Seychelles Conference 2013:

From Stabilization to Sustained Growth: Five Years of Successful Reforms and the Challenges Ahead

Victoria, October 31, 2013

Enhancing the effectiveness of monetary policy and promoting financial deepening

(Tobias Roy, African Department, IMF)

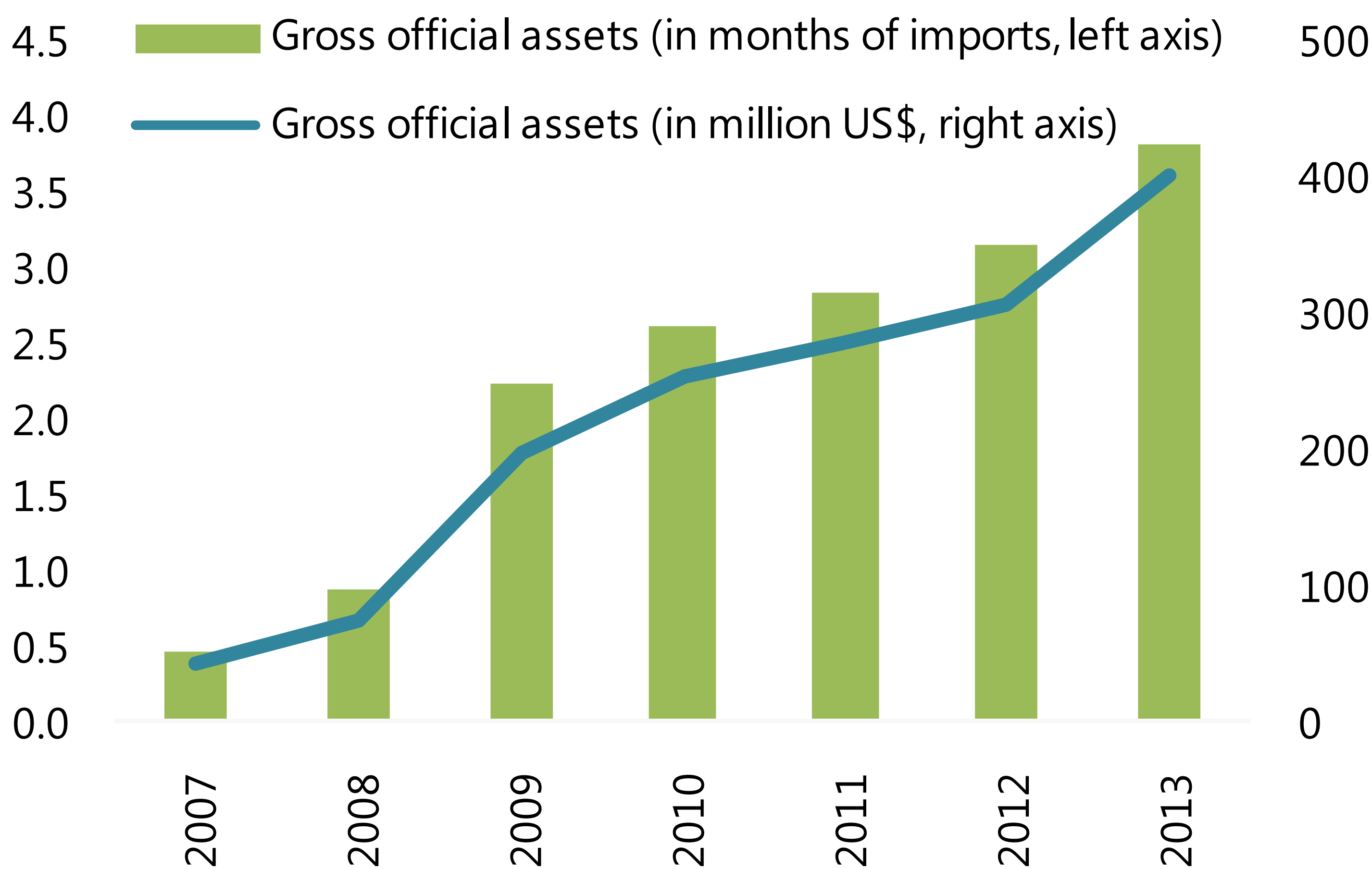
Monetary policy has made great strides since 2008

- ➔ Seychelles' international reserves have increased substantially.

