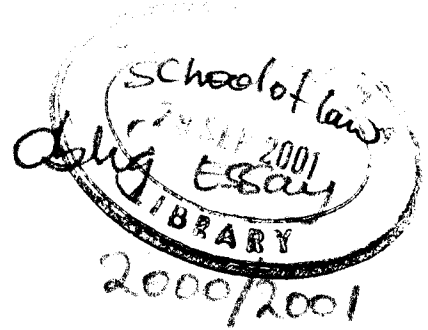


I RECOMMEND THAT THE OBLIGATORY ESSAY WRITTEN UNDER MY  
SUPERVISION

BY

A. CHITEMPA



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“CENTRAL BANK INDEPENDENCE: A CASE STUDY OF ZAMBIA – AN  
ECONOMIC, ADMINISTRATIVE AND LEGAL PERSPECTIVE”

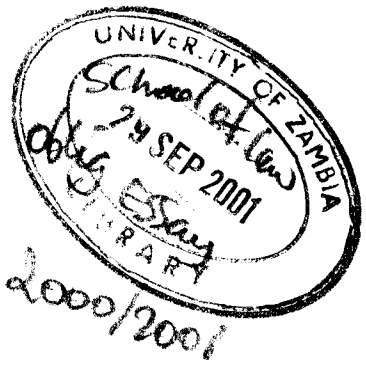
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SIGNED .....  
G. M. KANJA  
(Supervisor)

DATE 3<sup>RD</sup> AUGUST 2001

2001



**OBLIGATORY ESSAY**

**ON**

**“CENTRAL BANK INDEPENDENCE: A CASE STUDY OF  
ZAMBIA – AN ECONOMIC, ADMINISTRATIVE AND LEGAL  
PERSPECTIVE”**

**BY**

**ACKIM CHITEMPA**

**A DESERTATION SUBMITTED TO THE FACULTY OF LAW OF  
THE UNIVERSITY OF ZAMBIA IN FULFILLMENT OF THE  
REQUIREMENT OF THE AWARD OF THE DEGREE OF  
BACHELORS OF LAW (LLB).**

**SCHOOL OF LAW  
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P.O. BOX 32379  
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**JULY, 2001**

## **DEDICATION**

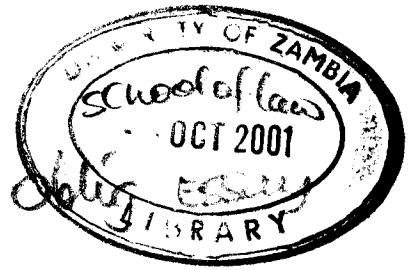
This work is dedicated to my wife Bridget and my children. To you my dear wife, I should say you have been a source of motivation in all my endeavours in life so far. Without your care to our family, this study would not have easily seen the day. Loving you for ever..... . To you my daughter Beene, as you were a baby when I was writing this work, it is a pit because you were deprived of fatherly care, but I promise that you will be compensated some way in the future..... And all of you my children, I am encouraging you to study because with school, your future is bright – knowledge is power. I also dedicate this work to my parents and other relatives who showed me the way to school and provided me with encouragement and material support.

## **ACKNOWLEDGEMENT**

In completing this work , I obtained numerous ideas and encouragement from several people without whom the task of writing this paper would have been difficult. In particular I wish to specially register my thanks and appreciation to Mr. G. M. Kanja for effectively and willingly supervising my work . I am immeasurably grateful for his guidance and ideas. I am also grateful to a good number of Bank of Zambia Staff particularly those from Economics, Financial Systems and Financial Markets depatments for giving me their views on the subject. My appreciation also extends to the Bank's Library staff for kindly allowing me to use various documents in support of my work. Indeed, the same gratitude goes to eminent writers whose copyright material I have used.

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# CENTRAL BANK INDEPENDENCE



## INTRODUCTION

In an environment where the economy is liberalized, the central bank has a far greater role to play as it is charged with introducing various policy instruments and effectively manage these instruments so as to keep the economy in stable condition. The central bank should therefore be considered as an essential player in the economy and to operate within a regulatory framework to underpin the effective development of market-oriented financial systems. The central bank, in a developing country therefore requires to be reorganized, especially to take account of the new role required of it in the context of restructuring and modernization of the financial sector.

