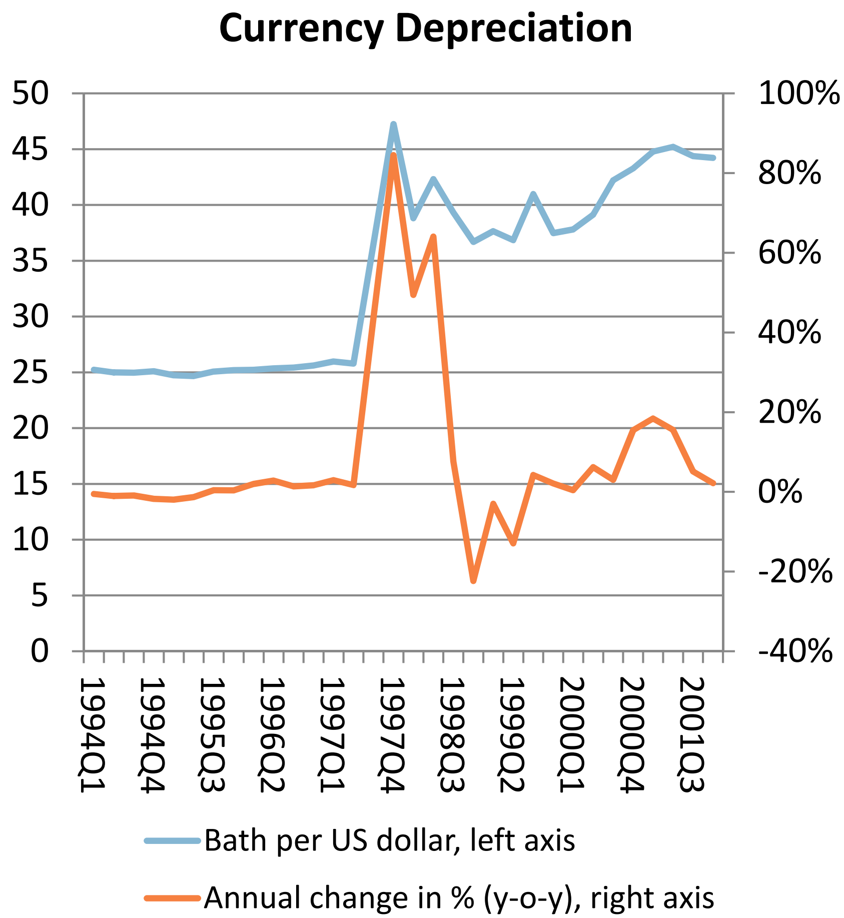
Central Bank Objectives: Foreign Exchange Stability

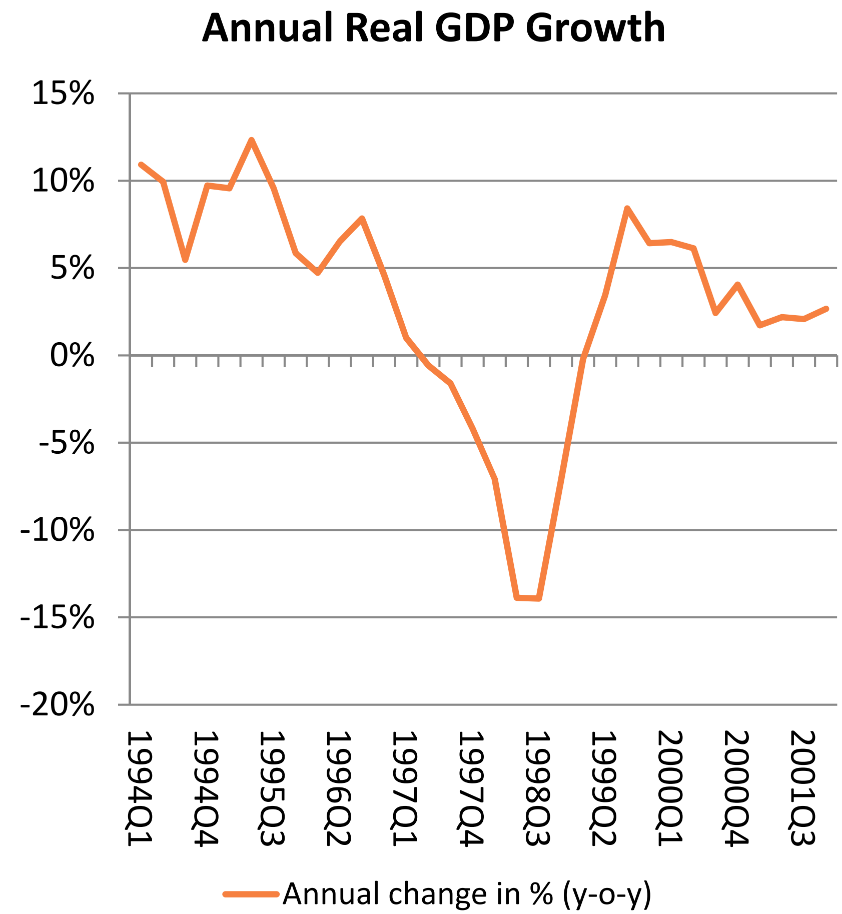
Avoid currency crisis!

- Many examples of currency crisis—always very painful!
- Typical immediate cause:
  - ✓ some type of external shock drains foreign exchange reserves
  - ✓ shortage of foreign exchange leads to loss of confidence in domestic currency
- Typical underlying cause: exchange rate became uncompetitive over time

Central Bank Objectives: Foreign Exchange Stability

One of many examples: Thailand (Asian Crisis, 1997-98)



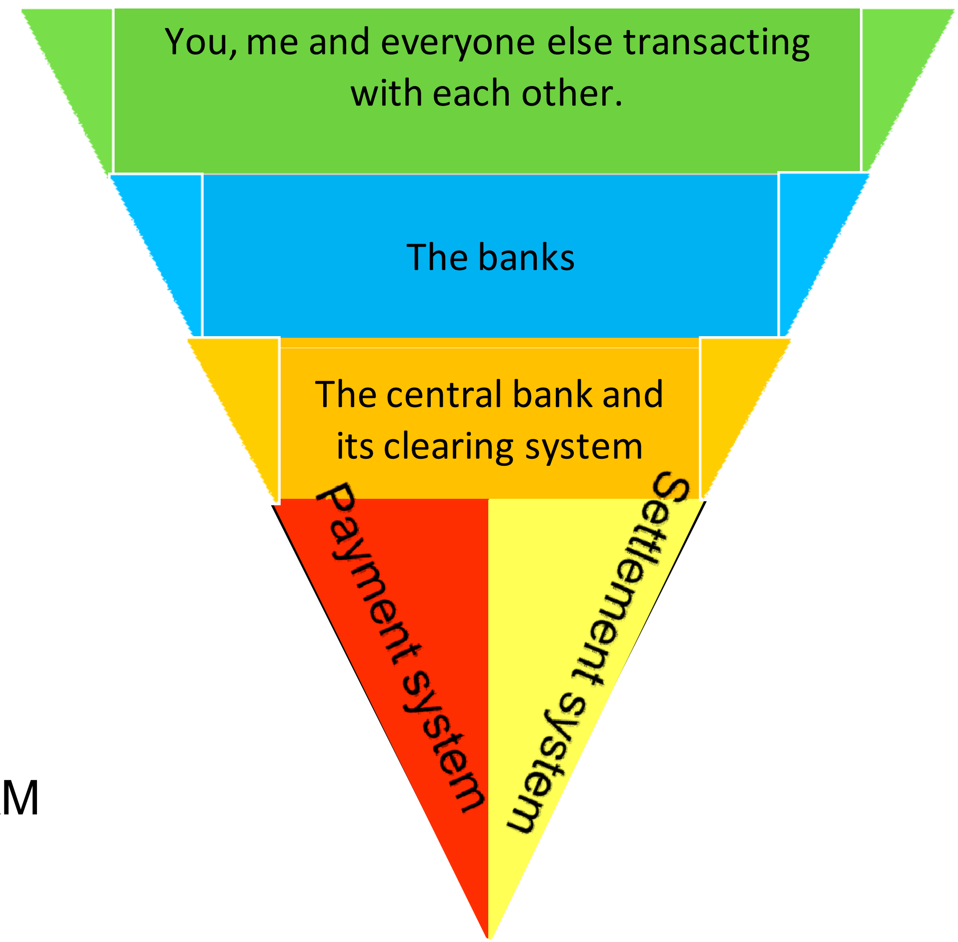


Central Bank Objectives: Financial System Stability

Keeping the banking system solvent!

