Bank for International Settlements

Central banks and the challenge of development

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Foreword

The Bank for International Settlements has been a centre for discussion and debate among governors and other senior central bankers since its foundation in 1930. An important aim has always been to help central banks learn from each other, deepening mutual understanding. The BIS's Monetary and Economic Department provides analysis to further this objective.

The more recent evolution of the BIS into a truly global institution has been accompanied by an increasing focus on the issues confronting central banks in developing countries. Last March, I invited governors from a score of central banks to meet at the BIS for a two-day roundtable discussion on some key challenges facing central banks. We are publishing the papers prepared for this meeting because I am convinced that many of the issues governors discussed are of wider interest.

Professor Amartya Sen of Harvard University gave a most stimulating and wide-ranging speech about the challenges of development. Jaime Caruana, who as Chairman of the Basel Committee on Banking Supervision guided the new international capital framework to completion, explained what Basel II really entailed. I am very grateful to them both.

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Malcolm D Knight

General Manager

About the Bank for International Settlements

Established in 1930, the Bank for International Settlements (BIS) is the world's oldest international financial organisation. Uniquely, its members are central banks rather than governments.

From the very beginning, the BIS has provided a forum for central bankers to meet their colleagues from around the world. This allows them to exchange views and share experiences as well as take the pulse of the world economy and financial markets. Over the years, the Bank has developed a range of financial and non-financial services specifically designed to address the evolving needs of central banks.

The BIS's head office is in Basel, Switzerland and it has representative offices in Hong Kong SAR and Mexico City.

Promoting monetary and financial stability

The BIS has four key roles in the global financial system. It is:

- a forum for discussion and decision-making among central banks and within the international financial and supervisory community;
- a centre for economic and monetary research;
- a prime counterparty for central banks in their financial transactions; and
- an agent or trustee in connection with international financial operations.

A meeting place for central banks

Currently more than 5,000 senior executives and officials from central banks and supervisory agencies participate in meetings organised by the BIS every year.

The most important meetings held at the BIS are the **regular meetings of Governors** and senior officials of member central banks. Held every two months in Basel, these gatherings provide an opportunity for participants to discuss the world economy and financial markets, and to exchange views on topical issues of central bank interest or concern. **Other meetings of senior central bank officials** focus on the conduct of monetary policy, the surveillance of international financial markets and central bank governance issues.

The three main committees that meet at the BIS are:

- the Basel Committee on Banking Supervision, which includes representatives from the major supervisory agencies as well as from central banks;
- the Committee on Payment and Settlement Systems;
- the Committee on the Global Financial System.

The work of these committees and other meetings at the BIS contribute to an improved understanding by participants of the developments, challenges and policies affecting various countries or markets. An atmosphere of openness, frankness and informality amongst participants is critical to the success of BIS meetings.

In addition, the BIS organises frequent **meetings of experts** on monetary and financial stability issues as well as on more technical issues such as legal matters, reserve management, IT systems, internal audit and technical cooperation. Though targeted mostly at central banks, BIS meetings sometimes involve senior officials and experts from other financial market authorities, the academic community and market participants.

Research and statistics

The economic, monetary, financial and legal research of the BIS supports its meetings and the activities of the Basel-based committees. The BIS is also a hub for sharing statistical information amongst central banks, and for publishing statistics on global banking, securities, foreign exchange and derivatives markets.

Research is carried out primarily by BIS staff, supplemented by visiting researchers from central banks and the academic community. From time to time, the BIS organises special meetings and conferences with central bank researchers and academics.

Many of the issues debated in BIS meetings and research by BIS economists are covered in the Bank's regular publications. The main publication is the *Annual Report*. Other publications include the *Quarterly Review*, *BIS Papers* and the *Working Papers* series.

Seminars and workshops

Through seminars and workshops organised by its Financial Stability Institute (FSI), the BIS promotes dissemination of the work undertaken by the supervisory community. The FSI not only familiarises financial sector supervisors worldwide with the recommendations of the Basel Committee, but also provides practical training for senior participants.

Cooperation with regional central banks also helps to make information about BIS activities more widely known. This cooperation takes the form of participation in meetings by regional central bank groups and the organisation of ad hoc joint meetings or workshops.

Banking services for central banks

The BIS offers a wide range of financial services to assist central banks and other official monetary institutions in the management of their foreign reserves. Some 140 customers, including various international financial institutions, currently make use of these services. BIS financial services are provided out of two linked trading rooms: one at its Basel headquarters and one at its office in Hong Kong SAR.

Safety and liquidity are the key features of the Bank's credit intermediation services, which are supported by a strong internal risk management framework. On average, over the last few years, some 6% of global foreign exchange reserves have been invested by central banks with the BIS.

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Central banks and the challenge of development: an overview of a roundtable debate

Malcolm D Knight

The 20 central banks represented at this meeting operate in very different circumstances. And it is of course almost a platitude to say that what constitutes an effective policy framework depends on a country's specific situation – its history, its stage of development, and so on. Yet discussions among Governors at this meeting underlined a surprising degree of common ground among central banks. Even where countries had made different policy choices, the dilemmas they had had to address were often rather similar.

The particular focus of this meeting was on Africa. The steady decline in inflation across the whole continent – sadly there are a few dramatic exceptions – is a justifiable source of pride for many African central banks, and this in itself creates an environment that favours development.

The following notes are not intended to be comprehensive, but rather distil some of the main points, organised (as was the meeting) under four headings. These are: the challenges posed by increased financial inflows from abroad; the relationship between the central bank and government; anchors of monetary policy; and the choice and design of exchange rate regimes.

The challenge of increased financial inflows

In the last few years, higher prices for commodity exports have lifted real incomes in many countries and have led to current account surpluses. Increased aid inflows and debt relief have also eased what were often severe external financing constraints.

These favourable developments almost always put upward pressure on the exchange rate, which can be a major problem in countries which depend on a few commodities for their export revenue. Currency appreciation also creates potential conflicts of interest among various domestic groups: consumers who buy imports like a strong currency, but exporters resist it. Some Governors said that the central bank was

sometimes cast as an arbitrator between the interests of consumers and exporters on this question, and some even reported demonstrations organised by trade unions and employers in the export sector. An additional important aspect is that underdeveloped financial markets in many countries mean that firms cannot hedge their exchange rate exposures. For all these reasons, how to adjust to increased inflows and thus counter or limit an incipient rise in the exchange rate has become a major policy concern for the central banks in the region.

All agreed that a permanent positive external shock required the exchange rate to rise. Yet several argued that – given the historically high volatility of the exchange rate and output in Africa – allowing the exchange rate to fully adjust to a shock that is perceived to be largely temporary would increase rather than reduce volatility.

Hence there is a prima facie case for central bank intervention in the forex market. Yet there are well known limits to this. One is that intervening in order to reduce appreciation in the face of large balance of payments surpluses has tended to increase liquidity in the local banking system. The textbook answer is of course "sterilisation". The ideal mechanism for sterilisation is to sell long-term government bonds to the non-bank private sector. Countries where bond markets are more developed have therefore been in a better position to achieve their exchange rate objectives without losing monetary control than those which lacked them. In many cases, however, the market for debt securities was very thin, with only short-dated paper available. In such circumstances, selling short-term treasury bills to drain excess liquidity can lead to sharp increases in short-term interest rates on particular papers or maturities. This can have almost immediate fiscal implications, entails obvious consequences for monetary conditions, and may lead to increased financial market risks.

All intervention sterilisation operations in practice lead the central bank's balance sheet to expand, whether or not associated with increases in liquidity in the economy as a whole (and not just in the banks). Thus, in addition to leakages into liquidity, sterilised intervention tends to imply significant running costs and could also run the risk of even larger central bank losses should the local currency rise relative to the currency in which the foreign exchange reserves are denominated.

Such costs could not be fully avoided by relying on higher reserve requirements, as central banks have to pay interest on them if they wish to limit the adverse impact on the banking system's profitability. Another implication of the issuance of high-yielding sterilisation instruments is that purchasing such paper provides very easy profits to banks. In many countries, virtually the only buyers for such bills are a few local banks. Increased bill issuance in this imperfectly competitive situation can lead to a big increase in treasury bill yields at quite short maturity. This can make banks "lazy" – not only in their efforts to enhance efficiency but also in seeking out new lending opportunities.

The key role of fiscal policy in mitigating some of these dilemmas was highlighted. A general point was that rules to frame fiscal policy can enhance a central bank's ability to respond to external shocks. One important example has been the recent effort by oil-exporting countries to establish commodity stabilisation funds and introduce rules limiting government spending from such revenue windfalls. Inflation and the exchange rate have been generally more stable in countries where the fiscal authorities have followed such rules. Another way in which fiscal policy could play a potentially important role is by directly assuming the costs of intervention and by reporting them in the budget. Such a policy would help improve fiscal transparency and subject intervention to greater public and parliamentary scrutiny.

The central bank and government

The history of fiscal dominance in so many developing countries means that the design of appropriate institutional arrangements is of paramount importance. The tenor of the discussion on this topic in the second session was that an appropriate legal framework is an important start. But legislation needs to be complemented by the development of a genuine culture in which the central bank is *both* allowed to exercise its necessary operational independence *and* held to account in an appropriate way. The credibility of the central bank with the public is very important in shaping the central bank's dealings with the government. Consultation and cooperation with the government must be conducted in such a way that it does not undermine the effectiveness of monetary policies.

Even central banks which have been granted a high degree of independence under the central bank law (for example, by having clear objectives and the powers necessary to achieve them, a board with security of tenure, as well as financial and budgetary autonomy) must still work hard to nurture a public understanding of the benefits of price stability and the central bank's role in achieving this objective. This dimension of central bank independence, one that has been earned, can be more important than formal independence. In the words of one Governor, central bank independence is pointless if it exists only in courtroom disputes.

In many of the economies represented at the meeting, the volatility of commodity prices and aid flows, as well as weather-related fluctuations in agricultural output, have led to crises more often than in industrial countries. Meetings of policymakers, including those between the central bank and the ministry of finance, have tended to be more frequent in such an atmosphere. Some felt that, in such circumstances, memoranda of understanding on the practical aspects of the central

bank/government relationship could help safeguard the autonomy of the central bank.

It is important for the Governor and the minister of finance to be able to discuss frankly and privately any policy differences they may have, without this leading to public disputes. It can also be quite useful for senior officials of the central bank to have seen what it is like on the other side of the fence (by having served as minister, as the president's or the prime minister's economic adviser, or at the ministry of finance). Particularly where the central bank has a mandate to act as an economic adviser to the government, the past involvement of the Governor at the Treasury, or as an economic adviser in a personal capacity, can help build bridges. But these things also carry an enhanced risk of the boundaries becoming blurred and operational independence being lost.

A number of Governors stressed the importance of timing major policy communications by the central bank in such a way as to make clear to the public that monetary policy is set by the central bank and need not be approved by the government. The announcement of monetary policy decisions directly to the media, before informing the government, is one increasingly common practice. Even so, it can still be useful to brief the government on the reasons for the central bank's decision, to help all policymakers to speak consistently to markets and the public.

There have been a number of successful central bank initiatives to reduce central bank financing of the government, to support government efforts to enhance fiscal discipline, and to introduce efficient, market-based stabilisation schemes. One important success factor was to have a clear objective (financial autonomy of the central bank and the absence of fiscal dominance). Another was to pursue the policy objective in well measured steps, in line with the development of financial markets. The capacity to implement practices and processes has also turned out to be crucial.

There was general agreement that deeper financial markets helped a central bank to carry out its policies. Thus, lengthening the maturity of debt instruments (and in time developing bond markets) was important. Government debt management policy has a major role in achieving this objective. Broadening access to financial services to more of the population was also an important element of economic development. A number of related challenges for central banks were also noted. One was the spread of new financial instruments (perhaps in tandem with developments in more advanced economies) at a pace the local regulatory and supervisory authorities had difficulty keeping up with. Another challenge was the growth of financial intermediaries (such as money lenders) which were not regulated by the central bank. These gave rise to financial stability issues, and some Governors argued that this underscored the need for maintaining extensive central bank responsibilities in regulation and supervision.

Anchors for monetary policy

The experience of inflation targeting (IT) countries shows that IT has enhanced the transparency of monetary policy and has led to the better communication and understanding of monetary authorities' decisions. It was, said one Governor, an effective means by which a central bank can be held accountable. Another said it forced the central bank to be forward-looking. In many countries, central banks have indeed used IT to gain public credibility.

How well has the IT framework worked? It is true that many inflation targeting countries have been able to bring down inflation to a low level. But so too have countries without an IT regime. It was also argued that, in some countries, a simpler non-IT framework – such as a fixed exchange rate or a monetary growth target – could work better because it was easier to understand and operate.

Nevertheless, the balance of opinion has in recent years shifted in favour of adopting IT in developing countries. In a forward-looking IT environment, central banks should, where possible, use model-based inflation forecasts to set interest rates. Developing credible models – and constantly testing them – is important because such models can nurture public confidence in the professionalism of a central bank's inflation assessment. But developing credible models is a demanding task. Views about such requirements have changed significantly since the 1990s. It was, said one Governor, quite feasible to adopt an IT regime even given only very simple analytical tools and control mechanisms. Indeed, many industrial and emerging market countries first adopted IT without satisfying what some would now regard as necessary preconditions.

It was further argued that industrial countries found that conditions helpful in an IT framework developed gradually as inflation fell and financial markets became more complete. The regime went through a constant process of refinement and improvement to enhance its operational relevance. There is, in short, "learning by doing".

In addition, certain of the so-called preconditions for IT – such as curbing fiscal dominance and providing greater autonomy to central banks to set monetary policy instruments – are highly desirable for the efficient conduct of monetary policy under any regime.

The discussion also focused on challenges to all forms of monetary policy stemming from changes to the monetary transmission mechanism. In many countries, large shocks to the income velocity of money have undermined the central bank's control over monetary aggregates. Many central banks have switched to indirect instruments such as a short-term interest rate for the conduct of monetary policy. Nevertheless, uncertainty about the impact of monetary policy on aggregate demand remains high. One source of such uncertainty is the

weak link between the central bank's policy rate and bank lending rates. Another is the high degree of inflation volatility caused by food having a very high weight in the consumer price index and large agricultural shocks.

The choice and design of the exchange rate regime

Governors noted that experience to date did not allow firm conclusions as to what constituted an optimal exchange rate regime. Actual choices would thus depend on the particular characteristics of individual countries, and the options were partly conditioned by history. Several factors were important in making such a decision, including: the nature of the shock; the degree of capital mobility; the extent of fiscal dominance; and the structure of the financial system.

Existing African currency unions had been maintained. Even so, consistent with the trend towards IT, one was able to detect a certain trend towards increased exchange rate flexibility in Africa, and away from pegged exchange rates. Several countries described an evolution of their exchange rate regime from single currency pegs to trade-weighted basket pegs of various sorts and then to a flexible exchange rate.

Governors discussed several challenges associated with managing flexible exchange rates, most notably due to a high share of primary commodities in exports and underdeveloped financial markets (ie thin foreign exchange markets). It was noted that flexible exchange rate regimes had dealt with such challenges more successfully than many had previously expected. Countries varied with respect to how tightly they managed their floats. Some intervened only occasionally in order to smooth extreme volatility on both sides of the market, whereas others were more active. Several countries had been faced with currency appreciation pressures caused by capital inflows.

Because single currency pegs could more easily lead to misaligned real exchange rates where trade patterns were diversified, there seemed to be a preference for trade-weighted baskets as a reference for unilateral pegs. For bilateral hard pegs, however, the case for a single currency peg is stronger. The peg of the CFA franc to the euro is the classic instance.

Views on preannounced fluctuation bands differed somewhat. On the one hand, some Governors felt that it might provide a target for speculative attacks. On the other hand, preannouncement might contribute to the anchoring of expectations and reduce volatility – provided there was sufficient credibility. Nigeria successfully announced a ±3% fluctuation band last year. Similar considerations were behind the divergence in views on whether or not to preannounce the rate of crawl for crawling pegs.

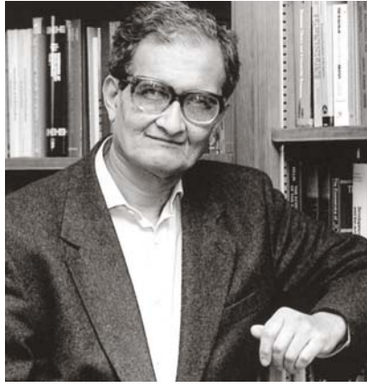
Governors discussed the shared history of currency unions in Africa and Europe. It was noted that the preparations needed for a currency union inevitably took a long time. Monetary union had taken 30 years to materialise in Europe once the original goal had been set; the target date for implementation had been postponed several times. It came as a milestone achievement in a long process of economic integration which is, even now, far from complete. It is therefore to be expected that a similar process in Africa, with its current relatively low level of economic integration, could take even longer. But it was also noted that motivations differed considerably. In Europe, the economic motivations behind monetary integration were to enlarge an already existing zone of monetary stability and to preserve the single market. In Africa, the desire for an external restraint on macroeconomic policies and for an improved institutional framework seems currently to be more important. Thus the operation of the two currency unions of the CFA franc zone has been improved by the strengthening of the macroeconomic surveillance mechanisms and the introduction of supranational supervision bodies.

Conclusion

One thread running through the discussions at this meeting was a growing sense of optimism about Africa's economic prospects. Growth in the past three years has been running at over 5% a year – compared with around 2½% in the 1990s. A favourable turn in the external environment has contributed to this improvement. But central banks have a major role in guiding policies that help to sustain this very recent improvement. Maintaining monetary and financial stability is key. Better laws, better governance, stronger and more accountable institutions and so on are all important. Central banks need to think hard about how best to frame and implement their policies – often in changing or volatile circumstances. We hope that the sharing of perspectives and experiences with each other, which was the aim of this meeting, contributes to this thinking.

The challenges of development

Amartya Sen



I cannot, I fear, claim to know the world of central banking well. Indeed, when the invitation to speak at this meeting came from Malcolm Knight, I did wonder whether Malcolm really knew how ignorant I am about banking. But since Malcolm and I coincided at the London School of Economics, I thought he must know that and there must be some "intelligent design" behind his asking me to give this lecture - certainly no evolutionary selection there, more like the survival of the *unfittest*. Maybe the design is to expose central bankers to the thoughts of distant people who are not contaminated by banking.

In fact, I too am a little contaminated by central banking through close friends, who became central bankers - I think of I.G. Patel, Manmohan Singh and Bimal Jalan who became sequentially the Governor of the Reserve Bank of India. Manmohan Singh has also established something that all of you should know, that being a central bank governor can be a good way of moving to the Prime Ministership of the country. In the case of another close friend who is the governor of a central bank now, I look forward to seeing Mervyn King's move, in the fullness of time, from Threadneedle street to Downing Street. Number 11 could be, at some date in the future, optimal, but Number 10 might be, as they say, "even better than optimal."

Despite my own distance from central banking, which has not been reduced through some kind of osmosis, one thing I do know is that banks and the central bankers also live in the same problem-ridden globe that we all inhabit, and have to address the same challenges that the world faces. It was suggested by Malcolm Knight and Philip Turner

that I might perhaps comment on what the challenge of development looks like, nearly a quarter century after I speculated on that subject in an essay called, "Development: Which Way Now?"[1]

Encouraged by this suggestion, I went back to my old essay. What the essay mainly did was to argue for taking a much broader view of development than was then common, seeing progress in terms of expansion of our freedoms and the enhancement of human capabilities (rather than merely the growth of the quantity of objects of convenience as reflected in the gross domestic product or the national product). That particular skirmish may not have ended yet, since these partially misleading indicators of success still receive far too much attention, but at the level of intellectual recognition the world has moved on towards paying more attention to much broader indicators of economic success. Perhaps the most influential role here has been played by my old Pakistani friend Mahbub ul Haq, now sadly deceased, who worked for a radical broadening of perspective through the visionary *Human Development Reports* which he initiated and led, and whom I was very privileged to advise throughout his stewardship of this extraordinary United Nations programme.

One of the changes that has occurred over the recent years is a real move away from the view that development is a very severe, austere and largely painful process, which so dominated the thinking of development elite and the international policymakers earlier on. Policy choices that were powerfully influenced by seeing development as a "fierce" process, with a call for "blood, sweat and tears" (to use Winston Churchill's rousing phrase used in a completely different context), has given way, happily, to at least recognising the possibility that it is a much more friendly - a more supportive - process. It was ridiculous when the cost of delivering extremely useful social support to precarious people, in the form of nutritional assistance, or free basic education, or subsidised health care used to be put down as luxuries that poor economies could not afford, rather than as programmes for which resources would have to be seriously sought.

It should not have been so difficult to generate this understanding, since that point was discussed even by Adam Smith more than two centuries and a quarter ago. Even though some alleged admirers of Adam Smith do not give the impression that they have ever read beyond the page and a half on the butcher, the baker and the brewer, which explained why self-help is quite adequate to make people keen on having a little exchange (a fairly modest and homely point, as Smith himself clearly thought), it was the same Smith who went on to discuss how socially financed well-chosen public services can make people more capable of helping themselves and others: "For a very small expence the publick can facilitate, can encourage, and can even impose upon almost the whole body of the people, the necessity of acquiring those most essential parts of education."

