



Towards a New Monetary Policy Regime in Mozambique

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Outline



- Motivation
- The old monetary policy regime
- The new regime
- Transition challenges
- Conclusions

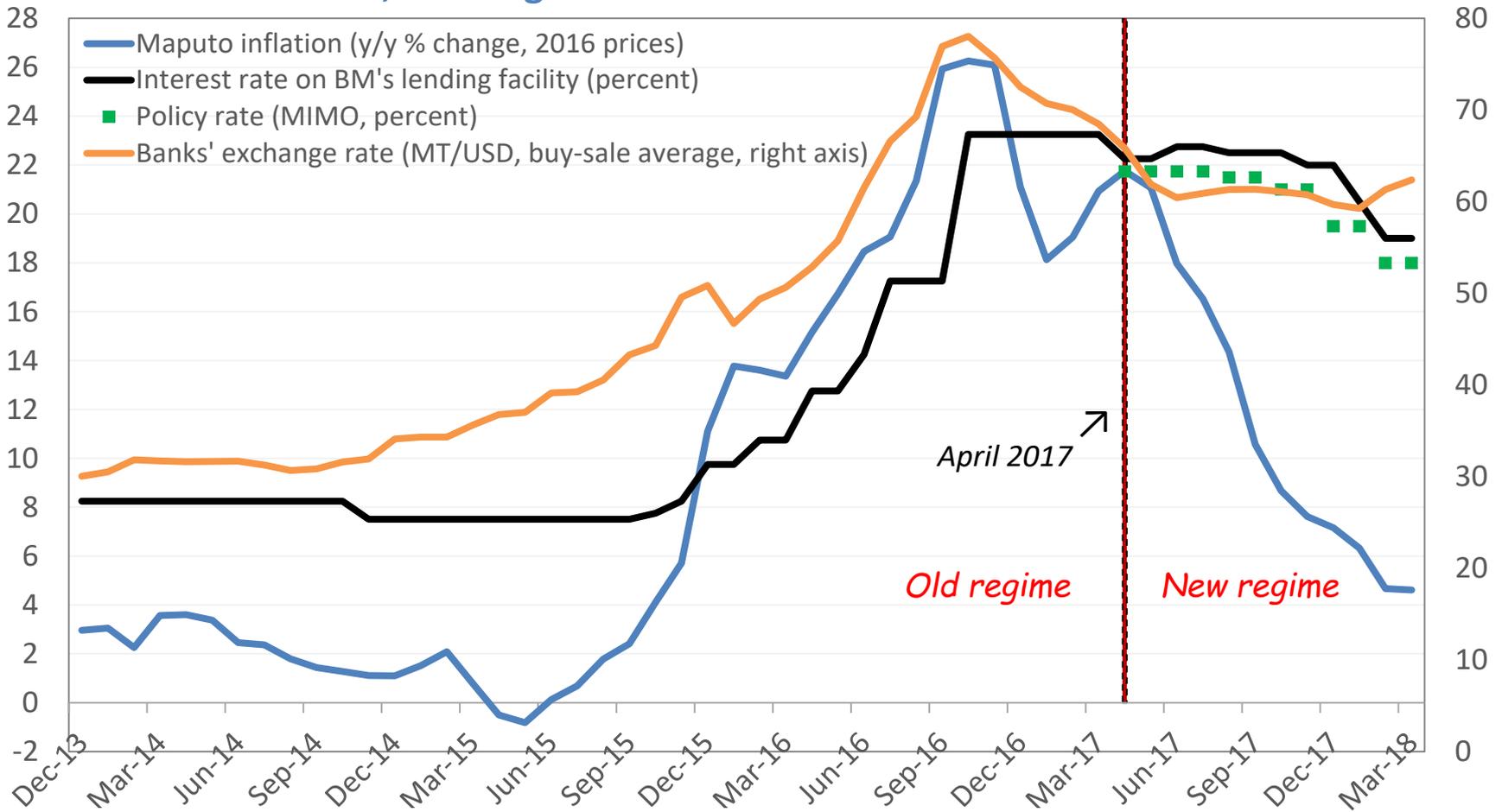


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Interest rate signal has provided an effective tool to anchor inflation expectations amid the transition to a new (interest rate-based) monetary policy framework.



