THE ROLE OF THE CENTRAL BANK IN A LESS DEVELOPED ECONOMY IN TRANSITION TO SOCIALISM

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INTRODUCTION

This paper will briefly examine two approaches to central banking - the traditional Western type marlet approach and the approach used in Socialist countries. An attempt is made to appraise the relevance of these models in a third World country, such as Guyana, which is in the process of transforming its economy along the Socialist path. In the paper, an examination will be made of Guyana's recent attempts to develop financial and foreign exchange policies more suited in its own circumstances.

Circumstances which identify it with innumerable other 3rd World countries in that, among the basic factors which characterise underdevelopment, there continues to be little diversification of the productive sectors of the economy. Growth and employment are therefore dependent on the performance ofaa few major primary producing export industries. This dependency on foreign trade is reinforced by the heavy reliance on imports both for consumption and for inputs to production. Further, the public sector is playing an increasingly greater role in the general level of econom ic activity. Not only has there been an increase in public sector enterprises primarily through nationalisation but also the Central Government has increasingly adopted a more direct role in implementing some of the measures which it feels are a necessary prerequisite for a country pursuing a socialist line.

In the result there is a greater demand for the use of resources by the public sector. The Central Bank of Guyana has therefore had to function within the constraints of not only open but a predominantly public sector economy. It has therefore found that it has had to move away from the traditional functions of a Central Bank and become involved in planning and monitoring the performance of the public sector = both Central Government and public sector enterprises - in order to identify the sources of available financing (surpluses) and the use of and need for both the domestic banking system and external finance.

Section I will deal with the traditional approach to Central Banking and its limitations in a less developed economy. Section II will examine Guyana's Central Banking experience. Section III will review socialist banking practice. The paper is concluded in Section IV with an analysis and an attempted prescription for Central Banking policies in Guyana.

SECTION I

THE TRADITIONAL MODEL OF CENTRAL BANKING AND ITS LIMITATIONS IN A LESS DEVELOPED ECONOMY

A major onjective of Central Banks in a traditional framework has been to direct the financial policies of the economies in which they function in keeping with national goals. National Governments expect Central Banks to promote a climate conducive to price stability, growth and full employment. However, the way the Central Banks achieve these objectives and wider goals which they seek to achieve differ in the various types of economic systems.

In most traditional Western models, the Central Bank sits at the pinnacle of the financial system to regulate the activities in the financial market. It is expected to maintain a sound banking and credit system and to provide an environment which fosters confidence and trust in the financial sphere. The underlying assumption of this model is that there exists within the economy, a large and viable private sector whose expenditure decisions play a major role in determining the aggregate level of economic activity. These decisions are based on the general economic climate which exists within the economy. Thus while there is no general agreement about the transmittal mechanism of monetary policy,[1)] it is generally accepted that money plays an important role in the real sector. The role of the Central Bank is therefore seen as a regulatory one. The bank through its role as a bankers' bank is therefore responsible for controlling and adjusting the credit needs of the economy and through its rôle as issuer of currency and the government's bank it is expected to regulate the monetary base of the system. It is expected to pursue foreign exchange policies which are consistent with this goal of promoting a stable economic environment. These functions remain basically the same in a less developed economy but the traditional instruments of monetary policy and control tend to be inappropriate in these economies.

The financial sector in a typical less developed economy tends to be characterised by an absence of developed money and capital markets. Traditional instruments of monetary policy such as Bank Rate and open market operations which operate through these markets are therefore of limited effectiveness. In some countries the monetary authorities have tried to control the commercial banks' lending by varying liquid assets and reserve requirement ratios. The success of these policies are based on the assumption that there is a stable relationship between the commercial banks' holding of cash and liquid assets and their willingness to expand credit. In many countries it became evident that no such stable relationship existed and therefore marginal variations in the ratios had no direct control effect. Many Central banks have had to rely on more direct methods such as moral suasion and credit directives.

