

Preconditions for IT: Financial soundness

Workshop
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Background and context

Financial soundness as precondition for inflation targeting

- 1. Operational capacity of central bank**
- 2. Financial depth**
- 3. Financial stability**

Conclusions

Background: Current exchange rate arrangements

- **Mostly “intermediate regimes”**
- **Orientation towards USD**

Jordan (USD)

Lebanon (USD)

Libya (SDR)

Morocco (EUR, USD)

Syria (USD)

Algeria (USD)

Egypt (USD)

Tunisia (EUR, USD)

Israel

Turkey



**Currency boards,
dollarisation**

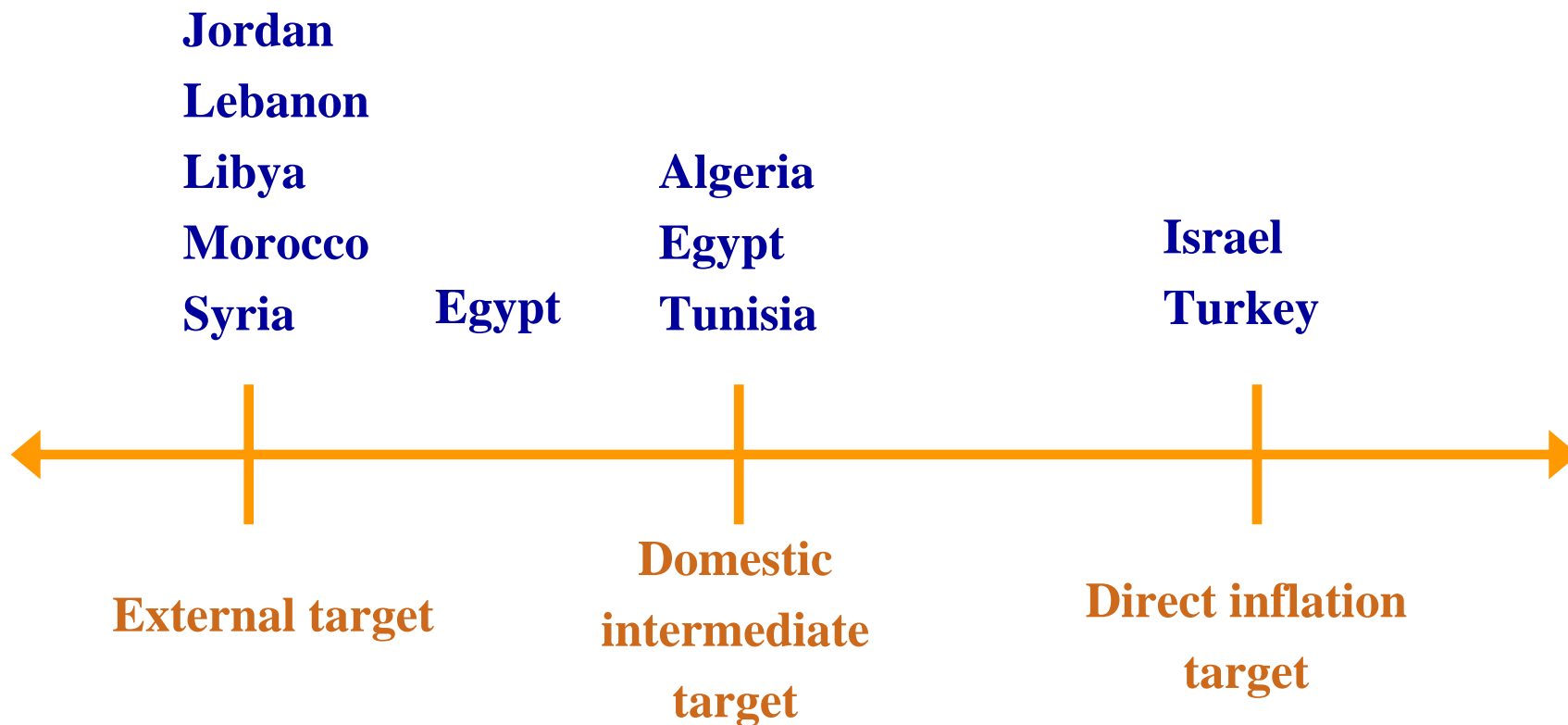
**Fixed pegs
(reference)**

**Managed floats
(main reference)**

Free floats

Background: Current monetary policy framework

- **Mostly external targets**
- **Two inflation targeters**



Background: Trends in monetary arrangements

- **Enhanced exchange rate flexibility**
 - **Egypt (2007)**
 - **Israel (1997)**
 - **Tunisia (2005)**
 - **Turkey (2001)**
- **Some autonomy of monetary policy from the anchor currency**
- **Reduced central bank role in FX markets**
- **Enhanced communication, transparency and accountability**
- **Modernised monetary policy tools**

Background: Global timeline on IT

New Zealand

Canada

United Kingdom

Sweden

Australia

Iceland

Norway

1990

1992

1994

1996

1998

2000

2002

2004

2006

2008

Israel

Czech Republic

Poland

Brazil

Chile

Colombia

South Africa

Thailand

Korea

Mexico

Hungary

Peru

Philippines

Indonesia

Romania

Turkey

Armenia

Source: IMF (2006a)

Background: Increasing inflationary pressures

Consumer price inflation

(Annual percentage changes)

	2003	2004	2005	2006	2007	Mar-08	Jun-08	Jul-08	Aug-08	Sep-08
