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NOBEL PRIZE FOR CENTRAL BANK INDEPENDENCE

Kydland and Prescott won the Noble Economics Prize in November 2004 for their paper advocating the independence of central banks. "One of the most important aspects of any reform is to make it credible, not just for a year or two, but over a long term," Kydland said, emphasising the need for time consistency in taxation and monetary policy".

Background

In 1977, Kydland and Prescott, and later Barro and Gordon in 1983, wrote about dynamic inconsistency in the administration of optimal monetary policy. These researchers discovered that perceived lack of commitment on the part of policy makers to achieve set inflation targets, result in those targets being missed as the public bid on a higher than targeted inflation rate. Therefore, it has been observed overtime that when economic policy makers who advocate for low inflation do not commit to that stance, this tends to exert upward pressure on inflation. When economic agents such as households and businesses observe that the monetary authority does not keep its commitment on low inflation, they plan on a higher than targeted inflation rate, this has a bearing on the attainment of the preferred rate of inflation. In response to these findings, the writers recommended that the central bank should be granted enough autonomy to independently pursue price stability without pressure to do otherwise.

The trust that the people can put on a central bank depends on whether the central bank is perceived to have been applying monetary policy in a consistent, fair and responsible manner. While low inflation is primarily the role of the central bank, the ability to achieve the target is dependent on it being empowered. This means the central bank has to be independent enough to take all decisions concerning monetary policy without external party interference. External interference could be in the form pressure for higher inflation from businesses or the need to finance the government deficit. Central banks are created by governments and as such they will ultimately be accountable to the legislators, but how they run their daily business is the prerogative of the central bank. It is within this broader context that the central bank independence should be understood.

What is Central bank Independence?

There are numerous indicators of central bank independence that are used, but two major ones include legal independence and governor turn over. Legal independence relates to the existence of laws that protects the central bank from undue external pressure that may compromise the execution of its mandate. It covers the extent to which the central bank can legally undertake its mandate when outside parties disagree with its actions. The turn over of the central bank governor relates to how long a governor takes on office in relation to the time stipulated in the law. A central bank that rarely changes its governors before their official departure time could be taken as relative by stable since it indicates continuity of policy and minimum interruptions. It should be noted that though central banks should be concerned with inflation, it must be clear that government and not the central bank should set the target on inflation and the central bank should just execute. That is, the central bank should be instrument independent – the freedom to pursue given targets using tools of its choice. Granting the autonomy means that the central bank would be made accountable for its decision in the future, this will ultimately ensure transparency. The government, being mandated by citizens to design national policy, should reserve the autonomy to set monetary targets (goal independence).

Guidelines that are important to central bank independence include the existence of a clearly defined mandate, which includes price stability. The central bank is granted authority to set monetary policy variables and rules in order to achieve its goals. In addition, the central bank is normally expected to make public announcements of its intermediate-term policy goals. The announcements could describe the allowances that will be made for changes in the terms of trade, interest rates, and indirect taxes in judging whether the target has been met. Accountability is also necessary, and is usually understood in two senses: responsibility for meeting its announced goals; and the requirement to explain and justify its policies to the legislature and the public. Presumably the Governor of the bank would testify in public on the performance of monetary policy in meeting its pre-announced goals, along with testimony in publication of a report such as an inflation report. The government is typically reserved the authority to override the bank's decisions, but such override decision should carry a cost to government. In New Zealand, the government has the right to override the Bank's policy targets, by means of an order in council that lasts no more than a year. This allows the government to prevent damage to the financial sector in cases where the central bank abuses its powers. This can include financing of the government deficit or management of the public debt, which should be left to some other branch, so that the central bank can concentrate solely of the price stability mandate.

Fixed Exchange Rate System and Central Bank Independence

For Lesotho, it is important to define central bank independence in the context of a fixed exchange rate system. Independence can mistakably be regarded as irrelevant for a fixed exchange rate system due to the limited nature of monetary policy. A fixed exchange rate peg is one of the forms of monetary policy rules, since it leaves less room for any discretion that will go against the conditions of the peg. A country that pegs to a more stable economy that is inflation averse is bound to benefit from low levels of inflation. This is the case of Lesotho, with the Loti pegged at par to the South African Rand. Monetary policy under a fixed exchange rate regime is not foolproof as the influence of non-tradable goods has impact on inflation in the economy. The balance to this challenge would be the development of fiscal policy rules, which will emphasise prudence in the management of fiscal deficits, management of a balanced budget and robustness of medium term budget expenditures. In such a situation, the independence of the central bank is still crucial to minimise the risk of conducting accommodative monetary policy.

Independence of Central Bank of Lesotho

Lesotho seems to have had sizable strides in the two criteria of central bank independence and have since performed well over time. On legal independence, the Central bank of Lesotho Act covers the appointment, dismissal, and term of office of the chief executive officer of the bank. The country also performs well on the governor turnover indicator. In Lesotho, the governors tend to take their full tenure of office, which can imply less interference in the running of the central bank.

Has Central Bank Independence brought Price Stability?

It has been observed that from over the last ten years global inflation has dropped from about 30 percent per year to about 4 percent per year. This trend signals remarkable improvement in the global economy. In developed countries inflation was on average 9 percent per year in the 1980s and it has moved to around 2 percent annually. While in developing countries the 1980s experienced 30 percent per year and dropped to about 10.3 percent in 2003. This highlights that there is still room for improvements in the efforts to reduce inflation.

