

# THE ROLE OF CENTRAL BANKS IN FACILITATING TRADE & INVESTMENT

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A unique feature that can be observed in the statutes creating central banks has been the restriction, or sometimes the total prohibition, imposed on them in getting directly involved in economic activities. This restriction has stemmed from another unique feature inherent with central banks: the power to acquire assets by raising their liabilities at will. If this power is irresponsibly exercised by a central bank, the consequential outcome would be to inflate the economy and through that process, destabilize the macro-economy. The underlying costs, both short term and long term, are so widespread that the drafters of central bank statutes have not taken a chance with regard to the options available. This has led them to confine central banks to their core objective of attaining and maintaining price stability and constrain them from pursuing multiple objectives that would act counter to this main objective.

The main distinction between a central bank and an ordinary economic entity, or for that matter even the government, stems from this unique feature. Whereas a central

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bank could raise both its assets and liabilities simultaneously, an ordinary economic entity cannot do so at its will. It could at most do only the exchanging of one asset for another type of asset or using an asset to discharge a liability. In the first place, the adjustment is only on the asset side and there is no change in the total assets or liabilities.

In the latter case, both assets and liabilities would decline simultaneously. An ordinary entity could raise both assets and liabilities simultaneously in certain circumstances. However, in these cases, another entity in the economy must be willing to exchange its assets for a liability to be issued by the entity concerned. This is a tedious process and an entity is not in a position to secure it at its own will.

This distinction between a central bank and an ordinary economic entity should be very clearly understood, when policies are designed to use central banks for facilitating trade and investments. This is because when central banks get involved in real economic activities, they can do so only by inflating the economies. Hence, central banks should do only what they can do safely without inflating their respective economies. To fill the gap, other economic entities should be promoted to undertake real economic activities. This paper will identify and outline what the central banks could do and should do in this respect.

Part I of the paper will outline the instruments available to central banks and present the case for using such instruments responsibly. Part II will present the model within which a central bank could operate to facilitate economic development. Part III is devoted to a summary and conclusions.

## **THE CENTRAL BANK INSTRUMENTS AND THEIR IMPACT ON THE ECONOMY**

A central bank's power to acquire assets by creating liabilities at will is known, in the general parlance, as printing of new money. From the stand-point of its impact on the economy, this is an over-generalization. What a central bank actually produces is not mere money, but seed money or reserve money that the rest of the banking system uses for creating further money in multiple terms. The process begins with the central bank's acquisition of assets through a mere book-entry: a debit entry creating an asset is matched by a credit entry in its books. In this case, a central bank would assume a demand liability to commercial banks (both currency and current accounts) or the general public (currency only). These demand liabilities of a central bank are used by commercial banks to create further deposits (and credit as well) in multiple terms through their multiple deposit and credit creating mechanism by resorting to simple book-entries. The result is that every unit of reserve money created by a central bank ends up as a bigger volume of money in the hands of the public enabling them to acquire a bigger basket of goods and services in nominal terms. Hence, the central bank's power to create reserve money, in actual practice, creates a much bigger volume of money supply, thus, giving the reserve money the title '*high-powered money*'.

Money leads to an expansion in an aggregate demand in nominal terms generating an upward movement in the general price level in the long-run. Thus, a central bank's action, if used irresponsibly, brings forth long run inflation thereby defeating its prime objective of maintaining price stability. An uncontrolled inflation over a long-period infests the minds of people (who may be traders or investors) with high inflationary

expectations. The result is disastrous for an economy's long-term economic growth momentum: economic agents avoid taking a long-term view of the economy and confine themselves only to short-term activities. Hence, inflation kills both incentives and actions needed for economic growth.

A central bank could get itself engaged in economic activities only through the creation of high powered money or in other words, inflating the economy in the long-run. Its lending to the government or banks so that the latter group could generate economic activities would bring forth the same outcome. Long term inflation is costly to an economy in a number of ways: apart from compelling the economic agents to shun long-term and prefer short-term, it re-distributes wealth from financial asset holders to unproductive, speculative type real asset holders; it brings the price system's resource allocation role to a halt; it taxes exports and subsidises imports thereby adversely affecting the balance of payments; and contributes to the development of social and political unrest thus denying the economy much needed stability for long-term planning.