When the priority - explicitly stated or implicitly assumed - of seeing development in terms "blood, sweat and tears" is subjected to a more informed critical scrutiny, whether by economists themselves, or the Fund, or the Bank, or - for that matter - the national central bankers (as has certainly become more common now), the cultivated harshness of some of the older policies cannot but receive more challenge. George Bernard Shaw voiced the suspicion (this occurs, incidentally, in the Preface to *Man and Superman*), that "an Englishman thinks he is moral when he is only uncomfortable" (there may be a touch of Irish rebellion there), but policymakers of economic and financial policies have reason enough to stop assuming that shortrun harshness must bring plentiful rewards in the long run.

If a fuller recognition of the role human freedom and capability in the process of development was one of my hopes a quarter century ago, another hope was a greater recognition of the role of democracy in particular in the fostering of development. The connection is, of course, partly constitutive, since democracy is intimately connected with political freedom, and if freedom in general is important, then democracy must contribute something directly no matter what indirect effects it may have. For many years after I published that paper and several others on related subjects, I used to face an immediate challenge based on some fairly casual statistics, one of which took the form of arguing that the low growth of the Indian economy clearly shows that democracy is hostile to economic development. It was difficult to be persuaded that this was a cause-effect relationship since economic growth must depend on the friendliness of the economic climate rather than the brutality of the political regime. But now that the Indian economy is growing much faster (and India has become the new bogey man allegedly swallowing up American and European jobs),

[1] The Economic Journal, 93 (December 1983), reprinted in my Resources, Values and Development (Cambridge, MA: Harvard University Press, 1984).

those who argued on the other side do not seem to be in a great rush to acknowledge that what has changed is the previous collection of severely counterproductive economic policies, not the openness and vitality of the political democracy in the country.

Since China is frequently compared in this respect with India, and China continues to grow even faster than India's quickened tempo of growth, perhaps I should also comment briefly on that comparison. Consider life expectancy. When, in the late 1940s, China had its revolution and India became independent, China and India had about the same life expectancy at birth, well below 40 years. But post-revolution China, with its egalitarian politics and continued public commitment to improve health care and education (a commitment that was carried over from its days of revolutionary struggle - and there was an element of popular participation in that too), brought a level of dedication in radically enhancing schooling and health care that the more moderate and conservative Indian administration could not at all match. Sure, China did also have the largest famine in history during 1958-61, when the so-called "Great Leap Forward" failed miserably. But the country pulled out of that crisis soon enough, and by the time the economic reforms were introduced in 1979, China had a lead of about 14 years over India in longevity. The Chinese life expectancy, then, was about 68 years, compared with India's 54 years - almost a decade and a half less.

Then the Chinese had the economic reforms of 1979, when the Chinese economy surged ahead and grew much faster than India's more modest performance. However, despite China's much faster rate of economic growth, the rate of expansion of life expectancy in India has been about three times as fast, on the average, as that in China, since 1979. China's life expectancy, which is now just about 71 years, compares with India's figure of 64 years, so that the life-expectancy gap in favour of China has been halved to 7 years, over the last two and a half decades.

Of course, note must be taken of the fact that it gets increasingly harder to expand life expectancy further as the absolute level rises. But this can hardly be the reason behind China's stagnation in life expectancy, since China's life expectancy of 71 years is still very far below the figures for many countries in the world, where the numbers stretch into the 80s. Indeed, China's longevity is lower even in comparison with parts of India.

At the time of economic reforms, the Indian state of Kerala, with a similar commitment to public health that China had in the pre-reform period, had a similar life expectancy to China's - about 67 years - at the time of the Chinese reform. By now, however, Kerala's life expectancy, which had already reached 74 years by 1995-99 (the last official report) and is now estimated to be about 76 years or so, is very considerably above China's. Even though Beijing and Shanghai, as city provinces, outdo Kerala with its 30 million urban-rural mix, most provinces of China have life expectancy figures far lower than Kerala's. Going further, if we look at specific points of vulnerability, the infant mortality rate in China has declined very slowly since the economic reforms, whereas it has continued to fall extremely sharply in Kerala. While Kerala had roughly the same infant mortality rate as China - 37 per thousand - at the time of the Chinese reforms in 1979, Kerala's present rate, 10 per thousand, reached already by 2002, is a third of China's 30 per thousand (where it has stagnated over the last decade).

There are three distinct reasons for this difference, and each has some connection with the relevance of democracy. First, even within the economic field, the poverty-removing character of Chinese economic expansion was much sharper in the early post-reform period than it is today. It cannot, of course, be doubted that this global integration and the related expansion of urban incomes have brought a great many rewards to the Chinese people. And yet the poverty-reducing character of Chinese economic growth has relatively slackened. Furthermore, there has been a big surge in Chinese economic inequality - much sharper than what embarrassed the BJP-led Indian government which was defeated and lost office in the democratic elections held in India in 2004.

Second, along with the political change that ushered in the economic reforms came a slackened social commitment to public health care. It led, in particular, to the eschewal of free public health insurance provided to all before the reforms. There was now a need to buy a private health insurance at one's own cost (except when provided by the employer, which happens only in a small minority of cases). Interestingly, this very retrograde movement in the coverage of health

care received little public resistance - as it undoubtedly would have met in any multi-party democracy.

Third, democracy also makes a direct contribution to health care in bringing social failures into public scrutiny. India's health services are quite terrible, and it deserves the public criticism it tends to get. But the possibility of such intense criticism is also a social opportunity - even compulsion - to make amends. The informational and incentive roles of democracy, working mainly through open public discussion, can be pivotally important for the reach of public policy. Even the Chinese famines of 1958-61 (I argued in the earlier paper) reflected the absence of a democratic engagement, but more recently the easy abandonment of public health insurance as well as the immunity from criticism that Chinese health services often enjoy could be linked directly to the lack of multi-party politics. It is the limitation of this role that came most sharply to attention in the context of the SARS epidemic of 2002-3. Although SARS cases first appeared in Southern China in November 2002 and caused many fatalities, information about this new deadly disease was kept under a lid until April 2003. This is a small example, but the general penalty of the lack of competitive democracy is much more pervasive than that.

These issues are perhaps particularly worth stressing in the context of discussing the challenges that Africa faces, because no continent has suffered so much from the cultivated abandonment of democracy that went with the cold war that was fought over that ill-treated continent. Africa, which I first visited in 1963, and which seemed then to be fully poised to further flourish on the new roots of democracy, already visible then, soon succumbed to a cluster of military rulers with powerful international supporters. Any military strong man who displaced a legitimate government would get support from either the Soviet Union, or the United States and its allies, depending on which side the new military rulers took. And yet as Nelson Mandela noted in his *Autobiography*, he learned about democracy from the consultative mode of governance that Africa has known well from its own past.

Mandela describes how impressed and influenced he was, as a young boy, by seeing the democratic nature of the proceedings of the local meetings that were held in the regent's house in Mqhekezweni:

Everyone who wanted to speak did so. It was democracy in its purest form. There may have been a hierarchy of importance among the speakers, but everyone was heard, chief and subject, warrior and medicine man, shopkeeper and farmer, landowner and laborer.[2]

Mandela's long walk to freedom began at home, and the recognition of the importance of public reasoning in democratic politics remains extremely relevant today.

I end with a final point. Given the centrality of public discussion in democracy as public discussion, the relationship between a democratically elected government and central banks with their expertise and qualified autonomy must be extremely important. The central bank and government is a subject that is critically important for democratic practice. For democracy is not just about voting, but also about plural perspectives. Central banks are not only public agencies with special roles in financial leadership and monetary policies, they are also important parts of the general political landscape of a country. Without neglecting the specialised roles of central banks in financial and monetary spheres, I would like to emphasise the importance of the voice of central banks as informed participants in public reasoning on a much wider range of economic and social problems. Democracy is not just majority rule, and sustaining a rich plurality of perspectives and arguments can be critically important for the successful practice of democracy. Even the controversial issue of the autonomy of central bankers relates to this question.

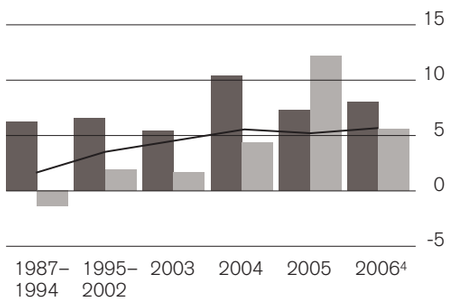
You would notice that I have dragged the central bankers down to my own level, as people who have to be committed to arguing. I am not, of course, arguing for central bankers to become obsessively "central talkers." But I would submit that they do have an important role in democratic public reasoning, in addition to their specialised tasks in monetary and financial affairs. If democracy is "government by discussion" - to use the old Millian phrase - central banking may well involve more than banking.

[2] Nelson Mandela, Long Walk to Freedom (Boston: Little, Brown & Co, 1994), p. 21.

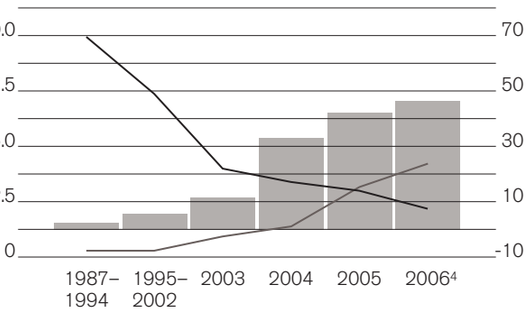
Graph 1

Africa and the global economy

World trade, the terms of trade and real growth[1]



External financing in Africa



World trade
Terms of trade in Africa
GDP in Africa

Debt service[2]
Current account balance[3]
Changes in reserves[3]

[1] Annual changes, in per cent.
[2] In per cent of exports of goods and services, left-hand scale.
[3] USD billions, right-hand scale.
[4] Projection.

Source: IMF, World Economic Outlook.

The global economy and Africa: the challenges of increased financial inflows

M S Mohanty and Philip Turner

Introduction

After years of weakness, economic growth in Africa has strengthened (Graph 1). A significant stimulus has come from large terms-of-trade gains as well as rising official and private inflows. The aggregate current account surplus continues to rise, debt service ratios in the region have fallen dramatically, and the latest IMF projections suggest that foreign exchange reserves will rise by $46 billion this year. Upward pressure on exchange rates and strong accumulation of reserves could create dilemmas for monetary policy. This note first outlines recent developments and then analyses some of these dilemmas.

Output and the balance of payments

Several African countries have recently achieved growth rates that are quite comparable to, or even higher than, those seen in Asia and Latin America (annex table). Oil exporters have grown faster than oil-importing countries thanks to sizeable improvements to their terms of trade (Table 1). Some metal exporting countries have also had substantial terms-of-trade gains (eg over 18% for Zambia between 2003 and 2005), while a number of oil-importing countries have suffered large losses (eg Kenya, Ghana and Tanzania). Cumulative changes in commodity prices are summarised in Table 2. In South Africa, higher domestic absorption combined with increased oil prices and a sharp deterioration in the net services balance, led to a record current account deficit (above 4.2% of GDP) in 2005.

Table 1

Output and balance of payments

	Real GDP growth[1]		Balance of payments				Total reserves[4]	
			Current account balances[2]		Net capital inflows[3]			
	2000–02	2003–05	2000–02	2003–05	2000–02	2003–04	2002	2005[9]
			As percentage of GDP					
Oil-exporting countries								
Algeria	3.2	5.8	12.4	15.8	…	…	40.7	55.2
Nigeria	3.3	7.9	1.5	4.8	–12.8	–13.4	15.9	28.5
Oil-importing countries[5]	**3.8**	**4.4**	**–0.6**	**–1.0**	**–0.1**	**0.9**	**14.0**	**15.2**
Egypt	4.0	4.1	–0.2	3.2	–1.8	–6.4	15.1	22.1
Kenya	1.9	3.9	–1.1	–3.4	0.7	1.5	8.1	9.4
Morocco	3.5	3.8	2.5	2.2	–3.0	–1.2	28.1	31.1
South Africa	3.5	4.1	0.2	–3.0	0.5	4.3	5.3	7.8
Tanzania	6.2	6.9	–4.6	–2.2	–6.1	0.8	15.6	16.8
Tunisia	3.8	5.3	–4.0	–2.1	4.2	4.8	10.9	14.5
Uganda	5.7	5.2	–5.2	–2.9	5.4	5.3	16.0	14.5
Zambia	3.9	5.2	–17.9	–11.9	…	…	14.2	7.9
Others[5, 6]	4.5	5.5	–2.0	–2.3	0.6	1.3	34.6	28.5
BCEAO (WAEMU)[5, 7]	2.0	3.5	–5.4	–4.7	…	…	15.0	10.6
BEAC (CEMAC)[5, 8]	7.9	6.3	–9.4	–4.9	…	…	5.1	10.6

[1] Average annual growth during the period.
[2] Including grants.
[3] Financial account, n.i.e.
[4] Excluding gold.
[5] Weighted average of the countries and regions shown or cited, based on 2000 GDP and PPP exchange rates.
[6] Botswana, Ethiopia, Ghana and Mauritius.
[7] Benin, Burkina Faso, Côte d'Ivoire, Guinea Bissau, Mali, Niger, Senegal and Togo.
[8] Cameroon, Central African Republic, Chad, Republic of Congo, Equatorial Guinea and Gabon.
[9] Latest available figures: for Uganda, as of September; for BCEAO, as of November; for the remaining countries, as of December.

Sources: IMF, *Regional Economic Outlook*: *Sub-Saharan Africa*; IMF, *International Financial Statistics*.

In many countries, inflows of official development assistance (ODA) remain large. For instance, such assistance accounted for 11-18% of GDP in Ethiopia, Ghana, Tanzania and Uganda during 2000-03, compared to 8-12% during 1996-99. According to a recent conservative estimate, annual incremental ODA inflows to the region are expected to rise from $14-18 billion during 2006-08 to $24-28 billion by 2015.[1] Moreover, many countries are expected to save large cash outflows from the recent decision by international creditors (under the so-called Heavily Indebted Poor Countries and Multilateral Debt Relief Initiatives) to partly or fully waive their outstanding loans.

In addition, several African countries have recently witnessed strong private capital inflows. The latest published IMF estimates put private capital inflows into Africa at around $30 billion in 2005. Net capital inflows to South Africa have remained very strong in recent years (about $15 billion in 2004 compared to $9 billion in 2003), led by a surge in portfolio inflows. Egypt and Morocco saw significant increases in both direct and portfolio foreign investments in 2003 and 2004. Inflows of foreign direct investment remained strong in Kenya, Tunisia and Uganda as well.

Foreign inflows and macroeconomic policy

Terms-of-trade gains, stronger private capital inflows, increased foreign official aid – all these represent good news. At the same time, there are major implications for exchange rates and monetary policy. Should the central banks intervene to resist upward pressure on the exchange rate? Should the monetary counterpart of intervention be sterilised or not?

The issue about the exchange rate is not easy to resolve. There may well be agreement *in principle* that the equilibrium real exchange rate needs to rise as the terms-of-trade improve (or capital inflows rise). But policymakers will not know how far the equilibrium real exchange rate has to rise in practice. In addition, the desirable policy response in the short term depends in part on the answers to three questions:

(a) *Are the shocks temporary or permanent?* If temporary, the authorities may want to intervene or resist changes to the

[1] See Gupta et al (2005). Under the United Nations Millennium Development Goals, required aid inflows into Africa would rise from $135 billion in 2006 to $195 billion by 2015.

Table 2

Cumulative changes in commodity prices[1]

	1997–99	2000–02	2003–05
Crude oil	6.4	11.5	102.4
Non-oil commodities	–15.4	–3.4	51.4
Agricultural raw materials	–14.6	–0.1	14.4
Cotton	–43.5	24.9	2.3
Coffee	0.5	–57.9	109.6
Cocoa	–37.7	120.5	–25.3
Metals	–6.3	–10.1	118.3
Copper	–22.1	–9.7	187.3
Gold	–23.3	17.3	53.6
Iron ore	–8.0	6.3	121.6

[1] In per cent.

Sources: IMF; HWWA.

exchange rate. But if permanent, attempts to delay adjustment may be counterproductive.

(b) *What is the country's initial position?* If foreign exchange reserves are dangerously low, for instance, then some rebuilding is desirable; but if foreign exchange reserves are already very high, further accumulation could have adverse monetary consequences. Equally, if inflation is high or rising, corrective monetary policy might be required; but if not, the central bank could acquiesce at least for a time in rapid monetary expansion.

(c) *Are disruption costs lower when the exchange rate moves only gradually to a new equilibrium level*?

Question (a) has much concerned policymakers in commodity-exporting countries.[2] The expansion of government spending programmes when the *terms-of-trade* are unusually favourable has so often created problems in the past. For this reason, many countries have established commodity resource funds. In such schemes, "excess" oil revenues are deposited in a special fund and invested in foreign assets. This not only preserves medium-term fiscal equilibrium, but also reduces pressure on the exchange rate. Algeria has successfully operated such a fund since 2000. With oil prices remaining consistently higher than the benchmark price over the past three years, the accumulated balance in the fund has risen sharply, inflation has remained well contained, and the real exchange rate has depreciated (Table 3). The authorities have also used part of the fund to repay large amounts of outstanding government debt. Nigeria has used a similar arrangement since 2004, depositing the excess oil revenues with the central bank and repaying government debt. At the same time, the real exchange rate has appreciated significantly. This has helped the monetary authority to counter rising inflation pressures. Similarly, in Zambia the authorities appeared to have used both intervention and exchange rate appreciation to various degrees while balancing the domestic and external objectives in the face of rising copper revenues.

Capital inflow shocks – particularly portfolio inflows – are probably seen as less permanent and predictable than terms-of-trade shocks. Yet improvements in the local policy environment and a medium-term

[2] For instance, Cashin and Pattillo (2000) show that terms-of-trade shocks tend to be temporary in half of sub-Saharan African countries (half the effects dissipate in less than four years).

Table 3

Macroeconomic indicators

	CPI inflation[1]			Fiscal balances[2]			Real exchange rates[1, 3]		
	2003	**2004**	**2005**	**2003**	**2004**	**2005**	**2003**	**2004**	**2005**
Oil-exporting countries									
Algeria	2.6	3.6	1.6	3.5	5.9	11.4	–10.1	0.7	–2.9
Nigeria	14.0	15.0	17.9	–1.3	7.7	10.0	–6.1	2.3	11.7
Oil-importing countries[4]	**6.0**	**5.0**	**6.1**	**–3.8**	**–3.3**	**–4.4**	**6.9**	**3.2**	**…**
Egypt	3.2	10.3	11.4	–6.1	–5.9	–9.3	–21.5	…	…
Kenya	9.8	11.6	10.3	–1.7	0.0	–1.7	–0.6	–3.0	…
Morocco	1.2	1.5	1.0	–5.4	–5.4	–6.8	–1.3	–0.7	–1.7
South Africa	5.8	1.4	3.4	–2.0	–1.7	–1.9	29.0	9.1	0.5
Tanzania	4.5	4.3	4.6	–1.4	–3.0	–4.5	–16.6	–9.8	…
Tunisia	2.8	3.6	2.0	–3.2	–2.6	–3.6	–3.7	–3.2	–4.7
Uganda	5.7	5.0	8.0	–4.3	–1.8	–0.7	–12.4	2.5	5.0
Zambia	21.4	18.0	18.3	–6.0	–3.0	–2.5	–1.7	8.1	12.2
Others[4, 5]	17.5	9.4	9.8	–5.8	–3.8	–4.0	7.6	–1.7	…
BCEAO (WAEMU)[4, 6]	1.0	0.3	4.7	–2.3	–2.4	–2.3	3.8	0.0	…
BEAC (CEMAC)[4, 7]	1.8	0.1	3.1	2.0	2.6	7.0	3.2	–1.1	…

[1] Annual changes; in per cent.
[2] As a percentage of GDP; including grants.
[3] An increase indicates an appreciation.
[4] Weighted average of the countries and regions shown or cited, based on 2000 GDP and PPP exchange rates.
[5] Botswana, Ethiopia, Ghana and Mauritius.
[6] Benin, Burkina Faso, Côte d'Ivoire, Guinea Bissau, Mali, Niger, Senegal and Togo.
[7] Cameroon, Central African Republic, Chad, Republic of Congo, Equatorial Guinea and Gabon.

Sources: IMF, *Regional Economic Outlook: Sub-Saharan Africa*; Economist Intelligence Unit.

rise in the real price of some of Africa's commodity exports (oil?) could create the basis for a sustained rise in private capital inflows.

As for *aid flows*, political commitments might suggest that aid flows rise and remain strong for several years. Yet past experience suggests that aid inflows have been highly volatile: in several countries they fluctuated by 10-30% of GDP in a single year in the 1990s.

Aid inflows: absorption and spending

How macroeconomic policy should respond to an increase in aid inflows has been much debated by economists for over 80 years.[3] As adjusting to private capital inflows and terms-of-trade shocks raises similar issues, the analysis of this issue is of wider interest.

Two concepts are central to the analysis of this problem:

(a) *Spending* – the impact of aid on aggregate demand depends on how the government spends the aid it receives. This is basically fiscal policy.

