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NATIONAL BANK
OF ETHIOPIA

NBE's MONETARY POLICY FRAMEWORK

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ሱዳን ጎዳጎ
SUDAN STREET



5550/2048



+251-11-551-7430



+251-11-551-4588



SWIFTCODE
NBETETAA



TABLE OF CONTENTS

I. Introduction	1
II. Monetary Policy Objective.....	1
III. Monetary Policy Strategy/Targeting Framework	2
3.1 Final and Intermediate targets	3
3.2 Operational target.....	3
IV. Monetary Policy Instruments.....	4
V. Legal and Institutional Framework.....	5
5.1 Board of Directors.....	5
5.2 Monetary Policy Committee.....	6
ANNEX 1: Terms of Reference of the National Bank of Ethiopia Monetary Policy Committee	7
1.1. Background.....	7
1.2 Composition of Monetary Policy Committee	8
1.3 Duties of Monetary Policy Committee.....	8
1.4 Time Allocation to MPC work and Adherence to Code of Conduct	11
1.5 Frequency of meetings.....	11
1.6 Manner of decision-making and Monetary Policy Proposal	11
1.7 Publication of Monetary Policy statement and Monetary Policy Review	11
ANNEX 2: NBE's Monetary Policy Committee Code of Conduct	12
2.1. Fundamental Principles and Core Values.....	12
2.2 Conflict of Interest	12
2. 3. Immunity from Personal Liability.....	13
2. 4. Compliance and Accountability.....	13
2. 5. Independence.....	13
2. 6. Confidentiality.....	14
ANNEX 3: Exchange Rate Regime.....	14



I. Introduction

Monetary policy of central banks in a simplified analysis amounts to the determination of the “optimal” quantity of money or (in a dynamic sense) the optimal rate of growth of the money stock. But there is more to monetary policy than the determination of the optimal stock or growth rate of money. More generally, monetary policy refers to a bundle of actions and regulatory stances taken by the central bank including all of the following:

- ✓ Setting minimum interest rates on deposits or the rediscount rate charged to Commercial banks borrowing reserves; ✓ Setting reserve requirements on various classes of deposits; ✓ Increasing or decreasing commercial bank reserves through open market purchases or sales of government securities.
- ✓ Regulatory actions to constrain commercial bank financial activity or to set minimum capital requirements; ✓ Intervention in foreign exchange markets to buy and sell domestic currency for foreign exchange; ✓ Decide on level of required reserve of commercial banks total deposit

It is self-evident that monetary policy plays an important role in the performance of an economy. However, the effectiveness of the policy in achieving the intended goal largely depends on the institutional factors that constrain or facilitate the implementation process of the policy. In what follows the monetary policy framework of the National Bank of Ethiopia will be described detailing the monetary policy objectives, the targeting framework, the instruments of monetary policy and legal & institutional framework of the monetary policy decision-making structure as well as the exchange rate regime of the country.

II. Monetary Policy Objective

The principal objective of the monetary policy of the National Bank of Ethiopia is to maintain price & exchange rate stability and support sustainable economic growth of Ethiopia. Price



stability is a proxy for macroeconomic stability which is vital in private sector economic decision on investment, consumption, international trade and saving. Finally, macroeconomic stability fosters employment and economic growth. Maintaining exchange rate stability on the other hand is considered as the principal policy objective of NBE so as to be competitive in the international trade and to use exchange rate intervention as policy tools for monetary policy to affect both foreign reserve position and domestic money supply.

More specifically, the objectives of Ethiopia's monetary policy are to:

- ✓ Foster monetary, credit and financial conditions conducive to orderly, balanced and sustained economic growth and development.
- ✓ Preserve the purchasing power of the national currency – ensuring that the level of money supply is generally consistent with developments in the macro- economy and intervening in the foreign exchange rate market for the purpose of stabilizing the rate when conditions necessitate.
- ✓ Encourage the mobilization of domestic and foreign savings and their efficient allocation for productive economic activities through the implementation of a prudent marketdriven interest rate policy.
- ✓ Facilitate the emergence of financial and capital markets that are capable of responding to the needs of the economy through appropriate policy measures. These measures would ensure the gradual introduction of trading instruments on a short-term basis.

