3 Role of Central Banks

3.1 Objectives of Central Banks

Central banks act in the broader financial system and in the macro-economy

The role of central banks in microfinance is related to their broader role in the financial system and in the economy more generally. Hence, any discussion of the role of central banks in microfinance must be informed by the debates that have taken place in recent years on their broader role and objectives.

Central banks have a number of objectives, which Chandavarkar (1996) has classified as follows:

(i) tactical or macroeconomic objectives (relating primarily to the domestic price level and the exchange rate);

(ii) long-term strategic objectives of financial sector development (including the development of an effective payments system and other forms of financial infrastructure); and

(iii) sectoral or microeconomic objectives (such as prudential supervision and deposit insurance).

The goals of monetary policy include economic growth, low inflation, and stability of the currency. However, most commentators now believe that the main contribution that monetary policy can make to economic management in the long run is to maintain low inflation. It is generally agreed that low inflation provides a necessary base for sustained economic growth and development. Indeed, in a number of countries, low inflation has proved important for the development of a sustainable microfinance sector. In some cases governments have set indicative inflation targets, with central banks expected to maintain the rate of inflation within a target band. It is also generally accepted that central banks are most effective in maintaining low inflation and in performing their other proper functions when they are independent of government.

Contemporary Thinking on Central Bank Objectives

For most contemporary commentators, central bank objectives should include:

- macroeconomic stability, relating to domestic inflation and the foreign exchange rate
- longer term considerations of financial sector development
- immediate issues of the sound management and financial health of financial institutions

There has been a trend in a number of industrial countries recently to divide the functions of the central bank between two separate agencies. In this model, the central bank proper retains responsibility for the conduct of monetary policy, stability of the financial system, and regulation of the payments system. A new bank supervision agency is established to undertake prudential regulation and supervision of deposit-taking institutions.

Central banks in DMCs retain their regulatory and supervisory functions. Indonesia is the only exception

However, so far at least, this model has not been adopted to any extent in developing countries of Asia. In all but one of the countries included in this study, the central bank retains responsibility for both monetary policy and prudential regulation and supervision of the banking sector. The exception is Indonesia, where responsibility for prudential supervision of licensed financial institutions is to be transferred from the central bank to a separate supervisory agency by the end of 2002.

3.2 Developmental and Promotional Activities of Central Banks

A more important issue for the purposes of this study relates to what may be called the "developmental" activities of a central bank. How central banks see these activities depends to some extent upon the level of maturity and development of each financial system. According to Chandavarkar, "In the early days of the 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…" (1996, 95).

Observing what a central bank actually does may be a better guide to its role than reading its legislation

Reference to the relevant legislation, or to the official "mandate" of a central bank, may not be very helpful as a guide to the character of its current activities. Such legislation tends to be changed infrequently and at long intervals; the actual activities of the bank may diverge from the legal situation increasingly over time.

In this context, Chandavarkar makes the distinction between "developmental" and "promotional" functions of a central bank. He argues that the exercise of developmental functions is justified, if at all, only in the very early stages of central banking. These functions should be divested over time, and divesting them may be a precondition for central banks to achieve independence of government. Such developmental activities include credit guarantees and insurance, participation in the capital and management of development institutions, priority sector lending, differential interest rates, preferential rediscount rates and facilities, and setting target credit/deposit ratios for rural branches of banking institutions. Government ownership of banks may also be considered as a developmental activity, although such ownership and the activities flowing from it may not necessarily involve the central bank directly. It is important to note that developmental activities are generally intended to contribute to the development of the economy as a whole, not to the development of the financial sector itself. In fact, they often contribute to situations of "financial repression" and are antithetic to financial sector development. However, this need not always be the case.

In "developmental" activities, financial institutions and mechanisms are used as tools by central banks to achieve broader development objectives

As against these "divestible" functions, 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. It should be envisaged in terms of active "supply-leading" initiatives rather than passive "demand-following" response considering that the financial system … is predicated on the dictum that "facilities create traffic" (Chandavarkar 1996, 120).

Chandavarkar further describes promotional activities as measures that generate externalities and reduce transaction and information costs. In this case, the central bank is cast in the role of innovator and catalyst. He sees the promotional role as a continuing one for central banks in developing countries. Promotional activities may include support for pilot projects using innovative approaches to microfinance, the conduct of research, the collection and publication of data, and advocacy and training.