Well-functioning credit and payment system

The payments pyramid



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Central Bank Objectives & Functions

Monetary Stability

- Monetary policy
- Exchange rate policy

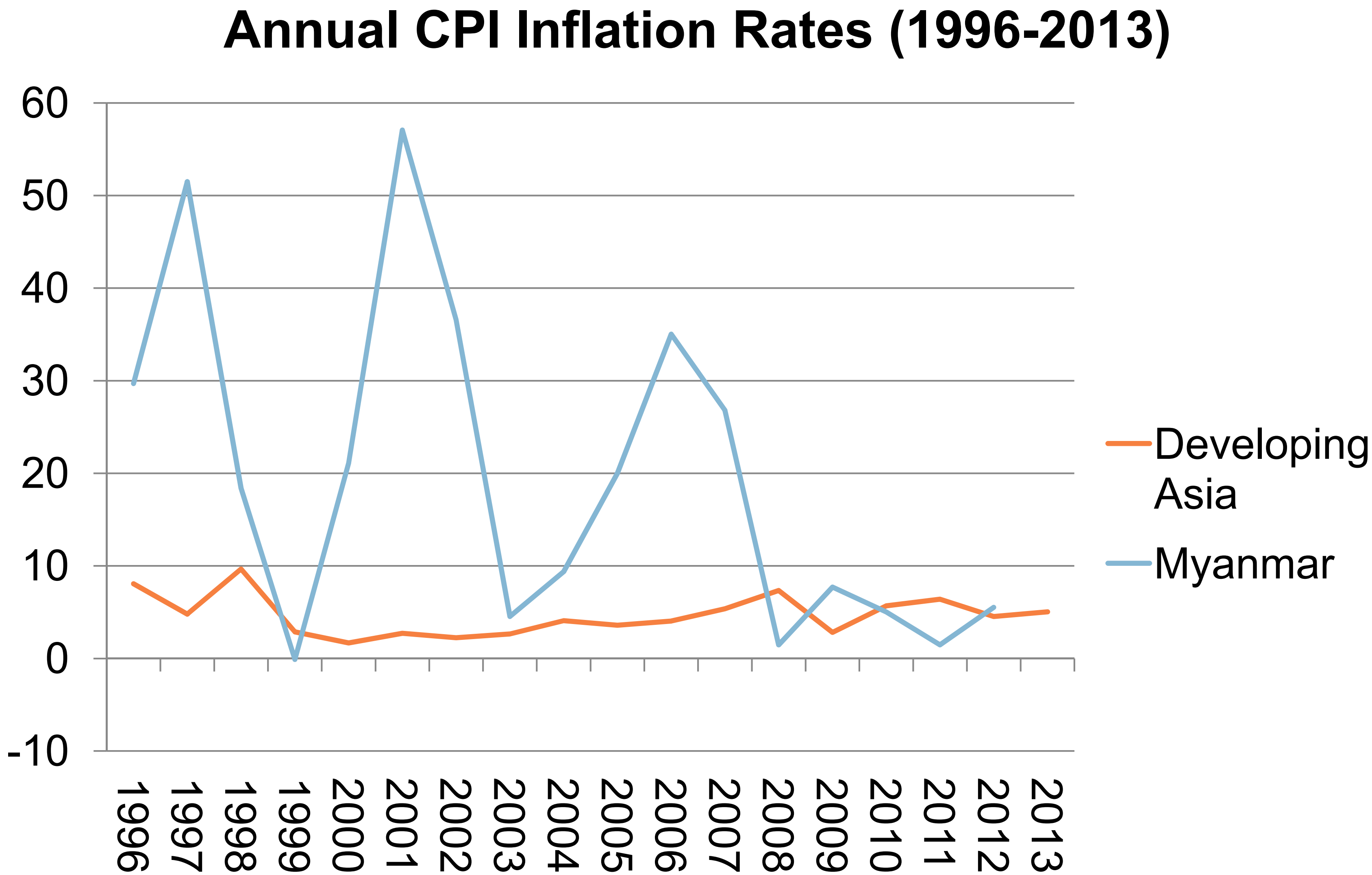
Financial stability

- Prudential policy
- Supervision, oversight

Policy Operation Functions

- FX intervention
- FX reserve management
- Liquidity management
- Lender of last resort

