Central Bank of Congo : Four Factors Affecting Monetary Policy Effectiveness

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Central Bank of Congo : Four Factors Affecting Monetary Policy Effectiveness

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Abstract

Four factors affect the effectiveness of monetary policy, three of which are exogenous, fiscal dominance, dollarization and global risks; one is endogenous, monetary policy framework that integrates strategy, tactics and governance of monetary policy. We show that the factors that undermine the effectiveness of the Central bank of Congo (BCC) are much more exogenous. However, the monetary policy framework needs to be rethought. For a lasting effectiveness of the BCC's monetary policy, it would be necessary to put in place sustainable fiscal discipline, serious de-dollarization measures, and economic growth policies that strengthen resilience.

Keywords : *Central Bank, monetary policy framework, fiscal dominance, dollarization, global risks.*

JEL codes : *E52, E58, E60, F4*

Résumé

Quatre facteurs affectent l'efficacité de la politique monétaire, dont trois sont exogènes, la dominance fiscale, la dollarisation et les risques mondiaux ; l'un est endogène, le cadre de politique monétaire qui intègre la stratégie, les tactiques et la gouvernance de la politique monétaire. Nous montrons que les facteurs qui nuisent à l'efficacité de la Banque centrale du Congo (BCC) sont beaucoup plus exogènes. Cependant, le cadre de la politique monétaire doit être repensé. Pour une efficacité durable de la politique monétaire de la BCC, il serait nécessaire de mettre en place une discipline budgétaire durable, des mesures sérieuses de dédollarisation et des politiques de croissance économique qui renforcent la résilience.

Mots-clés : *Banque centrale, cadre de politique monétaire, dominance fiscale, dollarisation, risques mondiaux.*

Codes JEL : *E52, E58, E60, F4*

I. Introduction

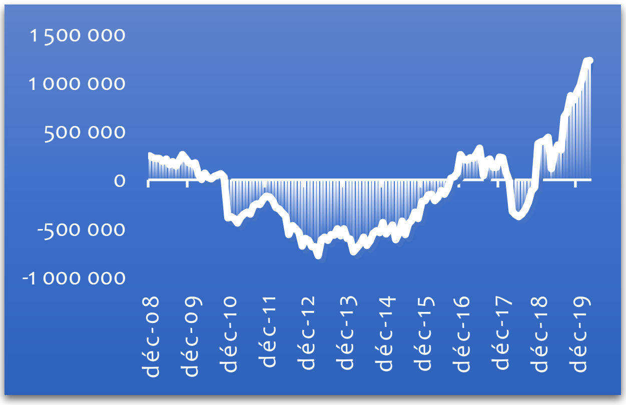
Since the early 2002s, Congolese economy has recorded positive performance without a recession - a prolonged period of record real GDP and a decline in single-digit inflation. This good performance was partly explained by a prolonged recovery in international activity, which also pushed up commodity prices, and partly by debt relief. Monetary policy of the Central Bank of Congo (BCC) also played an important role in its implementation, setting a clear mandate: price stability. However, this quantifiable display is masked by economic vulnerability combined with problems that undermine the effectiveness of monetary policy. We subdivide these problems into four factors which are exogenous and endogenous in nature, which affect the effectiveness and efficiency of monetary policy. We highlight these exogenous factors that compromise the implementation of the BCC's monetary policy: fiscal dominance (the hidden face of the failure to respect the independence of the BCC); dollarization; the shock linked to the international economy; as well as some endogenous factors like the obstruction of monetary transmission mechanisms, governance, all these endogenous factors we put in a single box called the monetary policy framework.

The paper is structured as follows. The second point examines the problem of fiscal dominance which limits the effectiveness of monetary policy. The third point preaches the problem of strong dollarization, which undermines the BCC's monetary regime and disrupts the conduct of monetary policy. The fourth point deals with the conduct of monetary policy during the exogenous shock associated with the international economy. The fifth point examines the intrinsic problem of monetary policy, including tactics, strategy and governance. The sixth point summarizes the main conclusions of the analysis.

