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III. Monetary Policy and Management[1]

A. Introduction

1. Eritrea's central bank, the Bank of Eritrea (BE), was established by a temporary proclamation (No. 32/1993) following independence in 1993. Prior to the introduction of the national currency, the nakfa, in November 1997, Eritrea was in a de facto currency union with Ethiopia—using the Ethiopian birr as the legal tender. In March 1997, the Bank of Eritrea Proclamation (No. 93/1997, hereafter "the Proclamation") was enacted and superseded the temporary 1993 Proclamation.[2] The Proclamation was intended to provide for an independent central bank, with expanded powers to issue a legal tender and conduct monetary policy with a broad set of instruments, as well as to license, regulate, and supervise financial institutions.

2. This section begins with a brief description of the financial sector and policy environment for the BE. It then undertakes an assessment of key aspects of the Proclamation and its implementation with respect to their implications for central bank independence, and discusses the main factors that have affected actual monetary management of the BE. While the Proclamation contains many provisions that are in line with best practices in central bank legislation, there are a number of areas that could be strengthened or modified to enhance the autonomy, transparency, and accountability of the BE. Furthermore, it appears that the Proclamation as it stands now would have to be strictly enforced to achieve greater authority and independence of the BE in the conduct of monetary policy. Finally, it is observed that the effectiveness of monetary management is constrained by such factors as the lack of a well-defined monetary policy framework and effective instruments.

B. The Eritrean Financial Sector

3. Eritrea's financial sector is small and relatively underdeveloped, offering only a limited range of financial services to the public. The sector is dominated by the three commercial banks, only two of which accept deposits. The government-owned Commercial Bank of Eritrea (CBE), with a share of more than 80 percent of deposits and domestic lending, is by far the largest bank in the country and provides the bulk of the basic commercial banking services. The Housing and Commerce Bank of Eritrea (HCBE) is majority owned by the ruling party, and about 85 percent of its loans are related to housing projects. The Eritrean Development and Investment Bank (EDIB) was established in 1998 to meet the long-term development finance needs of the private sector. It is owned by the government and does not take deposits. The other major players in the financial sector are the National Insurance Corporation of Eritrea (NICE), which covers a limited range of insurance activities, and about 30 licensed foreign exchange bureaus, dominated by the party-owned

[1] Prepared by Shuang Ding.

[2] A Financial Institutions Proclamation (No. 94/1997) was also passed in March 1997. It provides for the role and obligations of the financial institutions that are tailored to the functions of the BE, to facilitate an effective and efficient regulation of the financial system.

Himbol, which has accounted, on average, for some 75 percent of foreign exchange operations over the past couple of years.

4. The structure of the financial sector has resulted in a lack of competition—a situation further undermined by the fact that its institutions are not always guided by commercial criteria. Recommendations by the Fund and others to privatize the CBE, in full or in part, have not been successful. In the meantime, it appears unlikely that a foreign bank will establish a presence in Eritrea in the near future because of its precarious economic situation. In these circumstances, the authorities see no immediate alternative but to strengthen the existing banks by restructuring and consolidations.

5. For most of the period since the introduction of the nakfa, the banking system has had abundant liquidity, reflecting in large part the high level of transfers from the Eritrean diaspora and the absence of alternative savings instruments. At the same time, commercial banks have adopted very conservative banking practices and have been reluctant to provide credit to the private sector in the absence of appropriate collateral or established loan service track records. Lending opportunities have been further reduced in the aftermath of the war with Ethiopia, which caused a massive displacement of population and damage to property. Reflecting these developments, all commercial banks maintained substantial excess reserves with the BE until the sharp increase in credit to government during and after the war. In this situation, and given the small number of banks and their ownership pattern, there was no scope for the development of money and capital markets.

