

Chapter IV.

INSTRUMENTS OF CREDIT CONTROL

4.1 FINANCING THE ECONOMY

One of the crucial tasks of a central bank is to finance the economy, either directly, through credits to producers, or indirectly, through a supply of funds to the banking system.

The first method is on the wane everywhere, if indeed it has not already disappeared altogether (see Chapter Two above). To the extent that the practice of dealing with private customers survives, it usually takes the form of the central bank directly discounting private bills; this happens especially in cases where a central bank has its origin in the transformation of a former commercial bank¹. In some countries the central bank assists marketing boards, when bank credits are inadequate to finance their activities which are so important for the economy as a whole.

More in line with their institutional purposes, central banks nowadays prefer to finance the economy through rediscounts. The sums involved here are much larger, and are often made accessible not only to commercial banks but to other financial intermediaries as well. This latter practice is one to be recommended to all central banks in Africa, partly because of the considerable scale on which

¹ See G. Dell'Amore, *Le funzioni delle banche centrali*, op. cit., p. 94-95.

non-bank intermediaries sometimes operate, and partly because selective controls can be used effectively only if they are made to apply to all sections of the credit market (or at any rate of the organized credit market).

Central bank credits are one of the channels of monetary base creation, and as such are part of the measures by which liquidity policy is implemented. To be more precise, it is better perhaps, in the case of developing countries, to speak of monetary policy in a narrower sense, since what is involved is the money supply on the M_1 definition (and especially legal tender as its still predominant component), rather than secondary liquidities, which are of only marginal relevance¹.

Central banking is not, perhaps, always as effective in Africa as it might be, especially as regards the use of traditional instruments of credit control. There are good reasons for this. First of all, bank money is not used nearly as widely as in industrial countries, and hence commercial banks have little scope for creating money. Secondly, commercial banks are often flush with liquidity, not so much because there is little demand for credit (the contrary is often true), but because there are not enough projects judged profitable and worth financing. In addition, banks are often over-

¹ This view is shared by E.E. Jucker-Fleetwood (*Money and Finance in Africa, op. cit.*, p. 185) "The most important difference between developing and financially mature countries is that in the latter monetary policy must take into account the total liquidity position at the side of the money supply, whereas in the developing countries the state of liquidity is still largely a simple function of the money supply. This is because the developing countries do not have, in their money and credit sector, an important financial superstructure with a highly differentiated credit system."

For the strict distinction between liquidity policy and monetary policy, see G. Dell'Amore, *Economia delle aziende di credito*, Vol. II, *I sistemi bancari*, *op. cit.*, p. 1014-20.

cautious and, if there are guarantee funds, they frequently do not work very well. So banks generally have little need of refinancing funds. Finally, foreign banks can always turn to their parent banks abroad for liquid funds if they need them, thus depriving the central bank of any possibility of regulating credit ¹.

In countries where the banking system is nationalized, central banking has departed from the principles characteristic of market economies and has increasingly veered towards essentially administrative forms of intervention ². It is hard to tell in these circumstances whether controls are more effective or less so than in a free or mixed economy, because the whole basis of judgment shifts to the wisdom or otherwise of the government's planning decisions. The supply and distribution of credit hidden behind formally uniform and close controls may in fact not meet the nation's real needs.

In many developing countries the central bank is remarkably efficient in adapting the money supply to the pronounced seasonal fluctuations of cash requirements in connection with the production and marketing of agricultural commodities. The same cannot be

¹ Admittedly, the central bank can prohibit or at least restrict the conversion of imported foreign exchange into local money, but if it does it runs the risk of damaging the "reputation" of the national currency. (Cf. W. Petch, *op. cit.*, p. 100).

² With reference to Algeria, Bruno Rossignoli (*op. cit.*, p. 74) writes: "In the setting of a collectivist system, where the distribution of real resources and credits was increasingly governed by economic and financial planning, the [*Banque Centrale d'Algérie*] in effect became an administrative check point for the financial flows generated by the banking system in response to public action tailored to planning requirements. Inevitably, therefore, the central bank was institutionally subordinated to the government and became the mere technical agent for the implementation of the Finance Ministry's decisions on monetary and credit policy."

said of cyclical fluctuations nor of the monetary requirements due to the rigidity and sheer size of public expenditure¹.

In spite of these objective limitations, which will no doubt diminish with economic progress, monetary policy does have its valid purpose, especially in so far as it is designed to supervise the banking system and the credit market as a whole with a view to their vigorous growth on a sound basis. It is most of all by the prevention of illegal practices and bankruptcies that a central bank's competence must be judged in developing countries. Strictly speaking, credit control policy need not worry unduly about inflation so long as the latter derives predominantly from Treasury requirements or is imported from abroad. If allowance is made for these two sources of inflation, there is no case for unduly tight restrictions on refinancing facilities to the banking system — which indeed have not been applied in African countries².

4.2 THE TOOL-KIT OF CREDIT CONTROL

Central banks in Africa certainly do not lack means of credit control, witness the wide powers conferred upon them by their statutes. Everywhere the legislation is generous, even if it was realized at the time that some of the instruments of control would, or could, in effect not be used for quite a while.

¹ Recapitulating the experiences of the Central Bank of Egypt, G. Kardouche (*op. cit.*, p. 60) concludes: "Thus, for seasonal purposes, the weapons used by the central bank met with considerable success. For other purposes the record is not encouraging, mainly because of the Treasury's financial needs."

² "The relatively modest tightenings of monetary conditions that have taken place in Africa could not be called monetary stringencies. They have, however, shown that monetary policy has a useful part to play even in these developing countries." (E.E. Jucker-Fleetwood, *ibid.*, p. 242).

Without pushing empiricism to the point of saying "central banking is as central banking does"¹, it is yet not easy to lay down a single pattern for all central banks, partly because some of them still adhere in varying measure to past principles, and partly because things are changing at a varying pace in different countries. Nevertheless, the situation does not altogether defy generalization.

First, consider the fundamental distinction between quantitative (or classical or traditional) credit controls, and qualitative (or selective) ones. The first affect the overall volume of credit available to the economy, the second are aimed at specified sectors of activity, increasing or decreasing the amount of credit channelled to them, as the case may be.

Quantitative credit control measures used by central banks in advanced countries include variations in the official discount rate (and/or in the rate on central bank advances), open market operations, and reserve requirements in terms either of liquidity or some other similar coefficient. The demarcation line between quantitative and qualitative controls is not always sharp, because there may well be an element of discrimination in, say, the application of the discount rate or in the computation of obligatory reserves. This being said, let us try to discover what combination of the two types of controls is most common in African countries.

Traditional controls are ill suited to African economies, not only because of what has already been said in connection with monetary policy, but also because of the virtually total absence of money and capital markets, which are the natural field for quantitative measures. Open market operations being out of the question for the time being, we are left with the official discount

¹ L.K. Jha, "Banking and Development", Reserve Bank of India, *Banking and Development*, 1970, p. 33.

rate, which can be effective up to a point if it is combined with a differentiated rediscount policy, and reserve requirements, which quickly produce the desired results especially for purposes of credit restriction. These controls can be reasonably successful when banks are few in number and it is easy to consult frequently with their managers¹, but they are quite useless in collectivist economies².

