LAW AND DEVELOPMENT:

“CENTRAL BANK INDEPENDENCE IN AN AFRICAN CONTEXT: THE CASE OF ZAMBIA”

LLM Thesis

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"**Central Bank Independence in an African context: the case of Zambia**"

Contents

ABSTRACT:

This paper examines the importance of central banks and the argument made for their independence, especially in developing countries. The subject is deemed topical in view of the prevailing economic crisis and the reaction of governments and central banks. Utilizing a historical analysis of how the concept and legal frameworks have evolved in England, the United States, the European Community, China and some African countries, the paper then focuses on the case study of Zambia to study the implications and impact. Interestingly the paper's findings are that CBI matters in developing countries not only for the monetary arguments made in more developed economies, but as a preemptive mechanism for defending public assets, as well as a best practice tool for transparency (and therefore lessening corruption) in the public sector. In Zambia's case specifically, it is found that CBI is a necessary (though not sufficient) condition for stability in the financial sector and therefore critical to the attraction of Foreign Direct Investment, whilst providing for a more transparent and accountable framework for Official Development Assistance.

"**<u>Central Bank Independence in an African context: the case of Zambia</u>**"

Introduction:

The issue of Central Bank Independence (also referred to interchangeably herein as "CBI") has been granted prominence by recent events. In the credit crunch forced by the on-going global financial crisis, the line between government and monetary authority actions has often seemed blurred as both seek to restore some calm and confidence to the financial markets. Furthermore, the recent attempted sacking of the Governor of the Central Bank of Argentina by the President (for his refusal to transfer reserves to the government to be applied towards debt servicing), has served to give the issue further prominence.[1]

Does Central Bank independence matter? Is the independence of the central bank in a developing democracy a good thing? Does it matter more in a country that is in a hurry to develop? Does the independence raise questions of transparency and accountability particularly in a developing democracy?

[1] See the Financial Times, January 8, 2010

Maasaki Shirakawa, Governor of the Bank of Japan has put it this way:

> "Independence" means 'to decide on one's own with a decision that is not reversed by others'. Now, why is a central bank granted independence in a democracy? In general, monetary policy affects economic activity and prices after a time-lag. Against such a backdrop, if monetary policy is conducted, based only on judgments about short-term economic and financial conditions, it will likely lead to a situation in which economic stability is impaired, as experienced during the previous inflations and the bubble…while people are weak in that they are likely to be influenced by short-term interests, they are also equipped with wisdom that allows them to establish a system in advance to avoid a situation that is undesirable from a medium- to long-term perspective. This is the conception of central bank independence, which entrusts the conduct of monetary policy to an organization that makes judgments based on expertise from a medium- to long-term perspective.[2]

Central Banks are instrumental in shaping and implementing monetary policy and affect exchange rates, interest rates, and the success of the banking system within their home country. When allowed a degree of independence in policymaking, central banks aid in formulating monetary policy that promotes economic stability within their respective countries, and creates an atmosphere friendly for foreign investment. They must accordingly have the capacity to do so, and exhibit this capacity through their behavior.

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[2] Shirakawa, M: "The Central Bank from the Viewpoint of "Law and Economics", *Lecture at the Faculty of Law, the University of Tokyo, October 21, 2009 pp 8-9*

In the African situation, Megan Presnak frames the context:

> The geographical region of sub-Saharan Africa is home to a large percentage of the world's population, making it very important.... Due to the low level of economic development in the region, conservative monetary policy is needed to fight inflation and increase investor confidence in order to draw foreign direct investment. An independent central bank is best equipped to pursue a conservative policy track, as it is free from the pressure of government politicians.[3]

This paper argues that central bank independence matters and particularly in the context of developing African economies. The paper uses case study methodology on Zambia to argue that the independence of the central bank can be a crucial factor in building confidence in the banking system and general investment confidence.

Research Methodology:

I will rely primarily on secondary sources in the form of literature and materials from Zambia's legislature, Central Bank, UN Economic Commission for Africa, IMF, World Bank and the writings of experts on the subject.

[3] Presnak, Megan: "Central Bank Independence in Sub-Saharan Africa: An Analysis, 1960-1989" p.1, at www.iwu.edu/polisci/RP_2005/Res_Publica_Book_05_presnak.pdf first accessed Jan.28/2010

I will use the case study method, focusing on Zambia. No one country in Africa can be expected to be fully representative of all others. However, it is important to note that there are significant commonalities amongst them not the least of which would be the history, and the effects of the history of European colonization. In addition, there are specific, contemporary cultural dimensions that emanate from their histories as predominantly tribal societies. Accordingly, I conclude that by taking the Zambian case, important generalizations that apply to Africa in general can be made.

1. Concept of central bank independence (CBI)

The only good Central Bank is one that can say no to politicians -The Economist. [4]

1.1 The history of Central Bank Independence

In framing the concept of central bank independence, it is important to understand the functions of central banks. Whilst central banks may have existed since the 17th Century, their purpose, functions and operations have evolved over time. In most cases, central banks are owned by the government, and functionally they are government banks. Their first and principal function is to govern monetary policy and control how much domestic currency circulates in a country's economy at any given time. In the second instance, they act as financial agents on behalf of government in the management and disbursement of liquid funds. Additionally, they may play a role in setting a country's exchange rate and or managing its reserves. Finally, they have a number of supervisory and regulatory duties to ensure the on-going stability of the financial sector.[5]

Central Bank independence or autonomy[6] therefore, refers to the extent to which the central bank carries out these functions independent of any external control from the executive and legislature. An arguable point is whether "external control" would include controls imposed

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[4] *The Economist*, February 10, 1990, p.10

[5] Boylan, D.M: *Defusing Democracy, Central Bank Autonomy and the Transition from Authoritarian Rule* (Ann Arbor, The University of Michigan Press 2001), p.23

[6] Laurens has similarly used "independence" and "autonomy" in an interchangeable sense, but has elaborated that whereas autonomy refers to operational freedom, independence points to the lack of institutional constraints. See Laurens B.J, Arnone M, Segalotto J.F: *Central Bank Independence, Accountability, and Transparency: A global Perspective* (International Monetary Fund, Palgrave Macmillan,2009), p.6

from the outside under financial sector restructuring programs, such as those employed by the Breton Woods institutions and bilateral donors(but to this point we shall return later).

The history of central bank independence is consequently inter-related with the history of the central bank's functions as above mentioned, and especially its principal function of monetary policy and control. As earlier pointed out, monetary policy affects economic activity and prices and is therefore an important consideration in any political governance.

Fausto Vicarelli[7] has argued that the autonomy or independence of the institution cannot be discussed without taking into consideration a theory justifying its existence and explaining the logic of its evolution. In turn, the theory can only be explained by the linkage between the financial structure and economic development. Thus there would be little sense in carrying out a study of central bank autonomy without studying the inter-relationship with economic development. He cautions in this respect:

> Whilst, however economic historiography on banks and industries has a vast field of research within which to work, with an accompanying certainty in terms of knowledge and interpretation, that which deals with central banking autonomy encounters objective restrictions when it moves from the consideration of historical data to the interpretation thereof. Here, the lack of a theory of central banking has greater consequences in terms of analytical difficulties. The very concept of autonomy takes on different meanings according to the theoretical, and therefore general, view one has of the role of the central bank.[8]

[7] Vicarelli, Fausto: "Central Bank Autonomy: A Historical Perspective" in Gianni Toniolo, *Central Banks' Independence in Historical Perspective (*Walter de Gruyter, Berlin; New York 1988), p.1

[8] Vicarelli, *ibid in Toniolo, p.2*

Notwithstanding the lack of a central bank theory, the theoretical reflection which has accompanied the process of identifying the role of a central bank is key to understanding central bank independence. Paul Collier has observed that:

> Over the past thirty years, there has been a gradual but profound revolution in the way that central banks in developed countries have functioned. They have acquired a far larger measure of independence from government. Further, they now reach decisions through processes which are highly transparent. Not only are the processes transparent, but the key principle is that those decisions should be predictable on the basis of information that the bank has already shared with the financial markets, so there should be no surprises. [9]

These developments have mirrored general market oriented thinking, dating back to the period in 1962 when Milton Friedman asked the question "what kind of arrangements should a free society set up for the control of money?"[10] In the context of addressing this question, Friedman considered the concept of independence, and in turn examined automatic commodity standard such as the gold standard, CBI and the legislative rules governing money growth. He suggested a 'basic meaning of CBI' which is that the central bank should be an "independent branch of government, co-ordinate with the legislative, executive and judicial branches."[11]

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[9] Collier,P: "Central Bank Independence: Is it good for the Ministry of Finance?", paper presented at *Symposium on Central Bank Independence: Does it hurt the Treasury?* (Bank of Zambia, Department for International Development Symposium, Livingstone Zambia, 2008), p.23

[10] Friedman, M: "Should there be an Independent Monetary Authority?" (in L.B. Yeager [ed.] *In Search of a Monetary Constitution*, Boston: Harvard University Press, 1962), p.173

[11] Friedman, ibid, p.179

A large body of literature developed in the 1970s, came to support this view. In a nutshell, this literature argues that governments create independent central banks "in order to tie their own hands".[12] Boylan has referred to this as the "credibility literature", whose model is built from the premise that all politicians have the ability to use surprise inflation to generate short term gains. In order to solve this commitment problem politicians take monetary policy out of their own hands and place it in the hands of an autonomous central bank. This was not always the case. In the 1960s, the prevailing view amongst economists accepted the finding that a trade-off existed between inflation and growth. In the 1970s, more sophisticated expectations-augmented Phillips curves became popular.[13] The theory and empirical findings supported the conclusion that on average, countries with demonstrated CBI were able to achieve lower average inflation, cushion the impact of political cycles, enhance financial stability, and boost fiscal discipline without any additional costs or sacrifices in terms of output volatility or reduced economic growth.

During the 1970s and early 1980s, major industrialized economies experienced sustained periods of high inflation. To explain these periods of inflation, an understanding of the reasons why the central banks allowed them to happen is necessary.

An influential analytical model run by Barro and Gordon[14] advanced the line of argument that when a government is allowed to run monetary policy, it will produce high inflation.

[12] Boylan, *Defusing Democracy, Central Bank Autonomy and the Transition from Authoritarian Rule,* p.6

[13] The Phillips curve is a historical inverse relationship between the rate of unemployment and the rate of inflation in an economy. Stated simply, the lower the unemployment in an economy, the higher the rate of increase in nominal wages. While it has been observed that there is a stable short run trade-off between unemployment and inflation this has not been observed in the long run.

The argument is that monetary policy affects the general price level, and unexpected increases in the price level temporarily expand economic activity whilst unexpected declines in the price level, reduce activity. Voters value expansions of output, but they do not like inflation. In such a setting, governments have a motive to increase inflation so as to increase output (the so-called inflation bias argument)[15].

In the 1990s therefore, a consensus emerged among economists that price stability[16] should be the primary objective of monetary policy, and that central banks should have sufficient independence as a means to attain this goal.

1.2 Reasons for and Significance of CBI

Paul Collier has observed that "the standard case for independence of central banks is rooted in the yet more general argument as to why a government can increase its power to achieve its objectives by binding itself in respect of some aspect of its behaviour". [17]

He proposes that this is rooted in the foundation concept of the 'time consistency problem':

> The easiest way to grasp the 'time consistency problem' is through a simple story of the sale of government debt. Suppose, for example, that the government finds that it needs to sell a large amount of debt to cover an unanticipated deficit. The interest rate that the government must pay on the debt depends upon the anticipated inflation rate. Clearly, one concern of the potential purchasers is that once the government has sold all the debt it will partially default on its real value by increasing the rate

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[14] Barro, R.J and Gordon D.B: "A Positive Theory of Monetary Policy in a Natural Rate Model", *Journal of Political Economy*, Vol 91,(1983) pp 589-610

[15] Wood, G.E, T.C. Mills, and F.H. Capie : "Central Bank Independence: What is it and What will it do for Us?" (Institute of Economic Affairs, London 1993)

[16] Price stability is defined by economists as the condition in which the average price level does not change or changes very slowly. This is a key part of the macro-economic goal of stability (the other two being 'full employment' and 'growth'). Price stability is commonly indicated by the inflation rate calculated as percentage changes in either the Consumer Price Index (CPI) or the GDP Price Deflator.

> of inflation. If the government cannot commit itself to any particular future rate of inflation then the only rational assumption for the investor to make is that the government will optimize: that is, once the debt has been sold the government will increase the rate of inflation, since not to do so would be to have a higher debt than necessary. But having worked this out, the potential investor will anticipate that inflation will increase and so only purchase the debt at an interest rate that already compensates for it. The key consequence is that the government's power to increase inflation shoots the government itself in the foot: what it ends up with is that it is unable to achieve the partial default but it does get high inflation. By keeping its options open in the hope that it could achieve the ideal scenario of partial default, the government ends up with the worst-case scenario.[18]

In particular, this is worse than if the government were able credibly to commit not to increase inflation once the debt had been sold. If the government could make this commitment then it would avoid the inflation. The government's problem is thus to find a way of binding itself to a commitment. It requires a 'commitment technology'. The essence of a commitment is its credibility; if it is not credible it is ineffective in its objective. Hence, the commitment needs to be embedded in institutions rather than just be a promise. Granting independence to the central bank is an important example of an institutional 'commitment technology'. However, Collier adds that the credibility of the commitment is will depend upon the supporting details that can potentially reinforce it.

The historical roots of Collier's observations are contained in several empirical studies and models, which conclude that CBI is necessary to and will result in low inflation. This is rationalized on the premise that if the ability of elected officials to distort monetary policy results in excessive inflation, then countries whose central banks are independent of such

[17] Collier, P: "Central Bank Independence: Is it good for the Ministry of Finance?", p.25

pressure should experience lower rates of inflation.

Beginning with Robin Bade and Michael Parkin[19], an important line of research focused on the relationship between the central bank and the elected government as a key determinant of inflation. This empirical research found that average inflation was negatively related to measures of central bank independence. Alan Zukerman[20] provides an excellent summary of the empirical work. These empirical findings led to a significant body of work addressing the questions: What is meant by CBI? How should it be measured? What causal interpretation should be placed on the empirical correlations between CBI and macroeconomic outcomes discovered in the data? What is the theoretical explanation for these correlations?

The 1990s saw many countries, both developed and developing, adopt reforms that increased CBI (though not without robust debate as detailed below in the case of the Bank of England). This trend was strongly influenced by *empirical analysis* of the relationship between central bank independence and macroeconomic performance. Among the developed economies, CBI was found to be negatively correlated with average inflation. The estimated effect of independence on inflation was proved statistically and economically

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[18] Collier, ibid, p.25

[19] Bade, R and M. Parkin (1985) "Central Bank Laws and Monetary Policies"(unpublished; London, Ontario Canada: University of Western Ontario)

[20] Cukierman, A. *Central Bank Strategy, Credibility and Independence: Theory and Practice* (Boston: MIT Press, 1992), Chapters 19-21. Cukierman is the first author to argue that there can be a wide gap between "de jure" and "de facto" CBI. He argues that CBI is affected by the degree of de jure independence, but it is also determined by a host of other factors such as informal arrangements or actual practices, the central bank's quality of research, personalities of key staff, the treasury or ministry of finance. He further points out the difficulty in coding these elements to derive empirical measurements for CBI. For a more complete commentary on Cukierman, see Laurens, Arnone and Segalotto, pp 16-18.

significant. Carl Walsh[21] for instance, observes that the 1997 reforms which resulted in increased CBI for the Bank of England (to the same level as that enjoyed by the German Bundesbank), would, based on data from the high inflation years of the 1970s, be associated with a drop in annual average inflation of four percentage points.

The form of independence may also matter for inflation. Debelle and Fischer[22] report evidence that it is the combination of goal *independence* and instrument *independence* (see below) that produces low average inflation.

Another reason advanced for CBI especially in developing countries, is the *public good* of economic commentary. This assumes that a citizen advisory role for the central bank can be important where there are weaker alternative sources of reliable economic information and analysis for the citizenry. Given that economic analysis is a professional activity requiring professional economic knowledge in order to produce sound judgments on key economic issues, and the fact that citizens themselves may not be in a position to infer sound policy choices from raw data (even if they have access to that data and the time to study it), they will rely upon voices they can trust. Inevitably, citizens can only trust the voice of government up to a point (as they understand that governments are sometimes self-serving) and so they discount government justifications about its policy choices.

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[21] Walsh,C.E.:"Central Bank Independence" in *The New Palgrave Dictionary* (University of California, Santa Cruz, 2005) p.1

[22] Debelle, G. and S. Fischer. "How Independent Should a Central Bank Be?" in J.C. Fuhrer (ed.), *Goals, Guidelines and Constraints Facing Monetary Policymakers* (Federal Reserve Bank of Boston, 1994)pp 195-221.

Finally, in addition to providing a solution to the 'time-consistency problem', and the provision of the public good of trusted economic commentary, a further gain through CBI which Collier identifies, is the enhanced ability for discretionary supervision of the banking system and possibly other regulatory functions[23]. Banking and finance related industries require a degree of regulation. The problem with regulation is that because it is never possible to know everything that is pertinent to decisions in advance, it is generally not possible to make contracts – or the regulatory regime – 'complete'. Hence, there is an irreducible need for discretion on the part of the regulator. If the regulator has no discretion then, periodically the regulatory regime will generate very costly problems. However, the scope for discretionary regulation also opens up the scope for corruption. Even if the regulator is entirely honest, if the society believes that corrupt behaviour is likely, then every discretionary decision will face credible accusations that it is corruptly motivated and this will prove debilitating for the regulator. In the banking sector, where periodically discretionary intervention is needed, if the central bank is not independent such actions will risk being misinterpreted. An independent central bank has the opportunity to develop a reputation for integrity and this enhances the scope for discretionary public action. Of course, it is not inevitable that the central bank will develop such a reputation. However, independence gives the government the reasonable chance that this part of the public sector will not have its reputation contaminated by behaviour elsewhere in the sector. Potentially, if the central bank becomes seen as that part of the public sector which is the least subject to corruption, then other types of discretionary regulation could be placed under its authority. A related benefit could be that the central bank would lead other parts of the public sector towards the

[23] Collier, ibid, p.28

adoption of transparent processes that reduce corruption and pioneer the rehabilitation of reputation across the public sector.

1.3 The various meanings of CBI

Geoffrey Wood has asserted that "the most recent work on the connection between central bank government relations and inflation proceeds on the basis that the meaning of 'independence' is obvious. The implicit assumption is that it means simply that the government of the day has no formal means of influencing central bank decisions over monetary policy."[24]

Most discussions, however, have focused on two key dimensions of independence. The first dimension encompasses those institutional characteristics that insulate the central bank from political influence in defining its policy objectives. The second dimension encompasses those aspects that allow the central bank to freely implement policy in pursuit of monetary policy goals. In the terminology of economists, the dimensions encompass "de facto" independence and "de jure" independence (what is on paper against what is done in practice).[25]

Grilli, Masciandaro, and Tabellini (1991) referred to these two dimensions as "political independence" and "economic independence." Political independence refers to the independence of the central bank governor and board from political interference in setting

[24]Wood G.E, Mills C.M, Forrest H.C. "Central Bank Independence: What is it and what will it do for us?" in the *Institute of Economic Affairs* (Westminster, London, 1993), p.10
[25] See Cukierman above.

monetary policy. The objective of monetary policy is also set by statute. Legal provisions are also in place to strengthen the central bank's position in case of conflict with the government. Economic autonomy refers to the operational independence of the central bank, particularly limitations on the obligation of the bank to provide credit to government and its freedom to employ the instruments of monetary policy to achieve its objective. The objective pursued by the central bank could either be its own, in which case there is also target (or goal) independence or those of the government. Often, for instance, in countries that have adopted an explicit inflation targeting framework, the specific inflation target is set by the government, in consultation with the central bank.

The more common terminology, however, is the result of the work carried out by Debelle and Fischer who called these two aspects "goal independence" and "instrument independence." Goal independence refers to the central bank's ability to determine the goals of policy without the direct influence of the fiscal authority. In the United Kingdom, for instance, the Bank of England lacks goal independence since the inflation target is set by the government. In the United States, the Federal Reserve's goals are set in its legal charter, but these goals are described in vague terms (for instance, maximum employment), leaving it to the Fed to translate these into operational goals. Thus, the Fed has a high level of goal independence. Price stability is mandated as the goal of the European Central Bank (ECB), but the ECB can choose how to interpret this goal in terms of a specific price index and definition of price stability.

