

2/4/6/4/1/9

NO. 21

**CONSTITUTIONAL ASSEMBLY**

***THEME COMMITTEE 6.2***

**FINANCIAL INSTITUTIONS & PUBLIC ENTERPRISES**

**MONDAY, 12 JUNE 1995 - V475, OLD ASSEMBLY WING**

**12H00**

**DOCUMENTATION**

**Embargoed until 12h00  
12 June 1995**

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**EMBARGOED UNTIL 12  
JUNE 1995 : 12H00**

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# CONSTITUTIONAL ASSEMBLY

## THEME COMMITTEE 6.2

### FINANCIAL INSTITUTIONS AND PUBLIC ENTERPRISES

Please note that a meeting of the above Committee will be held as indicated below:

Date: 12 June 1995  
Time: 12h00  
Venue: Room V475, Old Assembly Wing

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#### AGENDA

1. Opening and Welcome
  2. Notice of meeting and Agenda (p1)
  3. Adoption and noting of previous minutes
    - 3.1 TC6.2 Minutes 5/6/95 and appendix (p2-45)
  4. Matters arising from minutes
  5. South African Reserve Bank  
Dr CJ de Swart to address the committee.
  6. Submission by Mr S Malherbe (46-53)
  7. AOB
- 

H EBRAHIM  
EXECUTIVE DIRECTOR

Enquiries: Mr S Nyoka and Ms P Fahrenfort, Regis House, Adderley Street  
Tel.: 24-5031

# CONSTITUTIONAL ASSEMBLY

## THEME COMMITTEE 6.2

### FINANCIAL INSTITUTIONS AND PUBLIC ENTERPRISES

MONDAY 5 JUNE 1995

PRESENT

Davies R (Chairperson)

Andrew K  
Hogan B  
Jacobsz F  
Makgothi H  
Marcus G  
Nair B  
Sisulu M

#### Apologies

Botha WA  
Jordaan JA  
Marais G  
Welgemoed P

#### Absent

Woods GG

**In attendance:** P Fahrenfort, M Ndziba and W Msizi (Law Advisors), S Nyoka, CDR Rustomjee (Technical Advisor)

#### 1. Opening and Welcome

The Chairperson opened the meeting at 09h10 and welcomed the members present.

#### 2. Notice of meeting and agenda

The agenda was adopted.

**3. Adoption of previous minutes**

The minutes of the meeting held on 29 May 1995 were adopted.

**4. Matters arising from minutes**

The Committee discussed the third draft formulation on the Auditor General and agreed that with the exception of ss5(1) and 5(2) (*Assignment of powers and functions and provision of funds*), the text be redrafted.

It was further agreed that:

- a) the revised document be circulated to members;
- b) members be given 48 hours during which to consider the revised draft prior to its submission to the Constitutional Committee;
- c) members also be given a transcription of the proceedings in order to ascertain whether the revised draft is a true reflection of agreements reached during the discussion
- d) in the event of the draft not being ready, it be tabled at the next Constitutional Committee meeting;
- e) during the discussion the committee reached a high level of agreement and consensus on the constitutional provisions for the Auditor General

**5. Submission from Mr N Alant on the role of the independence of the South African Reserve Bank**

The Committee noted the submission.

**6. Invitation from TC3 : Financial and Fiscal Relations Workshop**

Members were reminded to attend the above workshop.

**7. Presentation by Mr C Rustomjee, Technical Advisor**

Mr Rustomjee in his overview addressed the following issues, which are fully detailed in the attached appendix containing the slides of his full presentation:

- i) Background and summary of issues raised by Theme Committee 6.2
- ii) Report-back on meetings and discussions with the Minister of Finance, Governor of the South African Reserve Bank and the Constitutional Assembly Law Advisors
- iii) Independence
- iv) Concurrence and consultation between the Minister of Finance

and the governor of the South African Reserve Bank

- v) Conflict resolution mechanisms
- vi) Definitions/objectives/goals/instruments and terminology used in the literature on Central Banking
- vii) Highlighting aspects of consensus in Theme Committee 6.2
- viii) Recommendations by Technical Advisor

In summing up, the Chairperson indicated that the sentiments emerging from the input by the Technical Advisor appeared to suggest that consensus on the "goal" and "operational" independence of the Central Bank lies in the provisions of s196(2) of the interim constitution. The implication of this is that the contents of the draft formulations on the Reserve Bank which were tabled at the CA on 19 May 1995, especially s1(2) thereof, would have to be revisited.

It was suggested that an invitation be extended to the Governor of the Reserve Bank to address the Committee on the notion of independence and accountability of the South African Reserve Bank.

There being no further business the meeting ended at 11h00.

.....  
CHAIRPERSON

.....  
DATE

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**PRESENTATION TO CONSTITUTIONAL ASSEMBLY  
THEME COMMITTEE 6.2**

**SOUTH AFRICAN RESERVE BANK**

1. BACKGROUND AND SUMMARY OF ISSUES RAISED BY TC6.2
2. REPORT-BACK ON MEETINGS & DISCUSSIONS WITH MINISTER OF FINANCE, SARB GOVERNOR AND CA LAW ADVISOR
3. INDEPENDENCE
4. CONCURRENCE & CONSULTATION BETWEEN THE MINISTER OF FINANCE AND THE GOVERNOR OF THE SARB
5. CONFLICT RESOLUTION MECHANISMS
6. DEFINITIONS - OBJECTIVES / GOALS / INSTRUMENTS - AND TERMINOLOGY USED IN THE LITERATURE ON CENTRAL BANKING
7. HIGHLIGHTING ASPECTS OF CONSENSUS IN TC6.2
8. RECOMMENDATIONS BY TECHNICAL ADVISOR

**C.D.R. RUSTOMJEE  
TECHNICAL ADVISOR, T.C.6.2**

# 1. BACKGROUND & SUMMARY

## OF ISSUES RAISED

1.1 THERE HAS GENERALLY BEEN BROAD MULTI-PARTY CONSENSUS ON THE CLAUSES WHICH SHOULD BE INSERTED IN THE FINAL CONSTITUTION WITH REGARD TO THE SARB.

THERE HAVE HOWEVER RECENTLY BEEN PROPOSED CHANGES TO SOME CLAUSES, WHICH HAVE STIMULATED DEBATE ON CERTAIN ASPECTS OF THE SARB.

A WIDE RANGE OF ISSUES WAS RAISED FOR CLARIFICATION AT THE 22 MAY 1995 MEETING OF T.C. 6.2, INCLUDING:-

- INDEPENDENT STATUS OF THE CENTRAL BANK
- CONSULTATION & CONCURRENCE ISSUES
- DISPUTE RESOLUTION MECHANISMS
- QUERIES REGARDING DEFINITIONS (GOALS, OBJECTIVES, INSTRUMENTS) & TERMINOLOGY (GOAL VS INSTRUMENT INDEPENDENCE).

1.2 DOCUMENTATION WAS CIRCULATED ON 25 MAY, AS KEY TEXTS & BACKGROUND TO THIS MEETING & I PROPOSE DRAWING ON THESE TEXTS TODAY

(CONTINUED)



# **1. BACKGROUND & SUMMARY OF ISSUES RAISED**

1.3 SINCE 22 MAY 1995 I HAVE SPOKEN TO CA LAW ADVISOR AND HELD MEETINGS WITH THE SARB GOVERNOR AND THE MINISTER OF FINANCE ON THE PROPOSED DRAFT TEXTS BEFORE THE COMMITTEE AND THE CA LAW ADVISORS' OPINIONS THEREON.

1.4 PROPOSE PROVIDING A THUMB-NAIL SKETCH OF THE BROAD GIST OF WHAT IS BEING PUT FORWARD IN THE LITERATURE, ON THE THEMES UNDER DISCUSSION BY T.C.6.2

THEREAFTER REPORTING BACK ON THE MEETINGS

THEREAFTER DEALING WITH THE KEY ISSUES RAISED BY THE THEME COMMITTEE, INCLUDING  
CENTRAL BANK INDEPENDENCE  
ACCOUNTABILITY  
DISPUTE RESOLUTION MECHANISMS  
DEFINITION ISSUES  
AND FINALLY A FEWSHORT RECOMMENDATIONS FOR CONSIDERATION BY THE COMMITTEE.