Inflation, exchange rate and central bank interest rates



Sources: Mozambican authorities and IMF staff calculations. The inflation series uses a slightly different CPI basket starting from January 2016.

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The previous monetary policy framework exclusively targeted monetary aggregates.



- Reserve and broad money as operating and intermediate targets, respectively.
- Money multiplier and velocity of money implicitly assumed to be stable and predictable.
- Open market operations conducted through T-bills and reverse repos to affect market liquidity.
- Interest rate corridor (FPC and FPD) helped communicate the monetary policy stance.

It was mostly not aligned with the standard principles of monetary policy (2015 IMF paper*)...

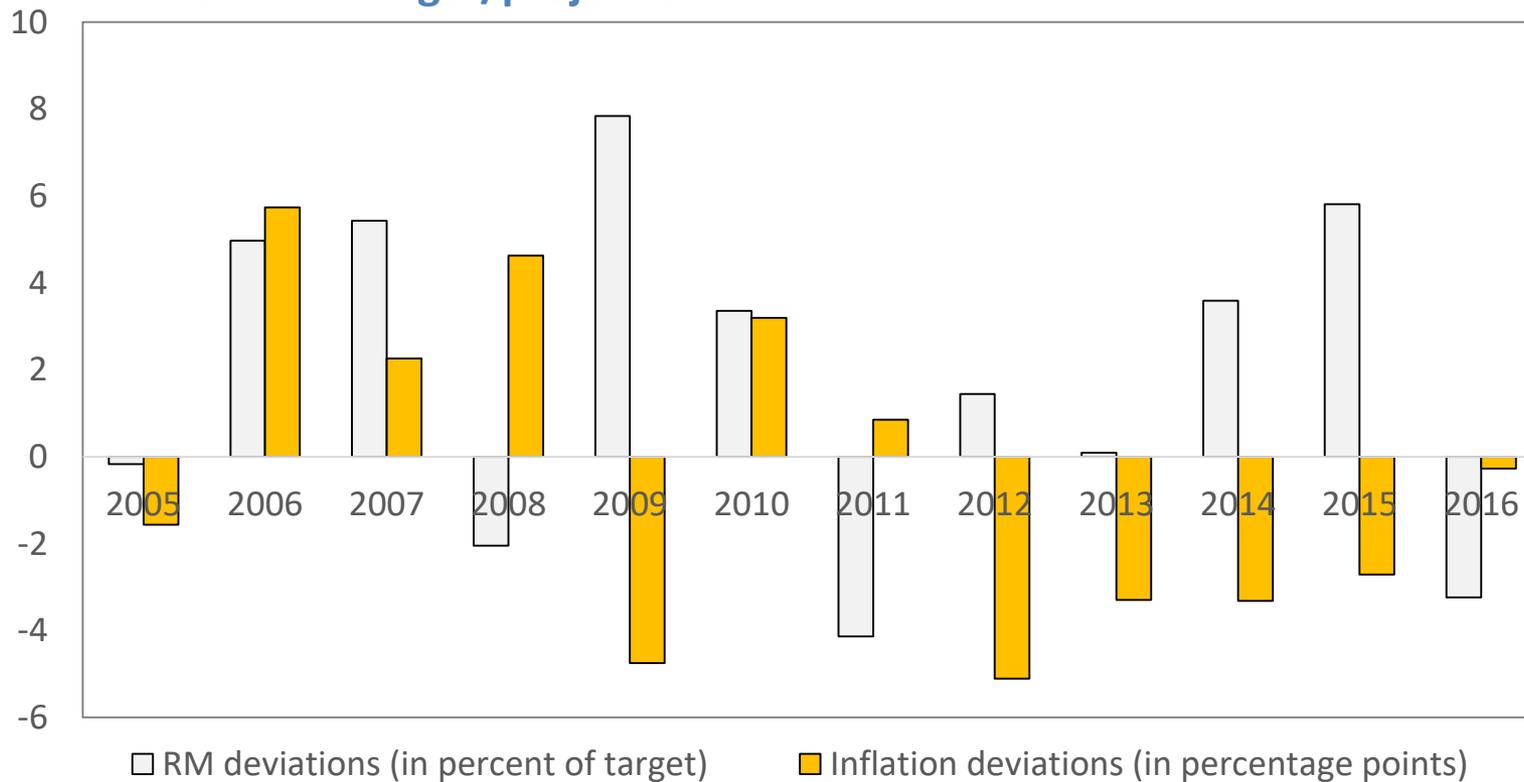


	Principle	Observations
1	Clear mandate and operational independence of the CB	Ambiguous mandate (price stability and exchange rate stability)
2	Price stability as the primary or overriding objective of the CB	See previous observation
3	CB has a medium-term inflation objective	Absence of a publicly known numerical inflation objective
4	Decisions take into account implications for macroeconomic activity and fin. stability	MPC reports placed extensive surveillance on macroeconomic indicators
5	The CB has a clear and effective operational framework	Framework clear, but not very effective
