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Evolution of Monetary Policy in the Maldives

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Abstract

This article chronologically describes the development of the monetary policy and exchange rate regime, since the establishment of the Maldives Monetary Authority (MMA). Different exchange rate regimes adopted over the years are explained and progression of the monetary policy framework is detailed, along with changes to the underlying monetary policy instruments used during the different phases. The article concludes with a review of the current framework in place, and a brief outline of future policy measures.

Introduction

Monetary policy goals among central banks vary from country to country, although, the most widely used monetary policy objective is price stability. While this is the predominant focus for many, central banks in advanced economies have broadened their horizon to include other objectives such as sustaining economic growth or employment. To achieve these goals, central banks use different operational frameworks which are appropriate in achieving their final objective. The operational framework adopted lays out the way in which monetary policy is carried out, regarding decisions on intermediate targets and the type of monetary policy instruments used. Countries that adopt an inflation targeting monetary policy framework aim to keep their inflation level within a specific target or range, while there are operational frameworks that focus on monetary aggregate targeting whereby aggregates such as the level of money supply are determined and set by the central bank. In Maldives, the MMA adopts an exchange rate anchored monetary policy framework, with the ultimate goal of maintaining price stability in the economy.

As the Maldives is a small and open economy with a high degree of dependence on international trade, the economy is highly vulnerable to external shocks and changes in international prices. The exchange rate plays a significant role in stabilising the effect on domestic prices from price shocks in the international market. Hence, the exchange rate has proven to be the most appropriate intermediate target for monetary policy. Accordingly, the monetary policy instruments are used to maintain bank credit at levels warranted by economic growth and to manage excess liquidity in the banking system to help mitigate any possible pressure on the exchange rate.

This article looks into the changes in exchange rate regimes and monetary policy since the establishment of the MMA. As such, the second section explains the evolution of exchange rate regimes throughout the years, which

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have evolved according to prevailing economic conditions at the time. The following section chronologically identifies the changes to monetary policy operations and instruments. Lastly, the article concludes with a description of the current monetary policy framework and the future policy measures as outlined in MMA's strategic plan 2018 – 2022.

Changes to Exchange Rate Regime

Dual rates and exchange rate peg (1980 - 1985)

Before 1981, the exchange rate was managed by the government. At the time, dual exchange rates were maintained comprising a market rate around MVR7.50 per US dollar and an official accounting rate at MVR3.93 per US dollar. The official accounting rate was primarily used to value all foreign exchange transactions of the government and used for the valuation of imports for customs purposes. Additionally, the accounting exchange rate was also used to determine domestic prices of fish and basic consumer goods. After the establishment of the MMA in 1981, management of the exchange rate regime and foreign currency exchange policies came under the jurisdiction of the central bank. As the official accounting rate used at the time was appreciated in comparison to the market rate, a policy to gradually depreciate the official accounting rate was pursued. It was expected to contribute towards raising government revenue, through possible increase in export revenue and thereby containing the balance of payments deficit. In early 1982, the dual exchange rate system was abolished and the MMA pegged the rufiyaa against the US dollar at a unified mid-rate of MVR7.05 per US dollar.

At the time, the economy was in the midst of a capital expenditure boom which was aimed at developing transport, communication and modernizing export oriented industries such as tourism and fisheries sectors. Improvements in tourism and fish export industries are integral to the county's economic growth and these industries are sensitive to any exogenous shocks. As such, the global recession in the early 1980's, coupled with the collapse in the world tuna market prices slowed the country's export revenue growth. Given the ongoing capital expenditure projects at the time, which were partly financed through concessional foreign loans, worsened the balance of payments deficit. Further, the decline in expected export revenue, resulted in an excess demand for US dollars in the domestic foreign exchange market which led to transactions taking place with a premium during the early 1980s. As the rufiyaa was pegged to the US dollar, the actual value of the rufiyaa against the US dollar was overvalued.

Basket peg (1985 – 1987)

As per the recommendation of the International Monetary Fund's (IMF) mission in 1984, it was decided that the foreign exchange market rates had to be restructured, and the exchange rate to be based on a weighted average of a selected basket of currencies of the country's main trading partners. As such, in 1985, the exchange rate peg to the US dollar was changed to a basket peg, where the rufiyaa was pegged to a trade-weight based basket of currencies. Essentially, the basket peg is more flexible compared to a pegged regime, and the exchange rate was allowed to depreciate, although, the MMA intervened in the domestic foreign exchange market to maintain the stability of the exchange rate value. The depreciating trend in comparison to the fixed peg, contributed towards favourable conditions in the export industries.

