Liquidity Management by Central Banks, The Role of Banks in Credit Allocation and Thoughts on Barriers to Financial Intermediation

by

Hervé Ferhani
(International Monetary Fund)

CCMS 9TH Annual Senior Level Policy Seminar
Port of Spain, Trinidad and Tobago
May 2-3, 2005

I want to thank the Caribbean Center for Monetary Studies for having invited the IMF to participate in its 9TH Annual Senior Level Policy Seminar. By taking part in a meeting such as this one, the Fund's objective is not so much to "teach" as it is above all to listen to central bank policymakers and practitioners, and market players. A second and related objective is to distill and share what we have learned from our involvement in country work the world over on the topics that will be discussed in this seminar.

This event has a long history, I believe as far back as 1996 when the first Senior Level Policy Seminar was held. As a matter of fact, I noticed that the theme of that first Seminar—Liquidity Management in Liberalizing Caribbean Economies—is similar to the one we will be discussing today. Tomorrow, we will be considering a set of issues having to do with the allocation of liquidity to the private and productive sectors of the economy. This is indeed an important dimension of monetary policy, which touches upon the channels of transmission of monetary policy.

The IMF involvement

- **Technical assistance** for liquidity management
- **Financial Sector Assessment Program (FSAP)** looks at stability *and* developmental issues in the financial sector

We at the Fund, and in particular in the Monetary and Financial Systems Department, have been involved in both dimensions of liquidity management. Almost since the Fund's beginnings, we have been providing assistance to central banks throughout the world so that they may establish robust frameworks for liquidity management. Most recently, we have developed a work program on financial sector issues, motivated primarily by stability considerations, but also looking at developmental issues. This has been a joint IMF-World Bank effort since the establishment of the Financial Sector Assessment Program (FSAP). Therefore, we, in MFD, have learned a great deal about banking systems and credit markets.

After this introduction, let me now turn to the two main topics that I am planning to cover. *First*, I will discuss liquidity management for the conduct of monetary policy. Here my objective is to discuss what has been our experience at the IMF, experience that we have gained from our technical assistance work to central banks around the world. *Then*, I will turn to the second topic—that is, the allocation of liquidity to the private sectors of the economy, and why regions or countries have had different experiences.

Systemic Liquidity Management

- Shift toward reliance on monopoly in the creation of base money
  - Direct controls lose effectiveness
  - Market forces allow more efficient allocation of financial resources

Let me first discuss liquidity management from the point of view of monetary policy implementation. Central bankers represented here know are familiar with the trend in monetary policy implementation that was initiated in the 1970s in industrial countries, and which was followed by most emerging market economies and developing countries. Central banks moved away from reliance on direct controls on the price or the quantity of commercial bank credit, to reliance on operational frameworks exploiting the central bank's monopoly in the creation of base money (Table 1). This move was motivated by two reasons. **First**, direct controls had become inefficient because of the growing importance of financial markets in the allocation of resources in the economy. Commercial banks no longer had a monopoly on the intermediation of financial resources, and there was a need to rely on monetary instruments that could affect markets rather than just banks' balance sheets.

Second, allowing market forces to distribute financial resources was associated with increased economic efficiency and growth.

The Fund has encouraged the shift to reliance on money market operations for monetary policy conduct, and has provided assistance to help countries make the transition. For instance, during the period 1999–2004, the Fund provided assistance to strengthen monetary policy implementation to more than 100 different countries (Table 2).

Use of Monetary Instruments in a Sample of Countries

(In percent of number of countries in the sample)

	Developing Countries	Emerging Countries	Developed Countries
Credit and interest rate controls	4	22	0
Liquid asset ratio (LAR)	65	30	9
Reserve requirements	100	96	70
Open-ended/standing facilities	96	96	100
Money market operations	96	96	100

Technical Assistance in Monetary Policy Implementation

(1999–2004)

	Number of Countries	Advisory Missions	Expert Assignments	Workshops & Training	Man-Years
Africa	25	43	184	5	38
Asia	21	23	148	11	23
Europe 1/	26	76	81	11	24
WHD	17	19	61	10	13
Middle East	20	36	48	4	10
Total	109	199	522	41	108

1/ Europe includes the Baltic states, Russia, and other countries of the former Soviet Union.