One of the common experiences with central banks, and especially those of developing countries, has been that of heavy politicization of the banks. This has had a negative consequence on the general performance of the banks and eventually the countries' economies. Political aspirations have always compromised the pursuance of good monetary policies and efficient stable banking systems. Politicians have often been using the monetary expansion, in form of printing money, as a means of stimulating the economy in the interest of short term electoral popularity. The result of that has always been the constrained central banks' statutory objective, which in many cases has been that of price stability.

The relationship between a country's central bank and its government is nowadays of intense discussion around the world. In exercising its responsibilities, the central bank can be dependent, autonomous or independent from the political authorities. Dependence implies subordination to the dictate of the executive. Autonomy or



independence indicates the absence of political interference and implies the widest possible room for manoeuvre in the conduct of the policies delegated to it.<sup>1</sup>

Central bank independence(CBI) is seen as a means of achieving the goal of price stability. The phrase, “price stability”, connotes the absence of inflation. Inflation is seen as a grave disease for the economic well-being of a country. It increases uncertainty, discourages investment and brings conflict into industrial relations.<sup>2</sup> It also brings about adverse social effects such as arbitrary distribution of income and wealth and discourages saving of money. Much of the justification for CBI is rooted in the conviction that the conduct of monetary policy should be aimed primarily at controlling inflation.

It has to be mentioned that inflation is not a recent phenomenon to Zambia. During the Second Republic era, the economy was entirely controlled by the state. That is to say, all prices of commodities were controlled and some commodities (e.g., maize meal, Zambia’s main staple food) were subsidized by the government.(This macro-economic environment could have been the cause of inflation). In that period the level of inflation in Zambia was already high. It has always been a subject of debate to ascertain exactly what the underlying cause of inflation was.<sup>3</sup>

In 1991, the Movement for Multiparty Democracy (MMD) came to power replacing the United Independent Party(UNIP) which had ruled the country for a period of 27 years. The new government’s priorities were the restoration of economic future growth and employment to the Zambian economy. Liberalising the economy, and thereby allow market forces a greater role in the allocation of resources, was to be the

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<sup>1</sup> R.M. Lastra, “Central Banking and Banking Regulation” (Financial Markets Group. London. 1996 ) p.10

<sup>2</sup> Ibid. p. 14

<sup>3</sup> N. DeAssis and S.M. Yikona eds. “Central Banking Evolution in Southern Africa” (Mission Press. Ndola 1996). See S. Musokotwane -Towards Indirect Instruments of Monetary Policy in Zambia p.39

main means to achieving this. Price controls were abolished, as were subsidies on all consumer goods.<sup>4</sup> The effect of the removal of subsidies and the decontrol of prices was a sharp rise in inflation from 111.0% in 1991 to 191.2% in 1992.<sup>5</sup>

Now, the government's focus on price stability as a key contribution to future economic growth prospects has paused a new challenge for the Bank of Zambia. Hence, for example, although it reluctantly got involved in things like providing credit to Parastatal organisations it has begun to re-orient its activities towards meeting the core objective of maintaining price stability and ensuring a sound financial system.<sup>6</sup>

The main issue therefore facing us is on how Zambia can effectively eliminate inflation, hence attain price stability.

Using various indicia of independence, Grilli(et al) concluded that for eighteen industrialised countries the average rate of inflation was lower in those with an independent central banks.<sup>7</sup> Importantly, however, Curkierman found that the relationship did not hold as well when the analysis was extended to include developing countries, although possibly because the measures of 'legal independence' did not throw good light on actual independence.<sup>8</sup> However, generally it is felt that a high level of CBI coupled with an explicit mandate for the bank to focus on price stability objective are important institutional devices for the assurance of price. Hence this paper has been written on this premises: Examining how tenable is central bank independence to Zambia, putting into account all the relevant factors surrounding the banking system.