1) The question of whether "money matters" is one which is still unresolved. The debate centres on the question as to whether money supply is exogenously determined or whether money supply adjusts to the needs of the economy. On the demand side, opinions differ as to whether demand function is stable and therefore whether monetary policies can affect aggregate spending in a predictable manner.

In the light of the prevailing structural limitation in the less developed countries, central banks need to play a more active role in the economy. These banks should conceive of their role as assisting in the transformation of the economies from a state of dependency to one of self-sustained growth in which the needs of the people for a decent standard of living is achieved. The provision of a stable monetary and financial climate is an important but not sufficient condition for growth and development. Economic development depends not only on the aggregate volume of investment but on its nature and location. In view of this, Central Banks should be concerned not only with the regulation of the flow of finance but actually assist in the mobilisation of domestic savings and in the channelling of these funds into productive areas. However, an important constraint on investment may be the availability of foreign exchange. The Central Bank in an under-developed country therefore needs to focus attention on pursuing foriegn exchange and reserve management policies consistent with developmental objectives.

SECTION II

GUYANA'S EXPERIENCE IN CENTRAL BANKING

Guyana has had about twelve years of Central Banking experience. During the first few years of its operations its policies were of a relatively passsive and accommodatory nature. No positive effort was made to mobilise savings nor to influence the level and direction of investment in the economy. The guidelines given to commercial banks were extremely broad. Foreign exchange policies were also of a relatively passive nature. Balance of payments deficits were accommodated by a reduction of the level of external reserves and by recourse to borrowing from overseas. Changes in the exchange rates occured as a result of changes in the value of the intervention currency and the foreign exchange controls were applied mainly to regulate the flow of capital funds. But, in the final analysis, the Central Bank exercised little control of the overall flow of foreign funds.

However, by 1974 the need for a more positive policy became evident. In that year an attempt was made to control the level of credit to certain sectors of the economy. The commercial banks were instructed not to provide loans and advances to the local branches of the foreign based firms since these branches were expected to obtain working capital from their head offices. There were two aspects to this policy. Firstly, additional domestic resources became available for use by the domestic sector. Secondly, the inflows helped, at least temporarily to improve the international reserves position which was low at times because of low export earnings and substantial increases in the payments for fuel. Towards the latter half of 1974, there was some recovery in the level of economic activity. Export earnings were boosted by unsustainably high sugar prices and foreign exchange reserves were rising. This continued into 1975 but unfortunately not into 1976.

By the beginning of 1977, the Central Bank found itself faced with the problem of managing a financial system in which there were critically low levels of foreign reserves. The inflow of external earnings as well as the stock position of foreign assets were too low to sustain the existing levels of current and capital expenditure. An ex-post review of monetary policy indicated that attempts to limit the growth in aggregate demand vis credit restraint had not been successful, amd as overseas borrowing was not forthcoming in the magnitude required, the Bank realised that something had to be done to ease the crisis in the external sector.

Perhaps many Central Banks would have attempted to solve the problem in the external sector by adjusting the exchange rate i.e. by devaluation, or by monetary and credit controls. In Guyana it was felt that a change in the exchange rate could not solve the immediate problems since the adjustment process was a lengthy one and its overall effects were unpredictable. Given the crucial nature of the problem at the time it was decided that a more direct method should be adopted to bring about some reduction in the gap between foreign receipts and payments. Consequently, a number of measures were introduced - measures which certainly deviated from the traditional laissez - faire approach.

Firstly, the Bank attempted to centralise all export receipts within the Central bank. By so doing it limited the extent to which commercial banks could offset import payments with export receipts. Secondly, a foreign exchange budget was introduced which planned the receipts and payments flows of the system. The aim of budgeting in this crisis situation was to close the foreign exchange gap by placing direct controls on the level of outflows while at the same time, to allocate scarce foreign resources in some order of priority.

