CBI Instruments of Monetary Policy

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Overview of Presentation

- Controlling base money
  - Buying and selling FX
  - Buying and selling t-bills (OMO)
  - Standing credit and deposit facilities
  - Placement of government deposits

- Influencing the money multiplier
  - Minimum reserve requirement

- Instruments and their design

Controlling Base Money

CBI Balance Sheet - Components of Base Money

Assets		Liabilities	
Gold and foreign currency (FA)		**Currency**	
			Outside banks (C)
Claim on banks (CB)			**Inside banks (VC)**
Claims on Government		**Deposits**	
	Credits to Government (CG)		**Banks current account (R_b)**
	Government securities (GS)		**Banks term accounts (R_{bt})**
			Government (R_g)
			FX (R_{bf})
		CBI bills (CS)	
Other Assets (OA)		**Other Liabilities (OL)**	

Base Money

- $B \equiv C + R_b + VC$ (uses)
- $B \equiv NFA + NCB + NCG + NOA$, (sources), where
- $NFA \equiv FA - R_{bf}$,
- $NCB \equiv CB - CS - R_{bt}$
- $NCG \equiv CG + GS - R_g$, and
- $NOA \equiv OA - OL$

Sources and Uses of Base Money

- $B = NFA + NDA + NOA = C + R_b + VC = C + RR + ER$
- $\Delta B = \Delta NFA + \Delta NDA$
- ΔNet Foreign Assets (ΔNFA) = FXP - FXS
  - Purchase and sales of FX with government and banks
- $\Delta NDA = \Delta NCG + \Delta NCB = \Delta CG + \Delta GS - \Delta R_g + \Delta CB - \Delta CS - \Delta R_{bt}$
  - Credit to government and banks
  - Purchases and sales of bills
  - Government deposits with CBI
  - Bank term deposits with CBI

Instruments of Control

- FX operations
  - Purchase of FX (increase in NFA) increases B
- CBI bills
  - Auction of bills decreases B
- Open market operations in domestic securities
  - Purchase of bills (t-bills) increases B
- Standing Facilities
  - Credits to banks (increase in NDA) increases B
  - Term deposits from banks (decrease in NDA) reduces B
- Credit to government
  - Credit to government (increase in NDA) increases B
- Placement of government deposits
  - Shift of deposits from CBI to banks (increase in NDA) increases B

Autonomous factors affecting B

CBI influences these with access rules and Policy Rate

- Credit to government
  - Increases NCG (increases B)
- Government deposits with CBI
  - Increase reduces NCG (reduces B)
- Credit to banks
  - Increase NCB (increases B)
- Bank term deposits with CBI
  - Increase reduces NCB (reduces B)

Instrument Design

Objectives of design

- Primary purpose is to provide effective control of B
- Secondary purpose is to promote efficient market liquidity management and market development

Open Market Operations

- Should provide for secular growth in B and absorb short-term shocks
  - Interest rate and exchange rate smoothing interventions should be modest

- Market development is promoted when:
  - Operations (FX and notes) are with the market by auction
  - Bill maturities reflect market demand and are predictable
  - CBI bill issues should be coordinated with MOF issue program
    - Coordinate maturities
    - Coordinate auction dates
    - Coordinate issue amounts

Standing Facilities

- Should not be a regular source of growth in B
- Should provide a market liquidity safety net while encouraging use of the market
  - Credit rate should be
    - modestly above market interbank rate
    - against proper collateral
    - to solvent banks only
  - Deposit rate should be modestly below market interbank rate

Minimum Reserve Requirement

- Changes in reserve ratio
  - Have large discrete impact
  - Should be used very infrequently

- Control of multiplier is maximized when:
  - rr applies to deposit component of M (D), and
  - reserve assets are components of B (R)

- Bank liquidity management is maximized when:
  - requirement is for average reserve holding,
  - Settlement period is long, and
  - banks determine mix of vault cash and current account balances at central bank

Use of Instruments

Exchange Rate

Target Exchange Rate

- What rate to target?
  - Explain target and reasons for it to public

- Monitor and forecast impact on Net Foreign Assets of CBI
  - This is part of liquidity forecast

Policy Interest Rate

- What rate to target?
  - Explain target and reasons for it to public
- Factors to consider
  - Positive real rate (nominal rate less expected inflation rate)
  - U.S. dollar rate plus rate of exchange rate depreciation plus country risk premium
  - State of market liquidity (excess reserves/deposits)

CBI bill auctions

- Market development and efficiency
  - Set and preannounce auction plans in coordination with MOF
  - Limited fine tuning to maintain market liquidity
    - Temporary increase in primary auction amount
    - Buy back from market (OMO, repos, FX swaps)

- Factors to consider
  - Scheduled auction amounts that are expected to produce desired base money growth (from liquidity forecast)
  - Short term operations reflect liquidity developments and forecast
    - Keep excess reserves at the desired (demanded) level

Conclusion

Summary

- Policy instruments should be designed to
  - effectively control B and m
  - promote bank liquidity management and market development
- Open market operations in FX and t-bills are flexible and under central bank control
- Standing lending and deposit facilities provide banks liquidity safe nets
- A minimum reserve requirement reduces m and can contribute to bank liquidity management, but should not be used actively.

Thank you

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