Given the shortage of funds available for development plans everywhere and their scales of priority, it is better to rely on selective measures, of which there is a diversified range, as will be seen presently. While this inevitably means discriminating between one sector and another, one project and another, there is at least the advantage that pre-determined funds are accurately channelled to where they are meant to go³.

In all, the best recommendation to make to African central banks at the present stage of their development, is to use the traditional instruments of credit control with suitable qualitative adjustments, together with such selective controls as may in particular cases appear expedient. This, to our knowledge, is more

¹ This view is expressed by H. Bosman, in "Aspetti monetari e finanziari dei problemi dei paesi in via di sviluppo", *Il Risparmio*, May 1965, p. 858.

² To quote Rossignoli once more on conditions in Algeria (*ibid.*, p. 75): "... it is obvious that to the extent that the financial flows which are to mobilize real resources are determined *a priori*, there is no scope for the classical manipulation of the cost and volume of credit as a means of stimulating or holding back production. Instead, we find a whole system of rules governing both the financial structure of firms and the conditions of bank lending."

³ Proponents of this view include S.N. Sen (*op. cit.*, p. 265-6) and Arnaldo Mauri (*Il mercato del credito nei paesi sottosviluppati*, *op. cit.*, p. 37). Dorrance ("The Role of Central Banking in the Less Developed Countries", *op. cit.*, p. 28) holds another opinion: "Bien que les politiques directionnelles de crédit aient leur place dans l'ensemble des politiques monétaires, on doit toutefois reconnaître que leur efficacité est limitée." And later (p. 30): "Il s'ensuit que, dans la plupart des cas, la banque centrale doit fonder ses politiques sur des principes non discriminatoires." [Quoted from the French version, to which the page numbers refer].

or less what central banks in Africa actually do at present. It is interesting to speculate on the future in the light of what happened in Latin America, where central banking emerged from this phase around the middle of the nineteen fifties and has since reverted to quantitative control techniques, in line with the changed objectives of the monetary authorities¹. It is not at all unlikely that the same sort of thing will happen in Africa once economic growth has really got going and problems of inflation and cyclical fluctuations come to the fore.

In the general picture described there are, of course, differences as between the French- and English-speaking countries of Africa, both as regards the actual working of the central bank and the views of economists. In French-speaking countries credit selection works chiefly through a diversified range of rediscount ceilings, applied in a most sophisticated way especially by the two multinational central banks. This policy relies much on the help of the central risk pool, a most valuable source of information hardly ever used in English-speaking countries. The latter on the whole place their faith in various ratios, such as the cash ratio or the liquidity ratio, and in that subtle method of control known as "moral suasion". But they are far too enamoured of the idea of open market operations, and in this keep being egged on by experts belonging to a school of Anglo-American thought not precisely famous for its realism. If one really wants to transplant into

¹ To quote Tamagna again on Latin America (*op. cit.*, p. 109): "In the ten years following the second world war, the overriding importance of the problems of economic development led to an adaptation of traditional instruments and to the use of new techniques of direct and selective credit control. From the middle fifties on inflationary pressures induced the monetary authorities to revise their policies and aims. The formulation of stabilization programmes marks the central bank's return to the use of traditional instruments."

developing countries some of the techniques successfully tried out in mature economies, then it is better to do as the French do, who keep a very close watch on how the arrangements they suggest actually work, so as to forestall sudden and perhaps painful reversions.

In the following sections individual instruments of credit control will be discussed separately, but still in an overall view.

4.3 REFINANCING POLICY

Refinancing policy, in the context of African central banks, means more than just manipulation of the official discount rate; it covers also the diversification of official rates and the standards applied in fixing rediscount ceilings. In this way qualitative aspects of credit control come to play a decisive part even in the application of this classical quantitative instrument of control. Indeed some central banks, notably those in French-speaking countries, use rediscount policy as the chief and most efficient means of financing the economy and at the same time introducing selectiveness at various levels.

This practice will be discussed presently; for the moment let us look at Bank Rate itself, which governs the whole system of interest rates via the rates charged by banks, whence its influence extends to all other short-, medium- and long-term rates. Theoreticians and central bankers agree that the effectiveness of this instrument of control is rather limited in developing countries, for a number of reasons having to do with the structural and functional characteristics of their economies. Generalization at the level of the whole African continent would be misleading, but at least the following two considerations apply universally. The public sector, which is notoriously insensitive to changes in the cost

of money, looms large everywhere, and what counts most for private entrepreneurs, on the other hand, is the availability of capital and the certainty of being able to obtain a loan, rather than its cost. In these circumstances, the problem for the monetary authorities was to fix a rate judged right for the achievement of certain aims¹ and then to leave it alone. This is in effect what has happened in many African countries, where Bank Rate often does not change for many years.

Elsewhere, especially in countries organized on the Anglo-Saxon pattern, it is the working of the banking system which deprives the rediscount rate of its efficacy. First of all, borrowing on overdraft is very common, which means there are no bills which the banks might present for rediscount at the central bank. Quite apart from that, commercial banks normally draw on rediscount

¹ Reference is made to two authors who explain very clearly the Bank Rate "philosophy" of the two multinational central banks in West and Central Africa, both of which have settled on 4 per cent.

First, Paul Marquis, *Principes et modalités du concours de la banque centrale au financement de l'économie ouest africaine*, BCEAO, November 1966, p. 5: "Attribuant au maniement du taux d'escompte une efficacité très limitée pour l'UMOA, le Conseil d'administration de la banque centrale a estimé préférable d'éviter de faire varier le taux d'intervention de l'institut d'émission et de le fixer à un niveau qui ne soit ni trop élevé, de façon à ce que le coût des financements bancaires ne freine pas l'expansion de l'économie, ni trop bas, pour éviter les excès d'un recours aux facilités bancaires, excès qui ne sont pas toujours faciles à déceler et à déjouer."

Second, B. Vinay, in his *L'organisation, les problèmes monétaires et la politique de crédit dans l'union monétaire d'Afrique centrale* (Paris, September 1971, p. 289) states that the BCEAEC, by fixing the rate at the chosen level, resolved the contradiction between "les considérations économiques qui incitent à pratiquer des taux modérés pour favoriser les activités de base et les considérations de nature financière qui justifieraient des taux élevés pour attirer des capitaux, et surtout pour décourager les capitaux locaux de chercher à l'extérieur des rémunérations plus intéressantes."

The BCEAO changed its attitude on interest rates in 1973, mainly in response to IMF criticism. See below, section 4.7.

facilities because they are in the habit of keeping their cash balances down to the minimum needed for current business, and investing all the rest. But in countries where demand for credit is high and there is no organized capital market, it is not so easy for the banks to liquidate their portfolio quickly and at reasonable prices, and so they keep a lot of cash in their tills — enough, often, to meet whatever credit demand comes their way. Finally, Bank Rate changes may be quite ineffective in the presence of any general expectation of sharp rises or falls in the prices of major commodities ¹.

