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2:30 p.m., March 26, 2014

## 3. Conditionality in Evolving Monetary Policy Regimes

Documents: EBS/14/24 and Supplement 1

Staff: Lane and Pattillo, SPR

Length: 1 hour, 23 minutes

## Executive Board Attendance

N. Shinohara, Acting Chair

| Executive Directors | Alternate Executive Directors |
|---|---|
| | C. Kapwepwe (AE) |
| | D. Sembene (AF), Temporary |
| | O. Hendrick (AG), Temporary |
| | N. Luu (AP), Temporary |
| | I. Oliveira Lima (BR) |
| | P. Sun (CC) |
| | M. Arbelaez (CE) |
| | N. Parent (CO), Temporary |
| J. Prader (EC) | |
| | M. Farnoux (FF), Temporary |
| | S. Meyer (GR) |
| | J. Raj (IN), Temporary |
| | A. Bassanetti (IT), Temporary |
| | I. Hishikawa (JA) |
| | A. Jbili (MD), Temporary |
| A. S. Shaalan (MI) | |
| | A. Friedman (NE), Temporary |
| | M. Lindpere (NO), Temporary |
| | M. Atamanchuk (RU), Temporary |
| | H. Alogeel (SA) |
| | R. Abdul Ghaffour (ST) |
| D. Heller (SZ) | |
| | J. Weiss (US), Temporary |
| | N. Meads (UK), Temporary |

C. McDonald, Acting Secretary
J. Morco, Summing Up Officer
D. Daly, Board Operations Officer
P. Martin, Verbatim Reporting Officer

**Also Present**
European Central Bank: G. Pineau. African Department: S. Wajid, O. Williams. European Department: K. Srinivasan. Finance Department: D. McGettigan. Legal Department: K. Christopherson Puh, I. Luca. Monetary and Capital Markets Department: B. Laurens, N. Maehle. Strategy, Policy, and Review Department: M. Arena Duffoo, C. Lane, S. Nolan, M. Opoku-Afari, C. Pattillo. Advisors to Executive Directors: M. Ben Hassine (MD), M. Kapur (IN), R. Kharel (ST), A. Landbeck (GR), T. Manchev (NE), R. Ngugi (AE), A. Tivane (AE), S. Waelti (SZ), T. Yamuremye (AE), K. Yanai (JA), M. Cheng (CC), I. Garrido (CE), F. Najjarian (BR).

## 3. CONDITIONALITY IN EVOLVING MONETARY POLICY REGIMES

Mr. Prader and Mr. Kollar submitted the following statement:

We welcome the revised paper, incorporating the points raised during the informal Board discussion on January13, and we support the paper's conclusions. We would like to provide the following points for emphasis.

We appreciate the added reference to the safeguards assessment in paragraph 40, reinforcing the staff assessment of central banks' independence in situations when the over-performance of NIR could lead to quasi-fiscal operations. Protecting Fund resources should be a guiding principle of the new framework.

Introducing the idea of a "standard" alongside the guideposts is useful. We would like to emphasize that clarity in the specification of the standard and realism in assessing whether countries are meeting the standard will determine the operational success of the new framework. Room for sound staff judgment as well as for taking country specificities into consideration should remain in place. The possibility to address moderate gaps in the institutional set-up during the program with an MPCC (paragraph 42) and staff's judgment to require additional institutional reforms (paragraph 43) provide sufficient room for maneuver. Lastly, we believe that the design of the new framework should allow for sufficient scope to take the authorities' views into consideration in the review process.

We welcome footnote 26 on page 26 that introduces the idea of considering financial stability implications of monetary policy where relevant. However, we would have appreciated to see this important consideration elaborated on in the main text, rather than being confined to a brief footnote. We strongly believe that the goal for programs with developing countries should not only be achieving lower and stable inflation, but also broadly defined financial stability.

We think that the new framework should not imply a recommendation for developing countries to move towards inflation targeting regimes if they are not ready. Given the depth and structure of their domestic capital markets, staff should continue analyzing the relationship between money, credit and inflation in these economies. Sound money as well as carefully paced financial deepening (particularly in bank lending) are important prerequisites for a stable economy.

We support the Fund's continued technical assistance to developing countries aimed at capacity development. For the time being, we believe this could be achieved within the current Fund's budget envelope by prioritization.

Finally, we expect to review the experience with the MPCC after sufficient experience is gained. Among other things, future reviews should focus on the extent to which the new framework safeguards the use of Fund resources and minimizes misreporting.

Mr. Yoon and Ms. Luu submitted the following statement:

We welcome the more flexible approach to conditionality for countries with evolving monetary policy regimes. The review-based approach to conditionality appropriately recognizes economic and financial developments in member countries and enhancements in monetary policy frameworks. The weakening relationship between money and inflation and the increasing non-observance of reserve money performance criteria provide a case for reviewing the usefulness of monetary aggregates as an indicator of monetary policy stance.

We are generally supportive of the proposal to include the monetary policy consultation clause (MPCC) as an option under the review-based conditionality framework. However, our preference is for both the MPCC—regardless of the target variable—and the ICC to be based on a single tolerance band. The proposal to introduce an inner band for MPCC where inflation has been chosen as the target variable reduces flexibility, adds complexity and could skew the incentive towards selecting monetary aggregates as a target variable. As we noted at the informal discussion on this issue, we favor a simple and parsimonious approach for consultation bands for both the MPCC and the inflation consultation clause (ICC). Can staff explain the rationale for why some countries, more recently, have been using single bands under the ICC framework, as noted in Box 3?

We support the strengthening of the criteria used to determine eligibility for the MPCC. The requirement of a good track record of monetary policy implementation would be important as evidence that policymakers have the technical capabilities and capacity to navigate, manage and adjust the transition to a more flexible monetary policy regime. In this regard, we support Fund technical assistance to strengthen the underlying institutional framework to help members to meet their monetary policy objectives, and to meet conditionality for countries transitioning to more flexible frameworks.

Finally, we underscore that external sustainability remains a core objective of Fund-supported programs. While maintaining the NIR floor as a performance criterion is important for ensuring external sustainability, this alone may not be sufficient. As such, we support staff's proposal to introduce additional tripwires to address country-specific risks, including the possibility of using NDA or monetary aggregates as tripwires.

Mr. Heller and Mr. Waelti submitted the following statement:

The gradual move toward more forward looking monetary policy regimes and financial market deepening motivates a reassessment of monetary conditionality for countries with scope for an independent monetary policy. The existing conditionality framework complicates the task of monetary policymakers, as it relies heavily on monetary targets when policymakers are moving toward more formal inflation targeting frameworks. As such, conditionality based on net international reserves, net domestic assets and reserve money is becoming increasingly less relevant in these countries.

We support the proposed review-based approach to program monetary conditionality for those countries that fulfill the required criteria. The implementation of the MPCC will provide constrained flexibility to the authorities in setting their objectives in an evolving context. In particular, this constrained flexibility should give the authorities enough legroom to design an adequate monetary framework while at the same time preserving credibility. This constrained flexibility should be accompanied, first by the design of a central path for inflation or monetary growth that is consistent with a clear inflation objective or disinflation path, and second by the necessary tripwires.

The use of the NDA ceiling as a tripwire should be mandatory. The staff rightly point out that removing the performance criterion on NDA may be conducive to exceeding the NDA ceiling in order to compensate for unprogrammed reserve losses. However, staff does not offer clear guidance on how this can be avoided. Replacing the performance criterion on NDA with a commitment by the authorities not to exceed the NDA ceiling (when the NIR floor is set with a considerable margin) is not sufficient. Moreover, the conditions under which a commitment is unnecessary are very loose (margins "relatively" modest and exchange rate "generally" flexible).

The guideposts proposed by staff are useful starting points but they cannot be treated equally. The first guidepost—central bank independence—is necessary when countries are moving toward a monetary regime based on inflation targeting. As such, meeting this guidepost should be indispensible.

The second guidepost—macro and financial development and stability—is desirable but hardly applicable in full to the countries under consideration. Judgment will be needed to assess whether sufficient progress has been achieved or can reasonably be expected to be achieved in the future. The same considerations apply to the third guidepost—data and analytical capacity. A minimum of capacity must be expected to be present. It will be applicable in full only when the authorities have accumulated enough experience in the implementation of the new monetary framework.

The current provision of TA and capacity building work related to monetary policymaking is adequate. A potential increase in demand can be met by finding synergies between training, TA and capacity building and prioritizing the use of resources in this area.

Mr. Assimaidou submitted the following statement:

In the past several years, improved monetary policymaking has enabled many developing countries to sustain relatively low inflation levels, thus helping further strengthen macroeconomic stability. In this context, more flexible and forward-looking monetary policy frameworks have increasingly looked more appealing to their central banks, as significant inroads were also being made toward financial development. At the same time, the staff paper documents, in both PRGT and GRA-supported programs, a lack of correlation between deviations in program reserve or broad money targets and inflation deviations in low-inflation countries but not in high-inflation countries.

Against this background, staff proposes an optional switch from the traditional conditionality setting in the form of performance criterion on net domestic assets or reserve money to a review-based monetary policy consultation clauses (MPCCs) for countries with evolving monetary policy regimes and scope for independent monetary policy. We broadly support the staff proposal, but we would like to underscore below a number of specific issues for emphasis and further consideration.

Design of Program Monetary Conditionality

In our view, successful implementation of the proposed framework will require continued, close policy dialogue between staff and the authorities in the context of program design. Indeed, setting adequate monetary or inflation target bands and shaping an effective policy response in the event of deviation from these bands will necessitate close alignment of monetary policy objectives and the design of the MPCC.

While preserving their ability to help secure program objectives, the tolerance bands should be large enough so that they will neither trigger frequent monetary policy consultations based on non-critical deviations from targets nor constrain unduly credit growth. This is particularly relevant to regimes with money target variable for which staff proposes a single tolerance band. In any case, program reviews should give the opportunity to review the adequacy of the width of target bands and revise them, as appropriate if warranted.

For the sake of streamlining conditionality, staff should refrain as much as possible from setting cumulatively program conditions related to both inflation consultation clauses and monetary aggregates, including reserve money and NDA. As a matter of fact, where ICCs are included, targets on NDA and RM should be purely indicative in the event they are deemed necessary, especially since staff analysis demonstrates their weak ability to influence effectively inflation dynamics in low-inflation countries.

We welcome the proposed focus of staff’s assessment on compensating factors in the event of deviations from the band. When formal consultations with the Board are warranted due to large deviations from the target bands, staff’s assessment of monetary policy stance should pay attention to the explanatory factors, analytical and capacity constraints that could undermine the effectiveness of the authorities’ remedial measures. It would be at odds with the spirit of the proposed framework, if all due flexibility is not provided before delaying the completion of program review or eventually recommending its non-completion.

Application of the Misreporting Policy

We question the relevance of the proposed application of the misreporting policy to the proposed MPCC framework, as explained in footnote 30. In many capacity-constrained countries, the risk of unintentional provision of inaccurate information on the target variable could be high in the context of quarterly or semiannual review schedules, particularly in cases where the latter is inflation, as preliminary estimates may end up being significantly different from final outturns. Under these circumstances, assimilating untimely reporting of deviations from the outer band with misreporting—albeit de minimis—could be detrimental to country authorities and involve unnecessary reputational costs. We would therefore encourage staff to reconsider their proposal for the application of the policy. The staff’s comments are welcome.

Technical Assistance

We welcome the intensive technical assistance activities that continue to take place in many countries concerned, particularly in Sub-Saharan Africa. Going forward, continued provision of Fund's technical assistance will be of paramount importance to help strengthen monetary frameworks, particularly in countries with evolving monetary regimes. That said, we would caution against shifting technical assistance resources away from countries with fixed exchange rate regimes and other non-evolving regimes to those with evolving monetary policy regimes. If increased demand for Fund's capacity building activities were to arise as a result of the proposed approach to monetary policy conditionality, we would expect the institution to provide the additional resources needed to accommodate it.

