International Monetary Fund

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IMF Executive Board Reviews Conditionality in Evolving Monetary Policy Regimes

Press Release No. 14/148
April 2, 2014

On March 26, 2014, the Executive Board of the International Monetary Fund (IMF) discussed the monetary conditionality framework in Fund-supported programs in developing countries.

Over the past decade there have been significant changes in monetary policy regimes in developing countries. Increasing numbers of both low-income and emerging market countries are shifting from exchange rate anchors and the use of monetary aggregates targets toward more flexible operational targets and more forward-looking policies, with increasing reliance on policy rates to signal the monetary policy stance. The financial landscape is also changing: significant financial deepening; lower inflation; and a weaker correlation between money growth and inflation. Empirical analysis of the performance of monetary conditionality in Poverty Reduction and Growth Trust (PRGT)- and General Resources Account (GRA)-supported programs in countries with scope for independent monetary policy finds that while a high proportion of reserve money targets were not observed, program inflation objectives were generally not compromised provided that initial inflation was low.

The evolution of monetary policy frameworks has implications for monetary conditionality in Fund-supported programs. There are clear guidelines and established practices for monetary conditionality for money targeting and inflation targeting frameworks. However, neither of these existing conditionality frameworks is well-suited for countries with evolving monetary policy regimes.

The paper proposes an enhancement to the existing review-based conditionality framework by introducing a monetary policy consultation clause (MPCC), as an option for countries with evolving monetary policy regimes in place of a performance criterion on reserve money or net domestic assets. Programs would set a central path for a target variable (either a monetary aggregate or inflation) with a single tolerance band (with an option to have an inner band where

deemed necessary). Deviations from the band would require a formal consultation with the Executive Board, and would be informed by staff's assessment of whether deviations are explained by compensating factors and proposed remedial measures, where necessary, in order to complete a review. The review-based approach to monetary conditionality rests upon enhanced central bank capacity to analyze monetary conditions. The MPCC is expected to provide flexibility in the conduct of monetary policy and align conditionality to the changing monetary policy frameworks in countries with evolving monetary policy regimes.

Executive Board Assessment[1]

Executive Directors welcomed the discussion of monetary policy conditionality in countries with evolving monetary policy regimes. They saw merit in employing a review-based approach to monetary conditionality and broadly endorsed staff's proposal to enhance the existing framework by introducing a monetary policy consultation clause (MPCC) as an option for countries that have the capacity to adjust policy settings in a flexible way to achieve their monetary policy objectives.

Directors noted that many developing countries with scope for independent monetary policy are moving toward more flexible and forward-looking monetary policy frameworks, generally focused around the broad objective of achieving price stability. They observed that a weaker relationship between monetary aggregates and inflation implies a decline in the relevance of monetary aggregates as reliable indicators of the monetary stance in countries with low inflation, changing financial landscapes, and facing exogenous shocks. Moreover, the non-observance of reserve money targets in Fund-supported programs have typically not been correlated with inflation deviations in countries that have already achieved single-digit inflation levels.

Directors discussed the proposed enhancement of the review-based approach to monetary conditionality in Fund-supported programs in the form of the MPCC. Under this approach, the MPCC would be based on a specified central path for a target variable (i.e., monetary aggregate or inflation). This target variable would normally have a single tolerance band. It would be subject to periodic reviews in conjunction with general program reviews, and would include an enhanced monetary policy assessment in the context of a clearly defined monetary policy objective. A formal consultation with the Executive Board would be triggered if the observed outcome of the target variable deviates from the band, and access to Fund resources would be interrupted until the consultation with the Board takes place and the relevant program review is completed. In MPCC regimes selecting inflation as the target variable, a narrower inner band could be an option to serve as an early warning mechanism that would trigger a consultation with staff when the observed outcome of the target variable deviates from the inner band. In the event a consultation with the Executive Board is triggered, the staff report would

include a comprehensive assessment of monetary policy explaining clearly the reasons behind the target deviations and proposing prompt remedial actions if deemed necessary.

Directors considered that the MPCC could enhance monetary policy conditionality in programs where countries have a strong track record of policy implementation, a relatively low and stable inflation rate, and adequate technical capacities. In this regard, Directors generally pointed to the importance of de facto central bank autonomy in monetary operations, macroeconomic and financial stability, and the capacity for quantitative analysis of the inflation process, for successful implementation of the flexible monetary policy framework under the MPCC. Directors underscored the importance of evenhanded application of the standard and urged staff to consider, on a case-by-case basis, whether it would be appropriate for a member to use the MPCC, noting that some countries may not currently meet all the institutional guideposts or have other characteristics that make the use of the MPCC premature. In the near term, relatively few arrangements are expected to adopt this new conditionality framework, but it is understood that staff will exercise flexibility in assessing individual cases. For some countries, the MPCC could be considered provided the program includes reforms to address capacity constraints and institutional weaknesses. Directors noted that the decision to implement the MPCC would be the outcome of discussions between staff and the authorities. They stressed that program design—including the features of the tolerance band—should take into account countries' characteristics. Some Directors cautioned that use of the MPCC should not imply a commitment to move toward inflation targeting.

Directors emphasized the importance of the proposed consultation clause in safeguarding the use of Fund resources. They were of the view that maintaining the floor on net international reserves as a performance criterion and, where warranted, indicative targets on indicators such as net domestic assets or net credit to government should provide sufficient safeguards for the use of Fund resources.

Directors considered that the traditional framework for monetary policy conditionality would continue to be relevant for many countries, including those with less-developed institutional frameworks and a track record of relatively high inflation. Nonetheless, the Fund should support developing countries that seek to modernize their conduct of monetary policy. Directors welcomed staff's efforts to build institutional capacity and enhance data provision and analysis in these countries.

Directors supported a measured approach by staff to the introduction of the MPCC in countries where conditions for successful implementation are broadly in place. The Operational Guidance Note on Conditionality will be updated to incorporate the enhancements of the review-based monetary conditionality framework discussed by the Executive Board today. Directors looked forward to taking stock of experience gained from selected countries implementing the new

conditionality framework after sufficient experience has been gained.

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[1] An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

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