

# The role of central banks in societal development – challenges in emerging economies

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Central banks have, through the years, been regarded as a prerequisite for an efficient economic system and for economic growth. In brief, one can say that their main task is to ensure that a country has liquidity in the form of banknotes and coins – to issue legal tender, to conduct monetary policy to ensure that money retains its value, to maintain an efficient system for payments and credits and to provide liquidity support in a crisis.

A central bank's fundamental tasks are similar all around the world, but in this article we would like to illustrate some of the challenges that central banks are facing in emerging markets and the role of the central bank as agent for development. We also describe the Riksbank's work on supporting central banks in some emerging markets with funding from Sida.

The challenges for central banks in emerging markets comprise a lack of legislative framework, an excess of tasks and objectives, undeveloped financial markets, a lack of competence and transparency. These are ingredients that are important for creating confidence in the central bank, its currency and the financial system as a whole.

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## 1 Introduction

When a new national state is formed, the central bank becomes an important part of the political sovereignty. Founding a central bank is therefore high on the agenda, not as high as designing a flag perhaps, but higher up than establishing a national airline. This is because of the central role played by a central bank with regard to economic stability and growth.<sup>1</sup>

Central banks' tasks in the political and economic system have varied over time and between countries, and there have been several attempts to define what central bank tasks are.<sup>2</sup> In brief, one can say that the main tasks for a central bank are to issue legal tender, to maintain a smoothly functioning system for payments and credit, to act as bank to the banks and to provide emergency liquidity assistance in a crisis and to conduct monetary policy with the aim of creating price stability. All of these tasks are necessary for the economy to function smoothly and for economic growth. The central bank's tasks and functions in society are similar all over the world, but for emerging economies, the conditions are more challenging. This affects the central bank's capacity to carry out its tasks and may also require different working methods.

In this article we highlight some of the challenges faced by many central banks in emerging markets. These concern, for instance, the lack of or shortcomings in basic

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1 Capie, Goodhart and Schnadt (2012), page 91; Georgsson, Vredin and Åsberg-Sommar (2015) and Lindé and Vredin (2016).

2 For instance, Kisch and Elkin (1932); Price (1998); Bruni (2001); Viotti and Vredin (2000); McKinley and Banaian (2005) and Singleton (2010).

legislative frameworks needed by a central bank to be able to conduct its operations and less developed financial markets that make it difficult for monetary policy to function. A lack of or shortcomings in statistics and analytical competence are other difficulties. Transparency regarding the central bank's tasks, objectives and means are a further area that often needs developing. Characteristic for many emerging markets is that they are more often subjected to major shocks, partly as a result of heavy dependence on energy and commodity prices. This in turn entails challenges for a monetary policy aimed at price stability.

The Riksbank cooperates with central banks in a number of emerging markets (currently Ukraine, Kenya, Palestine and Namibia). One of the purposes of this article is also to describe the Riksbank's work in this field.

## 2 The central bank in the economy

A central bank has several fundamental functions that are important to the economy. Here is a brief run-through of the most important central bank tasks.

### 2.1 Credible means of payment and smoothly functioning payments

One of a central bank's basic functions is to provide a country with a standardised product for the exchange of goods and services, which is to say money. Most central banks have a statutory mandate to supply the country with banknotes and coins and have the exclusive right to issue them.

It is essential to the development of a social economy that payments function properly. An economy has difficulty developing if there is no access to a credible means of payment or an infrastructure for making payments. Exchanging goods and services without money and credit impedes the development of the economy.<sup>3</sup> Many problems can arise when the population and the surrounding world lose confidence in a currency; in countries with hyperinflation it has a particularly severe impact on households with low income.

Giving central banks a monopoly on the issuing of banknotes and coins, along with a certain degree of autonomy, has been seen as an effective and credible way of supplying cash. Before central banks were given a monopoly on issuing money, commercial banks were able to issue their own cash. This did not work very well.<sup>4</sup> Trade was made more difficult with several different 'products' for exchanging goods and services. The effect was often that too much money was printed and that the bank suffered an acute liquidity shortage when there was a crisis of confidence in the banknotes the bank had issued.<sup>5</sup>

Technological advances, globalisation and innovations on the financial markets have led to competition for banknotes and coins from other means of payment, particularly different types of accounts with related payment services offered by banks and other financial institutions. Today, payments are made electronically to a large extent; both households and companies, for example, pay invoices and transfer money on-line or by mobile phone. Developments in payment services move rapidly and the central bank often plays an important role here.<sup>6</sup>

For payments to work, one also needs a functioning financial infrastructure. Central banks are often described as the 'plumber' in the financial system with overall responsibility for several functions that are necessary for the financial system to function. The financial

<sup>3</sup> See, for instance Tobin (1965) for a theoretical model and Levine (1997) for the role played by financial developments in economic growth.

<sup>4</sup> Wetterberg (2009).

<sup>5</sup> Stockholms Banco, Sweden's first bank in the 17th century, met this fate before it was converted into what is now Sveriges Riksbank.