(CONTINUED)

## 1.4 KEY CONCEPTUAL ISSUES HIGHLIGHTED IN THE DOCUMENTATION.

### 12 KEY POINTS OF THE DOCUMENTATION

- NO MEDIUM- OR LONGER-TERM TRADE-OFF NOW CONSIDERED POSSIBLE ALONG THE PHILLIPS CURVE.
- (NOTE THAT CREFSA CONFERENCE HEARD THAT EVEN IN THE SHORT TERM THERE WAS DEBATE AS TO WHETHER THERE WAS ANY LONGER ANY SIGNIFICANT TRADE-OFF BETWEEN INFLATION AND UNEMPLOYMENT - A SHORT-TERM STIMULUS TO THE ECONOMY THROUGH A RELAXATION OF MONETARY POLICY DID NOT NECESSARILY LEAD TO A REDUCTION IN UNEMPLOYMENT EVEN IN THE SHORT TERM)
- MONETARY POLICY AIMS HAVE REDUCED FROM A BROAD SERIES OF CHOICES, TO (PREDOMINANTLY) PRICE STABILITY. THIS HAS BEEN A MAJOR STIMULUS INTERNATIONALLY TO GREATER CENTRAL BANK INDEPENDENCE.
- BECAUSE THERE WAS PREVIOUSLY A CHOICE OF MONETARY POLICY AIMS (EACH WITH A DIFFERENT IMPACT ON THE REAL ECONOMY) THE DECISION AS TO THE MIX OF POLICIES WAS MUCH MORE SQUARELY A POLITICAL DECISION.
- BECAUSE THE CHOICE OF MONETARY POLICY AIM IS NOW REFINED TO PRICE STABILITY, THERE IS A REDUCED ELEMENT OF CHOICE AMONG POSSIBLY CONFLICTING AIMS OF MONETARY POLICY.
- WHERE AN INDEPENDENT CENTRAL BANK IS GIVEN THE MANDATE TO PURSUE A SINGLE, QUANTIFYABLE OBJECTIVE, IT CAN AND SHOULD BE HELD DIRECTLY AND MORE EASILY ACCOUNTABLE FOR THE DISCHARGE OF ITS MANDATE

## 1.4 KEY CONCEPTUAL ISSUES HIGHLIGHTED IN THE DOCUMENTATION.

1. CENTRAL BANKS TYPICALLY ORIGINATED FROM THE PASSAGE OF ORDINARY STATUTES. HENCE FOR EXAMPLE, THE SARB WAS CREATED BY AN ACT OF PARLIAMENT.
2. AUTHORITY FOR PERFORMING CERTAIN RESPONSIBILITIES WAS THEN VESTED BY PARLIAMENT, IN TERMS OF THE RELEVANT ACT, IN THE CENTRAL BANK.

ESSENTIAL TO THIS IS THE NOTION OF DELEGATED AUTHORITY. VIZ. THAT THE AUTHORITY WHICH CENTRAL BANKS WIELD IS DERIVED FROM ELECTED REPRESENTATIVES (IE:- PARLIAMENT) , WHO HAVE DELEGATED AUTHORITY TO A COMPETENT CENTRAL BANK.

NOTE THAT THIS DELEGATION CAN BE DIRECT (IN THE CASE OF AN ACT OR ORDINARY LAW WHICH SETS OUT THE RESPONSIBILITIES OF THE CENTRAL BANK) OR INDIRECT ( IN THE CASE OF A CONSTITUTION WHICH IN ANY EVENT IS ESTABLISHED BY AND CAN BE AMENDED BY ELECTED REPRESENTATIVES).

THERE ARE MANY REFERENCES IN THE LITERATURE TO THE NOTION THAT NO CENTRAL BANKS ARE EVER COMPLETELY INDEPENDENT OF GOVERNMENTS AND POLITICS. THIS NOTION FUNDAMENTALLY FLOWS FROM THE NOTION THAT AUTHORITY IS DELEGATED.

(CONTINUED)

## 1.4 KEY CONCEPTUAL ISSUES HIGHLIGHTED IN THE DOCUMENTATION.

3. FLOWING FROM THE NOTION OF DELEGATED AUTHORITY IS THE NOTION OF CENTRAL BANK ACCOUNTABILITY.

IN INSTANCES WHERE THE AUTHORITY OF CENTRAL BANKS DERIVES FROM AN ACT, THE CENTRAL BANK IS REGARDED TO BE ACCOUNTABLE TO PARLIAMENT, USUALLY THROUGH THE MINISTER OF FINANCE.

IN INSTANCES WHERE THE AUTHORITY OF CENTRAL BANKS DERIVES FROM A CONSTITUTION, IT IS USUALLY SAID THAT THE CENTRAL BANK IS ACCOUNTABLE TO PARLIAMENT AND TO SOCIETY.

4. ALSO FLOWING FROM THE NOTION OF DELEGATED AUTHORITY IS THE QUESTION OF HOW AUTONOMOUS (OR "INDEPENDENT") THE CENTRAL BANK IS, IN CARRYING OUT ITS DELEGATED AUTHORITY.

THERE ARE IN FACT MANY DIMENSIONS OF CENTRAL BANK "INDEPENDENCE" AND IT IS IN THIS AREA THAT MUCH OF THE DEBATE AND MUCH OF THE CONFUSION ABOUT THE "INDEPENDENCE" OF THE CENTRAL BANK ARISES.

(CONTINUED)

## 1.4 KEY CONCEPTUAL ISSUES HIGHLIGHTED IN THE DOCUMENTATION.

5. PREVIOUSLY THE CENTRAL BANK WAS HELD RESPONSIBLE FOR MANY MACROECONOMIC ISSUES INCLUDING PRICE STABILITY AND THE ATTAINMENT AND MAINTENANCE OF FULL EMPLOYMENT.
6. DEVELOPMENTS IN MACROECONOMICS AND IN FINANCIAL MARKETS, HOWEVER, CHALLENGED THE RATIONALE FOR VESTING A SPECTRUM OF RESPONSIBILITIES WITH THE CENTRAL BANK.

IN THE LITERATURE WHICH HAS BEEN DISTRIBUTED, THESE DEVELOPMENTS ARE ASSOCIATED WITH INCREASED UNDERSTANDING OF THE CAPACITY OF POLICYMAKERS TO INFLUENCE BOTH EMPLOYMENT AND INFLATION AS WELL AS THE POLICY INSTRUMENTS WHICH MOST EFFECTIVELY ADDRESSED EACH OF THESE OBJECTIVES. ACCORDING TO THE PHILLIPS CURVE, A RELATIONSHIP EXISTED BETWEEN THE LEVEL OF UNEMPLOYMENT AND THE LEVEL OF INFLATION. ACCORDINGLY, GOVERNMENTS WERE PREVIOUSLY THOUGHT TO BE ABLE TO CHOOSE, AMONG POLICY OPTIONS, AN OPTIMAL COMBINATION OR TRADE-OFF, BETWEEN INFLATION AND UNEMPLOYMENT.

(CONTINUED)

## 1.4 KEY CONCEPTUAL ISSUES HIGHLIGHTED IN THE DOCUMENTATION.

7. PREVIOUSLY THE CENTRAL BANK WAS HELD RESPONSIBLE FOR MANY MACROECONOMIC ISSUES INCLUDING PRICE STABILITY AND THE ATTAINMENT AND MAINTENANCE OF FULL EMPLOYMENT.
8. DEVELOPMENTS IN MACROECONOMICS AND IN FINANCIAL MARKETS, HOWEVER, CHALLENGED THE RATIONALE FOR VESTING A SPECTRUM OF RESPONSIBILITIES WITH THE CENTRAL BANK.

IN THE LITERATURE WHICH HAS BEEN DISTRIBUTED, THESE DEVELOPMENTS ARE ASSOCIATED WITH INCREASED UNDERSTANDING OF THE ABILITY OF POLICYMAKERS TO INFLUENCE BOTH EMPLOYMENT AND INFLATION. ACCORDING TO THE PHILLIPS CURVE, A RELATIONSHIP EXISTED BETWEEN THE LEVEL OF UNEMPLOYMENT AND THE LEVEL OF INFLATION. ACCORDINGLY, GOVERNMENTS WERE ABLE TO CHOOSE, AMONG POLICY OPTIONS, AN OPTIMAL COMBINATION OR TRADE-OFF, BETWEEN INFLATION AND UNEMPLOYMENT.

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PRESENTATION TO CA TC 6.2, 5 JUNE 1995,  
C.D.R. RUSTOMJEE, TECHNICAL ADVISER.

## 1.4 KEY CONCEPTUAL ISSUES HIGHLIGHTED IN THE DOCUMENTATION.

9. FOR THE PURPOSES OF OUR DISCUSSION THE ISSUE IS AN IMPORTANT ONE BECAUSE IT MEANT THAT THE CENTRAL BANK COULD NOW PURSUE ANTI-INFLATION POLICIES IN THE MEDIUM- AND LONG-TERM WITHOUT THERE BEING AN ADVERSE "TRADE-OFF" IN HIGHER UNEMPLOYMENT.

CONSEQUENTLY, THE OBJECTIVES OF CENTRAL BANKS, INTERNATIONALLY, NARROWED, FOCUSING ON PRICE STABILITY AS THE PRIMARY AND SOMETIMES ONLY OBJECTIVE OF THE CENTRAL BANK.