Experience of Countries at Different Stages of Market Development

- Study based on the experience of ECCU, Democratic Republic of the Congo, Egypt, Kyrgyz Republic, Malta, The Gambia, Tonga, Tunisia, Uganda, Ukraine, Vanuatu, and Zambia.

Our Executive Board encouraged us to examine the experience of countries with reliance on money market operations. The request came from Directors representing small countries, in particular the Caribbean or small Pacific Islands, and we decided to evaluate the experience of countries at different stages of market development based on a detailed analysis of one currency union and twelve countries: the Eastern Caribbean Currency Union, the Democratic Republic of the Congo, Egypt, the Kyrgyz Republic, Malta, The Gambia, Tonga, Tunisia, Uganda, Ukraine, Vanuatu, and Zambia. The study was discussed at an IMF Board seminar in November 2004, and made available to the general public.

Findings of the Study

- The policy shift was desirable and even necessary...but some countries did not develop the necessary infrastructure
- Three main obstacles
  - Fiscal dominance
  - Limited market participation
  - Weak operational framework to manage central bank's balance sheet

The study confirmed that reliance on money market operations for conducting monetary policy was desirable, including for countries with shallow markets. However, the study also showed that in some cases countries had not managed to develop the necessary infrastructure to ensure full effectiveness of the new framework.

The detailed review we undertook allowed us to identify three factors behind the difficulties in moving to market-based monetary policy operations: *First*, fiscal dominance, which is a multi-faceted problem, has been a strong barrier to the effectiveness of monetary policy in many countries. *Second*, limited market participation. And *third*, the lack of an effective framework to decide on the timing and size of central bank operations.

Five-plus one-Main Lessons

- One size does not fit all
- Separate money creation & gov. funding
- Be realistic in context of fiscal dominance
- Stable and sound financial system
- Institutional and operational autonomy
- +
- Greater integration of IMF's surveillance and capacity building assistance

What general conclusions for a reform agenda for capacity building can be drawn from this evaluation? Although there are many, I would like to highlight five of them:

First, monetary instruments need to be tailored to each country's particular circumstances. Clearly: one-size does not fit all. However, if the central bank has a fairly good command of its balance sheet, and there is a working interbank market, it can achieve its objectives by using simple and robust money (interbank) market instruments.

Second, early on in the process of strengthening monetary policy conduct, emphasis needs to be placed on the ability of the central bank to control its balance sheet. This requires setting a clear separation between money creation and government funding needs.

Third, in shallow markets, one has to be realistic about what monetary policy can deliver in an environment of fiscal dominance. The ability of monetary policy actions to compensate for an undesirable path of fiscal policy may be limited.

Fourth, one cannot overemphasize the importance of having a stable and competitive financial system and adequate supervisory framework.

Fifth, the central bank needs to have both institutional and operational autonomy. I want to stress the operational autonomy, that is the financial capacity for the central bank to undertake any monetary policy operations that may be needed to achieve its objectives. We found that the weak financial position of the central bank greatly complicated liquidity management in financial systems

Credit Allocation and Barriers to Financial Intermediation

- The concern: funding of SMEs
- Macroeconomic dimension
  - Crowding out
  - High interest rates
- A widespread but not universal problem

Now, let me turn to the second topic: how can liquidity that is available in the financial sector be efficiently transformed into resources that are made available to the private sector?

There is a **widespread concern** that banking systems do not provide enough support to new economic initiatives and, in particular, to the expansion of small- and medium-sized enterprises. This concern is supported by the low levels of credit to the private sector when compared to the gross domestic product (GDP). Banks' reluctance to expand credit to other than the most creditworthy borrowers has been observed even in countries where banks remain highly liquid. I should add that this phenomenon is not limited to this region; we have encountered similar problems, for instance, in Africa.