In such a situation of limited or nil sensitivity to moderate changes in the official discount rate, both in the modern and, even more so, in the traditional credit sector, it is obvious that, in their turn, the psychological and signalling effects of such changes are minimal — contrary to industrial countries, where they are meaningful at least to the extent of conveying a certain message to the economy. Lastly, it is very doubtful that any effects at all are likely to spread to the system of medium and long rates, since in developing countries there is so little near-money and so few financial assets generally ².

In an attempt to use price as a means of credit selection, most African central banks have adopted a more or less incisive policy of multiple rates, involving discrimination with respect to various categories of banks, to geographical location, to the type and

¹ See S.N. Sen, *op. cit.*, p. 40-45, and S. Ghosh, "Monetary Control in an Underdeveloped Economy", *op. cit.*, p. 606-7.

² This holds even though, as Deena R. Khatkhate rightly points out ("Instruments of Monetary Control in Developing Economies", *The Banker*, December 1967, p. 1063), it is often the case in developing countries that special credit institutes have access to the facilities of the central bank, which therefore is in a position to regulate long-term rates almost as directly as short-term ones.

maturity of bills, or the total amount of refinancing¹. The underlying logic is that multiple rates are a necessary response to existing differences in economic activities, some of which deserve to be encouraged, whereas others rank low in the priority scale and hence should be made to pay above-average rates². However, given the general, demonstrated ineffectiveness of discount rate manipulation, there seems little reason to expect multiple rates, as such, to produce the desired qualitative control³; they are likely to be more effective if they are combined with differentiated rediscount quotas.

This is indeed what is done in a rather sophisticated way by African central banks modelled on the French pattern. The practices of the West African Monetary Union are a very good example and it is worth looking more closely at how the refinancing mechanism works⁴. Rediscount ceilings are fixed at three levels:

¹ An excellent general explanation of multiple rates in the rediscount policy of central banks and of the modern intricacies of Bank Rate manipulation will be found in G. Dell'Amore, *Economia dei saggi attivi bancari*, Milan 1971, p. 173-84. For African practices, see S.K. Basu, *op. cit.*, p. 148-51.

² One of the activities which has not always received the support it should have is farming. Especially in the case of credit restrictions in defence of the purchasing power of money, there is a strong case — as Dell'Amore suggests (*Agricultural Credit in African Countries*, Milan 1973, p. 31) — for not applying any ceiling reduction to agricultural bills, or else for accepting bills of longer than normal duration and at a lower than normal rediscount rate.

³ This view is shared — with reference, it would seem, particularly to English-speaking countries — by Andrew F. Brimmer ("Central Banking and Economic Development", *Journal of Money, Credit and Banking*, November 1971, p. 786).

⁴ See Paul Marquis, *op. cit.*, p. 6-15; Bernard Hepp, *Monnaie et crédit en Afrique noire francophone*, Paris, March 1967, p. 30-34; Sergio Bortolani, *The Banking System of Niger*, *op. cit.*, p. 57-65. The reason why it is worth examining the BCEAO refinancing mechanism is that this bank finances the economy on a really massive scale, at a relative rate among the highest in the world and certainly unknown in more advanced countries.

for each country, for each bank, and for each individual borrowing firm. Furthermore, the rules and procedures differ according as the credits concerned are for the short or the medium term.

As regards short-term credits, the purpose of BCEAO intervention is to distribute available credit to suit the rhythm of annual production, in other words to help firms both during the marketing season and at other times to make up their working capital requirements. Since September 1970 short-term quotas no longer have to be re-examined every six months, as used to be the case; they are now fixed for an indeterminate period, subject to the central bank's power to revise them at any moment at its discretion. This makes it possible to adjust them quickly to short-term economic fluctuations and to the liquidity situation of the lending banks.

The first step is to deduct from the total volume of facilities for the country concerned the share earmarked for the Treasury for rediscounting the so-called *obligations cautionnées*, special securities issued by the Treasury which are subscribed by firms owing customs duties and give them four months' credit¹.

Deduction of this amount, then, leaves the total available for all the banks together. The most any one of them can obtain is an amount equal to the difference between the whole of the short-term credits it plans to extend and the resources available during the same period. Within these limits, however, the maximum may not exceed 50 per cent of "probable short-term credits."²

¹ Given that firms can draw on these credits as an alternative to bank borrowing, the amount of these indemnity bonds has to be included in the country's overall quota, lest this freedom of substitution impair the efficacy of the authorities' credit policy.

² In practice this rule is very often the more restrictive, given the banks' shortage of funds; it is an obvious constraint on their lending whenever their

Up to its fixed ceiling, every bank can utilize the central bank facilities either by rediscounting any types of bills eligible (commercial bills, documentary bills, mobilization bills)¹, or by lodging them as security for advances, up to 10 per cent of the quota. The difference is that, by lodging a bill *en pension* for an advance, the bank concerned can repay the sum at any moment until, at the latest, 10 days before it falls due, and that interest therefore does not have to be paid beforehand, as in the case of discounting, but only when the bill is retired. Whereas the fixed quota may not in any circumstances be exceeded in the case of rediscounts, advances may be granted in excess of it in exceptional cases when there is no other way of covering specific requirements; the decision is up to the National Monetary Commission².

Within the quota fixed for each individual bank, maximum limits are determined for the credit lines it may open to borrowing firms capable of meeting the conditions required by the central bank. These firms must be engaged in productive activities of general interest either in production, trade or services, and they must also satisfy the normal conditions of creditworthiness. This last phrase means that their accounts must be balanced, with short-term liabilities being at least fully covered by gross working capital

resources are less than half the credits they would like to extend. Since this is a rather rigid rule for the actual conditions in which banks have to work, the percentage may be raised to 65 in the case of those which take an active part in financing the marketing of agricultural produce and hence are very short of cash during the marketing season. Investment abroad and interbank loans are in any event excluded from the computation.

¹ Banks present or retire mobilization bills, within their quota, for the daily adjustment of their cash position.

² For such above-ceiling advances, banks have to pay a higher rate, rising with the amount concerned.

funds (cash, credits and stocks), that they must have a given minimum of circulating assets, and must not have more debts than ten times their own resources¹.

So much for the rules governing the distribution of short-term credit. Those for medium-term credit are rather different. In this case BCEAO support has the purpose of promoting the economy's take-off by refinancing specific projects forming part of each country's development plan. A careful watch is kept on the effects on monetary stability, because they could jeopardize planned development — but then monetary authorities always have the difficult task of reconciling these two conflicting requirements.

Because this type of credit is of such importance both in short-term economic policy and in the promotion of economic and social betterment, the central bank makes it subject to its own prior authorization, which it does not do for short-term credit. In other words, no project can be put in hand without the central bank's knowledge and approval, or at any rate no project for which its promoters hope to obtain central bank support either at the outset or later. The purpose of this rule is to enable the central bank to assess any project right from its planning stage, and to suggest such changes as it thinks necessary to make it eligible for access to rediscounting facilities.