C. Statutory Role of the BE

Key aspects of the proclamation vis-à-vis best practices[3]

Objectives of the BE

6. Article 5 of the Proclamation sets out the safeguarding of the value of the national currency as the principal policy objective for the BE.[4] The article also provides more specific objectives, such as pursuing stability in prices, maintaining a sound exchange rate policy, fostering economic growth, and promoting a sound financial system, but it does so without prioritization of these objectives.

[3] The comparison undertaken below is based; the IMF's Code of Good Practices on Transparency in Monetary and Financial Policies: Declaration of Principles; the Supporting Document to the Code, Part 2—Good Transparency Practices for Monetary Policy by Central Banks. The authorities agree in principle with most of the issues raised in the paper. They have separately reviewed the existing provisions of the Proclamation and are considering possible modifications, as described below.

[4] Article 5 provides that "the principal objective of the Bank shall be to manage money and credit in the Eritrean economy, subject to the provisions of this Proclamation with the purpose of safeguarding the value of the national currency."

7. Although all of these objectives are interrelated to varying degrees, the objectives of price stability and economic growth may at times conflict. Formulation of a priority objective helps to minimize conflicts between objectives and simplifies the policymaking and decision-making process of the central bank. Furthermore, a clearly defined objective enhances predictability, transparency, and accountability. Price stability is generally considered the best contribution monetary policy can make to macroeconomic stability and sustainable economic growth.

Relationship with the government

8. Article 6 of the Proclamation establishes the broad principles governing the central bank's relationship with the government, especially the independence of the central bank to perform its functions.[5] Part XI—Relation with the Government—deals with such a relationship in more detail. In particular, it specifies the BE's role as banker of the government and the BE's advances to the government, as well as the issue of government securities.

9. However, some arrangements under Part XI have the potential to undermine the autonomy of the central bank. Article 30 allows the BE to make temporary advances to the government that do not exceed 25 percent of the estimated annual revenues of the government in any fiscal year, at such rates of interest as may be specified by the BE. This limit on short-term financing of government operations is quite high by international standards and, together with the possibility of BE purchases of long-term government bonds, could give rise to significant monetary growth and inflationary pressure.[6] In countries with well-developed money markets, such credit is normally limited to the acquisition of short-term marketable government securities through the secondary market only. The government can also consider resorting to the banking system or to the public for deficit financing to limit its debt to the central bank.

10. Article 31 allows the BE to subscribe, hold, and sell shares of an entity set up with the approval or under the authority of the government for the purpose of financial sector development. This provision would generally be seen as problematic because it not only raises possible conflicts for monetary policy, but also introduces quasi-fiscal operations and costs to the central bank.

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[5] Article 6 provides that "(1) the Bank shall support the general economic objectives of the Government within the limits of its principal monetary objective; (2) the Bank shall be independent from and not be subject to instructions by the Government in performing its functions, determining its budget, and setting its procedures."

[6] Article 31 provides that "the total amount of securities with maturity exceeding two years, other than securities held by the Bank as collateral or held as a result of open market operations of the Bank...may not at any time exceed 10 percent of the estimated annual budget revenues of the Government for the current fiscal year."

11. Article 32 allows the central bank to guarantee government or government-guaranteed external debt upon the request of the government. Central banks are normally not obliged to provide such guarantees, since these operations could increase the potential for risk and losses, reduce fiscal transparency and accountability, and limit or encumber the availability of the foreign exchange reserves entrusted to the central bank. When activated, these guarantees also have the potential to significantly increase the central bank's claims on the government.

Management and governance

12. Under the Proclamation, the Board of Directors of the BE consists of the Governor, the Deputy Governor, a representative of the Minister of Finance, the Auditor General, and three other members. The Governor and Deputy Governor are appointed for five years by the President with the approval of the national legislature; the terms of the Governor and Deputy Governor are staggered. The three unspecified members of the Board are nominated from a list of nine candidates prepared jointly by the first four Board members; they are appointed by the President for initial terms of three years, after which reappointment is possible.