Floating regime (1987 – 1994)

Moving ahead to 1987, the currency basket exchange rate progressed to a floating exchange rate regime, which allowed the exchange rate to move broadly in line with market expectations, albeit periods of foreign exchange intervention to stabilise volatility. During this time, the exchange rate was devalued to MVR10.0 per U.S. dollar (Figure 1). This change was brought to further address the prevailing premium in the domestic foreign exchange market and also support growth of exports through maintaining international competitiveness.

Despite the de facto floating regime, the MMA intervened in the domestic foreign exchange market to keep the value of rufiyaa stable against the U.S. dollar. This proved costly in terms of the level of international reserves. Changes in policy to liberalize import quotas in 1989, accompanied by lax fiscal policies, ballooned the demand for foreign exchange in the domestic market. Additionally, the economic downturn in the Euro area during the early 1990's depreciated the European currencies against the US dollar, which increased the relative cost to travellers. Export revenue was further hampered by a slump in the international tuna market. As a result of the slowdown in export revenue growth and weaknesses in curbing domestic expenditure, it became increasingly difficult to maintain the exchange rate within the target range.

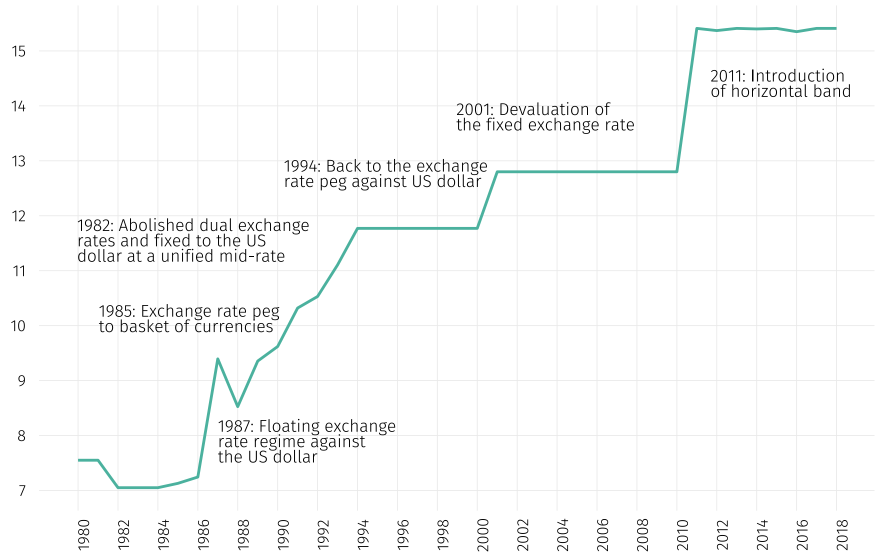
Back to exchange rate peg and devaluations (1994 – 2001)

The MMA reverted to the fixed exchange rate regime in 1994 and valued the rufiyaa at a mid-rate of MVR11.77 per US dollar, with a spread of 10 laari between the buying and selling rates. With the return to a fixed regime, the exchange rate against the US dollar became overvalued once again. Export revenue from the fisheries sector was squeezed owing to a combination of factors including low export prices, high oil prices and an appreciation of the real effective exchange rate of the US dollar. As such, during this period, the US dollar strengthened against major currencies, which also affected the tourism sector to some extent. Additionally, the growing fiscal expenditure added to the excess demand pressures in the domestic foreign exchange market. To ease such pressures and encourage competitiveness of exports, a devaluation of the exchange rate took place in 2001, whereby buying and selling rates were set separately at MVR12.75 and MVR12.85 per US dollar.

Horizontal band (2011)

The last revision to the exchange rate regime was made in 2011. The effects of the financial crisis during 2007-2008 affected the real economy with a lag, largely through the slowdown in tourism sector growth. Accompanied by rising fiscal expenditure year on year, excess demand for US dollar was still prevalent and put downward pressure on international reserves. The fixed exchange rate was significantly overvalued. Hence, a horizontal band was introduced to the exchange rate peg, whereby the rufiyaa was allowed to fluctuate within a 20% band on either side of the central parity of MVR12.85 per US dollar, i.e. between MVR10.28 and MVR15.42 per US dollar. However, due to the limited availability of US dollars in the domestic foreign exchange market, the excess demand has pushed up the exchange rate to the upper end of the horizontal band and it remains virtually fixed around MVR15.42 per US dollar.