II. Between the devil and the deep sea : fiscal dominance and BCC independence

Monetary policy in the Democratic Republic of the Congo (DRC) suffers from deep fiscal dominance (Figure 1). This implies that inflation expectations are automatically linked to fiscal performance. Therefore, a tightening of monetary policy can have a perverse effect on the economy. Instead of causing real interest rates to rise, the currency to appreciate, and aggregate demand and inflation to fall, such a tightening could fuel expectations of public debt default and thereby trigger a depreciation of the currency. exchange rate and an increase in inflation.

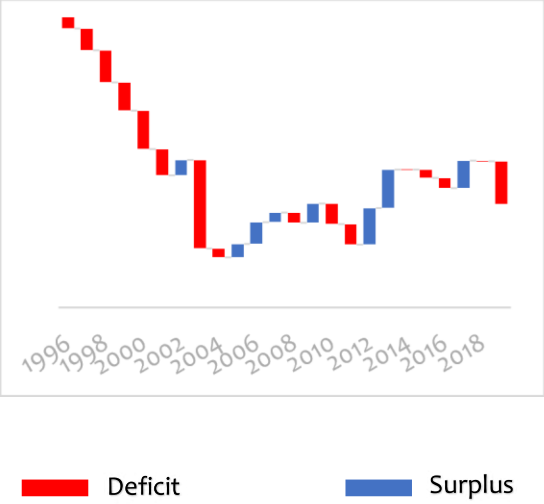
Figure 1. Net Claims on Central Government (Millions of Congo Francs)



Source : BCC

The Congolese economy is characterized by a structural public deficit (Figure 2), which leads to the subjugation of monetary policy to fiscal policy. In this situation, on the one hand, inflation expectations react to fiscal events and reflect the lack of credible anchoring. On the other hand, fiscal dominance undermines the independence of Congo's central bank and undermines the price stability mandate. More importantly, fiscal dominance typically crowds out private sector credit and dampens economic growth. The combination of fiscal imbalance and the effects of monetary growth induced by net claims on central government on inflation outcomes has been part of macroeconomic policy debates for decades. The hypothesis of fiscal dominance has been tested in the literature as an identifier of the inflationary nature of several countries (Blanchard, 2004; Nachega, 2005; Afolabi and Atolagbe, 2018; Sanusi, 2020; Mangani, 2020).

Figure 2. General government net lending/borrowing (% GDP)



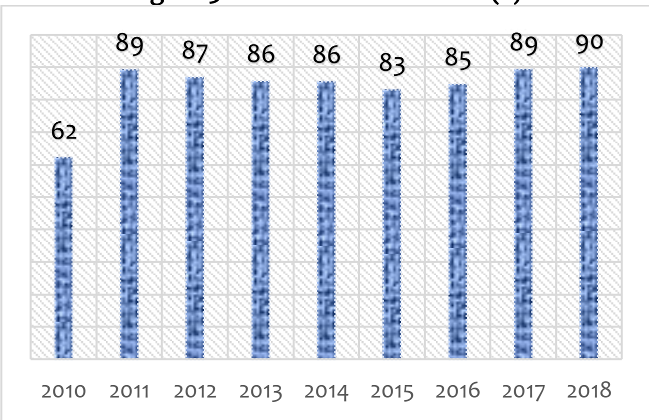
Source : IMF, World economic outlook (October 2019); Author

As economic growth picks up, the government should create fiscal space by applying fiscal discipline over the medium term. Otherwise, the effectiveness of monetary policy may become circumscribed in the future.