On the basis of planned inflows foreign exchange quotas were allocated to firms and these quotas were directly linked with import licensing system being run by the Ministry of Trade. In this system no importer was granted a license to import without an indication from the Central Bank that the foreign exchange required would be available for payment provided that the imports did not exceed quota allocations. Thus, the Central Bank assumed the additional function of approving licences for imports.[2)]

On a more routine and daily basis the Bank instituted a system by which permission was granted on a weekly basis to settle bills. These payments were directly linked to the availability of inflows of foreign exchange since reserves were already too low.

It is perhaps not untimely to pause and assess the effectiveness of the foreign exchange budget in terms of its proclaimed objectives and what if any, have been the side effects on the rest of the economy.

2) For a more detailed discussion on the "Foreign Exchange" Budget see paper "Foreign Exchange Budgets: Theory and Practice presented at the 9th Monetary Studies Programme by Central Bank of Guyana.

By the end of 1977, the budget had achieved its target in the area of the reduction in the flows of foreign payments. However, since the budget policies took some time to become effective, only a modest improvement in the balance of payments was realised. As a consequence there was a substantial build-up of arrears payments. This resulted in an increased growth in the level of deposits of the banking system and a substantial increase in the level of liquidity in the system. Thus it was not surprising that inflationary pressures built up.

One is tempted to condemn foreign exchange budgeting as a destablising tool if one attempts to judge it during a foreign exchange crisis. However, the shortages and rationing which have obtained in our system have been a result of the critically low level of foreign resources rather than from the budget per se. In fact budgeting can be beneficial when implemented in non-crisis situations. In these circumstances a more comprehensive approach to the budgeting could be taken - thereby ensuring that the foreign exchange budget links smoothly with the exercise of national planning in the domestic sectors. In Guyana, if the discipline learnt in the period of managing a system with inadequate reserves is carried over/into management when the situation improves then we would have benefitted from the exercise. If the budgetting exercise is to assist in the development of our economy then we must realise that national plans cannot divorce themselves from the issue of reserve adequacy and reserve management.

In the domestic sector, the Central Bank has attempted to control the volume and direction of the commercial banks' activities by way of directives and by moral suasion rather than by the traditional market mechanism. Clive Thomas' study of Central Banking in the Caribbean during the 1960-69 period pointed the weakness of market type techniquies in trying to control commercial banks in the Caribbean.[3/] These limitations are still evident today. Thomas pointed out that apart from the narrowness of the market, commercial banks seemed to have no fixed relationship between their liquid assets and deposits

3. 'Structure, Performance and Prospects of Central Banking in the

nor between their cash balances and their willingness to lend. Thus any attempt to vary liquid assets ratios or minimum reserve requirements could have unpredictable results. The foreign ownership of these banks also meant that they had almost direct recourse to their head offices and were therefore less dependent on the Central Bank for short term credit. This situation remains basically the same today despite the fact that about a quarter of the financial assets of the system is owned by the indigenous commercial bank - G.N.C.B.

The Central Bank has therefore tried to exercise control over the commercial banks via annual credit directives. These directives set guidelines for the targeted expansion of credit and the areas into which this credit should flow. However, there are some limitations in the use of credite guidelines as a positive tool to stimulate the flow of finance to certain productive sectors, since the banks to some extent still use their own credit-worthiness criteria to allocate credit.

In Guyana, recent guidelines have put more emphasis on credit to the public and productive sectors and away from non-productive sectors such as distribution to more productive areas. Loans to the public sector other than Central Government have risen by 36% and 50% in 1976 and 1977 respectively, while loans to the private sector increased marginally in 1976 and was actually reduced by about 6% in 1977.

The process of internalisation of the ownership of productive enterprises has led to a greater demand for financial resources from the domestic banking system. Since 1974, the branches of the multinational firms operating in the economy were forced to reduce their indebtedness to the domestic banking system. Thus working capital was obtained from their Head Offices. In addition, the inflow of depreciation funds had released additional resources for use in the domestic system. However, with nationalisation of the Booker's enterprises, the domestic banking system had to provide funds to meet the industries seasonal requirements.