For every bank, the absolute limits of its possibilities of borrowing from the central bank are set by its so-called medium-term lending potential, which is the maximum amount beyond which the bank's liquidity is assumed to suffer. This amount is calculated with

¹ The condition of balanced accounts may be waived in cases where the imbalance is due to an excess of investments of incontrovertible economic usefulness. In such cases the BCEAO does not withhold its help, but makes it subject to the firm's management taking corrective measures within a reasonable time.

reference to the bank's resources¹. It should be added that so far this limit has put no brake on economic development, since the central bank's project authorizations have fallen a good deal short of the "potential" in question. Preference is given to local expenditure; of the costs of buying foreign capital goods, only that part is refinanced which is not covered by a trade credit from the suppliers and has not been mobilized by them in their own country. It must, furthermore, be shown for such investments that they are likely to generate additional earnings and thereby to improve the profitability of the borrowing firm, so that it can repay the credit according to the agreed schedule.

Until September 1970, rediscountable medium-term credits could run for between two and five years; since then they may have a maximum duration of seven years. The change was decided by the Board of Directors with a view to giving the central bank more scope for intervention, which in any case is in principle quantitatively limited to half the total investment costs. In some cases the proportion is higher, namely 65 per cent for projects intended to raise agricultural or industrial production, and as much as 80 per cent for building of a social character.

The system in force in the Central African Monetary Union is rather similar². The main differences are that for medium-term

¹ The amount equals the sum of: (1) the bank's own free funds (i.e. financial resources less fixed assets, losses, credits outstanding and doubtful debts); (2) deposits and medium- and long-term funds from other sources or available from other sources at notice (less loans at notice not eligible for rediscount); (3) 20 per cent of demand or short-term deposits. For development banks with their particular purposes, the computation is slightly different and leaves room for more generous intervention by the central bank.

² See B. Vinay, *op. cit.*, p. 289-96, and Lorenzo Frediani, *The Banking System of Gabon and the Central Bank of Equatorial Africa and Cameroon*, *op. cit.*, p. 148-55.

credits one overall quota is fixed for the whole currency area, and that for short-term credits a distinction is made between "in-quota" and "ex-quota" operations. The former are termed permanent or seasonal, according as they concern current activities or the production and marketing of farm produce; the latter concern projects of particular economic interest, declared to be such by the central bank after investigation.

The same principles — though obviously applied only at national level — govern the rediscounting mechanism in Tunisia, Morocco and Madagascar. Other African countries have similar systems, but, to avoid repetition, they will not be discussed separately. The system of French-speaking countries is much the most significant, given the sheer volume of funds taken up by the banks through these particular refinancing facilities, and its analysis should be enough to illustrate the techniques involved.

But it may be well to say a few words on advances against securities, which have certain features in common with rediscounts. These are not much used as a weapon of credit control in African countries, contrary to industrial countries where this method has almost superseded Bank Rate manipulation or at any rate is used on a far larger scale than the latter, because of the relative decrease in the bill circulation and the enormous public bond issues floated to cover the cash requirements of the Treasury and public corporations. In developing countries there is as yet only a limited range of securities in circulation, and so the operation — which in any case for the time being is restricted to public bonds — lacks its natural raw material, as it were. Generally speaking, it may be said that the main purpose of enabling banks to mobilize their bond portfolio through the central bank is to make public securities more attractive; this is, of course, important since they contribute

so much to financing the public debt. No doubt the sums involved in such advances will grow in the future, and this is bound to have some qualitative implications too.

4.4 OPEN MARKET OPERATIONS

What has been said about advances against securities, applies with even greater force to open market operations, notwithstanding the insistence with which Anglo-Saxon writers recommend them in an attempt to transplant into underdeveloped economies an instrument of credit control used on a large scale only in a few industrial countries¹. But the majority of writers agree that the use of this method is premature in the absence of conditions in which it can produce the desired effects, and in Africa open market operations are not, to my knowledge, used at all². There is no point, therefore, in discussing their possible future use at length.

Just two aspects of the problem are worth mentioning. One of them has to do with the interrelations between security operations

¹ According to P.G. Fousek, (*Foreign Central Banking: The Instruments of Monetary Policy*, New York 1957, p. 31) open market operations have proved effective only in the United States, in the United Kingdom and in Canada. He refers, of course, to conditions some years back; but when, since then, a few other financially highly developed countries have gone in for open market operations, they often departed from the classical pattern and went well beyond it to encompass virtually any transaction of the central bank or some other public body with a view to injecting liquidity into the market or withdrawing liquidity from it, or to altering the composition of the financial intermediaries' bond portfolio or, more generally, their assets. (Cf. A. Confalonieri, *La banca centrale e il controllo del credito*, Milan 1967, p. 119).

² Not even in East Africa, where Kenya after all possesses one of the best organized capital markets in Africa. See E.J. Pauw, "Banking in East Africa", in: P. Marlin, ed., *Financial Aspects of Development in East Africa*, Munich 1970, p. 189.

by African central banks and public debt policy. It is common knowledge that African central banks do go in for security transactions (nearly always as buyers), but the purpose is not, or at any rate not directly, to regulate the volume of money in circulation; rather, it is to finance the Treasury and to create market conditions propitious for the absorption of Treasury bonds by the public and the banks. The important point, therefore, is to keep bond prices stable (sometimes with the help of appropriate stabilization funds), and nobody other than the central bank can do this¹.

The second point worth making refers to certain theoretical proposals for an unorthodox use of open market operations, in the sense of acting on the prices rather than on the volume of bonds, so as to induce the public to buy or sell according to the needs of the economic system (this comes up against a number of other obstacles)², and also of not restricting such operations to bonds alone. Commodities of interest to Africa in this connection might be certain agricultural products, but the main trouble here would be that there might be a conflict between the aims of monetary policy (e.g. credit restriction, which would require sales) and farm price support policies (which would require purchases)³.

¹ More will be said about the public debt in the next Chapter. In addition, reference is made to D.R. Khatkhate, *op. cit.*, p. 1062-63; C.D. Deshmukh, *op. cit.*, p. 249; and S.N. Sen, *op. cit.*, p. 75.

² See R. Porter, "Narrow Markets and Monetary Policy", *Economic Development and Cultural Change*, October 1965, p. 48-50, and also the critical comments by S.K. Basu, *op. cit.*, p. 132-33.

³ The point is discussed in detail by G. Simon, in a long article published some years ago ("La politique d'open-market dans les pays sous-développés", *Moneta e Credito*, June 1962). A critical appraisal of Simon's interesting arguments will be found in Arnaldo Mauri, *Il mercato del credito nei paesi sottosviluppati*, *op. cit.*, p. 32-34.

4.5 RESERVE REQUIREMENTS

Nearly everywhere in Africa banks are required to set aside obligatory liquidity reserves or to maintain certain ratios to the same effect. Whatever form reserve requirements take, they are a constraint on bank assets, in that they involve an obligation to keep part of them in cash or deposited with the central bank (cash ratio) or in other specified forms (liquidity ratio). Both ratios are fixed in terms of deposits.

