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Middle East and Central Asia Department

Exchange Rate Developments and Policies in the Caucasus and Central Asia

*IMF staff team led by
Mark Horton, Hossein Samiei,
Natan Epstein, and Kevin Ross*

The Middle East and Central Asia Department

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Executive Summary

Since late 2014, exchange rates (ERs) and ER regimes of the Caucasus and Central Asia (CCA) countries have come under strong pressure. This reflects the decline of oil and other commodity prices, weaker growth in Russia and China, depreciation of the Russian ruble, and appreciation of the U.S. dollar, to which CCA currencies have historically been linked. Weaker fiscal and current account balances and increased dollarization have complicated the picture. CCA countries entered this period with closely managed ER regimes and, in many cases, currencies assessed by IMF staff to be overvalued. CCA central banks have price stability as their main policy objective, and most have relied on ER stability to achieve this objective. Thus, the first policy response involved intervention in local foreign exchange (FX) markets, often with limited communication.

In this context, the IMF staff has reviewed ER policy advice and implementation strategies for CCA countries. Kazakhstan's adoption of a floating ER regime in 2015 was a key driver of the review, and Armenia, Georgia, and the Kyrgyz Republic were important cases to consider, in light of active Fund-supported programs. Staff's recommendation—with tailoring to specific CCA countries—has been to correct ER misalignments and increase ER flexibility (as opposed to occasional re-pegging), depending on institutional capacity and the size of buffers. Staff has also called for efforts to preserve financial stability, put in place supportive macroeconomic policies, and improve transparency and communications.

Greater ER flexibility is just one element of a broad-based macroeconomic policy and structural reform mix. Modernization of monetary policy frameworks and institutions, in particular, is essential for supporting ER flexibility. In the financial sector, banking supervision should be enhanced, together with measures to ensure liquidity, provisioning, and capital, especially where balance sheet risks stem from high dollarization and nonperforming loans. Fiscal policy may smooth the impact of shocks, where buffers allow and where spending is efficient or tax measures are well targeted. For CCA energy exporters, ER flexibility would help absorb the fiscal impact of lower hydrocarbon revenues, and reduce the need for offsetting monetary policy measures. At the same time, all CCA countries need a credible fiscal and external adjustment over the medium term. Structural reforms are needed to improve institutions and business environments, in support of greater competitiveness, integration, and diversification, and ultimately higher and more inclusive growth.

While CCA authorities recognize the need to adjust to the new economic environment, adopting greater ER flexibility remains challenging. CCA currencies have depreciated or been devalued against the dollar since late 2014, but in some countries they remain inflexible or overvalued in real terms. In some cases, countries have resorted to step devaluations instead of greater flexibility but this has only led to expectations of further devaluations. Resistance to flexibility has reflected a range of economic, political economy, and institutional impediments. There have also been concerns that greater flexibility may lead to heightened ER volatility and depreciation in the early stages of transition, along with higher inflation and greater dollarization. Such “fear of floating” is not unique to CCA countries or this particular moment and has been a major factor in other regions and at other times.

A key issue is how to help CCA authorities overcome fear of floating and modernize their monetary policy frameworks. The primary objective should be to establish greater central bank independence and the clear primacy of the inflation objective. Once these are in hand, self-reinforcing reforms that enhance credibility may proceed on multiple fronts—even during difficult periods. In the process of overcoming fear of floating and adopting modernized monetary policy frameworks, the pace of transition may reflect the country’s initial conditions as well as stakeholders’ preferences and perceptions. To start, CCA authorities should be convinced that the benefits of greater ER flexibility outweigh the costs. Building a local consensus among key stakeholders (for example, importers, policymakers, politicians), making the investment in capacity, and preparing for the rigors of ER flexibility (for example, tolerating ER volatility and overshooting) call for a medium-term strategy and greater IMF involvement, especially through knowledge sharing, analytical support, technical assistance (TA), and training.

CCA central banks should take a number of immediate actions to achieve greater ER flexibility in the near term. While no one standard sequencing or pace of reforms suits every country, some actions have clear priority. These include strengthening communications, establishing new nominal anchors, moving to develop deeper and more liquid money and FX markets, enhancing financial supervision, and creating robust lender of last resort frameworks.

1

Introduction

Recent ER Movements

Since late 2014, CCA currencies have been under pressure, given the decline of oil and other commodity prices, weaker growth in key emerging markets, depreciation of the Russian ruble, and expectations of a rise in U.S. Federal Reserve policy rates. Since CCA currencies are typically linked to the U.S. dollar, pressures have also reflected dollar appreciation against major currencies. CCA currencies have depreciated in nominal terms by 20–50 percent against the dollar (Figure 1), with Azerbaijan and Turkmenistan undertaking step devaluations of their currencies (by 20 and 25 percent against the dollar, respectively) in early 2015, and Azerbaijan devaluing again (by 32 percent) in December 2015. Kazakhstan took a similar step by devaluing its currency in early 2014 by 19 percent. The Kazakh tenge has depreciated by an additional 45 percent against the dollar following adoption of a floating rate regime in August 2015.

A depreciation of the Russian ruble over the period has offset changes in the values of most CCA currencies. Accordingly, both nominal and real effective ERs (NEER/REER) have experienced periods of appreciation during the past two years, particularly among CCA energy exporters (Figure 2). Moreover, for many CCA countries, the traditional NEER/REER measures understate the appreciation, as they are based on country trade weights and do not take into account movements in the predominant currency of denomination of imports—the U.S. dollar, which has been appreciating. While in some countries the real ER has depreciated in recent months, this may not imply gains in competitiveness given that the equilibrium real ER has also depreciated.

Besides links with Russia and China (Figure 3), other contributing factors have included slow growth in the Euro area—an important destination for CCA exports, as well as high financial dollarization (Figure 4) and unclear policy responses in many CCA countries. Strong links with

Russia and lower exports and reduced remittances have contributed to weaker current account and fiscal balances (Figure 5).¹ High dollarization has complicated all aspects of ER policy decisions, as it has limited monetary policy transmission mechanisms and raised financial soundness concerns. These factors have led some central banks to work to stabilize ERs. Indeed, the policy response of some CCA central banks has lacked clarity, consistency, and effective communication. Capital flight has not been a serious issue.

Monetary and ER Regimes in the CCA

All CCA central banks have price stability as their main monetary policy objective. However, the instruments to achieve this vary and typically include both the ER and the interest rate, as well as direct control over liquidity. Four CCA countries (Armenia, Georgia, Kazakhstan, and the Kyrgyz Republic) have a form of inflation-targeting (IT) in place. ER intervention remains an important instrument in these countries and in non-IT countries. De jure, only Turkmenistan has a pegged ER regime (see Table 1). De facto, however, many countries resort to some kind of management of the ER. Across all CCA countries, effective liquidity management remains challenging, owing to weak monetary transmission. Direct lending by central banks to governments or firms is applied in some CCA countries, and reserve requirements are generally low, with limited differentiation between local currency (LC) and FX deposits.

Primary reasons for tightly managed ER regimes in the CCA are limited operational capacity and “fear of floating.” Fear of floating reflects mistrust in the domestic currency, high and fast pass-through from ER changes to prices, significant balance sheet currency mismatches, and underdeveloped domestic capital markets. Pegs of CCA currencies to the dollar are also rooted in the immediate post-Soviet period of high inflation and are also associated with commodity-export characteristics, which argue for a nominal (ER) anchor and efforts to limit the pass-through of volatility in commodity prices. However, ER pegs cannot be sustainable if FX buffers are insufficiently large, or if supporting monetary, fiscal, and structural policies are inadequate. Tightly managed ERs may limit the scope for diversification and balanced growth—a key priority for all CCA economies.

¹ For CCA energy importers, lower energy prices have not translated into significant savings. This reflects the prevalence of long-term contracts priced in dollars and, in some countries, lack of competition and flexibility in supply arrangements.

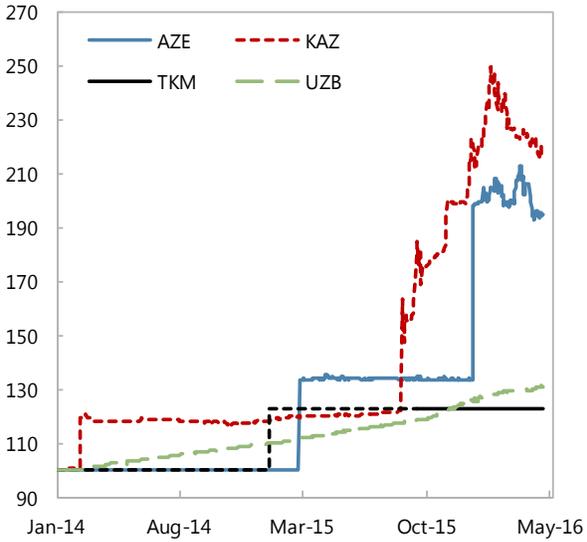
Table 1. CCA ER Arrangement AREAER² Classification <i>(as of March 2016)</i>		
	De Jure	De Facto
Armenia	Free floating	Floating
Azerbaijan	Managed floating	Stabilized
Georgia	Floating	Floating
Kazakhstan	Managed floating	Other managed arrangement ³
Kyrgyz Republic	Floating	Other managed arrangement
Tajikistan	Managed floating, no predetermined path	Other managed arrangement
Turkmenistan	Conventional peg	Conventional peg
Uzbekistan	Managed floating	Crawl-like arrangement

² Annual Report on Exchange Arrangements and Exchange Restrictions (AREAER).