Central Bank Objectives: Historical Experience in Myanmar



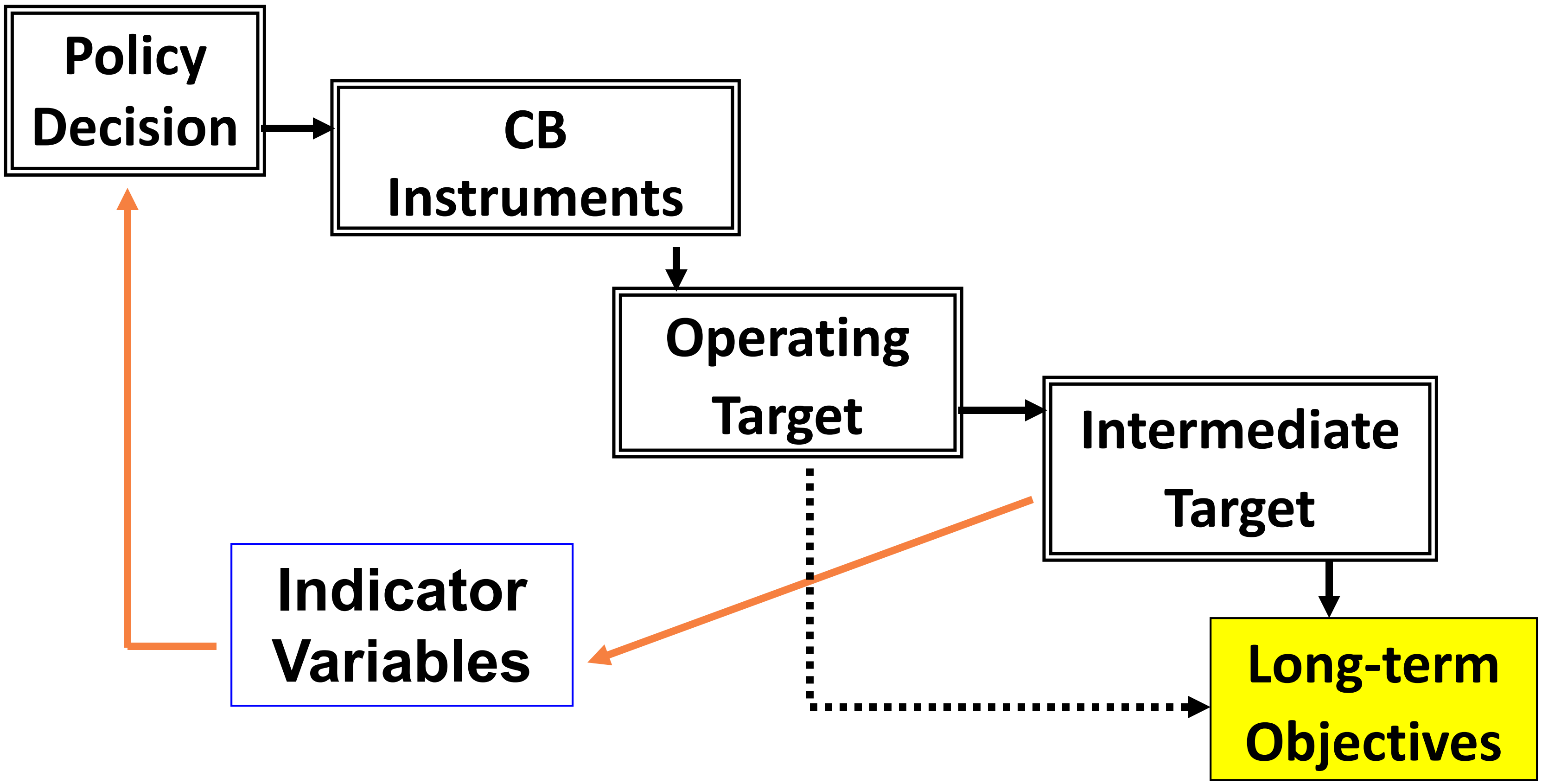
Central Bank Objectives: CBM Law

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

III Implementing Monetary Policy

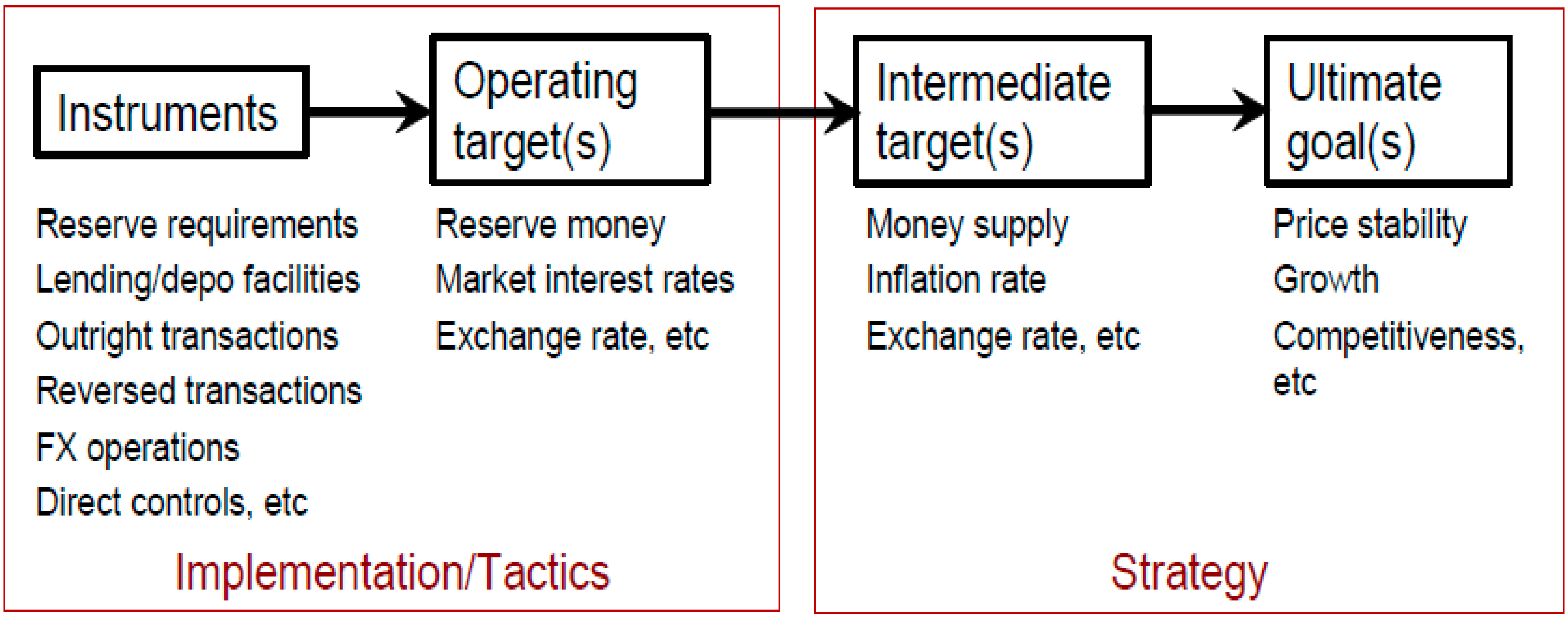


Implementing Monetary Policy: Choices

Monetary policy:

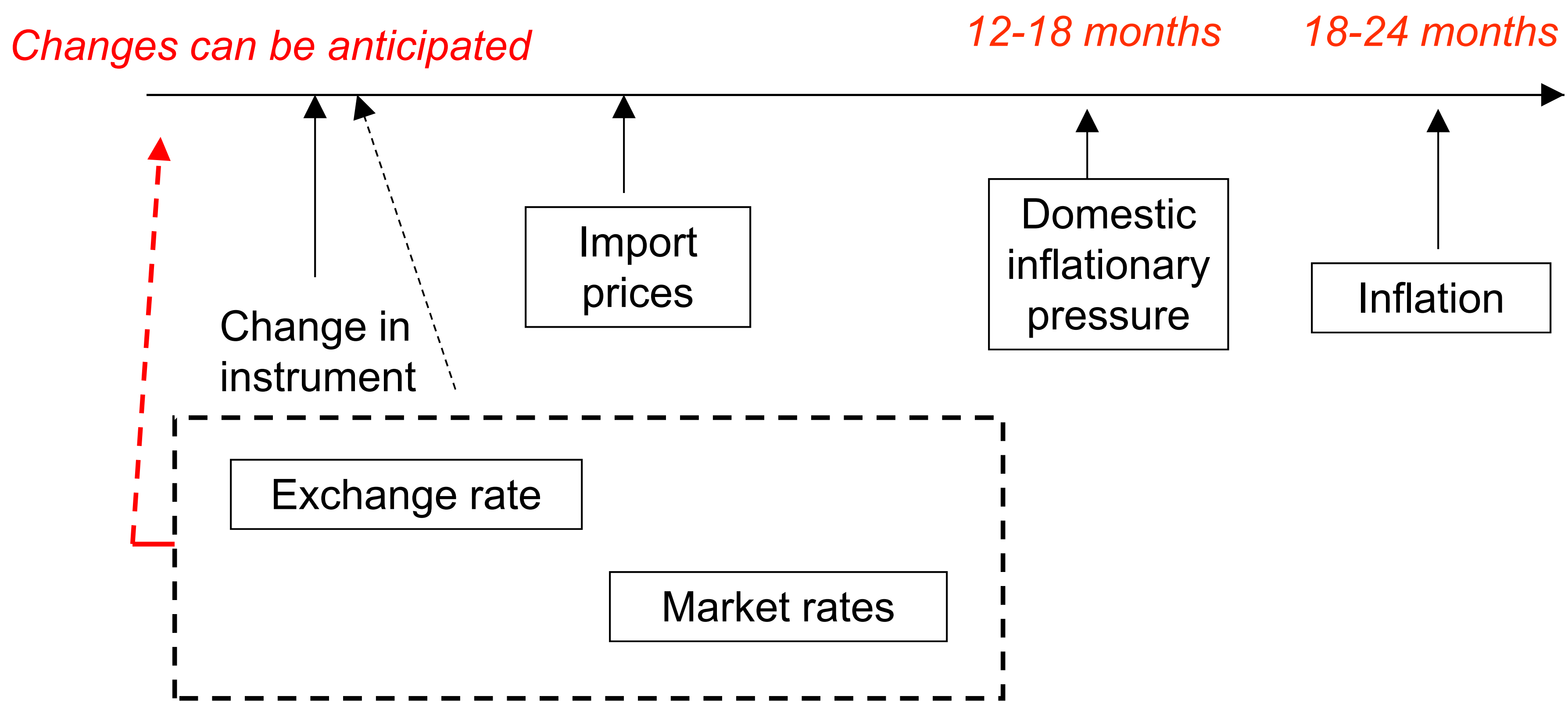
Instruments/ tools: (Direct) (Indirect) → **Operating Target:** (Reserve Money, Interest Rate) → **Framework: Intermediate Target** (nominal anchor: Exchange rate, Monetary Aggregate, IT) → **Ultimate Objectives**

Implementing Monetary Policy: Tactics & Strategy



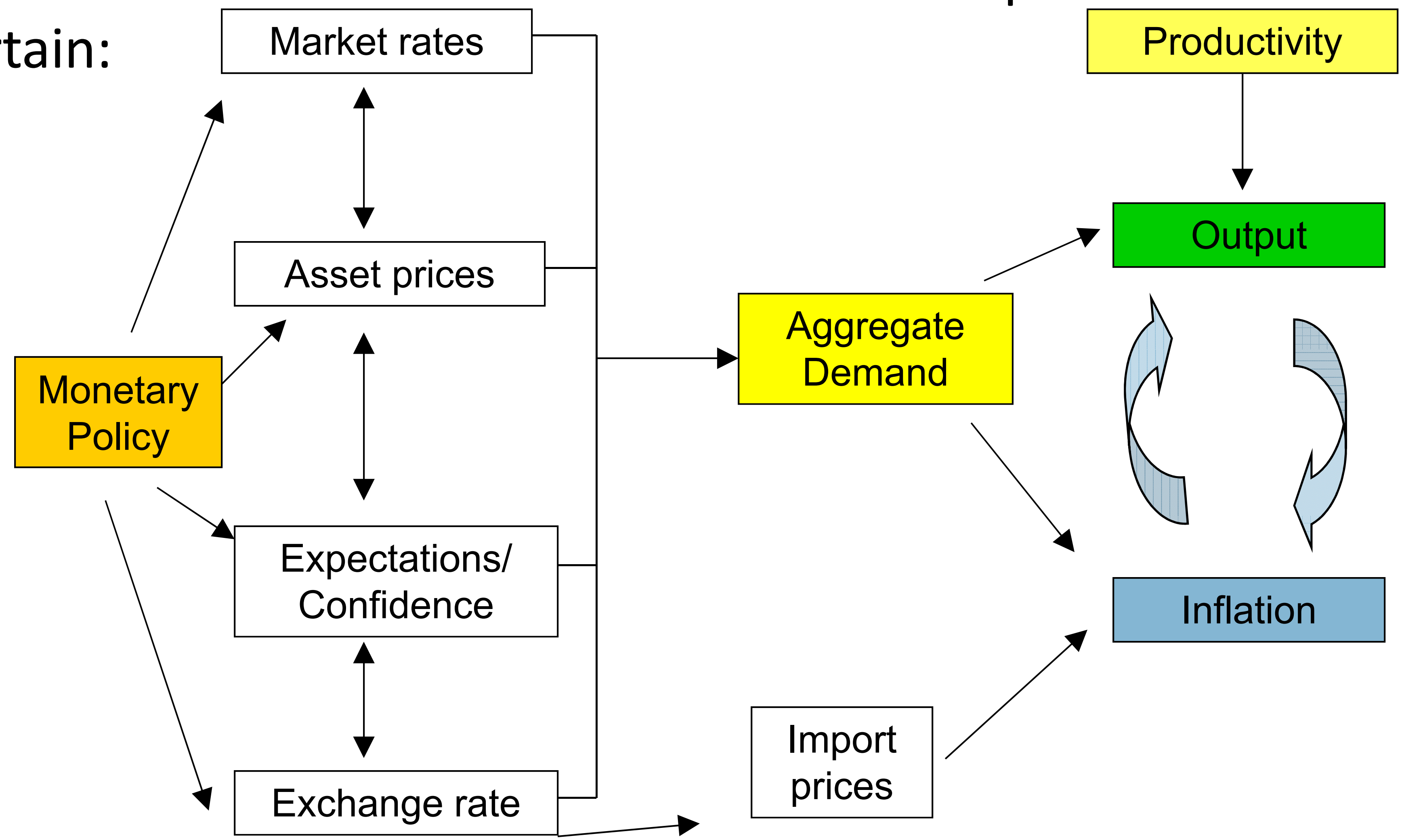
Implementing Monetary Policy: Why is there a Need for Strategy?