In "promotional" activities, central banks pursue financial development through catalytic initiatives, avoiding substantial commitments of resources

The dividing line between developmental and promotional activities is blurred. However, developmental activities are undertaken to affect the allocation of resources directly, often involve long-term programs, and generally require significant financing by the central bank with implications for aggregate money supply. By contrast, promotional activities involve short-term programs, are intended to catalyze unsubsidized and voluntary activity by the private sector, and involve negligible commitments of central bank financial resources.

3.3 Financial Repression as a Consequence of Developmental Activities

Financial repression endures because of its political appeal

Financial repression can be defined as "distortions of financial prices including interest rates and foreign exchange rates" (Shaw 1973, 34). In recent decades central bankers have become much more aware of the dangers of "financial repression," due to the works of McKinnon (1973) and Shaw (1973). Nevertheless, in a survey of developing countries' central banks conducted in 1995, Fry et al. (1996) noted the continuing operation of the instruments of financial repression. There are several reasons for the persistence of such practices. Governments may attempt, through their central banks, to encourage private investment in what they regard as priority activities. Also, in some developing countries (and some developed ones) governments have limited capacity or fiscal discipline to raise funds from nonbank sources. Under these circumstances, Fry et al. comment that "short-sighted governments have in many cases effectively used their central bank as a fiscal milch cow" (1996, 9).

Financial intermediation is discouraged by controlling interest rates and directing credit

It is now widely accepted that controlling interest rates and directing credit for developmental purposes have not been effective in achieving their objectives. In fact, such measures have had a negative effect on economic development by discouraging financial intermediation for the following reasons, among others:

(i) Below-market rates of interest discourage saving and hold saving and investment below their socially optimal levels.

(ii) Potential depositors tend to undertake investment projects with relatively low rates of return, rather than depositing their money in a financial institution for on-lending to the initiators of projects with higher returns.

(iii) Directed credit and credit rationing distort the allocation of bank lending between projects, reducing the average quality of investments.

Similar criticisms have also been leveled against government ownership of banks and the quasi-fiscal activities of central banks (for example, refinancing and credit guarantees). For example:

(i) In many countries, government ownership of banks and other financial institutions has been used deliberately as an instrument of financial repression, to direct subsidized credit to particular favored activities. A recent study by La Porta et al. (2000) found that government ownership of banks is associated with slower financial development and lower growth in per capita income in those countries where it occurs.

The "quasi-fiscal" activities of central banks undermine their independence

(ii) Fry et al. (1996) argue that by making central banks responsible for quasi-fiscal activities, developing country governments undermine both the independence of central banks and monetary policy objectives. Fiscal activities reduce central bank profits and may even produce losses. If losses are not met from government budget appropriations, they will eventually lead to an expansion in central bank money, compromising the objective of price stability.

These considerations suggest that central banks should not support microfinance through measures such as directed credit programs, interest rate controls, ownership of financial institutions, and quasi-fiscal activities.

3.4 Financial Liberalization

Since the pioneering analyses of McKinnon and Shaw, it has been widely accepted that central banks can contribute to economic development by eschewing financially repressive ("developmental" in Chandavarkar's parlance) activities in favor of financial liberalization. There is considerable empirical evidence that rapid financial development (resulting largely from legal and policy changes to liberalize the financial system) has been associated with rapid economic growth in many developing countries. Levine (1997, 720) found in a recent survey of the literature that:

> A growing body of empirical analyses, including firm-level studies, industry-level studies, individual country studies, and broad cross country comparisons, demonstrate a strong positive link between the functioning of the financial system and long-run economic growth.

Rapid financial development has been associated with rapid economic growth

More recently, however, there has been some reassessment of the efficacy of rapid financial liberalization in light of the East Asian financial crisis. While rapid liberalization and the associated financial development can contribute to economic growth, it can also create the conditions for financial collapse unless it is accompanied by complementary legal, regulatory, human resource, and informational reforms. Moreover, such complementary reforms may be very difficult to achieve. For instance, Demirguc-Kunt and Detragiache (1998) examined the relationship between financial liberalization and banking crises in 53 countries between 1980 and 1995. They found that, after controlling for other factors, financial liberalization had a non-trivial negative effect on the stability of banking systems. While this effect was moderated by the presence of strong institutional environments, they noted that governments cannot create strong institutions overnight. The researchers concluded that the path to financial liberalization should be a gradual one, and that there should be more research on the design and implementation of prudential regulation and supervision in developing countries. In similar vein, Cole and Slade (1999) note that in Indonesia, many millions of dollars and technical assistance were provided to improve the legal, accounting, and prudential regulatory infrastructure in that country, but it has remained weak.

