Caleb M Fundanga: The central bank, the media and the legislature – can they work together?

Remarks by Dr Caleb M Fundanga, Governor of the Bank of Zambia, at the 35th anniversary of the Central Bank of Swaziland, Mbabame, 21 May 2009.

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Governor M.G. Dlamini,
Fellow Central Bank Governors,
Your Excellencies the Members of the Diplomatic Corps,
Distinguished Guests,
Ladies and gentlemen,
And May I simply Say All Protocol Observed,

Mr. Chairman, it is indeed a great pleasure for me to be with you today as we commemorate the 35th Anniversary of the Central Bank of Swaziland. I consider it a great honour and privilege, on behalf of the Bank of Zambia and indeed on my own behalf, to have been invited to give a keynote speech at this historic event.

Mr. Chairman, allow me to first of all congratulate the Central Bank of Swaziland, the Government and all other stakeholders for having come a long way in promoting the effective conduct of monetary policy in this great country over the last 35 years. We at the Bank of Zambia have noted the important role that the Central Bank of Swaziland has played not only in the development of the Swazi economy, but in enriching the knowledge of central bankers throughout the region, through its participation in the regional groupings such as the Committee of Central Bank Governor's in SADC. Therefore, as you celebrate this great milestone, we join you in anticipating further progress and effectiveness in the execution of your mandate.

Mr. Chairman, the central theme of my address today is the important role that information plays in economics in general and in financial markets in particular. In 1970, some 39 years ago, or 4 years before the establishment of the Central Bank of Swaziland, an economist called George Akerlof published a paper called "The Market for Lemons." By lemons he was referring to used cars in the United States of America. Akerlof, who would later win the Nobel Prize in Economics for his work, demonstrated how information asymmetries between two contracting parties, a used car seller and a used car buyer, could lead to an inability of the car dealer to sell cars. More broadly, the moral of his story was that information asymmetries that allowed for no credible assessment of value of a given transaction, could lead to market collapse – in this instance the market for used cars.

Mr. Chairman, if we fast forward to the year 2008, and to the current financial crisis, we note that asymmetries in information between financial institutions, this time relating to the extent of exposure to and value of complex derivative products, led to a freezing up of credit markets, the eventual collapse of some important financial institutions, and the near meltdown of the entire financial system. In these events we can see the insights of Akerlof in his 1970 paper.

Mr. Chairman, the near collapse of the financial system has in turn led to a rapid and deep global recession – the sharpest since World War II and the first in which all regions of the world were suffering a downturn in fortunes at the same time. This downturn may well have its most devastating impact on poor countries, particularly in Africa – who incidentally were not responsible for the crisis. It is worth asking the question that if the basic insights on the powerful impact that a lack of information could have on markets was known as far back as 1970 – why were these lessons not assimilated into the policy making tool kit of central banks or in the financial architecture of our economies?

Mr Chairman, I have no doubt that perhaps a large part of the answer to this question is in the fact that the 1970s had a very different financial environment when compared to our current environment. As the financial markets developed, driven by technological and financial innovation and the deregulation of financial services, financial institutions were able to price and sell risks through ever more complex financial products. The very nature of complexity of these products created the asymmetries in information that has proved catastrophic to the world economy.

However, I wish to focus on another reason why Akerlof's insight was never fully absorbed by policy makers and the public: I believe that we allowed the workings of the financial sector to become more and more divorced from key stakeholders such as the legislature, who had the responsibility of enacting regulations governing the financial sector, and the public for whom the media was an important source of information – and so our fate was sealed.

Mr. Chairman, clearly Africa was not the source of the financial crisis, but it is being impacted by the crisis and there are many who believe that Africa may well bear the long term costs of the global economic downturn – if the broad gains of the past years are reversed and the productive capacities (e.g. human and social capital) are destroyed due to worsening health and education outcomes. From this perspective, the role of the legislature and the media in ensuring the African governments make the right policy choices in dealing with the crisis will be critical in determining how well African economies weather and recover from the crisis once it is over – as all crises do come to an end.