Faced with the need to control the level of aggregate domestic expenditure during 1977 and 1978, the central bank realised that there was need for a greater supervision over the distribution and utilisation of credit. With loans to the public sector entities increasing at a rapid rate it was decided that a closer scrutiny into the financial operations of these enterprises was needed. In the past, the bank collected data on the enterprises' cash flows and financial operations but these were used mainly for informational purposes. However, during the last year, it was decided that a more active use had to be made of these statistics.

In this respect, the Central Bank has deviated from the traditional approach and have moved nearer to adopting some of the supervisory functions, evident in the Socialist system where finance acts as a controlling mechanism.

In Guyana, monitoring of the cash flows and financial operations of the public corporations has had several advantages. Firstly, the cash flows and financial operation statements provides an early indication that the enterprises may need to borrow funds from the banking system or may have increased liquidity for investment in treasury bills or deposits. Secondly, the financial statements give an indication of current performances and their deviation from targeted levels thus signalling the need for the revision of other plans and projections. Thirdly, they provide a basis for the Central Bank and the government/diagnose the need for greater financial and management discipline. Fourthly, since the major export industries fall within the public sector the data from their financial statements provide a relatively reliable basis for revising projections of the flows of foreign receipts and payments.

This monitoring has assumed an even greater importance within the last two months. The Governor of the Central Bank has become a member of a monitoring committee comprising the major public sector planning and controlling agencies - the Central Government, Guystac and the State Planning Secretariat.

The Committee has been granted powers to monitor the performance of enterprises and to ensure that there is accountability in the enterprises and improved financial and management discipline.

In the area of central government financing, the Central Bank tends to play an accommodatory role. In a less developed economy, the traditional distinction between monetary and fiscal policy tends to become blurred. For fiscal policy to be independent of monetary policy, the government should be able to accumulate deficits or surpluses with the non-bank sector. In a country such as Guyana, where non-bank financial institutions are relatively few and the population tends to invest in real rather than financial assets, fiscal surpluses or deficits tend to find their way directly into the accounts of the banking system and are almost immediately released into money supply. The new purchasing power which is created then have effects on prices, wages and employment and if not carefully planned could have destabilising effects on the economy. Apart from advising the Government about the implications of its financial policies the Central Bank has little effective power to check the expansionary nature of the Government deficit budgets. The stringent conditions of the loan from the International Monetary Fund with its emphasis on monetary/financial disciplines have made it even more necessary for the Central Bank to monitor the total system, thus providing an early warning signal for remedial action.

SECTION III

SOCIALIST BANKING

In Socialist countries control by the banking system is relatively direct and complete. This stems from the social ownership of resources and the functioning of the Economic Plan. The banking system, in contrast with those in the capitalist countries is more centralised and relatively simple. In almost all these countries the commercial banks have been socialised and a State Bank introduced. This socialisation of the banks has justified not only a ideological grounds but also on the ground that the commercial banks could interfere with the centrally planned allocation of resources if they are allowed to freely create credit. The State Bank combines the functions of commercial and central banking and is responsible not only for the issue of currency but also is the exclusive supplier of short-term credit to enterprises. In the earlier years long-term funds which were in the form of non-repayable budget allocations, were channelled through the "Investment Bank". But with the move towards decentralisation, many countries introduced liberal reforms giving the State Bank a more active role in the granting of long-term loans and the supervisor of Plan implementation. The State Bank therefore enjoys much power and influence since it represents virtually the only source of credit in the economy.

Money tends to play a relatively passive role in these economies. The Socialist argue that under Capitalism money has become a social evil. It has been pursued as an end in itself and this persuit of personal wealth has led to exploitation of man by man, to social stratification and to class alienation. In keeping with this ideological orientation money is regulated to a sobordinate position. In sharp contrast to the Western market economies the ownership of money does not entitle the individual to ownership or control of resources. Its purchasing power in this contex is narrowly limited as the important decisions about production, distribution and investment are all Plan determined.

