

Why central bank independence is key

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HERE are two kinds of central bank independence. One is goal independence, where the bank does not get any instructions from the government. It sets its own goals and then uses the available instruments in order to meet them. The other is instrument independence, where the government sets the targets and the central bank is free to use the policy instruments at its disposal in order to meet them.

The central bank is free from any obligation to finance the government's budget. Separation between the policies of the central bank and the budgetary needs of the government is needed to ensure that the intrinsic inflation bias does not result in an actual inflation bias. Beside this distinction, the concept of central bank independence requires further classification.

One needs to distinguish between legal independence which can be inferred from the language of law, and actual independence which depends on the practice, interpretation, and implementation of the law. In developing countries, it is difficult to assess the degree of central bank independence by analysing only the language of central bank law, because the text of the law is convincing, but the implementation is not.

In some countries, the provisions contained in central bank law are not strong, yet the degree of independence is impressive. It is argued that central bank independence is not just a juridical issue but also a practical one.

Demand for central bank independence

Interest in central bank independence has grown over the past few years. From 1989 till today, over 30 central bank laws were revised and rewritten, for strengthening the independence of the central bank. Several reasons underlie the

movement towards strengthening central bank independence.

First, countries that had low inflation showed better economic performance than countries that were unable to control inflation. Second, the world has undergone a conceptual revolution. In contrast with previous beliefs, the experience of the 1960s and 1970s says that there is no long-term trade-off between inflation and unemployment.

One cannot produce jobs and sustain growth by creating inflation.

Attempts to exploit this trade-off have failed, resulting in disappointment, frustration and costly economic distortions. The conceptual revolution has shown that price stability contributes to good economic performance while inflation is a source of instability and economic cost.

Third, there has been a fundamental change in the views about the role that governments and economic policy can and should play in the market economy. There is scepticism about the effectiveness of central planning, and the ability of governments to be effective participants in the market place.

There is a conviction that free enterprise led by the private sector is the best framework for generating investment and sustainable growth.

Finally, there is also a conviction that, to promote investment and growth, one needs price stability. The new view about the role of government, and the desire to promote sustainable growth within a market economy, has renewed interest in the conditions necessary for price stability.

There have also been four important historical developments that contributed to the interest in central bank independence. First, the creation of the European Union brought about the creation of a European Central Bank. The Maastricht Treaty specified the key

characteristics of the law of the bank.

The central bank must be independent, and its main objective must be price stability; it must keep its distance from the governments, and be kept free from political pressures. The countries that signed this treaty have adjusted their own central bank legislation to conform to the law of the new bank.

This process heightened official interest, and the public's awareness of central bank independence.

The second development was the need for creating new central banks due to the collapse of the Soviet Union. This created independent republics, which have realised the need for an independent central bank.

The third development arose from the experience of several countries in Latin America, which recognised that high inflation was associated with having a weak and insufficiently independent central bank.

The fourth development has been the emergence of globalised capital markets. Many countries have realised that in order to succeed in this environment, they must be held in high regard by the various rating agencies that grade the economies' risk.

These ratings depend on the country's record of fighting inflation, and on the institutional setting governing the economic policy making process. Therefore, a country that wishes to maintain access to the international capital market must aim at achieving price stability, and have a good inflation record.

It must also have institutional and legal frameworks that underlie the policy making process, especially an independent central bank.

There are incentives that produce an intrinsic bias towards a higher rate of inflation, and an independent central bank can remove this. The following are the

criteria for independence of a central bank:

Political independence: The governor and board members should not be appointed by the government, and their tenure should be for more than 5 years; no mandatory participation of government representative in the board; no government approval of monetary policy is required; statutory requirement that central bank pursues monetary stability, and conflict with the government is not possible.

Economic independence: Economic independence includes the following forms of direct credit facility; on the market interest rate, temporary, and limited amount; central bank does not participate in the primary market for public debt; discount rate set by the central bank and no portfolio constraints or credit ceiling.