III. WEIGHT OF DOLLARIZATION: ETERNAL ANEMIA OF MONETARY POLICY EFFECTIVENESS

Often underestimated by its measure, the weight of dollarization in the DRC has reached a significant level. Monetary policy can have an impact on financial claims and liabilities in Congo Francs (Cdf) but not in foreign currencies (USD), the weight of dollarization complicates and calls into question the intermediate objectives and the transmission mechanisms of BCC's monetary policy. The more dollarization continues to be an eternal anemia of the economic circuit, the less room there will be for an effective and independent monetary policy. Dollarization could indicate that confidence in monetary stability is lacking. Foreign currencies represent on average more than 84% of the Congolese banking system (Figure 3).

Figure 3. Financial dollarization (%)



Source : BCC; Author

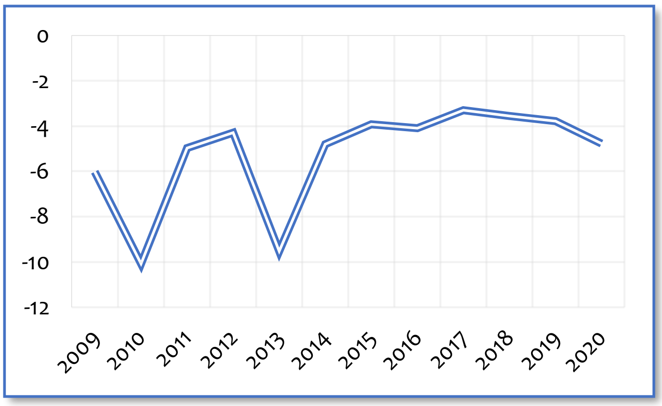
Dollarization requires the adoption of special measures of prudence. The banking system must be able to withstand large exchange rate adjustments, as well as the volatility of capital flows. The central bank must hold a volume of international reserves higher than normal to limit the harmful effects of exchange rate risk.

IV. GLOBAL RISKS

With a fairly large capital bonanza (Figure 4), the Congolese economy is exposed to global risks and exogenous shocks. This implies that with each global imbalance, the country's macroeconomic framework is affected by economic non-resilience. This situation impacts exports, widens the budget deficit, which leads to a monetary increase induced by the net claims on central government, and ultimately to a disruption of the effectiveness of monetary policy.

Government should reconfigure economic growth policies such as the accumulation of endogenous factors (knowledge, education, research, training, technology); attract foreign direct investment; macroeconomic stabilization; far-reaching structural reforms; strengthening of infrastructure (transport, telecommunications, water and electricity, building, roads); the creation of an environment conducive to the development of the private, judicial and regulatory sector; and the promotion of good governance, as well as the diversification of the economy. These measures would be crucial and important for improving economic robustness and resilience. This would help monetary policy easily adjust to imbalances.

Figure 4. Capital bonanza (Current account balance %GDP)



Source : IMF, World economic outlook (October 2020)

V. Monetary Policy Framework

The framework for an effective monetary policy requires several conditions: the independence and credibility of the central bank must influence not only the formulation of monetary policy, but also public expectations about the effectiveness of that policy.

The previous sections have outlined the external factors that undermine the effectiveness of monetary policy. From an internal perspective, however, the BCC's monetary policy framework should also be redesigned. Reform of monetary policy instruments would be helpful in strengthening monetary policy tactics. Likewise at the strategic level, it would be important for the BCC to adopt hybrid targeting between monetary targeting and implicit targeting of the exchange rate. The governance of the BCC should be reconfigured by placing more emphasis on accountability, transparency, communication, while preserving and making effective the real independence of the BCC.

VI. Conclusion

The BCC's monetary policy is affected by several external and internal factors that undermine its effectiveness. The factors that undermine the effectiveness of the BCC are much more external or exogenous, which are highlighted as fiscal dominance, dollarization and global risks. However, some internal factors regarding instruments, strategy and governance need to be rethought.

For a lasting effectiveness of the BCC's monetary policy, it would be necessary to put in place a sustainable budgetary discipline, flexible and specific de-dollarization measures, and economic growth policies will be necessary to strengthen resilience.

VII. Reference

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