It is argued that in a centrally planned economy all factors of production and finished goods could be allocated in physical quantities. In which case, the market mechanism and the use of money as a medium of exchange would become redundant. However, given the complexity of national economies, complete reliance on physical planning has not been practicable. The alternative method of approach has been for the central authorities to determine and control prices so as to achieve targeted allocations. In this case some amount of monetary flows has been required. The monetary counterparts of real flows are shaped on a planned basis in order to facilitate the real flows and to generally promote equilibrium. These monetary flows have been directed through financial plans.

One of the primary objectives of financial planning is to prevent excess liquidity of consumers from coming into existence and in general to avoid inflation. In order to combat these inflationary pressures and to create conditions favourable to the maintenance of price stability, centrally planned economies rely on fiscal, price, wage, foreign trade and monetary and credit measures.

Financial planning is formulated on three to four levels. At first level, the Ministry of Finance in consultation with the State Planning Commissions and other ministries, is responsible for the overall co-ordination of the financial plan. Secondly, enterprises plan their financial operations. Thirdly, the State Bank plans for cash and credit flows. These cash and credit plans are separated to reflect the division of monetary circulation into two streams which roughly correspond to the household and the production sectors. In general state enterprises could make transfers between themselves only in the form of bank account transfers in which case little cash is used. However, when payments are made to individuals or the private sector cash is withdrawn from the bank. Similarly all deposits received by enterprises are immediately banked. Thus cash only circulates within the private sector and between the private sector and the State sector.

With the exception of Yugoslavia, financial control is the responsibility of the State Bank which not only controls distribution of credit but also participates in management control of enterprises. Since enterprises must maintain their accounts with the State Bank one means of moentary control operates through the financial administration and economic discipline of socialised entities. All payments flow through the State Bank thereby placing it in a unique position to follow the performance of enterprises with regard to plan fulfillment. The State Bank therefore ensures that enterprises observe the mandatory plan indicators with regard to output, costs and investment and that all financial obligations are promptly met. Controls are also exercised through the wage fund. This supervisory role is an important one in the command type system especially in the ensurance of Plan conformity.

Panalties which could be imposed on enterprises for non-complicity with the Plan include the with-holding of material incentives or wage payments, the suspension of credits and the imposition of penalty interest rates. Thus, monetary policy as understood in the capitalist system is of limited scope in socialist countries.

In the external sector, all trading is state controlled and all the holdings of foreign exchange are monopolised by the State. Foreign exchange management is an integral part of a Socialist planned economy. For example in Hungary the basic principles for foreign exchange management were embodied in its Foreign Exchange Code. These were -

(a) Central handling by the National Bank of Hungary of the countries precious metals and foreign exchange stocks.

(b) A compulsory delivery of all foreign exchange to the National Bank of Hungary and a proper utilisation of foreign exchange received for import purposes.

(c) Regulation of foreign exchange aspects of export and import transactions particularly in the formulation of guidelines for export and import credits. Ensuring uniformity of conduct in foreign markets in raising any kind of credit.

(d) Central quotation of all foreign exchange rates.

There is some flexibility in the application of these rules depending on the economic situation of the country.

SECTION IV

CONCLUSION

In the formulation and implementation of monetary policies that serve the national objectives, socialist and capitalist economies differ reflecting their fundamental differences in capital ownership, economic organisation and political and social philosophy. As an economy moves towards the Socialist form of organisation the public sector plays an even greater role in the determination of economic activity, the indicative planning which characterises the Western or Capitalist form of economic organisation tends to be replaced by more comprehensive centralised planning. The market tends to be given a subordinate role in the distribution and allocation of resources while the plan becomes the major determinant of these factors. The role of the central bank in an under-developed socialist economy is therefore even more complex than in the traditional system. With the elements of both systems in their midst, the central bank needs to play a very active role and may need to radically transform its traditional methods of monetary policy to one more suited to the changing circumstance.

