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CONSTITUTIONAL ASSEMBLY

THEME COMMITTEE 6.2

FINANCIAL INSTITUTIONS AND PUBLIC ENTERPRISES

22 MAY 1995

12H00

V475, OLD ASSEMBLY CHAMBER

DOCUMENTATION

EMBARGOED UNTIL MONDAY, 22 MAY 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:	22 May 1995
Time:	12h00
Venue:	Room V475, Old Assembly Wing

AGENDA

1. **Opening and Welcome**

2. **Notice of meeting and Agenda** **(p1)**

3. **Adoption and noting of previous minutes**

   3.1 TC6.2 Minutes: 8 May 1995 **(p2-4)**
   3.2 TC6.2 Minutes: 16 May 1995 **(p5-7)**

4. **Law Advisor's reformulated draft on the Auditor General**

   Document to follow

5. **South African Reserve Bank**

   Further debate on the independence and impartiality of the SARB

6. **Report back of the CA proceedings**

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 8 MAY 1995

PRESENT

Davies R (Chairperson)

Andrew K
Hogan B
Makgothi H
Marais G
Nair B
Welgemoed P

Apologies

Botha WJ
Chiole J
Marcus G

Absent

GG Woods
H Bekker

In attendance: Fahrenfort P, C Rustomjee (Technical Advisor), S Nyoka. T Kgosidintsi and JP Vermaak (CPG)

1. **Opening and Welcome**

   The Chairperson opened the meeting at 09h05 and welcomed the members present.

2. **Notice of meeting and agenda**

   The Agenda was adopted.

3. Adoption and noting of previous minutes

The minutes of the meeting held on 3 April 1995 were adopted and signed.

4. Tabling and discussion of TC6.2's report on the SARB and the Auditor General

4.1 Schematic Summary of SARB

The Committee noted the Secretariat's schematic summary of the SARB.

4.2 Law Advisor's Draft - Constitutional Formulation on SARB

The Committee accepted the Draft Constitutional formulation prepared by the CA Law Advisors noting proposals put forward by the DP, namely that "such a law shall not derogate from the independence and primary objective of the South African Reserve Bank" and the ANC that the consultation between the Governor and the Minster of Finance should be "in consultation with" rather than "after consultation".

4.3 Schematic Summary of AG

After some discussion the Committee noted the following two positions regarding the role of the Auditor General namely **(a)** that there must be a constitutional obligation for the Auditor General to conduct audits at all levels of government in all and publicly funded institutions and **(b)** that the constitutional requirement be extended to local government and that legislation should provide for the remainder.

It was agreed that the committee meet on Thursday 11 May 1995 at 13h00 to discuss the draft report by the Law Advisors on the Auditor General.

5. Invitations

5.1 National Business Public Hearing

The Chairperson agreed to attend this hearing.

5.2 Meeting with Constitutional Expert

The Committee agreed that members from TC3 will be attending this meeting.

5.3 Workshop on Institutionalization of Intergovernmental Relations

The following members agreed to attend the above workshop:

H Makgothi, K Andrew and G Marais.

6. Report on the National Revenue Fund and other Constitutional Provisions on Financial Institutions

The Committee agreed to hold this over and include it in its final report.

7 Party Submissions on National Revenue Fund

7.1 National Party

7.1 ANC

The Committee noted the DP's request for an extension of time to hand in their submission.

There being no further business the meeting ended at 10h16.

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CHAIRPERSON

....
DATE

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CONSTITUTIONAL ASSEMBLY

THEME COMMITTEE 6.2

FINANCIAL INSTITUTIONS AND PUBLIC ENTERPRISES

TUESDAY 16 MAY 1995

PRESENT

Davies R (Chairperson)

Andrew K
Botha WJ
Jacobsz F
Makgothi H
Marais G
Marcus G
Nair B
Welgemoed P

Apologies

Hogan B

Absent

Woods GG

In attendance: P Fahrenfort, C Rustomjee (Technical Advisor), S Nyoka

1. **Opening and Welcome**

   The chairperson opened the meeting at 13h35 and welcomed the members present.

2. **Law Advisor's Draft Constitutional Formulation on the Auditor General**

   The committee dealt with the individual chapters of the of the law advisor's draft constitutional formulation on the Auditor General and agreed as follows:

2.1 *Establishment, independence and impartiality*

- section 2.(1) be reformulated as follows:

  The Auditor-General shall audit and report on accounts and financial statements of the following:

  (a) all state of departments and administrations at national, provincial and local levels of government, including all trust, special and other separate accounts kept in such departments and administrations

  (b) all accounts and statements required by a law to be audited by the Auditor-General.

- s2(3) and (4) be deleted provided the notion of audit referred to in s2(2) is construed to include performance audits.

2.2 *Reports*

- s3(1) <u>authorities</u> designated by law. The authorities referred to in this section need to be specified in detail.

2.3 *Appointments, qualifications, tenure and dismissal*

- s4(1) to be formulated as follows:

  The President shall whenever it becomes necessary appoint as Auditor-General a person-

  (a) nominated by a joint committee of the Houses of Parliament, composed of one member of each party represented in Parliament and willing to participate in the committee; and

  (b) approved by the national Assembly and the Senate by resolution adopted, without debate, by a majority of at least two-thirds of the members present and voting at a joint meeting

A further suggestion was made that the following provision be included in s4:

The Auditor-General shall not hold office in any political party or political organisation.

2.4 Staff and expenditure

It was agreed that provisions on staff and expenditure be constitutionalised.

It was agreed that all the above changes be brought to the attention of the law advisors for purposes of reformulation and that the amended draft be circulated for the meeting to be held on Monday 22 May 1995.

3. Report back of Constitutional Committee (CC) meeting held on Friday 12 May 1995

The Chairperson reported that the draft constitutional formulation on the SARB was tabled at the Constitutional Committee meeting on 12 May 1995.

It was noted that the CC recommended that the draft formulation be referred back to the Sub-theme committee in order to re-examine the issue of the independence and impartiality of the SARB and that a revised report be forwarded to the Constitutional Assembly (CA) for its consideration.

Following a lengthy discussion on whether the draft report be tabled at the CA, it was decided that it should not be. However, it was pointed out by the Secretariat that the committee's decision not to have the report tabled at the CA could be in conflict with the CC's decision that the report be so tabled.

The committee agreed that in the event of the CC insisting on having the SARB report tabled at the CA, the Chairperson of the committee would deal with the matter at the said CA meeting, highlighting that a debate within the committee on the issue of independence and impartiality of the SARB has not been resolved.

There being no further business the meeting ended at 15h20.

....

CHAIRPERSON

....

DATE

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2. SOUTH AFRICAN RESERVE BANK[27]

Establishment

1. (1) There shall be a South African Reserve Bank[28] which shall be the central bank of the Republic. The Reserve Bank shall be regulated by law.[29]

(2) The South African Reserve Bank shall be independent, impartial and subject only to this Constitution and the law.[30]

Primary objective

2. The primary objective of the South African Reserve Bank is to protect the internal and external value of the currency of the Republic in the interest of balanced and sustainable economic growth in the

[27]Prepared on basis of Report from Theme Committee 6.2 as at 9 May 1995. The following formulations should be read with the annexed legal opinion.

[28]It is suggested that the indirect way in which section 195 of the Interim Constitution secures the establishment of a Reserve Bank be replaced by a direct constitutional requirement that "there shall be a South African Reserve Bank".

[29]The requirement in section 195 that the SARB be regulated "by an Act of Parliament" is too specific and may eventually give rise to legal uncertainty, for instance whether the Bank could be bound by subordinate forms of legislation or ministerial directives issued under an Act of Parliament. It is suggested that "Act of Parliament" be replaced by the broader term "law". As the Reserve Bank will fall within Parliament's exclusive sphere of legislative competence there is no danger that the Bank can be regulated otherwise than by or under an Act of Parliament.

[30]This provision is suggested for inclusion in the text in order to comply with CPXXIX which requires the Constitution to provide for an "independent" and "impartial" Reserve Bank. The formulation used in section 196(2) of the Interim Constitution was not followed as this formulation does not satisfy CPXXIX. It does not refer to "impartiality" at all and further restricts the Bank's independent exercise of powers only to cases where it pursues its primary objective. Furthermore, the statement in section 196(2) that the Bank shall be subject only to "the Act of Parliament referred to in section 197" is constitutionally untenable. The SARB like all other institutions, including the Constitutional Court, is subject to the Constitutional and the law of the land.

Republic.[31]

Powers and functions

3. (1) The powers and functions of the South African Reserve Bank shall be as prescribed by law. They shall be at least similar to those powers and functions customarily discharged by central banks.[32]

(2) There shall be regular consultation between the South African Reserve Bank and the Minister responsible for national financial affairs on the discharge by the Bank of its powers and functions.[33]

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[31]The provision is similar to section 196(1) except for the insertion after "currency" of the words "of the Republic".

[32]Reformulation of section 197 of the Interim Constitution. The phrase in section 197 referring to the conditions upon which the Bank may exercise its powers, falls away in view of the proposed section 1(2) above.

[33]This provision is based on the proviso to section 196(2).

ANNEXURE

LEGAL OPINION : INDEPENDENCE AND IMPARTIALITY OF SOUTH AFRICAN RESERVE BANK

1.

We were requested by the Constitutional Committee to provide an opinion on the constitutionality of certain proposed adjustments to the draft on the S A Reserve Bank discussed by the Committee on 12 May 1995.

2.

The first proposal relates to clause 3(2) which reads as follows:

"There shall be regular consultation between the South African Reserve Bank and the Minister responsible for national financial affairs on the discharge by the Bank of its powers and functions."

3.

The suggestion by one of the parties was that this clause be changed in order that "consultation", as used in the clause, bears the meaning "in consultation with" and not the weaker "after consultation with".

4.

It is generally accepted that "in consultation with" means "with the concurrence of". This was also the accepted position in the Kempton Park process in relation to a number of constitutional provisions in which this expression was used. Eventually section 233(3) was inserted in the Interim Constitution to make it clear that where a functionary is required by the Constitution to take a decision in consultation with another functionary, the decision shall require the concurrence of the second functionary.

5.

Clause 3(2) deals with consultation between the Bank and the Finance Minister on the discharge by the Bank of its powers and functions. The adjustment of the clause as suggested would in our opinion have the effect that the SARB would be unable to exercise its powers and functions otherwise than with the concurrence of the Minister. It must be noted that the provision will affect all powers and functions of the Bank and not only those, for instance, which pertain to its primary objective. The result would be that no decision by the Bank on whatever matter within its competence would be capable of being implemented without the Minister's sanction.

6.

This raises the important question whether such a provision would be consistent with CP XXIX. This Principle reads as follows:

"The independence and impartiality of a Public Service Commission, a Reserve Bank, an Auditor-General and a Public Protector shall be provided for and safeguarded by the Constitution in the interest of the maintenance of effective public finance and administration and a high standard of professional ethics in the public service".

7.

It is common cause that this Constitutional Principle requires the inclusion in the new constitutional text of provisions providing for and safeguarding the independence of, inter alia, the SARB. It also indicates the context in which the independence of the Bank should be safeguarded in the new text, viz "in the interest of the maintenance of effective public finance and administration".

8.

In our view a provision which precludes the Bank from exercising any of its powers and functions otherwise than with the concurrence (approval) of the Minister of Finance would effectively neutralise its independence and would be inconsistent with CP XXIX.

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9.

However, during the discussion of this matter in the Constitutional Committee it was explained that the proposal was not intended to relate to the "operational independence" of the Bank, but to what was called "goal independence". In other words, the Bank should be free to exercise its powers and functions without ministerial intervention but within broad policy objectives or guidelines determined by the Bank "in consultation with" the Minister.

10.

As stated in par. 7 above CP XXIX requires constitutional safeguarding of the SARB's independence for a particular purpose, viz "in the interest of the maintenance of effective public finance and administration." In our view these words circumscribe the degree of "independence" intended here. We do not understand the Principle to require the Bank's independence to extend beyond the stated interest. Independence is not used in the Principle in the absolute sense, i.e. that the Bank should be free to operate in virtual isolation of the executive structures of government.

11.

Effective public finance and administration would in fact require the Bank to exercise its powers and functions with due regard to the realities of the day, including the policies of the government of the day. Intensive interaction between the Bank and the government, especially on ~~broad~~ policy guidelines to be applied by the Bank, would seem to us to be a natural prerequisite for effective public finance and administration. In our view a constitutional provision which would vest in the Minister a right to be party to the determination of ~~broad~~ policy frameworks relating to the bank's exercise of its powers and functions, would not detract from the Bank's independence as contemplated in CP XXIX.

12.

Whether or not the new constitutional text should contain such a provision is a purely political matter on which we express no opinion. However, in order to assist the process we have drafted the following provision for purposes of debate. It should be read as an addition to the present clause 3(2):

"The Bank shall discharge its powers and functions with due regard to a policy framework determined in the interest of the maintenance of effective public finance and administration by the Bank in consultation with the said Minister."

13.

The second proposal relates to clause 3(1) of the draft. Here one of the parties proposed that the clause be adjusted by inserting in the clause the words underlined below:

"The powers and functions of the South African Reserve Bank shall be as prescribed by law. <u>Such a law shall not derogate from the independence and primary objective of the Bank</u>. They shall be at least similar to those powers and functions customarily discharged by central banks."

14.

In our view the insertion of the words underlined is not really necessary as the law (statute) referred to in clause 3(1) will in any event have to be consistent with clauses 1(2) and 2 of the draft which provide for the independence and primary objective of the Bank, respectively. If the law in question deviates from these, or any other, constitutional provisions it will be invalid to the extent it so deviates. In fact this is what supremacy of the Constitution is all about. Laws must be consistent with the Constitution and if they are not they are null and void. The underlined words are superfluous and their inclusion in the draft is not supported.

CA Law Advisors
15 May 1995

LSE crefsA

Centre for Research into Economics & Finance in South Africa

QUARTERLY review

january 95

Centre for Research into Economics and Finance in South Africa

The Centre was established at the London School of Economics by the Commonwealth Heads of Government in 1990 to study the role of international finance in the South African economy. Until September 1994, the Centre was known as the Centre for the Study of the South African Economy and International Finance. The Centre was relaunched under its new name in October 1994 to mark the beginning of a new research programme funded by the UK Overseas Development Administration.

The Centre's objectives are twofold. First, to contribute to discussions of economic policy in South Africa by producing sound and timely economic research. Second, to contribute to specialist capacity building within South Africa in the area of economic policy, through its Distinguished Visitors Programme. The Director of the Centre is Dr Jonathan I. Leape.

Independence and accountability: The role and structure of the South African Reserve Bank

This Special Issue of the Quarterly Review provides a summary of the proceedings of a workshop on the role and structure of the South African Reserve Bank which was organised by the Centre and held at the South African Reserve Bank in Pretoria on 9th and 10th January.

