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

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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.