T T Mboweni: Central bank independence

Speech by Mr T T Mboweni, Governor of the South African Reserve Bank, at the Reuters Forum Lecture, held in Johannesburg, on 11 October 2000.

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"Independence signifies ignoring pressures, whatever its source. The independence of central banks goes, ... beyond independence from political, executive and legislative power. For me it also equates with independence from private or collective economic interests, autonomy versus the short term, frequently imposed by capital markets and, finally, freedom of action *vis-à-vis* the monetary policy of other central banks."

Prime Minister Lionel Jospin. Paris, May 2000.

1. Introduction

I am extremely pleased at this invitation to present this inaugural address in the Reuters Forum Lecture series. This is an important initiative and I wish you well for the sustained success of this lecture series.

We have chosen to discuss the issue of central bank independence since the topic is both current and highly significant. Incidentally when the Banque de France organised their bicentennial celebrations in May this year, they chose the topic of central bank independence as the theme for the colloquium.

At the said Banque de France colloquium, the Prime Minister of the French Republic, Monsieur Lionel Jospin remarked that: "the increased power and influence of central banks, the greater visibility of their role and their leaders, have inevitably focused attention on their role, their efficiency, the principles underlying their actions and, in some cases, their place in the democratic way of life."

Central banking is of cardinal importance in any country because of the legal right normally granted to central banks to create money. This money can serve as a means of payment, a unit of account and a store of value. One of the important issues immediately arising after granting this right to a central bank, is whether this function should fall under the ultimate control of the executive branch of government - the cabinet and its administrative departments - or whether parliament should leave this responsibility to be freely executed by an independent, autonomous powerful institution run by unelected people.

2. Advantages of an independent central bank

The traditional argument in favour of a strong, independent central bank is that the power to spend money should in some way be separated from the power to create money. Numerous episodes in the world's economic history testify to a government's potential abuse of its power to create money. Around the third century AD in the Roman Empire, for instance, the silver coins collected by the tax authorities were melted and combined with inferior metals, yielding many more coins to spend on the Caesar's priorities than the initial tax take. With too much money chasing too few goods, the end result was high inflation.

Much the same has happened all too frequently with paper money systems. Many governments have given way to the temptation to reduce interest rates ahead of elections. This may boost spending and employment in the short term, but ultimately it usually also causes higher inflation over the long term, unless the capacity of the economy can meet this higher level of demand. This higher inflation, however, only becomes apparent a couple of years later. An elected government concerned about its immediate popularity might be tempted to go for the short-term gains from lower interest rates, even at the risk of promoting somewhat higher inflation further down the road, because some other political party may then have to pick up the pieces.

Central bankers normally operate on a longer-term time scale than politicians and therefore do not face the same temptation to relax policy to achieve short-term objectives. By delegating decisions about interest rates and other monetary matters to such an independent institution, with a clearly defined mandate, society can hope to achieve a better inflation outcome over the longer term.

A number of studies have been undertaken to determine whether this argument is valid. These studies all seem to come to the following three conclusions. ***Firstly***, they provided evidence of a negative correlation between central bank independence and long-term inflation. A low inflation rate is therefore more likely to be found in countries with independent central banks than in countries where the central bank is subject to government control. ***Secondly***, they showed that there is a negative correlation between central bank independence and the long-term budget deficit expressed as a percentage of a country's gross national product. Countries with independent central banks tend to have smaller budget deficits than those with government-controlled central banks. ***Thirdly***, the studies in general did not find any evidence of a correlation between the independent status of a central bank and production growth. It therefore does not follow that production or employment will suffer as a result of the independent status of the central banks over the medium to long term.

3. Risks of central bank independence

Some critics of an independent central bank argue that although the average inflation rate and the degree of central bank independence are negatively correlated, this relationship does not reflect any causal link running from central bank independence to low inflation. They argue that countries where the electorate is particularly averse to inflation, are more willing to keep inflation down. These countries are also more likely to have made their monetary authorities functionally independent so as to help preserve low inflation. Germany, affected severely by the hyperinflation of the Weimar Republic, is an obvious case in point.

Conversely, countries where the electorate are more tolerant of inflation, are also less inclined to see monetary policy turned over to an autonomous central bank. These critics claim that average inflation is determined by history and the preferences of a country's inhabitants with causality running from inflation to the institutional structure. According to this view, attempts to impose an independent central bank and with it a more purposeful anti-inflationary stance in a country tolerant of inflation, are doomed to failure. The outcry against restrictive policies would simply be too great for the central bank to withstand.