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<sup>4</sup> 1964 –1994 The History of the Central Bank (Bank of Zambia Publication. Head Office – Lusaka. Regional Office – Ndola.)

<sup>5</sup> See Supra note 3

<sup>6</sup> See supra note 4

<sup>7</sup> V. Grilli et al., "Political and Monetary institutions and public financial policies in the industrialised countries" (1991) 13 Economic Policy 341.

‘Actual’ as opposed to ‘formal’ CBI depends on the degree of independence conferred on the bank by law, but also on a myriad of other less structured factors such as informal arrangement, the quality of the bank’s research department, and the personalities of key individuals in the bank and other policy making organs like the Treasury.<sup>9</sup> It has to be noted, here, that enacted laws per se are usually not sufficient in the measurement of CBI, because they do not specify explicitly the limits of powers between the central bank and the political authorities under all contingencies.

Given the foregoing, an inference is drawn that a central bank can enjoy independence even though that is not documented or guaranteed by law. That is to say it can originate from what actually goes on in practice. In Zambia the central bank statute does not provide for legal independence. In this connection, the issue is whether the Bank of Zambia enjoys a certain amount of independence from political authorities despite the absence of a provision in the Bank of Zambia statute guaranteeing that. If it does so, to what extent? This is the main question which this paper addresses.

What are the main categories used to measure CBI? According to Lastra, CBI manifests itself in three ways or safeguards. These are “organic”, “functional” and “professional”<sup>10</sup>. Organic safeguards of independence mean that the legal safeguards are directed towards the organisation of the central bank and to its institutional relationships with the government. Functional (or operational) safeguards connote the legislation for a central bank providing for its functions and the scope of powers entrusted to it. The third dimension is “professional” which is part of *de facto* independence which can be

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<sup>8</sup> A. Cukierman, “Central Bank Strategy, Credibility and Independence: Theory and Evidence” (MIT Press, 1992, Ch. 19-23

<sup>9</sup> Ibid. p. 370

<sup>10</sup> Supra note 1 at p. 13

determined by other factors such as the personalities of the governor and the minister of finance and even other high officials; the political and economic circumstances, for example economic recession or expansion; the history and national priorities of the country concerned; the depth and quality of monetary analysis; and the rate of turnover of central bank governors. The measurement of CBI generally focuses on the legal framework, though some studies also take into account elements of *de facto* dimension.

This paper seeks to address the following issues:-

- (a) The best way to ensure price and financial stability in Zambia;
- (b) The problems associated with the enforcement of the existing bank of Zambia statute;
- (c) The relationship prevailing between the BOZ and the Ministry of Finance; and,
- (d) The legislative reform which the law should come up with in order deal with the monetary and financial systems effectively.

The study consists of three chapters which have proceeded as follows:-

Chapter 1 examines the evolution of the functions of a central bank: the rational of central banking. This gives the reader a thorough basic knowledge for which central banking is created. Relevant concepts have been explained. Chapter 2 firstly examines the theory of inflation and highlights its sources and the required treatments for those various sources. In the second place, I have provided the historical background of the Federal Reserve System (of the United States) and the Bundesbank (of Germany). This has been done with a view to show the experiences which those central banks went through in their fight against inflation, particularly during those hectic periods of the

World Wars. By providing such details to these two nations, however, I have not placed a limitation for citing other central banks relevant to this work as I have done so. Suffice it to say above two mentioned central banks have been shown, by a number of researchers and scholars, to be prominently independent.

Chapter 3 spells out the “safeguards” for CBI. This is done in an effort to show how CBI has actually been effected in other countries. Finally, I have examined the notion of “accountability” as it has been applied to central banking. Here it has been shown how important accountability is to an independent central bank in curtailing the abuse of independence.

Chapter 4 is a comparative analysis. This compares the Bank of Zambia with other central banks which have, prima facie, shown success in the implementation of central bank independence. This analysis has been done from the realisation that one can gauge the direction of the Zambian central Banking system from the experiences of other jurisdictions, particularly from those with advanced and independent central banking systems.

