



Why Reducing Central Bank Independence Is Not a Good Idea

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Recently, the Finance Minister was all fire and brimstone when the Rupee fell against the dollar by about 3%. Sure enough, a day later, the acting Governor of the central bank was consigned to his temporal purgatory. There were hints also of a conspiracy that led to the fall in rupee, though SBP's announcement should have put that to rest¹.

Regardless of what drove the Rupee correction, one thing is clear. The Finance Minister was grossly misguided in his reaction. This episode was another reminder of what is wrong with our institutions.

Contrary to what the law and good practice say, the Minister visibly showed that the Central Bank was not independent². He reinforced this by chairing a meeting next day of the heads of all commercial banks to discuss the earlier day's change in Rupee value. The acting Governor was not invited³. Usually, the Governor of an independent central bank would preside such consultations. The Finance Minister also announced appointment of a new Governor State Bank of Pakistan, a retired civil servant who until a few days before was his Finance Secretary. Such brazen lack of respect for institutions may be good for the ego, but it is poison for the economy. These actions also defy economic logic. The state of the economy is a tribute to our contempt for institutions as well as for economic rationale.

Commenting on the incident, a former PPP Finance Minister said that "SBP is now part of Ministry of Finance" and retweeted a condolences message about its imminent demise⁴.

¹ SBP press release of 5 July 2017 defended the action. See also Express Tribune, Rupee dip meant to fix imbalances, Shahbaz Rana, 3 August 2017

² SBP Act 1956 amended, Section 9 B (6) and 46 B (2). The latter states that "The autonomy of the Bank shall be respected at all times and no person or entity shall seek to influence the members of the Board and Monetary Policy Committee or the staff of the Bank in the performances of their functions."

³ The News, Where does the SBP stand? 10 July 2017

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Why should the Central Bank be independent?

Few institutions affect the lives of citizens as much as the central bank. It makes monetary policy that controls money supply. It sets benchmarks which decides the cost of borrowing for businesses and consumers. It issues paper money and clears cheques drawn on banks. It also regulates all commercial banks. Central bank policies affect the job market as well as success of firms. More than any other arm of the state, it influences economic growth and stability⁵.

Leading experts universally hold faith in the autonomy of the central bank. The mandate of most central banks, including SBP, is to make economies grow and to keep prices low. As we see below, there is an inherent tradeoff between the two. This calls upon technocrats of the Bank to keep in place, at all times, a delicate balance.

Aggregate demand in an economy moves growth. One way to increase demand is for government to spend more, especially on investment. Usually, that is hard to do as revenue streams are given. Another way to change total demand is through the central bank's monetary policy. Its key instrument is interest rates. A lower interest rate increases demand for money. This leads to higher spending on working and fixed capital and on consumption. Increased demand stimulates growth, but also prices. High interest rates dampen demand for money. That lowers prices as well as growth.

What makes central bank autonomy critical is that monetary policy takes a long time to affect the economy. Monetary policy, hence, must have a long-term perspective. This is especially necessary because of the competing demands of the two goals of growth and low prices. The time lag makes it vital that central banks are insulated from short term political goals. For best economic outcome, growth must be consistent with the economy's productive capacity. On the other hand, short term goals of elected

⁴ Saleem Mandviwalla on Twitter.com

⁵ Most of the discussion in this and the next sections are based on Speech of Ben Bernanke, then Chairman Federal Reserve Bank, Institute for Monetary and Economic Studies, Bank of Japan, Tokyo, May 2010, titled Central Bank Independence, Transparency, and Accountability, by Professor Alan Binder, Princeton University and former Vice Chairman, Board of Governors of the Federal Reserve, titled Central Banking in a Democracy, and The Economist "How to preserve the balance of central bank autonomy", 27 April 2017

officials may influence the Bank to stimulate the economy beyond its potential. This puts the economy in long term jeopardy.

One of the Bank's key task is to manage money supply, including through printing of notes. Two centuries ago David Ricardo opined that the executive cannot be trusted with the task of printing paper money. There is too much temptation to abuse this power to help finance the budget. Since then, in every economy, the central bank has managed money supply. This also requires that the central banks place limits on government borrowing⁶.

Central bank independence does not mean complete freedom. The SBP Act enunciates its broad goals. Political leadership in parliament sets the goals for the economy, which SBP must follow. SBP's stipulated goals are monetary stability and growth of the economy⁷. Through regular reports to parliament, the central bank must show that it is following the given goals. Some central banks target a specific inflation band.

However, how the central bank goes about achieving the goals is for it to decide. It is also vital that the central bank's autonomy is visible to all⁸. This perception acts as a self-fulfilling factor. Economic agents, such as banks and others, follow central bank lead when they know that its policies are long term and would not be overruled. In most industrial economies, no government branch can change central bank decisions. Rather than get in the way of SBP functions, government must focus on increasing the economy's productive capacity. That would stimulate growth.

