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Makerebe Institute of Social Research.

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Van Arkadie.
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Central Banking in an East African Federation.

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This paper attempts a straight forward account of some of the problems that are likely to arise in the administration of a Central Bank in an East African federation. As the political framework for such a federation has yet to be established and as East Africa is still without a Central Bank the discussion is quite speculative, containing a consideration of a number of alternative possibilities.

The discussion is divided into two parts. The introductory section contains a resume of the main functions of a Central Bank and a sketch of the existing East African banking institutions. The second part is explicitly concerned with the problems that are likely to arise from the federal situation.

The main functions of a Central Bank.

The primary function of Central Banking is to further economic policy objectives through the control of the supply of money available in an economy. Other functions are to issue currency, to administer foreign exchange arrangements and to ensure the liquidity of the commercial banking system in times of financial crisis. Although many readers will be familiar with the traditional machinery of Central Banking, for others a brief re-statement may help understanding of the particular problems to be faced in East Africa.

Money is the total currency in circulation plus demand deposits at the commercial banks. Demand deposits are viewed as money because they are also used for transactions. Commercial banks may increase the amount of demand deposits by increasing their loans to the public or by purchasing securities. If the loan is spent most of the cash involved in the transaction will be re-deposited with a bank. Banks as a group are therefore able to expand loans and deposits well in excess of the reserves of cash they hold. The limit on their ability to do so will be set by "leakages" of cash from the banking system due to the failure of some users to deposit with the banks and due to expenditures abroad. The Central Bank may have the legal power to control the ability of the commercial banks to expand deposits by setting a minimum ratio of cash to deposits which the banks must hold.

If the Central Bank buys assets from the banks or the general public, the quantity of cash held by the commercial banks will increase, providing them with an opportunity to expand loans. If the Central Bank sells assets the reverse process will operate. This technique, known as open market operations, is the most important tool used by Central Banks to control commercial banks in countries with developed

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ditional tool, which may prove important in countries where capital markets have yet to be developed. It also makes possible the use of governmental funds. If the Central Bank opens accounts both with the commercial banks and with the public, it can influence the liquidity of the banking system by the transfer of funds from one set of accounts to another.

payments. It should be remembered that foreign reserves may be maintained at too high a level as well as too low. Foreign assets used for reserves could be used for the purchase of capital goods to help increase local production.

In addition to the traditional functions of Central Banking, it might also prove desirable for the monetary authorities to influence the credit policies of the commercial banks in relation to the type of loans they make as well as the quantity. It might even be necessary to promote new loan and credit institutions to fill gaps that the existing commercial banks are unable to fill. Although this question of development banking is in principle a separate subject from that of Central Banking it is likely to involve the same authorities in practice.

Where Central Bank leadership has been drawn from the banking community, sometimes the Central Bank has become the agency whereby the financial world makes its influence felt on economic policy. It is certainly open to the political authorities to allow the banking community such influence. It has been argued that to leave the Central Bank outside political control (which is likely to mean control by bankers in practice) leads to more stable policies. However, there is no inherent reason why monetary policy should be in the hands of bankers and it can be argued that control should be the prerogative of the central economic policy-makers, so that monetary policy can be co-ordinated with the other tools of economic policy.

East Africa does not yet have a Central Bank. The East African Currency Board fulfills some of the functions of a Central Bank but not all. The most important function of the Board has been to issue currency. In recent years the Board has been empowered to make a fiduciary issue of up to £20 million, with an additional £5 million to cover the seasonal finance of crop movements; these limits were raised in 1963 to £25 million and £10 million respectively. The rest of the issue must be covered by sterling asset holdings of the Board. As these foreign reserves are used to back the currency, a decline in foreign reserves could lead the Board to withdraw currency from circulation, with contractionary effects on the domestic economy.

Although the Currency Board has increased its holdings of East African debt it has not yet reached the limits of its fiduciary powers. Also, as the Currency Board holds assets in excess of its currency liabilities it has been able to hold East African government debt at the same time as substantially covering the outstanding currency with sterling assets. In June 1962 the currency outstanding in the East African territories was £53,656,000 against which sterling assets of £51,639,000 were credited. At the same time the Board held East African government debt of £15 million leaving the Board with a latitude of unutilized fiduciary powers of £5 million.

