



Implementing Monetary Policy through an Operating Interest Rate Target

(Translation of Annex 3 of the Inflation Report July- September 2007)

Banco de México's main objective is to safeguard the purchasing power of the Mexican currency. In order to accomplish its mandate of controlling inflation, the central bank must define an operating target to guide its implementation of monetary policy. Starting January 21, 2008, Banco de México will adopt as an operating target the overnight interbank rate (*tasa de fondeo bancario*) instead of the level of commercial banks' current account balances at the central bank (*corto*). This change does not affect Banco de México's monetary policy stance.

Background

Central banks' continuous assessment of both prices and the prospects for inflation is a key element in the conduct of monetary policy. Central banks also monitor the main economic variables that determine inflation, such as the international financial environment and the exchange rate; earnings, wages, employment and unit labor costs; aggregate supply and demand; administered and regulated prices; public finances; and, monetary and credit aggregates.¹

A central bank cannot directly control inflation or the key variables that determine it. However, central banks do have the necessary instruments to directly affect several nominal variables that, likewise, affect other determinants of inflation. This set of variables is known as "operating targets", and include, among others, short-term interest rates and commercial banks' current account balances at the central bank. The central bank must choose one of these targets to implement monetary policy.

Target Level for Commercial Banks' Current Account Balances at the Central Bank– the *Corto*

Since September 1995, Banco de México has implemented monetary policy through a target level for banks' current account balances at the central bank. The implementation of a neutral monetary policy under this framework involves providing or withdrawing liquidity, at market rates, so that banks' current accounts at the central bank equal zero at the end of the measurement period. When the central bank decides to maintain a restrictive policy, it announces a negative balance target, and for an accommodative monetary policy, a positive balance target.

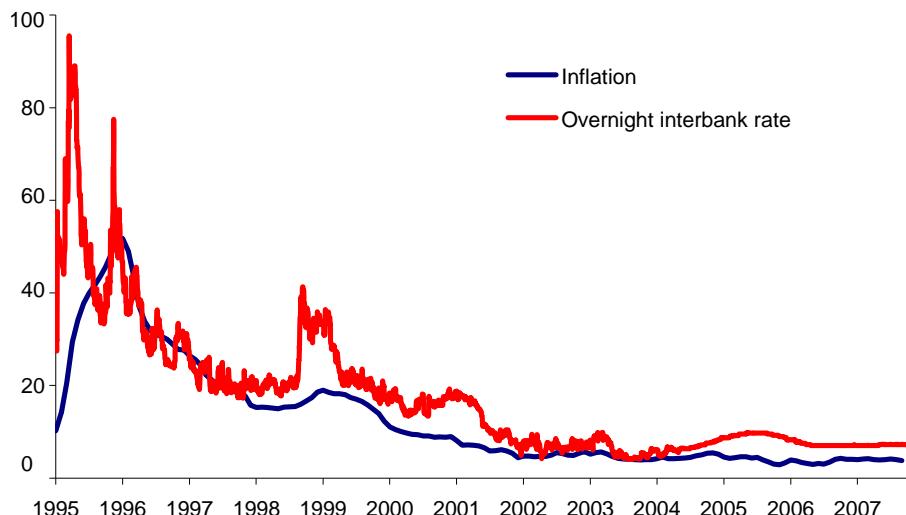
When a negative balance target (*corto*) is used, the central bank continues to provide all the liquidity needed by the financial system. However, part of this liquidity, the amount of the *corto*, is provided at above-market interest rates

¹ Monetary policy regimes conducted under an inflation targeting framework are based on the announcement of a multi-annual inflation target, on transparent monetary policy actions, extensive communication with the public, and, finally, on the systematic assessment of a broad set of indicators that provide information on the future path of inflation. Since 2001, Banco de México's monetary policy is conducted exclusively under this framework. For more details, see Monetary Program for 2001, p.57.

(the current penalty rate is twice the overnight interbank rate). This action pressures interest rates upward as banks try to obtain the funds through the interbank market to avoid paying the central bank's penalty rate.

Mexico's experience with the *corto* reveals that Banco de México's monetary policy stance was determined more by changes in the *corto* than by the specific level of the *corto*. Thus, an increase in the *corto* was interpreted as a tighter monetary policy stance, i.e., it signaled an increase in interest rates. In contrast, a reduction in the *corto* was interpreted as a more neutral stance, even though the level of the *corto* was not taken to zero.

Graph 1
Overnight Interbank Rate and Annual Inflation
Percent



Using a target level for commercial banks' current account balances at the central bank as an operating target has several advantages. First, monetary authorities do not have to determine a specific level for short-term interest rates. In Mexico, this was very convenient during years of high volatility in financial markets and when short-term interest rates were practically the only reference rates in the money market. Second, in an environment of decreasing inflation rates, a target level for banks' current account balances at the central bank allows interest rates to decrease in line with inflation expectations (Graph 1). This was the case of Mexico from 1995 to 2003, when annual inflation declined from 52% to 4%. Finally, the *corto* is efficient in allowing external and domestic shocks to be distributed between the exchange rate and interest rates. This feature is especially relevant when an economy is exposed to high inflation volatility.