■ This Quarterly Review was prepared by Jonathan Leape, Maria Ramos and Lynne Thomas. It is intended as a useful reference document for those interested in the South African economy. While care has been taken to ensure that information displayed is accurate, we do not accept any liability for any errors. ■

On the 9th and 10th of January, the Centre co-hosted a workshop with the South African Reserve Bank on "Independence and Accountability: The role and structure of the South African Reserve Bank". The workshop was organised by the Centre with the aim of contributing to the constitutional debate on the role of the South African Reserve Bank and also to the broader debate on issues surrounding central bank independence by creating a dialogue between South Africans active in the Reserve Bank debate and individuals with international experience of central banking issues.

The core group of twenty-one participants included central bankers, politicians, academics, and civil servants. The workshop was hosted by the South African Reserve Bank in Pretoria and international participation was made possible through financial assistance from the UK Overseas Development Administration. The workshop was opened by Dr Chris Stals, Governor of the Reserve Bank, and chaired by Dr Jonathan Leape, Director of CREFSA.

In this special issue of the *Quarterly Review*, we summarise the background papers presented at the workshop and review the key issues that were raised in discussion. The Centre intends to publish the full proceedings of the workshop later in the year. In the remainder of this introduction, we provide some background on the debate over the future role of the South African Reserve Bank and also on the issues that have driven the wider international debate on central bank independence.

■ The debate on the South African Reserve Bank

The Interim Constitution, which came into effect on the 27th April 1994, refers explicitly to the independence of the South African Reserve Bank. The clauses relating to Reserve Bank are as follows:

> *195. The South African Reserve Bank, established and regulated by an Act of Parliament, shall be the central bank of the Republic.*
>
> *196. (1) The primary objectives of the South African Reserve Bank shall be to protect the internal and external value of the currency in the interests of balanced and sustained economic growth in the Republic.*
> *(2) The South African Reserve Bank shall, in the pursuit of its primary objectives referred to in subsection (1), exercise its powers and perform its functions independently, subject only to an Act of Parliament referred to in section 197: Provided that there shall be regular consultation between the South African Reserve Bank and the Minister responsible for national financial matters.*
>
> *197. The powers and functions of the South African Reserve Bank shall be those customarily exercised and performed by central banks, which powers and functions shall be determined by an Act of Parliament and shall be exercised or performed subject to such conditions as may be prescribed by or under such Act.*

Moreover, the independence of the Reserve Bank is included as one of the Constitutional Principles to be enshrined in the new Constitution which is currently under debate.

Although the commitment to an independent Reserve Bank is therefore not in question, the form which this independence should take is now the subject of discussion and debate by the "theme group" appointed by the Constituent Assembly to examine all financial matters arising in the Constitution.

The workshop was designed to capture the fundamental issues which are likely to form the basis of discussion and debate on the issue of Reserve Bank independence in this group in the coming months as well as in broader discussions of the role of the Reserve Bank.

The clauses governing the Reserve Bank in the Interim Constitution reflects a clear choice between two aspects of independence. The first is "goal independence", which refers to the choice of the primary goal for monetary policy. The second is "instrument independence", which refers to the choice of instruments and the ability to use these instruments to achieve the primary goal. It has been argued that the choice of policy goals is a fundamental political one that should, therefore, be made by democratically-elected officials and not by an unelected body such as the central bank.

Accordingly, the Interim Constitution does not give the central bank goal independence but instead sets the primary goal of maintaining the internal and external value of the currency. However, the Interim Constitution and the Constitutional principles explicitly protect the independence of the Reserve Bank with respect to the instruments that it uses to achieve this goal. In other words, the Bank is to have instrument independence but not goal independence.

In recent years, the Reserve Bank has become increasingly independent in its conduct of monetary policy. This *de facto* independence was commented upon by Dr Chris Stals, Governor of the Reserve Bank, during a discussion on the philosophy of central banking at the Bank of England's Tercentenary Symposium in June 1994 (see Capie, Goodhart, Fischer and Schnadt, 1994, in *References*).

He argued that the political transition in South Africa had meant that politicians had had "little time for the central bank and for monetary policy". He noted that the Reserve Bank used the opportunities presented during this time to transform the Bank in an attempt to make monetary policy more effective. However, he also commented that this period of relative isolation had taught the Bank the importance of cooperation and regular consultation between the governor of a central bank and the minister of finance.

The task now facing the Reserve Bank is to build on the achievements made during this period of *de facto* independence to gain the support of the different communities that it serves. In this regard, there was much discussion within the workshop on the need to establish effective mechanisms to ensure accountability and the coordination of economic policies. Further, many participants in the workshop emphasised the importance of internal restructuring of the Reserve Bank such that it becomes more open, transparent, and representative of the diversity of the population as a whole.

In the following section, a summary of the workshop paper by Chris Stals and Mike van Rensburg provides a overview of the current structure and responsibilities of the South African Reserve Bank. It is complemented by an outline of the presentation made at the workshop by the Deputy Minister of Finance, Alec Erwin, which provides an overview of the government's economic policy.

■ The economic case for independence

In granting its central bank independence, South Africa has conformed with what has become a worldwide trend to narrowly define the primary goal of the monetary authority as that of price stability. The support for central bank independence among economists and central bankers has increased dramatically in recent years and a substantial literature has emerged on the issue.

The key empirical result which much of the literature is based (and draws its support from) is the negative correlation between the average rate of inflation and central bank independence. In explaining this relationship, much of the literature draws on the work of Kydland and Prescott (1977) and Barro and Gordon (1983) which argues that there is no long-term trade-off between inflation and unemployment. Moreover, these papers argue the public perceives governments to be incapable of committing to a low inflation policy because of electoral pressures such that a credibility problem arises.

However, the evidence on the importance of the "credibility bonus" arising from central bank independence is mixed. Fischer (1994) finds little evidence of a credibility bonus in the labour markets: even strongly independent central banks have to fight hard to bring inflation down when an inflationary shock has struck.

He also finds that there remains a short-term trade-off between the price level and output stability, which essentially means that governments must decide how inflation-averse they want their central banks to be. In making these economic policy choices, governments have to consider not only the preferences of the electorate, but also a number of institutional arrangements and operational techniques.

It is clear from the literature and practice of central banking that the debate has shifted from operational techniques (such interest rate control versus monetary base control; rules versus discretion) to concern with structure, incentives and accountability - in other words, the fundamental issues which collectively define central bank independence (Capie, Goodhart and Schnadt, 1994). This change in focus implies that consideration must be given to not only the structure of the central bank, its role and mandate, but also to the broader institutional framework in order to understand how monetary policy will interact with other economic policies.

The main conclusion to be drawn is that legal independence and the credibility it attaches to the central bank is a necessary but by no means sufficient condition for price stability. Other factors play an equally important role. The work of Alesina and Summers (1993) shows that increased central bank independence and the focus on a single objective, namely price stability, is associated with improved inflation performance without any real costs in terms of economic growth.

Narrowing the central bank's mandate so that it has no goal independence but has instrument independence is also a key factor in overcoming the inflationary bias of policy - the ability to use its instruments freely to achieve the given policy goal of price stability was shown by Fischer (1994) to be highly correlated with lower inflation.

The economic arguments in favour of central bank independence are considered in the workshop paper by Charles Goodhart. This paper also provides a selection of readings from the most recent studies of central bank independence.

The paper by Manuel Guitián also considers these arguments and analyses the implications of central bank independence for financial regulation and supervision and for exchange rate policy. Guitián considers alternative forms of independence, focusing particularly on the existence of government override or directive powers.

Central bank independence in the context of regulation and supervision is considered in-depth in the paper by Peter Hayward. Hayward highlights the importance of financial stability and the need for the supervisory process to be accountable to the various participants in the financial system.

The consequences of central bank independence for exchange rate policy in South Africa are examined in the workshop paper by Maria Ramos. Ramos considers how, in the presence of capital mobility, central bank independence can be limited by the choice of exchange rate policy by government.

These four papers are summarised in the third section of this *Quarterly Review*.

■ The political economy of central bank independence

The political economic dimension of central bank independence is likely to be an important area of debate in South Africa.

The impact of anti-inflationary policy on certain constituencies within society means many people must suffer "short-term pain for long-term gain". If a central bank is to use its independence effectively, it must gain the support and trust of the wider population in pursuing price stability - this means creating a public perception of the central bank as an institution concerned with the long-term benefits of society as a whole, and not serving the interests of a particular group.

An important component of gaining this broad support for the central bank's policies, is that the bank is seen to be sensitive to the needs of a range of different communities - as such the bank must be representative of society as a whole, both in terms of its board of directors and its staff.

The central bank must also embark on a widespread and ongoing educational campaign to build and maintain public support for anti-inflationary policies. Goodhart (1994) notes that:

> *(legal) independence, once granted, can only be maintained and effectively utilised by an unrelenting and continuous political and educational campaign to explain what*

monetary policy can, and cannot, effectively do

This point is especially relevant to developing countries, where legal independence has be shown to be of limited value in explaining inflation behaviour (Cukierman, 1992).

It is vital to establish well-functioning mechanisms for accountability of the central bank to the communities that it serves. One mechanism for ensuring accountability is the existence of formal override procedures. Fischer (1994) argues that the "undemocratic nature" of central bank independence means that there must be a process by which the government can override the decisions made by the central bank. He offers the examples of New Zealand, where the government has the right to override the policy decisions of the central bank but for a limited time only and with public disclosure, and of Canada where the minister of finance, with the agreement of Cabinet, may issue a monetary policy directive to the central bank, which must be made public.

Another important aspect of accountability is the need for transparency in the process by which the central bank formulates and implements policy. Transparency can be enhanced by the publication of target ranges for policy and Fischer (1994) argues that the central bank must be held accountable for achieving these targets. In addition, the publication of the minutes of meetings where policy decisions are made could be a further way of increasing transparency.

A further political dimension of central bank independence is the need for adequate consultation and policy coordination between the central bank and government. The central bank cannot successfully pursue its objective of price stability in an environment where the government's economic policies are incompatible with this goal (for example, if fiscal policy is over-expansionary). The central bank must therefore play a role in helping the government to understand the importance of price stability and making it a key goal of the overall economic framework.

The importance of policy coordination suggests that there should not only be regular meetings between the central bank governor and the minister of finance to ensure the day-to-day coordination of policies, but also a wider forum for agreeing a consistent economic framework.

These issues are considered in the fourth section of this *Quarterly Review* which summarises the workshop papers or presentations relating to the political economy of central bank independence.

The presentation by Gerald Corrigan provides an overview of the importance of accountability, policy coordination and the role of the central bank in the community and draws on his experience within the US Federal Reserve System.

The paper by Walter Fauntroy provides recommendations for South Africa on achieving accountability through legislative oversight and appointment procedures. These recommendations are based on efforts in the US to make the Federal Reserve more accountable.

An interesting case study of the successful outcome of central bank independence in Chile is discussed in the paper by Andrés Bianchi. This discussion is particularly relevant for South Africa as central bank independence in Chile was established during a period of political transition to democracy where issues of accountability and representation were at the forefront of the debate on the independence of the Chilean central bank.

Finally, the possible mechanisms for policy coordination and consultation in South Africa are considered in the paper by Ebrahim Patel, which argues for a strong role for the newly established National Economic, Development and Labour Council.

In this section we provide brief biographies of the workshop's speakers, together with a list of other participants. The papers summarised in this *Quarterly Review* were presented by their authors in personal capacity and do not necessarily reflect the views of the institutions to which they are affiliated.

■ Biographies of speakers

Andrés Bianchi was the first Governor of Chile's independent central bank, between 1989 and 1991. He is currently President of Banco Credit Lyonnais Chile and is consultant to the World Bank and the Inter-American Development Bank.

Gerald Corrigan was President and Chief Executive Officer of the Federal Reserve Bank of New York and also served as the Chairman of the Basle Committee on Banking Supervision. He is currently the Chairman of International Advisors at Goldman Sachs.

Alec Erwin is South African Deputy Minister of Finance. Before entering parliament, he was Education Secretary at the National Union of Metalworkers of South Africa and a member of the Cosatu negotiating team at the National Economic Forum.

Walter Fauntroy is a former US Congressman. He has served on the House Banking, Finance and Urban Affairs Committee and was chair of the Subcommittee on Domestic Monetary Policy, responsible for oversight of the Federal Reserve Bank.

Charles Goodhart is Professor of Banking and Finance at the London School of Economics. He was previously Chief Advisor at the Bank of England and has written extensively on central banking.

Manuel Guitián is Associate Director of the Monetary and Exchange Affairs Department at the International Monetary Fund and is involved in providing technical assistance in central banking and monetary and exchange policies.

Peter Hayward is Senior Advisor on Africa and Latin America at the Bank of England. He has previously been Deputy Secretary for Monetary Affairs in Hong Kong and served as the Secretary of the Basle Committee.

Jonathan Leape is Director of CREFSA. He was consultant in finance for the African Development Bank study of regional integration and recently served as Specialist Advisor on Southern Africa to the UK House of Commons Select Committee on Trade and Industry.

Ebrahim Patel is Deputy General Secretary of the South African Clothing and Textiles Workers Union and was a labour representative in the National Economic Forum.

Maria Ramos is Research Officer at CREFSA. She has been an advisor to the ANC Department of Economic Planning and was part of the ANC's constitutional negotiations team for finance issues.

Chris Stals is Governor of the South African Reserve Bank, a position he has held since 1989. He has held various other positions within the Bank over the past forty years and was Director General of Finance in the late 1980s.

■ List of other participants

Estian Calitz, *Director General, South African Department of Finance*

Mark Courtney, *First Secretary (Economics), British High Commission*

Callie Hugo, *Assistant to the Governor, South African Reserve Bank*

Brian Kahn, *Director of the School of Economics, University of Cape Town*

Gill Marcus, *Chair of the Joint Standing Committee on Finance*

Jacob H. Meijer, *Deputy Governor, South African Reserve Bank*

Ismail Momoniat, *South African Department of Finance*

Mike van Rensburg, *Head of Legal Services, South African Reserve Bank*

Christiaan J. de Swardt, *Deputy Governor, South African Reserve Bank*

Lynne Thomas, *Principal Research Assistant, CREFSA, London School of Economics*

PART 1: THE SOUTH AFRICAN FRAMEWORK FOR CENTRAL BANK INDEPENDENCE

Summary of the presentation by Alec Erwin

■ Introduction

Erwin began by stating that one of the central achievements of the Government of National Unity has been to reach agreement among the parties represented in the National Assembly on the Reconstruction and Development Programme (RDP) as the framework for economic policy. He argued that the approach of the Government of National Unity has been one that emphasises problem-solving and negotiations with key stakeholders. The main challenge that lies ahead is implementation.

