Monetary Policy and Central Banking

Central banks play a crucial role in ensuring 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 achieve their objectives. Operational processes tailored to each country’s circumstances enhance the effectiveness of the central banks’ policies. 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 to 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 for monetary policy. Central banks in Canada, the euro area, the United Kingdom, New Zealand, and elsewhere have introduced an explicit inflation target. Many low-income countries are also making a transition from targeting a monetary aggregate (a measure of the volume of money in circulation) to an inflation targeting framework.

Central banks conduct monetary policy by adjusting the supply of money, generally through open market operations. For instance, a central bank may purchase government debt from commercial banks and thereby increase the money supply (a technique called “monetary easing”). The purpose of open market operations is to steer short-term interest rates, which in turn influence longer term rates and overall economic activity. In many countries, especially low-income countries, the monetary transmission mechanism is not as effective as it is in advanced economies. Before moving from monetary to inflation targeting, countries should develop a framework to enable the central bank to target short-term interest rates.

Following the global financial crisis, central banks in advanced economies eased monetary policy by reducing interest rates until short-term rates came close to zero, which limited the option to cut policy rates further (i.e., conventional monetary options). With the danger of deflation rising, central banks undertook unconventional monetary policies, including buying bonds (especially in the United States, the United Kingdom, the euro area, and Japan) with the aim of further lowering long term rates and loosening monetary conditions. Some central banks even took short-term rates below zero.

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 limited scope for an independent monetary policy compared with one that has a more flexible exchange rate. Although some countries do not fix the 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 global financial crisis showed 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 because they have the capacity to analyze systemic risk. In addition, they are often relatively independent and autonomous. 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 model used to implement macroprudential policy, the institutional setup should be strong enough to counter opposition from the financial industry and political pressures and to establish the legitimacy and accountability of macroprudential policy. It needs to ensure that policymakers are given clear objectives and the necessary legal powers, and to 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 of and exit from unconventional monetary policy.

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

- **The Financial Sector Assessment Program** provides member countries with an evaluation of their financial systems 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, and capacity through training, and it provides advice on various central bank policies. Topics include monetary policy frameworks, exchange rate regimes, moving from targeting a monetary aggregate to inflation targeting, improving central bank operations (such as open market operations and foreign exchange management), and macroprudential policy implementation.