(b) *Absorption* – aid achieves a real resource transfer, ie is "absorbed" only to the extent that the current account deficit (at present or in the future) increases. Fiscal policy also affects this, but monetary policy and the exchange rate exert a decisive influence.

Typically, the central bank gives the government the local currency equivalent of the foreign aid received. What the central bank then does with this foreign exchange influences the exchange rate (and also local interest rates) and thus absorption. For instance, if the central bank uses foreign exchange received from aid to bolster the reserves in order to prevent the exchange rate from appreciating, then absorption is impeded.

A simplified description of four options for possible fiscal and monetary policy responses to aid inflows is set out in Table 4. Although this should illuminate some key choices, an important limitation is the absence of dynamics. In reality, as discussed in the previous section, actual policy choices are more complex. In particular, the policy stance

[3] This issue is related to the famous "transfer problem" that Keynes and others analysed in the 1920s. The effective transfer of resources by Germany to pay for reparations imposed after World War I required not only fiscal surpluses to raise local funds but also current account surpluses to effect the real transfer. Aid transfers are just reparations in reverse. The analysis presented here is based on IMF (2005).

Table 4
Absorption and spending of aid: textbook implications

Policy choices	Implications for: Current account deficit[1]	Fiscal deficit[1]	Forex reserves	Reserve money
1. Spend and absorb	↑	↑	0	0
2. Spend but not absorb	0	↑	↑	↑
3. Absorb but not spend	↑	0	0	↓
4. Neither spend nor absorb	0	0	↑	0

[1] Excluding aid.
Note: This table is based on IMF (2005) and especially Box 1.

could evolve as new information about the permanence (or otherwise) of the shock or about actual inflation pressures emerges. A policy stance (eg holding the exchange rate constant) that is feasible or desirable in the short run often becomes harder to maintain the longer it lasts. Hence, central banks may have initially resisted nominal exchange rate appreciation but over time allowed a real appreciation.

Option (1) is to *absorb and spend* – that is, to increase government spending (or lower taxes) and allow net imports to rise. The extent to which imports rise is determined by the resulting pattern of the incremental domestic spending and the relevant marginal propensities to import.[4] If inflows are used to finance expenditure on tradables (eg imported capital equipment), then the marginal propensity to import will be high. Conversely, spending on non-tradable goods and services will cause a much smaller rise in imports. These factors therefore determine how much real exchange rate appreciation will be needed to close this gap between the rise in imports and aid inflows.

Option (1) is usually seen as the appropriate long-run equilibrium response as neither foreign exchange reserves nor reserve money rise. But very few countries in Africa have followed this textbook prescription. One reason is that the danger of exchange rate overshooting and an associated risk of recession may be particularly great in the African context (see below). This consideration is anyway decisive when aid inflows are expected to be temporary – why risk damaging the tradables sector by accepting a large real appreciation that will have to be reversed?

Option (2) is to *spend but not absorb*. Larger fiscal deficits increase aggregate demand and must be financed by monetary expansion or increased government borrowing from the domestic private sector. But the central bank saves the foreign exchange because of fears that currency appreciation would undermine competitiveness. In the long term, of course, such a policy choice would either be inflationary or would entail shifting scarce investment funds from the private to the public sector.

Option (3) is to *absorb but not spend*. In this case, aid can be used to reduce the fiscal deficit and the central bank sells foreign exchange, reducing the monetary base and appreciating the real exchange rate.

[4] And in some circumstances the propensity to divert potential export goods to the home market. It should be noted that this analysis of spending takes potential output as constant. Increased aid, however, also raises potential output. This affects not only future income but also the future output of tradables and non-tradables – and thus the equilibrium real exchange rate in the medium term.

Table 5

Estimates of absorption and spending: five examples

	Incremental aid absorbed?	Incremental aid spent?	REER[1]
Ethiopia	Partly absorbed 20%	Not spent 0%	–2.1
Ghana	Not absorbed 0%	Not spent 7%	0.5
Mozambique	Mostly absorbed 66%	Spent 100%	–6.4
Tanzania	Not absorbed 0%	Spent 91%	–9.8
Uganda	Partly absorbed 27%	Mostly spent 74%	–6.3

[1] The real effective exchange rate during the period when foreign aid rose strongly.

Note: Non-aid account and fiscal balance deterioration both truncated at 0 and 100. In Ghana and Tanzania, the non-aid current account actually improved despite aid inflows; Mozambique's fiscal balance before aid deteriorated by an amount greater than the fiscal aid inflow.

Source: IMF (2005).

This can be an effective short-term stabilisation strategy when the fiscal deficit is too large, inflation pressures are accumulating or there is a lack of confidence in the domestic currency. However, the feasibility of this option depends on whether donors are prepared to support a strategy of not spending aid on its purported objectives.

Option (4) is to *neither spend nor absorb*. The net result is that aid increases foreign exchange reserves with the central bank and the fiscal position remains unchanged as the government uses aid inflows to repay debt. Like Option (3), this may be the preferred strategy when foreign exchange reserves are low. And if aid flows are volatile, such a policy applied in years when aid flows are particularly heavy may be stabilising. Some have argued that some combination of spending and reserve accumulation is perhaps desirable when donors do not distribute aid according to an optimal time path (Prati et al (2003)).

Table 5 presents a summary of a recent IMF case study of the impact of a surge in aid inflows on five African countries. In no case did increased aid lead to a real exchange rate appreciation, and subsequent export growth was generally strong. With the exception of Mozambique, aid inflows were generally not absorbed: the deterioration in the non-aid current account was much less than the incremental aid inflows.[5] Aid inflows were mostly spent in Mozambique, Tanzania and Uganda. But Ethiopia and Ghana spent very little of the incremental aid – largely because of macroeconomic instability as well as rather high domestic debt and low international reserves.

The monetary implications of these different choices are of considerable interest. Ethiopia and Ghana essentially chose Option (4). Reserves rose and the fiscal deficit was reduced. On balance, then, aid inflows did not increase the liquidity of the domestic banking system. Mozambique, Tanzania and Uganda, however, chose Option (2). The implication of this choice was an incipient rise in the monetary base. How to respond to this became an important element of the policy debate between the IMF and the central banks. The central banks – at least initially – chose to resist nominal appreciation and did not sell reserves.[6]

[5] In some cases, this was due to a simultaneous reduction in capital inflows. A general caveat for such exercises is that the counterfactual (ie what would have happened in the absence of aid inflows) is not of course known.

[6] The divergent views of the IMF and the central banks on the issue of how far large aid inflows should be sterilised are analysed in Buffie et al (2004) and Chapter 5 of Masson and Pattillo (2005). Both conclude that, on balance, the central banks were right.

Table 6

Bond sterilisation episodes in Uganda, Tanzania and Mozambique

In per cent

	Before	Active OMO	After
Tanzania			
91-day yield	7.3	13.9	4.6
Ex post real yield	–1.1	6.9	–0.5
Uganda			
91-day yield	7.1	13.8	6.7
Ex post real yield	–2.2	9.6	4.1
Mozambique			
91-day yield	12.6	22.9	…
Ex post real yield	1.8	10.4	…

Note: "Active OMO" denotes periods of aggressive open market operations by the central bank. These periods are: Tanzania, July 1999-April 2000; Uganda, December 1999-July 2001; Mozambique, July 2000 onward. "Before" refers to the six months prior to the Active OMO period and "After" to the full period since.

Source: Buffie et al (2004).

Scope for sterilised intervention and instrument choice

Intervention in the foreign exchange market, nevertheless, raises two major questions: should it be sterilised, and, if so, how sustainable might such a strategy prove in the African context? When the central bank buys foreign exchange to resist appreciation pressures, the monetary base tends to rise. It can counter this by selling government bills (or its own paper). Such sterilisation of domestic liquidity may be necessary to preserve a monetary stance consistent with inflation goals. Conversely, it is possible that in some circumstances the central bank may want both to resist appreciation and to ease monetary policy. If so, intervention would not create obvious dilemmas for monetary policy.

The scope for sterilising any excess liquidity in the banking system is generally greater when financial markets are well developed, helping the absorption of new debt issuance. But if financial markets are thin, such sterilisation could imply significant increases in interest rates.

The experience of Mozambique, Uganda and Tanzania during the periods of intensive sterilisation illustrates this challenge in the African context quite well (Table 6). The absence of a well developed bond market led the monetary authorities to rely heavily on short-term instruments (largely 91-day treasury bills). Because these markets were thin, interest rates rose sharply, raising debt service payments in the economy.

Higher interest rates resulting from treasury bill sales have the further drawback of attracting additional capital inflows – exacerbating upward pressure on the exchange rate and reversing part of the liquidity effects from the initial sterilisation operations.[7] The fact that residents typically hold bank deposits in both domestic and foreign currency, and switch in and out of domestic currency, reinforced this effect. Macroeconomic stabilisation in effect led residents to reduce their desired foreign currency deposits – effectively reversing private capital outflows.

Experience and model simulations suggest that such inflows (coming on top of aid inflows) are large – and can well lead to an overshooting of the nominal exchange rate in the short run (greater than the required real appreciation). With prices in the non-tradables sector sticky, this

[7] This is the argument of Calvo et al (1993) based on Latin American experience, namely that sterilisation could become self-defeating.

can lead to a severe recession. Buffie et al (2004) argue that this "dramatically undermines the case for a floating exchange rate".[8]

According to Buffie et al (2004), the mounting fiscal costs of debt service undermined the central banks' willingness to continue bond sterilisation and led to a policy reversal: they instead sold foreign exchange more aggressively (Uganda) and/or tolerated more rapid reserve money growth (Tanzania and Mozambique). Subsequent policy evolved as conditions changed. For instance, Tanzania started to sell foreign exchange as inflation rose and began to reduce liquidity in the banking system. In effect, over time the central bank moved to Option (1), in what the IMF called a delayed spend-and-absorb strategy.

The question of exactly which instruments to use to withdraw liquidity raises many issues.[9] One issue is the choice between *market and non-market instruments*. When capital markets are thin, the tendency is to use non-market instruments. Non-market instruments may also be used when only two or three local banks dominate the local money market – partly to counter the risk of oligopolistic gaming of the markets by these banks. Many countries in Africa have indeed used several non-market instruments for sterilisation. For instance, increasing compulsory reserve requirements on banks – particularly in countries where the initial level is low – could be one such instrument. But reserve requirements are a tax on banks, which reduces financial intermediation. In the past, many developing economies have used other non-market instruments, such as transferring government and public financial institutions' deposits from the banking system to the central bank. When such deposits are not remunerated at market interest rates, these public institutions are forced in a rather opaque way to bear part of the sterilisation costs.

A second issue is the *nature of the market instrument*. Market instruments include long-term bonds, shorter-term instruments such as swaps and repurchase operations, and direct borrowing from banks at market rates. Issuing long-term bonds to non-banks is the most effective and durable way of draining back liquidity; but few African countries have long-term bond markets.[10] In countries where foreign exchange and money markets are well developed, central banks might prefer to sterilise through foreign exchange swaps (typically through an agreement to buy forward) and repurchase operations ("repos", where the central bank sells securities to buy back at a later date). Swaps and repos are particularly suitable for temporary interventions.

A third issue is the choice between *government and central bank securities*. From the perspective of the consolidated budget of the public sector, the distinction between government and central bank securities matters little. But good governance considerations might indicate that the cost of forex interventions directed by the government should be borne in a transparent way by the government. This would facilitate public and parliamentary scrutiny.[11]

Whatever method is chosen, the costs of sterilisation tend to rise the longer it is continued. Prolonged intervention in the same direction, over several years, therefore suggests a need to re-examine macroeconomic policies more generally.

[8] On plausible assumptions, they show that the original exchange rate would have to appreciate by 24-55% to forestall incipient capital inflows.

[9] The question of the choice of sterilisation instruments is discussed more fully in Mohanty and Turner (2005): see pp 69-73, Table A4 "Main instruments for sterilisation" and the references for many central bank papers on this subject.

[10] A desirable reform in the medium term would be to develop long-term bond markets. On this, see Kahn (2005) and Christensen (2004).

[11] On this, see Reserve Bank of India (2004).

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Annex

Actual and expected developments in output growth, consumer price inflation and current account balances

	Real GDP growth (%)[1]			Consumer price inflation (%)[1, 2]			Current account balances (US$ bn)[3]		
	2004	2005	2006	2004	2005	2006	2004	2005	2006
World	**5.3**	**4.8**	**4.9**	**3.7**	**3.8**	**3.8**	…	…	…
Industrial countries	**3.0**	**2.6**	**2.8**	**2.0**	**2.3**	**2.3**	**–284**	**–511**	**–603**
United States	4.2	3.5	3.4	2.7	3.4	3.2	–668	–805	–898
Japan	2.3	2.6	3.0	–0.0	–0.3	0.4	171	168	170
Euro area	1.8	1.4	2.1	2.1	2.2	2.1	74	–16	–24
France	*2.1*	*1.4*	*2.0*	*2.1*	*1.7*	*1.7*	*–8*	*–42*	*–36*
Germany	*1.6*	*0.9*	*1.8*	*1.7*	*2.0*	*1.7*	*102*	*115*	*111*
Italy	*0.9*	*0.1*	*1.2*	*2.2*	*2.0*	*2.1*	*–15*	*–27*	*–29*
Emerging economies	**7.6**	**7.2**	**6.9**	**5.7**	**5.4**	**5.4**	**220**	**423**	**487**
Africa	5.5	5.2	5.7	8.1	8.5	9.1	0.9	15.2	23.5
Algeria	5.2	5.3	4.9	3.6	1.6	5.0	11.1	21.7	22.2
Botswana	4.9	3.8	3.5	6.9	8.6	8.9	0.9	0.8	0.5
Egypt	4.1	5.0	5.2	10.3	11.4	4.4	3.4	2.6	1.4
Ethiopia	12.3	8.7	5.3	8.6	6.8	10.8	–0.5	–1.0	–1.0
Ghana	5.8	5.8	6.0	12.6	15.1	8.8	–0.2	–0.7	–0.9
Kenya	4.3	4.7	3.3	11.6	10.3	11.5	–0.4	–1.5	–0.9
Mauritius	4.2	3.5	2.7	4.1	5.6	7.1	0.1	–0.2	–0.2
Morocco	4.2	1.8	5.4	1.5	1.0	2.0	1.1	0.5	–0.4
Nigeria	6.0	6.9	6.2	15.0	17.9	9.4	3.3	12.5	16.5
South Africa	4.5	4.9	4.3	1.4	3.4	3.9	–7.4	–10.0	–10.0
Tanzania	6.7	6.9	5.8	4.3	4.6	5.2	–0.2	–0.3	–1.0
Tunisia	6.0	4.2	5.8	3.6	2.0	3.0	–0.6	–0.4	–0.5
Uganda	5.6	5.6	6.2	5.0	8.0	6.5	–0.1	–0.1	–0.4
Zambia	5.4	5.1	6.0	18.0	18.3	13.3	–0.6	–0.7	–0.8
BCEAO (WAEMU)[4]	3.2	3.9	3.8	0.3	4.7	2.0	–1.5	–2.3	–2.3
BEAC (CEMAC)[5]	9.8	3.8	3.2	0.1	3.1	2.8	–1.2	1.1	2.4
Asia	8.0	8.0	7.7	4.4	3.4	3.8	184	252	220
China	10.1	9.9	9.6	3.9	1.9	2.2	69	161	137
India[6]	6.5	8.3	7.5	6.6	4.8	4.9	1	–16	–19
Other emerging Asia	5.6	4.7	5.0	4.1	5.6	5.9	114	107	102
Latin America[7]	5.9	4.3	4.6	6.1	5.7	5.2	22	39	31
Central Europe[8]	5.0	4.0	4.8	4.0	2.3	1.6	–25	–16	–17

[1] Annual changes; for the aggregates, weighted average of the countries and regions shown or cited, based on 2000 GDP and PPP exchange rates, as of May 2006.
[2] For India, wholesale prices.
[3] For the aggregates, sum of the countries and regions shown or cited; world figures do not sum to zero due to incomplete country coverage and statistical discrepancies.
[4] Benin, Burkina Faso, Côte d'Ivoire, Guinea Bissau, Mali, Niger, Senegal and Togo.
[5] Cameroon, Central African Republic, Chad, Republic of Congo, Equatorial Guinea and Gabon.
[6] Fiscal years starting in April.
[7] Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela.
[8] Czech Republic, Hungary and Poland.

Sources: Consensus Economics; IMF, *World Economic Outlook*; national data; BIS estimates.

The relationship between the central bank and the government

Paul Moser-Boehm

Information sharing and cooperation between the central bank and the government

In many countries the world over, the central bank has been given the mandate to preserve price stability as its single or primary objective, and been granted autonomy from government to make sure that short-term political considerations do not interfere with achieving this objective. Accountability to the legislature and the public at large balance the central bank's autonomy. Transparency – the third element of the modern paradigm of central banking – is important for holding the central bank to account, and for making monetary policy efficient by shaping inflation expectations. In principle, there is a clear division of responsibilities and accountabilities between the central bank on the one hand, and the government and the Minister of Finance on the other hand. Even so, information sharing, cooperation and coordination between the central bank and the government are important in a number of respects. The first and major part of this note focuses on practical aspects of the cooperation between the central bank and the government, and is based on a survey of central banks conducted in early 2006.[1] This is followed by a brief review of aspects of the financial relationship between the central bank and government. Before turning to the survey information, a brief discussion of the underlying issues may be useful.

Clarity of framework and objectives. In general, a strong appreciation of the different objectives and operating frameworks of the central bank, the fiscal authorities and development institutions (where applicable) will be conducive to a fruitful dialogue among them, because information and views are shared more easily when all parties understand and respect the others' rights and responsibilities.

[1] Central banks represented on the Central Bank Governance Network (which is part of the Central Bank Governance Forum at the BIS) were invited to participate in this survey. The statistics in this note are based on the 24 responses received to date (11 from industrialised countries, 13 from emerging market economies). The industrialised countries in the survey have a median per capita GDP of USD 31,000 (PPP-adjusted estimates for 2005) and the emerging market economies one of USD 10,400. The information suggests a number of differences between approaches taken in industrialised countries and this group of emerging market economies, but it is difficult to judge the extent to which these differences can be extrapolated to emerging market economies with per capita incomes substantially below USD 5,000 or so.

Clear and focused objectives for each authority and a high degree of transparency in pursuing them help the communications process within the public sector, in addition to shaping private sector expectations and providing a basis for accountability.

Coordination of monetary and fiscal policy. If the fiscal authorities know the central bank's policy reaction function and its formal or informal analytical model, they can anticipate the monetary policy response to a given fiscal action and adjust the action accordingly. In principle, coordination between monetary and fiscal policy can thus be achieved without negotiations between the monetary and the fiscal authorities, and the central bank can take advantage of being the first mover (by establishing a credible reaction function), which is important to avoid undermining its price stability objective. To implement this approach, it will still be useful if the central bank and the government can establish a culture of no surprises, to assist each other in staying the course in spite of a myriad of daily challenges.

Coordination in other areas. In some areas other than monetary policy, coordination between the central bank and the government may need to be quite close. For example, this is the case for fiscal agent functions of the central bank. In addition, the central bank's financial sector regulatory functions or advisory responsibilities (as well as its own participation in the financial system) allow it to foster the development of the sector, which will require close coordination with the government, for instance on legal reform.

Development role of the central bank. The single most important contribution central banks can make – in industrialised and developing economies alike – is to provide an environment of monetary stability, which in turn is conducive to economic growth and development. At the margins of this principle, central banks in some industrialised countries are making an effort to focus their activities ever more on this core responsibility. By contrast, in emerging market economies central banks are often a centre of resources and expertise that is asked to take on a number of development functions. It is worth noting that historically, many central banks have played an important role in developing the financial sector's capability – for example, the Bank of England has for most of its life seen itself as a champion of London as a financial centre, and the Monetary Authority of Singapore continues to see this as a major part of its role. But it is also worth noting the dangers in an institution shouldering too many tasks at once, and losing clarity of incentives in the process, for itself as well as for other economic agents. Therefore, central banks in developing countries often prefer to limit their development functions to the financial sector, where they are best placed to contribute to infrastructure building and human capital formation.

Macroeconomic management challenges. In low-income countries the dependence on selected commodity exports can make them highly susceptible to terms-of-trade shocks, the predominant role of the primary sector can lead to large fluctuations in output, demand and government revenues (in part simply as a result of fluctuations in the weather), and the volatility of aid flows can be a further huge challenge in trying to stabilise output (Bevan 2005). In addition, if market imperfections are such that monetary policy can have permanent effects on real variables, the central bank may be subject to yet more political pressures than in more advanced emerging market economies or industrialised countries.[2] These factors, and a scarcity of reliable statistics and analytical models, may require very close interaction between monetary and fiscal authorities, and in some cases development institutions. This in turn puts a premium on well considered governance arrangements.

Oil and other resource revenues. An important aspect of policy coordination in a number of developing countries concerns the management of oil and other resource revenues. For oil-exporting countries, two approaches may be used. One is to budget at a conservative, "normal" oil price. This reduces the danger of large budget deficits if prices decline suddenly, and is now done by, for example, Nigeria. The second is to establish a resource fund to set aside some or all of the resource revenues net of costs. In the industrialised countries this has been done by Norway and (at the provincial level) in Canada; in Africa it has been implemented by Gabon and now Chad for oil revenues, and in Botswana for revenues from diamond mining. Proper governance arrangements for such resource funds are essential but can be difficult to devise and implement.