<sup>6</sup> One example is the development of payments in real time using, which in Sweden is through the mobile phone service known as Swish.

infrastructure includes, for instance, the system for large-value payments between financial agents and the system for retail payments between private individuals and companies. The Riksbank's system for payments between banks and a number of other financial institutions; the RIX system, is the hub of the Swedish payment system.<sup>7</sup> In many countries, and in particular emerging economies, the central bank manages the domestic system for retail payments between private individuals and companies.<sup>8,9</sup>

## 2.2 Crisis management

The central bank is the 'banks' bank' and plays the role of 'lender of last resort', that is supplies emergency liquidity assistance in the event of a financial crisis.

There are good reasons to believe that the function of banks in society – facilitating payments, mediating credit and enabling risk diversification – is more efficient as a result of competition among private players rather than being run by the state. But banking activities can contribute to vulnerabilities in the financial system. The banks' funding is based to a considerable degree on short-term loans, for example deposits from the general public and short-term borrowing on the capital market. Their assets, on the other hand, often comprise lending of a more long-term nature. This imbalance in maturity and liquidity between debts and assets is typical for traditional banking operations and normally functions without any major problems, as long as confidence is maintained in the banks' debt-servicing ability. But if doubts arise, depositors may quickly try to withdraw their money – money that the bank cannot obtain in the short term. This causes liquidity problems.<sup>10</sup>

This type of inherent risk is the reason why there are special rules for banks, banking supervision and often a state deposit guarantee protecting depositors against losses. When a liquidity crisis arises, the central bank can alleviate the effects by lending money to a bank in crisis when no one else wants to lend money. This function as lender of last resort is based on the central bank's unique ability to create unlimited amounts of liquid funds in its own currency. In practice, the central bank can give generous ELA at a high rate of interest and against good collateral.<sup>11</sup>

## 2.3 Monetary policy

A central bank is 'the banks' bank', not just in financial crisis situations but also under normal circumstances. The banks make payments between themselves via the central bank's infrastructure for large-value payments, and they can borrow or deposit money there in the short term. The terms determined by the central banks for these transactions affect interest rate-setting and credit flows in the economy. This is how monetary policy is carried out in advanced economies.

Price stability means in brief that those who use a means of payment shall be able to rely on its value not being undermined quickly or unpredictably. It is a logical consequence of issuing banknotes and coins to also be responsible for maintaining their value, that is, ensuring prices are stable or increase at a predictable pace. This work is known as monetary policy. Most central banks conduct what is usually referred to as flexible inflation targeting. This means that their monetary policy is aimed at attaining a particular inflation target, but that it also gives consideration to how the rest of the economy is developing.<sup>12</sup> This is today regarded as the most effective means of conducting monetary policy, also in many emerging

7 Through RIX the Riksbank can also implement monetary policy and provide liquidity assistance in crisis situations. In addition, there is also an infrastructure for issuing and trading in securities.

8 For instance, Belgium, China, India, Russia, Italy and South Africa, see: Bank for International Settlements [BIS] (2016) p. 494.

9 In Sweden the dominant system for retail payments, Bankgirot, is owned by the banks.

10 Diamond and Dybvig (1983).

11 Bagehot (1873) and Calomiris (2016).

12 Apel et al. (1999).

economies,<sup>13</sup> although the conditions differ in several important aspects (read more about this in Section 3.3).

Even if the inflation-targeting regime in Sweden has been much debated in recent years, it has been positively rated in the evaluations of the Riksbank conducted by the Riksdag (the Swedish parliament).<sup>14</sup> The experiences are roughly the same in other countries that have followed the same strategy. In the countries that have introduced inflation targets, the inflation rate has been low and inflation expectations have been anchored around the target without causing greater volatility in GDP growth.<sup>15</sup>

## 2.4 Central bank independence

At the beginning of the 1990s, the view was established that central banks should be relatively independent public institutions kept at arm's length from political pressures.<sup>16</sup> The tasks of a central bank could in principle be managed by a ministry of finance, or the ministry of finance could have direct control over the central bank, but that would not be appropriate. This has partly to do with the possibility that governments would be tempted to finance budget deficits by printing more money. But it is also connected with it being considered risky to use monetary policy too actively in cyclical policy.<sup>17</sup> Experience has shown that this can lead to lastingly high and volatile inflation without any positive effects on employment and output.<sup>18</sup>

For these reasons, many countries have chosen to delegate a monopoly on issuing money and taking monetary policy decisions to a central bank with a high degree of independence. How great this independence should be depends on the functions the central bank receives from its principals. Its principal can be either the parliament or the government. The law or laws that govern the central bank's functions and its independence vary from country to country. In general, one can say that when a central bank's tasks are clearly delimited and defined by law, it allows for greater independence and vice versa.

Today, central banks often have a high degree of independence. However, this does not mean that the central bank is 'independent' of political decisions. Democratically elected politicians should, of course, take the decision on how independent the central bank is to be and which tasks it should be assigned.

