

Developmental central banking: winning the future by updating a page from the past

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The ongoing Great Financial Crisis that began in 2007–2008 has dramatically called into question the previously dominant neoliberal approach to macroeconomic and financial policy. Unfortunately, these lessons are being learned in a highly uneven manner – and in some important circles, not at all. In light of this struggle to adopt developmentally friendly financial structures, it is critical that the history and practices of these policies, as well as their costs and benefits, be well understood. There is much rich history of developmental finance and central banking to draw from and many lessons to be found there. In this paper, we survey some of this history, focusing on the late twentieth century, including a discussion of policies undertaken following the Great Financial Crisis. The major lesson we draw is that developmental roles of central banks and related financial institutions have been the dominant approach in many periods since the mid twentieth century at least, and that the neoliberal approach to these policies is much more the exception than the rule. The way forward out of this crisis is to recognize the current policies for what they are – experiments in more developmental policy – and to build on them for the longer run, rather than see them as exceptional aberrations that should be abandoned at the first opportunity.

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1 INTRODUCTION

The ongoing Great Financial Crisis that began in 2007–2008 has dramatically called into question the previously dominant neo-liberal approach to macroeconomic and financial policy. Unfortunately, these lessons are being learned in a highly uneven manner – and in some important circles, not at all. Whereas, at the start of the crisis, both national governments and international institutions such as the IMF adopted expansionary fiscal policies and overthrew long-standing opposition to taboo policies such as capital controls, 5 years on, many of these institutions have returned to their almost instinctive affinity for austerity and aversion to appropriate financial regulation (see, for example, Cynamon et al. 2013; Gallagher and Ocampo 2013; Gabel 2013; Palley 2013).

Still, some of the lessons learned from the need for alternatives to orthodoxy in macroeconomic and financial policy have stuck. When one surveys the landscape in the aftermath of the crisis, one is struck by the large amount of experimentation that is taking place with respect to monetary and financial policy. As with Shakespeare's Malvolio, much of this new policy has been 'thrust' upon the central banks as they attempt to cope with the enormous challenges they confront in defending their

economies from the onset and aftermath of the economic tsunami barreling down upon them, but experiment they have nonetheless. Of course, many of these central banks had hoped that the economic crisis would resolve quickly, and that they could simply return to their previous neo-liberal ‘inflation targeting’ frameworks which focused on achieving low inflation rates to the exclusion of employment, economic growth, or financial stability. But the reality of the economic meltdown would simply not cooperate. Instead, many of these central banks have had to implement more and more unorthodox policies.

Early on after the crisis, even prominent economists from the International Monetary Fund (IMF) and the Bank for International Settlements (BIS) were calling into question the dominant neoliberal approach to central banking, and in particular Inflation Targeting (IT). Olivier Blanchard, chief economist of the IMF, made a presentation at the ‘IMF Macro Conference’ in 2011: ‘Before the crisis, mainstream economists and policy-makers had converged on a beautiful construction for monetary policy. To caricature just a bit: we had convinced ourselves that there was one target, inflation. There was one instrument, the policy rate. And that was basically enough to get things done. If there is one lesson to be drawn from this crisis, it is that this construction wasn’t right, that beauty is not synonymous with truth. The fact is that there are many targets and there are many instruments. How you map the instruments onto the targets and how you use these instruments best is a very complicated problem. This is the problem we have to solve’ (Blanchard 2011, p. 1).

Despite the calls for a significant rethink in Central Bank Policy, and the fact that the practice of central banking, at least by the major central banks in the rich countries (in the US, Japan, UK and Europe), has been radically transformed by necessity, the *idea* of the ‘best practice of central banking’ has not seemingly changed much, if at all. The measures that have been taken since the crisis and the calls for a central banking ‘re-think’ have been seen by the dominant players in academia and the policy world primarily as a temporary, emergency deviation from standard practice, to be resurrected at the first available opportunity.

In the developing world, at the same time, some central banks (for example, the Central Bank of Brazil) that had already been pursuing more heterodox – even developmental – approaches to monetary and financial policy, found that not only did they face new challenges from the crisis, but that there was more policy space available (at least temporarily) to pursue non-neoliberal approaches. And other central banks in developing countries, notably Banco Central De La Republica Argentina, have taken the opportunity to try to expand the developmental roles of the central bank. And when the IMF attempted to reverse course and limit the new policy space that had been opened up, key developing countries fought back to preserve their new-found space for a variety of tools of developmental finance and central banking. This has been especially true in the area of capital controls (or capital management techniques).

Ilene Grabel calls this economic and political dance, specifically at the IMF, ‘productive incoherence’ (Grabel 2013, p. 563): the recognition by the powers that be that the crisis requires changes in policies and institutions, but the strong resistance to making the fundamental changes really required to adequately restructure policy and the economy.

