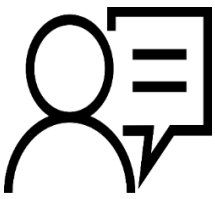
WEEK 8- INSTRUMENTS OF MONETARY POLICY

CONTENTS

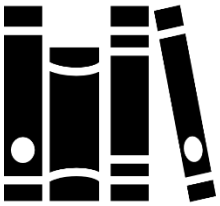
1.0. INTRODUCTION



The instruments used to implement monetary policy might be either quantitative, generic, or indirect, or qualitative, selective, or direct. These two instruments, however, have an impact on the level of overall demand through the availability of credit, the cost of borrowing money, and the supply of money. The first group of the two types of instruments includes changes in bank rates, open market operations

(OMO), and altering reserve requirements. Through commercial banks, they are intended to control the general level of credit in the economy. The purpose of the selective credit controls is to regulate certain forms of credit. They consist of controlling consumer credit as well as changing the margin requirement. As a result, we will discuss each one in turn to begin this presentation.

2.0. OBJECTIVES



At the end of this unit, you should be able to:

- Define and understand the meaning of instruments of monetary policy.
- Know the basic macroeconomics concepts

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3.0. MAIN CONTENT

3.1 Instruments of Monetary Policy

In order to attain the goals of price stability (or low inflation rate), full employment, and increase in aggregate income, monetary policy directs the central bank's money supply. Money serves as a medium of exchange, therefore shifts in its demand compared to supply require spending adjustments. Based on an estimation of the need for cash, the central bank issues fiduciary or paper money. To effectively implement monetary policy, the central bank adjusts the monetary aggregates, the policy rate, or the exchange rate to influence the variables that it does not directly control. The central bank's monetary policy tools are based on the economy's overall and the financial sector's level of development. These tools may be direct or indirect.

3.1.1 Direct Instruments of Monetary Policy

(a) Direct or Selective Credit Control

The central bank can direct Deposit Money Banks on the maximum percentage or amount of loans (credit ceilings) to different economic sectors or activities, interest rate caps, liquid asset ratio and issue credit guarantee to preferred loans. In this way the available savings is allocated and investment directed in particular directions as desired by the authorities.

Selective credit controls are used to influence specific types of credit for particular purposes. They usually take the form of changing margin requirements to control speculative activities within the economy. When there is brisk speculative activity in the economy or in particular sectors in certain commodities and prices start rising, the central bank raises the margin requirement on them. The result is that the borrowers are given less money in loans against specified securities.

Consider the below example

Raising the margin requirement to 60% means that the pledger of securities of the value of Ksh. 10,000 will be given 40% of their value, which is Kshs. 4,000 as loan. In case of recession in a particular sector, the central bank encourages borrowing by lowering margin requirements.

Finally, for an effective anticyclical monetary policy, bank rate, open market operations, reserve ratio and selective control measures are required to be adopted simultaneously. But it has been accepted by all monetary theorists that:

i. The success of monetary policy is nil in a depression when business confidence is at its lowest

ii. It is successful against inflation

The monetarists assert that as against fiscal policy, monetary policy possesses greater flexibility and it can be implemented rapidly.

3.1.2 Indirect Instruments of Monetary Policy

i. Reserve Requirements

This instrument is used by the central bank to influence the level of bank reserves and hence, their ability to grant loans. Reserve requirements are lowered in order to free reserves for banks to grant loans and thereby increase money supply in the economy. On the other hand, they are raised in order to reduce the capacity of banks to provide loans thereby reducing money supply in the economy.

This weapon was suggested by Keynes in his ***Treatise on Money*** and the USA was the first to adopt it as a monetary device. Every bank is required by the law to keep a certain percentage of its total deposits in the form of a reserve fund in its vaults and also a certain percentage with the central bank. When prices are rising, the central bank raises the reserve ratio. Banks are required to keep more with the central bank. Their reserves are reduced and they lend less. The volume of investment, output and employment are adversely affected. In the opposite case, when the reserve ratio is lowered, the reserves of commercial banks are raised. They lend more and the economic activity is favourably affected.

ii. Open Market Operations (OMO)

The most important and flexible tool of monetary policy is open market operations. It is the buying and selling of government securities in the open market (primary or secondary) in order to expand or contract the amount of money in the banking system. By purchasing securities, the central bank injects money into the banking system and stimulates growth whereas by selling securities it absorbs excess money. Thus, if there

is excess liquidity in the system, the central bank will in a bid to reduce the money supply sell the government securities such as Treasury Bills. On the other hand, in periods of liquidity shortages, the central bank buys government securities so as to increase money supply.