In this regard let me offer one simple example of how critical the role of the legislature and the media may be: The conventional wisdom is that one important way in which African economies can ensure that they are able to limit long-term damage to their economies is to ensure that they do not indulge in policy reversals for short term gain that sacrifice the long-term growth prospects.

Mr. Chairman, policy reversals are more likely to occur in an environment in which information flows and understanding is poor between economic managers such as central bankers on one side and the legislature and the media on the other. Populism can wreak havoc on good economic policy making. In this regard Africa does not need to rehash the false choice of market versus the state – both are part of the fabric of society and the economy. Furthermore, calls have been heard that African Governments should also nationalise banks and purchase car companies as the developed economies, the owners of capitalism, have done. These are ultimately dangerous calls as the nature of our individual economies matters in determining the appropriate remedy for our economic ills.

It is for this reason that my address today is entitled *"The Central Bank, the Media, and the Legislature: Can they Work Together?"* My simple answer is that they can, and that they must – particularly in the unprecedented circumstances in which we find ourselves in today.

Mr. Chairman, before I outline how the Bank of Zambia has engaged both the media and the legislature and the positive results that we believe we have reaped, allow me to state very quickly how a strong relationship between the media, the legislature and the central bank is a modern feature of central banking.

Mr Chairman, the role of modern central banks revolves around three key functions: price stability; financial system stability; and the maintenance of the payment system. Price stability has the greatest weight in the goals of most central banks. Advances in economic theory and computing power as well as the developments in financial markets have greatly enhanced our understanding of the economy and our ability to understand and forecast inflation. Central banks act to influence inflation some periods into the future – a period determined by the individual characteristics of the economy in question. Today we understand this process as targeting inflation expectations of households and firms – either implicitly or explicitly. Central to the success of such a strategy is the extent to which central banks have credible monetary policy frameworks and key pillars in such a framework are the ability to communicate policy in a predictable and intelligible way to the public – with the media playing an important role in this process – and the notion of accountability to an appropriate body whether this is the Minister of Finance, the legislature or both bodies.

Mr. Chairman, by publicising the actions of the central bank, the media has become an important agent in facilitating the desired behavioural response of economic agents to monetary policy actions of the central bank. Due to the critical role of the media in the successful execution of public policy, the central bank needs to have a clear communications policy that supports the goals of the Central Bank. One of the major goals of communication policy, for instance, is to help anchor inflation expectation by promoting credibility and understanding of monetary policy. Indeed a notable change in central banking over the past 15 years has been a world-wide movement toward increased communication by central banks about their policy decisions, the targets that they seek to achieve through those decisions, and their view of the economy's likely future evolution.

Mr. Chairman, It is argued that increased willingness to share the central bank's own assumptions about future policy with the public has increased the predictability of policy, in ways that have improved central bank's ability to achieve their stabilization objectives. Public information serves the dual role of conveying fundamental information as well as serving as a focal point for better coordination. As financial markets become more efficient in a country, and as the economy becomes more open, the central bank's communication policy needs to adapt to these on-going changes.

Furthermore, given the complexity of formulating monetary policy and getting accurate projections, the role of the media and other financial commentators is not devoid of risk to the central bank's credibility particularly, in challenging economic times. It is therefore, important for central banks to ensure that where projections on the future path of key macroeconomic variables are provided, these have to be set out in conditional forms and linked to incoming information with an assessment of the balance of risks.

Mr. Chairman, turning to the role of the legislature, it is important to note that legislative oversight of monetary policy has a long history in many countries. In this respect, the USA provides a good case in point of a country with strong legislative oversight over the central bank's operation. Congressional oversight of the Federal Reserve goes back to the founding of the central bank in 1913. However, the nature and purpose of oversight has changed overtime. Since 1978, the Federal Reserve has been subject to biannual oversight hearings before the Senate and House banking committees. Several other countries have similar arrangements where the central bank periodically appears before a committee of parliament.

