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Some Aspects of Financial Policies and Central Banking in Developing Countries

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Economic development is not only facilitated but its pace is quickened by the appropriate development of the financial system—structure of financial institutions, instruments and interest rates.¹

In any strategy of development, therefore, it is essential to emphasize the evolution of a sound and well-integrated financial system from the point of view both of resource mobilization and efficient allocation.² In Section I of this paper, an attempt is made to delineate the broad contours of a set of financial policies that seem to be consistent with any sound strategy of development. In Section II, the role of Central Banks is emphasized, not only as promoters but also as regulators of sound integrated financial systems. These two functions are interrelated: the function of Central Banks as regulators is in fact reinforced by their function as promoters.⁴

In spite of the dynamic catalytic role of the banking system in promoting economic development,⁵ it is somewhat strange that, at an international level, this role is not sufficiently stressed in providing technical and financial assistance to the developing countries for the purpose of promoting the evolution of sound financial systems. The International Monetary Fund emphasizes the regulatory role of Central Banks only, while the International Bank for Reconstruction and Development lays stress on the development of specialized financial intermediaries only. The result is that a large number of central banks have not been appropriately oriented towards development objectives in general, and to the development of sound financial systems in particular. Further, the evolution of specific financial intermediaries takes place in such a way as to promote further fragmentation of the capital market; or at any rate the policy of merely promoting specific financial intermediaries does not stress the need for an integrative mechanism and agency as provided by the existence of a Central Bank.

What needs special emphasis at an international level is the rationale and urgency of evolving a sound financial structure through the efficient performance of the twin interrelated functions—as promoters and as regulators of the financial system—by Central Banks.

I. SOME ASPECTS OF FINANCIAL POLICIES

The main object of this Section is to show the significance of saving and flow-of-funds analysis as an indicator of a set of financial policies—policies relating to the structure of financial institutions, instruments and interest rates—essential for resource mobilization and allocation consistent with a country's development objectives.⁶

In a large number of developing countries, the only reliable data available for understanding the trends in the economy and for policy purposes relate to monetary flows and the balance of payments. These data thus assume critical significance. Flow-of-funds data are not available for a large number of countries but are such as

4. See John Hicks, *Capital and Growth* (Oxford, 1965) Chapter XXIII, p. 292. Hicks writes: 'There is a place for monetary policy . . . It can perform its function more satisfactorily . . . if it is backed by an efficient system of financial intermediaries.' See also pp. 290–2
6. For a discussion of saving and flow-of-funds analysis as a technique for financial planning, see V. V. Bhatt, 'Saving and flow-of-funds analysis: A tool for financial planning in India', *The Review of Income and Wealth* (March 1971).
Table 1. Sectoral surpluses and deficits (−): 1950–59

<table>
<thead>
<tr>
<th></th>
<th>Developed countries</th>
<th>Less developed countries</th>
<th>All countries</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Households</td>
<td>6.1</td>
<td>3.5</td>
<td>4.8</td>
</tr>
<tr>
<td>2. Enterprises*</td>
<td>−7.6</td>
<td>−4.9</td>
<td>−6.3</td>
</tr>
<tr>
<td>3. Government</td>
<td>1.3</td>
<td>−0.7</td>
<td>0.3</td>
</tr>
<tr>
<td>4. Rest of the World</td>
<td>−0.1</td>
<td>2.1</td>
<td>1.0</td>
</tr>
</tbody>
</table>


* Includes government enterprises.

Table 2. Pattern of household saving

<table>
<thead>
<tr>
<th>Form of Saving</th>
<th>India (1963–4) %</th>
<th>USA 1909–14 %</th>
<th>USA 1960–4 %</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Financial assets</td>
<td>66.7</td>
<td>98</td>
<td>123</td>
</tr>
<tr>
<td>2. Financial liabilities</td>
<td>−16.7</td>
<td>−46</td>
<td>−86</td>
</tr>
<tr>
<td>3. Physical assets</td>
<td>50</td>
<td>48</td>
<td>63</td>
</tr>
<tr>
<td>4. Total (1+2+3)</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>5. Percentage share of household saving in national saving</td>
<td>67.2</td>
<td>61</td>
<td></td>
</tr>
</tbody>
</table>

Figures in brackets indicate proportion of personal disposable income.