Instruments commonly used for this purpose include treasury bills, central bank bills, or prime commercial paper. OMO enables the central bank to influence the cost and availability of reserves and bring about desired changes in bank credit and money supply. This important instrument of monetary policy has a number of advantages because it is flexible and precise, it is implemented quickly and easily reversed and the central bank has complete control. The effectiveness of OMO, however, depends on the existence of well-developed financial markets that are sensitive to interest rate movements. Open market operations (OMO) refer to sale and purchase of securities in the money market by the central bank. When prices are rising and there is need to control them, the central bank sells securities. The reserves of commercial banks are reduced and they are not in a position to lend more to the business community. Further investment is discouraged and the rise in prices is checked. Contrariwise, when recessionary forces start in the economy, the central bank buys securities. The reserves of commercial banks are raised. They lend more. Investment, output, employment, income and demand rise, and fall in price is checked.

iii. Discount Window Operations

This instrument is a facility provided by the central bank which enables the DMBs to borrow reserves against collaterals in form of government or other acceptable securities. The central bank operates this facility in accordance with its role as lender of last resort and transactions are conducted in form of short term (usually overnight)

loans. The central bank lends to financially sound DMBs at the policy rate. This rate sets the floor for the interest rate regime in the money market (the nominal anchor rate) and thereby affects the supply of credit, the supply of savings (which affects the supply of reserves and monetary aggregate) and the supply of investment (which affects employment and GDP).

iv. Exchange Rate

The balance of payments can be in deficit or in surplus and this can affect the monetary base, hence the money supply, in one direction or the other. By selling or buying foreign exchange, the central bank ensures that the exchange rate is at an optimal level. The real exchange rate when misaligned affects the current account balance because of its impact on external competitiveness.

Through the exchange rate channel, exports are reduced as they become more expensive, and imports rise as they become cheaper. In turn, GDP shrinks. Monetary policy has an important additional effect on inflation through expectations—the self-fulfilling component of inflation.

v. Prudential Guidelines

The central bank may require DMBs to exercise particular care in their credit operations in order to achieve specified outcomes. Key elements of prudential guidelines remove some discretion from bank management and replace them with rules.

Prudential regulation is a legal framework focused on the financial safety and stability of institutions and the broader financial system. The most important rationale for regulation in banking is to address concerns over the safety and stability of financial institutions, the financial sector as a whole, and the payments system.

vi. Moral Suasion

The central bank issues licenses to DMBs and regulates the operation of the banking system. Thus, it can persuade banks to follow certain policies such as credit restraint or expansion, increase savings mobilization and promote exports through financial support, which otherwise they may not do, on the basis of their risk/return assessment.

Moral suasion is a request by the central bank to the commercial banks to take specific measures as per the economy's trends. For instance, the central bank may direct banks not to give out certain loans. It includes psychological means and informal means of selective credit control. Moral suasion has been effectively used in the management of inflation in a number of countries and is also referred to as "open mouth operations" in the financial sector. The common factor for the success of moral suasion is the trust that stakeholders have on the central bank.

vii. Bank Rate Policy

The bank rate is the minimum lending rate of the central bank at which it rediscounts first class bills of exchange and government securities held by the commercial banks. When the central bank finds that inflationary pressure have started emerging within the economy, it raises the bank rate. Borrowing from the central banks, becomes costly and commercial banks borrow less from it. The commercial banks, in turn, raise their lending rates to the business community and borrowers borrow less from the commercial banks. There is contraction of credit and prices are checked from rising further. On the contrary, when prices are depressed, the central bank lowers the bank rate. It is cheap to borrow from the central bank on the part of commercial banks. The

latter also lower their lending rates. Businessmen are encouraged to borrow more. Investment is encouraged. Output, employment, income and demand start rising and the downward movement of prices is checked.

Bank rate is the rate charged by the central bank for lending funds to commercial banks. Description: Bank rates influence lending rates of commercial banks. Higher bank rate will translate to higher lending rates by the banks.

viii. Repo Rate and reverse repo rate

A Repo rate is a rate at which commercial banks borrow money by selling their securities to the central bank to maintain liquidity. Commercial banks sell their securities in case of a shortage of funds or due to some statutory measures. It is one of the main instruments of the central bank to keep inflation under control.

Reverse Repo Rate-Sometimes, the central bank borrows money from commercial banks when there is excess liquidity in the market. In that case, commercial banks get benefits by receiving the interest on their holdings with the Central bank.

At the time of higher inflation in the country, central increases the reverse repo rate that encourages banks to place more funds with the central bank, which will help it earn higher returns on excess funds.