The RDP has five policy areas which can be summarised as: (i) meeting basic needs; (ii) developing human resources; (iii) rebuilding the economy; (iv) democratising the economy; and (iv) efficient financing of the programme. These five areas must be integrated as far as possible and in this respect the need for fiscal and monetary discipline is clear. The RDP must be financed in a responsible, sustainable way, since rising interest rates and inflation would quickly undermine the ability of the RDP to achieve its objectives.

■ Restructuring the public sector

The government faces two key issues in its approach to delivering the aims of the RDP. First, what actions must the government take to restructure the public sector to meet the RDP; and second, how can the government facilitate the enhanced growth of the private sector.

Erwin argued that the restructuring of the public sector is essential. The lack of transparency and democratic accountability in the public sector inherited by the new government, as well as its fragmentation, severely limit its effectiveness in achieving the objectives of the RDP. He outlined the "six-pack" of programmes designed to achieve this restructuring.

Belt tightening The public sector needs to be more efficient and effective. The implementation of stringent controls on departmental spending can help to control overall spending and to free up significant resources for the achievement of new objectives.

Reprioritisation of expenditure While major restructuring of spending will not be in place until 1996-97, one of the government's first decisions was to set up an RDP Fund to be financed from enforced savings from departmental budgets. The RDP Fund was allocated R2.5bn in 1994-95 and will be allocated R5bn in 1995-96. The tight controls on departmental spending have forced departments to look closely at their priorities. The RDP Fund is intended to provide bridging finance to facilitate the transition to new priorities. Departments can apply to the Fund to finance projects integral to the RDP, although not for projects that have previously been rejected in the budget round. Overall government consumption expenditure will not be allowed to rise in real terms.

Public sector assets The reorganisation of public sector assets is needed for three reasons. First, the existing asset base is fragmented and distorted by past priorities. The new government's efforts to conduct a census of all state assets has been severely impeded by the fragmentation of information regarding assets and their use.

Second, the presence of large and ineffectively used state assets is immobilising resources. The government is investigating how restructuring strategies, including possible privatisation in certain areas, can help mobilise resources through, for example, debt reduction or the acquisition of new assets. The overall strategy for mobilising assets is scheduled to be completed by July 1995.

Third, financing mechanisms - especially for the provision of bulk infrastructure - must be made more effective. For example, housing development has been slowed not only by red tape but also by the lack of an effective process to finance the building of bulk infrastructure. There is a need to reorganise institutions like the DBSA to meet this need.

The public service The structure of the public service is far too complex; there are some 340 different job categories and 89 grades. In addition, the public service is bedeviled by a salary structure that, relative to the private sector, is too low at the low end *and* too low at the high end. However, within the public sector the differential between the bottom and top scales is too high. The government is determined to make the public service more effective. It has entered into a dialogue with the public service unions on how best to streamline the structure and enhance training. Finally, the public service must be made more representative.

Inter-government relationships The constitution establishes a framework for clearly defined financial relationships between levels of government. Revenues from the personal income tax, the value added tax and the fuel tax will be shared with the nine provincial governments. The biggest problem in inter-government relations is with local government. Local government will be responsible for most of the delivery of infrastructure, but is currently badly fragmented.

Performance monitoring The present capacity to monitor performance is weak and the intention is to strengthen this considerably.

■ Restructuring the private economy

Erwin then reviewed key points of the government's strategy for restructuring the private economy.

In the area of trade and industry, a salient aspect of government policy, as embodied in South Africa's agreement under the Uruguay Round of the GATT, is the liberalisation of trade policy. One aspect of this is the steady reduction of protective tariffs. Key sectors such as the motor industry, clothing and textiles and electronics are most affected by this tariff reduction. The government's approach is to work in partnership with the key actors in each industry in developing a restructuring strategy (many elements of which have been worked out in the National Economic Forum) to enhance competitiveness. A second aspect of liberalisation is the steady reduction in open-ended subsidies such as the General Export Incentive Scheme (GEIS). Government policy will be to pursue supply side measures that are more effectively targeted at long-term efficiency.

In the area of labour relations, the government is preparing a new labour law which aims to provide a new structural framework for relations between companies and unions in an environment of increasing competitiveness. The new legislation aims to establish an effective and efficient structure for bargaining and dispute resolution. More generally, the government is concerned to formalise support for micro-economic reforms.

The government's consultative approach to the restructuring of the private economy has been formalised in the establishment of the National Economic Development and Labour Council (Nedlac). The structure of Nedlac includes an Executive Council and four chambers - Public Finance and Monetary Policy, Trade and Industry, Labour Market, and Development - to facilitate the consideration of particular areas of economic policy. Nedlac builds on the success of the National Economic Forum and illustrates the approach to managing change with as much consensus as possible.

■ The role of the central bank

As the preceding comments demonstrate, the government does not wish to attempt to manage and influence all aspects of the economy. Following this approach, an autonomous central bank - operating within clear policy guidelines and accountability - is attractive to the government. The government would be pleased to delegate responsibility for certain aspects of economic policy to a competent and accountable central bank.

The government faces numerous challenges in the area of restructuring the financial sector and developing effective financing strategies. The government wants to encourage the extension of financial services to low income households and to increase transparency in lending decisions. The government also wants to encourage venture capital.

In addition, the government is concerned to protect small investors and to put into place a system for the supervision of financial markets and institutions that will be effective in an increasingly open economy.

Other important challenges include how best to establish a role in Africa; how to make effective use of international institutions such as the IMF and the World Bank; and how to restructure development finance (most particularly the DBSA).

The Reserve Bank can provide valuable expertise in these discussions as an advisor to government without cost to its autonomy. An important development in this regard is the Reserve Bank's special position within Nedlac which is part of the government's consensus-seeking approach to economic policy.

■ Conclusion

Erwin closed by emphasising that the government is not prepared to take short cuts. In giving priority to restructuring the budget process rather than attempting immediately to deliver on the RDP, it has demonstrated its commitment to fiscal discipline and ensuring that once programmes are started that they are sustainable.

Summary of "The role and structure of the South African Reserve Bank" by Chris Stals and Mike van Rensburg

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In this paper, Stals and van Rensburg set out the broad structure of the South African Reserve Bank in four keys areas: the legal framework; the institutional framework; the monetary policy framework; and the operational framework.

■ Legal framework

The South African Reserve Bank was founded in the early 1920s as part of a set of comprehensive measures to deal with the unsatisfactory monetary and financial conditions which prevailed at that time. The existence, management, powers and functions of the Bank are currently governed by the South African Reserve Bank Act No 90 of 1989.

More recently, the Reserve Bank was directly identified for the first time as the central bank of South Africa by the Interim Constitution of 1993. This Constitution, which came into effect on 27 April 1994, states as the primary objectives of the Reserve Bank "to protect the internal and external value of the currency in the interest of balanced and sustainable growth in the Republic". In addition, the Constitution sets out that the Bank is required to exercise its powers and perform its functions in pursuit of its primary objectives *independently*. This suggests that the Bank is to act independently of governmental or political instructions. However, the Constitution also requires that there shall be regular consultation between the Bank and the minister responsible for national financial matters.

The South African Reserve Bank Act of 1989 sets out the legal framework for the Reserve Bank in the following areas:

Management The Reserve Bank is managed by a board of fourteen directors. The Governor and three Deputy Governors and three other directors are appointed by the President of South Africa, in consultation with the two Deputy Presidents. The remaining seven directors are elected by the Bank's shareholders. The Governor and Deputy Governors serve for a period of five years and the other directors for three years. All directors are eligible for re-appointment or re-election.

The Governor must be a person of tested banking experience, four directors must have experience in commerce or finance, one director must have experience in agriculture and another in industry. Members of Parliament are not eligible to serve as directors nor are officers or employees of banks or mutual banks. Directors must also be resident South African citizens.

Capital and shareholding The Bank holds capital of R2mn consisting of two million ordinary shares of R1 which are quoted on the Johannesburg Stock Exchange. The maximum allowed shareholding is R10,000. The South African Reserve Bank Act requires that any surplus, after allowances and dividend payment of 10 percent of paid up capital, must be paid over to government (except for the one-tenth allocated to the Bank's reserve fund). Thus, the Bank is not driven by a profit motive.

Powers and duties Like most central banks the South African Reserve Bank has the right to produce and issue bank notes and coins. It also has a range of other powers and functions which can be summarised as:

> administration of the accounts of central government; custodian of statutory reserves of banking institutions; participation in the clearing, payments and settlements system in South Africa; custodian of gold and foreign exchange holdings; bank of rediscount and lender of last resort to banking institutions; cooperation with the Treasury on public debt management; influencing money market conditions through open market transactions in government securities; collection, processing and interpretation of financial and economic statistics; joint responsibility with government for formulation and execution of monetary and exchange rate policies; prudential supervision of South African banking institutions; and administration of exchange control.

The Bank also faces restrictions on its ability to lend and purchase certain debt instruments.

Accountability The Governor is required to submit an annual report on the implementation of monetary policy to the Minister of Finance and to submit a monthly statement of its assets and liabilities and an annual financial statement to the Department of Finance. The annual report on monetary policy and annual financial statement are considered by Parliament. In addition, the Governor is occasionally summoned to appear before the Parliamentary Joint Committee on Finance to explain monetary policy and to provide the Bank's views on financial and economic developments.

Under the legislation, if the Minister of Finance believes the Bank has failed to comply with the Reserve Bank Act, he or she can give written notice to the Board to make good or remedy the fault within a specified time. If this is not carried out, the Minister can apply to the Supreme Court for an order compelling the Board to comply - the Court may then make such an order as it sees fit.

Finally, the Governor, Minister of Finance and senior Department of Finance officials meet at least once a month. In addition, the Governor regularly consults with the Minister and Deputy Minister of Finance on matters of mutual interest.

■ Institutional framework

The Board of Directors has delegated its powers to the Governor and the Deputy Governors, with certain exceptions. In turn, the Governor has sub-delegated a number of these powers to the Heads of the various departments of the Bank. This delegation and sub-delegation of powers and duties is designed to achieve an effective deconcentration of functions without which the Bank would be unable to operate.

The Bank has eight departments: administration, bank supervision, economics, exchange control, information technology, international banking, management services, and money and capital markets. Each department has a general manager as departmental head and the size and composition of its staff reflects the nature and volume of the tasks for which it is responsible.

The various departments of the Bank are divided amongst the Deputy Governors for the purpose of executive control, coordination and supervision - each General Manager reports regularly to the relevant Deputy Governor. Policy decisions are made at the monthly (or more frequent) meetings of the Governors' Committee, which comprises the Governor and three Deputy Governors.

The Board of Directors meets at least four times a year but may, at its discretion, meet more frequently. The Governor presides at these meetings (or will nominate a Deputy Governor to preside in his or her absence) and has an additional casting vote where no majority exists for or against a particular decision.

The Board has three sub committees that meet more regularly:

(i) the Governors' Committee which is responsible for decisions on monetary policy and strategic decisions on the management and administration of the Bank;

(ii) the Audit Committee which is responsible for overseeing the financial activities, risk exposure and financial statements of the Bank;

(iii) the Remuneration Committee which is responsible for general employment conditions, including remuneration, of the Bank's staff.

■ Monetary policy framework

The Bank has defined its primary objective as "the protection of the domestic and external value of the rand". In pursuing this objective, the Bank operates within a framework of an intermediate objective, namely the effective control of the money supply. Thus, the Bank sets, at the beginning of each year, an acceptable range for the increase in M3 money supply - for example in 1994, this guideline was set at between 6 and 9 percent. The policy of pursuing money supply targets is not a rigid rule. Rather, the targets act as predetermined guidelines to form an anchor for monetary policy with the wider objective of preserving overall financial stability.

In attempting to achieve its objective of overall financial stability, the Bank works to:

(i) restrict the rate of growth of the money supply to predetermined and publicly announced guidelines;

(ii) maintain the rate of increase in domestic credit extension by the banking sector at a level consistent with money supply objectives;

(iii) promote a general level of interest rates which conforms with overall objectives;

(iv) support the foreign exchange markets to promote orderly adjustments of the floating rate of the rand and a relatively stable real value of the rand;

(v) increase the level foreign reserves;

(vi) support the development of well-managed banking institutions;

(vii) encourage the development of efficient and well-functioning financial markets.

■ Operational framework

The prime operational instrument used to implement policy is the Bank rate, which represents the rate at which the Bank is prepared to provide accommodation at the discount window to registered banking institutions. To make the discount window more effective, money market liquidity is influenced by the Bank through a number of other instruments such as:

(i) open market operations in government stock;

(ii) the switching of government funds between the Exchequer Account with the Reserve Bank and Treasury Tax and Loan Accounts with banking institutions;

(iii) spot against forward swap transactions in foreign currencies;

(iv) variations in minimum reserve requirements for banking institutions;

(v) the management of money market funds of the Corporation for Public Deposits.

Despite the existence of exchange controls, the Reserve Bank has encouraged the development of a relatively active foreign exchange market and a market-oriented floating commercial rand exchange rate. Intervention in the foreign exchange market takes place through spot purchases and sales, usually US dollar transactions, and spot against forward swap transactions with authorised dealers in foreign exchange.

The Reserve Bank is active in promoting sound financial practices in banking institutions through the implementation of its responsibility for bank supervision and regulation and also plays a leading role in the administration of the national money transfer, bank clearing and financial settlement systems. In addition, a Deputy Governor of the Bank serves as chairperson of the Policy Board for Financial Services and Regulation. Finally the Bank is taking a leading role in the preparation of South Africa's financial markets for an expected increased international participation in the South African development process.

PART 2: THE ECONOMICS OF CENTRAL BANK INDEPENDENCE

Summary of "Central bank independence: Some considerations for South Africa and a selection of readings" by Charles Goodhart

Goodhart's paper summarises the economic arguments in favour of central bank independence. In addition, the paper highlights the most important recent studies assessing these arguments. The references for this summary are given at the end of this *Quarterly Review*.

■ Arguments for central bank independence

Goodhart contends that there are two main arguments for central bank independence. First, in the medium to longer term, it is impossible to achieve superior economic performance, higher growth or lower unemployment, through inflationary policies: in other words, there is no long-term trade-off between inflation and employment.

In economics jargon, this is the notion that the long-run Phillips Curve is vertical. In the shorter-term, there may be such a trade-off - that is, a more expansionary monetary policy may stimulate higher output and employment - but this is because prices, wages, and expectations may be slow to react. But, all of these adjust over time - and more rapidly if inflation is already endemic.

Second, a government which is, electorally or fiscally, in a weak position will always be tempted to turn to faster monetary expansion as a short-run expedient to stimulate demand and raise finance. But, the public will soon come to realise this and wages and prices will adjust accordingly, thereby making the medium-term outcome worse. So, over the medium to longer term, the appointment of an independent central banker mandated to achieve price stability will lead to a lower average rate of inflation with no worse outcome for growth, employment or investment.