When an economy is hit by long-term inflationary tendencies, central banks are required to pursue anti-inflationary tight monetary policy measures. These measures invariably take the form of raising interest rates and curtailing credit creation so that uncontrolled expansion in money in the economy can be checked. Further, inflation reduces a country's competitiveness vis-à-vis its competitor trading nations, requiring it to allow the exchange rate to depreciate continuously to maintain external sector equilibrium.<sup>1</sup>

High interest rates, less credit and a depreciating currency are the killers of both trade and investments and, therefore, should be avoided if trade and investment are to be promoted. Hence, a central bank's action involving its direct participation in economic activities or opening its credit windows to support growth would act counter to any objective of facilitating trade and investment. If a central bank reduces interest rates and permits credit to expand in the wake of high inflationary tendencies, it constitutes a self-defeating exercise, since, at the end, this destroys the incentive system for trade and investment by inflating the economy.

It is, therefore, necessary for a central bank to use its instrument of printing new money responsibly in order to avoid an inflationary situations and thereby preserve the incentive system for both trade and investment. In fact, what a central bank could do to facilitate trade and investment is to maintain a low inflation regime for a sufficiently long period and thereby eliminate high inflationary expectations in the minds of economic agents. This creates a conducive environment for economic agents to plan for the future, make investment decisions by considering a long-term perspective and take measures to improve productivity and through it, enhance the competitiveness of the country. Such a policy regime would permit a country to gain in the long-run by way of promoting both trade and investments<sup>2</sup>.

In summary, central bank credit or low interest rate regimes cannot facilitate trade and investment. Such a policy regime can bring forth a major destabilizing impact on an economy by sowing the seeds of long run inflation, thereby acting counter to the very objective of promoting such activities. Thus, the facilitation of trade and investment through inflation would end up as a self-defeating strategy in the long-run. Therefore, what the central banks should do is to create a conducive environment for trade and investments to take place autonomously, by ensuring a low inflation in the long run and, through it, by establishing a low interest rate regime and a stable currency.

## **RESPONSIBLE POLICY ACTIONS BY CENTRAL BANKS**

As argued in the previous section, the best policy which a central bank could adopt to facilitate both trade and investments is the creation of a conducive environment for such activities to take place autonomously by maintaining a low inflation regime. However, within the central bank policy actions relating to the attainment of price stability, there is scope for facilitating trade and investment through indirect means without compromising the price stability objective. This involves basically two types of policy actions as follows:

- (a) Permitting non-inflationary monetary expansion
- (b) Lending the expertise of a central bank to the government in policy formulation.

### **(a) Non-inflationary Monetary Expansion**

When the real economy grows and the liquidity requirements of the economy increase, a central bank has to permit the money supply to rise correspondingly so as to avoid disruption to economic activities emanating from liquidity shortages. Such liquidity shortages create uncertainty, bring about volatility in interest rates, give way for the wide-spread use of money substitutes and make central bank policy actions impotent and inoperative. Hence, central banks are required to permit the money supply to increase at least at the rate of growth of nominal income, i.e., real growth rate plus projected inflation. The underlying money supply increase is considered non-inflationary, since the growth in real income would raise the demand for money by the same proportion as the growth in money supply thereby neutralizing its impact on aggregate demand. Hence, it has been argued that central banks could use the leeway available to them for permitting non-inflationary money growth for stimulating the economy.