Algeria	2.6	3.5	0.8	1.8	3.9	5.3	2.6	1.3	2.9	..
Egypt	4.5	11.3	4.9	7.6	9.5	14.4	20.2	22.2	23.7	21.5
Israel	0.7	-0.5	1.4	2.1	0.5	3.7	4.8	4.8	5.0	..
Jordan	1.6	3.4	3.5	6.3	5.4	14.1	16.6	19.4	19.8	..
Lebanon	0.9	2.5	-1.2	2.4	5.7	10.8	12.4	13.9	13.5	..
Morocco	1.2	1.5	1.0	3.3	2.0	3.1	4.6	5.1	4.8	3.9
Tunisia	2.7	3.6	2.0	4.5	3.1	5.8	4.9	5.2	4.5	..
Turkey	25.3	8.6	8.2	9.6	8.8	9.2	10.6	12.1	11.8	11.1
West Bank and Gaza	4.4	3.0	3.5	3.8	2.6	9.9	12.2	12.4	10.4	..

Source: National sources, IMF

Background: Summary

- **Strong external orientation of monetary policy**
- **But increasing exchange rate flexibility**
- **And increasingly “modern” monetary policy frameworks**
- **In a challenging environment (inflation, financial turmoil)**

Financial soundness as precondition for IT

- **Why does financial soundness matter?**
 - **Efficient monetary policy transmission**
 - **Avoid conflict monetary policy / financial stability objectives**
(Allen et al., 2006; Al-Mashat and Billmeier, 2007; Mishkin, 2004; Boughrara et al., 2008)
- **How does financial soundness matter?**
 1. ***Operational capacity*** : Existence of interbank market, transmission of interest rates to the market (Agénor and El Aynaoui, 2007)
 2. ***Financial depth*** : Transmission from banks to rest of economy; transmission through capital markets
 3. ***Financial stability*** : Sufficiently healthy banking sector
- **Are these conditions needed for inflation targeting?**
 - **Conditions are relevant for any systematic monetary policy framework**
 - **Endogeneity of some IT conditions – applies less for financial soundness**
(see e.g. Amato and Gerlach, 2000; Allen et al., 2006)