A third argument, based on emerging but still controversial evidence, is that a reduction of the trend rate of inflation is beneficial to growth. This evidence suggests that higher inflation results in lower growth because of its effects on the efficiency of resource allocation and on the predictability of future economic conditions which, in turn, affects the willingness of the private sector to invest. One reason for this is that potentially inflationary countries often appear, as now, to have to offer a real interest rate with a higher in-built risk premium.

This is important since in a country with entrenched inflation there is an initial, even if temporary, real cost (in the form of higher unemployment and lower growth) of reducing inflation to a new, much lower trend path. If lower inflation leads to a faster trend rate of growth, then bearing the initial costs of reducing inflation would be seen as worthwhile to almost all.

Goodhart notes that these arguments for central bank independence are best set out in the recent paper by Fischer (see references below). Also recommended is the paper by Capie, Goodhart and Schnadt, and earlier papers by Goodhart ("Central Bank Independence"), Hochreiter, and *Economic Journal* "Policy Forum" articles by Goodhart and Cukierman.

■ International evidence

Goodhart maintains that there is considerable evidence that countries with more independent central banks have managed to achieve lower inflation. Moreover, those countries which have adopted quantified inflation targets have done well in achieving, or exceeding, targets (these issues are discussed in detail in the papers by Freedman - which provides an account of the Canadian experience - and by Goodhart and Viñals surveying the approaches to independence and the modalities such as the choice of target).

However, Goodhart also notes that most of the countries that have adopted independence (and succeeded in maintaining low inflation) did so when inflation was already low and during the deflationary stage of the business cycle.

In addition, if one compares neighbouring countries that have not adjusted the status of their central bank with those that have (e.g., Australia with New Zealand), it is not obvious that the constitutional change has made a significant difference. Moreover, in Israel, the adoption of explicit inflation targets without a move towards greater central bank independence has run into difficulties (see the paper by Bufman et al).

The problems of setting specific numerical targets in circumstances different to those outlined above, for example, where inflation is high and the economic cycle is on the upswing, are illustrated by the current challenges facing Spain, which has recently granted its central bank independence. Inflation is around 5 percent, unemployment is high by European standards, and the economy is beginning to recover from a downturn. Goodhart argues that aggressive monetary policy with a tight numerical target aimed at rapidly achieving price stability risks aborting the recovery, prolonging unemployment, and consequently losing political and popular support for central bank autonomy. On the other hand, however, following too passive an approach risks having inflation rise above its current level and damaging credibility.

■ The role of political economy

Goodhart notes that it has been hoped that one of the benefits of granting central banks more independence is that their greater credibility might allow the authorities to reduce inflation at a lesser overall loss in terms of higher unemployment and lower output in the transitional period (otherwise known as the "sacrifice ratio").

There is, however, no evidence that this is the case. Indeed, as the paper by Posen shows, the correlation currently seems mildly in the opposite direction (these findings are confirmed by Debelle and Fischer). These findings have led to some reconsideration of the earlier optimism and enthusiasm for central bank independence.

Yet evidence still remains of an association between independence and lower trend inflation, and a somewhat weaker association between lower trend inflation and higher growth. Goodhart argues that, if these effects are not the result of greater credibility, then perhaps the explanation lies in the field of political economy.

The reduction of inflation in countries with more independent central banks may reflect greater policy determination (rather than policy efficiency). The granting of independence may signal popular and political determination to keep inflation down. Maintaining independence, despite unpopular actions, may indicate the ability of the central bank to develop a constituency that appreciates the need for price stability.

A second reason why independent central banks may be associated with low inflation is that inflation is often fundamentally caused by weak governments who cannot control their own fiscal balance and therefore print money to finance expenditure. If the central bank is mandated *not* to lend to the government to finance the public sector deficit, the government is pushed towards relating expenditure to its taxable capacity. Certainly, the prohibition of direct lending to the public sector is widely agreed to be a crucial feature of central bank independence.

■ Conclusion

Goodhart concludes that the main points of focus in discussing the independence of the South African Reserve Bank should be:

(i) The political economy of independence in the South African context.

(ii) The extent, if any, to which public sector bodies should be able to borrow from the central bank and the application of seigniorage revenues.

(iii) Whether to adopt an explicit inflation target and if so how to choose it.

(iv) Central bank accountability.

Summary of "Central bank independence: Issues and diversity of models" by Manuel Guitián

■ Introduction

Guitián's paper begins by reviewing the arguments for making central banks "independent" of the political process, starting with the view that monetary policy needs to be distanced from day-to-day political influence because political decision makers tend to take too short-term a view of the appropriate policy at any particular time. This view is linked to the long-standing debate on "rules" versus "discretion" in monetary policy.

Proponents of "rules" argue that, because of imperfect information and uncertainty about the economy's responses to particular monetary policy actions, active aggregate demand management through monetary policy is unlikely to be successful and a premium should be placed on establishing policy predictability through the adoption of clear and well-defined monetary policy rules.

Since the late 1970s, economic research into optimal monetary policy and the problem of time inconsistency (that is, the short-term incentive of the authorities to adopt inflationary policies that are inconsistent with their long-term objectives) has directed attention to the tendency of the authorities to switch between alternative monetary policy objectives, such as reducing inflation versus reducing unemployment. This leads to public uncertainty and lack of confidence in anti-inflationary policy. Unless the monetary authorities can in some way make a binding commitment to anti-inflationary policies, monetary policy will lack credibility and the costs of reducing inflation will be high.

Guitián considers a range of alternative institutional arrangements to remove political influence from the implementation of monetary policy - including commodity standards, legislated money supply rules, and exchange rate pegging - and concludes that central bank independence may, all things considered, be the most desirable.

However, Guitián notes that making central bank independence work in practice will depend on what drives or constrains the actual behaviour of both central bankers and politicians. He identifies three key issues: (i) the appropriate balance between independence and accountability; (ii) the relationship between monetary policy and exchange rate policy goals; and (iii) the relationship between monetary policy and the supervision and regulation of the banking or financial system.

■ Independence and accountability

Guitián discusses the intrinsic relationship between independence and accountability. Central banks are never completely independent of government and politics; they are simply given varying degrees of delegated authority for monetary policy. From this perspective, 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 authority delegated to it. Guitián argues that the whole point of independence is to promote confidence and certainty in monetary policy and accountability arrangements 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.

Guitián argues that three facets of accountability are particularly important. First, effective accountability must be focused on a clear, non-conflicting and realistic objective. Thus, establishing a clear single objective for monetary policy in the central bank's legislation is a crucial aspect of independence-accountability arrangements.

Second, it is desirable to have a relatively simple method to facilitate the monitoring of monetary policy performance by the public and government. The use of publicly-announced intermediate targets or, more recently, direct inflation targets are examples of this.

Finally, the structure of incentives and constraints on decision makers in the central bank should be used to align their behaviour with the overall institutional objective. Here, the overall structure of objectives, targets and accountability measures as well as the roles and relationships within the central bank and between the central bank and government are important.

▪ Price stability and exchange rate goals

Guitián goes on to consider the implications for exchange rate policy if domestic price stability is chosen as the predominant (or sole) macroeconomic objective for an independent central bank. Although there is unlikely to be a sustained conflict between price stability and exchange rate stability in the long run, conflicts can arise in the shorter term. For this reason, a statutory objective that includes stability in both the internal and external value of the domestic currency may hinder the establishment of independence and clear accountability. In addition, where responsibility for exchange rate policy rests with the government, as is commonly the case, there is potential for conflict between an independent central bank pursuing price stability and the government's power on exchange rate policy.

It is noted that exchange rate policy decisions may have wider implications than those related to monetary policy, in particular for the country's competitiveness. These considerations raise the issue of who should decide on the policy trade-offs in response to, say, a severe shock to the terms of trade. While it may be argued that such decisions should lie with elected policy makers, it must be recognised that doing so may limit central bank's monetary policy independence. Guitián concludes that the case for giving central banks responsibility for exchange rate policy appears to be strong, but that the international reluctance to do so suggests that the allocation of final exchange rate responsibility needs to be a matter of judgement in individual countries, on the basis of what is both politically feasible and sustainable.

▪ Lender of last resort and supervisory functions

Guitián further considers whether any microeconomic objectives or functions of the bank could conflict with its price stability objective and focuses on the central bank's role in preserving financial sector soundness or stability. In general, it is accepted that knowledge and information on the state of the financial sector can be a useful input in monetary policy. This does not mean that the central bank should undertake the whole supervision process but it may be more efficient for them to do so.

However, Guitián notes that care must be taken to avoid prudential policy becoming oriented to the health of individual institutions at the expense of the system as a whole as otherwise a risk of conflict with monetary policy may arise. A further area of concern is that the central bank may come under political pressure in the event of the impending failure of a financial institution and faces the risk of undesirable fallout in the event of such failure.

▪ Models of central bank independence

Guitián identifies two broad models of *de jure* independence. Model A allows for no formal governmental directive or override on monetary policy. Model B allows for such directives or overrides but makes them subject to explicit conditions which provide a constraint on the willingness or ability of the government to use these powers. The choice between these models involves some complex issues. Guitián argues that although, at first, model A appears to be the stronger form of independence, this need not necessarily be the case and depends on what happens in practice.

The argument for a model B central bank is that there is some mechanism to avoid the confrontational climate which does not necessarily compromise the basic price stability objective. This model enables the central bank governor to resist behind the scenes political pressures because he or she can point to the legal obligation to pursue price stability while noting the government's formal, albeit public, channel to change this obligation. In the absence of such a safety valve - that is, under a model A arrangement - the central bank governor may be in a weaker position in day-to-day dealings with the government, as forcing confrontation with the government is not always a credible option.

In contrast, the argument for a model A approach is that the existence of formal government override or directive powers under model B may weaken monetary policy independence and public confidence as the constraints on exercising these powers may not be seen as sufficiently effective to restrain politicians, thus eroding credibility. However, important issues here are how the legislation affects the balance of power in resolving conflicts behind the scenes and what information the central bank feels able to make public for the purposes of publicly monitoring policy progress.

In deciding between these broad models, a number of considerations related to the context in which the central bank operates will be important. Guitián notes that these considerations relate closely to those factors which are likely to determine whether there is political and public support for central bank independence in the first place.

■ Conclusion

Guitián concludes by noting four environmental factors that may influence the form or extent of central bank independence that is politically feasible in different countries.

One factor is the country's inflation history, which influences the strength of the public demand for arrangements that require politicians to maintain financial discipline. The stronger the support based on inflationary experience, the more likely a model A arrangement will be adopted.

The nature of constitutional and political tradition will also be important. A history of constraining the powers of government may well give rise to pressures for an independent central bank. The extent of independence - model A as opposed to model B - will depend on the public's trust for government officials and central bankers in particular.

A further factor is the level of public economic awareness and debate. The greater this awareness and debate, the more pressure there is likely to be for constraints on political decision makers (and the more likely is a model B arrangement to be an effective constraint on government).

A fourth factor is the extent to which financial markets are liberalised and developed. In an environment of sophisticated financial institutions, governments who intend to pursue responsible financial policies may find it in their interests to establish arrangements which limit their discretion in financial policy. Moreover, the larger the disciplinary and public information role which financial markets can play, the more effective a model B arrangement will be.

Summary of "Independence and accountability: The supervisory dimension" by Peter Hayward

■ Introduction

Hayward's paper begins by noting that the arguments about central bank independence and accountability neglect the central bank's role in the promotion of financial stability. Although often central banks prefer a single objective - sound money - a successful monetary policy demands a stable and sound financial system if open market operations are to be effective. Moreover, financial stability is arguably an important objective in its own right. Hayward argues that independence and accountability are no less important to preserving the stability of the financial system than to effective monetary policy.

■ The pursuit of financial stability

Hayward identifies three major goals for the central bank in the pursuit of financial stability:

(i) the efficiency of the payments and associated settlement system;

(ii) the efficiency and reliability of financial markets;

(iii) the soundness of financial intermediaries operating in those markets.

He notes that the beneficiaries of financial stability are much the same people who benefit from monetary stability - namely those people who use money - but that they benefit as depositors with or borrowers from the financial system and as users of banking services. A central bank may thus find itself confronted with different public views depending on the role it is fulfilling.

■ The payments system

Hayward argues that the key to any financial system is the ability of its users to make and receive payments and as such central banks must concern themselves with the viability of the payments system. He notes that in recent years many central banks have become concerned about the risks involved in the money transmission system. The traditional net payments system implies a certain exposure to risk for the central bank and Hayward considers various approaches which attempt to limit this risk. There are other systemic risks in the financial system's payment mechanisms, for example in the settlement of foreign exchange transactions and Hayward notes the progress that has been made in addressing such risks in various markets. He argues that although all central banks play a part in the process of addressing risk, the extent to which they regard it as consistent with their objectives will vary. However, all central banks are bound to be concerned with the quality of their lending to the banking system as well as the efficacy of the markets in which they operate.

■ Supervision of markets and financial intermediaries

Hayward goes on to consider the central bank's interest in the effective operation of financial markets. The tradition in many countries has been to rely to a considerable degree on self-regulation and Hayward notes that central banks have rarely sought direct involvement. However, growing fears of conflict of interest arising from self-regulation have led in many cases to some form of supervisory oversight by a public body. Turning to the supervision of financial intermediaries, Hayward notes that self-regulation of market participants has become much more subservient to supervision by the central bank or some other public body.

He identifies two objectives of supervision: (i) the prevention of systemic disruption; and (ii) the protection of depositors, investors and other consumers.

On the prevention of systemic disruption, Hayward notes that the central bank has a clear interest in those institutions which impact on its objective of monetary stability, but may also have an interest in other intermediaries which help transmit the impact of market transactions throughout the financial system.

Hayward highlights the problems particular to banks - their vulnerability to confidence factors and their susceptibility to liquidity problems - that can threaten the system as a whole. He further notes that bank supervisors practice supervision on a consolidated basis and that this practice leads supervisors to become consolidated supervisors of financial conglomerates which include non-bank business. In addition, he notes that the distinctions between different classes of financial intermediary has begun to break down making it difficult to confine the origins of systemic threats.

Hayward goes on to comment that the consumer protection aspects of supervision is changing and argues that much of this change has come about because of political pressure but also because of the risk to a bank's reputation if its customer relations are less than impeccable. He concludes that the conceptual difference between supervision designed to minimise systemic risk and that designed to protect consumers is becoming difficult to draw in practice.

■ Institutional arrangements for supervision

Hayward goes on to discuss the arguments surrounding the most appropriate institutional arrangements for supervision. The traditional argument is that there could be a conflict of interest between the central bank's pursuit of monetary stability and the supervisor's concern with the solvency of the financial system. Hayward argues that it is possible that such conflicts can arise but in practice it is difficult to find examples where they have proved to be a problem and that in any case institutional separation does not remove conflict. He further argues that it may be easier to resolve conflicts within a single institution rather than by negotiation between institutions and that the more familiar a central bank is with a developing crisis, the more effective its ultimate involvement will be.