Figure 1: Exchange Rate Regime (1980 - 2018)
(MVR/USD)



Source: Maldives Monetary Authority

Evolution of Monetary Policy Framework

Given that the MMA's monetary policy is centred around maintaining the exchange rate at the set level, the monetary policy instruments are largely used to influence the level of rufiyaa liquidity in the banking system. As such, the type of monetary policy instruments used are twofold – instruments which are used to inject rufiyaa supply into the banking system and those which are used to retain rufiyaa supply at the MMA. Over the years, different monetary policy instruments have been used and have evolved, under different names and with differing rates. Essentially, the instruments either absorbs or mops-up the excess rufiyaa funds in the banking system.

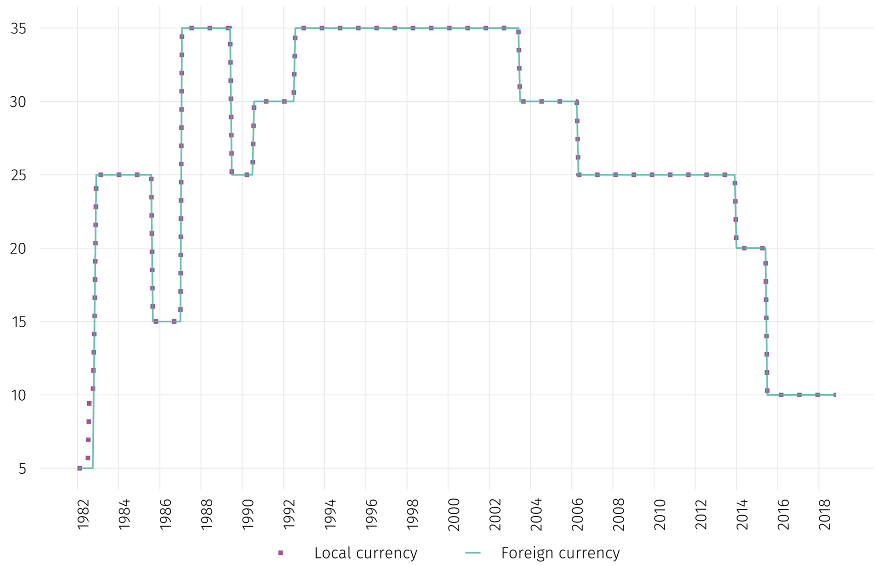
Direct controls (1981 – 1994)

During the earlier years, the MMA pursued direct and quantitative methods to conduct monetary policy. The instruments and measures adopted were highly administered and controlled the level of bank credit in the economy. The private sector businesses has a strong demand for foreign currency for their imports and business operations. By influencing the level of credit expansion, the authority was able to reduce build-up of excess demand in the domestic foreign exchange market.

Among the instruments adopted at the time, the Minimum Reserve Requirement (MRR) which was introduced in 1982, is still being utilised as a monetary policy tool to this day (Figure 2). Commercial banks are mandated to keep a specified ratio of their local and foreign currency deposits (excluding margin and L/C deposits) at the MMA. This affects the level of potential loans that the commercial bank can possibly provide to businesses and individuals, thereby influencing the money multiplier effect on the money supply. The MRR is predominantly a prudential measure, albeit being one of the main monetary policy tools used to control money supply and domestic credit. Since its introduction, the MRR ratio has been revised appropriate to current economic conditions at the time. As such, at the time of introduction the MRR was set at 5% and gradually increased to 35% in the 1990's, aimed at mopping up excess liquidity from the banking system.

Other monetary policy measures implemented during these years include credit to deposit ratio, credit limits and credit approval systems, and regulation on interest rates which were all used to directly control for the level of bank credit in the economy.

