

Indirect monetary policy and the pursuit of development

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A key component of financial liberalization in underdeveloped economies is the regime of indirect (or market-based) monetary policy. Indirect monetary policy (IMP) is seen as the alternative to the more direct monetary policy regimes that existed prior to the wave of financial liberalization that commenced in early 1980s in many underdeveloped parts of the world. Direct policies such as interest rate control, credit allocations to priority sectors, and reserve requirements are labeled as “financial repression.”

IMP holds that it is better for central banks (preferably independent ones) to manage excess reserves of the commercial banks through open market operations. The basic idea holds that excess reserves can stimulate bank loans, which in turn can boost domestic consumption and thus precipitate a rapid depreciation of the exchange rate and the attrition of foreign exchange reserves. The underpinning for such a causal structure stems from the financial programming framework, which motivates monetary policy in any developing country that comes under the purview of an IMF program.

In order to enhance the effectiveness of IMP, according to its proponents, significant market reforms must be implemented. These include the formation of primary and secondary markets for the domestic government bonds and Treasury bills, the “de-repression” of interest rates, and the privatization of commercial banks (especially to foreign interests). This short essay will highlight several key issues that undermine this line of policy making in poor countries.

IMP depends on the existence of a competitive banking sector that enables the central bank to exert its monopoly influence over the commercial banks. However, the banking sector of the developing world is highly oligopolistic and far removed from the competitive systems that exist in the United States and Europe. Owing to the fact that commercial banks are oligopolies, they possess market power in the loan market and even the primary market for domestic Treasury bills. As a result, commercial banks do not take the central bank’s benchmark rate of interest as given, but instead set interest rates exogenously of reserve shocks that emanate from the central bank. Hence, IMP is likely to be ineffective over certain range of the domestic interest rate.

Moreover, the oligopoly power enables private profit-maximizing banks to mark-up both the loan rate and Treasury bill rate. The mark-up is done over an exogenous base rate (usually a foreign interest rate owing to arbitrage arguments), marginal transaction costs (associated mainly with the loan market), and a suitable market-specific risk premium. Hence, these rates are set exogenously of the central bank’s monetary policy shocks. This is very different from the United States where banks take the US Treasury bill rate as given and exogenous.

This phenomenon of mark-up interest rates can be depicted by the aggregative commercial bank liquidity preference curve that is flat at a very high rate of interest (see

Khemraj 2006; 2007). The liquidity preference curves can be extracted using non-linear scatter plots of excess reserves (which are non-remunerated) against the loan rate or the local Treasury bill rate. This means, for instance, that banks in underdeveloped countries view business-augmenting loans (which pay interest) and excess reserves (that are non-remunerated) as perfect substitutes at a high loan rate. In other words, a profit-maximizing bank will accumulate excess liquidity when the marginal borrower cannot pay a rate of interest that compensates for the marginal transaction costs (of making the extra loan), a borrower-specific risk premium, and the foreign interest rate.

That in itself, therefore, is a market failure and a developmental challenge as banks are willing to accumulate excess liquidity at the expense of making business-generating loans. Unfortunately, the excess bank liquidity phenomenon in underdeveloped countries is pervasive but yet understudied. However, two recent studies that posit diverging views on the issue have tried to fill this gap (see Khemraj 2006; 2007; Saxegaard 2006).

Moreover, liquidity shocks – shifts in the central bank's reserve supply curve – over the flat range of the commercial banks' liquidity preference curve will have no effect on either the loan rate or the domestic Treasury bill rate. Hence, IMP is unlikely to alter consumption and investment decisions at the minimum mark-up interest rate, thereby rendering the policy regime ineffective. IMP can only become effective at very high interest rates when the liquidity preference curve is downward sloping. But such high rates are detrimental to growth and employment generation in poor countries. Indeed, after financial liberalization interest rate spreads – characterized by the difference between loan and deposit rates – have persistently remained wide. Such a phenomenon emerges from the prevalence of oligopoly banking sectors throughout the developing world.

As noted earlier, a key policy measure accompanying IMP is the formation of primary and secondary markets for government Treasury bills. One reason for doing this is to use the domestic Treasury bill yield as the benchmark upon which the deposit rate and the discount rate (the rate at which a central bank lends reserves to commercial banks) are tied (see Fry 1997; IMF/World Bank 2001). However, banks tend to have market influence as buyers of the government paper, marking up the rate at which they will bid for the new bills. The result is a movement from financial repression to oligopoly-controlled interest rates. Hence, the other key rates in the domestic economy are also tied to oligopoly minimum mark-up rates.

Resulting from the above conundrum is an important issue financial market practitioners will appreciate. That is, poor countries, in spite of substantial efforts to liberalize their financial system, will not possess a domestic benchmark interest rate that can be used as the basis for pricing other financial assets. It is therefore necessary to use foreign interest rates such as the LIBOR (to price short-term securities in the third world) or the longer term US government bond yields to price third world assets at the long end. In this sense, therefore, poor countries are likely to intensify the dependency relationship with the advanced economies.

Despite the problems outlined above, developing countries have accumulated substantial domestic debt in the name of IMP. In particular, central banks have sold significant quantities of Treasury bills as a way to mop persistent excess liquidity, which we noted is the result of the oligopoly pricing of interest rates. These are not new debt for productive purposes, but rather for the purpose of a dubious monetary management framework. In addition, the policy of mopping up excess reserves means that commercial banks have an alternative channel of investment in place of making business loans.

In conclusion, it is a contradiction that poor countries in which a large percentage of farmers and small businesses, in particular, are excluded from credit, their banking sector can hold asset portfolios that are unproductive. This stems from the fact that the reform agenda has ignored the way private profit-maximizing oligopoly banks will behave after market liberalization. It was argued that IMP, which focuses on managing excess bank reserves, can only be useful at very high interest rates that are a deterrent to growth and employment creation. This is because oligopoly banks will use their market power to mark-up the loan rate and other rates, thereby leading to a bank liquidity preference curve that is flat at the minimum rate. IMP, moreover, has tended to deflect attention from the more direct policies (such as industrial policies) that will have to be utilized for development.

References

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