...can be reliably compiled and presented. The data relating to corporate enterprises and financial intermediaries are available and can be consolidated in the required form with some effort. Similarly, data relating to the government sector and the balance of payments are available and can be presented in flow-of-funds form along with the data for corporate enterprises and financial intermediaries. The data relating to the government sector, corporate enterprises and financial intermediaries can provide the necessary information relating to the transactions of these sectors with the household sector—an omnibus term for the sector comprising all unincorporated enterprises and households. Thus, provided the usefulness of flow-of-funds analysis is recognized, it may not be difficult to collect and process data in this form.

Whatever the development objectives and whatever the nature of planning or programming, it is essential to aim at financial balance. This balance indicates that the investment demand for resources of the deficit sectors is met by the supply of required resources from the surplus sectors. In most of the developing countries, and in the developed countries, the surplus sector is the household sector which provides resources directly, or indirectly through the financial intermediaries, to the government sector as well as to the corporate sector. The other sector which provides resources to these deficit sectors in the developing countries is the external sector through official external assistance and private foreign investment. For the viability of a development program, it is essential that these resource-flows are consistent with the projected volume and pattern of investment. Further, various policy instruments can be rationally used for attaining financial balance only when the degree and nature of imbalances are clearly known through flow-of-funds analysis.

A. Characteristic features of saving and flow of funds

Saving and flow-of-funds analysis brings out the crucial importance of household sector saving for financing the saving deficits of the government sector and the private corporate sector. Generally, the latter two are deficit sectors and the only surplus sector is the household sector which finances directly and indirectly, through the financial institutions, a part of the deficits of the other two sectors. The external sector finances the residual deficits.

Table 1, on Sectoral Surpluses and Deficits during 1950–59 in 14 developed countries and 10 developing countries, brings out this fact clearly. In the developing countries, both the government and business sectors have deficits—that is, their total expenditures exceed their incomes, while the household sector shows a surplus and finances, along with the external sector, the deficits of the government and business sectors. In the developed countries, the government sector shows a surplus. However, in the data available, government enterprises are included in the business sector; if these enterprises were shown in the government sector, it is likely that the government sector too would have been a deficit sector.

The second significant implication of the saving and
flow-of-funds data is that the saving surplus of the household sector that can be potentially transferred to the other two sectors is represented by the household saving in the form of financial assets. Of course, a part of this surplus returns to the household sector via its borrowing from the financial institutions.

Household sector saving is partly in the form of physical assets like residential housing, equipment, and inventories of goods, and partly in the form of financial assets. Saving in the form of physical assets represents household sector investment, which is financed partly by direct saving of the sector and partly by borrowing from the financial institutions.

Table 2 shows the household sector saving pattern for India (1963–4) and for the USA (1909–14 and 1960–4). It appears from this table that about 50 per cent of household sector saving was in the form of net financial assets (net of financial liabilities) in India (1963–4) and the USA (1909–14). Thus, the household sector transferred half of its saving to the other two sectors.

The USA data for 1960–4 reveal a picture that is somewhat different and possibly indicates the nature of evolution of the household sector saving pattern for the developing countries. These data show that a dominant part of the saving was in the form of financial assets and that own saving used for direct investment was negligible. Household sector investment was financed completely by borrowing from the financial institutions. There was in fact excess borrowing (that is borrowing exceeded investment in physical assets) which financed the acquisition of consumer durables, which are not included in the data on saving.