[2] For example, if foreign exchange reserves are adequate, the central bank may be in a position to achieve an optimal allocation of spending over time in spite of aid flows not being disbursed with optimal timing (Prati et al 2005).

Table 1

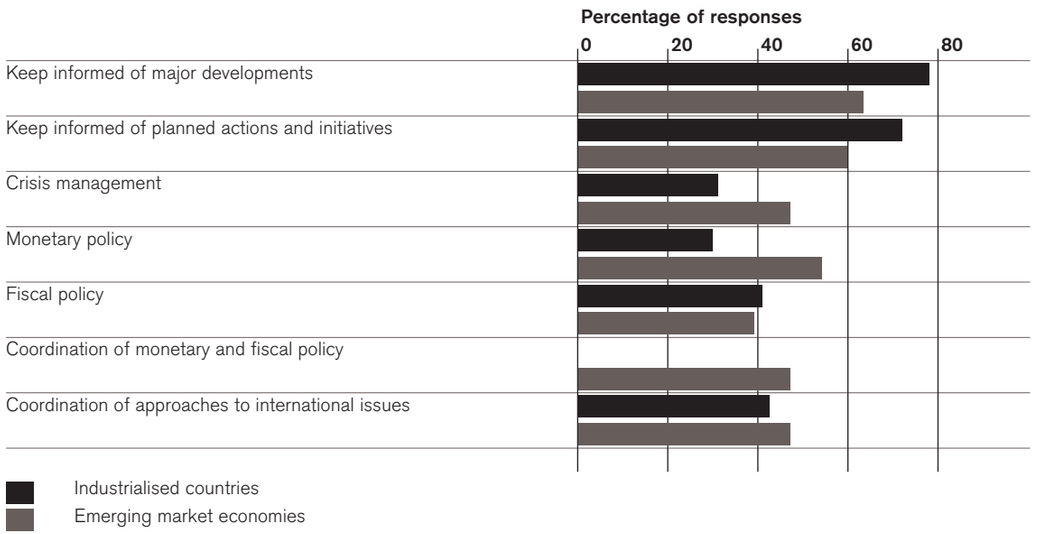
Frequency of meetings between the central bank and the government

Percentage of respondents (among 24 central banks)

Type of meeting	Percentage of central banks having this type of meeting		Average number of meetings per year	
	IC	EME	IC	EME
A Governor and Minister of Finance	73	31	8	9
B Governor and other high-level government officials	91	62	5	21
C Deputy Governor and high-level government officials	27	15	9	32
D Senior officials and department heads	36	15	7	12
E Government representative on central bank's board	18	62	17	17
F Governor at (economic) cabinet meeting	9	54	10	29
G Financial stability or supervisory committee	18	38	9	14
H Other	36	23	4	3
Number of meeting types and total number of meetings	**Percentage of respondents using …**		**Total average number of meetings per year**	
Single type of meeting used	-	-		
Two meeting types used	9	31		
Three meeting types used	36	31	23	47
Four meeting types used	55	38		

Figure 1

Purpose of high-level meetings between the central bank and the government



Meetings of senior central bank and government officials

Turning to the practical aspects of cooperation between the central bank and the government, virtually all central banks participating in the survey conducted for this note have processes in place to exchange information and cooperate with the government. However, there are considerable differences in how this is done. Table 1 provides information on eight different types of meetings between senior officials from the central bank and the government that are used in a significant number of countries. The following points may be noted:

– Meetings between the Governor and the Minister of Finance or other high-level government officials are a practice in a larger share of industrialised countries than emerging market economies. By contrast, in the latter having a government representative participate in meetings of the central bank's board or the Governor participating at meetings of the cabinet, or of an "economic cabinet" consisting of key ministers, is far more frequent than in industrialised countries.

– For almost all types of meetings, the average number of meetings held per year is substantially higher in emerging market economies than in industrialised countries. For all senior-level meetings together, the average total is 47 meetings per year (or about one meeting per week) in emerging market economies, and half of that (two meetings per month) in industrialised countries.

– By contrast, the number of different types of meetings tends to be higher in industrialised countries than in emerging market economies.[3]

The differences in the number of meeting types and in the frequency of meetings suggest that in industrialised countries, the relationship between the central bank and the government tends to be one of keeping one another informed in a variety of settings, while in emerging market economies it may more often be geared towards actual cooperation, the sharing of quite detailed information and analysis, and interacting on the larger number of subjects the central bank

[3] The survey questionnaire asked for information on up to four of the most important senior-level meeting types.

tends to be involved with there. Other survey evidence supports this impression, as will be shown later.[4]

Figure 1 summarises the purpose of the various high-level meetings between the central bank and the government. Most notably, for about half of the participating central banks from emerging market economies the coordination of monetary and fiscal policy is a key purpose of their high-level meeting(s) with the government, while none of the central banks of industrialised countries indicate that this is the purpose of any of their meetings with government. Similarly, discussing monetary policy is a purpose of the meetings considerably more often in emerging market economies than in industrialised countries. While it would be wrong to take this as a sign of a lack of monetary policy autonomy in some of the central banks of emerging market economies in the survey, it raises interesting questions about potential differences in the way central banks understand or perceive their role within government, or about whether they do in fact play a different role.[5]

The survey information presented above covered all senior-level meetings between the central bank and the government, irrespective of the personal involvement of the Governor. To illustrate that the degree of involvement by the Governor also varies considerably across countries, Annex Table A1 provides detailed information on all senior-level meetings where the Governor takes part in person.[6] For example, the Governor of the Reserve Bank of Australia generally meets with the Minister of Finance after the meeting of the Reserve Bank Board, while the Governor of the Central Bank of Norway and the Norwegian Minister of Finance meet on the day before interest rate meetings of the Bank's Executive Board. In the Czech Republic, the Minister of Finance has the right to participate in the weekly meeting of the board of the central bank, and the Governor (or Deputy Governor) has the right to participate in a weekly meeting of the government.[7] In the United States, a Federal Reserve/Treasury luncheon is hosted at the Federal Reserve Board by one of the Governors on a rotating basis once every three weeks or so. In addition, some general points may be taken from Table A1:

– There is a very wide range of practices – some Governors have less than a handful of meetings with senior members of government each year, while others meet with the head of government or the Minister of Finance on a weekly basis.

– The purposes of meetings involving the Governor tend to be more wide-ranging in emerging market economies than in industrialised countries. In part, this probably reflects the often broader range of mandates of central banks in emerging than in industrialised economies.

– In industrialised countries, if a meeting with senior government officials involves the Governor it is very likely that the Governor's attendance at the meeting is essential (and that the meeting would not be held without the Governor). In emerging market economies, the most frequent case is that the Governor will usually attend but substitution is possible. In part, this probably reflects the larger number of meetings in the latter, but it may also be the case that a larger number of the meetings in industrialised countries are held for the express purpose of hearing the Governor in person, as opposed to sharing information with the central bank.

Informal contacts

In addition to regular or ad hoc meetings between senior central bankers and government officials, yet more informal ways of consulting involve contacts over the phone and by e-mail. Table 2 shows the nature and frequency of such contacts between the Governor and the head of state, the head of government, the Minister of Finance and the Deputy Minister of Finance. In the vast majority of both industrialised and emerging market economies, the Governor and the Minister of Finance keep in touch over the phone (e-mail is considerably less

[4] The aggregate information in Table 1 hides a wealth of potentially useful information on the concrete mix of meeting types used by individual central banks, as well as on specific aspects such as timing, detailed attendance, the preparation of the agenda and meeting documents, and public communications about the meetings. This information is available to central banks, subject to preferences on information sharing expressed by participating institutions. Please contact cbgovernance@bis.org for details.

[5] Concerning the latter, it is widely acknowledged that central banks in emerging market economies often have development functions that do not arise elsewhere, but this does not directly explain why the coordination of monetary and fiscal policy would often be considered an important reason for the interaction between the central bank and government.

[6] Annex Table A1 thus covers a subset of the data included in Table 1. Moreover, Table A1 does not show information for central banks preferring to remain anonymous in this survey, and it does not cover meetings of the principal board of the central bank where a government representative is present, on the logic that these are typically not held primarily to exchange information with the government.

[7] In practice, the Minister of Finance participates in the meeting of the central bank board very rarely while the central bank representative takes part in almost all weekly meetings of the government.

Table 2

Informal contacts between the Governor and senior government officials

Percentage of responses (from 23 central banks)

Contacts between governor and …	Head of state		Head of government		Minister of Finance		Deputy Minister of Finance	
	IC	EME	IC	EME	IC	EME	IC[1]	EME
Generally not done	40	54	30	23	10	8	30	15
Frequency (per year):								
Up to five times	100	80	67	33	13	-		13
Six to 10 times	-	-	17	33	63	38		38
Eleven to 25 times	-	20	-	-	25	31		13
More than 25 times	-	-	-	22	-	23		13
Direction:								
Usually Governor contacts government officials	33	20	17	44	25	-		-
Usually government official contacts Governor	-	40	50	22	-	15		13
Both sides initiate contact with similar frequency	-	20	33	22	75	77		63

[1] Insufficient detailed information was provided for this column.

Table 3

Public comments on policies of counterpart

Percentage of responses (among 22 central banks)

	Must comment		Chooses to comment							
			Often or always		At times		Rarely		Never	
	IC	EME	IC	EME	IC	EME	IC	EME	IC	EME
Comments by the central bank on …										
Government's budget	10	8	30	33	40	42	10	8	10	0
General aspects of fiscal policy	-	-	50	17	30	50	20	8	-	17
Financial sector policy	-	33	33	17	60	25	10	-	-	8
Structural policy	-	-	40	17	40	42	20	25	-	8
Comments by the government on …										
Monetary policy decisions	-	-	-	17	70	42	30	17	-	8
General aspects of monetary policy	-	17	-	17	50	33	20	17	20	-

frequent), with both sides initiating the contact with similar frequency. Calls are typically made once or twice per month. The Governor and the head of government are also in touch over the phone in the majority of countries, but less frequently than with the Minister of Finance. Informal contacts between the Governor and the head of state are yet less frequent, and generally not made in about half of the countries surveyed. On the whole, informal contacts between the Governor and senior government officials are made somewhat more often in emerging market economies than in industrialised countries.[8]

This corroborates the impression from Table 1 that consultation between the central bank and the government tends to be a more continuous, frequent activity in the former than in the latter. A last piece of evidence pointing in this direction is that about a third of the emerging market central banks in the survey have established a general coordination group at the staff level to deal with all relevant central bank/government issues, and almost half have set up such a coordination group for monetary and fiscal policy coordination.

By contrast, such groups are rarely used in the industrialised countries. The only exceptions are coordination groups for financial sector/financial stability issues and for crisis management, which are used in a number of industrialised countries and emerging market economies alike.

Regional groupings and institutions

By their very nature, supranational central banks have quite different relations with governments than national central banks. In Africa, there are two such institutions: the Central Bank of West African States (BCEAO) and the Bank of the States of Central Africa (BEAC). The corresponding monetary and economic zones (WAEMU and CEMAC, respectively) have considerable power to resist pressures from individual member countries. In particular, WAEMU has prohibited the direct financing of governments by central banks since 2002. Instead, governments in the area are now forced to issue short-term securities to finance their deficits, which helps develop regional financial markets.[9]

[8] The level of the government counterpart who is contacted by the Governor also tends to be a little higher in emerging market economies than in industrialised countries. This is consistent with the central bank Governor in the surveyed emerging market economies having a somewhat higher average rank in official protocol than is the case in the participating industrialised countries: in the former, the most frequent case is the Governor having the same level as the Minister of Finance, while in the latter the most frequent arrangement is the Governor being at the level of the highest-ranking civil servant at the Ministry of Finance.

[9] Thus far, a similar move by CEMAC has been postponed several times. For details on the two zones, see IMF (2005) and van den Boogaerde and Tsangarides (2005).

An important aspect of regional integration in Africa has been putting in place regional surveillance over fiscal policies. This is the case for the two CFA franc zones but is also a feature of other regional groupings (COMESA, ECOWAS and SADC), where peer pressure is developing. Regional surveillance – including over governance issues – is also at the centre of the New Partnership for African Development (NEPAD) process endorsed by the G7/G8.

The institutional arrangements devised for the euro area may be of interest for other currency areas. The ECB's relationship with the EU Council and Commission (both of which perform executive functions in the European Union) is mainly based on statutory obligations, since the EU Treaty provides for a number of forms of interaction between the ECB and other policymakers of the EU, ranging from consultation to policy dialogue. In addition, the relationship is shaped by the practical consideration that contacts with other policymakers are useful in carrying out the ECB's functions and tasks, within the statutory limits established for the ECB and the European System of Central Banks – most notably their independent status and the primary objective of maintaining price stability.

The statutory legal framework guiding the ECB's relationship with the Council and the Commission has been laid down at the level of the EU and not that of the euro area. Since for the time being the regional scope of the euro area does not yet coincide with that of the EU, there has been a need to "replicate" – on a transitional basis – a similar framework at the level of the euro area. To that end, informal bodies have been set up to facilitate closer contacts between the ECB and the member states of the euro area on issues which are of common concern. In particular, the Eurogroup has been set up to allow for informal discussions regarding the euro area between the ministers of euro area member states, a member of the Commission and the President of the ECB. At the end of 2004, new working methods for the Eurogroup were introduced, including a more stable Presidency. In the same vein, the Economic and Financial Committee and the Economic Policy Committee have also – on a transitional basis – adjusted their working methods and meet in a separate euro area configuration to discuss issues which are of particular relevance for the euro area. The ECB is a member in these fora and participates in informal discussions that contribute to better communication and the fulfilment of the Eurosystem's tasks.

Another factor behind the evolution of the relationship between the ECB and the EU Council and Commission is the continued fostering of financial integration in the EU and the possible challenges for financial stability deriving from it. In order to ensure sound regulation, rigorous supervision and adequate crisis management tools, various specialised groups have been created within the framework of the so-called Lamfalussy structure. Given the Eurosystem's task of contributing to the smooth conduct of prudential supervision and to financial stability, the ECB is also involved, to varying degrees depending on the financial market segments concerned, in the workings of these groups.

In the survey, the most important high-level contacts between the ECB and the EU Council and Commission are: (1) the President of the Eurogroup and a member of the EU Commission have the statutory right to attend the meetings of the ECB Governing Council; (2) the President of the ECB is invited to attend meetings of the Eurogroup; (3) the ECB has a standing invitation to attend meetings of the Ecofin Council of Ministers and its preparatory committees;[10] and (4) there are a number of regular bilateral meetings between the ECB and the EU Commission.

Communication aspects

In some countries, the central bank has an obligation to comment publicly on selected aspects of government policy, and in a few cases the government has an obligation to comment on general aspects of monetary policy. However, in the majority of countries both sides have a choice over how frequently they comment on the policies of their respective counterpart (Table 3). It is notable that central banks in industrialised countries have a higher propensity to comment on fiscal and structural policies of the government than in emerging market economies, and central banks as a whole tend to comment more frequently on government policies than governments do on monetary policy matters. In fact, it is quite rare for central banks to consider it a taboo to comment on economic policies of the government, and vice versa for governments to minimise their comments on monetary policy.

[10] In practice, it participates regularly in meetings of the preparatory committees but only occasionally in Ecofin meetings, as most subjects of relevance to the ECB are usually already addressed in the preparatory committees or the Eurogroup.

Table 4

Central bank lending to government (national or federal level)

Percentage of central banks surveyed

Lending to government: the central bank …	Total	Industrialised countries	Emerging market economies
Must lend	10%	9%	9%
May lend	45%	36%	54%
Must not lend	48%	54%	36%

Source: 2004 survey among Central Bank Governance Network on central bank services to government.

Why do central banks comment on policies of the government quite frequently? In emerging market economies, formal rules are mentioned as a major factor most frequently, while in industrialised countries tradition, and to a lesser extent the personal preferences of the Governor, play the most important role (Annex Table A2).[11]

Satisfaction with arrangements

Concerning the sharing of information with the government, three quarters of the central banks in the survey are very satisfied, and the remainder (more often from emerging market economies than industrialised countries) are moderately satisfied. Regarding the relationship as a whole, almost 80% of the central banks in emerging market economies are highly satisfied but 40% of the respondents from industrialised countries are only somewhat satisfied. Reasons for the more muted satisfaction in industrialised countries vary. For example, one central bank was concerned about the relationship not being formalised enough and therefore being overly dependent on exogenous events and the personal preferences of key officials, and another about disputes between the central bank and the government too often being carried out in the public eye.

Aspects of the financial autonomy of central banks

This note began with the modern triangle of central banking (an autonomous central bank pursuing price stability in a transparent manner and being held to account for its performance) and then discussed practical aspects of the interaction between the central bank and government in this type of arrangement. The remainder of the note summarises aspects of the financial relationship between the central bank and government that have a bearing on the policy autonomy of the central bank.

Three aspects of the financial autonomy of central banks may be distinguished: (1) the ability to set the terms and conditions on the items in the central bank's balance sheet – this is essential for the conduct of monetary policy; (2) having the means to bear any losses that arise from central bank operations and having appropriate rules to

[11] It appears that formal rules may not always require the central bank to comment publicly on government policies but are understood to encourage such comments.

allocate profits (including rules that govern the accumulation of capital and reserves); and (3) the ability to cover operating expenses, and in particular to set salaries (typically the single largest component of operating costs) in a manner that allows the central bank to attract and retain the professional talent it requires.

Concerning the first aspect, monetary policy autonomy may be at risk if the central bank can be obliged to lend to the government or provide it with implicit or explicit subsidies in other ways, for example by supporting the price of government debt. Where financial markets are well developed, this risk is the principal reason why lending to government is typically prohibited when the central bank law is modernised, for example to comply with the Maastricht criteria in the case of actual or prospective euro area participants (Table 4 provides a snapshot of the frequency of such prohibitions). In emerging market economies, it is also important to address this risk, but there is a second reason why it is desirable to limit access to central bank credit by the government. This is to provide an impetus for the development of local money and bond markets, which will benefit from the government being motivated to develop a local market-based source of credit, and the critical mass the government's borrowing needs may provide.

At the same time, practical experience shows that it can be very difficult to convince governments, particularly in low-income countries, to agree to a reform of the central bank law that includes the wholesale prohibition of lending to government. To address this problem, great efforts have been made to draft central bank laws that limit government access to or facilitate a gradual weaning of the government off central bank credit, but not much is known about how effective such provisions are in practice.

The second aspect of financial autonomy concerns an adequate level of central bank capital in relation to the risks the central bank is expected to absorb, as well as clear and consistent provisions on accounting for valuation changes, on the creation of reserves, and on the transfer of a central bank surplus (or loss) to the government. The *Report by the Study Group on Central Bank Capital* (BIS (2005a)) addresses these issues in detail.

Concerning the third aspect of financial autonomy, the challenge is to devise an approach for funding the expenditure budget of the central bank that encourages the careful stewardship of resources but does not allow the government to control the central bank via the purse strings.[12] In a 2005 survey of related arrangements, in the majority of central banks a supervisory board is empowered to approve (and in some cases to veto or amend) the budget as well as staff salaries. By contrast, the Minister of Finance has a substantial say on the central bank's operating budget in only about 20% of the countries surveyed, and parliaments generally only have the right to be informed of the central bank's budget but need not approve it. The only notable exception is the salary of the Governor, which must be approved by parliament in about 20% of the cases, and can be vetoed or amended by a small number of others.

In many cases, the costs of providing services to government can be covered by pricing them, which also addresses the problem of implicit subsidies and competitive distortions. However, in practice it may be hard to agree on terms with the government, or the central bank law may restrict the pricing of some or all services to government. To illustrate, in a 2004 survey, half of the emerging market economies and a third of the industrialised economy central banks did not price services to the national government at all.

[12] Some aspects of this issue are discussed in a report, *Provision of Information on Central Bank Expenditure Budgets* (BIS (2005b)).

