Central Bank of Iraq

Press Communiqué

New Central Bank policy instruments

Summary

At its August 26 meeting, the Board of the Central Bank of Iraq (CBI) adopted a new Reserve Requirement regulation and a new Banking Facilities regulation. These regulations are attached. This Communiqué sets out the broad features of the new regulations and explains the reasons for adopting them in the context of strengthening the CBI's conduct of monetary policy and supporting the Ministry of Finance's (MOF's) new government securities issue program. The CBI will soon issue draft instructions for implementing the new regulations.

The changes in the CBI's regulations and operations are designed to give the Central Bank better control of the money supply while at the same time providing greater certainty to banks with regard to the options and terms for managing their liquidity. The new government securities market is also expected to play an important positive role in bank liquidity management in conjunction with these new regulations. Banks will be expected and financially encouraged to manage their short-term liquidity needs with other banks (or the market more generally), turning to the central bank as a last resort. The CBI will hold meetings with banks in the near future to discuss the proposed regulations.

The MOF has changed the way it finances its revenue shortfalls because of the new legal restrictions on its borrowing from the CBI and its desire to develop an active market in government securities. As required by the newly adopted Public Debt Law, all debt service will now be paid in cash. Thus the government securities held outside the Central Bank of Iraq (CBI) that matured July 1 were repaid with interest. The government securities held by the CBI are being dealt with in the context of an agreement between the MOF and the CBI to restructure the central bank's claims on the government. The MOF has begun issuing new securities to refinance the maturing existing ones. The new securities may be traded after issue in a secondary market.

The Central Bank of Iraq (CBI) has been recasting its operational relationship with banks in order to develop market based instruments of monetary policy and to facilitate the development of the market for the new MOF securities. Banks will no longer be required to hold MOF securities equal to 10 percent of total deposits (now contained in the reserve requirement regulation). The CBI will no longer buy or sell the existing MOF securities at the initiative of banks. In addition, the existing overdraft and advance facilities of the CBI have been closed and will be replaced by the new standing lending and deposit facilities just adopted by the CBI Board. The new reserve requirement regulation will go into effect in either October or November. The CBI may at its discretion buy or sell MOF securities with banks in a competitive auction as required for monetary policy purposes (so called "open market operations"). The details of all of these changes are explained below.

Explanation to Banks of New Monetary Policy Instruments

Monetary Policy Instruments

The design of a central bank's monetary policy instruments should serve both to foster efficient short-term liquidity management by banks and to deliver the central bank's desired monetary policy (which can be measured by a variety of intermediate variables, including the yield curve, the exchange rate, and the rate of growth of the monetary supply). With regard to liquidity management, the central bank's policy instruments must work together with money and securities markets and an efficient payment system to provide banks with confidence that they can always meet their payment obligations at a reasonable cost. The most certain, but also the most costly, form of liquidity is provided by excess reserves (vault cash and balances with the central bank in excess of required reserves). Intermediation spreads (the difference between interest rates on deposits and on loans) can be narrowed by enabling banks to minimize their holdings of non-interest yielding excess reserves. Bank's ability to minimize excess reserves depends on the availability of other reliable means of liquidity management.

The CBI currently has the following active and passive instruments that affect market liquidity (base money):

- Foreign exchange auctions, in which the CBI buys or sells dollars to the market in light of its policy objectives;
- A reserve requirement regulation that requires banks to hold in relation to their customers deposits: differentiated levels of deposits with the CBI, vault cash, and MOF securities.
- An Overdraft Facility, for banks with reserve account balances at the CBI that are not sufficient to settle their net end of day payment obligations;
- A Discount Window for bills of exchange and similar bank paper with a maturity of less than 90 days and at least two endorsements (currently charging 11% for good quality paper);
- Lender of Last Resort Facility, which provides individually negotiated loans against collateral, for banks with chronic liquidity problems;
- MOF securities Window, at which banks may buy or sell MOF securities at par (i.e. at issued interest rate).