Reserve requirements are definitely a better means of credit control than open market operations, because they produce immediate effects and need no developed capital market. But although this method is advisable for the very speed with which the central bank can thereby achieve its purpose, it also has some drawbacks. First of all, changes in reserve requirements work better everywhere in the direction of restriction than of expansion. In Africa, as in all other countries where economic development is the priority aim, it is more important to supply credit to productive sectors in adequate measure than to ration it, which means that this instrument may have to be used in the way in which it is less efficient. Secondly, the restrictive effects are partly offset in a country whose banking system comprises one or more foreign banks, which can obtain liquid funds from their headquarters abroad and are authorized to convert foreign exchange into local money¹.

In developing countries the techniques of control via the cash ratio differ somewhat from the usual pattern of advanced countries.

¹ This problem is discussed, with reference to a time when it was more important than now, by A.F.W. Plumptre, *Central Banking in the British Dominions*, Toronto 1940, p. 270-72.

In the former, the restrictive effect is stronger because banks find it hard to acquire alternative liquid assets by selling bonds from their portfolio without incurring heavy capital losses; the result is a sort of "freezing effect" induced by raising the reserve ratio¹. Before the central bank does so, therefore, it must make sure that the liquidity it mops up is indeed excess liquidity. Just because banks, especially in English-speaking countries, customarily keep rather large cash reserves, the central bank has to alter the reserve ratios quite considerably to achieve any appreciable effect; it can do so, however, without too much worry since the repercussions on the money supply are largely restricted to the monetary base, because of the extremely low credit multiplier in developing economies².

¹ O. Teriba (*op. cit.*, p. 52) seems to be overlooking this effect when he says: "A unilateral application of the cash reserve ratio technique would, on its own, achieve little by way of liquidity control. An increase in the cash ratio, unaccompanied either by open market sales and/or the imposition of higher liquid assets ratios or a greater cash-weighting in the structural composition of reserve-eligible assets, may lead only to a change in the distribution of the commercial banks' assets as between bills and, say, cash rather than a shift in their overall liquidity position."

More generally, there is no case for the objections of those who argue that the so-called locked-in effect of the availability doctrine is not always operative in advanced countries, because of the size of the capital market and the enormous volume of private bonds alongside public ones. In developing countries, as E.S. Nassef points out (*Monetary Policy in Developing Countries*, Rotterdam University Press, 1972, p. 42), "the locked-in effect is structurally and institutionally built-in, since: (1) the private asset holder's portfolios are highly liquid in the form of idle balances and mostly blocked in unproductive assets; (2) the concentration of the government securities market is within banks; (3) the external sources of private finance are much less important outside the purview of banks."

For purposes of credit availability the locked-in effect can be rendered inoperative by the banks' faculty of using their public security holdings to secure advances from the central bank; but this is unlikely to happen in an inflationary situation which the central bank tries to get under control.

² See also Edward Nevin, *op. cit.*, p. 59-60.

Technically, reserve requirements may take many different forms¹. There are differences in the method of computation (reference to the volume of deposits or their increase after a specified date)², different percentages may be set according to the type of deposits (demand or on time), to the category, size or location of the banks concerned³, or to the purpose of bank lending⁴. In some countries — as in Ethiopia, Nigeria and Ghana — there is provision for the introduction of so-called special deposits, that is, deposits at the central bank which differ from obligatory reserve deposits in that they do not count as liquid assets in the computation; hence they impose more severe restrictions.

¹ For a general classification of elements of differentiation in the application of changes in reserve requirements, see A. Confalonieri, *op. cit.*, p. 145-70.

² In the view of G.S. Dorrance ("The Instruments of Monetary Policy in Countries without Highly Developed Capital Markets", *IMF Staff Papers*, July 1965, p. 276), "high marginal reserve requirements, i.e., high minimum reserve ratios applied against increases in deposits, as distinct from total deposits, may be an appropriate method of applying effective pressure objectively on those parts of the monetary system most able to respond to such pressure without imposing a structural strain on the system."

An example of rather sophisticated handling of reserve requirements is the Tunisian practice of multiple ratios, varying according as monthly increases in deposits were above or below 1 per cent. See Paolo Mottura, *The Banking System of Tunisia, 1956-1970*, *op. cit.*, p. 182.

³ Discrimination according to category (commercial banks, development banks, special credit institutes) is fairly common; an example of discrimination according to size can be found in Nigeria (but see Teriba's reservations, *op. cit.*, p. 50-51); and location certainly is a problem in Somalia, where the north and the south of the country are profoundly unequal (see Buonomo, *op. cit.*, p. 564).

⁴ Some countries manipulate reserve requirements for the very special purpose of adjusting the system's liquidity on a seasonal basis. Ratios are altered frequently, and lowered at the time when the marketing of agricultural commodities has to be financed. This was done successfully more than once in Egypt (see G. Kardouche, *op. cit.*, p. 52).

As an alternative to the cash ratio, or, more often, in addition to it, the central bank may require banks to maintain a certain liquidity ratio, variously defined in terms of specified assets (those counting for the cash ratio, plus foreign exchange, interbank accounts and short-term or indeed longer-term securities) in proportion to the total volume of deposits¹. Generally speaking, the idea is to induce the banks to finance the public debt or, possibly, some productive sector, but there are cases in which the liquidity ratio has the edge over the cash ratio in controlling the monetary circulation. This happens when liquidity is so high that the monetary authorities would have to raise the cash ratio to such an extent that bank profits would suffer too heavily. It also happens whenever bank holdings of (public) securities are large while the central bank wishes to keep interest rates stable².

In French-speaking countries, the universal *coefficient de liquidité* has a somewhat different meaning and acts as a mere safety index resting on the extent to which credits may be transferred to the central bank. It is a ratio which groups together in the numerator a bank's liquid assets and short-term mobilizable or mobilized assets, and in the denominator, deposits plus other liabilities payable within less than six months, as well as short-term bills rediscounted. The ratio is usually rather high, between 50 and 75 per cent, and is intended to prevent banks from freezing their assets and to induce them to reject applications for credit in

¹ In Italy, a similar result is achieved by allowing banks to invest part of the obligatory reserve in specified public securities.

² "In these circumstances the central bank may lose its control over the cash base, since it would have to act as a residual buyer in the market, absorbing securities unloaded by the banks in their effort to expand their loans. By raising the liquid assets ratio, the authorities would restrict the ability of the commercial banks to expand the cash base at their initiative." (R.A. Sowelem, *op. cit.*, p. 282-83).

cases where either the borrower's situation or the returns likely to be earned on the net proceeds are too doubtful for the bank to be able to count on refinancing by the central bank.