Annex Table A1

Meetings between the Governor and senior government officials

	Meeting type[13]	Presence of Governor[14]	Senior government counterpart(s)[15]	Keep informed of developments	Keep informed of plans	Crisis management	Monetary policy	Fiscal policy	Coordination of monetary & fiscal policy	Coordination of approach to internatl issues	Specific other issues	Other	Where / Chair[16]	Number per year / type[17]	Comments
Industrialised countries															
Australia	A	E	MF(E)	▪	▪		▪					▪	M/NA	6/R	After RBA board meeting
Finland	B	E	HG(E), ME(E)	▪	▪								G/HG	12/R	Economic Council
Iceland	B	E	HG(E), MF(E)	▪				▪			▪	▪	M/M	4/I	
Israel	A	E	MF(E), ME(U)	▪	▪	▪			▪	▪	▪		G or o/NA	12/I	
	B	E	HG(E)	▪	▪						▪		G or o/NA	4/A	
	F	U	HG(E), AM (E)										G/G	15/R	Governor is economic advisor of Government
New Zealand	B	E	HG(U), MF(E)				▪						G/NA	4/R	Pre-Monetary Policy Statement meeting
	B	E	MF(E)	▪	▪								G/NA	3/I	Informal ad hoc meetings
	B	U	MF(E)	▪	▪								M/NA	3/A	Formal ad hoc meetings
	A	E	MF(E)	▪	▪	▪	▪	▪					M/NA	12/R,A	One-on-one meeting with Secretary of Treasury
Norway	A	E	MF(U)	▪	▪		▪				▪	▪	G/G	9/R	On day before interest rate meeting of Executive Board
Emerging market economies															
Chile	A	E	MF(E)	▪	▪							▪[18]	M/NA	20/R	
Czech Republic	F	U	HG(A), AM (A)	▪	▪	▪	▪	▪	▪	▪	▪	▪	G/G	50/R	
	H	U	Deputy HS (A), AM(A)	▪	▪		▪	▪	▪	▪	▪	▪	G/G	4/R	Government Economic Council
	B	U	MF(U)	▪	▪	▪	▪	▪	▪	▪	▪		M/ad hoc	20/I	
Hong Kong SAR	E	U	ME(E)	▪	▪	▪	▪[19]		▪	▪	▪		CB/G	6/R,A	Exchange Fund Advisory Committee
	G	U	ME(E), MF(U)	▪	▪	▪	▪[23]	▪	▪[20]	▪	▪		G/G	/R, A	Council of Financial Regulators
	G	U	MF(E)	▪	▪	▪	▪[23]	▪	▪[24]	▪	▪		G/G	/R, A	Financial Stability Committee
Hungary	A	U	MF(U)	▪		▪							M/NA	5/A	Economy Supervisory Meeting
India	B	U	HG(U), MF(U)	▪	▪		▪	▪	▪	▪	▪		M/NA	8/A	
Mexico	B	U[21]	MF(U)[22]	▪	▪		▪	▪	▪	▪	▪	▪[23]	M/[24]	[25]/A	Exchange Commission
Philippines	F	U	HS(E), ME(E), MF(E)	▪	▪	▪	▪	▪	▪	▪	▪		M/G	52/R	
Turkey	B	U	MF(D), HG&ME(D)	▪	▪			▪	▪	▪	▪		M/NA	/A	
	F	E	MF(U), HG&ME(D)	▪		▪	▪				▪		G/G	2/R	

13 Please see Table 1 for definitions
14 E = essential; U = usually; D = on demand
15 HS = Head of State
HG = Head of government
AM = All ministers
ME = Ministers with economic portfolio
MF = Minister of Finance
16 CB = Governor or central bank
G = senior government participant or government office
M = mixed; NA = not applicable (very small meeting)
17 R = regularly scheduled
I = irregular schedule
A = ad hoc
18 Financial and FX policy
19 Hong Kong SAR operates a Currency Board system and the monetary policy objective is set by the government
20 Hong Kong's monetary policy is exchange rate stability under the linked exchange rate system
21 No substitution
22 No substitution
23 Exchange rate policy
24 Chaired by MF if present; otherwise by Governor (if present)
25 No meeting in past 12 months

Annex Table A2

Major factors behind practices for public comments

Percentage of responses

	Major factor		Contributing factor		Not important or not applicable	
	IC	**EME**	**IC**	**EME**	**IC**	**EME**
Formal rules (eg central bank law, MoU)	20	75	30	-	40	8
Tradition	50	17	30	75	10	-
Personal preference of Governor	10	8	50	25	20	42
Personal preference of member of government	-	8	40	8	30	42
Other	10	17	-	-	-	-

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Financial access and financial stability

Penelope Hawkins[1]

Introduction

The provision of wider access to formal financial services is increasingly becoming a focus of governments and monetary authorities. An issue that must be considered is whether or not such increased access jeopardises financial stability. This paper takes the view that the promotion of access will enhance financial stability in both the long and the short run. The paper also identifies those areas where central bank involvement can promote such a mutually reinforcing process.

Access to services in banking as a development challenge

Countries are faced with the challenge of increasing provision of banking facilities to firms and households alike. A well functioning banking sector can play an important role in channelling resources to the best firms and investment projects. While large companies tend to be well catered for, small enterprises often have to rely on their own funds. The access to finance and the quality and cost of the service that small businesses receive from banks are key to their profitability and prosperity (and that of the economy). For a household, the implication of a lack of access to banking services is severe. The issue of access affects the ability of a household to receive government transfers, or to make payments or to accumulate cash surpluses for planned expenses or emergencies. Individuals who have no option but to carry cash are exposed to security risks. The lack of a vehicle for saving may result in low-income households resorting to expensive short-term debt.

[1] This paper was written for the BIS by Penelope Hawkins, FEASibility Limited, South Africa (e-mail penelope.hawkins@feasibility.co.za).

Table 1

Branch and ATM penetration across countries

	Geographical branch provision	Demographic branch provision	No of ATMs (year)	Geographical ATM provision	Demographic ATM provision
Botswana	0.11	3.77	84 (2003)	0.27	9.00
Kenya	0.77	1.38	242 (2005)	0.56	0.99
Mauritius	71.92	11.92	261 (2003)	133.0	22.04
Namibia	0.11	4.47	235 (2003)	0.30	12.11
Nigeria	2.41	1.62	>352 (2005)	-	370
South Africa	2.22	5.99	14,024 (2005)	6.49	17.5
Tanzania	0.23	0.57	67 (2005)	0.07	0.17
Uganda	0.67	0.53	>150 (2005)	0.90	0.70
Zambia	0.21	1.52	-	0.09	0.65
Zimbabwe	1.11	3.27	288 (2003)	1.15	3.38
Median of 99 countries	**4.80**	**8.42**		**10.07**	**16.83**

Note: Geographical branch or ATM provision refers to the number of branches or ATMs per 1,000 square km. Demographic branch or ATM provision refers to the number of branches or ATMs per 100,000 people.

Source: Beck et al (2005).

The data in Table 1 are those for the geographical and demographic provision of bank branches and ATMs for a selection of African countries. The data provide an indication of the potential access to financial services for firms and households. The median data for some 99 developed and developing countries are shown in bold.

The data suggest that only Mauritius exceeds the median values for both branches and ATMs. South Africa exceeds the median values for ATM provision only.

It is widely agreed that access to financial services can help to distribute opportunities more evenly, especially for poorer households and small businesses.[2] Discussions about access inevitably revolve around changing supply conditions so that the needs of the consumers can be met and usage encouraged. Policy to encourage access must, however, take the objectives of financial stability into consideration.

Financial stability in developing markets

Financial stability requires an effective regulatory infrastructure, effective financial markets and effective and sound financial institutions.[3] It should be noted, however, that while financial stability is associated with efficiency, efficiency on its own does not guarantee that the land is flowing with milk and honey. While efficiency is a necessary condition for net economic welfare, it is not a sufficient condition.

The financial system comprises a number of interrelated components – infrastructure (including legal, payment, settlement and accountancy systems), markets (stock, bond, money and derivatives) and institutions (banks, securities firms and institutional investors). A disturbance in any one of these areas can affect the stability of the system, and risks may arise in any one of these areas. For example, an inefficient payment or settlement system can undermine the speed and accuracy of transactions. The reputational risk of one set of participants can undermine public confidence in the banking institutions.

An independent and non-corrupt judiciary and effective laws to protect property are essential to promoting access to financial services. If loan

[2] Claessens (2005).
[3] South African Reserve Bank (2004).

contracts are not easily enforceable, then banks will not be willing to lend – a problem that may help explain the excess liquidity of banks in a number of African countries. An example is the case of Cameroon, where the legal system allowed the fraudulent attachment of bank deposits as the payment for alleged debts (the "saisie-attributions"). Subsequent legal reforms have helped to contain this problem, which discouraged the use of financial intermediaries.

Over and above these elements, there are potential exogenous risks, which stem from problems outside the financial system and include natural disasters, political disruptions or even the failure of a non-financial company.

Most of the central bank policy instruments designed to promote financial stability directly also affect it indirectly. Prudential instruments protect depositors, monetary policy fosters price stability, and payment and settlement systems promote the swift settlement of financial transactions.[4] While analysis of financial stability overlaps to a large extent with macroprudential analysis of the economy and microprudential analysis of systemic firms and markets, the analysis is incomplete without taking into account the ability of the system to absorb disturbances. In addition, more than one set of risks may manifest simultaneously. Emerging markets may be less resilient in the face of financial instability because their ability to absorb disturbances may be undermined by lack of industrial diversification and weak macroeconomic management.[5]

The issue of financial stability requires an explicit central bank focus – over and above the pillars of prudential soundness, stable monetary policy and an efficient payment and settlement system. The issue of enhanced access also requires explicit regulatory attention. A stable monetary policy on its own does not directly improve the access of small firms to bank credit.[6]

The discussion below identifies regulatory interventions that can both encourage access and reinforce these pillars of central bank policy.

[4] Shinasi (2005).
[5] BIS (1997).
[6] IMF (2005).

The role of the central bank

Each of the subsections below discusses the role of the central bank in enhancing both access and financial stability.

(a) Tiered banking

For the public sector it would be of great benefit if every citizen had a bank account, for which there are both private and social benefits. The private (individual) benefits of access to banking services include the ability to save and to build financial buffers against adversity. Such access also reduces the cost of making payments. Social benefits (ie benefits for society as a whole) include reduction of theft, improved mechanisms for social transfers and other remittances (including tax and benefit remittances) and improved economic linkages to rural and deprived communities.

Central banks can allow for different tiers of banking, with different permissible activities, so as to facilitate new banking entrance and harness these benefits – without exacerbating risk in the system.

Second-tier banks may be "narrow" or "core" banks: in the case of a so-called "narrow" (or savings) bank, all deposit liabilities are invested in approved highly liquid money market instruments and no other credit business is allowed, while so-called "core" (or savings and loan) banks can engage in lending to the private sector provided such loans are funded from their second-tier capital (in essence the core banks' subordinated debt).[7]

Third-tier banks, like first-tier banks, can use deposit liabilities for lending to the private sector, but only if their depositors and lenders are from the same community. Third-tier banks are smallish operations such as village banks, community banks and cooperative banks. The key issue here is that the possible bankruptcy of a third-tier bank should pose no systemic risk whatsoever for the financial sector at large.[8]

The minimisation of risk from the central bank's point of view is a consequence of limited credit risk exposures of second- and third-tier banks. The tiered banking mechanism does not compromise regulatory

[7] For more detail, see Bossone (2001).
[8] Falkena (2004).

Table 2

International comparison of selected banking and institutional indicators (2002)

	Number of banks in market for deposits	Net interest margin	Bank concentration (top three banks)
Botswana[1]	5	5.7	88
Ghana	17	11.5	55
Kenya	53	5	61.6
Lesotho[1]	3	11.96	99
Mauritius[1]	10	11.1	79
Mozambique	10	5.9	76.6
Nigeria	51	3.8	86.5
South Africa	59	5	77
Tanzania	29	6.5	45.8
Uganda	15	11.6	70
Zambia	16	11.4	81.9

[1] Hawkins (2003).
Source: Buchs and Mathisen (2003).

standards, but recognises that not all banks provide the full range of first-tier commercial banking services and that regulations and supervisory practices should be appropriate to the activities of banks.

Tiered banking potentially provides a mechanism for regularising informal financial service providers and extends the benefits of supervision. It provides a development mechanism for existing institutions such as microfinance institutions (MFIs). If, for example, we have a situation where large MFIs on a sound financial footing seek to grow (Senegal)[9] or if we have a situation where deposit-taking is restricted to banks (South Africa), the provision of a second-tier bank licence may encourage regularisation.

Through tiered banking, central banks can facilitate new bank entry to supplement the services offered by first-tier commercial banks, extend access and enhance financial stability through the extension of regulatory and supervisory reach.

(b) Competition in banking

Barriers to greater use of banking services include not only physical accessibility, but also inappropriate products and pricing. Competition can address this: because of the central role of the banking system in the economy, the role of competition is particularly important in banking.

The conventional analysis of competition in the banking industry usually focuses on factors such as the number of suppliers in an industry, the market share of the dominant players, etc. While the number of banks varies, the concentration levels for the top three banks are high in Africa (with Tanzania and Ghana the outliers); see Table 2.

However, the ease of entry and exit – in other words the contestability of the market – may be at least as important as the number of suppliers. Where contestability is high, incumbent firms are restrained from exercising monopoly power (such as through high costs, prices and profits) because if they were to exploit market power this would immediately induce new firms to enter the market. It is the credible *threat* of entry that deters anti-competitive behaviour by incumbents. While the number of actual competitors is largely irrelevant in

[9] IMF (2005).

determining competitive conditions in a contested market, it becomes a matter of greater concern where there are high barriers to entry or restricted access to essential infrastructure. In Table 2, the net interest margin varies widely, even where concentration levels are similar. While concentration levels are slightly lower in Zambia than Botswana, the interest margin is substantially higher in the former.

A market can be competitive (as measured in traditional ways) but competition may nevertheless not be *effective*. Even though there may be many competitors in a market, competition is only effective in practice if the consumer is able to (i) make a rational choice between competitors, and (ii) exercise choice at low transaction costs. Both may be impeded by obscure pricing and bundling of services.

Central banks can play a role in ensuring that there is sufficient contestability so that incumbents' market power is kept in check. This involves ensuring that licensing does not become too great a barrier. Allowing for tiered banks and foreign bank entry can also contribute to the contestability of certain market segments. Privatisation of state-owned banks can foster both competition and access if it is managed well. Ironically, state ownership of banks has not led to wide access to appropriate services, nor does it appear to contribute to economic development.[10] The central bank can assist the process of privatisation by encouraging sound supervision of state-owned banks through improved accounting standards and the like while they continue to operate as such.

Regional integration initiatives can also enhance effective competition and contestability. In both the CEMAC and the WAEMU (the two CFA franc zone groupings), banks need only a single banking licence to operate in the region. The central bank and bank supervisory authorities have roles to play in establishing a level playing field, facilitating payments within the region, and establishing an effective region-wide money market. Cooperation among central banks can provide the groundwork for more effective competition, even in the absence of a common currency, for instance through the harmonisation of payment systems (as in SADC).

In addition, the central banks can play a supervisory role in ensuring that banks disclose prices to consumers in a consumer-friendly way.

[10] Ingves and Berengaut (2004).

(c) The national payment system

For an economic system to function properly, a payment system is required so that settlement between buyers and sellers can be arranged efficiently. Payment inefficiencies, such as manual procedures and numerous paper-based controls, can impose major costs on financial intermediaries and thus on the economy. At the same time, the payment system must be well designed from a risk management point of view if it is not to be a potential source of systemic risk.[11]

The central bank can play a role in balancing the interests of larger and smaller banks and encouraging appropriate innovation. This may not only involve the central bank in providing a strategic leadership role in the payment system, but may also include establishing the principles of transparency of payment rules and procedures and access standards – for banks and non-banks alike.[12]

Outreach to rural and outlying areas (through facilitation of payment services) can be greatly enhanced by new technologies, but consumers may take some time to trust new instruments. Clearly access (supply) is not the same as use (demand), but the central bank can play a role in ensuring public confidence in new instruments.[13]

(d) Deposit insurance

The objective of a deposit insurance scheme is to promote confidence and stability in the financial system and to provide protection for unsophisticated and small depositors. The benefit of a compulsory deposit insurance scheme is that it cover all banks and depositors, and not only some banks or only the weaker banks. Some aver that without deposit insurance, small depositors will never migrate their support from the dominant banks in an economy. Hence deposit insurance may encourage confidence in small and second-tier banks and underpin their sustainability. But deposit insurance should not be introduced with the main objective of solving problems associated with emerging banks, and a financial system should be sound before deposit insurance is introduced.

Deposit insurance can be implicit or explicit. Implicit deposit insurance exists where there are no stated rules but depositors have assurances

[11] Committee on Payment and Settlement Systems (CPSS) (2001).
[12] CPSS (2005 and 2006).
[13] CPSS (1999), (2000), (2003) and forthcoming.

Table 3

Types of deposit protection systems in selected countries

	Implicit	Explicit	Date enacted/revised	Coverage limit ($)	Funded by
Cameroon	▪				
Ghana	▪				
Kenya		▪	1985, compulsory	1,750	Banks and govt
Nigeria		▪	1988, compulsory	2,435	Banks and govt
South Africa	▪				
Tanzania		▪	1994, compulsory	376	Banks and govt
Uganda		▪	1994, compulsory	2,310	Banks and govt
Zambia	▪				
Zimbabwe	▪				

Source: JDI Online Library (2006); Kane (2004).

implied by governments' action, through either precedence or stated intention. In Table 3, Cameroon, Ghana, South Africa, Zambia and Zimbabwe may be seen to have implicit deposit insurance. Explicit deposit protection, where the terms and conditions of the scheme are explicitly stated in a statute, exists in Kenya, Nigeria, Tanzania and Uganda. The scheme provides a legally enforceable guarantee on all, or a portion, of the principal, and in some cases the interest, of certain deposits. The table shows the date of the existing statute, the coverage limit and the source of funding in each country. Both the banking sector and the government typically bear the burden of deposit insurance in African countries.

Central banks can help identify the appropriate base for the funding of deposit insurance (as, say, a percentage of bank deposits and non-performing loans) and the appropriate coverage limits. In addition, their role in encouraging the soundness of each insured institution is crucial.

(e) Foreign-owned banks

The entry of foreign banks usually helps to improve financial sector efficiency and risk management, including capital allocation based on risk-adjusted profitability and corporate governance based on widely dispersed ownership. It can enhance competitiveness and may encourage innovation. In certain circumstances, it may lead to rapid extension of credit.[14] Foreign banks may also prove to be more resilient than local banks at times of crisis.[15]

However, foreign ownership poses challenges for host countries. This is primarily due to the different organisational structures of foreign-owned banks and the lack of harmony between foreign and local legal and regulatory systems.[16] The issue of foreign-owned banks in emerging markets was recently reviewed in a special Working Group of the BIS's Committee on the Global Financial System.[17] These issues were extensively reviewed in a series of workshops held to follow up some of the issues raised in the CGFS report.

Central banks need to have adequate information to ensure appropriate supervision of foreign banks and adequate assessment of their activities. Harmonisation of the legal and accounting frameworks and

[14] See also Domanski (2005).
[15] Clarke et al (2001).
[16] The discussions at these workshops are summarised in Committee on the Global Financial System (CGFS) (2005).
[17] See CGFS (2004).

bankruptcy procedures of host countries with international norms may ease this task.[18]

Conclusion

The discussion suggests that the central bank objectives of financial stability and financial service access may be mutually reinforcing. However, a central bank that adopts these strategies would need to be aware of the following practical implications:

– *The prioritisation of policies*. While the policies discussed above are complementary to achieving an accessible, yet stable, banking environment, some priorities may be easier to implement than others. For example, improved disclosure requirements on banking services and the development of enabling legislation for second- and third-tier banks may be easier to facilitate than the privatisation of state-owned banks. Setting up deposit insurance may be a prerequisite for the sustained participation of second-tier banks.

– *The impact on the regulatory and supervisory structures*. The successful implementation of these policies will require enhanced supervisory capacity and skills. Central banks must meet the challenge of assigning resources accordingly.

– *The communication of the objectives of such policy*. The central bank and government need to speak with one voice to the public and the financial sector, so that the objectives are clear and publicly supported.

[18] Song (2004).

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The implementation of Basel II

Jaime Caruana

Introduction and overview

I am honoured to have the opportunity to share some brief remarks on the ongoing implementation of the Basel II capital framework.

I realise that not all of our institutions are responsible for banking supervision, but, as central bankers, we all share a common goal of promoting financial stability. In that regard, I'm sure we can all agree that a stable banking system is critical to the long-term growth of an economy. Businesses and consumers need to have access to credit on fair and reasonable terms through all stages of the business cycle so that they can build and grow. And this access to financial services must be widespread, including all income brackets of the population, because it is one of the key elements that can help to improve living standards. We need an efficient and resilient payments system to maintain the flow of funds through the economy at all times. We need financial markets that remain active, liquid and trusted regardless of events in the economy.

We also know that banking crises can threaten macroeconomic stability through their potential effects on confidence, savings, financial flows, monetary control and the budgetary impact of bank rescue packages.

In sum, achieving an inclusive, efficient, sound and stable financial system is an important and complex task, and it has many dimensions. To me, Basel II represents a tremendous effort of more than six years to analyse and promote some of the main elements of a sound banking system: those related to risk management and capital.

My talk will address two main issues. First, I will share some reflections on how I believe Basel II will contribute to the stability of the financial system. Secondly, I will offer some thoughts on steps countries can take in preparation for adopting Basel II.

Basel II and financial stability

Banking is fundamentally about trust. Banks are charged with a special public trust to safeguard customers' wealth. We have all seen what

happens when customers lose trust in the ability of individual banks or the banking system as a whole to protect their savings. This puts a special onus on banking supervisors to ensure that banks operate soundly. No bank can maintain public trust for long if it lacks sufficient capital, so supervisors impose capital requirements to safeguard the banking system. Since capital is the last line of defence against bank insolvency, regulatory capital requirements are one of the fundamental elements of banking supervision.

This is why the Basel Committee has devoted so much effort to developing the so-called Basel II capital framework, which was released in June 2004.

