CENTRAL BANK INDEPENDENCE

The question of Central Bank independence has attracted a lot of attention in the aftermath of global financial crises of 2008/09. The rationale for independence of Central bank was reinforced by the need to prevent and limit panics in the financial markets. The theoretical justification of this independence arises from the premise that an independent Central bank is "a device to overcome the problem of time consistency: the concern that policy makers renege in the future on a policy promise made today. Keeping inflation low and stable requires a credible policy commitment to price stability that will from time to time, be highly unpopular". Such credibility and pre-commitment can only be believed by the markets if those giving such assurance are free from pressures of political expediency . The proponents of the independence argue that it was the initiative and effectiveness of Central bank's monetary policies that helped in averting enormous economic and financial losses. They also point to success of anti-inflationary policies pushed by the central bank all over the world. Since 1980's after two oil price shocks. Empirical studies have shown that inflation and actual independence of central bank are negatively related in both developed and developing countries. In crude non rigorous languages it implies that the countries which have independent central bank would have relatively lower inflation compared to those where such independence does not exist.

Those opposed to the independence are concerned about the legitimacy of the decisions taken by a group of unelected technocrats not. The actions of the Central banks affect the consumers, producers, investors, businesses, households in a variety of ways but these economic actors have no recourse to hold the Central bankers accountable for their actions. The central banks run mainly by technocrats thus lack political legitimacy behind their actions.

Thus there is an inherent conflict between the effectiveness of policy and legitimacy of policy makers. The uneasy tension that characterizes the relations between Ministers of Finance and Central Banks all over the world is in fact a manifestation of this conflict. There are distributional consequences of economic policies--- winners and losers--- and the elected officials do wish to ensure that their winners are their supporters and constituencies while the Central bank would strive that the benefits and losses are showed as widely as possible across the population.

Before we get into the substantive question of independence it is useful to focus on the role of a central bank. If the role is single minded focus on monetary policy or the price stability then the Central bank independence and monetary policy independence are the same . The situation become more difficult in the developing countries where the role of the central bank encompasses multiple objectives such as growth, employment, financial inclusion in addition to price stability and financial stability. The successful pursuit of these objectives can take place only by a joint collaborative effort of the federal, provincial, local governments and the Central banks. Fiscal and monetary policy coordination therefore become critical in achieving the desired results. Therefore the preferred option is to design a mechanism in which the *Central bank is not independent of the government but independent within the government.* What it implies in actual practice is that targets of economic growth, unemployment rate, inflation and other macroeconomic indicators are set by the democratically elected representatives in

consultation with the Central bank but the latter enjoys operational autonomy and the freedom to choose the appropriate instruments to achieve the given targets particularly in the areas of inflation, interest rate, exchange rate, financial sector soundness etc. In case of Pakistan , the targets are set by the National Economic Council (NEC) a constitutional body headed by the Prime Minister and consisting of the Provincial Chief Ministers, Finance Minister, four Federal Ministers to which the Governor State Bank Of Pakistan and other key economic officials are invited on a standing basis. The responsibilities for achieving the various targets cannot be assigned exclusively to any particular ministry or agency. To illustrate this point, let us take the example of inflation rate. Although under the SBP Act this is the responsibility of the Central bank but if the fiscal policy is expansionary and the deficit can only be financed through borrowing from the banking system then this conflict between a tight monetary policy to contain inflation and an expansionary fiscal policy to meet the budget deficit would have serious repercussion upon the achievement of the inflation target. Alternatively, if the food supply falls short of the demand, food prices are bound to rise and as forty percent of CPI is derived from food prices, the monetary policy instruments that work on the aggregate demand side in short term may not be able to contain inflationary pressures. Therefore policy coordination and consistency require trade-offs and these decisions can only be taken at the highest political level. It is the government of the day that has to face the wrath of the population who have brought them into power and they have to be accountable for the end results. The path chosen to reach the inflation target is specified but once the, target and the overall direction are set, the State Bank should be left alone to choose the strategy and instruments for meeting the target within the specified parameters. The path is not too smooth for the Central Bank to tread all the time and conflicts still take place despite clarity of goal and policy direction..