Lesotho inflation has been dominantly influenced by events in South Africa. The inflation trend has been fluctuating, though it maintained a downward trend. During the second half of 1999 to 2000. Inflation was 8.7 percent in 1999, compared to 7.8 percent in 1998. There has been a slowdown in observed inflation to 8.5 percent in 1997 from 9.1 percent in 1996. The circle on the direction of inflation changed again in 2001 which ended the year at 7 percent from 6.2 percent in 2000. The major contributors in 2001 were the increase in food prices as a result of domestic and regional shortages of cereal in the market. The annual inflation rate for 2002 jumped into a double-digit the first time in seven years at the rate of 11.9 percent. This reinforces the need for collaboration in efforts to combat inflation, and understanding that this is not the sole responsibility of the Central Bank alone; there is a complementary effort that needs to be played by government and private sector.

Monetary Cooperation as a way to achieve Independence

The challenge of independence of central banks is on the close cooperation to control inflation in the region, despite structural differences in the economies. On the average_inflation slowed down in 2001 to 2002, with a single digit inflation rate, Lesotho also experienced a moderately downward movement in the rate of inflation. The African Monetary Co-operation Programme (AMCP) had resolved to work towards a single digit inflation rate for the period 2004-2008 for all countries in the region

There are recent positive developments in Africa geared towards improving the environment of executing monetary policy in Africa. These initiatives are within the framework of African Union and New Partnership for Africa's

Development (NEPAD). There is a political will to pursue a single currency and establish an African central bank by the year 2021. This is underpinned by article 44 of the Abuja Treaty that calls for the harmonisation of economic policies in Africa. The executing structure will be the AMCP.

The Association of African Central Bank Governors has endorsed AMCP, and on the regional level Committee of Central Bank Governors in SADC (CCBG) also subscribed to the initiative. The latter was established in 1995 with a mandate to achieve greater harmonisation of monetary co-operation in the SADC region. CCBG has also been a greater platform for central bank capacity building with more training afforded to central banks' staff in the region.

The other important target is budget deficit/GDP ratio target of at least 5 percent for the period 2004-2008, and a ratio not exceeding 3 percent in 2021. This seems on track with the International Monetary Fund's World Economic Outlook 2004, that states that Sub-Saharan Africa growth is expected to increase to 5.25 percent in 2005. The harmonisation of monetary policy presents its own challenges because of dynamism within SADC countries. Some countries operate under managed floating exchange rate while others are on a fixed exchange rate (Lesotho, Namibia, and Swaziland)

This report benefited from Fischer, S. 1995. Modern Approaches to Central Banking, and www.worlbank.org/html/dec/publications/Bulletins/PRBvol3no5.html, Reserve Bank of Australia Bulletin, December 1994

Table 1. Monetary and Financial Indicators+

	Sept	Oct	Nov
1. Interest rates (Percent Per Annum)			
1.1 Prime Lending rate	12.17	12.17	12.17
1.2 Prime Lending rate in RSA	11.00	11.00	11.00
1.3 Savings Deposit Rate	1.35	1.35	1.35
1.4 Interest rate Margin(1.1 – 1.3)	10.82	10.82	10.82
1.5 Treasury Bill Yield (91-day)	8.27	8.44	7.90
2. Monetary Indicators (Million Maloti)			
2.1 Broad Money (M2)	2474.3	2360.70	2429.1
2.2 Net Claims on Government by the Banking System	-572.91	*-1058.59	-875.33
2.3 Net Foreign Assets – Banking System	4039.88	4303.20	4145.04
2.4 CBL Net Foreign Assets	3350.34	3741.50	3523.59
2.5 Domestic Credit	-2.89	-433.16	-263.76
2.6 Reserve Money	133.33	111.04	156.80
3. Spot Loti/US$ Exchange Rate (monthly average)	6.5445	6.3829	6.0536
4. Inflation (year-on-year percentage change)	4.7	4.6	4.7
5. External Sector (Million Maloti)	**2004**		
	Q1	**Q2**	**Q3**
5.1 Current Account Balance	-319.7	-281.2	-275.2
5.2 Capital and Financial Account Balance	146.8	319.3	155.5
5.3 Reserves Assets	282.8	-0.8	391.7

+These indicators refer to the end of period. Prime and deposit (savings) rates are averages of all commercial banks' rates operating in Lesotho. The Statutory Liquidity Ratio in Lesotho is 25 percent of commercial banks' short-term liabilities.

Table 2. Selected Economic Indicators

	2000	2001	2002	2003
1. Output Growth(Percent)				
1.1 Gross Domestic Product – GDP	1.3	3.2	3.5	3.3
1.2 Gross Domestic Product Excluding LHWP	0.0	3.5	3.3	3.2
1.3 Gross National Product – GNP	-3.2	0.2	1.6	6.3
1.4 Per capita –GNP	-5.2	-1.9	-0.4	4.1
2. Sectoral Growth Rates				
2.1 Agriculture	2.8	0.5	-4.2	-1.9
2.2 Manufacturing	4.4	7.8	6.9	5.2
2.3 Construction	9.7	1.4	6.9	4.3
2.4 Services	-0.9	2.2	2.2	4.4
3. External Sector – Percent of GNP Excluding LHWP				
3.1 Imports of Goods	64.4	68.2	82.8	74.5
3.2 Current Account	-21.3	-17.4	-24.5	-21.1
3.3 Official Reserves (Months of Imports)	8.9	11.7	6.4	5.5
4. Government Budget Balance (Percent of GNP)	-4.9	-1.0	-2.7	-2.5