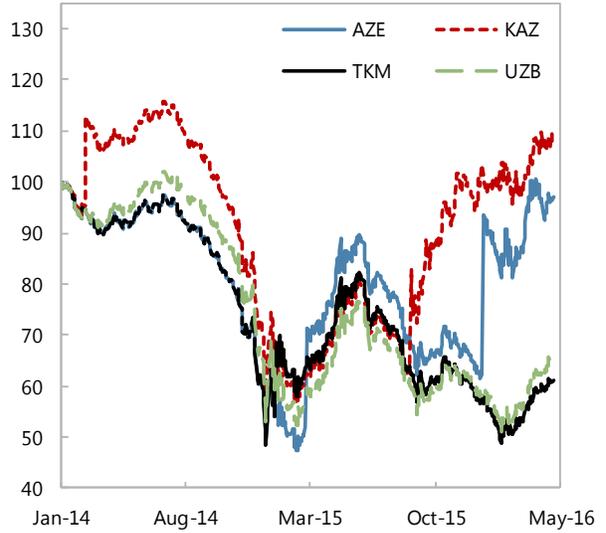
³ While Kazakhstan officially adopted a floating ER regime in August 2015, the IMF's AREAER reclassification to floating (de facto) requires a period of at least six months of increased volatility in the ER without noticeable short periods of stability. The Kazakh authorities have reaffirmed their commitment to a floating ER regime and noted increased volatility in the ER in recent months.

Figure 1. Bilateral Exchange Rate Movements
CCA Energy Exporters, 2014–15

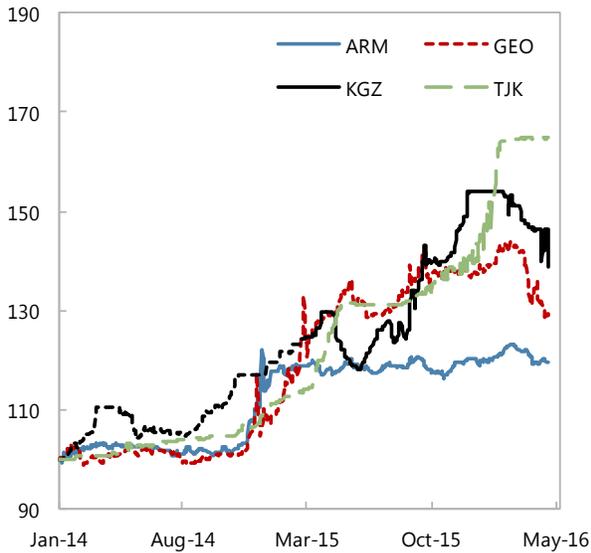
Domestic currency per USD
(Jan 1=100)



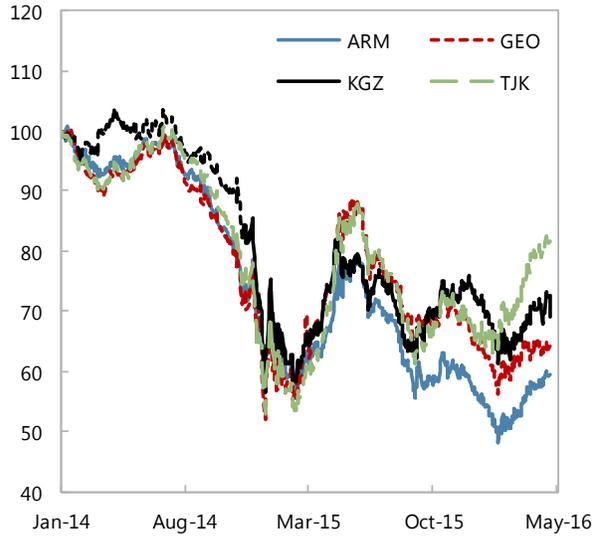
Domestic currency per ruble
(Jan 1=100)



Domestic currency per USD
(Jan 1=100)



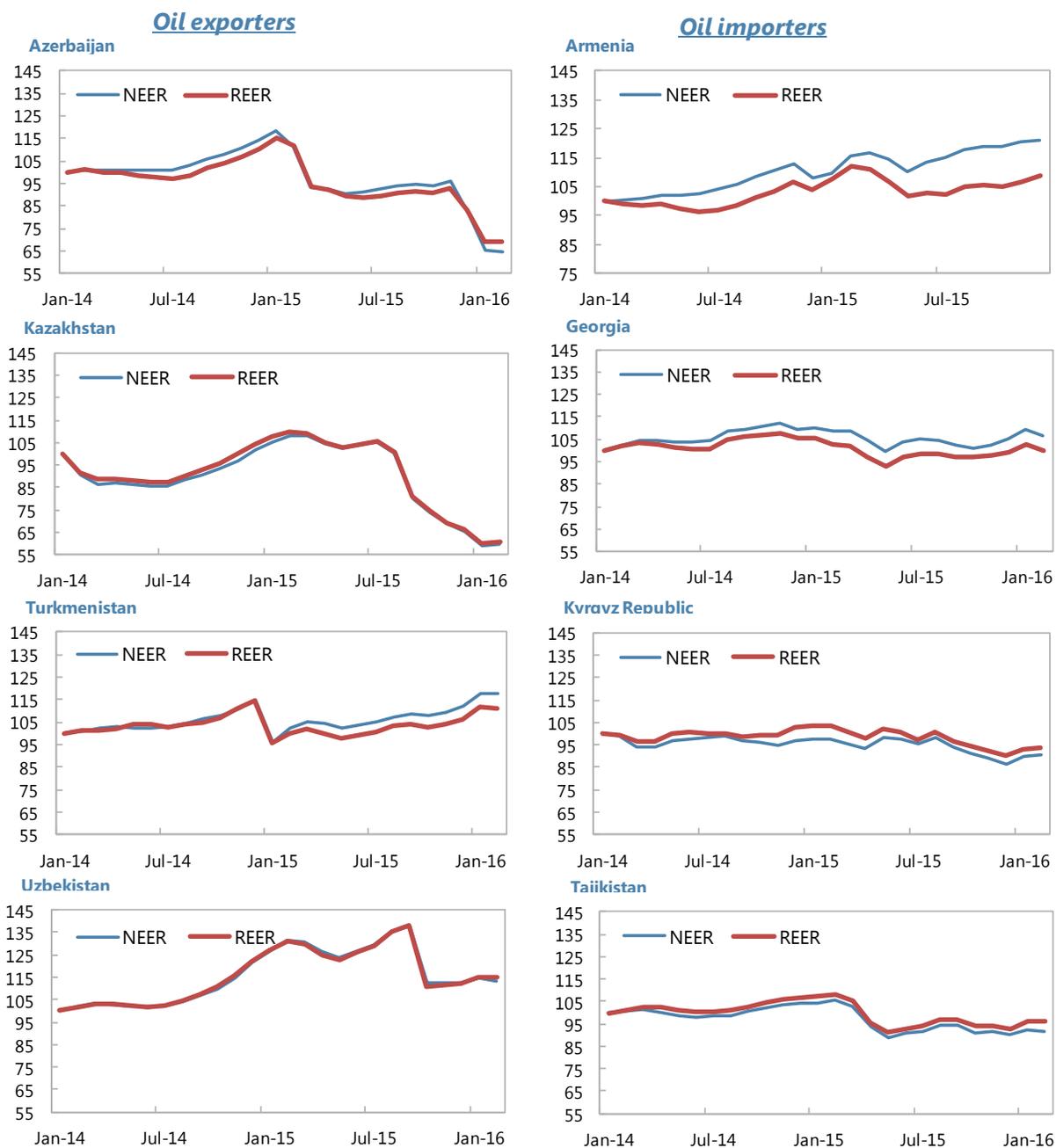
Domestic currency per ruble
(Jan 1=100)



Sources: Bloomberg and IMF Staff Estimates.

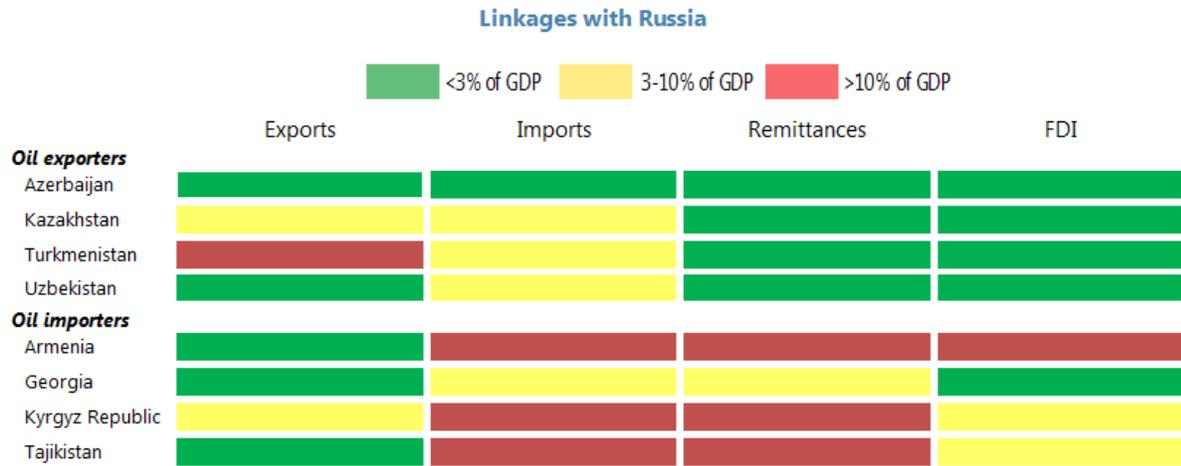
Figure 2. CCA: Nominal and Real Effective Exchange Rates

(January 2014=100, a rise means appreciation of the domestic currency, through Dec 2015)

