# Development, Central Banks and the International Monetary System

https://www.e-ir.info/2022/07/02/development-central-banks-and-the-international-monetary-system/

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One of the more immediate development hurdles that poor countries face is their vulnerability to external shocks. When the OPEC-led oil price shocks hit the global economy in the 1970s, balance of payments in many Latin American countries deteriorated. US money-center banks, encouraged by the US government, stepped in to lend vast sums, to the tune of $327 billion, to Latin American countries struggling with trade deficits. This only set them up for another shock: Steep rate hikes by the US Federal Reserve starting in 1979 to “slay the inflation dragon” ended in loan defaults and a “lost decade” on the continent, owing to rising unemployment rates, declining per capita incomes and stagnant or negative growth rates.

The sensitivity of poor countries to dynamics beyond their control is perhaps nowhere clearer than in international finance. Financial liberalization preached by the IMF in the 1970s and 1980s, enforced through conditional lending, ushered in an era of financial instability in the 1990s. The more industrialized countries in the Global South (let’s call them emerging capitalist economies, ECEs) began to experience financial crises, thanks to volatile short-term capital flows. The ability of international investors to withdraw capital on a whim had devastating consequences on domestic economies, as was seen in the 1994 Mexican peso crisis and 1997 Asian financial crisis. These crises produced deep and prolonged downturns in the real economy: In Mexico, real GDP fell between 1994 and 1995, with the unemployment rate settling at three to six percentage points higher than the previous year. In East Asia, average annual GDP growth fell by over 50 percent in Indonesia and Thailand, and by over 40 percent in Malaysia and South Korea.

Against this background, financial stability – via currency stability – has become an important, often an overriding, policy objective in ECEs. But such policy prioritization comes at a cost. Not only does it elevate technocratic institutions like the central bank to a position of power, it also subordinates democratically-determined objectives like social welfare, high employment, and fair wages to the interests of a globalized capitalist class. More broadly, the prominence of a financial stability objective indicates the acceptance of a deeply problematic status quo in international monetary arrangements that places countries of the Global South in a structurally subordinate position.

### Central Banks and Financial Stability

In a global financial system characterized by liquidity tsunamis, the problem of maintaining stability presented itself with new urgency. But how to achieve this in an era of capital mobility and floating exchange rates? The answer: stockpile vast amounts of international reserves as insurance against future crises (Feldstein 1999). Reserve accumulation, which is the purchase of hard currency, usually in the form of US dollar Treasury securities, allows ECE central banks to lean against the direction of rapid currency movements. So, for example, when a currency is in free fall thanks to investors pulling out, the central bank uses reserves to push up the “price” of its currency vis-à-vis the US dollar. Of course, holding reserves is nothing new, but in an era of rapid global financial integration, the level of reserves central banks held increased exponentially. The rate at which ECE central banks accumulated reserves prompted one observer to mark it as “one of the most robust empirical regularities in modern international economics” (Landau 2014).

When the 2008 global financial crisis hit, and financial markets were roiling in core economies, ECEs showed remarkable resiliency, thanks to their stockpiles of international reserves. Similarly, during the 2013 “taper tantrum,” countries averted financial crises by intervening heavily in forex markets (Eichengreen and Gupta 2014). In the ongoing Covid-19 pandemic, ECE central banks once again pumped a massive volume of reserves into forex markets to keep exchange rate volatility in check. The popularity of active reserve accumulation as a bulwark against financial crises notwithstanding, this tool alone has not been sufficient to deliver financial stability in the South. In addition to intervening heavily in forex markets, ECE central banks, like their counterparts in rich economies, also made large domestic asset purchases in the early stages of the Covid-19 pandemic.

**Central Banking and Development**

The above summary of central bank activities suggests financial stability to be the primary goal of central banking. However, central banking was not always defined by a stability mandate in the Global South. In fact, when central banks came into their own in the postwar era, they privileged *credit intermediation* over conventional central bank goals such as price stability or external balance. This was in part a reflection of historical circumstances. Colonies and newly independent nations lacked the kind of financial infrastructure that could nurture domestic industries; colonial financial infrastructure promoted trade over industry, creating “trading economies” that facilitated the export of raw materials to the metropolis and the importation of finished goods to the satellites (Koddenbrock, Kvangraven, and Sylla 2020).