This argument is not very convincing and does not seem to fit, for instance, the recent experience of New Zealand. For most of the postwar period the Reserve Bank of New Zealand was one of the least independent central banks in the OECD. However, in 1988 it was transformed into one of the most autonomous, with a very clear mandate to fight inflation. This helped the inflation rate to plummet from double-digit levels to under 2%, which strongly suggests that the structure of monetary institutions together with the determination to combat inflation, can be highly successful.

Another argument against the autonomy of central banks is that they form part of overall economic policy and that there can be no meaningful separation between fiscal policy, monetary policy, labour policy, trade policy or for that matter any other policy measures. If such a separation is attempted and if policies run at cross-purposes, then conflicting objectives will have to be solved one way or another. In the process, a conflict between the policies may inflict considerable damage on the economy. There is clearly substance in the argument that a tightly coordinated package of policies has a better chance of success than a set of conflicting ones. It can nevertheless be argued that such conflicts may be inevitable over the short term, as long as central banks have the primary responsibility for controlling inflation. However, over the long term, stable financial conditions promote sustainably higher economic growth rates, increased welfare and more employment opportunities.

The main criticism against making central banks autonomous entities is based not so much on economic as on political arguments. The political argument is that turning over decisions about interest rates, exchange rates, the efficiency of the financial system and other monetary matters to a body of unelected officials, is simply “undemocratic”. In a democratic society, it is argued, all decisions should be subject to scrutiny by the elected members of the legislature and the concept of an autonomous central bank is therefore not acceptable. Although there are plenty of other areas of national life where decision making is delegated to independent unelected officials - the judiciary is a prime example - there is a fundamental confusion here between being independent and lacking accountability. No central bank can be totally independent, in the sense that it is not answerable to anyone. Even the most autonomous central bank has to report in some form or another to the legislature, which in any case also has the ultimate power to change the laws governing the central bank. All the same, there is a difference between a situation where policy decisions are under continuous scrutiny, and an arrangement where the central bank reports to the legislature periodically.

The issue of independence and accountability also turns on the nature of the relationship between the government and the legislature as the political authorities on the one hand and the central bank on the other. At the same colloquium mentioned above, Monsieur Jean-Claude Trichet, Governor of the Banque de France, observed that: “respecting independence does not mean a lack of dialogue, on the contrary. However, it is true that an independent central bank is neither accountable to the executive power, nor to parliament, nor any other political institution. In France this was decided by the law makers, and in Europe by the will of the people and the European Parliaments, which ratified the Maastricht Treaty.”

In the case of the European Central Bank (ECB), the independence of the Bank is explained under Article 7 of the Statute which says that: “When exercising the powers and carrying out the tasks and duties conferred on them by this Treaty and this Statute, neither the ECB, nor a national bank, nor any member of their decision-making bodies shall seek or take instructions from community institutions or bodies, from any government of a member state or from any other body.”

The key issues here quite clearly are independence, accountability and dialogue with the political authorities.

In South Africa the Governor of the Reserve Bank must submit a report annually to the Minister of Finance relating to the implementation of monetary policy. In terms of Section 32 of the Reserve Bank Act, the Bank must also on a monthly basis submit a statement of assets and liabilities and annually its financial statements to the Department of Finance. These reports are then tabled in Parliament by the Minister of Finance.

Moreover, Section 37 of the Act provides further that if at any time the Minister of Finance is of the opinion that the Bank has failed to comply with any provision of the act or of a regulation made thereunder, he may by notice in writing require the Board of the Bank to make good or remedy the default within a specified time. If the Board fails to comply with such a notice, the Minister may apply to the Supreme Court for an order compelling the Board to make good or remedy the default, and the Court may make such order thereon as it deems fit.

4. Conditions for independence

In view of these risks involved in central bank independence, there are usually three preconditions for central bank autonomy. Firstly, there should be a clearly spelled out legal and operational framework in which monetary policy is conducted. In the legal framework, the central bank’s independence should be defined to avoid any misconceptions of what the central bank is supposed to achieve. In the monetary policy framework, the central bank must indicate what it is attempting to achieve, what operational variables it will apply and what monetary instruments it will use to achieve its objective. Because credibility is usually not gained overnight, it is important that a longer-term programme should be drawn up to show how the central bank will fulfil its mission.