6	The CB has a transparent forward-looking strategy	Present-but-incomplete forward-looking analysis in MPC reports. Good focus on expected inflation, but numerical forecasts not released. Partial discussion of risks
7	CB communication is transparent and timely	MPC reports issued timely and regularly, followed by a press conference. But contents not always understood transparently

...and performed weakly vis-à-vis reserve money targets and inflation outcomes.



Deviations of actual reserve money (RM) and average inflation from target/projection



Sources: Mozambican authorities and IMF staff calculations

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A new regime was introduced in April 2017 which switches focus from monetary aggregates to the interest rate.



Key features:

- A Reference Monetary Policy Interest Rate (MIMO).
 - BM interventions conducted through overnight reverse repos at the MIMO rate with full allotment, seeking to align overnight money market rates with the MIMO.
 - MIMO expected to help strengthen the interest rate formation mechanism and transparency.
 - MPC decisions regarding the level of the MIMO rate have gained greater attention from the public.
 - The new regime is *de facto* a precursor of an inflation targeting regime.
 - Monetary aggregates monitored for informational purposes.
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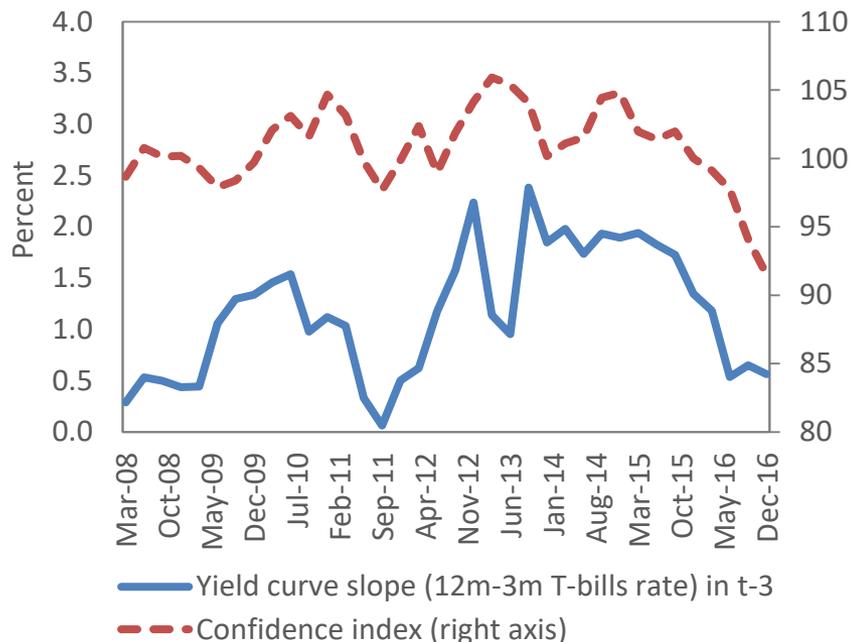
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(1) Strengthening forward-looking capacity (need leading indicators)