4.6 SELECTIVE CREDIT CONTROLS

In discussing the classical instruments of credit control, it has already been pointed out how they can in many ways be made to work selectively, by differentiation in, say, rediscounting policy and in reserve requirements. In addition, the central banks' tool-kit contains other instruments designed to make a direct impact on the distribution of credits to the economy rather than on their total volume. The underlying principle is that some sectors need more help from the banking system, while others should be kept on a short leash. It follows that selective controls can be applied in a positive sense, to encourage activities ranking high in the priority scale for economic development (e.g. usually agriculture), and in a negative sense, to discourage operations generously financed by the banks but either having a speculative character or indeed being damaging to the economy to the extent that they cause resources to be withheld from other, more important sectors. In these cases across-the-board measures by the monetary authorities would be unsuitable, and selective controls are likewise preferable in situations of mild inflation, provided the areas of highest concentration of bank credit are known¹.

¹ The degree of inflation is relevant in this connection, as I.G. Patel rightly points out ("Selective Credit Controls in Underdeveloped Economies", *IMF Staff Papers*, September 1954, p. 76): "Even if it is not possible to avoid a certain degree of inflationary pressure, as a result of budgetary difficulties, for example, it may be desirable to prevent a secondary expansion of bank credit. This can be done by general credit controls. But if the inflation is very mild and if the expansion in credit is likely to be concentrated in certain areas, such as credit for imports, it may be sufficient to control credit conditions on a selective basis."

Economists and businessmen broadly agree that selective credit controls are both effective and useful in developing countries¹. The conditions for their use are indeed propitious. First of all, throughout Africa people prefer to invest in real goods, in gold, buildings, commercial assets, to the detriment of useful ventures in agriculture and industry. Secondly, since there are few sources of credit, sectors which it is wished to keep under control cannot readily evade restrictions by borrowing from alternative sources. And finally, it is easier for the central bank to apply controls when financial institutions are few in number.

Nevertheless, there are a number of difficulties when it comes to applying such measures in practice. Direct controls involve bureaucratic and administrative complications, it is not always easy to single out the sectors of application, it may be difficult to find out just what use will be made of loans, and there is always the problem of where to stop interference with the individual banks' conduct of their business. If one goes far enough along this road, the end is complete nationalization, which in this context means a co-ordinated and permanent set of directives from above on how to manage the business of banking.

If central banks wish to apply selective credit controls, they have a very wide choice of instruments. Each one of them can, indeed, "invent" new and original techniques not previously used,

¹ With the notable exception of Dorrance ("The Instruments of Monetary Policy in Countries without Highly Developed Capital Markets", *op. cit.*, p. 273): "It is almost inevitable that such regulations will involve specific controls over the actions of individual institutions. Such a system of controls is more likely to freeze the status quo than to encourage competitive adjustment. It follows that this method of implementing monetary policy is likely to encourage rigidity rather than flexibility."

However, even this author takes a less critical view of selective controls if they are applied in connection with a well-conceived development plan.

if it thinks they are more suitable in the conditions of the local credit market. There is usually a common aim, namely, to control bank lending (and/or lending by other financial institutions), but there are many different ways of doing so, depending on circumstances and on what particular sectors one wants to encourage or discourage. All African countries have at some time or other used selective techniques, and it would be absurd to discuss and appraise them without reference to their operational context. All that can be done is to mention those most frequently applied, to wit, the determination of a maximum (or minimum) rate of increase for specified loans during a certain period (*encadrement du crédit*), prior authorization for loans exceeding a given amount, ceilings for credits to any one borrower, the requirement of specific collateral security for certain types of credit, control of consumer, mortgage or other credits, upper limits to the duration of individual types of loans, etc.

Given that African economies depend so heavily on foreign supplies of many goods, and given the resulting problems for the balance of payments, great importance attaches to control of demand via advance import deposits¹. These are sums, mostly in local currency, which importers have to pay into an account with the central bank or, less frequently, with a commercial bank (in which case the same restrictive effect can be achieved if the bank in its

¹ This matter is discussed at length in J. Marshall, "Advance Deposits on Imports", *IMF Staff Papers*, April 1958, and in E.A. Birnbaum and M.A. Qureshi, "Advance Deposit Requirements for Imports", *IMF Staff Papers*, November 1960. It likewise is central to the argument of central bank control over the money supply in financially less developed countries, in J.O.W. Olakanpo, "Monetary Management in Dependent Economies", *Economica*, November 1961. For comments on a concrete case, see J.H. Frimpong-Ansah, "Some Aspects of Monetary Policy in Ghana", *Bank of Ghana Quarterly Economic Bulletin*, April-June 1971.

turn has to deposit the whole amount with the central bank). The size of the deposit depends on the value of the imported goods, and it is here that the selective nature of the measure is most manifest, because the proportion can vary considerably — from a few percentage points to the total import cost — in accordance with the degree to which the authorities consider the particular foreign goods to be “essential”. The deposit usually has to be paid at the moment when the importer files his request for an import licence (or, in the unusual case in which no such licence is required, at the moment when a letter of credit is opened or the goods are despatched from abroad), and remains frozen for a certain period, which may be anything between a few days and several months, according to the different regulations in different countries.

The effect on the money supply is restrictive in all cases, but its immediate impact depends on the liquidity of the banking system at the given moment, and also on the value of the credit multiplier. Furthermore, if the importer takes up a bank loan in order to pay the import deposit, the resulting drain on reserves is larger than in the case of a normal loan, because the whole amount finds its way to the central bank and does not re-enter circulation until the time when the deposit is released, or possibly earlier on the assumption that the sums involved are used by the Treasury. Obviously, if the whole or part of the deposits can be invested in public securities, or if the Treasury can draw on the import deposit account for its cash needs, then the restrictive effect is annulled and the only aim achieved is to reduce imports.

In any event, a careful watch will have to be kept on the effect of such measures on the price level. The purpose of import deposits, as a means of monetary control, is to forestall or contain inflationary pressures, which may possibly be caused by excess

exports. But a drastic reduction of imports, in the typical situation of underdeveloped economies where the supply of local products is relatively inelastic, may entail a risk of sharp domestic price rises, not to speak of black markets for rationed goods. The important point is to make allowance for the composition of imports, and to apply differential treatment to goods of primary necessity and to those which are less essential.

It is not possible to pass judgment on advance import deposits except with reference to concrete situations, where there is enough information to assess the manner of application, as well as possible distortions and abuses. Personally, I am inclined to disagree both with the highly critical views of Birnbaum and Qureshi¹, who seem to dwell only on the negative aspects of this technique, and to some extent also with Olakanpo², who regards advance import deposits as the keystone of the whole of monetary policy in the conditions frequently found in dependent economies. In my own view, advance import deposits are one means among others at the disposal of the central bank, and I would regard them as particularly effective in certain circumstances, such as unduly high non-priority imports, or a desire to restrict liquidity on a selective basis. Admittedly, the results have sometimes been unspectacular, but this was essentially due to having put too much faith in that one instrument alone and in its not always orthodox use (e.g. allowing the deposits to be spent by the government).

In addition to acting on the distribution of bank assets, the central bank can influence the structure of interest rates. The relevance of the cost of credit for the promotion of economic development will be discussed presently; for the moment, the point

¹ *op. cit.*, p. 123-25.

