Structural Power and the Political Sources of Central Bank Policy in Developing Countries

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SUMMARY

There is a wide variation in central bank policy stances across developing countries: Some central banks emphasise stability, in both prices and the financial system; some emphasise financial deepening; and some place equal emphasis on both goals. This thesis explores the argument that those who control the sources of finance on which countries rely for investment shape central bank policy stances. The argument has its roots in the theory of the structural power of capital; a theory which has remained under-explored for developing countries. This thesis seeks to contribute to the literature on structural power by further developing and probing the structuralist theory in the context of developing countries, notably those dependent on aid and natural resource rents. Combining insights from the literature on structural power and on the economic and political correlates of aid and natural resource dependence, I explore whether and how those who control the sources of finance on which countries rely for investment shape central bank policy stances. To explore these questions the thesis employs a combination of qualitative and quantitative methods. First, I use case studies from Kenya, Nigeria and Uganda to shed light on the mechanisms through which variations in a country's major sources of investible funds induce changes in the stance of central bank policy. Second, I explore the relationship between dependence on aid and on natural resources and the stance of central bank policy econometrically, using cross-national statistical analysis. The statistical analysis contributes to theory-building by developing quantitative measures of key theoretical concepts and probes structuralist theory by examining the generalisability of the findings of the case studies. Collectively, the evidence presented in this thesis suggests that power rooted in the control of capital helps to account for central bank policy stances. The results of my research contribute to extending the theory of the structural power of capital to finance in developing countries and to the debate about the costs and benefits of different economic development strategies.

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Acronyms

BNM	Bank Negara Malaysia
BoE	Bank of England
BoU	Bank of Uganda
CBK	Central Bank of Kenya
CBN	Central Bank of Nigeria
CBPRs	Central bank policy rates
CGAP	Consultative Group to Assist the Poor
DAC	Development Assistance Committee
ERC	Economic Recovery Credit
ERS	Economic Recovery Strategy
ESAF	Enhanced Structural Adjustment Facility
FDI	Foreign Direct Investment
FSAP	Financial Sector Assessment Programme
GDP	Gross Domestic Product
GIZ	Gesellschaft für Internationale Zusammenarbeit
GMM	Generalised Methods of Moments
GNI	Gross National Income
HIPC	Heavily Indebted Poor Countries
IFIs	International Financial Institutions
IFS	International Financial Statistics
IMF	International Monetary Fund
IT	Inflation Targeting
KADU	Kenya African Democratic Union
KANU	Kenya African National Union
KEPSA	Kenya Private Sector Alliance
KYC	Know-Your-Customer
LDV	Lagged Dependent Variable
MoFPED	Ministry of Finance, Planning and Economic Development
NDP	National Development Plan
NEEDS	National Economic Empowerment and Development Strategy
NRM	National Resistance Movement
ODA	Official Development Assistance
OLS	Ordinary Least Squares
PCSE	Panel-Corrected Standard Errors
PSI	Policy Support Instrument
SAD	Sector Adjustment Credit

SAL	Structural Adjustment Loan/Credit
SAP	Structural Adjustment Programme
SDR	Special Drawing Right
SELIC	Sistema Especial de Liquidaçao e Custodia
SIL	Sector Investment Loan
SMEs	Small and Medium Enterprises
TAL	Technical Assistance Loan
TSCS	Time-Series Cross-Sectional
UCB	Uganda Commercial Bank
US	United States

1 Structural Power and the Politics of Central Bank Policy

The global financial crisis re-launched the debate about the appropriate role of central banks in governing financial markets and the wider economy. Countries as diverse as Argentina, the United States (US) and India are currently considering the breadth of their central banks' mandates.[1] For much of the past three decades, there has been wide agreement among policymakers and scholars that central banks should focus on fighting inflation whereas other potential goals should play a secondary role.[2] While the view that safeguarding financial system stability is an additional key element of central banks' mandates has gained ground, the reignited debate over the extent to which, if at all, central banks should broaden their mandates and promote economic growth continues to rage.[3]

For developing countries, which need to increase growth and reduce poverty, this is an important debate. In general, their central banks are, compared to other public institutions, relatively well staffed and have expertise in the governance of financial markets. With the tools they already have, their central banks could promote both stability and growth. With the rise of neoliberal economic thinking, however, the dominant policy paradigm had become that central banks in developing countries should use their powers primarily with a view to promoting stability in prices and the financial system and leave the promotion of growth to markets. By putting the role of governments in governing finance back on the negotiating table, the global financial crisis has thus opened a window of opportunity to rethink the role of central banks in promoting economic development in developing countries.

[1] In the US, for instance, the central bank's dual mandate of price stability and full employment has been a subject of intense debate since central bank policy became expansionary in order to raise employment in the wake of the global financial crisis. There has also been continual criticism that the mandate of the Central Bank of Argentina, which had focused on monetary stability, was broadened in 2012 to include the promotion of "jobs and economic growth with social fairness".

[2] This stylised fact does not fit all countries, but rather captures the convergence of a large number of central banks in both developed and developing countries towards a framework for central banking prioritising price stability over other objectives (Eichengreen et al., 2011). Some central banks in developing countries in particular have given similar emphasis to other objectives such as exchange rate stability.

[3] In the vast majority of countries, central banks have been assigned, implicitly or explicitly, a financial stability mandate, although in some countries financial regulation and supervision has been delegated to institutions outside the central bank. Assigning central banks a financial stability mandate has been justified on the grounds that central banks tend to have more expertise in, and information on, macro-economic and financial market developments than other public institutions through pursuing their mandate to promote price stability. In developing countries, the decision to assign central banks a financial stability mandate as opposed to creating a separate financial regulator and supervisor also reflects capacity and resource shortages.

The debate on central bank mandates in developing countries mainly concerns the question of what weight central banks should attach to pursuing the goals of price and financial stability on the one hand and financial deepening on the other. Following Beck (2013: 4), I define financial deepening broadly as an increase in the volume of financial transactions in an economy. The divergence of views on the relative importance stability and financial deepening should receive in central bank policy is reflected in the variation of central bank policy stances across developing countries. Some central banks emphasise stability, in terms of both prices and the financial system; some emphasise financial deepening; and some place equal emphasis on both goals.

There is broad agreement and empirical evidence that both stability and financial deepening are important for economic development.[4] Historically, central banks in developed countries have played important roles in promoting both stability and financial deepening. While there may be trade-offs between stability and financial deepening, there may also be some synergies.[5] Why is it then that a wide variation in policy stances is observable and not all central banks in developing countries place

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[4] It is widely agreed that a reasonable degree of stability in prices and the financial system is a precondition for growth. The relationship between financial deepening and growth has however been subject to greater debate. While some economists identified a causal link from financial deepening to growth, for instance Beck et al. (2000) and Levine et al. (2000), others questioned the robustness of this link such as Arestis and Demetriades (1997), Rousseau and Wachtel (2011) and Andersen et al. (2012). On balance, the evidence suggests that the relationship between financial depth and growth is non-monotonic (Easterly et al., 2000; Arcand et al., 2012; Cecchetti and Kharroubi, 2012). At low and intermediate levels of financial depth, the relationship between financial depth and growth is positive but at high levels of financial depth this relationship turns negative. The two main reasons seem to be that as financial systems deepen, economic volatility and the probability of economic crashes increase (Minsky, 1974; Kindleberger, 1978) as does the risk of a misallocation of resources (Tobin, 1984).

[5] Trade-offs are likely to emerge where central banks attach different weights to different objectives. For instance, where a central bank places more emphasis on price and financial stability than on financial deepening, negative effects on the latter are likely. Everything else being equal, the tighter monetary policy and the more stringent prudential regulation become, the more costly credit grows, so that financial deepening becomes challenging. Similarly, where a central bank places more emphasis on financial deepening than on price and financial stability, stability is likely to suffer. Allowing a major and rapid expansion of credit to the private sector as part of the financial deepening process may raise inflation by creating excessive demand and pose risks for financial stability by increasing exposures to risk. While such trade-offs are often unavoidable to cope with challenges to the achievement of one particular goal in the short-term, these trade-offs may be addressed in the longer term by carefully choosing a combination of policies that reflects considerations of both stability and financial deepening. There may to some extent also be synergies between price and financial stability on the one hand and financial deepening on the other. A reasonable degree of price and financial stability is an important – though insufficient – precondition for financial deepening. Financial depth in turn may support guarding price stability by improving the functioning of the monetary transmission mechanism through which central banks seek to influence inflation. Deep financial markets may also help with guarding financial stability by providing alternative sources of funding during times of financial fragility. However, as the emphasis placed on stability increases, any synergies with financial deepening tend to decrease, and vice versa.

equal emphasis on both goals, stability and financial deepening? Answering this question lies at the heart of understanding diverse development paths.

In the following chapters, I argue that variations in the sources of finance on which countries rely to finance investment help to account for variations in central bank policy stances. This argument, which I elaborate in Chapter 2, has its roots in what has been labelled the "theory of the structural power of capital". This theory was originally developed mainly in the work of Block (1987: Chapter 3) and Lindblom (1977: Chapter 13) and is the subject of a small sub-literature within the broad literature examining the relationship between state and capital. The scholarship on the structural power of capital shares the idea that states face strong incentives to implement policies which are in the general interest of the business community because states need to maintain a reasonable level of economic activity in order to be able to finance the state apparatus and maintain the popular support needed for staying in power. In a capitalist economy, the level of economic activity is largely determined by discretionary investment decisions of the business community, so that states face, the theory of structural power hypothesises, "structural imperatives" to create a business environment that reflects the policy preferences of business. Jeffrey Winters (1994) took these arguments one step further by developing a framework for analysing the potential power of different categories and sources of investible funds, which I shorthand refer to as "investment resources". His framework suggests that differences in the sources of finance upon which countries rely for investment explain differences in the general orientation of their economic policies.

I began to examine structuralist ideas when I was struggling to make sense of the political economy literature that intended to explain variations in central bank policy. A political economy approach seemed appropriate because it could take into account the complex interaction between economic structures and political incentives. Yet the two prevailing political economy explanations for central bank policy were not wholly convincing.

One of these explanations, the political institutions approach, focuses on the role of political institutions such as electoral democracy in policymaking (Girma and Shortland, 2008; Haber et al., 2008; Huang, 2010). The central contention of this literature is that, without political institutions that limit government discretion, a government, relying on the financial system to provide it with funds, has "strong incentives to govern the financial system so as to facilitate its own political survival at the expense of the development of a banking system that can finance the private economy" (Haber et al., 2008: 2). This approach has two major shortcomings. First, by taking political institutions as a given instead of recognising their endogeneity, this approach has difficulties in providing a satisfactory explanation for the variation in policy stances among countries with similar institutional environments.[6] Second, by taking a predatory government as a starting point, this approach does not give due account to the possibility that power asymmetries between the state and the private sector might as well give rise to policies that support the general interests of business.

In contrast, the societal interest approach seeks to explain monetary and financial policy as the outcome of struggles among societal interest groups such as sectors or classes.[7] Policy is conceived as an exchange where politicians provide favourable policies to those constituencies with the greatest economic strength. State interests are considered to be quite flexible in responding to societal preferences. The major shortcoming of the societal interest approach is that it treats the state as merely responding to private demands, denying states an independent role as actors who proactively seek support for their preferred policies.

The approach focused on structural power, meanwhile, seemed more promising. It suggested hypotheses to explain variations in central bank policy stances in developing countries with similar institutional environments. It does that through recognizing that states have not only incentives for exploiting the private sector but also for being responsive to business in their own interest. From a structuralist perspective, states are not merely responding to private demands. Rather, policies are considered the outcome of the strategic interaction of interdependent actors, whereby policymakers try to loosen constraints attached to the provision of investment resources and seek to enhance their policy space (Winters, 1994). Finally, the structuralist approach seemed promising because it can take into account domestic and international factors that shape economic policy by offering a framework in which the "nationality" and international mobility of the key sources of finance as drivers of economic policy may vary. This is more fruitful than explanations focusing entirely on either domestic or international factors.

[6] Studies by Sylvia Maxfield (1990; 1997), for instance, suggest that there were significant differences in the orientation of central bank policy in Brazil and Mexico, even during periods when the quality of political institutions has been similar.
[7] See for instance Frieden (1991), Pagano and Volpin (2001) and Rajan and Zingales (2003).

Despite their potential, the structuralist arguments have remained under-explored and underdeveloped in the context of developing countries. Few researchers have applied the structuralist propositions to developing countries, and fewer still have done so for finance in developing countries.[8] Moreover, research on structural power has given much attention to explaining economic policy in countries where the structural power of business is strong because it provides a large share of investible resources. Many developing countries, however, rely to a significant extent on aid and natural resource revenues. In these countries, aid and resource revenues substitute for a considerable share of the resources usually provided by business, so that its structural power may be lower. Note that, throughout the thesis, I follow Winters (1996) and use the term "business" interchangeably with the phrase "private investors".[9] The variation across developing countries regarding the sources of finance on which they rely for investment and in the contribution of business to investment creates the kind of variation needed to further develop and probe the theory of the structural power of capital. It is surprising that few researchers have seized the opportunity to exploit this variation.

I seek to begin to fill that gap in the literature by further developing and exploring the theory of the structural power of capital in the context of developing countries. Specifically, this thesis contributes to the structuralist literature by extending the argument to contexts of dependence for investible resources on aid and on natural resource rents. In these contexts, I draw inspiration from Winters's argument that variations in countries' major sources of investment finance imply variations in the pattern of control of these funds, which may in turn explain variations in the orientation of economic policy. Extending this argument to the area of central banking suggests that those who control the sources of investible funds on which a country relies for investment may influence the stance of central bank policy.

In developing and probing this argument, I combine insights from the structuralist literature and literature on the economic and political correlates of aid and natural resource dependence. Based on this literature, I also develop two propositions. The first is that in developing countries which are more dependent on aid, the central bank policy

[8] Studies focusing on the structural power of capital in developing countries include Jesudason (1989), Hidrobo (1992) and Winters (1996). Work in the area of finance includes Maxfield (1990), Woo (1991) and Maxfield (1997). Yet these studies all relate to middle-income countries.
[9] Most works with an explicit commitment to the structuralist position also use the word "capital" to refer to private investors. However, the term "capital" may also refer to actual investment resources. I only use "capital" in the latter sense to avoid confusion.

stance is more likely to be stability-oriented. The second proposition is that in developing countries which are more dependent on natural resources, the central bank policy stance is more likely to be oriented towards financial deepening. Chapter 2, which presents the theoretical framework of this thesis, elaborates on these propositions and the mechanisms linking the sources of finance to a particular central bank policy stance. The chapter also outlines the lineage of the propositions, specifies the research questions and explains the methodology I applied in order to explore them.

In Chapters 3 to 6, I probe the structural dimension of capital's power, using country case studies and cross-country regression analysis. I selected Uganda, Nigeria and Kenya as country cases because these countries vary with respect to the sources of finance on which they rely for investment. The case studies, which are based on extensive field research, offer an interpretation of central bank policy trajectories in three developing countries in light of the theory of the structural power of capital. Moreover, as arguments linking aid and resource dependence to policy outcomes are often under-developed in a causal sense, I pay particular attention to revealing some of the mechanisms through which those who control countries' major sources of investible funds shape central bank policy.

The case studies of Uganda and Nigeria cover new ground, assessing the extent to which structural forces may shape policy in contexts where the structural power of business is constrained. Chapter 3 offers a case study of central banking in Uganda. It explores how donors, notably international financial institutions (IFIs) such as the International Monetary Fund (IMF), may gain power over policy in a context of aid dependence and encourage a stability-oriented policy stance. Chapter 4, which contains a case study of central banking in Nigeria, explains how increases in the government's access to and control of natural resource revenues may induce a central bank policy stance oriented towards financial deepening. The case study of Kenya, presented in Chapter 5, contributes to the structuralist literature by offering the first account of the structural power of private investors in an African country. I explain how reliance on private investors and donors as sources of investible funds may encourage a central bank policy stance which is oriented towards both stability and financial deepening.

Chapter 6 expands the scope of this research by employing three sets of cross-national statistical analysis: a logistic regression analysis of financial deepening policies, ordinary least squares (OLS) and logistic regression analysis of prudential regulation and a pooled time-series cross-sectional (TSCS) analysis of monetary policy in developing countries. Regression analysis is an unusual approach to probe structuralist propositions as most research in this tradition has relied on country case studies. The statistical analysis contributes to building the theory of the structural power of capital by developing quantitative measures of key theoretical concepts, such as measures of policy stances, and to probing this theory by examining the generalisability of my propositions. While each of the three sets of statistical analysis has methodological limitations so that no one set is entirely convincing on its own, the three sets of analysis in combination provide some support for my propositions. Specifically, the results suggest that central banks in countries which are more reliant on support by IMF programmes are more likely to have a stability-oriented policy stance whereas central banks in countries which are more reliant on resource revenues are more likely to have a policy stance oriented towards financial deepening. However, the statistical data and tools at hand pose difficulties in establishing causality; thus any conclusions on the roles of countries' major sources of finance in shaping central bank policy should be drawn by considering the evidence from both the case studies and the statistical analysis.

The final chapter of the thesis, Chapter 7, correspondingly reviews the combined evidence from the statistical analysis and the case studies. The main conclusion is that, collectively, the evidence suggests that the power arising from the control over investible resources helps to account for variation in central bank policy stances. The chapter also offers a summary of the major contributions of the thesis and some of its limitations, pointing out scope for future research. The thesis concludes by highlighting some implications of the findings for the debate about the orientation of central bank policy in developing countries. In particular, the case studies suggest that a policy stance which emphasises one goal and neglects the other may be costly for developing countries and that it may be beneficial to pursue a stance which simultaneously promotes stability and financial deepening. If central banks pursue a balanced approach to both stability and financial deepening in countries where they have a mandate to promote both goals, then they could play the role of agents of economic development. The goal I have set for myself in this thesis is to work towards a better understanding of the political sources of central bank policy, which is an important step in enhancing the contribution of central banks to economic development.

2 Theoretical Framework

This chapter begins the exercise of theory-building which will be continued throughout this thesis. In pursuit of this goal, the chapter outlines the theoretical lineage of my central argument, namely: those who control the sources of finance on which a country relies to finance investment influence central bank policy stances. The next section situates this research within the context of work on structural power. In the section that follows, I extend the theory to contexts where the structural power of private investors is more limited, namely with regard to aid and resource dependent countries. The final section ties everything together. It specifies the research question and testable propositions which combine insights from research on structural power, the politics of aid dependence and the politics of natural resource dependence. In addition, this section concludes by describing the methodological implications of my theoretical framework.

2.1 The Theory of the Structural Power of Capital

This thesis is rooted in the theory of the structural power of capital. Its original propositions, which were developed in the 1970s, mainly originate in the work of Fred Block, Charles Lindblom, Claus Offe and Albert Hirschman. These scholars come from different theoretical traditions but their research shares a concern for the *structural* power of business – power that derives from the capacity to deploy scarce investment resources. The theory is built on four interrelated propositions.

First, in capitalist societies, states, which I define, following Weber, as the organisational structures within which binding collective choices are taken and implemented over a given territory, are structurally dependent on a reasonable level of economic activity. As Block (1987: 58) points out: “This is true for two reasons. First, the capacity of the state to finance itself through taxation or borrowing depends on the state of the economy (....). Second, public support for a regime will decline sharply if the regime presides over a serious drop in the level of economic activity". Given the financial and political complications resulting from a decline in economic activity due to falling investment, there is constant pressure on the state to maintain a continuous flow of new investment or, as Winters (1996: 9) puts it, to satisfy a country’s “investment imperative”.

Second, in capitalism, the level of economic activity is largely determined by the discretionary investment decisions of private investors (Block, 1987: 58). Governments, which I define as the actors (e.g. party politicians, military administrators, civilian administrators) who occupy dominant positions within the state, control political power. However, the discretionary power over resources on which citizens and their leaders depend are concentrated in the hands of an unelected, unaccountable few: Investors deploy capital based on individual profit calculations and governments can rarely command business to use their investment resources in ways that advance the interests of society or benefit the state. Thus, to satisfy the investment imperative, governments are left only with the option to induce business to invest (Lindblom, 1977: 173-175; Winters, 1996).

The third proposition follows from the previous ones: Since the failure to meet a country's investment needs brings complications in the economic and political realm and because investment can rarely be commanded but must be induced, governments have strong incentives to create a political and economic environment that investors find responsive. As Winters (1996: 11) explains, inducements "are none other than government policies responding to the interests and objectives of capital controllers."[10] Where governments fail to be responsive to business the "ultimate political sanction is non-investment or the threat of it" (Offe, 1984: 244).

The fourth proposition relates to the mechanisms through which the preferences of those with structural power translate into policy. One mechanism used by private investors to influence policy is direct political participation, for instance in the form of lobbying.[11] Yet often this mechanism plays only a minor role in the exercise of investors' power because the mere *threat* that investors could reduce investment is sufficient to induce governments to be responsive to the preferences of business. Investment decisions are taken individually, based on profit calculations which take into

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[10] In their focus on power associated with control over resources these claims bear similarity to those of fiscal sociologists and resource dependence theorists. Resource dependency theorists argue that the actors who gain discretionary control over resources that are critical to the smooth functioning and survival of systems shape organisational activities and outcomes (Pfeffer and Salancik, 1978). The central contention of research in fiscal sociology is that the sources of finance on which a government has to rely influence the way a society is governed and organised (Goldsheid, 1958; Schumpeter, 1991[1918]; Musgrave, 1992). While works rooted in fiscal sociology focus on how the sources of *public finance* shape policy, works rooted in the theory of the structural power of capital focus on how the sources of finance on which the state *and society as a whole rely for investment* shape policy.

[11] Power rooted in direct political participation is also referred to as instrumental power. For a discussion of three facets of power – instrumental, structural and discursive power – see Fuchs and Lederer (2007).

account the policy environment. Therefore, investors do not need to consciously coordinate their actions to act in concert with one another. Governments in turn are aware of the link between dissatisfaction with the policy environment and investment rates. The mere *anticipation* of a downturn in investment following policies which are not in the interests of business may be sufficient to elicit responsive policies. Using Hirschman's classic categories, investors exercise power usually through the capacity and threat of "exit", an economic mechanism referring to disinvestment or relocation to other jurisdictions, rather than "voice", the political mechanism of interest articulation (Hirschman, 1970). Thus, structural power, which is rooted in the control over resources on which countries rely for investment, refers to a particular way of exercising material power, namely to the capacity to shape the behaviour of other actors without the need to resort to open coercion, active leverage, political mobilization, or conscious coordination of actions.

Based on the theory I have outlined so far, it is easy to imagine a structural relationship where the state responds automatically to the interests of the business community. This image is, however, too simplistic because the policy preferences of different groups are likely to diverge, hence the prevalence of conflict in responding to structural forces. Business, for instance, is a heterogeneous group. Its members share many policy concerns related to the investment climate but are not always homogenous in their demands thus governments may sometimes have to deal with conflicting demands (Winters, 1996). Similarly, policymakers within the state are not a unified group and there are struggles within the state about how best to satisfy the investment imperative. Moreover, the policy preferences of business and state may diverge because policies responding to business interests may not be in the general interest of society and there may be tensions between generating a favourable investment climate and patronage politics to support the political power base of governments. As Winters (1996) stresses, the many examples of states failing to satisfy the preferences of business and to circumvent the constraints business imposes on them suggest that the relationship between the control of investment resources and policymaking is far from mechanistic.

Moreover, there are factors mediating the structural power of providers of investible resources and the ability of states to respond to the policy concerns of these providers. They include limitations in a government's organisational coherence and access to resources which can replace those provided by business, which I will refer to as "replacement resources".[12] Maxfield (1990), for instance, shows in a case study of Mexico how the state's vulnerability to the preferences of domestic bankers with respect to central bank policy decreased when Mexico gained access to foreign bank loans, which were provided with limited conditions on its domestic economic policy. Woo (1991) describes and explains how the South Korean state managed to loosen conditions attached to resources supplied by donors like the US by exploiting South Korea's geostrategic importance and then used these resources domestically to pursue statist economic policies. That said, structural forces rooted in the investment imperative do press themselves on policymakers in all capitalist systems and failures to respond result in penalties. As Lindblom (1977: 187) puts it: "Businessmen do not get everything they ask for. But they get a great deal. And when they do not get enough, recession or stagnation is a consequence."

At least two further insights from Winters's research require elaboration to extend the theory of the structural power of capital to the analysis of central bank policy in developing countries. First, structural power operates not only in democracies but also in contexts without regular elections, many of which are developing countries. Most of the early works dealing with the structural power of capital have focused on the procedural democracies of rich countries and, as result, on the role of elections in translating the pressures arising from falling investment to policymakers. Yet, as Winters's analysis of Indonesia for instance shows, falling investment may also destabilise authoritarian regimes and state leaders may then be replaced through means other than elections, for example military coups (Winters, 1996).

Second, cross-national differences in the categories of finance on which countries rely for investment imply cross-national differences in the pattern of control of these funds, which may explain differences in the orientation of economic policy. This insight is rooted in a framework Winters (1994: 446-452) developed. It suggests that different categories of actors, not only business, have power rooted in the control of resources which may allow them to influence policy and that their potential power varies. Starting from the observation that there are different categories of finance that can be used to finance investment (private direct investment, interstate loans, state capital, etc.), Winters's framework highlights three major points.

[12] For a discussion of factors which mediate structural power see Winters (1996: 35-41).

- The discretionary control of policymakers varies for each category of finance. Policymakers tend to have limited discretion over the use of funds deployed by private investors. Discretion over the use of interstate loans, including aid, however, may be somewhat greater, although the conditions attached to the provision of such funds vary greatly and depend, for instance, on the reasons for which they are supplied.[13] Discretionary control over the use of funds is greatest in the case of state capital, raised for instance from state-owned enterprises.
- Higher conditions attached to resources mean that, insofar as policymakers want or need these funds invested, policymakers will have to create a policy environment that those supplying the funds find favourable. The policy environment is thus likely to reflect the preferences of those providers of capital whose investible funds are needed to achieve a level of economic activity that is sufficient to finance the state apparatus and maintain the government's popular support.
- Correspondingly, weaker conditions attached to resources mean policymakers have more political space to pursue their own policy agendas. Thus, as the government's control of funds with weaker policy constraints attached to them increases and as these funds constitute an increasing share of investible resources, the government's policy space widens. In some instances, it may widen enough to even enable policies that impinge on the interests of private investors.

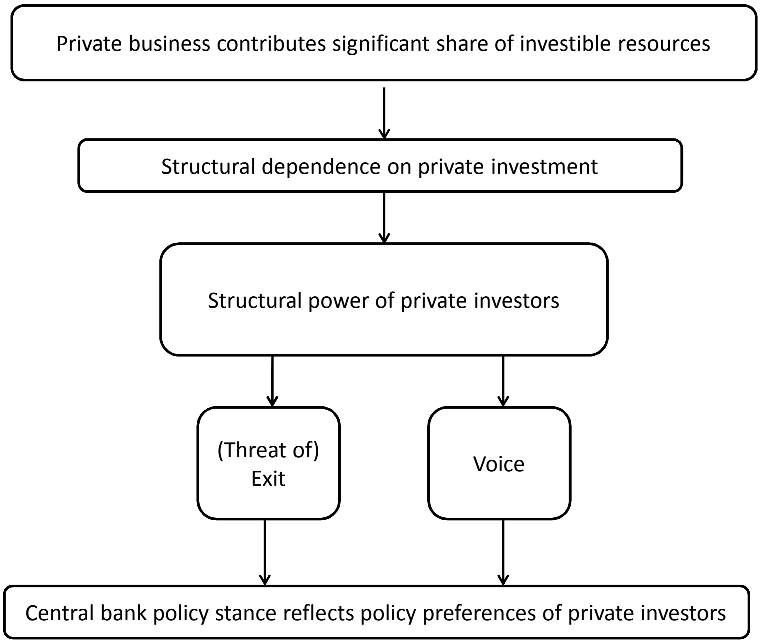
In addition, Winters's framework suggests that four main factors determine the power of the providers of a particular category of finance. First, the fraction of total investment finance the category constitutes and the degree to which it is invested in sectors and businesses that are important for economic prosperity, such as key earners of foreign exchange. Second, its ability to relocate to another jurisdiction, referred to as its mobility. Third, the extent to which resources with weaker policy constraints attached to them can replace that category of finance. Fourth, the discretionary control policymakers have over that particular category of finance.

This review of the literature on structural power outlined how considerations of power deriving from control over major investible resources may help to explain economic policy. Figure 2.1 illustrates an application of these insights to the realm of central banking. It shows that the structural dependence on investors, which implies limited

[13] For example, aid conditionality is likely to be lower for countries which are geopolitically important.

access to replacement resources, may increase investors' power to shape central bank policy through voice, exit or the threat of exit. This model provides a starting point for thinking about the relationship between structural power and central bank policy.

Figure 2.1: The Structural Power of Private Investors and Central Bank Policy



In exploring the political power arising from the control over crucial resources, my study falls squarely within the structuralist tradition. Few researchers have followed Winters and examined structuralist arguments in contexts where the structural power of private investors is constrained.[14] I build on Winters's work by exploring how structural forces shape the orientation of policy in contexts of dependence for investible resources on aid and on natural resource rents. Thus, I extend the theory of the structural power of capital in such a way that "capital" no longer refers to resources from business only but, rather, to the whole range of investible resources, including aid and resource revenues. Moreover, by combining elements from the structuralist theory with insights on the political economy of aid and natural resources, I develop a more predictive model than Winters, who argues that when "the structural leverage of investors is effectively blocked (…) one can account for the direction of policy changes only by looking at contextual factors that vary widely from jurisdiction to jurisdiction" (Winters, 1996: 141). The next section explains how, building on the literature on the political and

[14] On structural power in aid dependent countries see for instance Wood (1980) and Woo (1991).

economic correlates of aid and resource dependence, I seek to account for policy stances in contexts where the structural power of business is likely to be constrained.

2.2 Structural Power in Contexts of Aid and Resource Dependence

While it is not possible here to address in detail all the possible causal connections between aid or resource dependence on the one hand and the orientation of economic policy on the other, it is useful to consider three related questions to broaden ideas about structural power in contexts of aid and resource dependence and to develop propositions regarding the stance of central bank policy in such contexts. First, what are the implications of aid and resource dependence for the patterns of control of investible funds and for power over economic policy? Second, through which mechanisms can those who control aid or resource revenues influence policy? Third, what does the literature say about the economic policy preferences of those who control investment funds in aid and resource dependent countries? This section addresses these questions, looking first at contexts of aid dependence and then at contexts of resource dependence.

The Link between Aid Dependence and the Orientation of Economic Policy

Before exploring the link between aid dependence and economic policy, it is necessary to define what is meant by aid dependence. I define aid dependence as a situation where foreign donors provide a significant amount of the resources (i.e. funding and expertise) needed to maintain a level of economic activity sufficient to finance the state apparatus and maintain the government's popular support.[15] Very different types of actors fall into the category of foreign donors.[16] My focus is on Western governments, which are members of the Development Assistance Committee (DAC), and multilateral institutions, notably the World Bank and the IMF, as providers of assistance.[17] The reason for focusing on these two groups of donors is that they tend to have a significant

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[15] This definition is inspired by Bräutigam and Knack (2004: 157) who define aid dependence as "a situation in which a government is unable to perform many of the core functions of government (…) without foreign aid funding and expertise (provided in the form of technical assistance or projects)." My definition differs however in its focus on the reliance of the whole of society, and not only of the government, on aid because structural power derived from the control over resources is based not only on the ability to provide government finance but to provide investible funds for the economy as a whole.

[16] Some of the typical distinctions are: bilateral and multilateral donors, private and public donors (the former includes philanthropists), traditional donors and "new donors", whereby the latter refers to emerging countries engaging in South-South cooperation.

[17] Strictly speaking, the IMF is not a donor, partly because it does not give grants. I include the IMF in the category of donors because it is a crucial player in the international donor community as it provides financial and technical assistance in areas of economic policy and many donors make aid conditional on adopting an IMF programme and countries receiving positive reviews of economic policy from the IMF.

interest in influencing the orientation of economic policy in the countries they assist and that classifications of countries as aid dependent are usually based on the amount of resources countries receive from these two groups of donors.

But how can aid dependence be measured? One widely used indicator of aid dependence is net inflows of official development assistance (ODA) as a share of gross national income (GNI) and many studies apply a threshold of 10% to classify countries as aid dependent. This measure captures the degree of dependence by scaling aid to the size of an economy's income and is thus indicative of the extent to which aid constitutes a source of a country's investible resources and hence a source of power for donors. Another indicator of aid dependence is net aid inflows as a percentage of government expenditure. This measure captures the degree of dependence on donors by scaling aid to the size of government expenditure. The measure is thus indicative of the relative importance of foreign aid and government spending and hence the influence of donors.

The important analytical point and major difference between countries which are not reliant on aid and those that are is that in aid dependent countries, donors' resources may be large enough to replace a significant amount of private investment.[18] Donors' control and provision of investible resources in aid dependent countries may have two effects:

First, as aid dependence increases, the structural power of private investors is likely to decrease.[19] The underlying assumption is that as aid replaces an increasing share of the resources provided by private investors, dependence on the investment decisions of the private sector declines, as does the need to take policy decisions which are responsive to private investors. This assumption mirrors an argument that is often made in work on the relationship between the state's revenues and governance and in critiques of aid, namely that governments in aid dependent countries easily obtain funds from donors and therefore do not need to make much effort to promote economic development (Bräutigam and Knack, 2004: 263-264; Moss et al., 2006: 7-8).[20] From this perspective,

[18] The term "replace" conjures up the image that societies are free to choose among funds supplied by donors and by business. In fact, this is seldom true because donors base a country's eligibility for aid on economic and political considerations.

[19] Developing this argument for a broad range of replacement resources including aid in the form of inter-state loans, Winters (1996: 36) writes: "The impact of investors' structural leverage decreases as access to and control over investment resources that can replace those controlled privately increases."

[20] The underlying assumption is often that governments that are reliant on tax revenue as opposed to aid or natural resources have an interest in promoting the prosperity of the private sector as taxpayers in order

the effects of aid dependence are similar to the resource curse, as we will see below in the discussion of the correlates of resource dependence.

However, the view that aid dependence automatically or generally discourages policies that stimulate private investment is too simplistic for two reasons. One reason is that the investible funds that could be provided by large-scale business and foreign investors are often too large for their policy interests to be ignored by governments in aid dependent countries. Another reason is that, while donors and business may have interests in different policies, several economic policies are of common concern to both groups of actors, such as policies to create a stable economic environment and encourage private investment (Wood, 1980; Winters, 1996; Wade, 2003). That said, the policy concerns of businesses which only have limited mobility and investment resources may differ from those of donors. As the structural power of these businesses tends to be low, their policy concerns may receive lower priority than those of donors in countries reliant on aid (Winters, 1996: 91-92).

The second effect is that as aid dependence and thus the share of investible resources provided by donors increases, donors' power to influence policy is likely to increase. The underlying assumption here is that insofar as governments want or need support from donors they will have to be responsive to the policy concerns of donors. Often, becoming responsive to the policy concerns of donors involves changing a country's economic team because such a change permits signaling commitment to policy change to donors and placing personnel that is both committed and technically capable to implement responsive policies in key positions.[21]

Although donors may have considerable material power in aid dependent countries due to their control of significant investible resources and their ability to provide knowledge resources, their ability to influence policy is likely to be contingent on a range of factors. One factor is policymakers' discretion over the use of resources supplied by donors. While policymakers' discretionary control over aid depends on the channels the resources pass through and donors' motives for assistance, it is usually higher than the degree to which policymakers are able to control direct investment from private actors

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to maximise levels of tax revenue. Self-interest may thus lead tax-reliant governments to more actively seek to create conditions conducive to economic development (Bates, 2001: 69).

[21] Scholarship that links economic crisis and the subsequent dependence on external support to a change in economic teams includes Winters (1996) and Haggard and Maxfield (1993: 316-322).

(Winters, 1994: 448). Most of the assistance under consideration here are transfers by donor countries or multilateral institutions to governments and, as such, they pass through institutions of the recipient state, which opens up opportunities for policymakers to attach new purposes to donor funds as they are budgeted and allocated. Donors certainly attempt to tie these funds as much as possible to their own objectives and try to monitor their use. Yet, as Winters's study of Indonesia and Woo's study of South Korea suggest, governments are likely to make every effort to increase their flexibility in the use of aid. Moreover, as Winters (1994: 448) points out, there are limits to how far donors can go in auditing the books of a sovereign state. Resources supplied by donors are thus internally and externally controlled.

Donors' power is also contingent on their ability to coordinate. Donors often have different and competing objectives for giving aid, even among the relatively homogenous group of DAC donors, the IMF and the World Bank. Thus, in contrast to private investors, whose policy concerns tend to be more homogenous, donors often need to coordinate their actions to act in concert. If donor coordination is weak, recipient governments may be able to keep assistance high even if the conditions of some donors remain unsatisfied.

Through which mechanisms may donors influence economic policy? One mechanism is *voice*, often in the form of explicit policy conditionality, threatening to withdraw funds if there is no compliance with conditions. Explicit conditionality is, more than for other donors, central to the relationship between the Bretton Woods Institutions (the IMF and the World Bank) and recipient countries (Paloni and Zanardi, 2006). IMF arrangements, for instance, link the disbursement of tranches to the fulfilment of ex ante stated conditionalities. Sometimes donors also use cross-conditionality, that is they make the acceptance by the recipient country of the conditionality of one donor (often the IMF) a precondition for their own assistance (Griffith-Jones, 1992; Killick, 2006: 261). The empirical evidence suggests that explicit conditionality has often been ineffective in inducing the adoption of particular policies demanded by donors and that the effectiveness of conditionality depends on various factors, notably donors' willingness to withdraw funds if conditions are not met and domestic support for reform.[22]

[22] See for instance Mosley (1996), Collier et al. (1997), Killick et al. (1998), van de Walle (2005) , Collier (2006) and IEO (2007). Killick (2006) provides an overview of the literature questioning the effectiveness of IMF conditionality in shaping policy choices. Killick (2006: 256) also notes that in countries reliant on

While conditionality often seems to be ineffective, there is empirical support for the claim that donors have shaped the orientation of economic policy in developing countries (Boockmann and Dreher, 2003; Gómez-Mera, 2011). In particular, there is some evidence that donors have shaped policy by *encouraging social learning* (Kogut and Macpherson, 2008; Gómez-Mera, 2011). Social learning refers to the attempt to adjust policy in response to a new set of ideas. Hall (1993), who made a major contribution on the role of ideas in shaping economic policy, calls such sets of ideas "policy paradigms", as they specify the goals of policy, the kinds of instruments that can be used to attain them, and the very nature of the problems they are meant to be addressing. A focus on social learning is thus inextricably linked to a focus on the role of ideas in shaping policy. There is evidence to suggest that new ideas are more likely to lead to a change in the orientation of policy when: a) there have been policy failures associated with the old policy paradigm, leading to a search for a solution in the form of a new paradigm; and b) they are promoted by actors with political power (Hall, 1993; Gómez-Mera, 2011). In many aid dependent countries, donors are powerful actors owing to the resources they command and their resources may help them to promote solutions to economic problems based on their preferred policy paradigms.[23] In contexts of aid dependence, donors' power may thus help them to encourage social learning, in particular if there is an economic team whose policy interests parallel those of donors.

But social learning and voice are probably not the only mechanisms through which donors may shape policy. A third mechanism may be the *threat or possibility of exit* as recipient governments may be *aware* that the failure to be responsive to donors' policy concerns may lead to *exit*, which in this context refers to a suspension of aid disbursement, to re-directing aid to likeminded actors within or outside the state or to failing to provide additional loans. Recipient governments may feel pressure to be responsive to donor concerns because a withdrawal of aid would not only result in a loss of resources but may also send signals to other donors and eventually private investors that the policy environment is unsatisfactory.

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aid, macroeconomic policies have changed in directions reflected in the conditionality of the IMF and the World Bank but that it is unclear to what extent this is the effect of policy conditionality.

[23] As Hall (1993) argues, "powering" and "puzzling" often go together. In line with this, Harrison (2007: 200) observes for the African context that the IFIs have become increasingly strong intellectual actors in their endeavor to promote neoliberal reforms, generating data, producing research reports, and training civil servants.

That there may be situations in which certain donors influence policy without open coercion raises the question whether donors may, similar to private investors, exercise structural power. The answer is not deductively clear. Often donors exercise material power in a way that is non-structural, for instance by resorting to open coercion, using active leverage or making conscious efforts to coordinate their actions. There may however be circumstances in aid dependent countries where donors exercise material power in a structural manner, by shaping the behavior of other actors (the government or private investors) without the need to resort to open coercion, active leverage, or conscious efforts to mobilize and coordinate their actions.

One might for instance argue that the IMF may exercise some structural power in relation to central bank policy as it plays the role of a gatekeeper: Other donors, notably the World Bank, usually make the provision of aid conditional upon whether a country successfully participates in an IMF programme.[24] A country's successful performance under an IMF programme is often a precondition for getting foreign debts rescheduled, new credit extended or debt relief. Moreover, private investors often attach significant weight to the IMF's assessments of economic policy in deciding about investment in poor countries as information about their business environment is often difficult to obtain for investors. Thus, there is the possibility that a government pursues policies that are responsive to the concerns of the IMF *in the belief* that 1) the IMF reacts to policies deemed unfavorable by negatively assessing the performance of a program or suspending it and 2) that donors and private investors respond to the IMF's reaction by reducing aid and/or private investment.[25] The IMF would then pose powerful structural constraints on the range of policy options decisionmakers could safely consider.[26] The

[24] The IMF is the agency where conditions most often need to be accepted to obtain financial resources from other donors (Griffith-Jones, 1992: 60). In particular between the IMF and the World Bank there often exists "informal cross-conditionality": Without having a formal agreement in place, each of these institutions often only provides assistance to a country if it performs successfully under a program of the other institution (Griffith-Jones, 1992: 61-62).

[25] The empirical evidence that IMF programmes catalyse private capital inflows and lending by bilateral aid donors is at best mixed but this catalytic effect is widely believed to exist (Bird and Rowlands, 2002). To the extent that this effect is believed to exist, it will influence the behaviour of key actors such as donors and governments.

[26] In relation to policy areas other than central bank policy, other multilateral economic organizations may limit the policy space for developing countries. Gallagher (2005) and Wade (2003), for instance, describe and explain how the World Trade Organization limits the policy space for developing countries in the area of trade and industrial policy.

bottom line is that it is not a priori clear whether or not donors exercise structural power; rather this is an empirical question.[27]

That said, there is legitimate scope for disagreement, both theoretically and empirically, to what extent various kinds of donors might exercise structural power. For instance, there might be disagreement about the extent to which governments *believe* that other donors or private investors change their behaviour in response to the reactions of the IMF. There might also be disagreement about the extent to which an institution like the IMF encourages concerted action without conscious efforts to organise a response. Given this scope for disagreement it is thus not enough to simply assert that donors may have structural power. Rather it is important to examine how various donors exercise material power by being attentive to details of the interaction between donors and policymakers and to issues of perception and anticipation.

If central bank policy is responsive to donors, which policy stance may we expect? Although donors are a diverse group of actors and different donors have interests in different economic policies, several policies, including policies to enhance stability in prices and the financial system, are of concern to most donors. In linking the dependence on donors and central bank policy stances I draw on three distinct sets of literature, each of which suggests that the World Bank and the IMF, as key donors in the areas of central bank policy, have a preference for a stability-oriented policy stance.

The first set of literature comprises documents published by the IFIs to explain the objectives of their interventions. The second set of literature consists of work in economics and political science on the objectives of the IFIs in economic reform in developing countries. Both sets of literature conclude that the overarching goal of IMF lending and conditionality is the restoration of macroeconomic stability (Guitian, 1995; Collier et al., 1997; IEO, 2007; Abbott et al., 2010). To achieve this goal, the IMF considers the promotion of low and stable inflation to be essential (Epstein, 2006; Rodrik, 2006). Key goals of the IMF and the World Bank in financial policy have been the promotion of financial stability since the financial sector adjustment programmes in the 1980s and, until the global financial crisis, financial sector liberalisation, as reflected

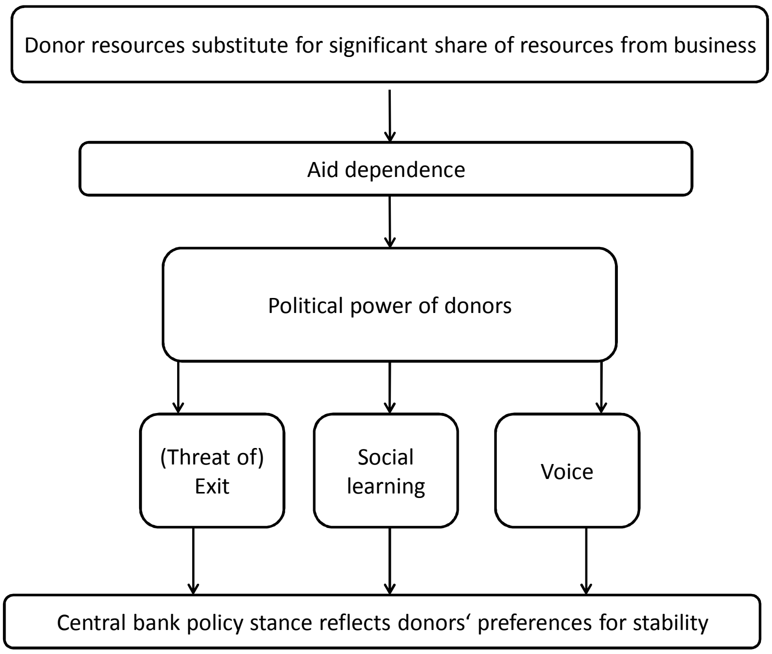
[27] We may also expect that the ways in which donors exercise material power differ across aid dependent countries. Harrison (2001), for instance, shows for Africa that there is a growing differentiation between states in aid dependent countries with respect to the nature of donor involvement and that in some countries donor-state relations are becoming less defined by direct coercion.

in the Washington Consensus (Cull, 1999; Rodrik, 2006; Beck et al., 2009). Financial deepening, an important goal of assistance before the 1980s, has only gained prominence again since the 2000s. Both sets of literature suggest that the view of both the IMF and the World Bank is that central banks may play important roles in deepening financial sectors but that financial deepening is, in contrast to price and financial stability, not among central banks' primary goals and should thus be afforded less importance (Honohan and Beck, 2007; Demirgüç-Kunt et al., 2008).

The third set of literature comprises work in political science on the sources of preferences of international organisations. This literature suggests that because the IMF tends to recruit staff trained and socialised in economics departments teaching neoliberal approaches, IMF policies tend to promote private sector-led development with a mainly supportive role for states, focused on ensuring a stable macroeconomic environment (Chwieroth, 2007). Moreover, the IMF and the World Bank are likely to pursue policies which reflect the interests of powerful member states as their major shareholders (Woods, 2006; Simmons et al., 2008; Mueller, 2011). Powerful states in turn are likely to have an interest in stable macroeconomic environments in developing countries, both to ensure the repayment of sovereign debt and to protect international investments in recipient countries.

Figure 2.2 summarises the discussion thus far. It illustrates how the provision of significant replacement resources may enhance the political power of donors. Exit or the threat thereof, voice and encouraging social learning may then allow donors to influence the orientation of central bank policy according to their preferences. By examining which influences operate in contexts of aid dependence where the structural power of business is likely to be weakened, which donors pose major constraints on policymaking, how various donors exercise power and to what degree various donors are able to exercise structural power, we can improve our understanding of structural power and further develop the theory of the structural power of capital.

Figure 2.2: Structural Power, Aid Dependence and Central Bank Policy



The Link between Resource Dependence and the Orientation of Economic Policy

The next important analytical concept covered in this thesis is natural resource dependence. I define resource dependence as a situation in which revenues from the sale – mainly export – of natural resources are important sources of funds needed to maintain a level of economic activity sufficient to finance the state apparatus and maintain the government's popular support. My focus is on point-source non-renewable resources such as oil and minerals to which large rents (that is the proportion of the sales value of a product that remains after all production and marketing costs have been accounted for) are often attached.[28] Studies on the economic and political correlates of resource dependence usually attribute the orientation of policy in resource dependent countries to the rents that can be generated from the exploitation of point-source natural resources.[29]

[28] Note that throughout the thesis I use the term "natural resources" to refer to point-source non-renewable resources.
[29] In the literature, natural resource dependent countries are often referred to as "rentier states" because rents are generated from the exploitation of natural resources, instead of resulting from production, investment, or the management of risk as in other countries (Ross, 2001; Jensen and Wantchekon, 2004).

There are various ways of measuring resource dependence, each capturing different aspects of the concept.[30] Widely used indicators of resource dependence are the value of natural resource exports as a percentage of exports or gross domestic product (GDP), or resource rents as a percentage of GDP. These measures capture the degree of dependence by scaling resource revenues or rents to the size of the economic output and are thus indicative of the degree to which natural resource exploitation constitutes a key source of a country's investible resources and hence a source of power. Another way to look at resource dependence is by expressing the measured quantity (e.g. the value of resource exports) as a share of government revenues. The respective indicators capture the degree of dependence by scaling the measured quantity to the size of a government's resource base, being thus indicative of the degree to which natural resources constitute a key source of a government's investible resources and to which a government relies on "unearned" income.[31] Unfortunately, reliable data on the proportion of government revenues from the extractive sector is difficult to obtain for many resource dependent countries. I discuss indicators of resource dependence in more detail in Section 6.1.3, which presents the explanatory variables of the quantitative analysis.

An important analytical point and difference between countries which are not reliant on natural resources and those that are relates to the pattern of capital control. In resource dependent countries, natural resource revenues may be large enough to replace a significant amount of private investment. In addition, governments tend to control a large portion of the revenues from the sale of point-source natural resources. In many countries, laws allocate the ownership of natural resources like petroleum to the state and governments may gain control of resource revenues through various ways such as revenues from a state-owned extractive sector or, if the extractive sector is in part or entirely private owned, through royalties, corporate taxes or concession fees.

What are the consequences if countries increase their reliance on natural resources as a source of finance? There may be two major effects. First, as the access to and control of

[30] Ross (2014: 4) develops this point nicely, pointing out that most measures of resource dependence have three components: First, the type of resource, that is whether the focus is, for instance, on oil, minerals or both. Second, the salient quality of the resource, such as the rents generated by the production or the value of exports. Third, the method used to normalise these values – that is, whether to express the measured quantity as a fraction of GDP, total exports, government revenues, etc. These three components can be combined in multiple ways to generate alternative measures of resource dependence.

[31] Following Moore (2001: 389), who introduced the terms "earned" and "unearned" income, resource revenues are unearned income because, in contrast to tax revenues, states do not have to put in organisational and political effort in working with citizens in order to get this money.

resource revenues by the state increases, the power of private investors and donors is likely to decrease. The underlying assumption is that as natural resources replace an increasing share of the resources provided by the private sector and donors, dependence on the funds they provide decreases, as does the need to take policy decisions which are responsive to the policy concerns of the private sector and donors.[32] This assumption mirrors the argument of work on the relationship between state revenues and governance, which suggests that governments not reliant on tax revenues have less interest in promoting the prosperity of taxpayers in order to maximise levels of tax revenue.[33]

Lower responsiveness to the private sector may be one reason for the resource curse, the paradox that greater abundance of natural resources tends to be associated with worse development outcomes. There are other reasons documented in the abundant literature on the pernicious effects of the exploitation of natural resources on development outcomes.[34] Windfalls from natural resource exports can, for instance, increase the real exchange rate of a country's currency and thus render most other exports non-competitive. This process is called the ''Dutch disease''. Another reason for the resource curse is that the volatility of resource revenues arising from international price fluctuations may hinder economic development, in particular because volatility makes it virtually impossible to implement investment projects that require long-term financing. Finally, the enclave nature of the extractive sector combined with its capital intensity creates only weak linkages to other sectors of the economy and little additional employment. As a consequence, talents go either into the extractive sector or the services industry which develops around it rather than into productive sectors.

What emerges from this discussion is that private sector development tends to face serious obstacles in resource dependent countries. As a result, relatively few private investors may have structural power, which derives from the control of a significant share of investible resources. The implication from a structural perspective is that as

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[32] See for instance Winters (1996) who examines how the structural power of investors was blocked in Indonesia when the country experienced oil booms.

[33] This argument is part of a wider literature arguing that governance tends to be better where the behaviour of the government is constrained by a need to bargain for their key financial resources with the actors who will be most affected by the consequences of the use of resources. Important scholarship in this area includes Chaudhry (1997), Ross (2001), Moore (2004) and Bräutigam et al. (2008).

[34] For an overview on the economic and political dynamics harming development see Gelb (1988), Neary and Van Wijnbergen (1986), Ross (2001) and Karl (2004).

policymakers' access to and control of resource revenues increases, voice and exit by the private sector pose weaker constraints on policymakers.

That said, trans-nationals in resource extraction are likely to be an exception. While the investments of these transnationals tend to be rather sunken and relocation thus difficult, the ability of these transnationals to redirect money for research and development and to expand extractive capacity in countries which compete in terms of the exploration and production environment is a source of structural power (Winters, 1996: 23). Thus, even as the access to and control of resource revenues by the state increases and the power of the non-extractive private sector may become increasingly undermined, the power of transnationals in the oil sector may remain significant in countries where governments want to keep the oil moving but have only limited or no production capacity. These governments may therefore have strong incentives to be responsive to the policy concerns of the extractive sector.[35]

The second, related effect is that as the access to and control of resource revenues by the state increases, the government's policy space widens. In resource dependent countries, governments gain access to a significant amount of investible resources over which they have discretion.[36] This pattern of capital control may allow governments to use resources in a way that reflects their views of how best to achieve the level of economic prosperity that ensures the popularity of the government and adequate state financing. What this amounts to is an inextricable link between economic and political power, which gives governments more policy space to pursue their own agenda.[37] In the exercise of power, governments do not have to use mechanisms such as voice and exit – they simply implement. As Winters highlights (1996: 36), the only limits on the state in the use of resource revenues stem from characteristics of the state itself, such as state coherence and internal capacity to implement policies.

[35] The policy concerns of the extractive sector are likely to be quite specific due to the enclave nature of the sector and to include policies to raise returns on investment and to protect investment and the security of staff in the extractive sector (Winters, 1996: 23-24; Frynas, 1998)

[36] The amount of resource revenues to which governments get access to and control of depends on several factors, notably the price of oil in international markets and the share of resource revenues that is deducted for private (in poor countries usually transnational) firms in the extractive sector. This share may range from 0, in the case of an entirely publicly controlled extractive sector, to some significant percentage which depends on the royalties, corporate taxes, concession fees and profit splits agreed with private extractive companies). Thus, the higher the oil price and the higher the share of resource revenues that remains after deductions for the private extractive sector, the higher the government's access to and control over resource revenues and thus its policy space, as Winters (1996) suggests.

[37] Winters (1996) shows for Indonesia, where transnationals play a major role in resource extraction, how rising oil prices and thus resource revenues increased the policy space of the Indonesian government.

Work on the economic and political consequences of resource dependence suggests that resource dependence leads to policies, institutions and frameworks for decision-making oriented towards spending and economic expansion, often at the expense of stability (Auty, 1994; Karl, 1997). Extending these insights to the realm of central banking suggests that countries which are more reliant on natural resources are more likely to have a central bank policy stance oriented towards financial deepening, which I, following Beck (2013: 4), define as a policy stance oriented towards increasing the volume of financial transactions.[38] This is because a central bank policy stance oriented towards financial deepening, which notably includes policies to increase the access to financial resources in an economy by lowering the costs of financing (for instance through loose monetary policy, lax financial regulation or central bank measures that subsidize the costs of credit), is in essence expansionary.

However, why do countries dependent on oil and other point-source natural resources choose expansionary and statist economic development policies in the first place? As laid out in Figure 2.3, explanations for this phenomenon fall into two broad categories, each of which in turn encompasses multiple, related causal pathways linking resource dependence to an expansionary policy stance. While further causal pathways exist, I will focus on explaining those most prominent in the literature.

The first category of explanations takes as its starting point that resource exploitation increases total government revenue. The literature suggests that there are two primary causal pathways linking increased government revenues to expansionary policy.

- The first causal pathway encompasses arguments centred on the idea that increased government revenues allow greater public spending. These arguments are based on the notion of a distributive state, which uses the resource rents extracted globally for distributing them internally. It has been well documented in the literature that governments facing the choice between spending resource rents on transfers to the private sector or public investment, and saving the rents, have usually opted for spending (Gelb, 1988; Karl, 1997). The reasons why governments spend rather than

[38] Note that my broad definition of financial deepening leaves open the purposes on which additional financing may be spend, reflecting the finding of the theoretical and empirical literature that financial deepening does not necessarily raise productive investment (Tobin, 1984; Easterly et al., 2000; Arcand et al., 2012; Beck et al., 2012; Griffith-Jones and Karwowski, 2013). Moreover, by choosing this broad definition of financial deepening I ensure that my definition encompasses the concepts of financial depth captured by various widely used measures such as the ratio of credit to the private sector to GDP.

save rents are economic and political. From an economic perspective, it is a sensible strategy for capital-scarce countries to invest funds domestically rather than abroad where the marginal rate of return is likely to be lower (van Der Ploeg and Venables, 2011). Politically, spending resource rents may be a sensible strategy to dispense patronage to political rivals and key constituencies (Ross, 2001; Morrison, 2009).

- The second causal pathway linking increased government revenues to expansionary policies is based on the argument that the scale of government revenues available from natural resource extraction encourages a struggle for resources, for instance in the form of rent-seeking or conflict (Karl, 1997; Kolstad and Wiig, 2009). When income opportunities are limited due to weakly developed private sectors, this may further increase the struggle for rents. Thus, in resource dependent countries, not only are the opportunities to distribute rents greater but the struggle for rents also grows, which may encourage expansionary policies.

The starting point of the second category of explanations for the prevalence of expansionary and statist economic development policies in resource dependent developing countries is the weakness of the private sector.

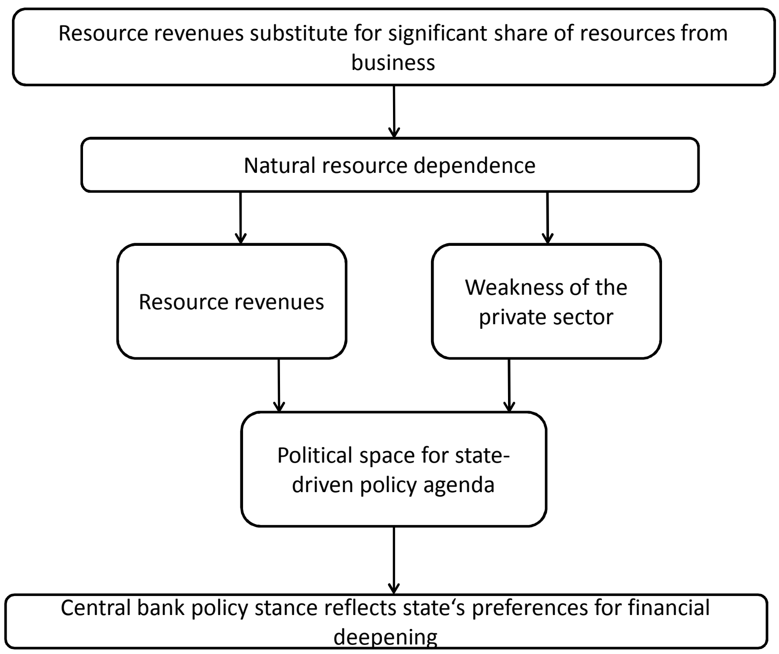
- One causal pathway linking weak private sector development to expansionary policies in resource dependent countries centres on the argument that due to their lower structural power private investors are not in a position to effectively demand restraining – and hence stability-oriented – policies and institutions if their general concern for a reasonable level of economic stability is violated (Winters, 1996).
- A second causal pathway linking weak private sector development to expansionary policies in resource dependent countries relates to the expansive role of the public sector. A corollary of the weakness of the private sector is that the state, strengthened by access to resource revenues, becomes considered the engine of economic development. As a result, the state may expand in new areas and new belief systems about the expansive role of the state may develop (Karl, 1997).
- Finally, the very phenomenon of weak private sector development may provide incentives for expansionary economic policies (Karl, 1997). Countries heavily dependent on a limited range of resource exports are likely to suffer from large macroeconomic shocks, transmitted by wide fluctuations in resource prices. Moreover, there is a risk that resources like oil and minerals may be exhausted or that resource revenues fall in response to technology shocks enabling the

exploitation of natural resources in ever more countries. For these reasons, the underdevelopment of productive sectors in resource dependent countries may lead to intensified efforts to develop and diversify the private sector through growth-oriented policies and improvements in access to finance for the productive sector.

A noteworthy implication of the previous discussion is that expansionary policy in resource dependent countries may serve to dispense patronage rather than to benefit the broader population. Similarly, a central bank policy stance oriented towards financial deepening in resource dependent countries may serve to increase consumption or to dispense largesse and patronage rather than to increase productive investment.

Figure 2.3 summarises the discussion of the relationship between resource dependence and the stance of central bank policy. It illustrates that access to significant replacement resources may reduce the structural power of the private sector and increase the policy space of the government to pursue a central bank policy oriented towards financial deepening. By examining how increasing access to resource revenues by the state may undermine the structural power of providers of investible funds such as business and certain donors and how it may widen policymakers' policy space, we can bring into sharper focus the structurally based limitations that may exist when governments have limited access to resource revenues. As Winters (1996: 139) argues, "we can learn as much about structural power when that power is severely undermined as when it acts to present strong constraints on the options policymakers can safely consider."

Figure 2.3: Structural Power, Resource Dependence and Central Bank Policy



2.3 The Research Agenda: Research Questions, Structuralist Propositions and Methodological Implications

The last two sections have hopefully conveyed how insights from three distinct fields of literature – work on structural power, the politics of aid and the politics of natural resources – can usefully be combined to examine the political sources of central bank policy. The structural forces shaping central bank policy in developing countries in general and in aid and resource dependent developing countries in particular have, however, been under-explored.

To redress this gap, this research sets out to explore two questions: First, do those who control the sources of finance on which a country relies to finance investment shape central bank policy stances? In other words, is there evidence that the pattern of control of investment resources has shaped central bank policy stances? Second, *how* do those who control the sources of finance on which a country relies to finance investment shape central bank policy stances? Specifically, do those who control investible funds influence policy through the threat of exit, voice or encouraging social learning? While there are many potential causal mechanisms I cannot explore all of them due to the need to keep the research manageable. Therefore, I focus on exit, voice and social learning, which the existing scholarship on structural power and aid dependence suggests are the most plausible mechanisms at work.