This dynamic has certain parallels with the fights over central bank and macroeconomic policies in the 1920s and 1930s following the instability after World War I and the response to the Great Depression of the 1930s. Financial orthodoxy in Europe and elsewhere pushed to restore the Gold Standard at prewar rates, while Keynes and others

warned of the grave consequences and the need for an alternative macroeconomic apparatus that would provide more government guidance and coordination of investment and where central banks would focus more on facilitating aggregate demand and employment, behind a wall of capital controls, rather than protecting a country's gold stock and price level. This was a vision of macroeconomic policy and the institutions that carried it out – central banks and fiscal authorities – playing a much stronger developmental role, as against the *laissez-faire* vision of dominant financial economic elites. (See Pérez Caldentey and Vernengo 2013; Kindleberger 1986).

It took the calamities of World War II to implement this more developmental vision as we discuss in more detail below, but the roots of this vision were contained in theoretical and polemical discussions and experimentation in many countries in the 1920s and 1930s. The developmentalist vision of central banking became the norm, both in the developed and the developing world, and there were numerous notable successes, including remarkably successful newly industrializing countries such as South Korea, Taiwan, Brazil, India, and China.

By the 1980s, however, the tide had turned again. Despite these successes, the rise of neoliberalism and the Washington Consensus in development policy embodied by much of IMF and World Bank policy, the turn against developmental central banking and in favor of 'inflation targeting' and 'inflation targeting lite' became dominant (Epstein and Yeldan 2009).

As this 'dialectical history' following major crises shows, when economic reality rears its ugly head, developmental finance of various types becomes a compelling set of tools to confront these difficult macroeconomic challenges. But the political forces behind neoliberalism stand waiting in the wings to snatch away those tools as soon as possible and reinstate the strictures of neoliberal policy as quickly as they safely can, and sometimes even before.

In light of this struggle to adopt developmentally friendly financial structures, it is critical that the history and practices of these policies, as well as their costs and benefits, be well understood. There is much rich history of developmental finance and central banking to draw from and many lessons to be found there. In this paper, we survey some of this history, focusing on the late twentieth century, including a discussion of policies undertaken following the Great Financial Crisis. The major lesson we draw is that developmental roles of central banks and related financial institutions have been the dominant approach in many periods since the mid twentieth century at least, and that the neoliberal approach to these policies is much more the exception than the rule. The way forward out of this crisis is to recognize the current policies for what they are – experiments in more developmental policy – and to build on them for the longer run, rather than see them as exceptional aberrations that should be abandoned at the first opportunity.

The rest of this paper is organized as follows: Section 2 introduces the concepts of developmental central banking, contrasting it with neoliberal thinking on the appropriate structure of central bank policy. Section 3 gives a brief survey of the use of developmental central banking by central banks in 'developing' countries with a very brief reference to 'developed' economies' experiences. Section 4 gives two case studies in recent developmental central banking: the Central Bank of Argentina and the Bank of Bangladesh, two banks that have recently explicitly adopted developmental roles. Section 5 draws some lessons from the case studies in Section 4. Section 6 introduces some additional important considerations: the important role of capital management techniques to create policy space, as well as discussing some other possible targets of developmental central bank policy. The final section summarizes and concludes.

2 CENTRAL BANKS AS AGENTS OF ECONOMIC DEVELOPMENT¹

Prior to the Great Financial Crisis of 2007–2008, the neoliberal approach to central banking had become the dominant approach to central bank policy in much of the world. The major tenets of this approach include the following recipe: (1) central bank independence; (2) a focus on inflation fighting (including adopting formal ‘inflation targeting’) to the virtual exclusion of all other goals; and (3) the use of indirect methods of monetary policy, such as short-term interest rates as the exclusive tool of monetary policy, as opposed to more direct tools such as credit allocation techniques (Bernanke et. al. 1999). It is not an exaggeration to argue that this neoliberal approach to central banking was a major contributor to the outbreak of the crisis. By rationalizing financial liberalization, turning a blind eye to asset bubbles (such as the real estate bubbles that precipitated the crisis) while rejecting the central banking tools such as credit controls that could have limited them, and by contributing to an environment where broad-based investment and employment generation in the real sector were not a priority, the neoliberal approach to central banking was a critical part of the entire neoliberal ideological and macroeconomic apparatus that set the stage for the greatest economic crisis in more than 75 years.

More specifically, the principles of neoliberal central banking have the following far-reaching implications. Central bank independence implies, first and foremost, that the central bank should not be subject to pressure from the government to finance government activities (deficits). The focus on goods inflation means that the central bank should not be concerned with other goals such as promoting full employment, supporting industrial policy or allocating credit to sectors of special social need, such as housing or limiting asset bubbles. Neither should the central bank attempt to manage exchange rates through monetary policy, and certainly not through using controls on capital flows. The pursuit of indirect tools of monetary policy means that the central bank should not use credit allocation techniques such as subsidized interest rates, credit ceilings, and capital controls to affect either the quantity or the allocation of credit. This approach was claimed by its advocates in the IMF and elsewhere to stabilize the economy, and provide a framework for robust and sustainable economic growth, and moreover, to be the ‘best practice’ and even ‘optimal approach’ to central bank policy.

