

Monetary policy formulation in Western Samoa

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Central banking is a relatively new institutional development in the South Pacific. Western Samoa is a typical developing country in the region, and provides an interesting case that illustrates the problems of monetary policy formulation in a small developing economy with an undeveloped money and capital market.

Monetary policy and instruments in Western Samoa

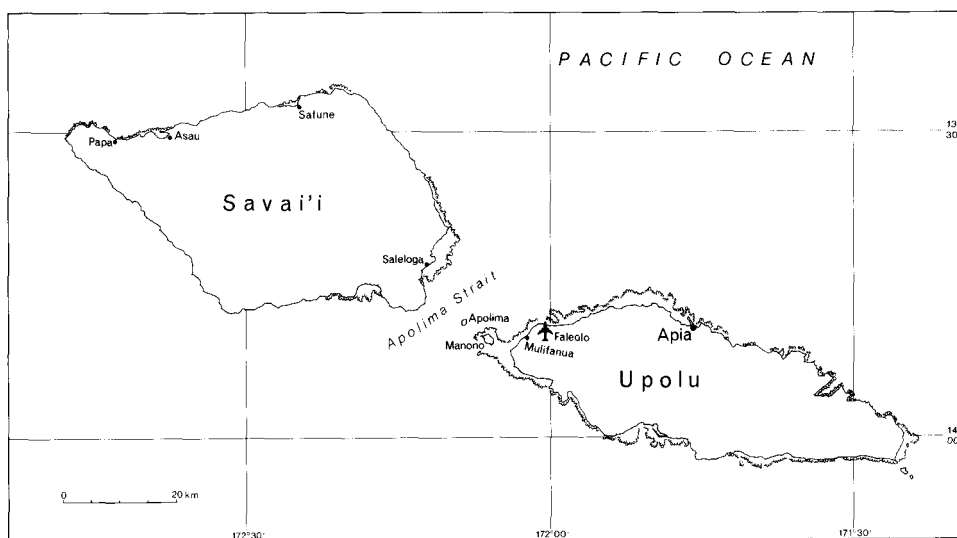
The Central Bank of Samoa commenced operations in 1984. It assumed responsibility, among other things, for the formulation and

execution of monetary policy. It was charged (under the Central Bank of Samoa Act 1984) with the promotion of:

- internal and external monetary stability; and
- credit and exchange conditions conducive to orderly and balanced economic development in Western Samoa.

In accordance with widely accepted precepts of economic policy, the Central Bank is required to achieve these objectives by regulating the supply of money and the cost of credit so as to strike a fine balance between stability and development.

Western Samoa



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The Bank has the following policy instruments to achieve its objectives:

- specification of limits on the aggregate level of lending by banks;
- variation of the minimum statutory reserve requirement and the minimum liquid asset requirement against different classes of deposits and other similar liabilities;
- control of interest rates of commercial banks;
- issue of treasury bills to non-bankholders;
- moral suasion;
- purchase from, sale to, discount or rediscount for banks, treasury bills or private debt instruments;
- variation of the Bank's discounting and rediscounting rates;
- grant of advances to banks; and
- issue and sales of Central Bank debt instruments to banks.

Constraints to monetary policy management

The efficacy of these policy instruments in Western Samoa is drastically limited, as in other small countries with relatively large foreign transactions, by economic and financial conditions.²

Western Samoa is an underdeveloped dual economy with a relatively large non-monetized sector. Subsistence output accounts for over 25 per cent of GDP and approximately 50 per cent of the agricultural production that contributes one-third of GDP.³ Therefore, an important part of the economy is only weakly responsive to market signals and monetary policy impulses.

In addition, there has been a large inflow of funds, equivalent to almost 50 per cent of the gross domestic expenditure (GDE).⁴ Private remittances alone are now equivalent to over one-third of the GDE and over one-half of total commodity imports. These inflows are outside the control of the Central Bank, yet they have a decisive influence on the level and pattern of domestic expenditures, and make the implementation of monetary policy more difficult than it is in most small, open economies.

