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Promotional Role of Central Banks in Developing Countries

Prepared by Anand G. Chandavarkar 1/

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Abstract

The literature on central banks neglects their promotional role whose rationale derives from the correction of financial market failures and externalities of financial intermediation. This paper analyses the rationale and such modalities of the promotional role as preferential interest and rediscount rates and guarantees. It argues that monetary stability and a liberal financial system are necessary conditions for promotional activities, that central bank credit subsidies should not be open-ended, and that they are not a substitute for genuine savings in financing development. The central bank's promotional stance is best viewed as that of a catalyst and innovator rather than of a participant in development.

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Summary

This paper maintains that the rationale of central banking has been argued too exclusively in terms of control of the banking system even though historically and logically development precedes control. Once the banking system has attained a critical threshold of development, the monetary, prudential, and promotional policies of a central bank tend to be concurrent rather than sequential. Since the major instruments of central banking can function both as instruments of credit control and of development, there is no necessary one-to-one relationship between instruments and targets. The promotional role of a central bank derives from a combination of factors. First, developing countries are prone to financial market failures that can be corrected only by the central bank. Second, the externalities of financial intermediation cannot be generated by the unaided efforts of the private sector. Finally, the central bank has a unique public policy role as a macroeconomic think tank for technocratic research, information, and advice to the public and private sectors and for training of financial manpower.

The paper argues that a stable and liberal monetary system and climate are essential prerequisites for the promotional role of a central bank. Their maintenance is, however, a continuing task given the oligopolistic tendencies of most financial systems. A central bank's expertise, status, and influence rather than its formal powers define its promotional role, which is not merely one of passively adapting its techniques to suit the changing economic structure but of actively modifying the financial structure itself to promote development. There are many promotional techniques, such as guarantees and insurance mechanisms, preferential interest and rediscount rates and facilities, differential reserve requirements, credit-deposit ratio targets, participation in development finance institutions, open market operations, and allocation of central bank profits and credit. Central bank profits or credit are not substitutes for genuine savings of the public for financing development. The central bank is best viewed as a catalyst and innovator, a Platonic guardian and curator of the financial system rather than a perennial participant in development finance institutions.

I. Introduction

"Central banks...must be quick to adapt their methods to suit the changing economic structure...they must be perspicacious and versatile" Sayers (1948).

"...where banking habits touch only a minor part of the economy, the contribution that a central bank can make to development is more important than what it can do in the way of stabilization." Ursula Hicks (1962).

This paper analyses the rationale, modalities, and implications of the promotional role of central banks in relation to the financial structure and economic development, including the harmonization of the monetary, regulatory, prudential, and developmental functions and objectives. It addresses the following main interlinked issues in order to assess "the contribution that central banking may make towards the healthy and speedy development of the economy." [Sayers, 1961, p. 33]

(a) "Should the central bank in a developing economy ...confine itself to the negative function of ensuring that no monetary sickness impedes the progress of industrial and commercial development?"

(b) "Or should it strive itself to make some positive contribution, stimulating enterprise in particularly important directions?"

(c) "And what should be the scope, in terms of institutions, of its activities?"

(d) "Should its contacts be limited to a narrow group of commercial banks, or should its parish include a wide range of financial intermediaries?"

(e) "Should it be, in the phrase of an English banker, primarily a bank or primarily a study group?"

(f) "And finally, should it be accorded some special independence of authority within the broad machinery of government?"

In the early days of a central bank the accent has necessarily to be on the development of a banking system to control because this is not only a logical order but also the typical historical sequence in underdeveloped countries. However, the issue is not simply that "once stabilization has been achieved, should it perhaps be the aim of the central bank to keep out of the way, merely ensuring that no financial crisis impedes the efforts of the enterprising builders of the country's industry and trade?" [Sayers, 1957, p. 34]. This is because once the banking system has attained a certain critical threshold of development the stabilization and developmental objectives and policies of a central bank tend to be necessarily concurrent rather than sequential. Consequently they pose problems of harmonization insofar as the two basic objectives may conflict. Even in the developmental sphere the role of a central bank should be viewed as not merely one of passively adapting the techniques of central banking to "suit the changing economic structure" [Sayers], but of actively changing and modifying the financial structure itself to promote development.

There is now a sufficient body of experience to be able to assess whether central banks in developing countries have responded to the following challenges [Brimmer, 1971, pp. 781-82]:

(1) "While not ignoring their traditional tasks - taken innovative steps to encourage economic development?

(2) "...been able to alter the flow of credit in favor of development needs?"

(3) "...assisted in creating institutions specifically designed to provide development finance?"

(4) " ...succeeded in efforts to encourage the mobilization of savings by private financial institutions?"

(5) " ... used their proximity to the centers of political power to advise their governments as to the importance of monetary and fiscal stability in creating a climate conducive to investment and economic growth?"