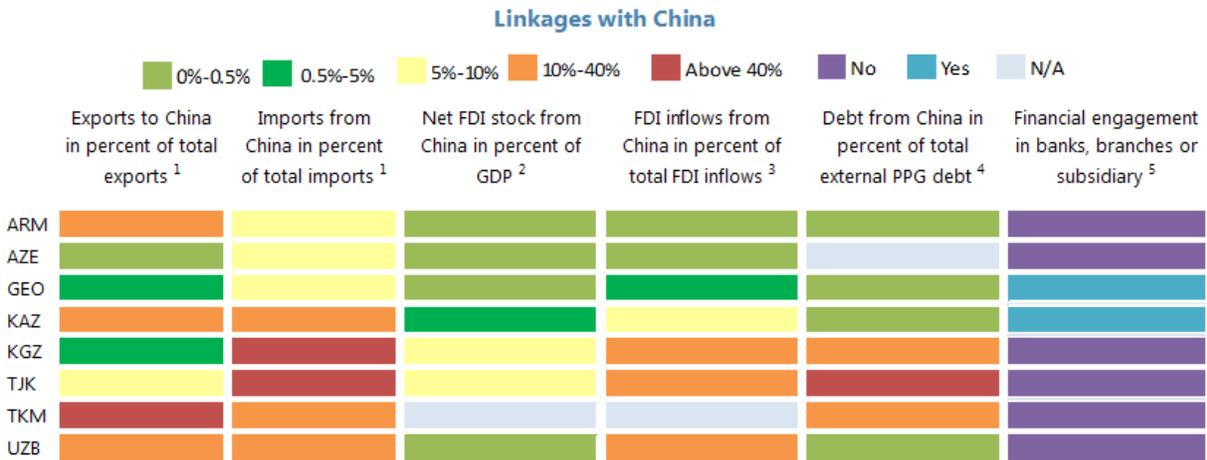


Source: GDS, and IMF Staff Estimates.

Figure 3. CCA Linkages with Russia and China



Sources: IMF Directions of Trade Statistics and Staff Estimates

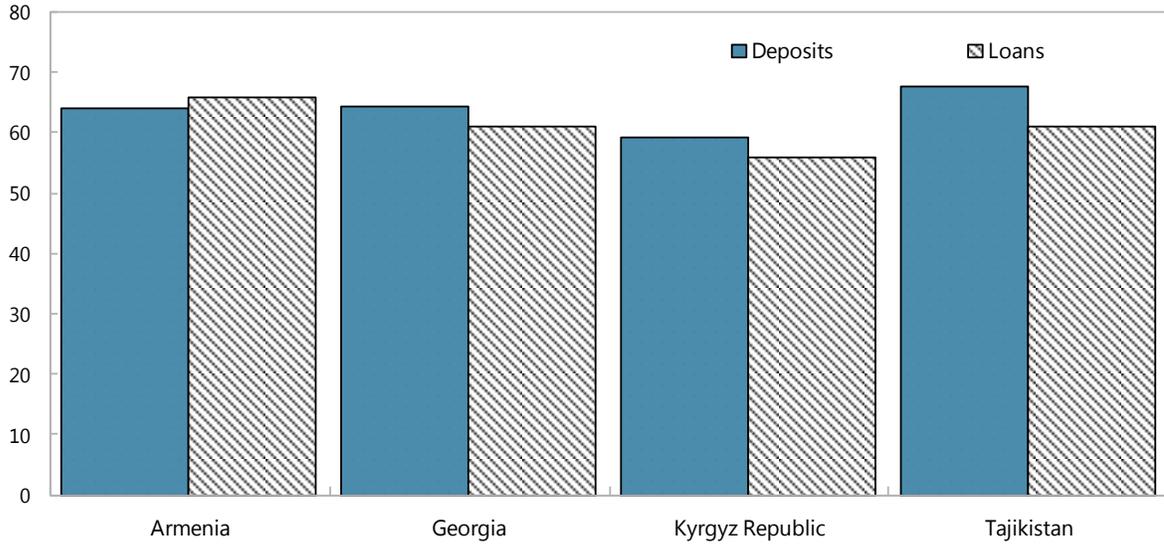


Sources: World Economic Outlook (WEO), Direction of Trade Statistics (DOTS), Coordinated Direct Investment Survey (CDIS), United Nations Conference on Trade and Development (UNCTAD), national authorities, and IMF staff estimates.

Figure 4. Financial Dollarization in the CCA

CCAOil Importers: Dollarization

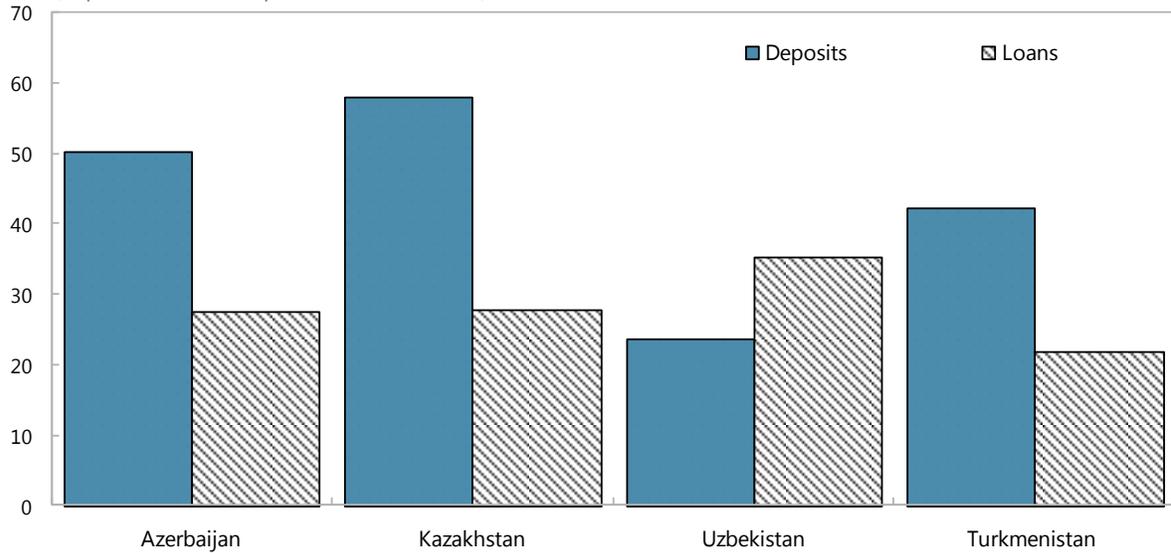
(as percent of total deposits and loans, 2014)



Sources: authorities, and IMF staff estimates

CCAOil Exporters: Dollarization

(as percent of total deposits and loans, 2014)



Sources: authorities, and IMF staff estimates.

Figure 5. CCA External and Internal Balances

Current Account Balance

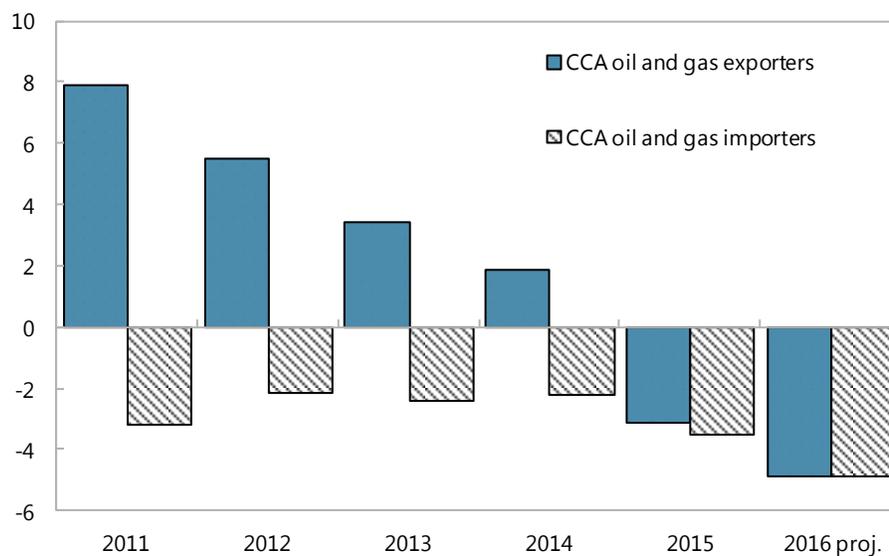
(Percent of GDP)

	2013	2014	2015 est.
Oil exporters			
Azerbaijan	16.4	13.9	0.2
Kazakhstan	0.4	2.8	-2.6
Turkmenistan	-7.2	-6.7	-12.7
Uzbekistan	2.9	0.7	0.0
Oil importers			
Armenia	-7.6	-7.3	-3.2
Georgia	-5.8	-10.6	-11.6
Kyrgyz Republic	-15.0	-16.7	-14.7
Tajikistan	-2.9	-9.7	-10.2

Source: WEO

Fiscal Balances

(Percent of GDP)



Sources: National Authorities, and IMF staff estimates.

Assessment of CCA Currency Misalignments

According to latest IMF external sector assessments, most CCA currencies were judged to need adjustments in real terms to bring external current account balances to equilibrium levels over the medium term. During the pre-shock period (2013), the degree of uncertainty around these valuation estimates was relatively large, with about half of CCA currencies assessed as possibly undervalued. Despite the depreciations over the past 18 months—both in nominal and real terms—in most CCA countries, the equilibrium real ER has also depreciated; hence, updated assessments for end-2015 indicate that seven out of the eight CCA currencies still require adjustment in the range of 5–30 percent to bring external current account balances to equilibrium levels over the medium term (Figure 6).⁴

While misalignments may call for efforts to adjust ER parities directly or to increase ER flexibility, other supporting policies are also needed. Complementary policies include maintaining sound fiscal positions and implementing structural reforms to reduce imbalances and restore equilibrium. This is illustrated by Georgia, where the ER is one of the most flexible in the region, but is still assessed to be overvalued by as much as 5–15 percent. This assessment, in part, may be due to the policy mix as well as transitory shocks that affect the current account balance—a key input in the misalignment estimate.