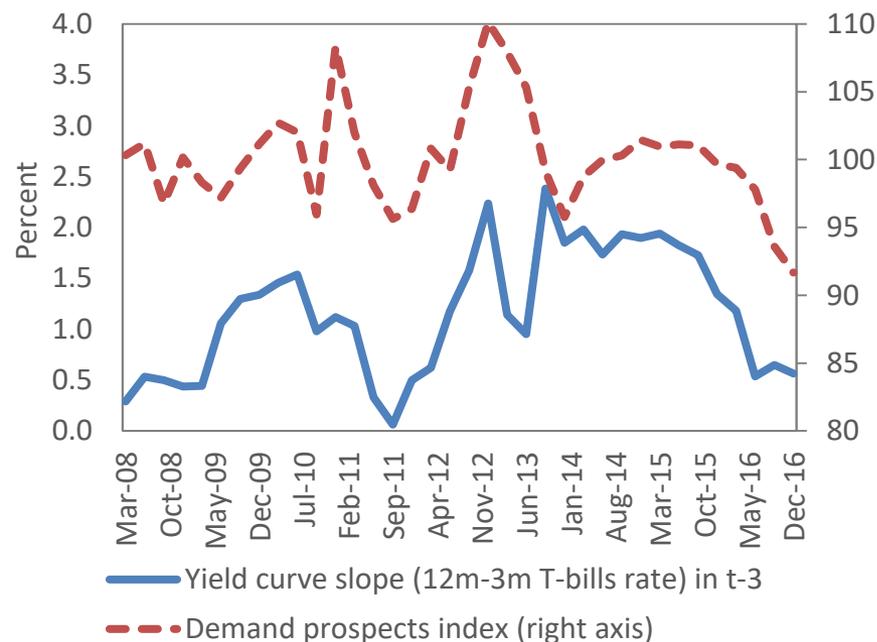


- The shape of the yield curve could be a potential leading indicator of economic activity and inflationary pressure.

Confidence index and yield curve slope



Demand outlook and yield curve slope



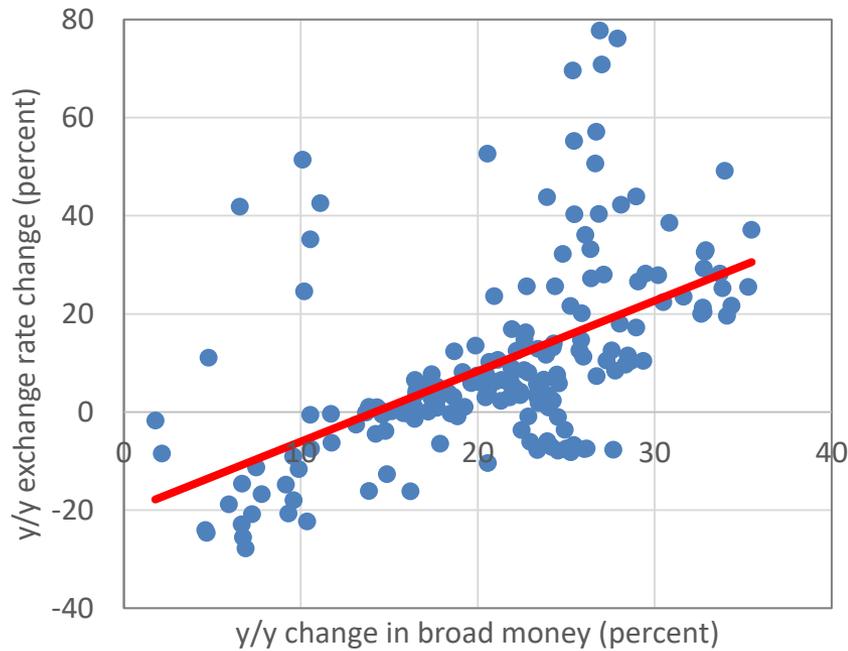
Sources: Mozambican authorities and IMF staff calculations

(2) Identifying the monetary policy transmission mechanism (exchange rate channel the most relevant?)