Instrument independence refers only to the central bank's ability to freely adjust the policy tools at its disposal in the pursuit of the goals of monetary policy. The Bank of England, while lacking goal independence, has instrument independence. Given its inflation mandate is set by the government, it is nonetheless able to sets its instruments without influence from the government. Similarly, the inflation target range for the Reserve Bank of New Zealand is set in its Policy Targets Agreement (PTA) with the government, but given the PTA, the Reserve Bank has the authority to sets its instruments without interference. The Federal Reserve and the ECB have complete instrument independence.

1.4 Measuring CBI

The most widely employed index of central bank independence is that ascribed to Cukierman, Webb, and Neyapti, although alternative measures were developed by Bade and Parkin (1984), and Alesina, Masciandaro, and Tabellini (1991), among others.[26]

The Cukierman, Webb, and Neyapti index is based on four legal characteristics as described in a central bank's charter:

-First, a bank is viewed as more independent if *the chief executive is appointed by the central bank board rather than by the prime minister or minister of finance*, *is not subject to dismissal, and has a long term of office*. These aspects help insulate the central bank from political pressures.

-Second, independence is higher *the greater the extent to which policy decisions are made independently of government* involvement.

[26] Cukierman, A. *Central Bank Strategy, Credibility and Independence: Theory and Practice* (Boston: MIT Press, 1992), Chapters 19-21. Cukierman is the first author to argue that there can be a wide gap between "de jure" and "de facto" CBI. He argues that CBI is affected by the degree of de jure independence, but it is also determined by a host of other factors such as informal arrangements or actual practices, the central bank's quality of research, personalities of key staff, the treasury or ministry of finance. He further points out the difficulty in coding these

- Third, a central bank is more independent if *its charter states that price stability is the sole or primary goal of monetary policy*;

-Fourth, independence is greater if there are *limitations on the government's ability to borrow from the central bank*.

Cukierman, Webb, and Neyapti combine these four aspects into a single measure of *legal independence*. Based on data from the 1980s, they found Switzerland to have the highest degree of central bank independence at the time, closely followed by Germany. At the other end of the scale, the central banks of Poland and the former Yugoslavia were found to have the least independence.

Legal measures of central bank independence may not reflect the relationship between the central bank and the government that actually exists *in practice*. In countries where the rule of law is less strongly embedded in the political culture, there can be wide gaps between the formal, legal institutional arrangements and their practical impact. This is particularly likely to be the case in many developing economies. Thus, for developing economies, it is common to supplement or even replace measures of central bank independence based on legal definitions with *measures that reflect the degree to which legally established independence is honored in practice*. Based on work by Cukierman, measures of actual central bank governor turnover, or turnover relative to the formally specified term length, are often used to measure independence. High actual turnover is interpreted as indicating political interference in the conduct of monetary policy.

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elements to derive empirical measurements for CBI. For a more complete commentary on Cukierman, see

In view of the fact that this paper's enquiry is being conducted in the context of law and development, particular attention will be paid to the legal measures of CBI.

2. Issues posed in CBI

2.1 Central Banks and Monetary Policy

Monetary policy is concerned with the *control of money supply* in the economy. Effective implementation of monetary policy is important for economic development due to its influence on the general level of prices for goods and services, financial stability, the cost of credit and employment.

There are four basic goals of monetary policy, which are pursued by central banks. These are:

- *Price Stability* (low inflation). This entails achieving and maintaining a low inflation rate;
- *Economic Growth*;
- *Low Unemployment*; and

Laurens, Arnone and Segalotto, pp 16-18.

- *Financial Stability*. This includes the stability of financial institutions, interest rates, and foreign exchange rates. Financial stability creates a favorable investment climate and promotes economic growth.

2.2 Theoretical Frameworks of CBI

CBI is often incorporated in theoretical models through the weight given to the inflation objectives of the central bank. When the central bank's intent to control inflationary forces exceeds that of the elected government, the central bank is described as a Rogoff-conservative central bank[27]. Conservatism of this type is consistent with the notion that independent central banks are more concerned than elected governments with maintaining low and stable inflation. Rogoff's formulation reflects both a form of goal independence (the central bank's goals differ from those of the government) and instrument independence (the central bank is assumed free to set policy to achieve its own objectives).

Critics have noted that a problem with Rogoff-conservatism's independence model is it implies a conservative central bank will allow output to be more volatile in order to keep inflation stable. However, the empirical research has found no relationship between real fluctuations and measures of central bank independence.[28]

An alternative model is to view the central bank as having its own objectives, which then must also take into account the government's objectives when deciding on policy. The

[27] So named after Kenneth Rogoff, who in his 1995 model of the conservative central banker showed that society can make itself better off by appointing a conservative central banker who does not share the social objective function but instead places too large a weight on inflation stabilization. See Rogoff K. "The Optimal Degree of Commitment to an Intermediate Monetary Target", *Quarterly Journal of Economics*, 100, pp 1169-90.
[28] Walsh,C.E., p.13

central bank might set either a lower than desired inflation target than the government or an output target that, unlike the government's, is consistent with the economy's natural rate of output. If actual policy is set to maximize a weighted average of the central bank's and the government's objectives, the relative weight on the central bank's own objectives provides a measure of CBI. Thus with complete independence, no weight is placed on the government's objectives and with no independence, all weight is placed on the government's objectives. If the objectives of the central bank and the government differ only in their desired inflation target, then it is argued that the degree of central bank independence affects average inflation but not the volatility of either output or inflation. Such a formulation is consistent with the empirical evidence discussed above.

2.3 Inflation and Other Factors

Even if CBI leads to lower inflation, the case for independence would be considerably weakened if it also leads to a greater degree of real economic instability. However, little relationship has been found between measures of real economic activity and central bank independence (Alesina and Summers 1993). In other works, countries with more independent central banks enjoyed lower average inflation rates yet suffered no cost in terms of more volatile real economic activity.

While standard indices of CBI are structured to weigh heavily the "independence" factor of central banks with respect to controlling inflation among developed economies, this has not always been the case among developing economies. In these economies, another factor also appeared to be at work. Countries that experienced rapid turnover among their central bank heads also tended to experience high rates of inflation although a recent exception can be cited in Zimbabwe's case, where in spite of its hyper inflation, the Reserve Bank governor has remained unchanged since 2003. This is a case, however, in which causality is difficult to evaluate. Is inflation high because of political interference that in turn leads to rapid turnover of central bank officials or are central bank officials removed because they are unable to keep inflation down?

The empirical work linking low inflation outcomes to central bank independence has been criticized in two respects. First, studies of central bank independence and inflation often failed to adequately reference *other factors* that might account for cross-country differences in inflation experiences. Countries with independent central banks may differ in ways that are systematically related to average inflation. After controlling for other potential determinants of inflation, Campillo and Miron (1997) found that central bank independence was not a major factor.

Second, treating a country's level of CBI as exogenous may be problematic. Posen (1993) has argued strongly that both low inflation and central bank independence reflect the presence of a strong constituency for low inflation. Average inflation and the degree of central bank independence are jointly determined by the strength of political constituencies opposed to inflation. In the absence of these constituencies, simply increasing a central bank's independence will not cause average inflation to fall.

2.4 Independence and accountability

While many countries have granted their central banks more independence, the idea that central banks should be completely independent has come under criticism.

Critics tend to emphasize:

- The danger that an independent central bank will not be accountable;

-although maintaining low and stable inflation is an important societal goal, it is not the *only macroeconomic goal*;

- Monetary policy may have no long-run effect on real economic variables, but it *can affect the real economy in the short run*.

-in a democracy, delegating policy to an independent agency requires *some mechanism* to ensure *accountability*.

Mark Wiesbrot has argued thus:

> The President of Argentina, Cristina Fernandez, recently fired the head of the central bank, Martin Redrado, when he rejected the government's plan to use $6.6 billion of international reserves to pay off debt. The domestic and international press response was overwhelmingly negative, with complaints that this would "kill central bank independence." Leaving aside the question of whether it is a good idea to use these reserves to pay off international creditors -- something that perhaps only the future will tell -- is there a good reason why central banks should be "independent" of their elected governments? The business press, which has the support of the vast majority of economists on this question, thinks there is. The basic argument is that if the central bank is not able to determine monetary policy free of "political considerations," then politicians will force the bank to be "too loose" with monetary policy and the country will end up with dangerously high levels of inflation.
>
> This would seem to be a tough argument to swallow for anyone who believes in representative democracy. Fiscal policy -- the government's decisions with regard to spending and taxation -- is also a major determinant of economic activity. There are important tradeoffs that affect the livelihood, income and employment of most of the population. Yet in the U.S., these decisions are entrusted to our elected representatives in Congress, together with the executive. There is no obvious reason why monetary policy -- the central bank's decisions with regard to interest rates and money supply -- is so different from other major policy decisions that it should be specially insulated from the electorate. There is no valid analogy, for example, to the independence of the judiciary -- which is based on a theory of separation of powers, or checks and balances, ostensibly to limit abuses of power or infringements on civil rights and liberties. The argument for an independent central bank is more purely an elitist argument.[29]

[29] Wiesbrot, M: "Central Bank Independence: From Whom?", *The Guardian*, 15th February, 2010

For this reason, Wiesbrot among others contends that reforms have often granted central banks *instrument* independence while preserving a role for the elected government in establishing the goals of policy and in monitoring the central bank's performance in achieving these goals.

3. CBI in the International Context

One can gain additional perspective on CBI and the issues posed by it by reviewing the experiences of developed economies such as the United Kingdom (Bank of England), United States (Federal Reserve), European Community (European Central Bank), and fast developing economies, such as China.

3.1 CBI-The Bank of England Experience[30]

Background:
In the case of CBI in the United Kingdom (UK) the independence factor must primarily be reviewed and assessed in relation to *monetary policy*. Although today, the idea of CBI has popular support in the UK, this was not always the case. Historically speaking CBI in the UK has led to frequent and serious debate regarding pros and cons. For just over 50 years (1946 -1998) the Bank of England (BOE) operated under legislation which, remarkably, did not define its objectives or functions. These in turn were simply assumed to have been carried over from the 17th Century.

The 1946 Bank of England Act conferred upon the BOE powers, subject to the agreement of the Chancellor of the Exchequer, to issue directions to bankers though the term 'bankers' was not defined. It provided for the Treasury after consultation with the Governor to give such directions to the Bank as were thought necessary in the public interest. Such directions would necessarily have been made public; none were in fact ever given.[31] In any event the Bank of England was in a formal and statutory sense strongly wedded to the Treasury.

In 1992, after the UK exited its currency from the European Exchange Rate Mechanism (ERM) of fixed exchange rates, there was a focus by the BOE on inflation targeting. Scholarly theoretical and empirical works (as noted above) suggest that an essential pre-requisite for inflation targeting is instrument independence for the central bank. However, during the period of 1992-1997 the UK experience proved unusual, as an inflation targeting regime was pursued without the BOE having operational independence to set interest rates. During this time, interest rates in the UK were set by the government pursuant to meetings between the Chancellor of the Exchequer and the Governor of the BOE. Gillian Hammond, a Director of the Bank of England, points out that at this time it was not universally accepted in the UK politically or academically that central bank independence was necessarily a good thing. The choice seemed to be between monetary policy decisions taken in the central bank by unelected officials (resulting in a "democratic deficit") or,

[30] Hammond, Gillian: "Central Bank Independence: The Bank of England Experience" paper presented at *Symposium on Central Bank Independence: Does it hurt the Treasury?* (Bank of Zambia, Department for International Development Symposium, Livingstone Zambia, 2008),pp 51-56

[31] *Bank of England Quarterly Bulletin*, November 2000, Speech by Governor Edward George.

alternatively, monetary policy decisions taken by politicians with a short term horizon (leading to "inflation bias").

Hammond has maintained that the key to resolving this dichotomy was seen to lie in *creating strong institutional arrangements*, and, most importantly, in ensuring *clear accountability for the central bank*.[32] Another executive director of the BOE recalls that, in the 1990s, "it was a real obstacle to independence that the Bank would not be able to account for its monetary stewardship on the Floor of the House of Commons".[33] A key part of the debate then was and now is how to make the central bank sufficiently accountable.

In 1997, the BOE gained operational independence in monetary policy, namely the ability to set interest rates independently from political influence from the government. The objective was stated to be that of achieving price stability. A new monetary policy framework was introduced under which the government sets an inflation target and the BOE conducts monetary policy in order to achieve this target. The new framework is generally regarded as a

[32] Hammond,G: "Central Bank Independence: The Bank of England Experience", paper presented at *Symposium on Central Bank Independence: Does it hurt the Treasury?* (Bank of Zambia, Department for International Development Symposium, Livingstone Zambia, 2008)pp 49-55
[33] "Central Banking and political economy; the example of the UK's Monetary Policy Committee". Speech by Paul Tucker June 2007, as quoted by Hammond G, p.51

success with inflation remaining within 1 percentage point of the target in all but one month over the last 10 or so years.

Some British scholars argue that during this period, *accountability* could serve as a substitute for *independence*[34], and consequently reduce the inflation bias. Transparency was and is seen as a key ingredient of inflation targeting. Moreover in the UK accountability took a number of forms: (i) publication by the Bank of England of its Inflation Report (noted as the most important); (ii) publication of the Minutes of the Governor/Chancellor meetings, and (iii) appearances by the Governor in *front of the parliamentary committee*. These channels, through which the Bank revealed its independent assessment of economic conditions and its policy recommendations, were seen to act as a constraint on the government in setting monetary policy. Through greater transparency and accountability the Bank of England arguably acquired greater credibility.

The idea of operational independence for the central bank gained support, and is reflected in the legislation underpinning the Bank's independence, namely the 1998 Bank of England Act which seeks to make provision for "the constitution, regulation, financial arrangements and functions of the Bank of England, including provision for the transfer of supervisory functions; to amend the Banking Act 1987 in relation to the provision and disclosure of information [and] to make provision relating to appointments to the governing body of a

[34] Briault, Haldane and King "Independence and accountability", October 1995.

designated agency under the Financial Services Act 1986."[35] The Act goes on to define the monetary policy objectives of the Bank of England:

(a) To maintain price stability; and

(b) To support the Government's economic policy, including its objectives for growth and employment.

Once again, the answer to managing any trade-off was seen to lie in democratic accountability.

One other concern in granting operational independence for monetary policy to the BOE was whether this would result in conflicts between monetary policy and banking supervision. There is a much wider debate about whether prudential supervision is best done by the central bank or a separate agency, and whether it is the same in industrialized and developing countries. In the UK case major concerns included:

i) Could there be a *conflict of interest* between monetary policy and banking supervision? (the concern being that BOE may have to modify monetary policy to take account of problems in the banking sector);

ii) problem banks may *divert the attention of senior managers* from monetary policy;

iii) *bank failures* could adversely affect the *central bank's credibility*; and

[35] Bank of England Act 1998

iv) *Too much concentration of power* in one institution.

Some of these factors may have been relevant in the decision in 1997 to create an *independent consolidated regulator*; the Financial Services Authority, at the same time as operational independence was granted to the BOE. However, the driving motivation for this was to consolidate prudential regulation which at the time was spread across more than 10 different regulators, under one roof.

Support for BOE independence increased during the 1990s, with growing acceptance of the economic argument that the primary goal of monetary policy should be price stability, and the experience of a transparent monetary policy framework which held policy-makers to account. European politics also played a part as *central bank independence was a pre-requisite* for Economic and Monetary Union in Europe.

Aspects of Bank of England Independence

Some of the key features of central bank independence in the UK include: the *mandate*; *terms of appointment*; *relationship with Government*; and *financial independence*.

(i) Mandate

The operational independence of the Bank of England is underpinned by legislation in the Bank of England Act of 1998. This sets out the details of the inflation targeting framework, and also details the new governance arrangements for the Bank. Under this framework, the inflation target is set by the Government. This is currently a symmetric point target for inflation of 2% per annum as measured by the consumer price index.

Monetary policy decisions are taken by a Monetary Policy Committee (MPC). Composed of nine individuals including the Governor and two Deputy Governors, the Chief Economist, the Executive Director responsible for market operations and, four External Members, who are appointed on the basis of their experience or expertise in monetary policy. The MPC meets every month to decide what interest rate is necessary to achieve the inflation target. Interest rate decisions are taken by a majority vote, with the Governor having the casting vote in the event of a tie. The minutes of the meeting, together with details of the individual votes, are published two weeks later.

The established traditions of transparency and accountability thus continue and are strengthened. The Bank is accountable to the government and to parliament. One aspect of this is the Open Letter; if inflation moves away from the target by more than 1 percentage point, the Governor must write to the Chancellor explaining why this is so, and what the MPC is doing to bring inflation back to target. The first such Open Letter was written in March this year.

Members of the MPC are *individually* accountable to parliament. The MPC reports to two Parliamentary committees, including regular appearances after publication of the Inflation Report. The MPC is also accountable to the Court of Directors of the Bank of England; an oversight body composed of the Governor, Deputy Governor and sixteen non-executive directors, and of course, to the public.

(ii) Terms of Appointment

An important CBI safeguard to be the term of appointment for each of the governors and other members of the Monetary Policy Committee, with the principal objective of *avoiding political influence*. The terms of appointment of the BOE's MPC are:

Internal Members	Governor	Appointed by the Crown for 5 years
	Deputy Governor For Monetary Policy	
	Deputy Governor for Financial Stability	
	Executive Director for Monetary Analysis (Chief Economist)	Appointed by the Governor for 3 years after consultation with the Chancellor of the Exchequer
	Executive Director for Markets/Monetary Policy Operations	
External Members	Can be full-time or part-time Can only do other jobs that do not pose a conflict of interest	Appointed for 3 years by the Chancellor of the Exchequer

A member of the Committee may only be removed from office if:

- He/she has been absent from meetings for more than three months without the Committee's consent;
- He/she has become bankrupt; or
- He/she is unable or unfit to discharge functions as a member.

In each case the removal may only take place with the approval of the Chancellor.

(iii) Relationship with the Government

-The relationship between the central bank and government is important for monetary policy, for the balance between monetary and fiscal policy, and in the area of financial stability. On monetary policy, it has already been noted that the government sets the inflation target, and the BOE has operational independence to achieve the target by its conduct of monetary policy. Since the Government is responsible for setting fiscal policy, and also sets the inflation target, there should be no conflict between monetary and fiscal policy. The MPC takes account of the overall fiscal stance, which contributes to domestic demand, in setting monetary policy, but does not comment, on individual fiscal measures. A representative of the Treasury is present at all meetings of the MPC, *as an observer*. He/she may participate in the discussion – to inform the Committee on fiscal matters or any relevant aspects of the Government's wider economic policies– but *may not express a view* on the monetary policy decision, or vote.

-In the area of financial stability, the tripartite arrangements and respective roles of the Bank of England, the Financial Services Authority and the Treasury are set out in a Memorandum of Understanding (MOU). The Lender of Last Resort arrangements set out in the MOU were exercised recently in the case of Northern Rock Bank. No doubt lessons will be learned from this experience.

(iv) Financial Independence

A major tenet of central bank financial independence is "non monetary financing", i.e., that the central bank should *not finance government deficits*. This is prohibited under the terms of the Maastricht Treaty in Europe, which prevents central banks in the European Union from making loans to government and public authorities. Neither may central banks purchase government securities in the primary market.

CBI in the case of the BOE has been accompanied by a great deal of transparency and accountability, to Government, to Parliament, to the Board of Directors (Court), and to the public. The monetary policy framework of inflation targeting, and operational independence for the central bank has been successful, with inflation remaining close to target, and inflation expectations well anchored. The resulting economic stability has surely been beneficial to the Treasury, and to the country as a whole. The nature of central bank independence in the UK is very much geared to its particular institutions, culture and history.

3.2 CBI- The U.S. Federal Reserve Experience

In the United States, the issue of the autonomy of the monetary authority has also long been the subject of much discussion and debate. A point of note is that, unlike the leading European nations, from the early decades of the American Republic, the US lacked a central bank that evolved with its financial system. The US Constitution written in 1787 only empowered Congress to "coin money" and "regulate the value thereof".