The new capital framework is built on three mutually reinforcing pillars. The first pillar aligns minimum capital requirements more closely with banks' actual underlying risks. The menu-based approach means that qualifying banks may also rely partly on their own measures of those risks, which will help to create economic incentives to improve those measures. In concept the first pillar is similar to the existing "Basel I" capital framework in that it provides a measure of capital relative to risk. What is new are the second and third pillars.

The second pillar – supervisory review – allows supervisors to evaluate a bank's assessment of its own risks and determine whether that assessment seems reasonable. It is not enough for a bank or its supervisors to rely on the calculation of minimum capital under the first pillar. Supervisors should provide an extra set of eyes to verify that the bank understands its risk profile and is sufficiently capitalised against its risks.

The third pillar – market discipline – ensures that the market provides yet another set of eyes. The third pillar is intended to strengthen incentives for prudent risk management. Greater transparency in banks' financial reporting should allow marketplace participants to better reward well managed banks and penalise poorly managed ones.

Basel II, in my view, is fundamentally about better risk management and corporate governance on the part of banks, as well as improved banking supervision and greater transparency. Thereby, it is also about increasing the stability of the global financial system, to the benefit not only of banks, but also consumers and businesses. This is especially critical in markets where banks are the primary source of funding and therefore key drivers of sustainable development.

How will Basel II contribute to financial stability?

Allow me then to take a few minutes to elaborate on several areas where I believe Basel II will foster financial stability.

First, I believe that Basel II is a major step forward in strengthening the incentives for the ongoing improvement of banks' risk measurement and management systems. The new capital framework is both incentive-based and risk-based. It therefore offers us the opportunity to ensure that supervision and regulation takes a forward-looking view on risk, that it remains up-to-date with sound practices in the industry, and that our supervisory framework motivates responsible risk-taking and prudent behaviour in our markets.

Improved and more formalised risk management will bring better assessment, better quantification and greater awareness of risks. To the extent that risk assessment and control methods become more formalised and rigorous, this will lessen the likelihood of making bad decisions and will improve risk-adjusted pricing policies. It will also contribute to the prompt detection of errors and deviations from targets, allowing banks to implement corrective measures at an early stage. Increased awareness of the risks and early reaction to problems is likely to lead to a smoother adjustment to new conditions or to the correction of mistakes, making decisions less abrupt. Basel II is built on the expectation that a country's banks should be able to manage their risks today and respond to challenges tomorrow.

The second reason I believe Basel II will enhance financial stability is that it promotes more effective corporate governance. A bank can have the most sophisticated measurement tools in the world, but if it is poorly governed, it will be vulnerable to financial and operational weaknesses.

While much attention has been paid to some of the more complex quantitative aspects of Basel II, I believe the most important aspects are those that address how the bank's risk management framework is governed. Banks that adopt Basel II will be expected to have a comprehensive and sound planning and governance system to oversee all aspects of their risk measurement and management process. The board of directors, senior management, and audit and other control functions will be expected to exercise their duties in a rigorous manner. I believe that better managed banks under Basel II will be safer, sounder and more resilient. I should also add that the Basel Committee last month published a paper on sound corporate governance practices for banks, which I believe will be useful for all countries, whether they are ready or not to adopt Basel II.

The third reason I believe that Basel II will promote financial stability is that it reinforces the need to implement sound policies in both capital and provisioning. I have already mentioned that no bank can maintain public trust for long if it lacks sufficient capital. One of the fundamental tenets of risk management and banking supervision is that banks need to create provisions to absorb expected losses and to have sufficient capital to absorb unexpected losses.

Let me add here that given the unique positions of banks at the crossroads of businesses and consumers in every economy – and their special role as intermediaries of credit to both – nothing threatens financial stability more than the presence of poorly managed and poorly capitalised and provisioned banking institutions. I believe that Basel II will contribute to a more resilient and stable banking system that is capable of promoting sustainable economic growth.

Adoption of Basel II: who and when?

Let me turn now to my second point, which is the timing of adoption of the new framework in different countries. Whenever I speak with colleagues from other countries, I stress that only national authorities can decide when to adopt Basel II. While the Committee believes that the framework is appropriate for all economies and banks, no country should adopt Basel II until it is ready. This view has been expressed consistently by not only the Basel Committee, but by the IMF and World Bank as well. We are all in agreement that if a country decides to adopt Basel II, the timing should be determined by its own circumstances, not the timetable for Basel Committee members.

Unlike the 1988 Accord, which was relatively simple to adopt, Basel II is more complex and demands more of banks and supervisors. Therefore, we don't expect Basel II to be adopted as widely and quickly as the 1988 Accord, at least at the outset. However, we expect and hope that the number of countries that adopt the new framework will grow over time. We believe that countries should adopt the options and approaches contained within the framework that are most appropriate for the state of their markets, their banking systems and their supervisory structures. Basel II is not a "one size fits all" framework. Supervisors can adopt the framework on an evolutionary basis and use elements of national discretion to adapt it to their needs.

For any country that is considering adopting Basel II but may not yet be ready, I like to suggest a three-stage approach towards building a foundation for the new framework: (1) strengthening the supervisory infrastructure; (2) introducing or reinforcing the three pillars; and then (3) making the transition from the 1988 Accord to Basel II.

The first stage is strengthening the supervisory infrastructure. Basel II is not intended simply to ensure compliance with a new set of capital rules. Rather, it is intended to enhance the quality of risk management and supervision. One of the things that I strongly encourage for all countries is a review of implementation of the Basel Committee's *Core Principles for Effective Banking Supervision*. These principles are key to laying a successful supervisory foundation. Likewise, sound accounting and provisioning standards are critical to ensuring that the capital ratios, however calculated, meaningfully reflect the bank's ability to absorb losses.

This brings me to the second stage. Supervisors do not need to wait for the formal adoption of Basel II to start introducing or using the principles of the three pillars. On the contrary, incorporating these principles is excellent preparation for adopting Basel II in the future. For example, supervisors might choose to move towards a more risk-based approach to supervision, developing skills in assessing the quality of a bank's risk management and its ability to assess risk exposures. At the same time, banks could be reminded of their responsibility to develop their own processes for evaluating their capital needs and a strategy for maintaining their capital levels, consistent with the principles of Pillar 2. With regard to the principles of market discipline in Pillar 3, supervisors may wish to focus initially on ensuring a baseline level of disclosures across all banks. This might include discussing with banks, investors and other users of financial information their information needs and the tools available so that supervisors can tailor requirements accordingly.

In my view, these two preliminary stages provide an excellent preparation for the "final" stage of moving to Basel II. With a strong foundation in place, supervisors can then select the alternatives within Basel II that are most appropriate for their own circumstances.

In addition to the steps I have outlined for supervisors, there is also a wider set of preconditions that we as central bankers can help to promote, including appropriate macroeconomic policies which are consistent and sustainable over time.

All these considerations allow us to underline the notion that the achievement of financial stability must be based on a broad range of tools which we should all seek to strengthen. I don't want to play down the challenge of achieving a coherent approach to financial stability that fosters financial innovation, promotes a level playing field and ensures that the banking system can remain resilient in the face of internal and external shocks. Nevertheless, I believe that the effective implementation of Basel II will contribute to the proper functioning of the economy under a wide range of circumstances.

Conclusion

To conclude, I think that Basel II recognises the importance of a combination of micro and macro factors for achieving greater financial stability. Furthermore, I would say that Basel II incorporates some of the key basic principles that are also built into modern approaches to monetary policy: a flexible and forward-looking approach, anticipatory rather than reactive behaviour to risk, and the need to take into account market views.

Looking into the future, we must direct our resources to ensure that banking supervision in the 21st century is more dynamic, more

preventive, more flexible, more inclusive and more transparent. We should continue adapting and learning. I believe the ultimate objective of financial stability increasingly requires cooperation and properly aligned incentives on the part of the industry, markets, central banks and supervisors.

Let me close by saying that the Committee welcomes the work being done in a number of non-member countries and believes that continued outreach is essential. Dialogue with countries outside the Basel Committee played a critical role in the development of the revised framework, and I am personally committed to continuing such dialogue in the future.

Table 1

Rates of inflation, selected African regions

Average annual percentage changes

	1997–2001	2002	2003	2004	2005 projected
Oil-producing countries	20.1	18.7	17.0	12.7	11.8
Non-oil-producing countries	13.2	10.3	12.4	8.4	9.4
Sub-Saharan Africa	14.6	12.1	13.4	9.4	9.9
Excluding Nigeria and South Africa	23.0	14.2	19.6	14.5	13.2
CFA franc zone	2.8	3.8	1.4	0.2	2.8
WAEMU	2.6	2.7	0.9	0.3	2.8
CEMAC	3.1	5.2	2.0	0.2	2.9
Fixed exchange rate regime	9.8	16.3	22.1	18.2	14.5
Floating exchange rate regime	15.9	11.1	11.4	7.4	8.8

Source: IMF (2005a).

Anchors for monetary policy

Paul Masson[1]

Introduction

African countries have generally seen a decline in rates of inflation since the beginning of the current decade, despite recent strong increases in the price of oil and other energy products. The favourable inflation performance has occurred among oil importers and oil exporters alike (Table 1). Interestingly, flexible exchange rate countries – led by South Africa, the continent's largest economy – have shown a better inflation performance in recent years, declining from a higher level, while fixed exchange rate countries have seen a pickup in inflation since the beginning of the decade. Nevertheless, inflation rates in most African countries – with the exception of members of the two CFA franc zones – remain higher than those in the OECD countries.

Lower inflation has been the result of a benign international environment combined with greater emphasis in a number of countries on containing fiscal deficits and limiting the recourse to central banks to finance those deficits. For instance, central bank independence has been boosted in several countries, and the CFA franc zones have prohibited direct monetary financing of fiscal deficits.

The issue discussed in this note is the choice of policy regime to provide a longer-term anchor for monetary policy and the implications of the choice of anchor for short-term economic outcomes. A companion paper ("The global economy and Africa: the challenge of increased financial inflows") considers monetary policy responses to aid, commodity price, and capital flow shocks. Individual circumstances, such as the degree of openness of the economy, the extent of fiscal

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discipline, and the level of financial development, are important for the choice of anchor, making it unlikely that a single regime will dominate the others for all countries.

Domestic versus external targets for monetary policy

An important choice relates to the operating target for monetary policy, and it is useful to distinguish between **domestic** and **external** targets. A **nominal exchange rate peg** (either to a single currency or to a basket) constitutes the principal external target. The exchange rate then limits the scope for using monetary policy to pursue any other objective.

An exchange rate target has the advantage that it provides a visible and easily monitored anchor for price expectations. Over the longer run, if it is fully supported by monetary policy, an unchanged peg will tend to produce the same rate of inflation as in the country of the currency peg. Thus, the rate of inflation in the CFA franc zones approximates that in the euro zone. An exchange rate peg may be particularly appropriate for a country that does much of its trade with another country or currency area, since a fixed exchange rate will tend to reduce temporary misalignments that can lead to misallocation of resources and improve the stability of relative prices. A common currency will, in addition, minimise transaction costs. The smaller countries in the Common Monetary Arrangement (Lesotho, Namibia and Swaziland) peg their currencies one-to-one to South Africa's rand, and the rand is also accepted as a means of payment in those countries.[2]

An exchange rate peg that is not fully supported by monetary policy and accompanied by fiscal discipline may, however, present a number of drawbacks. Excessive monetary expansion or fiscal laxity will increase inflation pressures. Non-tradables prices will rise relative to tradables prices, held down by foreign competition. Eventually, the deterioration in international competitiveness leads to external current account imbalances. Such a peg becomes less and less credible. Individuals and firms will also try to shift out of the domestic currency into foreign currencies, leading to capital outflows and/or a parallel exchange rate that is more depreciated than the official rate. Given limited official foreign exchange reserves, the authorities may resort to rationing of foreign exchange, opening the door to favouritism in its allocation and corruption, and inefficiencies as imports of necessary intermediate inputs are curtailed. In Africa, these inefficiencies became widely apparent in the 1980s and 1990s and led to abandonment of currency pegs in a number of countries in the context of structural adjustment programmes.

Domestic targets as anchors for monetary policy in Africa have usually consisted of a **monetary aggregate** target, but **inflation targeting** has become popular among a number of middle- and high-income countries around the world and is the principal alternative to monetary targeting. A target for central bank money is typically a feature of IMF-supported programmes. The rationale for using a monetary aggregate as intermediate target is that there exists a stable demand for the monetary aggregate that depends on economic activity and the price level. Unfortunately, money demand has proved unstable in many countries, limiting its usefulness as an indicator of the appropriate stance of monetary policy.[3] For instance, money/income ratios have grown over time as a result of financial development and successful macroeconomic stabilisation (Table 2): such changes are hard to predict since they tend to occur discontinuously. Demand for the domestic currency can vary because lack of confidence in economic policies leads residents to acquire foreign currencies. As a result, monetary growth can be erratic and deviations from target may not provide a useful guide for setting monetary policy.

Inflation targeting, as it has been practised in a number of industrial and emerging market economies (including the United Kingdom, Canada, New Zealand, Brazil, Mexico and South Africa), provides a transparent framework for formulating and communicating short-term adjustments of policy instruments in terms of a longer-term objective that is central to a central bank's mission – maintaining the purchasing power of the currency. There is some evidence that inflation targeting, accompanied by exchange rate flexibility, has helped reduce the incidence of financial crises in emerging market economies.

[2] But it is not legal tender in Swaziland.

[3] See BIS (1996).

Table 2

Money/income ratios,[1] selected African countries and regions

As a percentage of GDP

	1997–2001	2002	2003	2004	2005 projected
Oil-producing countries	18.0	22.4	20.2	19.4	17.3
Non-oil-producing countries	44.4	44.7	50.2	52.4	53.9
Sub-Saharan Africa	38.0	38.6	42.0	43.1	42.9
Excluding Nigeria and South Africa	24.7	28.5	28.5	26.9	26.6
CFA franc zone	18.3	21.8	21.3	21.0	20.7
WAEMU	22.2	26.5	26.0	26.4	26.7
CEMAC	13.2	16.0	15.5	14.9	14.4
Fixed exchange rate regime	23.3	28.5	28.2	25.3	25.9
Floating exchange rate regime	42.0	42.7	46.1	47.9	47.5

[1] Ratio of broad money to nominal GDP.

Source: IMF (2005a).

Table 3

Botswana: selected economic indicators

	1997–2001	2002	2003	2004	2005 projected
	Average annual percentage changes				
Real GDP	6.2	5.0	6.6	4.9	3.8
Consumer prices	7.7	8.1	9.6	6.6	6.8
Broad money	25.4	–1.1	15.5	16.0	13.7
	Ratios to GDP				
Overall fiscal balance[1]	1.5	–4.0	–2.8	–1.4	–0.7
Government revenue[2]	42.7	40.1	39.2	38.9	40.1
Government expenditure	41.7	44.3	42.1	40.7	41.3
Trade balance	13.1	11.4	12.3	7.0	7.5
Current account	10.4	2.2	6.5	9.5	9.3
	Indices, 2000 = 100				
Real effective exchange rate[3]	101.2	111.4	111.3	101.4	…
Nominal effective exchange rate[3]	101.3	107.9	111.9	106.8	…

[1] Including grants.
[2] Excluding grants.
[3] An increase indicates appreciation.

Source: IMF (2005a).

There are several key practical questions related to inflation targeting:

– How should the target rate be calculated (the consumer price index, or inflation excluding particularly variable items like energy and foodstuffs)?

– What should be the numerical target?

– Should there be an explicit target band, and, if so, should it be narrow or wide?

– What should be the horizon for hitting the target?

It needs to be recognised that no monetary regime is likely to be successful without supporting policies, in particular, fiscal discipline. Large fiscal deficits will lead to overheating of the economy, put pressure on monetary policy to provide financing, and detract from the credibility of a currency peg. Conversely, various monetary regimes have been successful in achieving low inflation and sustained growth when supported by fiscal discipline. A few examples taken from recent experience in Africa illustrating both of these principles follow.

Use of the exchange rate as an anchor for monetary policy in Botswana[4]

In the mid-1970s, Botswana chose to issue its own currency, the pula, and to abandon the fixed parity with respect to the rand that characterises the exchange rate regimes of other neighbours of South Africa – Lesotho, Namibia and Swaziland. The pula is pegged to a basket of currencies; the objectives of exchange rate policy are to maintain exchange rate stability and achieve low inflation. There have been a number of changes of parity, both devaluations and revaluations, and they have allowed the country to achieve relatively low inflation while at the same time safeguarding external competitiveness (Table 3). Botswana has been willing to adjust the currency peg up or down as circumstances merit, most recently by devaluing in May 2005.

Botswana has been very successful in achieving growth (it was the fastest growing country in the world in the two decades after independence), with moderate inflation. In this regard, it has benefited

[4] The descriptions of the monetary policy regimes of Botswana, Nigeria and South Africa are taken from Masson and Pattillo (2005).

Table 4

Nigeria: selected economic indicators

	1997–2001	2002	2003	2004	2005 projected
	Average annual percentage changes				
Real GDP	2.7	1.5	10.7	6.0	3.9
Consumer prices	10.0	13.7	14.0	15.0	15.9
Broad money	28.1	27.2	21.6	24.1	14.0
	Ratios to GDP				
Overall fiscal balance[1]	–2.8	–4.2	–1.3	7.7	10.0
Government revenue and grants	…	36.4	37.1	43.1	43.5
Of which: oil and gas	…	26.2	28.0	35.0	36.7
Government expenditure and net lending	…	40.7	38.4	35.4	33.6
Trade balance	15.8	8.6	17.5	26.9	27.1
Current account[1]	0.8	–11.5	–2.7	4.9	11.0
	Indices, 2000 = 100				
Real effective exchange rate[2]	135.3	110.6	103.9	106.3	121.9[3]
Nominal effective exchange rate[2]	143.7	85.8	72.3	65.5	64.9[3]
	In per cent				
Real Treasury bill rate	4.62	5.81	0.86	–0.69	–7.77[4]

[1] Including grants.
[2] An increase indicates appreciation.
[3] Average, January to October.
[4] Average, January to August.

Sources: IMF (2005a,b); IMF, International Financial Statistics.

enormously from the revenues from diamond mining, which have generated government surpluses, and from a government which has been responsive to the population's interests while not undertaking excessive spending. As a result, there has not been pressure on the central bank to provide government financing, allowing it to operate effectively to achieve the goals mentioned above.

Persistent government surpluses have meant that there has been no need for a government debt market. This has meant that the instruments for currency speculation have not existed, and, until now, portfolio capital flows have not led to strong pressures up or down on the exchange rate – unlike the case of other emerging market economies. However, increasing financial development may lead to the need for more flexibility in the exchange rate. In particular, allowing non-residents to participate in markets for Bank of Botswana certificates or other short-term paper could lead at times to strong speculative pressures, which might be difficult to resist without increased flexibility of the pula's exchange rate.

A managed floating regime: Nigeria

Nigeria is officially classified as having a managed float of the naira, but in the past has had pegged exchange rates accompanied by various systems for the allocation of foreign exchange. Rationing has led to inefficiency in the economy. The parallel market rate has in practice been considerably weaker than the official rate, and the parity has had to be changed frequently. Inflation has been persistently in double digits, and real interest rates have been low (and sometimes negative – see Table 4).

The past decade has seen a variety of policy initiatives and reversals. Starting from a regime that included interest rate ceilings and no free market in foreign exchange, in 1995 foreign exchange controls were liberalised, foreign exchange bureaus authorised, and a dual exchange rate regime installed with a pegged official rate and a flexible auction rate. In the next few years, inflation declined from a peak of 77% in 1994 to 10% in 1997, and real economic growth picked up. The dual rate gave way to a multiple exchange rate system and then to the abolition of the official rate. Large fiscal deficits starting in 1999 led to

Table 5

South Africa: selected economic indicators

	1997–2001	2002	2003	2004	2005 projected
	Average annual percentage changes				
Real GDP	2.5	3.6	2.8	3.7	4.3
Consumer prices	6.4	9.2	5.8	1.4	3.9
Broad money	13.0	18.1	12.9	13.1	13.5
	Ratios to GDP				
Overall fiscal balance[1]	–2.4	–1.2	–2.0	–1.7	–1.9
Government revenue[2]	23.5	23.4	23.4	24.4	24.9
Government expenditure	25.9	24.6	25.4	26.1	26.8
Trade balance	2.8	4.3	2.0	…	–0.7
Current account[1]	–0.8	0.7	–1.5	–3.2	–3.7
	Indices, 2000 = 100				
Real effective exchange rate[3]	103.4	75.5	97.4	106.3	107.3[4]
Nominal effective exchange rate[3]	108.4	67.5	83.8	91.8	91.4[4]

[1] Including grants.
[2] Excluding grants.
[3] An increase indicates appreciation.
[4] Average, January to October.

Source: IMF (2005a).

monetary financing and a pickup of inflation. The system at this point consisted in a predetermined fixed rate and a parallel market rate that was substantially more depreciated. Rapidly falling reserves by 2002 led to a series of devaluations of the predetermined rate. The depreciation of the naira helped stabilise the market and reduce the parallel premium. The rapid rise in the world oil price since 2002 greatly reduced fiscal pressures during 2004–05. Nonetheless, high inflation persisted, and though the naira has depreciated further in nominal terms, the real effective exchange rate has appreciated and is currently more than 20% above its 2000 level.