… because of long lags in the transmission of monetary policy,



Implementing Monetary Policy: Why is there a Need for Strategy?

… because the transmission mechanism is complicated and uncertain:



Implementing Monetary Policy: Choice of Instruments

When implementing monetary policy, central banks can either act directly, using its regulatory power, or indirectly, using its influence on money market conditions.

- **Direct instruments** operate by setting or limiting either prices or quantities through regulations
- **Indirect instruments** act through the market, by adjusting the underlying demand for, and supply of, bank reserves;

Implementing Monetary Policy: Direct Instruments

- Direct Controls on interest rates
  - For instance, minimum and maximum interest rates, preferential rates for certain loan categories, etc;
- Credit ceilings
  - At aggregate level or on individual banks;
- Directed lending policies
  - For instance, preferential central bank refinance facilities to direct credit to priority sectors;
- High reserve and liquid asset requirements
  - Designed both to absorb liquidity and to provide government deficit financing.

Implementing Monetary Policy: Indirect Instruments

- Open-market operations
  - Outright transactions and repo/reverse repo agreements
- Standing facilities
  - "Lender of last resort."
  - Discount window, lending and deposit facilities, etc.
- Reserve requirements

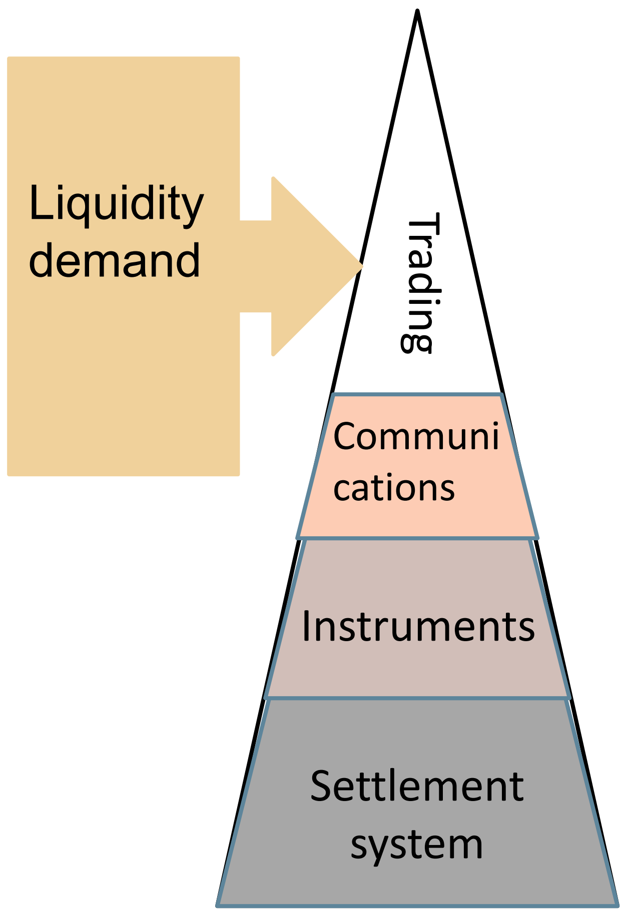
Implementing Monetary Policy: Pros of Indirect Instruments

- Indirect instruments are considered more market friendly and are less distortionary than direct instruments.
  - ➢ Focus on system-wide liquidity;
  - ➢ Transmit policy signals;
  - ➢ Allow for optimal allocation of financial resources on the basis of risk and return.
- Most countries have moved or are moving towards using indirect instruments.

Implementing Monetary Policy: Prerequisites of Indirect Instruments

- Eliminate insolvent banks and establish adequate prudential regulation
- Develop primary market for government securities
- Develop secondary market for government securities
- Establish interbank money market

Interbank requirements



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Implementing Monetary Policy: Choice of Operating Target

Price vs. Quantity

INTEREST RATE

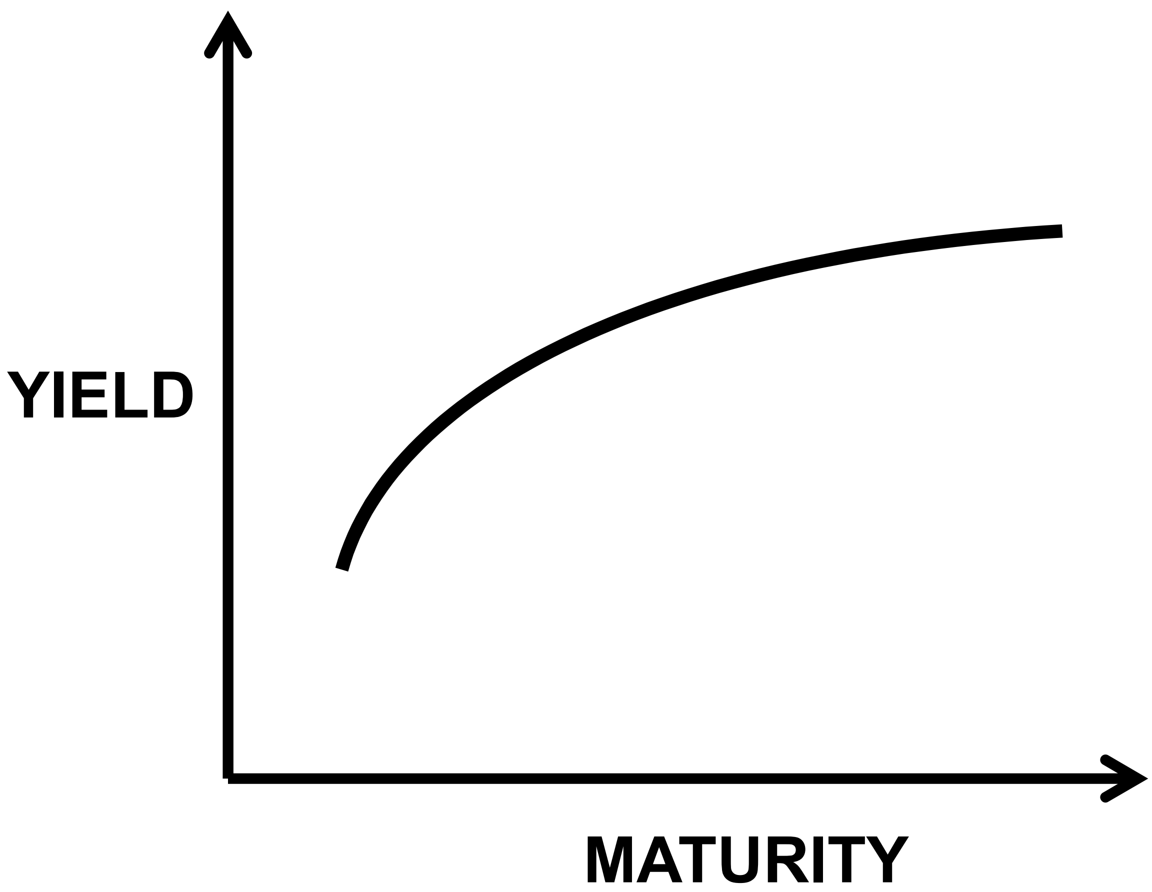
- Reduces rate fluctuations
- Easy to monitor
- Clear signal of monetary stance
- Requires strong interest rate channel
- Requires developed money markets

MONETARY BASE

- Appropriate when transmission is through quantities
- Developed money markets not necessary
- Generates interest rate fluctuations
- Less timely