Communication Strategy

We find it critical that a good communication strategy be developed to ensure that key features of the proposed framework are well understood, particularly among the universe of countries for which the proposed review-based approach is potentially suitable. Key among these features are the optional adoption of the proposed review-based MPCC framework and the fact that it does not imply moving eventually to an inflation-targeting regime.

Furthermore, staff's outreach activities should not carry the wrong impression that money targets remain relevant only in countries with high-inflation rates or low levels of financial development. In particular, such targets continue to be effective in many countries with non-evolving monetary policy regimes that have successfully kept inflation low and made major strides toward financial development.

Finally, the observed weaker relationship between money growth and inflation in LICs and emerging market economies should not be interpreted as corollary of ineffective monetary policy, as reminded by staff. The fact that this relationship is weaker in the 2002-2012 sub-period compared with the 1990-2002 is predictable since many countries selected in the sample moved away from fixed exchange rate arrangements to inflation targeting frameworks and other more flexible regimes starting from the early 2000s, and subsequently abandoned the use monetary aggregates as monetary policy anchor. Although such a move is acknowledged in footnote 6 of the paper, it is not captured in the panel regressions that support the correlation between money growth and inflation (Table II-2).

Mr. Kiekens, Mr. Friedman and Mr. Manchev submitted the following statement:

We broadly support staff's proposal to upgrade the Fund program conditionality for countries with evolving monetary policy regimes. A changing landscape of monetary policy in developing countries requires a more flexible approach to the Fund's program conditionality. Hence, assessment of the monetary policy along a number of dimensions appears more appropriate. We believe that the design of Fund supported programs should also encourage the development of more elaborate and forward-looking policy frameworks. Accordingly, we share the view that the program conditionality toolkit should reflect these developments. There is also merit in moving closer to the approach currently applied in program cases for countries that have adopted formal inflation targeting regimes.

The proposed review-based approach to the program conditionality, however, should only be considered as a useful alternative for members with an evolving financial landscape and monetary policy regime beyond the point where staff and the authorities reach a consensus view that monetary aggregates have become irrelevant targets altogether. Some of our constituency members fear that the approach might generate some additional rigidity in the normal operation of the programs. Hence, assurances from the management are warranted.

Although their relation to inflation has weakened, monetary aggregates can still play an important role. The newly proposed MPCC is flexible enough to keep monetary aggregates covered by traditional conditionality, in case it is deemed important, and we support that. However, it will be equally important to ditch traditional conditionality and to move solely to an ICC-type conditionality once monetary policy is assessed to be sufficiently mature. Otherwise, conditionality might overburden policy, and even delay the shift to an IT framework.

In our constituency we have some encouraging results with implementing the proposed guideposts for the degree of policy, institutional, and market development required before moving to the proposed MPCC framework. However, we remain to be convinced that the preconditions outlined in paragraph 41 of the paper look realistic for many developing countries. Therefore, a more precise measurement should be put in place before adopting the proposed MPCC. Similarly, we need a credible band setting under either monetary or inflation targeting regimes, where further deepening of the staff methodology is needed. We also see merit in broadening the framework through inclusion of indicators for closer monitoring of the credit aggregates and financial stability conditions. The staff's comments would be welcome.

Finally, we recognize the need for upgrading the institution's knowledge before the proposed move, and thus welcome staff's emphasis on the TA provision. Developing an adequate analytical and forecasting capacity at the central banks of the concerned countries is key. However, we underline that assurances for technical assistance should go far beyond assistance to the central banks. A national system for reliable high frequency statistical data is needed, and we believe the Fund should be more involved there.

Mr. Saho, Mr. Saidy and Ms. Dlamini-Kunene submitted the following statement:

We thank staff for a well written paper and welcome the opportunity to review and discuss the paper on conditionality in evolving monetary policy regimes. For the past decade, reserve money has been used with greater prominence in Fund supported programs especially for high inflation countries hoping to curb inflationary pressures and reduce inflation. However, evidence has shown that outcomes in monetary targets did not yield the expected results in inflation and growth. The weakening relationship between monetary targets, inflation and growth is an indication that monetary policy in our countries is transitioning as financial institutions, markets and instruments develop. The weakening link between monetary aggregates and inflation outcomes especially for low inflation countries has created a dilemma for policy makers because it has clouded the effect of policy rates in communicating the monetary policy stance. Therefore, the review based conditionality proposed by staff is a good initiative.

We see merit in pursuing a pragmatic approach that will make monetary policy more effective in achieving and maintaining price stability by selecting a more credible nominal anchor. Accordingly, we support staff view that employing a review-based approach to program monetary conditionality in the form of an MPCC for assessing monetary policy in place of performance criteria, for members with an evolving monetary policy regime that have developed a good track record of policy implementation underpinned by operational autonomy and technical and institutional development of the central bank. This will provide a framework for coherent monetary policy analysis and monitoring to achieve the objective of conditionality while responding to the changing needs of policy makers in evolving monetary policy regimes. However, the effective implementation of the review based approach would require continuation of capacity building in central banks. This will ensure that the migration to MPCC for assessing monetary policy as a performance criteria for members with evolving monetary police regimes will not have unintended consequences.

We also caution against having the review-base monetary conditionality as a one cap fit all Fund policy. Instead, it should be based on the monetary policy practice in the program country, making it country specific. In addition, we would like to underscore the importance of country ownership of the MPCC. Furthermore, the width of the tolerance band should be broad enough to provide flexibility based on country specific circumstances and balance against the need to direct monetary policy toward its intended outcome or objective. In this respect, we welcome staff assurances that the authorities are responsible for the selection, design and implementation of economic policies while the fund is responsible for the establishment and monitoring of conditionalities including the MPCC.

We endorse the introduction of the MPCC on a gradual approach, subject to review after sufficient experience has been gained. This will assist countries to strengthen their institutions, make their monetary policy frameworks more robust, enhance central bank independence and the timely generation of quality high-frequency indicators as well as minimize fiscal dominance. The measured approach will also enable staff to occasionally assess the authorities' capacity to implement the review-based monetary policy, including maintaining the MPCC target variables within the band. Furthermore, it will avail staff the opportunity to assist countries to develop a system that would help organize the underlying economic information in a structured way to support monetary policy implementation.

For those countries that have not made significant progress towards the guideposts for adopting flexible conditionality approach, staff should propose some structural reform measures that would ensure institutional reforms in central banks, strengthen the operation of financial markets and build statistical and analytical capacity to position them on a path to modernizing their monetary policy. Meanwhile the traditional framework for monetary conditionality could continue to be used by countries that have not fully transitioned to the flexible conditionality framework and where it has proven to be effective in achieving program objectives.

Finally, given that enhanced central bank capacity for monetary policy is needed in evolving monetary policy regimes, the Fund's capacity building efforts and data enhancement should continue. Also, we urge that these technical assistance and training be rolled out to other members. Equally important is Fund support and training on improving short-term monetary operations, liquidity forecasting and management. In this respect, we urge that adequate resources be devoted to capacity building while existing technical assistance and capacity building resources are well coordinated to effectively address the capacity needs of member countries.

Mr. Hockin and Mr. Parent submitted the following statement:

Overall, we believe that staff makes a strong case for modifying, when the conditions are met, the traditional monetary anchors for countries with evolving monetary policy regimes. Deeper financial markets increase both the feasibility and the desirability of using short-term policy interest rates to steer the monetary policy stance. Monetary targets should however be maintained for countries with less developed institutional frameworks as they may provide information about the presence of any monetary financing and credit expansion.

It is very important that Fund instruments and conditionality facilitate the evolution of monetary policy framework toward more flexible operational targets and more forward-looking policies. Moreover, it is clear that the weakening relationship between money and prices in the context of increasing instability in money demand and lower levels of inflation calls for a more nuanced policy framework. We welcome therefore the staff's proposal to replace performance criteria on net domestic assets or reserve money by a review-based conditionality to assess monetary policy for countries with scope for independent monetary policy. Adding some flexibility to the Fund's approach to monetary policy conditionality is important. Conditionality cannot be out of synch with welcome enhancements to monetary policy frameworks.

Obviously, many conditions need to be met. First, member countries should have made significant progress in achieving central bank independence. The importance of credibility to the success of inflation targeting in developing countries is also critical. When "fiscal dominance" takes precedence over the control of inflation, inflation targeting is not a credible policy. Moreover, inflation targeting will not be credible or desirable if the government must rely on the inflation tax to finance expenditures. A more refined approach to monetary policy implementation should go hand in hand with modernized and sound monetary and fiscal frameworks.

We consider adequate the current provision of TA and capacity building for monetary policymaking. Building capacity to support a solid quantitative understanding of the inflation process will be key. Hence, we welcome the efforts by staff already undertaken and those outlined for the future with regard to providing TA to facilitate transitions to more forward-looking monetary policy regimes.

Mr. Shaalan and Mr. Geadah submitted the following statement:

The staff paper convincingly argues against maintaining the current reliance of conditionality on monetary aggregates for countries with evolving monetary policy regimes. As discussed in the earlier staff paper and Board meeting in January, the relationship between inflation and monetary aggregates has weakened in low inflation countries, leading to instances where inflation targets are missed even when monetary targets are observed.

We accordingly agree with the proposed approach to modify monetary policy conditionality for evolving regimes. The proposed monetary policy consultation clause (MPCC), which would set periodic monetary or inflation targets within a tolerance band, should provide Fund programs with the needed flexibility in program design and monitoring. We also agree with keeping NIR as a PC to ensure external sustainability and to use indicative targets to address country-specific issues. The successful experience with the inflation consultation clause, together with PCs on NIR, for inflation targeting regimes helps to provide assurance that the proposed approach will be workable.

The staff paper proposes a single tolerance band for the target variable. The width of the band would be set on a case-by-case basis, taking account of the volatility in the target variables, and the choice and effectiveness of monetary instruments. This approach is reasonable. Nevertheless, it would be useful to review the experience with using a single band, and with the parameters used to set it, within a 2-3 year period, depending on the number of program in which the proposed approach is applied. The review would also cover whether the proposed framework provides sufficient safeguards for the use of Fund resources, even though there is little indication that the proposed change in conditionality would adversely affect these safeguards.

The staff foresees limited implications for capacity development related to the proposed approach since few Fund arrangements are expected to adopt this new conditionality framework in the near term. Nevertheless, it would be useful to monitor the additional demand for resources in area as well as functional departments.

Mr. Montanino, Mr. Catsambas and Mr. Bassanetti submitted the following statement:

Key Messages

We support the possibility to introduce a monetary policy consultation clause (MPCC) in programs for member countries with an evolving monetary policy regime.

The proposed framework looks well-balanced, and it sets the proper safeguards on the use of Fund resources. Nevertheless, the envisaged additional tripwires should be in place whenever they are deemed relevant.

We strongly agree with the proposal for a future review of the MPCC option, once sufficient experience has been gained.

We believe that the provision of technical assistance (TA) and capacity building is rather adequate at present.

We thank staff for an insightful paper. We broadly agree with its thrust and would like to offer the following specific comments.

Specific Comments

The staff provided compelling evidence in favor of employing a review-based approach to program monetary conditionality in the form of an MPCC for members with an evolving monetary policy regime. As the staff noticed, the new framework is a response to developments that are de facto already occurring in a number of countries. As such—together with the traditional monetary targeting conditionality and the inflation consultation clause (ICC)—it completes the tool kit available to the Fund to better adapt programs to the economic and institutional features of the membership, increasing the probabilities of success.