Inflation targeting in South Africa

South Africa has moved from a pegged exchange rate to inflation targeting, after a transition period with both money and inflation targets during which there was also extensive foreign exchange market intervention. Since 2000, the South African Reserve Bank (SARB) has been using the rate of inflation as the main operating guide to setting monetary policy, and the rand has been floating freely. The target for the rate of inflation, 3–6%, is somewhat higher and the band wider than for the industrial countries that announce inflation targets. The inflation target differs from headline inflation (which is also the case for most other inflation targeting countries) as it excludes mortgage interest. There are escape clauses that excuse the SARB from hitting its target should there be a sharp rise in the world oil price or international financial contagion.

After a period of sharp rand depreciation, since 2002 the rand has strengthened and inflation has come down to levels within the target range, or even below it (Table 5). While an appreciated real exchange rate has put pressures on some traded goods sectors (especially mining), the economy is now growing strongly. The SARB has shown that it is serious about meeting its inflation target, and in doing so is willing to allow variation up or down in the exchange rate. This flexibility of the exchange rate has minimised the unfavourable effects of financial crises elsewhere (eg Russia in 1998 and Brazil in 1999), which otherwise might have induced a full-blown currency crisis in South Africa.

In operating its policy of inflation targeting and flexible exchange rates, South Africa has benefited from a respected central bank with a history of independence, disciplined fiscal policies, and a diversified economy with well developed financial markets. South Africa uses short-term interest rates as its primary monetary policy instruments, and a competitive commercial banking system and extensive financial markets ensure the transmission of monetary policy to the real economy.

Can inflation targeting be adapted to a wider set of countries in Africa?

Inflation targeting works best if central banks have instrument independence (de facto as well as de jure); there is public support for low inflation; prices are flexible and are not subject to administrative regulation; and the existence of financial markets allows the use of indirect monetary instruments (ie interest rates). Experience in Africa and elsewhere has shown that statutory independence can be undermined by large fiscal deficits. Countries with no other sources of government financing are likely to see inexorable pressures on the central bank for monetary expansion. Conversely, the public's desire to see low inflation is a key factor bolstering central bank independence.

Flexibility in product and labour markets contributes to the effectiveness of the central bank in achieving its inflation targets. If, instead, prices are set by administrative fiat, inflationary pressures due to monetary expansion will be repressed, even if not completely eliminated. Targeting of an inflation rate by the central bank would then have little significance. Another problem may be the large weight of agricultural commodities in the index, since their prices may be very sensitive to growing conditions. Assuming a degree of price/wage flexibility, the central bank needs, in addition, to have a quantitative framework for predicting the effects of its instruments on the rate of inflation, taking into account the lags that are present.

If the supporting features are not present, making a full-blown inflation targeting regime difficult to put in place, elements of inflation targeting may be combined with other policy regimes. For instance, some countries have at times put in place hybrid systems combining fixed exchange rates or monetary targeting and inflation targeting.[5] Such regimes have often been viewed as transitional arrangements leading to full inflation targeting. While having several targets reduces the risk of going astray as the bugs are being worked out of the system and experience is being gained in gauging the effects of monetary policy instruments on inflation, it also detracts from transparency, since the central bank may have the discretion to shift from one target to the other when the two give conflicting signals. In any case, the exchange rate cannot be ignored even in a pure inflation targeting framework[6] because of its effect on import prices, but, in addition, exchange rate volatility may be too great in countries that do not have a well developed and competitive market for foreign exchange. Thus, the revealed preference of many developing countries not to permit full flexibility – "fear of floating" – also argues for a hybrid regime at least until financial markets develop more fully.

Effects of structural changes on the choice of monetary instruments and on the transmission mechanism

Central banks may use the amount of commercial bank reserves or the interest rate as short-run operating instruments. Use of the interest rate instrument requires markets for government treasury bills, commercial paper, or interbank claims. These markets may not exist, or, if they do, may not be very liquid. This complicates the task of monetary policy and may force the central bank to use quantitative restrictions on the amount of lending that commercial banks can do or ceilings on the amount of refinancing that is available from the central bank as policy instruments. In these circumstances, effects of monetary policy on inflation may not be very predictable, because they will depend in part on the existence of alternative sources of lending to the non-financial sector.

As discussed above, inflation targeting, because of the lags in the effects of instruments on inflation, needs a quantitative framework for predicting the effects of instruments on inflation with a one- to two-year (or longer) horizon. The transmission mechanism between the instruments of monetary policy and its ultimate targets – whether inflation or economic activity – is generally considered to operate through four channels:[7]

[5] For instance, Chile and Israel have in the past had both exchange rate and inflation targets. From 1998 to 2000, South Africa combined money growth and inflation targets, as does the ECB at present.

[6] And monetary aggregates may provide useful information concerning future inflation.

[7] See Kamin, Turner and Van 't dack (1998).

(i) direct interest rate effects, which influence investment decisions and the choice between consuming now and consuming later;

(ii) indirect effects via other asset prices, such as prices of bonds, equities and real estate, which will influence spending through balance sheet and cash flow effects;

(iii) exchange rate effects, which will change relative prices of domestic and foreign goods, influencing net imports, and also the value of foreign currency denominated assets, with resulting balance sheet effects; and

(iv) credit availability effects, which may include credit rationing if there are binding ceilings on interest rates.

The predictability of the effects of monetary policy through these four channels may be modified in a number of ways by structural changes in the economy. Those changes can affect the way instruments under the central bank's control – eg short-term interest rates or reserve requirements – impact financial conditions in the non-financial sector; and how those financial conditions affect the spending decisions of households and firms. Important factors influencing the transmission mechanism include the following:

– Official intervention can set interest rate ceilings or other limits on financial market prices, impose direct limits on bank lending, or provide government-financed credit to selected areas. Financial liberalisation generally reduces the role of official intervention, giving a greater potential role for the first three transmission channels, and a reduced role for the fourth, credit availability effects.

– Greater competition in the banking sector will tend to enhance the flexibility of deposit and loan rates, and their responsiveness to monetary policy.

– The presence and depth of domestic securities markets should accelerate the transmission of monetary policy changes, in particular through the second channel above.

– Alternative sources of financing – such as informal or "curb" markets for credit or microfinance – if they are highly segmented, will tend to diminish the impact of monetary policy through the interest rate and credit availability channels.

– The exchange rate transmission channel is most powerful when the exchange rate is flexible, there are few restrictions on capital flows, and domestic and foreign assets are good substitutes.

– Initial financial conditions – the extent of external financing (versus self-financing through accumulated saving) by firms and households, the degree of leverage, the maturity and market sensitivity of holdings, their currency composition, and the soundness and capital structure of banks – will affect all four of the transmission channels.

– The strength of the transmission channels will be affected by the structure of the real economy. Liberalisation of product and labour markets – eg abandoning administrative restrictions or enhancing competition among firms – will tend to make monetary policy instruments more effective in controlling inflation. Sectoral composition of the economy will also be important: an economy with a large informal sector or a large foreign-owned resource sector mainly financed from abroad may be little affected by what the central bank does. In contrast, a diversified economy may respond through a variety of channels to monetary policy, and bringing down inflation may be smoother and less disruptive.

In sum, structural changes, which are especially prevalent for countries experiencing rapid development, may make the effects of monetary policy more uncertain. This may constrain the scope for operating monetary policies that rely on forecasting the future effects of policy, like inflation targeting. However, they also make it very desirable to have a credible and transparent anchor for the central bank's policies.

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The choice and design of exchange rate regimes

Már Gudmundsson

Introduction

This paper discusses the design and management of exchange rate regimes in Africa.[1] It starts by looking at the current landscape of exchange rate regimes in the region and comparing it to other regions of the world. It then discusses relevant considerations for the choice of exchange rate regimes in developing countries, including the optimal currency area, but also their limitations in a developing country context. The ability of countries to deliver disciplined macroeconomic policies inside or outside a currency union is an important consideration in that regard, along with political goals and the promotion of financial sector development and integration. The paper then proceeds to discuss in turn the management of flexible exchange rates, the design of exchange rate pegs and monetary integration.

Exchange rate regimes in Africa

Exchange rate regimes in Africa reflect choices made at the time of independence as well as more recent trends in exchange rate regimes of developing countries. Original exchange rate pegs in many cases evolved over time into flexible exchange rates. That development was given a further boost by the stabilisation and liberalisation programmes in the 1980s and 1990s. Former colonies of France constitute a core group in the CFA franc zone of western and central Africa, which is composed of two currency unions with a hard external peg to the euro, underpinned by the French authorities. Three neighbouring countries of South Africa are part of the rand zone, where national currencies are

[1] The paper draws extensively on Masson and Pattillo (2005). See also Hawkins and Masson (2003).

exchanged at par with the rand and the rand circulates extensively inside their borders. Several countries in Africa operate pegged exchange rate regimes of the more traditional type.

The majority of countries in Africa are currently classified by the IMF as having flexible exchange rate regimes[2] (see Annex Table A1). The predominance of such regimes is even more noticeable if measured in terms of economic size, as such countries account for almost three quarters of the continent's GDP. Eleven African countries covering just over 13% of the continent's GDP have opted for pegged exchange rates; three of these countries have hard pegs against either the US dollar or the euro. However, it is important to bear in mind that the difference between a managed float and a peg may not be very large: countries which manage their floating rates tightly could exhibit more exchange rate stability than countries which have adopted crawling pegs or adjust their horizontal pegs rather frequently. Thus some countries in Africa that are classified as having a pegged exchange rate have significantly higher exchange rate volatility than many countries in the managed floating group (see Annex Table A1). However, exchange rate volatility measures are broadly consistent with the classification if outliers affected by war, severe internal conflicts and major instability are left out.

The remaining countries belong to monetary areas, ie they are either members of the CFA franc zone or are in an exchange rate union with South Africa through the Common Monetary Area (CMA). Both of these monetary areas combine features of different exchange rate regimes.

The CFA franc zone is made up of two currency unions, the West African Economic and Monetary Union (WAEMU) and the Central African Economic and Monetary Community (CAEMC), each with its own central bank that issues its own currency with a fixed parity to the euro. Both currencies are commonly called the CFA franc. They are, however, distinguishable and not freely interchangeable, except via the euro convertibility that is guaranteed by the French Treasury, which holds at least 65% of the pooled reserves of each area.[3]

The CMA is not a currency union as national currencies are issued in each of its member countries. However, these currencies are tightly pegged to the rand through a currency board-type arrangement and exchanged at par. The rand circulates extensively in the member countries and is legal tender along with the national currencies. There is free movement of capital between the member countries of the CMA. Using accepted terminology the CMA could be labelled a formal exchange rate union.

More African countries are members of monetary areas than have a pegged exchange rate. However, the economies on a pegged exchange rate are, on average, more than twice as large, and the share of monetary area members in the continent's total GDP is therefore smaller, at just over 12%.[4]

How have exchange rate regimes evolved in recent years in Africa and how does the pattern compare to those of the rest of the world? African countries seem to have shown a stronger tendency than other developing countries in the last decade and a half or so to move in the direction of flexible exchange rates (see Annex Table A2). This is a reflection of the liberalisation and stabilisation efforts in many countries in the 1980s and 1990s, mentioned above. This shift has brought Africa into line with patterns in other parts of the world in terms of the number of countries on flexible exchange rates. Slightly more countries are currently members of exchange rate or currency unions in Africa than at the beginning of the 1990s, and the share of countries in such unions is clearly higher in Africa than in the rest of the world, mainly due to the existence of the CFA franc zone. However, that share would be significantly smaller if measured in terms of GDP (see above).

Choice of exchange rate regimes in developing countries

There is a vast literature on the choice of an exchange rate regime, especially on the pros and cons of entering a currency union.[5] At the most basic level, the theory of optimum currency area (OCA) compares the microeconomic benefits of entering a currency union in terms of reduced transaction costs with the macroeconomic costs associated with losing the tool of independent monetary policy. These benefits and costs depend in turn on at least four factors. First, the more open a country is, the greater the potential microeconomic benefits of entering a currency union and the smaller the benefits of an independent

[2] The term "flexible exchange rate regime" is in this paper meant to cover what the IMF classifies as either independent or managed floating.
[3] Strauss-Kahn (2003) provides a comparative study of the institutional aspects of the euro area and the CFA franc zone.
[4] South Africa is in this comparison classified as having a floating exchange rate, whereas the other members of the CMA are classified as being in an exchange rate union.
[5] The classical texts being Mundell (1961), McKinnon (1963) and Kenen (1969).

monetary policy. Second, the more asymmetric the shocks hitting the potential partners, the greater the importance of the stabilisation role of independent monetary policy. Third, the higher the share of trade with the potential currency area, the greater the microeconomic benefits and, in some cases, the lower the probability of asymmetric shocks. Fourth, the higher the degree of nominal wage and price flexibility and/or labour mobility, the more these factors can compensate for the loss of the domestic exchange rate as an equilibrating factor.

It is important to bear in mind that the OCA theory in its raw form is based on significant omissions and simplifications. Furthermore, it can be argued that its applicability to developing countries is probably weaker than in the case of developed countries. The theory assumes that exchange rate flexibility is used optimally and thus overlooks problems of credibility and the misuse of monetary independence. This is, however, a crucial issue in many developing countries, especially if fiscal dominance is a problem. Countries that have less disciplined fiscal policies and more need for monetary financing will ceteris paribus gain more from entering a monetary union but will at the same time be less desirable partners. Thus Masson and Pattillo (2005) add fiscal asymmetry measures to the more traditional OCA criteria when assessing the net benefits of currency unions in Africa.

The OCA criteria are possibly partly endogenous in the medium to long run (see Frankel and Rose (1998)). Joining a currency union might increase trade with other union members, which in turn might lead to more symmetric business cycles. The counterargument has been made that trade integration will lead to concentration and specialisation of manufacturing industries and thus less symmetric business cycles (Bayoumi and Eichengreen (1993) and Krugman (1993)). However, empirical studies (eg Frankel and Rose (1998)) seem to indicate that trade integration is indeed associated with more correlated business cycles. This, along with the hope for enhanced financial integration, is probably one of the reasons that the political desire for monetary unions seems in many cases to be greater than warranted by the OCA criteria or other current economic conditions. However, the empirical case for this assertion can be challenged. Financial integration has, for example, progressed at a slower pace in the euro area than hoped and is to this day rather low in the CFA franc zone. Additionally, there are sometimes perfectly reasonable political reasons behind this desire, such as the hope that regional integration will, through peer pressure, create better conditions for disciplined macroeconomic policies and improved governance, or that it will contribute to a stronger sense of regional unity.

A clear distinction should be made between two separate but connected issues in this regard. One is the optimal degree of fixity or flexibility of a given currency. The other is the question of whether to have a separate currency at all. It could be that the microeconomic benefits of a fixed exchange rate do not become really significant until the currency has been eliminated or merged with other currencies. It is only at that point that expected exchange rate flexibility goes to zero and associated risk premia in domestic interest rates disappear.[6] This distinction might be one of the explanations for the contradictory results of studies that show, on the one hand, that reducing exchange rate volatility does not have a significant effect on foreign trade and other real economic variables (eg Krugman (1995), Levine and Carkovic (2001) and Rogoff (1998)) but, on the other, that entering a monetary union seems to have a strong trade creation effect without significantly affecting trade with third countries (Frankel and Rose (2002)).

For small countries, issues of monetary credibility only arise in the context of a separate currency. If credibility is low and/or there is a high probability that monetary independence will be misused, a policy of a stable exchange rate (with a separate currency) can impose some discipline, even if the OCA criteria suggest that a fixed exchange rate is not optimal. This is the basis for the use of the exchange rate as a temporary anchor for disinflation in many developing countries. However, thought needs to be given to an exit strategy to a more sustainable regime, especially when capital controls are limited or are in the process of being abolished, as experience has shown that it is difficult to sustain soft exchange rate pegs without such controls. Conversely, if the OCA criteria suggest that a fixed exchange rate is optimal for a given country, a flexible exchange rate may still be needed because there is a desire to have free capital movements and options for a suitable monetary union or bilaterally supported hard pegs do not exist.

[6] How far the process needs to go for this to happen is an open issue. The present monetary integration of Lesotho, Namibia and Swaziland with South Africa in the CMA does not entail the abolition of national currencies, but they are exchanged at par with the rand at negligible transaction costs. Formally speaking, the rates are not irrevocably fixed. However, markets seem to assume that they are, as interest rate spreads do not appear to incorporate the possible but very low-probability event that they might be changed.

The choice of an exchange rate regime in developing countries is subject to considerations that are both economic and political, and involve current conditions as well as expected future developments and development strategies. The stage of development of financial markets is key. On the one hand, very rudimentary and underdeveloped financial markets might make it difficult to operate a floating exchange rate. This might lead countries to adopt pegs of various sorts in the early phases of market development. On the other hand, currency unions or hard pegs to a strong currency could be adopted as a way to develop financial markets through integration. However, the options that countries have for currency unions and/or hard pegs to major currencies are historically determined. No single correct time-independent answer can therefore be given on the choice of exchange rate regime. The actual choices will be affected by the stage of development of the economy and its financial markets, the external environment and the options that exist in terms of monetary unions with trading partners.

Looking forward in an African context, there are several factors that could contribute to changing the relative merits of different regimes. On the one hand, a further liberalisation of capital movements and increased volume of such flows could make pegged regimes more difficult to operate. Further deepening of financial markets might make it easier to operate flexible exchange rates. On the other hand, a further widening of the euro area and the consolidation of the euro as an international currency could increase the attractiveness of maintaining and expanding euro pegs. Finally, further economic integration at the regional level might, along with political developments, give a boost to monetary integration.

Managing flexible exchange rates

There are at least three conditions for successful management of a flexible exchange rate, in terms of delivering low and stable inflation at the same time as the exchange rate works as a real shock absorber: first, the existence of a foreign exchange market with some minimum depth and efficiency; second, a domestic anchor for monetary policy; third, minimum independence and capability of the central bank in order to be able to deliver an effective monetary policy. The meeting paper "Anchors for monetary policy" discusses the framework and operation of monetary policy, including the choice of a domestic anchor, and the paper "The relationship between the central bank and the government" discusses several aspects of central bank governance. This section discusses the first aspect and makes a brief assessment of the performance of flexible exchange rate regimes in Africa.

Most countries in Africa operate some kind of flexible exchange rate regime (see Annex Table A1). However, these are, in all but a few cases, far removed from free floats operated by major developed countries. There are anyway more countries in the managed float group (16) than in the independent float group (9) and the distinction between tightly managed floats and loose pegs may not be very large in practice. Additionally, the scope for operating so-called intermediate regimes (ie between free floats and hard pegs) is probably higher in Africa than in many other parts of the world due to a higher degree of capital controls (see Annex Table A1), low integration with world capital markets and the fact that many of the countries would probably not be on the radar screen of international market participants even if controls were lower. Using the classification in Annex Table A1, many of the countries with a flexible exchange rate have not even moved to full current account convertibility and only very few have liberalised the bulk of capital movements.

Available indicators show that the shift to flexible exchange rates on the continent has indeed taken root. Masson and Pattillo (2005) quote an average increase in a measured flexibility index before and after official switches to a flexible exchange rate. But the increase is rather small, which might indicate that the "fear of floating" is a fact in many African countries, and perhaps for good reason.

Masson and Pattillo (2005) list financial sector weaknesses as a significant problem for the operation of flexible exchange rates in many African countries. The functioning of interbank markets is in some cases impeded by the existence of only few banks. That problem is compounded if information problems or, in extreme cases, strong rivalries inhibit banks from dealing with each other. Additionally, concentration in export sectors and the extreme seasonality of export earnings can strain these markets. In some countries, problems associated with interbank markets have prompted the development of

parallel auction markets, which may increase volatility and accentuate uncertainty for market participants.

Underdeveloped financial markets might be one of several good reasons to manage floats in developing countries more tightly than in more developed and diversified economies. The extreme lumpiness of foreign exchange earnings (especially aid inflows) could also constitute another reason. But at some point, beneficial smoothing could degenerate into an excessive emphasis on exchange rate stability and thus conflict with macroeconomic goals like low and stable inflation. A related question is the role of exchange rate movements in counteracting the effects of external shocks on inflation and output. Too much exchange rate smoothing through intervention will weaken that mechanism. However, there is a real danger of significant overshooting in thin foreign exchange markets where the excess demand for or supply of foreign exchange can develop into hot potatoes and vicious spirals.

The macroeconomic performance of countries on a flexible exchange rate varies greatly from country to country, as can be seen in Annex Table A1. Some have managed to deliver relatively low inflation whereas others have not been successful in substituting a domestic monetary anchor for an external one. Over the period 1996-2005, inflation was on average significantly higher among countries with a flexible exchange rate than among countries with a pegged rate or in a currency union, even if outliers are excluded (see Annex Table A1). However, countries on a flexible exchange rate have been more successful in the more recent period in lowering inflation (see the paper "Anchors for monetary policy"). Masson and Pattillo (2005) report that the growth performance of countries with intermediate exchange rate regimes is significantly worse in sub-Saharan Africa than among countries with a pegged exchange rate, controlling for the usual factors explaining growth differences. The difference in the case of floaters was not statistically significant.