III. Monetary Policy Strategy/Targeting Framework

Monetary policy strategy of a central bank depends on a number of factors that are unique and contextual to the country. Given the policy objective, any good strategy depends on the macroeconomic and the institutional structure of the economy. An important factor in this context is the degree of openness of the economy. The more open the economy is, the more the external sector plays a dominant role in monetary management.

Within a country's monetary management framework, there are basically three targets: the ultimate or final target, the intermediate target and the operating target.



3.1 Final and Intermediate targets

The final targets of monetary policy in Ethiopia are to maintain price and exchange rate stability and support sustainable economic growth. In achieving these objectives, the NBE sets money supply as an intermediate target. It should be noted that intermediate targets are not directly controlled by the central bank.

Traditionally, money supply is defined from its narrow and broader sense. Narrow money (M1) is a measure of money stock intended primarily for use in transactions. It consists of currency held by the public, traveler's checks, demand deposits and other checkable deposits. Broad Money (M2) is a measure of the domestic money supply that includes M1 plus Quasi-money (savings and time deposits), overnight repurchase agreements, and personal balances in money market accounts. Basically, M2 includes money that can be used for spending (M1) plus items that can be quickly converted to M1.

NBE takes the broader definition of money or M2 as money supply. The current target is to ensure that the money supply growth is in line with nominal GDP growth rate.

3.2 Operational target

The operational target is an economic variable that the central bank wants to influence, largely on a day-to-day basis, through its monetary policy instruments. They can be used to link instruments of monetary policy to intermediate targets set by the central bank and represent the first impulse in the transmission process of monetary policy. The growth of base money/reserve money is being used as operational target of the National Bank of Ethiopia. Reserve money (Base money) is defined as the sum of currency in circulation and deposits of commercial banks at NBE. The practice of targeting reserve money is based on the assumption that there will be a stable money demand function in the economy. If the money demand happens to be unstable over the medium to long term, then the NBE will shift its targeting in to another workable framework such as interest rate targeting or multiple indicator approach¹.

¹ Reserve Bank of India uses multiple indicator approach to monetary policy that provides a broad indicator of the stance of liquidity conditions. It uses indicators such as interest rate, exchange rates, fiscal and external positions and



In addition, the Bank shall maintain the international reserves at a level which, in its opinion, is adequate for Ethiopia's international transactions. In this regard, a minimum threshold at which foreign reserves are considered adequate is set at three months of imports of goods and services.

IV. Monetary Policy Instruments

The introduction of a wide range of monetary instruments by central banks engenders competition, efficiency and transparency and broadens financial intermediation in the banking system. It also promotes liquidity management of commercial banks and gradually leads to the development of well functioning money and financial markets which could serve as catalysts for economic growth and development.

So far, the use of such instruments has been extremely limited in Ethiopia due to the underdevelopment of the money market and the virtual non-existence of a financial market. Thus, it is envisaged to use a mix of diversified monetary policy instruments so as to effectively carry out the monetary management function of the NBE.

Open Market Operation (Sale & purchase of bonds or securities issued by governments) has generally been used by countries as one of the main instruments for the development of money markets. Trading in these instruments liquefies the financial system in particular and the national economy in general and increases financial intermediation among market participants. In light of this, the NBE will use open market operations (sale and purchase of government securities) as one of its monetary policy instruments. In the absence of its own securities, certain amount of government treasury bills needs to be allocated to NBE by the government for its monetary policy purpose. To prepare the ground for enhanced open market operations, the yield on government securities should be at least close to the minimum interest rate. As a next step, secondary market for government securities needs to be established.

flow of financial resources for purpose of monetary management. Multiple indicator approach has the advantages of basing monetary policy operations on a large set of information and providing flexibility in the conduct of monetary management.