## 3 The challenges of central banks in emerging economies

Over the last two decades, many emerging economies have improved their control of fiscal policy, deregulated their financial markets and stabilised inflation at lower levels. This is largely due to them adopting sounder economic policy with better frameworks for both fiscal and monetary policy, greater independence for central banks, reduced fiscal policy dominance and more substantial elements of market-based processes. Moreover, many countries are on the way towards a more forward-looking monetary policy in which transparency and implementation have also come more into focus. Financial developments and globalisation have accelerated this process, although many emerging economies still have plenty to do.<sup>19</sup>

The problems faced by central banks include weak legal frameworks and ensuing lack of independence from the political system, ineffective internal process and insufficient

13 International Monetary Fund [IMF] (2015c).

14 Goodfriend and King (2016).

15 Berg et al. (2013) and Loungani and Sheets (1997).

16 Singleton (2010).

17 Barro and Gordon (1983).

18 Georgsson, Vredin and Åsberg-Sommar (2015).

19 IMF (2015c).

transparency, which has a negative effect on confidence among the general public and politicians. Central banks are therefore exposed to more short-term political pressures and are finding it difficult to implement their monetary policies. Other fundamental problems are a lack of statistics and the statistics that do exist being unreliable. It is, of course, more difficult to conduct inflation targeting if the background material on which forecasts for employment and output is inadequate. Furthermore, less developed financial markets make it more difficult to use the interest rate to affect price formation in the economy.

The principles for conducting central bank operations and what functions a central bank should have are approximately the same for emerging economies and more developed or advanced economies although there are major differences in conditions.

### 3.1 The central bank's framework must be clear

Successful central banks mostly have a consistent and transparent monetary policy framework with a clear-cut mandate to achieve price stability in the medium term. Without disregarding this overall goal, however, they also have the objective to promote growth, employment and a stable financial system. A problem for many central banks in emerging economies is, however, that they receive too many and often contradictory objectives. It is not unusual for central banks to be expected to maintain price stability, low interest rates and a fixed exchange rate as well as promote general economic development all at the same time. Achieving all these objectives at the same time is virtually impossible. Too many objectives often lead to the inflation target being overshadowed if, for example, concerns about exchange rate movements, lending or unemployment increase and become the subject of political discussions. In combination with weak legal frameworks, this does not make it easier for central banks to withstand political pressure to, for example, cut the policy rate to increase lending. But this causes inflation to soar and central banks to lose their credibility.

Moreover, it is not unheard of for central banks in emerging economies to run institutions like universities, libraries, TV channels and hospitals. They sometimes also take on too many roles, conducting central government and commercial banking operations as well.<sup>20</sup>

To develop strong and clear central bank legislation and implement other necessary reforms, the central bank itself must often provide impetus. The central bank may also need to contribute to greater consensus among various groups in society, including politicians. Political support is essential in order to have an independent and efficient central bank. Politicians must set the framework and then work to support an independent central bank. It is a question of building strong institutions. If there is no political confidence in the central bank, it will be unable to achieve its objective or targets and contribute towards economic development.

The legal framework should also specify the central bank's institutional frameworks and describe how management and governance, decision-making processes and democratic accountability are to work. The workings of a central bank are complex and also require an effective strategy to guide internal operations.

Central bank independence is a key aspect and it, too, requires clear forms of accountability and transparency. History, academic theory and empirical data show that central banks can best contribute towards general economic development and secure confidence in their operations, monetary policy, the currency and the financial system when they have a clear mandate that is formulated by elected representatives and are at a certain distance from the political system. Many central banks in emerging economies currently

<sup>20</sup> Countries with three or more monetary policy objectives include Ethiopia, Vietnam, the Solomon Islands, Bangladesh, Malawi, Myanmar, Nigeria, Yemen, the Gambia, Rwanda, Mongolia, Pakistan and Zambia. Examples of countries that have two objectives include Liberia, Cambodia, Nicaragua, Bolivia, Honduras, Afghanistan, Tanzania, Indonesia, India, Romania and Uganda. (IMF (2015c). See also the table in Appendix 1.)

have judicial independence and an increasing number of them are also getting closer to independence in practice.<sup>21</sup>

Independence also strengthens public confidence in central banks, making it easier for them to run their operations effectively. Economic transactions and financial services are largely a question of pledges about future commitments. The higher the confidence, the lower the transaction costs. Confidence in a society functions like a lubricant, making it easier for everyone. There are numerous examples in history of countries where confidence in the central bank's ability to maintain the value of the country's currency has fallen so low that households and companies start using dollars or some other reserve currency instead. Several countries in Latin America have experienced this, including Argentina, Peru, Ecuador and El Salvador.

If a central bank with an inflation target fails to instil confidence in the target, it risks creating the wrong expectations, and it will be virtually impossible for it to achieve its objective. Zambia and Ghana are two examples of countries that have tried to establish an inflation target over the last five years but where inflation has repeatedly either overshoot or undershot the target.<sup>22</sup> This undermines confidence in the central bank, even if the causes of the missed target are beyond its control. Confidence in the central bank's operations is, of course, extremely important when it comes to the financial system. If the general public do not trust the central bank and other authorities to be able to maintain stability in the financial system, there is a risk of them withdrawing their money, and hence of their concerns materialising.

### 3.2 Greater transparency is crucial to building confidence

Over the last few decades, central banks around the world have become increasingly transparent. This can be explained by stronger demands for transparency from the general public and by the fact that independence sets requirements for accountability and hence openness. Accountability is important since the central bank should be independent of politicians. A well-functioning process for being able to present the central bank's work promotes independence and facilitates democratic control. Openness and transparency can build confidence in the central bank's activities among politicians and the general public. Confidence can also be achieved by the central bank being clear about what it spends its resources on, how policies are drafted and how decisions are taken.