In addressing these research questions, I seek to achieve two goals, both related to theory-building. My first goal is to extend the structuralist theory to contexts of aid and resource dependence and probe the relevance of structuralist arguments for explaining policy in countries which vary with respect to the sources of finance on which they rely empirically. By examining power relations between the state and providers of investible funds in contexts of dependence on private investors, on donors and on natural resources, I exploit the variation that exists with respect to the structural power of business. I intend to contribute to building the structuralist theory by exploring which actors exercise power rooted in the control over investible funds, how these actors exercise power, to what degree different actors are able to exercise structural power, how their power varies with changes in the patterns of resource control and to what extent policy is responsive to the policy concerns of major providers of investible funds. My second goal is to understand the mechanisms through which power rooted in the control over investible funds translates into central bank policy. A better understanding of these mechanisms is particularly important because arguments linking aid and resource dependence to policy outcomes are often under-developed in a causal sense.

With these goals in mind, I have developed two structuralist propositions, which will be explored in the chapters ahead. As Winters (1996: 141) has pointed out, a consideration of the structural power of investors "is most helpful in predicting the character or orientation of a country's policies when the impact of structural power is high", not when this power is effectively blocked. Thus, in developing the propositions related to the direction of policy when the structural power of private investors is lower, I look beyond the literature on structural power. I build on insights from two sets of literature: First, literature on aid and on the policy preferences of donors, which control a significant share of investible resources in aid dependent countries. Second, literature on resource dependence and on the policy preferences of governments in resource dependent countries.

My first proposition is that in developing countries which are more dependent on aid, the central bank policy stance is more likely to be stability-oriented. This stance may be reflected in relatively higher aversion to inflation, more stringent financial regulation and a lower prioritisation of policies to promote financial deepening. The key underlying contention is that donors have power over economic policy in aid dependent countries and that, as the literature on IMF and World Bank policy discussed in the last section suggests, both institutions have long considered price and financial stability to be the primary goals of central banks. Smaller businesses in aid dependent countries may have a preference for a policy stance oriented towards financial deepening. However, in aid dependent countries, donors are likely to have more power than smaller businesses, so that central bank policy is more likely to reflect donors' preferences.

My second proposition is that in developing countries which are more dependent on natural resources, the central bank policy stance is more likely to be oriented towards financial deepening. This stance may be reflected in relatively lower aversion to inflation, less stringent financial regulation and a higher prioritisation of policies to promote financial deepening. This argument is based on the structuralist literature and the literature on the political economy of natural resource dependence. The former suggests that access to resource revenues increases the policy space of governments while the latter suggests that economic policy in resource dependent countries tends to be expansionary. As a policy stance oriented towards financial deepening is, in essence, expansionary, it is plausible that the stance of central bank policy in resource dependent countries is oriented towards financial deepening. As outlined in the last section, there are two major strands of explanations for the tendency of economic policy in resource dependent countries to be expansionary: The first suggests that access to resource revenues a) allows for an increase in public spending and b) results in higher demands that the resource rents be shared, each of which encourages expansionary policies. The second strand of explanations suggests that the weakness of private investors – a corollary of resource dependence – limits the constraints private investors are able to impose on policymakers' ability to pursue expansionary policies and propels the state into the position of being the main engine of economic development. Moreover, the very weakness of the private sector provides an incentive to pursue policies oriented towards growth rather than stability.

I do not make a prediction related to the stance of central bank policy in countries which have only modest access to replacement resources in the form of aid and natural resources and are thus reliant on private business for investment. Whether the central bank policy stance in countries reliant on private investors is oriented towards stability, financial deepening, or both, is likely to depend on the particular policy concerns of those groups of private investors that are important providers of investment funds. What these particular policy preferences with respect to central bank policy are is likely to depend on private sector characteristics that vary from country to country.

Underlying these research questions and propositions is the view that the general orientation of central bank policy is determined by the government which, in turn, responds to structural pressures. The rationale behind this view is that even in countries where central banks enjoy considerable independence, there are limits to independence insofar as the mandates of central banks and thus their policy goals are usually set by the government and legislature whereas the central bank has discretion over the techniques and policy instruments used to attain those goals and the precise setting of these instruments. In fact, the most widely accepted definitions of central bank independence refer to central bank discretion to choose policy instruments with which to conduct policy that accords with directly or indirectly determined electoral mandates for economic policy rather than central bank discretion over the goals of policy

(Maxfield, 1997: 20-22). Thus, in analysing the stance of central bank policy it is important to keep in mind that this stance is the result of actions of policymakers within the central bank but inextricably linked to the government's views of what should be the goals of economic policy.

Methodological Implications

Given the comparative character of the propositions, the goal to examine mechanisms linking the sources of finance and central bank policy and the aim of building a theory that it is applicable to a wide range of developing countries, I opted for a mixed-methods design, consisting of the use of case studies of Kenya, Nigeria and Uganda, and a quantitative statistical analysis. This approach allows us to improve our understanding of structural power by examining and contrasting the ways in which various actors exercise power and how structural power varies across time and place.

Each country case study offers a historical narrative of the trajectory of central bank policy from the foundation of the respective central bank to the present. The case studies have two broad goals: First, to trace shifts in central bank policy and link those shifts to changes in power derived from the control of crucial investment resources. In doing so, the focus of the analysis is on variation within countries over time. Second, to explore the causal mechanisms which link countries' major sources of finance and central banks' policy stances. The major challenge here is that the structural forces which shape policy are rarely observable. To address this challenge, each case study seeks to establish a plausible causal chain. Specifically, each case study effectively answers five interrelated questions to illustrate and evaluate potential causal linkages.

First, which are the key sources of investible funds and to what extent do the actors who control them have political power? To answer this question I address three issues: a) the relative importance of the source of finance in question in raising a country's level of economic activity; b) the pattern of control related to the key sources of finance, which is defined by the actors who can position themselves as key providers of financial resources and the conditions they attach to the provision of funds; c) the vulnerability of the state to the use of structural power.

Second, which policy stance do those who control the key sources of finance prefer and is the preferred policy stance in line with my propositions? I conducted extensive interviews with members of the government, the business and the donor community and used secondary literature and statistical data to learn about their policy preferences.

Third, is the policy stance in line with the preferences of those who control the key sources of finance? I have relied on both primary data from interviews and secondary literature to categorise the stance of central bank policy as oriented towards stability, financial deepening or both. I have based my categorisation on the goals of monetary and financial policies, the main policy instruments used to attain those goals and in some cases on the precise setting of these instruments.

Fourth, is there evidence to suggest that those who control the key sources of finance influence policy through voice, the threat of exit or encouragement of social learning? In exploring whether influence is exerted through voice, I searched for overt engagement in the political process, for instance through business associations. In exploring whether those who control the major source of finance shape policy through exit, I tried to identify actions such as changes in investment behaviour which signal policy preferences. Yet providers of investible resources usually take such actions only after the failure of policymakers to accommodate their policy preferences. Often power operates in a more subtle manner, through the threat of exit and thus government anticipation. To support a claim that power operates through the threat of exit, I describe the constraints that limit the policy space of policymakers, point out the government's perceptions about the policy concerns of those who control capital and show that policy becomes responsive to these concerns during moments of vulnerability to structural power. In exploring whether influence is exerted through encouraging social learning, I examined whether social interaction, for instance in the form of professional meetings and technical assistance, enabled those with structural power to transmit ideas about the orientation of central bank policy.

Fifth, is there significant evidence that the sources of finance on which countries rely for investment shape central bank policy stances? In making a final assessment of whether the case study provides sufficient evidence of the existence of a causal relationship I am making standard ceteris paribus assumptions. I do not expect that a particular source of finance will always lead to the proposed policy stance. Following other structuralists, I reject the notion that there is an automatic relationship between structural factors and policy choices. My intention is rather to show how structures constrain or enhance the choices some actors can realistically consider. Therefore, the propositions I developed are probabilistic not absolute statements. Consequently, failure to establish the proposed linkages in some cases is not enough to reject a proposition. What then is sufficient evidence to consider a proposition as plausible? While there are widely agreed standards of significance for statistical analysis, this is not the case for qualitative research. Therefore, we have to rely on more subjective standards. I draw inspiration from Prichard (2010) in considering a case study to provide sufficient evidence for the proposed relationships where an account of central bank policy can be meaningfully enhanced by including a country's key source of finance and the political power arising from the control of capital as an explanatory factor.

In constructing plausible causal chains, the case studies rely on various data sources, in particular academic literature, government documents, programme reports by donors and newspaper articles. In addition, quantitative economic and political data from ministries and central banks, the World Bank and the IMF supply a backdrop to the analysis. The key research inputs, however, are key informant interviews. I conducted more than 130 semi-structured interviews with central bankers, other government officials, donors, researchers and the business community (primarily bankers) during fieldwork in Kenya, Nigeria and Uganda. These interviews served to gather assessments of the central bank policy stance, key developments in central bank policy, the role of those who control a country's key sources of finance in shaping central bank policy and the economic and political implications of a central bank's policy stance.

In selecting the country cases, I focused on African countries because the structuralist theory has not yet been applied to countries of this continent.[39] The selection of Kenya, Nigeria and Uganda reflects both theoretical and practical considerations. A key theoretical consideration was that these three countries do not have regional monetary and regulatory authorities, hence the ability of their central banks to determine central bank policies at the national level.[40] In line with the goal of this thesis to examine structural power in countries which vary with respect to the sources of finance on which they rely to finance investment, I selected Kenya, Nigeria and Uganda as country cases.

[39] The term "Africa" refers to Sub-Saharan Africa in this thesis.

[40] I had to exclude countries participating in the West African Economic and Monetary Union (Benin, Burkina Faso, Cote d'Ivoire, Guinea-Bissau, Mali, Niger, Senegal and Togo) and the Central African Economic and Monetary Community (Cameroon, Central African Republic, Chad, Congo, Equatorial Guinea and Gabon) from the group of eligible African country cases from the outset.

As Table 2.1 shows, the relative importance of aid allows for Uganda to be characterised as aid dependent while the relative importance of resource revenues allows for Nigeria to be characterised as resource dependent.[41] Table 2.1 also suggests that moderate access to replacement resources in the form of aid and resource revenues and the relative importance of funds from the private sector to finance the state allow for Kenya to be characterised as dependent on the private sector. In maximising variation with respect to the main explanatory variable, a country's major source of investible funds, this approach follows what Seawright and Gerring (2008) call the "diverse case method". The ability of the German International Cooperation (GIZ), which funded a research project on finance in Africa in which I was involved, to assist in establishing contacts with the central banks of Nigeria and Uganda was the main practical reason for selecting these two countries.

Table 2.1: Sources of Investible Funds, Averages 2000-2010

	Kenya	Nigeria	Uganda
Net ODA received (% of central government expense)	21.6	12.7	77.6
Net ODA received (% of GNI)	4.3	1.9	14.3
Natural resource exports (% of merchandise exports)	12	94.9	5.1
Natural resource rents (% of GDP)	0.03	34.5	1.4
Foreign direct investment, net inflows (% of GDP)	0.6	3.3	4.2
Tax revenue (% of GDP), average 2006-2010	17.8	4.1	11.6

Source: World Bank (2013c)

Before moving on to the empirical illustrations, the two major limitations of the case study methodology should be flagged at the outset. First, the elaboration of three country case studies reflects the breadth of the research question but implies the need to be selective in order to keep the research manageable. Given the breadth of my study, it has always been clear that it was not possible to describe every policy change that supports the claim of a relationship between the sources of finance and central bank policy and that I had to select appropriate case material that conveys the nature of that relationship. I also decided to limit the analysis to two areas of central bank policy, namely monetary policy and financial policy. In analysing financial policy I focus on

[41] A widely used threshold to characterise countries as aid dependent is net ODA exceeding 10% of GNI. Countries are often categorised as resource dependent if resource exports as a share of exports exceed 30%.

central banks' development finance activities, regulation and supervision.[42] Moreover, while I am aware that other factors might account in a causal way for variation in central bank policy, I focus on examining the explanatory power of the key sources of finance, owing to the need to limit the scope of this research.

Second, the focus on only three country cases permits an exploration of causal chains and historical specificity but raises concerns about the generalisability of the findings. In particular, conclusions with respect to each structural proposition are based on only one case. While inference based on a single case is quite common for studies with a focus on theory-building, there is a large risk of selection bias.

The cross-national statistical analysis, presented in Chapter 6, seeks to address concerns related to generalisability. In exploring monetary and financial policy in developing countries across the entire developing world, the analysis sheds light on the domain of cases to which my arguments may apply; the so-called scope conditions. The statistical analysis is also fruitful in two other respects. First, it encourages the development of quantitative measures of some key theoretical concepts in my framework such as a policy stance oriented towards financial deepening. The development of measures of central bank policy stances in developing countries is an important contribution of this thesis because there was a lack of off-the-shelf quantitative measures of central bank policy which were adequate for the context of developing countries. Second, the statistical analysis can include some rival explanatory factors as control variables. The main drawback of the statistical analysis is the availability of data which, in turn, limits the regression techniques that can be applied and the ability to draw causal inferences.

Thus, there is a lot to be gained by using a mixed methods approach which provides insights on causal mechanisms through case studies and on the generalisability of my propositions through statistical analysis. As we will see, each case study and each set of statistical analysis provides partial answers. Each piece of analysis is thus best seen as an incremental step on the way to reaching an assessment of the plausibility of the structuralist propositions. The next chapters present the first three steps, beginning with the case study of Uganda, followed by the case studies of Nigeria and then Kenya.

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[42] The analysis of regulation and supervision is mainly related to banking services because non-bank financial institutions tend to be regulated by authorities other than the central bank.

3 The Political Economy of Central Bank Policy in Uganda

This chapter presents a narrative of central bank policy in Uganda from the foundation of the central bank in 1966 to the present. It traces the evolution of Uganda's central bank, the Bank of Uganda (BoU), from a central bank whose policies were primarily aimed at financial deepening to one of the most stability-oriented central banks in the developing world. My focus is on examining whether and how reliance on donors to finance investment has shaped this transformation. Not every policy choice reflects the political power of donors. The overall stance of policy, however, has become oriented towards enhancing stability in prices and the financial sector and, as we will see, policymakers chose this policy path in an understanding that it is important to secure the support from donors to finance investment and production in Uganda.

The chapter, which spans the years 1966 to 2012, comprises three substantive sections followed by a concluding section which emphasises the main insights.[43] The substantive sections deal with three distinct periods of Uganda's central bank policy.

- The first section focuses on the years 1966 to 1985, when both reliance on aid and responsiveness to donors was low. This section documents how central bank policy became ever more oriented towards financial deepening, seeking to expand credit to the state and the private sector. Yet the increasing neglect of stability considerations in monetary and financial policy and nationalist economic policies alienated both donors and private investors and contributed to the breakdown of the economy.
- The second section spans the years 1986 to 2004. In this section I explain how the BoU's responsiveness to the demands of donors to orient policies towards price and financial stability increased as the reliance on aid increased. I also describe the alignment of interests among donors and policymakers. An important sub-theme in this section is the tension between displaying responsiveness to donors and government efforts to control the allocation of resources according to its own priorities.
- The third section focuses on the years 2005 to 2012, during which reliance on aid continued to be significant. This section describes and explains the emergence of a central bank policy stance which still places significant emphasis on price and financial stability but embraces financial deepening as a policy goal. As we will see,

[43] Table 3.A1 in the appendix providers a chronology of the major economic and political events.

the emergence of a policy stance which looks beyond guarding stability appears to have been facilitated by two factors: One is the widespread perception in Uganda that the stability-oriented policy stance has failed to transform the structure of the economy and generate broad-based growth. The other is donors' increased concern for financial deepening.

3.1 Expansionary Central Bank Policy, Neglect of Stability Considerations and Alienation of Donors and Investors, 1966-1985

"We must (…) work for every cent before the bank can produce one cent. The bank is not, and will not be turned into a charity institution" (quoted in EACB 1966, 122). With these words Milton Obote, Uganda's President, opened the BoU in 1966, five years after the country had become independent. The central bank was expected to become a hallmark of stability. When presenting the Bank of Uganda Bill to the parliament, the minister of finance at that time, Laurence Kalule-Settala, explained for instance that government borrowing from the central bank would be strictly limited to avoid inflation because that would reduce the value and the confidence in the newly created currency and ultimately undermine economic growth (Mutibwa, 2006: 55-56). As a lender of last resort the BoU would be prepared to lend to commercial banks in difficulties, but only at a price and against first-class security. Policymakers involved in drafting the central bank statute were aware that a delicate balance between stability and growth would have to be struck (Mutibwa, 2006: 55-58). Still, there was an agreement that the growth of the economy could only be achieved through sound economic policies, as also reflected in the preamble of the BoU Act of 1966 which states that the BoU "(...) shall issue legal tender currency and maintain external reserves in order to safeguard the international value of the currency, promote stability and a sound financial structure conducive to a balanced and sustained rate of growth of the economy (...)."

Ugandan officials understood that without policies to guard price and financial stability it would not be possible to tap into much needed foreign resources and support. They considered a stability-oriented central bank important in order to increase confidence in the currency and attract foreign capital inflows (Helleiner, 2001; Mutibwa, 2006: 83). Moreover, a central bank focused on stability was important to garner support from the British in opening a central bank. The British supported the opening of central banks in their former colonies only if these banks were stability-oriented, fearing that central banks would employ activist monetary management which contradicted the monetarist approach advocated by the Bank of England (BoE) (Helleiner, 2001: 9-10).[44] Being responsive to the British was essential because Uganda had to rely on foreign assistance, mainly from the BoE, for staffing key positions in the BoU during its first years owing to the lack of indigenous central banking expertise. In fact, the main architect of the BoU Act was a British official, seconded from the BoE, who also served as the deputy governor of the BoU. The threat of donors and private investors exiting had thus been a concern for policymakers when the central bank was founded and the British, as an important donor for Uganda, had ample opportunities to articulate their preferences with respect to the orientation of central bank policy.

Economic Decay

In the ensuing years, however, mounting political and economic pressures made stability-oriented economic policies increasingly elusive. Uganda's private sector was weakly developed at independence and estimates of the value of the subsistence economy in 1966 set the figure as high as one third of the GDP (Schultheis, 1975: 6). The economy was dependent on coffee and cotton exports, which in the mid-1960s contributed 56% and 25% respectively of foreign exchange earnings (Mutibwa, 2006: 147). There was broad agreement among policymakers that both the government and the private sector needed more funds to develop Uganda's economy (Mutibwa, 2006: 165-169).

Financing was also needed to pursue the government's "Ugandisation" strategy. Indigenous entrepreneurs hardly existed in Uganda and most large-scale enterprises and manufacturing were Asian- or British-owned (Schultheis, 1975; Kasozi, 1994; Moncrieffe, 2004). A major focus of public policy in the first decades after independence was thus on promoting the development of African traders and enterprises. A key element of this approach was the provision of subsidised credit to indigenous businesses, mainly through the state-owned Uganda Commercial Bank (UCB). In the name of "Ugandisation" both the regimes of Milton Obote (1962-1971) and Idi Amin (1971-1979) also nationalised foreign enterprises. The Amin regime also compulsorily purchased 49% stakes in three major foreign banks (Brownbridge, 1998a:

[44] There were also economic reasons why the British were against the foundation of central banks in their former colonies. In particular, they sought to preserve the Sterling area because it offered a source of balance of payments support and bolstered the City of London as a financial centre (Helleiner, 2001: 10).

131). The "Ugandisation" policy culminated in the expulsion of Uganda's Asian population in 1972 and the nationalisation of their firms by Amin's regime. The parastatal sector expanded through such nationalisations, as did the sector's financing needs. When military expenditure escalated under Amin, this put further strains on the government's budget. Thus, mobilising finance for the government and the development of the parastatal and private sector became a major concern for Uganda's policymakers.

Options for raising finance for the government and the private sector were, however, limited. Uganda's banking sector, which was mainly foreign-owned, was weakly developed in terms of size and diversity at that time and by focusing on short-term trade-related financing banks made only a limited contribution to meeting the country's financing needs. Instead banks' lending policies nurtured the belief that government intervention was necessary to ensure that the banking system made a greater contribution to the development of the economy (Brownbridge, 1998a: 127). Uganda's export volumes fell sharply between 1973 and 1980, with the decline amounting to an average of -9.5% per annum. Exports thus made an ever-lower contribution to financing investment. Uganda also experienced a prolonged decline of private investment. Increasing hostility towards the Asian community and plans to nationalise major firms had already depressed investment and increased capital outflows under Obote. In 1970, for instance, this decline amounted to about 4% of GDP (Schultheis, 1975: 10). Yet after Amin expelled the Asian minority in 1972, which denuded the country of skilled businessmen, capital flight was rampant and investment collapsed.[45]

Official development assistance to Uganda was low, amounting to a mere 1.7% of GNI during the 1970s, and under Amin, Uganda did not receive bilateral aid from Western countries. The contribution of aid to meeting the country's foreign exchange needs was thus negligible. The prospects for an increase of aid were bleak during the 1970s owing to the authoritarianism and militarism of Amin's regime. In short, Uganda's financing needs at that time far exceeded the financing available and there were severe shortages

[45] Figures for private investment for the 1960s and 1970s are not available but the available data for total investment (i.e. including public and private investment) is instructive: While investment in African low-income countries grew on average 6.3% between 1965 and 1973, the corresponding figure for Uganda is only 2.1%. In the following years Uganda's situation deteriorated: Investment growth between 1973 and 1980 was -9.1 % whereas the average for other low-income countries in Africa in the same period was 1.6% (Lateef, 1991: 22). Foreign direct investment during the 1970s was almost absent, amounting to an average of 0.02% of GDP (World Bank, 2013c).

of foreign exchange resulting in persistent balance of payment difficulties (Schultheis, 1975; Lateef, 1991; Mutibwa, 2006:147-169).

The state, including the central bank, was the most conceivable source of finance and in the eyes of Uganda's politicians, the BoU was ideally placed to govern the financial system in a way that supported financing the economy, notably the government. The global ideological climate appears to help account for the orientation of central bank policy to financial deepening during the BoU's first two decades. It was part of the predominant economic thinking at that time that states may play an activist role in financing development and many governments in developing countries pursued statist economic policies in the financial sector, supported by IFIs like the World Bank (Beck et al., 2009) and bilateral donors like the US government (Helleiner, 2001). That central banks would focus on meeting the financing needs of the state and the economy at the expense of safeguarding economic stability was not conceived by development economists and donors promoting such an approach, however. Nonetheless, this is what happened in Uganda from the early 1970s onwards. The BoU became, in the words of one observer, a mere service department for the government (Mutibwa, 2006: 260).

The BoU's monetary and financial policy became increasingly focused on financing the government and the private sector, rather than on guarding price stability. When Amin came to power through a military coup in 1971, one of the first steps of his government was to issue a decree to amend the BoU Act which increased the amount of money that the government could borrow from the BoU to finance its expenditure (Mutibwa, 2006: 188-189). From 1973 onwards, the government regularly exceeded the statutory limits of government borrowing from the BoU that were set at 18% of recurrent revenues in the BoU Act. In 1979, for instance, the government borrowed 5.3 billion Ugandan Shillings, whereas the statutory limit was 1.3 billion (Mutibwa, 2006: 390).

In order to improve access to finance for the private sector, the BoU created for instance credit schemes through which it sought to promote bank lending to agriculture. The BoU also regulated the allocation of financial resources in the banking sector by means of interest rate and foreign exchange controls. When inflation rose, nominal interest rates were seldom adjusted in response. Therefore, real interest rates were negative for much of the 1970s and 1980s (Brownbridge, 1998a: 128). The interest rate controls supported the government's strategy to allocate investment funds to sectors considered important to economic development such as agriculture and to channel funds to political constituencies.

Orienting central bank policy towards financial stability received less attention and neither the BoU nor the government sought to address deficiencies in the Banking Act of 1969, the framework for the prudential regulation and supervision of banks. For instance, the Banking Act did not impose clear restrictions on insider lending and was more explicit on allocative than prudential requirements (Brownbridge, 1998a: 137). Moreover, the Banking Act did not grant the BoU the authority to force banks to improve management, lending practices and internal controls unless the BoU had the support of the Ministry of Finance (Brownbridge, 1998a: 136-137). The Ministry of Finance also had the authority for bank licensing. Often, however, the Ministry of Finance gave priority to political rather than stability considerations. It sometimes granted, for example, licenses to undercapitalised banks, often justified in terms of the need to support the development of local banks (Brownbridge, 1998a: 134). The BoU did not adjust minimum capital adequacy requirements to rising inflation and thus banks' capital buffers were inadequate. Supervisory capacity within the BoU was also too weak to discharge many of the functions assigned to it and thus was unable to detect problems within the banking sector (Brownbridge, 1998a: 133). When the UCB and several local banks, which emerged in the 1980s, ran into financial difficulties, the BoU did not strengthen and enforce regulation but rather provided unconditional liquidity support.

The BoU's ever-increasing focus on financing the economy and the state apparatus was probably meant to make up for the fall in aid and private investment. By the 1980s, however, investment and production were close to collapse and the state faced a fiscal breakdown. In addition, there was a chronic shortage of foreign exchange (Mutibwa, 2006: 453-506). The BoU's monetisation of rising government debt contributed to inflation. Inflation rose from a modest 6% in the period between 1965 and 1973 to 45% in the period between 1973 and 1980 and skyrocketed in the 1980s, averaging 95% per annum between 1980 and 1987 (Lateef, 1991: 21).[46] Interest rate controls combined with high inflation generated negative real interest rates, which, in turn, depressed saving and lending to the private sector. Moreover, most of the productive sector

[46] For comparison: Inflation in low-income sub-Saharan Africa averaged 19% per annum in the 1973 to 1980 period and 28% per annum between 1980 and 1987 (Lateef, 1991: 21).

remained excluded from the credit it needed for production and investment owing to credit rationing in response to economic volatility, conservative lending policies of foreign banks and the direction of most subsidised credit to politically connected individuals. As Figure 3.A1 shows, bank lending to the private sector was marginal throughout the 1970s and 1980s, averaging 3% and 5% of GDP respectively. Growth fell at an annual rate of -6.2% between 1973 and 1980 and -2.4% between 1980 and 1987 (Lateef, 1991). Domestic investment collapsed in a business environment of rationed access to finance and rising inflation. Donors, however, were not inclined to substitute for the fall in financing from investors in the absence of stabilising policies and due to the political repression under Amin. Political instability and intermittent civil war were important causes of the economic crisis.[47] Yet the crisis was compounded by a policy stance which sought to provide finance to the public and private sectors at the expense of price and financial stability (Brownbridge, 1998a; Tumusiime-Mutebile, 2010).

In an effort to reverse the economic decline and entice donors, the regime of Obote, which had come to power through elections in late 1980, attempted stabilisation. In 1981, the government agreed on a structural adjustment programme (SAP) with the World Bank and the IMF. As Figure 3.A2 shows, aid, which had increased significantly after the fall of Amin in 1979, reached high levels between 1980 and 1983, peaking at 10% of GNI in 1981. However, the government soon violated the conditions of the SAP relating to fiscal restraint. Budget discipline deteriorated when Uganda's civil war intensified and government revenues were too low to cover expenditures. Moreover, the government did not dare to impose austerity on the public sector out of fear of losing popular support (Mamdani, 1990; Lateef, 1991). As a result, the government resorted to the BoU's printing press and inflation rose, breaching agreed fiscal and monetary benchmarks. The SAP was abandoned in 1984 with the initial recovery of the economy reversed.

[47] Idi Amin was overthrown in 1979. In 1980, after the short presidencies of Yusufu Lule (April-June 1979), Godfrey Binaisa (1979-1980) and Paulo Muwanga (May –December 1980), Milton Obote won allegedly rigged elections and became again President. Obote was overthrown in a military coup in 1985. Tito Okello, one of the leaders of the coup, became then President until 1986 when Yoweri Museveni came to power. It is estimated that politically inspired violence caused deaths of at least 800,000 Ugandans between 1971 and 1985 (Tripp, 2010: 23).

3.2 Aid Dependence and Orientation of Central Bank Policy towards Stability, 1986-2005

In 1986, Yoweri Museveni, the leader of the National Resistance Movement (NRM), which had been fighting Obote's regime since 1980 from the bush, came to power. When Museveni became president, he promised to pursue economic growth, political stability and legitimacy. Museveni was aware that to achieve these goals, he had to reverse the economic decline by restoring economic stability and raising the levels of investment. "The Museveni regime," explained a senior official of the BoU, "has always had an understanding of what is good for growth." Private investors, both domestic and foreign, would not start investing until the business environment had improved and the economy stabilised. Therefore, wooing donors was a priority. Donor support was desperately needed to obtain foreign exchange, reschedule foreign debt, reduce borrowing from the BoU and finance economic reforms. An important initial step was to negotiate new programmes with the World Bank and the IMF because only if these programmes were in place would bilateral donors step up assistance.

Yet when several months after Museveni came to power his economic ministers first suggested a new SAP supported by the IMF and the World Bank, Museveni disapproved. Museveni had been a student of Marxist ideas and had criticised World Bank and IMF policies, including the SAP under Obote, on the grounds that these policies had not only failed to restore economic prosperity but had rather increased indebtedness (Mugyenyi, 1991: 63-67; Tumusiime-Mutebile, 2010). The NRM's policy agenda, summarised in the 10-Point Programme, was aimed at building an "independent, integrated, self-sustaining and mixed economy" which combined private-sector-led and state-led development. Adopting an IMF and World Bank supported SAP would mean accepting a programme which promoted the private sector as the main engine of growth, reduced the role of the state in the economy and increased the influence of foreign providers of capital.

In 1986, however, the economic situation deteriorated further: government expenditure escalated, partly owing to ongoing civil conflict, the volume of exports declined due to a fall in world coffee prices and the balance of payment deficit increased. The new government also sought to meet expenditures by borrowing from the BoU, which contributed to skyrocketing levels of inflation, reaching 160% in 1986 and 200% per annum in 1987. The NRM realised that a prolonged economic crisis would become a source of political instability and, anxious about popular discontent, the regime considered a change of the orientation of economic policy (Mugyenyi, 1991: 70).

In November 1986, the NRM decided to begin serious negotiations with the IMF and in 1987 Uganda embarked on a SAP. The SAP allowed the government to raise donor financing, notably several large credits from the IMF and the World Bank (an overview is provided in Tables 3.A2 and 3.A3 in the appendix). The World Bank and IMF programmes also triggered assistance from bilateral donors. By 1990, aid from members of the DAC had increased by nearly 600% compared to the level of such aid in 1985. The overall nominal net inflow of ODA had gone from US$192.3 million in 1986 to US$668 million in 1990 (Stein, 2009: 18). The reform programme of the late 1980s and 1990s in Uganda followed the broad principles of the Washington Consensus. Getting prices right (e.g. through exchange rate and tax reform), establishing fiscal discipline and macroeconomic stability, helping markets operate (e.g. through trade reform) and an emphasis on private sector-led development (e.g. through privatisation) were considered as the best strategy to increase investment and production.

During these years, encouraging social learning through policy advice and technical assistance was an important mechanism through which donors shaped policy. "In the early days of the NRM government, IMF and the World Bank more or less ran a macroeconomic classroom with the president", according to an IMF representative (Holmgren et al., 2001: 136). An equally important mechanism through which donors sought to shape policy, however, was the use of conditionality (Holmgren et al., 2001). The pressure on the Ugandan government to comply with conditionality was high because structural adjustment loans were released in tranches and donors were able to delay disbursements when the government failed to implement measures as agreed upon.

There was some early progress in devaluing the exchange rate as agreed with the IMF and by 1990 the government had largely liberalised the foreign exchange market. Yet reigning in inflation seemed elusive because the Ministry of Finance was not entirely committed to macroeconomic stabilisation and structural adjustment (Tumusiime-Mutebile, 2010). Expenditures continued to exceed revenues and the government financed the gap through borrowing from the BoU. For this reason, inflation continued to be high, as Figure 3.A3 in the appendix shows. Stabilisation policies also faced strong domestic opposition from: line ministries trying to avoid a reduction of transfers, groups within the civil society who feared that expenditure cuts and the devaluation of the exchange rate would hurt the poor and benefit an unproductive elite and those who considered fiscal discipline as a form of IMF-imposed “neocolonialism” (Mamdani, 1990; Tumusiime-Mutebile, 2010: 41-42).

For several years, the World Bank and the IMF did not impose sanctions on Uganda for failures to comply with conditionalities. It is difficult to know precisely why the IMF and the World Bank were so patient with Uganda and why they had continued to disburse funds despite the slow implementation of reforms and the violations of conditionality. According to some analysts, donors were eager to continue supporting Uganda because the country achieved high economic growth rates at a time when other African countries which had SAPs in place failed to generate growth: Average annual GDP growth rates in Uganda amounted to 5% between 1986 and 1992, whereas the African average for that period was only 1% (World Bank, 2013c). Uganda’s high rates of growth were mainly the result of enhanced political stability, favourable terms of trade and aid itself (Dijkstra and Kees van Donge, 2001). Still, high growth coincided with the SAP and this convinced donors of the need to bolster Uganda’s performance through continued structural adjustment lending, which allowed donors to present Uganda as one of the few success stories in Africa (Mosley, 1996; Dijkstra and Kees van Donge, 2001).

By the end of 1991 and during the first months of 1992, however, donors began to exert pressure through “exit” and not only “voice”. Donors were concerned that the Ugandan government did not handle their import support in a transparent manner. They insisted that the rates in the government’s auctions of import support funds should be equal to the parallel rate of foreign exchange bureaus so that that the government’s auctions could no longer be a source of privileged access to foreign exchange (Dijkstra and Kees van Donge, 2001: 843). When the government refused to respond to donors’ requests, donors stopped disbursing, causing a fiscal crisis. The government failed to reduce expenditures and borrowed from the BoU to finance the resulting deficit. As a result, inflation surged, violating the benchmarks of the monetary programme. The IMF responded by suspending programme aid while donors requested control over expenditure and a full liberalisation of the exchange rate before further disbursements of aid. This marked the onset of another fiscal crisis.

Restoring Macroeconomic Stability

The fiscal crisis made the government painfully aware of the extent to which it had become dependent on aid and the constraints donors imposed on policymaking. Thus, Museveni made a turnaround and showed a commitment to a stability-oriented policy stance, reshuffling his cabinet as a result. He sacked the minister of finance and replaced him with Emmanuel Tumisiime-Mutebile, an advocate of fiscal discipline and a stability-oriented policy stance, who until then had been permanent secretary in the Ministry of Planning and was set to become the governor of the BoU in 2001. Museveni merged the Ministry of Planning with the Ministry of Finance so that the new Ministry of Finance, Planning and Economic Development (MoFPED) could become a strong centre of economic decision making. The merger also centralised control over domestically-mobilised resources and aid resources, which were both channelled to MoFPED. Under Tumisiime-Mutebile, who enjoyed strong presidential backing, MoFPED would become the most powerful ministry within the government and establish an international reputation as one of the strongest finance ministries in Africa (Whitworth and Williamson, 2010: 9). The president mandated MoFPED to sustain macroeconomic stability by matching spending to resources (Byaruhanga et al., 2010). Government borrowing from the BoU was limited through expenditure cuts and, as a result, inflation was contained within three months of Museveni's turnaround.

In a statement following the 1992 budget speech, President Museveni then announced: "There will be no inflation. Inflation is indiscipline" (Tumusiime-Mutebile, 2010: 42). This statement sent a clear signal to both policymakers and donors that the re-orientation of economic policy had full political backing. In the following months, Museveni's new economic team strengthened the coordination between MoFPED and the BoU to ensure consistent macroeconomic management through tight fiscal and monetary policies. From 1992 onwards, the Reserve Money Programme was developed as a key instrument in liquidity management and implementing monetary policy. The BoU set a point target for inflation at 5%, which was more stringent than the targets set in most other African countries around that time. In 1993, the BoU's statute was revised and the government delegated full authority for monetary policy to the central bank, consolidating the role of the BoU as the guardian of price stability. In the 1993 Statute, achieving and maintaining economic stability was also set as the ultimate objective of monetary policy. The BoU became very effective in pursuing this mandate: Inflation rates between 1995 and 2005 averaged 4.9%, which is both below the self-set target and below the African average of 6.5% during the same time period (World Bank, 2013c).

The fiscal crisis in 1992 marked a turning point, not only in the government's economic policy but also in its relationship with donors. Donors, and in particular bilateral donors, content with the orientation of policy towards stability, increased their assistance. From 1996 onwards, bilateral ODA flows have exceeded multilateral flows, which had hitherto dominated assistance (Holmgren et al., 2001). Figure 3.A2 illustrates the increase of ODA during the 1990s. With the exception of 1998, Uganda's ODA to GNI ratio was throughout the 1990s and 2000s consistently above 10%, the conventional threshold for aid dependence (World Bank, 2013c). As Figure 3.A4 suggests, aid inflows were also large compared to exports. Thus, aid became a major source of foreign exchange. Uganda was also the first country declared eligible for assistance under the Heavily Indebted Poor Countries (HIPC) Initiative. Uganda received a major debt relief in 1997, followed by a further debt reduction under the "enhanced HIPC Initiative" in 2000. Moreover, grants increased substantially and outnumbered loans in Uganda in the 1990s (Holmgren et al., 2001: 106). From the end of the 1990s, Uganda received a large share of aid in the form of budget support. For much of the 1990s, donors financed more than half of the government's budget. Budget support has certainly provided the Ugandan government with considerable policy space to spend funds in line with its development priorities. Yet budget support also gave donors significant influence on policy decisions because donors became considered legitimate stakeholders in policy processes and were consulted in important domestic matters such as the budget processes (Whitworth and Williamson, 2010: 17). The use of donor funds was thus controlled internally by the government and externally by donors.

Not only did the amounts and types of foreign assistance change, but so too did the mechanisms through which donors shaped economic policy in Uganda. Before 1992, the government had implemented reforms only reluctantly and in response to conditionality. From 1992 onwards, however, there was a strong ownership of reforms among key policymakers so that formal conditionality, although still included in World Bank and IMF arrangements, became less instrumental in inducing reforms (Harrison, 2001; Holmgren et al., 2001). Instead, encouraging social learning became an important channel through which donors shaped policy. Social learning was facilitated by an increase in technical assistance which allowed for more dialogue. While technical assistance grants had only accounted for about 10% of all ODA flows to Uganda in the early 1980s, this figure reached about 16% in the decade after 1992 (Holmgren et al., 2001: 110). By international comparison, Uganda has made unusually good use of technical assistance, especially the BoU (Holmgren et al., 2001: 110). With a view to improve the implementation of reforms agreed on in World Bank and IMF programmes, donors also funded the salaries of staff in the MoFPED and the BoU, seconded technical advisors to these institutions and sponsored study trips (Mallaby, 2004: 220; Tumusiime-Mutebile, 2010: 43-44). In order to intensify the exchange with donors, the BoU in turn offered the IMF and the financial sector programme of the GIZ office space within the premises of the BoU, where they remain today. Policy dialogue among the government, the BoU and donors also took place when new monetary and financial reform programmes were negotiated and existing programmes evaluated.

The interaction among donors and Ugandan policymakers facilitated the exchange of ideas on reform priorities so that donors and policymakers developed a common understanding of the goals of central bank policy and the kind of instruments that should be used to attain them. Rather than setting the agenda for reform, the role of donors became to facilitate the implementation of reforms by providing financing and expertise and by strengthening the hand of reformers. In some cases, donors assisted reformers also by including certain conditionalities requested by reformers in their programmes (Holmgren et al., 2001: 141).

In the following years, Uganda earned a reputation as ‘a pioneer of macroeconomic stabilisation and structural adjustment in sub-Saharan Africa’ among donors (Collier and Reinikka, 2001: xiii). Ugandan policymakers were committed to orienting central bank policy towards stability. Yet pursing this stance would have been more difficult if there had been more organised political opposition (Tumusiime-Mutebile, 2010: 49). Uganda’s political opposition was decimated by war, HIV/Aids and economic collapse while the NRM enjoyed popular support from citizens tired of civil conflict and economic chaos. Moreover, during the first decade of its rule, the NRM diminished organised political opposition by effectively establishing a one-party system.[48] "The lack of an organised political class," explained a senior official of the BoU, "gave Museveni a window of opportunity to rule in a technocratic way: he sought to ensure low inflation, and did not interfere in markets."[49] The reform process was, however, not always running smoothly. Often the process was slow and there was conflict about the direction of policy within the government. A case in point is the area of financial reform to which we turn now.

Financial Reform

After having created a policy environment in which the central bank could assume its role as the guardian of price stability, central bank policy reform focused on orienting financial policy towards enhancing financial stability. By the early 1990s, the two major public banks, the UCB and the Cooperative Bank, were insolvent. They had extended credit to borrowers unable or unwilling to repay loans with a view to deepening financial sectors and providing subsidised credit to politically connected individuals. Of the nine local banks, which were established in the second half of the 1980s and the early 1990s, four experienced solvency problems by the mid-1990s (Brownbridge, 1998a: 133). Several factors account for the distress in local banks: the tightness of financial markets, fraud, the lack of managerial capacity, the weakness of internal controls and deficiencies in the regulatory framework (Brownbridge, 1998a). Moreover, automatic overdraft facilities with the BoU undermined the banks' incentives to change business practices.

From the donors' perspective, the first meaningful steps to restore financial stability were the government's repayment of a substantial amount of its debt to the banking system between 1992 and 1994 and the agreement on a financial sector adjustment programme in 1993. As agreed under the financial sector adjustment programme, the government and the BoU liberalised interest rates by 1994. Policymakers tightened regulation in the 1993 Financial Institutions Statute, which replaced the Banking Act of 1969. The Statute gave the BoU the authority to employ a range of measures for dealing with banks in financial distress and to issue prudential regulations pertaining to capital adequacy, liquidity and data to be supplied for supervisory purposes. More generally,

[48] Tripp (2010) is an excellent source on Uganda's hybrid political regime, which adopts elements of democracy while perverting it through patronage, violence and repression.
[49] A similar view offers Tumisiime-Mutebile (2010: 49).

the Statute increased the BoU's independence from the MoFPED in licensing and regulating financial institutions. Nevertheless, rejected applicants for bank licenses had the right to appeal to the minister of finance and the BoU had to consult him before regulations were issued and insolvent financial institutions liquidated (Brownbridge, 1998a: 137).

With its new powers, the BoU took over and restructured three insolvent banks in 1993 and 1994. The BoU also increased the minimum capital requirements to 1 billion and 500 million Ugandan Shillings for foreign and local banks respectively (Brownbridge, 1998a: 137). The establishment of lower capital requirements for local banks reflected a compromise between reformers in the BoU, who shared the view of donors that enhancing financial stability was the main policy priority and would indirectly support financial deepening, and advocates of financial deepening through state intervention and development of the indigenous banking sector (Byaruhanga et al., 2010: 74). Donors would have liked faster progress in tightening regulation and supervision. Yet as donors were convinced of the government's commitment to reform, they also became less demanding, accepting that some measures were not implemented or implemented slower than expected (World Bank, 1997: 11; Dijkstra and Kees van Donge, 2001).

However, the initial reforms left the BoU ill-equipped to regulate and supervise the financial sector effectively. When the number of banks increased, the BoU did not have the capacity to supervise them effectively. Resource constraints did not permit the BoU to achieve its goal of examining all banks every year (IMF, 1999b: 15). Moreover, the shared responsibility of the Ministry of Finance and the BoU in closing insolvent banks delayed interventions in weak banks as actions could only be taken after consultation processes (IMF, 1999b: 15). The BoU's limited authority and capacity to regulate and supervise banks was a key reason for the banking crisis Uganda experienced in 1997/1998.

This crisis tipped the balance in the debate between reformers and supporters of a policy stance which was aimed at deepening financial sectors through state support of the indigenous banking sector (Byaruhanga et al., 2010). The IMF supported reformers by including the tightening of prudential regulation and supervision as a conditionality in lending arrangements and monitoring the financial reform process closely (IMF, 1999a; IMF, 2002). In the following years, policymakers strengthened the regulation and supervision of financial institutions considerably. In 2000, for instance, the BoU more than doubled minimum capital requirements for banks and adopted equal capital requirements for local- and foreign-owned banks. The BoU's authority in supervision was strengthened and the remaining shared responsibilities with the Ministry of Finance were minimal. In 2004, a new Financial Institutions Act, which included provisions on corporate governance and mandatory corrective action by BoU, replaced the 1993 Financial Institutions Statute. Another landmark in promoting financial stability was the regulation of deposit-taking microfinance institutions in 2003. Before 2003, such institutions had neither been regulated nor supervised despite holding a large share of the public's savings because the BoU had argued "don't regulate what you can't supervise". Donors, however, made the regulation of microfinance deposit taking institutions a priority in their assistance to financial reform: They sponsored study trips, seminars and consultants to encourage and support the BoU in drafting the Microfinance Deposit-Taking Institutions Act.

A final example of the constraints the stability-oriented coalition of donors and central bankers imposed on advocates of state-led financial development is the privatisation of the UCB. Both the BoU and donors considered the sale of the UCB necessary for safeguarding financial stability (IMF, 1999c; IMF, 2003c). The UCB was too big to fail and the BoU was unable to discipline the UCB owing to the UCB's developmental mandate (Brownbridge, 1998a). Therefore, the privatisation of the UCB became an IMF conditionality. Yet the planned sale of the UCB re-ignited the struggle between reformers and advocates of state-led financial development. The privatisation became a subject of intense debate in the parliament and among the public. Parliamentarians tried to stop the sale by arguing the BoU lacked legal powers to privatise the BoU. Museveni then intervened in support of the BoU, arguing that Parliament could not stop the central bank from selling the UCB because the sale was not a privatisation but rather a resolution of the BoU's intervention in the UCB (Byaruhanga et al., 2010). A team, funded by British donors, then investigated allegations that the BoU lacked a legal basis for selling the UCB and found no substance to these claims (Byaruhanga et al., 2010). In 2002, the UCB was sold to Standard Bank, a South African corporation.

It is unlikely that the UCB was sold only because of donor conditionality. Nonetheless, the role of donors appears to have been significant: The IMF's conditionality strengthened the hand of reformers by making clear how constrained the options policymakers could realistically consider in restructuring the insolvent bank were and that donors were only willing to support the restructuring process if the bank was privatised.

This section has hopefully illustrated the vulnerability of the Ugandan government to the demands of donors, the channels through which donors influenced policy and how the anticipated and actual consequences of not being responsive to donors shaped policy. But what was the impact of adopting a stability-oriented policy stance on the economy? I have already provided a partial answer, namely that donors, satisfied with the stability-oriented policies, provided a significant amount of investible resources. Another impact was an increase of the level of private investment owing to restored economic and political stability. Greater stability in the business environment certainly benefited not only large-scale business but also small entrepreneurs and smallholder farmers. Yet small-scale business received only limited redress from the state for their lack of access to finance, restraining investment and growth in this segment. The economy responded to increased levels of investment with an average growth rate of 6% between 1996 and 2000 and 7% between 2001 and 2005 (World Bank, 2013c). The rising level of economic prosperity also allowed Museveni and the NRM to strengthen their political power base: Economic activity increased popular support and, by increasing the state's access to and control of financial resources, permitted to "fuel a political patronage machine" (Tripp, 2010: 185). Moreover, the positive economic effects of stabilisation policies increased the credibility of donors' advice and in turn the government's receptiveness to further reforms (Mosley, 1996; Dijkstra and Kees van Donge, 2001).

The picture that emerges from the story told is thus that the political and economic gains of stabilisation policies initiated a virtuous cycle. Positive effects of previous stabilising reforms strengthened the government's support for further reforms, which themselves were facilitated by donor expertise and financing. As a result, a stability-oriented central bank policy stance, which donors and the government considered the most effective approach to enhance growth and deepen financial sectors, became entrenched.

3.3 Responsiveness to Concerns for Stability and Financial Deepening, 2005-2012

If the first two decades under the NRM government were devoted to enticing donors and putting firmly in place a set of stability-oriented policies, the years from the mid-2000s onwards have focused on developing the country's productive capacities and pursuing both stability-oriented and growth-oriented policy goals.

Why has the policy agenda become wider? One major factor is more political competition. In the 2000s, the regime took a number of steps to open up political space, the most important being the return to multipartyism in 2005. As a consequence of more political competition, President Museveni and other political leaders have become more concerned with maintaining political support through policies aimed at broad-based economic prosperity rather than, as in the past, mere poverty reduction (Tripp, 2010; Hickey, 2013). The NRM's Manifesto "Prosperity For All" is a fine example of this shift in focus (NRM, 2011). Moreover, with greater political openness, Parliament, academia and civil society became more engaged in debates on economic issues and criticised the government for what was perceived as a single-minded focus on macroeconomic stability, which neglected more broad-based growth and industrialisation (Doya, 2010; Tumusiime-Mutebile, 2010: 48; Kiiza, 2012). Another reason for the policy agenda widening is the growing political frustration that economic stability and growth have not translated into structural change in the economy, including industrialisation and formal sector job creation, with the country remaining aid dependent (Whitworth and Williamson, 2010: 25; NRM, 2011; Ssewanyana et al., 2011; Hickey, 2013).

The task, if the government was to jumpstart a structural transformation and to maintain political support, was to change the orientation of economic policy and step up efforts to mobilise investible resources. Since the mid-2000s, the government has therefore revised its approach to governing the economy, with the shift perhaps best encapsulated in Uganda's National Development Plan (NDP), which in 2010 replaced poverty reduction strategy papers and aims at structural transformation. In particular, the NDP promotes a greater role of the state in the facilitation of private-sector-led development. The NDP also reflects the shift in thinking that macroeconomic stability should remain a government priority but that macroeconomic stability alone is not enough to promote economic development and sustain high growth rates. In the NDP, the government proposes policies which directly promote the structural transformation of the economy and policies to deepen financial sectors to finance private sector development (GoU, 2010).

Not all parts of the government were happy with the change towards a policy stance that permitted a greater role of the state in promoting economic development and financial deepening. In particular the BoU and parts of the Ministry of Finance feared that the shift in policy bore risks for hard-won gains in macroeconomic stability (Doya, 2010; Tumusiime-Mutebile, 2010).[50] Moreover, even if most policymakers agreed that greater effort had to be made to develop the real economy "there remains," a MoFPED official explained, "foremost the fear of going back. You always hear: we do not want to have policy reversals."[51]

Support for the shift in the orientation of economic policy came, however, from an unlikely source: the donor community, notably the World Bank. Donors have generally been supportive of an orientation of economic policy towards the goal of structural transformation in Uganda and have encouraged the Ugandan authorities to make greater efforts to deepen financial sectors (IMF, 2007; IDA/IMF, 2010). The reasons for this change in attitude among donors lie in both the international and the domestic domain. The major international factor is a change in ideology, which consists of greater scepticism of markets, a rethinking of the role of government in promoting economic development and agreement on the need to promote structural transformation in developing countries. This change in ideology has been encouraged by the greater political and economic weight of emerging countries, by learning from failures of Washington Consensus policies, by experiences with state-facilitated development in

[50] An illustrative example provides the discussion about the financing of the NDP. When the National Planning Authority, which had the responsibility for drafting the NDP, drew up a budget which amounted to a deficit of 14%, this rang the alarm bells in the BoU. The BoU insisted on cutting the budget, triggering a heated debate about the relative importance of macroeconomic stability and growth. In the end, the BoU prevailed and the NDP's budget was reduced by 10% because of concerns about macroeconomic stability (Doya, 2010).

[51] Emmanuel Tumisiime-Mutebile, who has been the governor of the BoU since 2001, embodies this stance. He acknowledges that the country's investment needs must be met and that an environment attractive to investors must be created, also through financial market development. Yet in Tumisiime-Mutebile's view "(…) the only way to sustain this attractiveness [of an emerging market like Uganda] is through deepening and widening the financial markets and managing the economy in a prudent manner through avoidance of policy reversals (…)"(Tumusiime-Mutebile, 2007).

Asia and by the rampant market failures as exposed by the global financial crisis.[52] There are three main reasons in the domestic domain which account for donors' change in attitude: First, donors feared that without additional economic reforms growth would taper off in Uganda. Second, donors recognised that price and financial stability established the basis for financial deepening but that financial systems had remained shallow. Third, donors were convinced that the Ugandan government remained committed to guarding economic stability, which continued to be a key concern for donors, notably the IMF and the World Bank (IMF, 2005b; IMF, 2006b).

Getting donors' stamp of approval for the shift in the orientation of policy was important if policymakers were to mobilise financing to spur broad-based growth and a structural transformation. As Figure 3.A5 shows, the sum of net inflows of foreign direct investment (FDI), domestic private investment and export revenues has increased since the mid-2000s, indicating that private investors play an increasingly important role as sources of finance. Yet by African standards, Uganda's private sector has remained weakly developed and policymakers' discretion over the use of resources supplied by the private sector is limited. Policymakers' discretion over government revenues and aid, which is mainly provided on terms agreed upon with the government and often as budget support, is higher. Government revenues, which except for about 1% are tax revenues, have exceeded aid in recent years and dependence on donors as captured by aid as a share of government expenditure has been declining (see Figure 3.A6). Yet tax revenues, which averaged 13% of GDP between 2005 and 2011, have remained well below the average for sub-Saharan Africa. Moreover, from the perspective of the government, levels of tax revenues are not sufficient to finance the desired level of public investment (GoU, 2010: 64). The government is aware that aid remains a key source of finance and winning the material and technical support of donors remains critical due to the shortfall in government revenues, the government's ceiling on commercial borrowing under the country's IMF programme and weakly developed domestic financial sectors (GoU, 2010: 62-66).[53]

[52] In a speech in 2010, the president of the World Bank noted for instance: "As economic tectonic plates have shifted, paradigms must shift too. . . This is no longer about the Washington Consensus (but about) securing transformation" (Hickey, 2013: 194).

[53] Aid dependence may decline in the future as significant oil reserves have been discovered and oil production is expected to start in 2018. Donors, however, are likely to continue to play an important role in Uganda for some time: As advisors on how to invest the oil revenues in a way that maximises returns

Pursuing fiscal, monetary and financial policies that are in line with the preferences of donors has been at the centre of efforts to ensure the continued support of donors, notably the IMF. There are several reasons for policymakers being responsive in these particular policy areas: First, in the areas of fiscal, monetary and financial policy there is an alignment of interests among Uganda's policymakers and donors, particularly the IMF. Interaction of the IMF and policymakers has both facilitated and continuously strengthened this alignment of interests. As a senior BoU official explained: "The relationship [with the IMF] has become close and technocratic, some even argue too close." Second, donors have tolerated governance failures in recent years, but this was mainly because they were satisfied with the conduct of economic policy and economic performance (Tripp, 2010). Slippages in economic policy would further complicate Uganda's increasingly thorny relationship with donors. Third, Uganda's policymakers are keen on positive assessments of their monetary and financial policy by the IMF. Since 2005, Uganda has had a Policy Support Instrument (PSI) in place with the IMF.[54] Under the PSI, the IMF closely surveys Uganda's monetary, fiscal and financial policy and policymakers agree with the IMF on policy targets. Uganda no longer receives IMF financing but, as a senior government official explained, "we still need the IMF to give a signal that everything is alright – to donors and to markets." Donors make the provision of aid conditional on Uganda's successful participation in an IMF programme. Foreign investors, who are considered key to jumpstarting the economy's productive activities and mobilising additional financial resources, base their investment decisions in part on the assessments of the policy environment by the IMF. The influence of the IMF in Uganda thus no longer rests on the provision of financing, but the provision of knowledge and of signals to potential providers of financing.

Since 2005, policymakers have taken several steps which indicate the continued commitment to guarding stability and greater concern for financial deepening. In the area of monetary policy, the BoU continued to place significant emphasis on guarding price stability. The main reform in recent years in pursuit of this goal is a shift in the policy framework from a monetary targeting towards an inflation targeting (IT) regime.

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and, in the case of the IMF, as providers of a signal to investors about the quality of the country's economic policies.

[54] The IMF describes the PSI on its website as a "tool that enables low-income countries that do not want – or need – to secure Fund advice and support without a borrowing arrangement.(…) The PSI is designed to promote a close policy dialogue between the IMF and a member country, normally through semiannual Fund assessments of a member's economic and financial policies" (IMF, 2014).

The BoU felt that monetary targeting became increasingly ineffective in achieving the desired medium-term target of 5% inflation (Kasekende and Brownbridge, 2011). IT was considered a superior framework, even though IT requires setting inflation control as the primary policy objective, which, at times, involves allowing growth to dip below its potential. The IMF, which has advocated IT in a number of developing countries and supported reforms of Uganda's monetary policy framework for many years, welcomed this decision. Without support from the IMF, moving towards IT would have been difficult because the government lacked the technical capacities to implement an IT regime (IMF, 2013c). Moreover, the IMF encouraged reforms to strengthen central bank independence, which is a prerequisite for an IT regime but is politically contested. In particular, the IMF lent credence to the BoU's demands for more central bank independence by including institutional reforms to enhance central bank independence as goals in the PSI. In the area of financial policy, safeguarding financial stability has remained the BoU's major priority. The fact that Uganda's banks weathered the global financial crisis well because they were profitable and well-capitalised at the onset of the crisis also confirmed the BoU in its policy stance (Kasekende, 2010).

While the policy concerns of the BoU related to safeguarding price and financial stability paralleled those of donors and the BoU often spearheaded reforms, this was different in the area of financial deepening. In the late 2000s, there was a consensus among BoU officials on the importance given to different central bank objectives: Price stability was considered the primary goal, followed by financial stability. [55] Only some officials, arguing that the BoU had in recent years made greater efforts to promote financial development, considered financial deepening a tertiary goal. Still, throughout the 1990s and 2000s, there was a small group of staff in the BoU that felt that the BoU's policy stance should be oriented towards both stability and financial deepening instead of having stability as the paramount objective. This group did not share the position of the BoU's management; namely, that the major contribution of the BoU towards growth was to maintain stability.[56]

Donors encouraged the BoU to promote financial deepening by insisting that such efforts were within the BoU's mandate, by providing information that Uganda lagged

[55]Interviews with several BoU officials in Kampala, December 2010 and December 2011.
[56] Interviews with several BoU officials in Kampala, December 2010 and December 2011. See for instance Tumusiime-Mutebile (2011) for an illustration of the position of the central bank governor.

behind other African countries in financial access, by requesting the BoU to address the shallowness of Uganda's financial sectors and by funding activities that support financial deepening. In a Financial Sector Assessment Programme (FSAP) update in 2004, the World Bank and the IMF highlighted, for instance, that the banking sector was well capitalised, profitable and stable but that Uganda's financial sector had remained shallow and exclusive. Policymakers were urged to make greater efforts to increase financial access (IMF, 2006b: 32). In 2007, donors funded a survey on access to financial services in Uganda and provided figures underscoring the urgency of increasing access. A senior BoU official recalled in an interview: "We have price stability and financial stability, but the FinScope survey showed us that they [the banks] do not serve anybody."[57] In 2009, the World Bank published a study with the programmatic title "Making Finance Work for Uganda" which plainly criticised some of Uganda's prudential regulations, claiming that they were impeding financial access (World Bank, 2009). What followed was a tense debate between the World Bank and central bankers in which the World Bank argued that greater consideration should be given to potential trade-offs between financial stability and financial deepening. As these examples illustrate, donor support in the area of financial policy has become inextricably linked to greater central bank engagement in deepening financial sectors.

Smaller businesses had long voiced their concerns about the lack of access to finance but these concerns received only more redress from the BoU when the government and donors set financial access on the policy agenda.[58] As the BoU's regular dialogue with the private sector on financial reform includes only the banking sector, which is wary of policies to increase financial access that may reduce current levels of profits, donors have played an important role in voicing the demands of businesses excluded from access to finance.

A milestone from the donors' perspective in moving towards a policy stance which places more emphasis on financial deepening was the establishment of a credit reference bureau, a follow-up on a recommendation of the FSAP update in 2004 (IMF, 2006b: 36). Credit reference bureaus help borrowers to generate a credit history, thus

[57] FinScope is a study of consumers' perceptions on financial services which has been carried out in a number of African countries, funded mainly by British aid.

[58] The Enterprise Survey published by the World Bank, for instance, found that in 2006 around 48% of SMEs consider access to and/or cost of finance as a "major" or "very severe" obstacle (World Bank, 2013a).

supporting them in getting access to finance. Setting up the bureau, which started operating in 2009, would, however, have been difficult if not impossible if donors had not agreed to subsidise its operation because neither the banks nor the government were willing to bear the full costs of its operation. Assisted by donors, the BoU also took further steps to promote financial deepening such as the issuance of consumer protection guidelines in 2011 or the licensing of mobile money operators in 2013. From the BoU's perspective, the main challenge lies in identifying policies which increase access to finance without unduly increasing risks to financial stability and reversing the liberalisation of the financial sector.

Is the BoU shifting again to a policy stance which emphasises financial deepening and neglects stability? The government certainly exerts pressure on the BoU to support the government's efforts to mobilise resources for investment. For instance, in 2009 the government requested the BoU to administer an agricultural credit facility, which provides medium- and long-term financing for agricultural projects at subsidised interest rates. In 2011, President Museveni also increased government borrowing from the BoU above permitted levels leading to Uganda failing an IMF programme review (Manson, 2011).[59] Yet despite government pressure to pursue expansionary policies, most observers agree that donors place constraints on deviating from a stability-oriented policy stance. The managing director of an international bank explained in an interview: "Investors would not really mind if the BoU becomes more interventionist: if you have a controlled environment, you attract a certain type of investors. But the external partners in Uganda, the IMF and the World Bank, do not want to see a more interventionist BoU." Moreover, donors use their influence to assist policymakers in the BoU in building institutions which help to entrench a stability-oriented policy stance, as exemplified by efforts to increase central bank independence. That said, aid dependence is declining in Uganda and so the perceptions of policymakers in Uganda of the constraints they face regarding donors are beginning to change.

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[59] In 2011, the government increased domestic borrowing for election-related and military expenses above the levels agreed with the IMF under the PSI. Moreover, a substantial amount of the funds was borrowed from the BoU without parliamentary approval. Governor Tumisiime-Mutebile's criticised in a Financial Times article that Museveni's continued embrace of "elements of Marxism" was undermining the economy (Manson, 2011). Museveni's press secretary responded by saying there was no way the BoU governor could argue with the president over national matters (Wafula, 2011). He added: "If you disagree with the President you can write to him…and if the disagreement is fundamental then you resign."

