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Development of Money Markets and Coordination with Monetary Policy Operations



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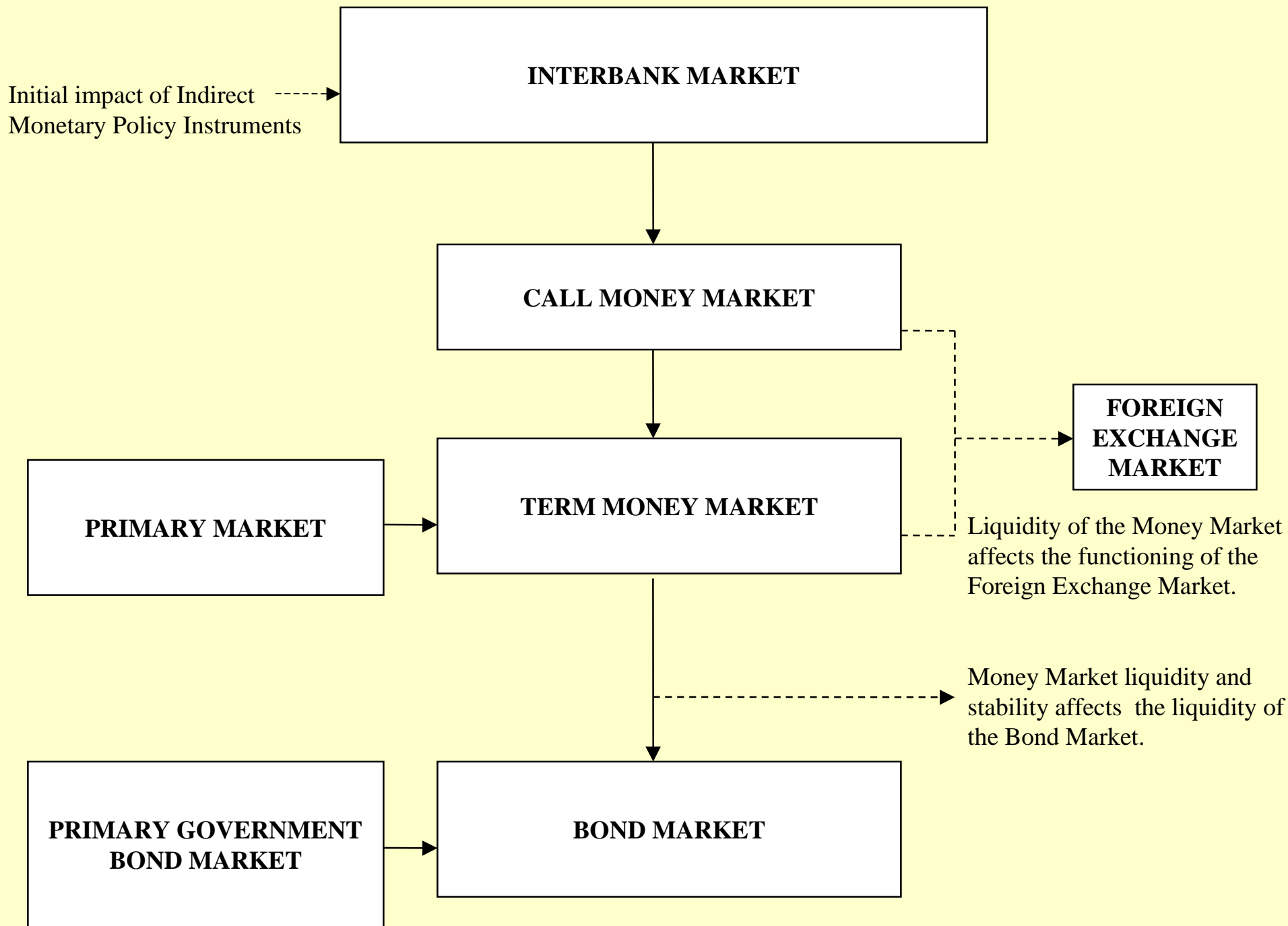
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Overview of presentation

- Money market and links to other markets
- Benefits of money markets
- Conditions for money market development
- Role of central bank in developing money markets
- Coordination between monetary operations and government cash management
- Summary: Factors for money market development



2. Benefits of money markets

- More effective monetary policy
 - First step of transmission of monetary actions to economy
 - Money market rates are a useful indicator of expectations regarding future monetary actions