For central banks that have started to apply a forward-looking monetary policy, communication and transparency are also a monetary policy tool. By communicating their forecasts and their forthcoming interest rate policy, the central bank can influence expectations and make it easy for financial market participants to react to the policy.

However, emerging economies still have a much lower degree of transparency and openness than advanced economies. Central banks in emerging economies often lack a communication strategy for their inflation forecasts and communication is further exacerbated by the fact that it is given several objectives that are incompatible.<sup>23</sup> When problems arise, there is a tendency for central banks in emerging economies to take a step back when it comes to transparency instead of communicating and opening up more. One of the most common questions that emerge when the Riksbank works with communication issues in emerging economies is how the central bank should communicate in a crisis or when it receives criticism.

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21 Laurens, Arnone and Segalatto (2009) and Lucotte (2009).

22 IMF (2014, 2015a, 2015c).

23 Crowe and Meade (2008) and Dincer and Eichengreen (2014). According to Crowe and Meade, progress towards greater transparency has come to a standstill in emerging economies, although Dincer and Eichengreen find that development is still moving forward.

### 3.3 Varying conditions for monetary policy

For a central bank to be able to conduct monetary policy, several conditions need to be in place. One such condition is a well-functioning financial system through which the central bank can influence the interest rate and thereby economic development, as well as political support in the form of a responsible fiscal policy. An increasing number of emerging economies are trying to follow an inflation-targeting policy that requires a forward-looking monetary policy, which imposes further demands. A forward-looking monetary policy contains a complete assessment of the economic outlook, a way forward for the policy in line with the inflation target, while attention can be paid to financial stability and other macroeconomic variables, as well as an appraisal of future risks and plans for how to tackle potential shocks.<sup>24</sup>

But even when the conditions for conducting monetary policy are in place, challenges remain for emerging economies as regards policy design, as the external factors influencing monetary policy differ from more developed economies. In particular, these factors include the size and frequency of external price shocks to commodities and assets. Other aspects may also need to be taken into consideration that more developed economies need not consider to the same extent, such as inadequate statistics, corruption and low confidence.

#### 3.3.1 Basic conditions for monetary policy

Sweden and other countries that came through the financial crisis of 2008–2009 relatively well are characterised not only by an efficient regulatory framework for central bank operations but also by the fact that they have been implementing reforms for a long time that have improved the functioning of the economy, above all with respect to fiscal policy. It is difficult to believe that a central bank can independently guarantee low and stable inflation, and financial stability, irrespective of how fiscal policy is designed and vice versa. A central bank, no matter how independent, will not succeed with its monetary policy if the political system does not support it via a sound and stable fiscal policy with a clear framework. Monetary policy cannot bear the whole burden of stability in the economy. This is a problem that currently occupies many emerging economies.<sup>25</sup>

Throughout the history of central banks, there has been an inbuilt conflict between their desire to maintain stable prices and their function as the government's bank. Governments have a natural preference for cheap funding from their own bank, printing extra banknotes, particularly in the event of various types of crisis and, ultimately, in times of war.<sup>26</sup> Funding budget deficits by printing money or conducting a fiscal policy that is so expansionary that the central bank can no longer control the interest rate is normally called 'fiscal policy dominance'. The successful implementation of monetary policy requires a responsible fiscal policy with a clear framework. It implies that fiscal policy must underpin monetary policy objectives and not revert to funding via the banknote printing press or an all-too-expansionary policy that undermines confidence in the price stability objective. An all-too expansionary fiscal policy that leads to a growing deficit and high, volatile inflation has been common in emerging economies, but the problems have eased somewhat in recent years.<sup>27</sup>

Many emerging economies have or have had a fixed exchange rate as their monetary policy regime, as Sweden had until we abandoned it in 1992. Nowadays, most emerging economies have a certain degree of flexibility in their exchange rate regime even though none of them has a completely floating exchange rate (in accordance with the IMF definition).

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24 IMF (2015c).

25 Sims and Del Negro (2016) and Leeper (2016).

26 Georgsson, Vredin and Åsberg-Sommar (2015).

27 IMF (2015c).

A forward-looking monetary policy demands a clearly defined target and tools for the central bank. But in addition to the legal framework, a forward-looking policy also sets higher demands on the central bank, which pose a number of other challenges for emerging economies. Inflation targeting is based on forecasts and analyses of the economy. In many emerging economies, the capacity for policy analysis is often weak. Recruiting competent staff can be difficult and the statistics are inadequate.<sup>28</sup> Inflation targeting also sets higher demands on transparency and existing communication channels, which are lacking in most emerging economies.<sup>29</sup>

It is often unclear which monetary policy is being conducted. Several of the countries that have a flexible exchange rate have, in practice, a money supply target<sup>30</sup> with some elements of inflation targeting (Albania and Armenia, for example). A target for money supply or the monetary base, i.e. banknotes and coins plus a liquidity surplus, can be controlled by the central bank via 'market operations'. Market operations involve the central bank buying or selling domestic currency, or borrowing or lending domestic currency against collateral. A money supply target can be seen as an intermediate goal, while the main goal is to achieve stable prices. An inflation target is therefore a final goal where the central bank adjusts its instruments (the money supply or a policy rate) to achieve a specific inflation target. Most people agree that there is a correlation between money supply and price level. However, there is not complete agreement on how strong this correlation is or how quickly changes in the money supply have an impact on prices. As a result, most central banks have decided instead to set targets directly for the final target variable, i.e. inflation.

