

---

# Monetary Policy Rate

---



## USAID-Funded Economic Governance II Project

**Presented To: Board of the Central Bank of Iraq**

**Date: 2005, November 28**

# Author

---

This document was prepared by:

## Warren

BearingPoint

1529 A Colonial Terrace

Arlington Va 22209

Tel: +1.703.608-2975

E-mail: WCoats@aol.com

This document is protected under the copyright laws of the United States and other countries: it has been prepared by BearingPoint, Inc. ("BearingPoint") Technical Advisors and/or contractors working directly for BearingPoint under the auspices of the U.S. Agency for International Development ("USAID") contract number 267-C-00-04-00405-00. This document and all accompanying pages are strictly for the use of USAID in support of their own consideration regarding the subject matter contained herein. Except where explicitly stated otherwise, the following information was prepared on the basis of data that is publicly available or was provided by USAID: it has not been independently verified or otherwise examined to determine its accuracy, completeness or financial feasibility (where applicable). Neither BearingPoint, USAID nor any person acting on behalf of either assumes any liabilities, expenses (including attorney's fees and legal expenses) fines, penalties, taxes or damages (collectively "liabilities"), resulting from the use of any information contained in this document.

© 2005 BearingPoint, Inc. All rights reserved.

# Outline of topics

---

## The Analytical Framework

## The Data and its analysis (Briefs)

## The Policy tools

- Open market operations (FX auctions)
- Standing facilities

## Interest Rates and uses of Standing Facilities

# Monetary Policy Rate

Two or more people can only understand each others views and proposals for monetary policy through a commonly understood analytical framework

---

## Analytical Framework

---

# The link between policy and inflation

---

## The Analytical Framework

$$MV = Pq$$

$$\text{or } M = kPq$$

**M** is the quantity of Money

**V** is the velocity of circulation of money

**P** is the price level (price index number like CPI)

**q** is real output (real GNP)

$$k = 1/V$$

# The link between policy and inflation

---

$$(1) \quad M^d \equiv kPq,$$

$$(2) \quad \Delta M^d/M = \Delta k/k + \Delta P/P + \Delta q/q$$

$$(3) \quad M^s = M^d$$

$$(4) \quad \Delta P/P = \Delta M^s/M - \Delta k/k - \Delta q/q$$

# Monetary Policy Controls M

---

- $M = mB^*$  (m = money multiplier)
- CBI controls the quantity of B (base money)
  - Net purchases of foreign exchange
    - Purchases from MOF
    - Sales in daily auctions
  - Standing facilities
- CBI influences m (money multiplier)
  - Reserve Requirement
  - Bank excess reserves
    - Payment systems
    - Liquidity management options
      - T-bills
      - Interbank lending

# Monetary Policy Rate

Policy decisions depend on what is happening – analysis of data

---

## Data – Policy Briefs

---

# Data – Policy Briefs

---

## The Board needs current data

- Inflation (CPI)
- Exchange rate
- Interest rates
  - T-bills
  - Deposit and lending rates
  - US and EU rates
- Money supply
  - Base, M1, M2
  - Excess reserves
- Income (GDP)

# Data – Policy Briefs

---

**The capacity to formulate and implement monetary policy must be built. Data must be timely and its importance for policy analyzed.**

- Formal structure is needed
  - Regular schedule of Board meetings on monetary policy
  - Regular schedule of staff data Briefs for Monetary Policy meetings
    - Staff leaders should attend to answer questions and hear Board views
- Feed back from Management to staff is needed

# Data – Policy Briefs

---

## Data quality and timeliness

- Market prices (exchange rates and interest rates) is well done
- CPI needs work
- Money supply
  - Monetary survey has made great progress
  - National accounts and accounting standards need improvement
  - Timeliness is poor – latest M is for August
    - Poor bank reports
    - Poor IT database support
- Income and employment
  - Non-existent

# Monetary Policy Rate

---

**Policy (monetary growth, interest rates, exchange rates) is implemented with the policy tools available - OMO, standing facilities**

---

## Monetary Policy Instruments

---

# Monetary Policy Instruments

---

## Open Market Operations

- FX auctions
  - Target exchange rates, or
  - Target FX reserves
- T-bill auctions
  - Target interest rates, or
  - Target excess reserves

# Monetary Policy Instruments

---

## Standing Facilities -- Purpose

- Dinar facilities
  - Lending
  - Deposit
    - Overnight
    - 14 and 30 days
- Dollar Deposit Facilities
  - Overnight
  - 30 and 90 days

# Monetary Policy Rate

---

The Policy Rate should be set to promote money market development and the desired money supply growth rate.

---

# Monetary Policy Interest Rate

---

# Monetary Policy Interest Rate

---

**The Policy Rate is 7 percent; Is it right?**

**How should we think about the answer?**

- The efficient market bench mark
  - Is the real rate positive?
  - Is interest rate parity preserved (with US dollar or Euro)?
- Is money market in balance?
  - Are excess reserves at reasonable level?
  - Are over night facilities at marginal levels?
- Is money supply growing at appropriate rate?
- Is inflation above or below target?