A second condition for greater autonomy is transparency. The government and the public should continuously be informed of the monetary policy programme followed by the central bank. Regular discussions between the central bank and the government will be necessary and some form of accountability to parliament will have to be established. It is also important to explain monetary policy decisions regularly to the public, together with an assessment of the progress made in achieving stated objectives. Priorities in the programme as well as operational instruments should be clearly spelled out, in order to keep the public well informed about developments and changes in monetary policy.

The third condition for central bank autonomy is the creation of an efficient institutional framework within which decisions on monetary policy and on its implementation can be made, without undue interference by political functionaries. This involves decisions regarding:

(i) functional independence, which means the right to decide on all matters regarding monetary policy and price stability;

(ii) personnel independence, which covers the selection and appointment of Board members with a high professional competence and without an obligation to yield to political and other pressures;

(iii) instrumental independence, which means control over the instruments that affect the inflation process, including in particular the prevention of any direct financing of government deficits; and

(iv) financial independence, which requires the central bank to have access to adequate financial resources of its own and full control over its own budget.

5. Legal and operational procedures in South Africa

The *legal framework* may provide an important foundation on which independence can be built, by giving clearly defined tasks to the central bank and demanding compliance in carrying out those tasks. By the early 1990s, when South Africa's Constitution was being drafted, central bank independence had already become a fairly widely accepted element of sound central banking in the international debate. This acceptance was shaped by the dismal experience of the many countries that had suffered high inflation in the 1970s and 1980s. Both the interim and the final Constitution of the Republic of South Africa therefore provide for an independent central bank. Section 224(2) of the Constitution states very clearly: "The South African Reserve Bank, in pursuit of its primary object must perform its functions independently and without fear, favour or prejudice, but there must be regular consultation between the Bank and the Cabinet member responsible for national financial matters."

In operating within this legal framework, the Reserve Bank has indicated that its primary goal in the South African economic system is the achievement and maintenance of financial stability. The Bank believes that it is essential that South Africa has a growing economy based on the principles of a market system, private and social initiative, effective competition and social fairness. It recognises, in the performance of its duties, the need to pursue balanced economic development and growth.

In the pursuance of its responsibilities, the Reserve Bank assumes responsibility for:

(i) assisting the government, as well as other members of the community of South Africa, in the formulation and implementation of economic policy;

(ii) formulating and implementing monetary policy in such a way that the primary goal of monetary policy will be achieved in the interest of the whole community;

(iii) ensuring that the South African money, banking and financial system as a whole is sound, meets the requirements of the community and keeps abreast of developments in international finance; and

(iv) informing the South African community and all interested stakeholders abroad about monetary policy generally, and the South African economic situation in particular.

As is well known, South Africa adopted a formal inflation-targeting framework for monetary policy in February of this year. Time does not allow a long discussion of this framework. However, it may be noted that it makes the aim of monetary policy much clearer, ie the achievement of an average annual increase of 3 to 6% for CPIX inflation in 2002. The government chose to set the 3 to 6% target level. The setting of monetary policy instrument values (like the level of the "repo rate") is entirely up to the

Reserve Bank. Therefore the inflation-targeting variable chosen provides for the instrument independence of the Reserve Bank, but not goal independence.

By means of the mission statement and an explanatory memorandum about the adoption of an inflation-targeting monetary policy framework, the public has been informed about the objectives of monetary policy. On the basis of this information the public can therefore evaluate the actions of the Reserve Bank in attaining these objectives.

6. Transparency of monetary policy

The South African Reserve Bank also fulfils the second condition for independence, namely transparency. Government and the public are provided with a stream of information on the monetary policy stance. Some of my staff and I regularly appear before the Parliamentary Portfolio Committee on Finance. We also issue comprehensive statements following each meeting of the Bank's Monetary Policy Committee. The Reserve Bank's Quarterly Bulletin, Annual Economic Report and Governor's Address at the annual meeting of shareholders provide comprehensive analyses of macroeconomic events. A six-monthly Monetary Policy Review will soon be introduced, describing in more detail the decisions taken by the Reserve Bank. Policy is also explained by the Governors of the Bank and comments on policy are heard at the Monetary Policy Forum meetings. These meetings are held twice a year in the main centres - at least one in each province - and involve organised business, labour, politicians, academics and the media.