10. IN THIS SCENARIO, IT BECAME INCREASINGLY FEASIBLE TO DELEGATE THE RESPONSIBILITY FOR MONETARY POLICY TO AN AUTONOMOUS CENTRAL BANK AND TO INTRODUCE IN THE LAW CLEARLY DEFINED PROVISIONS FOR ENSURING THAT THE CENTRAL BANK WAS ACCOUNTABLE IN DISCHARGING ITS RESPONSIBILITIES.

CONSEQUENTLY IN RECENT YEARS THERE HAS BEEN AN INTERNATIONAL SHIFT TOWARDS MORE INDEPENDENT CENTRAL BANKS, TYPICALLY DELEGATED CLOSELY FOCUSED MANDATE - MAINTAINING PRICE STABILITY.

11. GOODHART EXPLAINS THIS PROCESS AS FOLLOWS:-

## 1.4 KEY CONCEPTUAL ISSUES HIGHLIGHTED IN THE DOCUMENTATION.

"When an exploitable trade-off was perceived between inflation and unemployment, along the Phillips curve, the choice of the optimal point was inherently, and rightly, a political decision. So, when monetary policy aims at several objectives simulataneously, with the need for choice, and balance, - between them policy will be subject to greater political oversight and the Central Bank will be subservient. Greater autonomy is more likely when Central Banks are asked to achieve a single macro outcome, such as the maintenance of the Gold Standard up till 1914, or price stability now.

Thus current enthusiasm for independent Central Banks rests importantly on general acceptance of the vertical longer-term Phillips curve; that there is no medium, or longer term trade-off to exploit; that the best sustainable outcome that the authorities can achieve through monetary policy is price stability.

Those who do not accept this analysis, or who place great emphasis on the short-term, to which there remains a downward sloping Phillips curve, will find such argumentation unappealing. For thos who do accept the analysis, a shift to Central Bank "independence", in circumstances where there is a single, quantifiable objective which the Central Bank is mandated to achieve, makes the Central Bank much more, rather than less, democratically accountable (Roll Report, 1993). Both the objective and success in achieving that target, can be made crystalclear."

**(Goodhart C.E. What Should Central Banks Do. What Should Be Their Macroeconomic Oibjectives and Operations?, Economic Journal, Nov. 1994.**



**2. REPORT-BACK ON MEETINGS WITH  
MINISTER OF FINANCE AND SARB  
GOVERNOR.**

**2.1 COMMENTS BY THE MINISTER OF FINANCE:-**

- THE MINISTER OF FINANCE FAVOURS THE RETENTION OF THE WORDING OF THE INTERIM CONSTITUTION. ANY SUBSTANTIVE CHANGES NOW WILL HAVE AN ACCENTUATED IMPACT ON CONFIDENCE AND EXPECTATIONS AND WOULD IMPLY A CHANGE OF MINDSET.
  
- THE EFFECTIVENESS OF THE RESERVE BANK AND ITS CONTRIBUTION TO OVERALL MACROECONOMIC POLICY IS ULTIMATELY A FUNCTION OF THE WORKING RELATIONSHIP BETWEEN THE BANK AND THE MINISTRY OF FINANCE (THE GOVERNOR AND THE MINISTER OF FINANCE). IT IS THEREFORE ALSO IMPORTANT TO ENSURE REGULAR CONSULTATION BETWEEN THE TWO.
  
- IF DETAILED WORDING PERTAINING TO CONSULTATION BETWEEN THE SARB GOVERNOR AND THE MINISTER OF FINANCE IS TO BE USED. THEN THE MINISTER WOULD STRONGLY PREFER THE WORDS "AFTER CONSULTATION WITH" (THE MINISTER OF FINANCE) RATHER THAN THE STRONGER "IN CONSULTATION WITH"

(CONTINUED)

**2. REPORT-BACK ON MEETINGS WITH  
MINISTER OF FINANCE AND SARB  
GOVERNOR.**

**2.1 COMMENTS BY THE MINISTER OF FINANCE:- (CONTD)**

- WITH REGARD TO THE BALANCE OF POWERS BETWEEN THE BANK AND GOVERNMENT, THERE ARE SUITABLE CHECKS ON THE BANK, INCLUDING REQUIREMENTS TO REPORT TO PARLIAMENT ANNUALLY AND REGULAR CONSULTATION, IN THE SUBSIDIARY LEGISLATION AND THE MINISTER IS SATISFIED WITH THESE.
  
- AS A COMPARATIVELY MINOR ISSUE, THE MINISTER EXPRESSED A PREFERENCE FOR THE PRIMARY OBJECTIVE OF THE BANK BEING TO PROTECT "THE VALUE OF THE CURRENCY" RATHER THAN TO PROTECT THE "INTERNAL AND EXTERNAL VALUE OF THE CURRENCY".

PRESENTATION TO CA TC 6.2, 5 JUNE 1995,  
C.D.R. RUSTOMJEE, TECHNICAL ADVISER.

**2. REPORT-BACK ON MEETINGS WITH  
MINISTER OF FINANCE AND SARB  
GOVERNOR.**

**2.2 COMMENTS BY THE GOVERNOR OF THE SARB**

- THE GOVERNOR FAVOURS THE RETENTION OF THE WORDING OF THE INTERIM CONSTITUTION AS FAR AS POSSIBLE. HE CONCURS WITH THE VIEW OF THE MINISTER OF FINANCE THAT ANY SUBSTANTIVE CHANGES NOW WILL HAVE AN ACCENTUATED IMPACT ON CONFIDENCE AND EXPECTATIONS AND WOULD IMPLY A CHANGE OF MINDSET.
  
- THE PROPOSAL THAT THERE BE CONCURRENCE BETWEEN THE MINISTER AND THE GOVERNOR IN THE CONDUCT OF THE OPERATIONS OF THE BANK IS UNWORKABLE AND THE GOVERNOR DOES NOT AGREE WITH THIS APPROACH.

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PRESENTATION TO CA TC 6.2, 5 JUNE 1995,  
C.D.R. RUSTOMJEE, TECHNICAL ADVISER.

**2. REPORT-BACK ON MEETINGS WITH  
MINISTER OF FINANCE AND SARB  
GOVERNOR.**

**2.2 COMMENTS BY THE GOVERNOR OF THE SARB**

- THE BANK IS ACCOUNTABLE TO PARLIAMENT BECAUSE IT IS FROM PARLIAMENT THAT THE BANK HAS RECEIVED ITS MANDATE. PARLIAMENT ESTABLISHED THE BANK.

THE SUBSIDIARY LEGISLATION MAKES PROVISION FOR THE BANK TO DISCHARGE ITS RESPONSIBILITY TO ACCOUNT TO PARLIAMENT IN SECTION 31 OF THE SARB ACT, WHICH REQUIRES THE GOVERNOR TO SUBMIT TO THE MINISTER OF FINANCE A REPORT RELATING TO THE IMPLEMENTATION BY THE BANK OF MONETARY POLICY.

PRESENTATION TO CA TC 6.2, 5 JUNE 1995,  
C.D.R. RUSTOMJEE, TECHNICAL ADVISER.

## 2. REPORT-BACK ON DISCUSSION WITH CA LAW ADVISOR

### **2.3 DISCUSSION WITH CA LAW ADVISOR**

- PER THE TRANSCRIPT OF THE TC 6.2 MEETING OF 22 MAY, THE CA LAW ADVISOR WAS CONTACTED WITH THE REQUEST THAT ALTERNATE FORMULATIONS BE PROVIDED OF THE DRAFT CLAUSE IN PARAGRAPH 12 OF THE CA LAW ADVISORS' OPINION ON CENTRAL BANK INDEPENDENCE.

ALTERNATE FORMULATIONS HAVE BEEN PREPARED.

PRESENTATION TO CA TC 6.2, 5 JUNE 1995.  
C.D.R. RUSTOMJEE, TECHNICAL ADVISER.

### 3. CENTRAL BANK INDEPENDENCE

- NOTION OF DELEGATED AUTHORITY
  - SEE GOODHART, GUITIAN
  
- ACCOUNTABILITY:- NECESSITY TO ACCOUNT FOR DELEGATED AUTHORITY:-
  - TO WHOM (PARLIAMENT? SOCIETY?)
  - CURRENT ACCOUNTABILITY OF THE SARB
  - (FUTURE ACCOUNTABILITY WHEN CONSTITUTIONALLY INDEPENDENT)
  - COMPARATIVE MEASURES INTERNATIONALLY
  
- GOAL VS INSTRUMENT INDEPENDENCE
  
- MODEL A VS MODEL B INDEPENDENCE (SEE SECTION 5) - ILLUSTRATES THE MANY DIMENSIONS OF CENTRAL BANK "INDEPENDENCE"

PRESENTATION TO CA TC 6.2, 5 JUNE 1995.  
C.D.R. RUSTOMJEE, TECHNICAL ADVISER.