Imperial powers tightly controlled credit in the colonies. While the colonies often had visually distinct currencies backed by their own reserves, their hands were tied when it came to expanding the money supply: the currency of the colonies was held at parity with and readily convertible to the currency of the ruling power. The problems that colonies faced, thanks to this restrictive monetary environment, were acute. As primarily agricultural economies with seasonal fluctuations, elasticity and mobility in currency and credit were paramount for trade and commerce to thrive (Hopkins 1970). And yet, that was exactly what colonial monetary arrangements denied. The overarching goal of imperial powers was to facilitate world commerce by ensuring that currencies of the colonies were compatible with the gold or gold-exchange standard that guided international payments in the 1800s and the early 1900s.

Underdeveloped or fragmented credit structures in the colonies and in the periphery resulted in insufficient and expensive credit. The first task for central banks was then to build national banking systems that would ease credit into growing sectors. But conventional tools for credit expansion were off the table; the interest rate structure in these countries remained largely unintegrated which meant that interest rates in the broader economy were relatively insensitive to adjustments by the central bank (Bloomfield 1957). To influence the volume and direction of credit, central banks had to go beyond interest rate adjustments to increasing the *availability of credit*. In fact, in many countries, central banks took on the role of *direct credit provision*. In India for example, the 1934 Reserve Bank of India (RBI) Act called on RBI to study problems of agricultural credit, to coordinate with provincial co-operative banks, and to create a special Agricultural Credit Department to ease credit conditions in the agricultural sector. While the Agricultural Credit Department was set up in 1935 upon the inauguration of the Bank, RBI’s involvement in agricultural finance did not take off until the mid 1950s (RBI 1998). By 1954, RBI was making medium-term credit available by rediscounting bills and advancing loans for periods up to five years for agricultural purposes. RBI was also heavily involved in industry financing in the 1960s. Such practices rendered central banks key institutions of development, supplying credit where needed, and ensuring an effective payments system to facilitate commerce. In this early period then, central banks were protagonists of development, a far cry from the purveyors of financial stability that they are now.

The development mandate of central banks fell by the wayside with the end of the Bretton Woods monetary system in the 1970s. Tradeoffs between developmental goals and financial deepening, argued policymakers, were too hefty; Non-performing loans destabilized the financial system and the allocation of credit created inflationary pressures (Chandavarkar 1990). According to the World Bank’s 1989 World Development Report, directed credit programs “damaged financial systems” (WB 1989). Monetary interventions, celebrated in the 1950s and 1960s as a necessary developmental tool in the context of financial underdevelopment (Bloomfield 1957; Brimmer 1971) came to be disavowed as “financial repression” in the 1980s. In this context, policymakers no longer assumed a positive link between directed credit and economic growth, and measured performance based more on the development of financial markets and less on macroeconomic indicators.

Notwithstanding differences in the level of industrialization, economic diversification and credit systems between the industrialized North and the fledgling South, the neoliberal revolution was successful in rallying peripheral central banks around the twin goals of external balance (balance of trade) and internal stability (internal supply of money). The neoliberal agenda advocated a monetary regime fixated on stabilizing inflation by cutting government spending, privatizing state resources and liberalizing trade and financial accounts. This was also referred to as the holy trinity of the notorious "Washington Consensus" (see Williamson 1993). Thus, the scale tipped from developmentalism to price stability (inflation-targeting) and financial stability (minimizing volatility in the exchange rate).

Instead of facilitating long-term credit to productive sectors, the goal now was to provide liquidity to the financial system so as to ease market transactions for investors. In today's complex financial system, liquidity is king. Central banks in rich economies provide liquidity to maintain the "plumbing of finance" (Braun and Gabor 2019), while in ECEs, central banks do so to ensure that global investors (whether foreign or domestic) can enter and exit ECE assets without fear of a currency slide or inflation. The resources that ECE central banks pour into reserve accumulation, the opportunity cost of holding low-yielding securities, between 1–3 per cent of GDP (Rodrik 2006; Gallagher and Shrestha 2012), and the cost of sterilizing reserve purchases are significant. As I demonstrate in my own work, central banks in the Global South have become more concerned with de-risking crossborder transactions for investors than facilitating genuine development. *Credit intermediation*, which ought to be the primary goal of a financial system, has come to be replaced by the more immediate and short-term objective of *liquidity provision* that ensures financial gains for investors (Musthaq 2021).