(6) "Finally, what is the record of success, and of disappointment, harvested by these central banks in the struggle for economic development?"

II. Promotional Objectives

Central bank objectives may be broadly classified into: (a) the tactical or conjunctural objectives of short-or-medium monetary stabilization; and (b) the strategic or promotional objectives, including distributive and welfare objectives, relating to the development of the financial structure and improving the credit access of under-banked sectors. The conjunctural objectives are spelt out in all central bank statutes, whereas the promotional and developmental objectives are stated explicitly usually in the case of the developing countries and, exceptionally, in developed countries. For instance, in the U.S.A., where the Federal Reserve Act enjoins the Board of Governors and the Federal Open Market Committee to "maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates" (Section 2A.1). The Federal Reserve Act also specifies that the Board of Governors should act "in furtherance of the purposes of the Full Employment and Balanced Growth Act of 1948." In contrast, the statutes of the two oldest central banks, the Riksbank (Sweden) and the Bank of England do not specify any promotional goals of central banking. Nevertheless, the absence of reference to promotional objectives has not inhibited central banks in developed countries from using monetary policies to implement basic national economic goals. For instance, central banks in Italy, Japan, the Netherlands, Sweden and West Germany have used various techniques such as asset reserve requirements and government borrowing and relending to preferred sectors (with or without interest subsidies) such as housing, agriculture, exports, small business, and underdeveloped regions. Such promotional techniques are sought to be justified on the grounds that these are typically the sectors which tend to suffer disproportionately from credit restrictions in deflationary policies (See the Staff Report of the U.S. Committee on Banking and Currency 92d Congress, Second Session on "Foreign Experience with Monetary Policies to Promote Economic and Social Priority Programs" 1972). The Swedish Riksbank is an outstanding example of a central bank which has always played an active role in promoting various economic and social programs for preferred and priority sectors, such as housing, principally through asset reserve requirements. Similarly, the Bank of England which, historically, has always taken a very broad view of the central bank as the "Curator of Financial Organization", took novel initiatives in establishing specialized institutions like the Industrial and Commercial Finance Corporation, the Finance Corporation for Industry, the Securities Management Trust, and the Bankers Industrial Development Company [Sayers 1976]. Admittedly, central bankers are no less prone to fallacies of "misplaced concreteness" than other economic practitioners but it is much too sweeping a generalization to say that "as in other cases of economic development policy, central banks in developing countries have an unfortunate tendency to mistake bank legislation and regulation on advanced-country lines for financial development itself." [Harry Johnson, 1973]. In assessing their promotional role the central banks of developing countries have to be judged by their revealed practice rather than by the scope of their statutes. Happily, their promotional practices have usually been ahead of the letter of their laws which suggests that central banks, given the will and commitment, usually *have adequate implicit discretionary power to fulfil promotional* objectives. The statutes of the newer central banks and monetary authorities established in the 1970s and 1980s, with the technical assistance of the IMF, have specific provisions for promotional roles (e.g., Bhutan, Botswana, Fiji, Maldives, Solomon Islands, Swaziland, Vanuatu). The more basic problem is that central bankers seem to be subject to rather prolonged lags between perception and implementation even when they have the necessary legal mandate. For instance, the Statutory Report of the Reserve Bank of India, (under Section 55 (1)(G), 1938) observed: "During a period of financial development such as exists in India today, it may be desirable for Central Bank credit to be made available in a larger number of ways and with less restrictions than when the financial structure is more complete" (p. 35). But it was not until the 1950s that the Reserve Bank of India embarked on its promotional and developmental activities.

More than statutes and formal powers it is the central bank's status, expertise, and influence, in relation to the government, developmental agencies and the financial community, which defines its promotional opportunity-set as a regulator, innovator, participant, guarantor, and catalyst of financial development. Although a central bank generates profits it cannot be regarded as a profit centre concerned with the maximization of profits. Rather, a central bank's primary objective as a bureau is to create and maintain over time an opportunityset which enables it the maximum scope for discretionary control, as well as for innovation, in relation to the financial system. Central bank activities and policies, whether regulatory or developmental, are too diversified to be analyzed through a unitary paradigm. They are more meaningfully approached as a unique and complex amalgam of the theory of bureaucracy [Downs 1967, Chant and Acheson 1972], theory of public choice (Breton, 1966), principal-agent models, and welfare economics. A central bank may be regarded as a highly specialized autonomous bureau for monitoring and developing the financial system which is akin to an 'octopoid', i.e., spatially spread, public utility selling priced services. In other respects it acts as the agent of its principal (the Government), as, for instance, as the Government's banker. All these complementary conceptual models are relevant in assessing the scope and efficacy of the promotional role of central banks. On the other hand, the conventional dichotomy of instruments and targets is liable to be seriously blurred in evaluating central banking techniques, policies and objectives. For one thing, as the Radcliffe Committee (U.K.) rightly observed: "There is no single objective by which all monetary policy can be conditioned" (Para 980 Report, Cmnd 827 of 1959) since various desirable objectives such as stable prices and full employment might conflict with each other and in such conjunctures the authorities have to reconcile the claims of one objective as against the other. Nor is there a necessary one-to-one relationship between a monetary instrument and a target in developing countries where the same instrument can have multiple targets. Thus, the major instruments of central banking policy like variation of reserve ratios, open market operations, bank rate policy, selective credit controls, portfolio targets, rediscount and refinance facilities, and moral suasion can function concurrently as instruments of credit control as well as development policy. It is only some instruments like the shifting of government balances between the central and commercial banks or the use of margin requirements which could be said to have a purely monetary role. It is also possible for a multiplicity of instruments to achieve targets that could technically be achieved by one instrument so as "to obscure the ultimate thrust of its policy." A classic example is the Bank of Canada's use of transfers of government deposits between itself and the chartered (commercial) banks as a more covert action than open market operations because they do not have a direct impact on the security market.

