

Analyzing the Monetary Sector

Overview

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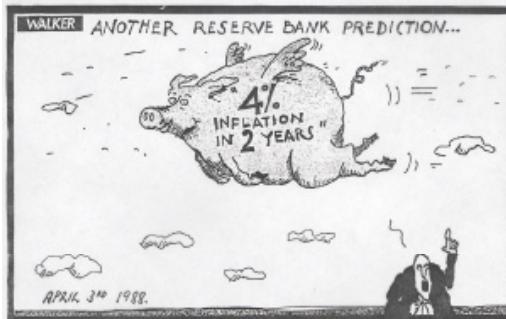
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Overview

- I. Central Bank Objectives
- II. Monetary Policy Frameworks

I. Central Bank Objectives

Keeping inflation under control



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

Don Brash, former RBNZ Governor

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



Financial System Stability

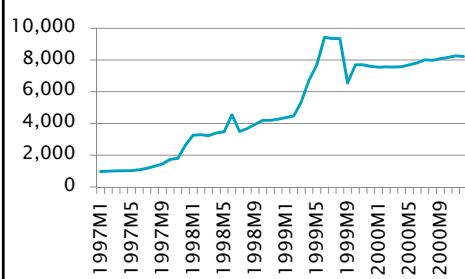
Keeping the banking system solvent!

Well-functioning credit and payment system

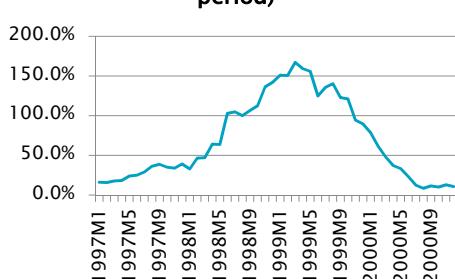


15 Years Ago, Lao PDR struggled with all three objectives:

Kip per US\$ (end-of-period, official rate)



Annual CPI inflation rate (end-of-period)



“ ... vicious inflation-depreciation circle emerged” (IMF 2000)

“ ... emerging signs that most banks, including all state commercial banks (SCBs), are insolvent” (IMF 1998)

Exercise

Analysis:

- ▶ What were the causes of this crisis?

You may still remember the crisis or you can look up its discussion in the provided contemporary IMF report from 2000:

- Par. 8
- Par. 26
- Par. 78–86



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Question

- ▶ What are the objectives of the Bank of Lao P.D.R.?

Take a look at Box 2 in the IMF 2012 IMF Article IV report ...



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Objectives of Bank of Lao P.D.R. (2012)

General objective (BoL law): maintaining stability of the kip

- Internal stability: price stability
- External stability: foreign exchange stability

Plus: financial stability mandate

Specific objectives:

- ▶ Keeping inflation rate below real GDP growth rate
- ▶ Keeping M2 growth rate below 25%
- ▶ Limiting exchange rate volatility vis-à-vis the U.S. dollar and the Thai baht within +/- 5 percent band each year

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Central Bank Objectives & Functions

Monetary Stability

- Monetary policy
- Exchange rate policy

Financial stability

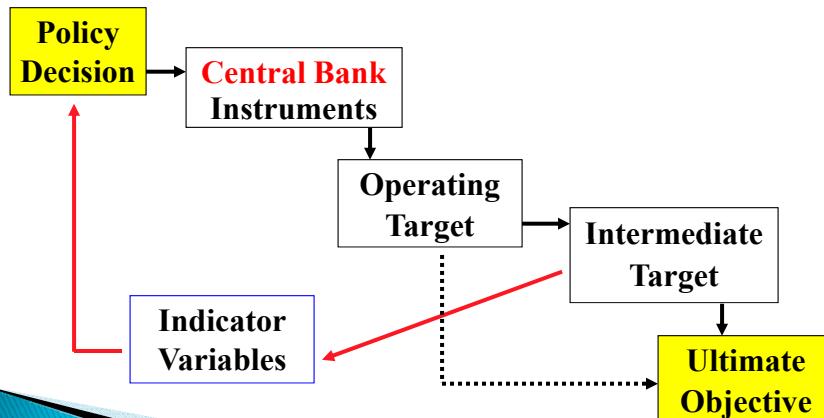
- Prudential policy
- Supervision, oversight

Policy Operation Functions

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

II. 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.)



Question

- ▶ What are the
operating targets
of the Bank of Lao
P.D.R.?
- ▶ And what are its
instruments?

We return to this
question when we
discuss monetary
statistics in the
next presentation.



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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



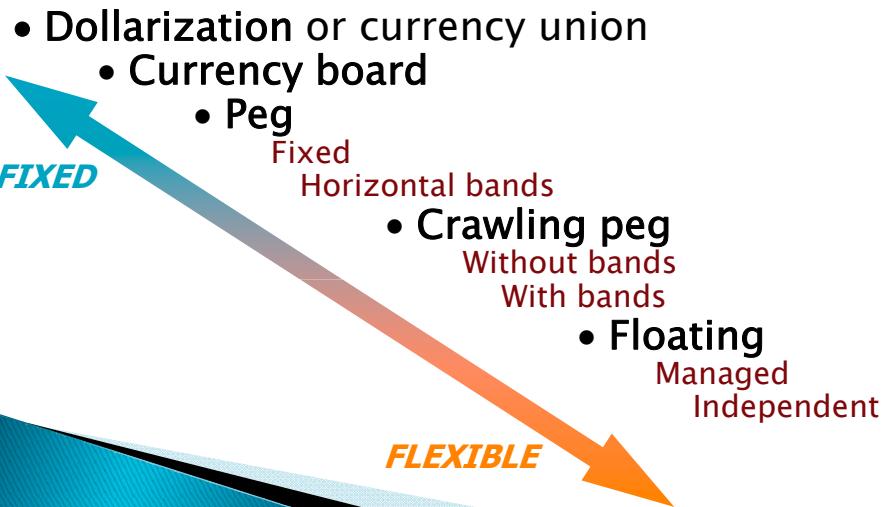
Intermediate Target as Nominal Anchor

- ▶ 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



Question

- ▶ What is the exchange rate regime of Lao P.D.R.?