Financial system

The range of domestic financial assets is extremely narrow. There is no organized equity or securities market, nor is there an inter-bank money market (with only two banks, such a market would have little justification unless the portfolio preferences of the banks were markedly different). There are no other channels for short-term financial institution investments: their foreign holdings are constrained and the issue of short-term government securities is limited. Therefore deposits with the banks are the predominant financial asset available to Western Samoans.

There are only two commercial banks. The larger bank accounts for 70 per cent of total assets and nearly 80 per cent of total deposits in the banking sector. However, the two commercial banks account for only 40 per cent of the loans provided to the private sector and public institutions, with less than 50 per cent of these loans being channelled to non-trading activities. Therefore, the role of commercial banks in promoting investment and growth has been limited.

The seven non-bank financial institutions account for 60 per cent of the loans provided to the private sector and public institutions. More than 90 per cent of these loans are absorbed by non-trading activities. Normally, loans from these institutions are available at interest rates below the commercial bank rates and with longer repayment periods. In addition, consumer credit is available from a number of informal sources.

The Central Bank of Samoa does not have supervisory or regulatory powers over the operations of non-bank financial institutions. Therefore, the Bank's monetary policy measures exert only limited influence on a large segment of the financial system.

The high level of liquid assets in the banking sector has been a regular feature of the monetary system in Western Samoa during the last six years. In 1985, in order to make the banks responsive to domestic monetary policy, rather than being subject to only balance of payments and foreign monetary conditions, the Central Bank required them to sell most of their foreign assets to the Central Bank, thus converting their liquidity from

2 See Graeme S. Dorrance, 'Instruments of monetary policy in countries without highly developed capital markets', *Staff Papers*, Vol. XXII, International Monetary Fund, Washington DC, July 1965 for a general discussion of some of the financial conditions.

3 Asian Development Bank, *National Accounts of Western Samoa 1984-1986*, Economic and Development Resource Center, Asian Development Bank, Manila, 1990.

4 Based on the national accounts estimates in Asian Development Bank, *Key Indicators of Developing Asian and Pacific Countries*, Vol. XXII, Asian Development Bank, Manila, July 1991.

foreign assets to domestic liquidity. As a consequence, their reserves of currency and deposits with the Central Bank shot up to 34 per cent of deposit liabilities from 9 per cent in 1984. Thereafter, because of the lack of sound short-term investment opportunities, it steadily increased to reach a peak of 56 per cent by June 1991 (Tables 1 and 2). This extraordinary monetary condition created three major

implications for the conduct of monetary policy in Western Samoa.

First, the high ratio of reserves to deposits (Table 1), together with the limit of 25 per cent on the reserve requirement under the Central Bank of Samoa Act, makes two of the traditional tools of monetary policy ineffective. Any realistic market intervention by the Central Bank could not have been large enough to bring the ratio down to the 25 per cent limit (see below) and this ratio could not be raised high enough to make it effective. Further, as the bulk of the excess liquidity was concentrated in the larger bank, any increase in the statutory reserve requirement placed the smaller banks in a tight liquidity position.

Secondly, high excess reserves raised the intermediation costs and, with ceilings on interest rates (see below) reduced the average interest spreads and the profitability of banks.

Finally, the imposition of direct credit controls encouraged financial disintermediation by banks, because of the negative interest spread earned on interest bearing marginal deposits.

In more advanced financial markets, the excess reserves of the banking system can be siphoned off by engaging in open market operations or by the issue of various debt instruments. Open market operations have become increasingly important in conducting monetary policy in several Asian countries.⁵ Even less developed island economies such as Fiji, Mauritius and the Solomon Islands have successfully issued central bank securities to sterilize excess liquidity on many occasions, and in Fiji the issue of reserve bank securities has now become a major instrument of monetary policy.⁶ However, in Western Samoa, central bank securities could not be used to effectively sterilize excess liquidity because there was no legislative provision to allow such issues to the non-bank public. Although the Central Bank could issue treasury bills on behalf of the government, there was a limit placed on such issues. Therefore, treasury bills alone could not mop up the excess liquidity in the economy.