3.2 Advantages, disadvantages and operational issues

Modes of operation

In implementing monetary policy, a central bank can act in two ways: directly through its regulatory powers, or indirectly through its influence on money market conditions as the issuer of central bank money (currency in circulation and balances with the central bank). The term “direct" refers to the one-to one

correspondence between the instrument (such as a credit ceiling) and the policy objective (such as domestic credit).

This distinction between direct and indirect monetary instruments can operate in two ways:

I. Direct instruments set or limit either prices (interest rates) or quantities (credit) through regulations, while indirect instruments operate through the market by influencing underlying demand and supply conditions.

2. Direct instruments in the form of credit ceilings are mainly aimed at the balance sheets of the commercial banks, while most indirect instruments arc aimed at the balance sheet of the central bank.

Influencing marker conditions does not exclude the possibility that the central bank targets certain key interest rates or quantities of credit (or sets those pertaining to its own credit facilities). Instead of direct controls, the market mechanism allows participants in the money markets to adapt to the settings of one of these parameters.

Indirect instruments are also referred to as market-based instruments, as they generally change the supply of bank reserves through transactions with banks and nonbanks at market-related prices on a voluntary basis. Different market-based instruments can be distinguished by the specific markets in which the monetary operations are carried out. But even though these instruments are called indirect and market based, they also involve a minimum degree of regulation to govern the conditions of their use: the eligible counterparties, the auction form, and the form of payment at settlement. Within this framework,

however, it is the market forces that, through the use of indirect instruments, affect changes to central bank money.

Specific Instruments: Advantages, Disadvantages, and Operational Issues

Indirect instruments

Indirect instrument	Advantage	Disadvantage	Design and operations	Experience and Assessment
1.Reserve requirement	1)Help to induce demand for reserves and therefore enhance predictability of reserve demand. 2) An increase in reserve requirements can be useful in one-off sterilization of excess liquidity, or otherwise to accommodate structural changes in demand for reserves.	1)A high requirement imposes tax on bank intermediation. This can be neutralized through reserve remuneration at market rates. The tax may result in a widening of the spread between lending and deposit rates, which can lead to disintermediation. 2)Not convenient for short-term liquidity management, as frequent changes disrupt bank portfolio management.	Design includes definition and monitoring of requirement base, eligibility of assets, and averaging rules and rate of remuneration. Averaging provides banks with greater flexibility in portfolio management.	Used extensively in some countries, especially in Latin America. Active variation for policy purposes has dropped significantly in industrial countries.
2.Open Market Operations	1. Flexible instrument for short-term liquidity. Flexible instrument for short-term liquidity management because issuance is at discretion of central bank, and various auction/tender formats can be used to steer interest rates. If treasury is not willing to accept sufficient interest rate flexibility,	Central bank may incur losses if large primary issuance is needed to sterilize liquidity. If central bank bills are used in parallel with treasury bills, problems may occur in the absence of strong coordination between the issuing agents.	Management of liquidity can be achieved through staggered primary issuance. Procedures involve decisions on auction system, counterparties, frequency, maturities, and settlement rules.	Used by many countries, particularly when there is a need to separate monetary policy objectives from public debt management objectives. Also used when secondary markets are insufficiently developed to permit open market operations in the secondary market.

	central bank papers preserve operational autonomy of central bank.			
3. Rediscount window	Rediscount rate often can enhance transmission of policy stance through announcement effect as a key rate (France, Germany, and United States). Initial impact is wider than with open market operations, which are limited to central banks' counterparties in one or a few financial centers. Develops demand for rediscountable paper. May also be useful in circumstances where open market operations are limited due to lack of paper.	Not very convenient for precise base money targeting, since access to window is usually at initiative of banks. Criteria for rediscountable paper and for access to window have often been utilized to implement selective credit policy.	Rediscount rate can be above-market rate to discourage access. In some countries (United States, Japan, Germany), rate is below market and therefore nonprice rationing must be used. Elements of design include eligible paper and access criteria.	Used in many countries as standard instrument for monetary control, although access at initiative of banks can complicate its usefulness for quantity transactions; its effectiveness is largely determined by provisions that regulate access. Also used for moral suasion.

