Operational Building Blocks for Moving Towards Inflation Targeting

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Preamble

- African Department of the IMF hosted a seminar to governors of Sub-Saharan African countries in April, at the IMF-WB Spring Meetings

- This seminar exchanged views how to modernize the monetary policy frameworks used by African money aggregate targeting (MT) countries

- African Department presented in this seminar a paper, which was prepared jointly with Monetary and Capital Markets and Research Departments, discussing alternatives to MT:
  - Flexible money aggregate targeting (FMT)
  - Inflation targeting (IT)

- This conference in Kigali offers an opportunity to continue the exchange of views on these issues

- The presentations in this conference will highlight various aspects of and challenges to the transition away from MT

- My presentation mainly examines the operational aspects of FMT and IT frameworks

- Country experiences with IT will be discussed in other presentations in this conference

- I will first highlight some of the key distinctions between:
  - MT,
  - FMT, and
  - IT

- Then I will review the operational building blocks of IT framework, focusing on:
  - Institutional,
  - Operational,
  - Technical, and
  - Other modalities

- I will also touch on other important considerations relevant for monetary policy implementation:
  - Macroeconomic stability
  - Absence of fiscal dominance
  - Stable and well-functioning financial markets
  - These are not unique to IT

- The issues being discussed in my presentation are not exclusive to African countries:
  - Apply to other countries in similar situations
  - Many of the features also apply to any monetary operating framework

- I will also briefly discuss how the Monetary and Capital Markets Department of the IMF can help countries with the transition to FMT/IT

- I welcome your views and suggestions on issues discussed in this presentation

- However, I ask you to hold your remarks until the end of the presentation

Alternative Monetary Operating Frameworks

- Key operating features are illustrated in the table below, highlighting differences between MT, FMT, and IT frameworks:

Framework	Short-term operating target	Primary medium-term objective	Primary long-term objective
Monetary aggregate targeting	Reserve money	Money supply	Price stability
Flexible monetary aggregate targeting	Policy rate	Money supply	Price stability
Inflation targeting	Policy rate	Inflation	Price stability

Transition to IT via FMT
Main Building Blocks

- As discussed in Washington, many central banks see a need to move away from MT:
  - MT is not adequate to address current needs
  - Targets often missed
  - Link between money growth and inflation weak

- However, transition to IT may not be practical, reflecting a number of constraints:
  - Institutional
  - Capacity
  - Macroeconomic
  - Market development issues

- FMT is seen as a feasible framework to strengthen monetary policy implementation:
  - Allows greater role for interest rates
  - Contributes to financial market development
  - Allows central bank to develop capacity in areas needed for IT (e.g., data collection and analysis, communication, setting the policy interest rate)

Institutional

- IT framework highlights the importance of proper institutional settings for policy implementation
- Strong governance structures important
- Emphasizes a strong institutional commitment to price stability and operational transparency
- Requires a highly accountable central bank and a strong communication on policy making with the public
- Price stability mandate is the primary objective of monetary policy (other objectives come after)
- Important to ensure operational independence

Operational
(FMT and IT)

- Appropriate monetary policy instruments
- A short-term interest rate is introduced as the key monetary policy signal
- A high quality short-term liquidity forecast and short-term liquidity management are needed to align short-term market interest rates with the policy signal
- However, moving to FMT represents challenges:
  - Having two policy targets complicates policy implementation
  - Short-term liquidity management becomes important
  - Quality of liquidity forecasts
  - Institutional reforms critical (to balance greater flexibility in policy implementation)
  - Uncertainty and effectiveness of policy transmission channels

Technical

- Specifying an explicit policy objective
- Modifying central bank's organization
- Establishing a Monetary Policy Committee (MPC)
- Expanding data on macroeconomic developments (e.g., high frequency surveys and quarterly GDP)
- Developing capacity to generate inflation forecast
- Developing capacity to analyze developments and forecasting errors
- Developing communication strategy and tools for monetary policy implementation
- Understanding policy transmission channels
- Enhancing policy coordination

Other considerations

- Macroeconomic stability
- Level of inflation at introduction
- Fiscal dominance
- External current account deficit
- Stable financial markets
- Development of financial and money markets
- Exchange rate policy

Supporting Transition to FMT and IT

Technical Assistance
(for FMT and IT)

- MCM has a lot of expertise in providing support to its member countries
- Provision of analysis and advice on operational aspects of central banking
- Support is tailored to country-specific needs
- Recommendations reflect international best practices and cross-country experiences

Thank you

Questions and comments welcome