Hayward notes that a more persuasive argument for the separation of roles is that a supervisory problem will damage the central bank's reputation and this damage may impact on its monetary policy credibility. However, he notes that most central banks that are involved in supervision would argue that the need to maintain a stable financial system should override this concern and notes that many central banks who do not have primary responsibility for supervision are still involved in the process to some degree.

He considers the relationships between supervision of different financial intermediaries and concludes that an independent agency responsible for all supervision with the central bank playing an undefined role as lender of last resort is not necessarily more effective than the less tidy alternative. Most countries accept that the supervisory function has to be dispersed among a number of authorities and that a number of ways must be used to ensure that these authorities work effectively together.

■ Accountability in the supervisory process

Hayward goes on to consider how the supervisory process can be made accountable and considers mechanisms for facilitating accountability to the market, to customers, and to shareholders.

He argues that greater exposure to the market facilitates supervision since ensuring that banks adopt what the market regards as good practice is a key element of supervision. This is the philosophy behind the US Securities and Exchange Commission, whose traditional role has been to require registered dealers to disclose their activities and to rely on the market to draw its own conclusions. In contrast, bank supervisors have traditionally had access to privileged information with which to deal with problems before the market became aware of them. Hayward notes the opinion that it is not possible to use the disclosure approach for banks but maintains that the New Zealand experiment which attempts this is worth monitoring and comments on the progress made on disclosure by other bank supervisors.

Accountability to the customer is also important, and an area in which banks have come under increasing pressure. Hayward argues that this is a reaction to the view that competitive processes were not working effectively in the consumer's interest.

Movements in share prices and the ability of banks to raise capital are elements of accountability to shareholders and represent a further external discipline forcing banks to be prudent. Pressure to introduce non-executive directors and audit committees also contribute to this process.

Hayward turns to consider the accountability of the supervisory agency itself, in particular where financial assistance is required. He notes the role of deposit insurance funds which are normally subscribed by banks and thus suggest accountability to the banks' shareholders and customers. He also considers a last resort credit line with the central bank or the government itself which he argues involves direct accountability to government and possibly parliament.

Hayward further argues that the supervisor's actions can be expected to be accountable to the courts but notes that the extent of this accountability is likely to vary substantially.

■ Constitutional position

In most cases the supervisor possesses some independence from the government but Hayward notes that the degree of this independence varies as does the extent of government override. He argues that more important than the constitutional and legal position is the willingness of government to subvert this position. Hayward argues that one of the principal causes of bank failure is inappropriate control of a bank and the fact that the law does not permit such control will not necessarily prevent decisions being improperly influenced. However, he notes that there are steps that may be taken to minimise the risk of the supervisory process being subverted.

Hayward notes the importance of the political weight of the supervisory agency and comments that one of the most powerful arguments for placing supervisory responsibility with the central bank is that the concentration of power will make the central bank more able to withstand pressure from interested parties - this is particularly the case for countries with weak democratic institutions. However, he comments that in some cases such concentration of power is unacceptable and here it is desirable to separate the supervisor from the central bank.

He further maintains that if the supervisory agency is to be empowered to respond without strict limitations, it must have earned the public's trust. In this regard, Hayward notes that central banks now find one of their growing functions is public relations, in particular explaining policy to those to whom they are accountable. He argues that this is no less true of supervision than of monetary policy.

■ Conclusion

Hayward concludes that there is a great need for the supervisory process to be fair and equitable and also for the supervisory authority to be trusted by the parties it serves, including the general public. This need is, if anything, more pronounced in a country that has been through major constitutional change.

Summary of "Central bank independence and foreign exchange policy in South Africa" by Maria Ramos

Ramos's paper focuses on the control of foreign exchange policy. In the presence of capital mobility, money supply and the exchange rate are not independent variables: only one may be exogenously determined. It follows that if the central bank does not have control over foreign exchange policy, the potential for institutional conflict will arise.

Whereas the mandate of the central bank can be defined in terms of a primary goal of price stability, the government faces a much broader mandate in which, for example, international competitiveness is an important consideration. Anti-inflationary policy may require stable nominal exchange rates which, in the presence of inflation differentials with major trading partners, could lead to uncompetitive real exchange rates. Thus, depending on the government's preference for competitiveness over price stability, conflict could arise between it and the monetary authorities. Ramos argues that, for this reason, central bank independence may depend on or be constrained by foreign exchange arrangements.

Ramos examines the areas of responsibility characterising control and management of foreign exchange policy. These are (i) choice of regime; (ii) choice of parities under a fixed exchange rate regime; (iii) setting of directives under a managed float; (iv) day-to-day decisions on intervention; and (v) execution of intervention.

She cites a survey of alternative systems by Cottarelli (1994), who finds that in all cases execution of exchange rate policy is assigned to the central bank and defines four models of the division of other responsibilities:

(i) the British-Japanese model where the government controls all aspects of exchange rate policy;

(ii) the Maastricht Treaty model where the European Council is responsible for choosing the regime and the general orientation of policy and the central bank for conducting and implementing policy;

(iii) the German model where the government controls the regime and the central bank is responsible for the orientation and conduct of policy;

(iv) the Swedish model where the central bank is responsible for all aspects of foreign exchange policy including the choice of regime.

■ Fixed versus floating exchange rates

Ramos considers first the implications of the choice of exchange rate regime. Adopting a fixed exchange rate system that links the value of the currency to that of a large country with an established record of price stability can be attractive to a country suffering from a credibility problem. However, Ramos points out that to obtain the full benefit of "imported" credibility, the monetary authorities must convince the market that the fixed exchange rate is irrevocable. This implies that the country should fix its currency to that of a country with both a high degree of credibility and subject to the same shocks to the terms of trade - a virtually impossible match for a small developing country.

Ramos argues that since a fixed exchange rate implies a loss of autonomous control over monetary policy, if control of the foreign exchange regime is in the hands of government, then the central bank has no effective independence.

In a system of free floating exchange rates, monetary policy is autonomous and the exchange rate adjusts to equate supply and demand. A flexible exchange rate is thus compatible with effective autonomy for the central bank in monetary policy. Ramos argues that in this case the issue of conflict between the government and central bank does not arise because by choosing a free floating exchange rate the government has given up responsibility for foreign exchange policy.

Most economies do not have fully fixed or fully flexible regimes and Ramos argues that issues such as the control of parities, the setting of policy directives, and the role of intervention are therefore important.

■ Foreign exchange intervention

Ramos argues that a distinction should be made between intervention to overcome temporary volatility caused by transitory shocks and intervention to address fluctuations caused by permanent shocks. In the former case, intervention can help to smooth out fluctuations and promote orderly markets. In the latter case, however, intervention may be counterproductive as realignment is required.

If intervention does not offer an effective instrument for affecting the exchange rate, as is now widely agreed, exchange rate policy and monetary policy are not independent and the link between them cannot be severed (except through the mechanism of exchange controls, which Ramos rejects as costly and inefficient).

■ Competitiveness and foreign exchange policy

If exchange rate policy and monetary policy are not independent, then conflict can arise between the government and central bank to the extent that the government seeks to use exchange rate policy to promote an export-oriented path for the economy.

Ramos considers arguments that a stable real exchange rate is needed to reduce uncertainty for business and that the best way to achieve this is to adopt a constant real exchange rate rule and thus to allow the nominal rate to fluctuate to offset inflation differentials. However, Ramos argues this assumes that there is agreement on the fundamental long-term 'equilibrium' real exchange rate and also that the economy is not exposed to permanent real shocks which could lead to exchange rate misalignment.

Ramos goes on to consider the widespread belief that depreciating the exchange rate can lead to faster growth and lower unemployment. She argues that this approach attempts to exploit a short-term trade-off between inflation and unemployment, rather than to address the underlying problem of inefficiencies in labour and output markets. This policy choice therefore implies a preference for higher output over lower inflation.

Ramos recommends against such an approach, arguing that exchange rate policy cannot successfully compensate for inefficiencies in labour and output markets, which must be addressed directly if competitiveness is to be increased. If exchange rate policy remains focused on price stability, exporters are forced to become more competitive through increased productivity.

■ Implications for central bank independence

Ramos argues that since the money supply and the exchange rate are not independent instruments, central bank independence will, in general, be compromised - and the potential for inconsistency between monetary and exchange rate policies increased - if the government has control over foreign exchange policy.

She notes that although the case for assigning responsibility for foreign exchange policy to the central bank thus appears strong, in practice central bank statutes assign responsibility for substantive aspects of policy to the government.

Ramos goes on to consider various arguments which support and explain continued government control of exchange rate policy. She concludes that these arguments are not robust and refers to Goodhart (1992) who comments that the continued division of responsibilities reflects "practicable politics for their own country". Ramos further comments that it may, in some cases, reflect the fact that although legal responsibility and control lies with government, *de facto* responsibility and control is in the hands of the central bank.

■ Exchange rate policy in South Africa

Ramos provides an historical overview of exchange rate policy in South Africa, drawing on Kahn (1992).

South Africa's recent history highlights the problems and conflicts that can arise when control over monetary and exchange rate policies is not clearly defined. It also illustrates that mechanisms for resolving policy conflicts are extremely important and should include an override clause with tangible costs to the government for its use. The South African experience also highlights the need for proper policy coordination and the costs of exchange rate intervention, including the under-development of forward markets and the resulting forward losses; the distortion of the industrial structure; and inflation.

Ramos argues that exchange rate movements for South Africa since 1988 signal a shift in policy objectives and management. According to Kahn (1992), the Reserve Bank has ceased accommodating the gold mining industry, signalling that it does not believe that problems of competitiveness can be solved through the exchange rate.

Evidence suggests that exchange rate policy has been anti-inflationary - the nominal rand exchange rate has been more stable. This has led to a slight appreciation in the real rand exchange rate which is consistent with the view that anti-inflationary policy is not supportive of a policy of maintaining competitive real exchange rates.

Since 1990, monetary policy has been more focused on the goal of price stability. The Reserve Bank has had greater independence and has succeeded in reducing inflation to single digits. This shift in focus has been mirrored in the Bank's conduct of exchange rate policy, presenting a situation in which both interest rates and the exchange rate are targeted at the same goal.

■ Institutional constraints: exchange controls and the forward market

Ramos goes on to consider institutional constraints in the form of the exchange controls and the forward market. She argues that exchange controls have allowed the Bank to sever the link between monetary and exchange rate policies but have created severe distortions that outweigh this benefit in the form of an under-developed foreign exchange market; domestic capital markets constrained by liquidity and lack of institutional development; and erratic exchange rate policy. Ramos further argues that the Reserve Bank's activities in the forward market have hampered the ability of monetary policy to achieve price stability.

■ The way forward

Ramos concludes with some views in the way forward. She suggests that a politically acceptable solution is one where the choice of the exchange rate regime remains with the government, but where the Bank has the right to refer any decision to change the regime to Parliament if it believes the change will undermine the goal of price stability. All other responsibilities attached to foreign exchange policy should be given to the Bank and an explicit override clause, with a cost to government of issuing directives, should be included.

Summary of "Central bank independence: Notes on the Chilean experience" by Andrés Bianchi

Bianchi's analysis of central bank independence from the perspective of the Chilean experience is divided into two parts. The first part examines some basic concepts and requirements related to central bank autonomy. The second part describes the legal foundations for the independence of the central bank of Chile and analyses the process through which the autonomy of the central bank became acceptable to the political parties and constituencies that had initially been highly critical.

■ Conceptual elements

Bianchi notes that in recent years there has been a growing and widespread trend towards granting greater independence to central banks, together with a tendency to restrict the objectives of the central bank. Thus central banks have been legally mandated to concentrate their efforts on achieving and maintaining price stability.

He argues that these simultaneous movements have arisen from first, a better understanding in academic and political circles of the negative consequences of high inflation for economic growth, social equity and even political democracy, and second, the accumulation of empirical evidence that in general central bank autonomy and price stability are positively correlated. Bianchi maintains that the promotion of central bank independence in Latin America can be interpreted as an attempt to institutionalise the systematic and persistent defense of macroeconomic stability.

However, Bianchi notes that central bank independence is neither a necessary condition for price stability - price stability has occurred historically without independence - nor a sufficient one: price stability also depends on the simultaneous implementation of coherent fiscal and wage policies. He further notes that a distinction must be made between the legal independence of a central bank and its real autonomy. Studies that attempt to measure the correlation between independence and price stability often fail to measure accurately effective autonomy.

Bianchi goes on to consider the extent of formal independence of the central bank and identifies three principal issues:

(i) the nature and scope of the responsibilities delegated to the central bank;

(ii) the legal status of the central bank's board members;

(iii) the limits imposed on central bank financing of the public sector and non-bank institutions.

He argues that central bank board members should be effectively protected from possible pressure from government, congress or private groups and goes on to outline arrangements that can address this need which are based on appointment and dismissal procedures, and the length of term of office.

In addition, the need to impose an institutional check on fiscal deficits is emphasised - for this reason the existence of strict legal constraints on central bank funding of the government is vital but it is noted that these could be circumvented unless the board of the central bank is truly independent.

Bianchi comments that real independence of central banks depends not only on legal statutes but on the level of political support they can elicit and receive from public opinion. Such support is likely to be greater in countries that have suffered inflationary crises but also depends on the central bank's efficiency and the results it exhibits in its struggle against inflation. A virtuous circle may be created whereby lower inflationary expectations help the central bank's stabilisation policies to show earlier and socially less costly results.

Bianchi further notes that independence of the central bank represents a considerable political change as it implies a transfer of power from the government to the bank, particularly in the area of short-term demand management. This raises the issue of coordination between the policies of the central bank and government and the need to devise mechanisms to harmonise their respective decisions.

■ Legal foundations of central bank independence in Chile

Bianchi turns to consider the case of the Central Bank of Chile. The legal basis for independence is the Constitutional Organic Law which became effective in December 1989 and fulfilled a mandate set out in the 1980 Constitution. The autonomy of the bank rests on three pillars:

(i) the statute governing the board or council;

(ii) the norms restricting central bank financing of the public sector and non-bank institutions;

(iii) the strong limitations imposed on government participation in the design and implementation of monetary, financial and exchange rate policies.

The central bank's powers are vested in a council of five members who are appointed by the President with approval of the Senate. Council members serve ten year terms and are appointed according to a staggered process once every two years. One of them is appointed Governor of the bank for a five year term by the President of the Republic.

This appointment structure means that council members serve for a longer term than the President of the Republic (six years) and thus the entire council cannot be replaced during the term of political office.

The independence of council members is further protected by the number and complexity of the legal requirements that must be fulfilled in order to dismiss any member. In practice such dismissal is nearly impossible. In addition, membership of the council is incompatible with any position in the private sector, whether remunerated or not. It is also incompatible with any position paid out of state or municipal funds, or within any public institution.