Has the independence worked?

We can see the benefits of central bank independence worldwide. Overall, there are improved monetary policy practices. In most economies, inflation has been in control. We no longer see economies in hyperinflation with money rapidly losing value. "Empirical studies support the view that independent central banks deliver better inflation outcomes than less independent banks, without compromising growth."⁹

There is, however, the devastating example of the 2008 fiscal crisis that soon became a world economic crisis. What happened is hard to say as the growing asset bubble was for everyone to see. There were clear warning signs as early as 2003, when economists pointed out massive macro imbalances because of heavy foreign borrowings by USA¹⁰. Did the Federal Reserve delay increase in interest rate to ensure low cost funding for the large US deficit caused mostly by its two wars? We would never know. Central bankers, especially those who assume star status in industrial economies, do not accept mistakes easily.

⁶ SBP Act, Section 9C

⁷ SBP Website, Functions of SBP, <http://sbp.org.pk/about/Func.asp>

⁸ For example, it was important enough to find specific mention in the Maastricht Treaty.

⁹ Op Cit 6, Ben Bernanke,

¹⁰ New York Times, The Financial Crisis Was Foreseeable and Preventable, Jeffrey A. Frieden, 30 January 2011

However, the entire world suffered the joint effect of US government and federal Reserve's egregious neglect.

This incident reinforces the perils of central banks working too closely with government and, even more, reiterates the need for autonomy in practice as well as in letter. Very quickly, the US federal reserve took measures to right the grave wrong.

This is a lesson that should not be lost on our State Bank. The law gives the State Bank autonomy, but it has not fully used it. There is wide gap between formal and actual autonomy. The result is for all to see.

What is the SBP's mandate? Are there issues with delivery of mandate?

As said before, SBP Act entrusts the Bank to conduct monetary policy in line with parliament's growth and inflation target¹¹. A Monetary and Fiscal Policies Co-ordination Board aligns fiscal, monetary, and exchange rate policies¹². It does these in support of the mandated goals of stability and growth. The law gives SBP enough autonomy to fulfil its responsibility to meet:

- “the primary functions including issue of notes, regulation and supervision of the financial system, bankers' bank, lender of the last resort, banker to Government, and conduct of monetary policy, and
- the secondary functions including the agency functions like management of public debt, management of foreign exchange, etc., and other functions like advising the government on policy matters and maintaining close relationships with international financial institutions.
- Non-traditional or promotional functions, performed by the State Bank include development of financial framework, institutionalization of savings and investment, provision of training facilities to bankers, and provision of credit to priority sectors.¹³”

Most experts find gaps between SBP's formal and actual autonomy¹⁴. According to them, its unwillingness to assert may have led SBP to fall short of delivering on its mandate. Experts say that there is no need to merely enhance autonomy on paper. SBP must put it in practice. They point to several lapses on SBP's part.

Foremost among these they say is MoF's role in decisions on “loaning policy and banking practices”¹⁵. For years, SBP has accommodated GOP's demand for borrowings. Rather than rely on its own rigorous macro analyses and set borrowing limits, the Bank often follows GoP's optimistic forecasts. SBP must decide monetary limits and enforce these on

¹¹ SBP website, Functions of SBP. The National Assembly approves Government's proposals in the Annual Plan.

¹² SBP Act, Section 9B 2(a)

¹³ SBP website, Functions of SBP, <http://sbp.org.pk/about/Func.asp>

¹⁴ Dawn, Autonomy for State Bank, Editorial, 22 April 2014, <https://www.dawn.com/news/1101407>

¹⁵ Dawn, State Bank's autonomy: legal status and reality, 5 January 2009

GoP during budget preparation. Disregard of its role is breach of Section 9A and 9B of the SBP Act. The Bank has also allowed GoP to use privatization receipts for current spending, rather than stay with the agreed practice to use it to retire debt.

The resulting structural imbalances in the economy are for all to see. Each year, the economy has missed its growth target. For several years, growth stayed below 4%. Inflation has been under control, but more because of the high Rupee value and low oil prices than fiscal prudence. In recent years, fiscal deficit has exceeded GOP's estimate. To finance these, GOP has borrowed way beyond the budget, often at the cost of insufficient private sector credit. The external account has been especially vulnerable. This has happened despite administrative autonomy where the Governor and the Board are in place for three years¹⁶. The economy is stuck with low savings and investment leading to low growth and a vulnerable external account¹⁷.