In creating the Federal Reserve System in 1913 Congress both *exercised and delegated* its constitutionally mandated monetary powers. Sylla has observed that the delegation of monetary authority to a new Federal Reserve System in many respects was intended to be *independent* of private business financial interests, duly constituted government (executive and legislative authorities) and other partisan political interests[36]. The Federal Reserve System evolved as a compromise between two earlier central banking traditions that were implemented and then rejected on the grounds that *they were not sufficiently independent* of particular economic and political interests.

The first tradition was that of the *Corporate Central Bank*, which was publicly chartered and privately owned. This arrangement was similar to that of the Bank of England which had, by 1913, been in place for two and a half centuries. This structure came to be perceived by political interests as inconsistent with democratic and republican principles. Additionally economists and bankers perceived it as contrary to their own economic interests, and both constituencies served to defeat the renewal of the charters, which were allowed by Congress to lapse.

The second tradition involved an *Independent Treasury System*, during which era, the Treasury also acted as the Central Bank. With the lapse of the second CCB charter in 1840, the US embarked upon the ITS system. The ITS was underpinned by a belief that the government's fiscal operations could be carried out *independently* of the nation's banking and financial systems by isolating the finances of the Federal government from those of the banking system. This was executed through the government's fiscal authority (the Treasury) as the

[36] *Ibid in Toniolo, p.17*

central bank. Under the ITS, the government established sub-treasuries in a number of cities to receive and hold its revenues which in the main consisted of import duties.

With rapid economic growth, the sub-treasuries accumulated substantial surpluses which would have had the effect of deflating monetary contraction in the economy. However, given the levels of the public debt, which had in the meanwhile been accumulated during the period of the civil war (1861-1865), the Treasury applied most of its surplus towards the retirement of this debt. In this way, Treasury actions were similar to open market purchases of securities offsetting otherwise deflationary effects and embodied what later became an important central bank function.

The ITS too *came* to be perceived by a new growing elite of managers and owners of the large manufacturing corporations (that were then first appearing), politicians, bankers and financiers as akin to placing the country in the hands of a few financiers and bankers as well as the Treasury itself. This perception was enhanced by Treasury interventions from time to time involving the depositing of excess reserves in select banking institutions. Jerome Clifford quotes a financial periodical commenting on the period 1900 -1914:

> A few years ago, when the United States Treasury was burdened with excessive revenues and the money market depended on the whim of the Secretary of the Treasury, practically all public men, of whatever shade of political belief, were agreed that the government ought to be taken out of the banking business.[37]

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[37] Clifford, A. Jerome: *The Independence of the Federal Reserve System* (Philadelphia: University of Pennsylvania Press, 1965), p.50

An additional unexpressed fear was that the Treasury would have a *long run bias towards easy money and inflation*, and these factors were uppermost in the elite's fight for an independent central bank under the Federal Reserve Act. The system was eventually undone by the series of crises resulting in the great financial panic of 1907, emphasizing the urgency for a strong independent federal reserve system.

Thus the Federal Reserve Act of 1913 considered both the CCB and ITS traditions, rejecting both and concentrating on several new features. In the first instance, the Act did *not* create a Central Bank, but a central banking *system* with twelve regional Federal Reserve Banks, each operating and having authority in a defined geographical area of the United States, with a coordinating Federal Reserve Board in Washington DC. The regional reserve banks were intended to be free from domination from either the nation's financial capital (New York) or its political capital (Washington D.C.).

Unlike the regional reserve banks, the Federal Reserve Board was a government institution. Its board consisted of 5 members appointed for staggered 10 year terms by the President of the United States, as well as two *ex officio* members, the Secretary of the Treasury and the Comptroller of the Currency. Its principal function was to oversee and supervise the operations of the Reserve Banks, to regulate relationships between them and between the government and the reserve banks, and to in general bring about a uniform *banking* and *monetary* policy in the United States.

Scholars have observed that the original system created in 1913 and implemented in 1914 was riddled with structural weaknesses:

-the authority of the Federal Reserve Board ("the Board") in relation to the regional Federal Reserve Banks ("the FRBs") was not clearly drawn;

-disputes arose as to whether the Board or the FRBs had ultimate power over open market operations and rediscount rates;

-there were worries (in view of the fiscal costs associated with Word War 1) that the Secretary to the Treasury exerted excessive influence and dominance.

These structural weaknesses which allowed the Banks and member banks influence and power over monetary policy, are said to have greatly contributed to the debacle of the Great Depression of 1929-1933. Out of that experience further changes to the legislative structure were subsequently effected with the Legislative Acts of the 1930s, notably the Banking Act of 1935 which increased the authority of the Board over both the FRBs and the member banks of the system.

Symbolic gestures included changing the name of the Federal Reserve Board to the *Board of Governors of the Federal Reserve System* (and the Head thereof termed Chairman) and powers conferred on the *Governors to appoint the President* (not termed Governor) of each of the FRBs as Chief Executive. Substantive powers conferred included the power of the Board of Governors to *alter the legal reserve requirements* of member banks, set *maximum interest rates* which the member banks could pay on time deposits and to set *margin requirements* on loans for purchase of securities. The two ex officio members, the Treasury Secretary and the

Comptroller of Currency, were removed and replaced by two members appointed by the President of the US, thus reducing direct Treasury influence on Board actions. The terms of Board Governors were extended to 14 years, thus making it difficult for any single President to make the board sympathetic to his Executive will.

Authority to determine open market operations was vested in *a new 12 member agency*, the Federal Open Market Committee (FOMC) consisting of 7 Board Governors and 5 FRB Presidents on a rotational basis (a change from the previous order where this power reposed in the Banks Governors, and the FRBs had discretion in the conduct of open market operations).

Richard Sylla has argued that "the legislative changes of the 1930s might seem to give lie to the notion of Federal Reserve independence from other duly constituted governmental authorities. They demonstrate that Congress could fundamentally alter the manner in which the system was constituted and how it was to carry out its functions whenever Congress deemed such legislative action to be proper."[38]

The Federal Reserve, known familiarly as "the Fed," was established during the days of the gold standard. The gold standard implied relatively stable prices over the long-run. Thus the Fed was created to prevent recurring bank runs, furnish an elastic currency and provide better banking supervision. The former was achieved through the establishment of the FRBs which all offered discount loans against commercial paper ('real bills'), which meant the

[38] *In Toniolo*, *ibid, pp23-24*

supply of money could – to some extent - breathe with the economy. This might explain the reason why the Fed is still seen as much a guardian of financial stability as a defender of price stability.

With the 1935 Act, the US Treasurer and the Comptroller of the Currency relinquished their seats on the Federal Reserve Board, because as expressed by Senator Carter Glass (himself a former Treasury Secretary) it gave the Treasurer too much influence upon the Board. The Fed has since worked at a distance from the Executive while nevertheless maintaining regular informal contacts.

The channels for the Executive to exert pressure on the policy of the Fed are limited to:

i) its right to appoint the members of the Board (for 14 years and they cannot be re-appointed or fired without serious cause); and
ii) Its right to appoint every four years the chairman of the Board from amidst the members of the Board – though in both cases the Senate has to consent.

This is an important element with regard to checks and balances, especially because the Senate and President do not always represent the same political party. The FOMC itself consists of the seven members of the Board and the twelve presidents of the FRBs, five of whom may vote. The FRB presidents are appointed not by the government, but by the member banks of their respective FRB, although the Board may veto such appointment. This represents further checks and balances, in this case between the public and private domain.

The US Congress has no effective way of putting pressure on the Fed, *except by threatening to change the Federal Reserve Act*. This is an interesting point in itself, as the American Constitution has vested in Congress and not in the Executive the power 'to coin money' and 'to regulate the value thereof'. Congress has delegated this power to the Fed through the Federal Reserve Act. These *institutional arrangements* position the Fed strongly in terms of its independence from the government.

There have been some notable instances, however, when the Fed succumbed to pressure from the Treasury. As outlined in the foregoing, in the early years (until 1935), the Treasury sat on the Board. At the time of the First World War, the Fed agreed to keep interest rates low with the objective of preventing financial panic (a government not being able to pay its bills would have been cause for such financial panic). In addition, at the start of the Second World War the Fed once again agreed to *guarantee the success and low cost* of the Treasury's war financing. Yet another oft-cited example is the period of low interest rates in the aftermath of the Savings & Loans crisis of 1985, which was meant to allow these banks to build up adequate capital again. However, this seems to have been a decision by the Fed itself, as has indeed the Fed's overall reaction to the on-going global financial crisis.

Attacks by Congress on the Fed's policies are quite common. During recessions or high interest rate periods, a substantial number of Federal Reserve reform bills are tabled in Congress, but these usually lack substantive support.

3.3 CBI -The European Experience

The European System of Central Banks (ESCB) is much younger than the two other examples cited thus far. Its Statute was drafted in 1990 by the Committee of Governors of the central banks of the European Community Member States and it was approved by the governments in 1991 as part of the Treaty of Maastricht. The ESCB was activated in 1998, but its Statute dates from 1990. There is a direct line from the Fed to the ESCB, because the post-war Bundesbank was modelled after the Fed (with some differences),[39] and the ESCB was modelled to some extent on the Bundesbank. The Fed, and Bundesbank as well as ECB have a federal character.

Despite being modelled after the Bundesbank, the Statute of the ESCB is one of the most comprehensive central bank laws seen in the last few decades. It was drafted in 1990 by a committee of twelve central bank governors and discussed by the ministers of finance of their respective countries. The collective experience of these individuals condensed into the Statute of the ESCB.

The core of the ESCB consists of the euro currency-system. The euro-system is composed of the central banks of the countries that have adopted the euro as well as a central body, the European Central Bank (ECB). Formally the central banks of the UK and of the other European Union (EU) countries are also members of the ESCB, but the monetary policy articles of the ESCB Statute do not yet apply to those countries.

[39] For instance, the independence of the Bundesbank was explicitly provided for. The regional offices of the Bundesbank (Landeszentralbanken) were established after the war as legally independent entities, but their entities and balance sheets were merged into that of the Bundesbank , while their presidents became member of the Bundesbank's decision-making body (1957).

The Governing Council is the highest decision-making body of the ESCB. The Executive Board manages the ECB and has to ensure monetary policy is executed in accordance with the guidelines and decisions taken by the Governing Council. The Governing Council consists of the governors of the (at this moment) thirteen national central banks of the euro area, appointed by their national governments, plus the six members of the Executive Board of the ECB appointed by the Heads of State of the EU countries. The Governing Council meets twice a month, every first meeting is used to discuss the economic and monetary situation – though if necessary they can take interest rate decisions at any moment. The chairman of the Council of Finance Ministers of the euro area and a member of the European Commission 'may participate, without having a right to vote, in the meetings of the Governing Council.' Confidentiality is a legal requirement: there can be no leaking on positions taken. (In fact, until now the Governing Council has always decided by consensus on interest rates, i.e., no votes are taken, though different views can be and are expressed around the table.) Likewise, 'the president of the ECB shall be invited to participate' in meetings of the euro-group (Finance ministers of the euro area). The ESCB Statute specifies that political authorities may not seek to put pressure on the ECB, the Governing Council or its members. It will be clear therefore that the emphasis is on dialogue; there is no hierarchy.

When the Committee of Governors drafted the Statute, they listed four areas in which independence would be secured: *institutional* independence (i.e., not being subject to instructions, mentioned above); *personal independence*; *functional independence*; and *financial autonomy*.

-*Personal independence* refers to *security of tenure* for the members of the decision-making bodies. This has been achieved by fixing the appointment of the Executive Board members at eight years, non-renewable. The national central bank governors have to be appointed for at least five years. Board members and governors enjoy protection against dismissal at will.[40] In case of a dispute about dismissal, they can go to the European Court of Justice.

-*Operational* or *functional* independence is ensured by enlisting in the Statute a wide array of instruments and operations which are available to the ESCB.[41]

-*Financial autonomy* of the ECB is secured as the ECB can cover its costs from the seignoriage of the euro-system; in case of losses *these losses are covered by the national central banks*, which are the sole shareholders of the ECB.[42] The budget of the ECB is approved by the Governing Council, while the budgets of the national central banks are shown to their national authorities, which however, may not block them.

Institutional independence implies complete prohibition of any form of *monetary financing* of the government, be it in the form of credit or buying government paper at issue. Central

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[40] This protection is considered to extend to all board members of the national central banks. Most national governors can be re-appointed once only, although this may differ per country.

[41] There is a simplified amendment procedure which especially relates to these technical articles, preventing the need to change the Statute which would require a Treaty amendment.

[42] The difficult issue in this area was the distribution of the seignoriage of the euro-system among the euro area NCBs, but that is an internal matter not affecting their external financial independence. In the end, surplus profits of NCBs flow to their Treasuries.

banks may only buy government paper in the secondary market in the context of open market operations of the System.[43]

The ESCB also has the common mandate of maintaining price stability.[44] It is noteworthy that the ESCB, as well as the Reserve Bank of New Zealand *were the first central banks statutorily enshrined* with the single objective of price stability. Even the most notable bank in the European Community, the Bundesbank, did not have such a clear mandate, as its mandate was stated to be that of 'safeguarding the currency'.[45] The Bundesbank's success in this regard has been attributed to its high degree of independence which was strongly supported by the population.[46] This experience set the benchmark for the Statute of the ESCB, which provided for the establishment of the ESCB as an independent central bank with price stability as its objective.

"Price stability" is not defined by the Statute of the ESCB. It is defined by the ECB. A few months before the start of Economic and Monetary Union in 1999, the ECB, established in June 1998, defined price stability - as part of its broader monetary strategy – as an inflation rate below two per cent, while adding that price stability is to be maintained over the medium-term. In 2003, the Governing Council clarified price stability meant 'close to but below 2%'. The ECB has been quite successful, because despite consistently overshooting

[43] In the Netherlands the government keeps its overnight balances with commercial banks and at the end of each day only a limited positive amount at DNB. During the day the government gets unlimited intra-day credit from the central bank; this lubricates the national payments system.

[44] The ECB's secondary objective ('without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Community.') hardly plays a role in practice, as price stability is almost never automatically secured.

[45] This could mean safeguarding the' external' or 'internal' value of the currency. In practice, the Bundesbank gave preference to stabilizing the domestic value of the currency.

[46] This strong support can be explained by the disastrous hyperinflation in the interbellum.

the 2% by a small margin almost every year, the medium-term inflationary expectations in the euro area always remained 2%.

The ECB's objective is more specific, the ECB's Board members may be invited to appear before the European Parliament, though parliament does not have a formal say over monetary matters. Comparatively, Bundesbank board members never appear before parliament. The difference is more defined when the actual practice is considered. The Governing Council gives a press conference after every first meeting of the month. The ECB has defined price stability, whereas in the case of the Bundesbank, it has always remained implicit. The Bundesbank operated in the age of *central bank secrecy*, while the ECB is clearly part of the more transparent world of today.

The ESCB is also considered by experts to be highly accountable and transparent, more so than the (pre-EMU) Bundesbank; i.e., it is considered more independent, yet still more accountable.[47] The *high degree of accountability of the ESCB has not proven a substitute or enemy of independence*, but improved the checks and balances and *in toto* and thus increased the strength of the framework and of its independence.

[47] See Van der Berg, C:"Central Bank Independence: The Experience of the European Central Bank and the Federal Reserve System", paper presented at *Symposium on Central Bank Independence: Does it hurt the Treasury?* (Bank of Zambia, Department for International Development Symposium, Livingstone Zambia, 2008),pp 57-63

The ESCB has in its early years seen some serious political pressure. The first instance was with the appointment of Wim Duisenberg as the ECB's first president for a term of eight years beginning in May 1998. Then French President Jacques Chirac wanted him appointed for a term of only four years after which his candidate Jean-Claude Trichet would take over. This almost succeeded until the German Chancellor Helmut Kohl backed off on fears that he would be accused of violating the Maastricht Treaty. A second occasion was in early 1999 when the German Minister of Finance Oskar Lafontaine openly criticized the ECB and called for lower interest rates. With his sacking by Chancellor Schroder for other reasons, his exertion of political pressure had no effect on policy. In 2008, French President Nicolas Sarkozy criticized the ECB and questioned whether its hike of interest rates by a quarter percentage point was "reasonable". This did not result in any change of policy by the Bank.

However, there have also been occasional attempts to change the articles relating to the ESCB in the wake of broader Treaty changes. In this way, unwanted changes which would affect the body's independence, arising from broader political concerns and deals could be the outcome. This requires the attention of the central banks to control the process, given the political dictates of their Heads of State. Although the foregoing examples do not apply directly to the central banks on the continent, nonetheless they go to show that a central bank's independence is *never guaranteed from political interruption and interference through the legislative process*.

Finally, economic and legal scholars have pointed out that the benefits of CBI are clear for industrialized nations as it offers great moderation, especially for 'inflation targeting' countries. The benefits include removal of the 'time consistency' problems associated with government actions and anchored inflation expectations, which enables decisions to be anticipated and minimizes shocks to the economy.

3.4 China and CBI

The People's Bank of China (PBOC) was founded in 1948 and is China's central bank. Its headquarters were originally in the Hebei Province, but moved to the larger city of Beijing. Within a year of the bank's inception, the ruling Communist party incorporated all of the nation's banks into the PBOC, making it responsible for the nation's commercial and central banking. This dual role lasted for almost half a century, and the commercial banking aspect was only separated from the central bank in the 1980s when it was divided among four independent but state-owned banks.

The PBOC started functioning as an independent institution in 1983, although its legal status was not confirmed by law until 1995. This change was reflected in the People's Bank of China Law adopted in 1998 and whose goal was to complete the transformation of the People's Bank of China into a central bank, consciously modeled after the United States Federal Reserve System. Accordingly, in 1998, the PBOC underwent a major restructuring. All provincial and local branches were abolished, and the PBOC opened nine regional branches, whose boundaries did not correspond to local administrative boundaries. Like its American counterpart, this was intended to reduce the influence that local officials had on the PBOC policy making process.

Until 1998, the bank was relatively dependent on the Chinese government, and had *limited* goal independence and instrument independence. In that year, the administrative system of the PBOC was effectively reformed and the independence of the bank was strengthened.

Empirical studies have shown the importance of central bank independence in avoiding financing for the government's spending at the cost of high inflation rate. China is no exception in this regard and the inflation rate in China became much lower and more stable after 1995, when the People's Bank of China gained its official recognition and independence.

The central bank's actions have gained greater importance in the 21st century as a result of China's economic reforms and the country joining the WTO (World Trade Organization) in December 2001. With its economy growing annually at over 10% per annum over the last 10 years, there has been need for strong and modern economic policy. Some aspects of economic reform have moved slowly though, and as a result, in 2003 the government stripped the PBOC *of its regulating responsibilities*, handing them over to the newly created China Banking Regulatory Commission. In the same year, the role of the PBOC in making and implementing monetary policy was further strengthened in law by the Standing Committee of the Tenth National People's Congress.

Although the structure of the PBOC is similar to that of the Federal Reserve, there are many significant differences between the two institutions, the most important of which relates to the *bank's independence.* All decisions of the PBOC *must be approved by the State Council*, which tremendously limits its power to fulfill its objectives. The bank's main task is to *maintain China's monetary policy*. It also prevents and resolves financial risks, and *safeguards the nation's financial stability*, in addition to the management and implementation of China's foreign exchange and reserves management policy.

China's example illustrates the fact that CBI is not limited to openly democratic political dispensations, and has been recognized by even those systems that are not, as a necessary but not entirely sufficient condition for economic growth.

3.5 CBI in Developing Countries

In developing countries, although the emphasis on inflation targeting is an important consideration, there are other motivational considerations when examining the issue of CBI, which the paper shall deal with. Examples of independent central banks, from anecdotal and empirical evidence in developing and emerging market countries include:

i) Ghana and Mauritius, with independent central banks and strong, unequivocal support from the Ministry of Finance;
ii) Mexico, Chile and Colombia, which have achieved sizable disinflation with substantial CBI and
iii) Singapore, which combines inflation targeting with exchange rate management and yet has attained success with disinflation.