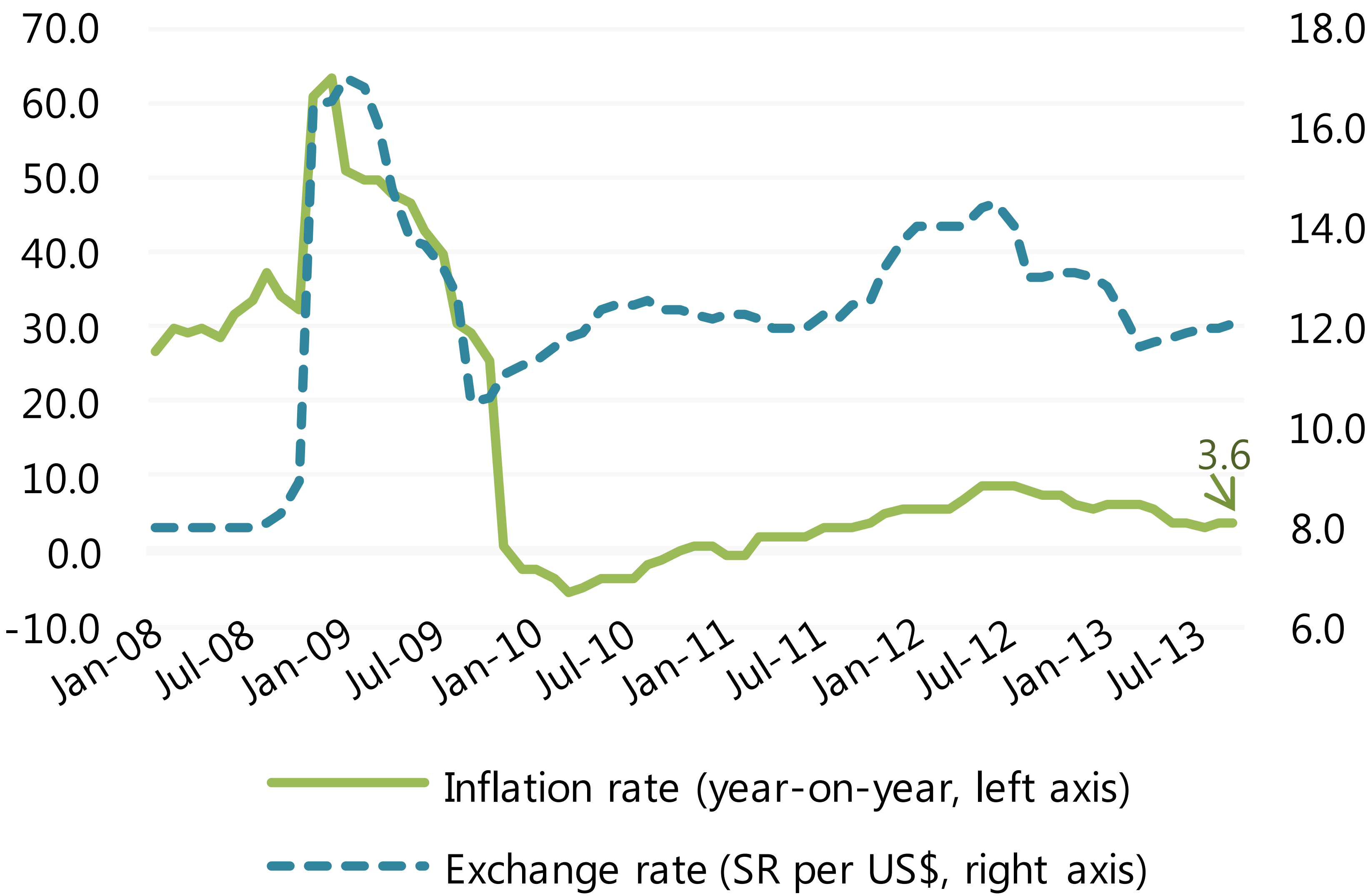
- ➔ Inflation came down after the crisis was tackled.