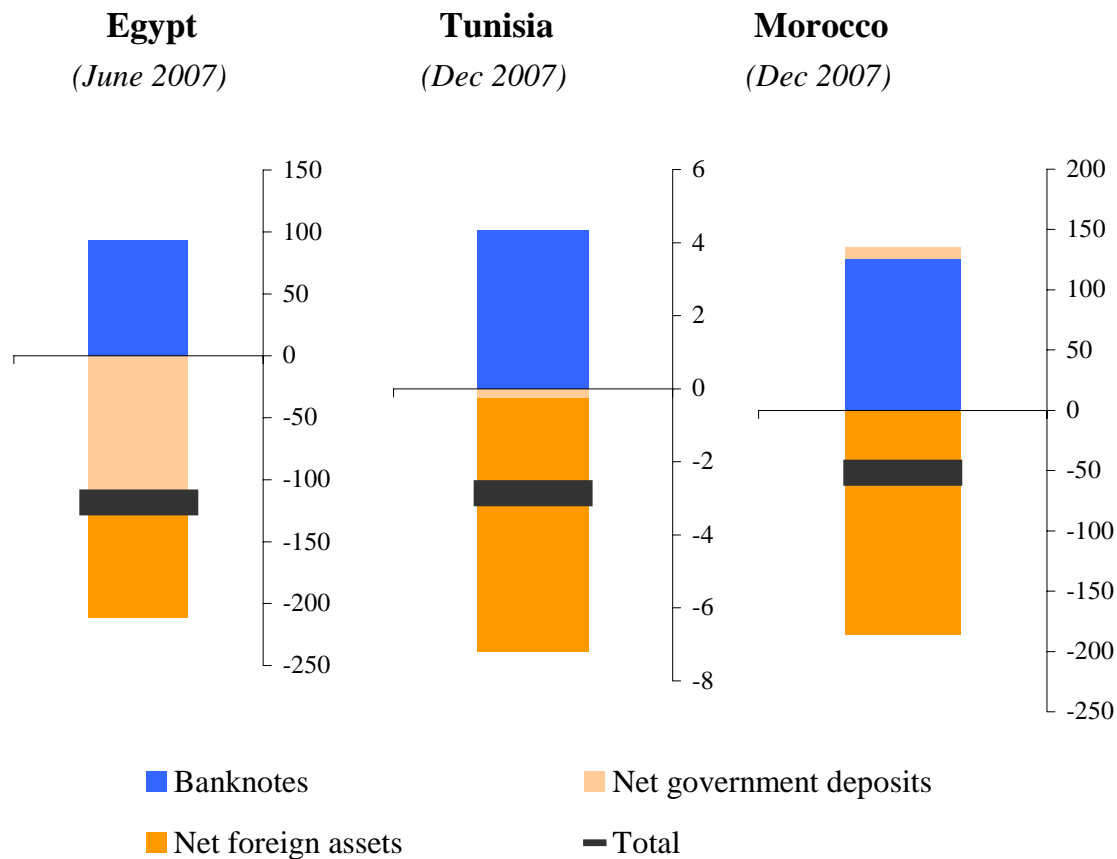
1. Operational issues: Structural liquidity shortage

- **Main sources of liquidity needs**
 - Banknotes
 - Net government deposits
 - Net foreign assets (-) } *autonomous factors*
- **If Σ autonomous factors < 0 , excess liquidity needs to be absorbed**
- **Measures to absorb liquidity**
 - Deposit auctions
 - Reverse repos
 - Central bank certificates of deposit / notes
 - Reserve requirements
- **Liquidity withdrawal as monetary policy instrument (Agénor and El Aynaoui, 2007)**

1. Operational issues: Examples of excess liquidity

Main autonomous sources ^(a) of liquidity demand

(in billion national currency)