13. International best practices generally propose that the terms of office of the Governor and the Board be longer than the election cycle of the entity with the predominant role in appointment. The goal is to enhance the autonomy of the central bank by detaching the appointment of its governing body from the national political cycle. Based on these arguments, the term of three years for the appointed members of the Board in Eritrea seems overly short. In addition, while it is not unusual to have the Auditor General and a representative of the Ministry of Finance on the Board, this practice can involve a potential conflict of interest and undermine the BE's independence, especially if the Directors have direct responsibility for ongoing policy decisions. In countries like Germany, by contrast, a representative of the Ministry of Finance is regularly invited to attend the Board meeting and can make statements and give recommendations, but does not possess voting rights.[7]

14. The Proclamation also stipulates that the Governor can be relieved of his duty by the President for "just cause" after consultation with the national legislature. The Deputy Governor can be removed for "just cause" by the President on the advice of the Governor and the recommendation of the Board. Board members lose their status if they are convicted for fraud or similar offenses or if it is demonstrated that they are unable or unfit to perform their duties.

15. The phrase "just cause" is a rather vague definition for an important decision like the removal of the most senior central bank officials. Internationally, it is more common to establish more specific grounds for removal, such as misconduct or incapacity. The same grounds for removal should apply to the Board. In both cases, it is essential to leave no room

[7] The BE has proposed a minimum term of office of five years for the members of the Board. It has also suggested limiting government representation to one member from the Ministry of Finance, while increasing representation from the private sector.

for removal on account of general dissatisfaction or disagreement with policies. Otherwise, the removal authority could be used to undermine the autonomy of the central bank.

Monetary policy instruments

16. Part X of the Proclamation—Monetary Functions—sets out the monetary policy instruments, such as rediscount, open market operations, interest rate, and reserve requirements, that can be used to influence monetary conditions, including the supply of money and credit.

17. Article 25 allows the BE to issue its own securities to provide a basis for open market operations. Studies on open market instruments show that the central bank may incur substantial costs if large issuance is needed to sterilize liquidity. Moreover, if central bank bills are used in parallel with treasury bills, policy conflicts may occur in the absence of close coordination. A preferred approach would be to have the BE conduct open market operations with appropriately designed treasury bills.

18. Article 26 permits the BE to determine and differentiate, in consultation with the government, the terms and conditions for loans and deposits of commercial banks. Within the monetary policy framework established by the central bank, interest rates should ideally be determined by market forces, because administrative intervention could create distortions in the level and allocation of savings and investment. It could also constrain portfolio choices and magnify risks in financial institutions. The authorities argue that, while the BE may issue directives on such terms and conditions as the maximum period of term deposits and collateral waiver for small loans, banks are free to set their interest rates.

19. Article 27 entitles the BE to impose reserve requirements on financial institutions and inflict penalty charges for noncompliance. Reserve assets are defined as cash in vault and deposits at the BE. The Legal Reserve Requirements Regulation (Directive No. 8/2000) requires deposit-taking institutions in Eritrea to hold reserve assets of at least 20 percent of all local currency deposits without remuneration. Attainment of this internationally high ratio was for a long time no problem for Eritrean banks because they were highly liquid. In fact, banks even held substantial excess reserves on top of the required reserves. More recently, however, the large financing needs of government have made compliance with the 2000 directive difficult. In response, the BE issued Directive No. 1/2002 in November 2002, under which the reserve requirements have been reduced to 10 percent.[8]

20. Unremunerated reserve requirements are equivalent to a tax on financial intermediation. Such a tax may result in a widening of the spread between lending and deposit rates, which can lead to disintermediation. While the BE recognizes these potential problems, it is not in favor of remuneration for reserves because, as discussed above, commercial banks in Eritrea had a tendency of building up excess reserves in the past even

[8] Simultaneously, the BE issued Directive No. 2/2002, which prescribes liquid asset requirements of 10 percent to be maintained by banks, including in the form of unencumbered government securities.

though the reserves were not remunerated. The risk of disintermediation was, therefore, not a concern of the BE. However, the authorities may need to reconsider the issue especially when some of the structural constraints on loan extension, such as collateral requirements, are eliminated and commercial banks begin to run down their excess reserves to meet increased demand for credit from the private sector. In addition, consideration may have to be given to requiring reserves on deposits held in foreign currencies, in order to avoid problems for commercial banks in managing liquidity and foreign exchange risks, especially when foreign currency deposits account for a significant portion of deposits.

