

2 THE GROWING RELIANCE ON MONEY MARKET OPERATIONS FOR MONETARY POLICY

Following a trend initiated in industrial countries in the 1970s (Box 2.1), central banks in emerging market economies and developing countries have moved toward reliance on money market operations for the implementation of monetary policy (Table 2.1), although they frequently continue to act as banker to the government. At the same time, they have continued to rely on reserve requirements and, at times, liquid asset ratios which create a captive demand for qualifying assets (typically, government securities). This move was the counterpart in the monetary area to the trend toward enhancing the role of price signals in the general economy. It has involved reducing direct government intervention in the economy, improving the capacity of financial institutions to mobilize domestic savings, and strengthening the role of market forces in the allocation of financial resources.

The Fund has encouraged this process, and technical assistance was provided to help countries make the transition. During 1999–2004, the Fund provided assistance to strengthen monetary policy implementation in more than 100 different countries (Table 2.2). Assistance was provided through advisory missions headed by Fund staff and including experts from cooperating central banks (33 missions per year on average), through visits by central bank experts supervised by Fund staff (87 visits per year on average), and through workshops and training activities (7 per year on average). These actions involved a total of more than 100 years of human effort over the six-year period. Some regions received a larger share of the Fund assistance, including Africa and Europe. Assistance has continued at a steady pace in Africa and Asia, but declined during the period in Europe, the Middle East, and Central and Latin America.

The experience of emerging market economies and developing countries has been mixed. Smaller countries have found that a lack of competition in financial markets has complicated their move toward greater reliance on money market operations, at times forcing them to resort to moral suasion. For larger countries, the process has been gradual and at times difficult. Some countries have been able to

overcome the difficulties, but others, despite lengthy periods of adjustment, still cannot fully rely on money market operations for liquidity management. The problems can be traced to weaknesses in the market infrastructure needed to ensure the effectiveness of money market operations. The country experiences show that reliance on money market interventions for the conduct of monetary policy is most effective when the following initial conditions are met:

- stable macroeconomic environment and sound fiscal policies;
- sound and competitive financial system and adequate supervisory framework; and
- a sufficient degree of institutional autonomy and operational capacity at the central bank.

Money market operations can be introduced before these conditions are met, but their effectiveness will likely be somewhat limited until progress is made toward meeting these initial conditions.

This study assesses which guiding principles a central bank can apply to design an action plan to develop strong operational frameworks for monetary policy implementation. Given the variety of country circumstances, a “one-size-fits-all” approach is unrealistic. To be successful, policymakers need to follow these steps: (1) take stock of existing market infrastructure conditions; (2) draw an action plan to address existing weaknesses; and (3) adjust the mix of monetary instruments as progress is made.

The policy conclusions in this study are relevant both to small countries unable to develop diversified financial markets because of a lack of demand for financial products and to countries for which the challenge is to eliminate the obstacles to market development. The study relies on an assessment of the experiences of a dozen countries or groupings of countries.¹ The group includes small countries with limited scope for developing diversified markets,

¹The countries included are: Democratic Republic of the Congo, Eastern Caribbean Currency Union, Egypt, The Gambia, Kyrgyz Republic, Malta, Tonga, Tunisia, Uganda, Ukraine, Vanuatu, and Zambia.

Box 2.1. The Conduct of Monetary Policy

To conduct monetary policy, a central bank may choose to regulate money creation by commercial banks through administrative measures that set limits on the price (interest rate controls) or the quantity (credit ceilings) of bank borrowing and lending operations. Alternatively, it may seek to exploit its monopoly in the creation of base money (currency and commercial banks' balances with the central bank that can be converted into currency) to regulate overall liquidity conditions in the economy by influencing the underlying demand and supply conditions for central bank money. It does so by exchanging financial assets (domestic assets or foreign exchange) for its own liabilities (transactions hereafter referred to as "money market operations"), or by requiring banks to maintain minimum balances with the central bank (reserve requirements). All of these are aimed at influencing the balance sheets of the commercial banks, either directly through administrative measures or indirectly through the balance sheet of the central bank (money market operations and reserve requirements). The use of money market operations also allows the central bank to influence financial markets conditions.

In the 1970s, industrial countries started to move from a reliance on credit or interest rate controls toward a reliance on money market operations. This was a result of the increasing inefficiency of the former in a context where financial markets had become more integrated both domestically and internationally. In addition, allowing market forces to distribute financial resources was associated with increased economic efficiency and growth. While the instruments in use have varied by country, common trends can be observed:

- less frequent recourse to open-ended/standing facilities which banks may use at their discretion to place funds with or borrow funds from the central bank under certain preestablished conditions;
- increased use of market-based operations conducted at the discretion of the central bank to add or withdraw liquidity from the system; and
- reduced reliance on reserve requirements, with a concomitant reliance by governments on markets, rather than central banks, to finance their needs.

Table 2.1. Use of Monetary Instruments in a Sample of Countries (percent of countries in the sample)

	Developing countries	Emerging countries	Developed countries
Credit and interest rate controls	4	22	0
Liquid asset ratio (LAR)	65	30	9
Reserve requirements	100	96	70
Open-ended/standing facilities	96	96	100
Discretionary and market-based	96	96	100

Sources: IMF, Monetary and Financial Systems Department, Information System for Instruments of Monetary Policy database. Data based on practices as of the end of 2001 in central banks from 23 developing, 23 emerging, and 23 developed countries.

Table 2.2. Fund Technical Assistance in Monetary Policy Implementation (1999–2004)

	Number of Countries	Advisory Missions	Expert Assignments	Workshops and Training	Years of Human Effort
Africa	25	43	184	5	38
Asia	21	23	148	11	23
Europe ¹	26	76	81	11	24
Central and Latin America	17	19	61	10	13
Middle East	20	36	48	4	10
Total	109	199	522	41	108

Source: IMF, Monetary and Financial Systems Department.

¹Europe includes the Baltics, Russia, and other countries from the former Soviet Union.