Figure 2: Changes to MRR Rate (1982 - 2018)
(percent)



Source: Maldives Monetary Authority

Market measures (1995 – 2008)

The artificial management of bank credit in the system, by controlling for the level of potential loan allocation and the interest rate, created mismatch in the demand and supply of loans. This led to an instable market and hence, made direct monetary policy controls less effective. In 1995, the MMA began to move towards more market oriented monetary policy instruments. Direct controls on sector specific level of credit was revised to overall bank credit limits, and was later completely removed in 2001. Furthermore, the interest rates chargeable on foreign currency deposits and loans were completely liberalized, while the same measures on local currency loans were capped to a maximum interest rate chargeable on loans at 20%. The monetary policy instruments were still focused on managing rufiyaa supply and bank credit, but a more market oriented approach was used. In line with these measures, the MRR was lowered in 2003 to 30% and then further down to 25% in 2006. This reduced the cost of funds for commercial banks and encouraged lending in the market.

A stepping stone in market oriented policies was the introduction of Certificate of Deposits (CDs) by the MMA in 1995. CDs were a central bank security issued by the MMA which were used to absorb excess liquidity in the banking system and subsequently, the MMA was assisting government's cash flow management. At the time of introduction, commercial banks were the only participants in the CDs market. Nonetheless, to further diversify and deepen the market, the issuance of CDs were extended to public enterprises as well. The tenures and interest rates on CDs were revised according to market conditions during specific periods. The

CDs market also contributed towards the development of an interbank market, where the interest rates on CDs provided a benchmark for a market-oriented interest rate.

Meanwhile, the MMA introduced the Lombard facility in 2001, which enabled commercial banks facing rufiyaa liquidity shortages to borrow from the MMA. Under this facility, commercial banks can avail loans from the MMA on a case by case basis upon request.

The issuance of CDs were discontinued and effectively replaced by the introduction of sale of government securities to commercial banks in 2006. Government securities transactions, i.e. issuance of treasury bills and bonds, are carried out by the MMA on behalf of the government.

The Lombard facility was also replaced by a similar facility called the repurchase facility in 2006. This new facility also aimed to provide short-term rufiyaa liquidity to those banks unable to raise funds from interbank borrowings. Concurrently, a rediscount facility was introduced which allowed the commercial banks to sell their holdings of government securities to the MMA before its maturity, which gave them rufiyaa liquidity reliefs. Interest rates on both repurchase and rediscount facility was set at a margin above the treasury bill rate of the shortest tenure, to provide an incentive for the banks to consider raising finance from the interbank market, before opting to apply for these facilities at the MMA.

Modernization of monetary policy (2009 – 2013)

The year 2009 marked the onset of major reforms to the conduct of monetary policy by MMA, with the assistance from the IMF[1], aimed to evolve the MMA into a modern central bank. On the monetary policy front, it was on re-forming and reactivating the Monetary Policy Committee which was initially formed in 2001, despite the committee being less active till then. In line with modernizing the central bank, the MMA was advised to halt direct monetization of the fiscal deficit, which was creating excess rufiyaa supply in the system, and ultimately, further putting upward pressure on the exchange rate in the unofficial domestic market for foreign exchange.

To actively manage the rufiyaa supply created through years of monetization, the MMA commenced Open Market Operations (OMO) in 2009 and started issuing MMA securities to absorb or inject rufiyaa funds. Moreover, in 2010, the MMA introduced two standing facilities for the commercial banks, where participation in these facilities were initiated by the banks. As such, the overnight Lombard facility (OLF) was introduced in 2010, which allowed commercial banks facing rufiyaa liquidity difficulties to borrow from the MMA on an overnight basis. The introduction of the OLF effectively replaced the repurchase facility which was previously offered by the MMA. The rediscount facility was also discontinued during this period. Additionally, the overnight deposit facility (ODF) was introduced during the same year, where the commercial banks can place their excess rufiyaa funds at the MMA, which are remunerated overnight.

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[1] During 2009, a series of Technical Assistance (TA) visits was conducted by the IMF's Advisors. The TA visits were focused on developing the MMA towards a modern central bank.