Thus, the high level of excess reserves of commercial banks, together with limits on the Central Bank's powers, drastically restricted the techniques available for regulating the

Table 1 Reserves to deposits ratios of commercial banks

Period	Total deposits (Tala million)	Total reserves ^a (Tala million)	Reserves to deposits ratio (per cent)	Adjusted reserves to adjusted deposits ratio ^b (per cent)
1984	43.76	3.87	8.8	-11.9
1985	49.53	16.65	33.5	24.5
1986	65.81	25.96	39.4	26.2
1987	83.15	29.84	35.9	24.0
1988	86.28	31.09	36.0	27.6
1989	102.30	45.53	44.5	36.2
1990	140.39	75.39	53.7	39.8
1991 (June)	135.88	75.71	55.7	39.0

^a Cash at hand and deposits with the Central Bank.

^b Deposits of the Central Bank and the government are excluded from deposits in and reserves of banks.

Source: Central Bank of Samoa, *Bulletin*, Apia, various issues.

Table 2 Commercial banks' liquidity ratios (Tala million)

End of period	Liquid assets			Liquid assets to deposits ratio ^b	
	Actual ^a	Required	Free	Actual	Free
1987	22.38	22.78	-0.40	31.9	-0.6
1988	26.30	24.53	1.67	34.5	2.2
1989	36.48	28.74	7.74	41.0	8.7
1990	46.83	28.26	18.57	43.3	17.2
1991					
1st qtr	45.24	26.74	18.50	44.2	18.1
2nd qtr	42.28	25.06	17.22	42.9	17.5

^a Comprises notes and coin, net deposits with the Central Bank and net deposits with the government.

^b Deposits exclude those of the government and Central Bank.

Source: Central Bank of Samoa, *Bulletin*, Apia, various issues.

5 Wanda Tseng and Robert Corker, *Financial liberalization, money demand and monetary policy in Asian countries*, Occasional Paper 84, International Monetary Fund, Washington DC, July 1991.

6 Research Department, Reserve Bank of Fiji, 'Reserve Bank of Fiji Notes: a new monetary policy instrument', *Pacific Economic Bulletin*, Vol. 5 No. 2, December 1990.

supply of money and credit, and determination of interest rates. Therefore, the persistent high level of excess liquidity can be identified as the major factor that influenced the choice of instruments in managing monetary policy in Western Samoa. In such a situation, policy instruments available for expanding credit were irrelevant.

Monetary policy formulation 1984–89

The evolution of monetary policy in Western Samoa can be divided into two major periods, separated by the emergency monetary measures introduced in February 1990 after the widespread damage caused by cyclone Ofa. Monetary policy prior to February 1990 treated credit expansion as an intermediate target.

Direct credit controls

During its first three years, the Central Bank of Samoa relied on direct quantitative controls on total bank credit to the private sector and public institutions, and these controls have continued to be the major policy instruments used by the Bank.

In 1987, the Bank realized that the continuation of overall credit ceilings was introducing rigidities on and distortions to the financial system, and was encouraging banks to disintermediate. Therefore, limits on total credit were replaced by a deposit-linked credit expansion formula that allowed credit expansion to be a proportion of increases in deposits. This formula was designed to immobilize the existing stock of excess liquidity accumulated in the banking system, and at the same time to provide for growth in bank credit, thereby encouraging financial intermediation. A progressively higher proportion of lending was allowed for increases in long-term deposits so that banks would be encouraged to mobilize genuine savings. These gearing ratios were adjusted from time to time to regulate credit growth.

From the early stages, the Central Bank issued qualitative credit guidelines requesting banks to increase their share of loans for non-trading purposes. In 1988, the banks were directed to reduce the share of loans to the trading sector by at least 5 per cent, to 50–55 per cent by the end of 1988. In 1989, this target was reduced to 50 per cent.