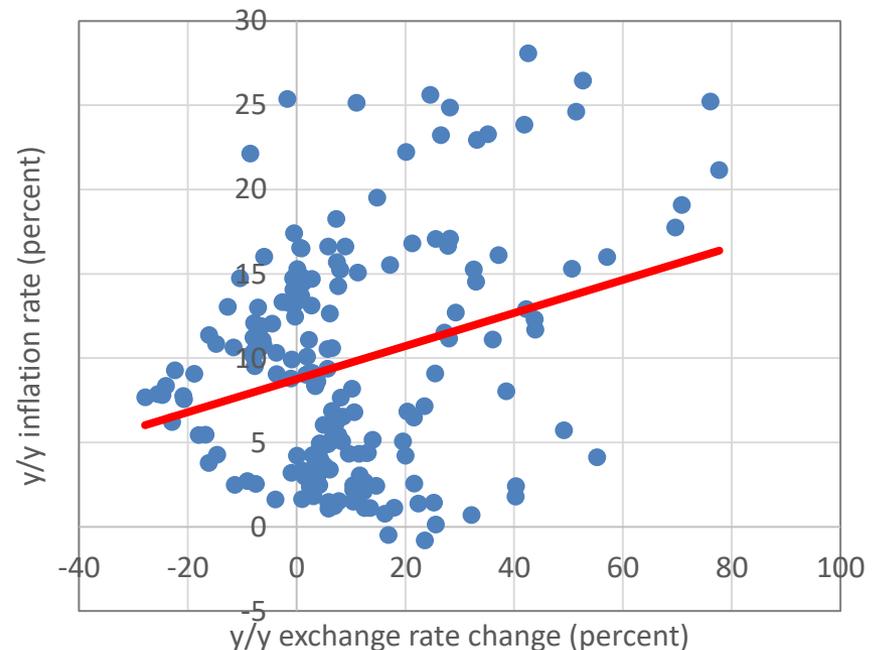


- Broad money correlate well with the exchange rate (despite possible FX valuation effects), while there is a substantial exchange rate pass-through to inflation.

Changes in broad money and MT/USD exchange rate (Jan. 02' - Jun. 17')



Changes in MT/USD exchange rate and inflation (Jul. 02' - Jun. 17')

