Strengthening Institutional Structures in Southern Sudan

Central Banks and Economic Development

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Introduction

South Sudan is establishing a central bank to issue and regulate a new currency, and to supervise payment systems and financial firms. The provisions of the law that establish and regulate the new central bank are critically important for how well it contributes to the economic development and well being of the new country. This note explores for discussion the key issues covered in a central bank law relating to its objectives for its currency, its independence for pursuing those objectives, and the governance structure under which it operations to maximize its commitments to those objectives.

Background

Over the last two decades, most African economies have come alive and begun to grow. Many factors contributed to this but a very important one has been the reorientation of economic policy and organization away from the Soviet central planning model toward market allocation of scarce resources. Africa has joined the rest of the world in opening up its economies to the private, competitive production of goods and services and thus joined the rest of the world in rapidly rising standards of living, albeit from a lower base. An important component of this reform has been a shift in most African countries from inflationary finance (i.e. central bank financing of expenditures by printing money), to money with more stable value in order to encourage more investment and to improve the quality of investment (by far the most important element of more rapid economic growth). The almost universal adoption of "price or exchange rate stability" as the goal of central banks around the world reflects the lesson that providing a currency with stable value is the most important way in which central banks can contribute to the economic development of their countries.

Over the first two decades following independence, most Sub-Saharan African countries did not grow (real GDP declined in many cases). State directed investment resulted in many worthless or marginally productive projects thus wasting their economies' very scarce resources. Inflation, invariably the result of central bank lending to government, averaged in the low teens. Such rates distorted and impeded sound investment decisions by making it more difficult for investors to forecast the market prices of future outputs. With the collapse of the Soviet Union in the early 1990s and the wide spread abandonment of centrally planned development, inflation fell to low single digits, and African economies began to grow. From the mid 1990 Sub-Saharan African countries matched the dynamic growth performance of the Emerging and Developing economies.

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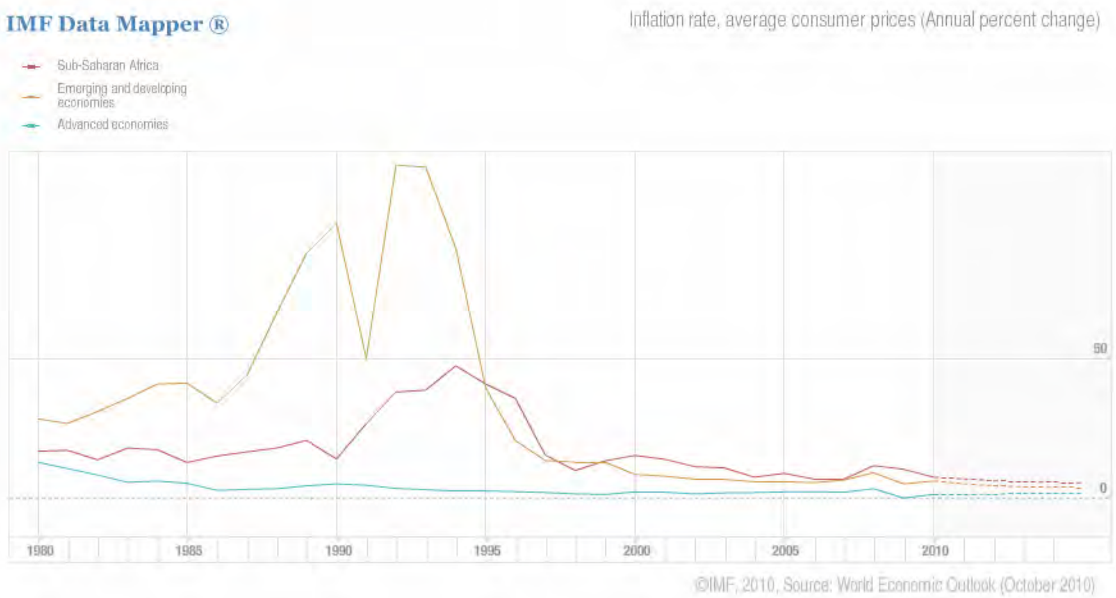

Independence

Following the failed efforts in the 1970s to "buy" more growth (lower unemployment) with more inflation (the so called "Philips Curve" fallacy), central banks around the world rapidly adopted monetary stability as their primary objective. However, to be accountable for achieving more stable value for their currencies, central banks needed to be protected from the pressures from their governments to help finance government projects and/or deficits. Over the history of central banking the pressures to finance the government have been the primary source of inflation. The most recent, devastating example has been the hyperinflation in Zimbabwe (see Annex).