The majority of emerging economies are in the process of modernising and introducing some form of inflation targeting but with a more flexible application, for example a broader interval (see Appendix 1). Those emerging economies that despite everything stick to both exchange rate and inflation targets reflect problems with undeveloped financial markets and an inadequate transmission mechanism. An efficient transmission mechanism enables the central bank to disseminate its monetary policy in the economy. Undeveloped financial markets and fixed exchange rates or capital controls weaken the transmission mechanism, which is often the case in emerging economies.<sup>31</sup> There are studies, however, that identify well-functioning transmission mechanisms in many emerging economies, especially in those cases where the central bank has communicated its policy clearly and followed it up with actions.<sup>32</sup>

Another common problem for less developed economies is the government's poor management of its daily liquidity flows. This concerns, for example, tax receipts and payments of different transfers from the central government budget. In most countries (although not in Sweden), these payment flows are taken care of via the central bank. The central bank must therefore manage and take these liquidity flows into account when they are required to satisfy their counterparties' need for liquidity on a daily basis. Central banks normally conduct monetary policy by determining the price at which counterparties may deposit or borrow central bank money. The worse the government manages its cash flows, the more difficult it is for the central bank to make reliable forecasts. Accordingly, it may also be difficult to assess when they need to supply or withdraw liquidity from financial agents. This leads to difficulties for the central bank to control the general conditions for liquidity in the economy and may thereby reduce the effectiveness of monetary policy.

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28 Levy and Misch (2014) and Grigoli et al. (2015).

29 IMF (2015c).

30 Reserve Money Targeting Regime, TMTR.

31 Mishra, Montiel and Spilimbergo (2012).

32 Berg et al. (2013).

### 3.3.2 Particular challenges to design monetary policy

Even when designing the monetary policy itself, there are factors that differentiate emerging economies from advanced economies. For example, there is a greater need for flexibility in emerging economies and the central bank needs to take greater account of other factors such as employment or financial stability. The appropriate target level for inflation can also be affected by the way the economy works or the central bank may have low credibility.<sup>33</sup>

Just as in advanced economies, situations sometimes occur that require a trade-off between price stability and other political goals such as employment or financial stability. These can be difficult to handle but, the more confidence a central bank has acquired, the greater the latitude it will have when conflicts of interest like this arise in an economy.<sup>34</sup>

Emerging economies are often harder hit by various shocks, such as major fluctuations in the price of commodities and food and different types of demand and supply shocks.<sup>35</sup> The effects are different depending on whether the countries are commodity importers or exporters. Volatility in inflation and growth, as well as large out and inflows of capital, often arise in the wake of this. Central banks cannot influence fluctuations in commodity prices, but they can exert some influence on the secondary effects of rapidly rising oil prices, for example. A well-anchored inflation target can, for example, help to mitigate the effects of major changes in commodity prices and the exchange rate on inflation.<sup>36</sup>

## 4 The Riksbank's Technical Assistance

The Riksbank has worked with technical assistance for about 15 years to support a number of countries as they build up and develop a functioning central bank. Today this work is carried out within the framework of an agreement with Sida. This cooperation is called the Staff Exchange Programme and, as the name suggests, it concerns cooperation and an exchange between colleagues at the Riksbank and in the collaborating countries.

As already mentioned, the central bank plays a decisive role in the development of society. In emerging markets, the central banks face special challenges. The Riksbank wishes to contribute with its technical assistance to developing central banks in emerging economies. It is assessed as efficient to use the Riksbank's internal competence to work on concrete issues that the central bank in the cooperating country chooses itself, and which are important to the development stage in which the central bank finds itself.

### 4.1 Flexible cooperation and results-based management

The contents of the technical assistance are largely governed by demand from the central banks in the cooperating countries. But the Riksbank must of course have the competence that is in demand and the work should not overlap what is being done by, for instance, the World Bank or the IMF in the country. No two cooperation projects are the same, and they can focus on a range of issues, such as cash management and electronic payments to monetary policy with an inflation target, governance and management and communication. The Riksbank tries to help these countries' central banks to clarify their objectives and means, to build up and develop their analytical capacity and their decision-making processes and, from their varying starting points, to open up and create dialogue with important target groups to build confidence. It is important to be able to flexibly adapt the content to the needs for the cooperation to be successful.

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33 Huang and Wei (2003).

34 Dincer and Eichengreen (2014).

35 Zambia, Angola and Mozambique are examples of countries that are often adversely affected by these fluctuations. See further IMF (2015a, 2015b, 2016).

36 Mishkin and Schmidt-Hebbel (2007).

The Riksbank determines in consultation with Sida which countries it will cooperate with. Demand partly steers the choice of cooperating country. One important factor is that the central bank in the country can make use of the Riksbank's assistance and competence. Some infrastructure needs to be in place already, in the form of statistics, analytical competence and a functioning governance and management of the central bank. Most often, these have been countries that aim to introduce inflation targeting. The cooperation must also be in line with Swedish foreign policy in general.