As regards CBI in developing countries, Argentina continues to be an interesting case. An article dated February 4th 2010, in the Financial Times notes:

> In a move that has surprised markets, Mercedes Marco del Pont has been chosen as the new Argentinean central bank chief with immediate effect. Markets had expected the interim governor and former chief, Mario Blejer, to remain in office until September, when ousted chief Martin Redrado's term was due to end. The appointment heightens fears for central bank independence in the country. "Ms Marcó del Pont is seen as very close to the government, which means that the central bank will continue to be virtually subordinated, in terms of policy directives, to the government," said Alberto Ramos, an economist at Goldman Sachs. Ms Marcó del Pont previously headed the state-run Banco de la Nación.

Further consideration of the African CBI context using selected examples is in order both to understand the issue of independence in general as (it relates to economic development) and in order to better lay the context for Zambia.

4. CBI in the African Context

4.1 General Overview

Megan Presnak[48] has emphasized that developing countries, and African countries in particular, are faced with many factors that affect their inflation rates. The government's role is seen as crucial in providing the necessary infrastructure and social capital to facilitate economic development. Citizens look to the government to compensate for market failures, which usually results in populist spending and debt accumulation. Politicians tend to twist monetary policy to benefit themselves and their loyalists, which results in large scale patronage and non transparent practices as well as economic policy that in the long term cannot be sustained.

4.2 Background to and issues in African CBI

Most of Sub-Sahara Africa has been plagued in the post-independent era, by political instability. In their work regarding political influence on central banks, Cukierman and Webb[49] confirmed that political instability negatively affects macroeconomic policy and outcomes, and leads to rising inflation rates.

An additional factor in Africa and the developing economies, is that *legal independence* of the central bank as contained in statutes tends to differ from *actual behavioral* independence

[48] Presnak, ibid, p.2

[49] Cukierman A, and Steven B. Webb: "Political influence on the Central Bank: International Evidence", *World Bank Economic Review*, Vol. 9, No. 3, 1995

mainly as a consequence of the supremacy of the Executive over other organs of power. The *actual* degree of CBI therefore, is determined by those who are in a position to delegate power, namely government officials. Further as the empirical work of Sylvia Maxfield[50] suggests, the behavioral independence of the central banks is determined by the incentives that financial structures impose on industrialists, politicians, and private financiers, and not necessarily by the bank's charter.

While *informal* central bank independence is best measured using a number of factors, collecting data for many countries is not practical. Instead, in her study, Presnak has suggested that using the empirical findings of Cukierman and Webb, the *turnover of central bank governors* serves as a more useful indicator of actual independence in most sub-Sahara African countries. The rates of governor turnover from periods shortly after a political transition are compared with turnover rates from other periods. During periods of heavy political influence, the rate of central bank governor turnover increases in both industrialized and developing countries. Most importantly, governor turnover is far more easily measured than factors such as the number of central bank victories over the government in policy debates. Using central bank governor turnover as a measure of behavorial bank independence is based on the assumption that a more rapid turnover rate indicates a lower level of independence. When governments take the time to choose a new governor frequently, it is probable that they will appoint someone who will cater to their demands. Conversely, frequent turnover may reflect dismissal of those governors who disagree with the government.

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[50] Maxfield, Sylvia:"Financial Incentives and Central Bank Authority in Industrializing Nations", *World Politics,* Vol. 46, No.4, July 1994

The use of central bank governor turnover, however, is not an ideal measure. A governor may be allowed to keep his position for an unusually long time simply because he or she is subservient or compliant to the government (as is the case of Zimbabwe cited earlier). Presnak suggests that this tends to be true generally in countries with stable authoritarian regimes. As Cukierman and Webb's pioneering study in this area has found, whereas governor turnover may have little bearing on bank independence in industrialized countries, it can act as a good indicator in developing countries.

Presnak's study concludes that when studying institutions, financial or governmental, sub-Saharan Africa cases cannot be lumped together with the whole of the developing world. Comparatively, African countries have fairly young institutions that were adopted from their colonial rulers after independence. Such institutions did not fit in to the traditional idea of leadership in African society, which in the main, was based on local units. Government authority in these largely authoritarian post-independent regimes usurped the power of the central bank in fighting inflation and pursuing a conservative monetary policy. She further points out that to effectively study the level of informal central bank autonomy in sub-Saharan Africa, further detailed case studies are required to address the various factors that affect it. In the interim and as African countries continue to develop and rid themselves of authoritarian regimes, governor turnover may serve as a valid indicator of informal CBI.

4.3 The Case for African CBI

Given the overarching importance of government and governmental institutions in most African citizens' lives, Ibrahim Stevens has argued that in the African context, the case for an independent central bank goes beyond the traditional monetary and financial stability objectives that are intended in OECD countries. He makes his contrasting argument for African CBI as follows:

> a number of factors make advantages of independent central banks *less obvious* for countries in Africa and include i) small local currency debt-GDP ratio; ii) high exposure to external shocks; and iii) governments' reluctance to relinquish control of monetary management. Nevertheless, a move for the *defence of public assets* makes arguments for independent central banks in Africa more compelling as opposed to the *defence of public debt in OECD countries* through inflation targeting. There are potential time inconsistency problems if *investments and savings decisions in extractive industries are left solely to politicians*. Additional roles for independent central banks in Africa (viewed as a possible solution to time inconsistency) include: i) negotiating and designing contracts for public assets; ii) informing and deciding on aggregate savings and investments; iii) creating a benchmark for public service ethos; and iv) Other regulatory functions in addition to traditional banking supervision. Discretionary regulation is more optimal if done by an independent central bank. [51]

[51] Stevens, Ibrahim: Discussion Paper presented at *Symposium on Central Bank Independence: Does it hurt the Treasury?* (Bank of Zambia, Department for International Development Symposium, Livingstone Zambia, 2008),pp 37-40

This case for the independence of the central bank as stated by Stevens has consonance with the role of custodian of and trusted advisor on the public good as perceived by Collier (and discussed earlier).

4.4 Brief African CBI Country Case Studies: Ghana and Mauritius

Ghana and Mauritius are widely reputed to be two case studies of successful CBI in Africa. A brief consideration of the historical context and issues involved is provided below.

(i) Ghana

Ghana's economy experienced severe crisis in the years 1960 to 2000, characterized by high inflation, high exchange rate depreciation and low growth. The poor performance was attributed to weak economic policies including fiscal dominance, where persistent fiscal deficits were financed by monetary accommodation. Inflation exhibited strong volatility. As part of the policy measures to restore macroeconomic stability, the government refocused the objectives of the Bank of Ghana to price stability through the passage of a new law, the Bank of Ghana Act, Act 612, in 2002.

The passage of the new Bank of Ghana Act, 2002 Act 612 helped to enhance the degree of independence of the Bank of Ghana in the conduct of monetary policy. First, the Act *established a Monetary Policy Committee* with the following responsibilities:

(i) Initiating proposals for the formulation of monetary policies of the bank;

(ii) Providing the statistical data and advice necessary for the formulation of Monetary policy.

Second, Section 30 of the Act *defined the framework for granting temporary advances to government*. Subsection 1 of Section 30 states that the Bank may make advances and loans to the Government on overdraft or in any other form that the Board may determine; or make direct purchase from the Government of treasury bills or securities representing obligations of the Government. Sub-section 2 further *limits the total of the loans*, advances, purchase of treasury bills and securities together with money borrowed by the Government from other banking institutions and the public at the close of a financial year *not to exceed 10 percent of the total revenue of the fiscal year* in which the advances were made. The Act also provides that any advance made shall be *repaid within three months* after the grant of the advance, and where that advance remains unpaid after the due date, the power of the Bank to make further advances in a subsequent financial year shall not be exercised unless the amounts due in respect of outstanding advances have been repaid. Where repayment of the advances and overdrafts is unduly delayed, the Bank *may transfer the debt to the public* through the sale of treasury bills.

These measures ensured that the Bank of Ghana was shielded from direct political or governmental influence in the conduct of monetary policy. As pointed out earlier, many scholars have argued that when Central banks are independent of political pressures they are able to effectively pursue policies that better focus on their immediate objectives.

Fiscal Dominance

At the time of the adoption of the inflation targeting regime in 2002, not all the preconditions for an inflation targeting framework had been fulfilled. The success of the new regime, as extensively discussed in the literature, depended on the fulfillment of certain preconditions such as the CBI, sound and well developed financial sector and the absence of fiscal dominance. Even though in 2002, independence of the central bank and a provision to tie the hands of the government in the new Act were in place it was not yet tested. The government implemented a series of reforms, rationalizing government expenditures and improving its revenue streams. In addition the country applied for debt relief under the IMF/World Bank HIPC Initiative leading to significant savings in interest expenditures. The budget deficit was reduced from over 9% of GDP in 2000 to about 1.7% of GDP in 2005. There were significant inflows of Aid to support the new reformist government. These developments helped to reduce financing needs of the budget and effectively shielded the Bank from possible testing of the new legal provisions under the new Bank of Ghana Act. One can conclude that the absence of fiscal dominance was *facilitated by concurrent reforms in fiscal policy* and a major ingredient of the success of the inflation targeting regime in Ghana.

(ii) Mauritius

Section 3 (3) of the Bank of Mauritius Act of 2004 provides that the Bank, in the pursuit of its objectives, shall perform its functions independently. The primary objective of the Bank is to maintain price stability and to promote orderly and balanced economic development. The other objectives of the Bank are to regulate credit and currency in the best interest of the economic development of Mauritius, to ensure the stability and soundness of the financial system of Mauritius and to act as the central bank for Mauritius.

One of the functions of the Bank is to conduct monetary policy and manage the exchange rate of the rupee, taking into account the "orderly and balanced economic development of

Mauritius".[52] In this respect, the Bank has to determine, with the concurrence of the Minister of Finance, the accepted range of the rate of inflation during a given period consistent with the pursuit of the price stability objective. That provision of the legislation cannot be an annual exercise. There is agreement that inflation should be low and stable.

Board of Directors

The Board of Directors consists of the Governor, who is the Chairperson, the two Deputy Governors and not less than 5 and not more than 7 other Directors. The Governor is *appointed by the President on the recommendation of the Prime Minister*. The Deputy Governors are *appointed by the President on the recommendation of the Prime Minister*. The Governor and the Deputy Governors are appointed for a *term not exceeding 5 years* and are eligible for re-appointment.

The Directors, other than the Governor and the Deputy Governors, are appointed by the Minister of Finance for a term not exceeding 3 years. They should not be actively engaged in any political activity. There is no official from the Ministry of Finance on the Board of Directors.

[52] Bank of Mauritius Act, 2004

A person is disqualified from holding the office of Governor, Deputy Governor and other Director if he is employed in any capacity in the public service or holds any office or position for which any salary or other remuneration is payable out of public moneys.

Accountability

In terms of Section 32 of the Bank of Mauritius Act 2004, the Bank, *not later than 4 months after the close of its financial year*, has to submit to the Minister of Finance a copy of the Annual Accounts certified by auditors with a report on its operations during that year. The Minister of Finance, at the earliest available opportunity, *lays a copy of the Annual Report and Audited Accounts before the National Assembly*. The Bank, as soon as may be practicable, after the last working day of each month, has to prepare and publish a return of its assets and liabilities as at the close of business on that day. A copy of the return is submitted to the Minister of Finance.

The Bank has to publish in the Government Gazette a copy of the audited accounts not later than 6 months after the close of the financial year and a copy of the return of its assets and liabilities.

Transparency

In terms of Section 33 of the Bank of Mauritius Act 2004, the Bank, in the conduct of its operations, has to *promote open discussions and comments* on its monetary and financial stability policies. The Bank has to publish, at least once a month, statements on its monetary policy and, at least twice a year, statements on price stability and on the stability and soundness of the financial system.

Monetary Policy Committee

In terms of Section 54 of the Bank of Mauritius Act 2004, a Monetary Policy Committee (MPC) has been set up. It is responsible for the formulation of monetary policy. It consists of:

(i) The Governor, who is the Chairperson of the MPC;

(ii) The two Deputy Governors;

(iii) two other Board Directors, who have recognized experience in the field of economics, banking or finance, who are appointed by the Minister of Finance; and

(iv) three external members, who have recognized experience in the field of economics, banking or finance, and who are not actively engaged in any political activity, and *who are appointed by the Minister of Finance*.

There are also *two observers* who have been appointed to the MPC. They take part in the discussions, but they do not have any voting power. One is the Chief Economist of the Bank. The other one is a Senior Economic Advisor in the Ministry of Finance.

Government Banker and Financial Advisor

In terms of Section 56 of the Bank of Mauritius Act 2004, the Bank is the banker of the Government, its advisor on monetary and financial matters and the depository of the official foreign exchange reserves of the country and of Government funds.

The Government may maintain working balances, at such rates as may be determined by the Bank, and may generally make use of the services of banks on such terms and conditions as may be agreed between the Bank, the Government and the parties concerned. The Minister of Finance may request the Bank to tender advice and to furnish reports on matters relating to the objectives of the Bank. The Bank advises the Minister on any matter which may affect the achievement of its objectives.

Public Loans

The Bank may undertake the issue and management of loans publicly issued in Mauritius by the Government.

Advances to and Deposits from the Government

The Bank may grant advances to the Government in *respect of temporary deficiencies* of Government's recurrent revenue at such rate as may be agreed with the Government. The total amount of such advances outstanding, together with the amount of Government securities in the ownership of the Bank, should not at any time exceed 25 percent of the Government's recurrent revenue for the current financial year. Any advances should be repaid as soon as possible and should, in any event, be repayable not later than four months after the end of the financial year in which they are granted. In the event that any advances have not been repaid within the time specified above, any balance outstanding is converted into Government securities at market rates.

Any Government deposits with the Bank are compensated at such market rates as may be determined by the Bank.

Bank as Government's Agent

Unless inconsistent with the Bank of Mauritius Act 2004 or with its duties and functions as a central bank, the Bank may act generally as agent for the Government on such terms and conditions as may be mutually agreed.

Monetary Policy Committee

There are two observers who have been appointed to the MPC. One of them is a Senior Economic Advisor in the Ministry of Finance. He takes part in the discussions, but he is not allowed to vote. His observer status allows him to inform the Minister of Finance about monetary policy and to brief MPC members of fiscal policy and Government's economic policies.

Macroeconomic Forecasts

Given that Government is casting the budget within a medium term macroeconomic perspective (Medium-Term Expenditure Framework [MTEF]), reliable analysis and consistent forecasts of the major macroeconomic indicators are required. In this respect, various meetings, chaired by the Ministry of Finance and attended by representatives of the Central Statistics Office (real sector), Bank of Mauritius (monetary and external sectors) and the Ministry of Finance and Economic Development (fiscal sector) are held during the year to work on these forecasts.

Sub-Committee on Borrowing Requirements of Government

A Subcommittee on the Borrowing Requirements of the Government (SBRG) has also been set up. The SBRG is chaired by the Bank of Mauritius and comprises representatives of the Treasury and the Debt Management Unit (DMU) of the Ministry of Finance. Its main function is to forecast the weekly borrowing requirements of the Government and determine the amount and type of Government instrument that should be auctioned to meet the financing needs of the Government. The SBRG meets weekly and examines the daily forecast of Government revenue and spending for the ensuing week.

This coordination committee is of crucial importance. It allows the Government to borrow exactly what it requires from the market to finance its deficit, thus ensuring that there is no financing from the central bank and no major disruption in the level of liquidity and in interest rates in the market.

Debt Management and Monetary Management

In terms of Section 57 of the Bank of Mauritius Act 2004, the Bank may undertake the issue and management of loans publicly issued in Mauritius by the Government. Prior to August 2004, Government Treasury bills were issued by the Bank for both debt and monetary management. As a consequence, however, government internal public debt was increasing at a faster rate than warranted by the budget deficit. Accordingly, Government took the decision to separate debt management from monetary management. Treasury bills and other Government securities are issued by the Bank to finance government's budget deficit only whereas Bank of Mauritius (BOM) bills are issued by the Bank for monetary management. But, given that both instruments are issued at the same time, this has occasionally led to an increase in yields, which could be a concern for the Ministry of Finance. The Bank's stance on this matter, however, is very clear. Government is concerned with financing its budget deficit at the lowest cost possible. But the Bank is concerned with the general level of interest rates in the country. The MPC takes a decision on the interest rate after looking at the evolution of various macroeconomic indicators and after carrying out a thorough analysis of economic developments. As such, the objective of the Bank might differ from that of the Government.

Since the enactment of the Bank of Mauritius Act in 2004, which granted independence to the central bank in Mauritius in the performance of its functions, there appear to have been no major problems between the Bank and the Ministry of Finance. A possible reason is that there is regular sharing of views between the two parties, at the MPC and SBRG levels, as well as in the context of the MTEF.

Mauritius CBI in Practice

Interestingly at the time of the writing of this paper, the issue was thrown starkly into the public arena, with the following headline from one of the national newspapers on November 25th 2009 -“Mauritius Central Bank row, fuels independence worry”.[53]

The article goes on to explain that although a coordinated fiscal expansion and aggressive monetary loosening approach between the Ministry of Finance and Central Bank, had shielded Mauritius from the worst of the global crisis, nonetheless the independence of the Bank was being called into question by the very dysfunctional board. Management of the Bank appeared to have two power centers, one at the Governor’s level and the other at the Ministry of Finance through some board members. The situation “came to a head … when the central bank and Treasury were at odds over how to tackle a slowing economy and near double-digit inflation”[54]. Six of the Bank’s nine board members called for the Governor’s resignation, but he insisted that he would stay on as he was doing the job he was hired to do. The Minister of Finance is reported as stating to Parliament:

> “The benefits of central bank independence are undisputed. The governor must not confuse between independence of the bank and his own accountability to the Board."[55]

[53] Reuters Africa, November 25, 2009, http://af.reuters.com/article/investingNews/idAF, accessed March 12th 2010.

[54] Reuters, ibid, p.1

The Governor's mandate subsequently expired on February 13, 2010 and it was not renewed. The President has since established a commission of enquiry to look into allegations of abuse of authority and power and harassment of employees made against the Governor during his tenure.

4.5 Implications of CBI for Africa

Central bank independence in Africa continues to be a topical policy issue, largely because of the on-going search for an institutional framework that steers monetary policy to deliver low inflation over the medium term. It can be seen as part of the lineage of the gold standard of the late 19th century, the Breton Woods system of the early post-war era, and the monetary targeting of the 1970s. Independence in this context means the freedom of central banks to pursue monetary policies which are not dictated by political considerations. It does not preclude Ministers from commenting on monetary policies, and it does not preclude central banks from consulting with the government on monetary and other policies.

In Africa as elsewhere, in practice varying degrees of independence have been exercised through a variety of approaches. Some of these constrain the central banks' room for maneuver by providing a single final objective or a single intermediate target, while others provide more flexibility to the central banks to respond to uncertainty.

[55] Ibid, p.2

The more important consideration appears to be that if central banks are to be independent of the government, then they must be accountable for their actions. Not only is this proper in a well run society, but also public accountability helps preserve the independence of the central banks. Provided the decisions of central banks are competent to begin with, and are transparent and understood by the public, there will be little opportunity for political interference. The competence of central banks and the personalities of their Governors, and of Treasurers and other Ministers, are obviously important, whatever the precise legislative framework. Integral to achieving price stability in Ghana, Mauritius and elsewhere, is that the central banks must avoid the direct financing of government budget deficits. This has been well captured by statutes and the framework appears to be working.

Collier has pointed out that CBI is essentially about credibility. As observed, the problem with African CBI lies not with the concept and legal framework, but with the practice. The benefits of independence therefore, are largely dependent upon whether citizens recognise their central banks as independent. To persuade citizens that their central banks are independent, the governments need to *say so publicly*, *commit themselves to maintain independence through legislation and practices*, and *avoid at all costs actions which might be interpreted by citizens as contradicting these statements* and commitments. As Collier puts it:

> De facto independence might be a sensible place to start, but it is not a sensible place to stop. Once the government has learnt to live without the need for day-to-day intervention, it should rapidly move on to signalling independence to citizens and publicly locking itself in to the strategy.[56]

[56] Collier, ibid, p.41

A good practice which directly confers independence and also signals intention is a *fixed term appointment* for the governor of the central bank. Another is to establish a Monetary or Economic Policy Committee which includes people drawn from *outside the government* and who is appointed for *fixed terms* on the basis of *demonstrated expertise*. Collier notes that widening the committees' terms of reference and terming them *Economic* Policy Committees makes their remit wider (and does not narrow their agenda to monetary policy matters).

