Monetary Policy [1]

Those concerned with economic affairs already know that any study relating to monetary policy requires the discussion of other major issues relevant to the study of money, monetary theories and fiscal and economic policies in general, in addition to the identification of structures of the economies that may be studied. Therefore, monetary policy is not an easy subject, especially when differences in viewpoints towards many aspects of this subject are still unsettled.

Since the scope of this speech is not broad enough to discuss many of these issues, I will attempt to demonstrate only the general outlines of monetary policy, explaining briefly the role of monetary policy in relation to overall economic policies, followed by an account of the monetary policy framework, its definition, goals, instruments and objectives, an finally, a brief demonstration of the experience of monetary policy in Kuwait.

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First: Monetary Policy and General Economic Policies

Monetary policy is basically a type of stabilization policy adopted by countries to deal with different economic imbalances. Since monetary policy covers the monetary aspect of the general economic policy, a high level of co-ordination is required between monetary policy and other instruments of economic policy. Further, the effectiveness of monetary policy and its relative importance as a tool of economic stabilization various from one economy to another, due to differences among economic structures, divergence in degrees of development in money and capital markets resulting in differing degree of economic progress, and differences in prevailing economic conditions. However, we may briefly mention that the weak effectiveness which is usually attributed to monetary policy in developing countries is caused by the fact that the economic problems in these countries are mainly structural and not monetary in nature, while the limited effectiveness of monetary policy in countries which lack developed money markets occurs because monetary policy is deprived of one of its major tools, the instrument of open market operations.

Also, there are those who belittle the effectiveness of monetary policy in time of recession, comparing the use of this policy in controlling recession as “pressing on a spring”. Many others see monetary policy as ineffective in controlling the inflation that results from an imbalance between the demand and supply of goods and services originating from the supply side, while they confirm the effectiveness of monetary policy in controlling inflation that results from increased demand. However, this does not preclude the effectiveness of monetary policy as a flexible instrument allowing the authorities to move quickly to achieve stabilization, apart from its importance in realizing external equilibrium in open economies.

Second: Framework of Monetary Policy

To study monetary policy as part of a general economic policy and as part of a comprehensive planning process requires us to be acquainted with the monetary policy structure within a framework of its goals, instruments and objectives. Before demonstrating these elements, it is useful to give a brief definition of monetary policy.

1- Definition of Monetary Policy

Monetary policy, in its narrow concept, is defined as the measures focused on regulating money supply. In harmony with monetary policy goals, as will be shown later, and adopting the most common concept of monetary policy as one of the central bank's functions, monetary policy is defined as " the set of procedures and measures taken by monetary authorities to manage money supply, interest and exchange rates and to influence credit conditions to achieve certain economic objectives". We find this definition more consistant with the practical applications of monetary policy, particularly with respect to the difference from one country to another in objectives selected as a link between the instruments of monetary policy and its ultimate goals.

2- Goals of Monetary policy

The goals of monetary policy have developed with the evolution central banking thought and the changes in both the behaviour and performance of different economies. There is worldwide agreement that the ultimate goals of monetary policy at present in both the developed and developing countries are price stability and high employment rates, enhancing economic growth rates and controlling imbalances in external payments, including the protection of the external purchasing power of the currency through maintaining relatively stable levels of exchange rates. These goals, though interrelated by their nature, may be contradictory. This explains the importance of co-ordination among different economic policies on the one hand, and the importance of diagnosing the economic problem before taking appropriate treatment measures on the other. The significance of this issue becomes evident when we stress the need to apply rational monetary policies, particularly with regard to the practicality of goals pursed by the monetary authorities and the possibility of achieving these goals without economic consequences that might aggravate economic problems.

Besides the above goals, some people believe that monetary policy should have other important goals, such as high and stable share prices, while others would include the maintenance of low interest rates as a major goal. Others stress increasing the efficiency of the financial system and maintaining the soundness of the banking system. In fact, each of these goals has special significance and directly relates either to the monetary policy goals discussed above or to the intermediate objectives of monetary policy, which represent the link between monetary procedures and the influence of these procedures on the path of economic activity. I believe, however, that despite the differences in viewpoints towards the goals of monetary policy, the goal of increasing the efficiency of the financial system and maintaining the soundness and stability of the banking system should rank first. This conviction may be supported by the fact that the effects of monetary policy measures on the economy occur through the banking and financial systems, which makes the system's response to monetary variables a very important issue. Furthermore, the increased relative importance of deposit money makes the protection of the banking system and enhancing confidence in it one of the major goals of central banks, as it means protecting the mechanism of the payments system in the economy.

Talking about the monetary policy goals as shown above should not mitigate the important role central banks may play in other economic areas, especially in the area of developing money and capital markets in countries where these markets are lacking. The development of such markets will enable central banks to use one of the important instruments of monetary policy, i.e. open market operations.