- ➔ The exchange rate has stabilized and is market-determined, responding to economic fundamental conditions.

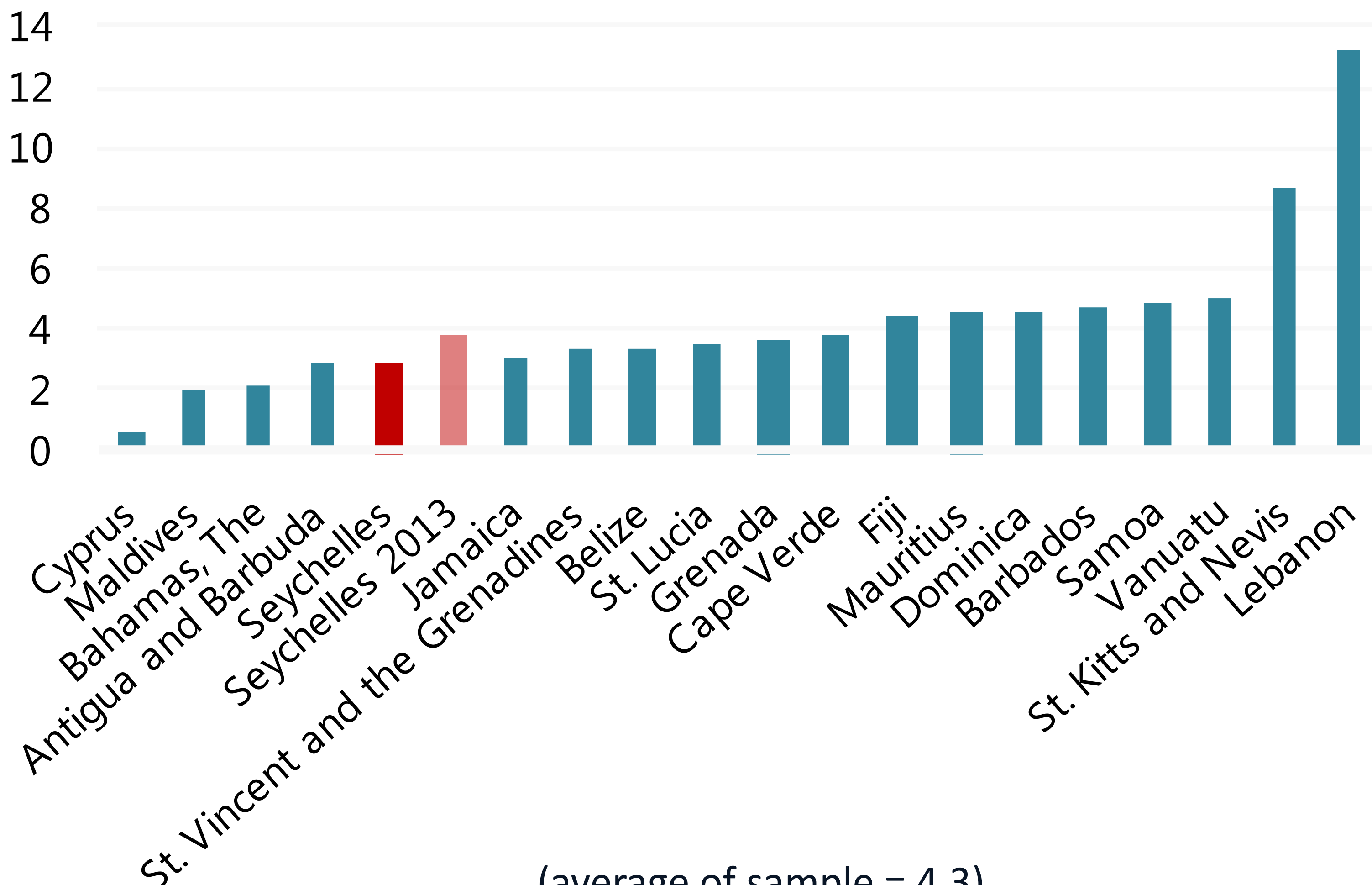
Central Bank Of Seychelles' gross international assets:



Inflation and the exchange rate



Reserves in months of imports: Selected other tourism-based economies (2012)



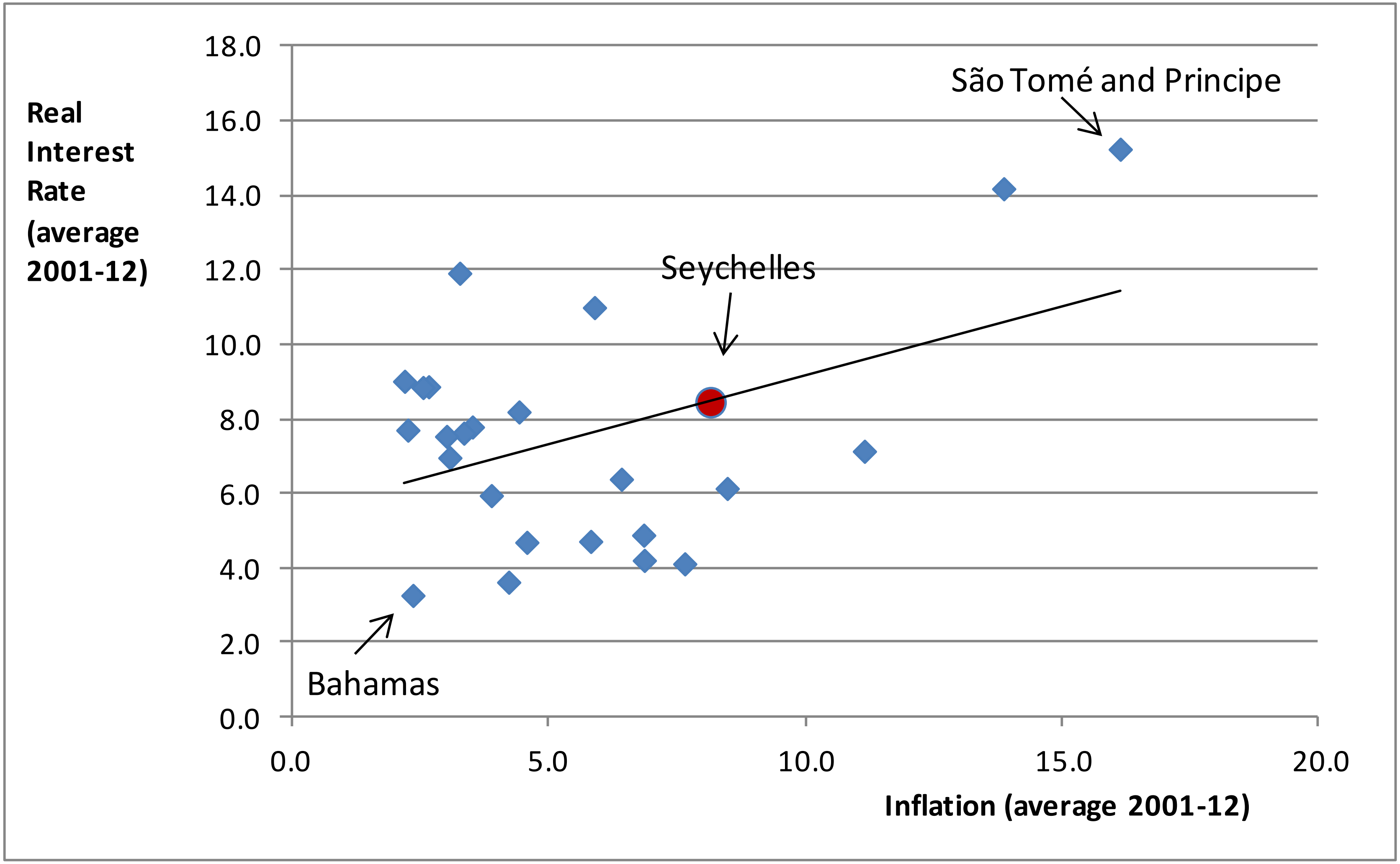
(average of sample = 4.3)