(Chant and Acheson, 1972). Moreover, since changes in government balances can also occur for reasons other than monetary policy it is correspondingly more difficult to determine the use of this instrument for monetary policy.

III. The Developmental Rationale of Central Banks

The rationale of central banking has been argued too exclusively in terms of control and regulation of the monetary system even though historically development precedes control. [See Vera Smith 1936, Victor Morgan, 1943] The promotional and developmental rationale of a central bank was first clearly stated by Keynes in his classic work on Indian Currency and Finance (1913) and related writings. [See Chandavarkar, 1985]. Surprisingly, despite the subsequent steady creation of central banks in emergent countries, the literature on central banking, barring a few exceptions, [Sayers [1956 and 1965], Chandler (1962), Brimmer (1971) and Bhatt (1974)], has been too narrowly focussed on problems of monetary policy to the neglect of its promotional and developmental role. Even the pioneering study of Sen on "Central Banking in Undeveloped Money Markets" (1952) did not analyse the promotional role of central banks until its fourth revised edition (1967).

The promotional role of central banks derives from a combination of the following factors:

Even in developed economies it has been noticed that passivity on the part of the central bank does not ensure the neutrality of monetary policy. Consequently, the absence of formal credit priority programs does not mean that priorities will not be created. The large corporate business sector effectively functions as the preferred sector for credit in all industrialized countries which suffers least even when it is the primary target of credit restrictions. It is the other sectors which therefore "suffer disproportionately from policies designed to deflate the economy." (Staff Report of U.S. Committee on Banking and Currency, 1972, op.cit., p. iii). This line of argument is even more cogent and persuasive in respect of developing countries, which have low financial intermediation ratios and are also more prone to financial market failures. These can only be remedied by the central bank as part of a coherent strategy of widening and deepening of financial intermediation and savings mobilization, involving greater maturity transformation, enlargement of portfolio choices of savers and investors, the reduction of transaction and information costs, and the redress of sectoral and regional financial imbalances (i.e. the so-called Urban Bias of the developing countries). Such externalities of financial intermediation cannot be generated by the unaided efforts of the private sector. The central bank can also be viewed as an appropriate agency for administering the necessary, but not open-ended, 'grant' element in the financial system reflecting the accepted principle of cross-subsidization of weaker by stronger groups. The differential advantages of the central bank as a unique strategically placed macroeconomic think-tank for conducting and disseminating technocratic research, information and disinterested advice to the public and private sectors and for financial man-power also underscore its promotional role.

IV. Modalities of the Promotional Role

1. Financial liberalization

A congenial financial and monetary climate is an essential pre-requisite for the promotional role of a central bank. This implies the elimination of the "financial repression" syndrome, defined as the cumulative repressive effects of microeconomic and macroeconomic factors such as usury laws, bank reserve requirements, credit controls, credit subsidies, discounting privileges, and inflation which interact to reduce and misallocate scarce capital. Such "repression" is said to be "the rule rather than the exception in less developed countries." [McKinnon, November 1984, p. 3]. However, financial repression, like all portmanteau concepts, has to be carefully evaluated, since not all its constituents are equally repressive in intent and substance. While interest rate ceilings act as repressive factors by generating negative rates of return to savers and the indiscriminate subsidization of borrowers, reserve ratio requirements cannot be wholly regarded as a source of repression. They are an essential instrument of prudential control of commercial banks by the central bank, and the variation of reserve ratios is possibly the most efficacious single instrument of monetary policy in developing countries. The earmarking of a specified proportion of reserve assets for preferred assets of a developmental character or the prescription of differential reserve requirements according to the regional location of banks and branches (as in Mexico) so as to help the regional spread of banking, points to the promotional aspects of this instrument. Insofar as commercial bank reserves are non-interest bearing they do constitute an implicit tax on commercial banks and may therefore contribute partially to financial repression. Thus, the variation of reserve ratios serves the role of a monetary instrument as well as a promotional device.