Evaluating the technical assistance is of course very important, although it may be difficult. It often takes many years to reach a result. At present, the evaluation of technical assistance is aimed more at the results than the output, for instance, the IMF works with results-based management to an increasing degree.<sup>37</sup> The Riksbank also works on results-based management that is designed in a flexible manner and easy to follow up. Sida and the Riksbank have jointly produced a results framework that is adapted to the conditions of the cooperation.

The results chain covers planning, implementation, follow-up of results and evaluation of the programme. The results to which the activities refer are assessed on three time horizons, where the two first ones must be measurable: immediate (output), 1–2 years ahead (outcome) and long term (impact). The Riksbank works continuously with the results framework and the results chain and with cost efficiency. Each activity is planned and followed up according to the results chain. During 2018, some of the first follow-ups will be made, of activities carried out in 2015 and 2016.

## 4.2 Towards greater focus

The Riksbank's various cooperation projects begin at different points in time and they continue for different lengths of time. The current agreement with Sida runs between 2015 and 2019 and covers cooperation with the central banks in Ukraine, Kenya, Palestine and Namibia.<sup>38</sup>

The number of countries included in the agreement has varied, but in recent years the Riksbank has chosen to focus most of its resources on the Ukraine, Kenya and Palestine. Since the cooperation with the National Bank of Ukraine began in 2015, the Riksbank has contributed technical assistance more or less every month. The regular contacts between colleagues in Sweden and the Ukraine has led to better continuity and better results because the measures in the various areas that have been discussed in the cooperation are implemented more quickly.

Focussing on one or a couple of countries at a time leads to a greater pay-off from the activities, at least judging by the rapid development of the Ukrainian central bank. Regular and focused exchange increases the pressure to change. The actual activities are of course important, but things don't get really good until ongoing contact is established between colleagues via email, for example. Then one knows that they are continuing to work on the issues and that their competence is increasing. The Riksbank has also tried to develop operations by stationing a researcher in the field of monetary policy at the Ukrainian central bank for six months for the purpose of further deepening the collaboration.

The Riksbank has also chosen to focus the resources in the cooperation with Palestine. There the cooperation is not as comprehensive as in the Ukraine. Instead, the Riksbank has focused on electronic payments and management and governance issues. For the Riksbank, this delimitation has meant that one can have a greater impact and really contribute a comparative advantage. It has also been a simple matter to coordinate with the IMF and communicate what activities the Riksbank is undertaking.

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<sup>37</sup> Crandhall (2009).

<sup>38</sup> Previous cooperation countries have included Albania, Sri Lanka, Uganda and Vietnam.

### 4.3 Colleagues – one size doesn't fit all

The Riksbank's stance is to behave as colleagues and in various areas communicate how we work today, but also how developments in Sweden have looked historically and what potential paths one can take. It is important that the country in question builds up its operations on the basis of its own history, culture and its conditions with regard to organisation, technology and competence. It is often a question of explaining what the Riksbank did when it introduced an inflation target, the processes when the Riksbank reduced the number of offices issuing cash and how Sweden has succeeded in reducing the use of cash in society. Electronic payments and a reduction in the use of cash are at the top of the agenda in many emerging economies, partly because it is socio-economically efficient and contributes to financial integration, and partly because it can reduce corruption in many of these countries.

The Riksbank does not claim to be able to offer the best solutions to all of the cooperating countries' various problems. Instead, the Riksbank acts as a sounding board for ideas and demonstrates how we work on these issues in Sweden or how we have dealt with them historically. There may also be more technical exchanges that are based on domestic data and aim to construct simple forecasting models. If collaboration is to be productive and lead to long-lasting results, it is necessary that this work is based on peer collaboration and on each collaboration partner finding their own way of working that suits them.

The Riksbank's method of working with regard to technical assistance is slightly different from how many other central banks in advanced economies work. Often these have specific organisations devoted to technical assistance, or they channel funds via the IMF or the World Bank. Norway has its own model in which, together with the IMF, it appoints a single country to work with for 4–5 years. They work in approximately the same way as the Riksbank does, but also base a member of staff in the partner country for the entire period.

The Riksbank's technical assistance is popular and more requests are received for an exchange than can be met. The Riksbank is in the forefront in many fields, such as transparency, electronic payments and in the monetary policy field. Moreover, the Riksbank is considered to be one of the most cost-efficient central banks. The international community expresses a high level of confidence in the Riksbank and its work. This contributes to many emerging economies seeking to cooperate with the Riksbank.

The activities are also appreciated by the Riksbank's own members of staff. They provide an opportunity for development within the employee's own area of expertise and are seen as a challenging and rewarding experience. The Riksbank's employees mostly travel to Frankfurt, Basel or Washington, so the opportunity to learn how things work in countries like Ukraine or Kenya is particularly educational.

The Riksbank's work on technical assistance also receives some international appreciation, as the IMF and the World Bank are familiar with the work and the Riksbank's staff are asked to take part in so-called technical assistance missions together with the IMF.

In the field of technical assistance, the Riksbank thus works across the entire spectrum of issues that a central bank must manage. But each central bank has its own problems and issues. As mentioned earlier, no two assistance cooperation projects are the same. On the other hand, many of the central banks the Riksbank cooperates with have some challenges in common, primarily management and governance issues, as well as transparency and communication.