2. Benefits of money markets

- Promote financial stability and development
 - Financial institutions can cover their short-term liquidity needs
 - Facilitate development of a liquid bond market

Reason: Enable to obtain regular financing of bond inventories to carry out their market making function

2. Benefits of money markets

- Reduce cost of government financing
 - Existence of liquid financial markets
 - reduce risk of auction failure
 - reduce borrowing costs

3. Conditions for money market development

Conditions for developing a well-functioning money market:

- Banks and other financial institutions should be commercially motivated to **respond to incentives to actively manage risk and maximize profits.**
- **Sound banks** and other financial institutions.
- Shift from direct to **indirect monetary policy instruments.**
- **Sound government cash management** and coordination with central bank.

4. Role of the central bank

- Monetary policy aims to achieve price or exchange rate stability
- Liquidity management of central bank
- Structure of reserve requirements
 - Operating procedures to encourage market stability and interbank activity
- Trading systems and trading practices

4. Role of the central bank

- Central bank operating procedures
 - affect the stability of the money market
and the incentives to use the money market to manage risk
- Trade-off between
 - encouraging **active trading** in the money market vs.
 - inducing **excessive volatility** in short-term interest rates

4. Role of the central bank

- Standing facilities
 - **penalty rates** should provide incentives for interbank activity
 - **wide enough corridor** should encourage trading

4. Role of the central bank

- Open market operations
 - foster the **development of secondary markets** in these papers
 - foster **collateralized money markets** (repos, buy/sell backs)
 - high **frequency** of operations can discourage interbank activity

4. Role of the central bank

- Reserve requirements

Trading in overnight market will be determined by

- Length of **reserve maintenance period**
- **Averaging provisions** for meeting reserve requirements
- Treatment of **interbank transactions** for reserve purposes
- **Penalties** for accessing **central bank lending and deposit facilities**

4. Role of the central bank

- Importance of accurate liquidity forecasts
 - Liquidity management decisions are based on liquidity forecasts
 - Help reduce volatility
 - Facilitate providing clear signals to the market
 - Items of the “autonomous supply component” that are most difficult to predict are govt. receipts and payments
- Requires close **coordination** with government

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5. Coordination between monetary operations and govt. cash management

- Government cash flows
 - can be a major **source of uncertainty** in central bank liquidity management
 - impact on the **autonomous component of liquidity supply**

5. Coordination between monetary operations and govt. cash management

Stylized balance sheet of the central bank

Assets	Liabilities
<ul style="list-style-type: none"> • Net foreign assets (NFA) • Net position of the govt. (NPG) • Lending to banks (L) • Other items net (OIN) 	<ul style="list-style-type: none"> • Currency (C) • Bank reserves (R)

$$\text{Supply of bank reserves} = \underbrace{\text{NFA} + \text{NPG} + \text{OIN} - \text{C}}_{\text{Autonomous position}} + \underbrace{\text{L}}_{\text{Policy position}}$$

5. Coordination between monetary operations and government cash management

Country X:

- Net position of govt. is most volatile item and explains the largest part of variance in bank reserves (variance composition of bank reserves shows for daily data 1999)

	Variance decomposit. (in percent)	Standard deviation (in millionunits)
Bank reserves	100.0	159.4
Net foreign assets	3.0	149.6
Net position of govt.	32.9	163.6
Lending to banks	4.8	50.0
Currency	22.7	77.4
CB bills	30.2	90.0
Other items net	7.8	99.5

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5. Coordination between monetary operations and government cash management

- Need for **sound management of government cash balances**
- Effective **information sharing** and **coordination** between CB, MoF, and debt managers is **critical** (see Guidelines for Public Debt Management)

5. Coordination between monetary operations and government cash management

- Coordination mechanisms
 - Government shares **cash flow projections** with CB on a daily basis and promptly informs about new information (**liquidity forecasting committee** can be useful).
 - **Prior notice** for use of deposits (e.g. Canada, Mexico).
 - **CB acts as fiscal agent** – information of debt calendar is available.
 - Requirement to hold a certain **average of deposits** with CB.
 - Uncertainty is reduced when **overdraft is limited or prohibited** and government deposits not held with CB (but: problems arise when banks are weak).

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6. Summary: Key factors for money market development

- Profit oriented and sound banks
- Monetary operations through market-based instruments
- Incentive structure for interbank trading provided through CB's operating procedure
- Coordination between government cash management and monetary operations