Implementing Monetary Policy: Interest Rate Targeting & Yield Curve

Normal Yield Curve



Implementing Monetary Policy: Interest Rate Pass-Through

Tools

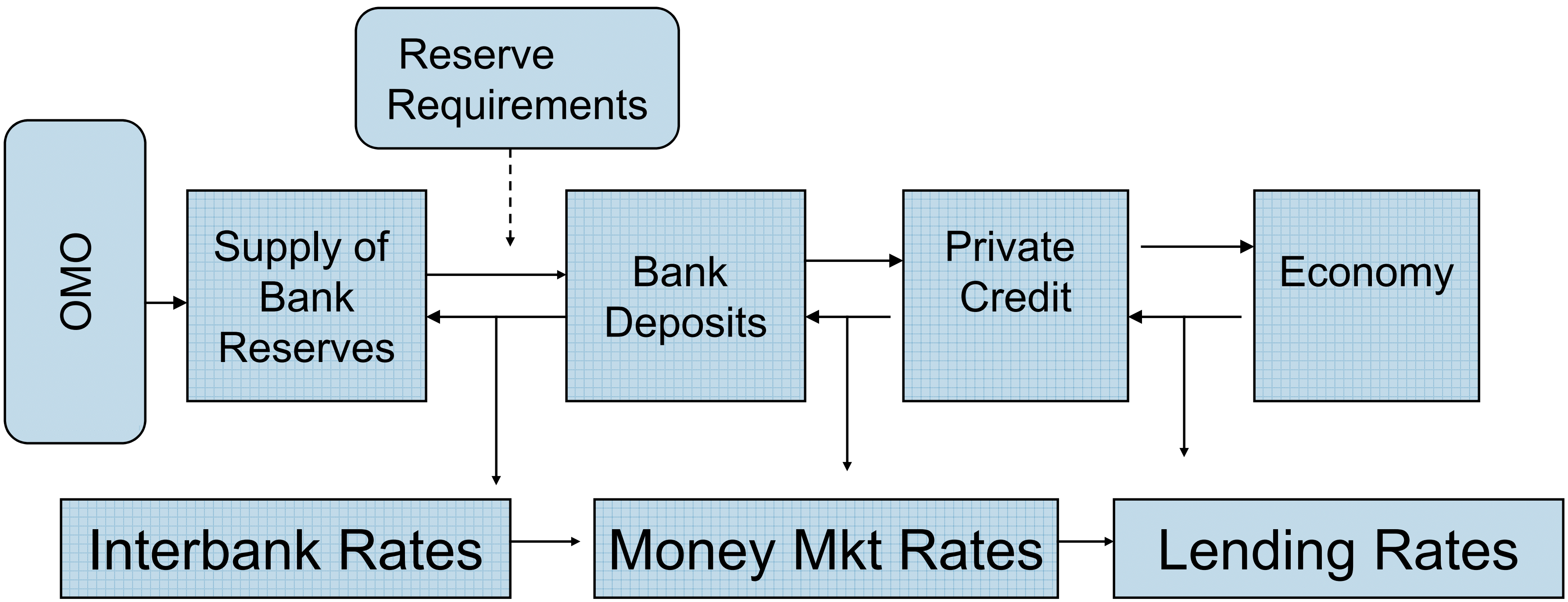
i. Open Market Operations

ii. Standing Facilities

iii. Reserve Requirements

Effectiveness

iv. Pass through from policy rate to money market rates



Implementing Monetary Policy: Intermediate Targets

Intermediate targets provides closer link to ultimate objectives:

- Criteria for intermediate targets
  - Consistent with ultimate goals
  - Can be accurately measured
  - Timely
  - Can be influenced by the central bank

Implementing Monetary Policy: Intermediate Targets as Nominal Anchor

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

Implementing Monetary Policy: Choice of Intermediate Targets

Classification of Monetary Policy Frameworks

1. Exchange rate targeting
2. Monetary aggregates targeting
3. Inflation targeting
4. Other “eclectic” frameworks

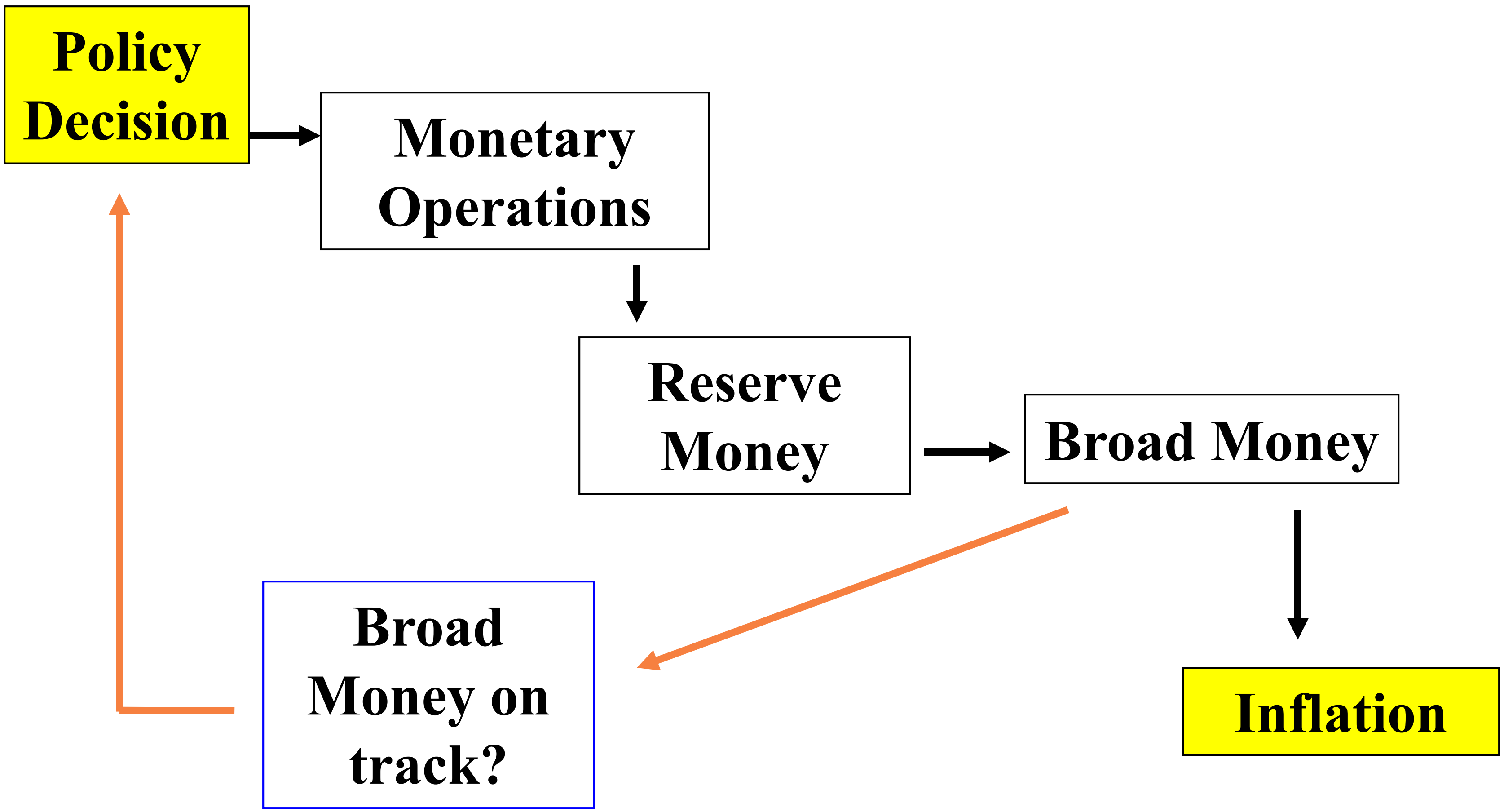
Implementing Monetary Policy: Choice of Exchange Rate Regimes

- **Dollarization** or currency union
  - **Currency board**
    - **Peg**
      - Fixed
      - Horizontal bands
        - **Crawling peg**
          - Without bands
          - With bands
            - **Floating**
              - Managed
              - Independent