Direct instruments

INSTRUMENT	Advantages	Disadvantages	Design and Operations	Experience and assessment
1. Interest rate controls	Contain the effects of noncompetitive pricing when entry into banking is limited. Limit adverse selection problems, particularly when information on borrowers is scarce or banking supervision is weak. Often resorted to when authorities cannot achieve a target	Allocation of financial resources not based on price mechanism; ceiling easily circumvented by shifting bank deposits into assets yielding market rates (such as foreign exchange) or into goods. Lead to administrative rationing of credit. Floors or ceilings encourage disintermediation or nonbank	Design can involve fixing interest rates or spreads.	Various controls are still used in some countries and were used even in industrial countries until the late 1980s. Increasingly ineffective as markets and financial instruments develop. Effectiveness requires a

	interest rate through market means or when longterm rates are a policy objective.	intermediation. Ceilings make borrowing appear less costly, which encourages overuse of capital.		credible enforcement system.
2.Bank-by-bank credit ceilings	Can deliver effective control over bank credit if reserve money creation is otherwise controlled. Can minimize loss of monetary control during transition to indirect instruments when transmission mechanism is uncertain.	Because credit ceilings are not market determined, they progressively distort the allocation of bank resources. Can lead to disintermediation and ultimate loss of effectiveness. Difficult to implement if there are many banks and if there are capital inflows.	Quotas may depend on capital, existing credit, and existing deposits. Secondary trading of unused credit quotas introduces elements of market allocation and mitigates distortions.	Used in Western Europe until late 1980s; still used in some African and Asian countries and in transition economies. Supply of base money must be consistent with money demand; otherwise instrument leads to buildup of excess reserves, thereby creating incentives for evasion.
3. Statutory liquidity ratios	By providing captive demand for qualifying assets (typically government debt), ratios reduce cost of borrowing for issuer of these instruments.	Distort competition by imposing constraints on banks' asset management. Distort pricing of securities and stifle secondary trading. Can lead to disintermediation and reduce government fiscal discipline, thereby losing effectiveness as means to control money.	Design involves choosing eligible securities, eligible maturities, and averaging methods, either of requirement, base, or both.	Still used in many countries, but mainly for prudential reasons and, more recently, to provide captive demand for government papers. Used as a monetary policy instrument only to the extent that proceeds from sale of securities are under the control of the central bank. This is typically not the case. May be helpful in short-term liquidity management when proceeds of security sales

				are sterilized (Singapore).

3.3 Monetary Policy Management in Kenya

Background

Kenya has been transformed from a directly controlled monetary policy to indirect monetary policy by using the reserve money as an operational target since the early 1990s. The 1990s transitional reforms included, but were not limited to, the liberalization of the exchange rate and capital accounts, and the amendment of the CBK Act in 1996, thereby clearly defining the monetary policy mandate. In November 2011, the Central Bank of Kenya (CBK) adopted a new monetary policy framework that gives more prominence to its policy interest rate, while retaining a monetary policy framework that targets monetary aggregates consistent with the inflation target. While monetary policy was largely inactive in the first decade after independence, the Kenyan economy enjoyed the strongest economic performance of high growth levels when compared with the post-independence era. Structural adjustment reforms and post liberalization policies have since yielded modest economic performance and reasonable macro stability. This has, in part, led to significant structural and financial developments, in particular leading to increased innovations in the financial markets and the economy at large. Although Kenya's financial sector is currently regarded as one of the most developed in Sub-Saharan African countries, like many other emerging economies, the sector still faces a number of challenges. These challenges include: the

intricacies associated with rapid financial innovations, the pursuance of multiple objectives, and the recent rising trend of domestic debt.

Monetary Policy Decisions

Monetary policy consists of decisions and actions taken by the Central Bank to ensure that the supply of money in the economy is consistent with growth and price objectives set by the government. The objective of monetary policy is to maintain price stability in the economy. Price stability refers to maintenance of a low and stable inflation.

Price Stability and Economic Growth

Price Stability and Economic Growth

The Central Bank's monetary policy decisions are made to maintain a low and stable inflation rate over time, which is an indication of price stability.

Inflation is a general increase in price levels over time. It is based on the prices of various consumer goods and services, which are evaluated and statistically represented in the Consumer Price Index (CPI). The month-on-month (or year-on-year) inflation rate is determined by comparing the CPI for a particular month to the CPI of that same month in the previous year.

Inflation is caused by numerous factors, both locally and internationally. For example, during periods of drought or excessive rain, the prices of food could increase, leading to an increase in the inflation rate. International factors like increases or decreases in oil prices can also lead to changes in inflation reflecting movements in energy and transport costs. Depreciation in the exchange rate against the major currencies can also cause inflation since Kenya is a net importer of goods. Inflation can also be caused by factors that influence the demand for goods and services, like the amount of money ordinary people have available to spend.