Challenges for the monetary policy framework going forward:

- ➔Central Bank needs to continue monetary policies that will deliver low and stable inflation.
- ➔Central Bank needs to continue accumulating international reserves, to maintain and (when possible) expand coverage of imports.
- ➔But accumulating reserves requires sterilization of excess liquidity, which is costly.

Why low inflation?

Low inflation may lower the cost of bank credit (evidence from selected small-island economies):



Further reserves accumulation is <u>necessary</u>, because:

- ➔ It protects the economy by ensuring liquidity and solvency in the event of external shocks.
- ➔ It boosts international confidence and lowers external financing costs (“risk premium”).
- ➔ It enhances domestic confidence and reduces macroeconomic uncertainty.
  - Lengthens time horizon of investment decisions.
  - Strengthens trust by depositors in stability of deposits➔ lengthens maturity of banks’ domestic funding.

But reserve accumulation is also costly, because:

→ Buying international reserves (from the market or from the government) creates liquidity beyond the banking system's basic needs.

→ Reserves build-up requires "sterilization" through CBS or Treasury instruments (deposit auctions; treasury bills).

- Interest must be paid on sterilization instruments.
- But interest income on international reserves is very low, because of the low international interest rates.

→ International reserves cause "carrying costs", because the domestic interest rate on instruments is higher than the international interest rate earned on reserves.

But if sterilization has a “fiscal cost”, shouldn’t we just accept and live with the “excess liquidity”?