3- Monetary Policy Instruments

The set of instruments available to monetary authorities may differ from one country to another, according to differences in political systems, economic structures, statutory and institutional procedures, development of money and capital markets and other considerations. In most advanced capitalist countries, monetary authorities use one or more of the following key instruments: changes in the legal reserve ratio, changes in the discount rate or the official key bank rate, exchange rates and open market operations. In many instances, supplementary instruments are used, known as instruments of direct supervision or qualitative instruments. Although the developing countries use one or more of these instruments, taking into consideration the difference in their economic growth levels, the dissimilarity in the patterns of their production structures and the degree of their of their link with the outside world, many resort to the method of qualitative supervision, particularly those countries which face problems arising from the nature of their economic structures. Although the effectiveness of monetary policy does not necessarily depend on using a wide range of instruments, coordinated use of various instruments is essential to the application of a rational monetary policy.

4- Intermediate Objectives of Monetary Policy

The intermediate objectives of monetary policy are defined as a number of variables linking the instruments of monetary policy with their ultimate goals. These variables are money supply, interest rates, disposable credit, the monetary base or any other variable deemed by the monetary authorities as an appropriate intermediate objective for monetary policy. In many instances, these objectives can be used as indicators of the effects of the applied monetary policy. This issue, thought it is a major pivot of the monetary policy framework, is still a subject of major viewpoint differences among economists. While monetarists believe that monetary authorities must select quantitative targets for their monetary policy through controlling growth levels in money supply and thereby adopting mostly the monetary base approach, non-monetarists, despite their recognition of the importance of money, see that changes in different components of aggregate demand have significant impact on the level of economic activity and, therefore, they give basic consideration to the adoption of price objectives through the selection of the interest rate as an intermediate objective representing a link between money and production.

The monetarists’ choice of money supply as a target is based on a number of hypotheses or principles. For instance, they believe that money supply is an exogenous variable that is controllable in the long run, and that the direction of causal relations in the exchange equation moves from money to prices and production. Furthermore, the strongest final effect will be represented by high prices, given the stability in the function of demand for money and a time lag for the effect of monetary policy, thus avoiding the adoption of fiscal policies as a stimulus. This is a lengthy issue, and it would not be appropriate to discuss it in detail here. We can sum up our point of view as follows:

a- The selection of intermediate objectives for monetary policy should be made according to the structural characteristics of the concerned economies and according to analytical studies on economic behaviour, including the demand function for money and the directions of the general economic policy. The dispute arising between monetarists and non-monetarists relates to other issues than simply the behaviour of the monetary policy to be applied. These issues may affect the nature of the role to be played by the state in the economy.

b- The choice of a certain intermediate objective by the monetary authorities does not necessarily mean that these authorities should adhere to that objective all the time. The objective should be reviewed in the light of structural and behavioural changes in the economy. Further, both the prevailing economic situation and the change in the priorities of monetary policy objectives may provide the monetary authorities with sufficient justification to shift from one objective to another.

c- Central banking is an art, which gives a strong reason to believe that the effects of monetary procedures may be transferred through several channels, such as the volume of disposable credit, interest rates, money supply and the general liquidity position in the economy. We believe that the estimation based on all relevant data is still the best approach for formulating monetary policy.

Third: Monetary Policy in Kuwait

1- Introduction

In general, it can be said that there are three main aspects which determine the framework of monetary policy in Kuwait. First, monetary policy represents one aspect of the state's general economic policy. The second aspect relates to existing legal and institutional procedures, particularly as the interest rate on the Kuwaiti dinar is governed by legal limits, in addition to issues related to the degree of competition inside the banking system. The third aspect relates to the basic features of the Kuwaiti economy, not only as an economy based on the philosophy of free markets and free capital movement, but also as an oil economy of high exposure, depending on imports to meet a major portion of consumption and investment demand. Also, the economy is characterized by the high relative importance of public expenditure in influencing the levels of economic activity, and the imbalance in the sectoral composition of the gross domestic product (GDP), in addition to the population characteristics represented in a high ratio of expatriate labour to the total labour force.

2- Framework of Monetary Policy in Kuwait

Article (15) of Law No. (32) of 1968, concerning currency, the Central Bank of Kuwait and the organization of banking business, specified the goals of the Central Bank of Kuwait, similar to those of central banks in general. The goals related to the function of the monetary policy of the Central Bank of Kuwait can be stated as follows:

a- to endeavour to secure the stability of the Kuwaiti currency and its free convertibility into foreign currencies.

b- to endeavour to direct credit policy in such a manner as to assist economic progress and the growth of the national income.

c- to supervise the banking system in the State of Kuwait.

These goals are in harmony with the ultimate goals of monetary Policy referred to before. Upon the practical application of the monetary policy framework and taking into account the basic features of the Kuwaiti economy, the above mentioned goals can be formulated in different contexts. Therefore, it can be said that the diversification of national income sources, as well as the expansion and diversification of the production base, comes on top of monetary policy goals as it is an axis of economic policy and one of the basic elements of economic development and social welfare. A discussion of real growth rates automatically leads to consideration of price stability and thereby stressing the importance of relative stability in the KD exchange rate against major foreign currencies, as Kuwait depends greatly on foreign imports to meet the demand for consumption and investment.

To achieve these goals, monetary policy in Kuwait endeavours to secure monetary and financial stability through regulating liquidity levels in the banking system on the one hand, and supervising the banking system on the other.