But rather than being a historically dominant and optimal approach to central bank policy, this recipe – no support for government expenditure, reluctance to manage exchange rates, opposition to the use of capital controls, and a refusal to engage in credit allocation policies to support economic sectors – is in fact a highly idiosyncratic one. As a package, it is dramatically different from the historically dominant theory and practice of central banking, not only in the developing world, but, notably, in the now developed countries themselves. Throughout the early and recent history of central banking in the US, UK, Europe, and elsewhere, financing governments, managing exchange rates, and supporting economic sectors by using ‘direct methods’ of intervention have been among the most important tasks of central banking and, indeed, in many cases, were among the reasons for central banks’ existence. The neoliberal policy package that dominated on the eve of the Global Crisis, then, is drastically out of step with the history and dominant practice of central banking throughout most of its history (Epstein 2007a).

1. This section draws liberally on some of my earlier work, including Epstein (2007a; 2007b; 2008).

3 CENTRAL BANKS AS AGENTS OF DEVELOPMENT: DEVELOPING COUNTRIES

The Great Depression and World War II were major watersheds in the historical evolution of central banking. This included the developing as well as in the developed world. In developing countries, central banks were emphatically *agents of economic development* and to a greater extent than witnessed in the developed countries during the same period.

As described by renowned monetary historian of the New York Federal Reserve, Arthur I. Bloomfield, in 1957:

During the past decade there has been a marked proliferation and development of central banking facilities in the underdeveloped countries of the world, along with an increasing resort to the use of monetary policy as an instrument of economic control. Since 1945, central banks have been newly established and pre-existing ones thoroughly reorganized, in no less than some twenty-five underdeveloped countries. In other cases the powers of pre-existing central banks have been broadened, in large part the recent growth of central banking in the economically backward areas has also reflected a desire on the part of the governments concerned to be able to pursue a monetary policy designed to promote more rapid economic development and to mitigate undue swings in national money incomes. (Bloomfield 1957, p. 190)

Bloomfield goes on to describe the functions, powers, and goals of these central banks:

Many of the central banks ... are characterized by unusually wide and flexible powers. A large number of instruments of general and selective credit control, some of a novel character, are provided for. Powers are given to the central bank to engage in a wide range of credit operations with commercial banks and in some cases with other financial institutions ... These and other powers were specifically provided in the hope of enabling the central banks ... to pursue a more *purposive* and effective monetary policy than had been possible for most ... that had been set up ... during the twenties and thirties ... [that] for the most part [had] been equipped with exceeding orthodox statutes and limited powers which permitted little scope for a monetary policy *designed to promote economic development and internal stability* ... (Ibid., p. 191, emphases added)

Of course, the Federal Reserve continued to be concerned about the importance of stabilization, controlling excessive credit creation and maintaining moderate inflation.

But [the central bank's] efforts need not, and in fact should not, stop here. The majority of central banks in underdeveloped countries have in actual practice adopted a variety of measures designed more effectively to promote the over-all development of their economies. Some of these measures are admittedly outside the traditional scope of central banking, but central banking in these countries should not necessarily be evaluated in terms of the standards and criteria applied in the more developed ones ... the central bank can seek to influence the flow of bank credit and indeed of savings in directions more in keeping with development ends. (Ibid., p. 197)

Bloomfield describes tools of credit manipulation that, as we will see, were also used by developed countries' central banks following World War II, and that have now been revived by some central banks in the aftermath of the Great Financial Crisis: '... selective credit controls applied to the banking system, through help in establishing and supporting special credit institutions catering to specialized credit needs, and through influence over the lending policies of such institutions, [the central bank]

can help to some degree to re-channel real resources in desired directions, both between the public and private sector and within the private sector itself" (ibid., p. 198).²

In a later article, Federal Reserve Governor Andrew Brimmer and his associates describe a variety of techniques that central banks pursued in the 1960s. These included: providing capital to development institutions, such as industrial and agricultural development banks; extending credit to development banks and purchasing their securities; buying a small part of the equity of development banks; establishing a 'securities regulation fund' to create a market for the securities of various development finance institutions, by using the profits from the ordinary operations of the central bank (Brimmer 1971, p. 785); using differential discount rates to allocate credit to capital development projects;³ the establishment of portfolio ceilings on activities having a low priority; various types of reserve requirements, including differential reserve requirements to influence the allocation of credit;⁴ using import deposit requirements, (primarily intended to deal with balance of payments difficulties) to also influence the allocation of bank credit⁵ (ibid.).