Notwithstanding this reassessment, most commentators would still accept that central banks can and should contribute to the development of microfinance through careful and appropriately sequenced financial liberalization. Liberalization enables the financial system to reach some households that would otherwise not have access to formal financial services. This study considers some important ways in which liberalization can contribute to the development of a sustainable microfinance sector, such as through deregulating interest rates and removing barriers to entry of new institutions into the formal financial system.

But uncritical advocacy of financial liberalization has been tempered by recent experience

How Central Banks Can Contribute to the Microfinance Industry

- Careful and appropriately sequenced financial sector liberalization supports the development of sustainable microfinance.
- It enables the extension of financial services to households previously beyond the reach of financial institutions.
- Central banks can support this process generally by deregulation and specifically by activities promoting microfinance.

3.5 Promotional Activities of Central Banks

Financial liberalization by itself is not a sufficient condition for ensuring that large numbers of poor households have access to financial services on a continuing basis. The formal financial system reaches only a small proportion of households in developing countries. And while this proportion may be higher in some countries that have undertaken extensive financial liberalization, even in these countries there are still large numbers of poor households that are not served by the formal financial system.

The central bank can exercise leadership from its position at the apex of the financial system

According to Fry et al. (1996), overcoming financial repression involves not only the removal of impediments on financial institutions and markets, but also positive encouragement, by the central bank and other relevant authorities, of financial markets. These measures of positive encouragement are the promotional activities described by Chandavarkar. This suggests a possible role for central banks in promoting financial systems able to reach poor households on a sustainable basis. As noted, promotional activities may include support for pilot projects using innovative approaches to microfinance, as well as research, collection and publication of data, advocacy, and training. Central banks can do these things by virtue of their role as apex bodies for their financial systems, which equips them to exercise leadership and provide coordination. The extent of central bank involvement in such activities in any country will depend on the central bank's comparative advantage with respect to other institutions, reflecting considerations such as the state of development of the financial system and the microfinance subsystem.

3.6 Activities of Central Banks in Practice

In practice, developmental activities have persisted

Central banks should generally limit their activities to monetary policy, the prudential regulation and supervision of licensed financial institutions, and promotional activities to encourage the development of the financial system, including microfinance. However, in practice the role of the central bank is generally much broader than this. In most countries, the mandate of the central bank supposes or requires an active role in fostering economic growth and development. More importantly, central banks have acted on such mandates and undertaken a wide range of developmental activities. These expanded in the 1950s and 1960s, when the nature and consequences of financial repression were not well understood. And while the focus of central banks on developmental activities has diminished gradually over time, in many countries they have persisted throughout the 1970s, 1980s, and 1990s and are still an important feature of the financial landscape.

Economies in Transition

The focus on developmental activities has perhaps been most pervasive, among the twelve countries in this study, in the three economies in transition, although all three have reduced the emphasis on developmental activities in recent years. In PRC the central bank served as a "monobank" until 1978. There were no separate commercial banks, and the central bank was the sole financial entity and provider of credit. The central bank was directly involved in developmental activities on behalf of the government, extending loans at administered interest rates to particular industry sectors and state-owned enterprises in accordance with the centrally determined credit plan. The Chinese banking system was re-established after 1978, but the central bank continued to perform certain commercial banking activities. The current legislation for the central bank was promulgated in 1995, and takes domestic price stability as its primary objective. However, the central bank still has responsibility for some developmental activities. For instance, the list of legislated central bank functions includes the power to “administer” financial institutions and to “control” financial markets.

Developmental activities have been most pervasive in the transitional economies

The situation is very similar in Viet Nam, except that the re-establishment of a banking system did not commence until 1986, and it was not until 1998 that the central bank yielded the last of its commercial banking functions. Indeed, the central bank still carries out government policy directives of a developmental nature.