3.4 Conclusion

Before moving to the next case study, which explores the policy trajectory of Nigeria's central bank, it is important to pause here and emphasise five basic points of this chapter which illustrate the arguments of this thesis.

First, the account of the trajectory of central bank policy in Uganda can be meaningfully enhanced by considering the structural constraints arising from aid dependence as an explanatory factor. The actual and anticipated consequences of not being responsive to donors' concerns for economic and political stability became important considerations for Uganda's policymakers and encouraged a stability-oriented policy stance as aid dependence increased. The IMF's policy concerns related to central bank policy have received major attention, owing to the signals the IMF provides to other donors and private investors regarding the quality of central bank policy.

That said, the evidence presented in this chapter suggests that reliance on donors is not the only factor which has shaped central bank policy in Uganda. As the description of central bank policy in the 1970s suggests, ideas about the role of central banks in financing the economy, an international factor, appear to have influenced policy. In the late 2000s, for instance, more political competition increased the pressure on the government to develop the real economy, including through a policy stance oriented towards financial deepening.

Donors influenced the stance of central bank policy through several mechanisms: During the BoU's early years, when Uganda was reliant on donor countries for the secondment of staff to the BoU, voice and contribution to social learning were the main channels through which donors influenced policy. Through explicit conditionality (voice) and withholding aid disbursements (exit), donors induced the orientation of central bank policy towards stability in the early 1990s. Since policy has become responsive to donors' policy preferences in the early 1990s, encouraging social learning and, at least for the IMF, the threat of exit, have become the dominant modes through which donors have shaped policy.

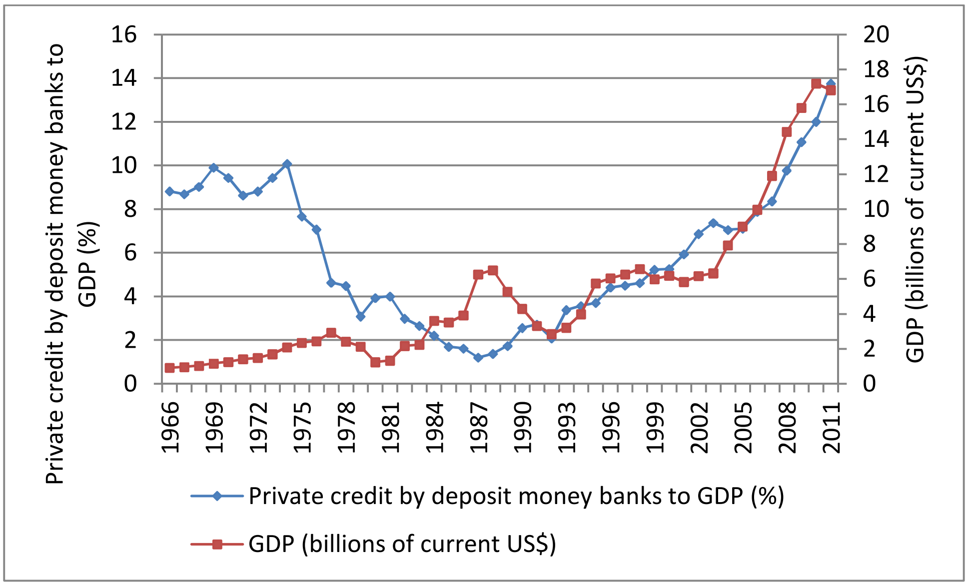
Second, the exercise of structural power is difficult to observe, hence those with structural power are not ordinarily seen as wielding significant political power. In the case of Uganda, the emergence of a common understanding of policy priorities and the alignment of interests among donors (notably the IMF) and Ugandan policymakers make it particularly difficult to establish the influence of donors on central bank policy from 1992 onwards. If a clearer distinction between the preferences of the Ugandan government and the preferences of donors was possible, this would help in deciding to what extent the case of Uganda supports my argument that donors shape central bank policy in aid dependent countries. It was therefore important to trace shifts in central bank policy, such as the orientation of policy towards stability in 1992 and the orientation of policy towards financial deepening in the late 2000s, and link these shifts to the government's vulnerability to the concerns of donors.

Third, while policymakers' perceptions of the constraints they face regarding donors help to explain the BoU's stability-oriented policy stance, the extent to which this stance has become entrenched has a great deal to do with the particular circumstances in Uganda. Four major factors appear to account for this entrenchment and to have influenced the responsiveness to donors as mediating factors. I have already mentioned one major factor: the weakness of Uganda's political opposition, which liberated the regime from pressures to pursue more expansionary policies and which allowed for the governing of the economy in a technocratic way with a strong centre for decision making. Another factor may be that orienting monetary and financial policy towards enhancing stability was a common concern to all donors during the 1990s and early 2000s. The alignment of interests among donors increased the effectiveness of donor pressure. A third factor may be that Uganda has continuity in political and technical personnel. The key figures in orienting the central bank policy stance towards stability in the early 1990s, notably President Museveni and Tumisiime-Mutebile, who was minister of finance before he became central bank governor, have remained in power. Personnel continuity has also facilitated the establishment of close relationships with donors which are conducive to social learning. Finally, it is also of no small importance that at the time when Uganda became highly dependent on aid, a new policy paradigm based on the idea that the role of the state in governing finance lies mainly in enhancing stability was emerging internationally. This major ideological change contributed to the shift to a stability-oriented policy stance in Uganda. That said, the case of Uganda appears to support the finding of earlier research, that ideas are more likely to translate into policy when they are supported by powerful actors (Hall, 1993; Gómez-Mera, 2011).

Fourth, in accounting for the direction of policy when the structural power of business is low it is important to look at the preferences of those who supply significant "replacement resources", which in Uganda are donors. I formulated the proposition that in developing countries which are more dependent on aid, the central bank policy stance is more likely to be stability-oriented because this is the stance donors prefer. However, as the last section shows, the BoU has, since the mid-2000s, placed more emphasis on financial deepening, apparently responding to both internal political pressures and external pressures from donors. This is not to say that the case of Uganda contradicts my proposition because promoting stability has remained a primary goal of the BoU. However, the finding that donors appear to have encouraged a greater focus on financial deepening is a reminder that the direction of the relationship between the reliance on aid and the central bank policy stance is likely to depend on the preferences of donors. Thus, when in aid dependent countries donors' policy concerns shift, the policy options policymakers can reasonably consider may shift as well.

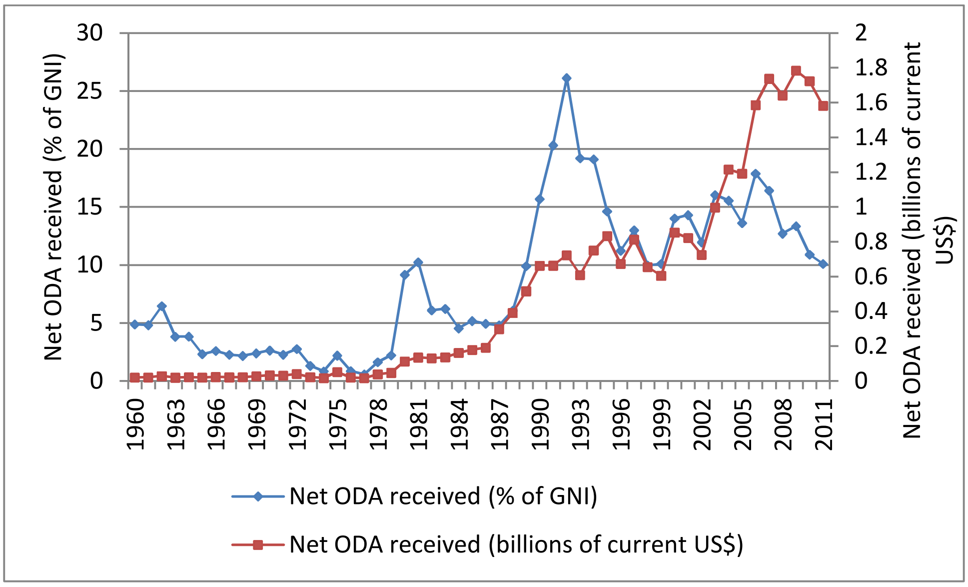
3.5 Appendix

Figure 3.A1: Private Credit in Uganda, 1966-2011



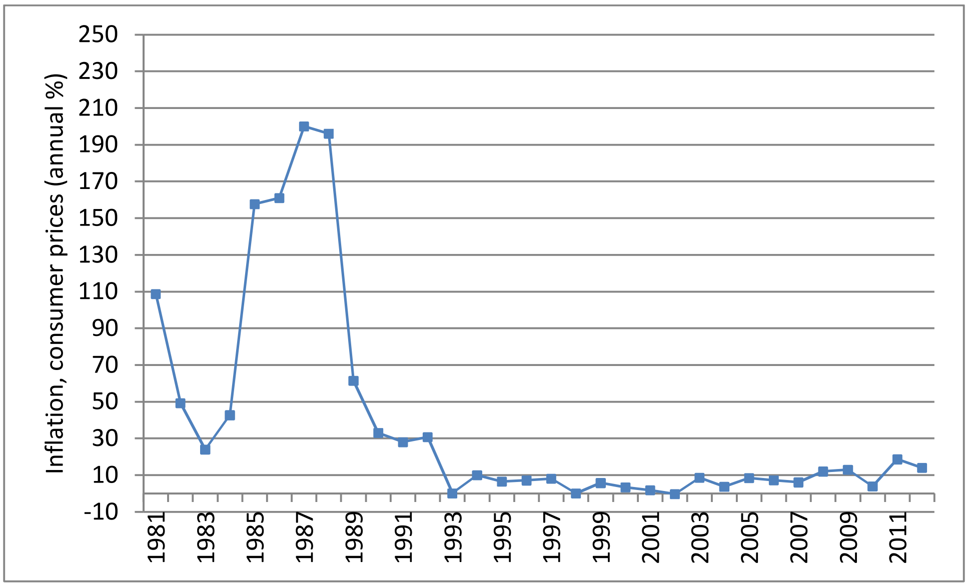
Source: Data on private credit drawn from the World Bank (2013b) and data on GDP drawn from the World Bank (2013c). Note: Data for Uganda before 1982 refers to total credit to the private sector.

Figure 3.A2: Net ODA to Uganda, 1960-2011



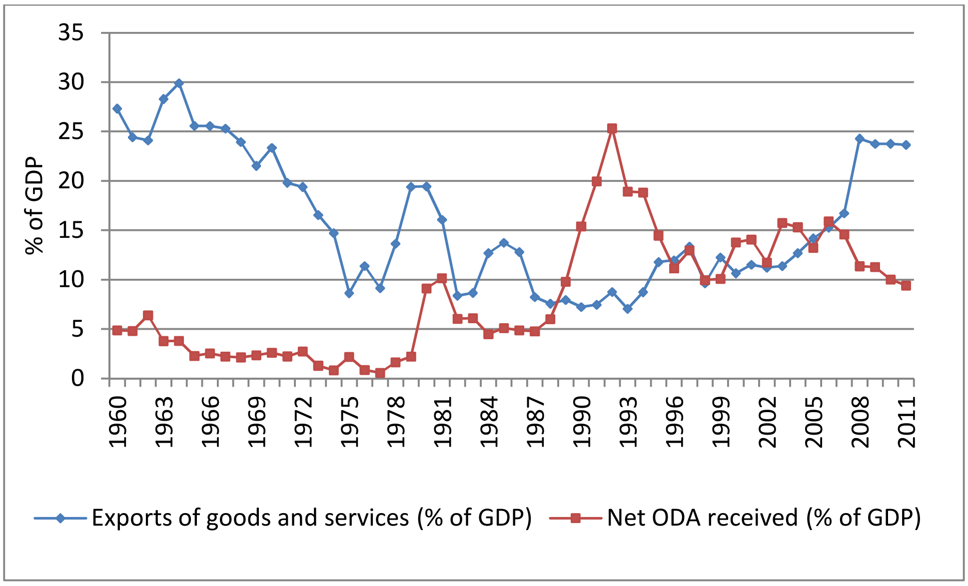
Source: Data drawn from the World Bank (2013c).

Figure 3.A3: Inflation in Uganda, 1981-2012



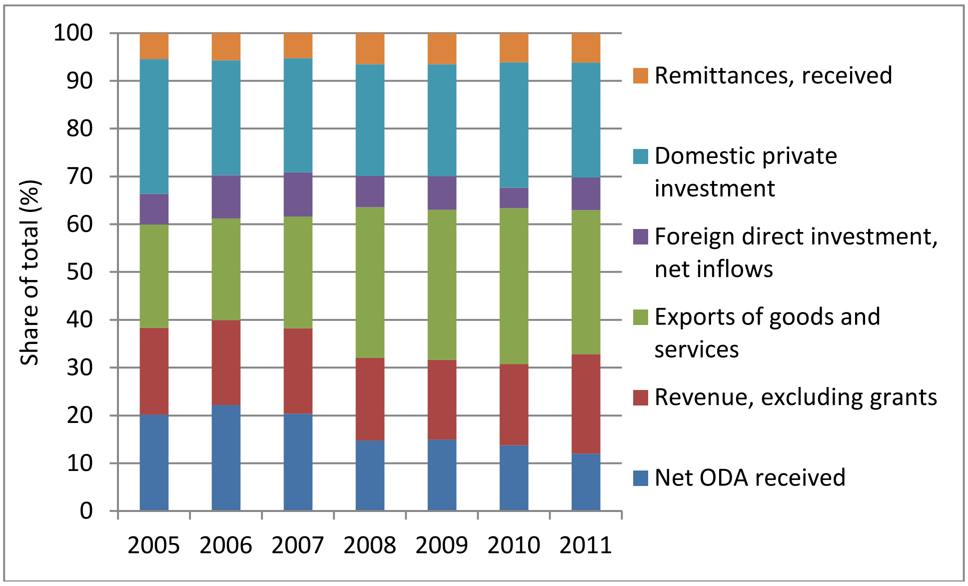
Source: Data drawn from the World Bank (2013c). Note: Data for Uganda only available from 1981.

Figure 3.A4: Net ODA to Uganda and Ugandan Exports, 1960-2011



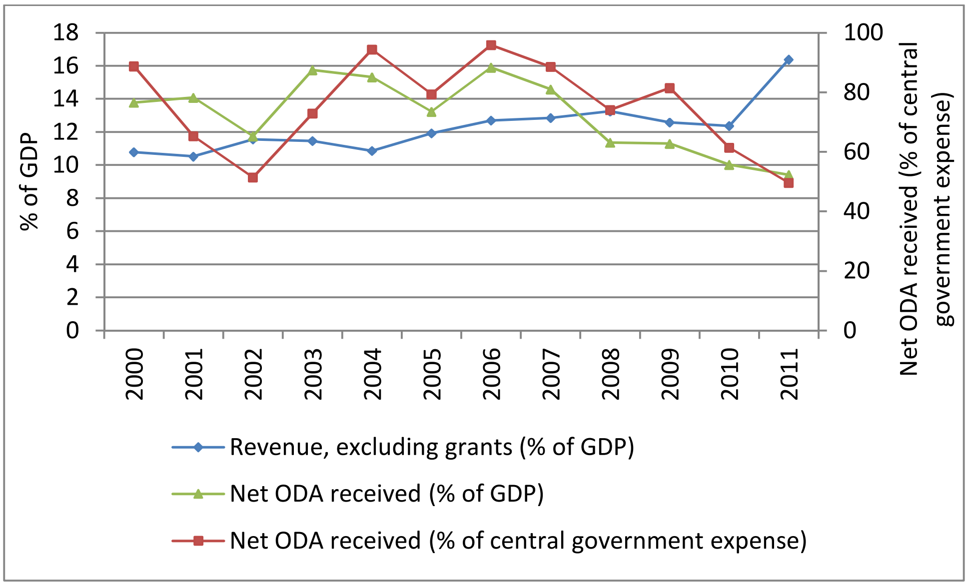
Source: Data drawn from the World Bank (2013c).

Figure 3.A5: Major Sources of Investible Funds in Uganda, 2005-2011



Source: Data drawn from the World Bank (2013c) except for data on domestic private investment, which is drawn from various IMF country reports.

Figure 3.A6: Aid and Government Revenue in Uganda, 2000-2011



Source: Data drawn from the World Bank (2013c).

Table 3.A1: Chronology of Major Economic and Political Events

1961	Uganda becomes independent from the United Kingdom.
1966	The BoU is established.
1971	Idi Amin seizes power through a military coup.
1972	Idi Amin expels Uganda's Asian population.
1979	Idi Amin is overthrown.
1981	Milton Obote's regime begins a structural adjustment programme (SAP).
1984	The SAP is abandoned.
1986	Yoweri Museveni, the leader of the National Resistance Movement (NRM) comes to power.
1987	The Museveni regime embarks on a SAP.
1991	Donors suspend aid until early 1992.
1992	President Museveni orients policy towards stability, announcing for instance that inflation is indiscipline.
1997	Uganda experiences a major banking crisis which lasts until 1998.
2001	Emmanuel Tumisiime-Mutebile is appointed governor of the BoU.
2005	Uganda returns to multipartyism. The first Policy Support Instrument with the IMF is put in place.
2006	Emmanuel Tumisiime-Mutebile is reappointed governor of the BoU
2010	Uganda's National Development Plan encapsulates the government's commitment to structural transformation and a greater role of the state in the facilitation of private-sector-led development.
2011	The BoU introduces an inflation-targeting framework.

Table 3.A2: World Bank Policy Reform Loans to Uganda, 1980-1998

		World Bank (millions of US$)		
Loan	Type	Amount Approved	Approval Year	Closing Year
Reconstruction Credit	ERC	72.5	1980	1982
Technical Assistance	TAL	8	1980	1985
Reconstruction Credit II	SAL	70	1982	1985
Technical Assistance II	TAL	51.3	1983	1992
Agricultural Rehabilitation Sector Adjustment Credit	SAD	66.1	1983	1992
Reconstruction III	SAL	50	1984	1987
Economic Recovery Credit	SAL	65	1987	1991
Technical Assistance III	TAL	18	1988	1995
Public Enterprises	TAL	15	1988	1995
Economic Recovery I/II Supplement	SAL	26.7	1989	-
Economic Recovery Credit II	SAL	125	1990	1993
Poverty and Social Cost of Adjustment	SIL	28	1990	1995
Agricultural Sector Adjustment	SAD	115	1990	1996
Structural Adjustment Credit I	SAL	125	1991	1994
Economic and Financial Management Technical Assistance	TAL	29	1992	1999
Institutional Capacity Building	TAL	36.4	1992	2000
Financial Sector Adjustment Credit	SAD	100	1993	1997
Structural Adjustment Credit II	SAL	80	1994	1996
Structural Adjustment Credit III	SAL	125	1997	1999
Education Sector Adjustment Credit	SAD	80	1998	-

Note: ERC = Economic Recovery Credit. SAL = Structural Adjustment Loan/Credit. SAD = Sector Adjustment Credit. TAL = Technical Assistance Loan. SIL = Sector Investment Loan. - not available.

Source: Holmgren et al. (2001: 108)

Table 3.A3: IMF Policy Reform Loans to Uganda, 1980-1998

	International Monetary Fund (1980-1984 in millions of SDR, 1987 - 1997 in millions of US$)			
	Time	Year	Amount approved	Amount drawn
Standby Operation	1 year	1980	12.5	12.5
Trust Fund Loan	1 year	1980	22.3	22.3
Compensatory Financing Facility	1 year	1980	25.0	25.0
Compensatory	1 year	1981	45.0	45.0
Standby I	1 year	1981/82	112.5	112.5
Standby II	1 year	1982/83	112.5	112.5
Standby III	1 year	1983/84	95.0	65.0
Structural Adjustment Facility	2 years	1987	69.7	49.8
ESAF	3 years	1989	179.3	179.3
ESAF, additional arrangement	1 year	1992	39.8	39.8
ESAF	3 years	1994	180.0	180.0
ESAF	3 years	1997	138.0	78[a]

Note: ESAF = Enhanced Structural Adjustment Facility. [a] Disbursements until end of 1998.

Source: Holmgren et al. (2001: 109)

4 The Political Economy of Central Bank Policy in Nigeria

The case study of Uganda shows that central bank policy trajectories can change dramatically and that economic collapse may be a critical juncture on the way to policy change. As this chapter will show, central bank policy in Nigeria is, in contrast to Uganda, characterised by relative continuity. Even though at various points in its history Nigerian governments sought to alter the policy trajectory and orient central bank policy to a greater extent towards price and financial stability, financial deepening has been a primary goal of the Central Bank of Nigeria (CBN) since its establishment in 1959. The evidence suggests that the incentives created by resource dependence and the government's control of resource revenues help to account for the orientation of policy towards financial deepening.

The chapter spans the years 1959 to 2012.[60] It comprises five substantive sections and a conclusion that summarises the basic points of the chapter. The main objective of the substantive sections is to trace how access to oil revenues has influenced the stance of central bank policy. Correspondingly, the level of oil revenues has been my main criterion for dividing the narrative of the Nigerian case into periods.

- The first section covers the years 1959 to 1982. It describes the pressures on the CBN to pursue policies oriented towards financial deepening and how access to and control of significant oil revenues widened the fiscal space to pursue such policies. I also explain how access to oil revenues moulded Nigeria's political economy, thereby raising barriers to orienting central bank policy more towards stability.
- The second section spans the years 1982 to 1985. The section is devoted to government attempts to orient policy towards stability in response to declining oil revenues.
- The third section covers the years 1986 to 1993. It offers an account of Nigeria's SAP, which was probably the single greatest effort to satisfy the policy demands of IFIs and foreign creditors in order to secure funds which would help to deal with a sharp decline in oil revenues. I also explain how the SAP lapsed due to a combination of pressures to consolidate political power, donors' failure to reduce aid in response to the inconsistent implementation of reforms and rising oil revenues.

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[60] Table 4.A1 in the appendix providers a chronology of the major economic and political events.

- The fourth section, which spans the years 1993 to 1998, describes the government's limited responsiveness to the policy concerns of donors and the private sector despite declining oil revenues. It also highlights that the theory of the structural power of capital does not provide an entirely satisfactory explanation of the orientation of central bank policy in all time periods.
- The fifth section focuses on the period from 1999 to 2012. It describes how, since the return of democracy in 1999, Nigerian policymakers have struggled to orient policy towards stability in the context of high oil revenues and have sought to maintain financial deepening as a primary policy goal.

4.1 Orientation of Central Bank Policy towards Financial Deepening in the Period of Buoyant Oil Revenues, 1959-1982

In the early 1950s, Nigerian politicians began to loudly voice their demands for the establishment of a central bank which could strengthen the indigenous banking sector and assist in financing the country's economic development (Uche, 1997: 143). Strengthening indigenous banks was a major concern for Nigerian businessmen and politicians. They felt deep resentment against the colonial, foreign-owned banks, which were perceived to discriminate against African business in the provision of financial services (Uche, 1997: 223). The hope was that, as indigenous banks grew, they would serve African businesses better. Yet most indigenous banks were expected to be closed with the introduction of banking regulation in 1952 because they were poorly capitalised and staffed. Many Nigerian politicians believed that the establishment of a central bank would help to rescue these indigenous banks. The BoE, however, opposed replacing the existing currency board system with a central bank until 1957 and delayed its establishment.[61]

When Nigeria's central bank was established in 1959, a year before the country's independence, the British had, as a colonial power, considerable influence over the orientation of central bank policy and tried to institutionalise a stability-oriented policy

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[1] In 1953, a BoE report came out against the establishment of a central bank in Nigeria because it considered financial markets too weakly developed for the central bank to carry out its monetary policy functions (Fisher, 1953). Another conclusion of the report was that if the central bank was to provide constant support to the weak indigenous banking sector this would ultimately hinder the development of a private banking sector. Only when neighbouring Ghana decided to abandon the West African currency board and issue its own currency and when a report by the International Bank for Reconstruction and Development came out in favour of a Nigerian central bank, the BoE gave up opposition and Loynes, an advisor at the BoE, recommended the establishment of a Nigerian central bank (Loynes, 1957).

stance. The views and recommendations of an advisor to the BoE, J.B. Loynes, formed the basis for the central bank statute (1979: 41). Reflecting Loynes's recommendations, the Central Bank Act of 1959 stated, for instance, that the promotion of monetary stability and sound financial structure were among the principal objectives of the CBN and stipulated limits on CBN lending to the government. In an effort to increase domestic and international confidence in the currency, the Nigerian pound was fixed at par with the pound sterling in the CBN Act.

When the central bank was established, it was envisaged that the CBN would support financial sector development and the mobilisation of domestic funds for financing economic development (CBN, 1979: 43; 56). Nonetheless, there was broad agreement, in the government and among politicians, that stability should not be compromised for political reasons (CBN, 1979: 42).

First Oil Boom and Other Pressures on the CBN to Pursue an Expansionary Policy Stance

Despite intentions to allow the CBN to operate above the political fray, pressures on it to pursue an expansionary policy stance mounted soon after independence. One source of pressure was Nigeria's bitter civil war, which was in part caused by Nigeria's ethnic divisions and lasted from 1967 to 1970. The civil war and subsequent reconstruction efforts increased the financial needs of the government and the CBN's policies became geared towards financing soaring government expenditure (CBN, 1979: 109-112). For example, in the late 1960s, the government adjusted the ratio of external reserves to the CBN's demand liabilities continuously downward and the statutory limits on outstanding government debt upward in order to facilitate credit accommodation to the government (CBN, 1979: 56-57).

The second significant source of pressure on the CBN to pursue an expansionary economic policy stance was the emergence of an economic development model, which was based on statist and nationalist economic policies. A major concern of the government was that the indigenous private sector was weakly developed at the time of independence. In particular, key sectors of the economy like industry and banking were dominated by foreign-owned firms. In the late 1960s, foreigners controlled about 95% of large-scale and 72% of small-scale industries in Nigeria (Balabkins, 1982: 55). Foreign investors had been welcome upon independence because investment capital was scarce. Yet from the late 1960s onwards, public sentiment, official ideology and policies changed: The small class of Nigerian businessmen vocally demanded more opportunities for profit, including through the indigenisation of foreign-owned businesses (Turner, 1976a: 65). The military government, which had come to power through a coup in 1966, considered statist and nationalist economic policies as a means to promote national unity, economic reconstruction after the war and the development of the economy, notably of the indigenous private sector (Balabkins, 1982). Import substitution, indigenisation[62] and the involvement of the state in economic activities, including banking, were the cornerstones of the government's economic development policies. For the CBN, the state's efforts to develop the economy through statist and nationalist economic policies translated into greater pressure to support the developmental aspirations of the government by providing financing to the private sector and the government, and by expanding the regulation of the financial sector.

The third source of pressure on the CBN to support an expansionary economic policy stance was the government's access to a vast amount of discretionary resources in the wake of the first oil boom in 1973/1974. Oil was discovered in Nigeria in 1956, but it was not until the late 1960s that the state took more interest in the commercial exploitation of oil. In 1969, the government issued the Petroleum Act which vests the entire ownership of all petroleum discovered within Nigeria's territorial boundaries in the state. The government also set up a state-owned oil company in 1971, which from 1973 onwards, began to acquire equity stakes in foreign oil companies and to operate through joint ventures with oil majors who were granted territorial concessions (Watts, 2004: 60).[63] By the mid-1970s, oil had moved to the centre of economic accumulation in Nigeria. Oil exports, which had constituted 8% of total exports upon independence, amounted to 93% of exports in 1977 (Karl, 1997: 206). Between 1970 and 1974, the relative share of petroleum in foreign exchange earnings rose from 28% to over 90% (Balabkins, 1982: 135). The Nigerian state gained access to and control of enormous financial resources when oil revenues began to rise in the early 1970s owing to the public ownership of oil and gas reserves and equity stakes in the oil and gas industry.[64]

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[62] The government issued in 1972 and 1977 indigenisation legislation, which required expatriates to take on Nigerian partners in some activities and reserved certain activities exclusively for Nigerians.
[63] See Frynas (1998) and Obi (2010) for more details on the evolution of Nigeria's oil industry.
[64] While the government's access to oil revenues rose, the power of the foreign oil companies remained significant because they, not the Nigerian state, controlled the exploration and production process (Turner, 1976b).

Then in 1973/1974, in the wake of the oil embargo of the Organisation of Arab Petroleum Exporting Countries, oil prices quadrupled and Nigeria’s foreign exchange reserves increased rapidly. As Figure 4.A1 shows, oil also became the single most important source of government revenues, accounting for an average of more than 76% of its revenues between 1975 and 1980 (CBN, 1994b: 97-98).

What was the effect of access to and control over a significant amount of discretionary, investible resources on the Nigerian state? Faced with the task of reconstruction following the civil war and pressure to rapidly deliver economic growth and spur the “Nigerianisation” of the economy, the government embarked on a massive programme of oil-funded, state-led economic development. The oil windfall was seen as a chance to finance economic diversification and industrialisation. As Figure 4.A2 shows, government expenditure soared following the oil boom. Whereas many other African countries struggled to mobilise the funds needed to realise their developmental aspirations, oil revenues provided the Nigerian government with a material basis for funding the indigenisation process and government policies to support private sector development.

When official ideology and policies became based on the idea of state-led and oil-financed development, the CBN aligned its operations with the government’s policy stance. Specifically, central bank policy became heavily oriented towards financial deepening by facilitating access to finance for the government and the private sector. The orientation of CBN policy towards financial deepening is most evident in the area of financial policy. The CBN promoted financial deepening, for instance, through its ownership of and provision of financial assistance to public development banks such as the Nigerian Industrial Development Bank and the Nigerian Agricultural Development Bank (CBN, 1979: 143-144). To carry out development financing functions, the CBN also established in 1977 an agricultural finance department, which, for instance, administered an agricultural credit guarantee scheme (CBN, 1979: 147).

In addition, the CBN made extensive use of financial regulation for allocative purposes (Brownbridge, 1998c: 106). The main piece of regulation in this regard was the 1969 Banking Decree. In particular, it empowered the CBN to set minimum deposit rates to encourage saving and it enabled the setting of sector specific maximum lending rates to encourage lending to sectors which were considered particularly important for economic development such as agriculture (Brownbridge, 1998c: 107). On the basis of the Decree, the CBN developed over time a scheme of interest rate controls. According to the World Bank (1983a: 43), Nigeria's scheme was "perhaps one of the most rigid and comprehensive credit allocation schemes" in market-oriented developing economies.[65] In addition, in 1977 the CBN issued rural branching regulation, which required commercial banks to set up rural branches to mobilise savings and facilitate the delivery of agricultural credit (World Bank, 1983a: 58).

The CBN's financial policy placed less emphasis on promoting financial stability than it did on financial deepening. The potential of the regulation laid out in the 1969 Banking Decree to guard financial stability, for instance, was deficient. Notably, the Decree did not require banks to classify loans according to quality or to make provisions for non-performing loans, which would have reduced financial deepening (Brownbridge, 1998c: 120). Moreover, banks with liquidity shortages had recourse to the CBN, regardless of the quality of their management (NDIC, n.d.). Thus, the CBN pursued "an implicit policy of not allowing banks to fail" (Brownbridge, 1998c: 119).[66] Why did the CBN pursue this policy? One likely reason was the aim to support banks owned by the state and by politically connected individuals. According to the government, another reason, underscoring its concern for financial deepening, was that bank failures would have adverse effects on confidence in the banking system and the economy (NDIC, n.d.).

Although price stability was formally a primary goal of the CBN, it often resolved trade-offs between price stability and financial deepening in favour of the latter. A principal source of inflationary pressure was the increase of government borrowing from the domestic banking system, notably the CBN's monetisation of government debt, from the mid-1970s onwards.[67] A major reason for the increase of government borrowing was the failure of the government to reduce expenditure when oil revenues

[65] The scheme specified for instance for the year 1981 interest rate ceilings for 16 different sectors, and requested banks to maintain a minimum credit allocation of 70% to indigenous borrowers, 16% of which should be reserved exclusively for small-scale enterprises owned by Nigerians (World Bank, 1983a: 44). In addition, the scheme specified that a minimum of 40% of merchant banks' loans and advances should be of long- term maturity (over three years) and a maximum of 20% with short-term maturity.
[66] According to Brownbridge (1998c: 119) there were only four bank closures before the early 1980s, all of them occurring between 1960 and 1972. The frequency with which banks accessed CBN lender of last resort loans is not publicly available (Oluranti, 1991: 59 cited in Brownbridge, 1998c: 119) .
[67] Data on government borrowing from the domestic banking system for the period 1970 to 1981 reveals for instance that from 1977 onwards, the share of government borrowing from the central bank as a share of total borrowing from the banking system exceeds 25%, peaking at 68% in 1978 and 69% in 1981 (World Bank, 1983b: 57).

fell, as happened for instance in 1977.[68] Although the CBN controlled the structure of interest rates, it avoided increasing interest rates to tame inflation because it wanted to keep the costs of borrowing for the government and the private sector at a low level to deepen financial sectors (World Bank, 1983a). Instead, the CBN imposed quantitative ceilings on the overall and sectoral expansion of credit to combat inflation.[69]

Sometimes, as in 1979, credit ceilings were effective in reducing inflation (World Bank, 1983b: 16).[70] Often, however, credit ceilings were ineffective in guarding price stability. In some cases this was because the CBN was unable to limit government borrowing from the banking system, including from the CBN (World Bank, 1983a: 12). In other cases, credit ceilings were ineffective because banks failed to comply with ceilings on private credit. This happened for two reasons. First, banks were often unable to comply with changes in credit ceilings because their asset portfolio management had become rigid due to the sectoral credit allocation guidelines (World Bank, 1983a: 16). Second, the CBN often failed to enforce ceilings on private credit. As the CBN admits, "in pursuit of the objective of fostering the growth of a sound financial system to mobilise adequate development-oriented finance, the CBN has been obliged to be less constraining on the credit operations of the banking system than it otherwise would have been" (CBN, 1979: 127). In sum, credit ceilings were often exceeded to facilitate access to finance for the government and the private sector at the expense of price stability.

The orientation of central bank policy towards financial deepening and the neglect of price and financial stability objectives was certainly not a phenomenon unique to Nigeria. Many other central banks in developing countries at that time, including the Bank of Uganda, pursued similar policies to deepen financial sectors and subordinated the goals of promoting price and financial stability. There are two main reasons for these cross-national similarities. First, in many countries civil conflicts and indigenisation imposed similar pressures on central banks to focus on financing the government and the private sector. Second, the idea that central banks in developing countries may play an activist role in financing development and use regulation to

[68] In addition, the federal government borrowed significantly from the banking system for on-lending to state governments and parastatals which experienced financial difficulties.
[69] The CBN rarely used the other monetary policy instruments it had at its disposal such as open market operations, discount rate, liquidity and cash reserve ratios, stabilisation securities and special deposits.
[70] When credit ceilings were effective, they often helped to reduce inflation by curbing credit to the private sector rather than to the government (World Bank, 1983b: 16-18).

deepen financial sectors was part of the predominant economic thinking until the rise of neoliberalism from the late 1970s onwards.

Yet what is different in Nigeria is that the state's access to and control of a sizable share of investible resources significantly widened the fiscal space of the state, including that of the CBN, for expansionary and statist policies. While we do not know which policies the CBN would have pursued if the government had not had access to abundant oil revenues, it is clear that the material abundance presented the CBN with a wider range of options to promote financial deepening. With the funds it controlled, the CBN was, for instance, able to promote financial deepening through both allocative regulation and the provision of direct financing to the economy, rather than having to rely on regulation alone. The acquisition of stakes in public development banks, the provision of funds to these banks and the granting of agricultural credit guarantees to commercial banks, were all facilitated by abundant resources.

Oil Dependence, State-Society Relationships and the Orientation of Central Bank Policy

An account of the orientation of central bank policy towards financial deepening would not be complete if it focused only on the point that oil provided a material basis for expansionary policy. It is also important to consider how oil revenues shaped the stance of central bank policy through the effects they had on the relationship between the state and other actors, like business or donors. Oil dependence and the government's control of oil revenues moulded the political economy of Nigeria in three major ways, each of which makes an orientation of central bank policy towards financial deepening and economic expansion, as opposed to stability, more likely.

One way in which oil revenues shaped Nigeria's political economy and, as a consequence, central bank policy was by making political stability dependent on the distribution of rents. In Nigeria, the state became a distributive state, using globally extracted resource rents to distribute these rents internally. The distribution of oil rents strengthened the government's political power base in two ways: First, rents helped to sustain social peace in a country divided by ethnic conflict and unequal access to economic opportunity (Herbst and Soludo, 2001: 649). Second, distributing oil rents allowed for the dispensing of patronage to political constituencies and thus helped to cement loyalties. When rents were distributed, they assumed a variety of forms: Public sector wages, the award of government contracts and licenses or subsidised credit for the private sector. Okolie (1995) for instance finds that the main beneficiaries of subsidised agricultural credit programmes were large-scale farmers made up mainly of serving and retired military officers, top bureaucrats and wealthy business people. In orienting CBN policy towards financial deepening rather than stability, the state's ability to enhance political stability by garnering political support could be greatly enhanced: The CBN could support the distribution of rents through its role as a financial intermediary, for instance through engagement in development financing, and its role as a regulator and supervisor, which allowed the CBN to micromanage economic opportunity.

Another way in which oil revenues shaped Nigeria's political economy and, as a result, a central bank policy stance oriented towards financial deepening was by increasing the importance of state support for private business. Oil revenues had created a difficult environment for Nigeria's private sector. In particular, oil dependence had made economic expansion highly volatile due to the fluctuations in oil markets. By the late 1970s, Nigeria had become an unpredictable stop-go economy in which the level of economic activity and government spending closely tracked the ups and downs of the oil sector.[71] Moreover, oil-financed fiscal spending and lending had unwanted macroeconomic consequences. One consequence was Dutch disease, the reduction of the international competitiveness of export sectors such as agriculture due to an appreciation of the real exchange rate. Another unwanted macroeconomic consequence was inflation, which, as Figure 4.A3 shows, was high and volatile from the mid-1970s onwards in Nigeria.[72] When the business environment deteriorated due to the negative effects of oil dependence, the private sector became weaker and more dependent on state support in forms such as subsidised credit (World Bank, 1983b). Moreover, the negative effects of oil dependence on private sector development increased the state's incentives to support the private sector through financial deepening. In fact, addressing the negative effects of oil dependence on the productive sectors by channelling funds to these sectors was a significant element of the rationale behind the use of the CBN's credit allocation scheme (World Bank, 1983b: 2).

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[71] An overview of the stop-go pattern of economic management provides Table 4.A2 in the appendix.

[72] Key drivers of inflation were oil-financed fiscal spending and the CBN's monetisation of government debt, which partly stemmed from the failure to rein in expenditure when oil revenues declined (World Bank, 1983a).

A third, and from the perspective of the broader arguments of this thesis, particularly relevant way in which oil revenues shaped Nigeria's political economy and, as a consequence, a policy stance oriented towards financial deepening was by reducing the political influence of non-state actors. Oil revenues allowed the government to gain control of a significant share of Nigeria's investible resources. As a result, the government's policy space increased, as did its power vis-à-vis other actors, including those which would have been in favour of orienting policy towards stability and restraining the role of the state.

Business, for instance, was a limited source of pressure for orienting central bank policy towards stability and reducing the role of the state. Many Nigerian businessmen supported a policy stance oriented towards financial deepening because they had become reliant on state support or hoped to benefit from policies to increase access to finance (Okolie, 1995; Herbst and Soludo, 2001: 663, 669). For many foreign investors, some of which had struck profitable deals with the corrupt political elite and an affluent state, access to the state as a client or regulator of market entry was the primary concern (Turner, 1976a). Although for a few investors orienting policy towards stability and restraining the role of the state was an important policy concern, this group of investors was comparatively small and so too was the share of investible resources they controlled, hence their limited structural power. Into this category seem to fall, for instance, the foreign shareholders of Nigeria's four largest commercial banks. These banks had been foreign-owned until the government, facilitated by oil revenues, acquired controlling equity stakes in the 1970s. The CBN's controls on interest rates, rural branching requirements and credit guidelines reduced the profits of these banks (World Bank, 1981: 13; World Bank, 1983a; Brownbridge, 1998c: 109-110). These direct impacts on profits probably upset foreign shareholders. However, reductions in the banks' profits did not impede credit expansion because the government as a major shareholder used its powers to reinforce compliance with the CBN's regulation (Brownbridge, 1998c: 109) and the state's access to oil revenues reduced the need to increase the profitability of banking operations. Therefore, the government could afford to display limited sensitivity to banks' foreign shareholders regarding their concerns over profitability.

The political influence of donors was also limited because they provided only a small share of investible resources in Nigeria. Specifically, Nigeria had never sought IMF financing involving conditionality by the early 1980s. In addition, aid as a share of GNI decreased as oil revenues increased in the 1970s, as Figure 4.A4 shows. On the one hand, low reliance on aid reflected donors' efforts to reduce aid in response to Nigeria's rising oil revenues in the 1970s (Herbst and Soludo, 2001: 652). On the other hand, Nigerian leaders had been keen to reduce their reliance on aid when oil revenues increased. Reliance on aid and the accompanying conditionality was seen to reduce the policy space gained through oil revenues (Okolie, 1995: 35-36; Herbst and Soludo, 2001; Vreeland, 2003). A commonly held perception in Nigeria has been, as a CBN official explained, that "as Nigeria is not an IMF debtor country, it is freer".[73] Given the limited reliance on donors until the mid-1980s, it is not surprising that the Nigerian government did not address donors' criticisms of elements of central bank policy such as the interest rate scheme, which the World Bank deemed "excessive" (World Bank, 1983a).

The powerful incentives of oil dependence to orient central bank policy towards economic expansion became particularly evident when Nigeria experienced a second oil boom and bust. Following the Iranian revolution, oil prices almost doubled between 1979 and 1981. Accordingly, government revenues increased by 31% in 1979 and 21% in 1980 (Karl, 1997: 247). Donors voiced warnings at the beginning of the boom that the government should exercise fiscal restraint to limit inflationary pressures and maintain careful debt management.[74] Even the civilian government of Shehu Shagari, which had just come to power through elections in 1979, stressed the need to limit expansionary policy (Forrest, 1986: 175; Tijjani and Williams, 2006).

Nonetheless, the oil windfall once again set in motion expansionary policies to finance an agenda of state-led growth. For instance, the CBN relaxed oversight over credit policy and credit to the private sector exceeded ceilings in 1980 and 1981 (World Bank, 1983a: 44; Lewis, 2009: 155-156). In addition, fiscal and monetary policy became expansionary. The 1981 budget, for instance, allowed for a sizable increase of expenditure. When oil revenues declined from mid-1981 onwards, the government was reluctant to reduce its expenditure (World Bank, 1983b). As a result, the budget deficit increased significantly, from a mere 0.5% of GDP in 1980 to 9.5% in 1981. To finance fiscal deficits, the CBN embarked on money creation and lent funds to the government

[73] Interview Abuja, 4 February 2012.
[74] See for instance World Bank (1979: iii-iv).

at an hitherto unprecedented scale of 4.1 billion naira, amounting to 7% of GDP (World Bank, 1983b: 3; Herbst and Soludo, 2001: 657). Even when government revenues declined by 44% in 1981 owing to falling oil prices, the budget for 1982 remained expansionary. It is difficult to know precisely why the government failed to orient its policy towards stability. Yet it appears that pressures to stimulate the economy, incentives to dispense patronage and the weakness of groups in favour of stabilisation such as donors combined to pose barriers to changing the course of policy.

4.2 Attempts to Adjust to Declining Oil Revenues, 1982-1985

The expansionary policy spurred by the second oil boom had generated a full blown crisis by 1982 when the boom had turned to bust. In particular, there was an acute lack of funds to finance imports and government expenditure as foreign exchange reserves had fallen and government revenues declined by 19% owing to falling oil prices. To meet its financing needs, the government turned to the domestic banking system. Government borrowing from the central bank and domestic banks expanded by 57% in 1982, increasing credit expansion to such an extent that the CBN was unable to enforce its ceiling on credit growth (Forrest, 1986: 12). The government also looked to international institutions to raise funds. Nigeria withdrew its final entitlement from the IMF in 1982 (Forrest, 1986: 12) and incurred international commercial debt through syndicated bank loans. In 1982 and 1983, the government contracted foreign debt over three times what the country had accumulated in the 20 years since gaining independence (Awoseyila, 1996: 28).

In addition, the government announced a stabilisation package in April 1982, which was laid out in the Emergency and Stabilisation Act. The Act aimed at short-term stabilisation rather than structural reform and included measures such as a cutback of government expenditure, and stringent import and exchange controls. The policy package also incorporated an increase of interest rates and the imposition of advance deposit requirements for imports to contain inflation and financial deepening (World Bank, 1983a: 5). In addition, the CBN stopped issuing letters of credit (IMF Survey 1982: 103).

Yet the government was unable to regain control over the economy. Investors responded to the deteriorating business environment with capital flight (World Bank, 1983b: 4; Forrest, 1986: 13). The government had difficulties to service its commercial debt because of a lack of foreign exchange. Moreover, by 1983, Nigeria's access to credit was severely constrained: Credit markets were tight because of the international debt crisis, sparked by Mexico's default in 1982, and international banks responded to Nigeria's loss of expenditure control with withholding capital.

In 1983, the government stepped up its efforts to stabilise the economy. The government's stabilisation strategy had three major elements: First, in January 1983, the government reinforced some of the measures of the Emergency and Stabilisation Act. Second, the government borrowed massively from the CBN for immediate financial relief (CBN, 1994b: 94). Third, the government began negotiations with the IMF. President Shagari had delayed this step because he did not want to be the first Nigerian leader in history to submit to IMF conditions (Vreeland, 2003: 36). Yet approaching the IMF was now necessary because international banks blocked credit to most developing countries unless they secured an IMF seal of approval (Okolie, 1995: 203). The strategy worked and the dialogue with the IMF helped Nigeria to secure refinancing agreements to convert some arrears on letters of credit into medium term loans (Forrest, 1986: 13).

However, the negotiations with the IMF reached a stalemate over key elements of a stabilisation programme such as the devaluation of the Nigerian naira and, as a result, the government did not reach a programme agreement with the IMF (Lewis, 2009: 158). A major reason for the stalemate was that 1983 was an election year and the government did not want to give the impression that it was going to institute a tougher reform programme (Herbst and Soludo, 2001: 661). Moreover, the government was keen to signal to the public that it would not bow to IMF conditionality because the public was opposed to an IMF arrangement (Vreeland, 2003: 35-37).

The failure to pursue a consistent reform programme had devastating effects. The economic situation continued to decline, with the country's GDP contracting by 5% in 1983 and inflation soaring from 8% in 1982 to 23% in 1983. Moreover, while Shagari was re-elected in 1983 due to a combination of vote-buying, fraud and intimidation, he was soon overthrown in a military coup by General Muhammadu Buhari. Among the reasons given for the coup were the enduring economic crisis and widespread corruption (Herbst and Soludo, 2001: 661-662). The fall of Shagari's administration and the economic decay thus underscore the economic and political instability which may arise when those supplying investible resources, such as commercial banks and donors, withhold their funds and the state has no access to replacement resources.

When General Buhari came to power in 1983, he announced a “war against indiscipline”, promising to restore economic stability and reduce widespread corruption. Confronting a fiscal crisis and a steep economic decline, the Buhari regime sought to regain control over the economy and win the confidence of international creditors so that debts could be rescheduled and new debt accessed. Negotiations with the IMF resumed, but the Buhari regime was unable to reach an IMF agreement due to its lack of willingness to be responsive to IMF concerns in key policy areas such as devaluation, privatisation and financial liberalisation (Lewis, 2009: 161). Instead, Buhari embarked on a reform programme which combined monetary contraction, fiscal retrenchment and tight import and exchange controls (Olukoshi and Abdulraheem, 1985; Okogu, 1986). The idea was to solve Nigeria’s liquidity problem by withstanding three years of austerity (Forrest, 1986: 24). Structural adjustment reforms, which the IMF and the World Bank advocated and which required more wide-ranging measures such as devaluation and financial liberalisation, could then be postponed.

Although the regime made some progress in restoring financial discipline, the economy suffered from the weight of the austerity measures. In addition, efforts to reschedule debts were not successful because international creditors rejected Nigerian proposals to reschedule debt in the absence of participation in an IMF programme (Forrest, 1986: 24). Moreover, due to the austerity measures, popular support for the government declined to the extent that protests ensued, which were swiftly repressed. Yet repression was unable to restore political stability. Divisions within the military about the use of repression and a lack of popular support for the government provoked a successful coup attempt in August 1985, led by General Ibrahim Babangida (Forrest, 1986: 23).

4.3 Structural Adjustment in the Context of Rising Oil Revenues, 1986-1993

The economy was in crisis when Babangida came to power. Average growth had been negative between 1980 and 1985. Moreover, the government was starved of revenue, challenging the state’s ability to distribute rents. The government understood that if it was to stay in power it had to undertake reforms which would help to mobilise investible funds. However, tinkering on the margin and intensifying the austerity measures and import controls, as Shagari and Buhari had attempted, was not a viable option. Such measures had failed to reverse the economic decline and lacked the support of the IMF which was needed both to begin debt rescheduling talks with private lenders and to access new credit (Herbst and Soludo, 2001: 650). The government was aware that the only option it could realistically consider was to embark on a SAP that was supported by the World Bank and the IMF (Herbst and Soludo, 2001: 662). As Babangida's Finance Minister Kalu Idika Kalu stressed, the question was not whether Nigeria should take the IMF loan and the accompanying conditionality but whether it could afford not to do so (Herbst and Soludo, 2001: 666). While the government also wooed domestic and foreign big business (Olukoshi and Abdulraheem, 1985: 100-101), getting the support of the IFIs was particularly urgent at that time because the balance of payments benefits of private investment would not be felt for some years.

Data on Nigeria's debt burden reveals that the government experienced immense structural pressures to be responsive to donors and private lenders by changing the orientation of policy in the mid-1980s. Non-concessional debt as a percentage of total exports serves as a relatively good measure of the pressure for reform because it indicates how much revenue government leaders had available in light of their almost complete dependence on oil export earnings for government revenue (Herbst and Soludo, 2001: 650). As Figure 4.A5 shows, the ratio of non-concessional debt to total exports, and thus the pressure for reform, was tremendously high in 1986. Moreover, oil revenues were, as Figure 4.A2 shows, at a very low level in 1986 as oil prices halved that year.

Given the immense pressure for reform by this stage, the government embarked on a set of structural adjustment reforms in July 1986. The objectives of the policy package included laying the basis for sustainable non-inflationary or minimally inflationary growth; reducing unproductive investments in the public sector; intensifying the growth potential of the private sector; and financial reform, including the removal of credit allocation and the maintenance of positive real interest rates (FRN, 1986). These objectives were broadly in line with those of the SAPs supported by the World Bank and the IMF in other developing countries. However, in an effort to secure domestic support for reform official rhetoric insisted that the SAP was "produced by Nigerians for Nigerians" (Babangida, 1987 cited in Herbst and Soludo, 2001: 665). Moreover, although the IMF officially monitored Nigeria's SAP, the government did not accept a conditional IMF loan and made minimal use of technical assistance, which would have facilitated social learning (Herbst and Soludo, 2001).

Though the prospect of debt rescheduling provided strong incentives for reforms, their implementation was very inconsistent (Moser et al., 1997: 12). The reform of Nigeria's central bank policy illustrates the inconsistency of the reform process. Monetary policy, for example, was tightened in 1986 and 1987. Yet after protests in 1988 and 1989, the CBN embarked on reflationary measures to cushion the effects of structural adjustment by reducing the costs of borrowing for the government and private sector (Lewis and Stein, 1997: 11). Between 1991 and 1993, monetary policy became increasingly expansionary, raising the volume of financial transactions. The CBN's advances to the government, for instance, increased by 359% between 1991 and 1993 (CBN, 1994a: 17).

The CBN's efforts to orient financial policy towards financial stability were equally inconsistent. The CBN, for instance, removed interest rate controls in 1986 and 1987. Yet in 1989, the CBN also introduced a maximum interest rate spread between saving and prime lending rates and in 1991 the CBN re-imposed ceilings on maximum lending (Herbst and Soludo, 2001: 668). Credit allocation guidelines were simplified but maintained and development financing schemes, such as the agricultural credit guarantee scheme, remained in place. The CBN also continued to support financial deepening through its ownership stakes in development banks.

In an effort to orient financial policy more towards financial stability, the CBN established a mechanism for dealing with distressed banks, provided limited deposit insurance and imposed stricter prudential standards (Brownbridge, 1998c: 120). The Banks and Other Financial Institutions Decree of 1991, which replaced the Banking Act of 1969, increased the CBN's disciplinary powers, providing it, for instance, with the authority to take over the management of distressed banks.

The degree to which the CBN was able to enhance financial stability was, however, limited. Although regulation had been tightened in 1991, political interference impeded its enforcement (Lewis and Stein, 1997: 11; Brownbridge, 1998c: 121). Another problem was that the state used the financial liberalisation process as a means to protect the patronage system and reallocate rents to political constituencies. In 1986 and 1987, the CBN liberalised entry into the banking sector and opened an inter-bank foreign exchange market. The persistence of multiple foreign exchange rates offered opportunities for arbitrage, allowing banks to garner returns of 300% or more on gross investment (Lewis and Stein, 1997: 7).[75] Given these immense profit-making opportunities, applications for banking licenses quadrupled within three years. The CBN and the government granted a large amount of licenses so that the number of banks operating in Nigeria tripled between 1986 and 1992 (NDIC, 1990: 44). Yet in an effort to distribute rents to political supporters most of these licenses were granted to politically connected individuals, many of whom lacked professional experience in banking (Lewis and Stein, 1997). Mismanagement and fraud in the new banks and limited capacities of the CBN to supervise the large number of banks dramatically increased financial fragility.

In 1992, the programme with the IMF expired and was not renewed due to the deterioration of economic management. What accounts for the inconsistent implementation of monetary and financial reform in Nigeria? One factor appears to be pressure to consolidate power by placating domestic political interests and consolidating the support of key constituents (Lewis and Stein, 1997: 12). As Herbst and Soludo (2001: 663; 669) explain, the structural problems in the Nigerian economy, such as a limited credit system and a difficult business environment, prevented business from supporting the SAP and both ordinary citizens as well as the ruling elite had become accustomed to subsidies, patronage and rents. Therefore, the SAP was met with mass rioting and unrelenting criticism from most groups within Nigerian society. The government, however, wanted to increase its popular support, particularly because Babangida had, in parallel to the SAP, initiated a process of transition to civilian rule and announced that elections were to be held in 1993. Expansionary monetary, fiscal and financial policy served to increase political support (Lewis and Stein, 1997).

Another factor may be that before 1992, donors did not sanction the inconsistent implementation of reforms by withholding funds, reducing the incentives to correct the course of policy. As Figure 4.A4 shows, from 1986 onwards donors began to reward the fact that Nigerians finally seemed to be taking reform seriously. Similarly, the IMF offered three standby arrangements between 1987 and 1991 which in turn led to three debt rescheduling agreements between 1986 and 1991 with the Paris Club of creditor

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[75] See Lewis and Stein (1997: 18) for details on the arbitrage opportunities in foreign exchange markets.

countries (Herbst and Soludo, 2001: 656). Only when the SAP lapsed in 1992 did donors respond to reform reversals and economic decay by reducing aid.

A third factor accounting for the inconsistent implementation of reforms, which directly relates to the broader arguments of this thesis, appears to be that access to replacement resources in the form of oil revenues increased over the course of the SAP. As Figure 4.A2 shows, oil revenues increased steadily from 1986 and, following the Iraqi invasion of Kuwait in 1990, Nigeria experienced an oil windfall which lasted until 1991. As explained above, the government was under strong pressure to buy political support through expansionary policy. Moreover, the access to oil revenues reduced the power the IMF and World Bank had gained over policymakers through their influence on debt rescheduling (Herbst and Soludo, 2001: 671-673). Thus, incentives to be responsive to the policy concerns of the IFIs declined. Given the pressure for expansionary policy and the reduced influence of donors, it is not surprising that, in the late 1980s and early 1990s, the CBN's emphasis on financial deepening increased. In particular, monetary policy became increasingly expansionary and interest rate controls were reintroduced, as outlined above. This suggests that the increase in oil revenues contributed to the return to a policy stance oriented towards financial deepening and economic expansion.

Economic mismanagement and several deferrals of the transition to democracy reduced Babangida's popular support and, in June 1993, he was defeated in the presidential elections. A few months later, General Sani Abacha overthrew an interim government in a military coup.

4.4 Reform Reversals and Stabilisation Policies after the Boom, 1993-1998

When Abacha seized power, oil revenues were still considerable and donors and large-scale private investors were unable to influence policy when economic management further deteriorated. Large firms and multinational enterprises, which had organized themselves under the umbrella of the Nigerian Economic Summit Group, lobbied the government extensively in 1993 to promote price stability and to rely more on market mechanisms, including by deregulating interest rates (Kraus, 2002: 423). Yet in 1993 monetary and fiscal policies remained expansionary and the Abacha government reversed core elements of the SAP, returning to a regime of administrative controls on finance, trade and foreign exchange (Lewis and Stein, 1997: 15). The CBN, for instance, introduced new interest rate ceilings in 1994 to deepen financial sectors.

Economic reformers, like the Finance Minister Kalu, who had been an architect of Nigeria's SAP, were replaced in 1993 and 1994. Moreover, governance deteriorated with regulators like the CBN, for instance, inadequately funded, frequently being undercut by intervention from the executive and plundered by senior officials, including Abacha (Lewis, 2009: 178). Opposition to the regime was met with political repression.

When oil revenues declined steadily after 1993, the regime oriented policy increasingly towards stability. For instance, the CBN was empowered in 1994 to pursue measures to address fraud in the banking sector which scholars considered to be "draconian" but arguably aimed at enhancing financial stability.[76] In addition, the CBN reduced the volume of financial transactions in the economy through monetary restraint and by raising interest rate ceilings in 1995, displaying greater responsiveness to the policy concerns of the large-scale private sector and donors to rely more on market mechanisms and promote economic stability (IMF, 1998: 6-7; Kraus, 2002: 423; Lewis, 2009: 176).[77]

However, the orientation of policy towards stability insufficiently addressed the policy concerns of donors and business. In light of the reversal of key elements of economic liberalisation, political repression and predation, donors drastically reduced aid, as shown in Figure 4.A4. Investors also responded to the policy environment by withholding funds. Debt rescheduling, for instance, was suspended (Herbst and Soludo, 2001: 656). Foreign firms disinvested and gross fixed capital formation dropped by 26% between 1994 and 1996 (Lewis, 2009: 177). In 1995, the economy contracted and between 1994 and 1998 GDP growth averaged a mere 2%. Greater efforts to respond to structural pressures only began when the retired General Olusegun Obasanjo came to power after elections in 1999, a year after Abacha's death.

Using an approach focused on structural power, we would have expected that the Abacha regime is more responsive to the policy concerns of business and donors given that oil revenues were declining and thus unable to replace investible resources provided by donors and private investors. The government's failure to be fully responsive to the policy concerns of donors and private investors suggests that the structuralist approach

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[76] See for instance Brownbridge (1998c: 120). While the banking sector was close to collapse, restoring financial stability was not the only objective of the measures to reduce fraud. The Abacha regime also prosecuted bankers because many of them were aligned with the opposition (Lewis, 2009: 178).

[77] The regime also made an effort to attract FDI by repealing indigenisation policies for most sectors in 1995.

does not provide an entirely convincing explanation for policy during Abacha's regime. The reasons for the government's failure to be more responsive are not clear. As regards donors' policy concerns related to the reversal of economic and financial liberalisation and the weakening of regulatory institutions such as the CBN, a likely explanation for the government's failure to be responsive is that responsiveness would have reduced possibilities for corruption and the micromanagement of opportunity, which the regime had used to benefit political supporters.

4.5 In Search of a Balance between Financial Deepening and Stability, 1999-2012

The task, if President Obasanjo was to rule with some political stability, was to enhance economic prosperity. Democracy, as Obasanjo relentlessly explained, would "not be sustained unless, in the shortest time possible, we are able to give what I call a democratic dividend to our people" (Reuters, 2000). The government was convinced that, after decades of military rule, multi-party democracy could only be cemented if standards of living increased. The government's strategy to enhance economic prosperity was based on two cornerstones: Securing debt relief and raising levels of private investment.

The government was aware that the effects of its efforts to raise private investment on production and economic diversification would not be felt for some years and that addressing the tremendous debt burden would bring quicker financial rewards. When the government came to power in 1999, servicing of external debt amounted to 9% of exports (World Bank, 2013c). Securing debt relief was imperative to free up government resources. Such resources would be needed to dispense patronage, stimulate economic activity and honour the government's pledge to improve basic public services such as health and education. Yet despite rising oil prices, a sizable share of government revenue continued to be diverted to servicing debt (IMF, 2001).

Raising private investment was the second cornerstone of the government's strategy. As Figure 4.A6 shows, in the early 2000s, government revenue still made up a significant share of investible funds, owing to the government's virtual monopoly over Nigeria's export earnings. The share of investible funds supplied by private investors was sizable. Yet the non-oil export sectors remained weakly developed: Between 1999 and 2003 fuel exports accounted on average for more than 98% of merchandise exports (World Bank, 2013c). Moreover, capital flight was extensive.[78] Macroeconomic volatility, uncertainty regarding the economic policy stance of the newly elected government, pervasive corruption and limited access to finance combined to create a poor investment climate. Yet the government knew that private investment in the non-oil sectors would be essential if there was to be a sustainable increase of economic activity and a reduction in Nigeria's vulnerability to oil price volatility (Obasanjo, 2003; NNPC, 2004; Okonjo-Iweala, 2007: 12).

The remainder of this chapter will describe how oil dependence has shaped the CBN's contribution to achieving the goals of debt relief and raising private investment. I make no effort to describe all of the CBN's policies to raise private investment. Instead, I selected case material which explains how the CBN's efforts to raise private investment appears to have contributed to a banking crisis in 2009 and shaped the crisis response. The focus of the analysis is on the dynamics surrounding the banking crisis because they are well suited to convey the orientation of financial policy in the 2000s and the role of oil dependence in shaping the policy stance.