The evolving mandates of central banks, and the costs that ECEs incur in maintaining access to international capital markets are important subjects of study, but they need to be supplemented with critical inquiries into the broader monetary and financial arrangements within which central banks are embedded. The recent literature on "subordinate financialization" pays heed to these dynamics (Powell 2013; Kaltenbrunner and Painceira 2018; Bonizzi, Kaltenbrunner, and Powell 2019). Given the hierarchy in the international monetary system, ECE central banks, and much less their counterparts in poorer countries, have little latitude in changing the current course (of privileging a financial stability mandate over credit provision) in any meaningful way. Add to this the fact that central banking is largely organized around preserving whatever system is in place, and designed to adapt only to financial innovations and not to democratic mandates. In order to understand the limitations and possibilities for the Global South, the ways in which historical legacies and structural arrangements condition the path to economic prosperity must be made clear.

### The International Monetary System and Development

In today's development discourse, two policy prescriptions have gained axiomatic status: good governance and private finance. Underlying these prescriptions is an assumption that poor countries remain so because of causes internal to it, such as political failures and bad economics. Thus, to unlock development potential, all policy elites had to do was create an environment that enforced the rule of law and property rights which would draw in foreign investors, bringing in the much-needed resources for development.

This neoliberal approach to development, which focuses almost exclusively on the agency and rationality of the immediate actors involved, would have deeply offended the intellectuals, policy elites and politicians of the Third World who led the development agenda from the 1950s through the 1980s. For intellectuals like Raúl Prebisch, and politicians like Julius Nyerere of Tanzania, the problem of development was not internal but structural. Dependency theorists have long reminded us that former colonies and peripheral countries are integrated into the global economy on uneven terms and serve as hinterlands for resource extraction. Poor countries export primary commodities whose prices are volatile whilst importing value-added manufactured products from the core that manifests in a perpetual balance of payments deficit. To sustain trade, peripheral countries end up importing capital at considerable cost from the core, which then ensnares them in a debt trap.

While dependency theory went out of vogue in the 1980s, it has continued to provide inspiration for new research agendas in development. A recent project in this regard is Isabella M. Weber's work on productive capabilities. Drawing on a new global commodity-level export database, Weber and her co-authors find that a country's initial productive capabilities (defined as production activities validated in market exchange) have a bearing on its current performance, that is, productive capabilities are path-dependent. Thus, countries' productive capabilities at the turn of the 20th century are a significant predictor of their income levels today (Weber et al. 2021). In their words: "Rather than catching up to high-value exporters, countries that started off as raw material exporters are likely to maintain low productive capabilities in the long run. On the other hand, early industrializers are expected to remain at the top of the global productive capabilities hierarchy" (Weber 2021).

Another important structural factor is the international monetary system that governs how countries settle their commercial and financial debts with one another. The impact of international monetary arrangements on development outcomes has long been recognized and in fact constituted the target of critical inquiry and policy reform in the 1970s and 1980s. The 1980 Arusha Initiative, a document penned by participants at the South-North conference held in Arusha, Tanzania in June/July 1980 effectively summarized the Third World's position on monetary arrangements. What inspired the conference was disillusionment with the IMF's engagement with Third World nations, specifically Jamaica and Tanzania. IMF assistance to Jamaica in the mid 1970s to address its external payments crisis resulted in the Jamaican government undertaking severe structural adjustments that did little to address the country's economic woes. In Tanzania, President Nyerere rejected IMF's assistance in 1979 primarily owing to the demand by the IMF to devalue the national currency. He called the IMF an "International Ministry of Finance" that sought to take away policy determination from newly sovereign countries (Nyerere 1980).

Participants at the conference levied a blistering critique of the IMF. They challenged the notion that the IMF was a "neutral," "objective," and "scientific" institution (The Arusha Initative 1980). The IMF was not neutral because it rejected alternative development models; the only legitimate model for it was market-based. The IMF was not objective because it failed to treat all countries equally. Those who were in geopolitically stronger positions received favorable treatment whether or not they abided by the Fund's rule. A case in point was the US, which ran a balance of payments deficit and yet escaped admonishment by the IMF, the very same institution that sternly rebuked, and withheld assistance to, Third World nations for the same reason.

Finally, the IMF was not scientific because of its "unscientific" treatment of trade imbalances. Participants challenged the IMF's position that trade deficits were a temporary phenomenon that could be corrected with short-term liquidity infusions. Instead, Arusha participants saw trade deficits as "structural deficits," resulting from the process of development itself: "to try to 'correct' the development deficit is to halt the development effort itself" (Abdalla 1980). The IMF then was born with an original sin: "the Fund's financial mechanisms were designed to cope with a typical problem of industrialized economies: to provide short-term breathing space to enable countries to work their way out of payments deficits and thus avoid unwarranted devaluations, which would threaten the system of relatively stable exchange parities" (ibid). The need to design new institutions equipped with the tools to accommodate the needs and aspirations of Third World nations could not be clearer.