The McKinnon definition of financial repression does not allow for the prevalence of restrictions on the entry and licensing of new banking units and financial institutions which is customarily the case in most developing countries. The banking industry does not enjoy the freedom of 'contestable' markets, i.e., of entry and exit, which is a necessary condition of a liberal system. Even if licensing of domestic entrants into the banking industry is comparatively liberal there are usually severe restrictions, if not an outright bar, on the entry of foreign units into the financial services sector, a matter which has now come up before GATT at the instance of some developed countries who would like to extend free trade to all types of cross-border services. The crucial issue is: Can the developing countries afford free international trade in financial services as a concomitant of domestic financial liberalization? The McKinnon definition of financial repression applies, strictly, to the organized financial sector in the developing countries. The substantial informal financial sector in developing countries is anything but repressed being exempt from all the controls applicable to the banking industry like capital and reserve requirements, interest and portfolio ceilings, selective credit controls, rediscount privileges, industrial relation awards, and even moral suasion by the central banks! (Chandavarkar, 1985). The McKinnon definition also overlooks that insofar as the organized financial sector in developing countries is subject to comparatively high ratios of concentration of ownership, indicative of monopolistic and oligopolistic elements, it poses problems of maintaining an effectively competitive financial system. Is it possible for central banks to maintain competitiveness in the financial sector given such structural peculiarities? The maintenance of a liberal financial system cannot be treated *as a onceover exercise in policy. It is a continuing task for the* central bank.

It has been critically remarked that central banks in developing countries "tend to trust to the subsidization of credit for purposes deemed socially worthy--in this case, development projects--to achieve the desired results." [Harry Johnson, 1973]. This raises the question whether all forms of credit subsidies like differential interest rates (e.g., India, or Bangladesh), preferential rediscount rates and refinancing facilities to the so-called priority sectors like housing, export finance, agriculture, cottage industries, co-operatives, small business, etc., are to be regarded as distortions in the efficient allocation of credit and capital. Subsidies can serve legitimate developmental and distributive objectives provided they are not open-ended and the benefits outweigh the costs. There is therefore nothing reprehensible in the cross-subsidization per se through the financial system of weaker groups by the government or the central bank, a principle which is embodied in all forms of transfer payments through the fiscal machinery in modern societies. A more difficult policy issue is whether within a subsidized category the more affluent groups should merit equal subsidization with the poorer groups. It is important that all forms of credit subsidies be kept under constant review so as to provide for timely graduation of their recipients to normal unsubsidized status somewhat on the analogy of the "graduation" principle of the International Development Association (IDA). Some appropriate variant of this principle could be applied to credit subsidies to groups and individuals within the group. An interesting mechanism for control of credit subsidies for priority loans "which are of benefit to the social economy, while not of obvious economic benefit to the enterprise" is provided for in Section 43 of the statute of the People's Bank of China, according to which "the interest rate that is to be subsidized shall be defrayed by the area or department approving the interest subsidy." Thus the onus of credit subsidies is shifted from the central bank to the approving area or institution. In addition, the relative merits of credit and non-credit subsidies also need to be carefully evaluated. The promotional role of central banks therefore implies a constant review and cost-benefit analysis of the preferential treatment of different types of commercial bank assets and all forms of credit in accordance with changing scale of developmental priorities. But most central banks do not seem to provide for effective control and review of credit subsidies. The operation of selective credit controls also raises the problem of reconciling such controls with developmental objectives insofar as preferred categories of borrowers like co-operatives, exporters, small-scale businesses, etc, are exempted from credit controls. The same conflict or trade-off can arise in respect of open market operations insofar as the requirements of credit policy may conflict with the needs of fostering a continuous wide and active market for government securities through repurchase agreements, etc.

2. Regulatory and prudential role

A central bank's traditional role as the regulator and monitor of the financial system as well as the lender of last resort to the banking system highlights its concomitant prudential functions and responsibilities. The central bank has to provide a safety net for the financial system, while monitoring the operations of financial intermediaries to ensure that they do not transgress the limits of financial prudence and pose systemic risks. In addition to the protection of depositors through mechanisms like deposit insurance, a central bank exercises its prudential functions through periodic inspection and supervision of commercial banks and in some cases specified types of non-bank financial intermediaries like finance companies. Such functions have a promotional angle insofar as the insurance of bank deposits and the inspection and supervision of financial intermediaries promote the banking habit and help financial intermediation by inspiring greater public confidence in financial institutions.