B. Desirable pattern of household sector saving

It is quite likely that in the developing countries, too, saving in the form of financial assets and borrowing from financial institutions would tend to dominate the saving pattern over a period of time. This may happen; however, it should be the aim of financial policies to quicken this process for several reasons:

(i) It is quite likely that the full potential saving of the household sector is not mobilized due to the inadequate development of financial institutions and instruments consistent with savers’ preferences. In the developing countries, the capital market in the rural and semi-urban areas is highly fragmented. Potential saving in one part cannot easily be transferred to other deficit units. Further, due to inadequate facilities for borrowing on reasonable terms, the potential saving may be inadequate to finance investment required by these units. For both these reasons, this potential saving may prove abortive and be used for consumption.7

(ii) The financial institutions finance a very small part of household sector investment. In India, the proportion of investment financed by the financial institutions does not exceed 15 to 20 per cent. A major part of investment is, thus, financed by own saving and borrowing from the surplus units and private moneylenders/indigenous bankers, which constitute the so-called unorganized market for capital funds. Interest rates in this market are very high and range from 20 to 35 per cent per year. These high interest rates have two consequences. Firstly, worthwhile productive projects cannot be implemented at these rates. And secondly, these high rates induce speculative investment—investment in land, real estate, scarce commodities, gold and the like. Thus, on the one hand, potential productive investment is not taken up and, on the other, resources are diverted toward undesirable forms of investment.

(iii) Because of the existence of this unorganized market, government economic policies—credit as well as fiscal policies—are not very effective in influencing the magnitude or the pattern of investment in the household sector.

(iv) Most of the plans in the developing countries require a rapid growth of investment in the government sector and the private corporate sector. This is not possible without an adequate transfer of household saving to these two sectors. Such a transfer can be facilitated only if a major part of household sector saving was in the form of financial assets. In that case, government economic policies could be effective in attaining an efficient allocation of saving among the various sectors of the economy.

C. Policy implications

For evolving an integrated and efficient capital market, it is thus essential to induce the household sector to save a greater part of its surplus in the form of financial assets. The next logical problem is to find out the type of financial instruments that are consistent with the saving preferences of the household sector.

The structure of household sector financial saving is shown in Table 3 for some developed as well as developing countries. This structure reveals that with the evolution of financial institutions, the household sector prefers to hold more than 50 per cent of its financial saving in the form of money and deposits. The second significant preferred asset seems to be claims on social security institutions—life insurance, pension and provident funds and the like. Thus the major part of financial saving seems to be in the form of claims on financial institutions. Excepting in a few countries like Belgium and Malaysia, saving in the form of direct claims on the non-financial sectors is less than 25 per cent of the total financial saving; in the USA and UK it is negligible.

The trend, thus, seems to be towards a financial structure in which indirect financial saving (that is, saving in the form of claims on financial institutions) is gaining at the expense of direct saving (in the form of direct claims on the government and corporate sectors) and in which borrowing is increasing in importance. It seems desirable for the developing countries to assist this trend and concentrate their efforts on bringing about or facilitating those changes in financial structure, and in the laws and regulations which affect it, that will ensure, or at least make more likely, that a predominantly indirect and institutional and largely contractual and compulsory flow of personal saving contributes as much as possible to economic growth.8 For this purpose,