Regulation and supervision of financial institutions

21. The legal framework for prudential regulation and supervision of banks and other financial institutions is primarily set out in the Financial Institutions Proclamation.[9] However, prudential supervision is also covered in the BE Proclamation, especially in Part XII—Relations with and Supervision of Financial Institutions—which gives the BE the power to supervise all financial institutions. Article 35 of the Proclamation provides the basis for the BE's lender-of-last-resort function, but most other provisions relate to matters of supervision and overlap with provisions contained in the Financial Institutions Proclamation. It is generally considered preferable for all provisions on prudential supervision to be consolidated in the Financial Institutions Proclamation, thus clearly distinguishing between the BE's roles as a supervisor and a lender-of-last-resort. International best practices require that central banks lend only on a temporary basis against highly liquid and safe collateral and only to solvent but temporarily illiquid banks. It is usually up to the government to provide financing, if it is needed to avoid a systemic crisis.

Actual implementation of the proclamation

22. The BE has made important progress in implementing the Proclamation and developing supporting regulations. However, practices that appear to be incompatible with the central bank law have raised the following issues:

- In conflict with the intentions of the Proclamation, the BE remains the main source of financing of the fiscal deficit. This reflects a combination of factors, such as the conflict with Ethiopia, the food crisis, and ambitious development objectives, all of which have increased the financing needs of government. In fact, although the Proclamation limits the government's borrowing from the BE at 25 percent of the estimated government revenue in any fiscal year, the ceiling was breached in 1999 when BE advances to government exceeded 100 percent of government revenues (see Figure III. 1).[10] The limit was surpassed again in 2002: when BE advances to the

[9] See in particular Part III on licensing, Part IV on prudential requirements, Part VI on prudential regulations, Part VII on prudential exposure limits, and Part XII on liquidation of institutions.

[10] Actual government revenues are used as a proxy for estimated government revenues.

government amounted to about 60 percent of government revenues at the end of that year.

- The Proclamation provides for the capital of the BE to be equivalent to US$10 million, to be subscribed and exclusively held by the government. The subscribed capital of the BE now actually amounts to ERN 6.1 million, or less than US$ 0.5 million, based on the official exchange rate. However, total capital, including the central and legal reserve fund and the income account, exceeds the statutory minimum.

- The Proclamation allows the BE to impose penalty charges on any financial institution that fails to maintain the required reserves. However, although the CBE had been defaulting in its maintenance of required reserves before the reduction of reserve requirements in November 2002, the BE did not take any corrective action to bring the CBE into compliance.

Central bank independence

23. Central bank independence is a key element for the effectiveness of monetary policy and management, as well as the achievement of price stability, which has increasingly been accepted as the primary objective of a central bank. Through delegation of the authority over formulation and implementation of monetary policy to an autonomous central bank, the credibility of monetary policy can be improved significantly and expectations rationalized.

24. While the Proclamation explicitly states that the BE shall be independent from, and not subject to instructions by, the government, some of the provisions of the Proclamation have the potential of weakening the independence of the BE and thereby undermining its capacity to conduct policy in line with stated policy objectives:

- The objectives of the BE are not prioritized, leaving room for the pursuit of potentially conflicting objectives, such as economic growth and overall development, which are not the key responsibility of a central bank. In order to achieve a clearly defined objective, preferably price stability, the BE needs to have the autonomy to pursue this objective without outside interference.

- The limit on BE financing of government operations appears high and could undermine the BE's ability to control the growth of money supply.