The objective of securing monetary stability is of special importance to the Kuwaiti economy, as the volume of domestic liquidity in the national economy is directly influenced by levels of domestic public expenditure, a variable that is far beyond the control of monetary authority. Further, the levels of domestic liquidity are influenced by net operations of the private sector with the outside world, a factor that has a contractionary impact on liquidity due to the rising rates of imports and the limited absorptive capacity of the economy, which encourages capital outflows, particularly when international levels of interest rates become higher than those on the Kuwaiti dinar.

Law No (32) of 1968, referred to above, has provided the monetary authority with a wide range of instruments: the traditional instruments of monetary policy discussed above, and a number of supplementary instruments, in the form of both qualitative instruments and direct supervision. I will try now to discuss briefly the mechanism of certain different instruments applied by the Central Bank of Kuwait:

1- Structure of KD Interest Rates

In November 1976, the Central Bank of Kuwait was authorized to determine interest rates by a legislative amendment to Article (166) of the Kuwaiti Law of Commerce of 1961. Moreover, the Central Bank of Kuwait was legally committed on fix legal limits on KD interest rates. In February 1977, the Central Bank of Kuwait set a structure of interest rates with a maximum ceiling of 10% per annum for contractual interest rates on loans of more than one-year maturity, 8.5% per annum on loans not exceeding one year if they were unsecured or unproductive, and 7% per annum on productive and secured loans granted for maturities of up to one year. Interest rates on foreign currencies were left to the contracting parties, who would determine these rates in accordance with interest rates applicable to those currencies in foreign financial markets. This structure remained in effect until March 1987, when the Central Bank of Kuwait set a new structure involving reductions in the maximum limits of interest rates, mainly the reduction in the ceiling on productive lending extended up to one year to 6% per annum and in the ceiling on unproductive loans granted up to one year to 7.5% per annum. Interest rates on loans exceeding one year were to be determined within a margin not exceeding 1% above the current inter-bank rate. The Central Bank of Kuwait found that the reduction in interest rates on KD included in the new structure applied in March 1987 came in line with the requirements of the prevailing economic situation, particularly when the Central Bank of Kuwait realized that continued application of high interest rates would produce several negative effects.

It can be noted that both interest rate structures, old and new, gave preference to financing the productive sectors in the economy, which is compatible with the expanding of the economic base and diversifying national income sources. Further, the existence of legal limits on KD interest rates enhanced the role of the Central Bank of Kuwait in regulating liquidity levels to secure monetary stability and thereby protect the structure of interest rates. This was particularly true when the KD liquidity levels declined due to heavy conversion into foreign currencies due to the widening interest rate gap. Thus, regulation of liquidity levels has become one of the major objectives of monetary policy in Kuwait.

2- Regulation of Liquidity Levels

The Central Bank of Kuwait has a number of instruments to use regulating liquidity levels inside the banking system to secure monetary stability, including operations of discounting and re-discounting of banks' commercial papers, swap operations, direct intervention in the money market through deposits, and direct lending operations with banks. With these instruments, the Central Bank of Kuwait can either inject dinars into the banking system or absorb them to influence KD liquidity levels, and thereby influence the levels of current interbank in interest rates.

However, since November 1987, following the issuance of treasury bills and bonds, the Central Bank of Kuwait has started using a new instrument to regulate liquidity levels: open market operations of Kuwaiti treasury bills. The Central Bank of Kuwait has been able to use this new instrument very effectively.

3- Exchange Rate Policy

The KD exchange rate has gone through several developments since it was pegged, in March 1975, to a basket of major currencies of the countries having trading and financial relationships with Kuwait. This CBK exchange rate policy was based on securing relative stability in the KD exchange rate, and thereby stability in domestic prices, especially because Kuwait depends greatly on foreign imports. Though the problem of price increase is still associated with external factors, the realization of relative stability in the KD exchange rate would exclude extra influences leading to further instability in these prices resulting from strong volatility in exchange rates, and would thereby alleviate the effects of imported inflation. In other instances, the exchange rate policy enhances the effectiveness of the prevailing interest rates on KD by lessening the transfer of KD to foreign currencies.

4- Protection of the Banking and Financial System

The Central Bank of Kuwait has applied many rules and regulations to protect the liquidity and solvency of the banking system. Among these are the liquidity requirements and the setting of maximum limits on loans granted to one customer. The Bank has also applied rules for rationalizing bank lending policies, and has continued to perform its inspection function on the banking system.

Furthermore, the Central Bank of Kuwait has stressed the importance of protecting the banking system during the past three years, 1986-1988, when it set a number of rules and regulations regarding the evaluation of different types of bank assets and the building up of necessary provisions. Also, the money-exchange companies have been subjected to Central Bank supervision, and the Bank has widened the scope of its supervision over investment companies.

The framework of monetary policy in Kuwait, as shown above, represents a summary of the monetary policy experience in Kuwait. Though the duration of this experience is very short compared with other countries, I believe that it has been a rich experience with its positive and negative aspects. We in the Central Bank o f Kuwait are looking forward to giving monetary policy a greater role, in harmony with many new economic developments.