### 4.4 Key issues and practical development work

In Ukraine, Palestine and Kenya the multinational organisations, primarily the World Bank and the IMF, contribute substantial technical assistance. It is important that the Riksbank does not overlap their work but instead builds on or fulfils unmet needs. In Ukraine, the central bank also has a number of other bilateral collaborations. There it is important to have

a good contact with the Ukrainian coordinator of the technical assistance and sensitivity to what needs they express, for the purpose of making a difference and avoiding any overlap. In Palestine, the Riksbank has direct contact with the IMF's person responsible for the country and conducts a dialogue regarding the Riksbank's cooperation with Palestine and what assessments the IMF makes.

A good way of coordinating with the IMF and the cooperating countries is via the IMF's Annual and Spring Meetings. At these meetings the Riksbank meets the IMF's staff responsible for the countries and central bank governors of the respective cooperating countries to discuss the ongoing exchange, the IMF's work in the country and their assessment of the situation and needs there.

In Ukraine, the central bank has made considerable progress in recent years in cleaning up its financial sector. More than 60 banks have been liquidated and in 2016 one of the largest banks was nationalised, as it had been a major problem for a long time. The central bank is reviewing its entire organisation with the aim of focusing on core activities. Furthermore, great efforts have been made to open up and to communicate clearly and openly on a large scale. In the Ukraine, as in Kenya, the major multilateral institutions are contributing a lot of technical assistance, but, in practice, a certain degree of courage is required from top management to break old habits. This applies of course to corruption, which is widespread in all of the countries with which the Riksbank cooperates. It is also important to ensure that the central bank focuses on its core business.

#### **4.4.1 Organisational issues, management and governance**

When a partnership is initiated, it is almost always clear that there are shortcomings in the central bank's management and governance. The internal processes do not function properly, they are bureaucratic and hierarchical, which creates inefficiency and slow decision-making processes. As a result, the central bank governors are weighed down by a burden of thousands of small decisions and cannot get the ship to move forwards. The employees in their turn often feel they do not receive the information they need to be able to do their jobs properly.<sup>39</sup>

The cooperation therefore has to start with discussions on organisational matters, operational management and communication, both external and internal. For instance, the Riksbank can share its experiences of organisational development. The Riksbank has gone from being a central bank with over 1,000 employees in 1995 to the current level of about 330 people. Many of our cooperation partners are interested in this journey. For instance, over the last two years, the National Bank of Ukraine has gone from having 12,000 employees to 5,000. Its target is around 2,000. The central bank management says they have the Riksbank as one of their role models. Palestine is also asking for assistance with regard to organisational matters and management and governance. There the exchange will be directly between the top management of the Palestine monetary authority and the Executive Board of the Riksbank.

Closely related to this are the working areas of the risk division and the internal auditing division. They are crucial for a modern central bank. In recent years, the demand for technical assistance in these areas has increased, and the Riksbank is working to meet this demand.

#### **4.4.2 Communication and openness**

Another area in which we often carry out initiatives is communication and transparency. The Riksbank is a world leader with regard to transparency, as is usually shown in various studies, for instance, regarding the extent to which the central bank publishes its decisions, minutes

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<sup>39</sup> IMF (2015c), p. 17.

of meetings and decision-making processes.<sup>40</sup> The central banks the Riksbank cooperates with often request an exchange within communication and openness, otherwise this is something the Riksbank is happy to suggest as a cooperation area. Of course, openness and communication are not secondary activities, they are core operations for a central bank. Transparency leads to confidence in what we do, which is completely decisive for both monetary policy and financial stability.

In all of the Riksbank's current cooperation countries they have invested considerable resources in increasing transparency and communicating more in society. Kenya's central bank is producing a communication plan and they are working intensively on organising their internal communication as a tool for management and governance. In Namibia, the central bank is the local leader in the field of plain language, that is, communicating in a clear and easy-to-understand manner, partly due to the exchange with the Riksbank in this field.

A cooperation usually starts with a number of workshops in the partner country, allowing us to reach a broad cross-section of managers and heads. Then a couple of representatives are invited to the Riksbank to attend the monetary policy meetings and see the processes regarding an interest-rate decision, or alternately the process regarding the Financial Stability Report. This is highly appreciated and a good way of sharing knowledge – showing what we do in practice.

During 2016 and 2017 the Riksbank worked together with the central bank of Kenya in a number of areas, including communication and monetary policy. This process provides a good example of how the technical assistance works in practice. Three people from the communication department of Kenya's central bank came to the Riksbank and attended and watched and listened to all preparations for the monetary policy decision, the actual decision-making meeting and subsequent press conference, chats and everything else we do. A few weeks after the visit, they sent a concrete plan and strategy for how they plan to move forwards, both internally and externally, with a request for opinions and comments. They had quickly picked up on a lot of what was discussed during their visit, reworked it into a form that works for them and then asked for the Riksbank's feedback. During the next step, two representatives from the Riksbank's communication division travelled to Kenya and discussed the central bank's new communication plan. In April, employees from the monetary policy department at Kenya's central bank came to the Riksbank and followed the monetary policy process again, but this time with more of a focus on technical issues, such as forecasts and background data, how the Riksbank's Monetary Policy Department works together with the Executive Board and how decisions are finally reached. In this way, a whole chain is formed regarding the monetary policy work, which includes both communication and the technical aspects.