Brimmer on the whole is somewhat negative about the effectiveness of many of these techniques, with the evidence from Brimmer's study providing mixed results about the effectiveness of these policies. The possible trade-off between the developmental central bank and the maintenance of financial and macroeconomic stability is also a continuing concern of Brimmer's.

Other research paints a much more positive view of the impact of these and related policy approaches on development in the 1950s, 1960s, and 1970s. Among the most significant is the evidence from Alice Amsden's seminal book *The Rise of 'the Rest'*. Amsden reports that the role of medium and long-term financing, often supported by central banking mechanisms as just described, were key to the 'Rise of "the Rest",' the newly industrializing developing countries that gained so significantly in the latter part of the twentieth century⁶ (Amsden 2001). The countries of 'the rest,' according to Amsden, acquired a manufacturing base in the years prior to World War II and then, after the war, industrialized rapidly, moving eventually into mid-level and even high-technology production (ibid., pp. 1–2). Among many other factors, Amsden stresses the important role of finance in the success of these countries, and especially the

2. Of course, Bloomfield cautions that: 'Such measures would for the most part be justified, however, only to the extent that they do not conflict with the overriding requirement of financial stability or involve the central bank in details of a sort that might distract its attention and energies from the effective implementation of a policy aimed at stability' (ibid. p. 197).

3. These were used in many countries: Argentina, Bolivia, Brazil, Colombia, Costa Rica, the Dominican Republic, Ecuador, Peru and Venezuela, Israel, India, Indonesia, Korea, Pakistan, the Philippines, Republic of China, and Thailand. The central bank charges a preferential rate on discounts or advances against favored types of paper to induce commercial banks to increase their lending (Brimmer 1971, p. 786).

4. These were used in: Argentina, Brazil, Chile, Columbia, the Dominican Republic, Israel, Mexico, and Peru among other countries (Brimmer 1971, p. 788).

5. Imports of developmentally important goods are subject to lower deposit requirements and hence are favored. This has been used in Argentina, Brazil, Chile, Colombia, Ecuador, Indonesia, Israel, Pakistan, Paraguay, the Philippines, Uruguay and Vietnam (Brimmer 1971, p. 789).

6. Amsden's 'rest' consist of China, India, Indonesia, Malaysia, South Korea, Taiwan, and Thailand in Asia; Argentina, Brazil, Chile and Mexico in Latin America; and Turkey in the Middle East (Amsden 2000, p. 1).

mobilization and allocation of medium-term and long-term finance for industrialization that was supported by a key set of public financial tools.

The state's main agent for financing investment was the development bank. Sometimes, the whole banking sector in these countries was mobilized to direct long-term credit to targeted industries, thereby 'acting as a surrogate development bank' (ibid., p. 129). Lending terms of development banks were almost always concessionary (ibid., p. 132). The public finance behind the rest's development banking was often 'off-budget' and related to non-tax revenues.

Many central banks played a key role here as well. More specifically, central banks played an important role in accommodating the development-oriented policies of these governments. Most kept effective real interest rates low, even negative. They also used capital controls to insulate domestic markets from hot money flows that could lead to over-valued exchange rates and crises. Furthermore, central banks also played an important role in the 'off-budget' financing of a number of these countries using the techniques described by Bloomfield and Brimmer. These experiences were not all unqualified successes, of course. Still, in many cases, as part of an overall, coherent government policy, they often helped underwrite significant economic development.

As an important historical note that has great relevance for the current conjuncture following the Great Financial Crisis, it is not well understood that in playing these developmental roles, the central banks of developing countries were following strong precedents set by central banks in many developed economies, especially after World War II (Epstein 2007a).

4 MODERN DEVELOPMENTAL CENTRAL BANKING: CASE STUDIES OF DEVELOPMENTAL CENTRAL BANKING IN ARGENTINA AND BANGLADESH

4.1 Case study one: the Central Bank of Argentina's new mandate

Prevailing ideology has held that the only legitimate task for central banks is to control inflation, which often comes at the expense of broader goals such as employment creation, financial stability or economic growth. Now, in a bold and important move, the government of Argentina has fought against this neoliberal 'conventional wisdom' and broadened the mandate of the Argentine Central Bank to include economic growth and financial stability, and empowered it to use more tools to support credit allocation to promote productive investment and job creation.