CCA Financial Sectors

Many CCA countries have reported rising stress in domestic financial systems, including due to ER changes and weaker economic conditions. In some countries, NPLs have increased, while bank capital, liquidity, and profitability have deteriorated. Recent IMF-WB financial sector stability assessments (FSSAs) have also noted vulnerabilities.⁵ In other CCA countries, the external shocks appear to have had a limited impact thus far, as evidenced by relatively healthy financial soundness indicators. This may reflect, in part, low levels of financial intermediation and state support, or the quality and timeliness of FSI data.

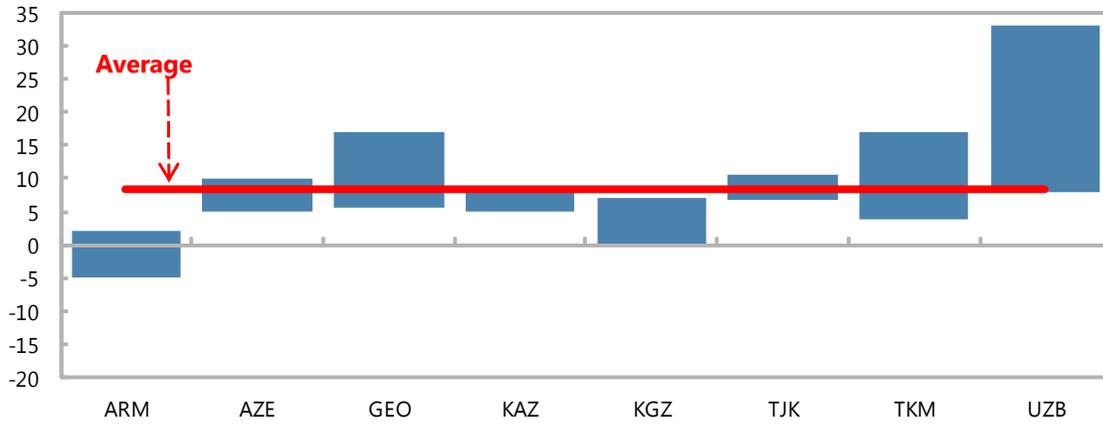
A challenge for financial stability is dollarization of lending, in light of credit risk associated with local currency depreciation. Lending dollarization is high, while limited hedging by FX

⁴ Armenia appears not to be overvalued at present, but this reflects to some extent supply side factors in 2015 that led to better-than-expected exports. These factors may be temporary in nature.

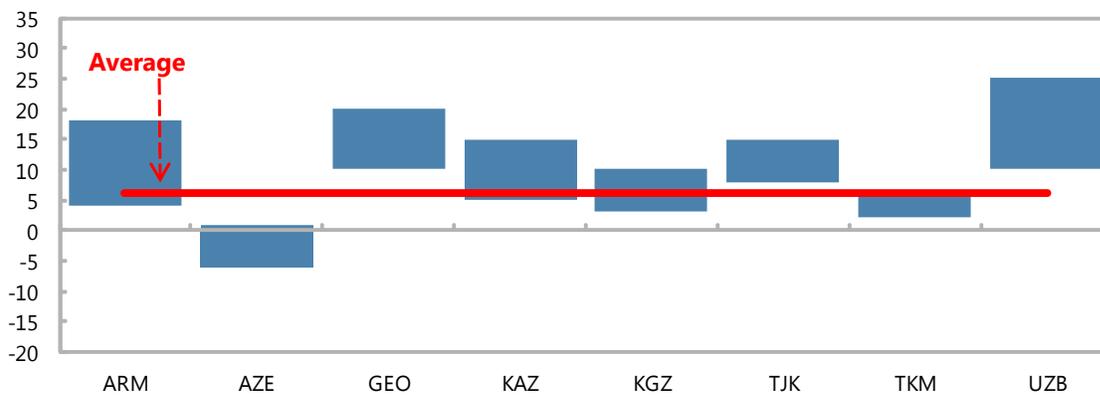
⁵ Six of the eight CCA countries have completed an FSSA report or update within the last three years.

Figure 6. CCA: Exchange Rate Misalignment
(In percent, +: overvalued)

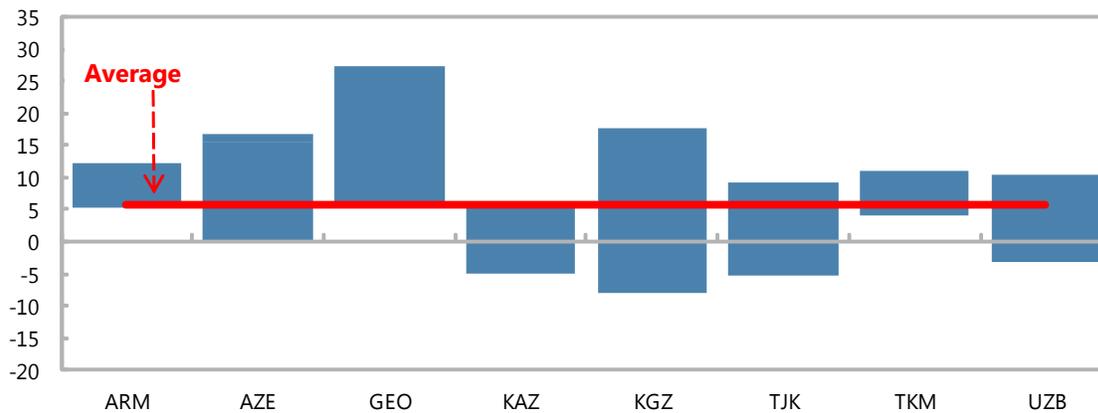
January 2016



Interim Shock - March 2015



Pre-Shock 2013



Source: IMF Staff Estimates.

borrowers (both household and corporate) accentuates risks. In addition, in the face of ER pressures, tight liquidity, and falling oil prices and exports, stability risks may arise from strains on bank profitability, provisioning, and capital.

Capital Controls in the CCA

As in other regions, CCA countries have maintained capital flow management measures (CFMs) to allow for more independent monetary policy while maintaining managed ERs. The extent of these measures has been higher among CCA countries with conventional pegs (Turkmenistan) or other peg type arrangements (Tajikistan, Uzbekistan). Most CCA countries have measures on: (1) issuance of securities by nonresidents; (2) FDI flows; (3) foreign borrowing by residents; (4) real estate purchases by nonresidents; and (5) resident personal financial transactions abroad (see Table 2). Administrative measures have also been employed.

Table 2. CCA: Controls on Capital Transactions

CCA Countries: Controls on Capital Transactions										
		ARM	AZE	GEO	KAZ	KGZ	TJK	TKM	UZB	Total
1	Repatriation requirements	No	No	No	No	No	Yes	Yes	Yes	3/8
2	On capital and money market instruments	Yes	Yes	Yes	No	Yes	Yes	Yes	Yes	7/8
3	On derivatives and other instruments	Yes	Yes	No	No	n.r.	Yes	n.r.	n.r.	3/8
4	On credit operations	No	No	No	Yes	Yes	Yes	Yes	Yes	5/8
5	On direct investment	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes	7/8
6	On liquidation of direct investment	No	No	No	No	No	No	Yes	Yes	2/8
7	On real estate transactions	Yes	No	Yes	No	Yes	Yes	Yes	Yes	6/8
8	On personal capital transactions	No	Yes	No	Yes	No	Yes	Yes	Yes	5/8
	Total	3/8	4/8	3/8	3/8	4/8	7/8	7/8	7/8	
Source: AREAER 2014. (Depending on the country, the positions are as of various months in 2015).										
Note: "n.r." is not regulated, and does not necessarily indicate a lack of market. Red highlights majority of cases.										

Central Bank Independence and Transparency in the CCA

Over recent decades, there has been a global trend toward increased central bank independence and transparency. Policymakers have gained greater freedom to choose objectives, tactics, and instruments in carrying out mandates, and independent central banks are considered to deliver better outcomes, including lower and more stable inflation, and less output volatility. As accountability goes hand-in-hand with independence, central banks have also become more transparent. A well-communicating central bank is able to explain to the public and markets its views on current and future economic conditions, the rationale for its actions, and the expected outcome of these actions. In doing so, it helps ensure that monetary and ER policies remain credible and that expectations are better anchored, even if inflation or ERs deviate from targets or an equilibrium level.

Based on legislation, CCA central banks appear to be relatively independent and transparent, although not necessarily in practice. Using measures developed by Dincer and Eichengreen (2014),⁶ the central banks of the Kyrgyz Republic, Armenia, Azerbaijan, and Georgia rank high in comparison to central banks in other regions on independence, while on transparency, most CCA central banks score well, with Armenia, Georgia, and Kazakhstan close in performance to the emerging market average. However, as discussed elsewhere, legislation does not always ensure adequate independence and transparency in practice.

⁶ The authors use central bank legislation to measure independence based on management control over mandates, policies, and objectives, and limits on lending to the public sector. They assess transparency by reviewing central bank publications and websites. Information is taken from 2010 or earlier.