- The government's apparent ability to exert, for political reasons, substantial influence on the appointment and removal of top officials and Board members of the BE could undermine the independence of the BE and its policymaking and decision-making process.

- Because the BE needs to consult the government in setting the interest rate policy, it lacks full instrument independence. Sufficient authority and adequate instruments are both crucial for the central bank to manage monetary conditions so as to meet its responsibility.

25. Independence is not an objective in itself. It serves the purpose of assigning the monetary policy instruments to the institution—the central bank—that is best suited to *achieve the domestic and external stability of the currency in the context of overall economic* policy. An indispensable complement to independence is credibility, which requires transparency and accountability. To achieve and maintain independence, it is therefore necessary to report regularly on the policies of the central bank and submit them to the judgment of outsiders. On this subject, much remains to be done in Eritrea.

D. Implementation of Monetary Policy

26. Although the Proclamation provides for an independent central bank and establishes the safeguarding of the value of the national currency as its objective, monetary policy has, soon after the creation of the BE, become captive to fiscal policy. Until late 1998, government domestic borrowing was entirely financed directly from the BE. At the end of 1998, approximately two-thirds of the related stock of debt was securitized into short-term treasury bills and issued to the CBE, thereby, significantly reducing excess liquidity in the banking system. Since then, the government has continued to run large fiscal deficits in connection with the conflict with Ethiopia and other special developments, and these deficits have been increasingly financed by domestic credit and money creation (see Table III.1).

27. The implementation of monetary policy has also been hampered by the lack of an analytically sound and transparent monetary framework, which makes it difficult to assess the performance of the central bank. The BE does not announce and explain its monetary policy objectives. In particular, it does not state its objectives for inflation and the exchange rate, which, if both were met, would achieve the objective of preserving the value of the currency. It is, therefore, not clear whether monetary policy pursues these objectives, aims to control the growth of a monetary aggregate—such as broad money, in the case of Eritrea—or simply responds to incidental factors, including the financing needs of the government. But even if a specific objective is pursued, it is not clear within which analytical framework that pursuit takes place and which key economic variables matter.

28. For example, if an inflation objective is pursued, is this done by targeting a monetary aggregate as an intermediate target? If so, has the relationship between the intermediate target and inflation proved substantially stable? To what extent have the large increase in the money multiplier and decline in velocity (see Table III.1) influenced the actual targeting and implementation of monetary policy? Moreover, to what extent do such developments as movements in the external current account of the balance of payments, foreign reserves, and the exchange rate (official and parallel) matter?

29. All in all, whichever monetary policy objectives were pursued in recent years, they were dominated by the need to finance large fiscal deficits that seemed unsustainable (fiscal deficits exceeded 30 percent of GDP in the past five years). As a result, reserve money growth was increasingly fueled by the BE's claims on the government (net claims on the government are now roughly 80 percent of reserve money). Additional effects were inflation rates deemed high by current international standards, large trade deficits (consistently over 60 percent of GDP), a rapid fall in the official exchange rate of the nakfa and the emergence

of a parallel market indicating even deeper depreciation, and a drop in the level of international reserves to less than one month of imports (see Table III.1).

30. The conduct of monetary policy is further complicated by the BE's lack of effective tools for controlling the monetary base. Currently, the BE uses mainly the statutory reserve requirements, interest rates, and the sale of government treasury bills as instruments to influence monetary conditions.

31. Reserve requirements are currently the main tool of monetary policy available to the BE. Owing to the high level of excess liquidity in the banking system, reserve requirements had until early 2001 no meaningful impact on the activities of the banks. However, as the BE moved government debt and borrowing to the commercial banks and the CBE transferred its debt in birr to the government,[11] excess liquidity in the banking system kept declining until the recent reduction in reserve requirements. On the one hand, a reduction in the liquidity of banks would increase the effectiveness of the monetary policy instruments. On the other hand, with declining bank liquidity, the deficits of the government would have to be financed increasingly by the BE, thereby further depleting its low level of foreign reserves. Moreover, an expansionary fiscal policy would in this case be more likely to crowd out private sector borrowing, which was not an issue when the banking system had substantial excess reserves.