Designing exchange rate pegs

The design of a currency peg involves two basic choices. First, what should be the reference currency? Second, what should be the nature of the peg in terms of commitment and tightness (currency board, horizontal, crawling, fluctuation band, etc)?

It can be argued that countries with a relatively diversified trade pattern should peg to an estimate of the effective exchange rate (in practice a trade-weighted basket) rather than to a single currency. Such a basket peg will minimise the effects of movements in major international currency pairs on the internal and external macroeconomic balance of the country at the same time as it should provide the desirable intermediate target and a nominal anchor, provided that major low-inflation currencies dominate the basket. However, it might be preferable for small countries to peg to the currency of one major trading partner instead of a basket, especially if financial integration with the trading partner is an important goal. Pegging to a single major currency might also be a sensible strategy, even in the face of a diversified trade pattern, if a monetary union with that currency is the preferred exit strategy. This applies for instance to those EU accession countries that have opted for exchange rate targeting.

It is sometimes argued that single currency pegs are by their very nature firmer and more credible than basket pegs.[7] A bilateral peg is generally more transparent and more easily understood by the public, although the experience of some countries that have followed a basket peg over a longer period seems to suggest that market participants and the public at large will learn how it operates and will be able to monitor its execution rather closely. In any case, the credibility argument can work in both directions. It is easier for the public to monitor a bilateral peg and it is more difficult for the authorities to cheat (changing weights to follow depreciating currencies etc). In that sense it can be said to be a more credible commitment. But if a bilateral peg is clearly not optimal due to the diversity of trade, it might in the end turn out to be less credible as it will not be as resilient to shocks. The problem will be compounded if this vulnerability is perceived by market participants.

There are pros and cons of operating fluctuation bands. Furthermore, there are the issues of whether they should have hard or soft edges and whether they should be publicly announced or not, which presumably only makes sense in the case of hard edges. These issues are of course not unrelated to the nature of the peg. They do not arise

[7] Frankel (2003, p 26), for instance, makes this point.

in the case of currency boards or other hard pegs, as for instance that of the CFA franc zone.

Having a fluctuation band in the case of a traditional horizontal peg avoids drawing a line in the sand for markets to make one-way bets against. This is a particular concern when capital movements have been liberalised. However, with an announced hard band the problem will arise anew at the edges of the band. On the other hand, announcing the band could help in anchoring expectations, provided that the peg has credibility. There are clearly several trade-offs to be considered in this connection (one being between flexibility and credibility), and different countries have made different choices in this regard.

Thirteen countries in Africa operate pegged exchange rate regimes in addition to the CFA franc zone, which has an external peg to the euro (see Annex Table A3). Equal numbers peg to a basket, the dollar and the rand, or three each. Two countries peg to the euro (in addition to the countries of the CFA franc zone). The remaining two are pegged to the SDR (Libyan Arab Jamahiriya) and the real effective exchange rate (Tunisia), which implies a crawling peg in nominal terms. The two currency unions (CFA and CMA) will be discussed in the next section. Of the other countries operating a peg, three very small ones operate currency boards against the USD (Dijbouti) or hard pegs against the euro (Cape Verde, supported by Portugal, and Comoros). None of the countries with a pegged exchange rate has an official fluctuation band around an announced central rate except Guinea, which has ±15% fluctuation band. However, Nigeria successfully operated a ±3% fluctuation band in 2005 within the framework of its managed float.

Excluding Zimbabwe, the countries on a pegged exchange rate in Africa (see Annex Table A1) have performed reasonably well and have had on average a lower inflation rate during the last 10 years than all other groups, except the CFA franc zone. The case of Botswana is interesting. It broke ranks with other members of the rand zone in 1976 and established an adjustable peg regime, first to the dollar and later to a basket composed of the rand (70%) and the SDR (30%). The first adjustment in the peg was a 5% revaluation. Over the past 10 years its inflation rate was slightly above that of South Africa but lower than that of the other members of the rand zone. However, its growth rate was significantly higher. Masson and Pattillo (2005) attribute the relative success of Botswana to the maintenance of fiscal discipline underpinned by tax revenues from exports of diamonds, a liberalised exchange control system, and some degree of central bank independence and occasional adjustment of the exchange rate in order to maintain competitiveness and/or keep inflation in check.[8]

Monetary integration

The existing forms of monetary integration in Africa have a long history. The two currency unions of the CFA franc zone go back to 1959 in their current forms and the rand zone has existed since the independence of South Africa's neighbours in the late 1960s. There is thus significant experience on which to build an assessment.

When assessing the CFA franc zone, it is important to bear in mind that it is composed of two elements, ie the internal currency union and the bilateral hard peg to the euro (previously, to the French franc). Some studies indicate that these unions are on the whole beneficial to zone members.[9] Studies further indicate that they have promoted internal trade but that financial integration remains low. The unions have been successful in delivering low inflation, probably mostly due to the external peg. However, this did not prevent a bank crisis. Nor did it prevent a serious overvaluation of the real exchange rate due to undisciplined fiscal policies and occasional monetisation of fiscal deficits. Lack of fiscal discipline along with a long period of deteriorating terms of trade and real effective exchange rate appreciation (partly due to the French franc's appreciation against the US dollar in the late 1980s and early 1990s) had serious adverse consequences for growth. The 50% devaluation of the CFA franc against the French franc in 1994 did, however, revive growth while avoiding significant inflation. A prohibition of direct monetary financing of government deficits and convergence criteria and surveillance of macroeconomic policies were also introduced in order to prevent similar misalignments arising in the future.

The experience of the CMA is also somewhat mixed. On the one hand, the South African Reserve Bank has probably the highest degree of central bank independence in Africa, and since adopting an inflation

[8] See also Masalila and Motshidisi (2003) on Botswana's exchange rate policy.

[9] For instance, Masson and Pattillo (2005, pp 103-107) find that, taking into account monetary externality, fiscal asymmetry and shock asymmetry, all members of WAEMU would suffer a welfare loss if they were to leave the union.

target it has been increasingly successful in delivering low inflation. On the other hand, the small members of CMA have experienced adverse effects on their macroeconomic balance and competitiveness due to significant swings in the rand vis-à-vis major currencies.[10] Botswana was able to avoid such adverse effects by leaving the rand zone in 1976 without paying a significant price in terms of monetary stability. However, it is not clear that the political economy of the other members of CMA would deliver the same results if they were to follow such a course.

There are currently several overlapping plans for monetary integration in Africa. Some of these plans seem to be driven more by desire than realism, and completion dates have in several instances been postponed. No doubt these plans are driven by worthwhile goals of imposition of external discipline on macroeconomic policies, promotion of economic and financial integration, and more regional and even pan-African political unity.[11] But the link of those with a monetary union is not always as clear cut as sometimes presumed. On the one hand, there is evidence from the CFA franc zone and other currency unions that they promote trade inside the union. Furthermore, there are several cases in history where sharing the same currency promoted financial integration. On the other hand, financial integration among members of the CFA franc zone is still at a relatively low level and the experience in the euro area has been disappointing to many. In Europe, economic and financial integration had progressed significantly before a common currency came into existence. Finally, the verdict on macroeconomic policies is mixed. Based on the experience of the CFA franc zone, Masson and Pattillo (2005) argue that monetary unions will not automatically provide a disciplinary effect on fiscal policies.

The proposed monetary union of the West African Monetary Zone (WAMZ)[12] is an interesting example. It is, in terms of planned completion date, next in line in Africa. It is currently scheduled to take place by December 2009, but earlier completion dates (2002 and 2005) were not met, partly due to the lack of economic convergence. The WAMZ monetary union is supposed to be a stepping stone to a monetary union of all member countries of the Economic Community of West African States (ECOWAS) (including both the current WAEMU of the CFA franc zone and WAMZ). Studies seem to indicate that both WAMZ and full ECOWAS monetary union will face problems due to asymmetric shocks. Additionally, should Nigeria's past lack of macroeconomic discipline continue, then its relatively large size would constitute a problem for both unions (Bénassy-Quéré and Coupet (2005) and Masson and Pattillo (2005)). The formation of such a union would anyway raise interesting issues concerning the potential expansion of the current WAEMU link to the euro to a wider area or the adoption of an alternative nominal anchor.[13]

A single currency for Africa has been a long-standing goal of African unity. The latest plan is part of the 1991 treaty establishing the African Economic Community (AEC). It envisages the creation of an African central bank and a single African currency at the latest by 2028. The road to that goal is supposed to be through the creation of regional economic communities, forming customs and currency unions that would then be progressively integrated. This could be seen as an ambitious goal given that Africa is, at present, very far from being an optimal currency area and the level of trade integration and labour mobility is low. Shocks tend to be asymmetric as exports of individual countries tend to be dominated by a few commodities whose prices move differently. Fiscal transfers are non-existent. Furthermore, existing areas of monetary integration have not expanded in recent decades. This goal is therefore probably to be seen as a political leitmotiv expressing some of the desires for economic integration and external discipline on macroeconomic policies discussed in the section above on the choice of exchange rate regimes. However, further progress in African economic and financial integration might, sometime in the distant future, lead to one or more African monetary unions.

[10] Foulo (2003) and van Zyl (2003) discuss the case of the CMA from the perspective of, respectively, Lesotho and South Africa.

[11] European monetary union was motivated by the perception that exchange rate volatility would be detrimental to the single market at the same time as free capital movements made pegged exchange rate regimes inoperable. In the case of Africa, institution building and external restraint on macroeconomic policies seem to be more important as motivation.

[12] Gambia, Ghana, Guinea, Nigeria and Sierra Leone.

[13] See Ojo (2003) and Ebi (2003) on the experience of and future plans for monetary integration in West Africa.

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Annex Table A1

Exchange rate regimes in Africa in 2004, by country

Countries grouped by IMF classification 2004	Currency	IMF classification, 1991[1]	Convertibility[5]	Inflation (%) (1996-2005)	GDP growth (%) (1996-2005)	Exchange rate volatility,[6] 2002-05 to the USD	to the EUR	NEER[9]
Independent floating								
Congo, Dem Rep of	New zaire	FP	2	208.5	0.1	6.8	7.6	N/A
Liberia	Liberian dollar	FP	1			9.4	9.9	N/A
Madagascar	Malagasy franc	MF	2	8.7	3.5	7.8	7.3	N/A
Malawi	Kwacha	FP	2	24.3	2.8	5.6	6.1	13.3
Sierra Leone	Leone	IF	2	13.1	2.1	3.8	5.8	7.6
Somalia	Somali shilling	MF	1			N/A	N/A	N/A
South Africa	Rand	IF	2	6.2	2.7	6.7	6.5	N/A
Tanzania	Tanzanian shilling	FP	2	8.7	5.4	3.9	5.3	N/A
Uganda	Ugandan shilling	FP	4	4.0	6	4.5	6.0	8
Simple average				*12.0*[2]	*4.5*	*6.1*	*6.8*	*N/A*
Managed floating								
Algeria	Algerian dinar	FP	2	5.0	3.8	3.8	5.5	8.4
Angola	New kwanza	FP	1	548.1	8	6.3	7.3	12
Burundi	Burundi franc	FP	1	13.3	0.4	6.3	7.0	N/A
Egypt	Egyptian pound	MF	1	4.4	4.5	6.2	7.1	N/A
Ethiopia	Birr	FP	1	2.7	4.8	0.6	5.4	N/A
Gambia	Dalasi	IF	4	6.5	5.1	5.7	6.7	10.3
Ghana	Cedi	IF	2	21.8	4.6	2.7	5.6	5.8
Kenya	Kenyan shilling	FP	2	7.3	1.9	4.2	5.2	N/A
Mauritania	Ouguiya	MF	2	5.0	4.5	3.0	5.3	N/A
Mauritius	Mauritian rupee	FP	3	5.6	4.9	4.6	5.1	N/A
Mozambique	Metical	MF	1	12.7	8.3	6.3	6.5	N/A
Nigeria	Naira	IF	1	13.5	4.2	4.0	6.0	7.7
Rwanda	Rwanda franc	FP	2	5.7	7.8	3.8	5.7	N/A
Sao Tomé and Principe	Dobra	MF	1	23.4	3.6	2.2	5.2	N/A
Sudan	Sudanese pound	FP	2	25.4	6.7	2.4	5.5	N/A
Zambia	Kwacha	MF	4	24.6	3.5	8.0	8.5	10.1
Simple average				*11.8*[3]	*4.8*	*4.4*	*6.1*	*N/A*

[1] IF = independent float; MF = managed float; FP = fix peg.
[2] Excluding Congo, Democratic Republic.
[3] Excluding Angola.
[4] Currency board.
[5] 1 = Article VIII of the IMF agreement does not apply; 2 = Article VIII applies but capital movement controls are in place; 3 = current account convertibility and partial freedom of capital movement; 4 = current account convertibility and free capital movements.
[6] Calculated as annualised standard deviation of monthly percentage change.
[7] Excluding Zimbabwe.
[8] Crawling peg.
[9] Nominal effective exchange rate.

Annex Table A1 continued

Exchange rate regimes in Africa in 2004, by country

Countries grouped by IMF classification 2004	Currency	IMF classification, 1991[1]	Convertibility[5]	Inflation (%) (1996-2005)	GDP growth (%) (1996-2005)	Exchange rate volatility,[6] 2002-05 to the USD	to the EUR	NEER[9]
Pegged								
Botswana	Pula	FP	3	6.9	5.4	6.7	6.1	N/A
Cape Verde	Cape verde escudo	FP	1	3.0	6.7	5.3	–	N/A
Comoros	Comoro franc	FP	2	4.0	2	5.3	–	N/A
Djibouti[4]	Djibouti franc	FP	2	2.1	1.5	–	5.4	N/A
Eritrea	Nakfa		1	14.8	2.1	2.6	5.5	N/A
Guinea	Guinea franc	MF	2	7.3	3.7	6.2	6.3	N/A
Libyan Arab Jamahiriya	Libyan dinar	FP	2			5.8	5.9	N/A
Morocco	Dirham	FP	2	1.8	4.1	4.8	2.5	2.2
Seychelles	Seychelles rupee	FP	3	3.7	2.3	4.2	5.3	N/A
Tunisia[8]	Tunisian dinar	MF	2	3.0	5.1	4.4	3.2	3.8
Zimbabwe	Zimbabwe dollar	FP	2	163.5	–2.7	50.7	50.8	N/A
Simple average				*5.2*[7]	*3.0*	*8.7*	*8.3*	*N/A*
Exchange rate and currency unions								
CMA								
Lesotho	Loti	FP	2	7.7	3	6.7	6.5	12.2
Namibia	Namibian dollar	IF	2	8	3.3	6.7	6.5	N/A
Swaziland	Lilangeni	FP	2	7.7	2.7	6.7	6.5	N/A
Simple average				*7.8*	*3.0*	*6.7*	*6.5*	*N/A*
WAEMU								
Benin	CFA franc	FP	2	3.3	5.1	5.3	–	N/A
Burkina Faso	CFA franc	FP	2	2.5	6	5.3	–	N/A
Cote d'Ivoire	CFA franc	FP	2	2.9	1.9	5.3	–	3.2
Guinea-Bissau	CFA franc	MF	2	13.0	–0.3	5.3	–	N/A
Mali	CFA franc	FP	2	2.3	5.3	5.3	–	N/A
Niger	CFA franc	FP	2	2.1	3.8	5.3	–	N/A
Senegal	CFA franc	FP	2	1.6	4.6	5.3	–	N/A
Togo	CFA franc	FP	2	2.4	2.2	5.3	–	3
Simple average				*3.8*	*3.6*	*5.3*	–	*N/A*
CEMAC								
Cameroon	CFA franc	FP	2	2.8	5	5.3	–	3.2
Central African Rep	CFA franc		2	1.9	0.8	5.3	–	2.8
Chad	CFA franc	FP	2	3.0	8.7	5.3	–	N/A
Congo, Rep of	CFA franc	FP	2	3.5	3.6	5.3	–	N/A
Equatorial Guinea	CFA franc	FP	2	6.3	31.4	5.3	–	2.3
Gabon	CFA franc	FP	2	1.9	0.9	5.3	–	2.8
Simple average				*3.2*	*8.4*	*5.3*	–	*N/A*

Sources: IMF, *Annual report on exchange arrangements and exchange restrictions*; IMF, *International financial statistics*; author's calculations.

Annex Table A2

Distribution of exchange rate regimes by country1

	Africa		All developing		All countries	
	1991	**2004**	**1991**	**2004**	**1991**	**2004**
Flexible[2]	26.9	47.2	34.8	46.5	34	45.2
Pegs:	44.2	18.9	54.0	42.1	56.6	38.2
Currency boards	1.9	1.9	1.5	4.4	1.3	3.8
Other[3]	42.3	17	52.6	37.7	55.3	34.4
Currency unions	28.8	34	11.1	11.3	9.4	16.7
Memo: number of countries	52	53	135	159	159	186

[1] End of period, as a percentage of countries in each category.
[2] Independently and other managed floating regimes.
[3] Composed of regimes with conventional fixed peg to a single currency or to a basket, peg within a horizontal band, crawling peg and crawling band.

Sources: IMF, *Annual report on exchange arrangements and exchange restrictions*; author's calculations.

Annex Table A3

Pegged regimes in Africa, 2004

Country/area	**Currency**	**Reference currency**	**Official fluctuation band**
Botswana	Pula	Basket[1]	No
Cape Verde	Cape verde escudo	Euro	No
Comoros	Comoro franc	Euro	No
Djibouti	Djibouti franc	USD	No
Eritrea	Nakfa	USD	No
Guinea	Guinea franc	USD	± 15%
Lesotho	Loti	Rand	No
Libyan Arab Jamahiriya	Libyan dinar	SDR	No
Morocco	Dirham	Basket	No
Namibia	Namibian dollar	Rand	No
Seychelles	Seychelles rupee	Basket	No
Swaziland	Lilangeni	Rand	No
Tunisia	Tunisian dinar	REER	No
WAEMU/CEMAC	CFA franc	Euro	No

[1] 30% SDR, 70% rand.
Sources: IMF, *Annual report on exchange arrangements and exchange restrictions*; author's calculations.

Central banks and the challenge of development

A special meeting of Governors at the BIS
on Tuesday 14 and Wednesday 15 March 2006
List of participants

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Chidozie Emenuga
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Taoufik Baccar
Jean-Pierre Roth
Daudi Ballali
Derick Latibeaudiere
Charles Soludo
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Tito Mboweni
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Rameswurlall Basant Roi
Anil Kumar Misra
Hallime Driss Boughida
Rigobert Roger Andely

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Tiémoko Meyliet Kone
Linah Mohohlo
Malcolm Knight
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The issues facing central banks in the developing world get much more attention from the BIS than they did a decade ago. The following notes summarise some of the more important elements that are of specific interest to developing countries. Also indicated are a few of the main relevant publications which are available on the BIS website (www.bis.org).

Of all the Committees that meet at the BIS, the Basel Committee on Banking Supervision is the best known. After an extensive review of the Core Principles of Banking Supervision (originally realised in April 1997), the Committee published in April 2006:

Core principles for effective banking supervision – consultative document (www.bis.org/publ/bcbs123.htm)

Core principles methodology – consultative document (www.bis.org/publ/bcbs124.htm)

The Committee on the Global Financial System (CGFS) recently reviewed foreign direct investment in the financial sector of emerging economies, and published two reports:

Foreign direct investment in the financial sector of emerging economies. CGFS Publications No 22. March 2004. (www.bis.org/publ/cgfs22.htm)

Foreign direct investment in the financial sector – experiences in Asia, central and eastern Europe and Latin America. CGFS Publications No 25. June 2005. (www.bis.org/publ/cgfs25.htm)

The BIS international banking and financial market statistics, which are gathered under the auspices of the CGFS, provide a comprehensive and consistent database of a significant part of the external assets and liabilities of developing countries. These statistics are published quarterly with an extensive commentary in:

BIS Quarterly Review (www.bis.org/publ/quarterly.htm)

The statistics are described in detail in:

Guide to the international financial statistics. BIS Papers No 14. February 2003. (www.bis.org/publ/bispap14.htm)

The Committee on Payment and Settlement Systems recently published:

General principles for international remittance services – consultative report. CPSS Publications No 73. March 2006. (www.bis.org/publ/cpss73.htm)

General guidance for national payment system development. CPSS Publications No 70. January 2006. (www.bis.org/publ/cpss70.htm)

As central banks review their oversight function, also of interest is:

Central bank oversight of payment and settlement systems. CPSS Publications No 68. May 2005. (www.bis.org/publ/cpss68.htm)

Deputy Governors from the major emerging market central banks around the world meet in Basel once a year to discuss themes of particular interest to central banks. Other special meetings are also arranged from time to time. Publications over the past year have included:

The banking system in emerging economies: how much progress has been made? July 2006. BIS Papers No 28. Forthcoming (www.bis.org/publ/bppdf/bispap28.htm)

Developing corporate bond markets in Asia. BIS Papers No 26. (www.bis.org/publ/bppdf/bispap26.htm)

Foreign exchange market intervention in emerging markets: motives, techniques and implications. BIS Papers No 24. (www.bis.org/publ/bppdf/bispap24.htm)