Reserve requirements

On its commencement, the Central Bank continued with the conventional simple statutory reserve requirement, which had been in operation under the Monetary Board. The banks were required to hold currency and deposits

with the Central Bank equal to 7 per cent of their demand deposits and 5 per cent of total savings and time deposits. With the centralization of foreign assets in the Central Bank in 1985, the excess deposits of banks with the Central Bank rose to T12.5 million, or almost five times their required level. Hence, the introduction of the statutory reserve requirement did not impose a liquidity restraint on the banks.

To strengthen its position, in January 1986 the Bank introduced a liquid asset ratio of 20 per cent on all deposit liabilities, in addition to the statutory reserve requirement. Banks' liquid assets were defined to include currency, deposits with other commercial banks, deposits with the Central Bank (excluding the statutory reserve requirement), deposits with the Treasury and government securities. This reduced the banks' free liquidity to about 20 per cent of total deposit liabilities—still a comfortable position but not as uncontrollable as the previous level.

However, the definition of the liquid asset ratio had a major drawback. The banks could utilize deposits of the Central Bank and the government to meet the statutory reserve requirement and the liquid asset ratio on the deposits of the private sector, and also to expand credit. In January 1987 the Bank strengthened its liquid asset ratio policy by redefining liquid assets and applying differential requirements according to the maturity of the deposits. Under the new definition, the claims on the Central Bank (including the statutory reserve requirement) and the government were netted out against the liabilities to the respective institutions. This, in effect, imposed a 100 per cent cash reserve requirement against the deposits of the Central Bank and the government, thereby eliminating their expansive effect on bank credit. The liquid asset ratio became an instrument which successfully limited bank credit to the private sector and public institutions by making credit a function of the deposits of these entities.

Under the disaggregated liquid asset ratio system, a progressively lower ratio was imposed on deposits with longer maturities. Initially, the liquid asset ratio ranged from 32.5 per cent on demand deposits to 20.0 per cent on time deposits of over 24 months. This was intended to induce the banks to mobilize longer-term deposits, so that long-term saving would be encouraged.

In January 1987, the statutory reserve requirement was linked to the liquid asset ratio

by expressing it as a ratio of the minimum liquid asset requirement, rather than of the deposit liabilities. Since then the statutory reserve requirement has been fixed at 25 per cent of the minimum liquid asset requirement, and the statutory reserve deposits have been counted as part of the liquid assets of the banks.

In October 1987, an additional statutory reserve deposit was imposed on bank lending in excess of the credit expansion guidelines. As macroeconomic conditions warranted further tightening of monetary policy in 1988 and 1989, this punitive statutory reserve requirement was raised.

As the bulk of the excess reserves held with the Central Bank originated in foreign reserves transferred from the commercial banks, and thereby reduced the banks' earnings, the Central Bank began to pay interest on holdings above the statutory reserve requirement from early 1985. Although the remuneration of excess reserves resulted in a reduction of the seigniorage benefit to the Bank, this practice was continued in order to discourage a possible rejection of deposits which could occur with the growth of excess liquidity. However, the remuneration rate remained lower than the lowest interest rate paid by banks on interest bearing deposits.

Control of interest rates

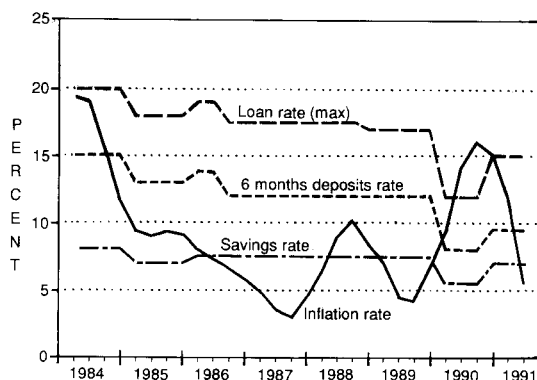
Because of the persistent excess liquidity situation and the extremely limited competition in the banking industry (a feature common among many developing South Pacific countries), there was a risk that interest rates on deposits might fall below the inflation rate, with possible adverse effects on domestic savings and the balance of payments. Therefore, the Central Bank continued the practice of controlling commercial bank interest rates on deposits and loans. To encourage competition, in September 1986 the two banks were allowed to negotiate the interest rates on deposits in excess of T20,000 and also on deposits with maturities over six months.