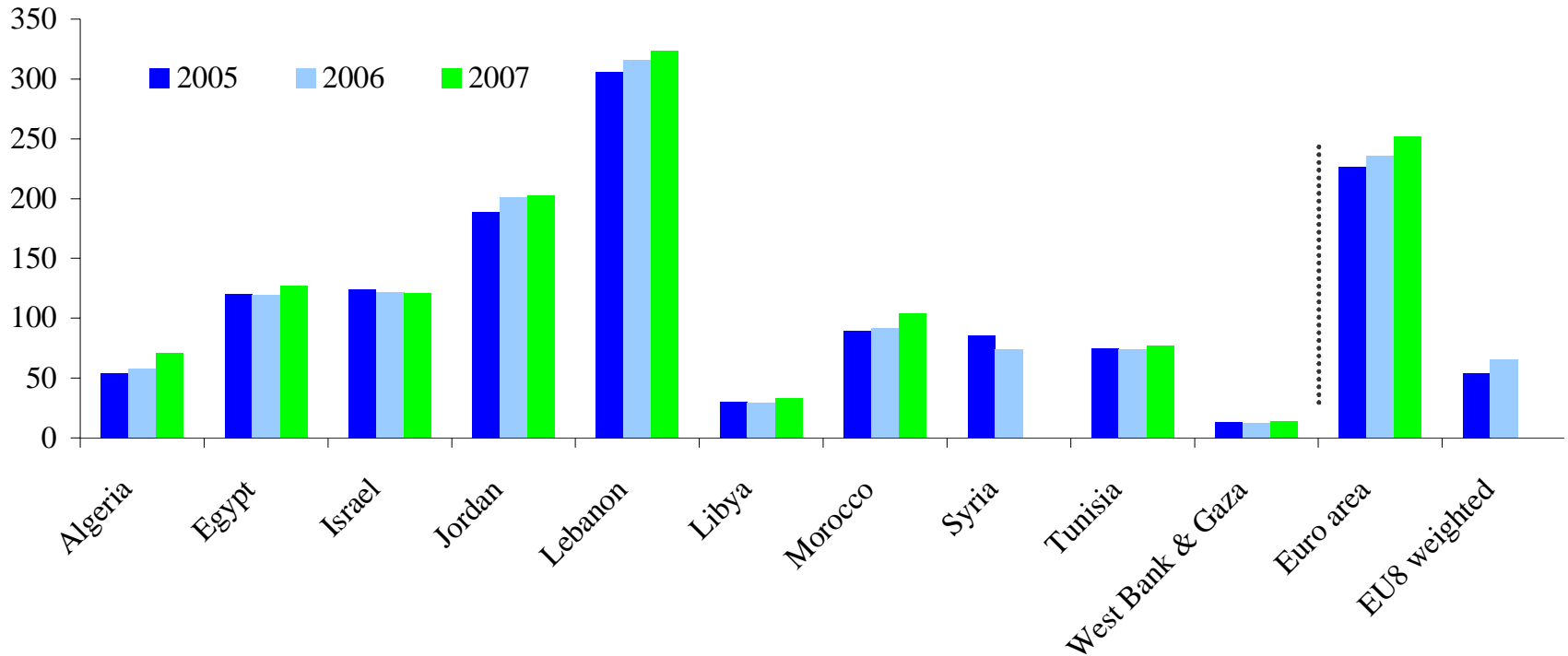


(a) Not all autonomous factors are included

Source: Central bank balance annual reports.