In this respect, we deem the institutional and structural guideposts envisaged in the staff paper for the adoption of an MPCC as crucial, including a strong track record of policy implementation and a relatively low and stable inflation rate. We understand that the evaluation of the compliance with such guideposts, which cannot be fully formalized, leaves unavoidably significant room for judgment by staff. Consequently, it will be important for such assessments to be thorough and evenhanded, and that they be conducted through a close dialogue with the authorities. We are reassured by the possibility for the authorities to request to modify the type of monetary conditionality during the program if circumstances change. In view of these considerations, we strongly endorse the proposal for a future review of the MPCC experiences once a sufficient number of cases becomes available.

The proposed MPCC framework looks well-balanced, providing the right degree of flexibility on a case-by-case basis. We agree with the suggested approach on how to establish the target variable and its tolerance band. Furthermore, when advising against the premature adoption of an MPCC—and therefore opting for the traditional monetary targeting conditionality—we see merit for staff to advise members about structural benchmarks aimed at modernizing monetary institutions and policies.

The envisaged safeguards on the use of Fund resources through consultations and reviews seem appropriate. Nonetheless, we would encourage staff to resort to the envisaged tripwires whenever they are deemed relevant to protect Fund resources. In particular we favor the possibility to retain a ceiling on Net Domestic Assets when risks to external stability are significant.

We believe that the provision of TA and capacity building is rather adequate at present, also considering that in the near term the new framework will likely be applied to a limited number of countries, as the staff noticed. In case of an increased demand for TA coming from other members that intend to modernize their policy framework, we believe that prioritization and leveraging on the resources already available in the current envelope would be the right approach to be followed.

Mr. Mohan and Mr. Raj submitted the following statement:

We thank staff for a comprehensive paper on conditionality in evolving policy regimes. We welcome the staff proposal to adopt a review-based approach to program conditionality for assessing monetary policy, if it provides greater flexibility to countries in choosing the appropriate monetary policy framework. However, we are apprehensive that the staff's current proposals instead might limit flexibility. The paper essentially suggests a choice between the two target variables, viz., monetary aggregate or inflation for countries that have abandoned or deemphasized the monetary targeting framework, but have not yet transited to inflation targeting framework—referred to as countries with evolving monetary policy regimes. However, the proposed conditionality framework may not be suitable for all such countries as is detailed below. In addition, we also have some issues with regard to the operational aspects of the proposed conditionality.

Many developing countries have not adopted an inflation targeting framework for a variety of reasons. In general, they are usually vulnerable to supply shocks not under their control from time to time. It may, therefore, be difficult for them to commit to inflation targets even for the purpose of the program. And even if they commit to inflation targets, there may be large and frequent deviations from the band.

Apart from the issue of supply shocks, successful realization of inflation targeting will also critically depend on the strength of transmission from the operating target to the inflation target. However, in many countries, financial markets are still not adequately developed thereby hindering transmission of monetary policy. In such a situation, the adherence to the target may not always be assured even as the authorities take all the necessary policy actions. Notwithstanding the overall significant improvement in financial systems, as pointed out in the paper, there could be wide divergences across countries. As a consequence, the time required to successfully adopt the new approach would vary markedly across countries.

The paper mentions that the target variable subject to a monetary policy consultation would normally have a single tolerance band. However, in regimes that select inflation as the target variable, in addition to an outer band, a narrower inner band could be used as an early warning to check that monetary policy is not veering off track. It is also stated that the width of the tolerance band would be set sufficiently wide to provide adequate flexibility on a case-by-case basis. The inner band in the case of money target variable will not be available on the ground that it may limit the additional flexibility the MPCC is meant to provide. We are not entirely convinced by the rationale for not having inner band in the case of money target. It is also not clear as to how the band will be fixed and operated. It may be necessary to specify the size of the deviation and the period of the deviation/s that would trigger Fund consultations. It is also necessary to specify as to who will decide/validate the central path for the policy instrument?

To accommodate supply shocks, many inflation targeting central banks, including advanced economies, aim to achieve the inflation targets over a 2-3 year cycle or sometimes even longer. The paper proposes that should the observed outcome of the target variable deviate from the band, access to the Fund resources would be interrupted until the consultations with the Executive Board take place and the relevant program review is completed.

This would lead to avoidable volatility in the economies of the borrowing countries. In recent years, even some major advanced economy central banks experienced inflation above their targets on a persistent basis. Therefore. to expect that central banks in countries with evolving monetary policy regimes, with underdeveloped financial markets and subject to recurrent supply shocks, will have a better control over inflation is too demanding. Rather than suspending disbursements and requiring a consultation with the Executive Board for every deviation, it might be better if this consultation is mandated only if deviations persist for more than one quarter—say 2-3 quarters.

There is also an issue of communication. The proposed framework suggests that the authorities would not have to publicly announce and commit to an inflation target. If inflation target is a critical ingredient in the Fund program (as envisaged by staff), the staff's proposal would indirectly force the central bank to commit to an inflation target and implicitly push countries towards an inflation targeting regime. Also, it may be difficult for the authorities to commit an inflation target to the Fund for the program and disbursement purposes and still argue to their own public that they do not have any inflation target. And if inflation target is made public, but not adopted formally, it will pose a major communication challenge.

Countries might encounter several infrastructural and procedural challenges, which could be difficult to foresee, a priori. The multi-faceted information requirements for adopting such a framework could prove to be a difficult proposition for certain central banks to negotiate. Skilled and highly technical manpower will be needed to oversee the smooth functioning of such a policy framework as part of the day-to-day operations. Meeting some or all of these conditions in several emerging and developing economy central banks could prove challenging. While the paper does highlight a case study where the transition to a flexible monetary policy has been a success, there is no gainsaying that there might also be several other instances where such a transition has been less than successful. Even in the successful case study, the evidence points to the fact that the time span between inception and adoption of the flexible monetary policy regime was quite high, given the significant number of institutional and operational reforms that were required to be put in place. In this context, it need hardly be overemphasized that several countries have witnessed severe economic and financial losses, not to mention social losses, during the recent North Atlantic financial crisis and are gradually rebuilding their financial systems in the aftermath. Under these circumstances, a 'shock therapy' in the form of a new approach might already burden their economic and financial apparatus.

An important aspect will have to be an assessment of the technical preparedness of the country in question in terms of technical and institutional development underpinning the policy framework. Several LIC central banks might not have the requisite technical expertise or manpower to implement the proposed new framework. The data and information requirements under this framework might also be a challenge for several of these countries. The success of the proposed framework clearly hinges on the central bank's capacity to analyze monetary conditions. We see a considerable role for the Fund's training and technical assistance (TA) provision in this area. There is a need to ensure that Fund-supported programs do not turn out to be overbearing in terms of setting goals/target bands and monetary policy consultation clauses.

The paper finds that the relationship between money and inflation has weakened. However, the paper does not provide enough and robust evidence whether a relationship exists between interest rate and inflation and how strong that relationship is. Also, the paper's evidence on the weakening of the relationship between money supply and prices is based on regressions of variables in growth rates. Such regressions are unable to properly capture the long-run relationships between the variables. A better approach to study the money-prices relationship is to run regressions in levels using co-integration approaches. In view of these conceptual issues, the paper's conclusion that money supply-prices relationship has weakened is not robust.

To sum up, the conditionality is an important issue. We are open to consider the proposed MPCC framework. However, we believe that much more preparatory work is required before introducing the proposed framework. As such, a more pragmatic and evenhanded approach should be to continue with the present framework, while introducing the new approach on a pilot basis. These two approaches could run in parallel for some time. It is only after the proposed framework is stabilized that it should be introduced on a full-fledged basis.

Mr. Sun, Ms. Ai and Mr. Cheng submitted the following statement:

We thank staff for this review of monetary policy conditionality, and we broadly support staff's proposal to replace the performance criteria on net domestic assets or reserve money with a review-based approach in the form of a monetary policy consultation clause (MPCC) for members with evolving monetary policy regimes. The new approach, closely resembling the review-based inflation consultation clause (ICC) approach for members with inflation targeting regimes, should be able to help members establish a credible policy anchor amidst evolutions in their monetary policy frameworks. As always, it is important to keep in mind that conditions should be tailored to country-specific circumstances while ensuring evenhandedness, given that the goal of conditionality is to help member countries to restore external and macroeconomic stability.

As evolutions of policy regimes are often associated with shifts in operational autonomy and technical capacity of central banks, a degree of judgment would be needed to consider whether a certain member would qualify for a review-based monetary conditionality approach. In view of such circumstance, we opt for a measured approach to accumulate experiences at the beginning, in order to safeguard the use of Fund resources and the long-term success of the MPCC. On the other hand, we view that the dropping of net domestic assets and/or reserve money from the misreporting framework is in line with the treatment as under the ICC, but it would be useful to ensure sufficient safeguards for the use of Fund resources.

As noted by staff, the relationship between monetary aggregates, inflation, and the real economy has been constantly evolving amidst rapid financial innovation and globalization, with both long-term and short-term relationships between broad money growth and inflation weakening over time. In this light, we encourage staff to continue to carry out analysis in this area so as to provide better guidance for members' policy conduct. We would also welcome reviews on the role of the NDA and net credit to the government on guarding against financial and fiscal risks.

To support the evolution of members' monetary policy regimes, we encourage the Fund to provide technical assistance (TA) and training as appropriate, while ensuring that members' needs would stay within the Fund's resource envelop. In particular, we share staff's view that the Fund could reprioritize resources, leverage on online training, and explore the synergy between TA and training along the line of the Fund's capacity development strategy. It may also be useful to seek collaboration with appropriate institutions.

Ms. Meyersson and Mr. Lindpere submitted the following statement:

We very much welcome this timely paper on monetary frameworks and conditionality in Fund programs. We also welcome the revisions to the paper that was circulated for the informal Board discussion.

Countries with evolving forward looking monetary regimes would benefit from review-based monetary conditionality rather than conditionality based on monetary aggregates only. While money continues to be of fundamental importance for sound economic development, the many examples of non-observance and ensuing waivers over recent years in Fund programs show that, in practice, the aggregate money targets have neither been the most relevant indicator of the monetary stance nor flexible enough to respond to the changing needs of the membership.

We appreciate that no one-size-fits-all approach is used when it comes to countries with evolving monetary policy regimes. Furthermore, to mitigate risks to the Fund, the assessments of members' "readiness" for arrangements including monetary policy consultation clauses (MPCCs) have to be thorough and evenhanded.

We stress that a more refined approach to monetary policy implementation should go hand in hand with modernized monetary and sound fiscal frameworks. As money aggregates may provide information about the presence of any monetary financing and credit expansion, monetary targets should be maintained for countries with less developed institutional frameworks. We would like to add that in some occasions the decision to apply the MPCC might need to take into consideration the availability and quality of statistics.

On the monetary side, central bank independence should be a prerogative for moving to MPCC. Strong internal governance in the central banks based on clear objectives, efficient decision making processes and transparent accountability principles and practices is also important.

On the fiscal side, we believe that a sound institutional framework for fiscal forecasting and well-anchored fiscal goals, that support monetary policy, are needed. There should be transparency regarding government expenditures and liabilities as well as realistic assessment of future government income. A sound institutional framework and transparency regarding fiscal forecasting would also help contain the risks related to the use of Fund resources when the NDA ceiling is removed (including when the over-performance on the NIR is an issue, reference to paragraph 38).

TA to help improve central institutions, crucial for sound macro-policies, such as national banks and national statistics agencies, should be given very high priority. It is worth noting that this is useful regardless of a potential move to MPCC, and therefore TA resources are well spent. Hence, we welcome the efforts by staff already undertaken and those outlined for the future with regard to providing TA to facilitate transitions to more forward-looking monetary policy regimes.

