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Monetary policy and its transmission mechanisms in Eritrea

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Abstract

The main purpose of this study is to identify the best practices of monetary policy implementation in the Eritrean economy. As such, the paper examines what kind of monetary policy and transmission mechanisms are relevant to the Eritrean economy. It also addresses which channels are effective and which are not and why. Vector Autoregressive modelling is employed over the study period 1996Q1–2008Q4. This paper addresses the argument that the bank lending is the sole functioning channel in low income economies. We find that interest rate and official exchange rate channels are inoperative. However, effective exchange rate and credit channels exist through the black foreign exchange market and credit issued to the government sector. The main policy implication of this study is that the Bank of Eritrea might be able to control inflation through manipulating the reserve requirement ratio.

JEL Classification: E2; E5; G2

Keywords: Monetary policy; Interest rate channel; Exchange rate channel and credit channel

1. Introduction

As in many developed economies, monetary policy is expected to be useful policy instrument in the general development framework of developing countries. Although the procedures for implementing monetary policy instruments vary from country to country, depending on the socio-economic and political settings, there are some generic standards which some economies can rely

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on. The main research problem that this paper seeks to address is finding the most effective monetary policy transmission channels by identifying what monetary policy instruments are available for the Bank of Eritrea. To achieve this, first an investigation has been made into what kind of monetary policy the Eritrean economy pursues. Second, an examination has been carried out into what the Eritrean monetary policy transmission mechanisms (MPTMs) look like and which channels are effective.

The main monetary policy instrument used by the Bank of Eritrea is the reserve requirement ratio. The Bank of Eritrea also uses government treasury bills. Another policy instrument, which was set at 5.5% in 1994 but has not been implemented since then, is the rediscount window. Since the rediscount window is inoperative and both the lending and the deposit rates are rigid, the interest rate channel is ineffective. However, the economy can be managed through the credit and exchange rate channels by minimizing government expenditure and addressing the black market rate.

The remaining part of this paper is organized as follows: discussion of the literature is followed by discussion of monetary policy and its performance in Eritrea. Section 5 presents the monetary policy transmission channels. This is then followed by the explanation of model specification and data collection. Section 8 provides the discussion of empirical findings. Section 9 presents the conclusion of the study.

2. Literature review

Although MPTMs differ across countries, Dabla-Norris and Floerkemeier (2006) discuss six channels in general. These are: the interest rate channel, exchange rate channel, bank lending channel, balance sheet channel, asset price channel and expectation channel. While most of these channels are commonly active in the economies of developed countries, only a few are operative in developing countries. In their studies, Mishra and Montiel (2012) pointed out that most developing countries are well known for substantial intervention of the central banks in the foreign exchange markets, weak links with private international capital markets and the absence of securities and equities markets. As a result, the exchange rate, the interest rate and the asset channels are constrained in implementing their functions within the system. In contrast, banks are the most dominant financial institutions in these economies, leaving the bank lending channel to be the most dominant channel. However, whether the bank lending channel is effective or not is an empirical question.

In the studies of African economies, for instance, Mugume (2011) demonstrates the presence of a weak and ineffective interest rate, exchange rate and credit channels in Uganda. By using vector autoregressive (VAR) analysis, Buigut (2009) also found an insignificant interest rate channel in Kenya, Uganda and Tanzania. Likewise, Saxegaard (2006) found a weak transmission mechanism in Kenya, Nigeria and Uganda. Slightly different from these studies, Cheng's (2006) results indicate that while prices respond significantly to changes in the short-term interest rate, output reacts insignificantly in the Kenyan economy. The study by Ngalawa (2009) also suggests strong price responses to changes in the exchange rate in Malawi. Prices, however, react weakly to monetary variables, bank rate and reserve requirement ratio.

Most of the studies outlined above, as Mishra and Montiel (2012) have also pointed out, have used short-term interest rates as monetary policy variables in their analyses. However, it should be noted that most of the economies in these studies adopt monetary aggregates as their intermediate targets. There is, therefore, lack of clarity as to whether or not the results are due to misrepresentation of an appropriate policy variable. Moreover, close examination of specific