A standing central bank credit facility is another instrument used to enhance the financial capacity of commercial banks and to promote financial intermediation and efficiency. The key advantages of such standing credit facility are transparency and predictability of accessing central banks' resources to cover short-term needs. This credit facility gives banks an assurance that, when confronted with problems of shortfall in the clearing and a lack of alternatives for raising immediate funds in the inter-bank market, they can settle the clearing with the central bank's funds at a reasonable interest rate which has a clear relationship with short term market interest rates. The NBE will use this facility as one of its monetary policy instrument.

Other monetary policy instruments used and to be used include:

- Reserve requirement
- Setting of floor deposit interest rate (until interest rate is fully deregulated)
- Direct borrowing/lending in the inter-bank money market and introducing re-purchase agreement (repo/reverse repo operations),
- Use of selected credit control when necessary, and
- Moral Suasion

V. Legal and Institutional Framework

5.1 Board of Directors

According to NBE Establishment proclamation No. 591/2008 (as amended), a Board of Directors composed of seven members governs the National Bank of Ethiopia. The Governor and Vice Governor of the Bank are as permanent ex-officio members while the Chairperson of

the Board of Directors as well as the remaining four members are to be appointed by the Government.

The Board of Directors plays a role in monetary policy formulation, as it is the highest decision making body of the Bank. To this end, the Monetary Policy Committee shall submit regular information & policy proposals to the Board regarding developments in the monetary sector, BOP,



exchange rate, price, interest rate and financial sector as well as the reasons for the proposed stance of monetary policy,. The Board of Directors will meet regularly at least once every three months and required within short intervals to discuss and decide on monetary policy stance. The monetary policy stance will be published as Monetary Policy Statement in hard copy and posted on NBE's website as per the pre-announced calendar. A press statement will also be given on the date of issuance of monetary policy statement.

5.2 Monetary Policy Committee

The Monetary Policy Committee (MPC) of the National Bank of Ethiopia is responsible for the periodic review of monetary, BOP, exchange rate, price, interest rate and financial sector developments of the country and propose monetary policy stance to the Bank's Board of Directors on regular basis as per a pre-announced calendar. The MPC will be chaired by the Governor of the Bank, and will have the following members:

- Chief Economist and Vice Governor of Monetary Stability (member and vice chairman);
- Vice Governor of Financial Stability (member);
- Vice Governor of Corporate Services (member),
- Senior Advisor to the Governor (member);
- Director of Foreign Exchange Monitoring and Reserve Management Directorate (member)
- Director of Monetary & Financial Analysis Directorate (member);
- Director of Bank Supervision (member); and
- Director of Economic Modeling and Policy Analysis Directorate (member and secretary).

The Governor may assign additional members to the MPC on the basis of their expertise in the area of monetary policy as the case may be.

The MPC meets quarterly based on a pre-announced calendar to deliberate on monetary policy matters. The Governor may also call for extraordinary MPC meetings at his/her discretion to discuss emerging domestic and global economic challenges. At each meeting, the committee shall take decisions on the appropriate stance of monetary policy for the next three months. The decision will be based on consensus unless it is absolutely necessary to take majority votes. If there is a tie, then the Governor shall have a final say.



During an MPC meeting, the Chief Economist makes presentations to the MPC on recent economic developments in the world and domestic economies, and on the inflation outlook. The MPC may also invite other professional staffs of the Bank to make additional presentations on selected issues. In terms of domestic economic developments, indicators such as the performance of the real sector, interest and exchange rate developments, the balance of payments, monetary aggregates, financial sector issues and fiscal trends will be taken into account.