32. Lending rates continue to be capped by a provision in the Civil Code that mandates that all loan contracts must carry an interest rate not exceeding 12 percent per annum.[12] There is, therefore, a conflict between the Civil Code and the need to conduct effective monetary policy and foster financial sector development. In particular, this conflict has helped generate interest rates that are at times highly negative in real terms. Until interest rates are liberalized and driven by market forces, their usefulness as an intermediate target of monetary policy will be limited.

33. The issuance of treasury bills to the commercial banks has the effect of absorbing excess liquidity in the banking system. The increase in treasury bill holdings by commercial banks also paves the way for the introduction of two-way open market operations as a new instrument of monetary policy. However, several issues need to be addressed before open market operations can become an effective tool:

- The current system for treasury bill sales is not a true auction system because of the small number of transactions and the heavy hand government is taking in its operation. As a result, it appears to operate like a long-term lending window for the government, and its parameters are not known. For effective monetary management,

[11] In June 2001, the government assumed the debt of the CBE to the Commercial Bank of Ethiopia. The CBE made a corresponding payment to the government by drawing down its reserves at the BE.

[12] In the proposed amendments to the Proclamation, the BE envisages introducing a provision to the effect that the Proclamation will prevail when provisions in any other laws are inconsistent with its provisions.

it is essential to introduce a transparent auctioning system that reflects the unfettered portfolio decisions of a greater number of banks.

- Interest paid on treasury bills is administratively set at 2.5 percent and is, therefore, in conflict with the notion of an "auction." It is clearly not market determined and provides the banks with a poor rate of return.[13] A willingness to accept market-based interest rates and to pay such rates on government debt is central to the success of open market operations. While adoption of market-based rates will have implications for the government's cost of borrowing, it would promote financial sector development and stability and improve the profitability of commercial banks.

- The current 180-day bill structure does not provide sufficient variety of term, portfolio, and liquidity management options.

- Without a liquid and deep secondary market for treasury bills, open market operations lack flexibility in terms of the amount and timing of intervention because they can be carried out only in the primary market through treasury bill issues and redemptions.

34. Given the limited scope for effective use of monetary policy instruments in the current financial sector setting, the achievement of price stability and avoidance of foreign reserve losses would, above all, require the maintenance of a prudent fiscal stance to avoid large domestic financing.[14]

35. An additional problem in Eritrea is the weak link between monetary and exchange rate policies. Currently, it appears that no attempt is being made to make the two policies coherent and thereby support both domestic and external policy objectives. Having started with a "managed floating" system, Eritrea has now de facto adopted a pegged exchange rate. Normally, under such a regime, the monetary authorities have to relinquish control over money supply since they are committed to intervening in the foreign exchange market to defend the exchange rate in case changes in domestic credit generate an excess supply of, or demand for, money. In Eritrea, however, the impact of the exchange rate regime on monetary policy is muted for a number of reasons:[15]

- Eritrea maintains restrictions on the current account payments (Article XIV status). The BE is, therefore, not obliged to provide foreign exchange for current account transactions at the official exchange rate. In addition, the foreign exchange market is

[13] However, to the extent that the purchases of treasury bills are financed by drawing down excess reserves that are not remunerated at all, they will increase bank profitability.

[14] It could be argued, of course, that the excess liquidity in the system should not remain idle. However, this argument would carry more weight if its use would be only for investment purposes, and not for consumption of government.

[15] For a fuller evaluation of the exchange rate regime of Eritrea, see the companion selected issues paper "Exchange Rate Policy and Management."

monopolistic, and foreign exchange bureaus are not selling foreign currencies in the retail market. They also appear to be selective in their sales of foreign currencies.

