Liquidity Management and Effectiveness of Monetary Policy in Central African Economic and Monetary Community (CEMAC) 1980 – 2009.

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Abstract

Liquidity management in Central African Economic and Monetary Community (CEMAC) *has been poor because of difficulties in harmonizing monetary and fiscal policy, lack of money market and monetary market integration in the region, weak underdeveloped and non-competitive banking system, differentiated reserve requirement across the countries of the region, underdeveloped financial instrument and problem with the payment system. As a result liquidity management has not been able to avert inadequate or excess liquidity in the region and in member countries. The region has been characterized in most cases by excess liquidity where-by broad money stock often overshoots its target. This is due to deposits into banks of aids and foreign exchange earnings from oil, banks hold reserves more than those mandated by law, there is lack of functioning money, interbank, capital and bonds market in the region and banks have higher yield on reserves than they do on loans. These have undermined the monetary policy transmission mechanism of monetary policy and thus the effectiveness of monetary policy. This study has merits on several folds. There is knowledge gap regarding the empirical literature for the region. Most of the studies in the area and in the region are on liquidity effect on monetary policy – (Cyrille, 2010; Christiano and Eichenbaum, 1991, 1992a, 1992b, 1995; Edmond and Weill, 2005; Fuesrt, 1992; Guirsgius, 1999; Leeper and Gordon, 1992 and Lucas, 1990. Others are on excess liquidity and effectiveness of monetary policy, for example (Saxegaard 2006; Kamgna and Ndambendia, 2008; Agenor, 2010; Belke et al., 2008 and European Central Bank (ECB) 2008). Some are on liquidity management but however theoretical in nature (Adebisi, 1988 and Ariyo, 2004). Despite the importance of liquidity management very few empirical studies exist in the region. For ensuring the effectiveness of liquidity management function, most studies examine the response of liquidity shocks on real Gross Domestic Product (GDP), Consumer Price Index (CPI) and neglecting the development in the labour market proxied by unemployment. As regards the estimation technique and or the diagnostic test, most studies in the region and the area did not use alternative ordering and identification schemes for their model. This reduces policy options for monetary authorities in the region. The Vector Autoregressive (VAR) impulse and variance decomposition that were used, only captured non-policy variables and* neglected policy variables. For all the studies the VAR Lagrange multiplier (LM) test and the tracking power of the models were not performed. This has implications for results and policy options for the region. This current study is out to fill these gaps. The objectives of this paper are three folds (i) to examine the impact of the liquidity management on effectiveness of monetary policy in the region (ii) to examine the causes of excess liquidity in the region (iii) to examine the impact of excess liquidity on effectiveness of monetary policy in the region. To realize these objectives we carry out diagnostic tests - stationarity test, LM test for VAR models and select the lag length for VAR using the appropriate criteria. We also examine the tracking power of the models. Structural and recursive VAR and structural and recursive identification schemes were adapted from previous studies. The report from the VAR technique that was used for this study are impulse response, variance decomposition and cointegration.

The results show that liquidity management has not been effective in managing monetary policy. This is shown by the sluggish response of these policies of real GDP, CPI and unemployment given a liquidity shock at both the regional and member countries level. The result also confirmed wide range of causes of excess liquidity in the region. Again, excess liquidity has not been effective in monetary policy effectiveness. This is also shown by weak response of real GDP, CPI, unemployment and the monetary system as a whole to liquidity shocks. The long-run relationships and the speed of adjustment are weak at the regional and countries level. There is need for adequate liquidity management especially those that take into account alternative ordering and identification schemes, unemployment and country specific need if regional integration is to be strengthened in CEMAC.

***Key words**: Monetary Policy, VAR, Liquidity Management, Excess liquidity*