The above instruments are not adequate for the development of an efficient market oriented financial sector. In particular, they are not adequate or appropriate for developing an efficient and liquid market in government securities or for conducting a market based monetary policy. While the new FX auctions are well designed and are functioning satisfactorily, the other instruments are being redesigned. The reserve requirement does not provide banks with a useful liquidity management tool and would have complicated the implementation of a monetary target. It also includes a government securities requirement that should not be part of the requirement. The various lending facilities are not very transparent and do not always serve policy objectives. The MOF securities window provides much needed liquidity to MOF securities, but under terms that undercut the development of secondary trading and of an interbank market. Furthermore, the MOF securities window deprives the CBI of one of its most important instruments of monetary control by leaving to banks the discretion to buy or sell MOF securities with the CBI.

Articles 28, 29 and 30 of the CBI law establish the CBI's powers to conduct open market operations, provide standing facilities for banks, establish reserve requirements, and, under exceptional circumstances, provide Lender of Last Resort credits. These articles provide the basis for the modern policy instruments being adopted by the CBI.

The new reserve requirement and banking facilities regulations are designed to help banks manage their liquidity more effectively in the market. Banks are encouraged to deal with each other more extensively rather than the central bank when managing their liquidity.

The reasons for and key features of each new instrument are set out below.

Reserve Requirement

The CBI's reserve requirement, confirmed as recently as December 12, 2003, is really three separate requirements in one Instruction. It requires banks to maintain frozen deposits with the CBI, which are currently 20% of their current/demand deposit liabilities of the previous month, 5% of their savings deposit liabilities, and 2% of their time/fixed deposit liabilities. In addition, the Instruction also contains two additional, basically unrelated requirements to hold MOF securities of at least 10% of banks' total deposit liabilities and vault cash of at least 5% of total deposit liabilities. These required reserves are not remunerated. The Reserve Requirement Instruction is addressed by CBI's Board of Directors to the Statistical and Research Department and the Credit and Banking Control Department. The report from banks in compliance with the Instruction is addressed to the Accounting Department.

This reserve requirement does not reflect best practice and the CBI is introducing a new requirement, better designed for the needs of monetary policy in a market economy. Where they exist, reserve requirements almost universally are seen as a tool of monetary policy rather than banking supervision. Thus the responsibility for monitoring each bank's compliance with the revised requirement has been moved from the Credit and Banking Control Department to the Agreements and Loans Department, the department with primary responsibility for monetary policy implementation.

For monetary policy purposes a uniform requirement (i.e., the same ratio for all reservable deposits) is preferable. The ratio in the new requirement is applied to all deposit liabilities in the definition of money because that makes the money multiplier (the ratio of the quantity of money to base money) more stable and predictable. In addition, it has a neutral impact on the public's choice of deposit maturities, which from a "tax" policy perspective is preferable. Foreign currency deposits are also included in the deposit base for the reserve requirement so as not to favor foreign currency deposits and hence dollarization. The requirement against both dinar and foreign currency deposits must be meet with dinars.

The current regulation imposes separate requirements on bank's deposits with the CBI and bank's vault cash. In the new requirement these are combined so that the single, uniform requirement may be satisfied by the sum of each bank's vault cash and current account deposits with the CBI.[1]

The primary benefit to banks of the new requirement results from allowing the requirement to be met on average rather than on a continuously basis. The requirement will continue to be established for monthly periods but the current frozen deposits will be moved into the single clearing account for each bank. The assets that must be held on average to satisfy the requirement will be banks' Iraqi dinar deposits with the central bank (other than in the standing deposit facility) plus their (new) Iraqi dinar cash in their vaults. A bank may use any and all of its deposits with the CBI on any day as long as its average end of day balance (plus its average ID vault cash) is equal or greater than the required amount.