The prudential responsibilities of central banks raise several policy and organizational issues. The system of formal deposit insurance has been adopted in very few developing countries like the Philippines and India. [See Ian McCarthy, 1980] Most of them rely on an implicit policy of the central bank not to let financial institutions fail. Central banks should however, examine the merits and feasibility of establishing deposit insurance in countries which do not have such systems. Even in countries which have long-established systems of deposit insurance there are still several unresolved issues, notably whether it is meaningful to retain it in respect of the deposits of nationalized commercial banks since these are effectively the liabilities of the national government. Likewise, it is important to stress that logically deposit insurance merits extension to all the liabilities of not only commercial banks but also the liabilities of all non-bank financial intermediaries. Deposit insurance has also to be under constant review to extend coverage to new types of institutions and instruments and to ensure that the limits of deposit insurance are adjusted to the pace of inflation. Consequently, deposit insurance cannot be regarded as a once-for-all exercise. Equally, it is important not to exaggerate the importance of deposit insurance which is basically an instrument of protection for the small saver, a principle which is embodied in the establishment of maximum limits to deposit insurance.

It is far more important for a central bank to ensure the financial health of intermediaries through timely and effective inspection and supervision procedures so that liquidity problems are not accentuated into insolvency situations. Likewise, the scope of central bank inspection and supervision, as also its obligations as a lender of last resort, should be extended to all non-bank financial intermediaries and not be limited to commercial banks. Traditionally, central bank inspection and supervision of banks has been much too orthodox, being geared to ensuring narrow compliance with banking laws, and with an overriding concern with monitoring of conventional quantitative banking ratios rather than with the quality of bank assets. In fact central banks in developing countries should revamp inspection and supervision procedures to give them a more developmental orientation rather than narrowly focussing on accounting and legal matters. Indonesia is a good example where banking supervision has also been "directed towards the development of a sound and effective banking system to support the national development objectives." (Bank Indonesia, Report for the Financial Year, 1983/84, p.30). Although bank examination and supervision are widespread in the developing countries, it is said that "its effectiveness as an instrument to reassure and attract savers is uneven" because of the widely varying standards used and their uneven enforcement. [Brimmer 1971, p. 784.] Complete reporting of the full exposure of each bank and of each bank's customers could be of material help in better banking and better protection of depositors.

The role of the central bank as a lender of last resort assumes a critical position in the event that liquidity crises are transformed into solvency crises which imposes the consequent obligation on the central bank to ensure that unit failures do not pose systemic risks. The central bank as a lender of last resort in effect underwrites the commercial banking system and provides a strong base of public confidence for its developmental role. Even developed countries have found it necessary to provide official support, either directly or indirectly, through the Treasury or the Central Bank to bail-out troubled industrial and banking firms, whose failure could have posed serious macroeconomic consequences as, for instance, in the U.S.A. (Lockheed, Chrysler, and Continental Illinois Bank) and Britain (Shell Oil Company Group). This aspect of central banking, although in no sense legally obligatory, has come to acquire a virtually mandatory imperative. This also raises wider issues of socialization of large risks and the enlargement of 'moral hazard.' The dangers of moral hazard, however, should not be exaggerated inasmuch as large units do not knowingly incur risks of probable failure and bankruptcy. The failures of small firms or banks may not warrant the same type of central bank intervention as they do not pose systemic risks.

Another conspicuous gap in the prudential network of developing countries, is the lack of an adequate unified machinery for the protection of the investor through monitoring of the capital and stock markets on the lines of the SEC in the USA or the newly constituted Securities and Investment Board in the U.K.. The case for establishment of an effective machinery is all the stronger because of the absence of adequate 'self-policing'. This is a gap which might well be filled through central bank initiatives, which should by law and in practice be adequately represented on the capital issues committees and the boards of stock exchanges.

There is one other area where the prudential and developmental roles of the central bank overlap, namely, the use of credit guarantee mechanisms by the central bank in respect of specified types of private lending by commercial banks. A number of central banks (e.g., India, Indonesia, Malaysia, Nepal, and Sri Lanka) have helped to establish institutions to guarantee loans made by commercial banks to small enterprises in specified sectors. Such guarantee institutions have played an influential role in improving the access of small borrowers to organized finance by eliminating or deemphasizing collateral based transactions and have proved to be a very useful channel of development finance. Although no systematic cost-benefit analyses of such guarantee mechanisms have been made taking into account factors such as defaults, write-offs of bad loans, the available evidence is sufficiently demonstrative of their success. Thus, in the case of Malaysia benefits are said to outstrip costs by 7.2 percent. [Rimal 1984, p. 10] The dangers of moral hazard under this scheme in Malaysia seem to have been largely averted because of the ownership stake of the commercial banks in the institution. In fact, it might even be desirable for the central bank not to participate in the ownership of such institutions and to vest it wholly on the lending bankers. On the whole, judging by their claims experience, such schemes have been successful in reaching under-banked strata of the populalation. However, like other central banking promotional activities they need to be kept under review not only for possible enlargement of their scope but, equally, to hive off categories which are no longer in need of special treatment.

