National Bank of Rwanda

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Monetary Policy in Developing Countries:
Practices and Challenges

Review of Relevant Country Experiences in Transitioning from Monetary to Inflation Targeting

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Objective and Outline

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Review of the experiences of a diverse set of countries during their transition to inflation targeting with a view to informing sub-Saharan African countries intending to adopt similar frameworks

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Outline:

- Prevailing macro conditions before transition and motivation for move to IT
- Key challenges and reforms implemented during the transition phase
- Main common features of the adopted formal IT frameworks
- Main aspects of program design (countries with Fund supported program)
- Main takeaways for SSA countries intending to adopt similar frameworks

SECTION I. PREVAILING CONDITIONS AND MOTIVATIONS OF THE TRANSITION TO IT

The study covers 7 countries:

- Two emerging market countries (Brazil and Turkey)
- Two African countries (South Africa and Ghana)
- Three Eastern European countries (Albania, Armenia, and Moldova)

SECTION I. PREVAILING CONDITIONS AND MOTIVATIONS OF THE TRANSITION TO IT

- Most countries experienced unstable macroeconomic environment (in addition to problems with nominal anchors)
- Also, most countries found the move to IT as the only viable alternative
- Two different monetary policy anchors were used by countries before transition
- Central banks suffered from limitations particularly in analytical capacity
- Move to IT was crucial to strengthen coordination between central bank and government

SECTION II. THE TRANSITION PHASE: CHALLENGES AND REFORMS

All but one country gradually transitioned towards a full-fledged IT framework

- Brazil was the only country that adopted big-bang approach
- The rest took advantage of a transition (ranging from 2 to 5 years) to develop capacity
- All countries announced an informal inflation target to begin to influence expectations
- Continued to monitor monetary aggregates (maintained money target as Anchor)
- Started developing and monitoring a new set of macroeconomic and financial indicators to better guide monetary policy

Opted for gradual transition to reduce risks from weak policy environment

- In particular, address early on the risks from large fiscal deficits and fiscal dominance (Albania and Turkey)
- Entrench fiscal discipline and reduce government debt (Turkey)
- Enhanced macroeconomic stability gradually led to the recovery of growth, further reducing the debt-to-GDP ratio, gradually lifting the constraints on monetary policy.

Used transition to introduce greater flexibility in the exchange rate; strengthen resilience to external shocks

- Most countries allowed the exchange rate to respond more freely to fundamentals (South Africa Reserve bank stopped all attempts to peg the exchange rate)
- Adopted policies that strengthened macroeconomic stability (in line with fundamentals and long-term sustainability)
- However, some central banks continued to manage the exchange rate even after IT, because of concerns of high pass-though effects to inflation (Armenia, central and eastern European economies)

Took advantage of transition to strengthen health of financial sector

- Enable banks to safely respond to monetary policy signals (raise the interest rates on loans without endangering financial system stability)
- Strengthened banking supervision and introduced reforms to strengthen banking system (Ghana and Turkey)
- Asked banks to clean balance sheets, have proper provisioning, and recapitalize if needed (private commercial banks)
- Introduced reforms to securitize government debt and restructure state owned commercial banks

Also, to strengthen central bank independence/Implementation capacity

- Put in place required legislation to strengthen central bank independence
- Add provisions to enhance coordination between fiscal and monetary authorities
- Strengthen analytical infrastructure for forward looking approach to monetary policy
- Strengthen data collection and analytical capacity
- Improve monetary policy signaling

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SECTION III. FULL INFLATION TARGETING – KEY FEATURES

Although inflation declined and credibility improved, countries still faced challenges during transition

- Lack of clarity of decisions in relation to inflation developments
- Not possible to fully elicit the same commitment to policy coordination
- During periods of shocks when the price stability objective is not fully in line with the growth objective (e.g. supply side type of shock).

Thus formal **IT** would help establish a structured decision process and stronger push for coordination; establishing central bank credibility

SECTION III. FULL INFLATION TARGETING – KEY FEATURES

Under Full IT, central banks worked to establish

- Coordinated decision/announcement of inflation target

Broad commitment to macroeconomic stability

- Clear and monitorable inflation target

Simple, transparent, and acceptable inflation measure by public

- Higher transparency and accountability
    - Regular/predictable timing of reporting and information
    - Formal mechanisms requiring central banks to provide explanations when inflation developments deviate from forecasts (open letter from Governor to the government)

Crucial for establishing credibility, thus better anchoring expectations

SECTION IV. IT AND FUND PROGRAM DESIGN

Fund program assessment criteria under monetary targeting frameworks

- Do not explicitly target an inflation rate
- Primary focus is to ensure that Fund-supported programs lead to external viability
- Set off signals to tighten the monetary stance if external target is being threatened (because of low NIR or excessive increase in NDA)
- Does not prevent a buildup in the gross reserve position in excess of target from fueling monetary expansion

Fund assessment criteria under IT frameworks

- Includes the inflation target as one of the program objectives
- Preserves initial primary focus of IMF assessment criteria (external viability)
- Consultation clause including two consultation bands:
    - informal consultation if inflation outside narrow band, and
    - formal consultation if outside wider band
- However, not applied to all countries in sample
    - Three kept traditional monetary targets (Albania, Armenia, and Moldova)
    - Others added a consultation clause (Brazil, Ghana, and Turkey)
- This appears motivated by capacity issues, extent and level of credibility of commitment to the inflation target

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SECTION V. KEY TAKEAWAYS

1. IT could be adopted by a wide range of countries including well prepared low income countries

2. No unique anchor is observed by countries during transition

3. Having in place certain building blocks could ease the transition

   - Commitment to price stability
   - Commitment to eliminate fiscal dominance
   - Basic understanding of transmission mechanism
   - Reasonably well functioning markets

4. Coordination between fiscal and monetary policy is crucial

5. The development of technical capacity including to forecast inflation and to understand the transmission channels is crucial

6. This will also require the development of high quality high frequency indicators of economic activity

7. Technical capacity is not sufficient, need professional judgment

8. Reasonably well functioning money and foreign exchange markets

9. Establishing policy credibility reduces the cost of shocks

10. IMF ready to help provide TA in wide range of reforms to facilitate smooth and successful move to IT in SSA countries

End,

Thank you…