In some African countries power, has been so highly concentrated in the presidency over extended periods, such that there is no way of making a national central bank *credibly* independent. Regardless of what rules are changed, citizens simply will not believe these will entail a change in behaviour. Experts have proposed that an alternative for these countries is to establish *regional central banks (*akin to the ESCB and ECB framework), so that no single President has authority, and with the likelihood that central bank governors of the region (and not politicians) compose the authority of the instituting and constituting organs. This model is already under active discussion in parts of East Africa, West Africa and the Southern Africa region.

5. CBI in Zambia

5.1 Country Over-view

Sharing borders with some 8 separate African countries, Zambia is a landlocked Southern African country with a population of 11 million (2005 UN estimate) more than 50 percent of whom reside in urbanized areas. It is rich in copper ore deposits, and most recently, has developed a tourism industry that has benefited from strong growth due to the political problems that have eviscerated the economy of one of its neighboring countries, Zimbabwe.

Zambia's contemporary history is traced from 1888, when Cecil John Rhodes (the British empire builder after whom Northern and Southern Rhodesia were named), spearheaded British commercial and political interests into Central Africa. As a colonial territory, Northern Rhodesia was administered by the British South African (BSA) Company between 1891 and 1923 and subsequently by the British Colonial Government between 1924 and 1963. Dr. Kenneth Kaunda was the first Republican President of independent Zambia and the United National Independence Party (UNIP) was the ruling Party, until 1990. From 1972 to 1990, Zambia was a one-party state under Kenneth Kaunda and UNIP. General multi-party elections were held in 1991, 1996 and 2001 and a by-election in 2008, all of which were won by the Movement for Multiparty Democracy (MMD).

Since independence in 1964, Zambia has broadly known two regimes: that of Dr. Kenneth Kaunda and UNIP from 1964 to 1991 (characterized by central planning and socialistiic inclined policies under the philosophy of Zambian Humanism), and that of the Movement for Multiparty Democracy (MMD) from 1991 to the present (albeit under three different Presidents, Frederick Chiluba, the late Levy Mwanawasa and the incumbent, Rupiya Banda, characterized by liberal democratic policies).

At independence, Zambia was one of the most prosperous countries in Africa. Its population, has, over the years witnessed a deterioration in living standards due to the decline in the country's economic performance, which in turn was largely a consequence oil price volatility that began in the 1970s and the decline in revenues from copper, its principal export). Exacerbated in no small measure by the erroneous economic policies of the Kaunda regime, the economy was essentially moribund throughout the decade of the 1980s.

Although Zambia's GDP has doubled since independence, per capita annual incomes are *currently at about two-thirds* of their levels at independence. Poverty, unemployment and underemployment are serious problems coupled with high HIV infection rates. The country therefore continues to face the challenge of growing and diversifying its economy, while simultaneously addressing widespread and worsening poverty levels and the HIV problem.

5.2 The Financial Sector

Since independence, the financial sector in Zambia has undergone two notable phases in its development, that under the Kaunda regime and that under the MMD. The first phase commenced in 1964, and many scholars have asserted that with the 1968 Mulungushi Economic Reforms, the course of Zambia's financial sector post-independence history was set. The Reforms were motivated by the Kaunda government's desire to redress past political and economic inequities and exert extensive government control over resource allocations. This phase was punctuated by the Government's nationalization program, which had an important impact upon the sector. Although commercial banks were not nationalized, all other major financial institutions were and merged to form government owned institutions such as the Zambia State Insurance Corporation (ZSIC) and the Zambia National Building Society (ZNBS). Entry of non-bank financial institutions into the financial sector became restrictive (although scholars such as Brownbridge have argued that this restriction was more political than the result of any stringent conditions). [57] The government also established financial institutions such as the Development Bank of Zambia (DBZ), the Local Authority Superannuation Fund (LASF) and the Zambia Export and Import Bank, all through Acts of Parliament.

[57] M. Brownbridge, Charles Harvey, Augustine F. Gockel: *Banking in Africa-the Impact of Financial Sector Reform since Independence* (First Africa World Press Inc. Trenton NJ, 1998)

The second phase of notable change in the financial sector has been marked by the liberalization of the sector, and the economy generally, since 1991 (the MMD era). The phase has been characterized by:

- *Growth in the financial sector*. In addition to the Central Bank, the sector now comprises over 15 commercial banks, several non-bank financial institutions (three building societies including the government owned Zambia National Building Society – ZNBS- several micro finance institutions, the National Savings and Credit Bank – NSCB- the DBZ, a fairly big number of Bureau de changes and leasing companies), insurance companies, pension funds and the Lusaka Stock Exchange. Despite the entry of new financial institutions post liberalization, the Zambian financial system has remained relatively small. The Ministry of Finance estimates the ratio of M2 to GDP as being in the range of 15 –20 percent[58], and *within the middle range for monetization ratios* of Sub-Saharan African Countries (this contrasts to the early 1980's, when M2 was about 35 percent of GDP). Bank credit at 8% of GDP is *among the lowest for Sub-Saharan countries* and this situation is made worse by the "crowding out" effect of *credit to the public sector*. Dollarization is high with about half of bank deposits and one third of loans in foreign currency.

- *Banking sector competitiveness*. The banking system is comprised of 13 commercial banks. The principally state owned Zambia National Commercial Bank (ZNCB) and foreign owned banks continue to dominate the financial sector (with only 2 indigenously owned banks). Commercial banks hold about 90 percent of financial system assets and foreign equity participation is significant, accounting for three quarters of the banking system capitalization. In terms of assets, Barclays Bank is the largest bank followed by the ZNCB, which was partially privatized in 2007.

- *More vibrant Insurance sector.* The insurance sector is still small in Zambia and contributes less than 2 percent of GDP in premiums. The market is dominated by the Zambia State Insurance Corporation (ZSIC), but has since deregulation of the sector in 1992, seen the emergence of strong private sector players (Professional Insurance, Madison).

- *Pension sector re-organization.* The pension sector in Zambia in the main comprises the National Pension Scheme (NAPSA), which is mandatory for all employees in the formal sector, and supplementary schemes, offered by private sector employers. There are over 200 of these independently administered pension schemes, which include both defined benefit and defined contributory plans. The supplementary pension schemes (estimated at about K 400 billion) have the largest assets in the pensions sector, while the NAPSA represents over K 230 billion.

- *Four types* of *non-bank financial institutions.* These are categorized as:

  (i). Institutions that accept deposits from the public, including the three building societies, some micro finance institutions, and the National Savings and Credit Bank (NSCB);

  (ii). Leasing companies and micro finance institutions;

  (iii).Thirty-seven bureaux de change; and

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[58] See Financial Sector Development Plan for Zambia 2004-2009, Ministry of Finance and Planning, May 2004, Chapter 3. Subsequent caution has been sounded regarding the difficulty of data collection, which resulted in a Donor financed structure known as the Finscope project in 2005.

(iv). The Development Bank of Zambia (DBZ), which is primarily funded from government equity and credit lines as well as credit lines from foreign development banks. Under the Financial Sector Development Plan, the institution has been allowed to access private equity.

The government continues to play a significant role in the financial sector, and apart from its partial ownership of ZNCB, three of the non-bank financial institutions are government owned (namely, the DBZ, the ZNBS and the NSCB).

5.3 The Bank of Zambia

The Bank of Zambia (BOZ or the Bank) is Zambia's central bank, and is charged with the responsibility of creating and implementing monetary policy to ensure the country's macro-economic stability. It has two offices, one located in the capital city of Lusaka and the other in the Copper-belt town of Ndola.

The BOZ traces its origins to 1938 and the formation of the Southern Rhodesia Currency Board, which was based in Harare, in present-day Zimbabwe. The Board's jurisdiction included Northern Rhodesia (present-day Zambia) and Nyasaland (present-day Malawi). In 1954 the Southern Rhodesia Currency Board was renamed the Currency Board of Rhodesia and Nyasaland, to cover the newly created Federation of Rhodesia and Nyasaland. After the dissolution of the Federation of Rhodesia and Nyasaland on 31st December 1963, the Bank of Rhodesia and Nyasaland continued as the central bank of Northern Rhodesia. On 7th August 1964, the Bank of Northern Rhodesia was established and later changed its name to the present Bank of Zambia after the attainment of independence. Between 7th August 1964 and 31st December 1965 a transfer of functions from the Bank of Rhodesia and Nyasaland to the Bank of Zambia was effected, resulting in the Bank of Zambia becoming fully responsible for all matters provided for in the Bank of Zambia Ordinance. BOZ was established by an Act of Parliament on 7 August 1964, although, this Act was only finally passed in June 1965.

The Bank of Zambia was administered by a Board of Directors consisting of a Governor, a Deputy Governor, and seven other Directors. The Governor and Deputy Governor *were appointed by the President of the Republic* for terms not exceeding five years and were eligible for re-appointment. The seven Directors were appointed by the Minister of Finance and the Ordinance required that one of them should be the Permanent Secretary in the Ministry of Finance, who, however, had no voting powers on the Board. The *Minister of Finance had over-riding powers of over the affairs of the Bank*, which could be exercised after consultation with the Governor.

Though regulator of the banking system, BOZ then was also perceived by the government of the day, as an instrument of national investment policy. It acquired an equity stake in the Development Bank of Zambia (the initially wholly government owned vehicle for long term debt and equity finance) and the Zambia National Commercial Bank (at the time the only commercial bank wholly owned by the government).

The 1965 BOZ Act has undergone several amendments. During the 1970s and 1980s and in line with the Kaunda regime's interventionist policies, the primary responsibility of the central bank was to ensure *compliance to controls* relating to foreign exchange, domestic credit and interest rates by financial institutions. As most of the banks in Zambia were either owned by well established foreign banks or the Government, it was felt that they required minimum prudential supervision.[59] In addition, the controlled economy provided a relatively safe environment for banking business.

With the 1996 BOZ Act, the BOZ was restructured to enable it to discharge its statutory duties in line with section 4 of the Act, namely to "*formulate and implement monetary and supervisory policies that will ensure the maintenance of price and financial systems stability so as to promote macroeconomic development*" in the newly liberalized environment.

5.4 Current legal framework for the Bank of Zambia

Currently, the legal framework for Bank of Zambia operations, defined as the legislation that directly impacts on the Bank of Zambia, comprises the Bank of Zambia Act, No. 43 of 1996 and the Banking and Financial Services Act, Chapter 387 of the Laws of Zambia. The 1996 Act repealed and replaced the Bank of Zambia Act of 1985. This was in an effort to establish

[59] C. Chiumya, "Banking Sector Reform and Financial Regulation: It's effects on access to financial services by low income households in Zambia", *Development Economics and Public Policy Working Paper Series* (University of Manchester, November 2004), p.14

a modern legal framework that would respond to the needs of the times following the liberalization of the economy in 1991.

As stated earlier, the Bank's primary objective is to "formulate and implement monetary and supervisory policies that will ensure the maintenance of price and financial system stability so as to promote balanced macro-economic development." Statutory responsibilities of the Bank under the Act include the following:

- Promotion of efficient payment mechanisms;
- Issuance of notes and coins to be legal tender in the Republic and regulation of all matters relating to the currency of the Republic;
- Custodian and manager of external reserves;
- Supporting the efficient operation of the exchange system;
- Banker to the banks;
- Lender of last resort;
- Banker and fiscal agent to Government; and
- Economic advisor to the Government on matters relating to economic and monetary management.

(i) The Bank of Zambia Act

In terms of the relationship with Government, Section 5 of the Bank of Zambia Act provides for the Minister to convey to the Governor such general or particular Government policies as may affect the conduct of the affairs of the Bank and the Bank shall implement or give effect to such policies.

Under Section 50 of the Bank of Zambia Act, Bank's lending to Government is limited to no more than 15 percent of the ordinary revenue of the Government in the previous financial year. This limit can be exceeded in special circumstances.

In terms of Governance, the BOZ Act provides that the Bank is headed by a Governor and two deputies appointed by the President of the Republic of Zambia. The Board of the Bank of Zambia is constituted of persons appointed by the Minister of Finance. The Minister appoints not more than six persons from amongst individuals with professional or academic experience in business or financial matters and who are not officials or employees of the Bank. The Secretary to the Treasury is an ex-officio member of the Board. All powers of the Bank are vested in the Board of Directors which is responsible for formulating policy of the Bank. The administration of the Bank is delegated to the Governor.

(ii) Accountability

There are several provisions that provide for accountability of the Bank to Government, Parliament and the general public. For example, the Bank is required to publish a monetary policy statement in the Government Gazette every six months. This report must be laid before the National Assembly by the Minister within the first sitting after the receipt of the report. The Bank is also required to publish in the Gazette one month in arrears, reports on monthly assets and liabilities and deliver the return to the Minister. The Minister can also call for any other information at any time. Further the Bank must within six months after the expiry of the financial year submit an annual report to the Minister, which must include an audited balance sheet, an audited statement of income and expenditure and any other information the Minister may require.

(iii) The Banking and Financial Services Act

The Banking and Financial Services Act (BFSA) was enacted in 1994. As in the case of the BOZ Act, it was a response to the new liberalized environment which rendered the existing law inadequate. In this respect the BFSA repealed the Banking Act, Chapter 700 of the Laws of Zambia. The BFSA was amended in 2000 to widen the Bank of Zambia's supervisory ambit to include non-bank financial institutions. The BFSA provides a comprehensive legal framework for the licensing of banks and financial institutions; the organization and administration of banks and financial institutions; their operations; their supervision and prudential regulation; and the resolution of banks and financial institutions in distress. The BFSA also provides for appeals to the Minister and for other miscellaneous matters.

(iv) Conduct of Monetary Policy in Zambia

The Bank of Zambia, like many other central banks, has chosen to make price stability its primary objective because of its importance in promoting balanced and sustained macroeconomic development.

(v) Use of Targets to Achieve Goals

To achieve price stability, the Bank, through its operational framework, influences the amount of money supply in the economy by increasingly using indirect instruments of monetary policy. The Zambian monetary policy operational framework uses a monetary aggregate in which broad money is the intermediate target. Since this aggregate is not entirely under its control, the Bank employs reserve money or the monetary base, which is a component of money supply, as its operational target.

The monetary framework underlying the design of monetary policy in Zambia works as follows: the Bank aims at achieving a specified end-year inflation target. To do this, it programs growth in both broad money and reserve money consistent with the inflation target and economic growth objectives. The Bank then conducts open market operations (OMO) by injecting or withdrawing funds to keep the growth of the monetary base at the programmed level.

While attaining the desired growth targets may be a necessary condition, it is not a sufficient condition to ensure price stability. There are other factors beyond the immediate control of the monetary authorities that can cause the central bank to miss its inflation target. These include, among others, *un-programmed Government expenditure*, *negative supply shocks* (such as, drought, deterioration in the terms-of-trade, inflationary expectations) as well as dollarization.

(vi) Use of Monetary Policy Instruments to Influence Targets

The Bank uses a blend of direct and indirect instruments in its quest to achieve and maintain price stability. These include:

- *Statutory Reserve Ratio*: This is a *direct instrument* which is used to influence money supply. Commercial banks are required by statute to keep a certain proportion of their reserves against (Kwacha and foreign currency) deposit liabilities with the central bank. An upward adjustment in this ratio reduces the amount of credit commercial banks can create, thereby reducing aggregate demand and inflationary pressures in the economy. Conversely, a downward adjustment can increase lending, which can positively affect the real sector.
- *Open Market Operations*: This is an *indirect* instrument. The Government, through the BOZ, issues Treasury bills in the primary market to absorb excess liquidity in the money market. In addition, the Bank undertakes repurchase transactions (repos), outright sale of Government Securities on its portfolio, auction deposits (term deposits) and/or sale foreign currency to absorb excess liquidity in the money market. To inject liquidity in the system, reverse repos, purchase of Government Securities from commercial banks, secured loans and/or purchase of foreign exchange are used.
- *Rediscount Facility*: Commercial banks facing a liquidity shortage can rediscount Treasury bills at the Bank of Zambia. The Bank of Zambia limits the amount that a bank can rediscount in proportion to its regulatory capital.
- *Bank Rate*: This is used to influence the cost of borrowing by banks from the Bank of Zambia and acts as a signal of the direction of monetary policy.

- *Moral Suasion:* This is an instrument the Bank of Zambia uses to persuade financial institutions to conduct their operations in line with the monetary policy direction.

In addition, the Core Liquid Asset Ratio is, from time to time, used to withdraw or inject liquidity from the system.

(vii) History of the BOZ and Monetary Policy

Though the stages in the evolution of monetary policy in Zambia can be divided into several timeframes, there are *two distinct eras*. The first is the *pre-liberalization period* which spans from 1964 - 1991, while the second, the *liberalization era*, spans from 1992 to the present time. Monetary policy from independence through to the early 1990s was largely characterized by administrative controls. Commodities prices and interest rates were controlled while the exchange rate remained fixed. The Bank also imposed stringent and high reserve requirements on commercial banks' deposit liabilities. All these controls contributed to a rise in financial disintermediation and inefficient resource allocation. After 1991, there was a general movement of the economy towards market-based structures and systems and involved the deregulation of prices of real and financial assets and other administrative controls alongside the introduction of market-based instruments of monetary policy.

Phase 1-Pre-Liberalization Period

1964-1972

On August 7, 1964, the Lusaka branch of the former Bank of Rhodesia and Nyasaland was institutionalized as the Bank of Northern Rhodesia. On October 24, 1964 the Bank became the Bank of Zambia by default (although the Act to recognize it as such was not passed until June 1965), when the formal dissolution of the Bank of Rhodesia and Nyasaland was finally achieved.

During the first four years after its establishment, the Bank was *unable* to effectively implement monetary policy. This has been attributed to the teething problems encountered by the Bank and the Zambian financial sector. [60]

In the first instance, the Bank was faced with severe human resource constraints at the time of its establishment as a break away from the larger federal central bank. A significant number of its skilled foreign personnel opted to leave and work in the Southern Rhodesian central bank, which was still under minority rule. It was not until the early 1970s after the Bank (with the help of the British Government) embarked on a deliberate policy to create capacity that it managed to gain sufficient indigenous capacity to run its affairs.

Second of all, despite being empowered by the Bank Act of 1965 to implement monetary policy, the Bank did not have a sufficient grip on the growth of credit creation in the economy because of the dominance of foreign banks in the banking sector.

These banks operated as branches of powerful overseas banks and were manned almost entirely by expatriate personnel. As such, their lending policies were by and large determined by their overseas head offices, which often influenced the provision of credit in ways that were unrelated and sometimes divergent from the national needs of the Zambia economy. Furthermore, these banks' credit policies were restrictively oriented towards the foreign dominated sector of the Zambian economy, a situation which left local businesses (which at the time accounted for 15 percent of total bank credit) without sufficient investment finance to assert themselves in the growing economy.

With this background, the Zambian government, in putting in place the Mulungushi Economic Reforms of 1968, also enhanced the powers of the BOZ by *placing the provision of credit* under the regulation of the Bank. It directed that all lending to non-Zambians were to be approved by the Exchange Control Office of the Bank. This meant that expatriates and foreign companies (as well as partially foreign owned companies) had to seek the BOZ's permission in order to access credit. This gave the Bank de facto control over the total volume of credit as well as its direction. Additionally, in 1972, the Government instituted further reforms which inter alia included the requirement that registered commercial banks should comply with a minimal paid up capital requirement (then put at K2 million-about $2million), in

[60] See "40 Years of Central Banking: Facing the Challenges of the 21st Century" Report on the 40th

addition to ensuring that their boards of directors were composed of at least fifty percent Zambian citizens. These measures were aimed at re-directing the orientation of the commercial banks towards a Zambian-centric approach in the formulation of their credit policies. Through these measures, BOZ was able to substantially reduce the rate of growth in money supply and direct credit towards areas that were viewed as government priorities. The goal of monetary policy then, *was provision of credit that would support employment and economic growth*. Given the dominance of the state in the economy, most of the financial sector's credit was directed to the state-owned enterprises.