3. Advisory, research, and training activities

Insofar as a central bank can be regarded as a highly autonomous bureau, rather than as the agent of a principal (i.e., the government), it constitutes a unique source of disinterested technocratic advice to both the treasury and the development agency, a role which was most memorably phrased by Governor Montagu Norman of the Bank of England as long ago as 1926 when publicly discussing the sensitive issue of the relationship between the central bank and the government.

> "I look upon the Bank as having the unique right to offer advice and to press such advice even to the point of nagging; but always of course subject to the supreme authority of the government." (Royal Commission on Indian Currency and Finance, Minutes of Evidence, Vol. V, 1926, Non-Parliamentary Question 14597)

This function and responsibility of a central bank in a developing economy acquires an even sharper focus in regard not only to the maintenance of monetary stability through informal and public admonition of governmental deficit financing but also in suggesting avenues of promoting an efficient and dynamic financial structure. A central bank in a developing economy is uniquely placed to provide a highly skilled and continuous research, economic intelligence, and independent advisory service to the government, development agencies, and to the financial community at large, by virtue, of its role as a market operator as well as an honest broker and intermediary between the public and private sectors. Above all, "If it is well equipped for its technical tasks... it can focus opinion, and yet defer, without loss of dignity, to the judgment of the nation through its central political machine" [Sayers, 1961, p. 45]. In states which have federal constitutions it is equally important for a central bank to remain in close and constant contact with the state or provincial governments, to tackle problems like those posed by the overdrafts of the State Governments to the Reserve Bank of India.

There are, however, some major desiderata to be fulfilled in order to enhance the advisory role of central banks. To begin with, central banks must ask themselves: Are they making the most efficacious use of their own economic research departments? Are these treated as a "frills" department, or as an integral part of a central bank's monetary and developmental responsibilities? Does the Economic Adviser have independent access to the Governor and the Board of Directors, as for instance, by being allowed to participate in the deliberations of the Board but without the right to vote on decisions, as for instance in the case of the Central Bank of the Philippines and Sri Lanka. Under Article II (Section 11) of the Central Bank Act of the Philippines "the ranking deputy governor...and the chief of the Department of Economic Research shall attend the meetings of the Monetary Board with the right to be heard but not to vote." Such provisions safeguard the quality and independence of advice without involving advisers in bureaucratic games of "second-guessing" the views of the powers-that-be! Unless the economic unit of a central bank has the requisite independence in addition to expertise, the credibility and influence of the central bank, in turn, with the treasury and the development agency is liable to be seriously eroded. As a minimum, a central bank should have formal and informal channels of communication and representation on joint organs of decisionmaking involving the Treasury, and the development agency, and, in federations, the state governments.

Among the informational activities of a central bank, the scope of credit information bureau should be extended beyond the conventional monitoring of credit lines to large customers in the context of credit controls to promote the ends of development finance. A central bank must also strive to identify areas of research with a bearing on developmental problems, as for instance, the development of an intermediate financial technology, the regional impact of monetary policy, constant review of the Negotiable Instruments Act to accommodate new financial instruments, the scope for central bank rediscounting traditional credit instruments (e.g., the hundis in India and the 'cek putih' in Indonesia), bad and doubtful debts experience of commercial banks and co-operatives (drawing on the records of the central bank's inspection and supervision departments), scope for new techniques and instruments like lease financing, relative merits of overdrafts and term loans, promotion of project related credit in place of collateral-oriented credit, replacement of the "token" by "teller" systems for cash withdrawals from banks, and development of efficient and economical clearing and remittance facilities. A central bank's research should focus more on the macroeconomic aspects of financial intermediation, while issues relating to the x-efficiency of financial institutions are best left to their respective research outfits. The part allocation of central bank profits to developmental finance raises the issue: whether the profits of seigniorage and deficit financing can be a legitimate and economically defensible source of development finance. Floating exchange rates also pose the problem of choosing the invoicing currency so as to optimize foreign exchange advantages to the economy. The choice of invoicing currencies by individual exporters and importers, which is determined by individual profit and convenience considerations, may not be necessarily to the country's advantage. For instance, a country's foreign trade may continue to be invoiced for reasons of history, tradition, etc., in depreciating currencies whereas its external liabilities may tend to be invoiced in appreciating currencies. In such circumstances the central bank may need to play a positive role in optimising the choice of invoicing currencies.

The training and development of financial man-power constitutes a special responsibility of central banks considering that this is by far the most critical bottleneck in the extending financial intermediation, much more so than premises and equipment. The training programs and institutions run by central banks merit constant review so as to ensure that basic skills of financial personnel keep pace with financial and technological innovation and deregulation, as distinct from thhe on-the-job skills which are best left to individual banks and institutions. Given the 'externalities' of such training and education individual banks do not find it worth their while to offer basic training to financial personnel. Central bank training facilities for personnel in the financial sector are an apt example of the macroeconomic benefits of investment in human capital.