There are several limitations to this approach. First, the leeway available may not be significant, since the real growth of many economies over the long-run averages out to annual growth rates below 5 percent. In view of the high money multipliers ranging between 3 –5, an increase in money supply at 5 percent without creating inflation permits a central bank to expand the reserve money base by less than 2 percent per annum. Second, the approach assumes a unit income elasticity of the demand for money to permit the entirety of the money supply growth to be absorbed by an equivalent increase in the demand for money. However, the demand for money functions in many developing

economies is highly unstable and also varies significantly from year to year. This makes the task of a central bank to raise reserve money by an exact amount difficult. Any excess creation of reserve money would therefore lead to inflation thereby foiling the central bank's policy action. Third, like the income elasticity of the demand for money, the money multiplier too in many developing countries is highly unstable. Hence, it is not possible for a central bank to identify the level of non-inflationary money supply growth precisely. Any unpredicted rise in the money multiplier<sup>3</sup> would cause an excessive monetary expansion thereby frustrating the bank's goal of stimulating the economy in a non-inflationary manner. Fourth, the use of central bank's money creating power even in a restricted manner is highly dangerous since the bank may not be able to say 'no' to the external pressure coming from interested groups for further expansion of its credit windows. Once a window is open, even for limited applications, it would be difficult to close the same, when the credit expansion is found to be excessive. In view of this, it is not advisable to use this leeway for the stimulation of the economy.

In this background, the central banks can facilitate trade and investments only through indirect means.

### **(b) Lending of Bank's Expertise**

The central banks, through continuous investment in human capital, have been able to amass a skilled knowledge base. This could be tapped to formulate long-term development policies, without running the risk of compromising its price stability objective. This knowledge base can be made available to the governments to formulate sustainable policies for promoting both trade and investments.

Expert knowledge is needed by governments for conducting negotiations with both bilateral and multilateral trade and investment liberalization. It is often the case that bureaucrats lack comprehensive knowledge of macroeconomic implications of such negotiations. Further, they may also not be sympathetic towards monetary stability objectives pursued by central banks and knowingly or unknowingly, propose measures that act counter to central bank policies. It has been observed that, when central bank officers serve on such committees, the reconciliation of divergent interests is made more easily. In this context, the knowledge base in central banks comes in handy. Many governments in developing countries have liberally tapped this source, when undertaking such negotiations.

## **Conclusion**

This paper argues that central banks which are statutorily required to attain and maintain price stability should not risk that objective by directly participating in economic activities. This is valid for their initiatives to facilitate both trade and investment. The only instrument available to a central bank is its ability to produce reserve money which, if produced excessively, would lead to inflation through a multiple expansion of money supply. Such a policy is a self-defeating exercise, since inflation discourages both trade and investments by compelling economic agents to take only a

short-term view of the economies concerned. Further, to fight inflation, central banks are required to tighten the monetary policy by way of raising interest rates and curtailing credit. Both measures are inimical to the promotion of trade and long-term investment. Hence, a central bank should facilitate trade and investment by creating a conducive environment by maintaining a low inflation regime and, through it, a low interest rate regime and a liberal credit policy. It is also not advisable to use the leeway available to a central bank for raising money supply without causing inflation for promoting the economy on account of the difficulties encountered by a central bank in determining the quantum of the safe money supply growth precisely. But, offering advisory services to the government to formulate prudent and sustainable policies for promoting trade and investments would help central banks to harmonise and synergise their role as facilitators of trade and investment.

### NOTES

<sup>1</sup> A good example in the recent past has been Zimbabwe which had a high money supply growth exceeding 250 percent and an inflation of over 500 percent per annum for many years: Treasury bill rates went upto over 500 percent per annum and Zimbabwean Dollar depreciated from 55 per US \$ in 2003 to well over 78000 in December, 2005.

<sup>2</sup> The best example for this is provided by Singapore which managed to raise its per capita GDP from a level below US \$ 250 in early 1960s to well over US \$ 25,000 in 2003. Its economic architect, Goh Keng Swee, says that the old guard who formulated Singaporean economic policies in early 1960s believed that “....financing budget deficits through central bank credit creation appeared to be an invitation to disaster..... The way to a better life was through hard work, first in schools, then in universities or polytechnics and then on the job in the work place. Diligence, education and skills will create wealth, not central bank credit”. **“Why a Currency Board”** in Prudence at the Helm (1992).

<sup>3</sup> In developed economies, the advancements in payment systems have led to a reduction in currency holdings by the public, leading to a gradual rise in the multiplier. The same trend has been observed in developing countries as well. For instance, in Sri Lanka, the money multiplier stood at about 3 in early 1980s. but in 2005, it has risen to 5.