The proposed framework seems to provide sufficient safeguards to Fund resources, given the proposed regime for reviews and consultations. We appreciate that while giving more flexibility in the program design, the proposal appears to imply rigorous follow-up. Also, it is important that the consequences of misreporting and unjustified target deviations are not softened.

Ms. Lundsager and Mr. Weiss submitted the following statement:

We thank the staff for their papers on this topic, which come at a time when an increasing number of developing countries are deepening their financial sectors, building their central bank institutional capacity, and moving away from monetary regimes that purely target monetary aggregates. The staff's analysis of the weakening of the link between monetary aggregates and inflation as financial sectors develop is convincing. At the same time, the staff's finding that over half of reserve money targets in Fund programs are missed—and that these misses are generally not correlated with inflation—is striking. This suggests that gradual changes to the staff's design of monetary policy conditionality are warranted.

With more members moving toward hybrid monetary regimes that combine elements of monetary aggregate targeting and inflation targeting, it is appropriate to allow greater flexibility on monetary policy conditionality to more closely match what authorities are carrying out in practice. The ICC framework has worked well for countries with inflation targeting regimes, and the staff's proposed MPCC could be similarly effective.

By providing an option for a band around either reserve money or inflation, the MPCC appropriately provides more flexibility than the ICC. At the same time, the MPCC (also appropriately) appears to impose somewhat stricter conditions, with a Board consultation triggered when the MPCC's (single) band is breached. We would appreciate further clarity on whether the MPCC's band would more closely resemble the ICC's inner band (the breaching of which triggers a staff consultation) or outer band (the breaching of which triggers a Board consultation).

As we move toward this new approach, it is important that the staff ensure that countries operating under MPCC conditionality have the capacity to do so. The staff lays out an appropriate set of principles in its paper: central bank institutional development, macro and financial development and stability; and data and analytical capacity. Clear and detailed guidance to area departments on implementing these criteria is critical to ensuring good standards, consistency across programs, and better adherence than under the current conditionality framework. We look forward to the provision of detailed guidance.

At the same time, many other developing countries that do not yet have the appropriate level of financial depth and institutional capacity should continue to target monetary aggregates.

As the staff notes, much TA is already being carried out to help countries develop their monetary policy capacity. In this regard, we are encouraged that the introduction of the MPCC should not increase demands on Fund resources and we are confident that sufficient efforts can be made to prioritize assistance in line with members' needs.

Mr. Daïri and Mr. Jbili submitted the following statement:

We thank staff for the paper and welcome the further discussion of these issues in a formal Board setting following the January 2014 informal Board meeting. We concur with the need to adapt monetary policy conditionality in Fund-supported programs, as laid out in the paper, and offer the following comments.

We agree that the weakening of the relationship between monetary aggregates and inflation in developing countries with evolving monetary policy regimes has made traditional monetary aggregate targeting in these countries redundant. The staff paper provides convincing evidence to this effect, and we support moving program conditionality for these countries away from traditional targeting of reserve money or net domestic assets (NDA), and closer to that of inflation targeting regimes.

A review-based approach—referred to as monetary policy consultation clause (MPCC)—would involve an inflation consultation clause (ICC) and would replace the reserve money or NDA targets. Since the evolving regimes are somewhat in an intermediate stage between traditional money targeting and IT regimes, with no formal commitment to a numerical inflation target within a pre-set time framework, monetary policy involves a great deal of judgment and discretion. In this regard, we appreciate the flexibility of making the decision to implement the MPCC the outcome of discussions between staff and the authorities, and the possibility for the authorities to request modifications to monetary policy conditionality during the program, as needed.

We agree that consultations with staff or the Executive Board should be triggered by deviations from the inflation band. We also support the option of retaining monetary aggregates as ‘tripwires” if needed, or in cases of programs with a disinflation path.

We see merit in following a cautious approach to introducing the MPCC option, and encourage staff to ensure that potential candidates have adequate track record of monetary policy implementation and are committed to strengthening their forward looking policy framework. We endorse the proposal to review the MPCC framework once sufficient experience is gained.

We support enhanced TA provision to strengthen central banks’ capabilities in the area of monetary policy analysis and implementation to help countries with evolving regimes further enhance their forward looking monetary policy framework. This should go hand-in-hand with upgrading statistical and analytical capabilities, including better understanding of the workings of the transmission channels, and establishing inflation bands with a reasonable degree of credibility.

Mr. Oliveira Lima and Mr. Najjarian submitted the following statement:

We thank staff for the well thought out paper on conditionality in evolving monetary policy regimes. We support staff’s proposal to introduce review-based conditionality in substitution of the traditional framework that relies on monetary targets as performance criteria (PCs). Given the weak link between monetary aggregates and prices, the proposal is better suited to assess the more flexible and forward-looking monetary policy rules adopted in developing countries that are experiencing financial market innovations and deepening.

The proposed review-based approach introduces a monetary policy consultation clause (MPCC) based on a central path for the target variable—either a monetary aggregate or inflation—and a target band. If the target variable is inflation, an optional inner band can be adopted. It will trigger consultations with staff in a similar way to the inflation consultation clause (ICC) that is applied to program countries with a formal inflation targeting framework. No inner band is envisioned for monetary aggregate targets. In this regard, we note that, as political and social pressures tend to arise when there is a need to tighten monetary policy, rather than to loosen it, the more relevant parameter will be the target's upper band, just like the ceiling on money aggregates under the traditional conditionality framework. Nevertheless, it is crucial that policy discussions focus on the central path for the target variable, allowing the authorities to take action early enough to avoid frequently triggering consultations with the Executive Board. Early action will also help dealing with the dilemma between achieving the monetary target and adequately managing short-term liquidity.

We find the proposed MPCC's safeguards to be adequate. Although informal consultations with staff in case of deviations from the inner band are not mandatory, breaches of the upper band will result in holding up disbursements until a review is approved by the Executive Board. We also support retaining the floor on net international reserves (NIR) as a PC to ensure external sustainability. Additionally, ceilings on reserve money (RM) and/or net domestic assets (NDA) may also be kept as tripwires, depending on program countries' specific risks. Moreover, we believe that the Fund's misreporting framework should continue to apply on data that are subject to consultation clauses.

We welcome the fact that substantial efforts on training and TA do not necessarily aim at countries that may adopt MPCC in the near future. In this sense, we believe that a road map for achieving structural benchmarks to enhance technical and institutional capabilities would provide helpful guidance to members wishing to modernize their monetary policies.

Finally, staff has suggested that MPCC may be implemented in program countries that do not meet the required conditions, as long as the authorities show strong commitment to reforms. We support a certain degree of flexibility when checking for the presence of those required conditions. In many cases, the proposed MPCC can facilitate a faster improvement of part of the requirements, provided that the majority of them are in place. The adoption of the MPCC may, for example, help justify difficult policy decisions or withstand political pressures.

Mr. Alogeel and Mr. Keshava submitted the following statement:

We thank staff for the revised paper to incorporate the points raised during the informal Board discussion on January13 and we reiterate the following points for the record.

We welcome the efforts to adapt monetary policy conditionality in program countries with evolving monetary policy regimes. At the same time, we recognize that only a few Fund arrangements are expected to adopt the proposed conditionality framework in the near term given the lack of requisite institutional and technical capacity.

The traditional framework for monetary conditionality with reliance on performance criteria on net domestic assets or reserve money has generally served well and will continue to be effective in many program countries. Similarly, a review-based approach with an inflation consultation clause for countries with inflation targeting (IT) regime remain suitable.

For countries with evolving monetary policy regimes, we agree with staff that neither the traditional framework nor the IT review-based conditionality may be well suited. Instead, a review-based approach using a set of monetary or inflation targets set within a tolerance band that the member would be expected to observe during the arrangement would be a useful option. It is also sensible that such an approach should be adopted for member countries that have met the required policy and capacity guideposts. We also support the continued maintenance of the net international reserves floor as a performance criterion to ensure external sustainability while safeguarding the use of Fund resources.

Finally, the review-based approach may require additional provision of resources for capacity building over the medium term, although resource implications are expected to be manageable in the near term. In this context, we agree that the Fund's strategy for capacity development should be reviewed to address a potential scaling up of training and technical assistance.

Ms. Arbelaez and Ms. Garrido submitted the following statement:

We welcome the formal meeting to discuss this issue, as requested by Directors in the last informal meeting. We thank staff for the paper and welcome the efforts made to better adapt conditionality criteria in Fund programs to the changing circumstances and policy regimes in the membership. We also appreciate the inclusion of some of the proposals suggested by Directors, among others the consideration of the safeguards assessment as a means to evaluate central banks' independence. In addition, we see merit in analyzing the implications of the new model for currency unions as well as the potential risks for financial and external stability for countries with evolving monetary policy regimes.

The evidence given by staff in the paper clearly justifies the need for a more flexible approach compared with the traditional framework in the design of monetary policy conditionality in Fund programs in countries with evolving policy regimes and that meet the criteria set up in paragraph 41. Against this backdrop, we broadly support the proposed monetary policy consultation clause framework (MPCC).

We welcome the introduction of the "standard" performance idea to better assess whether a country qualifies for the application of the MPCC. We also agree with the need for countries to show a strong track record of policy implementation and progress regarding the institutional and structural guideposts developed by staff. However, we want to offer two comments in this respect. First, the criteria included both in the "standard" performance and the guideposts should be defined in more detail, as they are still too general (e.g. stable financial sector). Further refinement would not only help staff in the decision making process and avoid excess reliance on judgment, but also would ensure a more transparent and evenhanded treatment among countries. Second, we note that a new pre-condition has been added (compared with the previous version of the paper) related to a relatively low and stable inflation rate. Although in principle we do not disagree, this condition can be contradictory with the objective of using MPCC in countries pursuing a disinflation strategy, which may not have low and stable inflation. Comments from staff would be welcome.

We are also puzzled by the fact that countries having an evolving monetary regime but not showing enough progress in the dimensions cited in the guideposts do not qualify for the application of the MPCC framework. This means that these countries will continue to be subject to the traditional conditionality, even if it has proved to be useless. We wonder whether the two approaches of conditionality can be applied at least temporarily and a roadmap towards meeting the criteria can be developed with the authorities.

While we consider that there is a need to apply the proposed framework to countries for which the traditional framework is useless, we would see merit in strengthening compliance with the guideposts to reinforce the safeguards of Fund resources. In this regard, in order to make these guideposts not too burdensome for these countries—or even preventing countries to graduate for this modality—we would see merit in considering either of the following options: (i) the establishment, at the onset of the program and in accordance with the authorities, of a roadmap to fulfill the institutional and structural guideposts. While lack of compliance with the roadmap would not interrupt the disbursement of Fund's resources, it would help evaluate in a transparent manner (as explained above) the country's progress and play a role as a peer pressure instrument; and, (ii) the inclusion in program reviews of technical assistance implementation assessment in these areas.

We consider that technical assistance to countries with evolving monetary policy regimes could be implemented within the current budget envelope, carefully prioritizing as needed. We also see merit in developing ways to leverage current resources, as suggested in the document, as well as the compilation of good practices that could be helpful in the implementation of new monetary policy frameworks.

Mr. Temmeyer and Mr. Landbeck submitted the following statement:

We thank staff for the informative report and the opportunity to discuss the proposal for a MPCC option in a formal Board meeting. As already stated at the time of the informal meeting, we welcome the assessment of the efficacy of the Fund's conditionality on monetary policy in the past years and concur with the proposal to introduce a review-based conditionality on monetary policy for developing countries with evolving monetary policy regimes. We agree that in some developing countries higher institutional and technical capacity enables a more forward-looking monetary policy focused on price stability. In order to provide a useful policy anchor for these countries, the conditionality toolkit and the design of Fund supported programs should be able to reflect these developments and encourage the use of more elaborate and forward-looking policy frameworks.