With its fiduciary powers and with the existence, for over a decade, of a reserve fund providing more than 100% coverage for outstanding currency the Board has been in a position, if it so desired, to cushion the domestic market from the effects of short-term fluctuations in the foreign exchange position.

It seems likely that one of the responsibilities of the monetary authorities, outside the strictly "Central Banking" area, will be to aid in the expansion of those government activities which already exist in the field of industrial and agricultural finance. Institutions will be developed to undertake tasks avoided by the existing commercial banking system. In relation to this issue it is worth remembering that in many countries, during the period of rapid development, the banks played a more venturesome role than would be possible within the tradition of British Commercial banking. This was true of the American banking system and of many continental European countries.

In the past the East African countries have operated under the Currency Board system with a passive monetary policy. There has been a severe limit on the freedom of the East African governments to engage in deficit spending financed through increases in the money supply. In the future it must be expected that a Central Bank will be developed which will not only take up the traditional functions of Central Banking but may be expected to accept additional tasks as part of the general effort to mobilize East Africa's resources for the tasks of economic development.

With the Central Bank becoming an important agency of economic development policy, its administration and co-ordination with the other agencies of economic policy will become more important. The second half of this paper discusses some of the problems of tackling this task in a federal situation.

The problems of federation.

The virtues of political federation lie in strong part in the resulting opportunities for economic co-operation. The alternative forms such co-operation may take are many and are in part dependent on the nature of the political and administrative framework adopted. With the current uncertainty regarding the future evolution of an East African federation a wide range of alternative economic arrangements have to be kept in mind. As the choice of economic institutions will be considerably influenced by the political structure, it is right that the economic alternatives be recognised explicitly during the consideration of the nature and pace of political development.

The first possibility which must be considered is the likelihood that the negotiations for federation will drag on for a much longer period than was originally envisaged. With such a delay there will be a strong incentive to delay developments in economic institutions, in part because of the fear that in the absence of political progress institutional innovation in the economic sphere is likely to be away from federal arrangements and towards greater autonomy for the individual territory. In the monetary sphere the East African countries have operated with the Currency Board system to date and presumably could continue to do so in the future. However, it has been pointed out that the Currency Board has operated within a very confined range. The continuance of such passive monetary policies would be an undue constraint on the range of policy tools available. It would also delay a process of learning and training which will have to be experienced in the early days of Central Banking. At this time the governments of East Africa are

However, despite these negative consequences, it has to be recognised that such a breakdown is not an impossibility; there are countries smaller than those of East Africa with their own currencies.

The possibility for such a deterioration provides a strong case for an attempt to develop a Central Bank for East Africa which could survive even in a situation where plans for closer political union prove abortive. The creation of such an institution might itself play a small positive role on developing an East African federation. For example, one effect of the creation of a Central Bank would be an addition to the federal civil service whose loyalties will be primarily to East Africa and whose careers and self-interest will be intimately involved in federal progress. Certainly, if federation does succeed a common Central Bank will be a natural counterpart and even without immediate success there is a good case for an East African Central Bank.

Because of these uncertainties regarding the degree of unity which may be expected in the near future it is necessary to consider the design of a Central Bank which could operate in a situation in which substantial territorial autonomy over economic policy was retained. There is considerable room for choice regarding the form of organization.

Some decisions inevitably must be made by a central body - such questions as the size of the total money supply, the allocation of foreign exchange resources in the event of exchange control and the allocation of the fiduciary issue as between the various territories. On these issues joint agreement must be reached, for the decisions of any one part will automatically limit the freedom of action of the others. Therefore it will be necessary to set up some sort of central body to represent the various interests and to provide for an equitable solution to conflicts of interest.