2

Exchange Rate Policy Advice

IMF ER Policy Advice and Rationale⁷

IMF ER policy advice for CCA countries—both oil exporters and importers—has been to move toward greater ER flexibility. This has been combined with recommendations to modernize monetary and ER policy frameworks, develop and deepen capital markets, and improve macroprudential supervision. These actions would support implementation of independent monetary policy and operations, based on a well-defined interest rate instrument. ER advice has been supported by calls to ensure fiscal sustainability and to promote structural reforms to make CCA economies more open, diversified, regionally and globally integrated, and competitive.

The rationale for advocating ER flexibility is that CCA countries are small, relatively open economies that are subject to frequent and persistent external shocks. The ongoing oil and commodity price shock and slower growth in Russia and China point to the need for adjustment, including of the ER for all countries in the CCA.

Adopting greater flexibility would allow the ER to play its natural shock-absorbing role by facilitating the adjustment of relative prices. Flexibility would also limit the rundown of central

⁷ After the breakdown of the Bretton Woods system and the adoption of the Second Amendment to the IMF's Articles of Agreement, member countries have been free to adopt the ER regime of their choice with few limitations as set forth in the Articles. In this context, the Fund has produced analytical studies on countries' choices of ER regime. These reviews are part of the IMF's surveillance mandate, and help inform member countries of how their choice of ER regime can affect their own macroeconomic performance and contribute to the stability of the international monetary system.

bank reserves, as well as preserve export competitiveness, thus helping prevent large current account imbalances. Greater flexibility may also help absorb the fiscal impact of lower hydrocarbon-related revenues, provided that expenditures are not raised in domestic currency, while reducing the necessity of excessive offsetting monetary policies. Absent this flexibility, domestic prices would bear the burden of adjusting misalignments in real ERs, or direct fiscal measures would be needed. Such price adjustments take time and may impose more far-reaching economic consequences. In addition, more flexible ERs, together with credible monetary and ER frameworks, supported by an effective interest rate instrument and deeper domestic financial markets, would make monetary policy more effective and help reduce dollarization.

This advice implies that a series of “step” devaluations in countries with more firm ER pegs may be less optimal than allowing more flexibility. Step devaluations may not restore balance, as they could increase expectations of further devaluation and instability. However, equilibrium could be regained if the step devaluation was accompanied by greater ER flexibility (subject to adequate institutional capacity) and measures that increase confidence in the currency, including strong communication (that is, greater clarity on the central bank’s key objectives and policy response). Changes in fiscal, monetary, or structural policies could also eliminate ER imbalances, regardless of the ER regime. However, this requires time and consensus and the result would not be market driven.⁸ On the speed of introducing greater ER flexibility, recommendations should consider the state of institutional capacity and the size of buffers.⁹

⁸ In some cases, modernization of monetary policy frameworks may be achieved through a “hybrid” regime, combining interest rate policy with some ER management, including through use of sterilized intervention in the FX market (see, for example, Ostry and others (2012), Epstein and Portillo (2014)). A risk in such cases, however, is lack of sufficient clarity of the policy framework and operations.

⁹ Fund staff has provided guideposts as countries make the transition to a more flexible ER regime. For example, given the current commodity shock, MCM has produced a note (“Commodity Price Shocks and Greater Exchange Rate Flexibility: Why, If, What and How”), which reviews alternative regime options under greater flexibility and modalities of how to transition to another regime, if an exit from the prevailing regime is deemed desirable by the country. The note draws on the extensive policy and TA work conducted in the Fund.

For example, in Turkmenistan—as in the Gulf Cooperation Council (GCC) countries—buffers may be large enough to maintain an ER peg. However, where buffers are limited, staff’s advice has been to introduce greater flexibility, together with bolstering the monetary policy framework and operations. In particular, staff has stressed the need to enhance the use of interest rate instruments, strengthen coordination with the government regarding debt issuances, and improve communications to build confidence and credibility in new, floating ER regimes.

A call for greater flexibility does not imply adoption of a fully floating ER immediately, with no future FX intervention. ER policy and operations should address two issues: first, misalignment of real effective ERs from their medium-term equilibrium levels and second, ER management in a post-adjustment steady-state. In the post adjustment period, there may be a need for some intervention for smoothing to prevent sharp, disorderly ER moves in thin markets. There may also be a need for FX purchases to build or rebuild reserve buffers. In addition, as noted, some countries may have sufficient reserve buffers and sufficiently flexible fiscal, labor market, and structural policies to maintain pegs, including at new parity levels. Countries that opt to maintain fixed ERs need to ensure such flexibility, to allow for effective and credible internal adjustment processes to emerge (for example, as in Latvia and Hong Kong SAR). One issue is that the continued FX intervention may undermine the clarity of monetary and ER policy frameworks. As such, it will be important for central banks to be clear on frameworks and operations in communications, especially on FX interventions. But the aim should be greater flexibility in a modernized policy and operational framework.

Macroeconomic Policy Advice Under Current Conditions

In support of greater ER flexibility, staff’s advice to CCA countries on macroeconomic policies under current conditions has included the following:

- Monetary conditions may need to be tightened in the short term, both to limit ER pressures and, where necessary, to address emerging signs of inflationary pressures. In tightening policies, care should be taken not to be seen as supporting a particular ER level, while central banks should be mindful of increasing economic and financial strain.
- Fiscal policy should aim to smooth the impact of shocks in the near term where buffers allow and where spending is efficient and short-term tax measures are well targeted. Policies should also ensure public finances are on a sustainable footing in the medium term.
- In the financial sector, stepped-up monitoring of banks is needed, including through

measures to ensure adequate banking sector liquidity, provisioning, and capital, especially where balance sheet risks stem from sizable dollarization and an already-high level of nonperforming loans.

Monetary Policy Modernization in Support of Greater ER Flexibility

While the transition to a more flexible ER regime may take time, modernization of policy frameworks and improvements in institutions should commence now (Box 1). The centerpiece of monetary policy modernization is a shift toward the primacy of the inflation objective to help anchor inflation expectations and establishment and use of an interest rate instrument as an operational target to support policy implementation. Fortifying central bank decision-making processes and de facto independence is also needed. Even in CCA countries that have made progress toward full inflation targeting, there is scope to bolster communications and enhance transparency and accountability.

ER Adjustment

CCA authorities have recognized the need to adjust to the new economic environment, including the role that ER flexibility might play. In practice, all CCA currencies have adjusted in response to the shocks. However, many countries have faced major difficulties in the adjustment process, including in implementing a flexible ER regime, due to a range of economic and political economy considerations.

Without the ER changes that have taken place, macroeconomic outcomes in CCA countries may have been more negative. With fundamentals having deteriorated, ERs would have become increasingly overvalued, with a loss of competitiveness and worsening trade and current account balances. While inflationary pressures may have been more contained, given the lack of pass-through from ER changes and depressed demand, internal price adjustment would likely have been more painful and more FX reserves would have been used. It should be noted that the benefits of the ER changes—for example, a stronger fiscal balance, higher non-oil exports, domestic substitution of imports—are likely to take time to materialize and will require both discipline on budgetary spending and structural reforms, especially on the business environment.

¹⁰ Note that in the Balassa-Samuelson framework, a supply shock leads to a permanent appreciation of the *real* exchange rate. For example, see Gauthier and Tessier (2002).

Box 1. Modernizing Monetary Policy Frameworks

The October 2015 IMF report on Evolving Monetary Policy Frameworks in Low-Income Countries provides useful guideposts in the monetary policy modernization process:

The central bank needs a clear mandate to pursue price stability, and it should follow a forward-looking strategy that promotes that goal while fostering macroeconomic and financial stability.

An explicit, numerical inflation objective is the cornerstone for monetary policy actions and communications. It anchors inflation and provides a clear benchmark for performance.

Tradeoffs may arise, but the primacy of the price stability objective should allow central banks more room to take other objectives into account in their policy decisions.

There is a need for a clear and unified framework within which to evaluate monetary policy and ER interventions. Analytical capacity should be strengthened, especially inflation forecasting capabilities.

The operational functioning of money and FX markets need to be strengthened, with an expanded set of instruments (for example, derivatives), and modern trading platforms and clearing mechanisms.

Monetary policy implementation should be based on the use of a specific short-term interest rate instrument. This reduces market interest rate volatility, promotes financial market development, and enhances the transmission of monetary policy.

In general, an interest rate–based operational framework would announce a target for a market rate (for example, overnight or seven-day interbank rate) or attach the policy rate to a central bank instrument. An interest rate corridor, open-market operations (OMOs), a robust short-term liquidity forecasting framework, as well as a functioning interbank market are essential. Monetary quantities (reserve or broad money) would lose their operational focus—although they could still play an indicator or cross-check role.

Modernization can proceed simultaneously on multiple tracks. Once a clear mandate and minimum central bank operational independence are established, reforms can proceed on many fronts, with greater ER flexibility helping provide a stimulus for interbank and FX market development. Attention should be paid in the near term to clarifying and communicating the policy framework and modernization process, to strengthening monetary and exchange operations and ensuring that they are consistent with the framework, and to addressing financial sector concerns, if any. Clear central bank communications are critical to guide the process.

3

Impediments to Greater Exchange Rate Flexibility

Fear of Floating and Related Factors

The challenge of adjusting to greater ER flexibility reflects several factors. These include: (1) the status of development of monetary policy institutions; (2) high ER pass-through to inflation (ERPT); (3) high liability dollarization; (4) concerns with excessive ER volatility; (5) shallow financial markets; and (6) political economy considerations. The first two factors are mainly related to the central bank's price stability mandate, while the other factors capture possible real costs of greater ER flexibility.