1973-91

The advent of the oil crisis of 1973/74 and the world economic recession that followed, marked a significant change in the environment within which monetary policy worked, bringing about a new challenge. The Zambian economy suffered severe terms of trade shock with the price of oil skyrocketing whilst the export price of the country's principal export, copper, plummeted on world markets. This had a severe negative effect on the performance of the mining sector (accounting for over 80 percent of total exports), as well as government expenditure. Without cuts in expenditure and experiencing budgetary difficulties, the country began to run huge fiscal deficits with regular recourse to BOZ to finance the gap. This marked the beginning of a continuing challenge to the attainment of low inflation rates.

By the late 1970s, policymakers realized that economic reform was inevitable and in the government's program of action of 1978, there was emphasis on the need to curb unproductive spending and unnecessary expansion of money supply through inordinate borrowing from BOZ. Also pointed out was the need to closely observe the growth of the commercial banks' credit to ensure it did not contribute to existing inflationary pressures.

Though the need for economic reform was recognized, no significant changes were effected and by 1982 the economic situation had considerably worsened characterized by persistent fiscal deficits and declining performance in the mining sector. These in turn fuelled expansions in credit and hence the increase in money supply and inflation. The situation was compounded by 83 percent of the deficit being financed through borrowing from BOZ.[61]

In an attempt to address this problem, Zambia undertook its first International Monetary Fund (IMF)/World Bank adjustment program between 1985 and 1987. The program led to a partial decontrol of interest rates and the introduction of a Dutch foreign exchange auction system as a way of allocating scarce foreign exchange through a quasi-market system. It also entailed the removal of some subsidies as a remedy to the persistent deficits. However, the measures had the impact of substantially increasing inflation, especially after the decontrol of prices. The reforms proved to be politically unpopular and culminated in public protests and an abandonment of the IMF supported reform program in May 1987.

[61] See 40th Anniversary report, ibid.

After the abandonment of the program, the government pursued an indigenous economic recovery program, which proved unsustainable. The rate of inflation escalated while the need for external financing grew, prompting the Government to return to the IMF and agree a new IMF supported program articulated in the policy framework paper of 1989. The main policy measures concerning monetary policy design and implementation included the following:

- Decontrol of interest rates;
- Abolition of exchange controls and a movement to a market-determined exchange rate regime;
- A shift to the use of indirect instruments of monetary policy;
- Introduction of Government securities auctions;
- Establishment of an inter-bank money market;
- Modernization of the national payments system;
- Strengthening of the financial system legal framework; and
- Establishment of a stock exchange.

Phase 2- Liberalization Period: 1991 - 2004

Following the first multiparty elections in nearly 20 years, a new government (the MMD) took office in 1991. Its priorities were to restore economic growth through market-based stabilization policies and promotion of the private sector. Hence, the economy was liberalized, giving the markets a greater role in the allocation of resources. Real and financial assets prices were decontrolled, while subsidies on all consumer items were abolished. This marked a significant change in the environment within which monetary policy was formulated and implemented, and the design of monetary policy changed in tandem. Although the ultimate economic objective has remained the same namely, *growth and employment*, it was generally accepted that investment and subsequently growth was unlikely to take place if macroeconomic instability, as reflected by characteristics such as high inflation, remained present. Consequently, from 1992 the emphasis of monetary policy has concentrated on the *creation of a stable macroeconomic environment as a precondition for sustainable economic growth*. This is to be contrasted with the pre-liberalization era when monetary policy targeted multiple objectives without clearly defined targets.

Recognizing the internal and external imbalances of the economy, the government further embarked on an IMF sponsored Rights Accumulation Program (RAP), which was implemented between 1992 and 1996. Under the RAP, monetary policy was principally aimed at reducing high growth rates of domestic credit and money supply by reducing reliance on direct instruments in preference for indirect instruments. The BOZ has argued that the adoption of indirect instruments was consistent with the Government's policy of economic liberalization as well as the prevailing world trends in the conduct of monetary policy. [62] As a result, monetary policy design and implementation in Zambia underwent significant transformation. In January 1993, the Government introduced the 28-day and 183-day Treasury bills and established a tender system. Prior to this, there was only the 91-day Treasury bill, which the Bank sold on behalf of the Government at pre-determined prices. In addition, the

[62] 40th Anniversary, ibid

Government introduced the 12-month and 24-month Government bonds, and re-introduced the 18-month Government bond that had been suspended earlier on.

Further and in order to improve the effectiveness of monetary policy, the array of instruments at the disposal of the Bank *was broadened*. Thus, the Bank adopted the use of OMO instruments in March 1995 and reduced reliance on cash and liquidity reserve requirements as instruments of credit control. These instruments were aimed at influencing liquidity conditions in the banking system through the *market price mechanism*. The operations were basically aimed at smoothening short-term liquidity imbalances. Furthermore, to curtail growth in broad money, which was largely driven by monetization of fiscal deficits, a cash-budget was introduced in 1993.

5.4 CBI and the Bank of Zambia

As stated earlier, the emphasis of this paper in a law and development context is on the legal independence of Bank of Zambia, and what this may mean in practice. Cukierman based on empirical findings has stated that "the legal independence of a CB [Central Bank] should be evaluated against the background of the regime of the country in which it resides".[63] This is the reasonable starting point for any assessment of CBI in Zambia.

Further, as observed earlier, CBI in most developing countries and in Africa has been based on the legal framework and charters of developed countries. However, as Cukierman and other scholars remind us, *due to different degrees of compliance with the law* in the developed and

[63] A. Cukierman: *Central Bank strategy, credibility and independence: theory and evidence*, ibid. p.454

developing countries, legal independence is not as effective in ensuring CBI in the developing countries, because: 1) the norm of general adherence to the law is more deeply entrenched in the developed democracies than in absolute regimes or transitioning democracy countries and, 2) due to the limited development of their financial systems, the developing countries are *more concerned with the deepening of the financial structure* and mobilization of savings for investments. The assessment of CBI in Zambia must take these two elements into consideration.

5.5 Issues in Zambian CBI

(a) CBI under Kaunda and UNIP: 1964-1991

The stated policy of the Kaunda and UNIP government (nuanced by the Mulungushi

Economic Reforms in1968 and the Matero Declaration in 1969), was state control of every organ in which the state had an interest. This was especially the case after 1972 when Zambia constitutionally became a one party state and public institutions became organs of 'the Party and its Government'.

As earlier observed, notwithstanding de facto independence of the bank as contained in its Act of 1965, its objective nonetheless under this dispensation was to effectively carry out government policy. To a large extent this objective blurred any pretence of independence from the government or indeed, the Party line during the period. Some indicators of the lack of independence include:

- Key announcements pertaining to exchange rates were often the domain of the Executive (the President) at national press conferences, followed by circulars from the central bank instructing the banks in this regard;

- The government's burgeoning budget deficit continued to be financed by the printing press of the Central Bank, which in turn fueled inflation. When the situation became untenable in 1991, just before the MMD government took over, that year alone saw a 95% increase in broad money and consumer price inflation of 93%;[64]

- Monetary policy was heavily influenced by the Party and its government's view as to where they wanted interest rates to be (in an environment of controlled pricing), and their priorities with regard to rural lending and or other Small and Medium Enterprise (SME) activity. In this regard BOZ Deputy Governor Danny Kalyalya has stated:

> Prior to 1992 monetary policy had multiple objectives. Targets had also not been well defined and the implementation of monetary policy relied mainly on direct instruments which included fixed interest rates and credit allocation, core liquid assets and statutory reserve requirements. Equally important, the financing of the Government fiscal budget relied heavily on central bank borrowing. As it turned out, real interest rates were for the most part negative which resulted in high levels of disintermediation, as economic agents shunned the banking system in preference for other forms of assets that could under the circumstances provide a hedge against loss of value. Moreover, more often than not the monetary policy was loose, mainly as a way of providing relatively cheap credit to state-

[64] Brwonbridge, ibid, p.156

owned enterprises, resulting in high growth rates in domestic credit and consequently in the money supply.[65]

- The Bank was perceived by government as "the government's bank". In this regard, its activities on behalf of government ranged from investment in institutions (DBZ, ZNCB as discussed above) to the operation of a Credit Guarantee Scheme for SME borrowers (to induce commercial bank lending) to acting as direct obligor in the case of major government imports (oil, fertilizer);
- The Bank was the sole counterparty for all of the Zambia Consolidated Copper Mines (the government owned conglomerate that controlled the mining sector) foreign exchange transactions, which were seen as critical to Zambia's FX requirements. In addition, the Bank had the responsibility of formulating and enforcing exchange controls on the government's behalf;
- Although the Bank was expected to supervise the banking sector, it had no control over who was licensed to operate. The Banking Act allocated this responsibility to the Ministry of Finance;

The rapid turn-over of governors in some instances indicated the displeasure of the Executive, notwithstanding any evidence or consideration of the merits of those dismissed. Leadership changes at the BOZ, hirings and dismissals were done publicly by the President at press conferences. The longest serving

[65] Kalyalya,D: "Monetary Policy Framework and Implementation in Zambia", Paper presented at South Africa Reserve Bank Conference on Monetary Policy Frameworks in Africa (Sept 17-19, 2001 Pretoria South Africa), p.6

governor lasted. 5 years. On average, most governors served 2 year terms and one served only a year.

Obadaiah Mailaifya observes in this regard:

> The auction [of foreign currency] had come under severe criticism for allegedly being excessive and fuelling inflation and thereby increasing general hardships for the "common man". The "technocrats" were replaced by the "politicians". Leonard Chivuno became Central Bank governor while Basil Kabwe, a one time Education Minister and Trade Unionist was made Finance Minister. Both were known to be protégés of UNIP Secretary General Grey Zulu…[66]

In summary, the Bank of Zambia during Phase 1 had little or no independence and its credibility both with its economic partners and the public was severely eroded as a result of the growing perception that government intervention was leading to rampant inflation and loss of value of the Kwacha.

(a) CBI under the MMD government (1991 to the present)

The MMD government's priority was to reform the damaged economy and put an end to the 'stop-start' relations with Zambia's donors which was a hallmark of the Kaunda government. The new government inherited a shadow IMF program from the Kaunda government. Brownbridge has observed that political constraints obstructed the adoption of a comprehensive and consistent structural adjustment program in Zambia,

[66] Mailaifya, O: *Europe and Economic Reform in Africa: Structural Adjustment and Economic Diplomacy* (Routledge, London 1997), p.165

and as a result financial reforms were delayed until the early to mid 1990s. Financial markets, however, were liberalized in 1992 and 1993 and new banking legislation enacted in 1994 and 1996 to accompany measures to strengthen supervisory capacities and the legal independence of the Bank.[67]

Although several scholars and analysts have criticized the haste with which the MMD government pursued economic liberalization on its rise to power, its choices were nonetheless limited.[68] Against the background of an economy under the diktat of the Breton Woods institutions, legislation such as the BFSA and the 1996 BOZ Act sought to ensure independence for the Central Bank from the government and its Ministry of Finance. As the BFSA pertains mainly to the Bank's role in supervisory matters, our focus is on the 1996 BOZ Act (the BOZ Act or the Act).

(b) CBI issues posed under BOZ Act

As earlier pointed out, when discussing de jure CBI, it is important to focus on three areas in which the influence of government is excluded or drastically curtailed, namely *personnel matters*, *financial autonomy* and *policy independence and accountability*:

[67] Brownbridge, M: "Financial Policies and the Banking System in Zambia" ,Institute for Development Studies (1996), pp 21-22

[68] See Osei-Hwedie, Bertha Z: "Development Policy and Economic Change in Zambia: A Re-Assessment", DPMV Bulletin, Volume X, No. 2, 2003, in which the author asserts that structural adjustment has not promoted viable development in Zambia but has compounded its debt and poverty burdens (this was prior to the HIPC discussed above). Inter alia she asserts that Zambia's excessive reliance on and unconditional acceptance of the IMF World Bank economic decision making reduced the state's capacity to develop the economy.

(i) Personnel Independence:

This element assesses the nomination and dismissal of the Governor and members of BOZ's decision-making bodies as pertains to the political authorities. In practice, it is not feasible to exclude government influence completely when appointments are made to such an important public institution as a central bank. Personnel independence therefore depends on the influence that government has in the appointment procedures. Various criteria are relevant here, such as government representation in the governing body of the central bank, appointment procedures, terms of office and procedures governing dismissal of the board of the bank.

Section 10 of the Act vests the power of appointing the Governor in *the President* of the Republic of Zambia. This appointment is for a period not exceeding five years, and hence protects the Governor's term of office. In terms of section 10 (2), this appointment however, is *subject to ratification by the National Assembly*.

Further, section 13(1) (b) vests the power of appointing Members of the Bank's Board *in the Minister of Finance and National Planning*. Finally, sections 10 (7) and 14(2) give the power to remove the Governor and members of the Board to the respective appointing authorities. Their terms in office is specified in sections 10(1) and 14(1), which gives the Governor five years and Directors three years, respectively. A key point is that the power to appoint and remove both the Governor and board continue to vest in the Executive.

(ii) Financial Independence

No central bank can operate in a credible and independent manner without proper financial means. As stated earlier, when this is the case, politicians can easily influence the Bank's policy directly or indirectly thus compromising not only its financial independence but also its legally mandated tasks. In this regard, four features necessary for financial independence include the *right to determine its own budget*; the application of *central bank-specific accounting rules*; clear provisions *on the distribution of profits*; and *clearly defined financial liability for supervisory authorities*.

The Act contains several provisions regulating the manner in which the Bank is to conduct its financial affairs and the government's responsibility towards its financial well-being. In the first instance, section 6(3) makes it clear that the Government is the *sole subscriber to the paid-up capital of the Bank* and its holdings of the paid-up capital is not transferable in whole or in part nor can it be subject to any encumbrance whatsoever. Per section 6(5), whenever the BOZ Board certifies that the assets of the Bank are less than the sum of its capital and other liabilities, the Minister is required to cause to be transferred to the ownership of the Bank negotiable and interest bearing securities issued by the Government for such amount as is necessary for the purposes of preserving the capital of the Bank from any impairment. In addition, Section 7 has elaborate provisions on how the net profits of the Bank are to be determined for each financial year, and where the Bank makes a loss on its profit and loss statement, as certified by the auditors, the Minister is again required to cause to be transferred to the ownership of the Bank. Cash or negotiable instruments bearing market interest rates and such securities shall be delivered to the Bank within sixty (60) days from the date of certification of the accounts by the auditors. The notable point here is the Ministry's obligation towards BOZ in the event of severe loss resulting in liabilities exceeding its assets.

(iii) Policy Independence

Policy independence is related to the *room for maneuver* given to the central bank in the formulation and execution of monetary policy. It may be useful to distinguish between *goal independence* and *instrument independence*, as discussed earlier.

A central bank has goal independence if it can decide on the formulation of its ultimate objective(s). In practice, most central bank laws formulate one or more objectives. For instance, Section 4 of the Bank of Zambia Act provides that the functions of the Bank shall be to formulate and implement monetary and supervisory policies that will ensure the maintenance of price and financial system stability so as to promote balanced macroeconomic development. However, if the central bank has been trusted with various and possibly conflicting goals such as achieving low inflation and low unemployment, it has considerable scope in deciding its priorities. In that case, the central bank has considerable goal independence since it is relatively free to set the final goals of monetary policy. It could, for instance, decide that price stability is less important than output stability, and act accordingly.

Instrument independence refers only to the central bank's ability to freely adjust the policy tools at its disposal in the pursuit of the goals of monetary policy. A bank that has instrument independence is free to choose the means by which it seeks to achieve its goals. Clearly, if government approval is required for the central bank's use of policy instruments, no instrument independence exits.

Perhaps, the most disconcerting provision of the Bank of Zambia Act is Section 5, which provides *that the Minister may convey to the Governor such general or particular Government policies as may affect the conduct of the affairs* of the Bank and *the Bank shall implement or give effect to such policies*. This provision is carte blanche for interference in the operations of the Bank.

(iv) Central Bank Accountability

In any evaluation of the democratic accountability of the central bank, the relationship between the central bank and the legislature plays a major role. This has not been the case historically in Zambia as a result of the over-arching influence of the Executive. However, it is recognized that no central bank can be totally independent in the sense that it is not answerable to anyone. Even the most independent central banks 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. It has been argued in this regard that the legislature holds the ultimate responsibility for monetary policy as it can change the legal basis of the central bank. However, 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.

In the Zambian context, Section 9 (1) of the Act requires the Bank, *in consultation with the Minister,* to publish in the Government Gazette every six (6) months , a policy statement that shall contain: (a) a description and an explanation of the reasons for the monetary policies to be followed by the Bank during the following six (6) months; (b) a description of the principles that the Bank proposes to follow in the formulation and implementation of monetary policy during the next two years or such other period of time as the Minister may decide; and (c) a review and assessment of implementation, by the Bank, of monetary policy during the period to which the last proceeding six months policy statement relates. The Minister is required, within the first sitting of the next National Assembly after the receipt of the monetary policy report, to place officially the report before the House.

In addition, Section 27 requires the Board of the BOZ as soon as is practicable but not later than six months after the expiry of each financial year to submit to the Minister a report concerning its activities during such financial year. The Minister may also request the Board to submit to him such other reports, returns or statements, duly certified by an auditor, as he may consider necessary. Furthermore, under Section 28(1), the BOZ is also required to cause to be published in the Government Gazette a return of its assets and liabilities, and to deliver to the Minister a return of its monthly assets and liabilities *whenever he so requires*.

The foregoing would appear to suggest that under Phase 2 the 1996 BOZ Act, although enunciating and enhancing BOZ's role (per section 4) to "*formulate and implement monetary and supervisory policies that will ensure the maintenance of price and financial systems stability so as to promote macroeconomic development*", has not resulted in enhanced BOZ legal independence.

It must be noted that the MMD government has been more consistent in allowing BOZ the maneuvering room it requires to particularly ensure price stability. This is to a large extent due to the donor impact on Zambia's structural adjustment program. An example of this occurred in 1991-92 when the government was placed on a "cash budget" (a deficit reduction measure with implications for monetary policy) as a continuing condition for Zambia's formal transition from an IMF shadow program to an actual program. The onus fell on BOZ to ensure implementation and compliance, and the transition was successfully effected.

In 1999, the government with the IMF's assistance adopted, a medium-term economic and structural reform program covering a three-year period. The main macroeconomic objectives of the program were to regain control over inflation mainly through continued fiscal adjustment and strengthening of the external position. It focused on strengthening macroeconomic policies, finalizing the privatization of ZCCM, accelerating the parastatal reform and privatization program for key public enterprises, and improving the financial sector. In 2004, the government adopted a comprehensive Financial Sector Adjustment Program, which inter alia sought to introduce best practices in the banking system, and targeted a strong independent central bank as a critical success factor.

Thus far, under the rule of the MMD party, the BOZ has been given a relatively free hand in the formulation of macroeconomic policies consistent with the requirements stated in IMF interventions. While there may have been occasional interference with the Bank's independence, one must concede that this interference has not been frequent. Accordingly, the general trend to allow the BOZ *more independence* than in the past is a positive sign. However, partial independence is not in the long-run likely to be as effective as would be more complete independence; at best, it is a step in the right direction.

A recent symposium of various stakeholders in the BOZ and scholarly experts, focused on the issue "Central Bank Independence, Does it hurt the Treasury?",[69] and concluded as follows:

i) There was recognition that the BOZ has a *relative degree of autonomy*. However, this is *largely informal* and has been attained on account of *personalities*. Therefore, there *is need to institutionalize* this autonomy by undertaking some of the following;

    a) To ensure that the Bank of Zambia autonomy is *enshrined in the new constitution* (a new constitution is presently under the active consideration of a National Constitutional Conference), and subsequently incorporated in revisions to

[69]"Central Bank Independence: Is it good for the Ministry of Finance?" *Symposium on Central Bank Independence: Does it hurt the Treasury?* (Bank of Zambia, Department for International Development Symposium, Livingstone Zambia, 2008)

the Bank of Zambia Act with clear checks and balances to foster transparency and accountability,

b) Autonomy of Bank of Zambia should *cover financial, political, economic, and operational aspects*, and

c) There should be *broad educational campaigns and training to promote public acceptance* and support of central bank independence;

ii) An agreement was reached on the *need to make amendments to the 1996 BOZ Act* in order to *enhance the autonomy and accountability* of Bank of Zambia. Areas of amendment to the Act were suggested and these included:

a) The clauses relating to the *appointment and removal of the Governors* and the Bank of Zambia Board and their terms of office, and

b) The *powers of the Minister* enshrined in the Bank of Zambia Act;

iii) Regarding monetary policy formulation, there was a recommendation that the *Monetary Policy Advisory Committee (MPAC) be transformed into a full-fledged Monetary Policy Committee* (MPC), which would make monetary policy decisions and be accountable for them;

iv) There is *need to enhance the portfolio of instruments of monetary policy at the disposal of the Bank* of Zambia. This may include issuing its own paper; and

v) There is a need to enhance the *Board's effectiveness by having an optimal mix of executive and non-executive members* on the Board.