As a routine activity of the Bank, all major economic and financial indicators will be monitored and the MPC briefed on these issues every quarter. These indicators include liquidity of the banking system, inflation and exchange rate trends, financial market developments, foreign exchange reserve position, real sector indicators, balance of payments, and fiscal trends. In addition, the Bank makes use of monthly and quarterly internal inflation forecasts. Forecasts will be based on price developments in selected commodities, using econometric methods. From time to time, the MPC may also request additional presentations relating to monetary policy, financial stability and reserve management issues by other invited staff of the Bank. However, only the views of MPC members shall be taken into consideration when making decisions on the stance of monetary policy. All decisions relating to monetary policy matters are taken by consensus. Where consensus does not emerge, the Chairperson will have the final say. Each member also needs to state his/her decision clearly, along with the reasons for taking such decision.

The MPC's Terms of Reference and Code of Conduct are attached as Annexes 1 and 2 respectively and the country's exchange rate regime as annex 3.

ANNEX 1: Terms of Reference of the National Bank of Ethiopia Monetary Policy Committee

1.1. Background

The Governor of the National Bank of Ethiopia, as chief executive officer of the Bank, has the right to establish committees to assist him/her in the implementation of the Bank's policies. In this



connection, the Governor hereby establishes a Monetary Policy Committee (MPC), responsible for the formulation of monetary and exchange rate policy of Ethiopia.

The MPC shall have the responsibility to discuss and formulate monetary and exchange rate policies, financial sector prudential regulation and supervision, and financial sector development of Ethiopia. Nevertheless, the ultimate responsibility for the soundness and effectiveness of monetary policy of the country rests with the Governor.

1.2 Composition of Monetary Policy Committee

The MPC shall consist of nine voting members and one non-voting member:

Voting members includes:- (a)

Governor, as chairperson;

(b) Chief Economist and Vice Governor of Monetary Stability as member and Vice Chairman;

(c) Vice Governor of Financial Stability as member;

(d) Vice Governor of Corporate Service as member;

(e) Senior Advisor to the Governor as member;

(f) Director of Foreign Exchange Monitoring and Reserve Management, as member;

(g) Director of Monetary & Financial Analysis as member;

(h) Director of Bank Supervision as member; and

(i) Director of Economic Modeling & Policy Analysis as member and secretary.

Non-voting members include:-

(a) Corporate Communications Officer (to prepare public announcements when necessary)

(b) Other staff to be invited by the Governor as necessary

1.3 Duties of Monetary Policy Committee

a) Major Duties



- Review international economic developments and evaluate their impact on the national economy;
- Review domestic economic conditions and assess their implication for monetary, exchange rate and prudential policies;
- Propose the country's financial and monetary policy stance;
- Recommend the general direction of exchange rate policy, given the prevailing economic, monetary, and financial circumstances;
- On the basis of the assessment of the existing financial conditions, recommend or determine policy measures on the financial sector and implement them;
- Study, review and evaluate the development of the country's financial sector and propose policies and measures that enhance the sector's short, medium and long-term developments.

b) Detailed Duties

- In assessing international economic developments, particular emphasis will be placed on the following developments:
 - ✓ Major commodity prices, particularly those of coffee, hides & leather and leather products, pulses, flowers, gold and chat etc
 - ✓ External foreign loans and grants ✓ Foreign direct and portfolio investment flows ✓ Merchandise trade flows ✓ Service Transactions ✓ Remittances
 - ✓ Tourism ✓ Foreign exchange movement of major trading partners ✓ International trade developments, etc
- In assessing domestic economic conditions, special attention will be given to the following:
 - ✓ Macroeconomic policy ✓ Overall and Sectoral development policies and strategies ✓ Fiscal policy ✓ Monetary developments ✓ Exchange rate developments