The Initiative called for the creation of a new international monetary system. Since the fall of the Bretton Woods system, monetary arrangements had been in disarray, bringing steep inflation to Northern economies and even worse inflation to the Global South. The Initiative called the existing monetary structure a "monetary 'non'system" that privileged the interests of the North over that of the South. The ability of one nation to anoint its currency as the international means of payment (as the U.S. did at Bretton Woods) conferred on it exorbitant privileges: countries that held reserves would do so in the form of interest-yielding instruments such as treasury bills, which meant they would be lending to the country that issued the reserve currency, in this case the US.

The new monetary system had to be democratic and universal, encompassing the interests of the North as well as that of the South. It had to be capable of achieving monetary stability, acceptable levels of employment and sustainable growth, and above all, it had to support the process of global development by design. Demands were made for an international currency unit, that no one country could control, and whose supply would be regulated, and made readily available to countries in need. The Initiative also called for a mechanism of international arbitration, independent from the IMF, that could resolve disputes between the Fund and member countries. Finally, a demand was also made for significant resource transfers (beyond the capacity of the IMF) from the North to the South. One of the ways in which this could be done, according to participants, was by instituting an international tax (for example on oil consumption in industrialized countries) that could be used to mobilize funds for resource transfers. In order to realize their vision of a truly democratic and universal monetary system, and to meaningfully escape the legacy of colonial exploitation, the Initiative called for a UN Conference on Money and Finance, that, unfortunately, never came to pass.

The Arusha Initiative evinced a deeply political understanding of a highly technical system. It incisively dissected the distributional implications of a monetary system that privileged the currencies and interests of a few core economies. Those very countries, the G7 (U.S. U.K. Canada, Italy, Japan, Germany, France and the recently added European Union as a ‘non-enumerated’ member), continue to hold the reins at key global governing institutions, making reform near impossible. The deficiencies with the existing system were brought home yet again in the Covid-19 pandemic. Of the US $650 billion of SDRs distributed by the IMF, a mere 3 percent went to low-income countries, 30 percent to middle-income, and the majority (60 percent) went to high-income countries; more than 17 percent went to the US alone (Eichengreen 2021). The system is based on two principles that badly need reform: SDRs are allocated based on automatic borrowing rights (quotas), which are in turn determined largely by aggregate GDP, and second, it is based on voluntary transfers between countries. Indeed, one of the demands of the aforementioned Arusha Initiative was to base access to SDRs on the size of deficits rather than IMF quotas. This was a modified version of a demand that was made at the conception of SDRs in 1965 – to allocate SDRs based on development needs and not on a quota system that perpetuated colonial legacies.

**The Only Game in Town**

The Covid-19 pandemic threatens another “lost decade” in the Global South (United Nations 2022). While all countries suffered damaging economic contractions owing to lockdown measures and supply chain disruptions, the ability to recover from the crisis has been uneven. Rich countries borrowed record sums at ultra-low interest rates to finance their pandemic recovery, an option that was not available to the poorest nations; in fact the latter group spent billions servicing debt, paying 14 per cent of revenue for interest on their debt, almost four times higher than rich economies (United Nations 2022). Countries that enforced strict shut downs, such as Sri Lanka, plunged into severe debt crises. Sri Lanka is currently in negotiations with the IMF for a bailout. Meanwhile, Pakistan is seeking an IMF loan of about US $6.4 billion to address its own economic crisis.

From the 1980s to the 2020s, very little has changed in the architecture of the global economy. Institutions like the IMF, the World Bank and the WTO remain at the apex of the global economy, writing the rules of the game and perpetuating existing vulnerabilities and power asymmetries in the system. The IMF still remains the “only game in town” when it comes to peripheral countries in distress.

Debates about democratizing and politicizing central banking are gaining momentum in policy and academic circles, driven by the twin challenges of the pandemic and climate change. From the perspective of the Global South, however, the debate needs to be much broader. The critique has to go beyond central banks to problematize the broader set of relations – trade, financial and monetary – that condition what countries (or even central banks) can and cannot do. The problem with much of the mainstream development discourse today is that it focuses on factors internal to countries, and proposes good governance and a turn to private finance as panacea for development woes. None of these touches on the systematic causes of development challenges, and as long as these remain intact, the aspirations of the Global South will be kept in check.

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 ISSN 2053-8626 