### 3. CENTRAL BANK INDEPENDENCE

#### 3.1 DELEGATED AUTHORITY & ACCOUNTABILITY

BEST EXPRESSED IN GUITIAN'S PAPER:-

"No central bank (or any other monetary institution, for that matter) is ever completely independent of governments and politics. They are, in their modern form at least, creatures of the political and legislative process and are given, through that process, varying degrees of delegated authority for monetary policy. By the same token, the delegated authority can always be removed or changed through the same political or legislative process, even if more easily in some circumstances than others. It can also be seen on a more day-to-day level that independence is never absolute because there are invariably a variety of formal and informal avenues through which governments and the political process impinge on and can potentially influence the decisions and actions of a central bank.

Seen from the perspective of delegated authority, it is natural to presume that the greater the degree of central bank independence, the stronger and clearer should be the accountability for the exercise of the delegated authority. It is certainly true the political acceptance of central bank independence is unlikely to be forthcoming without reasonably strong accountability provisions.

(Continued)...

### 3. CENTRAL BANK INDEPENDENCE

#### 3.1 DELEGATED AUTHORITY & ACCOUNTABILITY

" But, accountability should not be seen as the unfortunate cost to the central bank of obtaining more independence - a cost to be minimized if possible. On the contrary, it is the necessary and inevitable obverse of that independence - indeed, without it, there would be little economic justification for independence, because the whole point of independence is to promote confidence and certainty in monetary policy through predictability and transparency in its conduct and aims. For this, the central bank has to explain publicly what it is doing and why. Therefore, accountability arrangements, formal or informal, are central to the ability of the public and financial markets to gauge what is happening in monetary policy, what trade-offs are being made, and who is making them"

(Manual Guitian, Central Bank Independence: Issues and Diversity of Models, IMF)



### **3. CENTRAL BANK INDEPENDENCE**

#### **3.2 ACCOUNTABILITY OF THE SARB**

##### **3.2.2 A COMPARISON OF ACCOUNTABILITY PROVISIONS AMONG OTHER CENTRAL BANKS.**

- (REFER SEPARATE SET OF SLIDES)

### 3. CENTRAL BANK INDEPENDENCE

#### 3.2 ACCOUNTABILITY OF THE SARB

##### 3.2.1 ACCOUNTABILITY AS AN INDEPENDENT CENTRAL BANK

- NOTE THAT THE CENTRAL BANK WILL CONTINUE TO BE ACCOUNTABLE TO ELECTED REPRESENTATIVES AND, IN COMMON WITH INDEPENDENT CENTRAL BANKS MORE GENERALLY, TO SOCIETY AT LARGE.
- ACCORDING TO CENTRAL BANKING EXPERTS SUCH AS GOODHART, FISCHER, GUITIAN, ETC. THE POLITICAL DECISION TO CONFER INDEPENDENCE ON THE CENTRAL BANK WILL INFACIT STRENGTHEN DETERMINATION TO ENSURE ACCOUNTABILITY OF THE CENTRAL BANK.
- AN IMPORTANT QUESTION THE COMMITTEE WILL REQUIRE TO CONSIDER IS WHAT FORM THIS ACCOUNTABILITY WILL TAKE IN A CONSTITUTIONALLY INDEPENDENT CENTRAL BANK.

(CONTINUED)

### 3. CENTRAL BANK INDEPENDENCE

#### 3.2 ACCOUNTABILITY OF THE SARB

##### 3.2.1 ACCOUNTABILITY AT PRESENT

- ACCOUNTABILITY IS CONTAINED IN THE SUBSIDIARY LEGISLATION (SARB ACT NO. 90 OF 1989):-
  - SECTION 31:- THE GOVERNOR SHALL ANNUALLY SUBMIT TO THE MINISTER A REPORT RELATING TO THE IMPLEMENTATION BY THE BANK OF MONETARY POLICY
  - SECTION 32:- FURNISHING OF INFORMATION TO THE DEPARTMENT OF FINANCE AND TO PARLIAMENT. (NOTE THAT THE MINISTER OF FINANCE TABLES THE REPORT (IN SECTION 31 ABOVE) IN PARLIAMENT).
  - NOTE THAT ACCOUNTABILITY IS TO PARLIAMENT, NOT TO THE GOVERNMENT OR TO A PARTICULAR POLITICAL PARTY.

### 3. CENTRAL BANK INDEPENDENCE

#### 3.2 ACCOUNTABILITY OF THE SARB

##### 3.2.1 ACCOUNTABILITY AS AN INDEPENDENT CENTRAL BANK

- SPECIFICALLY:-
  - WILL ACCOUNTABILITY BE WRITTEN INTO THE CONSTITUTION OR INTO SUBSIDIARY LEGISLATION?
  - IF THE LATTER, WHICH IS THE NORM, WHAT FORM WILL ACCOUNTABILITY TAKE?
    - SPECIFIC MONETARY TARGETS?
    - ACCOUNTABILITY OF THE FORM CURRENTLY CONTAINED IN SUBSIDIARY LEGISLATION? (NOTE THAT WITH THE BANK BEING GIVEN A RELATIVELY PRECISELY-DEFINED CONSTITUTIONAL MANDATE - PRESERVING THE INTERNAL AND EXTERNAL STABILITY OF THE RAND- THE ACCOUNTABILITY REQUIREMENT CAN NOW ALSO BE RELATIVELY MORE PRECISELY BE DEFINED)
  - THE COMMITTEE MAY WISH TO CONSIDER INVITING THE GOVERNOR, AND THE MINISTER OF FINANCE, INTER ALIA TO COMMENT ON FUTURE ACCOUNTABILITY REQUIREMENTS OF A CONSTITUTIONALLY-INDEPENDENT SARB, INCLUDING HOW THE CURRENT PROVISIONS ARE LIKELY TO CHANGE..

### 3. CENTRAL BANK INDEPENDENCE

#### 3.2 ACCOUNTABILITY OF THE SARB

##### 3.2.2 A COMPARISON OF ACCOUNTABILITY PROVISIONS AMONG OTHER CENTRAL BANKS.

- (REFER SEPARATE SET OF SLIDES)

### 3. CENTRAL BANK INDEPENDENCE

#### 3.3 GOAL VS INSTRUMENT INDEPENDENCE

▶ OTHER COMMENTS ON INDEPENDENCE OF OBJECTIVES

- ▶ "Note in particular that the Central Bank is not independent with respect to the objectives that it should fulfil; indeed it may often, as in the case of New Zealand, be tied down rather rigidly to the achievement of a defined outcome. In that sense the Central Bank is autonomous with respect to the powers used to achieve its statutorily defined objective, but not independent to choose its objectives. By the same token an autonomous Central Bank can be more democratically accountable than a subservient Central Bank".

(Goodhart C.E. Central Bank Independence, March 1994).

### 3. CENTRAL BANK INDEPENDENCE

#### 3.3 GOAL VS INSTRUMENT INDEPENDENCE

IS THE DISTINCTION USEFUL?

- ▶ YES IN HIGHLIGHTING THE FACT THAT THE TERM INDEPENDENT IS NOT PRECISE AND THAT INDEPENDENCE CAN ALLUDE TO VARIOUS ASPECTS OF THE RELATIONSHIP BETWEEN GOVERNMENT AND THE CENTRAL BANK.
  
- ▶ NO AS TERMINOLOGY FOR INTRODUCTION INTO THE FINAL CONSTITUTION. THE WORDING WILL BE DIFFICULT TO INTERPRET; GOAL AND INSTRUMENT INDEPENDENCE ARE NOT DISTINCT CATEGORIES, BUT REFLECTIONS OF POLAR POSITIONS; AND IN PRACTICE EACH CENTRAL BANK HAS SOME DEGREE OF GOAL AND INSTRUMENT INDEPENDENCE (AND CONVERSELY SOME DEGREE OF ABSENCE OF SUCH INDEPENDENCE)
  
- ▶ RECOMMENDATIONS:-
  - ▶ (1) THAT THE TERMINOLOGY BE ACKNOWLEDGED AS A USEFUL CONTRIBUTION TO UNDERSTANDING ONE AMONG THE MANY CATEGORISATIONS OF CENTRAL BANK DEPENDENCE OR INDEPENDENCE IN THE LITERATURE AND PRACTICE OF CENTRAL BANKING.
  
  - ▶ (2) THAT THE TERMINOLOGY NOT BE CONSIDERED FOR USE IN THE FINAL CONSTITUTION FOR THE REASONS NOTED ABOVE.