- ✓ Financial sector developments ✓ Domestic investment
- ✓ Foreign investment ✓ Inflation ✓ Unemployment ✓
- Exports and imports ✓ External loans and grants ✓
- Remittances, etc
- To formulate and propose monetary policy, ✓ Assess current headline and core inflation ✓ Forecast headline and core inflation ✓ Set acceptable inflation target
 - ✓ Evaluate current growth rates of monetary aggregates such as NFA and loans and advances to the government and private sector
 - ✓ Set compatible growth rate of monetary aggregates ✓
 - Evaluate current and forecasted GDP growth rate ✓
 - Perform other related tasks as may be necessary
- To formulate and propose exchange rate policy, ✓ Assess developments in nominal and real effective exchange rates ✓ Figure out the real equilibrium exchange rate
 - ✓ Determine the rate of nominal depreciation or appreciation which may be acceptable under the prevailing economic circumstances
 - ✓ Evaluate merits and demerits of various exchange rate regimes including a peg to USD and/or basket of currencies ✓ Determine the BOP transaction and the foreign exchange reserve target etc
- Regarding prudential regulation and supervision, of the financial sector:- ✓
 - Improve the existing macro prudential indicators for banks based on Basel Standards ✓ Develop appropriate prudential indicators for insurance and microfinance ✓ Determine criteria for upgrading microfinance institutions to rural banks, cooperative banks etc
 - ✓ Improve data access for regulatory and supervisory purposes ✓
 - Enhance regulatory, enforcement authority and capacity of the Bank ✓
 - Determine the instruments used for prudential supervision
- To promote financial sector development, ✓ Conduct in-depth studies to identify financial sector reform needs of the country ✓ Propose specific financial sector



reform measures including restructuring of existing state owned banks, introducing stock market, venture capital, modern payment systems, other security markets (both primary and secondary), lease finance, etc.

1.4 Time Allocation to MPC work and Adherence to Code of Conduct

Monetary Policy Committee members are expected to devote a significant portion of their time to monetary policy matters in addition to their normal duties and responsibilities.

Members of the Monetary Policy Committee shall at all times adhere to the MPC's Code of Conduct set out in Annex 2 of this document.

1.5 Frequency of meetings

The Monetary Policy Committee shall meet at least four times a year (on quarterly basis) to deliberate on monetary policy matters and related issues and make a proposal on the appropriate stance of monetary policy for the next three months. The dates of the monetary policy meetings shall be communicated in advance to all MPC members and the public at large. The Governor may call extraordinary meetings of the Monetary Policy Committee to discuss monetary policy issues. A minimum of five members present constitutes a quorum.

1.6 Manner of decision-making and Monetary Policy Proposal

Before submitting a proposal to the NBE Board for decision, the MPC shall decide on the form and content of the proposal on monetary policy matters based on consensus. The Chairman shall have a casting vote in case consensus does not emerge. Each member is expected to clearly state his/her decision and the reasons for taking such a decision.

1.7 Publication of Monetary Policy statement and Monetary Policy Review



After each meeting, the Monetary Policy Committee shall sign minutes of its deliberations which record those in attendance, provide summaries of the significant discussions and themes emerged, giving a sense of the nature and balance of opinion on key issues. Matters identified for future considerations shall also be recorded by the Secretary and properly filed. The final quarterly report of the MPC shall be submitted to the NBE Board for consideration and decision no later than five days after the date of the quarterly meeting of the MPC. After decision by the Board, the MPC shall publish the Monetary Policy Statement as per the pre-announced calendar, both in hard copy and on NBE's website. In addition, MPC shall annually publish a Monetary Policy Review conveying information about macro- economic, monetary, inflation and financial sector developments in Ethiopia and the actions taken by the Bank in due time.

ANNEX 2: NBE's Monetary Policy Committee Code of Conduct

2.1. Fundamental Principles and Core Values

Monetary Policy Committee (MPC) members shall act with loyalty, honesty, objectivity, impartiality and with the highest standards of professional ethics, diligence, good faith and integrity. They shall avoid any action, or inaction, which could in any way impair the Bank's capacity to carry out its duties, or compromise its standing in the community and its reputation for integrity, fairness, and honesty.