In determining the interest rate structure, the Central Bank took into account the importance of an adequate spread to promote financial intermediation. Thus, when the interest rates were reduced in 1986, the differential between the highest deposit rate and the maximum lending rate was allowed to widen from 3 per cent to 5.5 per cent.

In contrast to the experience in many developing countries, the regulation of interest rates enabled the Bank to maintain a positive interest rate structure in an excess liquidity

situation. During 1984–89, all regulated interest rates except savings deposit rates remained positive in real terms (Chart 1).

Chart 1 Annual inflation and interest rates (end of quarter)



Monetary policy after February 1990

During 1984–89, the Central Bank attempted to move from direct controls on credit and interest rates to more flexible techniques of monetary control. After February 1990 the direction of monetary policy changed to meet the problems created by cyclone Ofa. The credit directives were suspended, the ceiling on interest rates was reduced and the negotiability of rates on large deposits was withdrawn to facilitate credit flows for reconstruction consequent on the cyclone damage. Therefore, the conduct of monetary policy after February 1990 reflected the Central Bank's response to a different monetary and macroeconomic environment.

Accelerated inflation and rapid growth in money and credit after February 1990 complicated the problems involved in managing monetary policy in an excess liquidity situation. Further, because of the government's desire to postpone the re-adoption of any credit controls until mid-1991, the Bank had to resort to an extremely narrow range of monetary control instruments.

In November 1990, for the first time the Bank shifted the intermediate target of monetary policy to broad money (M2) (currency and demand deposits (money) plus savings and time deposits (quasi-money)). In order to slow the growth of broad money, the Bank decided to issue treasury bills to the non-bank public. While this led some holders to convert their broad money assets into less liquid form, it could not reduce the excess liquidity to make either the liquid asset ratio or the statutory

reserve requirement effective as credit regulatory instruments. Nevertheless, the issue of treasury bills signified the widening of the financial assets available for the investment of short-term funds and thereby the initiation of the development of a money market. The initial issues of treasury bills were limited to public institutions, with the intention of gradually expanding their availability to the general public.

The growth of credit during the first quarter of 1991 appeared excessive when inflation was still at an historically high rate of 12 per cent, and the emerging outlook for the balance of payments was unfavourable. A reduction in the outstanding level of credit was necessary.

Therefore, in March 1991 the Bank exercised moral suasion to control credit, and as a *quid pro quo*, offered Central Bank Securities with three months and six months maturities for the commercial banks to invest their excess liquidity so that the adverse effects of credit control on intermediation costs would be minimized. Although the issue yields of securities did not match the full effective cost of long-term deposits, they were 2.5 to 3.5 per cent higher than the rate of interest paid on excess liquidity held with the Central Bank. Therefore, the effective return on excess liquidity improved.

The primary objective of issuing marketable securities, instead of increasing the interest rate on deposits held with the Bank, was to promote the development of a money and securities market. However, no secondary market activity took place at this early stage because of the banks' desire to hold the securities until final maturity.

With the gradual deceleration of the annual inflation rate (from 15.2 per cent in December 1990 to close to 3 per cent in July 1991) and the slowdown in the growth of credit, the unofficial credit ceiling was replaced in September 1991 with a deposit-linked credit expansion formula with some modifications.

This was followed by an adjustment of interest rates to allow the banks to improve their weighted average interest spread that had eroded steadily since the reduction of interest rates in February 1990. The term lending rate was raised by 2 per cent and the interest rates on deposits with maturities of six months and over, for sums in excess of T50,000, were allowed to be negotiated, subject to a minimum rate of 9 per cent.