In conclusion, although recognizing that CBI has considerably advanced in Zambia during Phase 2, the symposium recognized that there was still some way to go to ensure it is inculcated in both the regulatory and political DNA of the country.

6. Concluding Remarks

> When I ask two economists a question I get two different answers, unless one of them is Lord Keynes, in which case I get three. -Winston Churchill

CBI is regarded as a 'controversial subject in public debate. It is difficult to establish and entrench CBI by law and to ensure and guarantee it by invoking legal provisions. This is because it is a complex aggregate of de facto and de jure institutional arrangements, practices and the central bank's own actions including the attitudes and actions of the Treasury.

Central banks are crucial in any political and economic dispensation for the economic and regulatory roles they play in ensuring financial stability and financial services regulation. They are often the products of the prevailing socio-economic and political dispensations and their practices, structure, activities, authority and influence are determined and shaped by the political, economic and social conditions obtaining in a particular jurisdiction in which it is located and operates in at a given time.

The role and status of central banks, therefore changes as the political and economic environment, fortunes and philosophy of a country change. Such an evolution impacts on the Central Bank's authority, influence, practices, activities and structure. Using these criteria, it can be argued that the authority, influence, practices and role of the Bank of Zambia in its past two historical phases, is no exception. BOZ's situation in particular has been compounded (or complemented) by the political liberalization engendered by constitutional democratic politics and the liberalized economic environment backed by the country's principal donors.

There is a majority school of thought that posits that the main and only source of legitimacy is *accountability* to voters or their elected representatives. On the basis of this yardstick, the concept and existence of an independent central bank is a constitutional anomaly which does not fit squarely into the traditional mould and regime of controls, checks and balances. This has been termed the problem of the democratic deficit. Former Governor Tito Mboweni of the Reserve Bank of South Africa, however would agree with those who assert that this problem can be overcome through addressing three pre-conditions under which CBI is conducted, namely 1) *in the legal framework*, the CBI should be clearly defined to avoid any misconceptions of what the central bank is supposed to achieve 2) through *greater transparency*, involving the government and the public continuously being informed of the monetary policy program followed by the central bank and 3) the *creation of an efficient institutional framework* within which decisions on monetary policy can be made without undue interference by political functionaries.[70]

[70] Mboweni, T.T:"Central Bank Independence", BIS Review 88/2000, pp 3-4

This counter-school (invariably backed by central bankers themselves), seeks to protect the minority from the 'tyranny of the majority.' Rather than concentrate power in the hands of the majority it aims to limit and disperse power efficiently among different institutions.

It thus advocates delegating policy making responsibilities to independent bodies at either national or supranational level. This delegation, segregation and dispersion of policy formulation is considered as an effective instrument of diffusing power.

This paper asked the following questions at its outset: Does Central Bank independence matter? Is the independence of the central bank in a developing democracy a good thing? Does it matter more in a country that is in a hurry to develop? Does the independence raise questions of transparency and accountability particularly in a developing democracy?

Utilizing examples of global best practice (United States, United Kingdom, the European Union, and China), Africa (Ghana, Mauritius) and the case study of Zambia, the paper answers the question of whether CBI matters, affirmatively. On the question of whether CBI in a developing democracy is a good thing, the paper has demonstrated using the case study of Zambia and African scholarly thought (Ibrahim Stevens, Paul Collier), that CBI is not only a pre-requisite for financial stability, foreign direct investment and positive growth, but since it is about credibility, it has the potential to lead other parts of the public sector towards adopting transparent processes that reduce corruption. Stevens has gone further and made the argument that CBI goes beyond the traditional monetary and financial stability argument (which is posited in the developed economies), but can be used by developing countries in the defense of public assets.

On the questions of transparency and accountability, it is argued that Parliament as the oasis, fountain and repository of democratic authority has neither the time nor the expertise to formulate monetary policy, regulate and supervise banks. As a result it formulates legislation vesting an independent body such as the central bank to formulate policies, devise and implement regulatory and supervisory strategies which ensure a stable and sound financial system. In a democracy or budding democracy, this can be the fourth column in the separation of powers, ensuring soundness in the financial sector, which as revealed by recent global events, is the hub for positive economic growth. Parliament can then reserve and arrogate to itself the responsibility for oversight to ensure an accountable central bank. In this argument, accountability is perceived as a countervailing power to the independence of the central bank. The burden of the liability to account may be grounded in the constitution, a statute or hierarchical political structure or it may arise by virtue of law or contract. It is argued that accountability is one way of securing legitimacy and credibility, and this objective requires some form of demonstrable accountability.

On the specific question of transparency, this can also be met *ex legis*, in a similar manner to the provisions under sections 9 and 27 of the Zambian 1996 BOZ Act (and as soon to be reinforced). Additionally, in the process of transparency and accountability, the courts need not be absent, in a democratic or aspiring democratic order. The courts in Zambia and other Common Law countries like Ghana, have always insisted on reviewing all decisions involving the exercise of public power even where such powers are exercised by private bodies. Legal accountability to the courts is an aspect of the rule of law and entails the imposition of coercive remedies and sanctions.

I conclude by quoting a Bemba (Northern Zambian) proverb: "the child that does not travel praises his mother's cooking". The proverb literally translated deals with the value of globalization, precedent and experience. In a global world, with the precedent of best practice, aided by well meaning institutions and a clear idea of what developing economies like Zambia wish to achieve, there is no reason why they will not start with the foundational concept of a strong and credible central bank which has goal and operational independence and will thus ensure a sound financial system. A sound financial system, though not guaranteeing economic growth, is a necessary condition to it. Sustained growth in turn is an imperative if Zambia and Africa are to meet their Millennium Development goals and eventually emerge amongst the newly industrialized countries. We shall in this way not be satisfied with "praising our mother's cooking" until we see the global cuisine which comes with growth.

N. Justin Chinyanta, Medford MA, April 7th 2010.

Appendices

Appendix 1- 1996 Bank of Zambia Act

Bank of Zambia Act (Cap 360)

CHAPTER 360 THE BANK OF ZAMBIA ACT

CHAPTER 360

THE BANK OF ZAMBIA ACT

ARRANGEMENT OF SECTIONS

PART I PRELIMINARY

CHAPTER 360

BANK OF ZAMBIA Act No.

43 of 1996

4 of 1998

Statutory Instrument

191 of 1996

An Act to revise and consolidate the provisions of the Bank of Zambia Act; to revise the law relating to the composition, duties and powers of the Bank of Zambia and its Board; to revise and consolidate the law relating to the issuance of the currency of the Republic and the formulation and implementation of a monetary policy that will ensure the maintenance of price stability; and to provide for matters connected with or incidental to the foregoing.

[12th December, 1996

PART I PRELIMINARY

1. (1) This Act may be cited as the Bank of Zambia (Amendment) Act, 1998, and shall be read as one with the Bank of Zambia Act, in this Act referred to as the principal Act.

(2) This Act shall be deemed to have come into operation on the 31st January, 1998. Short title and commencement

Act No. 43 of 1996

2. In this Act, unless the context otherwise requires- Interpretation

"Bank" means the Bank of Zambia established under section three;

"bank" shall have the meaning assigned to it in the Banking and Financial Services Act; Cap.

387

"banking business" shall have the meaning assigned to it in the Banking and Financial Services

Act; Cap. 387

"Board" means the Board of Directors of the Bank established under section twelve;

"Deputy Governor" means the Deputy Governor of the Bank appointed under section eleven;

"financial institution" shall have the meaning assigned to it in the Banking and Financial Services

Act; Cap. 387

"financial service" shall have the meaning assigned to it in the Banking and Financial Services

Act; Cap. 387

"fine units" shall have the meaning assigned to it in the Fees and Fines Act; Cap. 45

"Governor" means the Governor of the Bank appointed under section ten;

"Ordinary revenue of the Government" means revenue from taxes, levies, royalties, fees, duties, rents, profits and income from any investment or any undertaking by the Government, its institutions and agencies, statutory bodies and local authorities, but does not include any funds raised by way of borrowing, grants in cash or in kind, or any other form of economic assistance.

PART II

BANK OF ZAMBIA

3. (1) The Bank of Zambia established under section three of the Bank of Zambia Act, 1985, is hereby continued as if established under this Act and shall be a body corporate with perpetual succession and a common seal, capable of suing and of being sued in its corporate name, and with power, subject to the provisions of this Act, to do all such acts and things as a body corporate may by law do or perform. Establishment of Bank

(2) The headquarters of the Bank shall be in Lusaka.

(3) The Board may establish branches of the Bank within the Republic, and with the approval of the Minister, in any place outside the Republic.

(4) The Board may appoint in Zambia or elsewhere agents and correspondents of the Bank, on such terms and conditions, as it may determine:

Provided that no fees, remuneration, commission or allowances paid to any agent or correspondent shall be computed by reference to the profits of the Bank.

4. (1) The Bank shall formulate and implement monetary and supervisory policies that will ensure the maintenance of price and financial systems stability so as to promote balanced macro-economic development. Functions of Bank

(2) Without prejudice to the generality of subsection (1) and subject to the other provisions of this Act the Bank shall-

(a) licence, supervise and regulate the activities of banks and financial institutions so as to promote the safe, sound and efficient operations and development of the financial system;

(b) promote efficient payment mechanisms;

(c) issue notes and coins to be legal tender in the Republic and regulate all matters relating to the currency of the Republic;

(d) act as banker and fiscal agent to the Republic;

(e) support the efficient operation of the exchange system; and

(f) act as adviser to the Government on matters relating to economic and monetary management.

5. The Minister may convey to the Governor such general or particular Government policies as may affect the conduct of the affairs of the Bank and the Bank shall implement or give effect to such policies.

6. (1) The authorised capital of the Bank shall be ten billion kwacha. Capital

(2) The Bank may, increase the authorised capital by such amounts and in such a manner as the Board may determine, and may in like manner with the consent of the Minister reduce the authorised capital:

Provided that no reduction shall be so effected as to reduce the amount of the authorised capital below ten billion kwacha.

(3) The Government shall be the sole subscriber to the paid-up capital of the Bank, and its holdings of the paid-up capital shall not be transferable in whole or in part or be subject to any encumbrance whatsoever.

(4) The amount of any increase in paid-up capital effected in accordance with subsection (2)

shall be paid up in full by the Government.

(5) Whenever the Board certifies that the assets of the Bank are less than the sum of its capital and other liabilities, the Minister notwithstanding the provisions of any other written law, shall, on behalf of the Government cause to be transferred to the ownership of the Bank negotiable and interest bearing securities issued by the Government for such amount as is necessary for the purposes of preserving the capital of the Bank from any impairment.

7. (1) The net profit of the Bank for each financial year shall be determined by the Bank after-

(a) allowing for the expenses of operations for that year;

(b) making provision;

(i) for bad and doubtful debts, depreciation of assets and contingencies;

(ii) for pensions, gratuities and other benefits for its officers and employees; and

(iii) for such other items which are consistent with the Bank's mandate.

(2) Where the Bank makes a profit any amount left over after making transfers in accordance with section six shall be paid to the Government within sixty days following the auditor's certification of the Bank's financial statements.

(3) Where in any year, the Bank makes a loss on its profit and loss statement as certified by the auditors, the Minister, notwithstanding the provisions of any other written law, shall on behalf of the Government cause to be transferred to the ownership of the Bank cash or negotiable securities bearing market interest rates, and such securities shall be delivered to the bank within sixty days from the date of certification of the accounts by the auditors.

8. (1) The general reserve fund of the Bank established under section twenty-two of The Bank of Zambia Act, 1964, shall continue to be maintained in accordance with the provisions of this Act, and to this fund shall be transferred, at the end of each financial year of the Bank-

(a) twenty-five per centum of the net profits of the Bank as calculated in accordance with section seven, when the balance in the general reserve fund is less than three times the Bank's authorised capital; or

(b) ten per centum of the net profit of the bank as calculated in accordance with section seven, when the balance in general reserve fund is three times the Bank's authorised capital, or more.

(2) The balance if any of the net profits remaining after transfers under subsection (1) shall be applied to the redemption on behalf of the Government of any securities issued and outstanding being securities issued against losses incurred by the Bank.

(3) No transfers shall be made under subsections (1) and (2) if the Board certifies that the assets of the Bank are, or after such transfer, will be, less than the sum of its capital and other liabilities.

9. (1) The Bank shall, in consultation with the Minister, within six months after the commencement of this Act, and at every six months interval thereafter publish in the Government Gazette a policy statement that shall contain:

(a) a description and an explanation of the reasons for the monetary policies to be followed by the Bank during the following six months;

(b) a description of the principles that the Bank proposes to follow in the formulation and implementation of monetary policy during the next two years or such other period of time as the Minister may decide; and

(c) a review and assessment of implementation by, the Bank, of monetary policy during the period to which the last proceeding six months policy statement relates.

(2) The Minister shall within the first sitting of the National Assembly next after the receipt of the report referred to under this section lay it before the National Assembly.

PART III ADMINISTRATION

10. (1) Subject to section fifteen the President may, appoint, for a period not exceeding five years, a person with recognised professional qualifications and experience in financial and economic matters to be Governor of the Bank and the President may re-appoint the Governor upon the expiry of the Governor's term of office. Governor

(2) An appointment under subsection (1) shall be subject to ratification by the National Assembly.

(3) The Governor shall be the Chief Executive Officer of the Bank and shall be responsible to the

Board for the execution of the policy and management of the Bank.

(4) The Governor may, with the approval of the Board, delegate any of his functions or powers to a Deputy Governor, or any other staff of the Bank.

(5) The terms and conditions of the Governor shall be determined by the Minister subject to the provisions of this Act, and shall not, during the Governor's term of office be altered to the Governor's disadvantage:

Provided that no salary, fee, wage, remuneration, commission or allowance to be paid to the

Governor shall be computed by reference to the profits of the Bank.

(6) During the Governor's term of office the services of the Governor shall be at the disposal of the Bank and the Governor shall not, without the written approval of the President, receive any salary, allowance, contribution or supplementation from any source other than the Bank, or

take up any other office or employment, whether remunerated or not, except as nominee of the

Bank:

Provided that the Governor may serve on any board, committee or commission established by the Government or may become Governor, director or member of a board or any other body or of any international financial organisation of which Zambia is a member.

(7) The Governor may resign from office by giving three months notice to the President and may be removed by the President.

11. (1) Subject to section fifteen the President, shall appoint up to two persons with recognised and appropriate professional qualifications and experience, to be Deputy Governors of the Bank for periods not exceeding five years. Deputy Governor

(2) The provisions of subsections (4) and (5) of section ten shall apply mutatis mutandis to a

Deputy Governor.

(3) A Deputy Governor may resign from office by giving three months written notice to the

President and may be removed by the President.

12. (1) There shall be a Board of Directors of the Bank in which shall vest all the powers of the Bank and which shall be responsible for the formulation of policy of the Bank. Board of Directors

(2) The Board may delegate to the Governor such of its functions as it considers necessary for the better administration of the Bank.

13. (1) The Board shall consist of, the following directors- Composition of Board

(a) the Governor, who shall be the Chairman of the Board; and

(b) not more than six other persons appointed by the Minister from amongst individuals with professional or academic experience in business or financial matters and who are not officials or employees of the Bank.

(2) The Board shall choose one of its members to be the Vice-Chairman.

(3) The Secretary to the Treasury in the ministry responsible for finance, shall be an ex-officio director of the Board and shall be entitled to attend and participate in any meeting of the Board but such person shall have no vote and shall not count for the purpose of a quorum.

(4) The Secretary to the Treasury in the ministry responsible for finance, may in writing, appoint a senior official in that ministry to be an alternate director to the Secretary to the Treasury and to attend any meeting of the Board which the Secretary to the Treasury is unable to attend, and when such alternate attends such meeting, the provisions of subsection (2) shall apply, mutatis mutandis, to such alternate.

(4) The director referred to in paragraph (b) of subsection (1) shall be paid such fees and allowances as the Minister may determine.

14. (1) Subject to the other provisions of this section, a director referred to in paragraph (b) of subsection (1) of section thirteen shall hold office for a period not exceeding three years and shall be eligible for re-appointment, on the expiry of such term, for a further three years. Tenure of office

(2) A director, other than the Governor and the Secretary to the Treasury, may be removed by the Minister at any time by notice in writing and may resign from the Board at any time.

15. (1) No person shall be appointed, re-appointed or continue to hold office of Governor, Deputy Governor or director if such person- Disqualifications

(a) is or becomes a member of the National Assembly;

(b) is a director, officer, employee or owner of, or shareholder in, any financial institution or bank which is under the regulatory jurisdiction of the Bank or of the Government, other than as a nominee of the Bank;

(c) has been convicted of any offence involving dishonesty, or is an undischarged bankrupt, or has been convicted of a felony;

(d) is detained, or his freedom of movement is restricted, under any law in force in Zambia for a period in excess of six months; or

(e) is of unsound mind.

16. (1) Subject to the other provisions of this Act, the Board may regulate its own procedure.

Proceedings of Board

(2) The Board shall meet for the transaction of the business of the Bank at least once every three months at such places and at such times as the Governor may decide.

(3) Upon giving notice of not less than seven days, a special meeting of the Board may be called by the Governor at any time:

Provided that if the urgency of any particular matter does not permit the giving of such notice, a special meeting may be called upon giving a shorter notice.

(4) Four directors shall form a quorum at any meeting of the Board.

(5) Where the Chairman and the Vice-Chairman are absent from any meeting of the Board, there shall preside at that meeting such director as the directors present may elect for the purposes of that meeting.

(6) A decision of the Board on any question shall be by a majority of the directors present and voting at a meeting and, in the event of equality of votes, the person presiding at the meeting shall have a casting vote in addition to his deliberative vote.

(7) The Board may invite any person, whose presence is in its opinion desirable, to attend and to participate in the deliberations of a meeting of the Board but such person shall have no vote.

(8) The validity of any proceedings, act or decision of the Board shall not be affected by any vacancy in the membership of the Board or by any defect in the appointment of any director or by reason that any person not entitled to do so took part in the proceedings.

(9) The Board shall cause minutes to be kept of the proceedings of every meeting of the Board and of every meeting of any committee established by the Board.

17. (1) The seal of the Bank shall be such device as may be determined by the Board and shall be kept by the Governor or an officer designated by him. Seal of Bank

(2) The Board may use a wafer or rubber stamp in lieu of the seal.

(3) The seal of the Bank shall be affixed to an instrument only on the authority of a resolution of the Board and in the presence of at least two directors who shall sign every instrument to which the seal of the Bank is so affixed in their presence.

(4) Any contract, or instrument which, if entered into or executed by a person not being a body corporate, would not be required to be under seal, may be entered into or executed without seal on behalf of the Bank by the Governor or any other director generally or specifically authorised by the Board.

(5) Any document purporting to be a document under the seal of the Bank or issued on behalf of the Bank shall be received in evidence and shall be deemed to be so executed or issued, as the case may be, without further proof, unless the contrary is proved.

18. (1) The Board may, for the purpose of performing its functions under this Act, establish committees and delegate to any such committee such of its functions as it considers fit.

Committees of Board

(2) The Board may appoint as members of a committee established under subsection (1), persons who are or are not directors of the Board and such persons shall hold office for such period as the Board may determine.

(3) Subject to any specific or general direction of the Board any committee established under subsection (1), may regulate its own procedure.