In our view, the proposal provides broadly adequate guidance to staff on the application and design of a MPCC. While we take note that staff has tried to take on board the concerns voiced at the informal meeting, on the whole we understand that the thrust of the proposal is broadly unchanged. We also acknowledge the need to be mindful of inherent limits to provide very strict and detailed guidance on the application of the MPCC. In this regard, we would stress the need for a careful and comprehensive assessment on a case-by-case basis. We also take the view that the effectiveness of the MPCC and issues such as the appropriate "band width" and "guideposts" for qualification should be reviewed after some experience with specific country cases has been gained.

In addition, we would like to make the following, more specific comments:

The specific band width needs to depend on a number of country-specific factors (inter alia the volatility of the target variable) and provide a credible anchor for monetary policy. We generally think that a narrower band width can be an important tool in this regard and see a case, in some instances, for "erring on the side of caution." At the same time, the design of thresholds would need to be mindful of the aim to not undermine the credibility of the monetary policy framework by raising "false alarms." In such cases an adjustment of the country-specific band width over the life of a program would need to be carefully considered. We would also encourage staff to review the appropriateness of the band width in light of initial experience with the use of the MPCC in individual program countries.

We can support the optional use of a narrower inner band if inflation is selected as the target variable. We take note that this would also be consistent with the standard design of the ICC. However, also in these cases, the careful choice of outer band (triggering consultation with the Board) would remain our key concern as deviation from the inner band would merely trigger a consultation with staff which one way or another should take place anyway.

We think that the proposed "structural guideposts" for adoption of a MPCC-based conditionality provide broadly adequate guidance to staff and need to be assessed carefully in each country case. We would like to reiterate that a review-based conditionality on monetary policy requires a sufficient degree of institutional capacity (e.g. sufficient autonomy of the central bank) and technical capacity (e.g. good understanding of transmission channels). In many program countries, these requirements are currently not in place; vigilance is needed in cases where staff considers introducing the MPCC on the basis of commitments to address existing limitations. Particularly, and in line with Mr. Heller and Mr. Waelti, we consider that central bank independence constitutes an indispensible precondition for the MPCC. At any rate, we would expect that initially the MPCC-based conditionality would apply only to a relatively small number of cases. In a similar vein, a premature shift to MPCC-based conditionality in the course of a program should be avoided.

We encourage staff to make use of NCG or NDA targets as "tripwire" where needed in light of country-specific risks. We also advocate the use of structural reform benchmarks and technical assistance if deemed necessary to further strengthen institutional and technical capacity.

We take note that staff expects relatively few Fund arrangements to adopt this new conditionality framework—an assessment which we share—

and that accordingly the “resource implications [for capacity development] are expected to be manageable within existing budget envelopes.” On a more general note, we think that capacity building for monetary policy making is an area where the Fund can offer valuable expertise to country authorities and we would generally support efforts to prioritize such assistance in line with members’ needs.

Mr. Mozhin and Ms. Atamanchuk submitted the following statement:

We thank staff for the informative report that justifies the necessity to revise the existing approach to the monetary policy conditionality under the Fund’s programs. The staff report provides a good empirical analysis of the changing landscape of monetary policies in developing economies, which supports the point that many of these countries are moving toward more flexible monetary policy framework and more forward-looking policies. The evolution of global practice, deepening domestic financial markets, and changes in monetary policy stance in developing economies in general—all this require the revision of the Fund’s conditionality and, therefore, we welcome the proposed MPCC framework.

The staff’s analysis confirms the need for enhancing the monetary policy conditionality toolkit by adopting a review-based framework for developing countries with evolving monetary policy regimes. We concur with the analysis that the weaker relationship between reserve money and inflation signals a decline in the relevance of monetary aggregates as reliable indicators of the monetary policy stance in developing countries. Therefore, the proposed approach to introduce a set of quarterly or semi-annual monetary or inflation bands and replace the current PC on reserve money is well taken.

The revised paper addresses the majority of key points raised during the informal Board discussion on the monetary policy conditionality in the middle of January. We appreciate clarifications that staff provided with regard to institutional and structural guideposts (paragraph 41-43), while introducing the rule of a “standard.” This will serve as an anchor for the country teams, when they are considering country-specific circumstances. Also, the addition of the last bullet point in paragraph 40 is highly appreciated, as it is important that the independence of the central bank and the absence of fiscal dominance are the basic requirements for the country to qualify for the MPCC.

We note that the way the MPCC is constructed puts much of responsibility on staff, and, therefore, vigilance is required. While the proposed framework has a number of guideposts that determine a “standard” for monetary policy stance, it might be premature to expect that all guideposts will be met in case of developing economies. Therefore, staff's judgment on the country's progress toward meeting the guideposts and staff's interpretation of country-specific circumstances will be crucial for the decision of the MPCC applicability in some cases. We would encourage staff to carefully analyze challenges that arise on the way to adopting the new monetary policy conditionality in each country. Going forward, we will be closely observing the developments under the incorporation of the new conditionality into the Fund's programs and stay open with regard to the revision of the MPCC, based on the lessons learnt from its implementation.

It is important to have clear communication when incorporating the new framework into the Fund's programs to ensure that it is not seen by a country's authorities as an eventual move to the inflation targeting regime. The MPCC should help strengthen the monetary policy framework, better anchor inflation expectations, and increase credibility of the monetary authorities in developing countries, while providing flexibility to those, who are not ready to commit to the inflation targeting regime.

Mr. Cumenge submitted the following statement:

We welcome staff's revised proposal for a review-based monetary conditionality framework for countries with evolving monetary regimes. We would like to emphasize the following points:

Many developing countries are de facto moving towards a formal inflation targeting framework. In this regard, if a country is ready, we see merit in implementing a review-based approach to monetary policy through the MPCC. While welcoming the more cautious presentation adopted in the paper to introduce the eligibility criteria to the MPCC. We call staff to be realistic in assessing whether countries are meeting the requirements to adopt this new conditionality framework. While agreeing that there are benefits in modifying monetary conditionality for evolving regimes, we emphasize that all three criteria must be fulfilled. Moreover, a certain level of financial depth, institutional capacity and a strong dialogue with authorities will be critical to move towards the MPCC. The calibration of the bands around a target inflation variable should also take into account the characteristics of the country but also the fact that one of the main goals of this move should be to enhance credibility of the monetary institution.

The success of this new proposed review-based approach on monetary policy framework will require a strong commitment from the authorities and accurate statistics to efficiently manage inflation targeting regime. Adequate technical assistance and forecasting capacity building should be provided without weighing on the existing budget envelopes. We therefore welcome staff's proposal to develop ways to leverage current resources and seek for better prioritization.

Unfortunately, this analysis excludes countries that are members of a currency union. We strongly encourage staff to deepen their analytic work on the specificities of the monetary unions and monetary transmission to help regional entities design appropriate tools to stabilize the macroeconomic framework, better control inflation and manage liquidity.

Mr. Yeates and Mr. Meads submitted the following statement:

We would like to thank staff for their revised paper on conditionality in evolving monetary policy regimes with which we broadly agree. It is important that Fund surveillance and program design evolve in a way that is reflective of changes in global thinking and practice. Given developments in the conduct of monetary policy, and increasing sophistication of domestic financial markets in developing economies, having an appropriate conditionality framework is important. We, therefore, support the proposed review-based monetary conditionality framework as an option for countries that may not be best served by existing conditionality frameworks for monetary targeting or inflation targeting.

Having made the case for greater flexibility, it is important to ensure that the use of a review-based MPCC framework is operationalized in an appropriate manner. We welcome that the MPCC appears to impose an appropriate level of safeguards: For example, we welcome the need for a Board consultation when the MPCC's band is breached. The careful calibration of the band width, however, and the use (or not) of an inner (warning band) as well, will have to take into account individual country circumstances and be closely monitored so as to strike the right balance between protecting the Fund, and preserving the credibility of the framework. The band widths should, therefore, not be seen as target ranges, but rather as defining points at which policy consultations are triggered to aid transparency and accountability while helping deliver a credible nominal anchor.

Having the appropriate institutional and structural guideposts as to whether conditions have been met for the MPCC to be introduced is also important. In particular, central bank independence/autonomy is crucial. Nonetheless, there will, remain a degree of judgment requiring clear guidance to staff to operationalize those guideposts in a consistent manner while taking into account country differences.

Lastly, while Fund TA can help to address (monetary policy) capacity deficiencies, we welcome that resource implications are expected to be manageable within existing budget envelopes reflecting appropriate prioritization.

Mr. Abdul Ghaffour, Ms. Moe Moe and Mr. Kharel submitted the following statement:

We thank staff for a well written report. We note that staff makes strong arguments for modifying the existing monetary policy conditionality, i.e. performance criteria (PCs) on net domestic assets (NDA) and reserve money (RM), and initiating review-based monetary conditionality framework for evolving monetary policy regimes. While the report has been revised substantially following the Board discussion on January 13, 2014, we would like to highlight the following two points for emphasis.

We generally welcome the new conditionality framework with useful toolkit given non-observance of PCs in more than half of the total Fund's program over the last two decades. We agree the challenges to rely on NDA or RM alone to assess monetary policy given statistically weak relationship between money and inflation and also frequent and large fluctuations of income velocity and money multipliers—a review of conditionality framework itself was inevitable. The evidence given by staff in the paper clearly justifies the need for a more flexible approach compared with the traditional framework in the design of monetary policy conditionality in Fund programs in countries with evolving policy regimes. Hence, we note that the new framework, which has already been tested for over dozen Fund's program in six member countries during last few years, is more flexible as it defines the set of indicators to assess monetary policy combining with inflation consultation clause and monetary policy consultation clause.

Capacity enhancement of central banks in assessing monetary policy is critical to better understand monetary policy transmission mechanism and for the success of the new conditionality framework. We believe that a comprehensive plan to enhance technical and institutional capabilities would provide helpful guidance to members wishing to modernize their monetary policies and welcome the plan to enhance technical capacity and putting in place necessary preconditions and mechanism, including having in place relevant economic data in moving towards this new conditionality framework.

Mr. Rojas-Olmedo and Mr. Hendrick submitted the following statement:

We see merit in employing a review-based approach to program monetary conditionality in the form of a monetary policy consultation clause (MPCC). We thank the staff for the revised paper which includes some of the suggestions and recommendations made during the informal Board meeting on this matter. This is a long overdue change in the Fund's toolkit to better reflect what "countries with an evolving monetary policy regime."

There is clearly some degree of discretion and judgment that will be exercised by the staff when determining which country would qualify for an MPCC. There might be some disagreement on how long a good track record should be, how much central bank autonomy is needed, and on what is a reasonable level of technical skills by the central bank staff in forecasting inflation. Thus, we welcome the staff's proposal that the decision to implement the review-based approach in a particular country would be made on a case-by-case basis, after a frank and candid discussion between the authorities and the staff. This will help to minimize problems with perceived lack of evenhandedness across countries. We would like to ask the staff if an operational guideline, with some more specific criteria, would be prepared in the near future on this matter. If so, we would greatly appreciate receiving a preliminary draft of this document prior to formal implementation by the staff.

We welcome the staff's statement that the application of an MPCC should not be interpreted as necessarily implying that the country should move to an inflation targeting framework (IT). Although several countries in our constituency have already had a successful transition to inflation targeting regimes, developing countries adopting an MPCC under a Fund-supported program should not feel compelled to move to a full IT, unless it is in their own interest and consistent with their own views in terms of how monetary policy should be implemented. This is of particular importance, considering that the Fund itself is still struggling with the notion of inflation targeting framework as the best option to anchor inflation expectations.