Thus the reintroduction of the deposit-linked credit expansion formula combined with the issue of treasury bills and Central Bank Securities enabled the Central Bank to regulate both broad money and credit, and to encourage financial intermediation.

Both the statutory reserve requirement and liquid asset ratio were ineffective in controlling credit in Western Samoa because the level of reserves in the banking system was well in excess of the maximum statutory reserve requirement that can be imposed under the law. The deposit-linked credit expansion formula introduced to circumvent this problem was successful in regulating commercial bank credit growth during 1987-89, mainly because of the backup provided by the punitive additional reserve requirements (Table 3). On the other hand, moral suasion accompanied by the issue of Central Bank Securities was effective in reducing the level of bank credit in the second quarter of 1991.

Table 3 Movements in monetary aggregates and bank credit (end of period)

	Credit ^a		Quasi-money		Narrow money		Broad money	
	Amount (Tala million)	Annual growth (per cent)	Amount (Tala million)	Annual growth (per cent)	Amount (Tala million)	Annual growth (per cent)	Amount (Tala million)	Annual growth (per cent)
1984	29.15	10.2	24.15	24.2	18.63	13.0	42.78	3.1
1985	34.48	18.3	32.44	34.3	19.54	4.9	51.98	21.5
1986	38.93	13.0	41.52	28.0	21.64	10.7	63.16	21.5
1987	43.31	11.2	51.96	25.1	28.71	32.6	80.67	27.7
1988	46.44	7.2	56.73	9.2	30.25	5.3	86.98	7.8
1989	46.69	0.5	68.29	20.4	33.16	9.6	101.45	16.6
1990	61.88	32.5	73.69	7.9	47.28	42.6	120.97	19.2
1991 1st qtr	64.34	20.6	71.68	-0.9	41.79	31.5	113.47	9.0
2nd qtr	64.02	12.8	75.02	-2.2	33.55	-0.5	108.57	-1.7

^a Bank credit to the private sector and public institutions only.

Source: Central Bank of Samoa, *Bulletin*, Apia, various issues.

Table 4 Sources of money supply (Tala million)

Sources of money supply	1984	1985	1986	1987	1988	1989	1990	June 1991	December 1984 to June 1991
1 Net foreign assets	2.50	5.25	24.64	25.69	31.69	32.58	37.53	11.27	168.65
2 Domestic credit	1.87	4.65	-10.93	-13.63	-18.41	15.20	-1.23	-32.17	-86.97
2.1 Government net	-0.82	-0.78	-15.43	18.00	-21.54	-15.46	-16.42	-34.31	-121.93
2.2 Private sector and public institutions	2.69	5.43	4.45	4.37	3.13	0.25	15.19	2.14	34.96
3 Net other items	-3.09	-0.70	-2.48	5.45	-6.97	-2.91	-16.78	8.50	-15.89
4 Broad money (M2)	1.28	9.20	11.18	17.51	6.31	14.47	19.52	-12.4	65.79

Source: Central Bank of Samoa, *Bulletin*, Apia, various issues.

The restrictions of monetary policy in 1984-90 were partially offset by the lending of the non-bank financial institutions, which was outside the Central Bank's control. This increased by T47 million or 113 per cent, compared with T32 million or a 110 per cent rise in commercial bank credit to the private sector and public institutions.

The selective credit guidelines issued by the Bank had very limited effect on the commercial banks' loan portfolios. The share of loans in the trading sector declined slowly from 61 per cent in 1984 to 52 per cent in March 1991.

The predominance of the trading sector in the loan portfolios of the commercial banks, as in many other countries, is largely a result of the prevailing economic and monetary conditions in Samoa. Partly, there was no incentive for commercial banks to provide loans for production-oriented activities that were normally riskier than the short-term advances extended for trading purposes.

The credit regulatory measures were inadequate to have full control over money supply in Western Samoa. During most of the period through 1989, broad money grew faster than credit (Table 3). The reasons for this can be understood by analysing the sources of money in Western Samoa.