There is a macroeconomic dimension to that issue: weaknesses in this regard will usually translate into high levels of borrowing needs for the public sector, and increase the price at which liquidity is made available to the private sector. Several countries in the Caribbean region which suffer from very high sovereign debt burdens coupled with large bank holdings of government paper. Attractive yields on these securities not only crowd out credit to the private sector, but also put upward pressure on bank lending rates, possibly making credit unaffordable to all but the riskiest projects. However, a discussion of fiscal issues is beyond the agenda of the meeting. For the remainder of this presentation I will therefore focus on micro issues, and in particular on the environment for private sector activity.

However, in some other regions we have not found such a problem. In particular, countries in Central and Eastern Europe and the Balkans are faced with rapid credit growth in recent years.

Lessons from Success Stories

- Quality of legislation on creditor rights and collateral
- Private sector ownership of banks
- Speed of structural reform process
- "Catching-up" hypothesis
- Growth of bank credit not sufficient nor necessary
- Reduced funding needs of public sector

I believe it is useful to look at the experience of these countries in the context of our discussions: what are the factors affecting the trends we are witnessing? Why has growth of bank credit to the private sector differed across countries? Is there something one can learn from the experience of these countries?

I will draw on three studies from the IMF that describe the causes of credit expansion in Africa and in Central and Eastern Europe and the Balkans. Let me focus on six key conclusions:

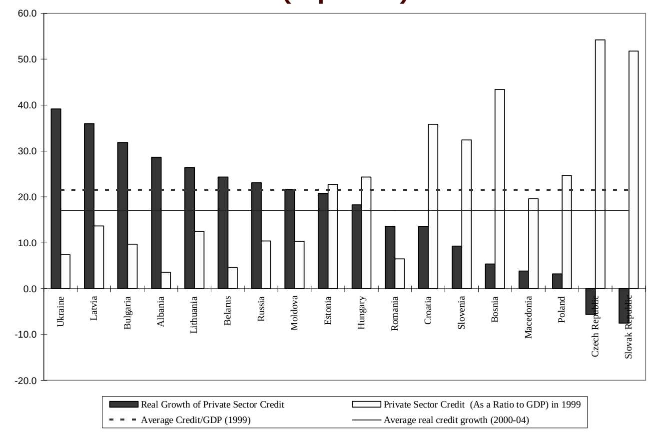
First, most importantly, credit growth is affected by the quality of legislation to protect creditor rights and the extent to which this legislation is enforced.

Second, private and foreign sector ownership of banks played an positive role for credit growth in Eastern Europe. However, there is no clear evidence that foreign ownership has played a positive role outside of Eastern Europe, and there is evidence that foreign banks tend to be cautious about lending to firms other than the largest ones, for instance in Africa.

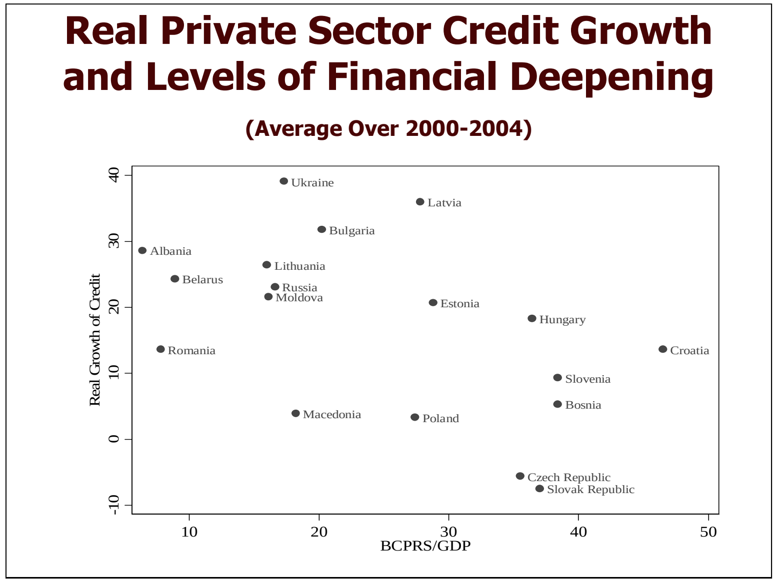
Third, the degree of progress in structural reforms is a factor that may help explain differences across countries, in particular among countries in Central and Eastern Europe and the Balkans. However, some countries which rank high in structural reforms have not experienced high growth of bank credit (Czech and Slovak Republic)