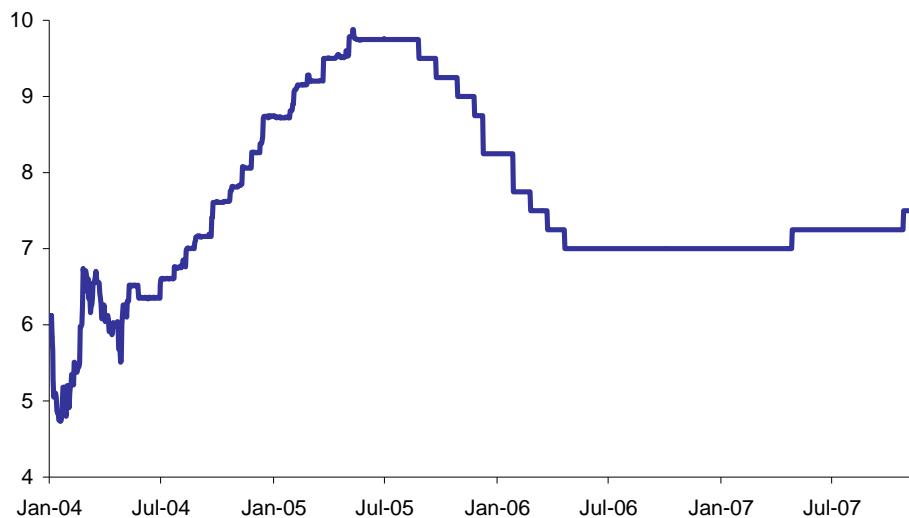
Once stability in financial markets and low inflation have been attained, the exclusive use of the *corto* to signal the monetary policy stance becomes less appropriate. In an environment of stable inflation, the desired level of interest rates needs to be specified more clearly. For this reason, and to strengthen monetary policy implementation, Banco de México implemented several measures conducive to the adoption of an operating interest rate target.

Transition to an Operating Interest Rate Target

Banco de México started modifying the implementation of its monetary policy in 2003. First, the target level for banks' current account balances at the central bank was no longer determined based on accumulated balances but instead on daily balances. In addition, Banco de México decided to announce its monetary policy stance on pre-established dates.²

In April 2004, the need to tighten monetary policy led Banco de México to announce, in addition to the level of the *corto*, specific levels of "monetary conditions" or interest rates. Through its press releases, Banco de México's signaling of an adjustment in monetary conditions led to a precise and stable adjustment of the overnight interbank rate (Graph 2).

Graph 2
Overnight Interbank Rate^{1/}
Percent



1/ July 2005, the graph shows the minimum level announced for monetary conditions.

Operating Interest Rate Target

Once macroeconomic stability has consolidated and greater financial deepening has been attained, establishing an operating target for interest rates is a natural step. The adoption of the overnight interbank rate as an operating target to substitute the *corto* concludes the transition that began in 2003. Since 2004, monetary policy announcements have set minimum interest rates, and the market has functioned *de facto* according to the interest rate signaled by Banco de México. Indeed, the last change in the overnight interbank rate associated with a change in the *corto* took place in February 2005. The formal transition to an operating interest rate target will thus be implemented without affecting Banco de México's current operations. This change will contribute to a better understanding of monetary policy actions and will standardize monetary policy implementation to that of several other central banks (Table 1).

² Although Banco de México has a preference for announcing changes in its monetary policy stance according to pre-established dates, just like any other central bank it reserves the right to announce them at any time.



Table 1
Operating Targets in Different Countries

	Target Interest Rate	Most Common Operating Instruments used in OMOs ¹	OMOs Rate ¹	Credit Facilities	Deposit Facilities
United States	Overnight interbank rate	Repos	Auction results	50 basis points above the target rate	Not remunerated
European Union	Minimum one-week refinancing credit rate	Repos	The European Central Bank sets a minimum auction rate	100 basis points above the minimum refinancing rate	100 basis points below the minimum refinancing rate
Canada	Overnight interbank rate	Repos	Auction results	25 basis points above the target rate	25 basis points below the target rate
Chile	Overnight interbank rate	Repos and auctions of promissory notes issued by the central bank	Auction results	By tranches from 0 to 400 basis points above the target rate	100 basis points below the target rate

1. OMOs: Open Market Operations.

Source: Central banks of U.S., Canada, and Chile, and European Central Bank (ECB).

Starting January 21, 2008, Banco de México will implement the following measures to formally adopt an operating interest rate target:

- The operating target for commercial banks' current account daily balances at Banco de México (*corto*) will stop being used and will be substituted by an operating target for the overnight interbank rate.
- Open market operations will be carried out with the aim of attaining a zero balance of banks' current accounts at Banco de México at the end of each day. Banco de México will continue to provide or withdraw all liquidity through these operations.
- The interest rate at which current account surpluses are remunerated will continue to be zero. The rate charged on banks' overdrafts will continue to be twice the overnight interbank rate.

These modifications do not imply a change in Banco de México's monetary policy stance. As mentioned in previous paragraphs, since the beginning of 2005 Banco de México has not signaled its monetary policy stance through changes in the *corto*.

Table 2 summarizes the main features of Banco de México's current implementation of monetary policy and the changes that will take effect starting January 21, 2008.



**Table 2
Operating Targets in Mexico**

Target Interest Rate	Most Common Operating Instruments used in OMOs ¹	OMOs Rate ¹	Credit Facilities	Deposit Facilities
Currently <i>Does not apply. The stance of monetary policy is announced through changes in both banks' current account daily balances and monetary conditions</i>	Auctions of credits, deposits, and repos	Auction results	Twice the overnight interbank rate	Not remunerated
Starting January 2008 <i>Overnight interbank rate</i>	Auctions of credits, deposits, and repos	Auction results	Twice the overnight interbank rate	Not remunerated

1. OMOs: Open Market Operations.