Most countries around the world now protect their central banks from the temptations of finance ministries to borrow from their central banks with measures in their constitutions and central bank laws that forbid or tightly limit central bank lending. Central banks have been made independent in their use of their policy tools toward the achievement of monetary stability. They have been given supervisory or policy boards that come from outside the government and are appointed by the head of the government and confirmed by the Parliament. The government is not permitted to give instructions to the central bank.

While central banks need to be protected from interference from their finance ministry, it is highly desirable for the two to cooperate closely. They need to agree on an inflation forecast for the next budget year and consult on macroeconomic policies, in particular the impact on monetary policy of the expenditures of foreign currency (oil and donor) revenue through the budget.

There are many practical reasons to encourage central bank independence. Experience around the globe has shown that governments often tend to act based on short-term political objectives, which can conflict with the long-term goal objective of monetary stability and can result in misuse of the central bank to advance these short-term political goals. To reduce this possibility, a well-designed central bank law should have specific provisions designed to isolate the operations of the central bank from political interference.

Many studies have shown that central bank independence achieves a number of desirable outcomes:

- Countries with independent central banks tend to have lower inflation rates than those where the central bank is subject to government control.

- Countries with independent central banks tend to have smaller budget deficits than those with government-controlled central banks.

- There is no evidence that production or employment will suffer as a result of the independent status of the central bank.

Although other mechanisms also may be helpful in achieving monetary stability, central bank independence is clearly the one most often recommended.[1] Independence must be matched with accountability. Independent central banks are not free to do whatever they want, rather they are free to use the policy tools given them in the law to achieve the monetary stability mandate give them in the law. They must then be publically accountable for the performance. Given that achieving and maintaining monetary stability should be the primary objective of the central bank, the law should provide the maximum amount of instrument or operating independence possible.

Governance

While there are important distinctions between central banks and commercial enterprises, there are many lessons from corporate governance for commercial enterprises that can be very useful to central banks, and to the legislative bodies that create them. The OECD's *Principles of Corporate Governance* notes that corporate governance

> "... involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure

[1] Ribiero, *Central Bank Independence, Governance and Accountability (2002).*

through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined."

The *Basel Committee's* paper *Enhancing Corporate Governance for Banking Organizations* supplements the OECD's principles with regard to commercial banks. Many corporate governance experts have noted that commercial banks should be held to a higher corporate governance standards than other enterprises, due to their special functions and their impact on a country's economy. This approach can be extended one step further for central banks, due to the implications of their actions.

It is generally recognized that monetary stability should be the primary objective of a central bank. In order to better position the central bank to achieve this goal, a high degree of instrument independence is usually recommended. To use this independence successfully, certain governance characteristics are desirable.

Type and number of boards

One of the issues that must be confronted is the nature of the governing board of the central bank. Central banks around the world typically have either a "supervisory board," or a "policy board" structure. Normally a supervisory board is comprised mainly of outside directors and plays a role in ensuring effective administration of the central bank, and compliance with relevant legislation but is not a policy-making body.

Particularly in a small, developing country, finding a sufficient number of qualified persons who are not precluded from service due to conflicts of interest may render a supervisory board impractical. In such cases, a more feasible approach may be to establish a governing board comprised mainly of full-time senior central bank officials, which will have both a policy-making function and responsibility for overseeing the management of the central bank. Such an approach can aid in isolating the central bank from political interference by placing the major policy-making functions in the hands of subject-matter experts, subject to provisions designed to ensure accountability of the central bank, preferably to the legislative branch (see below).

Appointment of Board members

In order to achieve independence from the shorter-run concerns of the finance ministry, responsibility for appointment of the most senior officials of a central bank (typically the governing Board) should lie with some institution other than the finance minister. In modern central bank laws, this responsibility is typically shared between the legislative branch and the head of state. Such a multifaceted appointment can help to reduce the influence of any single political party in the selection of the governor and other senior policymakers. This can help generate broad support for the central bank, and shield it from changes in the executive or legislature.[2]

Length of terms

Legal requirements for the length of the term in office can also strengthen central bank independence. Long terms for the senior policymakers relative to the political cycle, and the staggering of those terms, help to underpin the independence of the central bank as long as the terms are not cut short by, for example, a change of government. In many countries, the governor's term

[2] BIS, *Issues in the Governance of Central Banks* (2009)

lasts five or six years and the governor and other Board members are protected from arbitrary (or politically motivated) dismissal. The remuneration of the governor and other Board members should be protected from reductions during their terms and the central bank should be able to set its own salary scales for employees and its budget.