These gaps in SBP's performance are not minor. Its most serious effect lies in letting a profligate government avoid reforms. Rather than allow government easy access to credit, with long term deleterious effect on the economy, the SBP must enforce limit on borrowing. This would move GoP to practice prudence in public finance. GoP would then either increase revenue or limit spending, and hopefully make the latter more effective.

What is the SBP's role in fixing exchange rate?

The law gives SBP the power to manage foreign currency matters. Section 9A 1(b) says that SBP must "oversee foreign exchange reserve management" and send to parliament quarterly reports on the economy including on the balance of payments (9A 2). The document 'State Bank functions' says that "One of the major responsibilities of the State Bank is the maintenance of external value of the currency."

Still GoP has a role in the value of the Rupee. But this is through the Monetary and Fiscal Policies Coordination Board chaired by the Finance Minister. The law mandates the Board to "coordinate fiscal, monetary and exchange-rate policies"¹⁸. It specifies that the Board must meet quarterly. In recent years, the Board has met infrequently.

SBP also has fallen short on its goal to ensure "competitiveness of our exports." GoP's fetish for a high value of the Rupee may have caused exports to decline. Pakistan's REER¹⁹ has appreciated by 22% since 2013. While Pakistan has lost competitiveness, India, Bangladesh, and Sri Lanka have gained²⁰.

¹⁶ Ibid, the discussion here mostly from above Dawn column.

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¹⁸ SBP Act, Section 9B 2(a)

¹⁹ Real Effective Exchange Rate

²⁰ The News, Where does the SBP stand? Sajid Amin Javed, 10 July 2017

Of greater concern is the effect of an increasing current account deficit. To fund this, in four years, Government has added US \$ 35 Billion in foreign debt²¹. CPEC projects will add further to repayment liabilities. There is risk in keeping the Rupee value high. It is possible that at some time, the Rupee may decline in a sudden burst. This will leave the economy in long term disequilibrium. By allowing GoP to affect Rupee value, SBP has not met a key responsibility to “maintain stability in the foreign exchange market.”

What next for the new Governor?

Given the circumstances, the new Governor’s appointment has become controversial. This is not what SBP needed. Forty opposition members have moved a resolution in the Senate for his removal²². Other experts have called him not deserving of the job. It is now for the new Governor to meet expectation.

He must establish his bona fide and assert his authority. He must lead SBP to play its designated role in building a strong economy. Equally the Board must step up to support the Governor. SBP must²³:

- Independently make realistic economic analyses of macro-economic trends and forecasts.
- Insist on regular meetings of the Monetary and Fiscal Policies Coordination Board. The law calls for quarterly meetings.
- The Board sets targets for growth, inflation, and balance of payments, as well as foreign reserves. SBP must verify the extent and reasons for variation of GoP estimates from its analyses.
- Based on above, SBP must meet its Section 9C obligation to set limits for GoP borrowings and estimate private credit needs. SBP’s estimates must input into government budget.
- With government, it must watch and review progress on these targets, and persuade GoP to not go beyond the borrowing limit. In the past, SBP has denied such access to government.
- It must assume absolute control over monetary policy without formal or informal GoP influence. It must base interest rate movement entirely on its own analysis.
- SBP must meet its obligation to regulate banks and not compromise the trust that the law places in it.

²¹ Express Tribune, Nawaz added whopping \$35b to Pakistan’s debt, Shahbaz Rana, 3 August 2017
<https://tribune.com.pk/story/1469896/nawaz-added-whopping-35b-pakistans-debt/>

²² Dawn, Senate resolution demands immediate removal of SBP Governor Tariq Bajwa, 24 July 2017,
<https://www.dawn.com/news/1347357>

²³ Mostly from Dawn, State Bank’s autonomy: legal status and reality, 5 January 2009

- The SBP Board must play a more active and effective role and strengthen the hands of the Governor.
- The President must appoint the Governor SBP as well as all Board members. 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 matter, a Board of economic minister may recommend the candidate for the President's approval.
- 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.
- It must introduce financial instruments that redirects foreign remittances (about USD 20 billion) to investment rather than consumption.
- Autonomy equally calls for transparency. SBP must make known to Parliament and the people how it plans to meet the severe challenge of external imbalances. The people have a right to know the terms and conditions of all external aid, including credit swap arrangements and Balance of Payments support. The risks are too high to keep this secret. It is a risk that the whole nation must bear. There is a moral and legal obligation on SBP to be open.

Princeton Professor Alan Blinder quashes the notion that central banks must work “amidst secrecy, blue smoke and mumbo jumbo. Central Banks work through the financial markets and markets (do not) function better when they are less informed.” Former Fed Chair Bernanke says, “Transparency about monetary policy not only helps make central bank more accountable, it also increases effectiveness of policy²⁴.”

SBP must take heed.

²⁴ Op. Cit. 6