The CBI Board has set the reserve ratio at 25 percent. Because the new reserve requirement allows banks to use their dinar vault cash to satisfy the requirement, bank's reserve assets will be greatly increased. To limit the impact of this change on bank liquidity (without raising the requirement ration even more), the Board also stipulated that 20 percent (of deposits) must be meet by deposits at the CBI and 5 percent (of deposits) by vault cash.

A monthly averaging period can convert the reserve requirement into a quite useful tool for absorbing individual bank and system wide liquidity fluctuations in day to day positions.

The 10% government security requirement is being discontinued, as is the separate requirement for vault cash.

Standing facilities

"When…financial markets, and more broadly financial systems, are not well developed, central banks have to place greater reliance on standing facilities than on open market operations. In that regard, standing facilities can act as a safety valve in response to unexpected liquidity developments or to various obstacles or inefficiencies that prevent a smooth redistribution of reserves via the interbank market. The safety valve function is also important when the liquidity forecasting framework is weak…."

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[1] A bank's deposit at the CBI in the proposed standing deposit facility would not be counted toward satisfying the reserve requirement.

The new central bank law provides for the CBI to establish standing lending and deposit facilities. A standing lending facility and a lender of last resort facility will replace the existing over draft and advance facilities now in use. The new law does not permit overdrafts of banks' balances with the CBI.

The purpose of standing credit and deposit facilities is to provide assurance to banks that they can manage their excess liquidity within a modest range of interest rates that straddle the central bank's policy objective for short term rates. In the absence of well developed interbank money and securities markets in which the CBI's open market operations can be conducted, the CBI will express its view on the short term interest rate appropriate for monetary policy by setting a Policy Rate as a reference rate. The standing lending and deposit facilities will have interest rates in relation to this Policy Rate. The rates on these facilities also provide an interest rate spread between placing and receiving funds from the central bank for the given maturity period (overnight). This spread is important because it should encourage banks to develop an interbank market and manage their liquidity with each other in the first instance, rather than always dealing with the central bank. Once interbank markets are better developed, the CBI's open market operations will aim, in part, to keep short-term interbank interest rates well within the tunnel of the rates of the two standing facilities.

The rates on the standing lending and deposit facility should float above and below prevailing money market rates. Until an interbank money market and secondary trading of MOF securities are developed, the rates set on these two facilities will be set in relation to the Policy Rate of the CBI. The CBI will need to carefully monitor this rate in light of monetary policy objectives. The Board has initially set the Policy Rate at 6 percent.

Standing lending facility

A standing Primary Credit facility will provide over night credit to banks against suitable collateral at the initiative of the banks. Banks will be able to borrow overnight a maximum amount in relation to their capital (as long as they had eligible collateral) at that day's Primary Credit rate. The interest rate will be set at a premium above the CBI's Policy Rate. The Board has set the Primary Credit rate at the Policy Rate plus 2 percent, i.e., at 8 percent. In the future, as financial markets deepen, the facility's interest rate premium will be reduced. As a further safeguard of the intended temporary and occasional nature of the facility, a larger premium will be imposed for use of the facility for more than fifteen days each month under a Secondary Credit facility. A bank may use primary credit on 15 days in a month and may use it on additional days in a month with prior Central Bank approval. A bank may use primary credit up to 20 percent of the bank's capital and may use primary credit in excess of this amount with prior Central Bank approval.

The Secondary Credit facility has the same eligibility criteria as the Primary Credit facility but can be extended for longer periods at a some what higher interest rate and is granted at the discretion of the central bank. Initially the prolonged use premium will be 1 percentage points about the Primary Credit rate, i.e. 9%.

It will not be profitable for banks to borrow excessive amounts under these conditions for other than temporary distress situations, which CBI should accommodate in any event. Borrowing by more seriously distressed banks will be covered by a Lender of Last Resort Facility discussed below as part of supervisory measures imposed by the Bank Supervision Department.

CBI advances under all of these facilities must be collateralized with collaterals acceptable to the CBI. The CBI will publish the list of acceptable collateral for each facility and may revise the list at any time. Initially, for the Primary Credit facility the CBI will accept MOF securities with a remaining maturity of less than 180 days. Banks must pledge MOF securities they own in the MOF securities depository, by instructing the CBI to mark the required amount as pledged to the CBI as collateral.