2. Financial depth: Size of banking sector

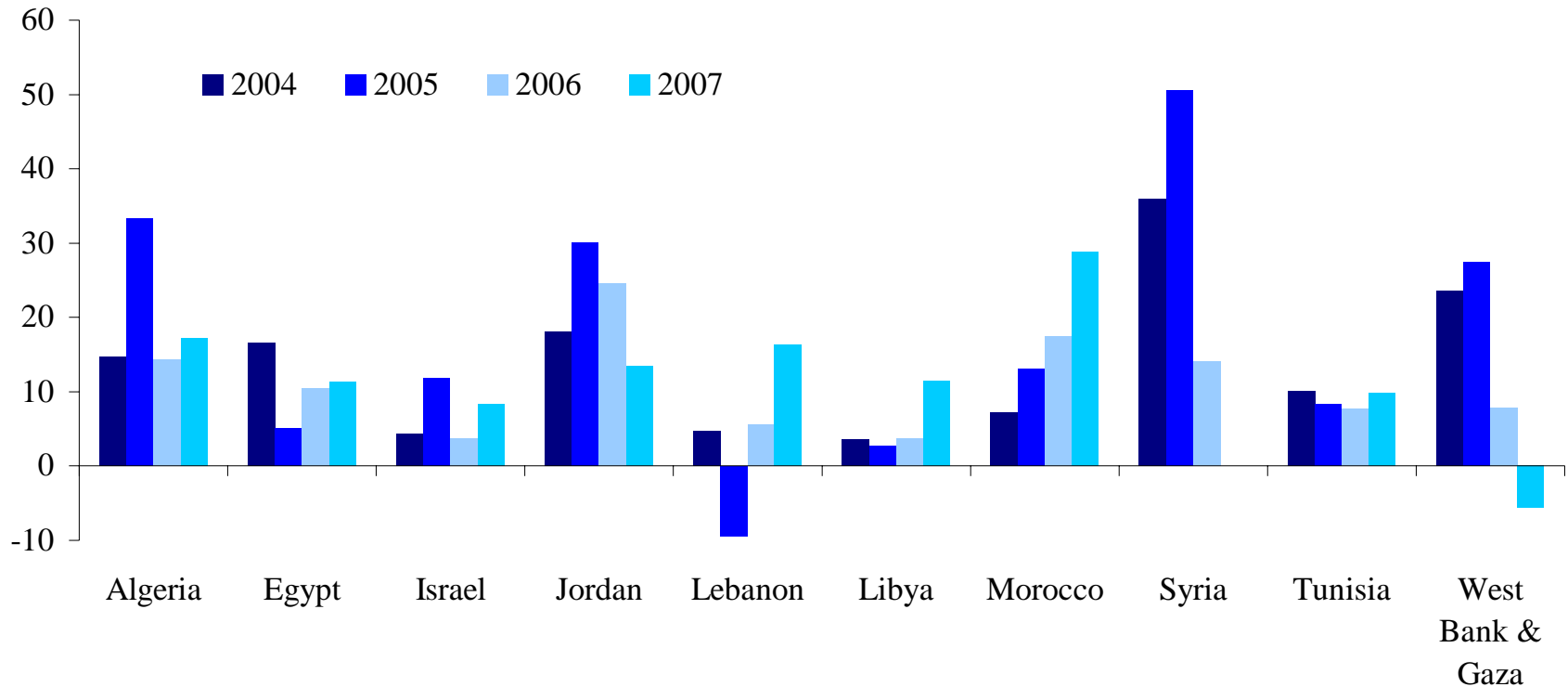
Total bank assets
(percentage of GDP)



Source: IMF and own calculations

2. Financial depth: Growth of banking sector

Credit growth to the private sector
(annual percentage changes)