Having examined the two approaches to Central banking and Guyana's experience it is evident that in moving away from what can be termed the traditional functions of a Central Bank Guyana has in fact came closer to the socialist view of the role of a Central Bank. In Guyana concern about ownership and control of resources has considerably narrowed the base and sources of finance. It is absolutely necessary therefore that the country identifies controls and effectively utilises all available financial resources. It would seem that the Central Bank is in the best position to perform this function. The socialist conception of an economy where a centralised financial institution is one of the integrating forces in the economy provides some useful insights for planning.

The Bank of Guyana in both its domestic and external operations has really only recently started on the path of strict monitoring and control. It therefore expects that it will need to draw upon the experience of other countries in a similar position. It will need to adjust and modify and evolve a system which is relevant to Guyana's needs.

The Central Bank is currently more actively involved in the planning and monitoring of public sector and foreign exchange flows. However, problems do arise in the area of financing, planning and discipline. A basic problem of planning in general is that deficiencies arise from incomplete and biased information. Moreover, errors of judgement on the part of planners are unavoidable and changes in conditions between the preparation of plans and their implementation do occur. These problems are greater in countries where planning is less comprehensive and sophisticated and could well be a major problem in Guyana's situation. In fact, it is the countries which need to plan most which are least able to do so. In economies where the planning is very centralised and rigid these errors in planning could have serious effects on the efficiency of allocation of scarce resources. This problem could be partly eliminated by the introduction of some degree of flexibility in the system so that the agencies which execute the Plan have within a given range of constraints the ability to adjust to changing circumstances.

Effective monitoring of the performances of enterprises becomes even more important when it is realised that in socialist countries, state enterprises that become insolvent or bankrupt, are unlikely to be closed down. Almost automatic recourse to credit could lead to inefficiency and encourage a wasteful use of resources. The Central Bank should by active monetaring of the cash flows and financial operation of enterprises, be in a better position to determine whether or not the enterprises are making the most effective use of their own and/or borrowed funds. A lack of financial analysis within the Bank does limit the degree of success of such a policy.

Another lesson which could be learnt from the Socialist banking experiences, is that it is possible to mobilise and allocate financial resources to push development without additional systems such as elaborate money and capital markets. Indeed, with the need to efficiently utilise scarce capital, the establishment of elaborate structures could actually lead to a wastage of this resource. In early years of socialist development the banking system had to provide for centrally directed economies undergoing socialisation and industrialisation with meagre resources and persistent shortages. The structure and functions of the financial systems were therefore adopted to meet this need but this could only have been achieved because of the restructuring of the productive sectors.

In Guyana, the whole question of nationalisation of the financial system would need to he examined. While the nationalisation of the commercial banks may be justified on ideological grounds, there is need to consider the economic realities of the situation. In the older socialist countries, there has tended to be a softening in attitudes towards Western banks. Some foreign banks have been allowed to re-establish branches. The activities of these banks have been limited primarily to providing banking and commercial advice, handling payments arising out of trade, industrial co-operation, travel and credit agreements.

The question in the less developed countries is to determine how best the services of these banks can be utilised without allowing them to control and direct the limited financial resources. One way this could possibly be done is by removing totally the credit allocational role from the banks and placing this function in an expanded State Bank (possibly an extention of the present Central Bank and the indigenous commercial bank). Alternatively this can be achieved by the establishment of a consortium of banks with the Central Bank being the lead bank determining the criteria for their functioning.

Clive Thomas in his book "The Structure, Performance and Prospects of Central Banks in the Caribbean" noted that traditional models were irrelevant to the Guyana situation. His conclusions that the Central Bank should co-operate with other branches of public policy and be actively involved in the planning process becomes even more relevant today as Guyana's public sector has expanded and the economy is in the process of being reconstructed. His suggestions for a more co-ordinated and integrated monetary structure and for the nationalisation of commercial banks takes root from the mono-bank State Bank system and should be seriously examined within the context of Guyana. The need for better diagnostic capacities and improvement in the use and collection of statistical information within the Central Bank is even more crucial as the Central Bank performs a more active part within the planning process.

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