### 3. CENTRAL BANK INDEPENDENCE

#### 3.3 GOAL VS INSTRUMENT INDEPENDENCE

COMMENTS ARISING FROM FISCHERS' DISTINCTION, WITH REGARD TO SA' FINAL CONSTITUTION:-

- ▶ PROPOSED "GOAL" IN THE FINAL CONSTITUTION IS CLEARLY DEFINED:- PROTECTING THE INTERNAL AND EXTERNAL VALUE OF THE RAND.
- ▶ IN FISCHERS' TERMINOLOGY, THE INDEPENDENT SA RESERVE BANK WILL NOT HAVE UNFETTERED GOAL INDEPENDENCE, BECAUSE ITS GOAL IS FAIRLY PRECISELY DEFINED..
- ▶ HOWEVER IT MAY HAVE SOME GOAL INDEPENDENCE, BECAUSE THE CONSTITUTION DOES NOT SET NUMERICAL TARGETS FOR ACHIEVING THE MANDATE OF PROTECTING THE INTERNAL AND EXTERNAL VALUE OF THE CURRENCY.
- ▶ THE INDEPENDENT SA RESERVE BANK WILL HAVE INSTRUMENT INDEPENDENCE. IN FISCHERS' TERMINOLOGY, AS THE CONSTITUTION (ACCORDING TO THE INTERIM CONSTITUTION WORDING) GRANTS THE BANK FULL DISCRETION AND POWER TO DEPLOY MONETARY POLICY TO ATTAIN ITS GOAL (PROTECTING THE INTERNAL AND EXTERNAL VALUE OF THE RAND)..



### 3. CENTRAL BANK INDEPENDENCE

#### 3.3 GOAL VS INSTRUMENT INDEPENDENCE

► A DISTINCTION INTRODUCED BY STANLEY FISCHER

"Because the term independence is not precise, some prefer to describe a central bank as autonomous, or "somewhat apart from government". Rather than fight the inevitable, I shall continue to use the term independence, but draw a distinction between goal independence and instrument independence. A Central bank whose goals are imprecisely defined has goal independence: at an extreme, one could imagine endowing a central bank with the power to conduct monetary policy and giving it the goal of doing good. At the other extreme, the goal may be as precisely specified as those in New Zealand, where there is no goal independence. A central bank with a mandate for price stability but no numerical targets has no goal independence. A central bank has instrument independence when it has full discretion and power to deploy monetary policy to attain its goals. A central bank bound by a monetary rule would not have instrument independence, nor would a central bank which was required to finance the budget deficit."

Fischer S. Modern Central Banking, April 1994.

#### 4. CONCURRENCE AND CONSULTATION

- WIDESPREAD ACKNOWLEDGEMENT IN THE LITERATURE ON THE NECESSITY FOR CONSULTATION BETWEEN THE GOVERNOR AND THE MINISTER OF FINANCE
- NEED TO RECALL THE FUNDAMENTAL REASONS FOR SUCH CONSULTATION:-
  - THE INTEREST RATE AS A CENTRAL VARIABLE INFLUENCING BOTH MONETARY POLICY AND FISCAL POLICY
  - THE IMPACT OF INTEREST RATES ON THE REAL ECONOMY
- THE "IN CONSULTATION WITH" FORMULA - WOULD REQUIRE CONCURRENCE, AS NOTED BY THE CA LAW ADVISOR.
- HOWEVER QUESTION IS TO FORMULATE PROVISIONS WHICH ENSURE THAT REGULAR CONSULTATION TAKES PLACE AND THAT THE NECESSARY TENSION INHERENT IN THE NOTION OF AN AUTONOMOUS INSTITUTION ASSUMING RESPONSIBILITY FOR A KEY ELEMENT OF MACROECONOMIC POLICY IS INCORPORATED IN A WORKABLE MANNER, WHICH ENSURES THAT THE AUTONOMOUS BODY OPERATES WITHIN THE MANDATE GIVEN TO IT.

## 5. CONFLICT RESOLUTION MECHANISMS

- KEY SOURCES IN DISCUSSING:- GUITIAN PAPER
- PROVISIONS IN THE INTERIM CONSTITUTION AND IN CURRENT SA LEGISLATION
- INTERNATIONAL COMPARATIVE PROVISIONS
- RECOMMENDATIONS FOR THE FINAL CONSTITUTION AND/ OR FOR SUBSIDIARY LEGISLATION

PRESENTATION TO CA TC 6.2, 5 JUNE 1995,  
C.D.R. RUSTOMJEE, TECHNICAL ADVISER.

## 5. CONFLICT RESOLUTION MECHANISMS

### 5.1 GUITIAN PAPER

- DISTINCTION BETWEEN MODEL A AND MODEL B INDEPENDENCE

- ▶ MODEL A:- NO FORMAL GOVERNMENT DIRECTIVE OR "OVERRIDE" ON MONETARY POLICY.

EXAMPLES:- CHILE, GERMANY, PROPOSED EUROPEAN CENTRAL BANK, SWITZERLAND, USA.

- ▶ MODEL B:- ALLOWS FOR SUCH DIRECTIVES OR OVERRIDES

EXAMPLES:- NEW ZEALAND, AUSTRALIA, BOTSWANA, CANADA, NETHERLANDS.

- "THE ISSUE THAT UNDERLIES THE CHOICE BETWEEN THE TWO APPROACHES IS THE QUESTION OF WHAT HAPPENS IN PRACTICE (AND PERHAPS BEHIND THE SCENES) IN THE CASE OF A CONFLICT ABOUT THE DIRECTION OR STANCE OF MONETARY POLICY AT A PARTICULAR TIME.... WHAT HAPPENS IN PRACTICE, UNDER EITHER BASIC MODEL, DEPENDS IMPORTANTLY ON HOW THE DETAILS OF THE LAW, PLUS TRADITIONS, CONVENTIONS AND ATTITUDES, AFFECT THE BEHAVIOUR OF POLITICIANS AND CENTRAL BANKERS BEHIND THE SCENES"

## 5. CONFLICT RESOLUTION MECHANISMS

### 5.1.2 KEY ARGUMENTS IN FAVOUR OF A FORMAL & PUBLIC OVERRIDE OR DISPUTE-RESOLUTION MECHANISM

- PROVIDES A MECHANISM WHICH MAY HELP AVOID A CONFRONTATION, WITHOUT COMPROMISING THE MONETARY POLICY OBJECTIVE.
- GIVES THE GOVERNOR GROUNDS TO RESIST POLITICAL PRESSURE:- THE GOVERNOR HAS A(N INDEPENDENT) MANDATE & THE GOVERNMENT HAS A PUBLIC, FORMAL CHANNEL TO CHANGE THIS MANDATE.
- WITHOUT THE OVERRIDE MECHANISM, THE GOVERNOR WOULD BE FORCED EITHER TO CAPITULATE TO PRESSURE BEHIND THE SCENES, OR TO ENGAGE IN A PUBLIC CONFRONTATION WHICH MIGHT LEAD TO EITHER THE GOVERNOR OR THE MINISTER OF FINANCE RESIGNING.

## 5. CONFLICT RESOLUTION MECHANISMS

### 5.1.2 KEY ARGUMENTS IN FAVOUR OF A FORMAL & PUBLIC OVERRIDE OR DISPUTE-RESOLUTION MECHANISM

- PROVIDES A MECHANISM WHICH MAY HELP AVOID A CONFRONTATION, WITHOUT COMPROMISING THE MONETARY POLICY OBJECTIVE.
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- WITHOUT THE OVERRIDE MECHANISM, THE GOVERNOR WOULD BE FORCED EITHER TO CAPITULATE TO PRESSURE BEHIND THE SCENES, OR TO ENGAGE IN A PUBLIC CONFRONTATION WHICH MIGHT LEAD TO EITHER THE GOVERNOR OR THE MINISTER OF FINANCE RESIGNING.

## 5. CONFLICT RESOLUTION MECHANISMS

### 5.1.3 KEY ARGUMENTS AGAINST A FORMAL & PUBLIC OVERRIDE OR DISPUTE-RESOLUTION MECHANISM

- NOTWITHSTANDING ANY CONSTRAINTS THAT MIGHT BE IMPOSED THROUGH PUBLICITY, THE EXISTENCE OF A FORMAL GOVERNMENT OVERRIDE OR DIRECTIVE POWER UNDER A MODEL B ARRANGMENT MAY WEAKEN MONETARY POLICY INDEPENDENCE AND PUBLIC CONFIDENCE, BECAUSE THE CONSTRAINTS WILL NOT BE, OR WILL NOT BE SEEN TO BE, SUFFICIENTLY EFFECTIVE TO RESTRAIN POLITICIANS. (IE:- THE POLITICAL COSTS OF USING THE OVERRIDE POWER MAY NOT BE SUFFICIENT TO PREVENT POLITICIANS FROM USING IT).
- MUCH WILL DEPEND ON HOW OTHER ASPECTS OF THE LEGISLATION AFFECT THE BALANCE BEHIND THE SCENES, INCLUDING FOR EXAMPLE, WHETHER THE LAW ESTABLISHES CLEAR OBJECTIVES AND ACCOUNTABILITIES, AND PROHIBITS THE CENTRAL BANK FROM TAKING OR SEEKING INSTRUCTIONS FROM THE GOVERNMENT OR OTHER PARTIES.