Monetary Policy Institutions and the Need for a Nominal Anchor

Because of the strength of institutions, including central bank independence, policymakers in developing countries may suffer from lack of credibility. Monetary policy may be subordinated to fiscal needs, leading to an excessive reliance on the inflation tax, and more generally, a difficulty to anchor inflation expectations. By serving as a clear, visible anchor, pegging the ER, especially *de jure*, can help make up for lack of credibility.¹¹

Allowing for greater ER flexibility may be seen as leading to a de-anchoring of inflation expectations and prompt calls for an alternative nominal anchor. This would, in turn, require that policymakers clarify their policy frameworks and strengthen monetary institutions, which can be challenging in the midst of shocks and in the absence of a strong commitment to price stability.

¹¹ The term "monetary institutions" denotes the central bank, its capacity/ability to deliver on its core functions (analytical, operational), the broader legal and political environment in which monetary policy decisions are made, and the scope for coordination with (and insulation from) fiscal policy and fiscal pressures.

High ER Pass-through (ERPT)

Policymakers in small open economies may be concerned about the potential inflationary effects of fluctuations of the nominal ER. Since the size of these effects depends on the degree of ERPT, policymakers from countries with high pass-through may prefer to limit ER fluctuations. The degree of ERPT is likely closely related to the policy regime and the degree of credibility. Countries with a history of high inflation are more likely to experience high pass-through: firms are more likely to raise prices in the event of a nominal depreciation if they suspect that it reflects excessively accommodative policies.¹²

Financial Dollarization

Like many developing and emerging market economies, CCA countries display high dollarization of their financial systems and of corporate and sovereign balance sheets. This reflects several factors. First, many EMs are limited in their capacity to borrow in their own domestic currencies and, therefore, accumulate foreign currency debt—the so-called “original sin.”¹³ In addition, given a history of high and volatile inflation (and financial repression), dollarization of the domestic financial system emerged as a mechanism for protecting domestic savings from the inflation tax. Savings by depositors in dollars contribute to funding for lending to dollars, and FX loans are often at rates lower than domestic currency loans. With a stable currency, this provides incentives to borrow in FX.

Although financial dollarization has advantages—it may help with the development of the domestic financial system and limit capital flight—sharp ER depreciations may drastically raise the domestic currency value of private and public debt. This may result in a large debt overhang, impairing the economy’s capacity to consume and invest and increasing the likelihood of a balance of payments or financial crisis. To forestall these effects, country authorities may try to stabilize ERs. It must be stressed that dollarization is itself endogenous to the ER regime, as greater nominal ER stability often results in higher foreign currency borrowing.

¹² In some CCA countries, market structure is another factor, as markets are characterized by limited entry and an absence of competition, particularly for imported goods.

¹³ See Eichengreen and others (2003).

Excessive Volatility and Deviations of the Real Exchange from Its Equilibrium Value

It has long been recognized that floating ER regimes can be characterized by heightened volatility of both nominal and real ERs (for example, Mussa 1986). For example, in a flexible ER regime with integrated financial markets, nominal ERs may be driven not only by fundamentals but also by short-term, speculative capital flows, resulting in greater volatility. With sticky prices and wages, this nominal volatility becomes real ER volatility. High real ER volatility can be costly, discouraging trade in goods and services and long-term capital inflows and reducing overall investment.¹⁴ It is unclear, however, whether higher real ER volatility has a negative effect on growth, although there is some evidence that it affects productivity growth at lower levels of financial development.

Shallow and Underdeveloped Financial Markets

Another source of nominal and real ER volatility is the incipient nature of financial markets in developing countries. In shallow financial markets, there may be limited capacity to absorb changes in the demand for FX. Allowing the ER to float freely in these circumstances may therefore result in excessively large changes in the ER, with negative effects. The development of an active money market would also support the effectiveness of central bank monetary operations.

Political Economy Considerations

Political economy factors may also contribute to fear of floating. ER pegs (either de facto or de jure) tend to be associated with overvalued real ERs (Ghosh and others 2010), possibly because external adjustment is much slower under pegs, and overvaluations can endure. If the dominant lobby represents net importers—which is the case in some CCA countries—then there may be a push for pegs as net importers benefit from an appreciated currency. The opposite holds for exporting lobbies. Countries that are more heavily specialized in commodities, for example, oil producers, are more likely to have strong import lobbies, as export industries are not sensitive to ER fluctuations. If exports consist of manufactured products or services, and if these sectors are dominated by powerful or vocal firms, then the opposite may hold. That being said, there may instead be fear of appreciation, and ER flexibility may be asymmetric: appreciating pressures may be resisted while depreciating pressures are accommodated. In the case of

¹⁴ See Gosh and others (2010) and Bleaney and Greenaway (2001).

remittances, migrant workers may have a similar mindset as exporters—a bias to depreciation to increase the local currency value of their transfers. However, these workers are likely to have limited lobbying power back home.

Another consideration may be a strong view of the public in favor of ER stability as the key objective of the central bank. The population may actually prefer ER stability over price stability if the former is interpreted as a sign of monetary stability, and if the latter is hard to achieve over the short term due to supply side shocks. This is different from the lack of credibility mentioned earlier in that the choice of regime is dictated by local preferences.

CCA Central Bank Communications

Central bank communications and information flows in CCA countries may be an additional impediment to ER flexibility. Greater ER flexibility entails more volatility, risk, and uncertainty. Good communications among all economic stakeholders are important to understand and manage these risks. Credibility of CCA central banks has typically come from long periods of stable ERs rather than from discussing and managing volatility and uncertainty. Central banks may be more comfortable and vested in ER stability.

Additional factors characterize central bank communications in the CCA, included next.

Trust, Independence, and Capacity

- CCA central banks operate in an environment of relatively low public trust in state institutions, low economic literacy, and limited public debate. Media, think tanks, academic communities, and surveys of public sentiments that foster accountability in other regions are less developed in CCA countries.
- CCA central banks may feel constraints in communicating openly and transparently. Key stakeholders for central bank communications may be relatively narrower, and central bank communications may not always be aligned with communications by governments or finance and economy ministries.
- CCA central banks may face capacity constraints in identifying risks, due to insufficient analytical capacity, limited data on economic conditions, and insufficient internal coordination and communications. At the same time, CCA central banks may have strong capacity relative to other local institutions (staff, financial resources, information) and be pulled in to solve problems outside their core areas (for example, advising on restructuring of companies or on public investment projects, or managing or channeling states funds).

Development of Communications Channels

- Communications channels in CCA countries may not be well developed relative to other regions: press conferences, interviews, and other statements by central bank governors may be infrequent; central bank minutes may not be published; and websites and social media presence may be limited. Central bank bulletins may be limited to factual information, providing little analytical discussion.
- CCA central banks may communicate more via indirect channels, “behind the scenes” or more in times of pressure. Thus, the public and markets may associate central bank communications with “crises,” so that audiences are conditioned to be nervous when central banks communicate.

Capacity of Other Institutions

- In some CCA countries, journalists are perceived as having limited training in economics, or reflecting views of their financial benefactors. Newspaper or website circulation may be limited, with few dedicated business or economics publications. National TV may not be a good medium for discussion of complex macroeconomic issues.
- Market participants in the CCA may benefit from stronger analytical capacity and independence. They may be reluctant to take opposing positions.

4

Managing the Transition to Greater ER Flexibility: Overcoming Obstacles

Addressing Fear of Floating

In tranquil times, exits from pegged ER regimes have involved gradual, step-by-step moves to a full float. Examples include Chile (1984–1999), Israel (1985–2005), and Poland (1990–2000).

Gradual transitions to greater flexibility are not always feasible. During shocks and crisis periods, exits from pegs may involve sharp, rapid depreciation, as in Brazil (1999), the Czech Republic (1996–97), and Uruguay (2002). Uruguay bears the most resemblance to CCA countries, given a high degree of dollarization, less developed local capital markets, and limited FX risk-management capacity at the time of transition.

A key question is how the authorities can overcome fear of floating and embrace a more modern monetary policy framework. As stressed in the IMF staff paper, “Evolving Monetary Policy Frameworks in Low-Income and Other Developing Countries,” the key is to establish greater central bank independence and the clear primacy of the inflation objective. With this in hand, self-reinforcing reforms that enhance credibility may proceed on multiple fronts—even during periods of stress.

Shifting away from multiple monetary policy objectives, establishing the preeminence of the inflation objective, and allowing greater ER flexibility call for:

- Presentation and acceptance of the case for modernization of monetary frameworks:
 - Stressing that ER rigidity may be helpful to stabilize high inflation but not to adjust to shocks nor to address dollarization issues.
 - Emphasizing that if CCA governments wish to develop and enhance their private sectors and nontraditional exports—a cornerstone of strategies to confront the current shocks and diversify and strengthen growth—they must become accustomed to uncertainties and risk.
- Building an “in-country consensus” and convincing stakeholders, including at the highest levels to accept the argument.

- Stressing that moving on multiple fronts is possible even during times of stress and that reforms to money and FX markets and communication frameworks build synergies that improve the functioning of the economy in general.
- Preparing for the rigors of flexibility and recognizing the need to tolerate ER volatility and overshooting—both of which may occur in the short run. This will involve enhanced communications.
- Expanding knowledge sharing, including among CCA central banks, finance ministries, and political authorities.

Modernizing Monetary Policy Frameworks

Key steps in building and maintaining credibility and in shifting away from the ER as an intermediate target during modernization include the following (from *Evolving Monetary Policy Frameworks in Low-Income and Other Developing Countries*).