#### 4.4.3 Payments

Payments issues, cash management and electronic payments are also areas where the Riksbank's competence is increasingly in demand. When it comes to electronic payments and reduced use of cash, Sweden has come further than many other advanced economies.<sup>41</sup>

Both Palestine and Ukraine are requesting cooperation on payments issues. Common to both of these central banks is that they wish to increase efficiency and facilitate financial integration with the aid of electronic payments. Moreover, it is an important factor to reduce corruption and increase tax income. The more traceability and the less cash usage there is, the less latitude there will be for the black economy.

In Palestine, a decision has been taken for a national strategy for electronic payments, which is taking shape with the Riksbank's experts acting as sounding board. In collaboration with the Ukrainian central bank, the Riksbank has over the past year held a number of

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40 Dincer and Eichengreen (2014).

41 BIS (2016).

seminars in Kiev on this subject and experts from the Ukrainian central bank have visited the Riksbank to learn from the Swedish process towards a cashless society. Going forward, it is likely that demand in the payments area will increase further.

## 5 Summary

Central banks are a key part of society and one of the first institutions that need to be established when a new nation is formed. As new states have come into being, the number of central banks has also increased; in 1950, there were 59 central banks in the world, now there are almost 180.<sup>42</sup> The functions of a central bank in society are necessary in order to safeguard economic stability and growth. In emerging economies, however, central banks are faced with several complex challenges that place particular demands on the central bank.

The work to strengthen the central bank and ensure that it can carry out its tasks in society starts with the establishment of a legal framework for an independent central bank that prioritises price stability in the medium term. The law should also define a transparent and democratic process for accountability. Greater transparency is important and central banks themselves need to work to be more open and communicate their policy to the general public. Being the linchpin of the payment system and with its role as the bankers' bank, the central bank will always have a responsibility for financial stability. The central bank's most important task is to ensure that the country's own currency maintains its value – the price stability objective – which is normally referred to as monetary policy. For central banks in emerging economies, the conditions for monetary policy differ in several respects compared to advanced economies.

The Riksbank cooperates with central banks in emerging economies to contribute competencies and technical know-how in these countries. So far, the experience of such technical assistance is overwhelmingly positive, even if it takes a long time to bring about change in some cases. One lesson learned is that central banks can act as agents for development in the national economy. Central banks around the world, even in emerging economies, often have staff in core activities who have higher-than-average skills. In those emerging economies where corruption is widespread, it is not unusual for central banks to function better in this respect. The colleagues whom the Riksbank meets are often knowledgeable and ambitious, they demonstrate courage and can lead development. This has been particularly apparent in Ukraine. Central banks can therefore often act as 'white knights' among other public institutions. They often have a higher standing and are more respected than other institutions and the rest of the political system. Central banks and their employees can be perceived more as technical experts who many times, if not always, stand above their own self-interest and corruption. Central bank executives often possess a high level of competence and are internationally educated economists. Of course, this doesn't say so much about their competence in governing and leading a central bank. But it means that they want to deliver what they say they will deliver and are open and clear about their operations.

The key role of central banks in price stability and financial stability, which in turn constitute the conditions for healthy economic development in general, is a cornerstone of all societal development. Sveriges Riksbank – the world's oldest central bank – has a great deal of experience and know-how to contribute. We try to do this in the form of technical assistance. Our experience is that this provides results even if it often takes many years and there may be setbacks along the way.

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<sup>42</sup> Capie, Goodhart and Schnadt (2012).

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## Appendix A

Table 1. Monetary policy objectives in emerging economies

		Exchange rate regime	Target for money supply	Inflation target	Other
<i>One objective</i>	<b>Price stability</b>	Burundi Morocco Sao Tome and Principe	Congo Mozambique Sierra Leone Sudan Ukraine Uzbekistan	Armenia Georgia Ghana Guatemala Kenya Moldavia Zambia	Egypt
	<b>Exchange rate</b>	Cape Verde			
<i>Two objectives</i>	<b>Price and exchange rate</b>	Liberia Tajikistan	Afghanistan Madagascar	Indonesia	Kyrgyzstan
	<b>Price and growth</b>	Cambodia	Guinea	India Philippines	
	<b>Exchange rate and other</b>	Nicaragua			
	<b>Price and other</b>	Bolivia Guyana Honduras East Timor	Tanzania	Paraguay Romania Uganda	Vanuatu
<i>Three or more objective</i>	<b>Price, growth, exchange rate</b>	Ethiopia	Bangladesh		
	<b>Price, growth, other</b>	Vietnam	Malawi Burma		Mongolia Papua New Guinea
	<b>Price, exchange rate, other</b>		Nigeria Yemen		
	<b>Price, other</b>	Solomon Islands			Pakistan Zambia
	<b>Price, growth, exchange rate, other</b>		Gambia Rwanda		

Source: IMF (2015c).

Note. 'Other' refers to one or more of the following objectives: stability in the financial sector, promoting macroeconomic development, maintenance of external reserves and support to general economic policy. The regime classification is based on responses from IMF country managers.