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<td>Money</td>
<td>8</td>
<td>27</td>
<td>51</td>
<td>8</td>
<td>45.7</td>
<td>61.7</td>
<td>19</td>
<td>18</td>
<td>84.4</td>
<td>38</td>
<td>5.6</td>
<td>23</td>
<td>45.2</td>
<td>53.4</td>
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<tr>
<td>Thrift deposits</td>
<td>52</td>
<td>38</td>
<td>47</td>
<td>8</td>
<td>20</td>
<td>11.5</td>
<td>44</td>
<td>33</td>
<td>25</td>
<td>31</td>
<td>8.6</td>
<td>58</td>
<td>22</td>
<td>27.7</td>
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<tr>
<td>Contractual saving</td>
<td>37</td>
<td>76</td>
<td>30</td>
<td>4</td>
<td>20</td>
<td>10</td>
<td>25</td>
<td>25</td>
<td>1.2</td>
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<td>68.9</td>
<td>38</td>
<td>43.6</td>
<td>11.0</td>
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<tr>
<td>Securities</td>
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<tr>
<td>Central govt. bonds</td>
<td>2</td>
<td>12</td>
<td>12</td>
<td>12</td>
<td>11.5</td>
<td>10.0</td>
<td>25</td>
<td>-16</td>
<td>-</td>
<td>1</td>
<td>-</td>
<td>8</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Other bonds</td>
<td>4</td>
<td>17</td>
<td>4</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>4</td>
<td>34</td>
<td>-</td>
<td>3</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td></td>
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<tr>
<td>Corporate stock</td>
<td>-3</td>
<td>-27</td>
<td>-</td>
<td>4</td>
<td>-</td>
<td>-</td>
<td>18</td>
<td>5</td>
<td>-</td>
<td>31</td>
<td>-</td>
<td>16</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>3</td>
<td>1</td>
<td>18</td>
<td>16</td>
<td>33.8</td>
<td>14.1</td>
<td>21</td>
<td>23</td>
<td>14.4</td>
<td>21</td>
<td>25.5</td>
<td>17</td>
<td>8.1</td>
<td></td>
</tr>
<tr>
<td>Others</td>
<td>-</td>
<td>-42</td>
<td>3</td>
<td>16</td>
<td>0.4</td>
<td>12.8</td>
<td>6</td>
<td>6</td>
<td>21</td>
<td>6</td>
<td>-</td>
<td>100</td>
<td>3.2</td>
<td></td>
</tr>
<tr>
<td>Total saving</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
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<td>100</td>
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several important changes will be called for in government and business policies from those now accepted in many countries. To give just one example, governments will have to abandon the policy of attempting to bring back, or to create, a broad market for government and corporate securities among individual buyers. It does not seem to be essential for developing countries to pass through that phase of the evolution of financial systems through which the developed countries passed several decades back.

D. Framework for economic and financial policies

To stimulate indirect financial saving, several institutional and policy measures seem to be essential:

(i) Since thrift deposits—saving and fixed deposits—seem to be a preferred asset, the institutional development that should have first priority should be the widening and deepening of the geographical and functional scope of the commercial banking system. This system has already evolved in the developing countries but its scope is largely restricted to urban areas and to the financing of modern enterprises in industry and trade. Instead of creating new institutions, it seems to be more rational and economical to expand the scope of this system through the creation of a nation-wide network of bank branches, and enlarging their functional scope. Such a system need not restrict its role to that of purveying credit and deposit mobilization; it can also provide entrepreneurial and managerial guidance to agriculture and small industry. The functions of such a system are discussed in my book, Structure of Financial Institutions. 9

(ii) Savers are likely to prefer a financial instrument that is simple, convenient and easily intelligible, that does not involve transactions costs and that can be easily and without loss converted into money. Interest-bearing deposits of various maturities do provide such a financial asset. However, to make them attractive to savers, it is essential to devise such deposit schemes as are linked to the basic motives to save. Apart from the link of deposits with saving motives, some deposit schemes should also be linked with certain services desired by savers. Some possible deposit schemes are discussed in my book. 10 Thus the real return on deposits—return inclusive of tangible and intangible benefits other than interest—would be sufficiently attractive to induce savers to prefer this form of financial asset to private lending or other physical assets like gold, real estate, commodity inventories and the like.

(iii) Apart from this, the monetary yield on various types of deposits should be comparable to the yield, exclusive of risk premium, on private lending. 11 The yield on private lending is high but involves a certain degree of risk. If the banks enter the field of lending so far monopolized by private lenders, the interest rate is likely to decline. Taking into account this possible decline in yield on private lending and the risk premium attached to such lending, deposit rates should be so fixed as to be comparable to these adjusted rates on private landing. Interest rates as such may or may not have much impact on total saving, but it certainly has a substantial impact on the pattern of saving. The interest rate structure, then, should be such as to induce savers to keep their saving in the form of bank deposits rather than in the form of private lending, gold, real estate or inventories of commodities. 12

(iv) Compulsory provident fund schemes have proved attractive in several countries like Malaysia and India. Such schemes should be introduced to cover wage and salary earners in as many sectors as possible. Social security deposits have been a preferred asset in both developed and developing countries as we have discussed earlier. Their full potential should be explored.