## 5. CONFLICT RESOLUTION MECHANISMS

### 5.1.4 KEY ISSUES ARISING FROM GUITIAN PAPER

- DE JURE OVERRIDE MECHANISMS VS DE FACTO POLITICAL ENVIRONMENT:-
  - A BANK CAN HAVE MODEL A INDEPENDENCE BUT IT MAY IN PRACTICE BE CLOSELY INFLUENCED BY POLITICAL PRESSURE; SIMILARLY A BANK CAN HAVE MODEL B INDEPENDENCE, WITH A FORMAL AND PUBLIC OVERRIDE MECHANISM. THE FACT THAT THIS MECHANISM IS NOT USED DOES NOT MEAN THAT POLITICAL PRESSURE HAS NOT BEEN BROUGHT TO BEAR ON THE CENTRAL BANK.
- IMPORTANCE OF THE EXTENT OF PUBLIC SUPPORT FOR CENTRAL BANK INDEPENDENCE
- IMPORTANCE OF THE EXTENT TO WHICH THE SUBSIDIARY LEGISLATION ESTABLISHES CLEAR OBJECTIVES AND ACCOUNTABILITIES.
- IMPORTANCE OF THE COUNTRY'S POLITICAL AND CONSTITUTIONAL TRADITION, PARTICULARLY CHECKS AND BALANCES ON THE POLITICAL LEADERSHIP.



## 5. CONFLICT RESOLUTION MECHANISMS

### 5.2 CONFLICT RESOLUTION MECHANISMS IN THE INTERIM CONSTITUTION AND/OR SUBSIDIARY LEGISLATION

- NOTE THAT CONFLICT RESOLUTION MECHANISMS, AS WITH CLAUSES PERTAINING TO ACCOUNTABILITY, ARE USUALLY CONTAINED IN THE RELEVANT SUBSIDIARY LEGISLATION.
- IN THE SOUTH AFRICAN INTERIM CONSTITUTION THERE IS NO PROVISION FOR THE RESOLUTION OF CONFLICT ON MONETARY POLICY.
- IN SOUTH AFRICAN SUBSIDIARY LEGISLATION, THERE IS SIMILARLY NO EXPLICIT CONFLICT RESOLUTION MECHANISM.
- IN PRACTICE, AND AS A LAST RESORT IF THERE WERE TO BE A FUNDAMENTAL CONFLICT OF OPINION BETWEEN THE GOVERNOR OF THE SARB AND THE MINISTER OF FINANCE ON MONETARY POLICY, IT IS CONSIDERED LIKELY THAT THE GOVERNOR WOULD RESIGN.

## 5. CONFLICT RESOLUTION MECHANISMS

### 5.3 INTERNATIONAL COMPARISONS OF CONFLICT RESOLUTION MECHANISMS

- (REFER SEPARATE SET OF SLIDES)
- KEY MATTERS ARISING:-
  - MECHANISMS VARY EXTENSIVELY
  - MECHANISMS ARE TYPICALLY CONTAINED IN THE SUBSIDIARY LEGISLATION.

PRESENTATION TO CA TC 6.2, 5 JUNE 1995,  
C.D.R. RUSTOMJEE, TECHNICAL ADVISER.

## 5. CONFLICT RESOLUTION MECHANISMS

### 5.4 CONSIDERATIONS FOR THE FINAL CONSTITUTION & FOR SUBSIDIARY LEGISLATION

- SHOULD EXPLICIT CONFLICT RESOLUTION MECHANISMS BE INCORPORATED IN THE FINAL CONSTITUTION OR (PREFERABLY) IN SUBSIDIARY LEGISLATION?
- IF SO, WHAT MECHANISMS?
- COMMENTS:-
  - THERE APPEARS TO BE A REASONABLY STRONG CASE, BASED ON GUITIANS' PAPER, FOR A MODEL B TYPE APPROACH IN SOUTH AFRICA.
  - THE MOST APPROPRIATE PLACE IS LIKELY TO BE THE SUBSIDIARY LEGISLATION.

PRESENTATION TO CA TC 6.2, 5 JUNE 1995,  
C.D.R. RUSTOMJEE, TECHNICAL ADVISER.

## 6. DEFINITIONS/TERMINOLOGY

- ACCORDINGLY WE REQUIRE TO TURN TO THE ORDINARY OR EVERYDAY MEANING OF THE WORDS UNDER CONSIDERATION. FOR EXAMPLE WITH REFERENCE TO A STANDARD DICTIONARY:--
  
  - COPIES OF CERTAIN OF THESE DEFINITIONS, ACCORDING TO:-
    - COLLINGS' 3RD. EDITION ENGLISH DICTIONARY;
    - CHAMBERS' 20TH CENTURY ENGLISH DICTIONARY;  
AND
    - THOMPSONS' 9TH EDITION DICTIONARY OF BANKING
- ARE CIRCULATED.
- IT IS SUGGESTED THAT THE CONFUSION PERTAINING TO TERMINOLOGY ARISES FROM THE GENERALLY INDISCRIMINATE USE OF SUCH TERMINOLOGY BOTH IN THE INTERNATIONAL LITERATURE ON CENTRAL BANKING IN GENERAL AND INDEED IN LEGISLATION PERTAINING TO CENTRAL BANKING.

## 6. DEFINITIONS/TERMINOLOGY

- WE HAVE EXAMINED THE CONCEPTS OF GOAL VS INSTRUMENT INDEPENDENCE. AS WELL AS GOODHARTS' INDEPENDENCE OF OBJECTIVES. WE HAVE ALSO EXAMINED GUITIAN'S TWO MODELS OF INDEPENDENCE, ACCORDING TO WHETHER OR NOT OVERRIDE MECHANISMS EXIST.
- IN CASE LAW ON THE SARB SINCE ITS INCEPTION, THERE HAVE BEEN NO DECIDED CASES WHICH CHALLENGE THE WORD OBJECTIVE OR CHALLENGE THE PRIMARY OR OTHER OBJECTIVES OF THE SARB. (REFER LIST OF DECIDED CASES ON THE SARB)
- SIMILARLY, THE DEFINITIONS SECTIONS OF THE ORIGINAL, AS WELL AS ALL AMENDED VERSIONS OF THE SARB ACT DO NOT DEFINE EITHER:- OBJECTIVES, GOALS, INSTRUMENTS OR FUNCTIONS.
- ACCORDING TO THE PRINCIPLES OF INTERPRETATION OF STATUTES. WHERE THE MEANING OF A WORD IS NOT DEFINED. IT IS ASSUMED THAT THE MEANING INTENDED IS THE ORDINARY MEANING OF THE WORD. NEVERTHELESS THE CIRCUMSTANCES OF EACH PARTICULAR CASE WILL BE TAKEN INTO ACCOUNT IN DETERMINE THE INTENDED MEANING OF A WORD.

(CONTINUED)

## 7. KEY AREAS OF CURRENT CONSENSUS

- ALL PARTIES REQUIRE THE CENTRAL BANK TO BE ABOVE PARTY-POLITICAL DAY-TO-DAY INTERFERENCE
- ACCORDINGLY ALL PARTIES HAVE DECIDED TO ENSHRINE CENTRAL BANK INDEPENDENCE IN THE CONSTITUTION
- IF SECTION 196(1) OF THE INTERIM CONSTITUTION IS RETAINED, ALL PARTIES WILL BE CONFERRING A RELATIVELY PRECISELY DEFINED MANDATE ON THE BANK (PRESERVING THE INTERNAL AND EXTERNAL VALUE OF THE CURRENCY)
- IF SECTION 196(2) IS RETAINED, ALL PARTIES WILL CONFER INDEPENDENCE ON THE CENTRAL BANK TO PURSUE ITS MANDATE. LOOSELY TERMED, THIS WILL BE EFFECTIVELY CONFERRING A FORM OF "INSTRUMENT INDEPENDENCE" ON THE BANK.
- ALL PARTIES APPEAR TO WISH TO ENSURE THAT THE BANK IS ACCOUNTABLE TO PARLIAMENT AND TO SOCIETY AT LARGE. IN PRACTICE THIS WILL BE A MATTER FOR THE SUBSIDIARY LEGISLATION.