An important and allied but sadly neglected area of central bank research and policy is the impact of information technology on the man-power requirements of the financial services sector. There does not seem to have been any systematic study of this problem in developing economies on the lines of studies in Great Britain. (Amin Rajan and Geoffrey Cooke, 1986). The principal conclusions of this study are significant. First, it shows that information technology need not necessarily destroy jobs. Second, the employment question is a complex process whose net impact depends upon the relative strengths of 'accelerators' (i.e., technological and economic factors hastening replacement of man-power) and 'moderators' (i.e., factors which more than offset the displacement of labor like the generation of additional business as a result of automation, etc.). Third, employment in the financial sector in the U.K. grew annually at 2 percent in the decade 1975-85 when business growth averaged 8 percent. This study also noted that Japan, "the second largest information technology-using nation has an enviable unemployment rate of only 2 percent" because "of a number of moderators in its favor".

In addition, a central bank can play a constructive role in the conciliation and arbitration of industrial disputes in the banking industry by acting as an independent technical assessors, particularly in judging the overall capacity of the banking industry to pay judicially determined wage-rates and emoluments. Industrial peace in the key financial sector is an essential part of overall incomes and growth policies.

4. The central bank as a catalyst and innovator

The promotional role of the central bank is crucial in financial development in terms of filling the gaps in the financial structure in respect of instruments, institutions, markets, and personnel. This role should be envisaged in terms of active 'supply leading' initiatives rather than passive 'demand-following' responses considering that the financial system, which is a special species of public utility, could be said to be predicated on the dictum that "facilities create traffic." Then again, on the analogy of efficient public utilities, financial institutions need a certain cushion of "excess capacity" to cope with not only seasonal peaks--seasonality of monetary aggregates is a feature of developing countries--but also to ease the adjustment to the long-term structural growth of the real sector. A central bank's promotional strategy has to be flexible and innovative in identifying current and prospective market failures and gaps, as well as in matching the flow of savings from the predominant household sector to the investment demands of the corporate and government sectors. In other words, a central bank has to be both an innovator as well as a catalyst in its promotional role for which there is a wide variety of formal techniques available in addition to moral suasion (see Table 1).

Table 1. Promotional Techniques of Selected Asian Central Banks

Instruments	Bangladesh	China	India	Indonesia	Korea	Malaysia	Nepal	Pakistan	Phili-pines	Sri Lanka	Thailand
Savings Policy Units	x			x	x				x		
Deposit Insurance			x						x		
Credit Guarantee and Insurance Schemes	x		x	x		x	x		x	x	
Participation in Capital and Management of Development Institutions	x		x	x	x	x		x	x	x	x
Portfolio Targets for Priority Sectors			x	x	x	x				x	
Differential Interest Rates	x	x	x			x	x			x	
Preferential Rediscount Rates and Facilities	x		x	x			x	x	x	x	x
Differential Reserve Requirements											
Repurchase Agreements									x		x
Allocation of Central Bank Profits	x		x		x		x	x	x	x	
Open Market Operations			x	x		x		x	x	x	x
Target Credit-Deposit Ratios for Rural Branches			x				x		x	x	x
Credit Bureau	x		x	x	x		x	x	x		

Note: The country information in this table is incomplete. It covers instruments that have been in use at one time or another.

It is noteworthy that in some countries, notably in Latin America, central banks, which were initially assigned specific commercial and development banking tasks, subsequently hived them off to separate institutions, in the light of experience of conflict of interest with the effective performance of basic central banking functions of monetary policy. This suggests that whatever the merits of multi-purpose banking for financial intermediaries [Khatkhate and Riechel, 1980] a central bank is not perhaps ideally suited to function as a universal multipurpose bank. But a separation of functions need not preclude the central bank's role in the creation of development banking institutions through initial provision of part or whole of their equity capital, or of working credit, and fostering a market for their securities. Athough this is a widespread technique it carries the risk that excessive dependence upon a central bank's capital credit and profits, as also devices like repurchase agreements for securities, is inflationary. Development finance institutions are best financed by genuine savings from non-central bank sources, and even if initially the whole or part of the capital of development finance institutions is provided by the central bank, consideration should be given to the eventual "privatization" or "mutualization" of the central bank's capital participation in such institutions. An apt example of this process is the gradual reduction of the Government of Bangladesh's share in the paid-up capital of the Grameen Bank for the landless poor from 60 percent (in September, 1983) to 25 per cent (July, 1986) with a corresponding increase in the shares subscribed by the borrowers of the Bank. Privatization, in turn, presupposes that the yields on the securities and the deposit and lending rates of the development finance institutions are realistic and market-oriented. However, the central bank might deploy some appropriate form of guarantee and credit risks mechanism to a limited extent so that there is central bank involvement without opening a conduit to inflationary finance from the central bank.