What is the appropriate type of authority? This is in large part a political question of how far each partner requires guarantees of its separate interests. The greater the co-ordination of other policies, the less difficult will be the co-ordination of monetary policy. However, in the absence of complete union the possibility of genuine conflicts of interest arising over the allocation of scarce resources must be recognised and allowed for. In this, as in other areas, the need will be for a structure which allows for positive policies and ambitious programmes but which also allows for each partner to have an adequate share in making policy. One suggestion for the administration of those functions of the Central Bank which must be centralized is to be found in the Blumenthal report,³ in which there is a proposal for a board of governors drawn equally from the four partners (Kenya, Uganda, Tanganyika and Zanzibar) plus professional officials of the Bank and a representative of EACSO. Whether such an arrangement is suitable depends on the nature of the political structure chosen. One question which might be raised of a practical political nature is whether the operations of such a board should be by simple majority or whether some policy areas should be subject to special voting arrangements giving veto powers to any one of the partners who feels that its special interests are being neglected.

3. Erwin Blumenthal, The present monetary system and its future. Report to the Government of Tanganyika, Government Printer, Dar-es-Salaam, 1963.

In particular, it is possible that even if a decentralized Central Banking system were established with a structure of formal territorial autonomy over considerable areas of policy, the locus of power would still concentrate in one centre, probably that with the most established financial and banking community.

The difficulties of administering a common Central Bank will vary according to its relationship to other policy agencies. In countries with long traditions of Central Banking the question of the relationship of the Bank to the fiscal and planning authorities has been a subject of some controversy. Professional bankers are rarely neutral about the large issues of economic policy, even where they make an honest attempt to be so. The professional Central Banker is often recruited from the ranks of the private financial community and in some countries is provided with substantial security of tenure to render him remote from direct political control. This is consistent with the view that economic policy is best evolved through a decision-making process involving checks and balances representing various interests in the society. It is not consistent with the view that planning should be the ultimate responsibility of a co-ordinating authority concerned with the consistency and success of economic policy. From the latter viewpoint the monetary authorities should have a responsibility to co-ordinate their policies with overall planning and policy objectives, and that responsibility should be translated into a well defined relationship of authority in the system of economic planning.

In East Africa the likelihood is that the foundation of a Central Bank will require the recruitment and training of a staff substantially without previous banking experience, probably with a background of academic training and previous civil service experience. This will lessen the likelihood at the outset that the Bank will be representative of commercial banking interests and will make it easier for the Central Bank to be viewed as part of the economic planning apparatus.

As was pointed out above, in a federal structure one virtue of co-ordination would be that if one partner receives less than its fair share of benefits in one policy area, this might be compensated for in other areas. For example, if industrial location policy were to benefit one country more than another, then may be this could be compensated for through the allocation of Central Bank fiduciary finance as between the regional authorities.

From this point of view there is a strong case for placing a Central Bank in a subordinate role to a strong central planning bureau, where the territorial interests could be balanced over the whole range of policy. Such co-ordination of policies would be easiest in a full federation, which would provide the political prerequisites for such central planning machinery.

In summary, it should be recognised that the major decisions of monetary policy will be necessarily indivisible and that territorial interests will have to be balanced within the central authority rather than through the devolution of responsibility to territorial agencies.

This discussion has been concerned with Central Banking in the framework of a loose federation, with the maintenance of considerable territorial autonomy in development programming. If a much more centralized federation were achieved some of these problems would become the concern of other agencies. Thus if the power to issue national debt became an exclusive federal right, then the allocation of funds generated by fiduciary finance would be the concern of federal fiscal policy. Similarly, if the allocation of investment projects and the location of industry were federal concerns, subject to central planning control, then credit availability would be a less serious constraint and the territorial impact that much less serious a concern.

However, the chances are that financial institutions will play an important role in the first years, because the lack of trained personnel renders a tightly organised system of planning unlikely in practice even if desired in theory. This is not to over-emphasize the positive role of monetary policy in the development process. Money has an enabling role when resources are idle and there are plans for mobilization, a negative role when seriously mismanaged, and is a useful control mechanism when the economy is operating at full capacity. The main initiative lies elsewhere. Yet within those limits there are delicate issues of policy which will involve genuine differences of interest between the territories. It is well that resolution of those differences be explicitly catered for at an early stage, rather than left as a potential irritant.