The BIS notes that there is a positive association between the turnover of the central bank's governor and the country's average inflation rate. There are a number of possible explanations for this:

- a longer tenure of the governor increases the independence of the central bank and allows it to pursue lower inflation;

- a lengthy tenure that heightens the governor's expertise and credibility may result in lower inflation;

- if a central bank governor in a country with high inflation is replaced because the government desires to reduce inflation or resigns because of the inflation problem, then the direction of causality could run from high inflation to high turnover.

Accountability

One of the key components of good governance is accountability. Even the most independent central bank has to report in some form or another to its stakeholders, so as to ensure that the central bank exercises its policy and functions effectively and efficiently and that it manages its resources in a cost-effective way.

Traditionally, central banks have been accountable to the minister of finance, the head of state, or in a few cases the cabinet. However, newer central bank laws increasingly make the central bank accountable to the legislature, which is elected by the people and has the ultimate power to adopt and change the laws relating to the central bank. Accountability to the legislature is most common in countries whose central banks enjoy instrument independence. By contrast, central banks that are accountable to the minister of finance generally have only limited independence.

There are different ways to ensure accountability, but timely and transparent reporting is crucial. Central banks generally publish policy statements at least annually. These statements should report on the outcome of the previous period and state the policy for the forthcoming period. Central bank laws typically require that an annual report on central bank operations and externally audited financial statements be published. Annual financial statements are usually audited by an independent external auditor, the auditor general, or both. Although most central bank laws still leave questions of internal organization to the management of the bank, some countries have found it useful to explicitly require an internal auditor or comptroller. Furthermore, periodic publication of summary balance sheet information is good practice and stipulated in several central bank laws, which allows the general public to continuously monitor the bank. Finally, in addition to the necessary coordination with the executive arm of government, many central bank laws now explicitly stipulate that the central bank be ready to answer questions raised by the legislature.

Annex

Zimbabwe's hyperinflation

Zimbabwe, formerly known as Rhodesia, became independent of British rule in 1980, much later than most other African colonies. President Robert Mugabe has headed the government one way or another since then.[3] Mugabe became a national hero leading the guerilla fighters in the Bush War (1964–1979) that overthrew the white-minority government ruling Rhodesia leading to its independence. He is/was revered throughout Africa.

Guided by the Lancaster House Agreement that provided for the transition from white to black rule of Zimbabwe, to which Mugabe was a signatory, Zimbabwe prospered. Over the past ten years, however, Mugabe became impatient with the pace of his people empowerment programs ("reallocating" property from white Zimbabweans to black ones). His "Fast Track Land Reform", which abandoned the land reform agreement among Zimbabwean stakeholders at Lancaster House, confiscated farm land from white corporate farmers and redistributed it to "poor' blacks. In reality the redistribution largely enriched Mugabe's political supporters. Every employee of the Reserve Bank, for example, was given land taken from its owners. Agricultural output plummeted.[4] Mugabe's "social" policies have bankrupted this beautiful and once prosperous country. The IMF reports "an estimated 14 percent fall in real GDP in 2008, on top of a 40 percent cumulative decline during the period of 2000–07."[5]

The greed and corruption of Zimbabwe's ruling classes diverted the government's resources. The Reserve Bank was increasingly called upon to lend to various government projects (i.e. print money) to cover the difference. Inflation (annual percent change in the CPI) averaged around 20 percent in the 1990 and gradually rose to 239 percent in 2005, over 1,000 percent in 2006, and 10,000 percent in 2007. In 2008 it exploded and "is estimated to have peaked in September 2008 at about 500 billion percent. This incomprehensible rate of inflation means that in September prices were doubling every 11½ days. Through the magic of compounding a 100 percent increase in 11½ days if continued at that rate for one year will result in a 500 billion percent increase.

When the Zimbabwe Stock Exchange stopped trading the ZIM dollar in Nov 2008, the exchange rate of the ZIM dollar to the U.S. dollar was estimated by the UN to be 35 quadrillion (35×10^{15}). This the rate generally used for 2008 year-end financial statements. This is after 9 zeros had already been dropped from the currency in mid 2007 and three had been dropped earlier. The largest note issued before its collapse (and after the removal of the 12 zeros!) was for 100 trillion ZIM dollars (100,000,000,000,000).

It is difficult to comprehend such rates and the impact on Zimbabwean economic life was devastating. The economy spontaneously dollarized, which was formally recognized by the new

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3 The early days of independence were marked by infighting between Maoist leaning Mugabe, whose support came largely from his Shona-speaking homeland in the north, and pro Soviet Joshua Nkomo, whose support came largely from the Ndebele-speaking south.