Securing Debt Relief

"I will not stop talking about debt remission," Obasanjo announced in 2000 (Reuters, 2000). Given Nigeria's experience of 20 years of arrears accumulation, debt restructuring and rescheduling, securing debt relief had become a priority of the Obasanjo regime. The government's strategy to reduce the debt burden had two elements: The first entailed visits to plead for debt relief (Nwozor, 2009). During his first administration from 1999 to 2003, Obasanjo travelled extensively to Western countries, making over 180 foreign trips within four years (Sonowo, 2003: 50). The second element of the government's strategy to reduce the debt burden was to intensify the dialogue with the IMF because creditors made debt relief conditional on the IMF's stamp of approval of Nigeria's economic policies. The Nigerian government's first major step was to agree on an IMF Stand-By Arrangement beginning from July 2000.

During his first term, Obasanjo's success in reducing the debt burden was limited. An initial achievement was that the Paris Club of international creditors agreed to reschedule US$23.4 billion of Nigeria's US$33.5 billion foreign debt in December

[78] According to some estimates, the figure of Nigeria's total private wealth moved off-shore is as high as 70% (Collier, 2003 cited in Utomi et al., 2007: 18).

2000. So long as Nigeria's policies would be approved of by the IMF, Nigeria would be given a grace period of three to ten years, depending on the category of debt (The Economist, 2000). Yet Obasanjo did not secure debt relief during his first term.

A key reason for the failure to secure debt relief was that, from 2000 onwards, the government and CBN pursued expansionary monetary and fiscal policies (IMF, 2003b: 5; Callaghy, 2009). Against the backdrop of buoyant oil revenues and pressure to deliver a democracy dividend before the presidential elections in 2003, the government massively increased expenditures (IMF, 2001).[79] Instead of fighting inflationary pressures, the CBN supported the government's expansionary policy stance by extending a significant amount of credit to the government and seeking to maintain a low level of interest rates in the economy.

The CBN was aware that expansionary monetary policy would impede its ability to reach the monetary and inflation targets agreed with the IMF. However, facilitating investment, particularly in the non-oil sectors, took priority (IMF, 2001: 21; IMF, 2004: 22). During Article IV consultations, the IMF urged policymakers to orient policy towards stability (IMF, 2003b), but without success. Once again, high oil revenues provided the material basis for expansionary policies and efforts to reduce oil dependence generated incentives for policies oriented towards financial deepening. It was clear that expansionary policy would alienate the IMF. Yet the government was willing to pay this price to ensure re-election and high oil revenues provided the policy space to pursue expansionary policies (Wallis, 2002; DMO, 2004: 14; Callaghy, 2009: 21). As the Nigerian government was not reliant on the IMF's financial assistance, the IMF resorted to its only disciplinary measure: It suspended the programme with Nigeria, which had been the precondition for debt relief.

When Obasanjo won another term of office in 2003, securing debt relief remained on the top of the government's policy agenda. A comfortable majority in the parliament and high oil prices generated a benign economic environment and thus a unique window of opportunity for economic reform (IMF, 2004: 6; Utomi et al., 2007: 21). Obasanjo seized this opportunity. He appointed a new economic team of internationally respected technocrats, including Charles Soludo, a renowned economist who was to become central bank governor in 2004, and Ngozi Okonjo-Iweala, a former Vice President of

[79] The fiscal deficit amounted to 3% of GDP in 2001 and 6% of GDP in 2002 (IMF, 2003b: 6).

the World Bank. The economic team knew that an IMF arrangement would be unpopular. Thus, the team designed a "home-grown" reform programme, the National Economic Empowerment and Development Strategy (NEEDS), which was to be formally monitored by the IMF but not supported by an IMF loan (Okonjo-Iweala, 2007: 5-6). The commitments of NEEDS were to create an environment conducive to investment, growth of the non-oil economy and poverty reduction. This was to be achieved by enhancing macroeconomic stability, increasing the effectiveness of public spending, promoting the private sector and addressing corruption and rent-seeking behaviour (NNPC, 2004). The hope was that if the reform programme was "as strong or stronger than what the IMF would have put in place" it would be acceptable to the Paris Club (Okonjo-Iweala, 2007: 5). The IMF agreed to a programme of intensified surveillance which was replaced by a PSI in 2005.

By 2005 the IMF was broadly satisfied with the orientation of economic policy in Nigeria. NEEDS responded to criticisms by the IMF that Nigeria lacked a comprehensive poverty reduction and reform strategy and the commitments of NEEDS were broadly consistent with the IMF's reform recommendations (IMF, 2004: 14-16). Fiscal restraint reduced pressures on the CBN to fight inflation through monetary policy tightening. When inflation rose, the CBN tightened monetary policy (IMF, 2005a; IMF, 2006a). Moreover, the CBN reviewed its policy instruments with a view to enhance price stability (IMF, 2005a: 6). Though financial deepening remained a primary goal of financial policy, the CBN implemented major reforms to enhance financial stability which had been recommended by a Financial Sector Assessment by IMF and World Bank in 2001/2002 (IMF, 2004: 15). Nigeria earned recognition from the IMF for its ability to maintain macro-economic prudence in an environment of high oil revenues.

In 2005, the Paris Club agreed to grant debt relief, which was fully implemented after a successful programme review under the PSI in 2006 (IMF, 2006a). The government achieved a 60% debt write-off. Policymakers had been able to use the policy space provided by buoyant oil revenues to design a "home-grown", politically acceptable reform programme, to buy off key political constituencies and to increase social service expenditure while maintaining fiscal and monetary restraint (Utomi et al., 2007: 21; Callaghy, 2009: 35). This episode underscores that oil dependence increases the propensity for expansionary policies but also shows that there is no determinism and that governments may use the policy space provided by oil revenues to employ those policies which seem best suited to enhance their chances of staying in power. That said, pressures for a policy stance oriented towards financial deepening did press themselves on policymakers. These pressures are the subject of the remainder of this section.

The Banking Sector Consolidation and the Banking Crisis of 2009

A serious concern for the government in the early 2000s was that many Nigerian banks were fragile, preferred lending to the government rather than to the productive sectors and had become reliant on public sector deposits rather than making efforts to mobilise savings from the public (Soludo, 2004). Therefore, financial reform was a key element of policymakers' efforts to raise private investment and diversify the economy (NNPC, 2004: 24; 75). NEEDS, for instance, aimed at strengthening the financial sector and encouraging it to play a developmental role by financing the real economy (NNPC, 2004: 75). When Charles Soludo, one of the key architects of NEEDS, became CBN governor in 2004, he seized the opportunity to develop a reform programme aimed at achieving exactly these goals.

Barely two months in office, Soludo shocked the banking industry when he presented the 13-Point Banking Reform Agenda to bankers at a special meeting in July 2004. The 13-Point Agenda included various measures to strengthen financial stability and increase banks' incentives to reach out to new customers.[80] The centrepiece of the agenda was the consolidation of the banking sector through an increase of the minimum capital requirement for banks from about US$15 million to US$190 million. Banks were given 18 months to comply with the requirement, which was envisaged to be achieved through mergers and acquisitions.

When Soludo (2004: 3) announced the reforms he argued that mergers and acquisitions would be an instrument for enhancing banking sector efficiency, size and developmental roles. Soludo argued the consolidation would help to ensure the safety of depositors' money, facilitate access to finance for entrepreneurs and create internationally competitive banks that would mobilise international capital, each of which supports financial deepening. Many banks were badly affected by the consolidation because it would force them to close down business or merge with other banks. Although the

[80] Other points on the agenda were for instance the adoption of a zero tolerance in the regulatory framework, the enforcement of dormant laws and the withdrawal of public sector funds from banks (Soludo, 2004).

affected banks voiced their complaints loudly over the next months, they were ultimately powerless: Many of Nigeria's 89 banks were weak players because they were dependent on government deposits and had a volatile resource base given that government revenues depended on volatile oil markets. This weakness helped Soludo to gain presidential backing for his reforms. In addition, the IMF and the World Bank supported the consolidation arguing that it would contribute to financial stability if the reform was accompanied by tighter regulation and supervision.

At first, the banking consolidation seemed to have achieved the expected positive outcomes: The number of banks declined, so that out of 89 banks, only 25 larger banks remained. The banking sector deepened and banks moved into the formerly untapped retail sector in response to pressure to use the funds raised from the increased capitalisation. As Figure 4.A7 shows, credit to the private sector roughly doubled in nominal terms between the end of 2005 and September 2007. High oil revenues fuelled the growth of deposits and thus credit. Nigeria's consolidated banking sector attracted the interest of international investors owing to strong global liquidity and Nigeria's high, oil-driven growth. Given the banking sector's high share on the stock exchange, the stock market boomed.[81]

However, the CBN failed to ensure the adequacy of the capital of merged institutions and the tightening of regulation and supervision in line with the expansion of finance. In 2008, the global financial crisis magnified the risks in the Nigerian banking system: When oil prices experienced large swings in the wake of the crisis, some Nigerian banks were badly affected because they were heavily exposed to the oil sector. Moreover, when, as a result of falling oil prices and the global financial crisis, international investors pulled their funds out of Nigeria, the share prices of banks declined. Some banks were heavily affected because the value of their equity declined and defaults on loans provided for equity investments increased.[82] A weak prudential framework, dependence on the oil sector, the downturn of the stock market and concerns about banks' rising share of non-performing loans and the accuracy of their financial reporting combined to produce a full-blown banking crisis.[83] In 2009, 10 out of the 25 remaining

[81] For an overview of the immediate effects of the banking consolidation see IMF (2008b: 23-28).
[82] Banks provided loans for borrowers to purchase equity in the banking sector, so-called margin-loans.
[83] For an overview of the causes of the banking crisis see Sanusi (2010) and World Bank (2010: xvii).

banks, accounting for about a third of banking system assets, were either insolvent or undercapitalised, underscoring the risks of major and rapid financial deepening.

It is difficult to know precisely whether there is a link between oil dependence and the banking reforms which aimed at financial deepening because the impact of oil dependence on the banking consolidation cannot be directly observed.[84] Yet such a link seems at least plausible: In Nigeria, the aim to reduce oil dependence was a major incentive for efforts to develop the private sector, including by improving its access to credit, while the banking consolidation was part of a larger strategy to position banks to finance the private sector (NNPC, 2004: 75; Soludo, 2004; Sanusi, 2012: 3). In addition, the banks that were most opposed to the consolidation because it forced them to close down or merge lacked the structural power to block the reform because the share of investment resources they provided was limited and their resource base depended on the state.

When Soludo's term as CBN governor ended at the onset of the banking crisis, President Yar Adua, Obasanjo's successor, nominated Lamido Sanusi as CBN governor.[85] Sanusi, a career banker, pledged to restore financial stability and enhance the contribution of the financial sector to the development of the real economy. Under Sanusi's leadership, the CBN took quick and firm action to address the banking crisis: It rescued the failing banks, guaranteed inter-bank transactions and announced a commitment to protect depositors and creditors. The CBN's bail-out of the failing banks suggests that banks had significant structural power despite the state's control of sizable oil revenues, probably because they had gained systemic importance after the consolidation. Thus, the central bankers faced powerful structural constraints in dealing with distressed banks. However, the CBN took some measures that directly impinged on the interests of the banks. In particular, Sanusi replaced the management in eight of the failing banks and published the names of loan defaulters, including some politicians. The CBN did not care that some parts of the banking industry complained loudly that, in their opinion, the CBN's measures were "draconian". One reason for the CBN's measures was frustration over the banks' limited contribution to raising private

[84] This is not to say that the banking consolidation did not simultaneously aim at enhancing financial stability. Yet, as both the reasons Soludo gave for the reforms and the failure to follow up on recommendations of the IMF to upgrade regulation and supervision during the consolidation suggest, deepening financial sectors was for the CBN at least as important as enhancing financial stability.

[85] Umaru Musa Yar'Adua was President of Nigeria from 2007 to 2010.

investment (Sanusi, 2010). Meanwhile, to what extent oil revenues provided the political space to take such measures is not clear.

The medium-term goal of Sanusi's crisis response was to position the banking sector so that it could support private sector development. Accordingly, the CBN strengthened prudential regulation and supervision to enhance bank stability.[86] Monetary policy was aimed both at price stability and at ensuring low interest rates to encourage bank lending to the private sector (IMF, 2011: 9). In addition, the CBN massively expanded its development financing activities. The CBN's Development Finance Department, which had replaced the Agricultural Financing Department, set up various schemes to provide loans at below-market interest rates and to guarantee bank loans to preferred sectors such as agriculture. Sanusi was convinced that to diversify the economy and develop the private sector "a more interventionist, directional economic policy stance should be adopted" and championed by the CBN (Sanusi, 2010: 15; 18). Buoyant oil revenues, which facilitated a significant increase in the CBN's capital in 2007 from 300 million to 100 billion Nigerian naira, provided the material basis for the CBN's development financing efforts.

While the CBN earned much recognition for the regulatory reforms to restore financial stability, its longer term agenda of supporting economic diversification and private sector development through "directional" central bank policy has been controversial. Business representatives complain that the funds of development financing schemes are diverted to political constituencies but remain in favour of such schemes as they lack other sources of financing.[87] The IMF criticised the CBN's efforts to stimulate lending to the private sector through expansionary monetary policy and development financing schemes and urged the CBN to focus on ensuring price and financial stability (IMF, 2011). Yet as the Nigerian government is not reliant on IMF financing, the IMF is not in a position to impose conditions which aim at orienting central bank policy towards stability. Moreover, other donors working on financial deepening admitted that the CBN was their preferred project partner because the CBN had, through its resource base, the political clout to implement reforms and well-skilled officials.[88] Even within the

[86] Measures include the repeal of universal banking guidelines in 2010 in favour of a "back-to-basics" banking model, the design of a macro-prudential policy framework and the adoption of International Financial Reporting Standards in 2012.
[87] Interviews with representatives from Nigeria's Manufacturing Association in Lagos, 2 February 2012.
[88] Various interviews with senior aid officials in Abuja, in October 2010 and January 2012.

government, criticism emerged that the scope of the CBN's interventions to support financial deepening had become too wide, that it was engaging excessively in what should be fiscal operations and that it was taking on responsibilities of other ministries such as capacity building for entrepreneurs. The CBN replied to such criticisms by saying that "it fills the gaps left by other ministries by adding its own resources," as a CBN official put it.[89]

Ultimately however, access to oil revenues and its political-economic consequences not only enlarged the CBN's policy space but also posed a limit on the extent to which the CBN under Sanusi was able to transform Nigeria's political economy. This became clear in 2014, when Sanusi charged that there was a shortfall of US$ 20 billion in oil revenue owed to the treasury by the state oil company. President Jonathan Goodluck subsequently dismissed him from office, allegedly due to financial malpractice. These allegations were never proven and it is widely believed that Sanusi's dismissal was the consequence of his efforts to defy powerful vested interests which benefited from the systemic corruption encouraged by resource revenues.

4.6 Conclusion

The material presented in this chapter is broadly in line with the proposition that in developing countries which are more dependent on natural resources, the central bank policy stance is more likely to be oriented towards financial deepening. In Nigeria, changes in oil revenues have tended to induce changes in its central bank policy. When oil revenues increased in the 1970s, for instance, the CBN's policy stance became oriented towards financial deepening. In response to declining oil revenues, efforts were made to orient Nigeria's central bank policy towards stability from the 1980s onwards. Yet reforms ended with an oil boom in the early 1990s. In the 2000s, high oil revenues complicated efforts to orient policy towards stability and oil dependence appears to have encouraged policies to deepen financial sectors.

The causal pathways linking resource dependence to a policy stance oriented towards financial deepening were broadly those outlined in Chapter 2. In particular, the evidence suggests that abundant resource revenues provided the material basis and increased the incentives for the Nigerian state to buy political support from key constituencies and to develop the private sector through policies to deepen financial sectors. Moreover, the

[89] Interview in Abuja, 24 January 2012.

state's access to resource revenues appears to have reduced the power of non-state actors, notably donors, to influence the stance of central bank policy. Specifically, when oil revenues increased, responsiveness to the interests of the IMF and the World Bank declined, even when both institutions sought to influence central bank policy through coordinated action.

That said, the approach focused on structural power cannot always explain the central bank policy stance in Nigeria. In the 1990s, for instance, the Abacha regime failed to respond to declining oil revenues by becoming more responsive to the policy concerns of donors to limit central bank interventions in financial markets. Moreover, the evidence suggests that oil revenues do not alone account for changes of the central bank policy stance. For instance, the events surrounding the implementation of the SAP under Babangida suggest that pressure to secure political support may also encourage a policy stance oriented towards financial deepening.

A final and important point that Nigeria's case demonstrates is that while higher resource revenues for the state may enhance the policy space for central bank activities to promote financial deepening, there may not necessarily accrue large benefits for the broader population. In Nigeria, a policy stance oriented towards financial deepening was often pursued at the expense of stability and served to dispense patronage, rather than to increase productive investment. In fact, central bank policy in Nigeria illustrates the contradictory tendencies of state-led and oil-financed development which are well documented in the literature (Karl, 1997; Watts, 2004). On the one hand, access to and control over oil revenues tend to enhance the policy space and render the state more visible. On the other, oil revenues often result in uncontrolled, corrupt and volatile development that undermines the state's ability to govern the economy.

4.7 Appendix

Table 4.A1: Chronology of Major Economic and Political Events

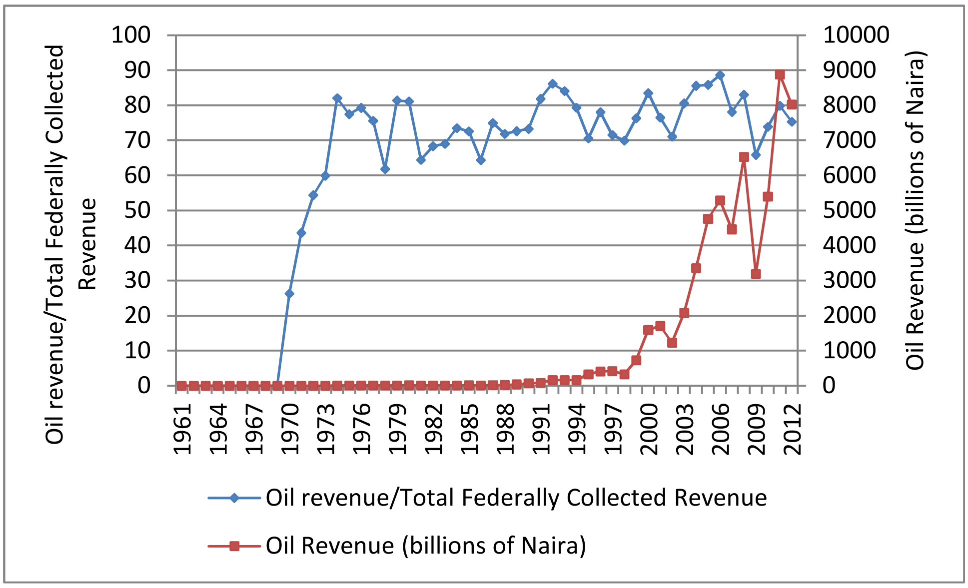
1959	The Central Bank of Nigeria (CBN) is established.
1960	Nigeria becomes independent from the United Kingdom.
1966	The Nigerian military seizes power through a coup.
1967-1970	Nigeria descends into civil war.
1974	Nigeria experiences its first oil boom.
1979	Elections bring the civilian government of Shehu Shagari to power.
1979-1980	Nigeria experiences a second oil boom.
1982	The Nigerian government enacts the Emergency and Stabilisation Act to cope with the decline of oil revenues.
1983	General Muhammadu Buhari seizes power through a military coup and begins the “War Against Indiscipline”.
1985	General Ibrahim Babangida seizes power through a military coup.
1986	Nigeria embarks on a SAP.
1990-1991	Nigeria experiences another oil windfall.
1992	Nigeria’s SAP lapses and expires.
1993	General Sani Abacha seizes power through a military coup.
1998	General Sani Abacha dies.
1999	Elections bring the civilian government of Olusegun Obasanjo to power.
2004	The Nigerian government develops the National Economic Empowerment and Development Strategy (NEEDS).
2004	CBN governor Charles Soludo presents the 13-Point Banking Reform Agenda.
2005	The Nigerian government secures a debt relief.
2008	Nigeria’s economy is badly affected by the global financial crisis.
2009	Nigeria experiences a systemic banking crisis.
2010	CBN governor Sanusi Sanusi resolves the financial crisis and begins to step up the CBN’s development financing operations.
2014	President Jonathan Goodluck dismisses the CBN governor Sanusi from office.

Table 4.A2: Nigeria’s Stop-Go Economy – Developments in the 1970s

Year	Developments in the economy
1974	When oil prices surged in 1974, the revenues of the Nigerian government did so as well. The real rate of growth of government expenditure, for instance, reached 58%.[90] State spending had a multiplier effect: Private investment rose, also because of direct incentives offered by the state, such as access to subsidised credit. The real rate of growth in the non-oil economy rose from less than 5% in 1973-1974 to around 15% in 1974-1975 (IMF, 1977: 1).
1975	In 1975, oil revenues fell dramatically: Demand for Nigeria’s oil had declined dramatically owing to the ensuing recession in Western countries and the oil glut in petroleum markets. Oil exports earnings declined by 28%. By that time, Nigeria was already oil dependent so that the level of economic activity and government spending closely tracked developments in the oil sector. Government expenditure and net lending fell by 86% in 1975. Real GDP growth fell by 5% in 1975 (World Bank, 2013c).
1976	In 1976, oil export earnings increased by 17%, and so did government expenditure and net lending, growing by a stunning 1166%. GDP growth reached 9% in 1976 (World Bank, 2013c). However, Nigeria had a large current account deficit despite high external reserves because of massive imports.
1977/1978	In 1977, oil export earnings increased be a meagre 4% and in 1978, oil export earnings declined dramatically, by 33%, owing to the discovery of North Sea and Alaskan oils and the failure of the Obasanjo government to reduce oil prices. The government was forced to cut expenditure and net lending by 30% in 1977 and 42% in 1978. Growth, amounting to 6% in 1977, fell by 6% in 1978 (World Bank, 2013c).

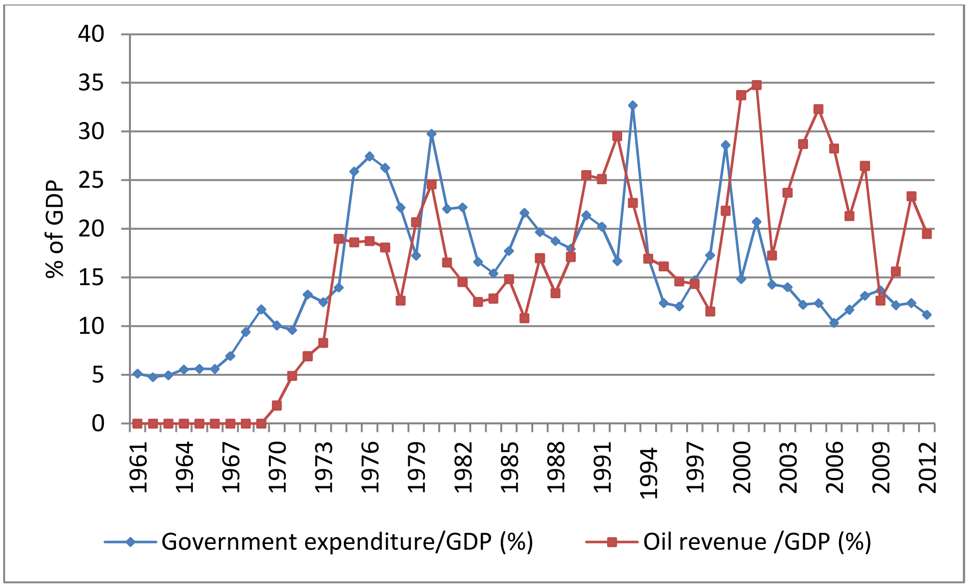
[90] Figures relating to the growth of government revenues, government expenditure and net lending, and oil export earnings are from Karl (1997: 244-267) and are real growth rates. The real rate of growth of government expenditures and net lending includes government expenditures plus lending minus repayments (1997: 250).

Figure 4.A1: Oil Revenue as a Share of Government Revenue in Nigeria, 1961-2012



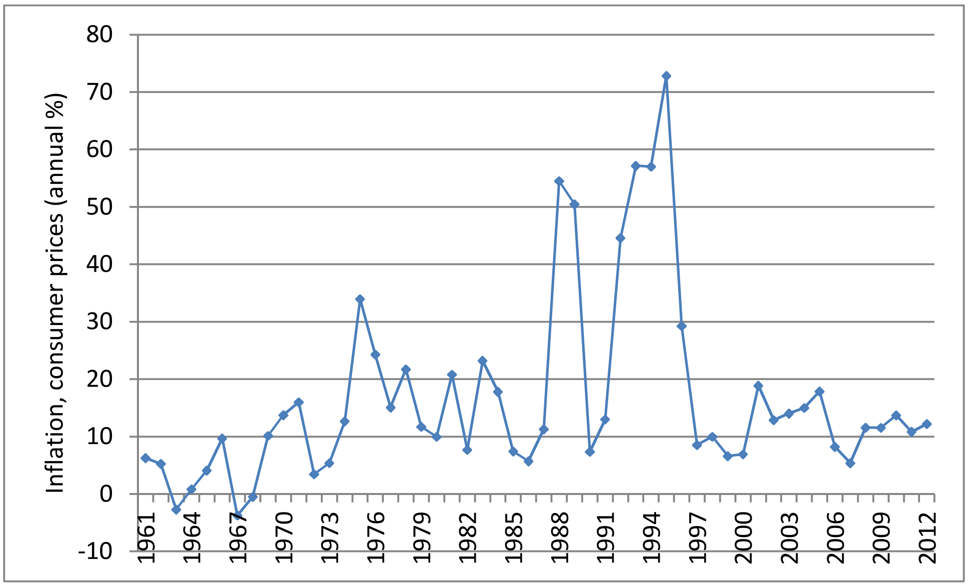
Source: Data drawn from the CBN (2009; 2012).

Figure 4.A2: Government Expenditure and Oil Revenue in Nigeria, 1961-2012



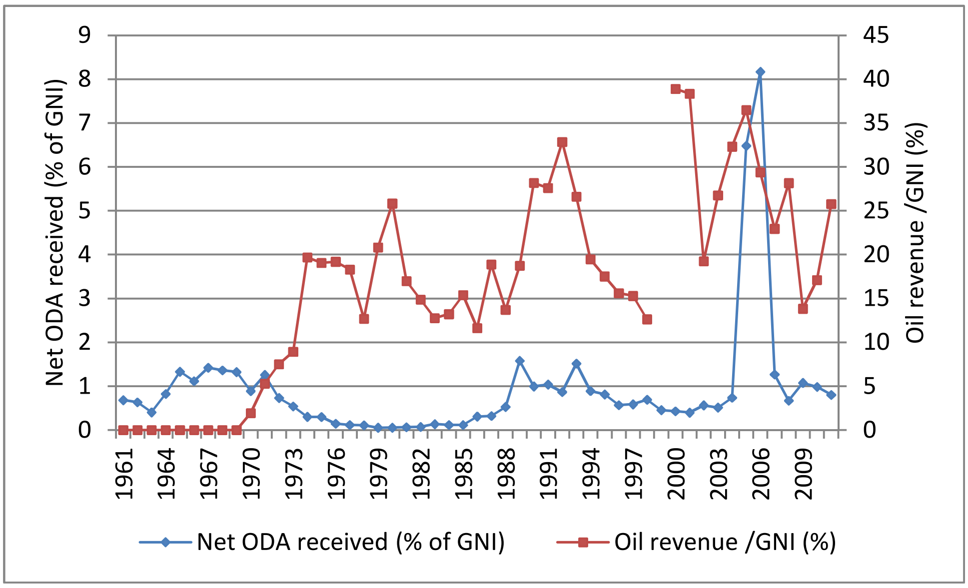
Source: Data drawn from the CBN (2009; 2012). GDP data drawn from the World Bank (2013c).

Figure 4.A3: Inflation in Nigeria, 1961-2012



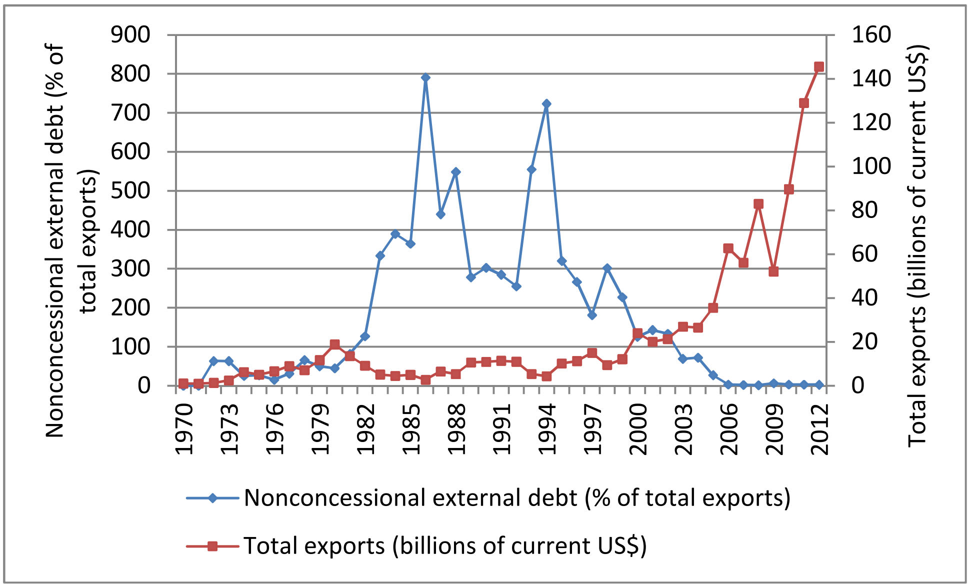
Source: Data drawn from the World Bank (2013c).

Figure 4.A4: Net ODA to Nigeria and Oil Revenues in Nigeria, 1960-2011



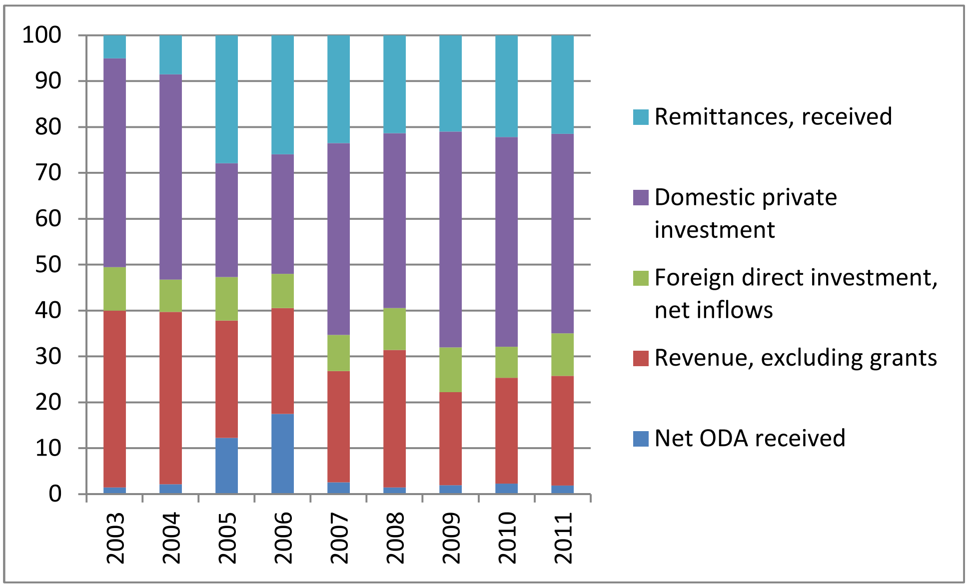
Source: Data on ODA drawn from the World Bank (2013c). Data on oil revenue drawn from the CBN (2009; 2012). Note: Data for oil revenue/GNI not available for 1999.

Figure 4.A5: Non-Concessional External Debt to Exports in Nigeria, 1970-2012



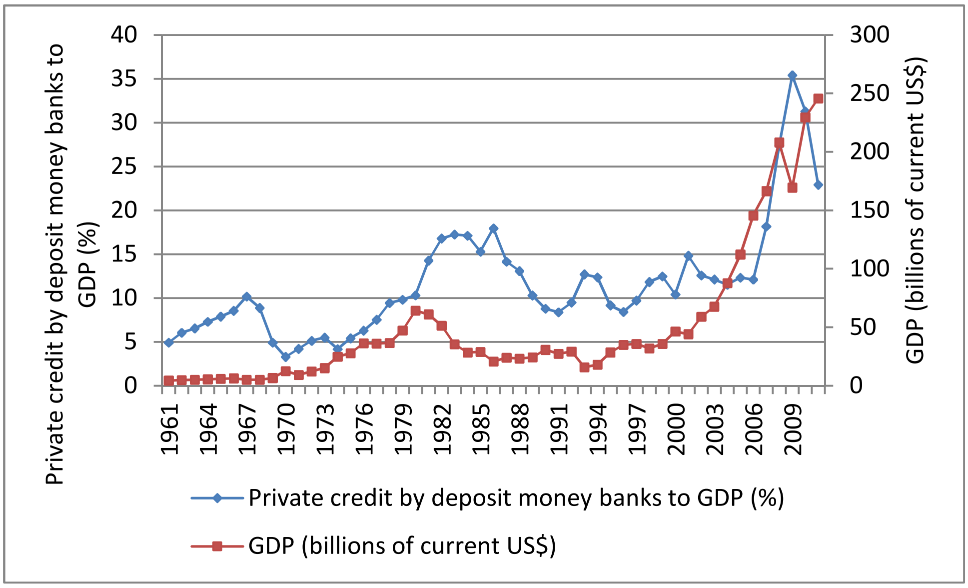
Source: Data drawn from the World Bank (2013c).

Figure 4.A6: Major Sources of Investible Funds in Nigeria, 2003-2012



Source: Data drawn from the World Bank (2013c) except for data on domestic private investment, which is drawn from various IMF country reports.

Figure 4.A7: Private Credit in Nigeria, 1965-2011



Source: Data on private credit drawn from the World Bank (2013b) and data on GDP drawn from the World Bank (2013c).

5 The Political Economy of Central Bank Policy in Kenya

Despite large differences between the cases of Uganda and Nigeria, they share a common feature, namely that both have had significant access to investible resources that could replace those supplied by private investors. The final case study looks at the trajectory of central bank policy in Kenya to examine the extent to which forces may shape central bank policy in a country that is dependent on private business to finance investment. Kenya appears to be an appropriate example of a developing country reliant on private investment: For much of Kenya's history since independence, private investment has been the most easily accessible type of resources to finance investment. Specifically, Kenya has not had significant access to resources that could have replaced private capital and enlarged the policy space, such as resource rents. As Figure 5.A1 shows, the only exception is the short phase from the late 1980s to the mid-1990s, when Kenya received a large amount of aid and reliance on donors increased.[91]

As I will delineate in this chapter, the evidence that private investors had structural power over central bank policy in Kenya is ambiguous. The material suggests that in the period from independence until the late 1970s and in the period from 2003 onwards, the policy stance of Kenya's central bank was responsive to the policy concerns of business and donors to induce them to supply financing. However, particularly in the period from the late 1980s to 2002, policymakers' responsiveness was partial and varied.

This chapter, which spans the years 1960 to 2012, has five substantive sections and a conclusion, which summarises the main insights of the chapter.[92] My criterion for dividing the narrative of the Kenyan case into periods is changes in the potential pressure to be responsive to the interests of providers of investible funds. As investment rates decrease, pressure to be responsive to the concerns of providers of investible funds increases and, structuralist theory hypothesises, policy should become more responsive. Correspondingly, each substantive section delineates the government's policy response to a decline of investment rates, focusing on central bank policy.[93] Thus, I expand the number of observations, from one country's case to a larger amount of periods.

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[91] Aid exceeded the commonly used threshold for aid dependence of 10% of GNI between1988 and 1993.
[92] Table 5.A1 in the appendix provides a chronology of the major economic and political events.
[93] Figure 5.A2 in the appendix illustrates the periodisation. I created a 3-year-moving-average trendline of investment rates which smoothes out fluctuations to identify trends. As pressure to be responsive to the policy concerns of the providers of investible funds is likely to be particularly high when smoothed

- The first section covers the period from 1960 to 1975. During this period, policymakers were attentive to the policy preferences of the groups controlling investible resources to reverse the outflow of capital that had begun before independence and restore investor confidence.
- The second section spans the years 1976 to 1984. The point of this section is to account for central bank policy reforms that were pursued following a series of economic challenges and which responded to some major concerns of donors and business.
- The third section, which covers the years 1985 to 1992, has two subsections. The first subsection explains that policymakers were keen to display responsiveness to the interests of major suppliers of investible funds in order to reverse a trend of declining investment and growth. The second subsection illustrates the efforts of the government to circumvent the constraints business and donors imposed on the use of other strategies to maintain power.
- The fourth section is devoted to the period from 1993 to 2002. While the government showed significant sensitivity to the interests of donors and investors at the beginning of the period, the government responded only partially to these interests from the mid-1990s onwards. I conclude that an explanation focused on structural power does not provide a wholly satisfying explanation for the stance of central bank policy over this period.
- The fifth section covers the period from 2003 to 2012. It focuses on government efforts to jumpstart investment and growth by creating a policy environment favourable to private investors. This section closes by highlighting the conflicts which emerged for Kenya's central bank between addressing the policy concerns of business related to financial deepening and their policy concerns related to stability.

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investment rates have been declining for several years, I used years when smoothed investment rates had declined for two or more consecutive years as cut-off points of periods. The criterion that pressure for policy change is considered high after two or more years of declining investment rates is conservative but somewhat arbitrary. Yet, there is no entirely objective criterion for deciding on when pressure for responsiveness is high enough so that we can expect policy to change because, as Winters (1996: 9) points out, "the ability and willingness of different populations (and even of the same population at different times) to tolerate investment shortfalls and collapses varies widely." As Figure 5.A3 shows, a similar periodisation would have been possible if I had selected the cut-off points of periods based on smoothed GDP growth rates.

5.1 Restoration of Investor Confidence and Orientation of Central Bank Policy towards Stability and Financial Deepening, 1960-1975

When Kenya became independent from the British in 1963, President Kenyatta's government embarked on an economic development model which was quite unusual in the African context and can be described as "managed capitalism" (Mwega and Ndung'u, 1994: 21).[94] Key features of the government's economic development strategy, which is best encapsulated in the Sessional Paper of 1965 on "African Socialism and its Application to Planning in Kenya", were the following: a mixed economy, which supported public and private participation in the economy as well as partnership between public and private enterprise; an agricultural export strategy; and the promotion of domestic and foreign private investment. Moreover, for the government, raising economic growth, rather than distributing wealth, was the overarching policy goal. For instance, the government argued in the Sessional Paper of 1965: "Other immediate problems such as Africanization of the economy, education, unemployment, welfare services, and provincial policies, must be handled in ways that will not jeopardize growth. The only permanent solution to all of these problems rests on rapid growth" (GoK, 1965: 18). Due to this attitude, Kenya was widely considered a vigorous follower of a pro-capitalist development path by the mid-1970s (Barkan, 1979; Lehman, 1990).

Before examining what this development model implied for the country's central bank policy, it is necessary to explore why the Kenyan government, in contrast to many others in newly independent African countries, opted for an economic development model which was market-based and supportive of the private sector. One major factor relates to the political constituency of the Kenya African National Union (KANU), Kenyatta's party. In the early 1960s, KANU had its primary base of political power among the Kikuyu, the ethnic group to which Kenyatta belonged.[95] Although among the Kikuyu income levels varied, they were collectively among the most prosperous ethnic

[94] In the early years after independence, official rhetoric was, however, that Kenya embraced African Socialism. There are many definitions and interpretations of African Socialism, a development paradigm followed by many African politicians in the 1950s and 1960s, including for instance Julius Nyerere of Tanzania. In 1965, the Kenyan Government outlined as the key features of African socialism in Kenya the following elements, which indicate the divergence from the socialist model followed in many other African countries: political democracy, mutual social responsibility, various forms of ownership, a range of controls to ensure that property is used in the mutual interests of society and its members, diffusion of ownership to avoid concentration of economic power, and progressive taxes to ensure an equitable distribution of wealth and income (GoK, 1965).

[95] In addition, KANU included and was based on the Luo, a smaller ethnic group, at that time.

groups in Kenya and many Kikuyu had been successful in private investment and capital accumulation.[96] In fact, many scholars interpreted the accumulation of capital which took place largely, but not exclusively, among the Kikuyu as the rise of a bourgeoisie (Leys, 1978; Swainson, 1980) or a gentry (Bates, 1989). A predominant explanation in the literature for the government's promotion of private capital accumulation has thus been that this policy stance was intended to benefit the government's political constituency.[97] From this perspective, responsiveness to the concerns of the private sector reflects the 'class' basis of electoral politics in Kenya, although one that had a strong ethnic dimension.

As I intend to show in this section, responsiveness to the interests of the government's political constituency is not the only plausible explanation for the government's commitment to private investment under Kenyatta. It can also be attributed to the structural power of those who control investible funds. The evidence suggests that political leaders possessed, separate from the economic interests of their political constituencies, independent interests to maintain a continuous flow of new investment and were aware that continued investment required policies favourable to those who control investment resources.

Structural Pressures to Encourage Investment

In the three years preceding independence, Kenya experienced a significant decline in investment. When at the first Lancaster Conference in 1960 constitutional concessions were granted to indigenous politicians and the British revealed their intention of giving power to the Africans, foreign investors, most of whom were British, began to withhold and relocate investment (Leys, 1975: 58; Tignor, 1998: 351-385).[98] Investors' behaviour was driven by an uncertainty about the attitude of an incoming African government towards the business sector. In particular, businesses feared the expropriation of private property and while the Kenya African Democratic Union (KADU), Kenya's second major African party besides KANU, had stressed its receptivity to private enterprise and foreign investment, KANU's attitude towards business was ambiguous (Tignor, 1998:

[96] The Kikuyu were among the most prosperous groups in Kenya because they had been the main beneficiaries of education, employment in the formal sector, and programs for the intensive development of smallholder agriculture during the colonial period (Bates, 1989; Barkan, 1994: 12).
[97] See for instance Throup (1987), Bates (1989) and Holmquist et al. (1994).
[98] Within four months after the conference, the securities on the Nairobi stock exchange declined by 12% and the transfer of capital out of the countries was as estimated at 4,250,000 pound sterling in 1960 (Tignor, 1998: 357).

380).[99] One faction of KANU had a pro-capitalist orientation, but KANU also had a vocal left wing with a socialist and Marxist orientation, the KANU ‘radicals’, which refused to guarantee property rights to foreign investors.

The decline in foreign investment affected Kenya’s economy badly because it was reliant on foreign business as a source of investment financing and employment. Kenya had a more sophisticated economic base than other colonies in the region owing to its legacy as a British settler colony. Specifically, Kenya had in comparison to neighbouring Uganda and Tanzania a larger export-oriented agricultural sector, large-scale agriculture was more prevalent and the economic structure was more diversified because there had been significant investment in the industrial sector from 1945 onwards. However, growth and employment in these sectors depended to a significant extent on the continuous flow of new foreign investment because the colonial government had established close links between multinational firms and African cash crop agriculture and a large share of investment in the industrial sector came from multinational enterprises (Swainson, 1980).[100] Moreover, in the early 1960s, European farmers and agricultural capital still played an important role in the Kenyan economy, as providers of investible funds and employers (Tignor, 1998: 365).[101]

Thus, when foreign business began to withhold investible funds and lay off staff from 1960 onwards, Kenya experienced an economic crisis from which it should not recover until 1964 due to the country’s reliance on foreign investment (Leys, 1975: 58). The economy contracted by about 8% in 1961, unemployment rose, and the number of bankruptcies increased (Leys, 1975: 58; Hazlewood, 1979: 13). Due to capital flight and loan defaults, banks, building societies and insurance companies came under severe financial pressure (Tignor, 1998: 357). The crisis also adversely affected the government’s finances to such an extent that Britain increased aid to Kenya (Hazlewood, 1979: 13).

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[99] KADU had a more economically marginalised constituency than KANU. That KADU was keen to signal its responsiveness to foreign and domestic private investment despite having a political constituency that was less economically dominant than KANU’s constituency is an additional indication that responsiveness to the economic interests of the political constituency is not the only explanation for a policy stance that supports private investment.

[100] Investment in Kenya’s industrial sector before independence came from foreigners and Kenya’s Asian population. Indigenous investment in industry only increased after independence.

[101] The contribution of African cash crop agriculture to the total marketed agricultural production between 1960 and 1962 was still limited, amounting to about 20% (Tignor, 1998: 365).

It is in this wider context that policymakers in Kenya embarked on an investor-friendly development model with Kenyatta (1968: 147) announcing before independence that the government of an independent Kenya would not be a "gangster government" but rather a government that would respect property rights and encourage foreign investment. When in 1963 KANU won the national elections and Kenya became independent, the KANU government sought to restore business confidence and a continuous flow of new investment (CBK, 1976: 17). Kenyatta and his economic team stressed in policy statements such as the Sessional Paper of 1965 that raising investment would be a priority.

From the perspective of the government, much attention would have to be given to eliciting foreign savings, from donors and foreign private investors, in order to raise levels of investment and growth. Domestic investment would be impeded for some time due to the shortage of capital stemming from the low rate of domestic savings and taxes, the latter being the single most important source of government revenue. "In order to compensate for our shortage of domestic capital, in order to grow rapidly so that our aspirations can be realized," acknowledged the government for instance in the Sessional Paper of 1965, "we must borrow from foreign governments and international institutions and stimulate the inflow of private capital from abroad" (GoK, 1965: 19). In raising foreign capital, the issue was not only about attracting new investors but, importantly, also about inducing those foreign investors already located in Kenya to supply needed resources and not to exit.

Eliciting funds from donors and foreign investors to finance investment would require displaying responsiveness to the policy concerns of business. In the years preceding independence, foreign business had used both voice and exit to indicate that foreign investment would only increase if the incoming African government would have a pro-business attitude and guarantee property rights (Tignor, 1998: Chapter 11). A World Bank mission, which had consulted extensively with the private sector in 1962, warned for instance in a report published just before independence that ensuring that foreign and Asian capital stayed and was invested in Kenya would require the government, after independence, to reassure investors that government interference in business would be limited. Other donor missions had also emphasised that it was necessary to improve the business environment for foreign investors in independent Kenya and that the promotion of private enterprise would be a central goal of their assistance (Leys, 1975:

60-61). Thus, the government was aware that "the foreign ownership and management of productive assets could mean that economic decisions in Kenya might be dominated by foreign rather than domestic considerations" (GoK, 1965).

Yet structural pressures stemming from the power of foreign investors and donors were not the only pressures to be considered. There were strong demands from indigenous business and trade unions to increase the participation of the indigenous population in the private sector. There was also agreement within KANU and the government that promoting indigenous business was important to reduce the economic dependency on foreign and Asian investors and acquire "economic sovereignty" in the future (Leys, 1975; Swainson, 1980; O'Brien and Ryan, 2001: 485). While KANU's left wing had lost influence as radicals had been purged from the party and KADU had dissolved to join KANU in 1964, Africanisation remained, as in other newly independent African countries, a central concern. The challenge was thus to support indigenisation without antagonising donors and foreign investors. A balance was struck by developing a policy framework which was responsive to the policy concerns of donors and foreign investors while promoting indigenisation. In promoting indigenisation the government followed a two-pronged approach. On one prong were measures to support indigenous private investment, while on the other was public investment in productive sectors and banking, sometimes in the form of joint ventures with foreign investors, to increase government control over investment in the economy (Leys, 1975).

Central Bank Policy Response to Structural Pressures

Central bank policy in the early years after independence illustrates the efforts of the government to be responsive to the policy concerns of donors and private investors. In 1965, the government decided to establish a central bank for Kenya. The government understood that if it was to prevent capital flight, create confidence in a new Kenyan currency and secure investment and donor support from abroad, it was important to signal that maintaining monetary stability would be a key goal of the central bank (Hazlewood, 1979: 146; Helleiner, 2001: 14). The minister of finance was therefore quick to provide reassurances in 1965 that "it is the firm intention of this Government to maintain a sound currency which will be strong and respected and a national credit policy based on the maintenance of as high a level of economic activity within the country as is consistent with the integrity of national money" (CBK, 1967: 5).

Yet ensuring monetary stability was not the only objective the central bank would have to fulfil. In line with the government's aspirations to raise domestic investment, the new central bank was also expected to support financial deepening by developing a stable financial sector and facilitating the expansion of credit, particularly to indigenous business (GoK, 1965: 32; CBK, 1976: 10). During this time, the IMF, which the Kenyan government had asked to provide support in the establishment of the central bank and expert personnel during the central bank's first years of operation, was generally supportive of assigning central banks a twin mandate of promoting stability and financial development (Helleiner, 2001). Thus, when the Central Bank of Kenya (CBK) was established in 1966, there were domestic incentives and support from the IMF to pursue a policy stance oriented towards both stability and financial deepening.

The main legislation signalling this stance was the Central Bank Act of 1966. It states the principal objectives of the CBK as: "to regulate the issue of notes and coins, to assist in the development and maintenance of a sound monetary, credit and banking system in Kenya conducive to the orderly and balanced economic development of the country and the external stability of the currency and to serve as banker and financial adviser to the Government."

To enhance price stability, the CBK sought to regulate the growth of the money supply by controlling the level of credit. In doing so, the CBK relied in particular on ceilings on credit expansion, minimum deposit and maximum lending rates as monetary policy instruments. During its first decade of operation, the CBK repeatedly demonstrated its willingness to use these instruments when challenges for price stability arose, for instance in 1971, when credit expanded rapidly, and in 1974, in the wake of the first oil crisis which affected Kenya badly, being an oil importer (CBK, 1976).

To promote financial deepening, the CBK relied, like many other developing countries at that time, to a significant extent on controlled interest rates. From the CBK's perspective, low and stable interest rates were important for encouraging investment. Frequent changes of interest rates in contrast would lead to uncertainty in repayments, which could discourage new investment (CBK, 1986: 54-55). Therefore, the CBK rarely changed lending rates until the 1980s and real interest rates became negative in the 1970s when inflation increased (O'Brien and Ryan, 2001: 497).

Besides controlled interest rates and aggregate ceilings on credit expansion, however, commercial banks were, unlike in many other African countries, not restricted in the allocation of credit and were able to make lending decisions based on commercial criteria (Brownbridge, 1998b). Rather than interfering in the allocation of credit of private banks, the government relied on moral suasion and on setting up government-owned financial institutions to direct credit to sectors which were considered a priority for economic development, like agriculture. One exception was the stipulation that banks lend at least 17% of their net deposit liabilities to the agricultural sector (Brownbridge, 1998b: 82).

It is difficult to know precisely why the CBK deviated in the case of agricultural lending from its policy of limited interference in private bank lending. One plausible explanation is that policymakers wanted to display responsiveness to the concern for affordable credit of the powerful agricultural sector, which was the major source of foreign exchange and had to be nurtured to achieve a high level of economic activity. That there were no penalties imposed on banks which failed to meet the agricultural lending requirement (Kariuki, 1993: 291) suggests, however, that the CBK was reluctant to alienate private banks and that the structural power of these banks, most of which were foreign-owned in the 1970s, was high.

The CBK's efforts to establish a policy framework to guard financial stability were limited. While the Banking Act of 1968 assigned the CBK the responsibility for bank supervision and specified some prudential requirements for banks and other financial institutions such as minimum capital requirements and restrictions on loan concentration, the CBK's prudential framework was weak: The CBK's supervisory capacity was limited, banking laws were lax and responsibility for licensing financial institutions remained, as in many other African countries at that time, outside the central bank, but rather with the Ministry of Finance (Brownbridge, 1998b: 95). A major reason for the limited emphasis the CBK placed on preventing financial crises was that until the late 1970s, the banking system mainly consisted of subsidiaries of multinational banks which were deemed to have qualified staff, strong internal controls and thus minimal need for regulation and supervision (World Bank, 1989: 14).

That the CBK's policies sought to create a policy environment conducive to investment by promoting monetary stability and financial deepening is reflected in economic indicators. As Figure 5.A4 shows, inflation was moderate, except for the years 1974 and 1975, when inflation increased in the wake of the first oil crisis. Moreover, in the late 1960s and 1970s, the financial sector was stable and grew rapidly. As Figure 5.A5 shows, credit to the private sector was expanding significantly. However, a large share of credit was extended to large-scale business, rather than to emerging Kenyan entrepreneurs. At times, the CBK would have liked to have been more proactive in encouraging lending to indigenous enterprises but the government's responsiveness to foreign investors posed limits on the extent to which this was possible. The CBK tried, for instance, to restrict lending to foreign-controlled companies in order to release funds for lending to indigenous enterprises, but the government often intervened in favour of foreign businesses (CBK, 1976: 17; Kaplinsky, 1980).

Rising investment rates suggest that investors considered Kenya's policy environment favourable. As Figure 5.A2 shows, domestic investment grew in the first decade after independence, from 12% of GDP in 1964 to 19% in 1974 (World Bank, 2013c). There was also a positive trend of net inflows of FDI, as Figure 5.A6 shows. External capital inflows, including both private and public, increased from almost 17% in 1966 to 43% in 1979 of Kenya's gross investment (GoK, 1983 : 43).

5.2 Economic Decline and Partial Responsiveness to Providers of Investible Funds, 1976-1984

The Kenyan economy entered 1976 in a weak economic position. Between 1973 and 1975 Kenya experienced a marked decline in investment and production, largely because of the first oil shock, which slowed down the world economy and affected Kenya's economy badly because of its dependence on the import of petroleum. GDP growth, for instance, fell from 6% in 1973 to 1% in 1975, as Figure 5.A3 shows. In addition, by the mid-1970s, Kenyatta's deteriorating health meant less attention was paid to policy, allowing for a weakening of economic management during the final years of his presidency (Throup and Hornsby, 1998: 20; O'Brien and Ryan, 2001: 487). In 1976, Kenya experienced a tea and coffee boom which eased the economic crisis of earlier years. The boom also helped to achieve a level of economic activity sufficient to raise tax revenues and maintain the government's popular support (Throup and Hornsby, 1998: 22; Prichard, 2010: 206). The improvement of Kenya's economic position was, however, temporary.

The tea and coffee boom came to an end in mid-1977 and Kenya experienced further challenges which threatened investment and growth. A major economic shock was the break-up of the East African Community in 1977, which ended the favoured access previously enjoyed by Kenyan exporters to the Ugandan and Tanzanian markets. Another economic shock was the decline of investor confidence and the capital flight stemming from the uncertainty surrounding Kenyatta's political succession after his death in 1978. While markets calmed down when Daniel Arap Moi, who was previously Vice-President, assumed the presidency, his economic team confronted additional problems, including: the limited job creation in the formal sector, which lagged behind the growth in the labour force; the low productivity of the state-owned enterprises sector; and slowing manufacturing sector growth as the limits to import substitution in the local market were reached (O'Brien and Ryan, 2001: 487).

Moreover, the public sector and public employment had expanded much faster than the rest of the economy and government revenues. The rise in public expenditure combined with the decline in government revenues after the tea and coffee boom increased the budget deficit from less than 5% of GDP in 1976/1977 to an estimated 9% in 1978/1979 (World Bank, 1980: 4). The government turned to the domestic banking sector, particularly the CBK, to finance the budget deficit. Accommodating the government's financing needs, the CBK eased its credit policy (World Bank, 1980: 4). This allowed government credit to expand at an annual rate of 80% in 1978 (CBK, 1986: 19). Expansionary fiscal and monetary policy contributed to high inflation, which in 1978 reached 17%, the highest value since independence except for the years 1974 and 1975 when the first oil shock raised inflation.

Investors responded to the deterioration of the business environment since the mid-1970s by withholding investment and relocating. Real private investment, for instance, fell from 14% of GDP in 1971 to 10.8% in 1978 (Matin and Wasow, 1992: 4). As Figure 5.A6 shows, net FDI inflows declined between 1976 and 1978. Inflows from public sources like foreign governments and the World Bank exceeded private capital inflows from 1975 onwards (CBK, 1976: 20).

Many economic policymakers were alarmed by these developments. By the late 1970s, they agreed that there had to be a significant change in the orientation of economic policy if Kenya's economic decline was to be arrested (O'Brien and Ryan, 2001: 487).

With presidential support for economic policy reform, senior economic policymakers, mainly from the CBK and the Ministry of Finance, began to systematically review the government's economic policies from 1978 onwards. Based on these reviews, the government developed a reform agenda and published several policy documents signalling its commitment to reform such as the 1979 Development Plan. Key goals of the reform agenda included the shift from import substitution to a strategy emphasising industrial competitiveness and export diversification and raising agricultural growth and foreign private investment. Among the policies proposed to increase private sector activity were: limiting government participation in productive sectors; reducing inflation, notably by reducing public borrowing; moderately increasing credit to the private sector and reviewing interest rate policy to increase savings and ensure adequate returns to financial institutions (GoK, 1979; World Bank, 1980; Lehman, 1990).

The proposed reform agenda was highly responsive to the policy concerns of the IMF and the World Bank (World Bank, 1980). After independence, the IFIs and other donors had endorsed Kenya's economic development model based on import substitution industrialisation and significant government intervention in the productive sectors and management of the economy. Yet in the late 1970s, there was an ideological shift away from government intervention to market processes at the international level and Kenya's reform agenda resonated well with this change and the IMF's and the World Bank's new agenda of structural adjustment, which favoured an export-oriented development model, a liberal policy on foreign investment and the promotion of private investment as the 'engine of growth'.

It is unclear to what extent Kenya's policymakers developed a strategy to promote investment that favoured economic liberalisation in order to elicit donor support rather than doing so out of genuine conviction. However, there are indications that donors' interests and behaviour were important considerations in developing the reform agenda. First, according to the government, maintaining creditworthiness vis-à-vis donors was an important goal of Kenya's economic reforms (World Bank, 1980: 50-57). Second, it seems that donors encouraged social learning. Specifically, from 1978, the policy dialogue between Kenyan and IFI technocrats intensified and the exchange of ideas helped to develop a common understanding of Kenya's economic problems and the policies needed to address the problems of its economy (World Bank, 1980; O'Brien and Ryan, 2001).

The collaboration with the IFIs allowed the Kenyan government to secure sizable foreign assistance. In 1978 and 1980, the government negotiated IMF programmes focused on fiscal and monetary management. Both programmes entailed the reduction of government borrowing from the CBK as part of the conditions to be met for the disbursement of funds. During 1979, Kenyan policymakers also worked out a reform programme with the World Bank, which allowed Kenya to become the first sub-Saharan African country to receive World Bank structural adjustment lending in 1980 (O'Brien and Ryan, 2001). The focus of Kenya's first structural adjustment loan was on increasing the export-orientation of the manufacturing sector. As Figure 5.A1 shows, reliance on ODA as a source of investible funds also increased steadily from the late 1970s onwards.

Despite agreement among Kenyan technocrats and donors on the contours of the policy change needed to reverse the decline of growth and investment, the reforms were poorly implemented. The government failed to meet the agreed ceilings on government borrowing from commercial banks and the CBK, thus the IMF programmes of 1978 and 1980 were cancelled. Progress in the implementation of the first structural adjustment programme of the World Bank was also slow.

Nonetheless, the IMF and the World Bank were willing to set up new programmes, although with greater conditionality (van der Hoeven and Vandemoortele, 1987: 13; World Bank, 2000: 4). An IMF arrangement set up in 1982 included, for instance, stricter ceilings on government borrowing from the banking system and the CBK, and an exchange rate devaluation as ex ante conditionalities (van der Hoeven and Vandemoortele, 1987: 13). The World Bank committed a second structural adjustment loan in 1982, which specified a larger reform agenda than the first loan, with key goals being to strengthen the export-orientation of the economy and economic liberalisation, which included the liberalisation of interest rates (World Bank, 1980).

Investor confidence remained low, probably because of limited progress in improving the business environment, which continued to suffer from factors such as private credit being crowded out by high levels of government borrowing. Meanwhile, domestic private investment stagnated between 1979 and 1981 (Matin and Wasow, 1992: 5). Foreign investors continued to withhold funds, with net FDI inflows declining from 1.3% to 0.2% over the same period. Kikuyu business, bureaucrats and politicians privately voiced their complaints that Moi was not managing the economy well (Leonard, 1991: 176). The dissatisfaction over economic management contributed to the pressures that led to a coup attempt by members of the Armed Forces in August 1982 (O'Brien and Ryan, 2001: 490).

Although the coup of 1982 failed, it put economic reforms on hold for some time as President Moi became preoccupied with reorganising the civil service and the military to consolidate his power. However, Kenya's senior economic policymakers eventually persuaded Moi that economic reform, to stabilise and liberalise the economy, had to proceed and IMF support had to be secured if the regime was to reverse the decline in investment and production (Leonard, 1991: 215-216; O'Brien and Ryan, 2001). By 1983, Kenya had entered a new agreement with the IMF focused on fiscal and monetary stabilisation and Moi had appointed some proponents of economic reform to leading posts. George Satitoti, for instance, a respected academic, became minister of finance and Philip Ndegwa, a senior official, became CBK governor.

With economic reformers in key positions, the government stepped up economic reforms. Kenya's policymakers were highly successful with respect to restoring macroeconomic stability (CBK, 1986: 12). Besides fiscal policy, which achieved a reduction of government debt, central bank policy played a crucial role in enhancing stability. The CBK increased the emphasis placed on "the pursuit of domestic price stability to improve the climate for investment" (CBK, 1986: 12). Specifically, the CBK decelerated monetary growth and adopted from 1983 onwards a more flexible interest rate policy to reduce inflation. Lending rates were raised significantly so that they became positive in real terms (CBK, 1986: 55). In addition, the CBK sought to promote private investment by increasing deposit rates to increase savings (CBK, 1986).

While Kenya's policymakers addressed the concerns of the private sector for stable prices and access to affordable financing and donors' concerns for economic stability and financial liberalisation, they made limited progress with respect to structural reform in areas other than central bank policy such as agricultural liberalisation. It is not clear why progress was limited. It may be that powerful groups opposed reforms or that

Kenya's policymakers favoured gradual reform and gave central bank policy reform greater priority because of its central importance for the investment climate.[102]

The response of Kenya's major providers of investible funds reflects the mixed record of reform. The IMF was satisfied with the efforts of the CBK and the Ministry of Finance to orient policy towards stability and offered a successor programme in 1985 (van der Hoeven and Vandemoortele, 1987: 13). Several other donors voiced complaints about limited progress in areas other than fiscal, monetary and financial policy. Yet ultimately, they disbursed their funds by 1984, albeit in the case of some major donors, like the World Bank, there were delays (Mosley, 1986). It is possible that donors realised that their good relations with Kenya might be jeopardised if they pushed too hard for structural reform at a time when Kenya's government was not entirely committed to reform. Private investors continued to withhold funds: Average levels of real private investment and net FDI inflows were lower in 1983 and 1984 than in 1978 and 1979 (Matin and Wasow, 1992; World Bank, 2013c), perhaps because Kenya experienced a drought in 1984, or perhaps because the reforms had only addressed a subset of investors' concerns.