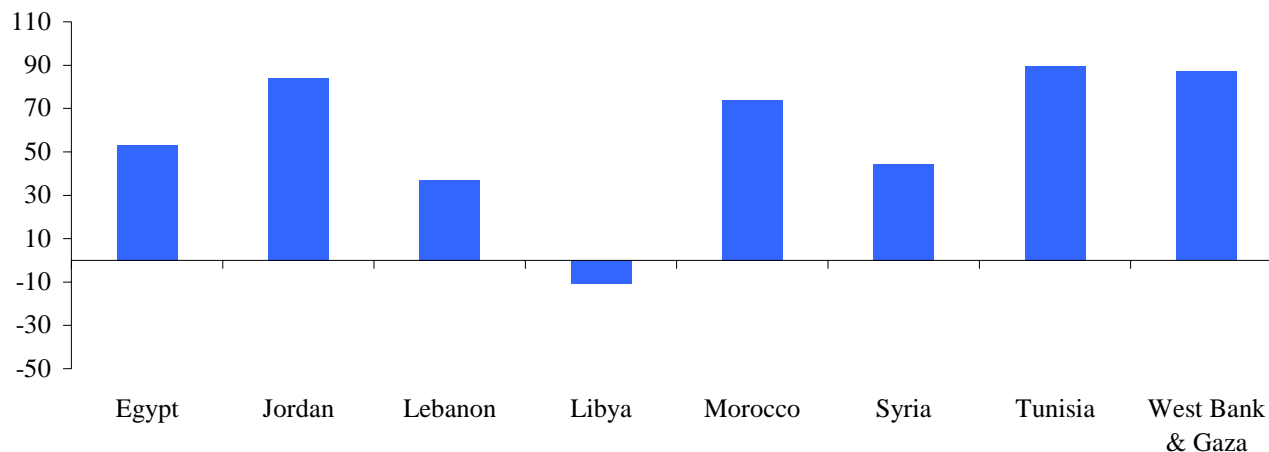
Source: IMF and own calculations

2. Financial depth: “Reach” of banking sector

- **Role of banks in government securities markets**
- **Sectoral distribution of bank loans**

e.g. split between public and private sector credit

Bank claims on the private sector to total bank claims



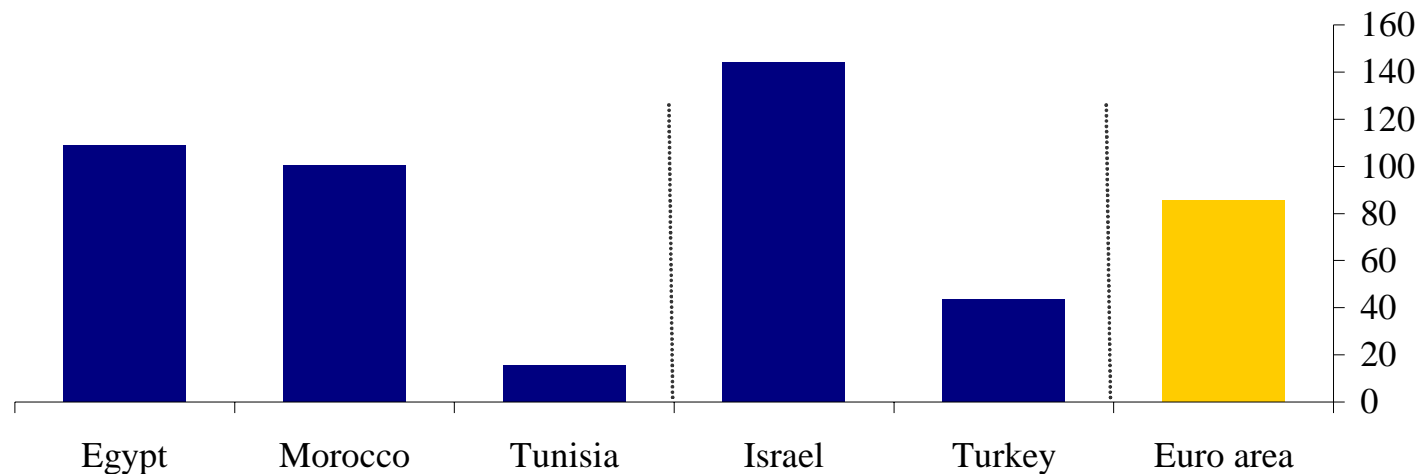
Source: IMF and own calculations.

- **Distribution of bank loans across population segments**
- **Currency denomination of bank loans**
 - **In case of heavily euroised/dollarised systems: Limited transmission**
 - **Mediterranean countries: Low level of euroisation/dollarisation (with exceptions, e.g. Lebanon)**

2. Financial depth: Capital markets

- **Capital markets important for other transmission channels (asset prices)**
- **Example: Stock exchange markets**