In March of 2012, the Argentinian Parliament approved a new charter for the Central Bank of Argentina, a charter that embodies some key goals of developmental central banking. Article 3 of the new Charter states that 'the purpose of the Central Bank is to promote monetary stability, financial stability, employment and economic development with social equity, within the scope of its powers and under the framework of the policies determined by the national government' (Banco Central De La Republica Argentina, July, 2012). As the premier issue of the Central Bank's *Macroeconomic and Monetary Policy Report* states, 'The Reform of the Central Bank of Argentina Charter has brought about a historical change in the institutional structure of our country's economic policy. From a Central Bank conceived as an institution with a minor role, minimum instruments and an inadequate coordination with the remaining economic policies, we have now a Central Bank with more comprehensive objectives, a wider set of instruments and a performance coordinated with the remaining areas of the economic policy' (ibid., preface).

The reform also creates new instruments of monetary and credit policy: it allows the Central Bank to lend directly to the government up to 12 percent of the monetary base and advance funds that correspond to no more than 10 percent of the government revenue in the previous 12 months. It also allows for the use of international reserves for the payment of the foreign debt obligations of the national government, eliminating some restrictions that were in place over the use of international reserves. Perhaps most importantly, the reform allows the bank to provide funds for domestic banks and other financial institutions involved in the financing of long-term productive investment.

These new mandates and tools, which came into force in April, 2012, embody a dramatic transformation from the neoliberal straitjacket that confined the Argentinian Central Bank and monetary policy just a little more than a decade before following the disastrous Convertibility Plan that tied the Argentine currency to the US dollar in 1991. This led to economic collapse in 2002 with a debt default and severe economic crisis. The Convertibility Law required that the Central Bank maintain the fixed value of the peso relative to the dollar, and, as such, was an extreme version of the neoliberal monetary policy focused on fighting inflation to the exclusion, and therefore at the expense of, economic growth, job creation and economic development. In fact, this charter reform allowed the Central Bank to recover the powers it had exercised from 1935 to 1992 when the charter was amended (BCRA Second Half 2012).

The new law is already attracting criticism from orthodox critics. *The Economist*, for example, proclaimed that the Argentine Central Bank had become the 'piggy bank' of the Argentine government, 'losing the last shred of its legal independence' (March 3, 2012, www.economist.com/node/21551507). This, they claimed, would lead to massive inflation and runaway budget deficits. But, as I have argued above, the new Argentine mandate is quite in line with historical practices of central banks.

The Central Bank of Argentina has begun implementing these new mandates. According to official central bank reports, steps taken by the Bank along these lines include the following:

1. *Medium and Long-Term Lending for Productive Investment.* The Central Bank has initiated the 'Bicentenary Productive Financing Program,' with the aim of increasing productive investment. To do this, the Central Bank gives a line of credit to banks to enable them to make longer-term loans (a minimum of 2½ years) to finance longer-term productive investment. This program was initiated in 2010 but has now been expanded with the passage of the new Central Bank Charter. The Central Bank instructs banks to set up a credit line for the financing of investment projects. The loans are to be for a term of 24 months or more (with an effective maturity of at least 36 months), with a fixed interest rate of no more than 15 percent p.a. By the end of 2012, each financial institution with at least 1 percent of the country's deposits, or which act as government agents, should have granted an amount equivalent to 5 percent of its deposits. Half of this was to be granted to micro, small and medium-sized companies. In August, 2012, the program was extended for certain real estate investment projects (BCRA Second Half 2012, p. 8).
2. *Extend Banking's Geographical Coverage.* A new system for licensing branches was implemented to encourage the extension of banking facilities to under-served areas. This should reduce financial exclusion and provide the basis for more credit provision later.

The Charter change is recent and so it remains to be seen how it will be implemented. But the charter change helps to set an important precedent for other central banks in

Latin America and elsewhere to recover the important roles that central banks can play as agents of development.

4.2 Case study two: Bangladesh Central Bank as an agent of economic development⁷

According to the Bangladesh Bank's document, 'Developmental Central Banking In Bangladesh; Recent Reforms and Achievements' (2009–2012), the Bangladesh Bank (BB) is mandated by its charter to promote and maintain a high level of output, employment, and real income, fostering growth and development of the country's productive resources along with preserving monetary and financial stability (Bank of Bangladesh 2012, foreword, p. 1). The BB adopts a two-pronged approach to promoting Economic Development and Economic Stability. First, its financial inclusion and developmental finance campaign tries to engage the private financial sector to help reach underserved households and businesses with both banking services and credit to help generate employment, investment and growth. Second, it tries to promote financial stability by helping to channel credit away from destabilizing activities and toward productive investments. Thus the BB has charted a course of engaging the private financial sector in pursuit of a norm of 'social responsibility' in which developmental central banking and policies to further 'financial inclusion' also promote financial and economic stability. In pursuing this agenda, the BB has set up modest refinance lines and interest subsidies from the government budget to promote lending to smallholder and tenant farmers and small and medium-sized enterprises (SMEs). The central bank has also encouraged private banks to provide access to banking facilities through mobile/smart phones and through active Micro Finance Institutions (MFIs). The Central Bank has also engaged state-owned banks to open bank accounts for small and rural customers, and it has opened as many as 10 million new accounts in recent years. The BB has also initiated a Green Banking program to promote projects that improve environmental outcomes.