Building and Maintaining Credibility during the Transition

- Declare medium-term inflation objectives; define objectives as continuous point targets/ranges.
- Invest in external communications, emphasizing the medium-term inflation objective and central bank independence and accountability.
- Communicate forward; explain current situations and policy decisions relative to objectives and economic outlook. Admit and explain the target misses and plans to address them.
- Ensure consistency between the monetary policy framework and operations.
- Invest in analytical capacities.
- Focus on de facto regimes when conducting internal analysis, not the de jure one.
- Strengthen central bank legal operational independence, including by phasing out direct credit to government.
- Extend policy horizons, as forecasting capacities improve. The minimum is one year.
- Make policy decisions at pre-announced dates.
- Encourage staff participation in the policy decision-making process.
- Integrate into a single process all decision making using various instruments (for example, key policy rate, exchange rate, reserve requirements, net open position limits).
- Take active measures (even administrative) to reduce and or prevent dollarization.
- Show strong resolve to make policy more effective even in difficult times. Build consensus and start applying the principles in practice.

- Split monetary policy formulation from implementation and supervision.
- When using several instruments with a primary impact on the monetary policy stance, use them consistently; avoid using these instruments for different objectives.

Shifting Away from ERs as Intermediate Targets during Modernization Process

- Set up a high-level coordination task force with authority; increase flexibility (asymmetrically) during appreciations.
- Create functional spot and derivative FX market; support market making activity by banks, encourage the functioning of trade organizations (for example, FX club).
- Liberalize capital account at a pace that is appropriate with the country's level of financial and institutional development.
- Keep the ER flexible in both directions, even if in a narrow corridor (minimum +/- 3 percent) to help the market develop.
- Channel the FX proceeds from the transactions with the government back to the FX market.
- Encourage government to issue local currency debt at benchmark maturities in sufficient quantities to form a yield curve and help integrate money and FX market rates and infrastructure.
- Seek greater foreign participation in domestic markets, which would increase volume and improve practices and standards of conduct.
- Hasten the resolve to implement an alternative anchor and a more effective monetary policy, especially after an ER/balance of payments crisis.
- Make an interest rate the operating target.
- Resolve the conflicts between the ER and inflation anchors consistently in favor of inflation. Gradually move the ER from being a target to being a monitoring transmission variable.
- Take a leading role in promoting good standards in hedging FX risks by the banks and the corporate sector.

Addressing Risks to Financial Sector Stability

Financial sector risk may emanate from high dollarization and balance sheet mismatches, financial, corporate, and individual. ER flexibility increases pricing volatility, and thus shifts in balance sheet valuations, and risks. Depreciation may impact banking sector profitability, nonperforming loans, and capitalization, given significant net open positions.

Effort is needed to structure comprehensive de-dollarization strategies. There is a wealth of cross-country and research experience on which to draw, be it on dollarization risks or on thinking about de-dollarization strategies and measures.¹⁵

Measures to Reduce Dollarization

Dollarization is mainly a credibility issue. It can stem from high inflation, financial repression, capital controls, ER rigidity and underdeveloped financial markets. In most cases, dollarization of deposits leads to dollarization of credits as banks try to balance FX positions. Most successful de-dollarization strategies include: (1) a sustained and credible macroeconomic stabilization; (2) liberalization that removes distortionary controls that discourage local currency use, and (3) prudential measures that reduce bank incentives to borrow and lend in foreign currencies—such as asymmetric reserve requirements and additional provisioning for currency-induced credit risks.

Market based measures de-dollarization measures may also be helpful. These include: (1) greater ER flexibility, improving central bank liquidity management (via reserve requirements, OMOs and an interest rate corridor) to make local currency more attractive (see Box 2); (2) fiscal consolidation, which reduces the need to borrow in foreign currency; and (3) unbiased taxation of foreign currency instruments (or biased toward local currency instruments such as bonds or deposits). Public debt management which fosters the development of the local currency bond market are particularly useful to de-dollarize government balance sheets and stimulate the development of domestic financial markets and local currency investor base. If confidence in the local currency remains shallow, indexation to local prices could be used. Promotion of hedging instruments is critical.

Addressing Financial Stability Concerns

CCA central banks are rightly concerned with ER changes and risks to financial stability. In addition to high dollarization, recent IMF-World Bank Financial Sector Stability Assessments (FSSAs) have identified bank profitability and NPLs as concerns across the region, along with banking sector and loan concentration, interconnectedness, reliance on short-term funding, gaps in bank and corporate governance, nontransparent bank ownership and complex financial group structures, and gaps in the supervisory framework (for example, overvaluation of assets and collateral, doubtful quality of restructured loans, weaknesses in regulatory powers and enforcement). In addition, there are shortcomings in crisis preparedness, management, and resolution frameworks.

¹⁵ For example, Ben Naceur and others (2015) looks at how to de-dollarize financial systems in the CCA; Mecagni and others (2015) describes effective de-dollarization strategies in sub-Saharan Africa; Garcia-Escribano (2010) discusses sources of dollarization and de-dollarization strategies in Latin America, and Kokenyne and others (2010) presents de-dollarization policies more generally across a number of regions.

Box 2. Active De-dollarization Strategies: Peru and Armenia

Peru: Although dollarization in Peru has declined since the introduction of the IT regime in 2001 (from around 75 percent to 35 percent today), it remains a key vulnerability. In 2015 the central bank (NBRP) implemented new measures, which mandate financial institutions to reduce their stock of dollar credit 5 percent by mid-2015 and 10 percent by end-2015 or face added RR (30 percent of the actual deviation over the target). Conditions are more stringent for dollar car loans and mortgages. To ease local currency liquidity constraints, the NBRP also created new repo facilities specifically for the expansion and conversion of loans to soles (on top of other mechanisms) and cut RR on local currency deposits. New measures complement long-standing regulations linked to FX exposure and active RR management, which have contributed to the economy's gradual de-dollarization:

RRs: The central bank imposes higher RR on FX liabilities. This year, marginal RRs on dollar deposits have been raised to historically high levels (70 percent in June from 50 at end-2014) to discourage dollar credit, while RRs on domestic currency liabilities have been eased (6.5 percent in June from 30 percent in July 2013).

FX risk: The bank regulatory framework seeks to minimize exposure to FX risks and curb ER volatility. Banking supervision limits FX positions: long (short) open positions cannot exceed 50 percent (10) of effective equity and the absolute value of net FX derivative positions cannot be over 20 percent of effective equity. Capital requirements on banks' FX credit to borrowers exposed to exchange risk (with revenues in local currency and liabilities in dollars) are being tightened gradually, increasing the associated credit risk weights from 102.5 in 2012 to 108 percent by 2016. This year, the NBRP ramped up restrictions to cut FX volatility by imposing additional RRs on banks that exceed certain limits on the flow and stock of FX derivative operations (excluding those carried out for hedging purposes).

Resident inflows: The central bank uses RRs on local currency deposits held by foreigners and fees on transfers of central bank-issued certificates of deposits for parties other than local financial institutions to discourage short-term speculative inflows. RRs are also applied to bank's external debt to reduce their vulnerability to outflows.

Armenia: Financial dollarization in Armenia historically has been high, although it has experienced wide fluctuations. Dollarization rates peaked at over 80 percent in the early 2000s, before declining to below 40 percent in 2007–08. With the global financial crisis, dollarization increased again. By end-2014, around 60 percent of total deposits and private sector credit was denominated in dollars, slightly below historical averages of 65 percent. Dollarization has been closely linked to exchange rate developments and less linked to inflation developments. The Armenian authorities have a broad de-dollarization strategy in place, including both macroeconomic stabilization and specific de-dollarization measures (see also Country Report No. 15/66).

Macroeconomic stabilization: Armenia has achieved relatively low inflation, and has for a number of years implemented a comprehensive strategy to reduce macroeconomic imbalances and vulnerabilities. That said, the authorities recognize that reducing inflation volatility would help increase the credibility of the inflation targeting regime and lay a sounder foundation for de-dollarization. In addition, better communications on the sources of inflation volatility could help improve the reliability of the local currency as a store of value.

Specific de-dollarization measures: Armenia has in place a wide range of specific actions from restrictions on use of FX for certain transactions, to prudential, supervisory, and crisis management measures.

RRs: The strategy has relied significantly on differential reserve requirements (2 percent on local currency liabilities and 12 percent of dollar liabilities) and use of the local currency as the currency of denomination of RRs, and has also included measures to reduce FX liquidity risk and strengthen capital buffers.

FX risk: The authorities have also introduced: (1) higher risk weights for the calculation of credit risk for FX loans; (2) minimum liquidity ratios for FX liabilities; and (3) improved monitoring of currency mismatches.

CCA central bank strategies and toolkits should involve some or all of the following:

- Crisis preparedness. Well-defined responsibilities, powers, and tools are needed, set out in a robust legal/regulatory regime. Agencies should have adequate resources and effective cooperation and information sharing, both domestically (with other agencies) and cross border (with other regulators). Strong ex ante planning is important, including on contingency planning, crisis manuals and guidelines, communications, bank recovery, and resolution plans. This is enhanced by ongoing meetings, information sharing, review and stress testing, and crisis-management simulations.
- Regulation and supervision. Shortcomings should be addressed, including weaknesses in asset classification and provisioning requirements (prompt identification), risk management requirements (liquidity risk, operational risk), related party exposures, gaps in consolidated supervision (important where groups are complex), and legal protections for central bank or deposit insurance fund staff. In some countries, the situation is more serious, and includes deficiencies in statutory powers, insufficient staffing and resources, interference by government and courts, inadequate contingency planning and testing of processes and powers, and limited solvability assessments or bank-specific resolution plans.
- Domestic and cross-border cooperation and coordination. Some countries would benefit from better sharing of information on problem banks between the central bank and the deposit insurance agency, and stronger coordination among central bank, ministry of finance, deposit insurance fund. This would involve more frequent meetings at policy and technical levels, more joint analyses, and contingency plans and crisis simulation exercises to prepare possible policy responses. Clearer and more explicit roles and agreements (MOUs) that elaborate on crisis management frameworks may be needed to support possible extraordinary actions. In some CCA countries, stronger cross-border arrangements are needed, including to improve information sharing, to recognize foreign resolution actions, and to firm up planning for possible liquidity support to foreign-owned banks.
- Crisis management (LOLR/ELA). While some countries have well-articulated frameworks for emergency liquidity assistance (ELA)—covering only solvent banks and with clear interest rates and strict access/collateral rules—frameworks could be strengthened in others, including by clarifying legal and institutional arrangements (for example, collateral, government guarantees, enhanced supervision).