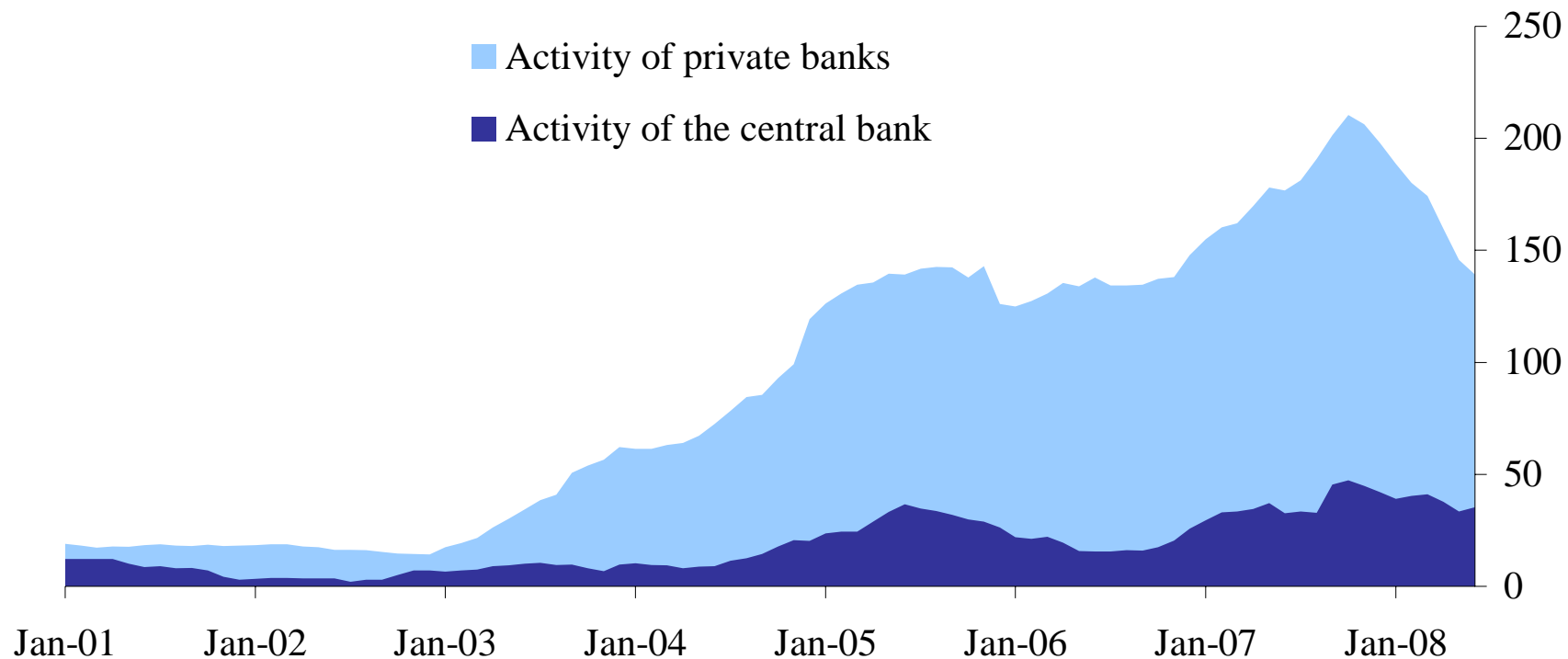
Stock market capitalisation in 2007
(percent of GDP)



Source: S&P Global stock markets factbook 2008, IMF and own calculations.

2. Financial depth: Deep and liquid FX markets

Foreign Exchange Market in Morocco
(million of dirhams)



Source: Bank Al-Maghrib.