A further foundation of the bank's independence is based on a set of restrictions which prevent the bank from granting its guarantee to banking institutions and purchasing debt instruments or lending to the public sector.

Finally, there are a set of norms regulating the participation of government authorities in the decisions made by the bank's council. The minister of finance has the right to attend council meetings and is entitled to propose certain resolutions but cannot vote and cannot issue policy directives. The minister is able to suspend for up to fifteen days the implementation of any decision of the council and can veto restrictions the council may wish to impose on foreign exchange operations but this may be overruled by the unanimous vote of the council.

Bianchi concludes that in legal terms the central bank of Chile is not only independent but also powerful - it has ample freedom to formulate and implement monetary, financial and exchange rate policies. The only limitation that the bank's council faces is that when making decisions, it "shall consider the general orientation of the government's economic policies".

■ The politics of central bank independence legitimisation

Bianchi notes that the granting of central bank independence in Chile took place under special historical and political circumstances. The draft law to establish the autonomous central bank became known to public opinion in 1988, a few weeks after the military regime had been defeated in a national plebiscite which suggested that opposition candidates would win the presidential and congressional elections to be held in 1989.

The timing of the draft law arose suspicions that the government of General Pinochet would continue to influence economic policy after power had been transferred to a democratic administration since the new board of the central bank was to be appointed by the old government. The new Central Bank Act thus lacked legitimacy in the eyes of a considerable majority of the political establishment and the opposition let it be known that the law would be extensively modified when they came to power.

As a result of this, the government initiated a process of negotiations with the opposition which produced a remarkable result. The five-member council appointed by Pinochet was, in the end, finely balanced: two members from the Pinochet government, two members from opposition parties, and a neutral economist acceptable to both sides (Bianchi himself) appointed as governor. Moreover, all five members of the Council were perceived as capable technocrats.

The carefully balanced political composition of the council and the technical capacity of its members was received with satisfaction by most sections of public opinion. However, the council faced both an economic and political challenge. The economic challenge was to control and reverse inflation and the political challenge was to build up support and win acceptance for the autonomous central bank.

Bianchi argues that considerable progress has been made in both fields. The council has made significant efforts to show that independence is not incompatible with adequate coordination with government and to create informal links with the Senate in order to assuage misgivings about the considerable power given to a largely unaccountable institution. Initiatives to improve coordination with government and relations with the Senate have contributed to the progressive legitimisation of the independent central bank.

However, Bianchi notes that this process would have been slower had it not been for the advances made in the struggle against inflation and more generally by the success achieved since 1990 in all fields of economic activity.

■ Conclusion

Bianchi concludes that the Chilean experience of an independent central bank has been basically positive. Owing to its large degree of autonomy, the bank has successfully pursued restrictive monetary policies which have helped to bring down inflation to its lowest level for 34 years. And, this was achieved at the same time that total output, investment, exports, foreign reserves, and employment grew at very high rates.

Bianchi argues that because of the pluralistic composition of its first board; the prudent and firm conduct of relations with the ministry of finance; and favourable economic results, the autonomy of the central bank has come to be widely accepted.

Summary of "Accountability, policy coordination, and the role of the central bank in the community" by Gerald Corrigan

■ Introduction

Corrigan emphasises that South Africa is undertaking an unprecedented transformation in human terms, in economic terms, in political terms and in financial terms.

International experience suggests that the Reserve Bank is going to have to play a vital role in this difficult and demanding process that will extend over a period of years. In the contemporary setting of an open economy such as South Africa, the role of the central bank will if anything be more important, rather than less important.

There is now a broad international consensus that central banks must have an appropriate degree of autonomy. Corrigan argues, however, that there is no such thing as absolute independence. The balance that must be struck was well described by former US Federal Reserve chairman McChesney Martin: "the central bank is independent *within* government but not independent *of* government".

Further, the appropriate meaning of independence within government must be determined on the basis of the particular economic and policy conditions prevailing in each country. Moreover, there will always be an important distinction between *de facto* and *de jure* independence. For example, in *de jure* terms, the most independent central bank is in the Netherlands, but *de facto* Dutch monetary policy is importantly determined by German policy.

There is also broad consensus, he argues, that the centrepiece of the responsibilities of the central bank must be creating and sustaining an environment of price stability. But he stresses that price stability must inevitably be linked to financial stability, arguing that they are essentially two sides of the same coin. These twin goals imply that the primary functions of the central bank are:

(i) its role in monetary policy;

(ii) its supervisory role;

(iii) responsibility for ensuring the efficiency and integrity of the payments system.

Corrigan adds a word of caution on what the central bank *cannot* do. No matter how well structured, organised and managed it is, a central bank cannot counteract the effects of bad policies in fiscal and budgetary matters nor of bad policies in the area of structural and micro-economic policies.

Even more to the point, it is important to recognise that while central banks can create money they cannot create savings. One of the challenges for South Africa, and indeed for all countries, is the effective mobilisation and utilisation of domestic and international savings, both of which are closely related to the ability to create and sustain that environment of price stability.

Corrigan focuses on two key issues that grow out of central bank independence: policy coordination and accountability.

■ Policy coordination

There are two important elements of policy coordination. The first relates to the goals of economic policy. Price stability must be seen not as a separate or independent policy goal but rather as an integral part of a coherent framework for economic policy. The central bank must frame its objectives in collaboration with government and, at the same time, ensure that government understands the importance of price stability in the determination of other economic policies. Price stability must be understood to be a fundamental component of the approach to economic policy.

The second element is the approach to day-to-day policy coordination. Coordination of fiscal and monetary policy can be achieved in a formal way, based on statutory obligations, or in an informal way, based on goodwill and personalities.

Corrigan argues that the central bank and government should strive for an informal approach, with formal coordination as a last resort. He maintains that there will always be tension between the ministry of finance and the central bank but the key is to ensure that this is a constructive tension. A legalistic approach to policy coordination in the form of a legislative mandate is more likely to result in rigidities and destructive tensions.

Corrigan concludes that although the coordination of policy can be difficult, effective day-to-day policy coordination should not pose serious problems.

■ Accountability

Corrigan emphasises three key elements of accountability: the need for transparency, the need for appropriate modalities for accountability, and the need to establish links between the central bank and the larger community.

Corrigan argues that transparency is crucial to accountability. The central bank must do all it can to ensure the greatest possible transparency in all its actions. Transparency is important with respect to the central bank's policies, with respect to its operations, and with respect to its financial position.

It is also important to establish effective modalities for accountability. There must be a formal mechanism by which the central bank explains itself to a higher authority. In the US, the principal mechanism is the congressional oversight process. Corrigan argues that the frequent appearances of the Federal Reserve Chairman before Congress - he, and the other members of the Board, currently average 25-30 such appearances each year - are fundamentally important to maintaining accountability, and the appearance of accountability, for the actions taken by the Federal Reserve.

Corrigan noted that the ultimate source of accountability is that parliament can change the law governing the central bank. He warned, however, that changing the law may change who or what is accountable but is unlikely to eliminate the underlying policy conflicts.

Corrigan argues that the third important element of accountability is the role and responsibility of the central bank in and to the community at large.

The central bank must work to ensure that it understands society and that society understands it. Corrigan drew on the US experience, where the Federal Reserve has constructed a broad network of instruments to facilitate the relationship between the central bank and the wider community.

One particularly successful component of the approach adopted in the US is the creation of mechanisms to provide systematic input of an advisory nature by particular groups. He cited the example of the regular meetings he was required to hold, when president of the Federal Reserve Bank of New York, with the Small Business and Agricultural Advisory Council. One such meeting was held two days after the stock market crash in 1987 and although before the meeting started Corrigan felt it was likely to be an irrelevant distraction, the meeting gave him an invaluable perspective into the implications (and lack of implications) of the crash for the economy as a whole.

Another important component has been educational initiatives. Corrigan claimed that the most widely circulated publication of the Federal Reserve is a comic book which was written to teach elementary school children about monetary policy and the role of the central bank.

The Federal Reserve's educational programmes have been tremendously successful but they also demonstrate the magnitude of the task of achieving an understanding of monetary policy in society at large.

This experience suggests that there are many ways of developing the relationship between the central bank and the community that strengthen rather than threaten the autonomy of the central bank.

■ Conclusion

Corrigan concludes by reiterating that South Africa's economic performance will rest, in part, on the contribution made by the Reserve Bank. This contribution will, in turn, be a function not only of the Bank's technical competence but also of its effectiveness in working with government and in establishing credibility and communication with the larger community.

These latter two elements of the Reserve Bank's role should work to strengthen the independence of the Bank but, ultimately, that independence must be earned through professionalism, competence and integrity.

Summary of "Legislative oversight and appointment procedures with respect to the question of the independence and accountability of a central bank" by Walter Fauntroy

■ Introduction

The contribution of this paper flows from Fauntroy's experience in legislative oversight of the US Federal Reserve System.

Fauntroy argues that historical experience in the US has demonstrated the desirability of placing responsibility for monetary policy and for banking regulation in an institution that is both independent of the partisan political process and accountable to the people it serves. However, it also suggests that the latter - effective accountability - is more difficult to achieve.

■ The US Federal Reserve - Background

Fauntroy provides a brief history of the US Federal Reserve System. Over its eighty year history, the Federal Reserve Board has been granted increasing powers by government in an effort to bolster its independence and authority to act, with some safeguards for accountability.

In 1935, the power to manage the money supply was put into the hands of the Federal Reserve Board and its Federal Open Market Committee (FOMC) which also includes representatives of the regional Federal Reserve Banks.

In 1962, the FOMC asserted its authority to intervene in foreign exchange markets to help manage the foreign value of the US dollar and the Fed now has what some have called an "unlimited pocketbook" to intervene.

Fauntroy argues that, as a result of these powers, the Fed has effectively become the chief instrument for helping to achieve maximum sustained economic growth, employment and economic opportunity.

Fauntroy maintains that government actions over the years have been heavy in their emphasis on independence but light on the question of representation of the population on the policy and operational side of the Fed. Further, he argues that this representation is the best way to ensure accountability on the part of policy makers.

■ Representativeness and accountability

In 1977, the US Congress concluded that there was "virtual exclusion" of women, blacks and representatives of labour, consumers, non-managerial and non-producer interest groups from the Board of Governors, the regional bank directors and various operations staff.

Legislation, in the form of the Federal Reserve Board Reform Act, was passed mandating that all Federal Reserve Bank Directors be chosen "without discrimination on the basis of race, creed, colour, sex or national origin".

Thirteen years later, a congressional study concluded that the 1977 Act had had little impact. The study showed that:

(i) out of 72 Class A and B directors, appointed by private members in the twelve Federal Reserve districts, only one was African American, three were women and none were Hispanic;

(ii) out of 36 Class C directors, who are chosen by the Board of Governors and are supposed to represent the public, half were former bank directors and none worked for a consumer or labour organisation.

Fauntroy accepts the need for the central bank to have officials with solid financial expertise and also that most people believe the Board of Governors operates in the best interests of the country rather than for particular interests. However, he argues that the US has a long way to go in perfecting its system to ensure that appointments are sufficiently diverse to secure accountability and to maintain confidence in the central bank's operations.

■ Lessons from HR 28: The proposed US Federal Reserve System Accountability Act

Fauntroy argues that efforts to improve the accountability of the US Federal Reserve System should focus upon four reforms:

(i) those responsible for formulating and implementing monetary policy must account for the actions they decide to take by providing to the public timely, detailed explanations of the factors which led to their decisions (namely, accurate minutes of the closed meetings at which decisions are made);

(ii) the appointment process for monetary policy decision makers must ensure that they serve in their independent roles at the pleasure of the executive and legislative branches of government;

(iii) the Federal Reserve System's operations must be subject to the authority of the General Accounting Office (which has responsibility for conducting performance and financial audits of US governmental and quasi-governmental agencies);

(iv) as emphasised above, the composition of the Federal Reserve Board and its staff must be more representative of the diversity of interests found in the population as a whole.

These four reforms are the backbone of a controversial set of proposals contained in proposed legislation (HR 28) that was originally introduced in Congress in 1993.

The prospects for the successful implementation of the legislation proposed under HR 28 have diminished following the recent election of a Republican majority in the US Congress. However, Fauntroy argues that South Africa can draw useful lessons from the bill for enhancing the accountability of the South African Reserve Bank.

He recommends that South Africa consider adopting an effective and systematic dissemination strategy to allow all citizens equal access to information on policy decisions, rather than a privileged few. Such a system should include the prompt publication of the minutes of meetings where policy decisions are taken.

Another important instrument for increasing the transparency and accountability of the central bank is competent oversight. The most important vehicle for such oversight in the US is the Banking Committee of the House of Representatives, which has in recent years called the Chairman of the Federal Reserve to explain monetary policy in public hearings more than twenty times a year.

Competent oversight of central operations can be reinforced by ensuring that the Bank is subject to external performance and financial audits by a independent agency. For example, HR 28 proposes that, in the US, this role be carried out by the US General Accounting Office.

Fauntroy argues that accountability can be further enhanced by ensuring that the Reserve Bank reflects the diversity of the South African population in the composition of its Board and its staff.

He suggests that special note should be taken of the recommendations advanced in HR 28 on how people are selected to serve within the Federal Reserve System. These recommendations include a provision for the regional Federal Reserve presidents to be appointed by the President and confirmed by the Senate in place of the current internal selection procedure that has been criticised as an "in-bred process with no public accountability".

He also notes the provision in HR 28 that requires the Fed to abide by the Civil Rights Act of 1964, which guarantees employees' basic civil rights, including the ability to pursue the Federal Reserve for discrimination.

Further, Fauntroy argues that the system should be a role model for the entire banking industry - in the US the Fed has reported extensive bias against minorities in bank lending. Such minorities are as under-represented on the boards of state and nationally chartered banks as they are on the boards of the Federal Reserves.

Fauntroy also touches on the regulatory function of the Federal Reserve, arguing that the current system is confusing, duplicative, inefficient and costly. Fauntroy urges South Africa to avoid this pitfall by consolidating banking regulation, possibly within the Reserve Bank, in order to facilitate legislative oversight and to reflect diversity and accountability.

■ Conclusion

Fauntroy concludes with appeals to both the directors of the Reserve Bank and the body politic in general.

He urges the directors of the Reserve Bank to exercise justly the powers that have been awarded to them and to apply the "short-term pain for long-term gains" equally amongst all segments of society.

Finally, he advises the body politic to evaluate the Reserve Bank's actions in terms of the common good - if the Reserve Bank's actions fairly spread short-term pain, then their decisions must be respectfully accepted.