(v) The other asset which savers seem to prefer is insurance policies. Life insurance facilities should be expanded. For farmers, life insurance may not be as attractive as crop insurance; it may be possible to introduce compulsory crop insurance schemes that are attractive to farmers. For these purposes, bank branches can function as agents of insurance companies so as to minimize administrative expenses. Some bank deposit schemes can be linked with life insurance as well as crop insurance. 13

(vi) To induce a higher rate of over-all saving through saving in the form of specified financial assets, it is possible to exempt such saving for the purpose of income tax by permitting such saving to be deducted from taxable income. 14 In a number of countries, provident fund subscriptions and insurance premiums are deductible for the purpose of income tax; the scope of such deduction can be widened by including all financial saving other than that in the form of currency and gold. 15

These policy measures are likely to modify the pattern of household sector saving in favor of financial assets. The saving-investment process thus can be made more efficient than it is. The allocative efficiency of an integrated capital market would be much greater than that of the isolated markets existing at present. Thus, these measures would not only raise the rate of financial saving, but also improve the productivity of investment.


10. ibid.


Further, it would then be possible to regulate the magnitude and allocation of investment by means of available policy instruments.16

II. ON CENTRAL BANKING

There is a significant difference between the role of a Central Bank in a developed country and that in a developing country; and this difference arises from their different stages of development. The monetary and financial system was already well-developed when the Central Banks were set up in the developed countries. In the theory and practice of central banking, hence, it is the regulatory role of the Central Bank that is emphasized.17

Central banking has to be thought of quite differently in the developing countries where the financial system has yet to evolve to a stage reached in the developed countries. In these countries, the role of the Central Bank cannot be restricted to that of a regulator, for the institutions to be controlled and the credit system to be regulated have still to evolve to necessitate a regulator.18

The role of the Central Bank has to be conceived in the context of evolving a sound financial infrastructure conducive to rapid development. It is the Central Bank that has to take the lead in evolving the credit institutions, instruments and yield-structure that are essential for:

(a) the efficient mobilization of saving, and
(b) the allocation of resources consistent with development objectives.

This developmental function needs to be performed in such a way that the Central Bank is able to maintain close, continuous and active contact with the credit system so essential for the success of its regulatory function. If such contact were maintained, the ability of the Central Bank to regulate credit would be much greater than it is in a developed country.

A. Promotional function

In a large number of developing countries, commercial banks have evolved to finance the credit needs of foreign trade, the industrial activities that are ancillary to such trade and the modern industrial structure. However, the credit needs of agriculture, small business and industry and a large number of traditional enterprises are still met by the non-banking traditional institutions like moneylenders. What is required in this set-up is a wider geographical and functional penetration of the banking system. It is the Central Bank that has to take a lead in this matter.19

Again, it should be the Central Bank’s responsibility to ensure that the evolving banking system is viable, its practices sound and its venturesomeness tempered by wisdom. Regular periodical inspection of banks from this point of view is essential for the sound development of banking. This would inspire confidence in the system. To inspire confidence among savers, some form of deposit insurance would be necessary and to induce the banks to meet the credit needs of agriculture and small enterprises of all types, some credit guarantee organizations need to be developed.