3. Financial stability: FSIs

Selected financial stability indicators for the banking sector

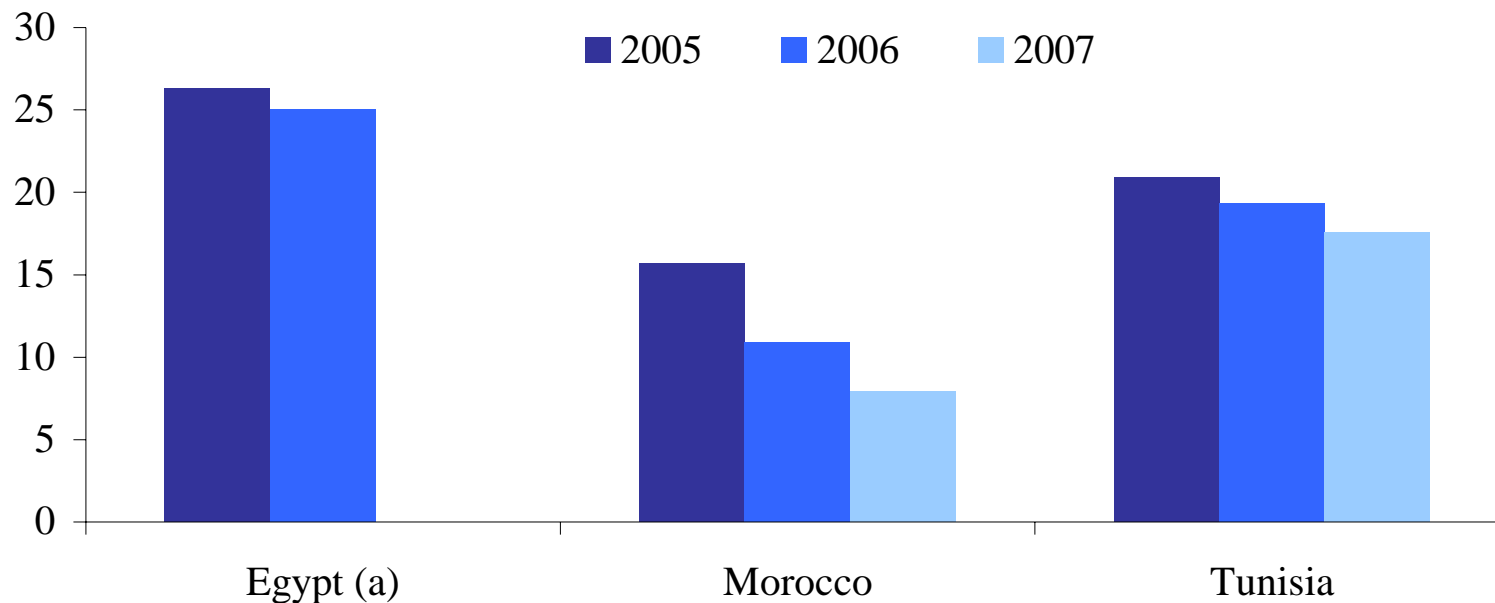
	Egypt (2006)	Morocco (2007)	Tunisia (2007)
Regulatory capital to risk-weighted assets	14.5	12.0 (a)	11.3
Nonperforming loans to total gross loans	25	7.9	17.6
Return on assets	0.6	1.5	0.9

(a) For banks operating under Basel I rules

Source: IMF, central banks.

3. Financial stability: Some progress in NPLs

Non-performing loans to total gross loans
(in percent)



(a) End of fiscal year.

Source: IMF, central banks.

Summary: Financial sector requirements for IT

- **Operational capacity**
 - **Existence of an interbank market**
 - **Liquidity withdrawal in case of excess liquidity**
 - **Toolkit for monetary policy implementation**
- **Financial depth**
 - **Size, growth and reach of the banking sector**
 - **Deep and liquid FX markets**
 - **Deep and liquid capital markets**
- **Financial soundness**
 - **Financial stability**
 - **Addressing non-performing loan problem**
 - **Legislative and regulatory frameworks**

Conclusions

- **The current environment is challenging**
 - **Global inflation shocks**
 - **Global financial shocks**
- **Financial soundness is key**
 - **Monetary policy transmission**
 - **Monetary policy versus financial stability objectives**
- **Financial sector development is multi-faceted**
 1. **Operational capacity of central bank**
 2. **Financial depth of banks and non-banks**
 3. **Financial stability**
- **These conditions are not only relevant for IT**