19. No action or other proceedings shall lie or be instituted against any director for or in respect of any act or thing done or omitted to be done in good faith in the exercise or purported exercise of such director's functions under this Act. Immunity of Directors

20. (1) No director shall act as representative of any commercial, financial, agricultural, industrial or other concern, or receive or accept directions therefrom in relation to such director's duties under this Act. Conflict of interest and disclosure of interest

(2) If any person is present at a meeting of the Board or any committee or the Board at which any matter, in which such person or his spouse is directly or indirectly interested in a private capacity, is the subject of consideration, such person shall, as soon as practicable after the commencement of the meeting, disclose such interest and shall not, unless the Board otherwise directs, take part in any consideration or discussion of, or vote on, any question touching such matter.

(3) A disclosure of interest made under this section shall be recorded in the minutes of the meeting at which it is made.

(4) Any person who contravenes any of the provisions of this section shall be guilty of an offence and shall be liable, upon conviction, to a fine not exceeding thirty thousand fine units or to imprisonment for a term not exceeding three years, or to both.

21. (1) The Board may appoint, on such terms and conditions as it may determine, such staff as it may consider necessary for the conduct or operations of the business of the Bank: Staff of Bank

Provided that no salary, fee, wage, remuneration, commission or allowance to be paid to any staff of the Bank shall be computed by reference to the profits of the Bank.

(2) The Board may establish pension schemes and permit the Bank to grant loans to its staff or guarantee such loans from any financial institution.

(3) The Board may establish training facilities for the staff of the Bank.

22. (1) Every person appointed under this Act or employed by the Bank shall take and subscribe, before a Commissioner for Oaths, an oath of secrecy as set out in the Official Oaths Act, and the provisions relating to affirmation and duplication of oaths contained in that Act shall apply mutatis mutandis. Oath or declaration of secrecy

(2) Any person to whom this section applies who, having complied with the provisions of subsection (1), does or omits to do any act in contravention of the oath of secrecy shall be guilty of an offence and shall be liable, upon conviction, to a fine not exceeding thirty thousand fine units or to imprisonment for a term not exceeding two years, or to both.

23. (1) Except in compliance with an order or a court of competent jurisdiction or with the written consent given by or on behalf of the Board, no person appointed under this Act shall publish or disclose to any person, otherwise than in the course of that person's duties the contents of any document, communication or information, whatsoever, which relate to, and which have come to that person's knowledge in the course of, such person's duties under this Act. Prohibition of publication of or disclosure of information to unauthorised persons

(2) Any person who knowingly contravenes the provisions of subsection (1), shall be guilty of an offence and shall be liable, upon conviction, to a fine not exceeding thirty thousand fine units or to imprisonment for a term not exceeding two years, or to both.

(3) If any person having information which to his knowledge has been published or disclosed in contravention of subsection (1), unlawfully publishes or communicates any such information to

any other person, that person shall be guilty of an offence and shall be liable, upon conviction to a fine not exceeding forty-five thousand fine units, or to imprisonment for a term not exceeding three years, or to both.

24. The financial year of the Bank shall be the period of twelve months ending on 31st

December in each year. Financial year

25. (1) The Board shall cause to be kept proper books of account and other records relating to the bank's accounts in conformity with generally accepted accounting principles. Books of account

(2) Such books of account and other records shall, at all reasonable times, be open for inspection by the directors or any person authorised by the Minister.

26. The accounts of the Bank shall be audited annually by an auditor appointed by the Board.

Audit of accounts

27. (1) As soon as is practicable, but not later than six months after the expiry of each financial year, the Board shall submit to the Minister a report concerning its activities during such financial year. Annual report

(2) The report referred to in subsection (1), shall include information on the financial affairs of the Board and there shall be appended thereto-

(a) an audited balance sheet;

(b) an audited statement of income and expenditure; and

(c) such other information as the Minister may require.

(3) The Minister may at any time request the Board, in writing, to submit to him such other reports, returns or statements, duly certified by an auditor, as he may consider necessary and the Board shall comply with such request.

28. (1) The Bank shall deliver to the Minister a return of its monthly assets and liabilities whenever he so requires. Reports on monthly assets and liabilities

(2) Within a period of thirty days, after the last working day of each month the bank make up, and cause to be published in the Gazette a return of its assets and liabilities as at the close of business on that day, and shall deliver that return to the Minister.

PART IV

MONETARY UNITS, NOTES AND COINS

29. (1) The units of currency of the Republic is the Kwacha (abbreviated as K). Currency of the

Republic

(2) The denominations of money in the currency of the Republic are the Kwacha and the ngwee

(abbreviated as N or as n).

(3) One ngwee is the one-hundredth part of the kwacha.

30. (1) The right to issue notes and coins in Zambia shall vest exclusively in the Bank. Right to issue currency

(2) Any person, other than the Bank, who issues in Zambia notes or coins (or other documents or token) which are payable to bearer on demand or purport to be the currency of the Republic or the currency of any other country shall be guilty of an offence and shall be liable, upon conviction, to a fine not exceeding one million fine units or to imprisonment for a term not exceeding ten years, or to both:

Provided that this subsection shall be complementary to and not in derogation of the provisions of the Penal Code relating to forgery, coining, counterfeiting and similar offences. Cap. 87

31. (1) The notes and coins issued by the Bank shall be- Denominations of notes and coins

(a) in such multiples or fractions of kwacha or ngwee as the Bank shall determine; and

(b) of such forms and designs as the Bank shall determine.

(2) The standard weight, composition and amount of remedy of coins issued by the Bank shall be determined by the Bank and shall be published in the Gazette.

32. The Bank shall have all such powers and make all such arrangements as may be necessary for the printing of notes, the minting of coins and for the issue, re-issue, exchange and destruction of notes and coins; and for the safeguarding thereof. Minting and issue

33. (1) A tender of payment of money shall be legal tender if it is in notes or coins that are made and issued by the Bank under this Act: Legal tender

Provided that the Minister may by regulation make restrictions as to any particular maximum amount considered as legal tender.

(2) Whenever the Board thinks desirable, the Bank may, with the approval of the Minister, issue coins or any denomination for purposes other than monetary use and designate the same to be legal tender within

the Republic and every such issue shall be publicised in the Gazette and may be further published in such manner as the Minister may determine.

34. (1) Whenever the Bank intends to call in, for the purpose of withdrawing from circulation or payment of the face value thereof, any notes or coins which it has issued, it shall give prior

notice in the Gazette and may further publicise its intention in such manner as it thinks fit.

Powers of recall

(2) Any notes or coins called in under subsection (1) shall cease to be legal tender on a date or dates fixed by the Bank and shall not be redeemed at their face value after a set date or dates.

(3) Notification of the date or dates after which notes or coins shall not be deemed shall be published in the Gazette.

35. Subject to section thirty-six, the Bank shall exchange, on demand and without charge, any notes or coins, which the Bank has issued, for notes or coins of equivalent value and of such denomination as may be requested by any person or agent surrendering such notes or coins in accordance with section thirty-four: Exchange of notes or coins

Provided that in the event of the denomination being requested, not being available, the Bank may deliver notes and coins of the nearest denomination available.

36. (1) No person shall be entitled to recover from the Bank the value of any lost or stolen

notes or coins, except as may be provided under the terms of a waiver of risk expressly executed in respect of an assumption undertaken by the Bank for the shipment of notes and coins:

Lost and mutilated notes and coins

Provided that the Bank shall be liable for any loss suffered by any person in consequence of the negligence or misconduct of any director, staff or agent of the Bank committed in the course of such person's official duties.

(2) The Bank may determine and publish in the Gazette the conditions under which mutilated or otherwise damaged notes may be exchanged by the Bank.

(3) The Bank, except in its sole discretion, shall not exchange coins which have been perforated, cut, clipped, broken or otherwise marked or defaced or the design of which is not recognisable.

37. (1) It shall be the duty of the Bank to ensure or cause the enforcement, in the Republic, of any law relating to the forgery of notes or counterfeiting of notes and coins. Counterfeit of notes and coins

(2) A certification by a duly authorised staff of the Bank that an item in question is or is not genuine shall be prima facie evidence of that fact in any legal proceedings in the Republic.

38. (1) Any person who wilfully- Penalty for mutilation of currency

(a) soils, tears, defaces or in any other way whatsoever mutilates any note issued by the

Bank;

(b) writes, paints, stamps or draws upon any such note; or

(c) wilfully defaces, mutilates or pierces a coin issued by the Bank;

shall be guilty of an offence and shall be liable, upon conviction, to a fine not exceeding five thousand fine units or to imprisonment for a term not exceeding two months, or to both:

Provided that this section shall be complementary to, and not in derogation of, the provisions of the Penal Code relating to forgery, coining, counterfeiting and similar offences.

(2) A person shall not, without the prior approval of the Bank-

(a) make, design, engrave, print or reproduce; or

(b) use, issue or publish;

any article or thing resembling a bank note or coin or so nearly resembling or having such a likeness to a bank note or coin so as to likely be confused with, or mistaken for, such bank note or coin.

(3) Any person who contravenes subsection (1), shall be guilty of an offence and shall be liable upon conviction to a fine not exceeding thirty thousand fine units or to imprisonment for a term not exceeding two years or both.

(4) Where a person is convicted of an offence against subsection (2), a court may order the article or thing, any copy of it, any plates, block, dies, and other instruments used or capable of being used for printing or reproducing, in the possession of that person, to be destroyed.

PART V

INTERNATIONAL RESERVE, AND FOREIGN EXCHANGE OPERATIONS

39. (1) The Bank shall maintain, on such terms and conditions as the Board may determine, an international reserve which shall consist of all or any of the following: International reserves

(a) gold;

(b) foreign exchange in the form of notes or coins or bank balances held abroad, denominated in such currencies and located in such countries as the Board may approve;

(c) any internationally recognised reserve asset, including-

(i) the facilities to make reserve tranche purchases from the International Monetary Fund;

(ii) holding of special drawing rights;

(d) bill of exchange and promissory notes denominated and payable in such foreign currencies and in such places as the Board may approve;

(e) treasury bills and other securities denominated in such foreign currencies, issued or guaranteed by such foreign governments and payable in such places as the Board may approve;

(f) securities issued or guaranteed by international financial institutions specified by the

Board; and

(g) such other international reserve assets as the Board may approve.

(2) The Bank shall use its best endeavours to maintain the international reserves referred to in subsection (1), at a level which is adequate for achieving the objectives of the Bank.

40. (1) The Bank may, subject to such terms and conditions as the Board may determine- Operations in gold and foreign exchange

(a) buy, sell or deal in foreign currencies using any of the instruments commonly in use for the purpose;

(b) buy, sell or deal in gold coin or bullion or other precious metals;

(c) buy, sell or deal in treasury bills and other securities issued or guaranteed by foreign governments or international financial organisations;

(d) open and maintain accounts with, and act as agent or correspondent for, international financial organisations, central banks, monetary authorities or financial institutions outside Zambia, and with the approval of the Minister, foreign governments or their agencies.

(2) In carrying out its functions under subsection (1), the Bank shall deal only with the Government, banks or other financial institutions in the Republic, foreign governments or their agencies, international financial organisations, central banks, monetary authorities or financial institutions outside the Republic.

PART VI

RELATIONS WITH BANKS AND FINANCIAL INSTITUTIONS

41. (1) The Bank may, by Gazette notice, determine- Minimum liquidity ratios and reserve requirements

(a) the minimum ratio of liquid assets which each financial institution is required to hold;

and

(b) the minimum reserve balance which each financial institution shall maintain with the

Bank.

(2) The Bank may, by Gazette notice, determine the class or classes of assets which shall qualify to be liquid assets referred to under this section.

(3) The Bank may, by Gazette notice, specify the class or classes of liabilities against which the ratio requirement may be calculated.

(4) No bank or financial institution shall be required to maintain higher percentages than any other bank or financial institution.

(5) If the Bank at any time increases any of the ratios referred to in subsection (3), every bank or financial institution shall be allowed not less than ten days in which to comply.

(6) The Bank may require any bank or financial institution to furnish such information as the Bank may consider necessary to satisfy itself that the bank or financial institution concerned is complying with the provisions of this section.

(7) Where the Bank holds a balance in an account for a depositor who is subject to a regulation made pursuant to subsection (1)-

(a) the Bank may pay interest on such balances, on such terms and conditions, as it considers appropriate;

(b) where a bank or financial institution which is subject to subsection (1) fails to maintain a balance in its account with the Bank sufficient to comply with its duty under that subsection, the bank or financial institution shall pay to the Bank daily interest calculated on the amount that its balance is deficient at the rate determined by the Bank for that purpose.

42. (1) The Bank may operate accounts for banks and other financial institutions on such terms and conditions, as the Board may determine. Accounts for banks and other financial institutions

(2) In respect of any account operated in accordance with subsection (1), the Bank may-

(a) purchase, sell, discount or rediscount any treasury bills or other securities issued or guaranteed by the Government, forming part or a public issue and their acquisition by the Bank;

(b) grant, for a period not exceeding six months, advances secured by:

(i) instruments specified in paragraph (a);

(ii) other securities issued or guaranteed by the Government and forming part of a public issue; and

(iii) holdings of any assets which the Bank is permitted to buy, sell or deal in under section thirty-nine.

(3) Where the Bank is of the opinion that an advance is necessary in order to-

(a) meet liquidity requirements; or

(b) forestall insolvency to safeguard the financial system;

of a holder of any account operated in accordance with subsection (1), the Bank may make an unsecured advance or an advance secured by such assets; and on such special terms and conditions as the Board may determine.

43. (1) The Bank may determine, and make public its rates for discounts, rediscounts and advances. Bank rates for discounts, rediscounts and advances

(2) The Bank may determine different rates for different classes of transactions or maturities.

44. The Bank may, in conjunction with other financial institutions, organise facilities for the clearing of their cheques and other instruments for effecting payments; and for this purpose organise a clearing system in Lusaka and elsewhere: Clearing facilities

Provided that only commercial banks at the discretion of the Bank may be permitted to maintain settlement accounts with the Bank.

PART VII

RELATIONS WITH GOVERNMENT

45. The Bank shall- Banker, fiscal agent and adviser to the Government

(a) be the banker to and fiscal agent of the Government; and

(b) through the Minister act as financial adviser to the Government and render advice and furnish reports on matters relating to the functions of the Bank and on other matters likely to affect such functions.

46. (1) The Bank shall be the official depository of Government funds: Depository of

Government funds

Provided that the Government may maintain accounts with, and generally use the services or, any bank or financial institution.

(2) When the Bank performs services for the Government pursuant to this Act or at the request of the Government, the Government shall pay the Bank such fees as may be agreed between the Bank and the Minster.

47. The Bank shall, on such terms and conditions as the Minister may determine, issue and manage Government loans or loans guaranteed by the Government which form a public issue.

Management of Government loans

48. The Bank shall act as agent for the Government for such purposes and on such terms and conditions as the Minister may determine. Agency functions

49. The Bank shall not advance funds to the Government except in special circumstances and on such terms and conditions as may be agreed upon between the Bank and the Minister.

Advances to Government

50. (1) Except as provided in section forty-nine and in subsection (4), the Bank shall not directly or indirectly, at any time, give credit to the Government by way of short term advances, purchases or securities in a primary issue, or any other form or extension of credit that exceeds fifteen percent of the ordinary revenue of Government in the previous financial year.

Limitations on lending to Government

(2) If in the opinion of the Bank the limitation provided for in subsection (1), is likely to be exceeded, the Bank shall submit to the Minister a report stating-

(a) the details of the amounts then outstanding of the funds advanced and credit facilities extended by the Bank and the Bank's holding of securities referred to in subsection (1);

(b) the causes which are likely to lead to such limitation being exceeded; and

(c) its recommendation to forestall or otherwise remedy the situation.

(3) The Bank shall continue to make further reports and recommendations on the matters referred to in subsection (2), at intervals of not more than six months until such time as, in its opinion, the situation has been rectified.

(4) Where the limitation provided for in subsection (1) is exceeded, the Bank shall forthwith advise the Minister of that fact and shall not allow any further increase, whether directly or indirectly, in the aggregate amount of the funds advanced and credit facilities extended by the Bank and the Bank's holding of securities referred to in subsection (1).

51. In respect of any dealings with any international financial organisation of which Zambia is a member, the Minister may designate the Bank to be the depository of any funds and the fiscal agency through which such dealings shall be conducted. Depository and fiscal agency for international financial organisations

52. The Bank may underwrite, purchase, sell or deal in securities issued or guaranteed by the

Government which form part of a public issue. Transaction with Government securities

PART IX GENERAL

53. Except as otherwise expressly authorised by this Act, the Bank shall not- Prohibited business

(a) engage in trade, purchase stocks or shares of, or otherwise have a direct interest in any commercial, agricultural, industrial, financial or like undertaking, save as the Bank may acquire as security for, or in satisfaction of, debts due to it, and any interest so acquired shall be disposed of at the earliest convenient opportunity;

(b) accept for discount, or as security for any advance, bills or notes signed by a director or by a member of the staff of the Bank;

(c) acquire by purchase, lease or otherwise, any right in, or to, any immovable property except in so as far as the Bank shall consider necessary or expedient for providing premises for the conduct of its business and requirements incidental to the functions or business of the Bank;

(d) make unsecured advances or advances secured otherwise than is provided for under this Act.

54. (1) For the purpose of carrying out its functions under this Act, the Bank may require any person to provide such information as it may specify. Right to call information

(2) Where the Bank believes that any information or data supplied by any person pursuant to subsection (1), is, or maybe, inadequate or inaccurate, it may, by notice in writing to that person, require that information or data to be audited by an auditor approved by the Bank.

55. The Bank shall carry out, periodically or at such times as the Bank may consider necessary, an inspection of any bank or financial institution in accordance with the provisions of the Banking and Financial Services Act. Inspection

56. (1) The Bank shall be exempt from the payment of any taxes levies or duties in respect of its profits, operations, capital, property or documents or any transaction, deed, agreement or promissory note to which it is a party. Exemption from taxes

(2) The bank shall be exempt from the payment of taxes or any duties in respect of notes or coins issued as currency under this Act.

57. (1) The Minister may, by statutory instrument, make regulations for the better carrying out of the purposes of this Act. Regulations

(2) Without prejudice to the generality of subsection (1), the Minister may, on the recommendation of the Bank, make rules or regulations prescribing any matter which the Bank is authorised by this Act to formulate, regulate or determine.

(3) Regulations or rules made under this Act may provide in respect of any contravention thereof that the offender shall be liable to a fine not exceeding one hundred thousand fine units

or to a term of imprisonment not exceeding ten years, or to both.

58. The Bank may construct, purchase or lease or otherwise acquire for the conduct of its business or, for the residence of its staff, property and may manage, insure, sell, lease or otherwise dispose of that property. Property

59. Notwithstanding anything to the contrary contained in any written law, where any judgment or order has been obtained against the Bank, no execution or attachment, or process in the nature thereof, shall be issued against the Bank or against any property or asset of the Bank; but the Bank shall cause to be paid such amounts as may, by the judgment or order, be awarded against the Bank to the person entitled thereto. Restriction on execution against property and assets of the Bank

60. The Bank may charge fees and recover expenses incurred in the carrying out of its duties or operations under this Act. Fees and recovery of expenses

61. The Bank shall not be subject to the Banking and Financial Services Act except in so far as that Act imposes a duty on the Bank. Exemption from Banking and Financial Services Act

62. (1) Any assets, liabilities, obligations, rights, interests of or anything belonging to or pertaining to or attached to, the Bank established under section three of the Bank of Zambia Act, 1985, shall continue to vest in the Bank. Savings

(2) The present staff of the Bank shall continue in service in accordance with any contracts of employment or conditions of service existing or in force before the commencement of this Act.

63. (1) The Bank of Zambia Act, No. 24 of 1985 is hereby repealed. Repeal of Act No. 24 of

1985

(2) Section 6 of the Currency Act which was repealed by the Bank of Zambia Act, may, notwithstanding that repeal, be resorted to for the purposes of money expressed in pounds, shillings and pence in any law, deed, instrument, security for money or other document made before the 16th of January, 1968, or in any contract or agreement, whether in writing or not, entered into prior to that date. Cap. 598 of the 1972 edition

(3) Notwithstanding subsections (1) and (2), every regulation, order, rule, notice or directive made or given under the Bank of Zambia Act, 1985, or the Currency Act, which stand repealed, and in force at the commencement of this Act shall remain in force, so far as it is not inconsistent with this Act, until the same is repealed and shall be deemed for all purposes to have been made or given under this Act. Act No. 24 of 1985

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