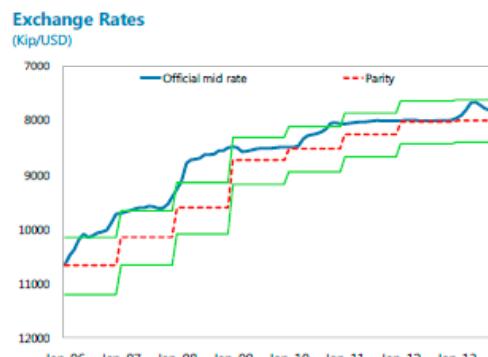
Start by taking a look at the IMF 2013 Article IV report, Informational Annex, p. 3 ...



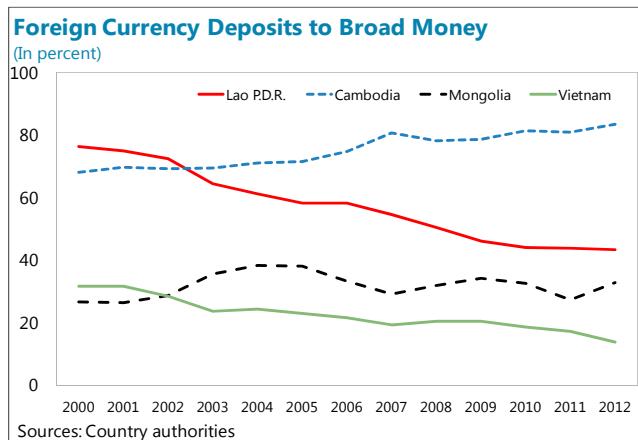
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Exchange Rate Regime from 2006 to Present

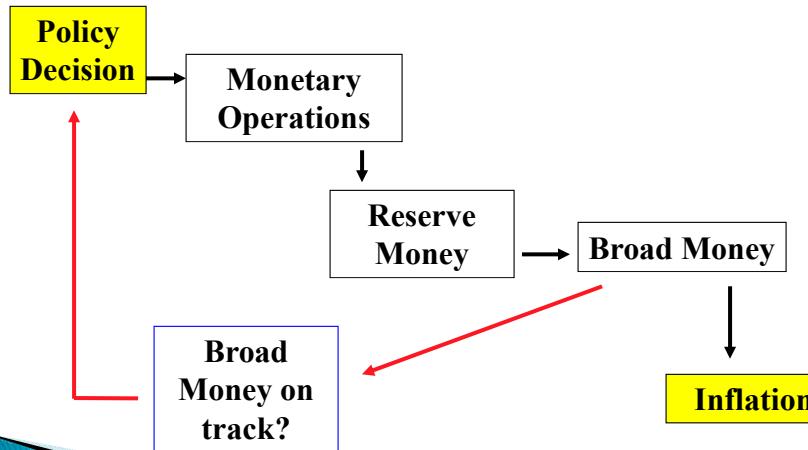
- ▶ De jure: floating
(Definition: A floating exchange rate is largely market determined, without an ascertainable or predictable path)
- ▶ 2012 classification: stabilized
(Definition: ... entails a spot market exchange rate that remains within a margin of 2% for six months)
- ▶ 2013 classification: crawl-like
(Definition: ... exchange rate must remain within a narrow margin of 2% relative to a statistically identified trend for six months)



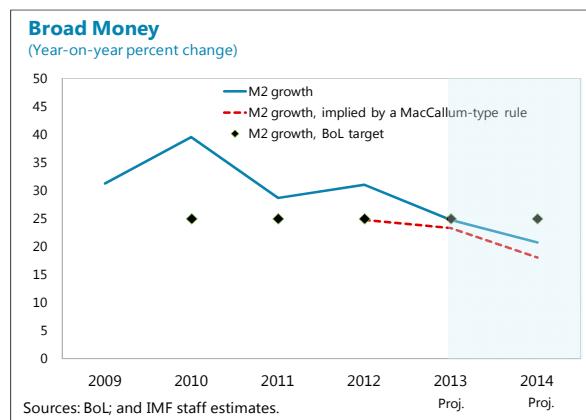
Dollarization Has Receded



Monetary Targeting Regime

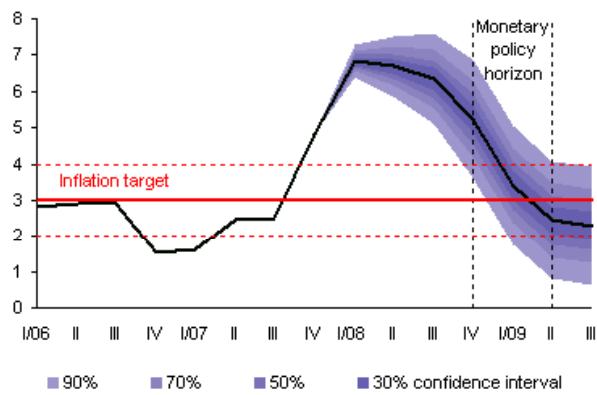


BoL's Objective to Keep M2 Growth Below 25%



Inflation Targeting Regime

Make a convincing case that inflation *forecast* is on track



Thank You!

Next, we are going to take a closer look at the link between reserve and broad money—to do so, we have to look into the monetary accounts ...