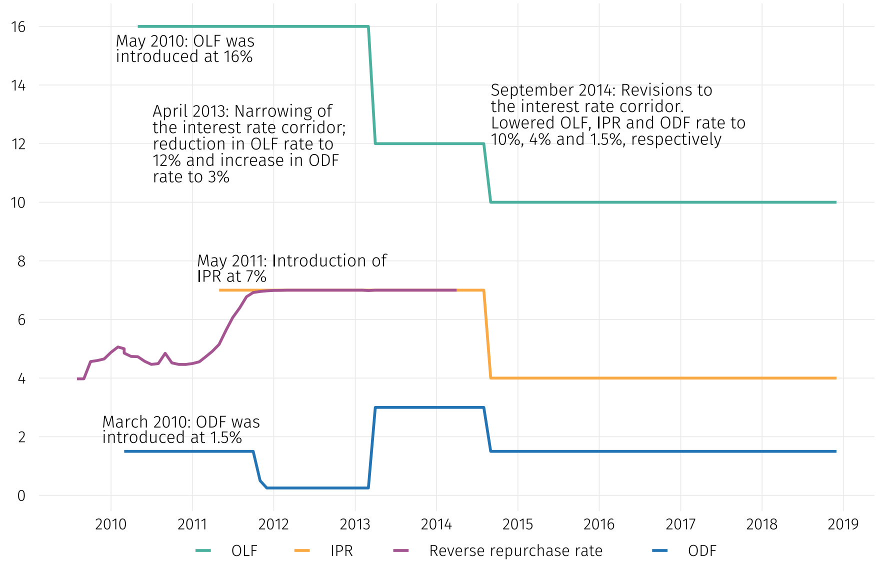
To signal the monetary policy stance of the MMA to the commercial banks, an indicative policy rate (IPR) was introduced in 2011 (Figure 3). A change in the IPR will indicate whether the MMA is pursuing a tightened or loose monetary policy. While the interest rates set for the OLF and ODF are essentially the official ceiling and floor rates of the MMA's interest rate corridor, the IPR was used in OMO for buying and selling of MMA's securities.

Further, a foreign exchange swap facility was also introduced in 2011. Under this facility, the commercial banks are allowed to buy or sell rufiyaa against foreign currency at an initial date and agree to reverse the transaction at a predetermined forward exchange rate on future date. This facility can be used to manage both local and foreign currency liquidity in the banking system.

The current framework (2014 – 2019)

In order to stabilise the exchange rate, the MMA has always been catering for the foreign currency demand of the market through sale of foreign exchange to commercial banks and began providing weekly foreign exchange to banks as early as 2011. To further ease the demand pressures for foreign currency in the domestic market, the MMA revised the foreign exchange intervention policy in 2017. The policy revision was made to address the high demand for foreign currency by SOEs and businesses, which mirrors the improvements in economic activity at the time. As per the foreign exchange intervention policy implemented, the MMA caters for the foreign currency requirements for developmental projects and business operations of the SOEs. The MMA provides weekly US dollar sales to commercial banks, which includes requirements for medical and education purposes. Additionally, the MMA provides US dollars for travellers. The current intervention policy has helped to ease the build-up of demand pressures in the domestic foreign exchange market, thereby stabilising the exchange rate changes.

Figure 3: Interest Rate Corridor (2009 - 2018)
(percent)



Source: Maldives Monetary Authority

Meanwhile, local currency supply continues to be managed through monetary policy instruments such as the MRR, standing facilities which comprise OLF and ODF, in addition to the foreign exchange swap facility made available to commercial banks. Underlying rates of these instruments have also undergone recent changes. As such, the MRR was changed in 2014 from 25% to 20% and was later revised in 2015 to 10% on both local and foreign currency deposits. These changes were brought mainly to encourage lending to private sector by commercial banks. Additionally, the MMA's interest rate corridor was also revised in 2014, to reflect the current economic conditions on the monetary policy operational framework. As such, the IPR was also revised to 4%, while OLF and ODF was changed to 10% and 1.5%, respectively. Since May 2014, transactions under OMO has been temporarily suspended to support domestic credit growth. Although OMO has been ceased for the time being, excess rufiyaa liquidity in the system is being absorbed as commercial banks continue to place their excess liquidity in the ODF.

Going forward

The MMA's strategic plan 2018 – 2022, lays out medium term goals to further strengthen the conduct of monetary policy. Policy measures have been planned to develop a more effective monetary policy framework by reviewing the current monetary policy instruments, to allow for more active management of rufiyaa supply. On the foreign exchange front, there are policy measures planned to restructure the foreign exchange market through developing a comprehensive legislative framework which will strengthen the foreign exchange market operations, and facilitate smooth flow and availability of foreign exchange in the banking system. Additionally, the planned policy strategies are aimed to make monetary policy more favourable towards rufiyaa, which will support a more active monetary policy management.

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