7. Institutional independence in South Africa

Finally, the present institutional framework in South Africa in the form of the South African Reserve Bank Act, Act No 90 of 1989, allows the Reserve Bank a great degree of autonomy in its operations.

The Reserve Bank's functional independence in monetary and related policies is clearly stated in Sections 10 and 35 of the South African Reserve Bank Act. Section 35 empowers the Board of the Bank to make rules "for the good government of the Bank and the conduct of its business". In Section 10 the powers and duties of the central bank are spelled out in great detail. Most of the functions described in this section are the normal functions that one would expect a central bank to perform. Section 10(2) also clearly states that "the rates at which the Bank will discount or rediscount the various classes of bills, promissory notes and other securities, shall be determined and announced by the Bank from time to time", plainly giving the Bank the right to determine Bank rate, or rather the repo rate, in an autonomous manner.

As banker to the government, however, the Bank administers exchange control regulations, monitors the prudential soundness in the banking system and handles the weekly tenders for Treasury bills and government securities. The Reserve Bank also takes care of various aspects of South Africa's dealings and relations with institutions such as the International Monetary Fund and the World Bank on behalf of the government. In performing these activities, the Bank only acts as an agent of government and the final responsibility and decision-making rest with the Minister of Finance. This kind of activity can undermine the functional independence of the Reserve Bank.

The personnel independence of the Reserve Bank is determined in Section 4 of the Act, indicating the conditions of appointment of the Governor, three deputy governors and other Board members of the Reserve Bank. This section clearly precludes any person actively involved in politics, non-residents or officials of private banks from becoming a member of the Board of the Bank. Seven of the directors, including the Governor and three deputy governors, are appointed by the President of the Republic, and the other seven are elected by the shareholders. By means of these appointments the government, of course, does, as some would argue, have an effective say in the policies of the Bank. The governors, however, after their appointment, normally operate independently without fear or favour.

Certain conditions are given in the Regulations under the Reserve Bank Act which will disqualify a person for remaining a Board member, such as conviction for theft, fraud, forgery or perjury. However, mechanisms for the dismissal of governors are not entrenched in the Act. Grounds for dismissal and the actual procedure could perhaps be more explicitly stated in legislation to improve the functioning of the Reserve Bank. Consideration could also be given to lengthening the tenure of office of the Governor and deputy governors, say to seven years, to improve the autonomy of the Bank further by separating the five-yearly political cycle from the appointments of governors.

The instrumental independence of the Reserve Bank is also clearly spelled out in the Act and the Reserve Bank is precluded in Section 13(f) from making excessive direct purchases of government stock. This section states that the Bank may not "hold in stocks of the Government of the Republic which have been acquired directly from the Treasury by subscription to new issues, the conversion of existing issues or otherwise, a sum exceeding its paid-up capital and reserve fund plus one third of its liabilities to the public in the Republic". This section therefore restricts the direct financing of government deficits.

At the same time, the Act also allows the Reserve Bank to provide unsecured loans and advances to government and companies in which it has acquired shares. Although there are limits on government borrowing, serious consideration in the revision of the Reserve Bank Act should be given to removing this potentially dangerous provision.

The South African Reserve Bank is also financially independent from the government because of its adequate financial resources and full control over its own budget.

8. Conclusion

In pursuing financial stability, the South African Reserve Bank is relatively well aligned with international best practice. It operates autonomously within a legal framework which affords it a substantial degree of independence, while remaining accountable to Parliament. But ultimately it is the appreciation by the public at large of the importance of financial stability, and their understanding of and support for the role of the Reserve Bank in this regard, that is needed to entrench and develop the Bank's independence. To this end, ongoing communication between the Reserve Bank and all levels of society is essential. In this connection, Governor Jean-Claude Trichet asked the question: "So to whom is the central bank accountable? In the end, I think it is accountable to public opinion itself. It is our great responsibility to communicate with public opinion as a whole, and not just market operators and investors. This communication must be as direct and precise as possible, in terms as simple as the subject matter allows while remaining very professional."

While we are fully aware that we face many daunting challenges, it is gratifying to note the degree of financial stability that has been attained over the past years. And it is exciting to note that financial stability provides a sound basis for sustainable strong economic growth and development; more and more evidence suggests that central bank independence and prudent policies in general are starting to pay off in South Africa.