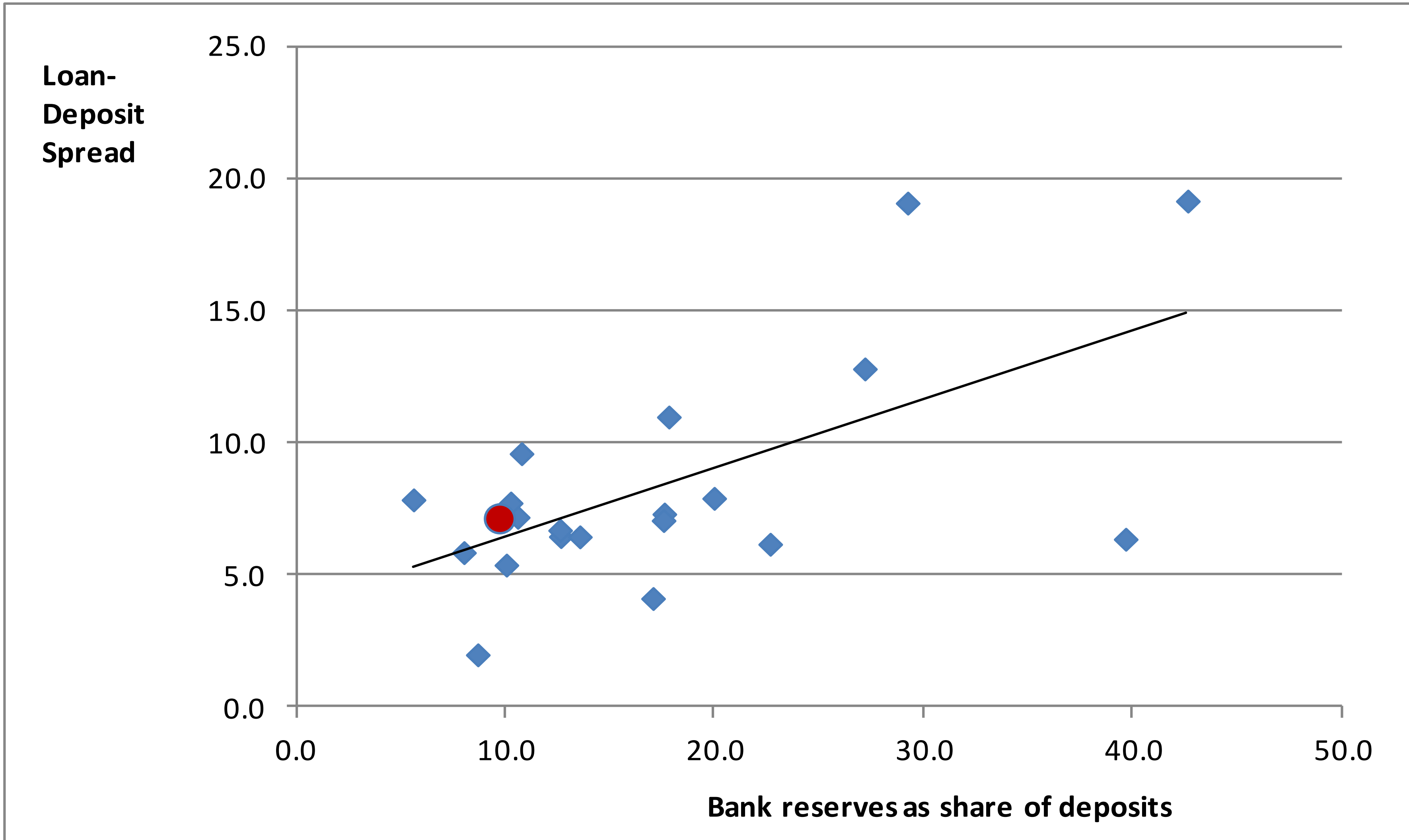
(…as long as it doesn’t cause inflation…)

No, because excess liquidity damages the financial system and undermines the efficiency of monetary policy.

- It undermines the “transmission” of monetary policy signals (no interbank money market; no interest rate signal).
- It creates huge volatility of interest rates whenever there needs to be a shift in monetary policy stance.
- It makes financial intermediation less efficient and raises the cost of credit (higher loan-deposit spread).

The higher the share of (non-interest earning) bank reserve assets, the higher the “spread” between loan rates and deposit rates.

Evidence from small-island economies:



Solutions (I)

- Continue to accumulate international reserves at a measured pace.
- Identify the appropriate level of bank reserves, and sterilize any excess liquidity resulting from the international reserves accumulation.
- Strengthen rules and coordination between CBS and MOFTI on how to deal with the costs of sterilization.
- Make the monetary policy framework more flexible: Focus on the appropriate level of bank reserves rather than “rigid” money targets.