We can support the proposal for the operational criteria to apply the MPCC and the option for the country to use inflation or monetary aggregate for the target variable. However, we believe that in essence, the mechanics of the MPCC is the same as those applied to a country with formal IT. A band for an inflation target, with inner and outer band triggering informal or formal Board consultation; is the same process followed by IT countries with programs. The only difference is that the country authorities would not have to publicly announce and commit to an inflation target, since they would be already committed with the Fund under the terms and conditions of the Letter of Intent and the Memorandum of Economic and Financial Policies. The only way to avoid revealing these targets is not publishing the staff report, which could defy the whole purpose of sending strong signaling to the markets about the authorities' commitment to the program targets. The staff's comments would be appreciated on this matter.

We would recommend a cautious approach regarding the comparison with the "standard" defined in paragraph 41 of the report. The idea of comparing country-specific circumstances relative to a "standard" shifts the focus to the definition of what is the "standard." For instance, we have serious doubts about the absence of high dollarization as a pre-requisite in terms of macro and financial development and stability. In fact, several countries with high dollarization have moved successfully to a fully fledged inflation targeting framework, including countries in our own constituency. Regarding central bank institutional set up and data and analytical capacity, even for countries that are formally transitioning to IT regimes, there is a lot of room for discretion on how much is needed as a prior, and what can be actually learned in the process. These doubts provide more reasons for us to ask for the preliminary operational guidelines to staff to be discussed at the Board for final comments and suggestions.

We support the provision of TA and capacity building for monetary policy making as needed, including the expansion of resources if there is more demand than envisaged. This will not only help countries to improve their technical skills for monetary policy implementation and inflation forecasting; but it will indirectly also help to safeguard the use of Fund resources due to the positive externality associated with economic stability achieved through successful reductions in inflation, and the anchoring of inflation expectations.

We are looking forward to discuss the experience with the first country cases and to refine the MPCC for future Fund-supported programs. In this regard, we would like to ask the staff about the estimate number of countries that would be needed in order to have a meaningful review and in how many years from now this review is expected to take place.

Mr. Hishikawa and Ms. Yanai submitted the following statement:

We support the proposal to introduce the monetary policy consultation clause (MPCC) as an option under the review-based conditionality framework. We generally see the merit of allowing flexibility in the program modalities in order to set the most desirable conditionality for each member country. In fact, we continue to believe in the importance of following a case-by-case approach and a careful review of each case to avoid excessively standardized applications of conditionality. We believe that the changes incorporated in the latest proposal have addressed important concerns raised in the previous discussions, and allow sufficient flexibility for the Fund to design program conditionality in a constructive manner.

As we broadly concur with staff's proposal, we will limit our comments to the following points mainly for emphasis:

We welcome staff's clarification on structural guideposts based on the discussion in January. We encourage staff to carefully develop meaningful and practical guidelines when launching the MPCC. While ensuring that a country's central bank has sufficient autonomy is clearly a crucial consideration, we view all three guideposts listed by staff as both important and indispensable.

In order to ensure proper implementation of the new approach, we urge staff to carefully evaluate each case concerning the appropriateness of adopting the MPCC framework as well as its calibration. In particular, when preparing the staff guidance note, we encourage staff to provide sufficient clarity concerning the practical aspects of the differentiation between the MPCC-based benchmarks and those benchmarks of the traditional approach.

We find appropriate staff's approach of allowing additional tripwires to address country-specific risks. In view of the need to properly address external risks, we continue to believe that, in a number of cases, utilizing additional tripwires could be the most constructive approach.

Mr. Friedman made the following statement:

There is a condition with regard to low inflation which might be a self-defeating condition. Sometimes inflation targeting regimes can facilitate and support the disinflation process. If a member is interested in moving toward an inflation targeting regime, the criteria for the monetary policy consultation clause framework should be flexible enough to allow for that.

My second point is about the bands—these can be either the bands around inflation or a different monetary aggregate or variable. The paper is not detailed on how this band would be set. More guidance is required on this point.

Some mature and experienced inflation targeters set a plus/minus 1 percentage point band, but it is unrealistic that beginners, or economies with a higher rate of inflation, will hit such a narrow band, especially given that it is well established in the literature that there is a positive relation between the level and the volatility of inflation. More thought should be given to this issue.

Specifically, I would like to reiterate the comment made by Mr. Mohan that the definition of a deviation from the band is not trivial. We should distinguish between transitory, random deviations, and persistent deviations that will trigger the consultation with the Board. The suggestion made by Mr. Mohan can be considered when elaborating on the details of how this will be implemented.

The last issue I would like to raise is about the data that are required to facilitate a policy such as inflation targeting. Many Directors touched on that point and noted that sufficiently good data were required to move away from traditional conditionality toward an IT regime. I would emphasize the importance of having data on expected inflation, because the essence of an IT regime is the attempt to stabilize expectations. The data can be either market-based or based on methodological surveys, but one way or the other policymakers should have a clue on what is the expected rate of inflation.

On this point, the staff’s advice on how to compile these data in case they are missing might be necessary, also in the form of technical assistance (TA).

Mr. Heller noted that if the central bank moved away from a traditional framework toward inflation targeting, then the policy rates became more important. If central banks used the policy rate to implement monetary policy, the balance sheet of the central bank, or the monetary base, became endogenous. If the new approach focused on the band for M0, and M0 was endogenous, there was a greater likelihood of breaching the band because demand was not stable, among other factors. Given this situation, he asked if it would make sense to put more emphasis on an interest rate band in the new approach. That would probably be a more relevant approach than imposing a band on net domestic assets (NDA) or M0.

Ms. Arbelaez made the following statement:

We thank the staff for the paper and appreciate the inclusion of most of the proposals suggested by Directors in the informal meeting.

We support the proposed monetary policy consultation clauses (MPCC) for countries with evolving monetary policy regimes and with the criteria set up in the paper. However, because this proposal implies a significant change in the conditionality for some countries in Fund programs, it would be important to have a review by the Board in three to five years, when enough experience with the framework has been gained.

Like Mr. Shaalan, we see merit in revising the tolerance band with regard to whether a single band has worked well or whether a double band would have been useful as an early warning instrument to check monetary policy developments, as suggested by Mr. Mohan.

As mentioned in our gray statement, we welcome the introduction of the standard performance concept to better assess whether a country qualifies for the application of the MPCC. The criteria proposed by the staff are adequate. However, the independence of the central bank and financial stability are indispensable conditions.

We take note from the staff's written responses to technical questions that the staff will prepare an operational guidance note, which is instrumental to ensure equal treatment to the membership by country teams. We propose that this guidance note be presented to the Board at least in an informal meeting before its implementation.

Finally, we would appreciate the staff's view on whether, for countries that have an evolving monetary regime but are not showing enough progress in the dimensions featured in the guideposts, the two approaches of conditionality, mainly the traditional one and MPCC, can be applied at least temporarily and the road map toward meeting the criteria can be developed with the authorities.

The staff representative from the Strategy, Policy, and Review Department (Mr. Lane), in response to questions and comments from Executive Directors, made the following statement:[1]

We have circulated answers to the technical questions, including a few of the issues raised in the Board. I thank Directors for their gray statements, and the staff would like to respond to the issues raised in the statements. We will focus on the structural and institutional guideposts, first the design and

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[1] Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes.

application of the consultation clause, a brief reference to capacity building, and then conclude with the next steps.

On the guideposts, three main issues were raised—whether it is realistic to expect many countries to meet the guideposts; whether there is a need to more precisely define specific guideposts and criteria; and whether some of the guideposts are more important than others, in particular, whether central bank independence is perhaps a preeminent condition.

In terms of meeting guideposts, the premise of the paper is that many developing countries are making significant progress in modernizing monetary policy and establishing sound financial relations between central banks and governments in terms of developing their monetary instruments, building both technical and analytical capacity, and strengthening the provision of data.

In this context, we expect some countries to make significant progress toward these guideposts—if not immediately, then over the relatively short to medium term. We do not expect this to be a null set of countries.

The question of the amount of precision in the guideposts is difficult, because there are clearly tradeoffs involved. On the one hand, there is the benefit of precise guidance to support evenhandedness, and a transparent approach as to whether it is an appropriate form of conditionality. On the other hand, we risk being overly prescriptive and having a one-size-fits-all approach for conditionality.

The intent of the paper is to allow some flexibility in the design of conditionality so that it can be tailored to the needs and preferences of members, but also consistent with their ability or capacity to implement policies. The proposal to review the application of this review-based conditionality after gaining sufficient experience would serve as an opportunity to reconsider the adequacy of the guideposts.

In this respect, I would like to make a clarification on one of the guideposts. A Director noted that we had specified there should be an absence of high dollarization as one of the structural prerequisites. The staff was referring to very high levels of dollarization, where the monetary transmission mechanism is very weak. We acknowledge there are countries that have introduced inflation targeting with somewhat significant dollarization, albeit on a declining trend—with Peru being the best example. Nonetheless most countries have had no dollarization or only moderate dollarization when they have adopted inflation targeting. It does point to one of the risks of setting very specific criteria—namely, the risk of having these exceptions that might still do well, whilst not crossing some threshold.

Directors asked whether some conditions are more important than others. We have set out three complementary pillars for guideposts. The first one was the institutional framework for the central bank. This first pillar has several related components: operational independence, clarity of monetary policy objectives, and structures for communicating monetary policy decisions.

Operational independence is critically important, but at the same time it is not a binary variable that is either met or not met, and its assessment requires judgment. An important part of this assessment would require looking at the track record of policy implementation and success in achieving stated policy objectives. We see central bank operational independence as a critically important part of the equation that needs to be assessed based both on an institutional perspective, the de jure independence, and also on an operational perspective, or de facto perspective.

A number of Directors asked whether we could consider having both the traditional conditionality and the consultation clause review-based approach at the same time, perhaps as a transitional arrangement. As parsimony is a key principle underlying Fund conditionality, we would not expect to have both types of conditionality at the same time. It might also be somewhat confusing to have both a band for inflation and a point estimate for a ceiling for money.

Related to this parsimony question, there was a suggestion to make the tripwire that we had proposed mandatory in cases where there were country-specific risks, especially a tripwire on NDA. Mandatory use would risk application in some cases where the condition might not be necessary, and therefore we would rather have a case-by-case approach to preserve that principle of parsimony in selection of conditionality.

Should we make a distinction between a temporary deviation and a persistent deviation from a target band? Prior to holding a consultation, the purpose of the consultation is to ascertain the reasons for the deviation from the band and whether any policy adjustment is warranted. The risk of delaying such a consultation by one or two quarters to see if it is persistent would result in possible costs from inaction. Triggering the consultation at the first review after a deviation is observed is probably the lowest risk approach.

Finally, there was a question about the application of the misreporting policy given data and capacity constraints in many developing countries. This is essentially in reference to inflation, as we do not currently have a performance criterion on inflation in countries with traditional monetary policy frameworks.

It is clear that reliable and timely information is essential as a basis for providing financial support to members. I note that the experience to date of using the inflation consultation clause (ICC) has not created issues related to misreported data on inflation. Given the importance attached to statistical systems for users of the review-based approach, we perceive the risk of misreporting to be generally low. However, in circumstances where revisions to inflation data are known to occur, it would be important to consider steps to improve the reliability of the inflation data.

The staff representative from the Strategy, Policy, and Review Department (Ms. Pattillo), in response to questions and comments from Executive Directors, made the following statement:

I will cover three issues: design issues specifically related to the target variable band, a few points on TA, and next steps.

On the design issue, particularly on bands, there was a question about whether there should be a single tolerance band. Although we agree with the comment that simple, parsimonious approaches to consultation bands are desirable—and the paper notes that normally there would be a single tolerance band—we have added an optional inner band to trigger consultations with staff in countries using inflation as a target variable. That is meant to provide an option, when the staff and the authorities feel it would be useful, to agree ex ante on lower tolerance levels where staff and the authorities would make sure to begin consulting. This inner band is not meant to become the official target.