- Resolution/restructuring. Experience has shown that the best arrangement is to establish independent resolution authorities with clear mandates and broad powers and tools and with a focus on medium-term viability and forward-looking business plans. Some countries in the region have a broad menu of tools available, as well as framework that provides for sound escalation from corrective to rehabilitation to restructuring measures. Others need a clearer delineation of resolution and liquidation procedures in the law, enhanced authority to assume powers of decision-making bodies of the bank, refined triggers to allow for intervention at an early stage and reduce time delays, and a clearer legal and institutional framework for government involvement in crisis resolution. In some countries, gaps and deficiencies in statutory powers or interference by government and the courts are concerns.

On balance, financial stability considerations should not justify significant or prolonged efforts to support a misaligned ER, instead be addressed by enhanced macroprudential policies. With price stability as the main policy objective, CCA central banks would allow greater ER flexibility in order to absorb shocks and prevent the buildup of price distortions and currency misalignments. If financial stability concerns arise during the transition to more flexible ERs and the elimination of currency misalignments, central banks should use a second tool, such as macro- or microprudential regulation. Building up capacity in this area is paramount to supporting financial sector stability. While FX interventions may buy some breathing room, they should not become sizable and prolonged, undermining policy credibility. The situation could become more acute if financial market participants and the public understand that central bank intervention is being motivated by banking sector weaknesses.

Improving Central Bank Communications

Good central bank communications can improve the effectiveness of monetary policies. Central banks should be able to explain their views on current and future economic conditions, the rationale for their actions, and the expected and actual outcomes of these actions. In doing so, central banks can help ensure that monetary and ER policies stay credible and that market expectations are anchored, even if inflation or exchange rates deviate from targets or from an equilibrium level. Clear, open, and timely communications are the main tenets of transparent communications, as they ensure that the central bank does not withhold any meaningful information in helping the public and markets form aligned expectations, without undue delay, while making communications easy to understand.

In this context, CCA central banks should develop communication strategies and plans covering a wide range of issues. These include central bank objectives and their rationale; the monetary and exchange policy strategy—how the central bank links its actions to inflation and output outcomes; and the expected future trajectory of the key policy rate and FX interventions in meeting inflation and ER objectives. Communication is especially important during regime transitions, explaining changes in the framework and their rationale. Tailoring strategies to country specifics is vital, including central bank capacity and country communications environments. Central bank communications should be well aligned with communications by governments and finance ministries.

Progress in strengthening central bank communications may require substantial capacity development. Ideally, communications capacity should be strengthened before the process of transitioning to greater ER flexibility; however, there may be periods of pressure and volatility in the interim. If these are managed poorly, gains could be threatened. Efforts should on:

- Clarifying the central bank’s policy framework, objectives, strategy, risks and legal protection, and developing a formal communications strategy.
- Informing a wide range of stakeholders of the goals of monetary and exchange policy and of the central bank’s communications strategy. Enhancing staff and communications capacity across the range of changes (press conferences, other public and closed-door meetings, Internet, print, TV/radio, central bank websites).
- Communicating regularly—in both good and bad times—through a variety of channels and discussing risks and reactions. This should include: (1) introducing or broadening the audience of the “not-for-attribution” meetings with representatives of the business community, think tanks and government and legislative bodies; (2) organizing high-level seminars and workshops, for example, with officials from other countries with a history of inflation targeting; and (3) holding more frequent news conferences, with the chairman as the keynote speaker.
- Working to ensure that few public officials speak about monetary and exchanger rate policies and when they do, they speak on coordinated messages. Ensuring that communication on these issues happens during both times of pressures and times of calm.
- Monitoring and analyzing communications channels and adjusting the implementation of the communications strategy accordingly.
- Raising economic, financial, and consumer literacy, including by developing a cadre of journalists who understand macroeconomic and central bank issues.¹⁶

⁶¹ The IMF is contributing to this effort by organizing media training programs—including for the CCA—and by inviting journalism fellows to the Spring and Annual Meetings.

Prioritizing IMF Technical Assistance Resources

The IMF staff is ready to provide continued support to CCA central banks through TA and the Financial Sector Assessment Program (FSAP). Fund TA and FSAPs to CCA countries since 2010 highlight areas where the Fund could play an enhanced role in preparing the ground and promoting greater ER flexibility:

- CCA country authorities and IMF mission teams could strengthen TA prioritization by preparing medium-term TA strategies—in which ER related activities are prominently covered.
- TA on model building, legal reforms, and FPAS support should be part of medium-term strategies, with other organizations (for example, World Bank, EBRD, ADB) providing support in key areas (for example, capital market development, local currency bonds).
- TA should also focus on communications, IT implementation, and monetary and ER instrument and market development in order to promote pricing, trading, and risk management.
- TA related to improving financial regulation and supervision should focus on dollarization and FX-related risks, which are impediments to greater ER flexibility.
- TA could have a regional element, as the eight CCA countries face common issues and have a fairly common institutional setup and path. This would contribute to peer-to-peer learning.
- Further efforts would help enhance peer-to-peer networks related to monetary and ER market activities.
- Gaps and vulnerabilities identified in FSSAs should continue to be addressed. The Financial Sector Stability Review (FSSR), a new IMF TA instrument for low and middle income countries, can help CCA countries better design, sequence, and implement financial sector reforms.
- TA should be demand-driven to be productive and meaningful.

5

Conclusions and Next Steps

Since late 2014, CCA ERs and ER regimes have come under pressure. This has reflected the decline of oil and other commodity prices, weaker growth in Russia and China, depreciation of the Russian ruble, and appreciation of the U.S. dollar, to which CCA currencies have historically been linked.

In light of these pressures, IMF staff assessed the Fund's policy advice and engagement on ER issues with CCA countries. Recommendations—with tailoring to specific CCA countries—have been to correct misalignments and increase ER flexibility, while preserving financial stability, putting in place supportive macroeconomic policies, and improving communication. The staff review reaffirmed these recommendations. CCA central bank officials broadly concur with the recommendations, while noting challenges in implementing flexible ER regimes and stressing the benefits of increased IMF engagement (policy guidance, TA, training).

A broad-based modernization of policy frameworks and institutions is a key component of implementing flexible ER policies. While the transition to a flexible ER regime may take time, modernization of policy frameworks and improvements in institutions are essential, based on the primacy of the inflation objective and establishment and use of an interest rate instrument. Enhancing central bank decision-making processes and independence is also needed.

While CCA authorities recognize the need to modernize the policy framework, they have noted continuing challenges to greater ER flexibility. This has reflected economic, political economy, and institutional impediments. In particular, greater flexibility may contribute to ER volatility and depreciation in the early stages of transition, along with higher inflation and dollarization. CCA central banks face challenges in analyzing and communicating these issues.

To help CCA authorities overcome obstacles, enhanced Fund engagement is needed. This should involve high-level interactions, enhanced focus on implementation in support of policy recommendations, stepped up knowledge-sharing and peer-to-peer learning, greater outreach on analytics, and increased TA. More specifically:

- Increased high level interaction: CCA heads of state—in consultation with ministries of finance and central banks—help determine decisions on ER policies and frameworks. Accordingly, high-level engagement is needed.
- Increased focus on implementation in support of policy recommendations: Interactions with CCA officials have stressed policy recommendations, with somewhat less weight placed on implementation. Thus, in some cases the reform agenda has been left unfinished. A stress on implementation would involve a mapping of impediments and obstacles and development of country-specific roadmaps to greater flexibility and modernized frameworks.
- Clearer assessments of TA and training priorities: It would be important to prioritize Fund TA to achieving the goal of modernizing policy frameworks and achieving greater flexibility. Increased TA and training is needed in a number of areas, while cooperation with other IFIs should be enhanced:
 - Monetary operations: TA and training on monetary operations and communications should be expanded.
 - Communications: Greater advice and training on reforming communications is also needed. Coverage would include internal and external communications, how to communicate policy decisions and expectations, discussions of risks, engagement with the market and the public, and communications platforms.
 - Interbank and capital market development: Well-functioning interbank and domestic capital markets are essential to monetary policy regimes that are based on a clear inflation objective. In most CCA countries, these markets are not well developed, and diagnostic instruments and guidance on reforms is needed.
 - Financial sector assessment: An important issue for greater ER flexibility is possible financial sector implications. Enhanced policy advice, TA, and training would be important.
- Stronger understanding of IMF external sector assessment methodologies: CCA authorities would usefully prepare their own external sector assessments as a basis for policy actions. The IMF should help by providing toolkits and training.
- Expanded knowledge sharing: CCA central banks would benefit from greater access to more information and experiences of other countries. This would be supported by expanding outreach, communications, and partnerships, through peer-to-peer networks across the region.
- Funding for increased IMF interaction: External funding may be needed for increased analysis, outreach, TA, and training in the CCA region. This could support regional TA advisors on monetary operations, banking supervision, crisis management, and communications—and possibly eventually, a regional TA center.

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