High levels of inflation inhibit economic growth and cause the Kenya Shilling to lose value compared to international currencies, thereby discouraging the purchase of Kenyan goods and services. It also makes it difficult for people to make long-term financial decisions, as they cannot be sure about the future value of their investments and savings. If there is a general decrease of prices over time due to a collapse in demand or increased supply of goods and services, then there is deflation. Deflation inhibits economic growth by reducing profit and lowering investor incentives.

Inflation

As is the case the world over, a central bank exists in a country to safeguard the value of its currency in terms of what it can purchase. When prices of goods and services in an economy keep on rising, the value of these goods and services that the currency can purchase – or exchange for – diminishes. This leads to loss in value of the currency. Monetary policy is the main tool used in safeguarding the value of the currency in an economy. It involves the control of liquidity circulating in an economy to levels consistent with growth and price objectives set by the government. The volume of liquidity in circulation influences the levels of interest rates, and thus the relative value of the local currency against other currencies.

It is the responsibility of the *Monetary Policy Committee* to formulate the monetary policy of the Central Bank of Kenya. Maintaining price stability is crucial for a proper functioning of a market-based economy. It encourages long-term investments and stability in the economy. Low and stable inflation refers to a price level that does not adversely affect the decisions of consumers and producers. Price stability is a precondition for achieving a wider economic goal of a strong and sustainable growth and employment. High rates of inflation lead to inefficiency in a market economy and,

in the medium to longer term, to a lower rate of economic growth. Movements in the general price level are influenced by the amount of money in circulation and productivity of the various economic sectors. The Central Bank of Kenya regulates the growth of money stock that is consistent with a predetermined economic growth target as specified by the Government and outlined in its Monetary Policy Statements.

Monetary Policy Decisions and Instruments

Monetary policy is guided by a monetary programme, which is premised on the economic growth and inflation targets provided by the National Treasury. Monetary policy decisions are made by the Monetary Policy Committee (MPC). The MPC meets at least once every two months and reviews data and analysis from various sources including the Central Bank Departments enabling it to decide on any action to maintain or vary its stance.

Monetary Policy Committee

Role and Legal Status

The Monetary Policy Committee is the organ of the Central Bank of Kenya responsible for formulating monetary policy. The Committee was formed vide Gazette Notice 3771 on April 30, 2008, replacing the hitherto Monetary Policy Advisory Committee (MPAC)

Membership

- The membership of the MPC is as follows:
- The Governor, who is the chairman.

- The Deputy Governor.
- Two members appointed by the Governor from the Bank, one being a person with executive responsibility within the Bank for monetary policy analysis (Director of Research Department) and the other being a person with responsibility within the Bank for monetary policy operations (External Payments and Reserves Management).
- Four external members who have knowledge, experience and expertise in matters relating to finance, banking and fiscal and monetary policy, who are appointed by the Cabinet Secretary for the National Treasury.
- The Principal Secretary, National Treasury, or his designated alternate as representing the National Treasury. The National Treasury representative is a non-voting member of the committee.
- Each external member of the Committee serves for a term of three years, which is renewable once.

MPC Meetings

The Chairman of the MPC convenes a meeting of the Committee at least once every two months and will convene an additional meeting if requested in writing by at least four members. The quorum for meetings of the Committee is five members, one of whom must be the Chairman or Vice-Chairman. The decisions of the Committee in these meetings are communicated to the public through press releases from the Chairman.

Statutory Requirements

At least once every six months the Committee prepares and submits a report to the Cabinet Secretary for the National Treasury with respect to its activities. The Minister presents the Report to the National Assembly. In addition, the MPC is responsible for preparation of the bi-annual Monetary Policy Statement of the Bank. The Committee is supported by a Secretariat, responsible for the information flow between itself and the rest of the Departments of the Bank.

4.0 CONCLUSION

Central banks are normally mandated to achieve certain goals such as price stability, high growth, low unemployment etc. But central banks do not directly control these variables. Rather they have set of instruments such as open-market operations, setting bank rate etc. which they can use to achieve these objectives.

The problem of central bank is compounded by the fact that their instruments do not directly affect these goals. These instruments affect variables such as money supply and interest rates, which then affect goal variables with lag. In addition, these lags may be uncertain. Due to above mentioned problems, in the conduct of monetary policy distinction is made among (i) goals (or objectives), (ii) targets (or intermediate targets), (iii) indicators (or operational targets), and (iv) instruments (or tools).

5.0 SELF- ASSESSMENT EXERCISE

1. Explain the direct instruments of monetary policy
2. Distinguish between The direct and indirect instruments of monetary policy
3. Discuss the advantages and disadvantages of 3 monetary policy tools
4. Explain how Open Market Operations are used to control the availability of credit in the economy

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