There are likely to be cases where staff and the authorities think that the inner band is not necessary. That is likely when regular and structured discussions on the inflation outlook and monetary policy are already becoming more the practice. It is an option, something that is there in the ICC and has worked well for some countries, but it might not be necessary for some countries.

There was a question about the merits of having an inner tolerance band in the case of money targets. We do not believe that having this optional inner band would add value. Having two bands in the case of monetary aggregates as the target variable could place excessive attention solely on the monetary aggregates instead of what we are hoping for—the broader assessment of the inflation outlook and how policies should respond. It also could be associated with higher interest rate volatility.

The MPCC is expected to provide an incentive for monetary policy discussion, whether the macro developments are pushing the variable close to the band. The discussions should become more regular and ongoing.

Directors made the point that more guidance was needed on the width of the band. We agree that as we start implementation of this new option, we will benefit from more experience and study to help determine what band width is appropriate for the particular country circumstances. It will relate to the level and volatility of inflation, the history, and the types of instruments. We anticipate that the exact width of bands will be country specific, as has been the case in the ICC. But we agree that more analysis could help country teams in deciding on the appropriate band width.

As important as discussions of the width and types of the target band are, the conditionality policy is seeking to provide incentives for enhanced or new discussions based on forward looking analysis of inflation and macro forecasts. The policy seeks to provide baseline scenarios with alternative assumptions based on continuous assessment of the balance of risks and moving toward preemptive rather than purely reactive policies. As the central banks start to build credibility, often it is not crucially important if inflation, if that is the chosen variable, goes outside the band temporarily. If the central bank has preemptive policies and a communication strategy, that helps build resilience to temporary shocks so that inflation expectations stay well anchored.

I will now turn to the second point on TA and some related points on currency unions. Most Directors welcomed the paper’s emphasis on TA and training to help build central bank capacity and agreed that resources appear broadly adequate given the scope for prioritization.

Several Directors also emphasized the need for statistics TA given the importance of better data, including high-frequency indicators. Technical assistance is taking place in this area. There are pilot programs by the Statistics Department and the Africa Regional Technical Assistance Centers in particular that are working with central banks and national statistical organizations, and this is expected to be rolled out to other countries.

The point about the need for data on expected inflation relates to some of the statistics TA, which is helping with surveys, leading indicators, and developing surveys that could also include inflation surveys.

Mr. Assimaidou raised a valid point that increased provision of TA for these evolving MPCCs should not crowd out efforts in fixed exchange rate regime countries. To date, the Monetary and Capital Markets Department in particular has not experienced pressures to the point of having to shift TA resources away from countries with fixed exchange rates, and this will continue to be monitored.

On the fixed exchange rate regime point, a few Directors encouraged the staff to deepen its analysis of monetary unions. Although the focus of this paper is on countries with the scope for independent monetary policy, the staff is also working in that area. For example, the staff is working on deepening analysis of interbank markets and monetary unions with capital controls and some scope for short-term monetary policy; reserve adequacy in monetary unions; and TA for the East African Community countries that have announced a plan to move to monetary union in the longer term.

With regard to next steps, there was a question about whether it would be advisable to have a pilot phase for implementation of the new policy, rather than opening to full implementation. We did not see a need for an official pilot period since we expect a measured approach to the introduction. We expect that the number of countries that will be opting for this would be relatively low initially. We expect a measured approach, and with a review following the experience of some country cases. Countries that would opt out of this review-based approach to monetary conditionality would need to demonstrate that they have the capacity and meet the standard that we put forth in the paper.

On operational guidance, following this Board meeting, the staff will update the operational guidance note on conditionality to incorporate the enhancements to the review-based monetary conditionality framework that is being discussed today.

As with the guidance on design and implementation of conditionality in other areas, this note will have relatively condensed guidance. The more detailed information that Directors have been asking about—on the criteria for eligible countries and conditionality design considerations—would be communicated through the in-reach process to area departments, outreach to country authorities, and through the review process.

Several Directors encouraged the staff to continue analysis in this area, which gives me the opportunity to flag that there are several other strands of work under way. We are working on another paper that analyzes the design of monetary policy framework, and operation of monetary policy in developing countries with evolving monetary policy regimes. This will draw on research financed by the Research Department; a project financed by the Strategy, Policy, and Review Department and the Department for International Development; ongoing research on the monetary transmission mechanism in low-income countries, including how it depends on the policy regime itself; and research on how monetary policy deals with food price shocks, forecasting and policy analysis systems, and managing a managed floating.

Last week there was an IMF/Bank of Uganda conference on transitioning to modern monetary policy frameworks in low-income countries that featured some of that research. A further workshop is planned that will help exploit tight synergy between research, training, and TA in this area.

In response to TA requests, the Monetary and Capital Markets Department has developed a conceptual framework for helping countries choose a monetary regime in these evolving regimes, stressing that an appropriate framework can lie anywhere in a continuum between strict adherence to money targets, such as in the conventional money targeting, all the way to the constrained flexibility that goes with a formal inflation target, as is the case with the inflation targeting. Monetary regimes in between can be characterized as de facto two-pillar regimes combining elements of both monetary and economic analysis. These are some examples of the type of ongoing analysis that will help enhance our policy advice.

I would like to close on the question about interest rate bands. For most developing countries, using interest rate bands could overly tie the hands of the central bank in terms of flexibility and policy options. The underlying assumption is that the central banks in these regimes, which are increasingly focused on inflation, are adjusting their policy instruments in the way that is necessary to meet their objectives.

Mr. Sembene made the following statement:

We support the proposed review on the monetary policy conditionality framework that is being advocated by the staff. We are reassured by their assurance that the TA to countries with evolving monetary policy regimes will not cut off TA to other countries. That is a good step. We also appreciated the staff's comment that it will continue to be parsimonious in setting conditionality, not necessarily bundling additional conditionality and the new MPCC-based conditionality. Those comments are reassuring.

We remain a bit unsatisfied about the application of the misreporting policy. I want to be clear. We are not against applying the misreporting policy to the new framework, but we have reservations about the manner that is proposed. The staff indicates that whenever the target variables deviate from the outer band and the authorities do not report it in a timely manner, then they would be deemed to have misreported inflation data or data on the target variable. The staff has noted that the experience with ICC has not shown any problem of misreporting of inflation data, and if a country is having a problem with its data, they are not reliable, maybe they have to strengthen it. We have some reservations about both points.

We are talking about broadening the framework not only to emerging market countries, but also to low-income countries, and when we do that, we are covering some countries that have problems in terms of the reliability and frequency of data. The problem is that if there is a low-income country that has a quarterly review, and then the country is required to provide data on inflation on a timely basis, the country could be required to provide inflation data more than once a quarter, which would put the country in a difficult position. In that situation, one could apply the misreporting policy, but a good suggestion would be along the lines suggested by Mr. Mohan with regard to the suspension of eligibility. Maybe it is better to wait two quarters to see whether the reported data is not in line with the actual data before declaring misreporting. There is scope for considering the application of the misreporting policies, just to avoid situations where the authorities would be unfortunately accused of misreporting when it was not their intention. There is scope for reconsidering that.

Mr. Hendrick made the following statement:

On the issue of publication for those countries that agree to have inflation as the trigger for the MPCC, paragraph 32 in the staff report clearly indicates that the authorities would not have to publicly announce and commit to an inflation target.

The staff's technical responses state that this will not be a problem for publication of the staff reports in the review. Our constituency supports full transparency and full publication of documents. Having said that, the meaning of this paragraph is not clear. It might be misleading for future readers and users of the programs in the following sense. If a country wants to move to an MPCC, but does not want to disclose the commitment made with the Fund for political reasons or other reasons, the only option for the authorities is not to publish the staff report.

There might be various reasons why the authorities will not make public the inflation commitment with the Fund in a program. The only point I want to make is that this report will be published. This will be used as a reference for the countries. If I am a policymaker and I read this, I could interpret the document as indicating that I do not need to make public my inflation target agreement with the Fund. Are we sure we want to put this in writing? My recommendation would be to delete that sentence.

If the country chooses not to make public the inflation target agreed under the MPCC for valid reasons, it will not publish the staff reports anyway. If it does not have an issue, the authorities will publish. It is clear what the paper is trying to clarify, but maybe it is too much information. Perhaps we do not want to make it explicit that the authorities do not need to publicly announce the inflation target commitment under a Fund program.

We also agree with the standards. That is why we asked for more detailed guidance, like Ms. Arbelaez. There is a different case with countries with dollarization, including my own country, which has a successful formal inflation targeting framework. But it is not only that. I know how the operational guidelines will end up, but dollarization is too broad a word for a program design. One has to take into account if the country is a credit dollarization, a deposit dollarization, if the country's dollarization is a way of savings, but all transactions are done in domestic currency. It is a different diagnosis of why and what is dollarized, which leads to different designs of programs. The phrase "high dollarization" is too broad.

The use of the phrase "high dollarization" might be suitable for this paper, but in the operational guidelines to the staff, I would expect more precision on what is meant by dollarization, and therefore the design of the policies that we will support to help the country deal with an inflation target, despite what we call dollarization.

The same goes for the operational independence of the central bank. I agree that this is a judgmental and discretionary issue. There are countries with significant fiscal dominance, but that have a successful inflation record—and there are countries with de jure independence, but with the facto fiscal dominance.

An issue is presented by countries with strong central bank independence and inflation. This is the fact. The problem is determining how we avoid or minimize a possible perception of lack of evenhandedness among country members when we implement this policy. Some countries, maybe for reasons that they might believe are strategic, may claim they have not been given the same treatment as other countries, so it raises the possibility. We would like more clarity on the guidelines.

My next point is about the guidelines. Maybe in this initial step, which we do not call a pilot, we can accumulate experience with whatever countries come up in the next two or three years, give the staff and management the freedom to play it by ear, to learn by trial and error, and after two or three years of gaining experience, we come back to review this strategy, and then we might be able to be more precise in what we mean in the standards and in the benchmark for the future programs. I accept that at this point we do not have enough experience. Perhaps we need to gather that experience and afterwards we may need to modify our original proposal.

Mr. Oliveira Lima made the following statement:

I thank the staff for the papers and for the informal meetings with Executive Directors' offices. The paper is an important initiative and a step in the right direction. There will remain a number of challenges. I encourage frequent reviews of the success of the implementation of this model, as the process will be to a certain extent one of learning by doing.

One challenge will be trying to focus on the central target rather than on the upper ceiling of the band. This is a challenge even in many official inflation targeting countries. It will be more so in those with evolving monetary policy regimes. Nevertheless, focusing on the central target will be key for the authorities to take preemptive actions, as Ms. Pattillo mentioned. This is probably one of the most important results we should expect from the adoption of the MPCC—namely, that the central bank will react early, and will act early, to try to keep things going in the right direction and avoid frequently triggering the consultation clauses, which is something to be avoided.

We see some other issues, like the one raised by Mr. Hendrick on the communication of the expected path of inflation vis-à-vis the absence of a formal commitment for inflation. This will need to be carefully targeted in the communication policy.

Finally, on the guideposts: I can see the tradeoffs between evenhandedness and flexibility. But in this case we will have to struggle to achieve evenhandedness without sacrificing flexibility. As we mentioned in our gray statement, flexibility will be crucial as it is not expected that many countries will entirely fulfill the conditions for the implementation of this model.

Mr. Jbili made the following statement:

I would like to add a comment on the conditions or eligibility for this new framework, the MPCC. We should not set the bar too high so that we do not get many candidates or no candidates at all. The Fund had some experience in setting new initiatives with such demanding conditions so that there are no takers. We have to strike the right balance. I agree with Mr. Friedman on the question about using low inflation as a condition. There may be countries that in recent years have some experience with not-too-high inflation, but they could qualify, so this should not be a rigid condition. The same is true with the condition of independence of the central bank. There are various degrees of independence of central banks in developing countries. It is important to have flexibility since the current framework does not work effectively, as highlighted in the report. We should encourage more countries to get on this system, with all the caveats and with all the options to keep NDA and reserve money targets as indicative, and with technical conditions. I am a bit concerned when I hear from the staff that there will be few candidates. We should try to enlist as many candidates as possible.