Financial Independence: Financial independence includes, budgetary independence; salaries determined by the central bank; allocation of profit is determined by the central bank; degree of financial independence can be assessed considering these variables.

Assessment of independence: The criteria for assessing central bank independence are: the length of the term of the governor; the dependence of this term on the changes of governments; whether a new government can replace the governor before the end of his term; whether interest rate decisions can be taken by the board, and how large the board should be. How many board members should be insiders, how many outsiders? Can the board members earn salaries from other sources? Who determines the budget of central bank?

What happens when there is disagreement between government and the central bank? Who determines the inflation target?

Is the bank endowed with all instruments needed for the conduct of monetary policy or does it need to get government approval in each case? In what way, and to whom, is the bank accountable? Who appoints the auditor of the bank and his remuneration? Who authenticates reliability check of FDI figures? And to whom the central bank reports -- whether to the ministry of finance, to the president, or to the parliament?

Bangladesh Bank: The Bangladesh Bank Order of 1972 is the legacy of former Pakistan Central Order drawn in 1950s. This does not provide the criteria applicable for an efficient central bank for operation of market economy, because of political interference since the independence of the country.

An amendment to the central bank order was made by the previous government, but did not bring any change. The nine-member board included governor, deputy governor, three GoB officials, and three GoB nominated persons.

The finance minister chairs the co-ordination council, and the members are commerce minister, governor, finance secretary, secretary IRD, and a member of the Planning Commission.

A central bank independence index by Alesina and Grilli (1992), based on eight points, and by Bade and Parkin Indices of Financial Independence (1992), based on four points, shows that the Bangladesh Bank Order does not meet the criteria for an independent central bank.

Under section 9 (3) (d) of Bangladesh Bank Order, the government has the authority to appoint 3 government officials to the board, which is a political appointment.

The tenure of the governor is shorter than those in the Asian neighbours. The current governor joined in February 2005. During 1972-2007, the longest tenure of a governor was 11 years (between 1976-87), while the second highest was five years. Four governors



served four years each, one three years, and others less than two years.

Moreover, there was no fixed term for governor, deputy governor(s) and the director(s). Under articles 10(9), 15(1) (b), the tenure of the governor, deputy governor(s) and director(s) depends on the pleasure of the government.

Moreover, section 10 (10) authorised the government to grant leave to the governor and deputy governor(s) for as long as desired by the finance ministry. This power was misused on several occasions, by transferring them.

The most striking example was the case of deputy governor Mr. Ruhul Amin, who was granted forced leave because of difference of opinion with the finance minister.

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consistency among macroeconomic targets.

Article 82 (2A) states that salary and compensation package of employees are subject to approval of government, which is an obstacle to reward, punishment, and employee motivation.

Section 65 defines the procedure of appointment of external auditors by the GoB, which is done by the board in other countries, and the audit fee of Bangladesh Bank is Tk 300,000 divided between two firms, compared to Pakistan's Rs 2.5m and India's Rs 4.5m.

This indicates the current state of governance in Bangladesh Bank. For transparency and proper governance, these provisions need to be deleted from the statutes.

Now the time has come to make recommendations to the government for the independence of Bangladesh Bank, to promote and facilitate ongoing economic liberalisation towards market economy.

The proposed committee should examine the central bank charters of

two neighbouring, one West European, one East European and one Latin American, countries, and compare them with the Bangladesh Bank Order.

It should recommend ways to ensure compliance with independence criteria on the terms of appointment of governor and deputy governor, restructuring of the board, freedom from political pressure, and redefine the terms of reference of the board of directors, and ensure legal, operational, economic, and financial independence.

Professional bodies dealing with economy, business, industry and trade should raise their voices to ensure independence of Bangladesh Bank, and to take the Bangladesh economy from state to market.

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Questioning JI's way of thinking



Due the fact that some Muslims are involved in acts of terror under Indonesian law, Muslim leaders in this country have the moral duty to remind and guide them to the "right path" by having intensive dialogues with them. It is not enough to echo the words "don't link terrorism with Islam."