Summary of "Accountability and policy coordination in South Africa" by Ebrahim Patel

▪ The debate on central bank independence

Patel notes that the era of open markets coupled with a retreat from state intervention has meant national governments have less power to shape economic policy. He predicts that, as one of the few available instruments of public policy, monetary policy will be the subject of broad public debate in South Africa. This debate will be focused on both the substance of policy and the institutions through which it is carried out.

Patel argues that the question of central bank independence and the central bank's relationship with government arises because, in achieving its mandate, the Bank may face a range of alternative policies (e.g., different target ranges for the growth in money supply) which involve different trade-offs or costs. He suggests that the debate is not about independence itself and identifies five questions that he believes will define the debate on the Bank's role:

(i) What are the parameters of its operational autonomy;

(ii) How to build legitimacy for the central bank;

(iii) How to develop a political constituency in favour of price stability;

(iv) How to establish effective mechanisms of accountability in executing the mandate;

(v) How to coordinate the policies of the central bank with fiscal and wage policies to yield coherent anti-inflation and pro-growth policies.

▪ The South African Reserve Bank

Patel argues that in the past the South African Reserve Bank operated in a framework isolated from rigorous public scrutiny and public accountability. Its Board and staff were unrepresentative of the wider society and its public pronouncements were perceived by outsiders as occasionally lapsing into ideological prejudice.

Within this context, Patel asks how to go about building a political constituency in favour of price stability and the central bank as the instrument to achieve this objective. He maintains that given South Africa's history, it means building a constituency among powerful social movements.

▪ The Reconstruction and Development Programme

The public policy framework for South Africa is set out in the Reconstruction and Development Programme (RDP). Patel notes that the RDP provides a new vision of public policy making, calling for institutions of "participatory democracy in partnership with civil society". Patel argues that the section of the RDP dealing with public corporations sets out a useful basis for the relationship between statutory bodies and government:

> *"... statutory bodies must be independent of government departments in the sense that they should not be directly part of any government department ... The emphasis should be on creating stable long-term policies rather than volatile short-term policies."*

The RDP also endorses a strong role for trade unions and other organisations in public policy making:

> *"Trade unions and other mass organisations must be actively involved in democratic public policy making. This should include involvement in negotiations ranging from the composition of the Constitutional Court to international trade and loan agreements"*

With specific reference to the South African Reserve Bank, the RDP calls for changes to the Act governing the Reserve Bank to "ensure a board of directors that can better serve society as a whole", including representatives from "trade unions and civil society".

▪ International experience

Patel draws on international experience of coordinating policy between the central bank and other powerful stakeholders in society, and identifies three different models.

The first, which has been adopted in Belgium, Australia and the Netherlands, requires the inclusion on the board of directors of the central bank of either employer and trade union representation.

In the second, adopted in Austria, the Netherlands and Denmark, the central bank is represented in tripartite bodies responsible for developing economic and social policy.

In the third model, business, labour and government have concluded agreements which specifically seek to address price stability and employment. This arrangement has been adopted in a number of countries.

■ The National Economic, Development and Labour Council

South Africa has recently moved in the direction of the second model with the establishment of the National Economic, Development and Labour Council (Nedlac). Nedlac is to consist of representatives of the state, labour, business and community-based organisations. Its task is to develop consensual economic, development and labour policies and will have four chambers to consider different policy areas. Nedlac will include representation by the Reserve Bank in its Public Finance and Monetary Policy Chamber.

Patel calls for this chamber to play a vital role in developing or renewing the Reserve Bank's mandate, monitoring its management of this mandate, and coordinating the different elements of macro policy. His support for this role is based on four arguments:

First, the intrinsic value of inclusivity. Patel argues that public institutions derive their legitimacy from the involvement of stakeholders. Nedlac can provide a forum for the involvement of stakeholders and can help build public perception of the legitimacy of the Reserve Bank.

Second, the market power of other stakeholders. Patel maintains that in the absence of public support for policies, public protest will be directed at central banks, possibly leading to demands for a review of its status. Nedlac can play an important part in building and maintaining public support for the Reserve Bank's policies.

Third, the development of consensual policy. Patel contends that effective policies are difficult to achieve if social partners do not trust the policy makers. Nedlac can therefore play a role in the development and coordination of more effective economic policies. In emphasising the importance of consensual policy, he cites the example of South Africa's offer to GATT in 1994 which was developed through negotiation between government, business and labour in the National Economic Forum.

Fourth, the consideration of all relevant costs and trade-offs. Monetary policy involves a series of choices with a range of different costs. Patel argues that the inclusion of more stakeholders allows for a more informed debate about these choices, and ensures that policy serves the best interests of society.

Patel recognises that for the central bank to fulfil its mandate it will require certainty in the policy framework within which it operates; autonomy in the day-to-day management of its affairs; and insulation from the pressures of the electoral cycle which could otherwise result in policies that undermine long-term economic performance. However, he argues the bank must be held more accountable in its implementation of agreed policies and needs to be made more representative both in terms of its Board and its staff.

■ Conclusion

Patel concludes that a restructured Reserve Bank with a clearly defined mandate and adequate autonomy together with broad oversight located in Nedlac, can provide a more legitimate institution, with greater support for the tough policies that may be required, and also a more effective institution, with greater coordination between monetary and other macro policies.

■ Key issues from the workshop discussions ■

In this section, we review the key issues to emerge during the workshop discussions. This review is intended not to be comprehensive in its coverage of the many issues that were raised in the two days of discussion but rather to supplement the summaries in the preceding section by highlighting points and debates of particular importance.

■ The case for central bank independence

There was broad agreement among the workshop participants - drawing on a wide range of experience in developed and developing economies - on the force of the arguments for central bank independence. The main arguments were seen to be twofold, as outlined in the paper by Goodhart:

(i) First, that it is impossible to achieve sustained higher growth or lower unemployment through inflationary policies;

(ii) Second, that governments in fiscally or electorally weak positions will always be tempted to print money as a short-run measure to stimulate demand.

The first argument was the subject of lively discussion, with a number of participants arguing that there is now substantial evidence internationally that even the short-term gains from monetary expansion are at best marginal and short-lived since markets now respond quickly to what they perceive as unsustainable monetary policy changes.

Not only participants in financial markets but also suppliers and workers in other sectors are increasingly sophisticated in their assessments of likely future inflation, and these expectations feed through rapidly to higher wages, prices, and interest rates thereby curtailing the benefits of the monetary expansion.

All of this suggests that there may be no significant policy trade-off between inflation and employment even in the short term.

The second argument, which was also explored in the paper by Guitián, was seen as repeatedly confirmed in the experiences of different countries where short-run pressures induce elected officials to take monetary policy decisions that are inconsistent with their announced long-term goals.

Insulating monetary policy decisions from short-term political manipulation was therefore perceived as important to achieving sustained macroeconomic stability. Delegating authority for monetary policy to an independent central bank was broadly agreed to be the most desirable approach.

There was, therefore, strong support among the participants for the approach taken in South Africa of establishing the independence of the central bank as a Constitutional principle. Enshrining the principle of independence in the Constitution was seen as an important commitment to protecting the central bank from short-term political maneuvering and thereby reinforcing its credibility. This credibility was, in turn, agreed to be essential to the effectiveness of anti-inflation policies, which often succeed or fail according to market perceptions of whether or not they are sustainable.

What needs to be more fully developed in South Africa, however, are the modalities of independence. A wide range of issues were discussed, including:

(i) the objectives of the Reserve Bank;

(ii) the choice of intermediate targets for monetary policy;

(iii) responsibility for exchange rate policy; the Reserve Bank's role in preserving financial stability;

(iv) the role of the broader political and social context;

(v) policy coordination;

(vi) the central importance of accountability;

(vii) the internal structure of the Reserve Bank.

■ Defining the objectives of the central bank

Much of the recent debate in South Africa has focused on whether the Reserve Bank should have a narrowly defined goal, or a more broadly defined set of goals. What came out clearly in the workshop discussions was the understanding that underlying the arguments in favour of a broader set of goals is the belief that there is a trade-off between inflation and employment or, more generally, that the narrow pursuit of price stability can be incompatible with other economic objectives and policies.

It was recognised that such a trade-off may, at times, exist in the short run although, as noted above, there is evidence that the effects of a monetary expansion on employment even in the short run has weakened considerably in recent years. But it is now widely agreed that there is no such trade-off in the medium and longer term. For this reason, there was broad agreement among the participants on the desirability of defining the objectives of the central bank narrowly on a single goal: achieving price stability.

In discussing central bank objectives, an important distinction was drawn between "goal independence" and "instrument independence", as defined by Fischer (1994). As noted earlier, goal independence exists when the central bank is able to choose its own objectives, typically because its formal goals are imprecisely defined. Fischer notes an extreme example of this is endowing the central bank with the power to conduct monetary policy and giving it the goal of doing so.

By contrast, a central bank does not have goal independence if its objective is precisely defined and legislated, as in the case of the Reserve Bank of New Zealand where the mandated goal is price stability and the government sets a specific target, in consultation with the Bank. It was generally accepted that since choosing a particular goal, such as price stability, involves a choice of costs to achieving it, it is a political decision that rests properly with government, although some participants argued that the central bank should still play an advisory role. It was thus generally accepted that central banks should not have goal independence.

Instrument independence exists when the central bank has autonomy in the choice and use of monetary policy instruments in pursuit of its pre-defined objectives. Instrument independence was felt to be essential to the effectiveness of monetary policy as it was necessary for preventing political interference in monetary policy decisions.

The issue of how to manage conflicts that arise between government and the central bank - on the appropriate level of interest rates, for example - was seen to be of great importance in defining and establishing central bank independence. Participants assessed the potential role of a formal "override mechanism", whereby government can overturn decisions of the central bank, drawing heavily on the analysis presented by Guitián in his paper.

Although such a mechanism appears to limit the independence of the central bank, there was significant agreement among participants that, to the contrary, it is likely in practice to protect independence. As conflicts are almost certain to occur at some point, what is important is that there be a formal, transparent mechanism for resolving them. In the absence of such a mechanism, central banks are likely to find it hard to resist ministerial pressure.

■ The role of intermediate targets

One issue that was the subject of considerable discussion was whether the focus of South African monetary policy should shift from monetary targets to inflation targets.

International participants argued that inflation targets offer a number of advantages. First, they reduce the uncertainty surrounding monetary policy by providing the public and financial markets with clear indicators of the direction of policy.

Second, they facilitate accountability by providing a clear and readily understandable yardstick against which the performance of the central bank can be measured.

Third, since they are set by agreement between the government and the central bank, they require political commitment and bind both parties to pursuing policies consistent with the targets agreed. For this reason, targets send a powerful message to the public at large of the government's commitment to anti-inflationary policies.

The advantages of targets quickly turn into disadvantages if the targets are not met. Since targets are broadly seen as a public commitment to sound economic policy, not meeting the target adversely affects the credibility of both the central bank and government. Indeed, the advantages of targets derive primarily from the fact that the costs associated with failure to meet pre-announced inflation targets are high.

Attention must, however, be paid not only to these costs of failure but also to the potentially excessive costs of attempting to meet targets, particularly if only monetary measures are relied upon. The decision to adopt targets must therefore be carefully considered.

Participants emphasised that inflation targets can only succeed if meeting them is a national objective. The target must be an important objective of economic policy as a whole, not just of monetary policy. In addition, there are many inflationary forces at work in the economy, including wage and other cost pressures. Thus, as discussed below, public commitment to low inflation is of fundamental importance. Introducing targets in the absence of widespread political support could undermine the position of the central bank.

For these reasons, it was argued that it is premature at this stage to introduce formal inflation targets in South Africa. The complex transition in the framework for economic policy and the structure of relevant institutions which South Africa is currently undertaking implies that the environment is not yet appropriate for such formal targets. Moreover, public support for fighting inflation will be closely linked to delivery of the RDP. In the medium term, however, as the uncertainties of the transition are resolved and the importance of price stability gains wider acceptance, a move towards the adoption of targets merits serious consideration.

■ Exchange rate policy

The issue of control over exchange rate policy was also discussed extensively, with debate focusing on formal versus effective control, on how exchange rate policy is conducted, on the conditions under which there can be a separation of objectives between monetary and exchange rate policy and on the sustainability of pursuing different objectives.

It was widely accepted that in the absence of some form of exchange controls it is difficult if not impossible to separate the objectives of exchange rate policy from those of monetary policy, a point emphasised by Ramos in her paper. Since monetary and exchange rate policy are essentially two sides of the same coin, the question arises of who should decide on exchange rate policy including the choice of exchange rate regime. It was argued that giving the government authority over exchange rate policy risks undermining the objective of price stability, if the former is used as a short-term instrument to boost international competitiveness.

It was suggested that the trade-off between nominal exchange rate stability and international competitiveness is a 'Phillips Curve' type relationship that is, at best, exploitable only in the short run. It was argued that in South Africa depreciation may be ineffective even in the short run as an instrument for increasing competitiveness, since it rapidly works through to the costs of production.

As competitiveness is more to do with the ability to sustain employment in a changing world, micro-economic and structural reforms that enhance flexibility and productivity should be the primary focus of policy. Moreover, such reforms will be considerably more difficult to implement in an inflationary environment. For these reasons, it was argued that the Reserve Bank should be responsible for both monetary and exchange rate policy.

Questions were also raised about the potential for conflict arising from the stipulation in the Interim Constitution that the Bank is to maintain the internal *and* external value of the currency. The recent financial crisis in Mexico was offered as an example of a situation where a policy of external price stability proved incompatible with general financial stability.

Participants highlighted the difference between a policy of stabilising the *real* exchange rate (as has been pursued in South Africa) and one of stabilising the *nominal* exchange rate (as was essentially attempted in Mexico). Meeting exchange rate targets, especially nominal targets, was seen to require flexibility in labour and other markets. It was argued that any conflict between internal and external stability is essentially short term in nature. There was general agreement that primary emphasis should be on internal price stability, which is a precondition for long-term exchange rate stability.

It was noted that the delegation of exchange rate policy is an area of great political sensitivity and that most governments are not prepared to delegate all responsibilities for exchange rate policy to the central bank. The exceptions are Sweden and Chile. Andrés Bianchi described how, in the case of Chile, the central bank has legal responsibility for exchange rate policy but in reality consults with government on exchange rate issues because of the political nature of some of the decisions.

One reason given for the reluctance on the part of government to delegate responsibility in this area is that exchange rate policy has historically been seen as part of foreign policy. However, some participants argued that the globalisation of capital markets could reduce this role by severely limiting the scope for discretionary exchange rate policy.

Finally, the ambiguous allocation of control over exchange rate policy in South Africa was highlighted. While formal responsibility rests with the Minister of Finance, the Reserve Bank makes policy on a day-to-day basis (e.g., deciding on the scope and objective of intervention). Responsibilities within exchange rate policy are also complicated by the existence of exchange controls, which are the government's responsibility. It was generally agreed that there needs to be a clarification of policy responsibilities.