## 8. RECOMMENDATIONS BY TECHNICAL ADVISOR

- THAT THE THEME COMMITTEE SHOULD CONSIDER REVERTING AS CLOSELY AS POSSIBLE TO THE WORDING OF THE INTERIM CONSTITUTION, IN PARTICULAR THE PROVISIONS OF SECTIONS 196(1) AND 196(2). THIS WORDING ACCURATELY REFLECTS THE NECESSARY AND INHERENT TENSION WHICH IS IMPLICIT IN THE DELEGATING OF A CENTRAL FACET OF MACROECONOMIC POLICY (IE:- MONETARY POLICY) BY GOVERNMENT, TO AN AUTONOMOUS BODY SUCH AS AN INDEPENDENT CENTRAL BANK.
- THAT CONSIDERATION BE GIVEN TO WITHDRAWING THE SUGGESTION THAT THE BANK SHOULD ACT "IN CONSULTATION WITH" THE MINISTER OF FINANCE BUT RATHER CONSIDER THE DETAILED MECHANISMS FOR SUCH CONSULTATION IN THE SUBSIDIARY LEGISLATION.
- THAT IN CONFERRING CONSTITUTIONAL INDEPENDENCE ON THE BANK, ATTENTION SHOULD BE GIVEN TO THE NECESSARY ACCOUNTABILITY CLAUSES EITHER IN THE CONSTITUTION ITSELF OR (PREFERABLY) IN THE SUBSIDIARY LEGISLATION. THIS IS PARTICULARLY ACCENTUATED BY THE CONFERRAL ON THE (INDEPENDENT) CENTRAL BANK OF A RELATIVELY PRECISELY DEFINED MANDATE.
- THAT THE CONSTITUTIONAL CLAUSES FINALLY AGREED BE KEPT AS SIMPLE AS POSSIBLE.

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June 2, 1995

Mr. Cyrus Rustomjee  
Technical Advisor  
Theme Committee 6(2)  
Constitutional Assembly  
Per facsimile # (021) 455-076

Dear Cyrus

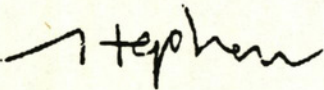
The response in many quarters to the renewed focus on Reserve Bank independence and the extent to which it can be reconciled with democracy has been dismaying. Ritual exhortations of the supposedly self-evident goodness of independence and unreflective kow-rowing to the momentary preferences of the international markets are not sound motivations for constitutional provisions, especially those which limit the power of elected representatives.

I believe the issue, and the proposal for "operational" independence of the Bank, deserve a more serious response. Hence this submission, which I believe raises a number of novel and pertinent points, and which is grounded in recent theory and evidence. I am making this submission as a private citizen.

I am sending this now in the hope that you will have time to consider it during the weekend in preparation for the meeting on Monday. In any event, I believe you will find it interesting.

Please excuse the use of the royal "we" in the submission!

Yours sincerely



Stephan Malherbe



## RESERVE BANK INDEPENDENCE AND DEMOCRACY

The relationship between the Reserve Bank and the elected branches of government cuts to the heart of what we mean by representative government, of the expectations of citizens when they use money, and of how economic policy is made. For that reason, we believe a full and unhurried consideration of the issue is warranted.

Our approach starts with the question: When, in a democracy characterised by individual freedoms, is it justified to limit the policy role of the elected branches of government, namely the legislature and the executive? Our response indicates that the only possible basis for excluding monetary policy from the normal legislative and executive process is when the elected branches of government have a "systemic disability" in dealing with that area of decision-making. So the focus of our enquiry is:

**Do the elected branches of government have a systemic disability in the making of monetary policy which, in the interests of the citizenry, ought to be addressed by an independent reserve bank?**

In answering this question, we also analyse the recent proposal that the legislature set the objectives of monetary policy, while the Reserve Bank has freedom to implement it as it sees fit.

Our position turns on two points. The first is the remarkable consensus which has emerged about the uses and limitations of monetary policy as an instrument of government. The second point is probably the decisive element in the debate: The recognition that the eventual consequences of monetary policy for the real economy are not straight-forward, but determined by the reactions of citizens in the economic arena to policy and anticipated policy. We show that, when parliament holds sway over monetary objectives, the interplay between government and agents in the economy will have the perverse consequence that any employment gain is nullified, but that inflation is higher than would otherwise have been the case. This result does not in any way rest on assumptions about political short-sightedness or incompetence. It is simply a result of the institutional set-up.

Economic beliefs which do not accommodate these two points lead, we believe, to a misunderstanding of the issue and faulty prescriptions. But we do not rely on reason alone. The evidence is weighed using meticulous and comprehensive empirical exercises.

### *Fiat money may have Created a Need for Constitutional Innovation*

The western constitutional tradition is one of democracy. As is discussed in the next section, this tradition recognises certain inconsistencies and tensions in representative democracy, and has sought to deal with it by way of various divisions of power.

Because of this constitutional tradition was developed before the twentieth century, it was formulated in a political context where *fiduciary*, and not fiat, money was used. Unlike fiat (or paper) money, fiduciary money is linked to a commodity, often a metal, which is scarce. In other

words, there was a natural limit to the money supply, and monetary policy as we understand it was not in the hands of government. Little wonder that, to the extent that there are systemic pitfalls in making monetary policy, they are not addressed in the western constitutional tradition.

The emergence of *fiat* money in the twentieth century means that government gained a new, and for most of this century badly understood, policy instrument: manipulation of the money supply. Now the only limit on growth in the money supply is the government's self-control. This has created the possibility of far more frequent and intense inflations, including "very high" (100% per year) and "hyper" (50% per month) inflation. All fifteen cases of hyperinflation took place this century, and very high inflation is almost exclusively a twentieth century phenomenon.<sup>1</sup> There have been at least 34 cases of inflation in excess of 100% per annum since 1952, involving 21 countries. Ten of these cases, involving four countries, have taken place in Africa, all since 1977.

The costs of ordinary levels of inflation are briefly mentioned below. In the cases of very high or hyperinflation, the economic and political foundations of a country are shaken, and the social fabric may rupture as happened in Germany after the First World War. It is not surprising that the latter years of this century have seen an intensive investigation into the institutional causes of inflation, and that certain conclusions for constitution-making have been drawn. This submission reports on the lessons from these endeavours.

### *When is it Justified to Limit the Power of the Elected Branches of Government?*

In a democracy there are three grounds for limiting the role of the legislature and the executive:

- The protection of rights essential for the continuing and proper functioning of the democracy itself.
- The protection of a set of core values, for example individual freedoms.
- Cases where the legislature and executive *for systemic reasons* are unable to discharge properly a particular role. In other words, for reasons related to the nature of those two branches of government, a *fundamental and perennial disability* vis-à-vis the particular role exists, leading the makers of the constitution to entrust it to another institution.

The third ground, that of "systemic inability", is the only possible ground for an independent Reserve Bank. We look at it in more detail.

One example of limitation on the grounds of systemic inability is the system of justice. The separation of the judicial branch from the legislature and the executive is based on the insight that members of the latter two are charged with the representation of interests of their electorate, a particular portion of the citizenry. This representational role precludes the exercise of a function premised on disinterested application of the law. Another example is the position of the auditor.

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<sup>1</sup> The only pre-20th century cases of inflation in excess of 100% per annum occurred during the rare occasions when fiat money was issued when the existence of the state were threatened: during the French Revolution, during the American War of Independence, and by both sides during the American Civil War.

general who, having to audit the activities of the executive, cannot at the same time be under their control.

The ground of systemic disability ought to be applied rarely and circumspectly. Removing a function of government from the supervision of the democratically elected representatives is no light matter. On the other hand, these autonomous bodies, if animated by a clear and beneficial imperative, are a valuable component of democratic societies. They fulfil tasks and protect citizens' interests in ways which the other organs of government cannot do.

Thus, if a new strong case of systemic disability is found, the society, state and the democratic process are served by the creation of a suitable autonomous body.

### *Monetary Policy as an Instrument of Governance*

We now investigate the nature of monetary policy as an instrument of government by looking at in turn at its two classical objectives, price stability and employment growth.

#### The objective of price stability, and its real effects

Instability - in the price level, rate of inflation, and interest and exchange rates - depresses investment in productive capacity, and therefore growth. The instability increases uncertainty, which raises the returns required by investors before they are willing to invest. The link between macroeconomic stability and the levels of fixed investment is borne out by the evidence.<sup>2</sup> Instability also retards the efficient allocation of resources by blurring the relative values of different activities. Inflation and its attendant volatility is the root cause of almost all manifestations of macroeconomic instability.

Inflation is both a tax and a mechanism for redistribution. But its operation is opaque, arbitrary and sometimes regressive. Inflation is a tax on all persons who hold money, leaving them poorer while the government, as the issuer of money, gains. This tax is regressive, because currency is a larger part of a poor person's assets or income than a wealthy person's. It is a tax which falls more heavily on the financially unsophisticated, who do not or cannot hedge against inflation.

Inflation, when it is unexpected, redistributes income from citizens with nominally denominated claims to those against whom they hold the claims. Examples of those who lose are pensioners and recipients of social security, depositors with fixed interest rates, and workers with wages fixed in nominal terms.

Of course, taxation and redistribution are not in and of themselves bad, but inflation is a bad way to do it. It is never clear exactly who is bearing the inflation tax, and at what cost. In the case of redistribution, it is not clear who the beneficiaries are, how much each gets, and why they would deserve this handout. In short, the laborious but necessary budgetary legislative process that other

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<sup>2</sup> See Servén and Solimano (1993).

taxes and programmes go through to estimate their effects and to ensure that they are in the national interest are in the case of inflation not only avoided, but also to some extent impossible.