Parliament in New Zealand also has a role in monitoring the Bank's conduct of policy. By statute, each Monetary Policy Statement is referred to Parliament's Finance and Expenditure Committee. That Committee, with the assistance of its own professional adviser, can choose to extensively scrutinise the extent to which policy was, and has been, conducted consistent with the Policy Targets Agreement. Additionally, the Office of the Auditor General – an agent of Parliament, is also able to commission quite extensive investigations into the activities of the Bank. Similarly, the Australian Parliament undertakes particularly close scrutiny of interest-rate issues and associated economic policy through the Reserve Bank's appearance before the House of Representatives Standing Committee on Economics, Finance and Public Administration. This is the main mechanism through which the Reserve Bank is accountable to the people of Australia.

As with the case of the media, the central bank's interface with the legislature needs to be managed strategically, so as to enhance the former's credibility to the public which, as discussed earlier, is a necessary condition for effective transmission of monetary policy.

Mr. Chairman, turning to Zambia, some seven years ago we at the Bank of Zambia commenced media seminars in which we invited a cross-section of participants from media institutions to explain our monetary policy to them. We also used these seminars to educate members of the media on basic economic concepts. This exercise was to a great extent driven by our alarm at the level of misunderstanding of monetary policy issues and decisions by the media, and their failure to communicate discussions on monetary policy effectively to the public without simply copying or paraphrasing a press statement or simply printing opposing quotes from favoured commentators on economic issues.

I must admit here that initially this seemed to cause more harm than good – a little knowledge truly did seem a dangerous thing now that we had opened ourselves up to the media. The greater access to central bank officials and information, e.g. through our website, without the full understanding of issues on the part of journalists seemed to fuel erroneous stories. However, our perseverance over time has meant that the level of understanding and quality of questions has improved significantly. As a result, the level of reporting has also improved – although much work still needs to be done. Today issues surrounding the causes and likely impact of the global financial and economic crisis have been covered in a more balanced way with a greater thoughtfulness on the economic linkages and Government policy – as well as with increased reference to related developments around the world.

Mr. Chairman, following on from the media seminars, six years ago the Bank of Zambia began conducting seminars for members of Parliament – particularly members of oversight committees such as the Committee of Economic and Labour Affairs and the Public Accounts Committee. Again, what we have seen is a greater appreciation by members of Parliament of the challenges facing the central bank in the implementation of monetary policy in particular and economic policy in general because the central bank is often called upon to comment on the Government's economic policies as well.

We have tried to consolidate the gains from these seminars through the holding of quarterly media briefings as well as efforts to place as much information as possible on our website http://www.boz.zm. An example of the benefits of this improved dialogue is the recent developments in the Zambian economy related to the global financial crisis. Between July 2008 and March 2009, the Zambian Kwacha depreciated by about 65% against the US dollar. However, unlike in other periods of extreme volatility in the exchange rate, although the Minister of Finance was asked to make a statement on the exchange rate – an important aspect of accountability – he was able to deliver a strong message that an adjustment in the exchange rate under such conditions of stress was an important way in which the economy could adjust to external shocks. There were no (loud) clamours for the re-imposition of exchange controls. We believe that our efforts to communicate our policies more effectively to the public and members of Parliament and the media and Parliamentarians improved understanding of the economic landscape was an important reason for this observation.

Mr. Chairman, let me conclude by recapping some of my main points: The role of formulating and implementing monetary policy is very challenging and often attracts a lot of public interest. If not well addressed, this external pressure can distract the focus of the central bank. It is therefore, imperative that the central bank strategically manages its relationships with key stakeholders to promote mutual benefit.

Media coverage of monetary policy actions is a central channel of a central bank's communication with the wider public, and thus an important factor for its credibility and policy effectiveness. The evidence suggests that communication can be an important and powerful part of the central bank's toolkit since it has the ability to move financial markets, to enhance the predictability of monetary policy decisions, and potentially to help achieve central banks' macroeconomic objectives.

Unlike the media, the legislature's oversight over the operations of the central bank is normally enforced by statutory provisions. However, it is equally important for the central bank to proactively engage the two stakeholders in a way that maximises the transmission of accurate information to the market as well as promotes the transparency, accountability and credibility of the central bank.

Finally, I thank you all for your attention and would like to reiterate my gratitude, Mr. Chairman, for inviting me to share in your celebrations. I thank you.