Real Credit Growth over 2000-04 versus Credit to GDP in 1999

(in percent)



(Figure 1)


Real Private Sector Credit Growth
and Levels of Financial Deepening
(Average Over 2000-2004)
Real Growth of Credit
BCPRS/GDP
-10
0
10
20
30
40
50
Ukraine
Latvia
Bulgaria
Albania
Lithuania
Belarus
Russia
Moldova
Estonia
Hungary
Romania
Croatia
Slovenia
Bosnia
Macedonia
Poland
Czech Republic
Slovak Republic

(Figure 2)

Experience in Latin America

- Benefits of foreign bank entry seem to greatly outweigh potential costs
- Weaknesses in protection of creditors
- Poor quality of information about creditors

I should add that a recent study by the Inter-American Development Bank on the experience in the Latin American and Caribbean countries reaches conclusions that are consistent with our studies at the Fund.[1] Let me summarize three key findings and conclusions of the Inter-American Development Bank study:

First, the benefits of foreign bank entry seem to greatly outweigh potential costs. However, the evidence is still inconclusive regarding the effects of foreign bank presence on lending to small enterprises.

Second, the countries in Latin America and the Caribbean fare poorly with regard to the protection of creditors: laws and regulations are weak, as well as law enforcement. In addition, the inadequacy of property registries limits the usefulness of property as collateral, and places serious constraints on access to bank credit.

And third, lack of reliable information about creditors is a major impediment to the extension of bank credit. The study however, notes that commendable progress was made in the region with regard to credit registries.

Conclusions

- Challenges for the central bank
- Avoid the temptation of monetary easing
- Central bank: a key player but not the only or main player

In conclusion, let me offer a couple of considerations to summarize how I see the role of the central bank in the Real-Financial Nexus.

Clearly, the central bank is a key player, and it is faced with formidable challenges, particularly in countries where the environment for banking and business is difficult. On the one hand, the central bank has to confront those who believe that it is its responsibility to ensure that bank credit does flow to the private sector. After all, in most countries the central bank is both the bank regulator and the agency in charge of monitoring and managing overall liquidity conditions in the economy. On the other hand, it is clear that a number of conditions that are needed to "unlock credit" are not within its purview.

Confronted with lingering bank credit growth, the temptation may be strong to relax monetary policy, for instance by letting the level of free bank reserves in the system exceed what would be strictly needed to ensure the smooth operations of the payments system. Indeed, in a context where commercial banks are well managed and have a capacity to assess risks appropriately, it may not even pose an immediate threat to the macroeconomic framework. However, such a policy would conflict with the need to create the stable liquidity conditions that are needed to allow the development of financial markets, starting with the short-term money market.

This dilemma serves to highlight that the central bank is only one player among others in the Real-Financial Nexus. I am saying this because it is not infrequent for policymakers to turn to the central bank to "fix" the problem, and to ensure that bank credit will be available wherever and whenever it is needed. It is important that policymakers and the public understand that strengthening the channels of transmission of monetary policy involves a host of issues, and that some important ones are not within the responsibilities or competence of the central bank. Even in countries with developed financial markets, monetary policy is not a simple matter. In particular, the central bank has only very indirect control over long-term yields, bank lending conditions, or asset prices. The central bank can aspire at controlling very short-term interest rates effectively. But it can influence only one component of long-term rates, that is the expected short-term interest rate. As for bank lending conditions, or the other components of long-term rates such as the risk or liquidity premium, they are largely outside of the control of the central bank. If uncertainty with regard to these components is high, it will be difficult to unlock credit, and the central bank can only contribute at the margin to lifting those constraints. Unlocking bank credit will require removing the obstacles to banking activity that emerge due to weaknesses in the business environment. This is indeed a lesson we have learnt in our country work.