5.3 Tensions between Responsiveness and Other Strategies to Maintain Power, 1985-1992

Moi's economic team was aware that economic reforms had to go beyond stabilisation. Fiscal and monetary policy tightening had restored economic stability but had failed to raise investment to the levels of the 1970s and increase economic growth, which fell from an average of 5.6% between 1979 and 1981 to 1.5% between 1982 and 1984. Reversing the economic decline would require further efforts to improve the business environment and elicit donor support. There was disagreement between Kenya's policymakers and the IFIs over the timing, pace and scope of politically sensitive reforms which reduced the role of the state. Yet Kenya's technocrats did not dispute the view of the IMF and the World Bank that structural reforms that made the private sector the engine of growth were necessary (Lehman, 1990; O'Brien and Ryan, 2001).

[102] Progress was particularly limited in the area of agricultural liberalisation. Kenya's powerful agricultural producers had benefited from a framework of public policies and controls oriented to supporting agriculture and was to be hurt by some of the agricultural liberalisation policies (Bates, 1989). Eager to maintain a policy environment that was responsive to the interests of agriculture, the government delayed structural adjustment in the agricultural sector (Mosley, 1986).

Responsiveness to the Concerns of Providers of Investible Funds

From 1985, the government took decisive steps to entice donors and investors. The main document signalling the government's commitment to create a responsive policy environment was the Sessional Paper No.1 "Economic Management for Renewed Growth" of 1986. Among the main themes of the Paper were: the key role of private investment in reviving growth, which was deemed to have been necessitated by fiscal stringency and the declining efficiency of the government's direct investments; the need to establish a market-based "incentive environment under which private participants of all sizes in all sectors can make profits while simultaneously contributing to widely shared development" (GoK, 1986: 24-25); and the importance of financial sector development for raising national savings, which were needed to reduce reliance on foreign aid and investment, and for raising the productivity of investment by channelling savings to its most productive uses (GoK, 1986: 16; 37). In the Paper, the government also stated that monetary policy was a key element of government efforts to establish an investment climate hospitable to domestic and foreign investors (GoK, 1986: 98-99).

From the mid-1980s onwards, the policy stance of the CBK broadly followed the thrust of the Sessional Paper. Responding to a major concern of donors, the CBK began, for instance, to shift from direct instruments of monetary control such as credit ceilings to more indirect instruments of monetary policy, in particular more flexible lending rates (Swamy, 1994: 24). The government considered financial instability an impediment for investment and growth because it limited confidence in the financial system and efficiency of financial intermediation (CBK, 1986; World Bank, 1989: 39; 41). Therefore, the CBK tightened regulation and supervision in the wake of Kenya's first major financial crisis during the mid-1980s, when several locally owned financial institutions failed. The CBK strengthened the prudential framework through amendments to the Banking Act between 1985 and 1988, covering, for instance, an increase of minimum capital requirements and the establishment of a system of deposit insurance. In facilitating the private sector's access to investment funds, the CBK focused on measures which showed sensitivity to donors' concerns for financial liberalisation and market-based allocation of resources. Specifically, the CBK supported government efforts to develop a private capital market and adjusted deposit rates to reflect inflation with a view to stimulating savings (CBK, 1986).

Donors and investors responded favourably to the government's efforts to create a favourable policy environment. Between 1985 and 1989, the IMF offered a series of financing arrangements for structural reforms. From 1986 onwards, the World Bank provided several sectoral adjustment credits, including a Financial Sector Adjustment Credit in 1989, which aimed at supporting the CBK's shift from direct to indirect monetary policy instruments, the full liberalisation of interest rates and strengthening the prudential framework. ODA continued to rise, amounting to 14% of GNI at the peak in 1990. Private investment and net FDI inflows also increased slightly, as Figures 5.A7 and 5.A6 show respectively.[103]

Policy Drift

The economic policy reforms yielded financial returns for the economy. Yet Moi and his political allies were not entirely satisfied with the narrow, technocratic pursuit of economic reform because it posed constraints on providing benefits to political supporters, which was important for staying in power (Throup and Hornsby, 1998: 47-48). The popularity of the regime had been declining during the 1980s (Throup and Hornsby, 1998). The Kikuyu elite was alienated by Moi's efforts to redistribute economic resources from the Kikuyu towards other, more economically disadvantaged groups, notably the Kalenjin, the ethnic group to which Moi belonged. Moi's regime had also lost popular support due to political repression, culminating in a constitutional amendment in 1982 to make Kenya a de jure single-party state, and the electoral fraud and intimidation that had marred the elections of 1983 and 1988. At the same time, pressure on the government by donors and domestic groups, including some KANU politicians, to hold multiparty elections increased from the late 1980s onwards. Given Moi's goal to redistribute resources away from the Kikuyu, the regime's decline in popularity and looming multiparty elections, from the late 1980s onwards Moi and his political allies shifted their attention increasingly towards maintaining power through providing benefits to their political supporters (Throup and Hornsby, 1998). These benefits often took the form of public office or financial rewards.

The CBK played a key role in the regime's efforts to consolidate power. In 1988, Phillip Ndegwa, who had been a strong proponent of economic liberalisation, was replaced by

[103] There is a slump of FDI inflows in 1988, perhaps because the election of 1988 increased political uncertainty.

Eric Kotut as CBK governor. Under Kotut, the CBK followed a parallel strategy: On the one hand, the CBK sought to comply with some of the conditions imposed by the IMF and the World Bank, such as the full liberalisation of interest rates and the introduction of open market operations as an instrument of monetary policy, while on the other, the CBK's policies became oriented towards fuelling the system of patronage and corruption that increasingly underpinned Moi's rule. For instance, the CBK became involved in several corruption scandals. The most notorious scandal was the Goldenberg affair, in which the CBK assisted in the fraudulent abuse of pre-shipment export finance and export compensation facilities provided to commercial banks. In doing so, the CBK, in collaboration with the Ministry of Finance, facilitated between 1990 and 1993 the misappropriation of US$600 million, which was equivalent to 6% of Kenya's GDP (IMF, 2008a: 8).

In addition, the CBK's financial policy became oriented towards providing benefits to political allies at the expense of guarding financial stability. In particular, the CBK protected so-called "political banks", which were financial institutions owned by politicians or individuals with high-level political connections. The CBK lent large sums to political banks which, in turn, lent them on to politicians for purposes such as election campaign financing (Brownbridge, 1998b: 95; Throup and Hornsby, 1998: 562-563). Moreover, when in the early 1990s many of these political banks experienced financial distress and became insolvent due to mismanagement and fraud, the CBK delayed the closure and restructuring of insolvent institutions by allowing them to circumvent regulation and by providing them with financial assistance (Brownbridge, 1998b; O'Brien and Ryan, 2001: 497).

Monetary policy became from the late 1980s onwards increasingly oriented towards supporting the government's efforts to consolidate power at the expense of stability. Rather than addressing inflationary pressures stemming from increasingly expansionary fiscal policy, lending to political banks and the Goldenberg payouts, the CBK allowed the money supply to increase beyond the ceilings agreed with the IMF (Grosh and Orvis, 1996: 56; O'Brien and Ryan, 2001: 497). As a result, inflation increased dramatically after 1989, reaching 20% in 1991.

Kenya's major providers of investible funds were quick to respond to the deterioration of the business environment through large-scale corruption, macroeconomic instability and financial fragility. Most foreign investors responded by withholding investment and relocating to other jurisdictions, as reflected by a decline in net FDI inflows between 1989 and 1992. A few foreign investors voiced their complaints, using for instance international newspapers or foreign embassies as channels through which to convey their criticism (Throup and Hornsby, 1998: 84). Many domestic businesses responded by exit rather than voice, partly because their complaints had been ignored in the past, and partly because they feared sanctions from the state (Holmquist, 2002: 10-11).

Donors also responded strongly to Kenya's deteriorating policy environment. During the 1980s, donors had been willing to supply funds despite the Kenyan government having implemented reforms selectively and slowly because Kenya had a better record of economic reform and performance than many other African countries and because Kenya had aligned itself consistently with the West throughout the Cold War years, both economically and politically (O'Brien and Ryan, 2001: 474). The government was thus shocked when donors coordinated to suspend aid in response to Kenya's deteriorating policy environment in November 1991.[104] While aid for ongoing and new development projects, technical assistance, and emergency relief continued, donors froze the balance of payments support, which, since the 1980s, had become an essential source of financing imports and Kenya's economic recovery more generally. Donors announced that aid would be suspended until progress was made in areas such as restoring macroeconomic stability, reducing corruption and creating an environment that is consistently supportive of private investment. Donors also stressed their ability to shift operations to countries with a more responsive policy environment where they deemed aid to be more effective, arguing that "there is growing competition for increasingly scarce donor resources, and that aid programmes are being re-examined with a view to ensuring the most effective use of these resources" (World Bank, 1991: 11).

5.4 Varying Responsiveness to Providers of Investible Resources, 1993-2002

The period from 1993 to 2002 is characterised by varying responsiveness to the concerns of business and donors. As I will delineate in this section, power deriving from the control of capital helps to account for the policy stance in 1993 but does not provide

[104] The fact that Kenya had lost some of its strategic importance with the end of the Cold War appears to have facilitated coordinated donor pressure for reforms (Throup and Hornsby, 1998: 54).

a satisfying explanation for central bank policy in the years that followed. Specifically, from 1994 onwards, policymakers responded to some key concerns of business and donors and violated others despite significant pressures to raise investment.

Responsiveness to Prevent an Economic Breakdown

During the aid freeze, donors employed rolling conditionality where, as Grosh and Orvis (1996: 57) explain, “donors would request reforms, the government would implement reforms, the donors would demand additional reforms, and so on”. Multiparty elections, for instance, had been a precondition for resuming aid, but after they were held in 1992 and returned Moi to power due to a combination of a divided opposition, vote buying and intimidation, donors imposed additional conditions on economic reform. The Kenyan government was frustrated that donors, in their opinion, kept “shifting the goalposts” (Grosh and Orvis, 1996: 57; Throup and Hornsby, 1998: 560-561). Yet the government sensed that it had to be responsive to donors because Kenya had become highly dependent on aid since 1988, with ODA as a share of GNI exceeding 10%, and because the country was unable to service its foreign debt without balance of payments support. For this reason, the government responded to donor conditionality from 1992 onwards with gradual reform.

In February 1993, amidst an investment and foreign exchange crisis, the government floated the exchange rate for the first time and relaxed price and foreign exchange controls to display responsiveness to the IMF. However, when an IMF mission concluded that reform had not yet gone far enough to justify aid, citing for instance Kenya’s failure to control inflation, Moi lost his patience. In March 1993 he announced that Kenya would abandon “economically suicidal” IMF policies (Throup and Hornsby, 1998: 561). Moi regretted that he had implemented any reforms in pursuit of aid as he believed donors never intended to restore aid (Grosh and Orvis, 1996: 57). Then private investors threatened to exit. International airlines, for instance, announced a withdrawal from Kenya as they could not repatriate earnings because the CBK did not have foreign exchange reserves. Horticultural farmers demanded a renegotiation of the SAP, arguing that their sector would otherwise collapse (Himbara, 1994: 153). Thus, within a month, the government bowed to structural pressures, needing capital to stabilise the system.

In April 1993, Moi reached an agreement with the IMF and the World Bank. Among the first steps taken by the Kenyan government were the replacement of the CBK governor

Kotut with Micah Cheserem, a dedicated reformer, the closure of several political banks and the radical tightening of monetary policy to rein in spiralling inflation which reached 45% in 1993. In exchange, donors began to release frozen funds from mid-1993. The re-engagement of the IMF and the World Bank also paved the way for a rescheduling of non-concessional Paris Club debt in 1994.

Partial Responsiveness

The deterioration of the business environment and the aid freeze had left the Kenyan economy in a weak position. Investment had declined from 20% of GDP in 1988 to 17% in 1993. Growth averaged only 0.3% between 1991 and 1993. To reverse the economic decline, the government designed various economic reform programmes, notably the Policy Framework Paper "Economic Reforms for 1996-1998" and the "Interim Poverty Reduction Strategy Paper" in 2000. A key goal of these reform programmes was the creation of a policy environment responsive to private investors through maintaining macroeconomic stability and promoting economic liberalisation.

While the pressure to be responsive to the concerns of donors and private investors to induce them to supply investible funds was high in the period between 1994 and 2002, Kenya's central bank policy was only responsive in some areas. The government made significant progress in enhancing macroeconomic stability, which it deemed important for raising private investment as well as being a major concern for donors (GoK, 1996; GoK, 2000). The CBK's monetary policy, for instance, was oriented towards keeping inflation at low levels (IMF, 2000; IMF, 2008a). The government also resisted political pressure to reintroduce interest rate ceilings, which would have violated IMF conditionality and hurt the interests of commercial banks.[105]

However, in other areas of central banking, the pace of policy reform was slow (O'Brien and Ryan, 2001:495). The CBK's policy in relation to financial stability is a case in point: The CBK gradually strengthened the prudential framework and closed down political banks, possibly in response to, or assisted by, pressure from the IMF. Yet overall progress in orienting financial policy towards financial stability was slow, owing mainly to the CBK's reluctance to discipline state-owned banks, which were financially distressed and had a large share of non-performing loans (IMF, 2008a).

[105] In 2000, for example, parliamentarians tried to introduce interest rate ceilings but the government put the so-called "Donde bill" on hold.

Kenya's major suppliers of investible resources responded to Kenya's policy environment by withholding investible funds. Despite gradual progress in economic reform, many donors, including the World Bank, reduced aid from the mid-1990s onwards as they felt that the Kenyan government had failed to tackle corruption adequately. Governance issues were also the main reasons for the IMF cancelling programmes agreed with Moi's government in 1996 and 2000 despite deeming Kenya's macroeconomic policies sound and acknowledging that progress in structural reforms, e.g. in finance, had been made (IMF, 2008a).[106] Thus, the stop-go pattern of structural adjustment lending, which had begun in the late 1970s, continued.[107] As Figure 5.A7 shows, domestic private investment experienced a steady decline from the mid-1990s onwards.

While an approach focused on structural power provides a plausible explanation for the government's reforms of Kenya's central bank policy in 1993, this approach cannot wholly account for the partial responsiveness to donors and business from the mid-1990s onwards. It is not clear why the government failed to be responsive to some of the major policy concerns of donors and investors. Yet a key factor seems to be that full responsiveness would have entailed reforms to reduce the role of the state and corruption. Such reforms would have limited possibilities to redistribute resources away from the Kikuyu, benefited the Kikuyu economically and threatened the patronage system which underpinned Moi's regime (Throup and Hornsby, 1998: 597).[108]

5.5 Wooing Investors and Orientation of Central Bank Policy towards Stability and Financial Deepening, 2003-2012

Elections in December 2002 brought President Mwai Kibaki, the leader of a unified national opposition, the National Rainbow Coalition, to power and put an end to 24 years of government under Moi and almost 40 years of KANU rule. Years of economic and political decay had taken a heavy toll on KANU's popular support.

The incoming government inherited a poorly performing economy. Growth had declined from an annual average of 7% in the 1970s to 4% in the 1980s and 2% in the

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[106] As the IMF (2008a: 34) admits "the Fund became overly reactive to events on the ground, likely catalysed in part by pressures and second-guessing from donors and other parties."

[107] Tables 5.A2 and 5.A3 in the appendix provide an overview over Kenya's SAPs with the IMF and the World Bank, illustrating the stop-go pattern of assistance.

[108] For instance it is widely believed that Moi won the 1997 elections due to a combination of political repression, divided opposition and dispensing patronage.

1990s. The economic decline had to be reversed, both to enhance the government's popular support, which also hinged on Kibaki's election pledge to revive growth, and to raise tax revenues for financing the state apparatus and the spending promises made during the election campaign. For this reason, reviving the economy was a priority for Kibaki, who announced that his government would not rest until it achieved a GDP growth rate of at least 6% (GoK, 2003b).

As soon as the new government took office, Kibaki's economic team began to prepare a policy agenda for economic recovery, the Economic Recovery Strategy (ERS) 2003-2007. Investment was expected to be the primary driver of the economic recovery (GoK, 2004: 12). But how could it be encouraged? To answer that question, the government organised consultations with a wide range of stakeholders. Kibaki's economic team made particular efforts to exchange ideas with aid donors and the private sector.

The exchange with donors was important to ascertain which policies would induce them to increase aid, which had declined from 8% of GNI in 1995 to 3% in 2002. Government revenues from taxation could only partly cover the intended increase in public investment. Thus, if domestic borrowing and the subsequent crowding out of the private sector was to be limited, budgetary support from donors was necessary. For this reason, the government reiterated in policy statements its determination to restore good relations with donors, and policymakers collaborated closely with donors in developing the ERS (IMF, 2003a: Statement by the Executive Director for Kenya; GoK, 2004: 3).

The exchange with private investors was important to ascertain which policies they would find most favourable and convince them of the government's commitment to reform. Providing a business environment conducive to private investment was considered important for two reasons: First, the government considered the decline of private investment and the inefficiency of public investment a major cause of Kenya's economic decline (GoK, 2003a: v; GoK, 2004: 15). Second, donors would only support the ERS if it was aimed at creating a policy environment conducive to private investment. The IMF, for instance, made it clear early on that privatisation, including of public banks, should be a key element of the ERS (IMF, 2003a: 30).

The first major occasion for the government to display its responsiveness to business was the National Investment Conference in November 2003, which the government had jointly organised with the private sector. At the conference, the government used the opportunity to present an interim version of the ERS and to send a clear signal to private investors about the importance the government attached to raising private investment. President Kibaki himself, for instance, delivered the opening speech and announced that his government would tackle pressing concerns for investors, including corruption and access to credit. Specifically, he announced that access to credit would be increased by establishing "a vibrant financial market" and by implementing "prudent fiscal and monetary policies" (GoK, 2003c). For the private sector, which had organised itself under the umbrella organisation Kenya Private Sector Alliance (KEPSA) ahead of the conference, the event was an important occasion to voice its policy concerns and provide feedback on the ERS. Other important initiatives to attract investors were the organisation of an International Investor Conference in 2004 and the establishment of the National Economic and Social Council, a body comprising policymakers and the private sector to oversee the economic reform process.

When the ERS was finalised in 2004, it included many of the issues to which donors and the private sector had attached importance for raising investment in the consultations, such as private sector-led growth, a low level of interest rates to increase access to affordable investment funds and stable exchange rates (IMF, 2003a; KEPSA, 2003). In particular, the ERS called for "redefining the role of the state as a facilitator for private sector growth and investment" through "strengthening the policy and regulatory functions of the state" (GoK, 2004: 12). Among the main commitments the government made in the ERS were a "conservative monetary policy", which ensured a level of inflation sufficiently low to maintain a stable exchange rate and low interest rates, and reform of the financial sector, which strengthened its regulations to increase savings and investment (GoK, 2004: 12).

In the following years, Kenya's central bank policy focused on increasing access to affordable financing and on strengthening prudential regulation and supervision, broadly reflecting the priorities set out in the ERS and sensitivity to the policy preferences of donors and private investors. A major piece of legislation strengthening the CBK's role in enhancing prudential regulation and supervision was, for instance, the Banking Sector Amendment Bill of 2006, which transferred bank licensing, regulatory and disciplinary authority from the Ministry of Finance to the CBK. In addition, from the mid-2000s onwards, the CBK made decisive steps to strengthen the financial system by increasing efforts to restructure publicly-owned banks and limiting advances to these banks (IMF, 2009). IMF assessments conclude that slow but important progress was made in enhancing the CBK's authority in regulation and supervision and in tightening the prudential framework (IMF, 2008a; IMF, 2009). The progress in strengthening the CBK's role in guarding financial stability is reflected in a steady decline in the ratio of non-performing loans to total loans, from over 60% in 2003 to 23% in 2007.

Before 2007, the major policy initiative of the CBK to increase access to affordable financing was the elaboration of the Microfinance Act of 2006, which regulates deposit taking microfinance institutions. The Act permits licensed deposit taking microfinance institutions to mobilise savings from the public, which, the CBK hoped, would help the microfinance industry to "play a pivotal role in deepening financial markets" (CBK, 2008). Besides the regulation of microfinance institutions, there were no major policy reforms to enhance access to finance. Instead, the CBK relied on strengthening the financial system and monetary policy to support access to finance. While monetary policy was broadly oriented towards keeping inflation at low levels, an additional goal was maintaining low and stable interest rates to contain the cost of public and private borrowing (IMF, 2008a: 23-24; IMF, 2009: 24). For this reason, the CBK often hesitated to raise interest rates to address inflationary pressures, despite complaints of the IMF that price stability should be the primary goal of monetary policy.

Renewed Focus on Financial Deepening and Tensions With Other Objectives, 2007-2012

From 2007 onwards, the most significant reforms of Kenya's central bank policy aimed at financial deepening through increasing access to finance. The CBK's efforts to deepen financial sectors appear to reflect four factors.

- First, with financial stability restored and supported by a context of macroeconomic stability and a vibrant private sector, the CBK was, as an IFI representative explained, able to look beyond ensuring stability. The representative added that Kenya had, "the kind of benign conditions where a focus on serving the real economy can be followed through."[109]

[109] Interview with an official of an IFI in Nairobi, 7 December 2012.

- Second, the leadership of Njuguna Ndung'u, who became CBK governor in 2007 and was reappointed for another four-year term in 2011. Several central bankers and donors interviewed in Nairobi argued that Ndung'u had the authority, capacity and personal commitment to mobilise support within the CBK and other parts of the government for policies that increase financial access.
- Third, there has been a rethinking of the role of the state in promoting financial deepening at the international level since the late 2000s and the idea has gained ground that central banks may use their regulatory powers to encourage financial institutions to expand access to financial services (Beck et al., 2009). In addition, the exchange among central bankers, IFIs and donors on how central banks could promote financial deepening without compromising stability has intensified.
- Fourth, and most relevant from the perspective of the broader arguments of this thesis, incentives to raise private investment through facilitating financial access and development have increased over time due to shortfalls in aid. While the relationship with the IMF improved gradually as the Kenyan government made incremental but steady progress in economic reform and the IMF began to place greater emphasis on its stipulation that any conditions attached to IMF assistance should be critical to macroeconomic performance, other donors continued to withhold aid due to concerns about corruption. Between 2003 and 2007, aid as a share of GDP increased by only 1.4%, rising from 3.5% of GDP to 4.9%. Over the same time period, private investment increased by 7.7% of GDP, rising from 7.8% to 15.5% of GDP. Moreover, as Figure 5.A8 shows, the share of investible funds contributed by donors is small compared to the share provided by private sources, like tax-payers or private investors. Given the limited inflows of investible resources from external sources, both donors and foreign investors, it is not surprising that the government's attention turned to the domestic financial sector as a source of financing public and private investment. In fact, financial deepening through financial development and access was a key goal of Vision 2030, Kenya's development plan for the period 2008-2012, which expected the financial sector "to drive high levels of savings to finance the country's investment needs".

The thrust of the CBK's reforms has been to use market-based mechanisms to facilitate private sector access to financial services, focusing on reducing the cost of financial services provision and enhancing competition among financial services providers. In

2008, for instance, the CBK issued a regulation to permit the establishment of credit reference bureaus in an effort to improve the private sector's access to credit.[110] Other important reforms were to permit, as one of the first African regulators, mobile payment services in 2007 and agent banking in 2010.[111]

In interviews, CBK officials explained that they relied on market-based mechanisms to deepen financial sectors in an understanding that banks would not increase lending if the CBK interfered in their business activities.[112] The CBK's responsiveness appears to have been fruitful. Among banks, the CBK has earned a reputation as "an empowering regulator which builds regulation to deepen financial sectors around private-sector initiatives," as stated by one CEO of a commercial bank.[113] Developments in the area of financial deepening reflect the responsive policy environment. As Figure 5.A5 shows, credit to the private sector has increased steeply since 2007. According to Kenya's Financial Access Survey 2013, the percentage of Kenyans with access to financial services from formal, regulated financial institutions increased from 15% in 2006 to 33% in 2013 (FinAccess, 2013).[114]

In light of the pressures to create a policy environment responsive to private investors, it is easy to imagine that the CBK makes significant efforts to simultaneously promote stability and financial deepening as both are important concerns for private investors in Kenya. Nonetheless, it has sometimes been difficult for the CBK not to promote one goal at the expense of another owing to the trade-offs that may emerge between goals.

Monetary policy decisions aptly underscore the dilemma faced by the CBK in addressing competing objectives.[115] After reining in inflationary pressures in 2008,[116] the CBK's monetary policy remained relatively loose in 2009 and 2010 as Kenya faced

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[110] Credit reference bureaus may facilitate access to credit by helping borrowers to create a credit history and reducing the cost of screening borrowers.

[111] Agent banking involves such third parties as petrol stations and other retail outlets in the provision of certain banking services.

[112] Interviews with several CBK officials in Nairobi, 9 December 2010.

[113] Interview with the CEO of a commercial bank in Nairobi, 17 December 2010.

[114] In the survey, the category formal, regulated financial institutions comprises banks, deposit taking microfinance institutions and savings and credit cooperatives, capital markets and insurance providers.

[115] A similar dilemma exists in the area of financial policy. On the one hand, the CBK seeks to promote financial stability through regulatory stringency because the CBK considers a stable financial system important for raising investment. On the other, the CBK has sought not to stifle financial innovations that increase access to finance, such as mobile banking, through regulation because it considers enhanced access to financial services important for growth.

[116] Major reasons for the acceleration of inflation in early 2008 were supply disruptions following the outbreak of violence along political and ethnical lines after the presidential elections in December 2007.

an economic slowdown due to a series of shocks, including a drought and repercussions of the global financial crisis. In light of the multiple crises Kenya had faced and the government's fiscal restraint, the IFIs considered the loose monetary policy stance appropriate.[117] However, when in mid-2011 inflation accelerated due to strong domestic demand, fuelled by rapidly expanding credit to the private sector, the CBK hesitated to tighten monetary policy despite advice from the IMF to do so (IMF, 2012b). Loose monetary policy facilitated a growth of private sector credit of 36% in September 2011, about twice the rate of the year before, and contributed to rising inflation. Only when inflation reached 19% in October 2011 did the CBK tighten monetary policy. Although the CBK argued that it had delayed the response of monetary policy because it had assumed that inflation had been driven by international and domestic food price increases which would soon be reversed, it is widely believed that the CBK was also hesitant to tighten monetary policy out of concerns about financial deepening (Ochami, 2011; Rapuro, 2011). A senior official of an IFI explained: "The CBK came out of a benign environment with successes in financial inclusion and wanted to maintain the growth momentum (...). The focus on financial inclusion may have taken away the focus on price stability, but one depends on the other."[118]

This episode is an important example of the conflicts that emerged for the CBK between addressing the concerns of business related to financial deepening and concerns related to stability. On the face of it, the failure to rein in inflation appears to indicate unresponsiveness to private investors. Yet, given the pressures on the CBK to raise private investment, it is likely that the CBK's intention was in fact the opposite, namely to create a favourable environment for business by facilitating access to credit.

5.6 Conclusion

This chapter has offered an interpretation of the trajectory of Kenya's central bank policy in Kenya through the lens of the theory of the structural power of capital. The Kenyan story offers four main insights which are relevant to probing the theory and extending it to central banking in developing countries.

First, a major challenge for establishing a causal relationship between the structural power of capital and policy stances lies in the difficulties to observe the processes

[117] Interview with a senior official of an IFI in Nairobi, 7 December 2012.
[118] Interview with a senior official of an IFI in Nairobi, 7 December 2012.

involved in the operation of structural power and to isolate these processes from other factors. For instance, it is difficult to establish whether policies that address the policy concerns of private investors are driven by the intention to elicit funds from private investors, as official rhetoric holds, or by the intention to elicit donor funds because donors advocate improvements of the investment climate.

That said, the material presented in this chapter does suggest that the policy concerns of those who control the sources of finance on which a country relies for investment help to account for the orientation of central bank policy in Kenya. The first and last section in particular suggest that the power derived from the control over scarce investible resources constrained the range of policy options Kenya's policymakers could consider if they wanted to ensure a continuous flow of new investment.

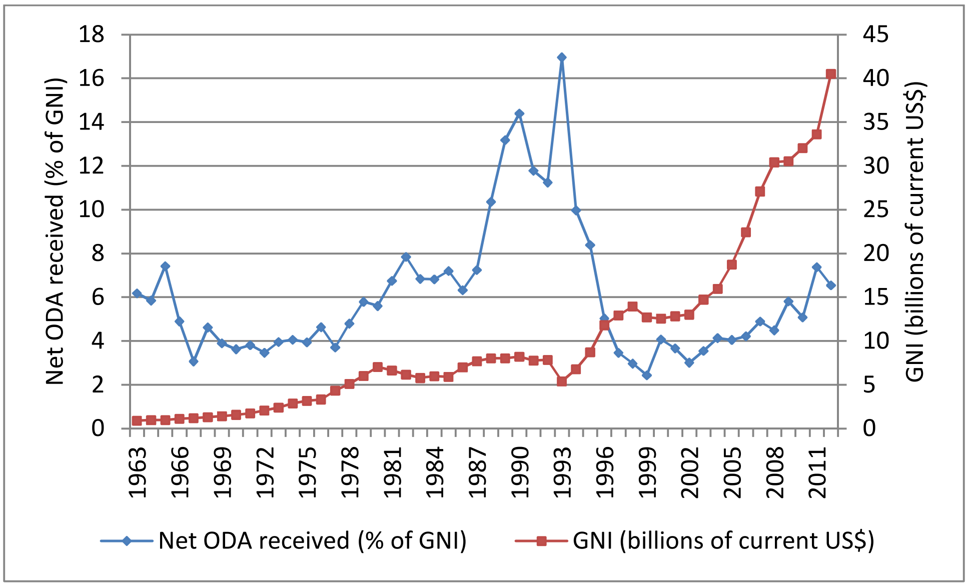
Second, different suppliers of investible funds tend to influence investment through different channels. In Kenya, donors relied heavily on voice, openly threatening exit if their conditions were not fulfilled. In addition, donors responded with exit when their policy preferences were violated, as happened in the 1990s. Facilitating social learning appears to have been an important mechanism for donors to shape central bank policy when relationships with the Kenyan government were good, as in the late 1970s, and in areas where there was an alignment of interests, as was the case in the late 2000s with respect to the promotion of financial access. While donors often sought to influence central bank policy through efforts to coordinate their actions, they were at times also able to shape the policy stance through the mere threat of exit, as was the case in the early years of the Kibaki government. Investors, in contrast, have usually shaped policy through more silent signals of support and protest, notably exit. That business was able to shape the ERS through voice suggests that voice may be an effective mechanism when the government faces strong pressures to be responsive and business is able to coordinate.

Third, the case study of Kenya reaffirms the insights of the case studies of Uganda and Nigeria, that for explaining the orientation of policy it is necessary to look at the policy concerns of those who are important sources of investible funds. That the CBK's policy stance in the late 2000s, for instance, was broadly oriented towards price stability, financial stability and financial deepening, appears to reflect that private investors and donors considered stability in prices and the financial sector and access to finance all to be important elements of an environment favourable for investors.

Finally, another point already familiar from the case studies of Uganda and Nigeria is that structural pressures to raise investible funds are not the only pressures on policymakers. In Kenya, the patronage network underpinning Moi's rule, for instance, appears to have exerted strong pressures to pursue a parallel strategy of employing some policies which were responsive to the policy concerns of major suppliers of investible funds and others which violated them. Thus, an approach focused on structural power does not fully explain the trajectory of central bank policy in Kenya, but rather meaningfully enhances an account of Kenya's central bank policy trajectory.

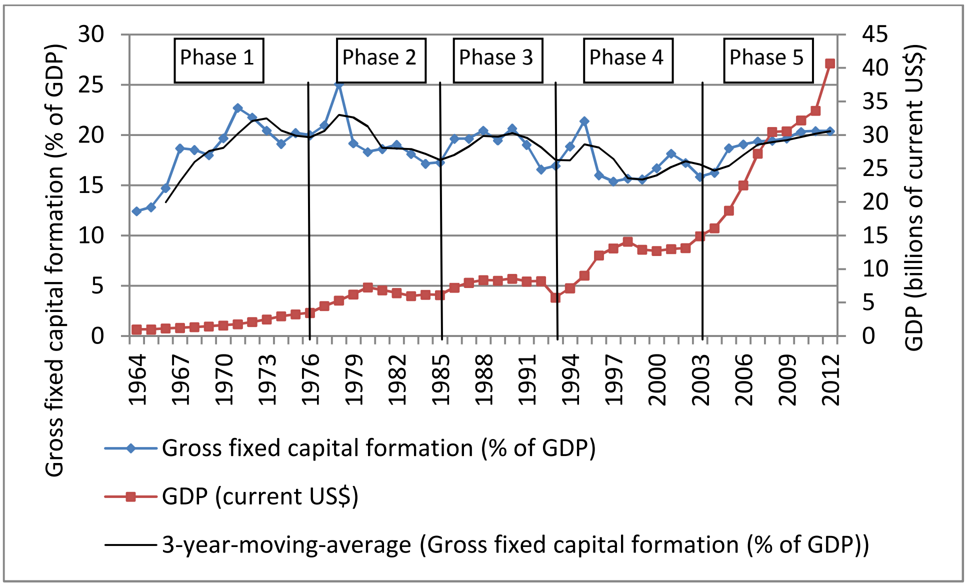
5.7 Appendix

Figure 5.A1: Net ODA to Kenya, 1963-2012



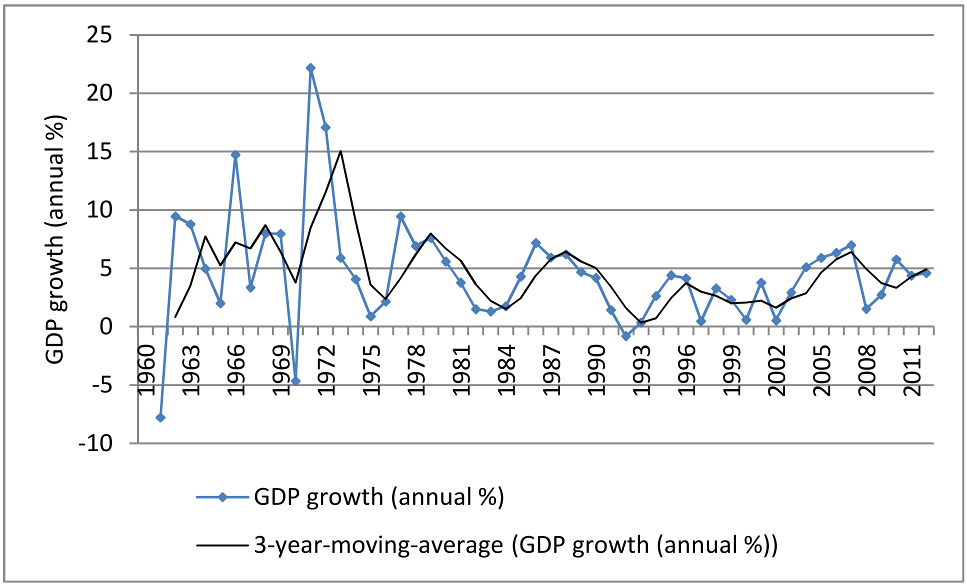
Source: Data drawn from the World Bank (2013c).

Figure 5.A2: Investment in Kenya, 1964-2012



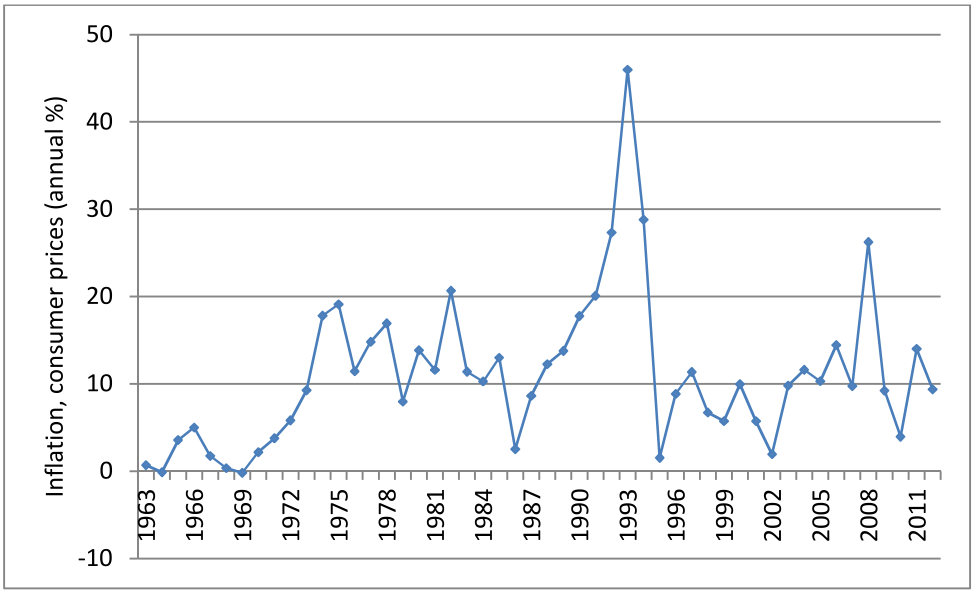
Source: Data drawn from the World Bank (2013c).

Figure 5.A3: GDP Growth in Kenya, 1964-2012



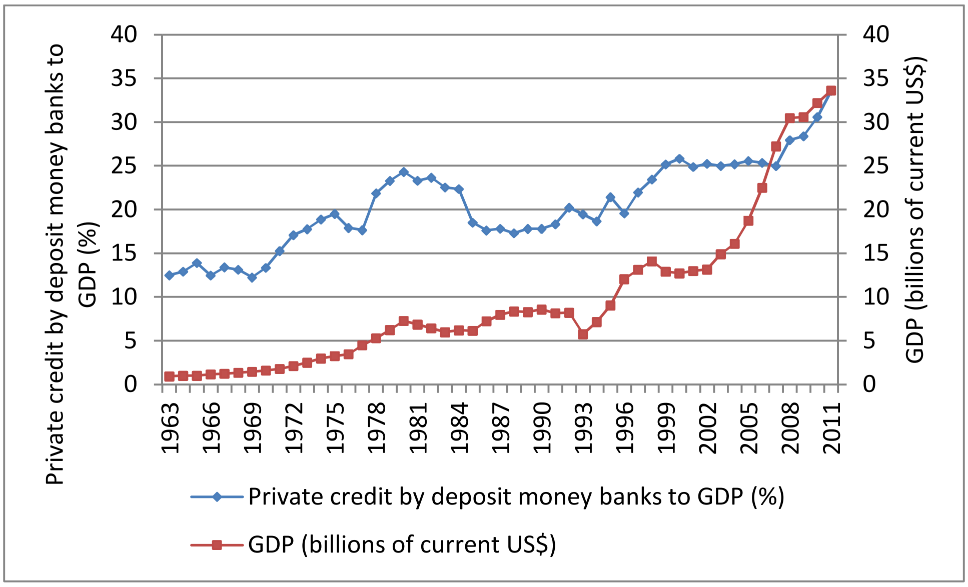
Source: Data drawn from the World Bank (2013c).

Figure 5.A4: Inflation in Kenya, 1961-2012



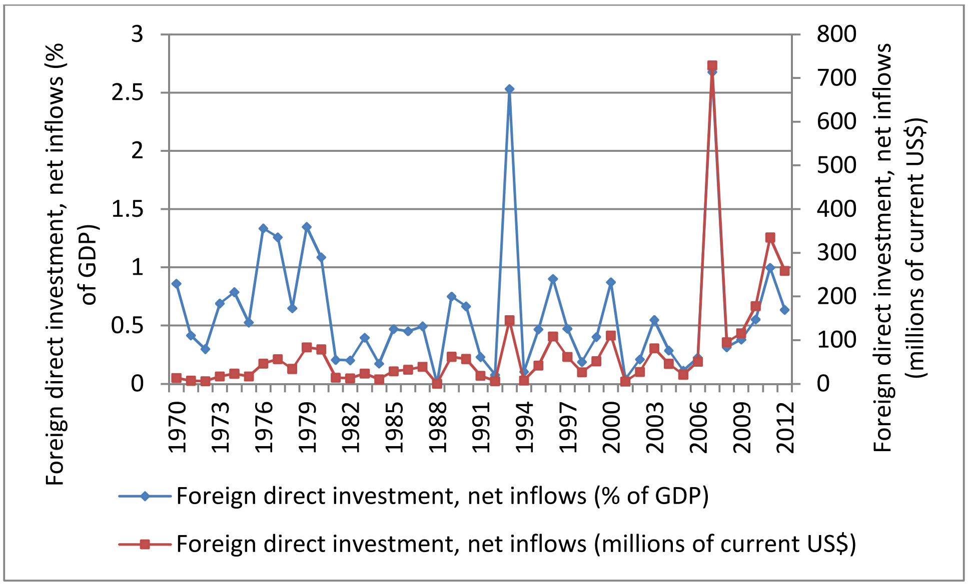
Source: Data drawn from the World Bank (2013c).

Figure 5.A5: Private Credit in Kenya, 1963-2011



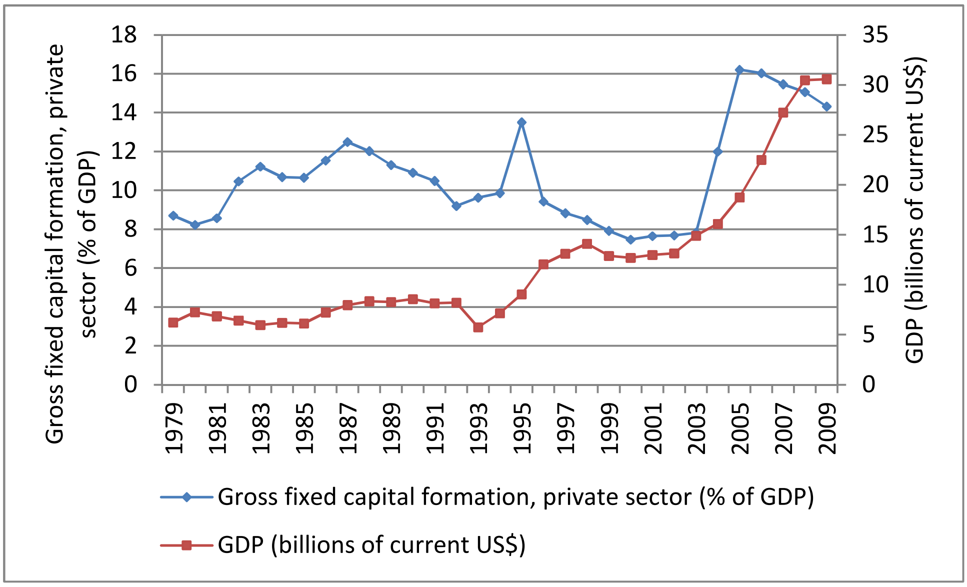
Source: Data drawn from the World Bank (2013b).

Figure 5.A6: Foreign Direct Investment in Kenya, 1970-2012



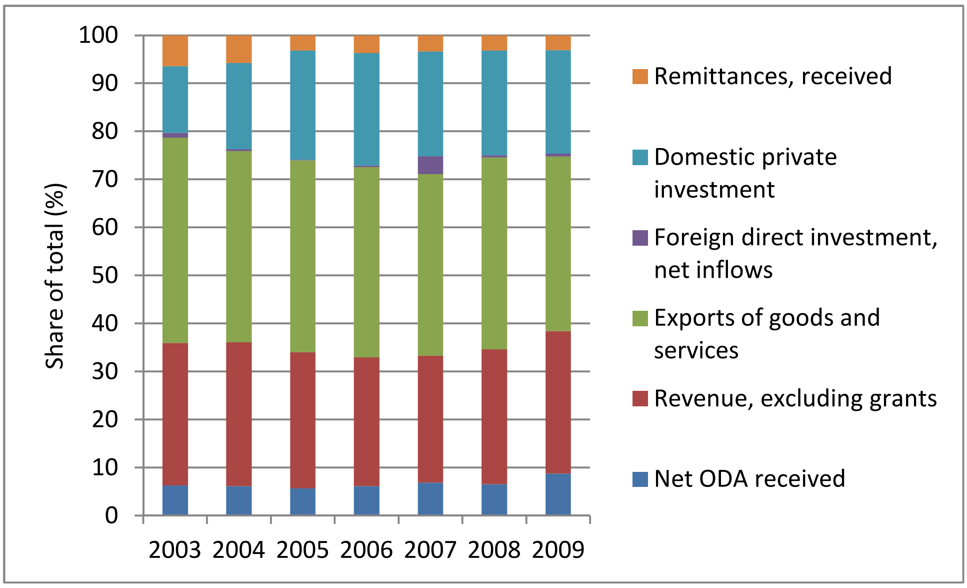
Source: Data drawn from the World Bank (2013c). Note: Data on foreign direct investment only available from 1970.

Figure 5.A7: Private Investment in Kenya, 1979-2009



Source: Data drawn from the World Bank (2013c). Note: Data on gross fixed capital formation of the private sector only available for the period 1979-2009.

Figure 5.A8: Major Sources of Investible Funds in Kenya, 2003-2009



Source: Data drawn from the World Bank (2013c).

Table 5.A1: Chronology of Major Economic and Political Events

1963	Kenya becomes independent from the United Kingdom.
1965	The Kenyan government signals its commitment to a pro-capitalist development path in the Sessional Paper No. 10 of 1965 "African Socialism and Its Application to Planning in Kenya."
1966	The Central Bank of Kenya (CBK) is established.
1973	Kenya's economy is badly affected by the first oil crisis.
1976-77	Fiscal discipline declines in the wake of a coffee boom and the subsequent decline in coffee prices worsens fiscal balance and contributes to large-scale public borrowing from the CBK.
1977	The East African Community breaks up.
1978	When President Jomo Kenyatta dies, capital flight increases until he is succeeded by Vice President Daniel Arap Moi.
1979	Kenya's economy is badly affected by the second oil crisis.
1980	Kenya launches its first SAP with support from the IMF and the World Bank.
1982	Kenya becomes a de jure single-party state. A coup attempt against President Moi by members of the Air Force fails.
1986	The government signals its commitment to reform in the Sessional Paper No. 1 of 1986 "Economic Management for Renewed Growth."
1990-1993	The CBK and Kenya's Ministry of Finance facilitate large-scale fraud in the Goldenberg Affair.
1991	At a Consultative Group meeting in November donors decide to suspend balance of payments support.
1992	Daniel Arap Moi is returned to power in the first multiparty elections since independence.
1993	Donors begin to release frozen aid.
1997	Daniel Arap Moi is returned to power in multiparty elections.
2002	Multiparty elections bring Mwai Kibaki to power.
2003	The government develops the Economic Recovery Strategy 2003-2008, signalling its commitment to reform.
2008	Vision 2030, Kenya's development plan for the period 2008-2012, underscores the government's commitment to private investment and financial deepening.

Table 5.A2: IMF Lending for Structural Adjustment to Kenya, 1978-1996

Loan type	Year	Amount (millions of US$)	Comments
Standby	1979	122.5	Not drawn, cancelled 14 October 1980.
Supplemental Facility	1979	70.7	Not drawn, cancelled 14 October 1980.
Compensatory Facility	1979	69	
Standby	1980	241.5	Only SDR 90 million drawn, cancelled 7 January 1982
Supplemental Facility	1980	184.8	Only SDR 50.1 million drawn, cancelled 7 January 1982
Standby	1982	151.5	Only SDR 90 million drawn, cancelled 7 January 1983
Supplemental Facility	1982	96.8	
Compensatory Facility	1982	60.4	
Standby	1983	175.9	
Standby	1985	85.2	
Compensatory Facility	1986	37.9	
Standby	1988	85	Only SDR 62.6 million drawn, cancelled 15 May 1989
Structural Adjustment Facility	1988	99.4	Only SDR 28.4 million drawn, replaced by ESAF 15 May 1989
Enhanced Structural Adjustment Facility	1989	261.4	SDR 216.2 million drawn prior to November 1991, was suspended January 1992, expired March 1993. Balance renegotiated December 1993, drawn by December 1994.
Enhanced Structural Adjustment Facility	1996	149.6	Only SDR 25.0 million drawn, suspended July 1997, expired April 1999

Source: O'Brien and Ryan (2001: 476)

Table 5.A3: World Bank Lending for Structural Adjustment to Kenya, 1978-1996

Loan type	Year	Amount (millions of US$)	Comments
Structural Adjustment Loan I	1980	55	IDA lending terms.
Structural Adjustment Loan II	1982	130.9	$70.0 million on IDA terms, $60.9 million on IBRD terms.
Agricultural Sector Adjustment Operation I	1986	40	IDA terms. Also IDA reflows of $20.8 million.
Industrial Sector Adjustment	1988	102	IDA terms. Also IDA reflows of $63.1 million.
Financial Sector Adjustment	1989	120	IDA terms. Also IDA reflows of $114.6 million.
Export Development Programme	1990	100	IDA terms. Also IDA reflows of $53.0 million.
Agricultural Sector Adjustment Operation II	1991	75	IDA terms. Only $30.9 million of balance of payments support disbursed, balance cancelled December 1992.
Education Sector Adjustment Credit	1991	100	IDA terms. 2nd and 3rd tranches affected by November 1991 aid freeze, credit not fully disbursed until 1995. Also IDA reflows of $96.2 million.
Structural Adjustment Credit I	1996	90	IDA terms. Only $44.5 million of credit and $35.3 million of IDA reflows disbursed. Balance of credit and $42.1 million of IDA reflows cancelled June 1998

Source: O'Brien and Ryan (2001: 477)

6 Control over Investible Funds and Central Bank Policy: Statistical Analysis of Cross-National Patterns

The case studies presented in the previous chapters have hopefully conveyed some impression of *how* those who control the sources of finance on which a country relies to finance investment may shape central bank policy stances by outlining and clarifying causal pathways. I have not yet broached the question of the extent to which the findings on the link between the key sources of finance and central bank policy for developing countries can be generalised. After all, the evidence presented so far is based on three country cases and the conclusions, with respect to each structural proposition, are based on only one case. Moreover, all three cases are African. Therefore, there is a significant risk of selection bias. To address this risk, this chapter presents a cross-national statistical analysis of the relationship between a country's key sources of investible funds and central bank policy stances. Thus, I continue the exercise of theory-building and -testing using a larger sample of developing countries. However, now the focus will shift from examining causal pathways to examining the generalisability of the structuralist propositions for developing countries.

There are at least two other ways in which the cross-national statistical analysis contributes to extending and probing the structuralist propositions. First, the statistical analysis can include rival explanatory factors as control variables. Second, the statistical analysis encourages the development of quantitative measures of key theoretical concepts, some of which may be difficult to operationalise but are important to measure for cross-country comparisons. The major challenge I faced concerned the conceptualisation and measurement of central bank policy stances. The structuralist literature dealing with finance offered limited guidance in this respect because it is mainly qualitative.[119] There is a fairly large literature rooted in economics which is concerned with central bank policy but this research has made little effort to find adequate measures of the *stance* of central bank policy, except for the field of monetary policy. Given the lack of off-the-shelf quantitative measures which are adequate for the

[119] An exception is Sylvia Maxfield's research on the sources of central bank independence, which presents both case studies and statistical analysis (Maxfield, 1997). Yet her statistical analysis tests structuralist propositions at best indirectly and she does not develop measures of central bank policy. In *Governing Finance,* which is based on case study evidence from Latin America, Maxfield (1990) uses the concepts "stability-oriented" and "growth-oriented" central bank policy, but she does not employ quantitative measures of the policy stances.

context of developing countries, a major contribution of this thesis thus relates to the conceptualisation and measurement of central bank policy stances.

In designing the statistical analysis, I systematically used insights gained from the case studies of Kenya, Nigeria and Uganda. In particular, the case studies suggest that the period before the end of the 1980s is unlikely to exhibit enough variation in policy stances to be analysed statistically. Until the 1980s, central bank policies oriented towards financial deepening were pursued and considered legitimate in much of the developing world. We have seen, however, a greater variation in central bank roles from the late 1990s onwards: The international ideological climate changed during the 1980s and the idea that central banks should place greater importance on promoting price and financial stability gathered momentum. Beginning in the 1980s and throughout the 1990s, a major wave of monetary and financial reform as part of structural adjustment programmes took place in developing countries. Yet, as the cases of Kenya, Nigeria and Uganda illustrate, the degree to which countries embraced reform varied substantially.[120] Correspondingly, the statistical analysis that follows relates to the period from the late 1990s, the time by which most developing countries had already undertaken drastic monetary and financial reforms, until the global financial crisis in 2008, which required many countries to deviate from policy paths and which re-launched the debate about the role of central banks in governing finance.

The evidence from the case study of Kenya also reinforced my decision to focus on examining the propositions related to aid and resource dependence in the statistical analysis. The Kenyan story suggests that, to account for the direction of policy in countries reliant on private investors, it is important to look at their policy preferences which in turn are shaped by private sector characteristics. However, taking into account private sector characteristics in the cross-national statistical analysis would have expanded the scope of this research significantly. Given that a key objective of this thesis has been to extend the structuralist theory to contexts of aid and resource dependence, and that I had to keep the scope of the research manageable, the focus on the role of aid and resource dependence rather than on the role of reliance on private investment as key explanatory variables of the statistical analysis appears appropriate. The focus of this chapter is thus on examining the following two propositions:

[120] For an overview over variation in the timing, pace and scope of banking reform in Africa see for instance Boone (2005).

- First, in developing countries which are more dependent on aid, the central bank policy stance is more likely to be stability-oriented. The key underlying contention is that by providing a significant share of investible resources, donors gain political power over economic policy vis-à-vis other actors in aid dependent countries so that policymakers in these countries have strong incentives to be responsive to donors' concerns that price and financial stability should be primary goals of central banks.
- Second, in developing countries which are more dependent on natural resources, the central bank policy stance is more likely to be oriented towards financial deepening. The key underlying contention here is that access to and control over resource revenues widens the policy space for policymakers so that central bank policy in these countries reflects the concerns of governments in resource dependent countries that financial deepening should be a primary goal of central banks.

Note that to account for the *direction* of policy I refer to the *preferences* of donors, as those who control capital in aid dependent countries, and of governments, as those who control capital in resource dependent countries. As Winters (1996: 141) points out, when the structural power of business is low, as is likely in contexts of aid and resource dependence, one can account for the direction of policy only by looking at additional information, which in this thesis are findings from research on the policy preferences of donors and of governments of resource dependent countries. Thus, a decline in the structural power of the private sector does not lead to clear predictions regarding the stance of policy and may, as the case studies of Uganda and Nigeria and the literature on aid and resource dependence suggest, be associated with distinct policy stances in aid and resource dependent countries. Therefore, I use aid and resource dependence as proxies for the degree to which donor and government preferences respectively are able to shape policy rather than as proxies for the structural power of the private sector.

A major challenge I faced in the statistical analysis of central bank policy stances was that there is no natural metric capturing simultaneously the policy stance in relation to price stability, financial stability and financial deepening. Following the case studies, in which I base assessments of each central bank's policy stance on the weight the central bank attaches to the promotion of each of the three goals – price stability, financial stability and financial deepening – I opted for three distinct measures of policy stances: First, measures of the promotion of access to finance in order to capture the policy stance in relation to financial deepening; second, measures of the stringency of banking regulation to capture the policy stance in relation to financial stability; and third, a measure of the degree of aversion to inflation to capture the policy stance in relation to price stability. The more consistent my findings are in line with the structuralist propositions across these three measures, the greater the support is for my propositions.

Correspondingly, this chapter has three substantive sections. The first explores the relationship between dependence on aid or natural resources and the policy stance in relation to financial deepening using cross-country logistic regression analysis. The second section explores the relationship between the dependence on aid or natural resources and the policy stance in relation to financial stability based on cross-country regression analysis. The third and final substantive section presents a pooled time-series cross-sectional (TSCS) analysis of the relationship between dependence on aid or natural resources and the policy stance in relation to price stability.

On balance, the results suggest that the pattern of cross-country data is broadly consistent with the structuralist propositions I developed: Developing countries which are more reliant on natural resources are more likely to have a policy stance oriented towards financial deepening and less likely to have a stability-oriented policy stance, at least as policies to enhance price stability and financial access are concerned. Moreover, developing countries which are more reliant on aid are less likely to have a policy stance oriented towards financial deepening and more likely to have a stability-oriented policy stance, at least if aid dependence is measured by participation in IMF programmes.

However, the results of the analysis of the policy stance in relation to price stability suggest that greater reliance on foreign *financial* assistance, as measured by volumes of ODA or IMF credit received, is associated with lower aversion to inflation. This finding, which contradicts my proposition that aid dependence induces a stability-oriented policy stance, suggests that my model linking aid dependence and the stance of policy needs to be adapted. One such adaptation might be to take into account that the effects of aid dependence on the policy stance may differ, depending on the channel through which donors exert influence and, correspondingly, on the variables that are used to measure donors' influence.

The final section summarises the insights we have gained from the statistical analysis. It concludes by arguing that although each of the three sets of statistical analysis has methodological limitations, which may mean that one set is not entirely convincing on its own, the three sets of analysis when considered together provide some support for the propositions and thus for future work to refine the structuralist arguments.

6.1 Analysis of the Policy Stance in Relation to Financial Deepening

Over the past few years, reforms that promote financial access have increasingly moved to “the core of the international development agenda for policy makers and development institutions” (Ardic et al., 2011: 2). Increasing financial access, also referred to as “access to financial services” or “access to finance”, is a key element of financial deepening in developing countries because in these countries a key constraint to increasing the volume of financial transactions is limited access to finance. However, despite the growing policy literature on the role of central banks and regulators in promoting financial deepening[121] and donor funding to encourage such engagement, much less attention has been paid to developing indicators which capture the weight central banks attach to financial deepening and gathering the respective data. This section proposes exactly such measures and uses them to probe the relationship between dependence on aid or natural resources and the policy stance in relation to financial deepening.

6.1.1 Conceptualising the Policy Stance in Relation to Financial Deepening

An ideal measure of the policy stance in relation to financial deepening should have at least three features. First, it should capture whether and to what extent a central bank is committed to financial deepening, that is to increasing the volume of financial transactions through, for example, financial sector development and increasing access to finance. Second, the measure should be available for a wide range of countries and years. Third, it should capture commitment to financial deepening with a measure that it is comparable across countries.

Unfortunately, existing scholarship offers no template to copy for capturing commitment to financial deepening in such a way. Many works on this subject are qualitative case studies, which tend to gather information on a variety of actions to

[121] See for instance De la Torre et al. (2007), Beck et al. (2011) and AFI (2014) .

enhance financial access in a particular country, often over time.[122] Compiling a new dataset based on these case studies is, however, beyond the scope of this thesis.

There are also a small number of quantitative studies, most of which can be grouped into two broad categories. One group of studies explores the use of a single policy such as the setup of credit information bureaus or of a small set of policies to promote financial access at one particular point in time.[123] Using data from these studies as an indicator of the policy stance is, however, problematic because a very limited set of policies is incapable of capturing the stance of policy. In principle, I could have compiled data from various studies into one dataset covering a greater variety of financial deepening policies and constructed a composite indicator.[124] In practice, however, I would have confronted the problem that there is only a weak analytical basis for selecting the policy measures to be included in a composite indicator because there is no agreement in the policy and academic literature on what the most relevant policies to deepen financial sectors are.[125]

The second group of studies[126] provides data on cross-country variation in financial "repression" and liberalisation (Bandiera et al., 2000; Kaminsky and Schmukler, 2008; Abiad et al., 2010).[127] While some studies (in particular Abiad et al., 2010) have collected datasets with a wide coverage of countries, years and financial repression policies, the validity of measures of financial repression as indicators of a policy stance oriented towards financial deepening in the 2000s is limited: A high degree of financial "repression" may indicate a strong commitment to financial deepening in the 1970s or 1980s when ideology and policy were based on the idea that governments in developing countries may intervene heavily in financial markets to promote financial access; yet this is not the case for the 2000s. Financial deepening policies have changed over time and become more market-based. Similarly, a high degree of financial liberalisation

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[122] See for instance Maxfield (1990), Haggard et al. (1993), Brownbridge et al. (1998) and Haber (2008).
[123] See for instance Bruhn et al. (2013).
[124] I follow the OECD (2008) in defining a composite indicator as a single index into which individual indicators are compiled to capture multidimensional concepts.
[125] The headline conclusion of much recent work on financial access policies in developing countries is "no size fits all" (Beck et al., 2011). In fact, views on which policies are most effective to enhance financial deepening have changed significantly over time and are likely to vary from country to country.
[126] See for instance Bandiera et al. (2000), Kaminsky and Schmukler (2008) and Abiad et al. (2010)
[127] The term financial repression is often used to refer to government interventions in financial markets to deepen financial sectors which were common in the 1950s to1980s. Such interventions typically included interest rate ceilings, high reserve requirements, controls on credit allocation and restrictions on capital transactions with the rest of world. In the late 1970s, industrialised countries then led efforts to liberalise financial markets and many developing countries followed in the 1980s and 1990s.

today does not necessarily capture a strong commitment to financial deepening because, over the past decade, the view that minimising government intervention in financial markets has not been very effective in promoting financial access and development has spread (De la Torre et al., 2007; Beck et al., 2011).

In sum, disagreement concerning the most relevant policies to deepen financial sectors and data limitations hint at the need to construct a new measure of the policy stance in relation to financial deepening for this research project. This measure should be sufficiently broad to comprise the variety of measures central banks take in order to promote financial deepening.