² *op. cit.*, p. 401 f.

of interest is the variety of central bank attitudes to this matter in Africa. In some countries, banks are left virtually free to charge what they think right, in others the monetary authorities enforce an automatic link with the official discount rate¹, and there are yet others where the entire range of bank lending rates is fixed in detail by the authorities.

All the selective controls mentioned are in practice enforced by the central bank through coercive instructions, and very often, too, through that most important policy aid known as moral suasion. This is a most flexible, informal and intangible way of getting things done, and as such commends itself to a central bank in its dialogue with bankers and for conveying to them directives which it is often better not to publicize². This approach fits in well with the broader

¹ An automatic link between official rates and bank lending rates certainly does not make for flexibility in monetary policy, as G. Dell'Amore cogently demonstrates in *Economia dei saggi attivi bancari*, *op. cit.*, p. 223-6. In the same work (p. 206-7) the author gives an extremely lucid account of bank lending rates at successive stages of economic development. It is worth quoting the passage in full: "At first, there are no central banks as yet, and banks freely decide at their own discretion and in the light of local economic conditions what rate to charge for their loans. Once central banks have been set up, at a second stage, they try increasingly to influence all the banks, chiefly commercial ones, through refinancing facilities. Official rediscount rates then directly affect bank lending rates, and a host of other free rates is established in the tissue of direct credit relations involving the most disparate techniques. The third stage is one of consolidation for the banking system, which eventually attracts the bulk of credit demand and whose lending rates increasingly influence non-bank rates, even though the business transacted by non-bank financial intermediaries may be expanding greatly ... By now the central bank, however, is learning how to control the market by a variety of instruments, among which manipulation of Bank Rate is often of subordinate importance and intermittent. In many cases the central bank thus manages to make bank lending rates conform to the desired pattern without any change in the price of its own credit."

² Sowelem (*op. cit.*, p. 309) makes an interesting point with respect to the use of quantitative controls and moral suasion in the context of the whole approach

aim of strengthening financial institutions through constant discipline and supervision¹. The same may be said of regulations concerning the capital of banks, which may require a minimum absolute amount and/or a certain ratio of own resources to deposits or to specified classes of assets².

4.7 CONCLUSIONS: AVAILABILITY AND COST OF CREDIT

After this survey of instruments of credit control, we can return with new insights to the broader theme of the functions of monetary policy in African countries. It will have become clear that monetary policy is less important in Africa than in industrial countries, and that it has no scope for full deployment, mainly because of the absence or deficiencies of organized money and capital

of economic policy: "One of the advantages of monetary policy, frequently put forward, is that it operates in an impersonal manner through the market mechanism. Reliance on directives and requests as a means of influencing credit conditions is, of course, contrary to this kind of approach. Therefore, to the extent that importance is attached to operations through the market mechanism, the need to equip a central bank with effective weapons for the control of the banking system without resort to issuing directives must be emphasized."

¹ See Giordano Dell'Amore, *Le funzioni delle banche centrali*, op. cit., p. 80-88, as well as the pages (109-15) on central bank action in defending the solvency of the banking system.

² An interesting solution has been adopted by the countries of the West African Monetary Union, where a fairly high minimum capital requirement is combined with an own-resources/total risks ratio. Even more interesting, perhaps, are the arguments on which this choice rests. The minimum capital requirement is high so as to prevent the mushrooming of small private firms, which might elude the control of the monetary authorities and perpetuate the practices of usury. The own-resources/total risks ratio was chosen in preference to the more common own-resources/deposits ratio, because the latter would not be very meaningful in West Africa, given that deposits from the public are generally small in volume and rather unevenly distributed at that.

markets¹. This, together with the need to promote fast and balanced economic development, predisposes central banks in favour of the selective distribution of scarce financial resources, by means of direct intervention². Given that a conspicuous part of resources goes into public expenditure as a matter of priority and that further inroads are thus made into an already scarce supply of funds, what matters most to a businessman is to be able to get credit at all, and never mind its cost.

The question whether, and to what extent, to rely on the first of these variables, supply, rather than on the second, cost, in the conduct of monetary policy in developing countries, has its counterpart in the controversy between the theory of interest rates and the availability doctrine. According to the first, any imbalance in the market for capital funds can be set right by a movement of the rate of interest, whereas the second denies the equilibrating function of the interest rate whenever there exist imperfections which split the credit market into separate compartments. In these conditions, which are prevalent in African countries, the link

¹ Deena R. Khatkhate ("Analytic Basis of the Working of Monetary Policy in Less Developed Countries", *IMF Staff Papers*, November 1972, p. 555) stresses the interdependence — and not the independence — which exists between instruments of credit control and economic development: "... in fact, interaction between the two is mutually reinforcing. Monetary policy instruments, such as the interest rate, if vigorously and purposively adapted to the conditions in the developing countries, can themselves become the agent to promote the money and capital markets, which, in turn, create further favorable conditions for the effective exercise of a broader range of instruments of monetary policy." Up to a point this argument is acceptable, if only so as to avoid having to reject all the classical instruments until such time as conditions for their use are optimal.

² E.S. Nassef (*op. cit.*, p. 192) puts the point bluntly: "... the predominance of direct controls of credit in a developing country is a sign of the awareness of policy makers that the price mechanism is a poor invisible hand of allocating the scanty financial resources."

between financial and real phenomena consists of the quantum of credit, and hence the central bank's supply management of credit assumes primary importance¹.

All this must, unconsciously or consciously, have influenced the common post-independence policy of African countries. The rule has been more or less to ignore the rate of interest altogether and to alter it very rarely, but in any case to keep it low because it was taken for granted that this would encourage investment and promote development². There remains the question whether there is at all room in Africa for an active interest rate policy, and to what extent it can be effective; in several Asian countries, it must be remembered, successful recent experiments are on record³.

Two aspects of interest rates have to be considered in this connection: they are a stimulant for domestic saving, and a cost element in investment. From the first point of view⁴ other variables, including the level of national income and monetary stability, are

¹ See E.S. Nassef, *op. cit.*, p. 46.

² A striking example is the BCEAO, which never changed its discount rate between 1956 and 1972. Lately its policy has come in for sharp criticism by the IMF, and this has caused the bank to revise its approach radically, as will be seen presently. See BCEAO, "La Politique des taux d'intérêt de l'Union Monétaire Ouest Africaine", *Note d'information et statistiques*, February 1973, p. 24.

³ One of the leading advocates of a dynamic interest rate policy is Anand G. Chandavarkar, who has conducted extensive research to back his argument in two recent works, "Interest Rate Policies in Developing Countries", *IBRD-IMF Finance and Development*, March 1970, p. 29-37, and "Some Aspects of Interest Rate Policies in Less Developed Economies: The Experience of Selected Asian Countries", *IMF Staff Papers*, March 1971. In the last-named paper the author defines (p. 60) interest rate policy as "any official action designed to influence the level and structure of money rates of interest through statutory means, money market intervention, or moral suasion to attain given ends of credit policy and to help in the mobilization of savings through financial media."

