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# Central Bank Governance Under Democracy

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## Summary

Two important components of central bank governance in a democratic society are independence and transparency. Where former insulates the central bank from political pressures that characterised politicians in a democracy; while later is necessary to fill out the democratic deficit associated with the central banks independent from the democratically elected government. Unfortunately, State Bank of Pakistan is not enjoying *de facto* independence and it also lacks in various dimensions of transparency. A credible and consistent policy stance is not possible without establishing the basic rules of central bank governance in a democracy.

During recent years, State Bank of Pakistan has been governed in an erratic way. In a quick succession, SBP governors pass the exit door while various communiqué of the Bank go on lamenting the unnecessary government pressures. How severe the consequences of this arbitrariness at the SBP for the macroeconomy of Pakistan are important to understand.

There are two fundamental components of the governance structure of a democratic central bank: Independence and transparency.

Independence means that central bank has the necessary latitude to pursue its macroeconomic targets. This minimum space is central bank's exclusive discretionary sphere allowing it to do whatever is required to achieve macroeconomic stability. This autonomy gives central bank the right to decline government's desires for deficit financing if central bank think that doing so would sabotage macroeconomic stability. In fact, there exist strong arguments that political pressures can cause central bank to use policy levers for short term political adjustments. As the history bears witness, governments are prone to such short term adjustments to avoid decisions likely to affect their popularity. Not only have this means sacrificed long term growth but it also breeds higher long term inflationary expectations. Many years of research and evidence has shown that actual level of inflation is determined by the expected level of inflation. Therefore, if due to lack of credible policy stance or institutional weaknesses people start expecting higher inflation than actual inflation will be higher and volatile. That is why it is necessary to insulate central bank from short term political tinkering.

The second aspect of central bank governance is transparency. In a democracy, elected government is the principle over all the institutes in a country. A central bank that is independent from the elected government thus creates 'democratic deficit'. This deficit can best be filled out by making the policy processes at the central bank publicly visible and transparent. In the prevalent wisdom, transparent and forward oriented monetary policy is necessary for low and stable inflation.

To cut the story short, a modern central bank is expected to be sufficiently insulated from the short term political pressures and is required to maintain high level of transparency.

Transparency is generally achieved by releasing periodic information about important policy areas. Debarring technical quantification of transparency, one can identify at least four aspects: transparency about the instruments that it uses to achieve the policy objectives, where objectives are given to it by the elected parliament; transparency about the governance

structure; the monetary policy committee structure that is responsible for policy decisions; the information and macroeconomic model that it uses to analyze the happenings in the macroeconomy.

Evaluating State Bank of Pakistan (SBP) on these two aspects of governance structure — independence and transparency — we find it lacking significantly behind the other regional banks.

First, independence from short term political pressures is far from being a reality. It would not be wrong to say that whatever level of independence we have achieved during the first half of 2000s has been eroded during the second half of the decade. An important indicator of *de facto* independence is the turnover rate of central bank governors. In SBP, for instance, no governor managed to complete the legitimate two terms quota after Dr. Ishrat Hussain (see Table 1). More tragically, the last three governors could not complete even their first terms and all have resigned under (implicit or explicit) political pressures.

One way to ensure the *de facto* independence is to set the term in office of the central bank's governor longer than the term in office of an elected government. In the present set up, SBP governor has three years office term. And each governor can enjoy at the most two terms in office. In most of the other countries the term of the central bank's governor exceeds that of the elected government's term. This effectively creates a wedge between short term goals of the elected representatives and the long term consistency of policies endeared to the central bank. In Pakistan on the other hand, governor has to comply with the government's requests because his second term (or even the completion of the first one) depends entirely on the government's discretion. This structure cannot ensure independence and consistency in policies. Without which the inflation is unlikely to be low and stable, the principal objective of the central bank.

What about transparency? On the part of SBP, one can easily observe that except providing data and speeches of governors on its web site, it is not disclosing any information about the policy processes and internal management of the central bank. For instance, there is no way to know whether SBP has a specialised monetary policy committee for the formulation of policy or not? The minutes of policy deliberations and voting record, if decision is taken through voting, are completely absent. In a democracy, people have the right to know the bureaucrats responsible for interest rate decisions of monetary policy; their profiles and backgrounds. To what extent they stand accountable for interest rate decisions? How the decision makers at the

bank have been selected and who selected them? These questions have important implications for the direction and effectiveness of stabilization policy and thus cannot be unbeknownst to public.

The central bank of a country is responsible for protecting the economic frontiers of the economy. The working and management of the central bank therefore need to be transparent otherwise its actions will not enjoy credibility.

<b>Table 1 SBP Governors Tenures</b>					
<b>Governor</b>	<b>Enter Office</b>	<b>Left Office</b>	<b>President of Pakistan</b>	<b>Prime minister of Pakistan</b>	<b>Time in Office (Term; days)</b>
Dr. Muhammad Yaqub	25-07-1993	05-11-1999	Farooq Ahmad Khan Leghari; Mohammad Rafiq Tarar	Benazir Bhutto; Mohammad Nawaz Sharif;	2; 2295
Dr. Ishrat Husain	02-12-1999	01-12-2005	Mohammad Rafiq Tarar; General Pervez Musharraf	Mir Zafarullah Khan Jamali; Shaukat Aziz	2; 2192
Dr. Shamshad Akhtar	02-01-2006	01-01-2009	General Pervez Musharraf;	Shaukat Aziz; Yousaf Raza Gillani;	1; 1096
Syed Salim Raza	02-01-2009	02-06-2010	Asif Ali Zardari;	Yousaf Raza Gillani;	<1; 517
Mr. Shahid Hafiz Kardar	09-09-2010	18-07-2011	Asif Ali Zardari;	Yousaf Raza Gillani;	<1; 313
Mr. Yaseen Anwar	20-10-2011	31-01-2014	Asif Ali Zardari; Mamnoon Hussain	Yousaf Raza Gillani; Raja Pervaiz Ashraf; Nawaz Sharif	<1; 835
<i>Author's calculation from SBP website</i>					