6.1.2 Measuring the Policy Stance in Relation to Financial Deepening

In light of the shortcomings of existing data and measures, I constructed a measure of the policy stance in relation to financial deepening based on data from the Consultative Group to Assist the Poor (CGAP) *Financial Access Survey 2010*. This survey was conducted in 2009 and provides data on access to financial services and the engagement of central banks and regulators in promoting financial access (CGAP, 2010). The *Financial Access 2010* survey, for instance, asked the main financial regulators which of the following topics relevant for financial access were under the purview of their agency: consumer protection, financial capability, regulation of microfinance, promotion of savings, promotion of access to finance for small and medium enterprises (SMEs) and promotion of rural finance. The survey also explores each of these areas, and precisely whether the regulator has a team or unit that works on this area. In addition, regulators were asked whether there were reforms in the following ten areas in 2009: consumer protection, financial literacy, basic accounts, government-to-person transfers, access to finance in rural areas, microfinance, know-your-customer (KYC) requirements, access to finance by SMEs, branchless banking and over-indebtedness.[128] Based on the CGAP data, I developed two different measures of the central bank policy stance in relation to financial deepening:

- First, *Team*, a binary variable indicating whether regulators have a team or unit working on the promotion of savings, SME finance or rural finance in order to

[128] The survey also explores whether a country has a financial inclusion strategy in place. I did not use this information to develop an indicator because the measures I selected capture the devotion of resources and actions to promote financial access more directly and financial inclusion is a narrower concept than access to finance.

capture whether the regulator has actually devoted resources to promote financial deepening. The variable takes a value of 1 if a team working on one or several of these issues exists and 0 otherwise. The variable captures only the promotion of savings, SME finance or rural finance because the other categories - consumer protection, financial capability and regulation of microfinance – are less directly linked to the promotion of access to finance and may as well indicate a concern for financial stability. I opted for a binary variable as opposed to an index to avoid double-counting since the overlap between policies to promote savings, SME finance and rural finance may be large.

- Second, *Reform*, a binary variable which takes a value of 1 if reforms took place to promote access to finance for SMEs and/or access to finance in rural areas in the year 2009 and 0 otherwise. *Reform* captures only reforms related to SME and rural finance because the other reform categories on which data is available – consumer protection, financial literacy, basic accounts, government-to-person transfers, microfinance, KYC requirements, branchless banking and over-indebtedness – are less broad-based and to a substantial extent covered by the reform categories of SME and rural finance.

Using these measures has some drawbacks. First, data is only available for one year, 2009. The reliance on data from a single year is problematic because it limits the number of observations. Moreover, there is the risk of not capturing commitment to reform where regulators implemented reforms before or after 2009. A second issue is that the focus on the devotion of human resources and implementation of financial access reforms only gives an indication of implementation *capacity*, but not of the *quality* of implementation, which may be a better proxy of commitment. A third issue is that the three variables only allow a binary distinction on whether an institution is committed to financial deepening or not whereas a measure of degree would mirror reality more closely. Finally, using data from the survey is problematic because the survey does not provide information on whether it was the central bank or another financial regulator which filled in the questionnaire and whether data on the promotion of financial access refers to actions of the central bank or another regulator.[129]

That being said, superior alternatives are unfortunately not available for this study:

[129] According to CGAP (2010: 45-46), the "questionnaires were sent directly to the governors' offices of central banks. When appropriate, they were also sent to monetary authorities or banking supervisory agencies." This leaves open which agencies filled in the questionnaire.

- There is a dearth of cross-country data on the promotion of financial deepening, and a dataset tracking such engagement over multiple years does not exist. It is nonetheless plausible that *Reform* captures commitment to reform because financial reform processes usually take place over multiple years and reform needs in developing countries are large so that it seems reasonable to expect a central bank committed to financial deepening to have at least one reform to facilitate access to finance for SMEs or in rural areas ongoing in 2009.
- By using relatively broad measures of commitment to financial deepening which are not based on particular policies, I can capture the diversity of policies pursued by governments to promote financial deepening, thereby ensuring the cross-country comparability of measures. Unfortunately, using these broad-based measures comes at the price of not being able to capture the *degree* of engagement. Still, both *Team* and *Reform* are conceptually meaningful indicators of the policy stance since they capture the devotion of resources and actions to enhance financial access. Moreover, among datasets with broad-based measures of engagement in financial deepening, the CGAP data covers the largest number of countries.
- Cross-country data on the quality of implementation of financial deepening policies does not exist.
- There is no easy solution for the problem that the CGAP database does not provide information on whether the financial deepening policies of interest have been pursued by the central bank or another financial regulator. Other datasets with similar data on engagement in financial deepening face this problem as well.[130] Using only those observations where the central bank is the main regulator is also problematic. First, because it implies losing the observations of those countries which have separate financial regulators outside the central bank but whose central banks promote financial deepening and filled in the questionnaire of the CGAP survey; second, because identifying those countries which have a separate, independent financial regulator is not straightforward. In the context of developing countries, such an identification often involves subjective judgement because there tend to be organisational and personnel overlaps between central banks and other regulatory agencies, and the hierarchy between central banks and other regulators is

[130] See for instance the World Bank survey on banking regulation and supervision (Čihák et al., 2012), which provides information on whether banking regulators have responsibility for financial market development and access, but leaves open whether the answers provided refer to central banks or separate regulatory agencies.

often not evident from formal statutes. With these challenges in mind, I made a decision to include all available observations and accept the limitation that the results of the statistical analysis would refer to the *stance of financial policy* or of *financial regulators*, which in the majority of countries are central banks but not in all of them. For the purposes of extending and probing the structuralist theory, this is not a major concern because employing the selected measures can shed light on the relationship between the key sources of finance and financial deepening policy, and the theory of the structural power of capital seeks to explain not only institutional behaviour but also the orientation of policy.

6.1.3 Explanatory Variables

At a general level, an important question related to the explanatory variables is whether an observation shall represent one year or an average of several years. In the analyses that follow, I use, unless otherwise stated, five-year averages of explanatory variables to reduce the effects of cyclical fluctuations. Specifically, values for explanatory variables are, unless otherwise stated, the average of the annual observations over the years 2005 to 2009, which is the five-year period preceding the CGAP survey and including the survey year.[131]

The key explanatory variables are a country's dependence on aid and natural resources, which I defined in Chapter 2 as the degree to which aid and the sale of natural resources respectively are an important source of the funds needed to maintain a level of economic activity that permits financing of the state apparatus and maintaining the government's popular support. The rationale behind using dependence for investible resources on aid and on natural resources as key explanatory variables is the argument that policy reflects the preferences of those who control a significant share of the resources on which a country relies to finance investment. This argument has its roots in the structural theory of the power of capital as outlined in Chapter 2. Thus, I use aid dependence as a proxy for the power of donors and resource dependence as a proxy for the power of governments to shape policy stances.

[131] Where data in the five-year period is missing, I calculated averages using available data if at least half of the observations of the five-year period (i.e. three or more observations) are available and one of these is from the year preceding the survey or the year in which the survey took place. Otherwise, I coded data as not available.

Aid dependence is a broad concept, of which different measures capture its different aspects. My first measure, *ODA*, follows most existing quantitative research in using net ODA as a percentage of GNI as an indicator of aid dependence (Knack, 2001; O'Connell and Soludo, 2001; Hayman, 2009).[132] I decided to use a measure which captures the degree of dependence by scaling the value of ODA a country receives to its income rather than to government revenue because data for ODA as a share of GNI is available for a larger number of countries.[133] Moreover, my primary interest is to capture the share of a *country's* investible funds provided by donors rather than the share of a *government's* investible funds provided by donors. Scaling aid to GNI comes closer to capturing the former concept than scaling aid to government revenue.

As additional measures of aid dependence, I use two variables capturing reliance on the IMF. My focus is on the IMF because, among development institutions, the IMF is, as the case studies confirm, the institution whose assessments of monetary and financial policy are regarded as most authoritative and which has most leverage in the areas of monetary and financial policy because these areas are within the primary responsibility of the IMF.[134] One indicator for reliance on the IMF is *IMFcredit*, a continuous variable capturing the use of IMF credit as a share of GDP.[135] This measure also scales aid flows to the size of the economy. The other indicator is *IMFprogr,* which seeks to capture the influence the IMF may gain through conditionality, promoting new ideas and the signal which having an IMF programme in place sends to other donors and markets. The choice of this variable thus reflects the insight from the case studies presented in this thesis that often the IMF's influence over policy rests particularly on its ability to encourage social learning and its signalling function rather than on the provision of funds. I constructed the variable *IMFprogr* as the sum of the annual number of IMF

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[132] Net ODA is disbursement flows (net of repayment of principal) that meet the DAC definition of ODA and are made to countries and territories on the DAC list of aid recipients.

[133] I replicated the analyses with aid as a share of government revenues. The results are qualitatively similar to those of the main specifications presented here but provide more consistent support for the proposition linking aid dependence and the policy stance in relation to financial deepening. The results are available upon request.

[134] In fact, donors often provide ODA only under the condition that countries are under an IMF arrangement.

[135] "Use of IMF credit" denotes members' drawings on the IMF other than amounts drawn against the country's reserve tranche position (World Bank, 2013c). The variable refers to purchases and drawings under Stand-By, Extended, Structural Adjustment, Enhanced Structural Adjustment, and Systemic Transformation Facility Arrangements as well as Trust Fund loans. I scaled IMF credit to GDP to provide an indication of the importance of IMF finance in relation to investible funds in the economy.

arrangements in effect over the five-year period from 2005 to 2009.[136] While *IMFcredit* may also capture the intensity of IMF conditionality, conditionality and credit volumes need not be proportional (Boockmann and Dreher, 2003: 637). In fact, as Boockmann and Dreher (2003) point out, the number of arrangements as captured by *IMFprogr* may be a better measure for IMF conditionality than the flows of finances because each programme tends to include a set of standard conditions independent of the amount of credit. The number of IMF arrangements may also be a better measure for the intensity of knowledge exchange with the IMF and thus its contribution to social learning than the flows of finance because each programme negotiation, implementation and review intensifies the contact between recipient country and IMF and hence implies a learning process (Boockmann and Dreher, 2003; Gómez-Mera, 2011). Data for *ODA* and *IMFcredit* are from the World Bank (2013c) while Dreher (2006) provides data on IMF arrangements.

The measurement of natural resource dependence also requires some clarification. On a conceptual level, researchers need to define what they subsume under the heading "natural resources". As outlined in Chapter 2, I follow most existing literature to subsume under this heading the point-source non-renewable resources of oil, minerals and, where data is available, natural gas. Much of the resource curse literature posits that the significant amount of rents that can be generated from natural resource exploitation accounts for negative development outcomes and expansionary policies in resource dependent countries. Therefore I use *ResRents,* a variable constructed based on data from the World Bank (2013c), as the main resource dependence variable of interest. *ResRents* is the sum of rents from oil, minerals and gas as a percentage of GDP, whereby rents are the difference between the price of a commodity and the average cost of producing it.[137] As an additional measure, the analyses that follow employ *ResExp*, which is the sum of the value of fuels, ores and metals exports as a share of GDP. This measure focuses more broadly on the revenues generated from natural resource exports. Data for *ResExp* is taken from the World Bank (2013c).

[136] To construct the variable I calculated the sum of the annual number of IMF Standby Arrangements, IMF Extended Fund Facility Arrangements, IMF Structural Adjustment Facility Arrangements and IMF Poverty Reduction and Growth Facility Arrangements which have been in effect for at least five months in a particular year between 2005 and 2009.

[137] The World Bank (2013c) calculates the estimates of natural resources rents by estimating the world price of units of specific commodities and subtracting estimates of average unit costs of extraction or harvesting costs (including a normal return on capital). These unit rents are then multiplied by the physical quantities countries extract or harvest to determine the rents for each commodity as a share of GDP.

I did not scale the resource rents and revenues to government revenue because available data on government revenues from the extractive sector is limited and for many countries unreliable. Instead, I capture the degree of resource dependence by scaling resource rents and revenues to a country's economic output, the GDP, which allows capturing the share of a country's investible funds deriving from the sale of natural resources. By scaling resource revenues to the size of all funds generated through economic activity in the economy *ResExp* also captures the lack of economic diversification in resource dependent countries which itself might increase the government's incentives to promote access to finance as a means to develop the private sector, as explained in Chapter 2.

Control Variables

It may be that the aid and resource dependence variables pick up the effects of other variables. There are very few studies of the determinants of government commitment to financial deepening.[138] The most robust findings from these studies are that levels of GDP per capita (Ardic et al., 2011), the quality of political institutions (Haber, 2008; Huang, 2010)[139] and access to finance (Maxfield, 1994; Ardic et al., 2011) shape the policy stance in relation to financial deepening. Accordingly, I include the following political and economic control variables: The first control variable is *lnGDPPC,* the natural log of GDP per capita in constant 2005 US$ (World Bank, 2013c). The second control variable is *Polity2*, which measures regime types on a scale ranging from –10 (strongly autocratic) to +10 (strongly democratic) and is taken from the Polity IV dataset (Marshall et al., 2011). The third control variable is *PrCredit*, which measures credit provided to the private sector by deposit money banks and other financial institutions as a share of GDP. This variable is drawn from the World Bank (2013b).

Like the aid and resource dependence variables, the control variables are averaged over the years 2005 to 2009. Section 6.5.1 of the appendix shows the summary statistics for the main variables in our sample. The sample includes only developing countries, which

[138] There are several of econometric studies which examine the drivers of government commitment to financial development using some measure of financial development as the dependent variable. These studies include for instance research which uses the openness of political institutions as explanatory variable such as Keefer (2007) and research which uses legal origin as explanatory variable such as Beck et al. (2003). These studies, however, capture commitment to financial deepening at best indirectly: Financial development is affected by a myriad of factors outside the control of governments, raising doubts about the validity of financial development as a proxy for commitment to financial development.

[139] The case studies of Uganda, Nigeria and Kenya also suggest that greater political competition is associated with a policy stance oriented to financial deepening.

I define as the group of countries classified by the World Bank as low- and middle-income economies in the time period 2005 to 2009.

6.1.4 Model Specification and Caveats

I use cross-country logistic regressions to examine the relationship between dependence on aid or natural resources and the policy stance in relation to financial deepening. This technique is widely applied to analyse cross-sectional data with binary dependent variables. For the analysis, I specify a model in which the log odds[140] of my variable capturing the policy stance in relation to financial deepening, that is *Team* or *Reform*, are a function of an aid or resource dependence variable (*Dependence*), the log per capita GDP, the quality of political institutions and private credit:

$$\ln\left(\frac{p_i}{1-p_i}\right) = = \mathrm{a} + \mathrm{b}_1\, Dependence_{\mathrm{i}} + \mathrm{b}_2\, lnGDPPC_{\mathrm{i}} + \mathrm{b}_3\, Polity2_{\mathrm{i}} + \mathrm{b}_4\, PrCredit_{\mathrm{i}}$$

whereby p_i is the probability that y_i , my variable capturing the policy stance in relation to financial deepening, = 1.

The specification of the model follows directly from the conceptual framework and the data available for the analysis. Yet using the model implies limitations in establishing causation and even correlation. These limitations arise in particular from the small number of observations, which mainly results from data limitations.[141] The analysis extends to a maximum of 75 developing countries, observed at one point or period in time.[142] The small number of observations is problematic because it limits the degrees of freedom. Limited degrees of freedom generate large standard errors in the regression

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[140] The odds are defined as the ratio of the probability of y, which here refers to *Team* or *Reform*, being 1, over the probability of y being 0.

[141] Some observations were lost due to missing data. I did not include some countries in the sample from the outset because they have uniform financial policies due to regional regulatory and monetary authorities. Among developing countries the first group of excluded countries consists of Anguilla, Antigua and Barbuda, Anguilla, Antigua and Barbuda, Dominica, Montserrat, Saint Kitts, Saint Lucia, Saint Vincent and the Grenadines, which form part of the Eastern Caribbean Currency Union (ECCU). The second group consists of Benin, Burkina Faso, Côte d'Ivoire, Guinea-Bissau, Mali, Niger, Senegal and Togo, which form part of the West African Economic and Monetary Union (WAEMU). The third group consists of Cameroon, the Central African Republic, Chad, Congo, Equatorial Guinea and Gabon because they form part of the Central African Economic and Monetary Community (CAEMC). In addition, I followed existing research and excluded countries with less than 500,000 inhabitants from the outset because in very small economies, economic development strategies, including financial policies, are likely to be driven by different dynamics than in larger countries.

[142] As already noted, observations of the dependent variable are from 2009 and observations of the explanatory variables are, in most cases, the average over the years 2005 to 2009.

analyses and make it difficult to estimate more fully specified models and to discover statistically significant relationships.

Moreover, it is not possible to explore causal relationships with the models and data employed here because they are unable to address problems of endogeneity. The propositions I formulated in Chapter 2 were that dependence on aid and dependence on natural resources influence the policy stance. Yet causality may also run in the other direction. For instance, a stability-oriented policy stance in aid dependent countries may perpetuate aid dependence, and a policy stance oriented towards financial deepening in resource dependent countries may perpetuate resource dependence. In fact, existing research suggests that central bank policy both reflects and reinforces economic structures (Maxfield, 1994). In addition, endogeneity may arise from third variables, which affect both the dependence variables and the policy stance. To address endogeneity at least partly, I control for those variables which in previous research have been most robustly associated with commitment to financial deepening, namely GDP per capita, the quality of political institutions and private credit.

Despite the inability of the analyses that follow to establish causal relationships, the value added by insights based on the data and methodology at hand is still high. This is an exploratory research project and the data and methods proposed here allow a first set of statistical explorations as to whether the pattern of cross-country data is broadly consistent with the structuralist propositions about the relationship between the sources of finance and the stance of policy and with the evidence found in the case studies. Is financial policy in countries that are more reliant on aid less likely to promote financial deepening? Is financial policy in countries that are more reliant on natural resources more likely to promote financial deepening? These are the broad questions that the data and model employed are able to answer. The combined results of the case studies and the statistical analysis will then help us to gain a more nuanced understanding of the relationship between the sources of finance and central bank policy.

6.1.5 Results

With these methodological challenges in mind, the remainder of this section presents the results of the cross-national analysis of the relationship between the sources of finance and the policy stance in relation to financial deepening. I present specifications using several measures of dependence and of the policy stance owing to the exploratory character of this research and the aim of evaluating different conceptualisations of key elements of my theoretical framework.

Aid Dependence and the Policy Stance in Relation to Financial Deepening

In Chapter 2, I developed the proposition that central banks in developing countries which are more reliant on aid are more likely to have a stability-oriented policy stance, one indication of which may be a lower prioritisation of policies to promote financial deepening. The analyses that follow probe this proposition and explore whether there is a negative relationship between aid dependence and engagement in the area of financial deepening. Columns 1 to 3 of Table 6.1 report results on the relationship between aid dependence and the existence of a team of financial regulators working on financial access. Columns 4 to 6 of Table 6.1 report results on the relationship between aid dependence and the implementation of financial access reforms.

Table 6.1: Aid Dependence and Policy Stance in Relation to Financial Deepening

	(1) Team	(2) Team	(3) Team	(4) Reform	(5) Reform	(6) Reform
lnGDPPC	-1.023^{*}	-0.809^{*}	-0.575^{+}	-0.0194	0.0783	-0.471
	(0.442)	(0.339)	(0.294)	(0.331)	(0.294)	(0.323)
Polity2	-0.0209	-0.0224	-0.0189	-0.107^{*}	-0.0983^{+}	-0.0504
	(0.0464)	(0.0478)	(0.0475)	(0.0522)	(0.0532)	(0.0565)
PrCredit	0.00247	0.00110	0.00183	-0.0147	-0.0105	-0.0237^{+}
	(0.0117)	(0.0117)	(0.0114)	(0.0118)	(0.0112)	(0.0127)
ODA	-0.0840			-0.00404		
	(0.0611)			(0.0247)		
IMFcredit		-23.96			0.837	
		(17.26)			(3.220)	
IMFprogr			-0.110			-0.679^{**}
			(0.171)			(0.218)
Constant	7.394^{*}	5.854^{*}	3.879^{+}	1.511	0.656	6.186^{*}
	(3.340)	(2.473)	(2.165)	(2.406)	(2.035)	(2.567)
Observations	69	71	75	69	71	75
Pseudo R^2	0.0908	0.1033	0.0562	0.0753	0.0523	0.1979
Log-likelihood	-41.56	-41.82	-46.25	-42.71	-44.69	-40.49

Standard errors in parentheses. Results of logistic regression, dependent variable takes the values 0 or 1.
$^{+}$ $p < 0.10$, * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

The results in Table 6.1 are almost universally statistically insignificant. There is only one exception: The negative and significant coefficient for *IMFprogr* in column 6 suggests that, in line with the structuralist propositions, countries which are more reliant on aid as measured by the number of IMF arrangements are less likely to have implemented financial access reforms.

Why has there been a failure to find more evidence for a significant relationship between aid dependence and the policy stance in relation to financial deepening? My hypothesis is that the results presented in Table 6.1 are driven by the African countries in the sample. As the case studies of Uganda and Kenya suggest, donors have changed their preferences and accept or even support a central bank policy stance in Africa which embraces financial deepening as an additional goal, partly because Africa lags behind in international comparison in financial development.[143] In many developing countries outside Africa, financial development is less of a bottleneck, therefore donors may be less supportive of regulators pursuing a policy stance oriented towards financial deepening. As a consequence, the relationship between aid dependence and the policy stance in relation to financial deepening may differ in African countries and non-African countries and we may observe a negative relationship between aid dependence and the policy stance in relation to financial deepening in non-African countries. To explore these hypotheses I re-examine the specifications presented in Table 6.1 but include in each specification an Africa dummy and an interaction term of the Africa dummy and the indicator for aid dependence. Table 6.A2 in the appendix presents the results. The evidence presented in columns 1, 4, 5 and 6 of Table 6.A2 provides support for these hypotheses: Significant and negative coefficients on the variables to capture aid dependence suggest that non-African developing countries which are more reliant on donors are, in line with the structuralist propositions, less likely to have a policy stance oriented towards financial deepening.

Resource Dependence and the Policy Stance in Relation to Financial Deepening

Where developing countries are reliant on natural resources, their regulatory authorities are more likely to promote financial deepening. This is the second structuralist proposition I developed in Chapter 2. I derive this proposition from the structuralist literature and literature on the political economy of natural resource dependence. The

[143] See Allen et al. (2012) for an empirical analysis of why Africa lags behind in financial development.

former type of literature suggests that natural resource revenues, as untied replacement resources, increase the policy space of governments; the latter suggests that economic policy in resource dependent countries tends to be expansionary, and a financial deepening-oriented policy stance is in essence expansionary.

Table 6.2 reports the results of the logistic regression analysis of the relationship between resource dependence and the policy stance in relation to financial deepening. Columns 1 and 2 report results on the relationship between resource dependence and the existence of a team working on financial access. Columns 3 and 4 report results on the relationship between resource dependence and the implementation of financial access reforms.

Table 6.2: Resource Dependence and Policy Stance in Relation to Financial Deepening

	(1) Team	(2) Team	(3) Reform	(4) Reform
lnGDPPC	-0.902^{*}	-0.684^{*}	-0.0656	-0.0962
	(0.354)	(0.297)	(0.305)	(0.275)
Polity2	0.00367	0.0148	-0.0801	-0.0781
	(0.0587)	(0.0522)	(0.0615)	(0.0551)
PrCredit	0.0124	0.00911	-0.00942	-0.00874
	(0.0123)	(0.0116)	(0.0116)	(0.0114)
ResExp	5.047^{+}		1.107	
	(2.635)		(2.708)	
ResRents		0.0389^{+}		0.0347
		(0.0207)		(0.0250)
Constant	5.170^{*}	3.737^{+}	1.482	1.488
	(2.301)	(1.919)	(2.061)	(1.838)
Observations	64	75	64	75
Pseudo R^2	0.1123	0.0724	0.0530	0.0903
Log-likelihood	-34.17	-42.84	-37.25	-42.39

Standard errors in parentheses. Results of logistic regression, dependent variable takes the values 0 or 1.
$^{+}$ $p < 0.10$, * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

Columns 1 and 2 suggest that the regulatory authorities in developing countries which are more reliant on natural resources as measured by the ratio of resource export revenues and resource rents to GDP are more likely to have a team dedicated to promoting financial access, which is in line with my structuralist proposition. Although in columns 3 and 4 the signs of the coefficients on the indicators of resource dependence point, in line with the structuralist propositions, in a positive direction, it is not possible to establish a positive relationship confidently given the lack of statistically significant results.

6.1.6 Conclusion

This section has contributed to the building and probing of structuralist theory by developing a measure of the policy stance in relation to financial deepening and analysing the relationship between the sources of finance and the policy stance in relation to financial deepening using logistic regression analysis. While there are caveats related to the analysis, owing to the inability to establish causal relationships with the available data and methods used here, it nonetheless provides some evidence that the pattern of cross-country data is broadly consistent with the structuralist propositions.

The first set of results on the relationship between aid dependence and the policy stance in relation to financial deepening is almost universally insignificant. However, there is evidence that greater reliance on the IMF as indicated by the number of IMF arrangements in place is associated with a lower likelihood of having implemented financial access reforms.

Moreover, the evidence suggests that in non-African developing countries which are more reliant on aid, the policy stance is less likely to be oriented towards financial deepening. This finding, which is in line with the structuralist propositions, suggests that the failure to find more significant relationships between aid dependence and the policy stance in relation to financial deepening is at least in part driven by African countries. Thus, the relationship between aid dependence and the policy stance in relation to financial deepening seems to differ in African and non-African countries.

One possible explanation for why the relationship seems not to be consistently negative in African countries is that donors may be more supportive of a policy stance oriented towards financial deepening in Africa than elsewhere owing to Africa's comparative lag in financial development. The case study of Uganda and flagship publications by the World Bank (Honohan and Beck, 2007; Beck et al., 2011) suggest that donors have, since the mid-2000s, embraced the idea that financial regulators in Africa should pursue policies aimed directly at financial deepening. While the promotion of greater government engagement in financial deepening is a global trend among donors (Dashi et al., 2013), they may place particular emphasis on this goal in Africa because of the limited success of stability-oriented policies in indirectly increasing financial access, which has left many African countries with, by regional comparison, very shallow financial sectors in a context of well-capitalised banks.

The second set of results also provides some support for the structuralist propositions: Regulatory authorities in developing countries which are more reliant on natural resources seem more likely to have a policy stance which promotes financial deepening, at least where this is measured by having a team working on financial access in place. There is, however, no significant evidence for a positive relationship between resource dependence and financial access reforms. The literature on the effects of resource dependence finds that, despite being less financially restrained, natural resource dependent countries have limited implementation capacity (Auty, 1994; Karl, 2004). Limited capacity to implement reforms may thus be a likely explanation for the failure to find a significant relationship between resource dependence and the implementation of financial access reforms.

6.2 Analysis of the Policy Stance in Relation to Financial Stability

The preceding section has provided a clearer picture of the cross-country patterns of the relationship between aid or resource dependence on the one hand and the policy stance in relation to financial deepening on the other. Another way to approach the question of whether the major sources of finance account for the stance of central bank policy is to examine policy stances with respect to stability-oriented policy goals. We therefore shift now to policy areas concerned with stability, analysing first the policy stance in relation to financial stability, before turning to the policy stance in relation to price stability in the next section.

6.2.1 Conceptualising the Policy Stance in Relation to Financial Stability

In order to capture the policy stance in relation to financial stability I use measures of the stringency of prudential financial regulation.[144] I define "stringency" as the degree of strictness of regulatory frameworks and "prudential" as geared towards reducing the likelihood and/or costs of financial crisis.[145] I decided to use the stringency of regulation as a proxy for the policy stance in relation to financial stability because stringent

[144] More correctly would be the "stringency of regulation and supervision". For ease of reference, however, I use "regulation" and "regulatory" interchangeably for "regulation and supervision" and "regulatory and supervisory".

[145] This notion of regulatory stringency is thus distinct from the notion of comprehensiveness. In this study, a regulatory framework can be very stringent, even if it comprises only a few elements.

prudential regulation and supervision are widely regarded as cornerstones of regulators' financial stability frameworks (Brownbridge and Kirkpatrick, 2000b; Barth et al., 2005).[146] My focus is on regulation and supervision in relation to the banking sector because financial systems in developing countries tend to be bank-based and non-bank financial institutions tend to be supervised and regulated by institutions other than the central bank.

I use two main indicators to capture the stringency of regulation: First, I gathered data on minimum required regulatory capital ratios because they are the main regulatory instrument. Second, I look beyond capital ratios and construct a composite indicator. Employing a composite indicator has the advantage that it is able to capture the multiple components comprised in regulatory frameworks. The construction of the composite indicator posed, however, significant conceptual and measurement challenges because there is no unique way of selecting, quantifying, weighing and aggregating variables.

A Composite Indicator of Regulatory Stringency

Much of the existing research using measures of regulatory stringency has relied on composite indicators capturing the comprehensiveness of regulatory frameworks (Barth et al., 2005; Barth et al., 2012; Klomp and Haan, 2012). Yet in the context of this study, an ideal composite indicator would consist of a small number of components which capture only those elements of bank regulation and supervision in developing countries on which exists a consensus that they are important for safeguarding financial stability. There are two main reasons for this narrow focus: First, resource and skills shortages in developing countries warrant a slim, economical regulatory framework, reflecting the need for prioritising actions (Stiglitz, 2001; Brownbridge, 2002; Fuchs et al., 2012). Second, only those elements of regulation, for which there is a consensus that they are important for financial stability, can form a cross-country comparable indicator of commitment to financial stability.

[146] Obviously, the stringency of regulation is only an imperfect proxy for the weight a central bank attaches to safeguarding financial stability. More stringent regulation may indicate the attachment of greater weight, but this is not necessarily the case. Interest rate caps, for instance, may indicate both an intention to deter risky lending (high interest rates serve to cover expected losses) and to increase access to credit. Moreover, there may be a difference between the proclaimed intention of a measure and the real intention. Whether interest rate caps, for instance, are intended to enhance financial stability or financial deepening is difficult to establish through quantitative analysis. The case studies, which provide a more nuanced picture of the objectives of particular regulatory policies, are thus an important complement to the quantitative analysis.

But which aspects of banking regulation are widely considered as important for financial stability in developing countries? Existing work offers little guidance here because there is a lack of agreement in the literature on this issue.[147] Views regarding the necessary and sufficient components of prudential frameworks in developing countries or regarding the relative importance of components vary considerably – across countries, time and ideological perspective, often depending on what is considered as the major cause of financial instability. This lack of agreement in the literature complicates the selection of the components of the composite indicator and decisions on the weighting of variables. Moreover, even if it was possible to develop a composite indicator capturing the key elements of bank regulation in developing countries, exploring the relationship between the key sources of finance and regulatory stringency would still be hampered by data limitations. Data on prudential regulation is only available for a limited number of developing countries and years.

Consequently, I opted for an approach which seeks to balance the need to capture complex concepts against practical data limitations and inconclusive evidence on the key elements of regulation in developing countries. Specifically, my strategy has been to select a parsimonious set of components for the composite indicator of regulatory stringency capturing only those elements which have been considered with great consistency as key elements of prudential frameworks in developing countries during the 1990s and the 2000s, in different strands of the literature, and in relation to different world regions. Employing the criterion of consistency should help to ensure that regulatory stringency is not measured by prudential policies which are not widely regarded as relevant for financial stability in a broad range of countries. In addition, I considered data availability throughout the conceptualisation phase.

6.2.2 Measuring the Policy Stance in Relation to Financial Stability

In order to capture the central bank policy stance in relation to financial stability I employ three measures, which serve as dependent variables in the analysis: *HCapital, Capital* and *CIStr*.

[147] See for instance the diverging views on the importance of official supervisory authority of Brownbridge and Kirkpatrick (2000a) and Fuchs et al. (2012) on the one hand and Calomiris (1997) and Caprio and Honohan (2004) on the other.

The first two measures are capital adequacy ratios. *HCapital* is a binary variable which equals 1 if the minimum required risk-based regulatory capital ratio is high (exceeding 10%) and 0 otherwise. *Capital* is a continuous measure of the minimum required risk-based regulatory capital ratio. Capital requirements have long been considered and promoted as the main regulatory instruments to enhance financial stability, particularly in developing countries (Brownbridge and Kirkpatrick, 1999; Stiglitz, 2001; BIS, 2012; IMF, 2012a). Capital requirements, which force banks to maintain a certain level of net worth, both serve as a buffer in case of losses and provide incentives for prudent behaviour because higher capital requirements increase the funds owners have at risk.

HCapital, which is a binary measure, is my main measure of capital adequacy ratios because IFIs and donors have long recommended developing countries to employ "high" capital ratios owing to the macroeconomic volatility they experience (Bossone and Promisel, 1998; Caprio and Honohan, 1999; Brownbridge and Kirkpatrick, 2000b; Stiglitz, 2001; Čihák et al., 2012; Fuchs et al., 2012; Klomp and Haan, 2012).[148] What constitutes a "sufficiently high" level of capital requirements should then be decided on a country-by-country basis. Yet most donors and representatives from IFIs agree that minimum required capital ratios exceeding the Basel minimum of 8% may be appropriate given developing countries' higher risk profile and their ability to offer some limited compensation for otherwise weak supervisory authority and capacity (BIS, 2012; Fuchs et al., 2012). For this research, I choose a cut-off-point of 10% for capital ratios to be considered high because 10% constitutes the median among developing countries in the sample and substantially exceeds the Basel minimum required risk-based regulatory capital ratio of 8%.

The third measure is *CIStr,* a composite indicator capturing the stringency of micro-prudential regulation and supervision in its two key areas: *capital requirements* and *supervisory authority* for bank intervention. Organisations like the IMF and the Bank for International Settlements, the main standard setting body for bank regulation and supervision, as well as research on prudential regulation and supervision in developing countries (Glaessner and Mas, 1995; Caprio and Honohan, 1999; Brownbridge and Kirkpatrick, 2000b; Fuchs et al., 2012; World Bank, 2012) have emphasised that supervisory authority to intervene in problem banks is as crucial as capital requirements

[148] For a critical discussion of the pitfalls of overly relying on capital adequacy see for instance Caprio and Honohan (1999), Stiglitz (2001) or IMF (2012a: Chapter 4).

for fostering financial stability. Delayed intervention due to regulatory forbearance and limited authority of central banks to intervene in distressed banks have been major causes of banking distress and crises in developing countries and the recent global financial crisis has underlined the importance of supervisory capacity to intervene timely in problem banks (Glaessner and Mas, 1995; Caprio and Honohan, 1999; Brownbridge and Kirkpatrick, 2000b; Fuchs et al., 2012; World Bank, 2012). There is broad agreement in the literature that regulatory frameworks should comprise a variety of supervisory policies which vary with respect to their extent of bank intervention to address different degrees of banking distress (Brownbridge et al., 1998; Caprio and Honohan, 1999; Brownbridge, 2002; Čihák et al., 2012).[149] Accordingly, I constructed a composite indicator of *supervisory authority.* This composite indicator consists of four subcomponents that I selected based on the literature on regulation and supervision in developing countries and data availability:

- First, the power to require a bank to meet heightened regulatory standards, a relatively light form of bank intervention. Based on data availability, I selected the power to order banks to constitute higher provisions for covering potential or actual losses as a proxy. Inadequate provisioning has received much attention in the literature, partly because it was a major source of weakness in the East Asian countries that experienced a financial crisis at the end of the 1990s (Brownbridge, 2002).
- Second, the power to change the organisational structure of a bank. This is a higher form of bank intervention than the requirement to meet heightened regulatory standards because it affects the rights and responsibilities of bank directors and managers and thus induces lasting organisational changes. The literature highlights the need for supervisory power to change the organisational structure of a bank in the context of discussions about bank resolution frameworks and about the role played by managerial failures in banking crises in developing countries (Brownbridge and Kirkpatrick, 2000b).
- Third, the power to take measures of bank liquidation. This is the highest form of bank intervention because it affects the existence of a bank. Here the power to

[149] Limiting the discretion of regulators through prompt corrective action rules is not uncontroversial (Caprio and Honohan, 1999: 58). Yet it is widely agreed that some basic rules limiting discretion are important for ensuring financial stability given the weak power of supervisors in many developing countries and the pressures from both the banking sector and politicians to delay action (Caprio and Honohan, 1999; Brownbridge and Maimbo, 2003).

declare a bank insolvent serves as a proxy. Adequate bank resolution is considered a key element of prudential frameworks because the lack of resolution frameworks has prolonged distress and exacerbated the costs of financial crises in many developing countries (Beck et al., 2011: 205-208).

- Fourth, the existence of prompt corrective action rules. Such rules are considered important because they may help counterbalance pressures for regulatory forbearance which are considered a major challenge for financial stability in developing countries (Brownbridge, 2002).

To form the composite indicator of regulatory stringency, *CIStr*, I combined the composite indicator of *supervisory authority* with an index of the *stringency of capital requirements*. The aggregation rule for the composite indicators is simple but transparent: I employ equal weighting and an additive aggregation of the components, following existing research (Barth et al., 2013). The sum of the values of the components of a composite indicator is then divided by the number of components so that a composite indicator has a range from 0 to 1. Section 6.5.2.1 of the appendix provides more details on the construction of the composite indicator.

This research uses data on regulatory stringency from the World Bank surveys "Bank Regulation and Supervision Around the World" because the survey data covers a large number of developing countries and indicators. The surveys capture regulation and supervision "on the books" (de jure). The World Bank has gathered the data in four rounds of surveys, capturing the state of bank regulation and supervision in 1999 ((Barth et al., 2001, Survey I), 2002 (Barth et al., 2003, Survey II), 2005/2006 (Barth et al., 2007, Survey III) and 2008-2010 (Čihák et al., 2012, Survey IV). The analyses that follow are based on data on regulatory stringency from Survey II because this has allowed maximising the number of observations.[150] While the limited variation of regulatory and supervisory frameworks over time precludes a pooled TSCS analysis

[150] I did not use data from Survey I because the questionnaire and data collection process improved after the first survey and later surveys are more representative of prudential frameworks of the 2000s and thus the post-financial liberalisation reform phase. I also opted against the use of data from Survey IV on the grounds that it captures regulation during and after the global financial crisis and is hence not representative for the late 1990s and the 2000s before the financial crisis in 2008. The decision to use data from Survey II rather than Survey III in the analysis is due to the fact that the relevant data is available for a larger number of countries in Survey II than in Survey III.

(Kittel, 1999; Wilson and Butler, 2007), I have exploited the information provided by Survey III and used the data for robustness checks.[151]

While I made considerable effort to balance data availability and conceptual considerations, there remain potentially intractable questions about the ability of my measures – *HCapital, Capital* and *CIStr* – to capture the central bank policy stance in relation to financial stability. In particular, there remains the concern that the construction of the composite indicator is subjective. To address this issue, I have tried to make educated choices in selecting, quantifying and aggregating variables based on the literature on regulation and supervision in developing countries and to be as systematic and transparent as possible in this process. Nonetheless, the indicators ultimately present my judgement of sensible ways to conceptualise and measure regulatory stringency in developing countries.

Another concern is that data on regulation and supervision on the books might only give an incomplete picture of the commitment to promote financial stability because the measures of regulatory stringency leave open the degree to which rules are actually enforced and implemented. Yet using data which captures assessments of the implementation of regulation and supervision was not possible in this study because the only datasets with a wide coverage of the implementation of prudential policies are the assessments of compliance with the Basel Core Principles for Effective Bank Supervision and these are mostly classified information (Demirgüç-Kunt and Detragiache, 2010).

Finally, as with measures of commitment to financial deepening, there is the caveat that we cannot be sure whether the data relate to the regulatory policies of the central bank, a separate regulatory agency or both.[152] As outlined in more detail in the previous section on financial deepening policies, correcting for this problem is in practice problematic for several reasons. First, because of data availability – there are no alternative datasets with information on central bank regulation with a similarly wide coverage of countries. Second, using only those observations where the central bank is the main regulator would result in a considerable loss in the number of observations and identifying those

[151] The results for Survey III, which are not shown here, show broadly similar patterns.

[152] The World Bank addressed the questionnaires generally to the head of banking supervision in the central bank or the head of a separate banking supervision agency. From the published dataset it is not always evident which institution ultimately filled in the questionnaires. Additional information I had requested from the World Bank was not able to solve this problem of attribution.

countries which have a separate, independent supervisory agency is not straightforward. Given these challenges, I decided to include all available observations and accept the limitation that the results of the statistical analysis do not refer to the *central bank* policy stance but to the *stance of financial or regulatory policy* or the *policy stance of financial regulators*, which in most, but not all, cases are central banks.

6.2.3 Explanatory Variables

Before shifting to the control variables, I should briefly describe the main explanatory variables, aid and resource dependence. I keep this short because Section 6.1.3 covering financial deepening policies outlined conceptual issues related to the measurement of aid and resource dependence already in greater detail. Generally, for all explanatory variables, if not stated otherwise, I use five-year averages to reduce the effects of cyclical fluctuations. For explanatory variables, a data point is thus the average of the annual observations over the years 1998 to 2002, the five-year period preceding the World Bank survey and including the survey year.[153] Table 6.A3 in the appendix provides an overview of the descriptive statistics of the sample, which covers countries classified by the World Bank as low- or middle-income countries in the time period 1998 to 2002.

The three measures of aid dependence, which I introduced in Section 6.1.3, are already familiar from the analysis of financial deepening policies. The first measure is *ODA*, net ODA as a percentage of GNI. The second measure is *IMFcredit*, a continuous variable capturing the use of IMF credit as a share of GDP. In an effort to capture the influence donors may have through conditionality, encouraging social learning and signalling, I use *IMFprogr*. I constructed *IMFprogr* by summing up the annual number of IMF arrangements in effect for at least five months in a particular year between 1998 and 2002.

In Section 6.1.3, I also introduced the measures of reliance on natural resources, *ResRents* and *ResExp*. *ResRents* is the sum of rents from oil, minerals and gas as a percentage of GDP, whereby rents are the difference between the price of a commodity

[153] Where data in the five-year period is missing, I calculated averages using available data if at least half of the observations of the five-year period (i.e. three or more observations) are available and one of these is from the year preceding the survey or the year in which the survey took place. Otherwise, I coded the data as not available.

and the average cost of producing it. I calculated *ResExp* by adding fuels, ores and metals exports and dividing the sum by the GDP.

Control Variables

The aid and natural resources variables may pick up the effects of other variables that influence regulatory stringency. Therefore I include several political and economic control variables in the analysis. The handful of econometric studies exploring the drivers of regulatory stringency have focused on the quality of political institutions as a key explanatory variable (Barth et al., 2005; Barth et al., 2012). Political competition also turned out to be an important driver of changes in central bank policy in the case studies presented in this thesis. Therefore, the analysis includes *Polity2*, which measures regime types on a scale ranging from –10 (strongly autocratic) to +10 (strongly democratic) and is taken from the Polity IV dataset (Marshall et al., 2011).

In addition, I employ two other control variables. First, the natural log of GDP per capita in constant 2005 US$ *(lnGDPPC)* (World Bank, 2013c) because it may affect both dependence on aid or resources and regulatory stringency. Second, *Crisis*, a variable capturing the number of years in the five-year period between 1998 and 2002 in which a systemic banking crisis occurred. I calculated *Crisis* based on Leaven's and Valencia's (2012) database on systemic banking crises. *Crisis* is only included in specifications where the main explanatory variable is aid dependence. The rationale here is that the prevalence of financial crises may increase both the level of reliance on international assistance, in order to deal with the immediate social and economic costs of the financial crisis and implement reforms to prevent future crises, and the level of regulatory stringency because financial crises usually catalyse actions to address regulatory failures (Griffith-Jones and Ocampo, 2009; Čihák et al., 2012).[154]

[154] My preliminary analyses included a much wider set of control variables. As measures of economic conditions these analyses included GDP in constant 2005 US$, GDP growth, the inflation rate, banking sector concentration, the current account balance as a share of GDP, log reserves as a share of GDP, gross national savings as a share of GDP, external debt as a share of GDP. As measures of financial market development the analyses included credit to the private sector, liquid liabilities as a share of GDP and the ratio of bank credit to bank deposits. Some analyses also included a variable capturing the quality of government from the International Country Risk Guide. These variables are not included in the specifications shown here because they were either not significant or findings with respect to the main variables are qualitatively similar and model fit improved when they were excluded.

6.2.4 Model Specification and Caveats

For the analysis I specify a model where regulatory stringency, which refers to the continuous variables *Capital* and *CIStr*, are a function of an aid or resource dependence variable, the log per capita GDP, the quality of political institutions, the prevalence of financial crises (only in specifications where aid dependence is the key explanatory variable) and an error term:

$$Regulatory\ stringency_{\mathrm{i}} = \mathrm{a} + \mathrm{b}_1\ Aid\ Dependence_{\mathrm{i}} + \mathrm{b}_2\ lnGDPPC_{\mathrm{i}} + \mathrm{b}_3\ Polity2_{\mathrm{i}} + \mathrm{b}_4\ Crisis_{\mathrm{i}} + \mathrm{u}_{\mathrm{i}}$$

or

$$Regulatory\ stringency_{\mathrm{i}} = \mathrm{a} + \mathrm{b}_1\ Resource\ Dependence_{\mathrm{i}} + \mathrm{b}_2\ lnGDPPC_{\mathrm{i}} + \mathrm{b}_3\ Polity2_{\mathrm{i}} + \mathrm{u}_{\mathrm{i}}$$

In addition, I specify for the analysis where the dependent variable is the binary variable *HCapital* a model in which the log odds of *HCapital* are a function of an aid or resource dependence variable, the log per capita GDP, the quality of political institutions, and, in specifications where aid dependence is the key explanatory variable, the prevalence of financial crises:

$$\ln\left(\frac{p_i}{1-p_i}\right) = \mathrm{a} + \mathrm{b}_1\ Aid\ Dependence_{\mathrm{i}} + \mathrm{b}_2\ lnGDPPC_{\mathrm{i}} + \mathrm{b}_3\ Polity2_{\mathrm{i}} + \mathrm{b}_4\ Crisis_{\mathrm{i}}$$

or

$$\ln\left(\frac{p_i}{1-p_i}\right) = \mathrm{a} + \mathrm{b}_1\ Resource\ Dependence_{\mathrm{i}} + \mathrm{b}_2\ lnGDPPC_{\mathrm{i}} + \mathrm{b}_3\ Polity2_{\mathrm{i}}$$

whereby p_i is the probability that $HCapital_i = 1$.

There are caveats related to the analysis based on these models. In particular, the analysis is based on a small number of observations, which reduces the degrees of freedom, increases the standard errors of the regression coefficients, and makes it difficult to estimate more fully specified models and to discover statistically significant relationships. Because of the limited variation of the stringency of regulation across the survey rounds, I was not able to employ a time-series analysis. Therefore, the analyses that follow employ simple cross-country logistic regression for specifications with the binary dependent variable *HCapital* and Ordinary Least Squares (OLS) regression for specifications with the continuous dependent variables *Capital* and *CIStr*. In addition, missing data has severely reduced the number of observations.[155] While I made every effort to close data gaps, the analyses that follow only extend to a maximum of 74 developing countries. Another limitation is that it is not possible to establish causal relationships with the model and data used here because they do not address problems of endogeneity. Despite efforts to control for those variables which previous research suggests are most consistently associated with the explanatory variables and regulatory stringency, such as the quality of institutions, these controls can only insufficiently address concerns of endogeneity. It was, however, not possible to include a wide range of control variables, because the small number of observations poses limitations on the number of variables that can be included in the model and good instrumental variables are not readily available.

That said the data and models I use are able to provide an answer to the question whether the cross-country pattern of the data is broadly consistent with the structuralist propositions and the evidence found in the case studies. While we have to refer to the case studies in the previous chapter to learn about causal pathways, the cross-national analysis of regulation does provide insights on the generalisability of the structuralist propositions. Thus, while the statistical analysis has some limitations, it helps us to make another incremental step in assessing the plausibility of the structuralist propositions.

6.2.5 Results

This section reports the results from the most econometrically robust specifications in Tables 6.3 and 6.4. These tables show only a subset of the total number of regressions I have run but do provide a representative sense of the results. We will first look at the results for specifications in which aid dependence is the main explanatory variable and then at the results for specifications in which resource dependence is the main explanatory variable.

[155] Moreover, I excluded several countries from the sample at the outset. Some had to be excluded because they have uniform bank regulations and supervisory practices due to regional regulatory authorities, others because they have less than 500,000 inhabitants (see footnote 141).

Aid Dependence and the Policy Stance in Relation to Financial Stability

The analysis presented in Table 6.3 explores the first proposition I formulated in Chapter 2, namely that the policy stance in developing countries which are more reliant on aid is more likely to be oriented towards financial stability. Columns 1 to 3 of Table 6.3 report results from the logistic regression analysis of the relationship between aid dependence and the setting of high capital requirements (*HCapital*). Columns 4 to 6 of Table 6.3 report results of the OLS regression analysis of the relationship between aid dependence and the level of capital requirements (*Capital*). Columns 7 to 9 of Table 6.3 report results of the OLS regression analysis of the relationship between aid dependence and the stringency of regulation as measured by the composite indicator *CIStr*.

Table 6.3: Aid Dependence and Policy Stance in Relation to Financial Stability

	(1) HCapital	(2) HCapital	(3) HCapital	(4) Capital	(5) Capital	(6) Capital	(7) CIStr	(8) CIStr	(9) CIStr
lnGDPPC	0.0439	0.190	-0.0586	-0.454	-0.0637	-0.326	-0.0482	-0.0156	-0.0292
	(0.406)	(0.367)	(0.333)	(0.392)	(0.406)	(0.343)	(0.0343)	(0.0295)	(0.0258)
Polity2	0.0278	0.0215	0.0225	0.0705^{+}	0.0447	0.0537	0.00642	0.00411	0.00347
	(0.0570)	(0.0600)	(0.0606)	(0.0405)	(0.0367)	(0.0402)	(0.00465)	(0.00408)	(0.00439)
Crisis	-0.231	-0.401	-0.351	-0.119	-0.210	-0.170	0.0122	0.000910	0.00511
	(0.316)	(0.358)	(0.326)	(0.149)	(0.138)	(0.134)	(0.0190)	(0.0186)	(0.0182)
ODA	0.0641			-0.00249			0.00139		
	(0.0644)			(0.0557)			(0.00634)		
IMFcredit		17.70^{**}			7.892			1.024	
		(6.855)			(5.878)			(0.693)	
IMFprogr			0.294^{*}			0.100			0.0241^{*}
			(0.149)			(0.105)			(0.0117)
Constant	-1.762	-3.149	-1.562	12.77^{***}	9.856^{**}	11.63^{***}	0.933^{***}	0.687^{**}	0.749^{***}
	(3.127)	(2.714)	(2.524)	(3.029)	(3.161)	(2.671)	(0.261)	(0.221)	(0.195)
Observations	66	69	74	66	69	74	66	69	74
Pseudo R^2	0.0363	0.1275	0.0809						
Log-likelihood	-35.23	-33.61	-36.66						
Adjusted R^2				-0.006	-0.000	0.006	-0.002	0.011	0.046
F				0.847	1.806	1.415	1.185	1.039	2.352
df_m				4	4	4	4	4	4
df_r				61	64	69	61	64	69

Robust standard errors in parentheses.
$^{+}$ $p < 0.10$, * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

The results reported in Table 6.3 provide some support for the proposition that there is a positive relationship between aid dependence and the orientation of policy towards financial stability. In particular, in columns 2 and 3 there is some evidence that greater reliance on the IMF, whether measured in financial terms or by the number of IMF arrangements, is associated with high capital requirements. Where aid reliance is measured by *ODA*, however, the results are not significant, which may be due to the fact that this category comprises a wide range of types of assistance (health, governance, etc.) which may be provided without conditions related to financial policy.

Somewhat surprisingly, the results for specifications in which the dependent variable is *Capital* are universally statistically insignificant. Thus, while greater reliance on the IMF serves as a predictor of whether some countries exceed some threshold in capital adequacy, there is no linear relationship between reliance on the IMF and capital ratios. One reason why reliance on the IMF seems to be associated only with *HCapital* may be that donors have usually given the policy advice to adopt "high" capital ratios with their exact level to be decided on a country-by-country basis.

The results for the relationship between aid dependence and the composite indicator of the stringency of regulation are almost universally statistically insignificant. Yet a positive and significant coefficient on *IMFprogr* suggests that a greater number of IMF programmes is associated with more stringent regulation.

Resource Dependence and the Policy Stance in Relation to Financial Stability

Developing countries which are more reliant on natural resources are more likely to have a policy stance oriented towards financial deepening, one indication of which may be a lower prioritisation of policies to enhance stability. This is the second proposition I formulated in Chapter 2. The analyses that follow probe this proposition and explore whether there is a negative relationship between resource dependence and the orientation of policy towards financial stability. From a purely economic perspective, such a negative relationship is counterintuitive because resource dependence, which is associated with greater economic volatility, would warrant more stringent regulation. However, from a political economy perspective, which I outline in Chapter 2, a negative relationship may be plausible because natural resource dependence may increase incentives for expansionary as opposed to stability-oriented policies.

Columns 1 and 2 of Table 6.4 report results from the logistic regression analysis of the relationship between resource dependence and the setting of high capital requirements (*HCapital*). Columns 3 and 4 of Table 6.4 report results of the OLS regression analysis of the relationship between resource dependence and the level of capital requirements (*Capital*). Columns 5 and 6 of Table 6.4 report results of the OLS regression analysis of the relationship between resource dependence and the stringency of regulation as measured by the composite indicator *CIStr*. The results in Table 6.4 are universally statistically insignificant, suggesting that there is no significant relationship between resource dependence and the policy stance in relation to financial stability.

Table 6.4: Resource Dependence and Policy Stance in Relation to Financial Stability

	(1)	(2)	(3)	(4)	(5)	(6)
	HCapital	HCapital	Capital	Capital	CIStr	CIStr
lnGDPPC	-0.0660	-0.149	-0.166	-0.269	-0.0254	-0.0309
	(0.294)	(0.291)	(0.315)	(0.317)	(0.0274)	(0.0289)
Polity2	-0.00586	0.00243	0.0168	0.0297	0.00126	0.00228
	(0.0550)	(0.0538)	(0.0388)	(0.0396)	(0.00491)	(0.00500)
ResExp	3.453		1.036		0.419	
	(2.858)		(2.417)		(0.329)	
ResRents		0.00470		-0.00346		0.000165
		(0.0231)		(0.0189)		(0.00236)
Constant	-0.889	-0.101	10.76^{***}	11.52^{***}	0.779^{***}	0.837^{***}
	(2.072)	(2.030)	(2.406)	(2.363)	(0.199)	(0.206)
Observations	62	66	62	66	62	66
Pseudo R^2	0.0216	0.0038				
Log-likelihood	-37.96	-41.18				
Adjusted R^2			-0.039	-0.021	-0.009	-0.024
F			0.177	0.315	0.805	0.383
df_m			3	3	3	3
df_r			66	71	66	71

Robust standard errors in parentheses.
$^{+}$ $p < 0.1$,* $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

How can we reconcile this finding, which fails to confirm my proposition that there is a negative relationship between resource dependence and regulatory stringency, with the finding of the case study of Nigeria, which suggests that such a negative relationship exists? One possibility is that, for some reason, the relationship between resource dependence and the policy stance in relation to financial stability differs in African and non-African resource dependent developing countries. To examine this hypothesis I employed some additional statistical tests, of which the results are reported in Table 6.A4 in the appendix. Columns 1 to 4 of Table 6.A4 present a replication of the analysis shown in columns 3 to 6 of Table 6.4. However, each specification presented in Table 6.A4 includes in addition an Africa dummy and an interaction term of the Africa dummy and the resource dependence variable in order to explore whether the relationship between resource dependence and the policy stance in relation to financial stability differs for developing countries in Africa and elsewhere.[156]

[156] I do not include specifications in which the dependent variable is the binary variable *HCapital*, because interpreting interaction terms in logistic regression analysis is less straightforward.

The results reported in Table 6.A4 suggest that this relationship indeed differs: The coefficients on the interaction terms of the Africa dummy and resource dependence variables *ResExp* and *ResRents* are negative and significant compared to the main effects. There is thus some evidence that the relationship between resource dependence and the orientation of policy towards financial stability is significantly weaker in African countries. To give an example, while the estimated slope coefficient for the relationship between resource exports as a share of GDP and the level of regulatory stringency is 0.6, the estimated slope coefficient for African countries is 0.9 points lower and thus likely to be negative. In other words, as resource dependence in Africa increases, the orientation of policy towards financial stability seems to decrease. Why the relationship between resource dependence and the policy stance in relation to financial stability differs for developing countries in Africa and elsewhere is, unfortunately, not clear. Examining the causes of the distinct relationships may be an issue for investigation in future research.

6.2.6 Conclusion

If the structuralist propositions were accurate, the pattern of cross-country data should be minimally consistent with them. In this section, I explored the pattern of cross-country data by developing a measure of the policy stance in relation to financial stability, capturing the stringency of regulation, and by using regression analysis.

While many of the results lack statistical significance, some patterns emerge from the analysis. In particular, the results suggest that greater reliance on IMF assistance is associated with more stringent regulatory standards in developing countries. As in the analysis of policies to promote financial access, reliance on the IMF as captured by *IMFprogr* performs well as a predictor. The relative consistency of results using *IMFprogr* as an explanatory variable may reflect that IMF assistance, rather than donor assistance in general, shapes financial policy in developing countries. Moreover, while both *IMFcredit* and *IMFprogr* may capture the influence the IMF potentially gains through conditionality, encouraging social learning and sending a signal to markets and donors, conditionality, social learning and signalling are more likely to be proportional to the number of IMF arrangements than to financial flows. This may explain why *IMFprogr* performs somewhat better as an explanatory variable than *IMFcredit*.

The results for the relationship between resource dependence and the policy stance in relation to financial stability are insignificant. These results thus fail to confirm the proposition I had formulated and the findings obtained from my case study of Nigeria. However, additional tests suggest that in African countries positive relationships between resource dependence and the policy stance in relation to financial stability are significantly weaker and likely to be negative. The structuralist theory cannot explain why results for African countries differ. The causes of the distinct relationships may thus be a subject for future research.

6.3 Analysis of the Policy Stance in Relation to Price Stability

The last two sections offered some supportive evidence that in developing countries which are more dependent on aid, the stance of financial policy is more likely to be oriented towards stability and in developing countries which are more dependent on natural resources, the stance of financial policy is more likely to be oriented towards financial deepening. These results are also in line with the findings of the case studies of Uganda and Nigeria. This section now shifts to monetary policy to explore the relationship between the sources of finance and the central bank policy stance, using a pooled TSCS analysis.

6.3.1 Conceptualising the Policy Stance in Relation to Price Stability

Monetary policy is the most appropriate policy area for analysing the policy stance in relation to price stability because it is the single most important type of policy to enhance price stability and to signal the policy stance in relation to price stability. In the context of this research, a good measure of the policy stance in relation to price stability should have at least two attributes: First, it should capture the commitment to price stability or, in other words, how averse the central bank is to inflation. This is for instance evident in the degree to which it reacts to changes in the price level. Second, the measure should be based on an indicator which is under the control of the central bank. Inflation rates, for instance, would not constitute an ideal measure, because they are not fully under the control of central banks and may be influenced by various factors other than central bank policy or a commitment to price stability, particularly in the context of developing countries.

While there is no natural metric for measuring the policy stance in relation to price stability, the measurement of monetary policy and of the central bank's reaction to inflation have been the subject of a substantial body of work in economics which can inform the selection of an appropriate measure of the central bank policy stance in relation to price stability. For the purposes of this thesis, studies which estimate monetary policy reaction functions are most informative. These studies usually use regression analysis to examine how monetary policy or some monetary policy instrument reacts to changes in the macroeconomic situation. A typical estimation equation then has the following form:

$$MPIns_{it} = a_i + \beta X_{it} + u_{it}$$

The index i refers to the N observational units, and t indexes the T time periods. MPIns is a proxy for the monetary policy instrument. The a_i term signifies a unit-specific contribution to the dependent variable, the unit fixed effect. The vector of independent variables, X_{it}, is a set of observed macroeconomic variables (e.g. inflation or GDP growth) and may contain lagged values of X or MPIns. u_{it} is the error term associated with unit i at time t. The level of the monetary policy instrument is thus specified as a linear function of certain macroeconomic variables whereby the βs are the coefficients of interest because they capture the strength of the reaction to changes in the macroeconomic variables.

There appears to be agreement in the empirical literature on monetary policy that quarterly data is preferable to annual data, and that, in this case, contemporaneous correlations or one period lags of the explanatory variables are appropriate.[157] Much less agreement, however, is on the monetary policy instrument to be employed on the left side of the equation. In fact, one of the major messages emerging from the literature is that different measures are appropriate for different types of countries and different time periods (Bernanke and Mihov, 1998; Taylor, 2000; Xiong, 2012). Two types of indicators, however, stand out and have commonly been used as measures of monetary

[157] For several reasons, notably the time-lag in the response of the price level to changes in monetary policy, it is widely agreed that central banks should react timely to inflationary pressures. For many countries, inflation data is available on a monthly or at least quarterly basis and changes in inflation and monetary policy tend to occur on the same basis. Given the frequency of changes in both variables, the use of annual data would induce an aggregation bias. Therefore, studies usually use quarterly data. However, quarterly data is often not available for developing countries, so that some analyses of monetary policy based on global or developing country samples, such as Dreher (2006), use annual data.

policy in the cross-national estimation of monetary policy reaction functions: the growth of monetary aggregates such as M1[158] and interest rates.[159]

Until the 1990s, central banks in developed countries targeted money supply growth, so that empirical research widely used the growth of monetary aggregates or the monetary base as a measure of the policy stance in relation to price stability. This was before central banks in developed countries shifted their focus to inflation targeting. Many central banks in developing countries continue to target monetary aggregates, thus some literature on monetary policy in developing countries still considers the monetary base and money supply growth as adequate measures of the policy stance (Dreher, 2005; Kasekende and Brownbridge, 2011; Xiong, 2012). Measures of monetary policy based on the growth of monetary aggregates or the monetary base are not related to one particular policy instrument. This characteristic is valuable for studies which examine monetary policy in settings where central banks employ several instruments so that a single instrument only partly captures the central bank's policy stance (Gerlach and Svensson, 2003; He and Pauwels, 2008; Xiong, 2012).[160] Moreover, a measure which is not based on one particular policy instrument is less sensitive to changes in monetary policy operating procedures over time and thus to the time frame chosen for an analysis. However, a broad body of work in economics has severely criticised the use of the growth of monetary aggregates as indicators for monetary policy on the grounds that money growth depends, in practice, on a variety of factors outside the control of the central bank, most notably shifts in the demand for money (Bernanke and Mihov, 1998; Xiong, 2012). In light of these criticisms researchers began to look for alternative measures of monetary policy.

[158] M1 typically includes currency and checkable deposits. Yet definitions of monetary aggregates vary by country.

[159] I do not discuss measures of monetary policy instruments which are less commonly used such as magnitudes of open market operations and reserve requirement ratios because for these measures cross-national datasets covering developing countries typically do not exist. In fact, most studies of monetary policy are either time series analyses covering a single country or contain only a small set of countries due to the lack of cross-national comparable data on monetary policy instruments.