In pursuing these multiple objectives, the BB has utilized multiple tools, including the standard monetary tools such as manipulating short-term interest rates, as well as other tools including moral suasion, direct rules and regulations and subsidies for desired activities.

The specific types of developmental banking activities that have been pursued by the BB include:

1. *Financial Inclusion Campaign* has attempted to engage private financial institutions in providing banking services to a wider range of households and individuals, especially in rural areas, including through mobile banking.
2. *Support and promotion of agricultural lending.* While state-owned banks continue to provide credit to the agricultural sector, the BB has encouraged private financial institutions to also deliver agricultural services and credits. These private banks extend credit either directly to agricultural borrowers, or indirectly through micro-credit institutions or through other institutions in the agricultural 'value-chain.' This is achieved through moral suasion and occasional subsidies and is monitored by a dedicated office at the central bank. Under one set of programs, agricultural credit is extended at a concessional 4 percent per year interest

7. The main source for this discussion is the BB: 'Developmental Central Banking in Bangladesh; Recent Reforms and Achievements (2009–12),' Bangladesh Bank, Dakha.

- rate; the banks get a 6 percent interest subsidy that is paid by the government budget and administered by the Central Bank. Among these projects is a joint project with private banks in which the banks finance a technology to help farmers turn cow manure into cooking gas. The BB offers a line of credit so that banks are incentivized to finance the purchase of cows and the equipment to make this possible. This program was designed jointly by the BB and the private banks with the help of local farmers and farming organizations.
3. *Credit program for share croppers.* Sharecropper farmers are typically excluded from credit and other banking services, largely because they typically lack collateral. To overcome this problem, the BB launched a refinance scheme for landless sharecroppers in Bangladesh. They partnered with BRAC, one of the largest and best known non-governmental development organizations in the world. The scheme uses 'social collateral,' that is, peer pressure among groups of sharecroppers to sustain repayment. This is the first ever credit program for sharecroppers in Bangladesh, and undoubtedly a rarity (if not a unique program) worldwide. Under this scheme, BRAC has provided loans to almost 481 000 sharecroppers as of September, 2012. In support of this program, the BB has provided BRAC with a refinance facility.
 4. *Green credit support.* The BB has introduced a refinance line for banks against their loans to environmentally beneficial projects at a concessional 5 percent interest rate. These projects include effluent treatment plants and new energy efficient technologies.
 5. *Small and medium-sized enterprise (SME) credit programs.* SME development has been a central developmental goal for the BB. An indicative yearly target of disbursing SME credit by banks and financial institutions has been fixed for every year since 2010. The SME activities of all banks and financial institutions are subject to strict monitoring by the BB. In addition to indicative targets, the BB, with the help of the government and various development agencies, is implementing five refinance schemes in the form of revolving funds for SMEs.
 6. *Women's entrepreneurship development.* The BB has taken several initiatives to improve women's access to financial facilities and credit. It has stipulated that at least 15 percent of the total BB refinance fund for the SME sector must be allocated to female entrepreneurs at a reduced interest rate of 10 percent. Banks and financial institutions may offer loans up to a certain level to female entrepreneurs without collateral, as long as they provide a personal guarantee in order to use the BB refinance facility. The share of women entrepreneurs in total SME loan disbursements has been increasing successively.
 7. *The BB and industrial policy.* The BB has also given guidelines and helped to play a facilitating role in several industrial policy schemes. These include a strategy to develop industrial clusters around particular manufacturing products, especially with a goal of promoting small and medium-sized enterprises. The BB encourages banks and financial institutions to provide credit in support of the development of such clusters.
 8. *The BB and green development.* The bank issued policy guidelines for Green Banking in February, 2011. The guidelines stipulate that all banks need to undertake and report on green banking activities. The BB has also launched a revolving finance scheme for solar energy, bio-gas and effluent treatment facilities at a subsidized rate. The BB report indicates that they take into account the management capacity of banks in this area so as not to over-burden them with reporting and implementation demands. At the same time, the BB does keep track of these

activities and takes them into account when making decisions with respect to approving new branching requests and similar changes for individual banks.