Lender of Last Resort (LLR) facility

The central bank law also provides for lending to distressed banks under exceptional circumstances. An example might be to stem a run on a bank hit by unfounded rumors. Another example might be to provide an otherwise sound bank time to work out of a chronic liquidity shortage. For this purpose, the bank would generally be under enhanced supervision and would be expected to carry out specific supervisory measures to correct its problems.

Most often, however, what first looks like a liquidity problem is really a solvency problem. Many countries have wasted a great deal of the public treasury propping up insolvent banks through liquidity support loans. The CBI will not generally lend to an insolvent bank. The law places strict limits on the conditions for these exceptional loans in Article 30. Such a loan is not allowed unless:

> “a. the bank, in the opinion of the CBI, is solvent and provides adequate collateral, and the request for financial assistance is based on the need to improve liquidity; or
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> b. such assistance is necessary to preserve the stability of the financial system and the Minister of Finance has issued to the CBI a guarantee in writing on behalf of the Government securing the repayment of the loan.”

The LLR facility can advance collateralized funds for longer periods and can accept a broader range of less traditional collateral (conservatively valued). The interest rate charged on Lender of Last Resort facility loans will be the Policy Rate set by the CBI plus 3.5 percent. i.e. 9.5%.

Deposit facility

The CBI will open a standing deposit facility, which will accept overnight deposits from banks with excess reserves. Funds will not be placed in the facility unless explicitly ordered by a bank. The interest rate on these deposits will be set below the CBI Policy Rate. Initially the rate will be set at 2 percentage points below the Policy Rate. The facility will provide a floor to very short-term interest rates, which will help bring some stability to bank expectations about interest rates. Moreover, until a t-bill market develops in which the CBI can conduct its open market operations, the deposit facility can "automatically" drain excess liquidity from the banking sector.

The Policy Rate

The monetary policy of the CBI expresses itself, in part, in the short-term money market interest rates that it brings about. That market is now very undeveloped and thus cannot yet be relied on to reflect the central bank's policy stance. Until that market, or the secondary market in very short-term MOF securities is adequately developed, the CBI will signal its target for over night, interbank interest rates by setting a bench mark reference rate. It calls this interest rate its Policy Rate. Banks are free to set their own interest rates and to deal with each other and others in the market at any mutually agreed interest rate. The Policy Rate is the bench mark rate from which the Primary Credit, Secondary Credit, Lender of Last Resort credit, and Overnight Deposit rates are set. It is the rate the CBI thinks is appropriate to maintain price stability and that its monetary policy will attempt to achieve (by keeping bank liquidity at levels consistent with the Policy Rate).

Open Market Operations

The CBI can influence bank liquidity (excess reserves) and thus short term interest rates by buying and selling government securities. Selling such securities to the market from the CBI's own holding would drain liquidity from the banking system (by reducing bank's balances in their reserve accounts with the CBI). Buying them from the public would increase banks' liquidity (i.e., their reserve account balances). Such open market operations (OMO) would provide an important second instrument (along with the foreign exchange auctions) of active liquidity management.

Various strategies for the use of OMO are possible. The CBI might, for example, choose to provide for desired long-term monetary growth through the accumulation of foreign exchange reserves. The monetary effect of higher or lower rates of foreign exchange reserve growth resulting from interventions to stabilize the exchange rate could be sterilized with OMO. Otherwise OMO would be limited to stabilizing bank liquidity and keeping short-term money market interest rates within the tunnel of the CBI' Credit and Deposit facility rates.

OMO will generally by undertaken on an auction bases with banks. Such auctions will look very much like the foreign exchange auctions now being conducted.

After the government securities market has developed some depth, the CBI will consider introducing purchase/ repurchase agreements (repos and reverse repos) as its primary OMO tool.