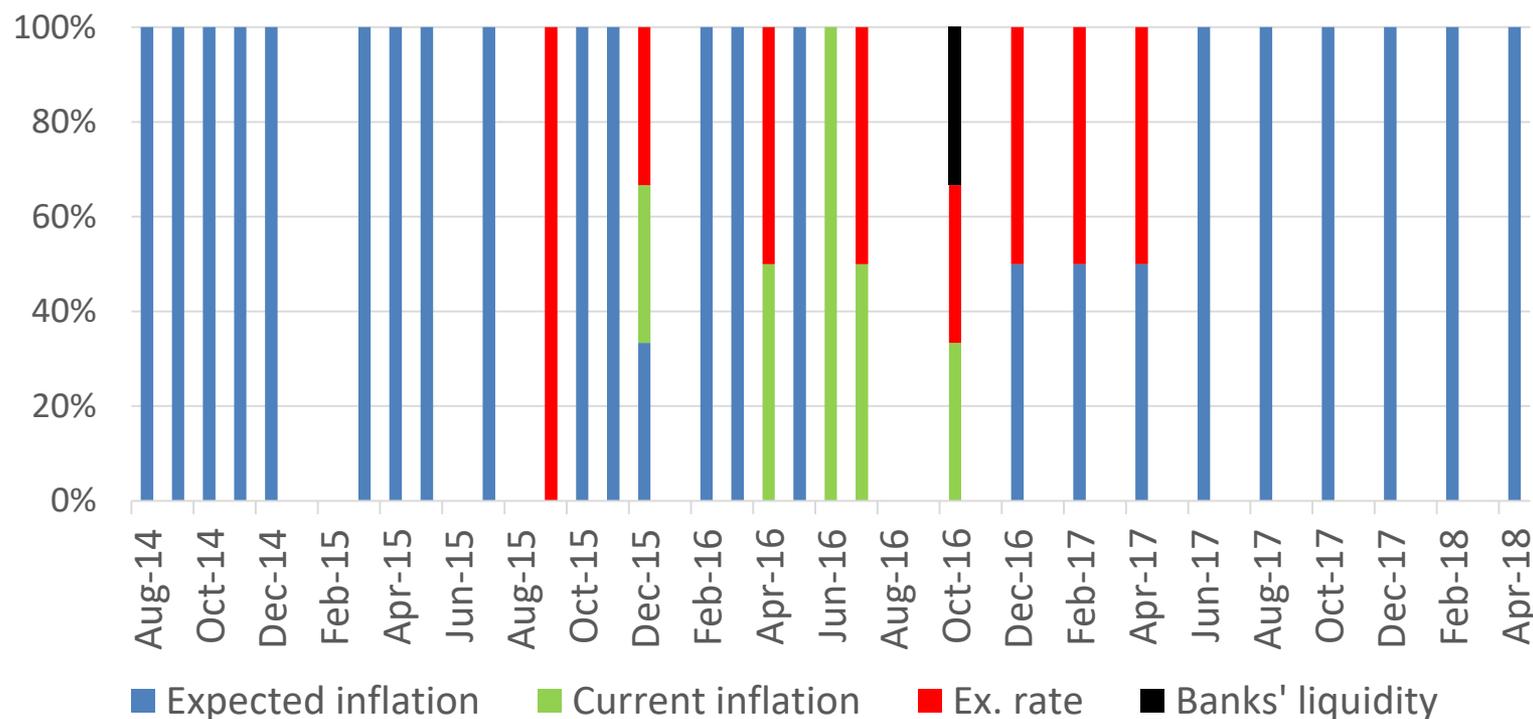


(3) Improving communications (need focus on expected inflation)



- Policy decisions have not been always grounded on inflation considerations, and have at times also emphasized the exchange rate or current (not expected) inflation.

Main reason for MPC decisions



Sources: Authors' interpretation of MPC reports

(4) Exchange rate targeting vs. inflation targeting (choose one)



- Exchange-rate variations may have to be factored in the interest rate decision. Avoid targeting it at a specific level or rate of change.
- Having two targets (inflation and exchange rate) and two instruments (interest rate and FX interventions) might not be the best alternative for Mozambique- challenging to communicate for an embryonic regime.
- Commendable to continue pursuing a free-floating exchange rate regime and limit intervention solely to reduce excessive volatility and building the stock of NIR.
- Total and daily volumes and periods during which the BM plans to buy FX for reserve accumulation could be pre-announced.

Other challenges



Monetary and fiscal policies coordination

- Plan jointly and publish the calendar of issuances of T-bills and Government bonds ahead of time and maintain unchanged.
- The Treasury could inform the BM on a weekly basis about its liquidity needs.
- Important to limit Treasury's use of liquidity at the BM overdraft facility to only exceptional circumstances.
- Ensure MEF's support to the BM in paying for the monetary policy-related costs.

Reforming the 1992 BM Law

- Establish a clear primary objective to achieve and maintain price stability.
- Avoid mix BM objectives with BM functions (ex., conducting monetary and credit policy, managing foreign reserves, and supervising banks).
- Avoid provisions allowing the BM to lend to the Government above the statutory limit as they may lead to monetary financing of fiscal deficits. If misused, could undermine BM's quest for monetary stability and autonomy .

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The new interest rate-based regime is proving effective in anchoring inflation expectations in Mozambique.



However, further steps are needed to consolidate it:

- Improve the **forward-looking capacity**, particularly regarding expected inflation.
- Identify the monetary policy **transmission mechanisms** (exchange rate channel apparently the most relevant, but not a reason to target a level of exchange rate variation).
- Promote a **well-functioning interbank market** by addressing the barriers that prevent banks to trade actively among each other.
- Improve **communications**: focus on expected inflation, and not on the exchange rate or other variables, as the main reason driving policy decisions; disclose the numerical inflation forecast in MPC reports.
- Strengthen **coordination between fiscal and monetary** policies.
- Reform the BM Law (adopt a clear “**price stability**” objective, and reduce the incentive for direct BM financing of the budget).



Thank you