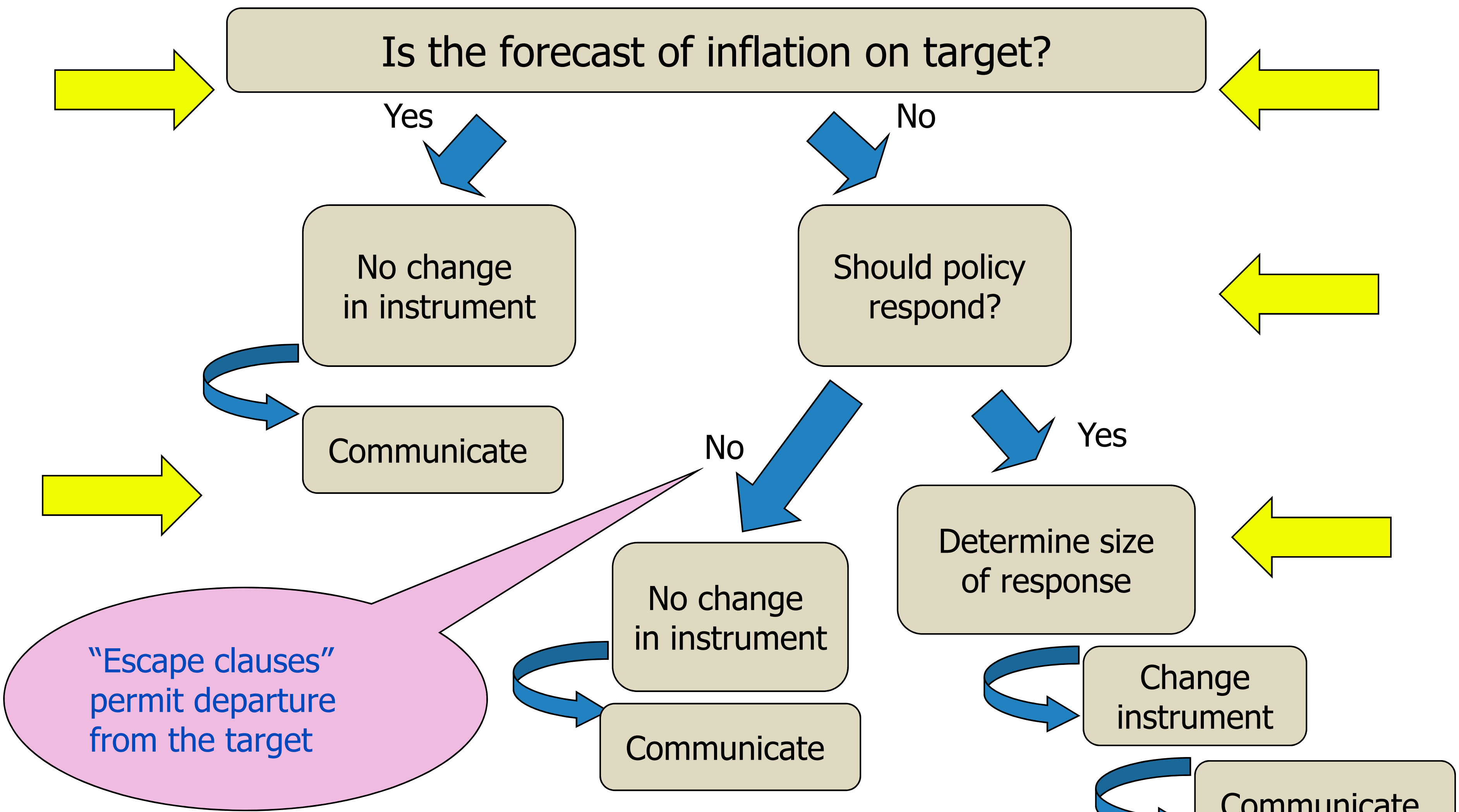
FIXED

FLEXIBLE

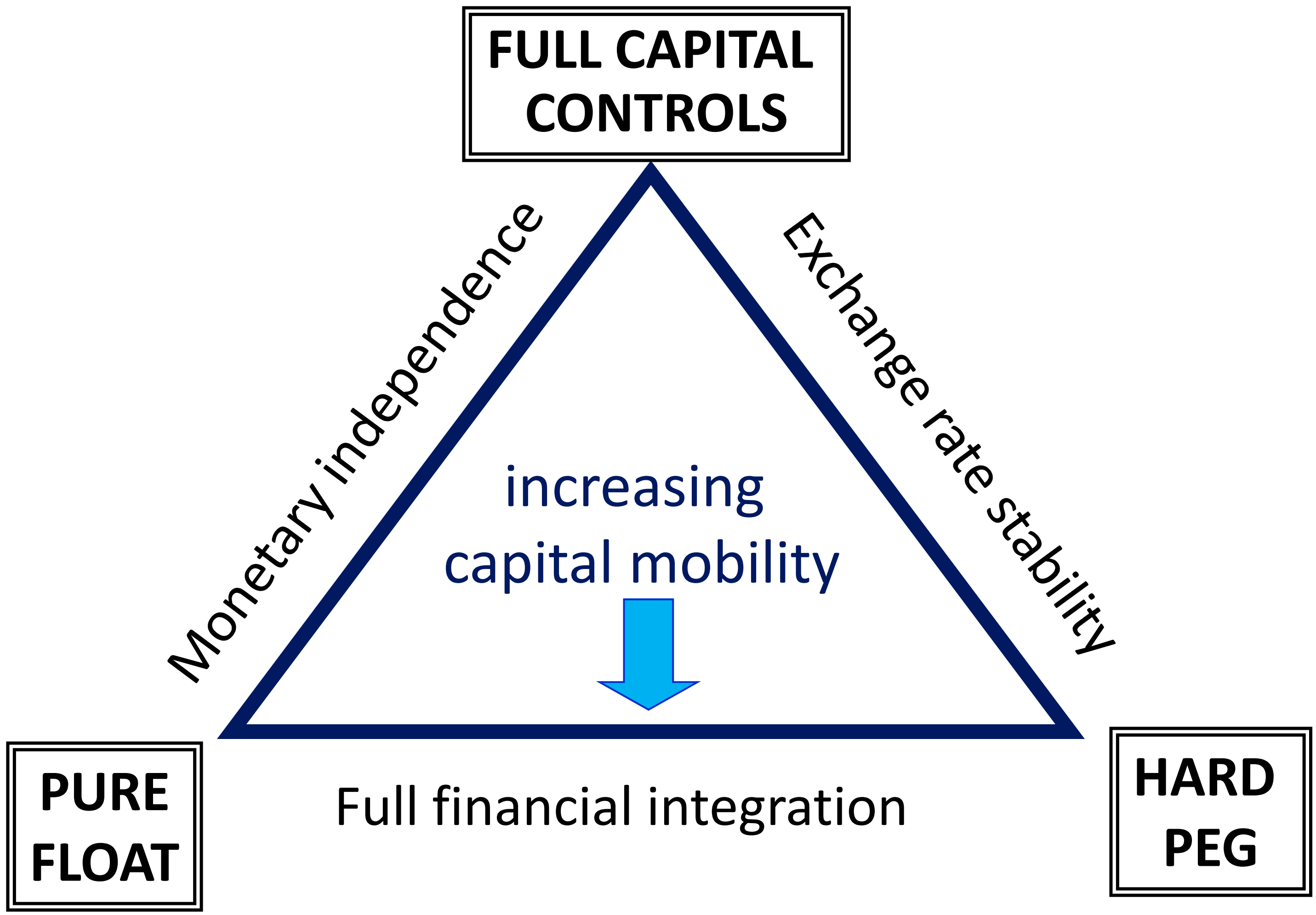
Implementing Monetary Policy: Monetary Targeting



Implementing Monetary Policy: Inflation Targeting



IV Fundamental Policy Trade-Offs: Monetary Policy Trilemma



Fundamental Policy Trade-Offs: Monetary Policy Trilemma

It is impossible to simultaneously maintain:

- a fixed exchange rate

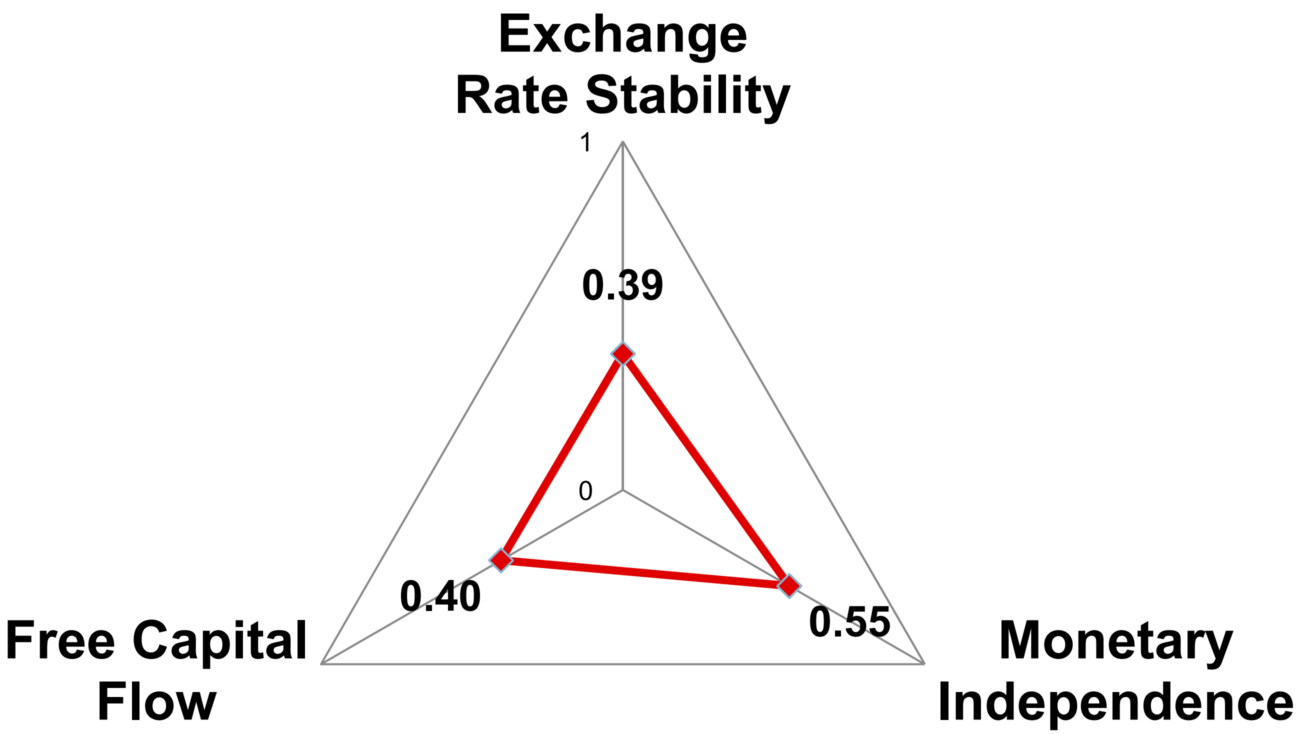
AND

- the autonomy to use monetary policy to pursue goals for domestic economic activity and price stability

IF

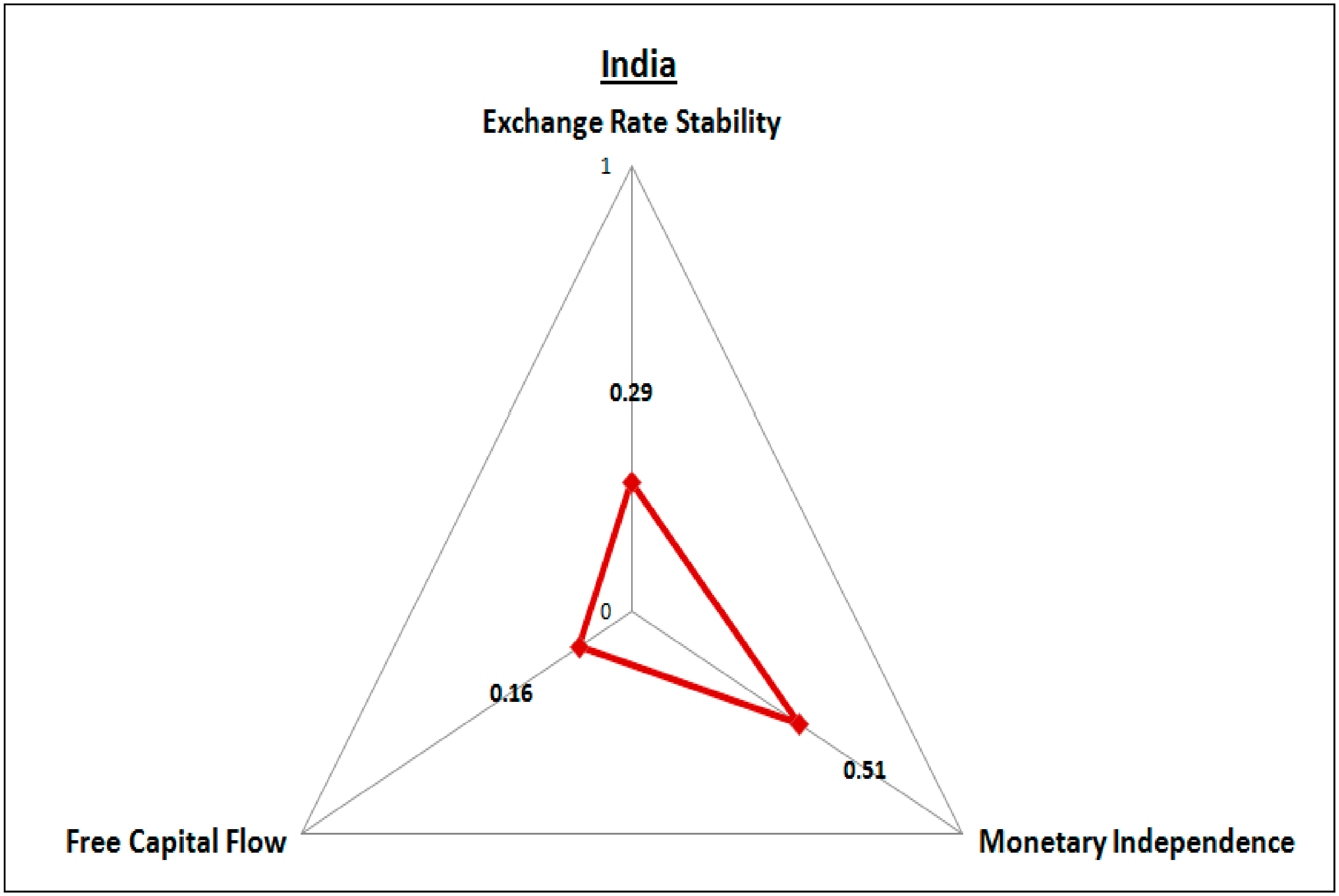
- the economy relies on a large volume of potentially volatile and internationally mobile sources of finance—capital mobility

Fundamental Policy Trade-Offs: The Trilemma Index



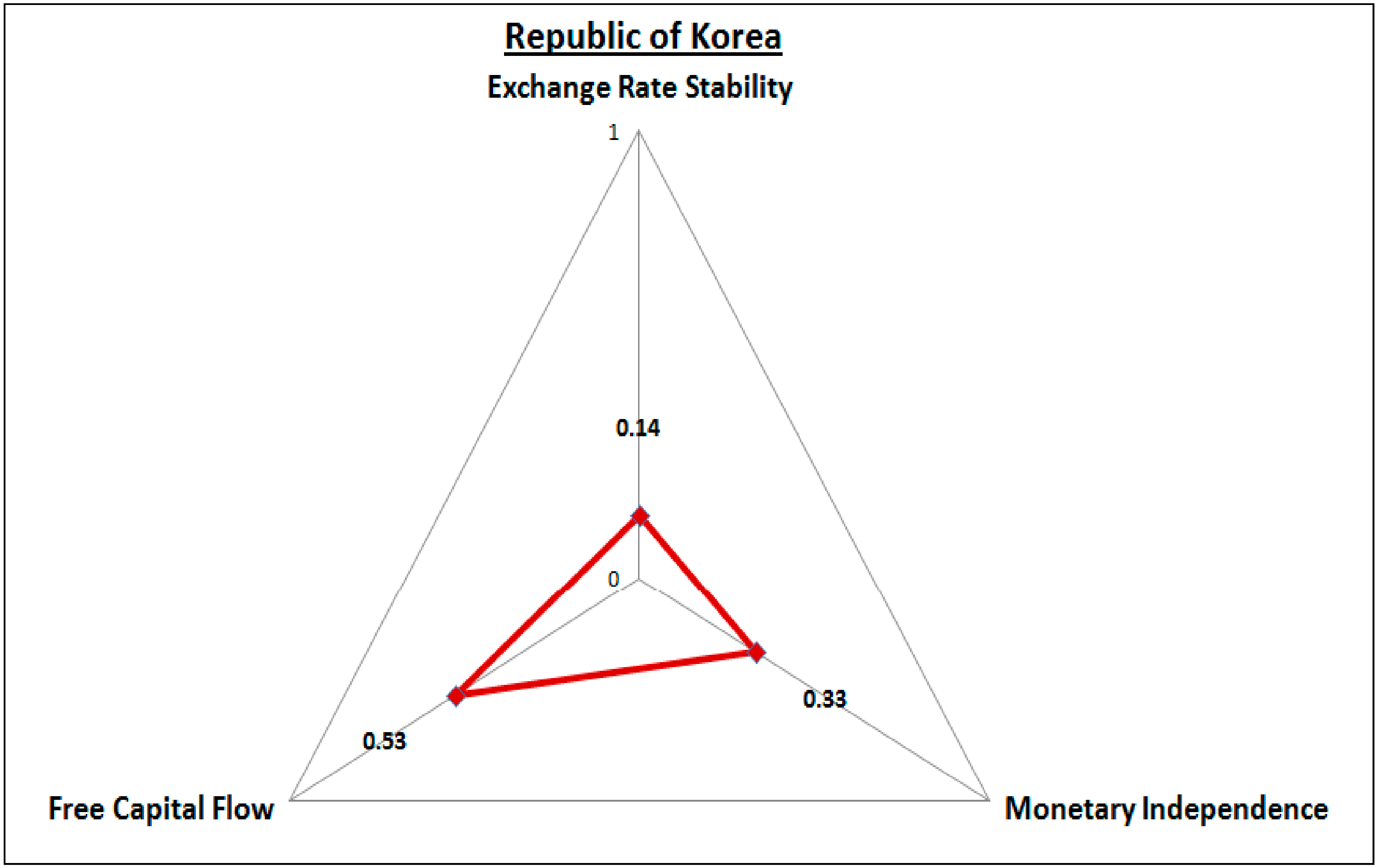
Source: Aizenmann, Chinna, Ito Database (2009)