During the period between December 1984 and June 1991, broad money supply rose by 153 per cent or T66 million, mainly because of the substantial build-up of net foreign assets stemming from the balance of payments surpluses and a smaller increase in credit to the private sector (Table 4). These balance of payments surpluses were generated entirely by the large inflows of remittances and external assistance (Table 5). In particular, a loan of T20 million received from the Asian Development Bank accounted for over 50 per cent of the overall surplus in 1990. Net foreign assets

posted a phenomenal rise from a mere T2.5 million in 1984 to T169 million in June 1991 (Table 4). Consequently, during the same period, the ratio of net foreign assets to money stock (broad money) shot up from 3 per cent to 156 per cent. Thus, the rise in the money supply was more than accounted for by external factors that were almost entirely beyond the control of the Central Bank. On the other hand, the government's net deposits with the monetary system rose substantially between December 1984 and June 1991, exerting the largest contractionary effect on money supply.

The issue of treasury bills was important in containing the growth of broad money to 19 per cent in 1990. In the absence of treasury bills, broad money would have expanded by 27 per cent. Yet, these contractionary influences were inadequate to fully offset the expansionary impact of the balance of payments surpluses.

Table 5 Analytic presentation of balance of payments, 1984 and 1990 (Tala million)

	1984	1990
A External earnings	50.7	103.3
(i) Exports of goods	34.2	20.5
(ii) Services	16.5	82.8
B External payments	111.8	222.8
(i) Imports	93.2	186.1
(ii) Services	18.6	36.7
C External payments gap	-61.2	-119.5
D Financing of gap	63.7	157.1
(i) Private transfers	37.8	92.0
(ii) Capital (net)	25.9	65.1
E Overall surplus	2.5	37.6

Source: Central Bank of Samoa, *Bulletin*, Apia, various issues.

Conclusion

The conduct of monetary policy for the realization of the goals enshrined in the Central Bank of Samoa Act has been somewhat constrained by the economic, financial, legal and social conditions in Western Samoa. The Bank faced a dilemma in regulating credit and promoting financial intermediation simultaneously because of the presence of a large volume of excess reserves in the banking system.

Foreign remittances that contributed to the expansion of money supply exerted pressure to lower interest rates and appreciate the exchange rate. In such a situation, market clearing interest and exchange rates would have aggravated the already negative domestic savings rate⁷ and discouraged exports. Therefore, the Bank had to remunerate excess reserves and contend with relatively high interest spreads between deposit and lending rates of banks.

The Bank has already initiated action to create an environment conducive to more efficient conduct of monetary policy. A new Financial Institutions Bill has been drafted to allow the Central Bank to extend its supervisory and regulatory powers over the non-bank financial institutions. Legislative provisions are also being made to allow the Central Bank to issue its own securities to the non-bank public.

These amendments will widen the array of instruments available to the Central Bank to conduct monetary policy more effectively, but alone they are insufficient. As in other devel-

oping countries, the development of the financial system and the economy is essential for monetary policy to be fully effective. Policy initiatives combined with an intensification of economic activity are essential if the process of financial market development is to be fully realized.

One of the most important policy initiatives will be to create a competitive environment in the financial sector. It is essential to encourage the entry of new financial institutions and the introduction of new financial assets (such as securities, shares and bonds) to improve the mobilization of savings and the diversification of financial resources to productive activities. For example, the public sector institutions that presently depend on government budget funds, can be encouraged to mobilize savings from the non-bank public by issuing various debt instruments. Policy measures are also necessary to induce the integration of various segments of the financial market so that monetary policy impulses will be transmitted to the entire sector.

The development of money and capital markets is a long term process. It has to evolve with economic advancement. Until this occurs, fiscal policy will have to play a major role in maintaining price stability and promoting balanced development, particularly when an excess liquidity situation arises in the economy. In this regard, the build-up of government deposits with the Central Bank will be very effective in regulating money supply. It can also create more room for the expansion of credit necessary for the growth of the private sector.