2.2 Conflict of Interest

(a) In the performance of their duties, MPC members shall avoid any situation that may give rise to a conflict of interest. No discrepancies may exist between a member's official responsibilities and any kind of personal or external interests which could jeopardize his or her impartiality and integrity in performing his or her responsibilities.

(b) MPC members may not undertake remunerated activities outside the Bank, without the consent of the Chairman and in accordance with the general rules and procedures of the Bank on



extra-mural activities. Remunerated activities that have a bearing on monetary policy matters must be avoided at all times. More especially, MPC members shall not become a shareholder, director, manager, or officer in any banking or other financial institutions during their tenor of membership.

2. 3. Immunity from Personal Liability

MPC members shall not be personally liable for any civil or criminal proceedings, arrest, imprisonment or damages for anything done in the discharge of their duties as MPC member unless it is established that it was done in bad faith.

2. 4. Compliance and Accountability

- (a) The Chairman of the MPC will monitor compliance with this Code of Conduct. If MPC members (or members of the public) become aware or suspect that a member(s) of the MPC has, or may have, contravened this Code, this information should be reported immediately to the Chairman of the MPC, preferably in writing and in a confidential manner. The Chairman shall initiate a mechanism to investigate the alleged breach of its own violation or upon request.
- (b) Deviation from the standards of this Code shall be dealt with as misconduct on the part of the member concerned and such a member will be disciplined in accordance with the rules and procedures of the Bank.
- (c) For the duration of any investigation into any allegation of a contravention of this Code, the Chairman of the MPC reserves the right to suspend the member concerned from carrying out duties for the MPC and the Bank.
- (d) Any investigation into a suspected or possible contravention of this Code shall be kept confidential.

2. 5. Independence

The MPC members shall not act as delegates or representatives of any interest groups or industry in the discharge of their duties.



2. 6. Confidentiality

Members of the MPC are required to maintain strict confidentiality of the information discussed at MPC meetings and not to divulge any confidential information obtained by members in the performance of their duties. Such confidentiality restriction shall be lifted one year after they have ceased to be members of the MPC. Members shall also avoid any situation where they might be perceived as having acted with the benefit of knowledge not available to the general market for their own interests.

ANNEX 3: Exchange Rate Regime

The exchange rate regime is the way a country manages its currency in respect to foreign currencies and the foreign exchange market. It is closely related to monetary policy and the two are generally dependent on many of the same factors.

There are various types of exchange rate regimes being practiced by countries. The main types include floating, pegged floating and fixed.

Floating Exchange Rate: They are the most common exchange rate regimes today. For example, the dollar, euro, yen, and British pound all float. However, since central banks frequently intervene to avoid excessive appreciation/depreciation, these regimes are often called *managed float* or a *dirty float*.

Pegged Floating Exchange Rate: Here, the currency is pegged to some band or value, either fixed or periodically adjusted. Pegged floats are:

- *Crawling bands:* the rate is allowed to fluctuate in a band around a central value, which is adjusted periodically. This is done at a preannounced rate or in a controlled way following economic indicators.
- *Crawling pegs:* Here, the rate itself is fixed, and adjusted as above.

Pegged with horizontal bands: The currency is allowed to fluctuate in a fixed band (bigger than 1%) around a central rate.



Fixed Exchange Rate: Fixed rates are those that have direct convertibility towards another currency. In case of a separate currency, also known as a currency board arrangement, the domestic currency is backed one to one by foreign reserves. A pegged currency with very small bands (< 1%) and countries that have adopted another country's currency and abandoned its own also fall under this category.

The choice of exchange rate regime is determined by various factors, such as the objectives pursued by the policy makers, the sources of shocks hitting the economy and the structural characteristics of the economy. But once the choice is made, the authorities are presumed to adjust their macroeconomic policies (especially fiscal and monetary policies) to fit the chosen exchange rate policy. Considering the underlying economic situation of the country, **managed floating exchange rate regime** is being practiced in Ethiopia since 1992. This exchange rate regime will continue to be adopted in the years to come.