Fundamental Policy Trade-Offs: The Trilemma Index in Practice—India



Source: Aizenman, Chinn and Ito (2008)

Fundamental Policy Trade-Offs: The Trilemma Index in Practice—Korea



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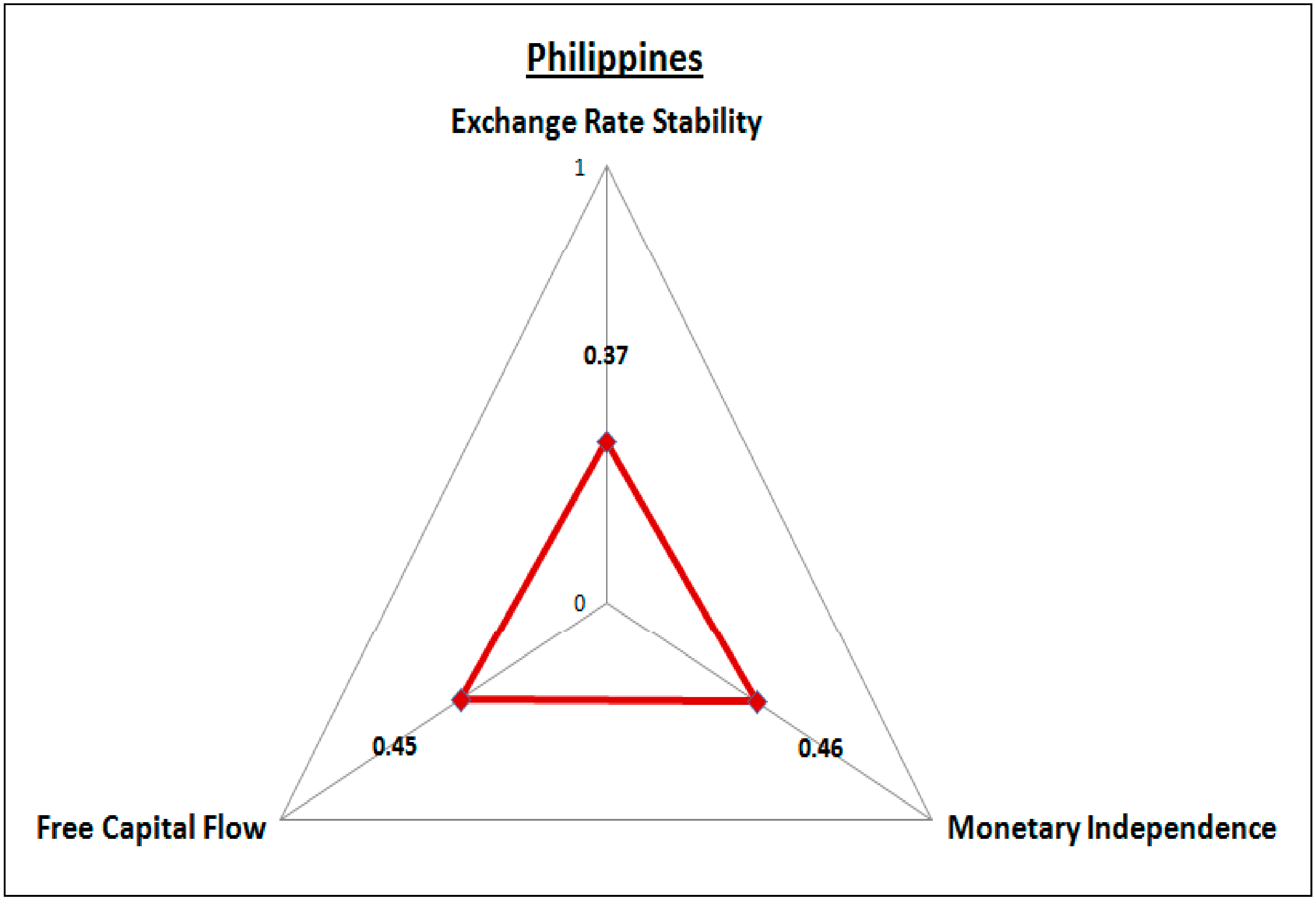

Source: Aizenman, Chinn and Ito (2008)

Fundamental Policy Trade-Offs: Implication for Monetary Policy Regimes

Properties of Policy Regimes

- The different monetary/exchange rate policy regimes have implicit choices; a regime can only have 2 out of 3 properties;
  - Independence of Monetary Policy: authorities' ability to control domestic monetary conditions, interest rates, quantity of money, and not follow other countries' monetary conditions;
  - Financial Integration: ability to freely trade financial instruments/ contracts with other economies; reduced by capital account regulations or controls;
  - Exchange Rate stability and predictability: maximized with a fixed exchange rate regime, and minimized under free float;

V Designing a Monetary and Exchange Rate Policy Regime for Myanmar

Design a policy regime for Myanmar Now and for Myanmar in Five Year's time:

- Decide on Myanmar's position on the trilemma index
- Specify the nominal anchor, i.e.,
  - Exchange rate anchor
  - Monetary aggregate target
  - Inflation targeting

Designing a Policy Regime for Myanmar—Considerations

Factors to consider:

- Structural characteristics of Myanmar's economy, such as
  - Openness to trade
  - Capital market integration
  - Similarity and integration with trading partners
- Intended role of monetary and exchange rate policies
  - What type of shocks are most likely to hit economy that require a policy response (e.g., domestic real, external TOT, domestic monetary)?
  - How important (and effective) is independent monetary policy for Myanmar?

Designing a Policy Regime for Myanmar—Specific Factors to Consider

Openness to Trade

- In a highly open economy, ER changes tend to be largely reflected in domestic price level changes
- Flexible ER not a very effective channel to influence output and employment.

Capital Market Integration

- Countries with significant links to international capital markets cannot maintain narrowly fixed exchange rates unless they are willing to relinquish monetary autonomy

Designing a Policy Regime for Myanmar—Specific Factors to Consider

Similarity of Shocks to Trading Partners

- The more similar (relative to trade partners) are shocks to real variables (e.g., productivity, real wages etc), the weaker is the case for a flexible ER
- The case for nominal ER flexibility is stronger when country is exposed to different kinds of shocks from its main trade partners.

Reliance on/Integration with Trade Partners

- Case for a fixed exchange rate is stronger when
  - A country's economic and financial system relies on its partner's currency more heavily;
  - There is stronger desire for economic integration with trade partners

Designing a Policy Regime for Myanmar—Specific Factors to Consider

Nature of Shocks

- With capital mobility, if policy objective is to stabilize real output
  - Floating ER regime works best when
    - shocks are primarily external (especially external TOT)
    - domestic shocks tend to be real shocks
  - Fixed ER regime works best if shocks are mostly monetary shocks

Designing a Policy Regime for Myanmar—Specific Factors to Consider

Willingness to Forego MP Independence

- Countries with significant links to international capital markets cannot maintain narrowly fixed ER unless they are willing to relinquish monetary autonomy

Credibility of Monetary Policy

- Case for fixed ER (against strong anchor currency) is strong if there is need to import monetary stability, due to among others
  - History of hyperinflation
  - Absence of credible public institutions
  - Danger of contagion from neighboring countries??
  - Large exposure to nervous international investors??

Designing a Policy Regime for Myanmar—Summary

Hard Peg for ...

- Small open economies whose trade is dominated by a single low-inflation partner
  - Symmetric real shocks
  - Flexible labor market and/or migration
  - Access to fiscal policy as a counter-cyclical tool
- Countries with low credibility of domestic monetary policy and a high degree of currency substitution
- Countries trying to dis-inflate against a history of high inflation
- Beware of difficulty of engineering a graceful exit from hard pegs

Designing a Policy Regime for Myanmar—Summary

Floating ER Regime for …

- Economies that are not heavily dependent on trade;
- Economies that are affected by mostly idiosyncratic macroeconomic shocks and have relatively inflexible labor markets;
- Countries with an independent central bank that is credible and able to implement counter-cyclical monetary policy;
- Countries with well-developed capital markets.

Designing a Policy Regime for Myanmar—Summary

Soft/Intermediate ER Regime for…

- Economies that are vulnerable to asymmetric shocks that cannot be addressed through any other policies but can be addressed by monetary policy

- Countries which lack a strong financial infrastructure, in particular a broad, deep and resilient foreign exchange market and needs time to develop

Designing a Policy Regime for Myanmar