⁴ More will be said in Chapter Six about central bank action to promote saving.

far more relevant for savings promotion than the interest rate. Nevertheless, a sizeable increase in the interest on savings deposits — leaving aside other economic and extra-economic motivations — can obviously make a tangible impact on saving in a developing economy¹, where the public have to be induced to hoard less in any of the usual unproductive forms (gold, goods, bank notes), and instead to put their money into financial assets, of which the range will be the wider the more developed is the capital market. If the public respond to such a rise in the interest rate, the purpose is achieved; if they do not, the monetary authorities have to take steps to strengthen the system of financial intermediaries, because the weak response may well have been due to lack of appropriate institutions².

Interest rates more realistic than those generally ruling in Africa might also make it possible to keep step with price rises, so that savers get a least non-negative real returns. The opposite policy of very low interest rates left unchanged for many years must surely have discouraged even those people who might otherwise have been willing to abandon hoarding tangible goods and to put their money into an intangible deposit.

¹ This is not so in advanced countries, where "in the last twenty years rates of interest have lost much of their power of direct stimulation of the propensity to save" (Giordano Dell'Amore, "Il risparmio in un'economia dinamica", in *idem, Saggi sul risparmio privato*, Milan 1972, p. 651). The reason for this statement are explained by the author in the preceding pages.

² H.T. Patrick ("Financial Development and Economic Growth in Underdeveloped Countries", *Economic Development and Cultural Change*, January 1966, p. 175-77) makes an interesting distinction between two types of development of financial institutions: their development is "demand following" when the supply of financial assets increases in response to higher demand for them (which, among other things, may be due to higher interest rates), and "supply leading" when supply falls short of demand and the central bank has to create new financial assets, which in their turn may generate new demand.

Unattractive rates of interest, furthermore, have caused some cash resources to look abroad for better returns, especially since the middle sixties when rates rose in Europe and North America, but were left virtually unaltered in Africa, so that the gap kept widening. This damaging drain was worst in those African countries which belong either to the franc zone or the sterling area, because there was no exchange control to prevent the free transfer of funds. It was precisely because of the rules of convertibility governing monetary relations between the West African Monetary Union and France, that the International Monetary Fund advised the BCEAO to align its interest rates to those of France¹.

It should be added that wherever commercial banks draw heavily on the facilities of the central bank, not least because they are cheap (which is generally the case in French-speaking Africa), the banks have no particular reason to chase up funds from savers. A very useful step in the right direction was taken by the central bank of Madagascar, when it issued new rules under which banks are penalized if they ask for rediscounts when the average increase in their deposits during a given period has fallen short of a certain percentage².

All things considered, there is no real difficulty in agreeing that if higher interest rates help to mobilize domestic savings, they should be raised, but the problem does not end there. There are many who worry how this can be reconciled with capital costs sufficiently low not to discourage what few investment projects there are in developing countries. This is the argument of

¹ BCEAO, "La politique des taux d'intérêt de L'Union Monétaire Ouest Africaine", *op. cit.*, p. 6 and 11.

² A similar measure was introduced early in 1973 by the Central Bank of the West African States. See BCEAO, *ibid.*, p. 10.

Keynesians and Neo-Keynesians, who see investment as the key variable in economic growth and advocate that investment should be encouraged by a policy of cheap interest rates coupled with monetary expansion. Nobody denies, of course, that investment stimulates growth, but there is more to say about the role and limitations of credit expansion. This will be discussed in Chapter Six.

It remains for me to say where I personally stand on this question of interest rates. First, I would point out that they are not the only element to enter into the calculation relevant for an investment decision, especially in Africa. Other factors are usually more important, since investment most often needs foreign capital. Among the factors which count, therefore, are monetary stability, guaranteed government protection against the entry of competing producers, the tax treatment of profits and the rules governing their repatriation, the size of the potential sales market, the amount of own resources in relation to borrowed funds, and the (generally high) investment returns.

When all these considerations come into play in any concrete situation, we can be certain that no project will be discouraged just because the rate of interest is high. Furthermore, the cheap money policy prevalent so far has attracted foreign investment of the highly capital-intensive kind, which took full advantage of money costs so much lower than at home, but contributed little to raising employment in the host country¹. If, instead, foreign investors were attracted to Africa by the low cost not of credit but of labour, this would at least alleviate unemployment.

¹ See Paolo Mottura, *Savings Mobilization in Developing African Countries*, UN, Economic and Social Council, E/CN.14/HOU/107, 12 November 1973, p. 86-87.

A somewhat different approach would be in order in the case of certain local projects of high priority, but no immediate returns. These must be encouraged by all means, including credit and tax privileges. For enterprises owned by the state or a public corporation, a substantial initial capital contribution might be more advisable, so as to prevent firms getting into the habit of calling again and again for all kinds of subsidies and special treatment, without worrying enough about sound business management.

In many situations, though perhaps not in all, there surely is no antinomy between high interest rates for savings promotion, and low ones for the sake of investment. In Africa, there would seem to be a case for differentiating interest rates. Any such policy must begin with a realistic revision of the present level and structure of rates of interest. No detailed prescription can be given, of course, because different cases need different action. But generally speaking, interest rates will at first probably have to be raised, which, among other things, will have the advantage of making the organized credit market absorb more and more of the non-organized one¹.

Artificially low rates in the modern section of the credit market certainly help to channel some funds into more remunerative — if also more risky — uses in the traditional section. Basically, this

¹ On the formation, nature, characteristics and structure of rates of interest in the two sections of the credit market, especially the non-organized one, see the two related papers by U Tun Wai, "Interest Rates in the Organized Money Markets of Underdeveloped Countries", and "Interest Rates Outside the Organized Money Markets of Underdeveloped Countries", *IMF Staff Papers*, August 1956 and November 1957; and two articles by J.A. Bottomley, "The Premium for Risk as a Determinant of Interest Rates in Underdeveloped Rural Areas", *The Quarterly Journal of Economics*, November 1963, and "Monopoly Profit as a Determinant of Interest Rates in Underdeveloped Rural Areas", *Oxford Economic Papers*, November 1964.

problem can be solved only by an attack on the usury rates charged by private moneylenders; but since in practice it is impossible to impose on them direct controls of any efficacy at all, the best thing is to encourage the spread of alternative sources of credit by setting up new financial institutes and inducing existing banks to open new branches.

And so we have come the full circle, and are back at the overriding importance of availability of credit as against its cost. But to bridge the gap between credit supply and demand inevitably takes a long, perhaps very long, time. For the short and medium run the best advice is to adopt a less agnostic and more incisive interest rate policy¹.

¹ "In the absence of any universally valid a priori criteria, interest rate policies have to be determined in terms of a judicious empiricism as part of an overall savings and development strategy, with perhaps a little more accent on the role of interest rates as a savings incentive than heretofore." (Anand G. Chandavarkar, "Some Aspects of Interest Rate Policies in Less Developed Economies: The Experience of Selected Asian Countries", *op. cit.*, p. 105-6).