Apart from these devices, it is essential for the Central Bank to do banking business with the banks and the other institutions without inhibitions. Unless the Central Bank becomes not only ‘central’ but also a ‘bank’, its function to supervise and direct the growth of banking would be without adequate sanctions. It should not be merely a lender of last resort; it has to be a lender of early resort and in some cases a lender of primary resort. This need not mean continuous indebtedness; the banks, however, should feel free to approach the Central Bank for help from time to time. Only then would the banks have an incentive to listen to Central Bank advice with respect.20

For meeting the long-term credit needs of various sectors for financing investment projects, it is not essential, in principle, to evolve separate institutions like development finance companies. The banks, as the principal mobilizers of saving, should be able to perform this function at least in the initial stages. With their nation-wide branch network, it is the banks which would have close and intimate contact with agriculture and industry and, at the same time, it is they who would be in a better position to meet the term credit needs of these sectors than would a new institution without a branch network and without the banks’ resources. For the purpose of division of labor and exploiting the advantages of specialization and scale economies, the banks could develop specialized departments or specialized subsidiaries.21

Such an evolution of the banking system has considerable advantages from the point of view of strengthening and fortifying the power of the Central Bank to regulate credit; Central Bank policy instruments to affect the cost as well as availability of credit would be much more effective in influencing not only inventory investment but also fixed investment than in the case where term credit institutions were isolated from the banking system.22

B. Regulatory functions: limitations

A Central Bank’s effectiveness is regulating credit depends upon the geographical and functional scope of the banking system and the extent of the latter’s dependence on the Central Bank for assistance.


19. See Sayers, op. cit., p. 7. Sayers writes: ‘Another service having immense potentialities . . . is the contribution a Central Bank can make to the growth of a sound structure of commercial banks and other financial institutions . . . but the emphasis in early days must be on the development of a banking system to control. This is not only a logical order; it is also the historical order of events in the underdeveloped country I have most studied the England of earlier centuries . . . . It must be not only central but also, and very actively, a bank.’


If the banking system's functions are restricted to meeting the credit needs of only modern industry and trade, a Central Bank's power to regulate credit allocation among the other sectors would be limited, as it has been in many countries. The funds in the so-called unorganized market can be switched from one line to another in search of speculative profits and the Central Bank would not have much control over interest rates or lending patterns. Of course, the over-all supply of funds and over-all money supply would still be within the powers of the Central Bank to regulate, but the lending pattern and the yield pattern in sectors other than those covered by the banking system would be outside the Central Bank's control. The availability of credit outside the system would affect the Central Bank's control over the modern sector also.

In such a situation, a Central Bank faces a dilemma. Too tight control on the banks may mean starving the modern sector of required credit, while lack of such control would mean supplying resources to the unorganized market, over which the Central Bank has no control. This is, doubtless, one of the reasons why credit-creation by the Central Bank turns out to be excessive in some developing countries.

There is another reason for a similar situation to arise, and that is the excessive reliance of government on Central Bank credit. Being short of resources in relation to mounting needs, governments tend to rely on Central Bank credit to an extent that generates excessive increases in money supply, with inflationary consequences.

In a situation like this, the Central Bank's ability to control and regulate credit again becomes limited. Of course, it can tighten credit and make it costly for the modern private sector; but then this tends to affect output in this sector adversely and thus aggravate inflationary pressures.

C. Regulatory function: policy instruments
A Central Bank's ability to regulate credit depends upon:

(a) the extent of reliance of the modern sector on bank credit;
(b) the reliance on trade credit from the modern sector of the sectors linked with the modern sector;
(c) the dependence of the banks on Central Bank assistance; and
(d) the policy instruments available to Central Bank.

In a large number of developing countries, with a rapidly expanding modern sector, the latter does rely on bank credit to a significant extent. Again the modern large enterprises do extend trade credit to sectors linked with them.

The banks' dependence on Central Bank credit depends on alternative sources of funds. If branches of international banks are dominant, their reliance on the Central Bank may be marginal. If the inflow of banking funds is controlled and the modern sector is rapidly expanding, banks may find their own resources inadequate periodically to meet the credit needs of the modern sector. Again, if the Central Bank has powers to vary the net liquidity ratio of banks, it can make the banks marginally dependent on Central Bank credit.