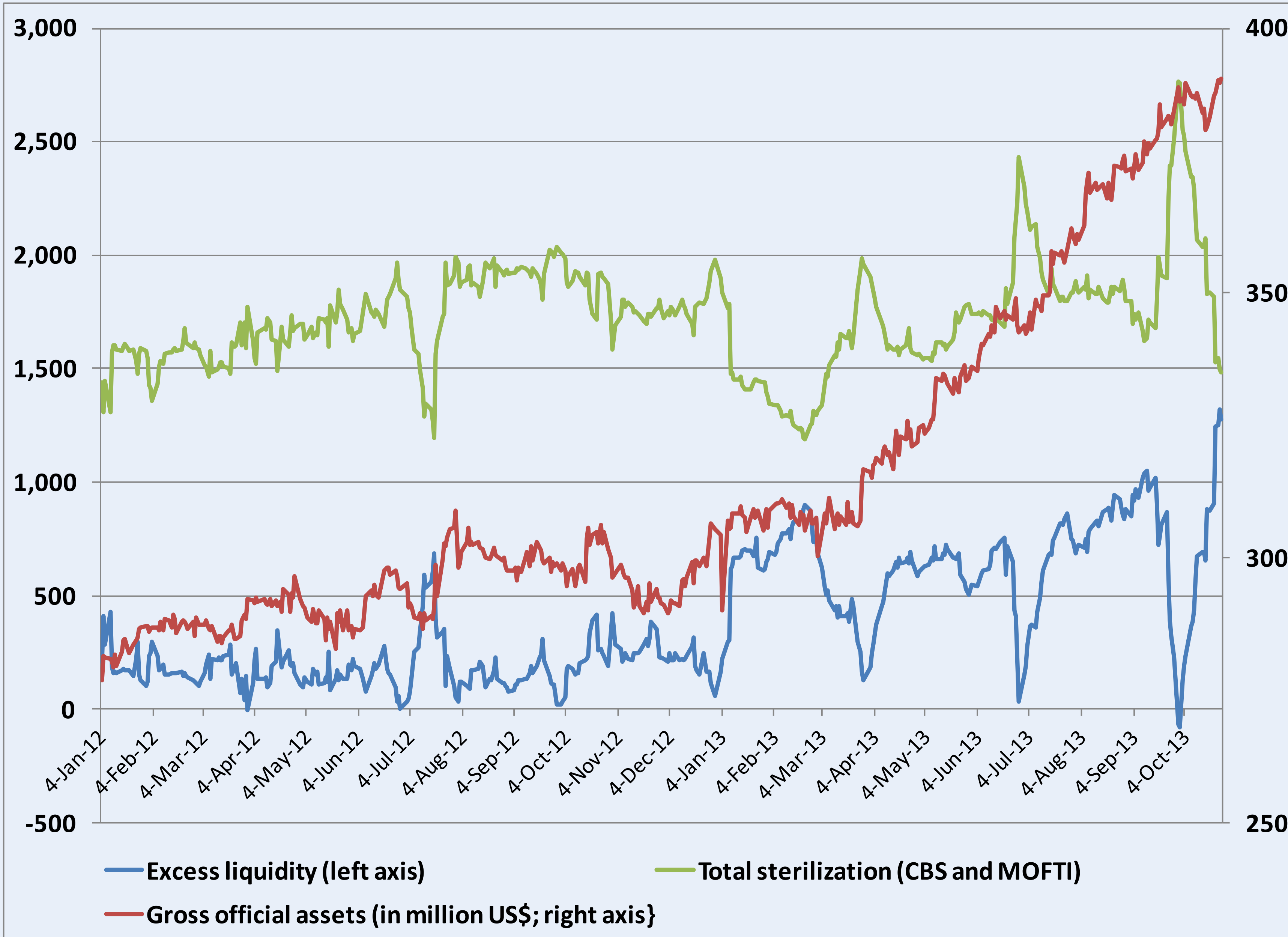
Solutions (II)

- ➔ For the time being, keep reserve money targets as the main "nominal anchor" for monetary policy, but derive them from a continuous and frequently updated liquidity forecast.
- ➔ As bank reserves stabilize and the financial system becomes more responsive to interest rate signals, strengthen the role of the CBS policy rate.
- ➔ Use the policy rate to guide market expectations on future interest rates and inflation, and to better communicate shifts in the monetary policy stance.

Thank you.

(end of presentation)

Annex I:
Reserve accumulation, sterilization, and excess liquidity (2012-13)



Annex II:
Interest rates on treasury and CBS instruments(2012-13)