NURROHMAN

DO NOT link the terrorists to any religion, particularly Islam." This sentence often comes out of the mouths of some religious leaders here.

The leaders, as well as their followers, are disappointed by their religion being linked to terrorists. A recent survey conducted by the Wahid Institute and pollster Indo Barometer confirmed this stance. Most respondents (71.8 percent) rejected the notion that terrorism is linked directly to a specific religion (The Jakarta Post, June 22).

But how do we not link terrorists, particularly those who are involved in bombing attacks in this country such as Imam Samudra and Abu Dujana, to Islam? They named their organisation Jamaah Islamiyah (which

means Islamic community). JI aims to establish a pan-Islamic state in Southeast Asia under Indonesia. Even when they are captured by police or stand trial, the attorneys defending them call themselves the Muslim Defender Team. So we actually, albeit indirectly, must acknowledge that some Muslim activists were involved in terrorist attacks in this country.

In my opinion, openly and honestly admitting that some Muslims activists are linked to terrorism will be more helpful in addressing the root problems than refuting or concealing this reality.

There are many reasons for individuals to get involved in acts of terror, such as economic, education and political ideology. For me, however, the most important factor is the way of thinking. The black and white way of thinking

that divides the world into followers of Allah (hizbulah) and followers of Satan (hizbu al-shaitan), or between Darul Islam (state of peace) and Darul Harb (state of war), and attacks others based on the difference is more relevant. Indonesia's experience shows that victims of terror attacks are not only "infidels" but also Muslims. There has been no single scholar of Islamic law who has condoned random killings.

In his book "War and Peace in the Law of Islam," Majid Khadduri says that there was a significant change in the Muslim world after the establishment of the United Nations.

He says that the decision of Muslim states to join the UN was an important one, because traditional Islamic law is not in accordance with the principles embraced by the UN Charter.

Muslims, who in the seventh century appeared to be the con-

querors of other nations, did not acknowledge any system of law other than their own.

Therefore, it was assumed that Muslim states' alignment with the UN was temporary, pending the achievement of their own political ideals to conquer the world. But recently, this assumption was proven wrong.

Traditional Islamic laws have undergone reforms in order to adjust to modern situations.

There are many scholars in Islam who back the principles of international relations which include, among others, the principles of peace and mutual respect. There is even the speculation that the principle of international relations adopted by the UN was inspired by Islamic law.

Hugo Grotius, a Dutchman known as the father of international law, said that international law grew alongside the growth of humankind, but as a complete science it was produced by Islamic law. Islam, which was spread by the Prophet Muhammad, originated from the Koran which brought the principles of international law teachings. Grotius' opinion was under-

lined by Prof Baron Michel de Tubb, another international law expert in the Hague, through his speech in 1936.

So

there is no reason for Muslim states to reject the UN charter or the principles of international relations.

For Indonesia, principles of Islamic law do not run counter to the Pancasila state ideology, the 1945 constitution and its amendments. There is no single part of Islamic law that cannot be implemented in Indonesia.

As a moral guidance for individuals or community, Islamic law does not depend on the state. That is why, if viewed under one of the criteria of an Islamic state, Indonesia can be called an Islamic state. If JI really wants to establish a pan-Islamic state, it should explain what a pan-Islamic state is. Imitation of the theocratic state which was established by the Taliban regime in Afghanistan will be difficult to accept here.

JI's

way of thinking is close to

Arab Wahhabis, or the Salafis, variant of Islam. The group emphasises rituals and codes of conduct rather than the sub-

stance of Islam. Such a vision of Islam leads believers to think of the religion as an absolute truth while other religions are false, and that there can be no meeting ground between a Muslim and a non-Muslim.

Even among Muslims, this way of thinking causes disharmony and can lead to violence, especially if combined with political ends. It's not suitable for Indonesian Muslims, who believe that tolerance among all religious communities is important.

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