■ Financial stability

Since financial stability is a prerequisite of monetary stability, it was argued that both must inevitably be objectives of the central bank. As Hayward emphasises in his paper, the central bank's responsibility for financial stability focuses on the goals of maintaining the integrity and efficiency of the payments system and of financial markets, both of which are essential to effective monetary policy.

The potential for conflict between the pursuit of monetary stability and the need to maintain the solvency of the financial system was highlighted, as was the risk that the central bank's credibility may be damaged by too close an involvement in supervision. It was suggested that the use of legal requirements for full public disclosure by financial institutions, as New Zealand has done, may prove to be a useful mechanism for giving the market a greater role in supervision.

It was argued that retaining Reserve Bank responsibility for banking supervision was desirable for ensuring the effectiveness and independence of the supervisor. The Bank attempts to keep an arms length relationship between this supervisory role and its monetary policy role. Although questions of systemic risk may, at times, bring the two roles together, the maintenance of this arms-length relationship was regarded as desirable.

■ The social and political context for central bank independence

Granting independence to the central bank represents a considerable political change, participants emphasised. It is a transfer of power over a key aspect of macroeconomic policy from government to the central bank. It was argued that the desirability and likely success of such a transfer in a particular country depends on the social and political context. Such a transfer also raises critical questions of accountability, to government and to the public more generally; of policy coordination, between the central bank and government; and of the structure and composition of the institution to whom this power is delegated.

One point that received particular emphasis throughout the workshop discussions is that legal or constitutional independence for the central bank is not sufficient (or even necessary) to achieve price stability. A successful anti-inflation strategy also requires a disciplined approach to fiscal policy as well as appropriate exchange rate and wage policies. More generally, international experience has demonstrated that sustained reductions in inflation are only possible when supported by a broad political and social commitment. Thus, central bank independence must be seen in its broader social and political context.

The South African government's commitment to reducing inflation was underscored by the Deputy Minister of Finance, Mr Alec Erwin. In his presentation, he commented that the government believes that price stability is integral to the sustainability of the Reconstruction and Development Programme (RDP). Rising prices and interest rates would rapidly undermine the government's ability to fund RDP initiatives. Moreover, it was noted that as economic growth will depend critically on sustained increases in domestic and foreign investment, any perceived weakening of the government's commitment to reducing inflation would have adverse consequences for growth.

The independence of a central bank and its success in reducing inflation also depend crucially on the level of support it can elicit from public opinion. Several participants noted that the success of certain countries such as Germany in fighting inflation rests importantly on strong popular support that derives from the lasting memory of earlier inflationary crises.

The point was made that in the absence of such an experience to galvanise public support, the central bank and government must together build a broad constituency for price stability. Unambiguous public statements of the importance of price stability to economic prosperity and, in South Africa, to the success of the RDP, are essential.

Other factors noted by participants that can reinforce the pressure for central bank independence include the existence of constitutional and political precedents of restraining the powers of government (such as those embodied in the set of Constitutional principles agreed before the elections); the level of public economic awareness; and the extent to which financial markets are liberalised and developed - and hence the larger the disciplinary and public information role they can play (as discussed in the paper by Guitián).

It was emphasised that over time the perceived success of the central bank in reducing inflation will help to reinforce public support. Indeed, reduced inflationary expectations may help the central bank's stabilisation policies to show earlier and socially less costly results.

■ Accountability

Accountability was widely agreed by the participants to be the essential counterpart to independence in a democratic system. Independence and accountability are, in the words of one participant, two sides of the same coin.

While the constitutional principle of independence for the Reserve Bank has now been established, the meaning and implications of this independence now must be more fully developed. This process will, it was argued, require changes in the range of structures that link the Reserve Bank to the institutions of government and to the population at large, in recognition of the responsibilities associated with this independence, as well as changes in the operating procedures and priorities within the Reserve Bank.

Participants agreed that the central bank is ultimately an agent of the government and the greater its independence the stronger and clearer should be the accountability for the exercise of delegated authority. Moreover, the primary goal of independence is to promote confidence and consistency in monetary policy and mechanisms for accountability are central to the ability of the public and financial markets to assess monetary policy.

There was broad agreement on the three facets of accountability emphasised by Guitián in his paper. First, it was recognised as crucial to accountability that the central bank have a clear, unambiguous and realistic objective. Second, participants emphasised the importance of mechanisms for the monitoring of monetary policy performance by the public and government, as noted in the earlier discussion of inflation targets. Third, participants agreed that the structure of incentives and constraints on decision makers in the central bank must be designed to ensure that their behaviour is consistent with the overall objective of the bank.

It was noted that the Reserve Bank's ultimate accountability is to Parliament, through the

Minister of Finance. This fundamental point is often obscured by the fact that in the past, neither the government nor Parliament properly exercised their oversight function. It was also noted that this has already started to change, with the new Joint Standing Committee on Finance playing a much more active oversight role.

International participants emphasised that greater accountability will be encouraged and developed through better public awareness of the Bank's role and this requires greater efforts on the part of Reserve Bank to explain its monetary policy actions. As noted earlier, the importance of public support for the central bank's policies was a strong theme throughout discussions. In addition to greater representation within the Reserve Bank, as discussed below, it was argued that an open process of public debate and input will be vital in gaining public support.

Most importantly of all, participants argued that the Reserve Bank must act swiftly to enhance the transparency of all aspects of its operations. To be effective, it was argued, central banks must continuously strive to earn the trust of the public, as well as their representatives in government, and transparency is - particularly in a period of transition - of fundamental importance.

It was noted that the National Economic Forum had provided a platform for debate in the past, and that this role has now been formalised in the newly formed National Economic, Development and Labour Council (Nedlac). Although not formally represented as a constituency, the Reserve Bank will participate in the Public Finance and Monetary Policy Chamber. Several participants stressed the importance of Nedlac as a mechanism for building a broader social consensus on monetary policy, a point made forcibly in Ebrahim Patel's paper.

There was strong agreement on the importance of achieving a proper balance between consultation and effective implementation. It was argued that there must be broad participation in the decision-making process but in a way that does not result in an inability to implement policy.

▪ Policy coordination

This led to the issue of policy coordination. The need for frequent meetings between the monetary and fiscal authorities was widely agreed. Participants shared the view expressed by Gerald Corrigan in his presentation that informal processes of coordination are likely to be more effective than rigid, legislated mechanisms, which can prove counterproductive.

It was emphasised that one of the essential characteristics of independence is that the central bank should not be permitted to finance the budget deficit, directly or indirectly. This principle is increasingly being recognised in deliberations on central bank independence around the world. If the central bank is forced to accommodate a government's excessive deficit, it cannot effectively pursue the objective of price stability.

Finally on the issue of policy coordination, the role of cost push factors in inflation was considered. It was suggested that Nedlac could play a part in explaining the problems of high wages and through this make inflation easier to manage. It was noted that inflation is an important factor in wage negotiations and that a macro-level dialogue on the wage-inflation relationship could result in lower-level bargaining being more informed.

▪ The internal structure of the Reserve Bank

Although changes in the external relationships between the Reserve Bank and the institutions of government as well as society at large were felt to be essential to the credibility and effectiveness of the Bank, so, too, were changes in the internal structure of the Bank. External and internal changes cannot, of course, be discussed in isolation from each other. External changes that enhance accountability will require or lead to changes in the internal structure, and changes in the internal structure will have implications for the Bank's external relations.

A number of participants shared Ebrahim Patel's view, summarised earlier, that the Reserve Bank has historically been isolated from strict public scrutiny and public accountability. It was further argued that the Board of Directors is perceived by large parts of the public to be unrepresentative of the broader community. Although the point was made the Board does currently include representatives from agriculture, industry, and commerce or finance, there was broad agreement that a more representative Board was essential if the Reserve Bank is to gain the widest possible public support and, in particular, if it is to gain public acceptance of policies which may involve short-term sacrifices.

It was noted that the RDP specifically calls for new appointments to ensure that the Bank's Board of Directors "can better serve society as a whole", and explicitly mentions the inclusion of representatives from "trade unions and civil society". Other participants added that racial and gender sensitivities are particularly important, a point emphasised by Walter Fauntroy in his paper.

It was further emphasised by several participants that appointing from a broad population does not necessarily imply political appointments. The overriding concern should be to appoint competent people from diverse backgrounds. There was much discussion of the example of Chile, assessed by Andrès Bianchi in his paper. Although the first Board of the newly independent Chilean central bank had a delicate political balance, all board members had extensive experience and a high degree of technical competence.

The process of policy making at the Bank was widely discussed. A number of participants felt that the process needs to become considerably more open and transparent. Discussion focused on the role of the Board of Directors and of the Governors' Committee and on the potential role of public debate, input and evaluation.

It was noted that the Board currently meets four times a year and receives a summary of the current economic position and an explanation of monetary policy decisions. Members of the Board are invited to give their views and through this influence policy decisions. Although it was recognised that formal authority rests with the Board, it was argued that, in practice, policy decisions are taken by the Governors' Committee.

There was general agreement that the role of the Board should be extended to facilitate a more open and participatory policy-making process. International models of the role of the central bank board were considered. It was noted that in most cases the Board delegates authority to a smaller committee for the execution of policy.

The complex regional arrangements in the US were discussed and it was noted that these arrangements serve as a useful two-way conduit: conveying information on the state of regional economies to the Federal Open Market Committee (FOMC) and explaining to the regions decisions taken by the FOMC. Various suggestions were advanced for how best to incorporate regional, sectoral and community interests on the Board.

The issue of training was also raised. It was argued that if the Bank wishes to have a better and broader technical staff, then it must build on its recent training initiatives, investing even more in training and taking full advantage of opportunities available internationally.

The discussions which took place in the workshop suggest a number of issues and strategies that could be considered to ensure that the Reserve Bank's mandate is in line with the new political and economic order in South Africa. In this section, we draw together these issues and strategies and build on them in order to provide a focus for future debate. The ideas presented below were developed by CREFSA staff and do not necessarily reflect the views of the participants of the workshop.

The overarching objective of any strategy concerned with the South African Reserve Bank should be to enhance the effectiveness of the Bank as an institution responsible for a key area of economic policy. In doing this, it must focus on two principal elements. First, the *external structures* that link the Reserve Bank to the government, to Parliament, to key stakeholders, and to society as a whole. These structures determine the political framework within which the Reserve Bank operates. Second, the *internal structure* of the Bank. These two elements together can help ensure the continuing credibility and effectiveness of the Reserve Bank in carrying out its responsibilities.

■ External structures

A possible strategy for broadening the external structures that determine the political framework within which the Reserve Bank operates could be based on three main components: measures to increase transparency; measures to strengthen accountability; and measures focused on education and community outreach.

Transparency

The government and the Reserve Bank should continue to work together to promote the role of the Reserve Bank in the overall framework of economic policy. The Reserve Bank should be unambiguously seen as contributing to the aims of the Reconstruction and Development Programme (RDP) by providing the foundation for sustainable growth and development through price and financial stability.

The Reserve Bank should develop procedures to promote greater openness in all aspects of its operations, particularly in policy deliberations, appointments and promotions, and financial accounts. Such procedures could include the delayed publication of minutes from meetings of the Board of Directors. Consideration could also be given to the delayed publication of minutes from meetings of the Governor's Committee. In addition, targets for increasing the amount of information made available to the public by the Bank, particularly in the three areas noted above, could be set and monitored in publicly available reports

An overall communications strategy to enhance transparency should be developed. Such a strategy could improve the presentation of policy priorities and their motivation, and clarify the role of the Reserve Bank in economic policy. With respect to the latter, emphasis could be given to the point that the Reserve Bank has been given autonomy in its choice of instruments and tactics in managing monetary policy, but not in the choice of its objectives.

Accountability

An important focus for the relationship between the Reserve Bank and government should be a continuing and high profile government commitment to price and financial stability. This commitment should be seen as fundamental to the government's strategy for sustainable economic growth and development as set out in the RDP and to the central role of the Reserve Bank as the guardian of the internal and external value of the rand.

The accountability of the Reserve Bank to Parliament could be formalised in a requirement that the Reserve Bank Governor report to Parliament at least twice in each Parliamentary session. A possible reporting mechanism could be a public hearing held by the Joint Standing Committee on Finance.

The National Economic, Development and Labour Council (Nedlac) should play a central role in promoting the accountability and effectiveness of the Reserve Bank, particularly through its Public Finance and Monetary Policy

Chamber. Nedlac could be the primary vehicle for building consensus among key stakeholders on anti-inflation policy (and the objectives of price and financial stability) and, more generally, on the role to be played by the Reserve Bank.

The active participation of the Reserve Bank in the Public Finance and Monetary Policy Chamber could also facilitate the coordination of economic policy. As was noted throughout the workshop, a successful anti-inflation policy cannot be based on monetary policy alone. Nedlac could play a crucial role in developing a coordinated and comprehensive anti-inflation policy built on a coherent economic policy framework and a joint commitment by business, labour, and government.

Nedlac could also be a useful vehicle for addressing the conflicts that may arise between different policy objectives as well as for helping the government to manage policy effectively in the absence of consensus.

Education and community outreach

The Reserve Bank should develop programmes for communicating to the greater public the functions of the Reserve Bank through simple but informative publications. It could expand and formalise its contacts with schools and universities to ensure that its support in providing appropriate course materials, speakers, etc., reaches a broad and representative cross-section of the population. The Bank could also consider the expansion of scholarship programmes.

Consideration could be given to establishing advisory councils to the Governor to facilitate communication between the Reserve Bank and particular sectors of the economy such as agriculture, small business, the financial sector, etc.. A new strategy could be developed to target an appropriate and representative range of different groups in public speeches by the Governor and other senior officials. Such a strategy should be driven by the recognition that the constituency of the Reserve Bank must be broadly conceived to include the whole of society.

■ Internal structure of the Reserve Bank

Adapting the internal structure of the Reserve Bank could play an important role in gaining public support for the Bank. In this respect, emphasis should be given to the composition of the Board of Directors, and possible strategies for building capacity throughout the organisation.

A possible strategy could include a set of measures to make the Board of Directors more representative and more effective. This could help ensure that Reserve Bank policy is informed (and is seen to be informed) by the interests of society as a whole. It could also help communicate back to key interest groups and communities the role of the Reserve Bank in economic policy.

The process of building capacity at all levels of management could be improved through investment in in-house training; through the use of external training opportunities; and through the development of a formal "fast track" procedure. Priority could be given to the development of a comprehensive training strategy with clear targets for bringing the composition of the Reserve Bank staff - including all levels of management - into line with the composition of the population as a whole.

The Reserve Bank's recent training initiatives are a first step which should be broadened through additional investment to provide the basis for a new training strategy. In addition, a coordinated "fast track" procedure for the intensive training and rapid promotion of capable managers could be put into place. Such procedures can be an effective way to attract and retain "high flyers" and could be particularly appropriate in an institution in transition.

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