5 CENTRAL BANKS' ROLE AS AGENTS OF DEVELOPMENT: LESSONS FROM THE CASE STUDIES

A number of key lessons emerge from the case studies of developmental central banking in Argentina and Bangladesh that can be extended and generalized with respect to developmental central banking elsewhere. Several other key points can be added:

1. *One Size does not Fit All: goals and tools can be tailored to fit specific national and conjunctural needs.* Unlike with inflation targeting, which establishes a low inflation rate as the central bank's single goal and a short-term interest rate as the central bank's single instrument, the targets and instruments associated with developmental central banking can be diverse and specific. Goals include the development of small and medium-sized enterprise, the development of green energy or conservation, employment generation, and financial inclusion; tools include moral suasion, subsidized credit, regulatory leverage over private financial institutions, and coordination roles and market makers, to name just a few. And the central bank must pay attention to targets and instruments. As Tinbergen argued in his classic piece on policymaking (Tinbergen 1952), one needs at least as many independent instruments as targets to reach one's objectives.
2. *Specific groups and areas can be targeted.* In the case of the Bangladesh Bank, group targeting included specific programs designed for women, other programs designed for sharecroppers, and others for small business entrepreneurs, among others. In both Argentina and Bangladesh, under-served regions were targeted allowing the central bank to have finely honed tools to develop specific regions.
3. *Central banks become focused on more than inflation.* In both cases, the central bank leadership and staff must focus on issues beyond simply controlling inflation. It helps to change the culture of the central bank from a culture of being isolated from broader economic concerns and from the broader government, to a culture of being connected to broader economic concerns and cooperating with others in the government and broader economy, such as NGOs, private financial institutions and others, to achieve broader goals.
4. *Central banks develop broader expertise and search for new tools.* Central banks are required to develop broader expertise beyond an understanding of inflation to one of understanding employment issues, distributional issues, green technology, and a concern with poverty and development. As these cases show, they also develop new tools to achieve these goals.
5. *Developmental targeting.* Central banks can develop explicit developmental goals, make them public and then report on their degree of success in achieving these goals. Like with inflation targeting, this approach can increase the accountability and transparency of developmental central banking.
6. *Developmental central banking can enhance coordination with broader governmental macroeconomic and developmental policy.* Developmental central banking works best when the central bank coordinates with the broader government to achieve developmental goals. The central bank can and should still retain some autonomy, especially with respect to broader stabilization issues, but it is best if the Central Bank engages with the government in discussion about

- trade-offs, modalities and coordination of all policies, including stabilization policies.
7. *Trade-off between stability and development?* There need not be a trade-off between developmental central banking and financial and economic stability. Indeed, the approach of the Bangladesh Bank is to help direct credit to productive investment, rather than to speculative uses. In this sense, developmental central banking can promote financial and economic stability.
 8. *Developmental goals must be consistent with capacity.* Both the Bank of Bangladesh and the Bank of Argentina have adopted goals that are consistent with the banks' capacity to implement and monitor the programs, and also are sensitive to the capacities and goals of the private sector firms and NGOs they interact with. It is important not to over-reach beyond the institutional and economic capacity to successfully implement these policies.

6 OTHER CONSIDERATIONS: CAPITAL MANAGEMENT TECHNIQUES AND OTHER GOALS OF DEVELOPMENTAL POLICY⁸

It is also important to step back from specific case studies and consider some key macroeconomic enabling institutions that may be required to implement developmental central banking. Most importantly, governments may need policy space from the vagaries of international capital markets to preserve autonomous monetary and other policies along the lines discussed here. In particular, to achieve this policy space they may need capital controls, exchange controls or, more generally, capital management techniques. The IMF has come to refer to these as capital flow management techniques, but I will call them Capital Management Techniques (CMTs). As Grabel (2013) shows, even the IMF has now changed its tune somewhat, and in some publications has accepted the view that CMTs can be helpful to macroeconomic management under some conditions. These can help stabilize the economy, and can also support credit allocation policies for developmental ends.

CMTs can enhance policy autonomy in a number of ways: they can reduce the severity of currency risk, and can thereby allow authorities to protect a currency peg; they can create space for the government and/or the central bank to pursue growth-promoting and/or reflationary macroeconomic policies by neutralizing the threat of capital flight; by reducing the risk of financial crisis in the first place, CMTs can reduce the likelihood that governments may be compelled to use contractionary macroeconomic, microeconomic and social policy to attract foreign investment back to the country or as a precondition for IMF assistance; finally, CMTs can reduce inappropriate foreign control or ownership of domestic resources. It follows from the above that capital management can enhance democracy by reducing the potential for speculators and external actors to exercise undue influence over domestic decision-making directly or indirectly (via the threat of capital flight). CMTs can reduce the veto power of the financial community and the IMF, and create space for the interests of other groups (such as advocates for the poor) to play a role in the design of policy. They can thus be said to enhance democracy because they create the opportunity for pluralism in policy design (Epstein et al. 2003).

8. This section draws heavily on joint work with Ilene Grabel and K.S. Jomo. See Epstein et al. 2003.

6.1 Other possible real targets for monetary policy

Employment targeting

The central bank can identify a number of quite specific developmental goals depending on the specific needs of the economy. These can include, for example, targeting employment generation, which is a good in and of itself, and is also a key component of poverty reduction.

