Deutsches Institut für Entwicklungspolitik

German Development Institute

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Briefing Paper 8/2015

Financing Global Development: The Role of Central Banks

Summary

The UN Conference on Financing for Development in Addis Ababa in July 2015 will pave the way for the implementation of the post-2015 development agenda. The Briefing Paper series "Financing Global Development" analyses key financial and non-financial means of implementation for the new Sustainable Development Goals (SDGs) and discusses building blocks of a new framework for development finance.

In many developing and emerging economies, central banks have begun over the past decade to place renewed emphasis on the promotion of economic development and structural transformation, looking beyond narrow mandates for macroeconomic stability. Developmental central bank policies have included policies directed at financial sector development, the promotion of financial inclusion and aligning the financial system with sustainable development.

This marks a shift from the orthodoxy that has dominated central banking since the 1980s and that has been promoted in developing countries by institutions such as the International Monetary Fund (IMF) and multilateral development banks. The orthodox approach to central banking – according to which central banks should primarily focus on price stability – has been severely undermined by the global financial crisis. It has become clear that central banks also ought to take responsibility for safeguarding financial stability. Moreover, in the aftermath of the crisis, many central banks have adopted unconventional policies to address problems of debt, stagnation and deflation. This has opened up a new discussion on the scope of – and limits to – the mandate of central banks. In practice, many central banks in developing countries nowadays proactively seek to promote sustainable economic development. Specifically, an increasing number of central banks and financial regulators have become active in promoting financial inclusion and in greening financial systems, rendering them important – albeit in international policy discussions often underrated – actors in development financing.

Widening the mandate of central banks can help to promote sustainable economic development by improving the framework conditions for financing the post-2015 development agenda. However, a wider mandate undoubtedly complicates matters, as developmental objectives may at times conflict with stability objectives. As central bank mandates widen, it will therefore be important to reform central bank policy frameworks with a view towards addressing the risks arising from a wider central bank mandate. The reform of central bank policy frameworks may help to ensure that central banks promote economic development and stability in a balanced manner, and thus be an important building block of a new framework for development finance.

The changing role of central banks

Since the 1980s, a broad consensus emerged among economists regarding the role and mandate of central banks. Central banks, it was widely believed, should focus their energies on maintaining price stability and refrain from any other goals, such as growth and employment generation, that may be in conflict with this goal. Safeguarding price stability, it was argued, would be the best contribution that central banks could make to economic growth and development. This thinking was best embodied in the concept of "inflation targeting" (IT), a monetary policy strategy in which the central bank publicly announces a medium-term inflation target and adjusts its policy rates in order to meet this target. Numerous central banks all over the world, in advanced and developing economies alike, have adopted IT frameworks. International financial organisations such as the World Bank and the IMF have promoted IT in developing economies as being the state of the art of central banking, along with financial market and capital account liberalisation as well as flexible exchange rates.

The IT orthodoxy has had serious implications for economic policy-making in developing economies, since central banks with a narrow IT mandate cannot assume the "developmental" role that central banks have historically played in virtually all of today's advanced economies in supporting financial sector and industrial development. Moreover, a narrow focus on inflation may keep the central bank from responding adequately to supply or terms-of-trade shocks and risks to financial stability.

The global financial crisis has led to a rethinking of the prevailing consensus in central banking – which then-IMF Chief Economist Olivier Blanchard dismissed in a speech as "a one target one instrument world" – which, despite its analytical rigour, was not fit for purpose. Indeed, not only have central banks around the world rediscovered their financial stability mandates, they have also adopted all kinds of unconventional monetary policies in the aftermath of the global financial crisis in order to deal with problems of debt, stagnation and deflation. In developing countries, central banks and financial regulatory authorities are confronted with further challenges, including the promotion of financial development and inclusion as well as the pressing question of how to align the financial system with sustainable development.

Historical experiences with developmental central bank mandates

When reassessing the mandate of central banks, it is worth looking at the developmental roles they historically played in advanced and developing countries until the 1980s. Central banks in today's developed countries played important roles in rebuilding their economies following the Great Depression and the Second World War, utilising a variety of credit allocation techniques, which were supported by capital and exchange controls (Epstein, 2006). In Japan, for instance, the central bank supported the government's industrial policy through credit allocation policies. In France, Italy and Belgium, central banks used variable asset-based reserve requirements, lowering required reserve rates on privileged assets to promote lending to desired sectors such as manufacturing. In the United Kingdom and the United States, the Bank of England and the Federal Reserve played promotional roles by supporting the growth of the financial sector.

