SESSION 2
MONETARY POLICY IN RESOURCE RICH COUNTRIES

Knowledge sponsor: IMF

The second session began with opening remarks by **Mr. Krishna Srinivasan** | Director, Asia and Pacific Department, IMF. In his remarks, he emphasized that resource rich counties often face significant terms of trade shocks, which have major implications for growth and external balances. The recent surge in commodity prices has also presented challenges for central banks in many other countries. Mr. Srinivasan outlined the main discussion points as follows: 1) How should monetary policy respond to adverse terms of trade shocks, 2) The importance of monetary and fiscal policy consistency for the successful implementation of an inflation targeting framework, and 3) The specific challenges central banks face in maintaining credibility in countries prone to commodity price shocks and fiscal dominance.

Keynote speech

The keynote speech was delivered by **Ms. Silvana Tenreyro** | Professor of Economics, London School of Economics, on the topic "Monetary policy in resource rich countries", drawing on the work of Dreschsel, McLeay, Tenreyro and Turri (2024) and McLeay and Tenreyro (2023). Ms. Tenreyro and her colleagues examined the role and challenges of central banks in managing terms of trade shocks under various scenarios. They used a small open economy New Keynesian model with commodity exports and imports to compare the performance of different monetary policy and exchange rate frameworks in response to commodity price shocks.

Main findings:

- *Inflation targeting vs. pegged exchange rates:* In response to export price shocks, both CPI targeting and domestic inflation targeting outperform pegged exchange rates, closer to the efficient outcomes in advanced economies.
- *Impact on emerging and developing countries:* For emerging or developing countries, an increase in commodity prices leads to a much bigger boom in output and consumption due to a fall in risk premiums. Pegged exchange rates are the least effective option, resulting in excessive economic booms and domestic inflation overshoots.
- *Advantages of inflation targeting:* The benefits of inflation targeting over pegs are particularly pronounced in commodity-exporting emerging or developing economies facing commodity price shocks. Domestic inflation targeting leads to greater output stability. Inflation targeting combined with flexible exchange rates is more effective than pegs in managing commodity price shocks for both advanced and emerging commodity-exporting economies.
- *Effectiveness under dollar dominance:* The effectiveness of monetary policy in a world of dollar dominance varies. It has a small effect for monopolists with sticky USD prices, but

a large effect for commodity producers with flexible USD prices, with the impact depending on supply capacity.

Panel discussion

The discussion was moderated by **Mr. Krishna Srinivasan** | Director, Asia and Pacific Department, IMF, joined by **Mr. Lkhagvasuren Byadran** | Governor, Bank of Mongolia, **Mr. Grant Spencer** | Teaching Fellow, Victoria University of Wellington, **Mr. Philip Lowe** | Chair of the Future Generation Australia, and **Ms. Silvana Tenreyro** | keynote speaker.

Managing negative terms of trade shocks

- New Zealand as a small, resource-rich open economy, implemented monetary policy reforms to ensure economic stability and growth. Key elements of these reforms included i) allowing a floating exchange rate, ii) granting financial independence to the central bank and iii) deregulating the financial system. These measures collectively strengthened the country's economic framework, enabling it to better navigate global economic fluctuations.
- Mongolian economy faced serios balance of payments pressures due to sudden stop of FDI and weak commodity prices in 2015-2016. FX market expectations shifted in one direction, causing the exchange rate to depreciate sharply, which could also have a negative implication on inflation. As a result, the BoM hiked the policy rate 450 basis points to 15 percent in August 2016, proven to be effective in preventing a potential currency and banking crisis.
- In times of trade and commodity price shocks, Australian experience has shown that allowing the exchange rate to fluctuate has been much more effective than relying on foreign reserves.
- From New Zealand's experience, sequencing is important in certain areas, such as implementing a floating exchange rate before pursuing inflation targeting. However, speed and urgency are also critical. While achieving perfect sequencing is challenging, timely execution remains essential.

Fiscal and monetary policy consistency

- Political commitment was crucial for the success of New Zealand's monetary policy reforms. It is not sufficient to rely solely on the central bank, the ministry of finance, or the IMF; robust political commitment is essential to ensure that these changes are effectively implemented.
- The central bank should not finance the government as fiscal policies can pose significant challenges for the central bank. The best outcomes are achieved with a robust fiscal framework in place. Australia's fiscal policy framework has proven to be quite effective.
- Achieving better consistency between fiscal and monetary policies is desirable in resource-rich countries, yet it becomes particularly challenging during difficult times.

- In Mongolia, fiscal expenditure has expanded significantly for the last years, now representing 35-36% of GDP, up from about 27-28% before the pandemic. This budget growth has led the central bank to tighten monetary policy, which in turn limits the central bank's ability to provide liquidity and support to other sectors of the economy.

Central banks' credibility and balance sheets

- If there is a policy that involves hidden or secret funding through a continuously loss-making central bank, it risks undermining confidence in the central bank and its operations. Therefore, it is important to address this issue and restore positive capitalization. Ultimately, a central bank should generate a profit through seigniorage.
- The markets will always question whether, in times of crisis or difficulty, fiscal authorities will lean on the central bank. The credibility of the central bank is crucial during such times.
- If the central bank is perceived to be financing the government through indirect means or other methods, it can lead to suspicion and undermine trust. Even if the central bank is acting appropriately, the market may react negatively during a crisis. The only way to overcome this is to ensure that there is clear and transparent communication about the fiscal role of the central bank.