4 Eddie Cross, "The Cost of Zimbabwe's Continuing Farm Invasions", Cato Foundation, Economic Development Bulletin no. 12, May 18, 2009

5 Zimbabwe—Staff Report for the 2009 Article IV Consultation, International Monetary Fund, April 20, 2009.

"inclusive" government in February 2009.[6] Thus for the time being inflation is over (prices—now in U.S. dollars—increased 6.5% in 2009 and 4.7% in 2010.)

Under the conditions of 2008 economic calculation becomes impossible. Over a year before the collapse of the currency many firms had already established financial accounts in U.S. dollars for internal management purposes. In real terms the banking sector in early 2009 was little more than a quarter of its size in 2004. Banks are well capitalized today because they invested all they could in real estate and the stock market rather than lending in order to protect the real value of their assets. As a result, however, in 2009 they had very little lendable resources.

In December 2006 the shelves in the shops were empty and there were long lines for gasoline. The Reserve Bank couldn't print new currency notes fast enough to keep up with the demand as people spent ZIM dollars faster and faster before prices went up even more. This is what happens in hyperinflations. The velocity of circulation of money accelerates reflecting raising expectations for further inflation with the result that the real value of the money supply shrinks. The total amount of ZIM dollars currency in circulation at the end of 2008 was 22,400,000,000,000,000. Its value in U.S. dollars is 64 cents, yes 64 cents. The Zimbabwean people and economy have been brutally raped. The governor of the Reserve Bank drives a Lamborghini.

Because the Reserve Bank could not keep up with the demand for currency, it imposed a limit on the amount of cash depositors could take out of their bank accounts at one time. At one point this amount was not enough to pay for a gas tank fill up, thus multiple trips to the bank were required. Zimbabwean's could write checks on their bank accounts, but paying for gasoline with a check would entail a much higher price reflecting the inflation expected over the several days it would take the gas station to collect the money via check.

To help their customers pay for gasoline, wholesalers issued coupons denominated in litters of gasoline. These were purchased months before the holder intended to use them to pay for gasoline and locked in the real gasoline value of the later actual purchase of gasoline. Some firms bought large quantities and used these coupons to pay their employees. The coupons circulated as currency. The early sale of coupons for cash and its immediate use to pay for imported gasoline protected the wholesaler just as well as holding the inventory of gasoline for subsequent sale at a higher ZIM dollar price.

Restaurants put prices of menu items on a sheet at the back that could be replace every day with new prices and some stated prices in "units" where the ZIM dollar value of a unit was updated every day. These few examples barely scratch the surface of the brutal attack on Zimbabweans by their government.

While the shops are full again and you can order almost everything on the menu, the practice of listing menu prices on a separate sheet is falling out of use. With dollarization (the USD or the South African Rand), thus no more ZIM dollar, and stripping the powers of the Reserve Bank to the minimum needed to perform its remaining core functions of banking and payment system supervision, hyperinflation is no longer possible.

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[6] In general elections held March 29, 2008 Mugabe's party, the ZANU-PF, lost its majority in the Parliament, and informal returns indicated that Mugabe had lost the Presidency to Morgan Tsvangirai of the MDC, whose party in coalition with a relatively small party (MDC-M) now has a majority of Parliament. Mugabe refused to concede and won an uncontested run off in the midst of considerable violence as Tsvangirai refused to participate in the run off to protect his party members from violence. A coalition government was finally formed in February 2009 with Mugabe as President and Tsvangirai as Prime Minister and the Ministries were divided up.

This was made possible by ending government borrowing from the Reserve Bank thus limiting its disbursements to cash on hands as tax revenues were received. However, this meant that many obligations could not be honored. Government employees could not be paid their salaries (all receive month stipends of $100 in 2009). The Reserve Bank could not repay all depositors, etc. The economy can only earn USD by exporting and many of its industries in 2008 were operating at one-third capacity because they did not have the money to pay for electricity and other imported inputs needed to operate. Private banks could not lend to them because significant amounts of their money is deposited with the Reserve Bank, which cannot repay it. There is no quick and easy way to repair the damage done by Zimbabwe's central bank. Nonetheless, with the return of stable prices, the real economy began to grow for the first time in a decade. Real GDP increased 4.0% in 2009 and 5.9% in 2011. The situation is not sustainable without significant further reforms.[7]

[7] See also: http://www.imf.org/external/pubs/cat/longres.aspx?sk=23901.0