The interference in the monetary policy arises, for example, when the policy interest rates are high and the politicians want these rates to be cut down because they believe lower rates would stimulate investment and output growth. As the time horizon of the politicians is limited to the five year electoral cycle they express anger, frustration and at times open criticism of the Central bank if they find that they would not be able to take advantage of the benign effects of lower interest rates during their tenure of office. If the Central bank sticks to its guns, the ruling party in power resorts to heavy public spending which is financed by the banking system at high costs. The government is not pushed and leaves a heavy public debt stock and public debt servicing liabilities as legacy for the successor governments . The fiscal crises in Pakistan at the time of changes in government in 1999, 2007 and 2013 when the governments had no other option but to approach the IMF for bail out owe much to the electoral politics compulsions. Hence despite a strong independent Central bank the governments are still capable in practice of producing pernicious effects on the economy..

In many developing countries, an explicit inflation targeting goal is specified and the performance of the Central bank is judged against that commitment. The loss of credibility is something that the Central bank have to zealously safeguard against. This instrument independence requires the Central banks to have a transparent framework that would permit accountability for results. In many jurisdictions, the governor of the Central bank has to write a letter to the Minister of Finance explaining the reasons for deviations in actual performance from

the set goal. This letter is made public and analysts, legislators, experts and the media can analyze the explanatory factors and come to conclusion whether the reasons for the deviation were legitimate or a result of incompetence, slack, or ultimately action. In Pakistan there is no explicit quantitative inflation targeting framework and hence such an exercise is not carried out. But in its Annual Report to the Parliament the SBP does attempt to provide an analysis as to why some targets were missed, achieved or exceeded – particularly in the areas of monetary and financial stability. Of course there is room for improvement and the depth and quality of such analysis can be further enhanced. The consumer confidence surveys do provide insights about inflationary expectations that can be anchored in monetary policy choices.

The difficulty in ensuring transparency arises in case of financial stability mandate assigned to the Central Banks. Unlike the monetary policy, the quantitative framework for monetary policy , that for financial stability that makes it amenable to transparency and accountability is not so well-developed. There are Financial Soundness Indicators for the system as well for individual institutions, stress test are carried out regularly, macro prudential regulations are enforced when needed but the privileged information about the health of individual financial institutions is available only to the regulators and cannot be disclosed to the public due to the fear of runs on the banks, panic and systemic risk to the financial system. When any of these institutions do run into difficulty and cause harm to depositors, investors, bond holders, the credibility of the regulator is challenged. Accusation of the undue concentration of power in the hands of unelected and nonresponsive technocrats become common place and pressures on governments and parliaments to contain the independence of Central banks do intensify.

To conclude, the popular debate about 'independence' vs 'lack of independence ' of Central banks is both flawed and misplaced. The Central banks cannot be entrusted with 'goal independence' but should enjoy 'instrument or operational independence'. However the conflict between the policy credibility and effectiveness and legitimacy of the Central bank can be mitigated to some extent through greater transparency and accountability. If the Central banks have only a single goal mandate such as price stability then the accountability is easier to ensure but if there are multiple objectives then the framework for transparency and accountability becomes more entangled and challenging. In the aftermath of global financial crisis of 2008/09 financial stability has become a prime goal but the tools and instruments to develop a robust, forward looking quantitative framework to provide early warning signals without triggering panic or disequilibrium in the markets is not easy to assemble. Judgement calls by the regulators would continue to form an integral part of the decision making with all its attendant risks. An added layer of oversight on the Central banks would lead to confusing signals to the markets and create greater uncertainty impairing economic performance. At the same time unfettered freedom to a group of technocrats without strong accountability for their actions is equally risky.