In many developing economies, central banks were assigned developmental mandates when they were established to promote weakly developed private sectors. Besides using capital and exchange controls, central banks intervened directly in financial sectors to facilitate access to credit for priority sectors. In India, for instance, the central bank used regulations which required banks that wanted to open branches in urban areas to open branches also in unbanked locations. One of the instruments used by the central bank of Nigeria was the provision of capital to development financing institutions. In Mexico, Argentina, Brazil and Chile, central banks used variable asset-based reserve requirements to influence the sectoral allocation of credit.

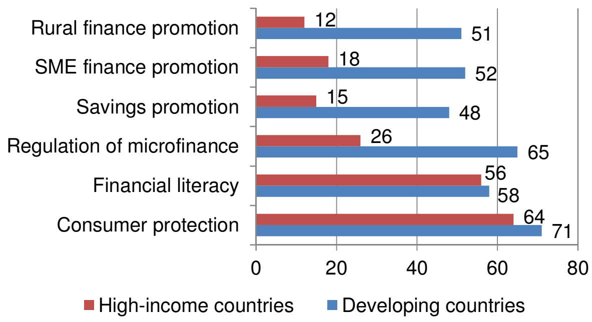
In the 1980s and 1990s, major central bank policy reforms took place in developing countries to orient central bank policy towards the promotion of price stability. The main reasons for this turnaround were the rise of neoliberal economic thinking and, correspondingly, a change in donors' priorities. Another important reason was the perceived failure of developmental central banking policies. Although the effectiveness of such policies varied from country to country, there was broad agreement that they were often ineffective at best, for example often benefiting only narrow interest groups within the state or the private sector rather than the broader economy (Dafe, 2012).

A developmental role for central banks – Back to the future?

Over the past decade, many central banks in developing and emerging economies have begun to place renewed emphasis on the promotion of economic development and structural transformation, looking beyond narrow mandates for macroeconomic stability. The greater appeal of alternative approaches to central banking is related to the blatant failure of the neoliberal economic model as well as the apparent success of more interventionist, developmental approaches followed by several East Asian economies, including Japan, Korea and China. One area where an increasing number of central banks have become active is improving financial inclusion.

In many developing countries, central banks and financial regulators have been at the forefront of promoting access to financial services (see Figure 1). Since 2011, central banks from countries as varied as Uganda, Nepal and Ecuador have for instance signed the Maya Declaration, an

Fig. 1: Intensity of trade finance in emerging markets (ratio of trade finance to trade in goods, in percentage)



Note: Results are based on a sample of 142 economies, of which 98 are developing countries.

Source: CGAP. (2010). *Financial access 2010. The state of financial inclusion through the crisis*. Washington, DC: Consultative Group to Assist the Poor and World Bank Group, p. 18.

international initiative in which countries make measurable commitments to promote financial inclusion. The instruments used by central banks to promote financial inclusion vary significantly across countries. Consumer protection and financial literacy have become important areas of central bank engagement in a variety of countries. In Armenia, for example, the central bank established a consumer protection and financial education centre. Proportionate regulation, which considers the implications of financial regulation for both financial stability and financial inclusion, has become a guiding principle for many central banks. Kenya's central bank has been at the forefront of promoting the principle of proportionality, providing an enabling regulatory environment for the provision of mobile payment services, which allowed for their rapid expansion. Central bank promotion of small and medium enterprise (SME) and agricultural finance has also been on the rise. In Nigeria and Pakistan, for instance, the central banks established SME and agricultural credit guarantee schemes in recent years; the central bank of Bangladesh regularly organises training programmes for SME entrepreneurs. Compared to the period before the 1980s, central bank policies to promote financial inclusion in developing countries tend to be more market-based, more focussed on institution-building and rely more on technical solutions to reduce the costs of financial services provision rather than on public subsidies and direct intervention in financial institutions' lending activities.