[160] A more recent, creative approach has therefore been to construct monetary policy stance indices which account for several policy instruments. See for instance Gerlach and Svensson (2003), He and Pauwels (2008) and Xiong (2012). However, the construction of a monetary policy stance index is not without challenges, owing particularly to limitations in the availability of cross-country data on policy instruments. Moreover, the construction of indices requires researchers to identify the appropriate policy instruments that should be included in the index and to assign them appropriate weights, which is likely to be difficult in a cross-national setting.

Short-term interest rates have thus become the second type of commonly used measure of monetary policy. The inherent logic of the focus on interest rates is that central banks affect spending and hence inflation mainly through interest rates.[161] A typical monetary policy reaction function would then explore the relationship between the interest rate and some macroeconomic variable (e.g. inflation).[162] Which type of interest rate studies use as measures of monetary policy varies: Measures like the federal funds rate in the United States and the Bank Rate in the United Kingdom have been used as indicators of monetary policy instruments in developed countries since their central banks shifted from targeting monetary aggregates to inflation-targeting in the early 1990s. Studies of monetary policy in developing countries often use discount rates, which are the interest rates at which central banks lend or discount eligible paper for deposit money banks (Mishra et al., 2010: 22). While developed countries no longer use discount rates as monetary policy instruments but rather as signals of their policy stance, some developing countries still use them as monetary policy instruments (Buzeneca and Maino, 2007; Mishra et al., 2010).

Interest rates have as measures of monetary policy, in contrast to monetary aggregates, the advantage that central banks can effectively influence them. A drawback, however, is that while a large number of developing countries provide data on discount rates, not all of them use discount rates as monetary policy instruments and it is difficult to identify those countries in which discount rates are among the major monetary policy instruments. In a simple inspection of discount rate data for developing countries from the IMF, I discovered that in many countries, changes of discount rates over time are very rare, raising doubts about the extent to which discount rates are able to capture the policy stance in relation to price stability.

6.3.2 Measuring the Policy Stance in Relation to Price Stability

In light of the criticism that the growth of monetary aggregates may not necessarily reflect central bank policy actions but rather non-policy influences I decided to employ an interest rates based measure of monetary policy, namely the central bank policy rate

[161] Central banks can influence interest rates through a variety of instruments such as reserve requirements, lending to banks, and open market operations.

[162] Taylor (1993) has developed the most famous model using interest rates as a measure of the policy stance, namely the Taylor rule. The Taylor rule indicates that the federal funds rate should respond to changes in the price level and deviations in real GDP from a target, so that the federal funds rate becomes an important signal of the monetary policy stance.

(*PRate*) from the IMF's International Financial Statistics (IFS), line 60 (IMF, 2013a). Central bank policy rates (CBPRs) are monetary policy related interest rates which are available from the IMF as monthly, quarterly and annual data. My main specifications are based on quarterly data from the time period 2000 to 2007. The focus is on the 2000s because most monetary policy reforms related to structural adjustment programmes were implemented in the 1990s, so that variations in monetary policy across countries with different sources of finance should be visible by the 2000s. Moreover, the use of interest rates as monetary instruments in developing countries has gained ground in the 2000s. Before, many developing countries used more direct interventions such as reserve requirement ratios or credit ceilings. The time period considered here ends in 2007 because the global financial crisis introduced a disruptive element to monetary policy.

Using CBPRs as the dependent variable has the advantage that these rates capture movements of a monetary policy instrument fully under the control of the central bank because the data central banks provide to the IMF under this heading refers to the interest rates determined by central banks to increase and decrease liquidity in the economy. Moreover, CBPRs are by definition the main signals of the central bank's policy stance, even in cases in which central banks use additional policy tools. Yet high construct validity comes at a price. A major disadvantage is that the number of eligible[163] developing countries for which data on CBPRs is available is limited. In fact, in some of the analyses that follow, only seven countries are included owing to limitations in the availability of quarterly data relating to CBPRs and the control variables.[164] Another drawback is that the definitions of CBPRs may vary across countries, which may limit cross-country comparability.[165]

As troubling as the limited number of observations and the cross-national variation in definitions of CBPRs are, there are significant advantages in using CBPRs as a measure of monetary policy and it is doubtful that other commonly used measures are more appropriate for this research. Data availability for monetary aggregates such as M1 and

[163] In the context of this study, only countries which are not part of a monetary union are eligible because they do not have uniform monetary policies. Uniform monetary policies preclude the influence of national-level political economy factors such as the sources of investible funds on monetary policy. Following much of existing research, I also exclude countries with less than 500,000 inhabitants from the group of potential country cases.

[164] These seven countries are: Brazil, Colombia, Indonesia, Malaysia, Peru, Thailand and Turkey.

[165] Table 6.A5 in Section 6.5.3.1 of the appendix provides an overview of the definitions of CBPRs for the countries included in the main specifications.

M2 is, at least on a quarterly basis, even more limited for developing countries than data on CBPRs. Moreover, as already noted, the growth of monetary aggregates is influenced by a variety of factors outside the control of central banks and is thus a poor measure of the policy stance.

The most promising alternative to the use of CBPRs is the use of discount rates (line 60a in the IFS), which are the rates at which central banks lend or discount eligible paper for deposit money banks. Conceptually discount rates are similar to CBPRs, which in many countries are as well defined as the rates at which central banks lend or discount eligible paper for deposit money banks.[166] Like CBPRs, discount rates are not fully comparable across countries because their definitions may vary slightly from country to country. With respect to data availability, however, discount rates outperform CBPRs because discount rate data is available from the IMF's IFS for a large number of developing countries and several decades.

In spite of this, discount rates perform worse with respect to construct validity because cross-country data on the employment of discount rates as monetary policy instruments is limited. In fact, many central banks in developing countries provide data on both discount rates and CBPRs, suggesting that in these countries discount rates have, at best, only minor importance as instruments of monetary policy.

In order to deal with the trade-off between construct validity and data availability I decided to rely on *PRate,* the CBPRs, as main indicators of monetary policy but to experiment with a variety of alternative specifications as robustness checks.

- First, I use additional specifications with the differenced policy rate (*PRate_d*) as a dependent variable.[167] These specifications explore how changes in inflation affect changes in interest rates.
- Second, I use specifications based on annual observations. Using annual data allows increasing the number of observations because data on growth, which as we will see below serves as a control variable, is for many developing countries only available on an annual basis.

[166] However, the terms associated with credit provided at discount rates and credit provided at central bank policy rates are usually different. In fact, many countries provide data for both discount and central bank policy rates and the two sets of rates usually differ.
[167] A differenced variable, var, is the variable that results from subtracting var_{t-1} from var_t. It thus refers to the change in var that takes place in the time between t-1 and t.

- Third, I use specifications where the dependent variable is *DRate*. *DRate* refers to quarterly discount rates (line 60A of the IMF's IFS) where quarterly data on CBPRs (line 60 of the IMF's IFS) is not available and to CBPRs otherwise. Specifications where *DRate* is the dependent variable include a larger number of countries than those where *PRate* is the dependent variable. Yet specifications with *DRate* have the drawback that our confidence that discount rates are actually used as monetary policy instruments is lower because the central banks providing the respective data have not categorised the discount rate data as CBPRs. To increase this confidence, however, I include in the analysis only data on discount rates from countries which used these rates as a monetary policy instrument between 2000 and 2007 according to the IMF's database on monetary policy instruments.[168] Section 6.5.3.2 of the appendix presents the tables with results of these additional specifications.

6.3.3 Explanatory Variables

As in the analysis of financial deepening and regulatory policies, the main explanatory variables are aid and resource dependence. I limit the discussion of these variables to a definition of the indicators and their transformation to quarterly data because I already outlined conceptual considerations in Section 6.1.3.

With respect to aid dependence, I use three already familiar measures: First, *ODA*, net ODA as a share of GNI. Second, *IMFcredit*, a continuous variable capturing the use of IMF credit as a share of GDP. Third, *IMFprogr*, a variable capturing the number of IMF programmes in effect. Data for *ODA* and *IMFcredit* is from the World Bank (2013c) and is available on an annual basis. Dreher (2006) provides annual data on the IMF arrangements a country has had in effect for at least five months in a particular year. I constructed *IMFprogr* by summing up the number of IMF arrangements (IMF Standby Arrangements, IMF Extended Fund Facility Arrangements, IMF Structural Adjustment Facility Arrangements and IMF Poverty Reduction and Growth Facility Arrangements) in effect in a particular year.

The two measures I employ to capture resource dependence are also familiar: First, *ResRents*, which is the sum of rents from oil and minerals as a share of GDP, whereby

[168] The only exception is Botswana, which I included in the regression analysis despite not being covered by the IMF's database because the quarterly discount rate varies significantly. Specifically, there were nine changes during the 28 quarters between 2000 and 2007.

rents are the difference between the price of a commodity and the average cost of producing it. Second, *ResExp*, which is the sum of fuels, ores and metals exports as a percentage of GDP. Annual data for both variables is available from the World Bank (2013c). As data for all aid and resource dependence measures is only available on an annual basis, I divided each data point simply by four to transform it to quarterly data or, more correctly, to obtain quarterly averages, as needed for the main specifications.[169]

In addition, I employ two other explanatory variables: *Inflation* and *GDP growth*.[170] As noted before, I consider the strength of the reaction of monetary policy (which is captured by movements in the interest rate) to inflation as the proxy for the policy stance in relation to price stability. Since my aim is to explore whether aid and resource dependent countries differ in the reaction to inflation from other countries, I include not only inflation but also an interaction term of inflation and the main explanatory variable in the analyses that follow. Following existing research (Xiong, 2012; Neuenkirch and Neumeier, 2013), I calculated data on inflation as the four-quarter percentage change in the consumer price index.[171] The data is available from the IMF's IFS (line 64) on a quarterly basis. Similarly, I calculated GDP growth as the four-quarter percentage change in the GDP volume indices. Quarterly data is available from line 99bvp of the IMF's IFS. The rationale for including GDP growth is that central banks tend to adjust interest rates not only in response to inflation but also in response to changes in growth. Not controlling for growth might lead to biased results because growth may affect both inflation and interest rate setting.[172] All explanatory variables cover the time period 2000 to 2007. Section 6.5.3.1 of the appendix provides the summary statistics for all the variables.

[169] There are various methods such as linear extrapolation to transform annual to quarterly data. I used the simple but widely applied transformation of dividing annual data by four because of its transparency and to keep the scope of this research manageable.

[170] Initial specifications included nominal effective exchange rates as additional control variable (line nec in the IMF's IFS). In conducting monetary policy, developing countries are likely to consider movements in the exchange rate so that these may be included in monetary policy reaction functions (Taylor, 2000; Calvo and Reinhart, 2002). However, limitations in the availability of quarterly data on nominal effective exchange rates reduced the number of countries in the estimated regressions to only three countries so that I decided to exclude nominal effective exchange rates from the estimation of monetary policy reaction functions, a limitation which may be considered by future research.

[171] The four-quarter percentage change in prices is the price change relative to the same quarter one year earlier.

[172] For the specifications based on annual data, I use annual data on inflation and GDP growth from the World Bank (2013c).

6.3.4 Model Specifications and Caveats

The preceding discussion of the monetary policy instrument and explanatory variables sets the stage for setting up a model for exploring the relationship between the sources of finance and aversion to inflation, which is the proxy for the policy stance in relation to price stability. Following existing research (Neuenkirch and Neumeier, 2013), I specify a relatively simple model where the interest rate in country i at time t is a function of inflation, GDP growth, the main explanatory variable (which in this study is *Dependence*, an indicator of aid or resource dependence), an interaction effect between inflation and the main explanatory variable, a country fixed-effect a_i and the error term u_{it}:

$$Interest\ Rate_{i,t} = a + a_i + \beta_1 Inflation_{i,t} + \beta_2 Growth_{i,t} + \beta_3 Dependence_{i,t} + \beta_4 Dependence_{i,t} * Inflation_{i,t} + u_{i,t}$$

The specification is similar to the original Taylor rule but deviates from it by including GDP growth instead of deviations of real GDP from a target, the dependence variable, the interaction term and fixed-effects. Following other studies of monetary policy reaction functions in developing countries (Dreher, 2005; Xiong, 2012), I include GDP growth as an explanatory variable because the availability of output gap data for developing countries is severely limited, in particular at a quarterly basis. *Dependence* is included to explore whether the key sources of finance shape a central bank's reaction to inflation. In the model, β_4 then becomes the main parameter of interest because it indicates whether the reaction to inflation in aid dependent countries is stronger and in resource dependent countries weaker than in other types of countries, as implied by the structuralist propositions. Put differently, β_4 reflects the difference in the slope for aid or resource dependent countries. Accordingly, β_1 indicates the reaction to inflation where *Dependence* has a value of 0 and β_3 the effect of *Dependence* on monetary policy where inflation is 0.

I include fixed-effects to account for the possibility that countries may differ in ways not explained by observed independent variables, which is also referred to as unit heterogeneity. Fixed-effects serve to capture country-specific constant factors, which, if not included in the model, would give rise to omitted variable bias (Wilson and Butler, 2007). In accounting for unit heterogeneity, the introduction of fixed-effects may also reduce concerns related to the cross-national comparability of central bank policy and discount rates: Fixed-effects models are “within” models in the sense that introducing fixed-effects removes the cross-sectional variation and leaves only longitudinal variation within countries, where definitions of monetary policy rates are coherent. Differences in the definitions of policy or discount rates across countries may thus be captured by country-specific intercepts, the fixed-effects. For the interpretation of results, however, using fixed-effects has the drawback that my model cannot shed light on the question whether cross-national variation in the sources of finance can account for cross-national variation in aversion to inflation. Nonetheless this restriction is worthwhile because the inclusion of fixed-effects reduces the risk of biased results arising from unit heterogeneity and can help with probing the structuralist propositions by exploring whether longitudinal variation in the key sources of finance within countries can account for longitudinal variation in aversion to inflation within countries.

Alternative Specifications

Using a TSCS model, as specified above, has advantages but is not without challenges. There are two major advantages associated with pooling as compared to a pure cross-section of units or a pure time series: First, it allows increasing the number of observations. Second, pooling permits to control for exogenous shocks common to all countries (by including time fixed-effects) and to reduce omitted variable bias (by including country fixed-effects) (Plümper et al., 2005: 329). However, as Plümper et al. (2005: 329) outline, there are four major ways in which OLS standard assumptions could be violated in panel data and thus raise the risk of biased estimates:

- errors tend to be autocorrelated (referred to as serial correlation of errors), that is, they are not independent from one time period to another;
- errors tend to be heteroscedastic, that is, they tend to have different variances across units (referred to as panel heteroscedasticity);
- errors tend to be correlated across units due to common exogenous shocks (that is contemporaneously correlated errors); and
- errors may be non-spherical in both the serial and the cross-sectional dimension (that is autocorrelated and heteroscedastic at the same time).

To address these risks, I follow much of existing work, which has been strongly influenced by Beck and Katz (1995; 1996), by using two major types of models to work with the TSCS data:

- First, the so-called an AR1 error model. It employs panel-corrected standard errors (PCSE), country fixed-effects and a Prais-Winston transformation.[173] This is the basic model presented above:
  $Interest\ Rate_{i,t} = a + a_i + \beta_1\, Inflation_{i,t} + \beta_2\, Growth_{i,t} + \beta_3\, Dependence_{i,t} + \beta_4\, Dependence{*}Inflation_{i,t} + u_{i,t}$
- Second, the so-called a lagged dependent variable (LDV) model. It employs panel-corrected standard errors (PCSE), country fixed-effects, time fixed-effects and a LDV. In this case the model becomes
  $Interest\ Rate_{i,t} = a + a_i + a_t + \beta_0\, Interest\ Rate_{i,t-1} + \beta_1\, Inflation_{i,t} + \beta_2\, Growth_{i,t} + \beta_3\, Dependence_{i,t} + \beta_4\, Dependence{*}Inflation_{i,t} + u_{i,t}$

The first model uses PCSE to address panel heteroscedasticity and country fixed-effects to address unit heterogeneity. To address any serial correlation of errors, this model relies on Prais-Winston regressions, which involve a transformation of the data based on an estimate of the autocorrelation of the error terms.[174]

The second model relies as well on employing PCSE to address panel heteroscedasticity. It employs unit and time fixed-effects to control for the possibility of non-spherical errors in the time and cross-sectional dimensions and a LDV to address serial correlation. The LDV is included because it is a relatively effective measure to remove the serial correlation of the errors. Moreover, the inclusion of the LDV may be justified on theoretical grounds: Existing research (Clarida et al., 2000; Neuenkirch and Neumeier, 2013) has included a LDV measuring the level of the monetary policy instrument to capture inertia in monetary policy making, owing to central banks' desire for interest rate smoothing which may stand in the way of an immediate adjustment of interest rates in the event of a change in the macroeconomic situation.[175]

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[173] Regression analysis with PCSE adopts heteroscedasticity robust standard errors.
[174] I employed the Wooldridge test for serial correlation which revealed the presence of serial correlation of the errors.
[175] Rudebusch (1995) provides evidence on the serial correlation of interest rate changes. The literature on monetary policy provides several explanations for central banks' efforts to smooth interest rates, including fear of disruption of financial markets (Goodfriend, 1991) or uncertainty about the effects of interest rate changes (Sack and Wieland, 2000).

There are, however, disadvantages related to including a LDV, most notably the absorption of time-series variance by the LDV (Plümper et al., 2005). The LDV may capture large parts of the trend in the dependent variable, leaving little variance to be explained by the independent variables of interest. In the presence of a persistent effect of at least one of the independent variables and a trend-ridden dependent variable the coefficient of a lagged dependent variable is likely to be biased upwards (Plümper et al., 2005). Thus, if fixed-effects are included, the inclusion of a lagged dependent variable renders estimates inconsistent, with the bias being large for the coefficient on the LDV but quite small on the other explanatory variables of interest (Wilson and Butler, 2007: 107-108). Given that the coefficient on the LDV is of little direct interest in this study and that the bias of the βs is likely to be small, I follow existing research in employing an LDV model with country fixed-effects but comparing the results with those of the AR1 error model which tends to absorb less time-series dynamics.

In addition to the AR1 error model and LDV model, I employ a generalised methods of moments (GMM) estimator designed by Arellano and Bond (1991), although only in the analysis using annual data because GMM estimators are designed for situations with large N (the number of countries) and small T (the number of time periods). The advantage of this estimator is that it accounts for the issue that the unit fixed-effect is by construction correlated with a lagged dependent variable and for any endogeneity of explanatory variables by using their lagged values as instruments.

Caveats

While my model specifications build on existing work in political sciences using TSCS data and existing studies of monetary policy reaction functions, there remain some important methodological concerns. The most serious concerns refer to the number of countries included in the analysis and the establishment of causal relationships. Although the number of observations is higher than in the statistical analysis of financial deepening or regulatory policies, the coverage of countries remains fairly limited, owing notably to the lack of quarterly data on GDP growth in developing countries. In particular, the specifications based on quarterly data in which the dependent variable is *PRate* cover a maximum of seven developing countries in the time period from 2000-2007 and include a maximum of 192 observations.[176] The limited number of countries and hence observations both limits the power of statistical tests and the generalisability of the results. In addition, it is not clear how the AR1 error model and LDV model specified above can address potential reverse causality and endogeneity and thus establish a causal relationship between the sources of finance and the central bank's aversion to inflation.

My strategy to deal with these limitations relies essentially on the use of a wide variety of models. To address limitations related to the number of countries included in the analysis, I employ specifications based on annual data and specifications using discount rates where central bank policy rate data is not available as robustness checks. Both types of specifications use data which is available for a greater number of countries. Specifications based on annual data extend to a maximum of 19 developing countries and a maximum of 128 observations; specifications using discount rates where central bank policy rate data is not available extend to a maximum of 19 developing countries and a maximum of 503 observations. Table 6.A9 in Section 6.5.3.1 of the appendix provides an overview of the countries included in the TSCS analysis. In addition, I employ specifications using different lag structures to address concerns related to causality. While questions related to the establishment of causality remain ultimately intractable, much of the existing research has, at a minimum, sought to ensure that changes in the explanatory variable precede changes in the dependent variable by using lags of explanatory variables.[177] This research employs lags of one and two quarters in addition to exploring contemporaneous relationships.[178] Obviously, employing lags is

[176] Similar to the preceding sections, I define countries as "developing" if the World Bank classifies them as low- or middle-income countries in the time period from 2000 to 2007.

[177] Lags of explanatory variables are employed to establish causality in a Granger sense (Granger, 1969). Granger testing allows evaluating the null hypothesis that x does not Granger cause y by estimating an equation in which y is regressed on lagged values of y and lagged values of an explanatory variable x. If one or more of the lagged values of x is statistically significant, the null hypothesis that x does not Granger cause y can be rejected, while the evidence suggests that x Granger causes y.

[178] Higher lag structures seem not appropriate for both theoretical and statistical reasons. Theoretically, lags of a maximum of 2 quarters seem appropriate because central banks take decisions on interest rate setting at a relatively high frequency (monthly or quarterly) in order to react timely to inflationary pressures. The use of a maximum of two quarters seems also appropriate from a statistical perspective because the use of higher lag structures reduces the number of observations and hence the degrees of freedom. In specifications using annual data, I employ one-year lags of the dependent variable in addition to exploring contemporaneous relationships. I did not consider higher lag structures because interest rate responses with a lag of two or more years are unlikely given that interest rate setting occurs at relatively high frequency in order to react timely to inflationary pressures.

an imperfect solution because it does not address the risks of endogeneity[179] arising from omitted variables and causal heterogeneity (Hood et al., 2008).[180] I use the lags nonetheless because their use constitutes an improvement over much of existing research on monetary policy which only examines contemporaneous relationships.

6.3.5 Results

Given the methodological challenges of the statistical analysis of TSCS data, the next section presents a relatively wide array of TSCS regression analyses, using different measures of aid and resource dependence and different model specifications. The tables presented below report results from the main specifications. Tables with results from specifications serving as robustness tests are in Section 6.5.3.2 of the appendix. While I present in this thesis only a subset of all the TSCS analyses employed, the findings presented below do give a representative sense of the results.[181] I do not report estimates for country and time fixed-effects because they are not of direct interest for an assessment of the structuralist propositions. I first present results on the relationship between the commitment to price stability and aid dependence before turning to the relationship between the commitment to price stability and resource dependence.

Aid Dependence and the Policy Stance in Relation to Price Stability

Greater reliance on aid is associated with greater aversion to inflation – this is a variant of the structuralist proposition that central banks in aid dependent countries are more likely to be stability-oriented than central banks in other countries. Tables 6.5 and 6.6 explore this proposition, using the AR(1) error model and the LDV model respectively. In both tables, columns 1, 4, and 7 refer to contemporaneous relationships; columns 2, 5 and 8 use one-quarter lags and columns 3, 6, and 9 use two-quarter lags.

[179] Researchers usually address endogeneity through an instrumental variables framework, but for the main explanatory variable of interest here, the interaction of *Dependence* and *Inflation,* a good instrument is not readily available.
[180] If causal heterogeneity is not taken into account, there is the risk of inferring a causal relationship in all cross-sections when it is only present in a subset of cross-sections and of rejecting the presence of a causal relationship for an entire group of observations when a subset of the sample actually does manifest the hypothesised causal relationship (Hood et al., 2008).
[181] I experimented for instance with a wider range of lag structures than is shown in the tables below.

Table 6.5: Aid Dependence and Policy Stance in Relation to Price Stability – Fixed-Effects with PCSE and AR(1) Correction Using Different Lag Structures

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
	PRate	PRate	PRate	PRate	PRate	PRate	PRate	PRate	PRate
GDP growth	0.104			-0.00135			0.182		
	(0.157)			(0.194)			(0.145)		
L.GDP growth		1.049***			0.887***			0.990***	
		(0.132)			(0.133)			(0.128)	
L2.GDP growth			0.624***			0.336***			0.548***
			(0.0890)			(0.100)			(0.0833)
Inflation	0.122			0.653***			0.241***		
	(0.0977)			(0.138)			(0.0584)		
L.Inflation		0.868***			0.974***			0.246**	
		(0.0657)			(0.0828)			(0.0910)	
L2.Inflation			0.977***			1.205***			0.251**
			(0.0433)			(0.0586)			(0.0791)
ODA	-7.177^{+}								
	(3.811)								
L.ODA		20.70***							
		(4.385)							
L2.ODA			20.15***						
			(4.100)						
ODA*Inflation	2.506***								
	(0.614)								
L.ODA*Inflation		-2.362***							
		(0.610)							
L2.ODA*Inflation			-2.111***						
			(0.638)						
IMFcredit				-346.5					
				(215.4)					
L.IMFcredit					394.9**				
					(125.4)				
L2.IMFcredit						550.9***			
						(102.6)			
IMFcredit*Inflation				-30.13***					
				(7.984)					
L.IMFcredit*Inflation					-19.90***				
					(5.073)				
L2.IMFcredit*Inflation						-30.80***			
						(3.642)			
IMFprogr							4.146^{+}		
							(2.402)		
L.IMFprogr								-6.611^{+}	
								(3.452)	
L2.IMFprogr									-8.310**
									(2.684)
IMFprogr*Inflation							-0.372		
							(0.396)		
L.IMFprogr*Inflation								2.156***	
								(0.428)	
L2.IMFprogr*Inflation									2.576***
									(0.342)
Constant	15.74***	7.080***	7.789***	15.20***	5.977***	5.922***	14.48***	9.914***	11.11***
	(1.295)	(1.087)	(0.678)	(1.926)	(1.277)	(0.895)	(1.139)	(1.161)	(0.809)
Observations	192	188	183	192	188	183	192	188	183
R^2	0.1027	0.2782	0.3644	0.1540	0.2634	0.3456	0.0771	0.2681	0.3419
Number of countries	7	7	7	7	7	7	7	7	7

Standard errors in parentheses. $^{+}$ $p < 0.10$, * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

Table 6.6: Aid Dependence and Policy Stance in Relation to Price Stability – Fixed-Effects with PCSE and LDV Using Different Lag Structures

	(1) PRate	(2) PRate	(3) PRate	(4) PRate	(5) PRate	(6) PRate	(7) PRate	(8) PRate	(9) PRate
L.PRate	0.320***	0.284***		0.377***	0.274***		0.316***	0.282***	
	(0.0250)	(0.0282)		(0.0271)	(0.0255)		(0.0255)	(0.0279)	
L2.PRate			0.0732**			0.0455*			0.0636*
			(0.0235)			(0.0232)			(0.0256)
GDP growth	0.577***			0.360**			0.518***		
	(0.116)			(0.125)			(0.114)		
L.GDP growth		1.322***			0.896***			1.133***	
		(0.146)			(0.121)			(0.129)	
L2.GDP growth			1.250***			0.674***			1.159***
			(0.130)			(0.126)			(0.123)
Inflation	0.693***			1.147***			0.226**		
	(0.0438)			(0.0656)			(0.0727)		
L.Inflation		0.864***			1.097***			0.267***	
		(0.0535)			(0.0578)			(0.0745)	
L2.Inflation			1.089***			1.661***			0.124
			(0.0501)			(0.0559)			(0.0845)
ODA	-0.770								
	(3.283)								
L.ODA		13.47**							
		(4.425)							
L2.ODA			7.235						
			(5.503)						
ODA*Inflation	-0.259								
	(0.428)								
L.ODA*Inflation		-2.187***							
		(0.600)							
L2.ODA*Inflation			-0.539						
			(0.872)						
IMFcredit				195.1*					
				(86.40)					
L.IMFcredit					286.1***				
					(81.50)				
L2.IMFcredit						615.8***			
						(106.7)			
IMFcredit*Inflation				-33.01***					
				(3.778)					
L.IMFcredit*Inflation					-24.91***				
					(3.454)				
L2.IMFcredit*Inflation						-46.60***			
						(3.236)			
IMFprogr							-21.47***		
							(3.578)		
L.IMFprogr								-17.70***	
								(3.693)	
L2.IMFprogr									-26.42***
									(3.992)
IMFprogr*Inflation							1.830***		
							(0.346)		
L.IMFprogr*Inflation								2.074***	
								(0.356)	
L2.IMFprogr*Inflation									3.936***
									(0.381)
Constant	1.905	-5.512**	-4.936**	0.0293	-3.165*	-4.042*	6.861***	0.285	0.876
	(1.512)	(1.771)	(1.590)	(1.794)	(1.552)	(1.615)	(1.514)	(1.489)	(1.467)
Observations	185	185	178	185	185	178	185	185	178
R^2	0.7420	0.7653	0.7714	0.7639	0.7765	0.8133	0.7446	0.7659	0.7774
Number of countries	7	7	7	7	7	7	7	7	7

Standard errors in parentheses. $^{+}$ $p < 0.10$, * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

The results presented in Tables 6.5 and 6.6 contradict the structuralist proposition, at least where aid dependence is measured by reliance on donor and IMF financing. Negative and significant interaction terms suggest that the positive relationship between inflation and central bank policy rates (CBPRs) is significantly weaker in countries with greater reliance on aid in the form of ODA or IMF credit than in other countries. The only exception is the contemporaneous, positive and significant relationship between inflation and the central bank policy rate in countries reliant on ODA in the AR(1) error model. I assign this finding, however, a low weight in the overall consideration because in specifications with quarterly data the focus of this thesis is on the role of lagged explanatory variables, in line with the Granger framework. Where aid dependence is measured by the number of IMF arrangements, Tables 6.5 and 6.6 show, however, that the relationship is conform with structuralist propositions: The positive slope of the relationship between inflation and CBPRs is significantly higher in countries with greater participation in IMF arrangements than in other countries, suggesting that in countries which have more IMF arrangements in place, there is a higher degree of aversion to inflation.

Overall, the findings from the main specifications can be confirmed in the robustness checks based on alternative specifications (see Tables 6.A10 through 6.A16 in the appendix). In the specifications where the dependent variable is *PRate_d,* results are qualitatively similar to those in Tables 6.5 and 6.6. Using annual data, the conclusion is, again, that in countries reliant on aid as measured by *ODA* and *IMFcredit* the slope of the relationship between inflation and the policy rate is significantly lower than in other countries. This suggests that with increasing volumes of ODA and IMF credit, the reaction to inflation becomes weaker. In contrast, where aid dependence is measured by *IMFprogr*, the interaction term is positive and significant: Having a higher number of IMF arrangements in place is associated with a stronger reaction to inflation.

In the Arellano-Bond LDV model, the interaction terms of interest are universally insignificant. Arellano-Bond estimators are usually considered more robust than the simple AR(1) error model or the LDV model where datasets have asymptotics in N and small T. In this study, however, N extends to a maximum of 19 countries and can thus not be considered large, raising doubts about the robustness of the results (Wilson and Butler, 2007: 107-108). Moreover, the number of instruments employed by the estimator is very large relative to the number of countries. This raises the risk of overfitting endogenous variables and failing to remove their endogenous components as well as weakening the Hansen J-test of instrument validity (Roodman, 2009). In light of the limitations of the Arrelano-Bond estimation here, its results should be interpreted with caution and I give them less weight in the final consideration of the results.

The last type of robustness check is based on TSCS regressions using quarterly data and *DRate* as the dependent variable. The results are qualitatively similar to those of Tables 6.5 and 6.6. The results suggest that receiving greater volumes of ODA and IMF credit is associated with a weaker reaction to inflation, whereas participation in a larger number of IMF programmes is, although only in the LDV model, associated with a stronger reaction to inflation.

The headline conclusion from these results is thus that where aid dependence is measured by volumes of ODA and IMF credit received, aid dependence is, contradicting the structuralist propositions, associated with a weaker reaction to inflation. However, greater participation in IMF programmes appears to be associated with a stronger reaction to inflation, a finding which is in line with my proposition.

Resource Dependence and the Policy Stance in Relation to Price Stability

Tables 6.7 and 6.8 explore whether greater reliance on natural resources is associated with lower aversion to inflation, using the AR(1) error model and the LDV model respectively. In both tables, columns 1, 4, and 7 refer to contemporaneous relationships; columns 2, 5 and 8 use one-quarter lags and columns 3, 6, and 9 use two-quarter lags.

The evidence from the analysis of the TSCS data provides some support for the structuralist propositions related to resource dependence. Whether resource dependence is measured as reliance on revenue from resource exports or on natural resource rents: An increase in the reliance on natural resources is associated with a decrease in the slope of the relationship between inflation and CBPRs. This finding holds for specifications using both the AR(1) error model and the LDV model. The only exception is the contemporaneous relationship between the interaction term of *ResRents* and *inflation* on the one hand and *PRate* on the other in the AR(1) model, which is positive and significant. However, I attach less weight to this finding in the overall consideration because in specifications with quarterly data the focus is on the role of the lagged explanatory variables, in line with the Granger framework.

Tables 6.A17 through 6.A23 in the appendix suggest that these findings are relatively robust to alternative specifications. Results from specifications where the dependent variable is *PRate_d* are qualitatively similar to those in Tables 6.7 and 6.8. Results based on the AR(1) error model and the LDV model using annual data also show some negative, statistically significant relationships between the interaction term and annual *PRate*s, although in the AR (1) model only contemporary relationships are significant.[182] The Arellano-Bond estimation, which we should consider with caution due to the small number of countries included in the analysis, provides also some evidence in support of structuralist propositions: Inflation aversion is lower in resource dependent countries, at least where resource dependence is measured by resource rents and contemporaneous correlations are considered. Specifications using quarterly data and *DRate* as dependent variable confirm the results from Tables 6.7 and 6.8 as well: The reaction to inflation in resource dependent countries – regardless of whether resource dependence is measured by *ResExp* or *ResRents* – is significantly weaker than in other countries, at least where lagged explanatory variables are considered.

[182] This finding does not point to causality in the granger sense. Yet it is an important finding because, in the use of annual data, contemporaneous relationships are more plausible because it is more likely that monetary policy responds in the same year than that monetary policy corresponds with a one-year lag.

Table 6.7: Resource Dependence and Policy Stance in Relation to Price Stability – Fixed-Effects with PCSE and AR(1) Correction Using Different Lag Structures

	(1) PRate	(2) PRate	(3) PRate	(4) PRate	(5) PRate	(6) PRate
GDP growth	0.177			0.189		
	(0.153)			(0.148)		
L.GDP growth		1.005***			1.004***	
		(0.130)			(0.128)	
L2.GDP growth			0.433***			0.399***
			(0.0821)			(0.0818)
Inflation	0.176+			0.225*		
	(0.0947)			(0.0918)		
L.Inflation		0.754***			0.740***	
		(0.0650)			(0.0667)	
L2.Inflation			0.859***			0.836***
			(0.0392)			(0.0416)
ResRents	-0.331					
	(0.332)					
L.ResRents		0.0410				
		(0.596)				
L2.ResRents			1.339***			
			(0.322)			
ResRents*Inflation	0.104+					
	(0.0624)					
L.ResRents*Inflation		-0.235***				
		(0.0633)				
L2.ResRents*Inflation			-0.387***			
			(0.0477)			
ResExp				-72.58*		
				(36.56)		
L.ResExp					43.31	
					(59.45)	
L2.ResExp						155.2***
						(31.43)
ResExp*Inflation				-2.479		
				(4.193)		
L.ResExp*Inflation					-18.98***	
					(4.532)	
L2.ResExp*Inflation						-28.52***
						(3.518)
Constant	29.25***	-3.766**	-2.212**	4.157***	-4.730*	9.828***
	(4.088)	(1.433)	(0.752)	(1.215)	(2.231)	(1.693)
Observations	192	188	183	192	188	183
R^2	0.0895	0.2247	0.2712	0.0939	0.2057	0.2431
Number of countries	7	7	7	7	7	7

Standard errors in parentheses. $^{+}$ $p < 0.10$, * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

Table 6.8: Resource Dependence and Policy Stance in Relation to Price Stability – Fixed-Effects with PCSE and LDV Using Different Lag Structures

	(1) PRate	(2) PRate	(3) PRate	(4) PRate	(5) PRate	(6) PRate
L.PRate	0.319***	0.284***		0.318***	0.278***	
	(0.0249)	(0.0274)		(0.0261)	(0.0289)	
L2.PRate			0.0663**			0.0585*
			(0.0245)			(0.0261)
GDP growth	0.577***			0.620***		
	(0.116)			(0.121)		
L.GDP growth		1.224***			1.249***	
		(0.131)			(0.140)	
L2.GDP growth			1.282***			1.311***
			(0.124)			(0.134)
Inflation	0.722***			0.746***		
	(0.0412)			(0.0438)		
L.Inflation		0.834***			0.852***	
		(0.0442)			(0.0479)	
L2.Inflation			1.150***			1.169***
			(0.0405)			(0.0449)
ResRents	0.326					
	(0.301)					
L.ResRents		-0.503				
		(0.461)				
L2.ResRents			-0.499			
			(0.526)			
ResRents*Inflation	-0.216***					
	(0.0326)					
L.ResRents*Inflation		-0.293***				
		(0.0410)				
L2.ResRents*Inflation			-0.403***			
			(0.0500)			
ResExp				-41.76		
				(35.37)		
L.ResExp					-94.20*	
					(46.00)	
L2.ResExp						-87.27
						(53.50)
ResExp*Inflation				-22.94***		
				(2.856)		
L.ResExp*Inflation					-27.07***	
					(3.537)	
L2.ResExp*Inflation						-34.74***
						(4.311)
Constant	1.471	-4.522**	-6.215***	1.480	-4.259**	-5.954***
	(1.446)	(1.515)	(1.431)	(1.452)	(1.584)	(1.532)
Observations	185	185	178	185	185	178
R^2	0.7432	0.7665	0.7761	0.7447	0.7681	0.7779
Number of countries	7	7	7	7	7	7

Standard errors in parentheses
$^{+}$ $p < 0.10$, * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

6.3.6 Conclusion

The pooled TSCS regression analysis constitutes the third of three sets of cross-national statistical analyses to build and probe structuralist theory. In this final set of analyses, I develop an estimation strategy to explore whether the policy stance in relation to price stability in countries dependent on aid or natural resources is different from the policy stance in other types of countries.

The analysis has provided some evidence that the pattern of cross-country data is broadly consistent with the structuralist propositions related to the effects of natural resource dependence: The greater the reliance on natural resources is, the weaker the relationship between changes in prices and changes in CBPRs becomes – regardless of whether resource dependence is measured by *ResExp* or *ResRents*. In other words, the evidence suggests that resource dependence reduces aversion to inflation. Results related to aid dependence, however, are less clear: Greater participation in IMF arrangements is associated with a stronger reaction to inflation than in other countries. This finding is in line with the proposition that central bank policy in aid dependent countries is more likely to be stability-oriented than in other countries. However, where aid dependence is measured by volumes of ODA and IMF credit received, the findings contradict the structuralist propositions: The relationship between aversion to inflation and reliance on donor and IMF financing is negative.

It is difficult to know precisely why the findings of specifications in which I measure reliance on donors by *IMFprogr* are in line with my propositions whereas the findings of those specifications in which I measure reliance on donors by *IMFcredit* or *ODA* contradict my proposition. One explanation may be that greater reliance on aid simply does not induce a policy stance oriented towards stability and may even induce a policy stance oriented towards financial deepening. This, however, raises the question of why the evidence presented in the analyses of the policy stance in relation to financial deepening, and of the policy stance in relation to financial stability, suggests that aid dependence is associated with a policy stance oriented towards stability. Another explanation may be that the variables capturing financial flows to developing countries are less appropriate to test propositions about donors as external constraints on policy because these variables capture, quite directly, the extent to which aid increases government revenues and hence the policy space for expansionary policies by easing the budget constraint.[183]

In general, the number of IMF arrangements may better capture the influence the IMF gains through its signalling function, conditionality and contribution to social learning than the amount of financial assistance the IMF provides because conditions, social learning and the signalling function are more likely to be proportional to the number of IMF programmes than to credit volumes. The consistency with which, in the entire chapter, specifications using *IMFprogr* support the proposition related to aid dependence also suggests that *IMFprogr* is an appropriate variable to explore a hypothesis about donors as an external restraint.

6.4 Summary of the Statistical Analysis and Avenues for Further Research

This chapter has continued the exercise of extending and testing the theory of the structural power of capital to the context of developing countries by employing cross-national statistical analyses of financial deepening, regulatory and monetary policies. The statistical analysis has helped to develop and probe the structuralist theory in several ways but has also limitations that open up avenues for future research. Before turning to the scope for future research, I will offer a brief summary of the ways in which the statistical analysis has helped to develop and probe the structuralist theory.

One way in which the statistical analysis has helped to develop and probe structuralist theory is by requiring the development of quantitative measures of key structuralist concepts. Cross-national statistical analysis has not been the method of choice for researchers who follow the structuralist tradition. Instead, most of this research uses qualitative case study methodologies. Employing statistical methods, however, can help theory-building and -testing by dictating the development of clear measures of some of the key theoretical concepts which can then be used in more formal models and for comparative purposes.

[183] Boockman and Dreher (2003) present similar results in a study of the contribution of the IMF and the World Bank to economic freedom. They use indicators of market-friendly and stability-oriented economic policies to measure economic freedom. Specifically, Boockmann and Dreher find that the number of World Bank projects increases economic freedom, while the volume of World Bank credits reduces freedom. The interpretation of the results that Bookmann and Dreher (2003: 647) offer is that “the number of programs increases freedom because it increases both the conditions imposed by the IFIs and the number of contacts between them and national politicians, which raises the transfer of knowledge. However, if the level of financing associated with the programs rises, this eases policy constraints for governments, which has a negative impact on governments’ willingness to undertake reforms.”

In this research, the main theoretical concepts to be explained are the stability-oriented and financial deepening-oriented central bank policy stance. For this purpose, I developed three different measures based on theory and data availability: a measure of the policy stance in relation to financial deepening, as captured by the devotion of human resources to the promotion of financial access and the implementation of financial access reforms; a measure of the policy stance in relation to financial stability, as captured by the stringency of prudential regulation; and a measure of the policy stance in relation to price stability, as captured by the reaction of central bank interest rates to inflation, which serves as a proxy for aversion to inflation.

The main theoretical concepts to explain central bank policy in my framework are the structural dependence on donors or IFIs and on natural resources. To measure aid dependence, I have used variables capturing ODA and IMF credit flows, serving primarily as proxies for the influence gained by donors through the provision of financing, and a variable capturing the participation in IMF arrangements, serving primarily as a proxy for the influence the IMF gains through its signalling function, conditionality and contribution to social learning. To measure resource dependence, I have constructed indicators of reliance on resource export revenues and natural resource rents as proxies for the reliance of the economy on natural resource exploitation.

Another way in which the statistical analysis has contributed to developing and probing structuralist propositions is by facilitating a comparative assessment of the explanatory power of the variables to capture aid and resource dependence. Which conceptualisations of aid and resource dependence perform best in explaining central bank policy stances? Is it possible that effects attributed to aid and resource dependence simply capture the level of economic or political development? The statistical analysis employed here provides an answer to the first question by using a variety of measures of aid and resource dependence and by comparing their statistical significance. The analysis reveals, for instance, that the participation in IMF programmes performed particularly well in predicting the central bank policy stance. The analysis also provides an answer to the second question by including some control variables. Yet, as stressed from the outset, the aim of this thesis is not to discover the myriad of factors that explain central bank policy. Instead, its aim is to further develop and probe structuralist explanations for central bank policy. For this reason, and because the number of control variables that could be included in the analyses was restricted by the limited number of observations and hence limited degrees of freedom, I considered rival explanations only when excluding them from the analysis would have posed significant risks of omitted variable bias.

A third way in which the statistical analysis has contributed to developing and probing structuralist propositions is by generating evidence on the relationship between the sources of finance and the central bank policy stance based on a relatively large number of developing countries. While the case studies provided some supportive evidence that those who control the sources of finance on which a country relies to finance investment shape central bank policy stances for a sample of African countries, the statistical analysis was intended to explore the generalisability of this evidence beyond Africa. The statistical analysis thus sheds light on the contexts to which the structuralist propositions may apply, on their so-called scope conditions.

Turning to financial deepening policies, the pattern of the data is broadly consistent with the structuralist propositions. The logistic regression analysis suggests that greater reliance on aid, whether measured by reliance on ODA, IMF credit or IMF arrangements, is associated with less engagement in financial deepening, at least in developing countries outside Africa. In the analysis that does not distinguish between African and non-African countries, the only relevant significant relationship I find is that as participation in IMF programmes increases, the implementation of financial access reforms becomes less likely. Why is there more evidence for non-African countries suggesting that there is a negative relationship between aid dependence and a policy stance oriented towards financial deepening? A possible explanation is that Africa's weakly developed financial sector may have induced donors to support, or at least to not discourage, African regulators to employ a policy stance oriented towards financial deepening. For resource dependent developing countries, I find some supportive evidence that these countries are more likely to have a policy stance oriented towards financial deepening.

The cross-country regression analysis of prudential regulation provides some additional evidence for the generalisability of the structuralist propositions. Countries which are more dependent on aid are, at least where aid dependence is measured by reliance on IMF assistance, more likely to be committed to financial stability. With respect to resource dependence, the analysis has failed to establish a significant relationship and thus to reaffirm the findings of the case study of Nigeria. However, additional tests suggest that in African countries, any positive relationships between resource dependence and the policy stance in relation to financial stability are significantly weaker and are likely to be negative. For a better understanding of the relationship between resource dependence and the policy stance in relation to financial stability it would be helpful to know why results for African and non-African countries differ. This question, which the theory of the structural power of capital is not able to answer, might be an issue for further research.

The final pieces of statistical evidence come from the TSCS analysis of monetary policy. The conclusions that can be drawn from this analysis on the generalisability of the propositions are mixed. In particular, greater reliance on aid as measured by the volume of ODA or IMF credit received is correlated with less commitment to price stability as indicated by a weaker reaction to inflation. This finding contradicts the structuralist propositions. However, where aid dependence is measured by participation in IMF arrangements, it is associated with a greater aversion to inflation, in line with the proposition. For resource dependent countries, the pattern of cross-country data appears to be broadly consistent with the structuralist propositions: Resource dependence is associated with lower aversion to inflation.

Table 6.9 compares these findings and the structuralist propositions. Obviously, the statistical results are not fully consistent with the structuralist propositions and case study results. Notably, the results related to aid dependence in the analysis of monetary policy contradict my proposition. However, for the areas of financial deepening policy, prudential regulation and in part also monetary policy, there is evidence suggesting that the pattern of cross-national data is broadly in line with the structuralist propositions. Each of the three sets of statistical analysis has – largely due to data availability – methodological limitations, rendering each not entirely convincing on its own. The evidence taken together, however, suggests that we must at least not reject the possibility that the propositions can be generalised beyond Nigeria and Uganda.

Table 6.9: Comparison of Structuralist Propositions and Statistical Findings

Policy field	Expected influence of aid dependence	Expected influence of resource dependence	Significant evidence that supports the proposition related to aid dependence?	Significant evidence that contradicts the proposition related to aid dependence?	Significant evidence that supports the proposition related to resource dependence?	Significant evidence that contradicts the proposition related to resource dependence?
Financial deepening policies	–	+	Yes (*IMFprogr*; for non-African countries: *ODA; IMFprogr*; *IMFcredit*)	No	Yes (*ResExp*; *ResRents*)	No
Prudential regulation	+	–	Yes (*IMFprogr*; *IMFcredit*)	No	No (Yes for African countries)	No
Monetary policy	+	–	Yes[a] (*IMFprogr*)	Yes (*ODA*; *IMFcredit*)	Yes (*ResExp*; *ResRents*)	No[b]

Note: "+" denotes positive relationship and "–" negative relationship. Significant variables in parentheses. [a]Contemporaneous significant relationship in three specifications but no granger causality (*ODA*). [b]Contemporaneous significant relationship in one specification but no granger causality (*ResRents*).

What do the insights we have gained through the statistical analysis imply for the development of structuralist theory? Given that there is some supportive statistical evidence for the structuralist propositions but that some methodological and some substantive questions remain unresolved, a key conclusion is that there is an added value of adapting, refining and additional testing of the structuralist propositions.

The unresolved substantive questions relate primarily to the role of aid dependence in shaping central bank policy. The finding of a negative relationship between aid dependence as measured by the volume of donor financing received and inflation-aversion may indicate that the variables capturing the volume of donor or IMF financing received may be less appropriate to test a proposition about donors as an external restraint because they may also capture the extent to which aid eases the budget constraint and facilitates expansionary policies. More appropriate for testing a proposition about the IMF as an external restraint seems to be the variable which captures the number of IMF arrangements in place. This variable, which turned out to have the expected effect across a wide range of specifications, appears to be particularly appropriate to measure the power of the IMF over central bank policy and its role as a gatekeeper because it is likely to capture the influence the IMF may gain through conditionality, encouraging social learning and the signal which having an IMF programme in place sends to other donors and markets.

Moreover, the finding of a negative relationship between aid dependence and the orientation of policy towards price stability, which contradicts my proposition, points to the need to adapt and refine my model linking aid dependence to central bank policy. What could such an adaptation look like? I see two major issues which should receive consideration regarding such adaptations.

One issue is the need to incorporate the possibility of changes in donors' policy preferences. Paradigms of foreign assistance changed substantially between the 1990s, when promoting macroeconomic stability was a key goal of aid, and the 2000s, when financial deepening became an increasingly important goal. In countries where donors have political power, this change in preferences should, as structuralist theory hypothesises and the analysis of central bank policy in contemporary Uganda suggests, translate into a policy stance which places emphasis on both stability and financial deepening. This chapter has presented statistical evidence indicating that in African countries, donors are supportive of a policy stance oriented towards financial deepening. This suggests that in adapting the model which links aid dependence to the orientation of central bank policy, it is important to acknowledge that donors not only continue to prefer a stability-oriented central bank policy stance but that, in recent years, they also prefer policies to deepen financial sectors.

Another issue which should be considered in a refinement of the model linking aid dependence to the stance of central bank policy is that the effects of aid dependence on the orientation of policy may differ, depending on the channels through which donors exert influence and, correspondingly, depending on the variables used to measure donors' influence. In this chapter, I presented evidence suggesting that larger volumes of donor financing are associated with less central bank commitment to guarding price stability whereas greater participation in IMF programmes is associated with more central bank commitment to guarding price stability. These results provide indications that where donors influence central bank policy through revenue incentives (as captured particularly by the indicators of aid volumes received), this may be associated with expansionary policy, whereas where donors influence central bank policy through conditionality, encouraging social learning or signalling (as captured particularly by the indicator of participation in IMF programmes), this may be associated with a greater orientation of policy towards price stability.

Future research may also be able to address some of the methodological limitations of the statistical analysis presented here. The main problem I faced concerned data availability: Due to the lack of data, finding measures which are both meaningful and comparable across countries and conducting powerful statistical tests was difficult. There also remain unresolved questions related to causality in the statistical analysis presented in this thesis. There appears to be scope for alternative, creative econometric approaches, in particular as the quality of available data improves. That said, the potential of case studies to reveal more about the relationship between the sources of finance and central bank policy is substantial, not least because case studies are less limited in temporal scope and may shed light on causal pathways. Thus, complementing cross-national statistical with case study analysis seems to be a promising route to build and probe structuralist theory. The next and final chapter of the thesis correspondingly reviews the combined evidence from the statistical and case study analysis.

6.5 Appendix

6.5.1 Analysis of the Policy Stance in Relation to Financial Deepening

Table 6.A1: Analysis of Financial Deepening Policies: Summary Statistics

Variable	Observations	Mean	Standard deviation	Minimum	Maximum
Team	87	0.3678161	0.4850064	0	1
Reform	87	0.6321839	0.4850064	0	1
ODA	91	5.735134	11.22162	-0.1211605	93.17417
IMFcredit	90	0.0260721	0.0798883	0.0005329	0.7522758
IMFprogr	97	1.494845	1.780237	0	7
ResExp	80	0.105098	0.1324426	0.0006544	0.528942
ResRents	98	12.42313	19.20122	0	88.9287
GDPPC (ln)	96	7.455463	1.129401	4.995622	9.553375
Polity2	95	3.427368	5.862583	-9	10
PrCredit	87	32.02252	25.04043	3.891362	142.8013

Table 6.A2: Aid Dependence and Policy Stance in Relation to Financial Deepening: Interaction of Africa Dummy and Aid Dependence Variable

	(1) Team	(2) Team	(3) Team	(4) Reform	(5) Reform	(6) Reform
lnGDPPC	-1.251^{**}	-0.458	-0.259	-0.266	0.177	-0.281
	(0.486)	(0.373)	(0.338)	(0.390)	(0.346)	(0.368)
Polity2	-0.0113	-0.0248	-0.00604	-0.102^{+}	-0.0809	-0.0332
	(0.0502)	(0.0492)	(0.0486)	(0.0535)	(0.0547)	(0.0582)
PrCredit	0.00174	-0.000852	0.000309	-0.0146	-0.0138	-0.0240^{+}
	(0.0114)	(0.0113)	(0.0111)	(0.0121)	(0.0115)	(0.0128)
Africa	0.763	0.606	0.265	-0.479	-0.346	-0.436
	(0.892)	(0.859)	(0.802)	(0.844)	(0.790)	(1.023)
ODA	-0.441^{*}			-0.264^{+}		
	(0.197)			(0.142)		
Africa*ODA	0.301			0.255^{+}		
	(0.185)			(0.139)		
IMFcredit		-65.23			-57.03^{*}	
		(40.59)			(27.05)	
Africa*IMFcredit		53.51			59.22^{*}	
		(45.15)			(27.39)	
IMFprogr			-0.358			-0.875^{**}
			(0.258)			(0.281)
Africa*IMFprogr			0.465			0.448
			(0.345)			(0.374)
Constant	9.480^{*}	3.367	1.503	3.864	0.600	4.817^{+}
	(3.781)	(2.763)	(2.539)	(3.058)	(2.517)	(2.916)
Observations	69	69	70	70	69	103
Pseudo R^2	0.1861	0.1625	0.1005	0.1184	0.1313	0.2164
Log-likelihood	-37.20	-39.06	-44.08	-40.72	-40.97	-39.55

Standard errors in parentheses. Results of logistic regression, dependent variable takes the values 0 or 1.
$^{+}$ $p < 0.10$, * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

6.5.2 Analysis of the Policy Stance in Relation to Financial Stability

6.5.2.1 The Construction of the Composite Indicator Regulatory Stringency: Measurement and Aggregation

With respect to the selection of the measurement level and coding, I follow Barth et al. (2013), who were engaged in conducting the first three rounds of the World Bank surveys on "Bank Regulation and Supervision Around the World" and have published a dataset with coded[184] data from the four rounds.[185] I constructed the composite indicator *supervisory authority* based on that dataset, both because it helped to keep the scope of the research manageable and because Barth et al. (2013) devoted substantial effort to identifying and resolving inconsistencies and missing values by reviewing each of the four surveys individually and by considering the time-series of answers for each country to raise the data quality. Most of the relevant survey questions are in a yes/no format so that, following Barth, Caprio and Levine (2013), I assigned indicators in most cases binary values of 0 or 1.

The aggregation rule used here is simple but transparent. It has two elements:

- First, the employment of equal weighting and additive aggregation for the components. In employing equal weighting and adding the components my process of aggregation follows existing research (Barth et al., 2013). The employment of equal weighting also reflects the lack of conclusive evidence on the relative importance of different components of regulatory and supervisory frameworks: Assigning different weights suggests a theoretical and empirical knowledge about the relative importance of the components which does not exist and equal weighting of the different components of composite indicators allows to give equal consideration to the diverging views on what constitute key elements of developing

[184] In the coding process Barth et al. (2013) converted raw data into quantitative measures. They applied four major coding rules: First, to fill in blanks, if there are responses to a question in at least two surveys and these responses are the same, the missing two (or one) is filled in as the same (except in Survey IV, see second rule). Second, missing responses for Survey IV are never filled in based on responses to earlier surveys, since the financial crisis that emerged in 2007 may have led to many regulatory changes in countries. Third, missing responses from countries of three groups with uniform bank regulations and supervisory practices (Eastern Caribbean Currency Union, West African Monetary Union, and Central African Economic and Monetary Community) are filled in based on responses from other countries in the same groups. Fourth, in all other ambiguous cases in which changes were made, additional information from published sources, online documents, and official releases were used to make those changes.

[185] Barth et al. (see for instance 2001; 2005; 2013) also constructed composite indicators based on their available data. I decided not to use these indicators as a template for the main composite indicators of this study because in constructing the composite indicators Barth et al. placed emphasis on comprehensiveness, rather than on relevance for enhancing financial stability.

countries' prudential framework. Additive aggregation reflects the assumption that compensation between different components of regulation is to some extent possible. In other words, the aggregation rule is based on the assumption that low scorings in one component of a composite indicator can be compensated by a higher scoring in another component because the components are substitutes. Obviously, there are limits to compensation with some policies in regulatory frameworks being to some degree dependent on other policies working well. However, the assumption of compensability is in line with research highlighting that high levels of capital can to some extent compensate for lower supervisory authority (Fuchs et al., 2012), justifying the additive aggregation of *supervisory authority* and *capital stringency*. Besides this theoretical argument, multiplying instead of summing up the values assigned to the components to express complementarities would have been problematic due to the binary coding (0 and 1) of the indicators. Multiplication increases the number of cases where the composite indicator has a value of 0, resulting in a loss of variation in stringency measures.

- Second, the calculation of an average scaled index in the case of *supervisory authority* in order to maximise the number of cases, following Barth et al. (2013). In general, a composite indicator is created by adding together the values assigned to the indicators at the preceding hierarchical level and dividing the result by the number of these indicators, so that a composite indicator ranges from 0 to 1, whereby higher values indicate greater stringency. I only considered an index value as "not available" if less than 50% of the answers to the corresponding questions were available and less than three questions were used in any particular index. Otherwise, i.e. if at least 50% of the answers are available and at least three or more questions are used in any particular index (as is only the case for *supervisory authority)*, I would first calculate the index as an average of the available question responses multiplied by the total number of questions asked for in the index.[186] The result is then divided by the total number of questions asked for in the index (i.e. 4 in the case of *supervisory authority*) so that it ranges from 0 to 1.

[186] For example, if two of the four questions related to supervisory authority were not answered, I calculated an average of the available two responses and multiplied it by four. If three of four questions were not answered I assigned "not available".

I created the composite indicator *stringency* by adding the values assigned to the two components, *capital stringency* and *supervisory authority*, together and dividing the result by two. The composite indicator thus ranges from 0 to 1. The remainder of this section explains how I assigned values to the two components with reference to the survey questions.

Indicator *Capital Stringency*

The indicator relies on the following survey question:

What is the minimum required risk-based regulatory capital ratio?

I assigned the following values to the minimum required risk-based regulatory capital ratio (r): If $r \leq 8\%$ I assigned a value of 0 because 8 % is the minimum required risk-based regulatory capital ratio by Basel I and II; if $8 < r \leq 10$ I assigned a value of 0.5; if $10 < r$ I assigned a value of 1.[187]

Composite Indicator *Supervisory Authority* to Intervene

The composite indicator relies on the following survey questions:

Indicator/Survey question	Sub-component
Can the supervisory agency order the bank's directors or management to constitute provisions to cover actual or potential losses?	Power to require a bank to meet regulatory standards which are above the minimum standards as a preventative measure
Can the supervisory authority force a bank to change its internal organisational structure?	Power to take measures where banks are still solvent but preventative measures have failed
Can the supervisory agency supersede bank shareholder rights and declare bank insolvent?	Power to take measures where banks become insolvent
Does the law establish pre-determined levels of solvency deterioration which forces automatic actions such as intervention?	Existence of prompt corrective action rules

To each of the answers I assigned a value of 1 if the answer was "yes" and 0 otherwise. I created the index by adding these four values together and dividing the result by four.

[187] These thresholds are chosen to create three groups with an equal size of observations. They capture the distance from the Basel minimum required capital ratio of 8%.

6.5.2.2 Data and Results

Table 6.A3: Analysis of Prudential Regulation and Supervision: Summary Statistics

Variable	Observations	Mean	Standard deviation	Minimum	Maximum
HiCapital	79	0.2658228	0.4445932	0	1
Capital	79	9.696203	2.091524	6	20
CIStr	79	0.6292194	0.2298305	0.25	1
ODA	81	5.570249	6.552461	0.0082461	29.40801
IMFcredit	83	0.0442653	0.0616397	0.0002007	0.3477598
IMFprogr	92	2.456522	2.269787	0	8
ResExp	80	0.0688871	0.0970497	0.0000163	0.3985044
ResRents	91	8.639846	20.75939	0	142.38
GDPPC (ln)	90	7.264908	1.090474	4.917824	9.383806
Polity2	88	2.618182	5.933938	-10	10
Crisis	88	0.5113636	1.050389	0	5

Table 6.A4: Resource Dependence, *Capital and CIStr*: Interaction of Developing Country Dummy and Resource Dependence Variables

	(1) Capital	(2) Capital	(3) CIStr	(4) CIStr
lnGDPPC	-0.395	-0.442	-0.0538^{+}	-0.0507
	(0.416)	(0.388)	(0.0313)	(0.0313)
Polity2	0.0216	0.0324	0.00215	0.00253
	(0.0385)	(0.0370)	(0.00482)	(0.00467)
Africa	-0.631	-0.769	-0.0646	-0.0903
	(1.050)	(0.932)	(0.0879)	(0.0795)
ResExp	2.323		0.616^{+}	
	(2.619)		(0.347)	
Africa*ResExp	-6.564^{+}		-0.963^{*}	
	(3.511)		(0.465)	
ResRents		0.0195		0.00260
		(0.0171)		(0.00308)
Africa*ResRents		-0.0539^{*}		-0.00571^{+}
		(0.0257)		(0.00342)
Constant	12.60^{***}	12.92^{***}	1.002^{***}	0.998^{***}
	(3.404)	(3.102)	(0.244)	(0.237)
Observations	70	75	70	75
Adjusted R^2	-0.021	0.031	0.028	0.033
F	2.341	22.55	1.841	19.17
df_m	5	5	5	5
df_r	64	69	64	69

Robust standard errors in parentheses
$^{+}$ $p < 0.10$, * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

6.5.3 Analysis of the Policy Stance in Relation to Price Stability

6.5.3.1 Data

Table 6.A5: Definitions of Central Bank Policy Rates of the Countries Included in the Main Specifications

Country	Definitions of central bank policy rates
Brazil	Target rate for overnight interbank loans collateralised by government bonds, registered with and traded on the Sistema Especial de Liquidaçao e Custodia (SELIC). The actual SELIC rate is used to determine the discount rate charged by the CBB.
Colombia	Intervention rate determined by the Bank of the Republic to either increase or decrease liquidity in the economy.
Indonesia	Refers to the Bank Indonesia rate, which is the policy rate reflecting the monetary policy stance adopted by Bank Indonesia and announced to the public.
Malaysia	Refers to the overnight policy rate, which is set by Bank Negara Malaysia (BNM) for monetary policy direction. It is the target rate for the day-today liquidity operations of the BNM.
Peru	Reference rate determined by Central Reserve Bank of Peru to establish a benchmark interest rate for interbank transactions, impacting operations of the financial institutions with the public.
Thailand	Policy rate is the rate announced by the Monetary Policy Committee in conducting monetary policy under the inflation-targeting framework. The monetary policy stance is signalled through the policy interest rate. Beginning on May 23, 2000, the 14-day repurchase rate was used as the policy interest rate. Beginning on January 16, 2007, the one-day repurchase rate was used.
Turkey	Interbank rate at which funds can be lent and borrowed for one day (overnight). The Central Bank of the Republic of Turkey uses this base rate for monetary policy purposes. The level of the overnight rate has a direct effect on the level of interest rates for products such as savings, loans and mortgages.

