OVERVIEW OF MONETARY AND EXCHANGE RATE POLICY REGIMES

Yangon
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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

Real Sector

Fiscal Policies

Balance of Payments

Monetary Policies

CA=S-I

G; T

Interest rates/exchange rate

RM=NFA+NDc

Monetary financing
• 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)

- Currency Depreciation
- Annual Real GDP Growth

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Central Bank Objectives: Financial System Stability

Keeping the banking system solvent!

Well-functioning credit and payment system
Central Bank Objectives: Financial System Stability

You, me and everyone else transacting with each other.

The banks

The central bank and its clearing system

Payment system

Settlement system

Ian Nield, TAOLAM
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

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
III Implementing Monetary Policy

- Policy Decision
- CB Instruments
- Operating Target
- Intermediate Target
- Long-term Objectives
- Indicator Variables
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

**Implementation/Tactics**
- Instruments
  - Reserve requirements
  - Lending/depo facilities
  - Outright transactions
  - Reversed transactions
  - FX operations
  - Direct controls, etc.

  Operating target(s)
  - Reserve money
  - Market interest rates
  - Exchange rate, etc.

**Strategy**
- Intermediate target(s)
  - Money supply
  - Inflation rate
  - Exchange rate, etc.

- Ultimate goal(s)
  - Price stability
  - Growth
  - Competitiveness, etc.
Implementing Monetary Policy: Why is there a Need for Strategy?

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

Changes can be anticipated

12-18 months

18-24 months

- Change in instrument
- Import prices
- Domestic inflationary pressure
- Inflation
- Exchange rate
- Market rates
Implementing Monetary Policy: Why is there a Need for Strategy?

... because the transmission mechanism is complicated and uncertain:

- Market rates
- Asset prices
- Expectations/Confidence
- Exchange rate

- Aggregate Demand
- Productivity
- Output
- Inflation
- Import prices
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
Implementing Monetary Policy: Prerequisites of Interbank Markets

Interbank requirements

- Liquidity demand
- Trading
- Communications
- Instruments
- Settlement system

Ian Nield, TAOLAM
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

YIELD

MATURITY
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

Diagram:

- **OMO**
  - Supply of Bank Reserves
  - Interbank Rates

- Reserve Requirements

- Bank Deposits

- Private Credit
  - Money Mkt Rates
  - Lending Rates
  - Economy
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
Implementing Monetary Policy: Monetary Targeting

Policy Decision → Monetary Operations

Reserve Money → Broad Money

Broad Money on track? → Inflation
Implementing Monetary Policy: Inflation Targeting

Is the forecast of inflation on target?

Yes  No

No change in instrument  Should policy respond?

Communicate  No

Yes

No change in instrument  Determine size of response

Communicate  Change instrument

Communicate

"Escape clauses" permit departure from the target
IV Fundamental Policy Trade-Offs: Monetary Policy Trilemma

**FULL CAPITAL CONTROLS**

- **Monetary independence**
- **Exchange rate stability**
- **Increasing capital mobility**

**Full financial integration**

- **PURE FLOAT**
- **HARD PEG**
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

Source: Aizenman, Chinn and Ito (2008)
Fundamental Policy Trade-Offs: The Trilemma Index in Practice—Philippines

Source: Aizenman, Chinn and Ito (2008)
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;
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?
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