In such a situation, the Central Bank can regulate both the cost and the availability of credit, both to the modern sector and to the sectors linked to it. It can raise the cost of its credit to the banks which, in turn, would raise their rates to their borrowers. The increased cost of borrowing can be made effective by restricting the banks' lending power by raising their net liquidity ratios—that is, the ratio of cash and liquid assets, minus Central Bank borrowing, to total deposits.

A Central Bank can also regulate credit to specific sectors by means of selective credit controls operated in the context of over-all credit control. Since it has sanctions, it can ask the banks to raise margin requirements as well as the cost of advances to specific sectors which require separate regulation for example, where there is speculative stock building of commodities in short supply.

It can, likewise, encourage banks to lend to specific sectors by linking its own credit to banks with the latters' credit to such sectors.

The traditional central banking instruments like open market operations are unlikely to be successful in view of the narrowness of security markets. Bank rate coupled with powers to vary reserve ratios and net liquidity ratios are likely to be much more effective. Depending on the contact of the Central Bank with the banks and the latters' dependence on it, moral suasion can also be quite effective in regulating the over-all volume and structure of credit.

The real limitations on the Central Bank arise as a result of:

(a) the excessive reliance of the government on Central Bank credit; and
(b) the lack of integration of money and capital markets.

The second limitation would be overcome with the geographical and functional extention of the role of the banking system.

D. Structure of interest rates
Central Bank policy with regard to interest rate structure has considerable significance from the points of view of:

(a) inducing savers to invest in bank deposits and other financial assets; and
(b) bringing about a rational allocation of resources.

Savers can be induced to keep their savings in the form of financial assets if the yield on such assets is comparable to that on physical assets like real estate and gold and commodities, after making allowance for risk premia and transaction costs.

In a climate of reasonable price stability and with such comparable yields on financial assets, it is possible

24. See Sayers, op. cit., pp. 19–25. He writes: '... central banks, if they are not narrowly conceived, can be a real help to these countries in making economic activity less irregular—but that their power must remain slight if they have to work in a banking vacuum. The encouragement of the growth of sound commercial banking throughout the economy must always occupy first place on the agenda of a new Central Bank' (p. 24).
to raise the rate of financial saving and thus bring about greater integration of the money and capital markets.

Again, to achieve a rational allocation of resources, interest costs to borrowers should reflect the relative scarcity of capital. The rate of interest on bank credit, as well as the interest costs of other forms of borrowing, should, therefore, be related to the yield on real investment that is consistent with the attainment of growth targets.

It appears that, in most of the developing countries, the lowest rate—that is the rate on one year’s deposits—should not be lower than 6 per cent per year and the annual rate of return on agriculture and industrial projects should not be lower than 15 per cent. The other rates should fall within this range depending on risk premia, transaction costs, marketability and liquidity attached to specific financial instruments. This rate structure should be in real terms. On the assumption of price stability, the rate structure should be as suggested.

E. Basic limitations of monetary policy

Central Banks had effective monetary policies in an environment which now no longer exists—in which governments had, by and large, balanced budgets and exchange rate stability was the primary concern of policy. With other domestic objectives like full employment and development becoming dominant, governments have become aware of the monetary implications of fiscal policy. Monetary policies thus have become secondary to fiscal policies and the latter have proved to lack the flexibility of the former.

On the other hand, with multinational firms and an international banking system, the international monetary system has evolved into a credit system. Now this international credit system is as unstable and fragile as the domestic credit system had earlier become—evolving from a currency system.

For both these reasons, a Central Bank is no longer central; in the domestic sphere, its flexibility is restricted by government fiscal policy and, in the international sphere, by an international credit system. The international system now requires a ‘central’ bank to manage a system that is inherently unstable. But since in the domestic system, governments are not willing to give the power of control to their Central Banks, the question is: how will they entrust the power to regulate the international system to an international central bank?