Source: IMF (2013b)

Table 6.A6: Analysis of Monetary Policy: Summary Statistics, Quarterly Data

Variable	Observations	Mean	Standard deviation	Minimum	Maximum
PRate	501	10.83436	11.99693	1.25	183.2
DRate	1516	15.05421	22.04478	1.25	316.01
Inflation	1520	9.851089	22.52757	-11.44118	405.7238
GDP growth	520	5.174525	3.162861	-9.848425	24.31127
ODA	1456	1.370963	1.801961	-0.1723793	16.80005
IMFcredit	1408	0.0079035	0.0124476	0.0001037	0.0942807
IMFprogr	1568	0.1256378	0.1360378	0	0.5
ResRents	1500	2.098584	4.736041	0	34.78637
ResExp	1360	0.0214855	0.0347676	3.95E-06	0.1935185

Table 6.A7: Analysis of Monetary Policy: Summary Statistics, Quarterly Data for the Seven Countries Included in the Main Specifications

Variable	Observations	Mean	Standard deviation	Minimum	Maximum
PRate	192	13.24755	17.65432	1.25	183.2
DRate	207	12.91391	17.1083	1.25	183.2
Inflation	224	8.136803	11.86496	-1.010103	70.32743
GDP growth	224	4.852085	2.809209	-9.848425	11.93874
ODA	224	0.0736677	0.088919	-0.1723793	0.2749182
IMFcredit	224	0.0041919	0.0059973	0.0001037	0.0239093
IMFprogr	224	0.1517857	0.1312118	0	0.5
ResRents	224	1.078309	0.7898431	0.039008	3.261337
ResExp	224	0.0155668	0.011956	0.000946	0.044412

Table 6.A8: Analysis of Monetary Policy: Summary Statistics, Annual Data

Variable	Observations	Mean	Standard deviation	Minimum	Maximum
PRate	128	11.28789	17.22873	1.25	183.2
Inflation	391	9.882127	20.98902	-10.06781	324.9959
GDP growth	299	5.282936	4.414652	-8.388323	55.55552
ODA	364	5.48385	7.215287	-0.6895173	67.20018
IMFcredit	352	0.0316141	0.0498436	0.0004147	0.3771229
IMFprogr	392	0.502551	0.544673	0	2
ResRents	375	8.394334	18.96315	0	139.1455
ResExp	340	0.0859422	0.139224	0.0000158	0.7740741

Table 6.A9: Analysis of Monetary Policy: Countries Included in the Analysis

Main specification (dependent variable *PRate*, quarterly data)	Alternative specification 1 (dependent variable *DRate*, quarterly data)	Alternative specification 2 (dependent variable *PRate*, annual data)
Brazil	Bolivia	Albania
Colombia	Botswana	Armenia
Indonesia	Brazil	Brazil
Malaysia	Colombia	Colombia
Peru	Costa Rica	Dominican Republic
Thailand	Croatia	Gambia
Turkey	Egypt	Guyana
	India	Indonesia
	Indonesia	Iraq
	Macedonia	Jordan
	Malaysia	Malaysia
	Morocco	Moldova
	Peru	Nepal
	Philippines	Papua New Guinea
	Romania	Peru
	Rwanda	South Africa
	Thailand	Thailand
	Turkey	Turkey
	Uruguay	Vietnam

6.5.3.2 Results

This section presents tables with further results of the analysis of the relationship between the sources of finance and the policy stance in relation to price stability. While tables with results from the main specifications and the related discussion are in the main part of the thesis, the tables shown in the appendix present results from model specifications serving as robustness checks. A brief discussion of the results from the robustness checks can be found in the main part of the thesis. Note that I do not report estimates for country and time fixed-effects. This section first describes the specifications used in the tables and then presents the actual tables.

Aid Dependence and the Policy Stance in Relation to Price Stability

Tables 6.A10 through 6.A16 report results for a variety of specifications exploring the relationship between aid dependence and the aversion to inflation, which is the proxy for the policy stance in relation to price stability. In particular:

- Tables 6.A10 and 6.A11 report results for regressions where the dependent variable is the differenced central bank policy rate, *PRate_d*. The main relationship of interest is thus how changes in the consumer price index (i.e. inflation) in a context of aid dependence affect changes in the central bank policy rate.
- Tables 6.A12 through 6.A14 report results from specifications using *PRate* as the dependent variable based on annual data. Table 6.A12 uses the AR1 error model and Table 6.A13 the LDV model. Table 6.A14 reports results from an Arellano-Bond LDV model, a two step difference GMM.[188] I implemented the estimator using State's xtabond2 command. I used forward orthogonal deviations as an alternative to differencing that preserves sample size in panels with gaps, and the Windmeijer finite sample correction to the reported standard errors in two step estimation without which those standard errors tend to be severely downward biased (Roodman, 2006).[189] I implemented time fixed-effects, whose estimates are not reported here, to reduce the risk of a contemporaneous correlation of errors. Note, that some standard errors in Table 6.A14, model 2, are missing, due to a non-symmetric or highly singular variance matrix.

[188] I did not employ System GMM because it uses more instruments than system GMM, which is problematic when the number of countries in the dataset is small.
[189] I implemented two-step GMM because two-step standard errors, with the Windmeijer correction, are considered quite accurate and seem modestly superior to robust one-step (Roodman, 2006).

- Tables 6.A15 and 6.A16 report results for regressions where the dependent variable is *DRate*, i.e. the central bank policy rate (IFS, line 60), or, where it is not available, the discount rate (IFS, line 60A).

Table 6.A10: Differenced Dependent Variable: Fixed-Effects with PCSE and AR(1) Correction Using Different Lag Structures

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
	PRate_d	PRate_d	PRate_d	PRate_d	PRate_d	PRate_d	PRate_d	PRate_d	PRate_d
GDP growth	0.619***			0.249**			0.717***		
	(0.0683)			(0.0783)			(0.0756)		
L.GDP growth		0.959***			0.815***			0.888***	
		(0.106)			(0.0989)			(0.0977)	
L2.GDP growth			-0.117*			-0.442***			-0.207***
			(0.0588)			(0.0596)			(0.0586)
Inflation	-0.0123			0.517***			0.155**		
	(0.0312)			(0.0376)			(0.0525)		
L.Inflation		0.311***			0.339***			0.0242	
		(0.0460)			(0.0490)			(0.0575)	
L2.Inflation			0.0792**			0.176***			-0.0170
			(0.0257)			(0.0322)			(0.0497)
ODA	-3.808								
	(3.144)								
L.ODA		16.78***							
		(2.444)							
L2.ODA			1.240						
			(1.686)						
ODA*Inflation	2.986***								
	(0.456)								
L.ODA*Inflation		-1.909***							
		(0.397)							
L2.ODA*Inflation			0.0285						
			(0.271)						
IMFcredit				-414.6***					
				(111.2)					
L.IMFcredit					204.2***				
					(59.52)				
L2.IMFcredit						137.7**			
						(49.69)			
IMFcredit*Inflation				-30.91***					
				(2.627)					
L.IMFcredit*Inflation					-9.611***				
					(2.900)				
L2.IMFcredit*Inflation						-10.94***			
						(1.939)			
IMFprogr							4.971*		
							(1.988)		
L.IMFprogr								-2.434	
								(2.123)	
L2.IMFprogr									-1.969
									(1.540)
IMFprogr*Inflation							-0.265		
							(0.223)		
L.IMFprogr*Inflation								0.887***	
								(0.261)	
L2.IMFprogr*Inflation									0.354
									(0.216)
Constant	-3.629***	-13.76***	0.504	-2.607***	-5.635***	-0.874	-9.655***	-11.85***	-1.322
	(0.508)	(1.777)	(0.394)	(0.493)	(0.677)	(1.101)	(1.125)	(1.496)	(0.987)
Observations	189	185	181	189	185	181	189	185	181
R^2	0.0122	0.0174	0.0025	0.0723	0.0182	0.0049	0.0094	0.0151	0.0025
Number of countries	7	7	7	7	7	7	7	7	7

Standard errors in parentheses. $^{+}$ $p < 0.10$, * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

Table 6.A11: Differenced Dependent Variable: Fixed-Effects with PCSE and LDV Using Different Lag Structures

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
	PRate_d	PRate_d	PRate_d	PRate_d	PRate_d	PRate_d	PRate_d	PRate_d	PRate_d
L.PRate_d	-0.394***	-0.392***		-0.379***	-0.444***		-0.395***	-0.392***	
	(0.0240)	(0.0305)		(0.0191)	(0.0220)		(0.0300)	(0.0317)	
L2.PRate_d			-0.0740***			-0.0937***			-0.0682***
			(0.0176)			(0.0166)			(0.0157)
GDP growth	1.159***			1.049***			1.290***		
	(0.141)			(0.118)			(0.170)		
L.GDP growth		1.395***			1.122***			1.387***	
		(0.181)			(0.127)			(0.174)	
L2.GDP growth			-0.158			-0.195*			0.0147
			(0.0969)			(0.0863)			(0.0870)
Inflation	0.0251			0.746***			0.00342		
	(0.0439)			(0.0536)			(0.0845)		
L.Inflation		0.225***			0.565***			-0.0741	
		(0.0573)			(0.0496)			(0.0751)	
L2.Inflation			0.00477			0.346***			0.0323
			(0.0337)			(0.0344)			(0.0803)
ODA	-10.24***								
	(2.981)								
L.ODA		6.957+							
		(3.586)							
L2.ODA			-0.550						
			(4.119)						
ODA*Inflation	2.521***								
	(0.387)								
L.ODA*Inflation		0.282							
		(0.539)							
L2.ODA*Inflation			2.488***						
			(0.625)						
IMFcredit				-62.72					
				(78.77)					
L.IMFcredit					38.28				
					(60.97)				
L2.IMFcredit						332.7***			
						(53.69)			
IMFcredit*Inflation				-39.13***					
				(3.029)					
L.IMFcredit*Inflation					-25.88***				
					(2.975)				
L2.IMFcredit*Inflation						-20.40***			
						(2.024)			
IMFprogr							-9.787*		
							(4.059)		
L.IMFprogr								-5.560+	
								(3.115)	
L2.IMFprogr									10.24***
									(2.715)
IMFprogr*Inflation							0.366		
							(0.425)		
L.IMFprogr*Inflation								1.278***	
								(0.377)	
L2.IMFprogr*Inflation									0.371
									(0.342)
Constant	-11.09***	-15.97***	-1.174	-12.87***	-14.29***	-4.312***	-10.97***	-15.03***	-5.768***
	(1.773)	(2.240)	(1.162)	(1.415)	(1.422)	(1.041)	(1.857)	(1.906)	(1.135)
Observations	182	182	175	182	182	175	182	182	175
Adjusted R^2	0.3466	0.3534	0.2468	0.4335	0.3923	0.2546	0.3443	0.3535	0.2442
Number of countries	7	7	7	7	7	7	7	7	7

Standard errors in parentheses. $^{+}$ $p < 0.10$, * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

Table 6.A12: Annual Data: Fixed-Effects with PCSE and AR(1) Correction Using Different Lag Structures

	(1) PRate	(2) PRate	(3) PRate	(4) PRate	(5) PRate	(6) PRate
GDP growth	0.00686		1.347^{***}		0.185	
	(0.231)		(0.339)		(0.398)	
L.GDP growth		-0.0419		0.119		0.0231
		(0.0700)		(0.217)		(0.0539)
Inflation	1.004^{***}		1.793^{***}		0.333	
	(0.222)		(0.326)		(0.311)	
L.Inflation		0.395^{***}		0.522^{***}		0.244^{*}
		(0.0860)		(0.117)		(0.0972)
ODA	1.868^{**}					
	(0.615)					
L.ODA		0.287^{+}				
		(0.167)				
ODA*Inflation	-0.0589^{***}					
	(0.0173)					
L.ODA*Inflation		-0.00650				
		(0.00496)				
IMFcredit			108.0^{***}			
			(31.73)			
L.IMFcredit				39.39^{*}		
				(16.80)		
IMFcredit*Inflation			-8.384^{***}			
			(2.199)			
L.IMFcredit*Inflation				-2.464^{**}		
				(0.895)		
IMFprogr					-2.477	
					(1.827)	
L.IMFprogr						-0.384
						(0.689)
IMFprogr*Inflation					0.429	
					(0.353)	
L.IMFprogr*Inflation						0.162^{+}
						(0.0871)
Constant	-4.659	4.028^{***}	-7.804^{**}	3.368^{*}	6.731^{*}	5.514^{***}
	(4.132)	(1.179)	(2.602)	(1.483)	(2.689)	(0.830)
Observations	128	115	124	112	128	116
R^2	0.4987	0.7468	0.6328	0.7651	0.4495	0.7508
Number of countries	19	19	18	18	19	19

Standard errors in parentheses. $^{+}$ $p < 0.10$, * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

Table 6.A13: Annual Data: Fixed-Effects with PCSE and LDV Using Different Lag Structures

	(1) PRate	(2) PRate	(3) PRate	(4) PRate	(5) PRate	(6) PRate
L.PRate	0.156***	0.235***	0.119***	0.228***	0.236***	0.230***
	(0.0238)	(0.0209)	(0.0226)	(0.0253)	(0.0327)	(0.0205)
GDP growth	-0.0319		0.150+		0.133	
	(0.102)		(0.0904)		(0.0897)	
L.GDP growth		-0.270***		-0.386**		-0.184***
		(0.0430)		(0.121)		(0.0421)
Inflation	0.373***		0.482***		0.0786	
	(0.0597)		(0.0552)		(0.138)	
L.Inflation		0.0867*		0.112*		-0.00541
		(0.0373)		(0.0495)		(0.0553)
ODA	0.627***					
	(0.102)					
L.ODA		0.181				
		(0.111)				
ODA*Inflation	-0.0239***					
	(0.00359)					
L.ODA*Inflation		-0.00706*				
		(0.00333)				
IMFcredit			15.20*			
			(7.019)			
L.IMFcredit				4.249		
				(9.605)		
IMFcredit*Inflation			0.434			
			(0.780)			
L.IMFcredit*Inflation				-0.767*		
				(0.360)		
IMFprogr					0.792	
					(0.900)	
L.IMFprogr						0.00861
						(0.541)
IMFprogr*Inflation					0.0520	
					(0.154)	
L.IMFprogr*Inflation						0.110*
						(0.0429)
Constant	2.236**	5.392***	4.296***	7.153***	3.074*	6.032***
	(0.861)	(0.808)	(0.451)	(0.975)	(1.207)	(0.639)
Observations	109	109	106	106	109	109
Adjusted R^2	0.9408	0.9269	0.9526	0.9270	0.9129	0.9287
Number of countries	19	19	18	18	19	19

Standard errors in parentheses
$^{+}$ $p < 0.10$, * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

Table 6.A14: Annual Data: Arellano-Bond LDV Model

	(1)	(2)	(3)
	PRate	PRate	PRate
L.PRate	0.101	0.0825	0.203
	(0.0598)	(.)	(0.124)
GDP growth	-0.0964	-0.720	0.0794
	(0.325)	(.)	(0.543)
L.GDP growth	-0.198	-0.570^{*}	-0.178
	(0.313)	(0.222)	(0.773)
Inflation	0.514^{**}	0.591	0.253
	(0.145)	(0.418)	(0.976)
L.Inflation	0.0378	-0.0995	-0.0941
	(0.0560)	(0.133)	(0.336)
ODA	0.559		
	(0.504)		
L.ODA	-0.0468		
	(0.496)		
ODA*Inflation	-0.0222		
	(0.0142)		
L.ODA*Inflation	-0.00894		
	(0.0159)		
IMFcredit		99.39	
		(85.95)	
L.IMFcredit		-14.40	
		(.)	
IMFcredit*Inflation		-2.017	
		(6.068)	
L.IMFcredit*Inflation		0.788	
		(1.924)	
IMFprogr			2.932
			(13.07)
L.IMFprogr			0.714
			(4.122)
IMFprogr*Inflation			-0.149
			(1.045)
L.IMFprogr*Inflation			0.187
			(0.225)
Observations	90	88	90
Number of countries	19	18	19
Number of instruments	41	41	41

Standard errors in parentheses. Missing values for standard errors are due to a non-symmetric or highly singular variance matrix. $^{+}$ $p < 0.10$, * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

Table 6.A15: *DRate* as Dependent Variable: Fixed-Effects with PCSE and AR(1) Correction Using Different Lag Structures

	(1) DRate	(2) DRate	(3) DRate	(4) DRate	(5) DRate	(6) DRate	(7) DRate	(8) DRate	(9) DRate
GDP growth	0.0109			-0.0359			0.0225		
	(0.0316)			(0.0374)			(0.0301)		
L.GDP growth		0.188^{***}			0.160^{***}			0.170^{***}	
		(0.0273)			(0.0246)			(0.0262)	
L2.GDP growth			0.0532^{+}			0.0165			0.0320
			(0.0273)			(0.0266)			(0.0254)
Inflation	0.276^{***}			0.642^{***}			0.314^{***}		
	(0.0685)			(0.0961)			(0.0636)		
L.Inflation		0.403^{***}			0.606^{***}			0.372^{***}	
		(0.0481)			(0.0484)			(0.0448)	
L2.Inflation			0.526^{***}			0.694^{***}			0.472^{***}
			(0.0491)			(0.0388)			(0.0411)
ODA	1.246^{***}								
	(0.362)								
L.ODA		0.782^{+}							
		(0.415)							
L2.ODA			1.820^{***}						
			(0.312)						
ODA*Inflation	-0.0834^{+}								
	(0.0487)								
L.ODA*Inflation		-0.334^{***}							
		(0.0781)							
L2.ODA*Inflation			-0.349^{***}						
			(0.105)						
IMFcredit				-119.9					
				(198.0)					
L.IMFcredit					285.2^{**}				
					(98.90)				
L2.IMFcredit						369.9^{***}			
						(76.43)			
IMFcredit*Inflation				-31.07^{***}					
				(6.800)					
L.IMFcredit*Inflation					-17.29^{***}				
					(3.225)				
L2.IMFcredit*Inflation						-16.94^{***}			
						(2.991)			
IMFprogr							3.137^{*}		
							(1.392)		
L.IMFprogr								1.417	
								(1.683)	
L2.IMFprogr									1.120
									(1.664)
IMFprogr*Inflation							-0.0513		
							(0.210)		
L.IMFprogr*Inflation								0.147	
								(0.138)	
L2.IMFprogr*Inflation									0.0633
									(0.102)
Constant	4.909^{***}	6.484^{***}	4.516^{***}	6.579^{***}	3.368^{**}	3.085^{***}	5.911^{***}	5.384^{***}	5.654^{***}
	(0.726)	(0.878)	(0.563)	(1.878)	(1.128)	(0.606)	(0.719)	(0.834)	(0.605)
Observations	471	454	437	471	454	437	503	485	467
R^2	0.1783	0.1438	0.1753	0.2202	0.1804	0.2117	0.1749	0.1530	0.1701
Number of countries	18	18	18	18	18	18	19	19	19

Standard errors in parentheses. $^{+}$ $p < 0.10$, * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

Table 6.A16: *DRate* as Dependent Variable: Fixed-Effects with PCSE and LDV Using Different Lag Structures

	(1) DRate	(2) DRate	(3) DRate	(4) DRate	(5) DRate	(6) DRate	(7) DRate	(8) DRate	(9) DRate
L.DRate	0.335***	0.319***		0.407***	0.337***		0.357***	0.344***	
	(0.0150)	(0.00968)		(0.0292)	(0.0254)		(0.0153)	(0.0133)	
L2.DRate			0.113***			0.133**			0.142***
			(0.00999)			(0.0411)			(0.0167)
GDP growth	0.0900**			0.214***			0.146***		
	(0.0287)			(0.0511)			(0.0304)		
L.GDP growth		0.143***			0.214***			0.161***	
		(0.0339)			(0.0447)			(0.0305)	
L2.GDP growth			0.132**			0.125+			0.127**
			(0.0462)			(0.0732)			(0.0391)
Inflation	0.603***			0.698***			0.436***		
	(0.0193)			(0.0346)			(0.0211)		
L.Inflation		0.636***			0.679***			0.453***	
		(0.0129)			(0.0301)			(0.0216)	
L2.Inflation			0.888***			0.998***			0.618***
			(0.0145)			(0.0521)			(0.0366)
ODA	2.739***								
	(0.175)								
L.ODA		2.752***							
		(0.265)							
L2.ODA			4.171***						
			(0.498)						
ODA*Inflation	-0.414***								
	(0.0535)								
L.ODA*Inflation		-0.545***							
		(0.0693)							
L2.ODA*Inflation			-0.787***						
			(0.112)						
IMFcredit				-78.22					
				(82.84)					
L.IMFcredit					8.506				
					(66.76)				
L2.IMFcredit						56.63			
						(91.41)			
IMFcredit*Inflation				-15.53***					
				(2.864)					
L.IMFcredit*Inflation					-12.85***				
					(2.331)				
L2.IMFcredit*Inflation						-23.71***			
						(4.002)			
IMFprogr							-3.408**		
							(1.136)		
L.IMFprogr								-1.926	
								(1.308)	
L2.IMFprogr									-2.393
									(1.641)
IMFprogr*Inflation							0.415***		
							(0.0844)		
L.IMFprogr*Inflation								0.363***	
								(0.0727)	
L2.IMFprogr*Inflation									0.540***
									(0.130)
Constant	1.729***	1.912***	2.644***	-0.423	1.046+	2.043**	2.419***	2.796***	4.136***
	(0.356)	(0.399)	(0.510)	(0.597)	(0.558)	(0.786)	(0.411)	(0.408)	(0.477)
Observations	458	453	435	458	453	435	489	484	465
R^2	0.7549	0.7633	0.7605	0.7757	0.7788	0.7817	0.7669	0.7730	0.7625
Number of countries	18	18	18	18	18	18	19	19	19

Standard errors in parentheses. $^{+}p < 0.10$, $^{*}p < 0.05$, $^{**}p < 0.01$, $^{***}p < 0.001$

Resource Dependence and the Policy Stance in Relation to Price Stability

Tables 6.A17 through 6.A23 report results for a variety of specifications exploring the relationship between resource dependence and the aversion to inflation, which is the proxy for the policy stance in relation to price stability. In particular:

- Tables 6.A17 and 6.A18 report results for regressions where the dependent variable is the differenced central bank policy rate, *PRate_d*. The main relationship of interest is thus how changes in the consumer price index (i.e. inflation) in a context of resource dependence affect changes in the central bank policy rate.
- Tables 6.A19 through 6.A21 report results from specifications using *PRate* as the dependent variable based on annual data. Table 6.A19 uses the AR1 error model and Table 6.A19 the LDV model. Note, that some standard errors in Table 6.A20, models 3 and 4, are missing, due to a non-symmetric or highly singular variance matrix. Table 6.A21 reports results from an Arellano-Bond LDV model, a two step difference GMM.[190] I implemented the estimator using Stata's xtabond2 command. I also used forward orthogonal deviations as an alternative to differencing that preserves sample size in panels with gaps and the Windmeijer finite sample correction to the reported standard errors in two step estimation without which those standard errors tend to be severely downward biased (Roodman, 2006).[191] I implemented time fixed-effects, whose estimates are not reported here, to reduce the risk of a contemporaneous correlation of errors.
- Tables 6.A22 and 6.A23 report results for regressions where the dependent variable is *DRate*, i.e. the central bank policy rate (IFS, line 60), or, where it is not available, the discount rate (IFS, line 60A).

[190]I did not employ System GMM because it uses more instruments than system GMM, which is problematic when the number of countries in the dataset is small.

[191] I implemented two-step GMM because two-step standard errors, with the Windmeijer correction, are considered quite accurate and seem modestly superior to robust one-step (Roodman, 2006).

Table 6.A17: Differenced Dependent Variable: Fixed-Effects with PCSE and AR(1) Correction Using Different Lag Structures

	(1) PRate_d	(2) PRate_d	(3) PRate_d	(4) PRate_d	(5) PRate_d	(6) PRate_d
GDP growth	0.749***			0.723***		
	(0.0781)			(0.0817)		
L.GDP growth		0.925***			0.877***	
		(0.105)			(0.101)	
L2.GDP growth			-0.205**			-0.244***
			(0.0652)			(0.0630)
Inflation	0.0874**			0.105**		
	(0.0304)			(0.0334)		
L.Inflation		0.263***			0.262***	
		(0.0408)			(0.0414)	
L2.Inflation			0.0915***			0.0907***
			(0.0262)			(0.0260)
ResRents	-1.118***					
	(0.336)					
L.ResRents		-0.849*				
		(0.387)				
L2.ResRents			0.830***			
			(0.191)			
ResRents*Inflation	0.0301					
	(0.0292)					
L.ResRents*Inflation		-0.152***				
		(0.0363)				
L2.ResRents*Inflation			-0.140***			
			(0.0297)			
ResExp				-100.5**		
				(35.33)		
L.ResExp					-30.17	
					(39.44)	
L2.ResExp						94.43***
						(22.07)
ResExp*Inflation				-4.785+		
				(2.520)		
L.ResExp*Inflation					-9.439***	
					(2.657)	
L2.ResExp*Inflation						-10.05***
						(2.118)
Constant	-2.402***	-12.89***	0.0969	-8.523***	-12.41***	-1.913+
	(0.705)	(1.680)	(0.399)	(1.334)	(1.671)	(1.040)
Observations	189	185	181	189	185	181
R^2	0.0100	0.0166	0.0032	0.0092	0.0145	0.0032
Number of countries	7	7	7	7	7	7

Standard errors in parentheses. $^{+}$ $p < 0.10$, * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

Table 6.A18: Differenced Dependent Variable: Fixed-Effects with PCSE and LDV Using Different Lag Structures

	(1) PRate_d	(2) PRate_d	(3) PRate_d	(4) PRate_d	(5) PRate_d	(6) PRate_d
L.PRate_d	-0.395***	-0.399***		-0.394***	-0.397***	
	(0.0292)	(0.0320)		(0.0311)	(0.0340)	
L2.PRate_d			-0.0726***			-0.0711***
			(0.0176)			(0.0182)
GDP growth	1.456***			1.413***		
	(0.165)			(0.180)		
L.GDP growth		1.562***			1.514***	
		(0.180)			(0.194)	
L2.GDP growth			0.0572			0.0266
			(0.0939)			(0.0974)
Inflation	0.156**			0.140*		
	(0.0503)			(0.0547)		
L.Inflation		0.290***			0.267***	
		(0.0525)			(0.0568)	
L2.Inflation			0.104***			0.0865**
			(0.0286)			(0.0293)
ResRents	-3.607***					
	(0.722)					
L.ResRents		-3.542***				
		(0.711)				
L2.ResRents			-1.147***			
			(0.320)			
ResRents*Inflation	-0.0380					
	(0.0508)					
L.ResRents*Inflation		-0.171***				
		(0.0513)				
L2.ResRents*Inflation			-0.00939			
			(0.0359)			
ResExp				-354.1***		
				(69.67)		
L.ResExp					-298.0***	
					(59.30)	
L2.ResExp						-68.24+
						(35.78)
ResExp*Inflation				-7.323+		
				(4.415)		
L.ResExp*Inflation					-12.66**	
					(4.171)	
L2.ResExp*Inflation						2.903
						(2.994)
Constant	-13.70***	-16.88***	-3.601**	-12.80***	-16.05***	-3.239**
	(1.936)	(2.067)	(1.098)	(2.054)	(2.195)	(1.112)
Observations	182	182	175	182	182	175
R^2	0.3491	0.3604	0.2415	0.3477	0.3573	0.2412
Number of countries	7	7	7	7	7	7

Standard errors in parentheses. $^{+}$ $p < 0.10$, * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

Table 6.A19: Annual Data: Fixed-Effects with PCSE and AR(1) Correction Using Different Lag Structures

	(1) PRate	(2) PRate	(3) PRate	(4) PRate
GDP growth	0.212		0.361	
	(0.143)		(0.292)	
L.GDP growth		-0.0593		-0.127
		(0.0921)		(0.110)
Inflation	1.149***		1.248**	
	(0.221)		(0.434)	
L.Inflation		0.370***		0.375***
		(0.0793)		(0.113)
ResRents	-0.0584			
	(0.0966)			
L.ResRents		-0.00696		
		(0.0373)		
ResRents*Inflation	-0.0135***			
	(0.00306)			
L.ResRents*Inflation		-0.000444		
		(0.00259)		
ResExp			8.057	
			(36.84)	
L.ResExp				8.230
				(12.88)
ResExp*Inflation			-2.899**	
			(1.006)	
L.ResExp*Inflation				-0.773
				(0.723)
Constant	2.858*	5.706***	1.531	5.984***
	(1.395)	(0.676)	(2.482)	(0.871)
Observations	128	115	119	108
R^2	0.5272	0.7396	0.5517	0.7334
Number of countries	19	19	19	19

Standard errors in parentheses. $^{+}$ $p < 0.10$, * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

Table 6.A20: Annual Data: Fixed-Effects with PCSE and LDV Using Different Lag Structures

	(1) PRate	(2) PRate	(3) PRate	(4) PRate
L.PRate	0.125***	0.237***	0.111	0.235
	(0.0242)	(0.0215)	(.)	(.)
GDP growth	0.256***		0.198	
	(0.0715)		(.)	
L.GDP growth		-0.291***		-0.251
		(0.0657)		(.)
Inflation	0.540***		0.573	
	(0.0497)		(.)	
L.Inflation		0.0781*		0.0890
		(0.0314)		(.)
ResRents	-0.162***			
	(0.0228)			
L.ResRents		-0.141*		
		(0.0586)		
ResRents*Inflation	-0.00639***			
	(0.000645)			
L.ResRents*Inflation		-0.00256+		
		(0.00149)		
ResExp			18.26	
			(.)	
L.ResExp				2.556
				(.)
ResExp*Inflation			-1.391	
			(.)	
L.ResExp*Inflation				-0.516
				(.)
Constant	2.414***	6.702***	1.914	5.995
	(0.539)	(0.616)	(.)	(.)
Observations	109	109	100	102
R^2	0.9503	0.9265	0.9491	0.9264
Number of countries	19	19	19	19

Standard errors in parentheses. $^+ p < 0.10$, $^* p < 0.05$, $^{**} p < 0.01$, $^{***} p < 0.001$

Table 6.A21: Annual Data: Arellano-Bond LDV Model

	(1)	(2)
	PRate	PRate
L.PRate	0.0927^{+}	0.128*
	(0.0482)	(0.0518)
GDP growth	-0.00380	-0.0948
	(0.289)	(0.564)
L.GDP growth	-0.153	-0.546
	(0.198)	(0.635)
Inflation	0.578**	0.448**
	(0.158)	(0.131)
L.Inflation	-0.00138	-0.0162
	(0.0848)	(0.274)
ResRents	-0.0980	
	(0.208)	
L.ResRents	0.00259	
	(0.250)	
ResRents*Inflation	-0.00703**	
	(0.00191)	
L.ResRents*Inflation	-0.00174	
	(0.00389)	
ResExp		54.24
		(143.9)
L.ResExp		23.80
		(114.7)
ResExp*Inflation		-1.317
		(0.795)
L.ResExp*Inflation		-2.333
		(2.158)
Observations	90	81
Number of countries	19	18
Number of instruments	41	41

Standard errors in parentheses. $^{+}$ $p < 0.10$, * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

Table 6.A22: *DRate* as Dependent Variable: Fixed-Effects with PCSE and AR(1) Correction Using Different Lag Structures

	(1) DRate	(2) DRate	(3) DRate	(4) DRate	(5) DRate	(6) DRate
GDP growth	0.0279			0.0288		
	(0.0283)			(0.0288)		
L.GDP growth		0.173^{***}			0.171^{***}	
		(0.0251)			(0.0245)	
L2.GDP growth			0.0375			0.0352
			(0.0256)			(0.0281)
Inflation	0.260^{***}			0.269^{***}		
	(0.0756)			(0.0742)		
L.Inflation		0.429^{***}			0.431^{***}	
		(0.0505)			(0.0506)	
L2.Inflation			0.586^{***}			0.591^{***}
			(0.0470)			(0.0482)
ResRents	-1.158^{***}					
	(0.234)					
L.ResRents		-0.443^{**}				
		(0.162)				
L2.ResRents			0.188			
			(0.168)			
ResRents*Inflation	0.0582					
	(0.0402)					
L.ResRents*Inflation		-0.0880^{**}				
		(0.0283)				
L2.ResRents*Inflation			-0.212^{***}			
			(0.0291)			
ResExp				-130.8^{***}		
				(18.76)		
L.ResExp					-53.96^{**}	
					(17.78)	
L2.ResExp						2.259
						(28.66)
ResExp*Inflation				2.709		
				(2.641)		
L.ResExp*Inflation					-6.556^{**}	
					(2.135)	
L2.ResExp*Inflation						-17.08^{***}
						(2.518)
Constant	9.787^{***}	5.881^{***}	5.746^{***}	10.26^{***}	6.083^{***}	6.999^{***}
	(0.879)	(0.810)	(0.730)	(0.864)	(0.798)	(1.567)
Observations	503	485	467	503	485	467
R^2	0.1630	0.1466	0.1856	0.1646	0.1470	0.1817
Number of countries	19	19	19	19	19	19

Standard errors in parentheses. $^{+}$ $p < 0.10$, * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

Table 6.A23: *DRate* as Dependent Variable: Fixed-Effects with PCSE and LDV Using Different Lag Structures

	(1) DRate	(2) DRate	(3) DRate	(4) DRate	(5) DRate	(6) DRate
L.DRate	0.349***	0.329***		0.349***	0.327***	
	(0.0123)	(0.00785)		(0.0119)	(0.00747)	
L2.DRate			0.121***			0.116***
			(0.00815)			(0.00733)
GDP growth	0.116***			0.127***		
	(0.0320)			(0.0315)		
L.GDP growth		0.142***			0.152***	
		(0.0356)			(0.0358)	
L2.GDP growth			0.0973+			0.111*
			(0.0510)			(0.0526)
Inflation	0.595***			0.613***		
	(0.0166)			(0.0163)		
L.Inflation		0.628***			0.653***	
		(0.0121)			(0.0138)	
L2.Inflation			0.887***			0.934***
			(0.0180)			(0.0219)
ResRents	0.974***					
	(0.134)					
L.ResRents		1.114***				
		(0.134)				
L2.ResRents			1.644***			
			(0.136)			
ResRents*Inflation	-0.212***					
	(0.0119)					
L.ResRents*Inflation		-0.268***				
		(0.0125)				
L2.ResRents*Inflation			-0.424***			
			(0.0215)			
ResExp				80.34***		
				(18.37)		
L.ResExp					97.86***	
					(18.06)	
L2.ResExp						155.2***
						(24.70)
ResExp*Inflation				-17.57***		
				(1.301)		
L.ResExp*Inflation					-22.90***	
					(1.582)	
L2.ResExp*Inflation						-38.42***
						(2.365)
Constant	1.592***	1.929***	2.685***	1.618***	1.973***	2.552***
	(0.347)	(0.379)	(0.457)	(0.361)	(0.406)	(0.447)
Observations	489	484	465	489	484	465
R^2	0.7692	0.7773	0.7730	0.7699	0.7784	0.7763
Number of countries	19	19	19	19	19	19

Standard errors in parentheses. $^{+}$ $p < 0.10$, * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

7 Structural Power and Central Bank Policy: Conclusions

Why countries differ in the orientation of economic policy is a central question for students of political economy. I have approached this question through the lens of theory of the structural power of capital and by examining one particular type of economic policy, namely central bank policy. Understanding the sources of central bank policy is important because central banks influence many of the variables which determine a country's level of economic prosperity, such as the stability of prices, the stability of the financial sector and access to finance. Moreover, the analysis of central bank policy is well suited for an approach which examines how the choices of policymakers may be constrained by structural power, which Winters (1996: x) defines as power derived from the capacity to deploy scarce investment resources. The stance of central bank policy sends important signals to private investors and donors about a country's investment climate and creditworthiness, so that central bankers are likely to face pressures to pursue policies that are responsive to the policy concerns of major providers of investment funds.

I have built upon the work of earlier scholars of structural power. Few such scholars, however, have applied the theory to the realm of finance in developing countries. Moreover, despite the variation across developing countries in the sources of investment finance on which they rely to finance investment, existing work on structural power has largely focused on examining how structural dependence on private investors shapes policy. This study begins to address these gaps in the research. In an effort to further develop the theory of the structural power of capital, I have examined central bank policy with an approach focused on structural power in developing countries that vary with respect to the sources of finance on which they rely.

As I summarised at the end of each chapter the key points that emerged from the preceding analysis, the main task that remains is to review the combined evidence. This is the subject of the next section. Following this review, the remainder of the concluding chapter turns to the contributions of the thesis, its limitations and implications for the debate on central bank mandates in developing countries.

7.1 Review of the Combined Evidence

I opted for a broad and exploratory research design as my focus was on theory-building. In particular, I employed case studies of Uganda, Nigeria and Kenya and cross-national statistical analyses to examine the relationship between the control over investment funds and central bank policy stances. Each of the preceding empirical chapters presented one set of analyses to tell part of a larger story of the power deriving from the control of capital. While each analysis has methodological limitations and is not entirely convincing on its own, the sets of analysis in combination provide some evidence that patterns of capital control do influence the orientation of central bank policy. This section reviews the evidence for this claim.

Do Those Who Control Investment Funds Shape Central Bank Policy Stances?

The first and main question posed by this research has been whether those who control the sources of finance on which a country relies to finance investment shape central bank policy stances. This question was the subject of the case studies of Uganda, Nigeria and Kenya. The evidence I have presented suggests that the accounts of central bank policy in these three countries can be meaningfully enhanced by considering the pattern of control of investment resources as an explanatory factor.

The material presented in the case study of Uganda suggests that donors have influenced the stance of central bank policy in Uganda since becoming major providers of investible funds. More specifically, the policy concerns of donors began to pose constraints on the options policymakers could consider in the field of central bank policy when Uganda became reliant on aid.

The evidence I have presented in the case study of Nigeria suggests that when access to, and control of, resource revenues increases, the policy space for the government in the area of central bank policy increases as well. In particular, as the Nigerian government's oil revenues increase, they provide the government with a material basis to pursue a wider range of policy options than would be possible under resource scarcity and the influence of non-state actors over central bank policy, notably donors, is increasingly undermined.

The evidence presented in the case study of Kenya is less conclusive. The material suggests that in the period from independence until the late 1970s and in the period from 2003 onwards, investors wielded structural power which derived from the resources they controlled and their decisions about the volume of investment and the areas in which to invest. Central bank policy was designed with a view to inducing business to supply investment resources. However, particularly in the period from 1989 to 2002 policymakers failed to satisfy some important policy concerns of business and donors, the second major source of investible funds, despite declining levels of growth. The case study suggests that one reason for this was the patronage network underpinning Moi's regime, which exerted pressures to pursue policies that violated some of the policy concerns of major suppliers of investible funds. Thus, the theory of structural power cannot explain central bank policy during that period.

There were additional ambiguities in the case studies because the processes through which donors and private investors exerted influence were not always observable. In Uganda, for instance, donors and policymakers developed a common understanding of policy priorities over time, which sometimes made it difficult to distinguish whether policies were pursued because of "faith" or because donors were able to demand responsive policies. In the analysis of the Kenyan case, I had difficulties distinguishing whether policies to improve the business environment were, as official rhetoric held, intended to address the policy concerns of private investors, or of donors because for the latter improving the business environment was also a major policy concern. That said, I have made considerable effort to trace the ways through which the constraints posed by those who control investment funds get expressed in policies.

Through Which Mechanisms Do Investors and Donors Shape Central Bank Policy Stances?

The particular ways through which the constraints posed by those who control investment funds get expressed in policies were the subject of the second research question, namely: Through which mechanisms – exit, voice or encouraging social learning – do those who control the sources of finance on which a country relies to finance investment shape central bank policy stances? The case studies of Uganda, Nigeria and Kenya have provided the basis upon which to examine these mechanisms. In examining mechanisms, I focused on those through which donors and investors influence policy because governments do not have to rely on exit, voice and social learning to exercise power, they merely implement their preferred policies.

The evidence suggests that donors used all three mechanisms – exit, voice, and encouraging social learning – to influence policy. Exit and voice appear to assume greater importance when relationships with donors are strained. The IMF, however, often appeared to shape central bank policy through the mere threat of exit, both when relationships with recipient countries were good and when they were difficult. Social learning, in contrast, appears to become more important when relations with donors improve or when donors and recipient governments have a common understanding of reform needs in specific policy areas. The material suggests that private investors mostly shaped policy silently, through exit and the threat of exit. In examining how business's control over investment translated into influence over policy, I thus had to pay considerable attention to issues of perception and anticipation.

Propositions

I also developed two propositions. The first is that in developing countries which are more dependent on aid, the central bank policy stance is more likely to be stability-oriented. The second proposition is that in developing countries which are more dependent on natural resources, the central bank policy stance is more likely to be oriented towards financial deepening.

The empirical investigation of whether aid dependence is associated with a policy stance oriented towards stability began with the case study of Uganda. The evidence I have presented in this case study suggests that increasing reliance on donors has indeed induced a central bank policy stance oriented towards stability. It is significant, however, that since the mid-2000s, the Central Bank of Uganda has embraced financial deepening as an additional policy goal, a development which has in part been driven by donors, whose policy concerns in the realm of central banking have changed to include both stability and financial deepening.

Is it possible to strengthen these findings and establish a relationship between aid dependence and the stance of central bank policy through cross-country comparison? One way to approach this question is by comparing the stance of policy in Uganda with the stance of policy in Nigeria and Kenya. As Figure 7.A1 shows, reliance on ODA was, from 1990 onwards, consistently higher in Uganda than in Nigeria and Kenya. Has central bank policy in Uganda also exhibited a greater orientation towards stability after 1990? Answering this question is not straightforward owing to data limitations and the conceptual challenges in measuring the orientation of central bank policy. The orientation of central bank policy towards price stability, for instance, cannot be captured by a readily available indicator, as I explained in the last chapter. It is significant, however, that among the three country cases, Uganda is the only one which officially introduced an inflation-targeting framework, which is used to signal a prioritisation of price stability over other central bank policy goals and is unusual for countries in the low-income category. As regards the policy stances in relation to financial stability and financial deepening, it is useful to turn to the quantitative measures developed in this thesis.[192] Data on the policy stance in relation to financial stability in Table 7.A1 reveals that Uganda achieves higher scores on all three measures of regulatory stringency developed in the thesis than Nigeria and Kenya. As stated in the introduction, another facet of a policy stance oriented towards stability might be that less emphasis is placed on financial deepening. As Table 7.A1 shows, Uganda has, like Nigeria and Kenya, implemented reforms to promote financial access. However, in contrast to Nigeria and Kenya, Uganda has no designated team to promote financial access reforms. In short, the limited, illustrative data supports the view that policy in Uganda was more oriented towards stability than in Nigeria and Kenya in the 2000s.

In the last chapter, I used another, more robust form of cross-country comparison to establish whether there is a relationship between aid dependence and the stance of central bank policy, namely cross-national statistical analysis. Specifically, I employed three distinct sets of analysis: logistic regression analysis of financial deepening policies, ordinary least squares (OLS) and logistic regression analyses of prudential regulation; and pooled time-series cross-sectional (TSCS) analysis of monetary policy. One set of analyses, the TSCS of monetary policy, contradicts the proposition, suggesting that higher volumes of financial assistance received from donors are associated with less emphasis on price stability. On balance, however, the evidence from the three sets of analysis suggests that aid dependence is associated with a policy stance oriented towards stability, at least where such dependence is measured by participation in IMF programmes. The evidence presented in the case studies of Uganda, Nigeria and Kenya supports the claim that the IMF has, compared to other

[192] The data on regulatory stringency is from 2002 and the data on the policy stance in relation to financial deepening from 2008. During both years, aid dependence was higher in Uganda than in Nigeria and Kenya.

donors, exerted particularly high influence in orienting the stance of central bank policy towards stability.

I began to examine whether resource dependence is associated with a policy stance oriented towards financial deepening by analysing the case of Nigeria. The evidence presented in the case study suggests that increasing access to oil revenues has indeed encouraged a central bank policy stance oriented towards financial deepening, broadly defined as a stance oriented towards increasing the volume of financial transactions. This raises the question of whether we can also establish a relationship between resource dependence and the stance of central bank policy through cross-country comparison.

As Figure 7.A2 shows, reliance on resource rents was higher in Nigeria than in Kenya and Uganda between the 1970s and the 2000s.[193] Was central bank policy also more orientated towards financial deepening in Nigeria than in Uganda and Kenya? With respect to price stability, it is significant that in the late 2000s, when it was internationally agreed that price stability should be a primary objective of central banks and with Uganda and Kenya having inflation targets of 5%, the inflation objective of Nigeria's central bank was merely to aim for "single-digit inflation". Moreover, like the CBK, the CBN has used monetary policy not only with a view to promote price stability but also to reduce the cost of credit by maintaining low interest rates (IMF, 2008a; IMF, 2011). The quantitative measures developed in this thesis allow a comparison of the policy stances in relation to financial stability and financial deepening. Based on these measures, central bank policy in Nigeria seems to be as much oriented towards financial stability as in Kenya but less so than in Uganda. Similarly, central bank policy in Nigeria seems to be as much oriented towards deepening financial sectors by promoting financial access as in Kenya and more so than in Uganda.

That said, it is noteworthy that until the mid-1980s, Nigeria's system of credit allocation was more pervasive than in Kenya and Uganda (Brownbridge et al., 1998). In fact, according to the World Bank, Nigeria had "one of the most rigid and comprehensive credit allocation schemes" in capitalist economies at a time when it was part of the predominant economic thinking that central banks may pursue a policy stance oriented

[193] Data on resource rents in Figure 7.A2 is the sum of rents from oil and minerals as a percentage of GDP. While the quality of the underlying data is poor, the figure allows conveying that resource dependence in Nigeria has been higher than in Uganda and Kenya.

towards financial deepening (World Bank, 1983a: 43). Moreover, among the three central banks, the Nigerian central bank is the only one which continues to have a department dedicated to development financing and to operate development financing schemes. In sum, the limited, illustrative data suggests that central bank policy in Nigeria has been at least as oriented towards financial deepening as in Kenya and more so than in Uganda.

To compare the relationship between resource dependence and the stance of central bank policy across countries in a more robust and systematic way, I also employed cross-national statistical analysis. There is no evidence of a significant relationship between resource dependence and the policy stance in relation to financial stability. However, there is some evidence suggesting that in countries which are more dependent on natural resources, the central bank policy stance is less oriented towards price stability and more oriented towards deepening financial sectors by promoting financial access. These two sets of evidence together with the case study provide support for the claim that access to resource revenues encourages a policy stance oriented towards financial deepening.

Conclusion

In this thesis, the approach that focused on structural power has not always been able to explain variation in the orientation of central bank policy. In particular, the case studies indicate that other variables may also affect outcomes and mediate structural power. That said, on balance the combined evidence from the case studies and the statistical analyses does suggest that structural forces rooted in the control over investment resources influence the likelihood of certain central bank policy stances as expected.

7.2 Contributions

This thesis has made four major research contributions. First, it contributes to the literature on structural power by extending its arguments to contexts of dependence for investible resources on aid and natural resource rents. Structuralist arguments have mainly been examined in countries where the structural power of business is high because it provides a significant share of investment resources. However, to further develop and probe the theory of the structural power of capital it is important to also examine the power deriving from the control of capital in contexts where the structural power of business is constrained. This thesis took advantage of the variation across developing countries in the sources of finance on which they rely by examining and comparing how power deriving from the control of capital shapes the orientation of central bank policy in contexts characterised by resource dependence, aid dependence and reliance on private investors.

Second, in order to develop empirically testable propositions I have combined insights from three distinct sets of literature, namely literature on structural power, the political economy of aid and the political economy of resource dependence. I used findings from research on the policy preferences of donors to develop the proposition that the stance of central bank policy in countries more dependent on aid is more oriented towards stability. Based on findings from research on the policy preferences of governments of resource dependent countries, I developed the proposition that the stance of central bank policy in countries more dependent on natural resource rents is more oriented towards financial deepening.

Third, while most research on structural power has used qualitative case study methodologies, this thesis has presented evidence based on a mixed-methods design combining three detailed country case studies and various types of cross-national statistical analysis. Case study evidence has allowed constructing historical narratives showing that variations in the sources of finance on which a country relies may induce changes in the stance of central bank policy over time and the mechanisms through which this may occur. The cross-national statistical analysis consists of three parts: logistic regression analysis of policies to promote financial deepening; logistic and OLS regression analyses of prudential regulation; and TSCS analysis of monetary policy. These analyses have been able to provide some evidence to suggest that cross-national variation in aid or resource dependence accounts for cross-national variation in central bank policy stances. Moreover, the statistical analyses have helped to shed light on the types of populations to which the structuralist propositions may apply and facilitated a comparative assessment of the explanatory power of different variables to measure aid and resource dependence.

Fourth, I have developed quantitative measures of the stance of central bank policy. While the stance of central bank policy is a key concept in this thesis and is important to measure for cross-country comparisons, it is difficult to operationalise. Moreover, there was a lack of off-the-shelf quantitative measures of central bank policy which were adequate for the context of developing countries. Thus, the measures of policy stances I developed were original, while I made considerable effort to balance conceptual considerations and considerations of data availability because data on central bank policy stances in developing countries that is comparable across countries is very limited.

7.3 Limitations and Opportunities for Future Research

Looking to the future, it is important to highlight the limitations of this thesis, in order to point out potentially fruitful directions for further research, and the implications for the debate on the mandates of central banks in developing countries. First, the limitations. Although I opted for a broad and exploratory research design, I had to focus on some research questions and exclude others to keep the scope of the research manageable. I will highlight three of the limitations this creates.

First, although the objective of this thesis was to examine the general orientation of central bank policy, the analysis has not covered all areas of central bank policy. In particular, I focused on monetary policy to evaluate the policy stance in relation to price stability and on financial policy to evaluate the policy stance in relation to financial deepening and financial stability. I excluded the analysis of exchange rate policy although achieving low and stable exchange rates is an important goal of central banks in many developing countries. Given the trade-offs between exchange rate stability and other central bank policy goals, and the importance of low and stable exchange rates for export sectors, an analysis of central bank policy that includes exchange rate policy would be a fruitful area for future research on the structural power of capital.

Second, due to the breadth of the research agenda, the case studies have focused on the power of relatively broad categories of providers of investible resources such as domestic and foreign investors. The case studies have not focused on the subtle differences in the power of different categories of private investors (e.g. portfolio investors, foreign direct investors, international banks and domestic banks) or of donors. Similarly, the case studies have not examined what differences regarding the mobility of capital imply for the structural power of different suppliers of investment funds; for instance Maxfield (1997) examined the implications of such differences in her analysis of the determinants of central bank independence. Focusing on the differences in the structural power of private investors and of donors, and on the role of mobility in shaping these differences, would improve our understanding of the challenges central banks face in promoting access to long-term capital.

Third, I have focused on capturing only a small number of relatively observable causal mechanisms that link the control over investible resources to the stance of central bank policy, notably exit, voice and encouragement of social learning. Thus, the analysis probably excluded other causal mechanisms at work. For instance, I have not examined how path dependence links the control over investible funds to the stance of central bank policy although previous research suggests that central bank policy has elements of path dependence (Maxfield, 1994). In addition, I also did not discuss in greater detail how structural power may shape policy through an alignment of interests between the government and non-state actors. Moreover, the result of the statistical analysis that suggests that aid dependence is associated with a weaker orientation of central bank policy towards price stability raises questions related to the mechanisms through which donors may exert influence. Specifically, through which mechanisms may donors impose constraints on expansionary policy and through which may they encourage expansionary policy? Much remains to be done in capturing the ways through which structural power may translate into policy.

7.4 Rethinking Central Bank Mandates in Developing Countries

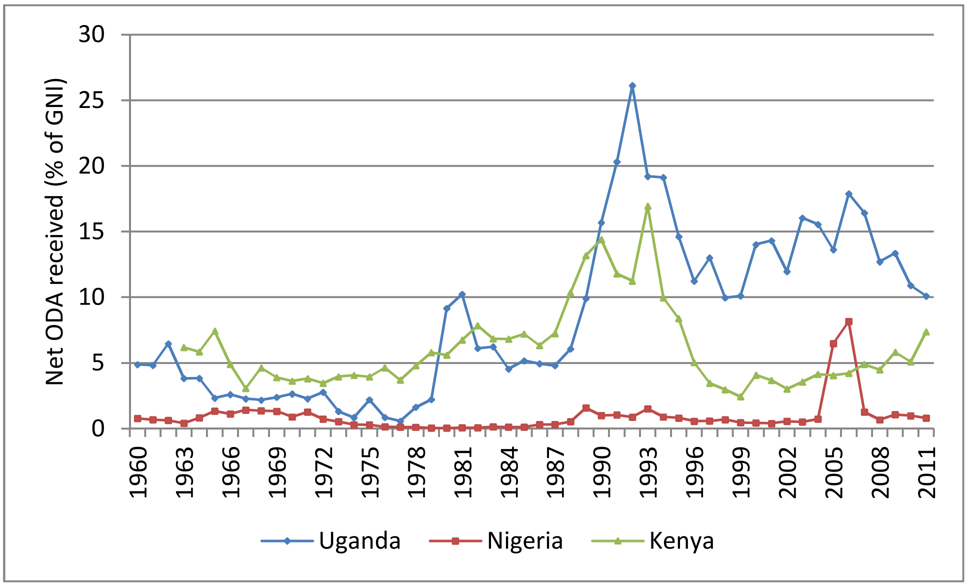
The findings presented in this thesis raise some important questions for the debate on the appropriate mandate for central banks in developing countries I referred to in the introduction of the thesis. I will conclude by raising two of these questions.

First, how feasible is it to adapt central bank policy stances? Often discussions on central bank mandates in developing countries reflect the assumption that central bank roles and goals can be adapted quickly by changing legislation. Although in these discussions, there appears to be an awareness that central bank policy in developing countries often follows some political logic, discussions hardly ever acknowledge the role power relations play in shaping central bank policy, and that this power is often rooted in structural features of the economy. The findings presented in this thesis suggest that central banking may not be amenable to fundamental policy shifts in the short-term owing to the structural sources of central bank policy.

Second, what are the costs and benefits of different central bank policy stances? Arguments related to the advantages and disadvantages of different central bank mandates often reflect ideology. There is very limited empirical evidence that allows comparing the economic and political costs of central bank policy stances oriented towards stability, financial deepening or both. While the case studies make no effort to fill this research gap, they do suggest that a policy stance that emphasises one goal and neglects the other may be costly for developing countries. The evidence presented in the case study of Nigeria suggests that societies may pay a high price if a central bank policy stance oriented towards financial deepening is pursued at the expense of stability. For instance, the costs of cleaning up the balance sheets and recapitalising the banks which failed in the banking crisis of 2009 is estimated by the Nigerian authorities at about 7.5% of GDP (IMF, 2011). The evidence presented in the case study of Uganda suggests that focusing entirely on stability may also come at a price. Many policymakers and donors assumed that with economic stability firmly in place, financial deepening and access to finance would follow in Uganda. Yet the Ugandan story suggests they will not follow necessarily and that more systematic policies to promote financial deepening are important for increasing access to finance. What emerges is thus that there may be benefits to assigning central banks a mandate to promote both stability and financial deepening and to pursuing a balanced approach to stability and financial deepening in countries where central banks have such a dual mandate.

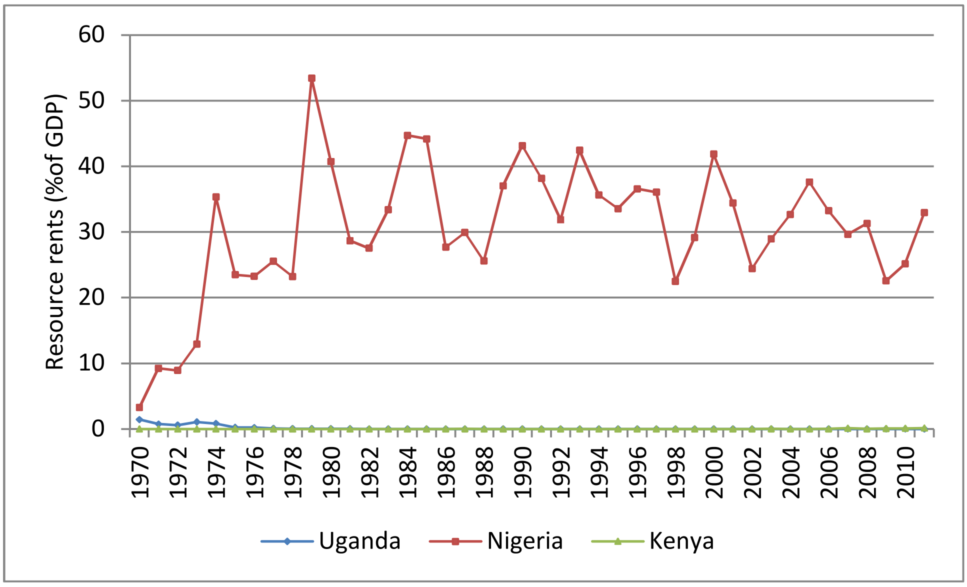
7.5 Appendix

Figure 7.A1: Net ODA Received, 1960-2011



Source: Data drawn from the World Bank (2013c).

Figure 7.A2: Resource Rents, 1970-2011



Source: Data drawn from the World Bank (2013c). Note: Data for resource rents only available from 1970.

Table 7.A1: Central Bank Policy Stances in Kenya, Nigeria and Uganda

Indicator	Kenya	Nigeria	Uganda	25th percentile	Median	75th percentile	Observations
HCapital (binary variable)	0	0	1	0	0	0	115
Capital (continuous variable)	8	8	12	8	8	10	115
CIStr (Index of regulatory stringency)	0.5	0.5	1	0.375	0.5	0.75	115
Team (binary variable)	1	1	0	0	0	1	119
Reform (binary variable)	1	1	1	0	1	1	119

List of Key Interviews[194]

Kenya

Africa Enterprise Challenge Fund
Association of Microfinance Institutions
CBK, former governors
CBK, Monetary Policy Committee
CBK, Research Department
Equity Bank
Family Bank
Fina Bank
Financial Sector Deepening Trust Kenya
GIZ, Macroeconomic Policy Advisor
GIZ, Private Sector Development Programme
IFAD
IMF
Institute of Development Studies, University of Nairobi
Kenya Association of Manufacturers
Kenya Bankers' Association
Kenya Institute of Public Policy Research and Analysis
Kenya Private Sector Alliance
Kenya School of Monetary Studies
Micro Enterprises Support Programme Trust
Ministry of Finance, Economic and Financial Policy Division
Ministry of Planning
Price Waterhouse Coopers
Tax Justice Network
World Bank, various programmes

Nigeria

Access Bank
Africa Finance Corporation
African Institute for Applied Economics
Bank of Industry
Budget Office of the Federation
Bulwark Investments and Trusts Limited
CBN, Advisor to the Governor
CBN, Development Finance Department
CBN, Financial Policy and Regulation Department
CBN, Financial Sector Strategy 2020
CBN, Monetary Policy Department
CBN, Monetary Policy Department, International Economic Relations Unit
CBN, Monetary Policy Committee
Centre for Policy and Economic Research
Centre for the Study of the Economies of Africa
Citibank Nigeria
Consumer Protection Council

[194] The data has been anonymised to ensure confidentiality. Therefore, I only list institutions here.

Covenant University, Department of Economics and Development Studies
Credit Awareness
DFID
Ecobank
Enhancing Financial Innovation & Access (EFInA)
Enhancing Nigerian Advocacy for a Better Business Environment (ENABLE)
Equipment Leasing Association of Nigeria
GIZ, Financial and Private Sector Development Program
IMF
Lagos Business School
Lagos Chamber of Commerce and Industry
Manufacturers Association of Nigeria
Mortgage Banking Association of Nigeria
Nigerian Association of Small and Medium Enterprises
NOI Polls
Oceanic Bank
People and Passion Consulting
Roland Berger Strategy Consultants
Small and Medium Enterprises Development Agency of Nigeria
United Nations Development Program, Financial and Private Sector Development
University of Lagos, Department of Economics
West African Institute for Financial and Economic Management, CBN Learning Centre
World Bank, various programmes

Uganda

Association of Microfinance Institutions of Uganda
BoU, Accounting
BoU, Advisor to the Governor
BoU, Banking Supervision
BoU, Commercial Banking Department
BoU, Financial Stability Department
BoU, former governor
BoU, Governor’s Office
BoU, Human Resources
BoU, Research Department
BoU, Statistic Division
BRAC Uganda
Citibank
Compuscan, Credit Reference Bureau
DFCU Bank
DFID
Economic Policy Research Centre
Fina Bank
Genesis Analytics Consulting
GIZ, Financial Sector Development Program
IMF
Makerere University, Department of Political Science and Public Administration,
Faculty of Social Sciences
Microfinance Supervision Institute (MSI)

Ministry of Finance, Planning and Economic Development, Economic Development Policy and Research Department
Ministry of Finance, Planning and Economic Development, Microfinance Division
Plan for Modernisation of Agriculture in Uganda
Pride Microfinance Limited (MDI)
Stanbic Bank
The Microfinance Support Centre Ltd.
UGAFODE
Uganda Cooperative Alliance
Uganda Development Bank
Uganda Investment Authority
Uganda Private Sector Foundation
Uganda Revenue Authority
Uganda Small Scale Industries Association (USSIA)
USAID
World Bank, various programmes

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