Hidden, arbitrary and uncosted taxation and redistribution is simply not in keeping with good representative democracy, especially if the underlying tendency of the instrument is regressive.

Given these negative consequences of inflation, why is inflation such a ubiquitous phenomenon? Are there other real effects which are beneficial, for example employment and output growth?

### The objective of employment and output growth

Governments are particularly interested in monetary policy as a tool to stimulate employment and output in the economy. The claim that monetary policy can be used to stimulate output and employment deserves close scrutiny.

Most economists agree that only *unanticipated* or *surprise* monetary policy can influence output and employment in the real economy. The mechanism is that unanticipated inflation erodes the real wages of workers, enabling firms to increase output and hire additional employees. If the inflation rate rise had been perfectly anticipated at the time of wage-setting, the real wage rate would not fall, and there would be no impact on either output or employment.

How lasting would the benefits of such a surprise bout of inflation be? Here, too, a remarkable professional consensus now exists that monetary expansion engineers at best a false dawn. The increased output from monetary expansion is transitory, but leaves the country with a permanent increase in the level of inflation. Further, the output effects, such as there are, are difficult to time and control.

*(The importance of surprise also means that a legislature or executive which exercises monetary power by way of announcing monetary policy objectives, and which keeps to its word, effectively gives up all possibility of using monetary policy to influence employment and output).*

### How other economic actors nullify the output effect of monetary stimulation

However, both theory and evidence now suggest that all employment and output effects, whether limited or not, may turn out to be illusory in any event. This is due to the ability of economic actors to anticipate the actions of a monetary policy-maker.

To understand this, we return to the point that monetary policy only stimulates jobs and output by way of a bout of inflation which had not been anticipated in the previous round of wage negotiations.

A government which announces a particular inflation target, which then becomes the basis of wage settlements, will immediately have an incentive to renege on the target, as that will lead to

an increase (albeit temporarily, as we suggest above) in output and employment. This is how monetary policy is used to stimulate employment!

However, in the real world the wage negotiators realise this, and increase their wages in anticipation of the *higher* inflation rate. Now the government is caught in a bind. If it does not match the inflation rate anticipated in the wage increases, the real wage level *increases*, leading to a drop in output and production. So it is forced to allow the money supply to expand to reach that inflation rate. The result is bad for all concerned: high inflation and no spurt in output.

The reader should take time to appreciate the power of this insight. In all cases where the policy-maker has the discretion to change policy, and is concerned about employment, it will have an incentive to inflate in order to have output and employment spurt. Yet, when other agents, for example unions and management, have sufficient knowledge, they will pre-empt this move in order to protect real wage rates. They build in a higher increase in nominal wages, which eventually leaves the country a high inflation rate and no output spurt.

*When the objectives of monetary policy is at the discretion of a policy-maker who cares about employment as well as stability, the perverse effect is that stability is sacrificed with no gain, even temporarily, in employment.*

This is essentially what is meant by the notion of "dynamic inconsistency" first propounded in 1977 by Finn Kydland and Edward Prescott<sup>3</sup>, and subsequently applied to monetary policy by Robert Barro and David Gordon in their seminal 1983 article.<sup>4</sup> While simply stated here, this argument is the theoretical basis for the dramatic movement to central bank independence since the mid-1980s.

This analysis does not rely on assumptions about parliamentary short-sightedness or political opportunism. The policy-maker is assumed to be well-informed and benevolent. The root of the problem is a *systemic* weakness, a species of what is known in game theory as "the prisoners' dilemma," where lack of certainty leads to an outcome undesirable to all.

How can this fate be avoided? Theory does hold out three possible solutions to the problem..

The first solution is that the government acquire a reputation which they find valuable to protect. The second possibility is to institute rigid rules for managing the money supply that cannot be deviated from. However, the building of reputation presupposes a costly learning period, which starts afresh after every election.<sup>5</sup> And the institution of strict and specific rules is simply too inflexible to deal with the occasional external shock to the economy.

<sup>3</sup> "Rules rather than discretion: The inconsistency of optimal plans." *Journal of Political Economy* 85: 473-492.

<sup>4</sup> Rules, discretion and reputation in a model of monetary policy. *Journal of Monetary Economics* 17:101-122.

<sup>5</sup> A new policy-maker, say the legislature, needs to build its reputation. This it can only do by repeatedly confounding the inflationary expectations of wage-setters, which entails precipitating recessions and layoffs. Every time there are new policy-makers, or a new government, this costly process has to be repeated.

The third solution is to leave monetary policy to an independent agency which does not have the incentive to renege, and so avoids the sub-optimal outcome. It will only have no such incentive if it clearly limits its objective to the stability of the value of money. In so doing, it ensures more stability, *at no cost to jobs and output*, and with the prospect of higher growth. This solution, essentially the institution of an independent reserve bank, is the most attractive one, and has been implemented widely. In the next section we turn to the evidence to see whether it has worked.

*It follows from the above that the proposal that the Reserve Bank be given implementational independence, while allowing the elected authorities to set the objectives a solution, does not resolve the systemic weakness.*

That proposal, unfortunately, is simply a recipe for precipitating the undesirable outcome. Because the discretion of the elected authorities in the setting and re-setting of targets cannot be limited, the sequence of events described above is set into motion, and society ends up with high inflation and no gain in output.

### Evidence on how central bank independence affects the real economy

In earlier years, research in this area was inhibited by the difficulty in measuring central bank independence. This has been overcome very successfully by Cukierman's composite measurement of independence using sixteen variables to measure legal independence and nine variables to measure functional independence, of which the most important is the average turnover rate of governors. The data set covers 70 countries for the period 1950-1989.<sup>6</sup>

The exercise, the most comprehensive of its kind, points out that in developed countries, there is a statistically significant negative relationship between the level of legal central bank independence and the level of inflation. *Inflation is lower in countries where there is central bank independence defined constitutionally or by statute. In developing countries in particular, the study shows that developing countries with lower actual independence tend to have higher inflation rates.*<sup>7</sup>

The study finds a similar relationship between central bank independence and the *variability* of inflation. Thus there is persuasive evidence for the salutary effect of central bank independence on macroeconomic stability.

We now turn to the effects of independence on growth and investment. The first analyses of this question were limited to industrial countries and did not control for other important determinants of growth.<sup>8</sup> These efforts have been superseded by the more comprehensive study of Cukierman,

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<sup>6</sup> The statistical exercise is reported in Cukierman, A., Webb, S. B., and Neyapti, B., "Measuring the independence of central banks and its effects on policy outcomes," *The World Bank Economic Review* 6:3 353-398, and in Cukierman, A. *Central Bank Strategy, Credibility, and Independence: Theory and Evidence* 349-454.

<sup>7</sup> This bears out earlier work by Alesina, as well as by Grilli, Masciandaro and Tabellini, on various subsets of countries that showed that there was a strong negative relationship between independence and inflation.

<sup>8</sup> See Grilli, Masciandaro, and Tabellini, "Political and monetary institutions and public financial policies in the industrial countries," *Economic Policy* 13: 341-392, and Alberto Alesina and Lawrence H. Summers, "Central

Kalaitzidakis, Summers and Webb.<sup>9</sup> *The study finds there is a significant positive relationship in developing-countries between central bank independence and growth - in other words, the more independent the central bank, the higher the growth rate.*

The study also yields some empirical support for the view that low central bank independence retards private investment and reduces the share of equipment investment in GDP.

Is an independent central bank a justifiable limitation on democracy?

We can now respond to the question we set out to address:

Do the elected branches of government have a systemic disability in the making of monetary policy which, in the interests of the citizenry, ought to be addressed by an independent reserve bank?

We believe that the analysis and evidence presented above indicate a clear "yes". The phenomenon of dynamic inconsistency, whereby the very discretionary nature of legislative decision-making combined with concern for unemployment perversely leads to a loss of stability with no employment pay-off, is now well-established as a *systemic* disability on the part of the elected branches in monetary policy.

The experience of other countries bears this out. The more independent the central bank, the lower inflation and the higher investment - and, in the case of developing countries, the higher economic growth.

In addition, reserving the setting of monetary objectives for the legislature not only scotches any chance of an employment effect, but also reinforces the systemic weakness we are trying to avoid. The problem can be resolved by simply returning to a well-stated central bank independence provision in the constitution as earlier envisaged by Theme Committee 6(2) of the Constitutional Assembly.

*Simply put, society is consistently better off when monetary policy is left to an independent body concerned only with price stability: There is lower inflation, with no loss in output.*

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bank independence and macro-economic performance: Some comparative evidence," Unpublished manuscript, Harvard University.

<sup>9</sup> "Central bank independence, growth, investment and real rates." Unpublished manuscript, February 1993.