My second question is on the inner band that would trigger consultation with the staff. If anything, the staff is always and continuously in contact with the authorities for program monitoring. Reviews are on a quarterly basis most of the time and the consultation with the staff is ongoing. I do not see the need for these consultations, except that it would cause the authorities anxiety to have to contact the staff, especially on these issues. It is necessary if we have only the consultation with the Executive Board for the enlarged band.

Finally, I agree with TA, but also I would suggest having some seminars for people in central banks to get them to be familiar with these issues and what they need to do.

The staff representative from the Strategy, Policy, and Review Department (Mr. Lane), in response to further questions and comments from Executive Directors, made the following additional statement:

I will start by addressing the questions about misreporting. Misreporting is triggered when a member provides information on the target variable that suggests that a target variable remained inside the band, and then there is no monetary policy consultation—a formal one with the Board—and the review is completed and disbursement is made. Then, if it turns out after disbursement is made that there was a deviation, and that a consultation with the Board should have taken place, then the purchase or the disbursement would be noncomplying and subject to the misreporting policy. However, if it is a question of nonavailability of the data, then there is a waiver of nonavailability at the time of the Board meeting and that would not constitute misreporting.

But I agree that we need to be absolutely sure that the data for the target variable is reliable. I also do not necessarily see a correlation between the level of development of a member and the risk of misreporting. Conditionality is tailored to the member, so typically speaking, with a less developed member, conditionality would be technically easier to monitor.

Mr. Sembene noted that there would be a tolerance band that would be set for every country if it opted for the MPCC framework, which meant that the country would have to provide an estimate for inflation for every review. His point was that if the estimate was not available due to non-frequency, the country would still have to provide an estimate. If the final outturn of that estimate ended up being higher than the earlier reported estimate, it could be defined as misreporting.

The staff representative from the Strategy, Policy, and Review Department (Mr. Lane), in response to further questions and comments from Executive Directors, made the following additional statement:

Conditionality would be set relative to actual data released, not typically by an estimate from the statistical agency. In all cases of use of

ICCs, it has been actual inflation data, not an estimate of inflation at some future point in time.

On the qualification criteria, we face this in a number of areas, and it is difficult to design a robust system of qualification criteria for eligibility for a facility, or for a type of conditionality. The main reason is that these criteria are dynamic. They change over time. What is appropriate at T-time will then lead to a different set of countries at time T-plus-one, but the relationships between the various criteria and the intended actions change over time. We would be able to be more precise in the future. I noticed that in the recent review of the Flexible Credit Line and the Precautionary and Liquidity Line, there was a sense that there should be more precision in some of the qualification criteria. That would be possible also in this case at some future point in time.

On the question of low inflation, the written responses to technical questions indicated that our expectation is that demand for review-based consultation will come mostly from countries that have already achieved low and stable inflation. But the new paper that we are discussing today does envisage circumstances where the past track record has been lacking in some respect, which could include past inflation performance and where the authorities have committed to reforms that would improve the performance.

In the first paper, we also noted that the ICC was introduced at the same time as Brazil's ambitious disinflation strategy. It is not our intent here to discourage appropriately ambitious policy changes, including for disinflation strategies.

The staff representative from the Strategy, Policy, and Review Department (Ms. Pattillo), in response to further questions and comments from Executive Directors, made the following additional statement:

With regard to the statement in the paper that countries would not have to publicly announce and commit publicly to an explicit inflation target, the idea is to not say that a country using the MPCC has to be an official inflation targeter, or that is that it has to publicly announce a medium-term inflation numerical target, to which it is then held accountable by the market, by the public, and committed with the government. The idea is not to say that is absolutely necessary, though perhaps we would not discourage that either, if there are countries that are ready and want to do that. But the objective is not to force countries to do that.

We did not see that this would create difficulties for publishing the staff report. We have countries that have implicit inflation objectives in their Fund programs, and the staff reports for those countries are published, because it is not an issue of not wanting to reveal to the public that they have this inflation objective in their Fund program. There is a distinction between the adoption of an inflation target for program purposes, which might be shorter term compared to the formal adoption of a publicly announced inflation target by the central bank.

It is true that these are countries that are increasingly putting more of an emphasis on inflation objectives. Consequently, the commitment to the band in the program context is not at odds with the practice of publishing the staff report with this increased emphasis on inflation in the program.

On the question about inner bands and whether they are necessary, we see it as an option. The question was whether this was necessary given that the staff was in continuous contact with the authorities and whether it would create additional anxiety. In some countries, the staff is in continuous contact. However, the type of dialogue on monetary policy could be enhanced with the idea of setting an inner band for consultation. Perhaps the current dialogue might be more about quarterly reserve money targets, and making sure to hit them because of program purposes. The discussion might focus less on an established practice and comfort them with structured discussions about the range of variables to look at, to get an idea of the inflation outlook, and the macro outlook, and the need for policy adjustments to keep inflation on track.

If it is something that the staff and the authorities feel could be valuable to help institute that practice of these more structured discussions, then that would be an option. If not, then it would not necessarily be required.

Finally, the point on TA is well taken as is the point that seminars are also useful as a vehicle. I mentioned the seminar with the Bank of Uganda where there were a number of governors and deputy governors from African central banks. We are thinking about using these kinds of seminars as outreach on this issue at various levels, both at the high-level seminars with central bank governors and the more technical seminars on monetary policy with technical staff from central banks.

The staff representative from the Strategy, Policy, and Review Department (Mr. Lane) clarified that with regard to misreporting, if data on a performance criterion was not available, one option would be to request a waiver depending on how critical the data were for the completion of the review. That review could also be delayed. In the case of data pertaining to the target band, it would be necessary to wait for the availability of the data before proceeding with the review. There would not be a waiver because it was not a performance criterion.

Mr. Hendrick agreed with Ms. Pattillo’s comments on the authorities’ commitment to inflation targeting. His concern was more semantic. The paper stated that the authorities had the option not to publicly announce the commitment to inflation targeting. However, if a country published the staff reports related to Fund programs, it would become clear to the markets that there was inflation targeting. Consequently, if a country had a policy of publishing staff reports, it was not clear how policymakers would avoid disclosing their commitment with regard to inflation targeting.

The Acting Chair (Mr. Shinohara) noted that such issues would have to be considered in individual cases. Management and the staff understood the sensitivities involved and were always careful about the potential impact on markets. Management and the staff would continue to have close communication with central banks in working on this new framework.

The following summing up was issued:

> 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-observances 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.

APPROVAL: September 18, 2014

JIANHAI LIN
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

**Design and Application of MPCC**

**1. *What is the rationale for some countries using single bands under the ICC framework?***

- The design of the ICC did not explicitly specify whether there should be single or dual bands. While a couple of Fund-supported programs have used single tolerance bands in recent years, the majority continue to use both inner and outer bands in the design of the ICC. Although Fund supported programs with ICCs may vary in their rationale for using single bands, one general theme is that the inner band—which would trigger a consultation with staff—may be unnecessary in some cases, as discussions with the team are expected to take place on a regular basis.

- A relevant example is Colombia, where in 2003 the ICC framework was revised to a single tolerance band and the size of the band narrowed to signal the authorities' commitment to take the necessary actions to meet the inflation target, while the team and authorities continued to share monthly information on inflationary developments and policy actions as a way of maintaining informal consultation with staff.

**2. *How will the tolerance band be operated in the case of a monetary target? Who will decide /validate the central path for the policy instrument?***

- The monetary target (the central path) would be decided as is normally done under Fund programs where understandings are reached between staff and authorities on reserve money program targets derived based on the premise of a stable relationship between broad money and base money, and an assumption on velocity. This becomes the operational tool by the central bank to calibrate its monetary operations.

- Bands around reserve money targets are already being used in some Fund-supported programs. The difference under the MPCC is that deviations from the band would not require a waiver as is currently the case. It would trigger consultation with the Executive Board and staff and authorities would have to explain what the underlying causes of deviation are and where necessary, introduce remedial measures to complete the review.

**3. *We would appreciate further clarity on whether the MPCC's band would more closely resemble the ICC's inner band (the breaching of which triggers a staff consultation) or outer band (the breaching of which triggers a Board consultation).***

- The width of the band under the MPCC would be set on a case-by-case basis with the objective of providing adequate flexibility but at the same time able to steer inflation. The direct comparison of this band would be the outer band under the ICC.

4. ***We also see merit in broadening the framework through inclusion of indicators for closer monitoring of the credit aggregates and financial stability conditions.***

- As indicated in paragraph 35, staff and authorities would use a set of multiple indicators (which could include credit aggregates) in the enhanced monetary policy assessment. This would be done in the context of a general economic policy assessment which among other objectives would consider implications of monetary policy for financial stability where relevant. In this case, analysis of financial stability conditions would also be done as part of the enhanced monetary policy assessment under the MPCC framework.

- We would therefore encourage staff to reconsider [the proposed application of the misreporting policy to the MPCC framework.

- Reliable and timely information is essential for the Fund's policy advice and as a basis for providing financial support to members. The experience to date of using the inflation consultation clause has not created issues related to misreporting inflation data. Given the importance attached to developing statistical systems for users of the MPCC we perceive the risk of misreporting to be generally low. In circumstances where revisions to inflation data are known to occur, it would be important to consider steps to improve the reliability of the inflation data.

5. ***We would like to ask the staff if an operational guideline, with some more specific criteria, would be prepared in the near future on this matter.***

- Following this Board meeting, staff will update the Operational Guidance Note on Conditionality to incorporate enhancements of the review-based monetary conditionality framework discussed by Directors today. As with guidance on design and implementation of conditionality in other areas, this note will have relatively condensed guidance. The detailed information on the criteria for eligible countries, and conditionality design considerations would be communicated through the in-reach to area departments and through the review process.

6. ***Are there any transparency issues with implicit inflation targets? The only way to avoid revealing [inflation] targets is not publishing the staff report, which could defy the whole purpose of sending strong signaling to the markets about the authorities' commitment to the program targets. The staff's comments would be appreciated on this matter.***

- The expectation is that staff reports would be published in countries that adopt the MPCC and choose inflation as the target variable.

- There is a distinction between the adoption of an implicit inflation target for program monitoring purposes and the formal adoption by a central bank of a publically announced, official inflation target. We would not expect the adoption of an inflation target for program monitoring purposes to lead to difficulties in publishing staff reports.

### Structural and Institutional Guideposts

**7. *Can the MPCC be used to support a disinflation strategy for a country that initially does not have low inflation?***

- As stated in paragraph 32, for economies aiming to reduce inflation, the inflation path could be designed to decline by a certain proportion over time. This path could either be a disinflation path or a monetary aggregate path set to achieve a specific inflation objective over a given time horizon. This is similar to disinflation programs under the ICC framework.

- This is not inconsistent with noting that one of the types of evidence that the "standard" was met would be a strong track record of policy implementation evidenced by low and stable inflation, but that an MPCC could also be considered when the track record has been lacking in some respects but the authorities are undertaking reforms to address these gaps.

### Review of New Proposal

**8. *In there an estimate of the number of countries that would be needed in order to have a meaningful review of the MPCC implementation and in how many years from now is review the expected to take place.***

- We would need a handful of programs implementing the MPCC to be able to conduct an informative review of implementation experience. It is not clear how long it would take, as it depends on the specifics of country programs, but it would most likely be not later than the next Review of Conditionality.