The greening of the financial system

A second area where a growing number of central banks and financial regulators have become active is the greening of financial systems. There are important reasons why central banks should care about environmental risk (Volz, 2014). First, environmental risk – and risk arising from climate change in particular – constitutes a significant systemic risk for the real economy, and therefore also for the financial sector. Second, the provision of finance for socially undesirable activities – such as carbon-intensive businesses – can be characterised as a market failure. Environmental regulation and carbon pricing should be the preferred policy tools to correct this market failure and discourage such investments. Yet, as long as carbon-pricing markets are not functioning and no effective environmental policies are in place, there may be a case for financial authorities to use their powers to affect credit creation and allocation. Third, the case for an environmental role for financial authorities can be made for developing countries, where these institutions typically have a strong institutional standing in the policy framework, whereas environmental authorities lack clout.

A number of central banks and financial regulatory authorities are the vanguard that has already stood up to the challenge of climate change and environmental degradation. Already in 2011, the central bank of Bangladesh introduced a comprehensive green banking framework. In 2012, the China Banking Regulatory Commission issued *Green Credit Guidelines "for the purpose of encouraging banking institutions to, by focusing on green credit, actively adjust credit structure, effectively fend off environmental and social risks, better serve the real economy, and boost the transformation of economic growth mode and adjustment of economic structure"*. In 2014, the Chinese central bank launched a *Green Finance Task Force*. The same year, the Indonesian Financial Services Authority published a *Roadmap for Sustainable Finance in Indonesia* (Volz, 2015), whereas Mongolia's central bank launched the *Mongolian Sustainable Finance Principles and Sector Guidelines*, a voluntary framework to support local banks in integrating environmental and social considerations into lending decisions and product design. For sure, all of these frameworks have their shortcomings, and the effects they have had on financial markets have been negligible to date. But we are just seeing the beginning of a greater trend, in which central banks and financial authorities are starting to respond to the challenges posed by climate change by requiring adequate management and disclosure of climate and other environmental risks from financial firms.

Challenges arising from a wider mandate

However, a wider central bank mandate may not only have benefits but it would also raise new challenges. There are at least three main risks of mandating central banks with developmental or environmental objectives. First, tradeoffs may arise in achieving developmental and stabilisation objectives. On a functional level, central banks will encounter problems if they are supposed to achieve too many objectives and have too few policy instruments at their disposal, as described by the so-called Tinbergen rule.

Second, assigning central banks a wider mandate may be dangerous, as it may vest too much power in institutions that have only limited accountability. In many countries where central banks are seeking to play a promotional role, the performance of developmental policies is not systematically evaluated, and the effectiveness of policies is not regularly reported.

Third, where central banks are assigned a wider, developmental mandate, they may face significant political pressure to pursue developmental policies at the expense of stability, particularly where central bank independence is limited, as is the case in many developing countries. The history of central banking is full of examples in which central banks have been used by governments to monetise public debt.

Balancing development and stability – The way forward

Over the past decade, many central banks in developing and emerging economies have begun to place renewed emphasis on the promotion of economic development. A central bank with a wider, developmental mandate can make important contributions to a country's economic and social development and may play an important role in improving the framework conditions for financing the post-2015 development agenda. Yet, multiple objectives will make central banking much more challenging, not least because tensions may arise between policies that promote price or financial stability, on the one hand, and development on the other. How may these challenges be addressed?

1 A first step is to enhance transparency and central bank policy communication to signal commitment to the central bank's objectives, to justify policy decisions and to ensure accountability.

2 A second step is to establish clear monitoring and evaluation frameworks for central bank interventions that seek to proactively promote development, given the risks that such interventions may entail for price and financial stability.

3 A third step is to make clear that central bank policy is only one part of the broader, integrated public policy framework for fostering sustainable development, with clear limits to the central bank's developmental mandate.

4 Finally, it is important that central bank policy frameworks acknowledge both the importance of developmental objectives and their potential tensions with stability objectives. In many developing countries, central banks' formal mandates extend only to price and financial stability, whereas in practice these central banks also pursue other objectives. Moreover, only a few countries have a central bank policy framework that acknowledges the potential tensions between competing objectives such as financial stability and financial development. Acknowledging these tensions will make it easier for central banks to justify unpopular yet necessary policies for maintaining price or financial stability and avoid capture by policy-makers or private actors.

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ISSN 1615-5483