Monetary policy framework of Central bank of Montenegro

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Summary

The Central Bank of Montenegro is very specific central bank that operates within the euroisation regime. Its monetary policy objectives and instruments are specific in such a regime. The main monetary policy objective, which is also defined by the Constitution, is to preserve the financial stability.

When it comes to price stability, it is envisaged by the law that the CBCG contributes to the accomplishment of price stability. The reason for these somewhat specific objectives is reflected in the absence of monetary policy instruments, i.e. low efficiency of the existing instruments. Given that the CBCG is not an issuing central bank, it does not have reference interest rate. Carrying out open market operations is possible in theory in this regime, if capital and reserves available to the CBCG are used. However, bearing in mind their limitations, this instrument has not been used in practice so far. Also, there are several different credit lines for liquidity support to banks. The only real monetary policy instrument is reserve requirement.

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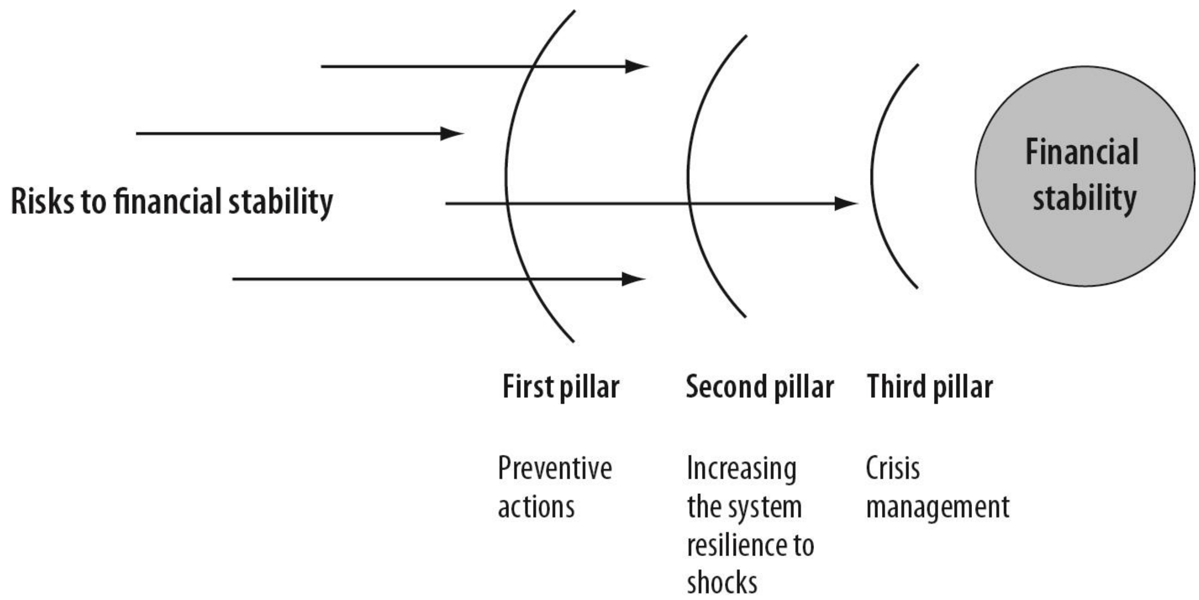
Maintaining financial stability in Montenegro can be described via three lines of defence. The first line is prevention, the second one is increasing the system's resilience to shocks, and the third line is crisis management. All three dimensions are equally important.

Figure 3 – Three-dimensional approach to preserving financial stability



The CBCG has developed mechanisms to monitor and preserve financial stability. The key challenges that the CBCG is facing in the implementation of the framework for preserving financial stability include: limited instruments, the absence of reliable time series, and some experience in the implementation of this framework. The key threat to financial stability is a relatively high level of non-performing loans.

Maintaining confidence into the banking sector is of vital importance to avoid massive bank run and maintain the financial sector stability. Fast payout to depositors and limiting negative economic effects of bank bankruptcy or liquidation on the remaining portion of the banking sector may boost public confidence. Quick bank resolution implies lower costs and the loss of assets and franchise values is minimised. Allowing problem banks to continue operations causes market disruptions and increases moral hazard and costs of problem bank resolution. In order to prevent or at least mitigate crisis in some banks, the CBCG may provide liquidity support to solvent banks to ensure regular settling of their operations or, in exceptional circumstances, when it assesses that providing financial assistance is necessary to prevent aggravation of the banking sector's stability and soundness.

We have, also, established Financial Stability Council (FSC). The Council is chaired by the Governor of the CBCG, and the members are also the Minister of Finance, the President of the Securities and Exchange Commission and the President of the Council of the Insurance Supervision Agency. The FSC is the point of discussion about all potential risks to the financial stability and coordinates activities for preserving financial stability. The FSC passed the National Contingency Plan and the proposal of the Lex Specialis to be sent for adoption to the Parliament in case of a crisis, which would increase the rights of institutions included in the financial crisis resolution. Moreover, the Law allows the use of additional instruments other than those prescribed under the existing legislation.

Regarding the inflation as the traditional objective of the central bank our clear conclusion is that we cannot affect inflation with the existing monetary policy instruments. However, the euroisation system, in the conditions of highly open and liberal economy looks like a kind of self-balancing mechanism. This means that if the inflation rate is viewed in longer period, it actually is on the average inflation rate in the Euro area. Broken down by individual years, deviations are evident in both directions, but in long-term, the inflation rate returns to the Euro area average. This means that there are time lags, which are not long.