The course of development of the banking system was similar in the Kyrgyz Republic, but as a member of the former Union of Soviet Socialist Republics (USSR) until 1991, Kyrgyz did not have its own central bank. The Kyrgyz central bank was established in 1993 with a mandate to implement monetary policy and to regulate and supervise the banking system. While the legislation does not provide explicitly for the central bank to undertake developmental activities, it has in fact undertaken some such activities.

South Asian Countries

In all of the five countries in South Asia covered by this study, the central bank has traditionally had a wide mandate to undertake both developmental and promotional activities.

Central banks in South Asia have been interventionist

(i) In Bangladesh, the mandate of the central bank includes maintaining a high level of production, employment, and real income in the economy, and fostering growth and development of the country’s productive resources in the best national interest.

(ii) The mandate of the central bank in India includes development of financial markets and financial infrastructure.

(iii) The objectives of the central bank in Nepal include mobilizing capital for development and industry, and developing the banking system.

(iv) In Pakistan, the central bank is required to focus on agriculture by setting up a specific agricultural credit department, and by coordinating other organizations engaged in agricultural credit.

(v) At the time of writing, the central bank in Sri Lanka is still charged with responsibility for the promotion and maintenance of a high level of production, employment, and real income, as well as the encouragement of the full development of the productive resources of the country.

These central banks have all undertaken a wide range of developmental activities that have, in the process, contributed to financial repression:

(i) In all five countries, government-owned commercial banks and development finance institutions have dominated the financial system and continue to play an important role. Central banks have often had a direct or indirect interest in these institutions.

(ii) India, Nepal, and Pakistan retain detailed directed credit requirements. Only Bangladesh and Sri Lanka have abolished such requirements.

(iii) All five previously imposed interest rate restrictions, although most such restrictions have now been abolished.

(iv) All continue to undertake quasi-fiscal activities, such as refinancing and credit guarantees to promote commercial bank lending to particular sectors or for particular activities.

Market Economies of East Asia

Deregulation commenced earlier in Indonesia and the Philippines and the phase-out of developmental activity has proceeded further

Until the 1980s, the central banks in Indonesia and the Philippines performed functions similar to those of the central banks in South Asia, already described. However, these two countries began deregulating their financial systems earlier, and have proceeded further, than the South Asian countries. The Philippines deregulated interest rates from 1980, while Indonesia deregulated them in 1983. While a range of developmental activities were phased out during the 1980s and 1990s, both central banks have, at least until recently, continued to engage in some developmental activities. The Philippines continues to impose directed credit requirements, although these are of relatively minor significance. In Indonesia, the requirements fell into abeyance during the financial crisis, from 1997, and are not to be continued. However, in Indonesia, government ownership of financial institutions is still extensive and was associated with significant central bank refinancing of particular sectors and activities. This was brought to a close only with the reorganization of central bank functions after the crisis. It should be noted, however, that one government-owned bank in Indonesia, Bank Rakyat, has been a very successful provider of microfinance services.

Both Indonesia and the Philippines have seen considerable changes in the mandate of the central bank in recent years. In the latter, a new central bank was established in 1993 with a mandate to maintain price stability and to regulate and supervise banks and quasi-banks. The Act explicitly prohibits the central bank from engaging in development banking or financing (but as noted, has not precluded directed credit requirements). In Indonesia, a new central banking law was enacted in 1999, reducing the mandate of the central bank to the primary objective of maintaining the stability of the currency. The function of prudential supervision is to be transferred to a new institution by the end of 2002, and the central bank's previous role as an "agent of development" has been abolished.

Pacific Island Countries

The Pacific Island central banks have avoided financially repressive measures

By contrast with the Asian central banks, the central banks in PNG and Vanuatu have had very little involvement in developmental activities. In each country, the government owns the commercial bank with greatest outreach in rural areas. In each country the government also established a development finance institution. In the case of Vanuatu this institution has recently been merged with the government commercial bank, and in PNG it has become a subsidiary of the government commercial bank. Apart from being responsible for regulating and supervising these government-owned banks, the central banks have had little involvement with them. Both central banks have largely avoided financially repressive measures such as interest rate restrictions, directed credit requirements, and quasi-fiscal measures.