Real GDP growth (economic growth)

Economic growth is a natural alternative target for central banks, since it is generally considered a broad measure of economic performance and is widely thought to be influenced, at least in the short to medium term, by macroeconomic policy, including monetary policy. Moreover, many other important variables, such as employment and investment, are broadly affected by the rate of economic growth. Its breadth and generality might also make it less amenable to monetary and credit policy than narrower measures such as employment and investment. As a broad measure, it might also be less directly linked to specific outcomes with high social priority, such as poverty reduction and employment.

Investment

For some countries, employment generation is not the most immediate macroeconomic problem. Rather, productivity growth is a more important concern. In this case, investment, rather than employment, might be a more appropriate target. If the central bank were to adopt an investment target subject to an inflation constraint, it could do so in a targeting framework. In this case, the central bank would adopt target ranges for investment and would estimate the relationship between central bank policy and investment. It would also estimate the relationship between policy, investment and inflation and other important variables, such as exchange rate instability. It would choose a target range for inflation and assess whether the investment goal and the inflation goal are consistent. Just as in the inflation targeting framework, decisions would have to be made as to the proper index of investment to use. Based on the estimate of the relationship between the central banks' policy instrument, the central bank would try to achieve its target. Here, too, the problems that arise will be similar to those that arise in the inflation targeting approach. What is the best instrument to use? Most central banks use short-term interest rates as their policy tool. But other variables are likely to be more directly related to investment, including long-term interest rates and credit availability. Therefore, central banks may find that other instruments, such as open market operations directed at long-term debt securities, directed lending, or incentives such as asset-based reserve requirements to induce banks to lend longer term, are more effective.

A stable and competitive real exchange rate (SCRER)

A number of central banks and governments in Asia and Latin America, including China, Singapore, Brazil, and Argentina, have adopted a *stable and competitive real exchange rate (SCRER)* as an important monetary and exchange rate target (Epstein and Yeldan 2009). This target highlights the importance of the traded goods sector

for employment, productivity growth, and development. Capital management techniques and foreign exchange reserve accumulation and intervention are key complementary tools to achieve this target.

7 CONCLUSION

The current day orthodoxy of central banking – namely, that the top priority goal for central banks is to keep inflation in the low single digits – is, in general, neither optimal nor desirable. This orthodoxy is based on several false premises: first, that moderate rates of inflation have high costs; second, that in this low-inflation environment, economies will naturally perform best, and in particular, will generate high levels of economic growth and employment; and third, that there are no viable alternatives to this ‘inflation-focused’ monetary policy. In fact, moderate rates of inflation have very low or no costs; countries where central banks have adopted formal or informal inflation targeting have not performed better in terms of economic growth or employment generation, and even the impacts of these regimes on inflation itself is a matter of dispute. And there are viable alternatives to inflation targeting, historically, presently, and looking forward.

Historically, countries both in the currently developed and developing worlds had central banks with multiple goals and tools, and pursued broad developmental as well as stabilization goals. Currently, very successful economies such as Argentina, Bangladesh, China and India have central banks that are using a broad array of tools to manage their economies for developmental purposes.

Inflation-focused monetary policy has an insidious impact on central banks and, indeed, on the whole macroeconomic policy apparatus. It creates in central banks a *culture* of single-minded inflation focus, or even inflation obsession. Hundreds of thousands and even millions of dollars are spent on studying every aspect of inflation and few aspects of unemployment; thousands of hours of the time of highly scarce, skilled economists are spent poring over complex models designed to show how to get inflation down from 8 percent to 4 percent, but not how to create a single high-paying job; and if other government officials or those in civil society ask the central bank to do something about employment creation, the central banks can respond, ‘that’s not our job.’

In short, more than anything else, the cost of inflation-focused monetary regimes is to divert the attention of some of the most highly trained and skilled economists and policy-makers in developing countries away from the tasks that previous generations of central bankers took for granted as being their main job: to help their countries develop, to create jobs, and to foster socially productive economic growth. It is time to return to an earlier generation of central banking where central banks were seen as agents of economic development, including being agents of employment creation.

Central banks and economists in many parts of the world have discovered that the recently dominant neoliberal approaches to central banking were not adequate for either preventing the great financial crisis or for promoting recovery. Experiments in central banking are taking place in many countries, including those ostensibly most dedicated to the old orthodoxy – the European Central Bank, the Bank of England, and (the less orthodox) Federal Reserve. Developing countries’ central banks should no longer take their leads from what the advanced countries’ central banks and the IMF say, but rather look at what *they do* and go beyond them in their own, careful experimentation. As they do so, like the Bank of Argentina and the Bangladesh Bank, they will create a revived tradition of developmental central banking that, like some of the earlier practices, can help promote inclusive and sustainable development along with economic and financial stability.

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