By far the most favored technique of central banks in promoting economic development has been through preferential rediscount rates and facilities against officially favored types of commercial bank paper to induce greater lending to the preferred or priorty sectors or to reduce the cost of credit to sectors from which the paper originates. The use of multiple preferential rates (i.e., below market levels) by the central bank could seriously frustrate restrictive credit policy when such a policy is warranted on macroeconomic grounds. Even with a unitary rediscount rate for eligible assets banks may overextend credit to such sectors. Preferential rates may also be combined with portfolio ceilings or ratios on priority and non-priority credits but such ceilings are extremely difficult to monitor and enforce.

Differential reserve requirements linked to the composition of commercial bank portfolios and/or to the regional location of credit (rural or semi-urban branches) have been employed most extensively in Mexico and to some extent in Argentina, Brazil, Chile, Colombia, Israel, and Peru. Reportedly, Mexican experience of differential reserve requirements has been on the whole successful. Surprisingly, this technique has not been used in Asian, African, or the Middle East.

An allied technique which may be used to redress the urban bias in the financial system is to specify minimum credit-deposit ratios for rural or semi-urban branches of banks, as for instance in Thailand where bank branches in the undeveloped North-East Region are required to extend not less than 60 percent of local deposits for local credit and not less than 20 percent for agriculture. In India a target credit-deposit ratio of 60 percent has been set for rural or semi-urban areas. The credit-deposit ratio, however, is not an unambiguous indicator unless further refined to take account of population density (per capita), the man-land ratio (per unit of land cultivation) and the relative credit absorption capacities of different regions. [Chandavarkar, 1985]. More importantly, such targets may not always be attainable for reasons beyond the control of the lending institutions. Consequently, they have to be reviewed critically from time to time.

V. Concluding Remarks

Central banks in developing countries have no doubt undertaken several innovative measures to encourage development but it is difficult to say categorically whether they have been able to alter the flow of credit to developmental needs in the most efficient manner. The efforts to mobilize savings seem to have been hampered by the persistence of financial repression, notably the lack of realistic and flexible rates of interest in most instances. The promotional role of central banks needs to be critically evaluated particularly the open-ended approach to credit subsidies and the tendency to use central bank resources as an alternative to mobilization of genuine noninflationary savings for the capitalization of developmental institutions. Irrespective of the modalities of the promotional role it is important to safeguard the autonomy of central banks if they have to play their appointed role of being the Platonic Guardians and Curators of the financial sector and as constructive critics and advisors of the Government. This, however, does not imply the infallibility of central banks and one has to allow for the possibility of central bank failures as a sub-species of non-market failures. Central banks are also known to have hampered innovative developments in the private sector through doctrinaire adherence to legal niceties and financial orthodoxy.

The maintenance of overall monetary stability and a liberal financial climate for the effective mobilization of domestic savings is a necessary desideratum for the exercise of the promotional role of a central bank. It cannot be emphasized too strongly that "a central bank that uses its powers to discharge effectively these traditional central bank responsibilities [i.e., reasonable stability in domestic finances and equilibrium in the balance of payments] makes a fundamental contribution to development because these are conditions that encourage and sustain economic growth...a survey of the actions of central banks in developing countries suggests that the nations that have prospered most are also the ones that have the best long-term records in maintaining internal stability and external balance...whatever additional responsibilities a central bank may acquire its basic commitment to the maintenance of economic stability--both domestically and externally--should not be downgraded." [Brimmer, 1971, p. 781] It may be argued plausibly that there need not be a conflict between stability and growth given that the former is a necessary although not a sufficient condition for the latter. Nevertheless, the dual character of central banking instruments as credit controls and as promotional devices does pose trade-off situations both at the micro and macroeconomic levels. Typically, they occur in regard to whether the preferential status of sectors like housing, agriculture, small businesses, co-operatives, etc., should be retained in the event of aggregative credit restriction as part of adjustment programs. Similarly, if one concedes the validity of credit subsidies for limited periods what should be the machinery for review and termination of such subsidies? Should these be limited to the small-scale borrower or extend to all classes and sizes of borrowers? Given the fungibility of finance, how does a central bank monitor promotional techniques and also ensure the fulfillment of the norms of macrofinancial policy like optimality of debt-equity ratios in corporate finance? Should the promotional role operate via the price or the supply and availability of credit? What is the scope for developing security markets through direct issue of securities by the central bank? Is it feasible to create active secondary markets for financial assets through the instrumentality of the central bank? How does one ensure the requisite autonomy and influence of the central bank? These and related questions need to be studied in depth before one can formulate a country-specific agenda for the promotional role of a central bank, which requires it to be innovative and flexible without detracting from its basic function of effective discretionary control of the monetary and banking system.

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