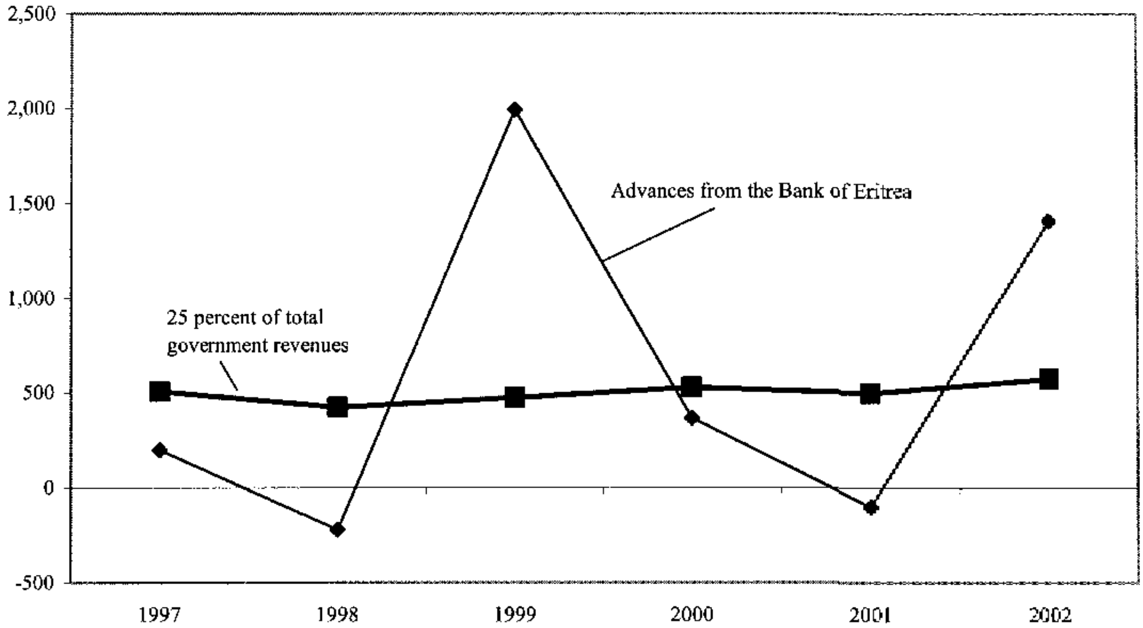
- Significant excess demand for foreign exchange has resulted in the emergence of a parallel market that carries an exchange rate premium as large as 60 percent. It appears that a large portion of foreign exchange transactions are now conducted in the unofficial market—a development that introduced a certain degree of flexibility into the current system, although in an undesirable way.

36. A further problem for monetary management and financial sector stability is that the state-controlled banking sector is burdened with a high ratio of nonperforming loans, owing to war-related payment problems and poor risk evaluation. This situation poses a considerable challenge for the BE in implementing its monetary policy, especially when there is a need to tighten the monetary condition.

E. Tentative Conclusions

37. On balance, monetary management in Eritrea has been constrained by a certain lack of independence of the central bank, the absence of a transparent and analytically sound monetary policy framework, and the absence of effective monetary instruments for a financial sector that is, in addition, characterized by monopolistic structures. The difficult financial condition of the banking sector also limits the scope for effective monetary policy. In addition, the low level of foreign reserves severely restricts the conduct of an independent monetary policy. Finally, the consistency of monetary and exchange rate policies is undermined by the substantial interventions of the government in both the distribution of domestic credit in favor of fiscal deficit financing and the operations of foreign exchange dealers in allocating scarce foreign exchange. As the country moves to peacetime economic management, well-sequenced reforms are called for, in order to enhance the independence of monetary policy and the effectiveness of monetary management.

Figure III.1. Eritrea: Bank of Eritrea's Advances to the Government, 1997-2002
(In millions of nakfa)



Sources: Eritrean authorities; and staff estimates.