Institute for Policy Reforms

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GOP must ensure SBP independence

GOP must not restrict SBP's autonomy. This is stated in a Fact Sheet issued today by the Institute for Policy Reforms. Referring to Finance Minister's reaction to correction in Rupee value last July, the Fact Sheet cautions that lack of respect for institutions harms the economy. "These actions also defy economic logic. The state of the economy is testimony to our contempt for institutions and for economic rationale," it says.

An autonomous SBP strengthens the economy. SBP Act reassures that "autonomy of the Bank shall be respected at all times," and forbids any influence. It mandates SBP to ensure economic growth and stability. It also stipulates it to watch the value of Rupee, to ensure foreign exchange stability, and export competitiveness. But imbalances in the economy are for all to see.

Each year, the economy has missed its growth target. Inflation has been under control, but more because of the high Rupee value and low oil prices than fiscal prudence. Fiscal deficit often has exceeded estimates with GOP borrowing beyond the budget and at the cost of private sector credit. The economy is stuck with low savings and investment leading to low growth and a vulnerable external account.

SBP has not played its role. These are not minor gaps in performance. Its most serious effect lies in letting a profligate government avoid reforms. Rather than allow government easy access to credit, with long term economic consequences, SBP must limit borrowing.

A worsening external account is a greater concern. In four years, Government has added US $ 35 Billion in foreign debt. CPEC projects will add to liabilities. Consequently, GOP's preference for high Rupee value is hazardous. At some point, the Rupee may decline suddenly. If this happens, it will leave the economy in long term disequilibrium. SBP has not met its foreign exchange management responsibilities. We also do not know how SBP plans to meet the severe balance of payment challenge.

Because of circumstances, the new Governor's appointment is under scrutiny. It is critical for him and the Board to prove their bona fide. The law gives SBP autonomy. It is for the Bank to put it in practice and reduce the gap between formal and actual autonomy, so that they meet their mandate of economic growth and stability.

SBP must make independent analyses of economic trends and forecasts and insist on regular meetings of the Monetary and Fiscal Policies Coordination Board to set targets for growth, inflation, and balance of payments, as well as foreign reserves. SBP's estimates must input into government budget. It must meet its Section 9 obligation to set limits on GoP borrowings and to estimate private credit. It must base interest rate movement entirely on its own analysis.

The President must appoint the Governor and Board of SBP. News about the Governor's appointment must not come from the Finance Ministry. Ideally, parliament must have a say in the appointment. As a transition, a Board of economic ministers may recommend the candidate. SBP must play its role in exchange rate and Balance of Payment management. The risks and the downside to the economy of not doing so are very high.

SBP also must introduce financial instruments that redirects foreign remittances (about USD 20 billion) to investment rather than consumption. With autonomy comes the need for transparency. SBP must make known to Parliament and the people how it plans to meet the rising external imbalances. The people have a right to know the terms and conditions of all external aid, including credit swaps and Balance of Payments support. The risks are too high to keep this secret.

The Fact Sheet states that respected international experts universally advocate autonomy of the central bank. The reason for this is clear. There is an inherent tradeoff between the central bank's goals of economic growth and low inflation. This calls upon the Bank's technocrats to keep a delicate balance. Monetary policy takes a long time to affect the economy and, hence, must have long-term perspective. Governments often have short-term compulsions.

Central Bank independence shows benefits worldwide. Overall, there are improved monetary policy practices. In most economies, inflation has been in control and hyperinflation is now outdated. There is, however, the devastating incident of the 2008 world economic crisis. But this too reinforces the view that it is risky to have too close a relationship between government and the central bank.