This is the dilemma at present with regard to the international monetary system.26

F. Central banking in Japan: a model for developing countries

Monetary policy in Japan has been very effective—and much more so than in any other country during the last two decades. Since the financial structure in the developing countries is likely to evolve on the Japanese lines—and conscious attempts to do so may hasten the process—it is worthwhile to know the factors behind the success of Japanese monetary policy.

A significant factor in Japanese success in this field, as well as in others, is the strong tradition of cooperation between business and government. But this success is also due to its financial structure; and it is possible to evolve such a structure in the developing countries.

The rate of household saving in Japan is very high—almost double the rate in the USA, France or Germany. During 1960–9, this saving comprised 19 per cent of disposable income, as against 9.6 per cent in the USA, 10.3 per cent in Germany and 10.0 per cent in France. A much more important factor has been the dominance of financial saving (more than 11 per cent of disposable income) and again the dominance of bank deposits in financial saving (about 80 per cent or more of financial saving being in the form of bank deposits or bank debentures).27

Thus saving of the household sector is mobilized primarily by the banks and it is they who finance investment in the economy. Because of the high rate of investment (about 40 per cent of GNP) and its rapid growth, the business sector is able to finance only 46 per cent of investment by ploughing back profits; of the rest, more than 80 per cent is financed by the banks. Straight issues of stock and foreign borrowing are of marginal significance.

The banks—the big city and long-term investment banks—finance mainly large enterprises and their projects, and the large enterprises finance—via trade credit—the small firms. Thus, the small firms too are indirectly financed by the banks.

Banks have even been willing to provide long-term credit by taking big risks involved in low cash ratios, ‘operations at level of illiquidity that would drive an English or American banker into a state of permanent neurosis’.28 This is made possible by the willingness of the Central Bank to provide credit to banks, which, at the peak of a boom, rises to as high as 10 per cent of the banks’ loans and investments.

Government accounts are generally balanced but tend to show a surplus during boom periods, with expenditure lagging behind revenue. This permits the Central Bank to take effective measures to regulate credit in times of emerging payments problems even before the inflationary pressures become serious.

The policy instrument, largely, is credit rationing. Official interest rates are generally inflexible. The Bank of Japan is able not only to ration its own supply of funds to the banking system, but also by other means to exert a strong influence over the expansion of loans and

26. John Hicks, Critical Essays in Monetary Theory, op. cit. Hicks writes: 'The remedy...would be an International Central Bank, an International Bank which would underpin the credit structure, but in order to underpin it must have some control over it. That was what Keynes, who understood this international aspect very clearly, wanted to get at Bretton Woods, but all he got was a Currency Board (for it is little more than a Currency Board, being so tied up with rules and regulations)—the IMF. That, we are finding—and Mill could have told us, one hundred and twenty years ago, that it is what we should find—is not enough. But how should the powers, which governments have been unwilling to entrust to their own Central Banks (once they have realized what is involved) be entrusted to an International Bank? That is the dilemma, the old dilemma, to which we have now come back, on the international plane' (pp. 172–3).


over the credit rationing carried out by the individual banks. In addition to moral suasion, a number of specific devices are used, such as reserve requirements, import deposit requirements, a complicated discount rate structure (with penalty rates partly dependent on the amount of borrowing of the individual bank) and limits set on the loans and investments of each bank.\textsuperscript{29}

Because of the Japanese economic and financial structure, the monetary restraint measures work very quickly, with a lag of barely a few months. Inventory investment is the first to be affected, along with imports, spreading from large firms to small firms through the effect on trade credit.

Since the results of monetary restraint are attained quickly, there are generally no longer-term dampening effects on fixed investment and growth. Equally, the elimination of the restrictive measures is also effective in stimulating rapid expansion. Thus, the Central Bank is effective both ways—in curbing booms and in effecting a quick revival of business activity. In no other country has monetary policy been effective in both directions.

The Japanese banking structure, be it noted, can be duplicated easily in developing countries, but on one condition: if the governments are prudent and responsible in the management of the banking system.

\textsuperscript{29} Lundberg, op cit., pp. 338–9.
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