## CHAPTER ONE

### THE EVOLUTION OF THE FUNCTIONS OF A CENTRAL BANK: THE RATIONALE OF CENTRAL BANKING

The purpose of central banking has been defined in various ways: to maintain stability of the price level, to keep the economy on an even keel, and so on. These aims could be varied for more than they are in literature. Under some circumstances the purpose of central banking might be defined as the maintenance of gold standard and the maintenance of sterling standard, or the maintenance of dollar standard.<sup>11</sup>

Hanson's "Dictionary of Economics and Commerce" explains the principle functions of a central bank as being to carry out the monetary policy of a country, and this requires that it should work closely with the Government and must have some means of controlling the commercial banks.<sup>12</sup> Furthering this explanation, a prominent economist once said that money is as money does. By this he meant that anything is money that performs the functions of money; any thing is money which serves as a medium of exchange, a storehouse of value, a standard of value, and a standard of deferred payments. If in like manner it can be said that a central bank is a central bank does, what then does a central bank do? Sir Ernest Harvey, then Comptroller of the Bank of England, noted some years ago in a lecture in Australia that a central bank should have the sole right of note issue; should serve the needs of commercial banks and other financial institutions; should be the principal fiscal agent of its government; should have the main responsibility for the maintenance of the gold and foreign- exchange reserves of

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<sup>11</sup> R. S. Sayers, "Central Banking After Bagehot" (the Clarendon Press. Oxford. 1967) p.15

the nation; and should have principal responsibility for the control of the volume and use of money in the interest of economic stability and growth.<sup>13</sup> It has a distinctly public purpose. It is not primarily a profit-making institution, although its profits may at times be large. It is above all a guardian of the national interest.<sup>14</sup>

Only since World War I has the term “central bank,” a term descriptive of the functions of such institutions, come into common usage. Previously, institutions now known as central banks had been referred to either individually – the bank of England, the Banque de France, the Reichsbank - or collectively as note issuing banks, the common expression on the European continent. Bray Hammond pointed out, in his classic study, that the term had actually been used as early as 1834 by a French traveler to the United States, Michel Chevalier, who had referred to the Bank of United states as a *banque centrale*.<sup>15</sup>

Today nearly all nations have central banks. The world wide movement toward central banking was furthered by a resolution at the International Financial Conference held at Brussels in 1920, which advocated the establishment of a central bank in every nation that did not have one. The establishment of such banks, so the resolution read, would not only facilitate the restoration of stable banking and monetary systems but would also promote international monetary cooperation.<sup>16</sup> Even if a country has little need today for a central bank it must poses one. A central bank, housed in an imposing

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<sup>12</sup> J. L. Hanson, “A Dictionary of Economics and Commerce” (MacDonald and Evans Ltd. London. 1969)

<sup>13</sup> E. Harvey, “Central Banks” (General Press. London. 1928), pp. 16 - 23

<sup>14</sup> See B. H. Beckhart, “Federal Reserve System” (American Institute of Banking. Distributed by Colombia University Press. 1972) pp. 1 - 2

<sup>15</sup> B. Hammond, “Banks and Politics in America” (Princeton: Princeton University Press, 1957), p. 306

<sup>16</sup> This movement was greatly encouraged throughout the common wealth by Montagu Norman, governor of Bank of England during the 1920s.

chrome-and-glass structure, is as much a status symbol for a developing nation as a steel mill.<sup>17</sup>

The main traditional functions of central banking are:– issuing of notes; formulation and implementation of monetary policy; serving as bankers' bank; bank supervision; serving as government's bank; and the undertaking of developmental and promotional tasks. Other functions which are not falling directly under the purview of central banking, such as 'debt management' and "exchange controls", have been highlighted since very often these functions have been considered to cause a trade-off between central bank independence and governments.

## **I. Note-issue**

The privilege of issuing money is considered as the first *raison d'être* of a central bank, a task generally associated with financing the government. In most countries today, central banks have a monopoly power over note-issuing. The central bank issues all the notes in the country. This enables the central bank to control the seigniorage<sup>18</sup> and to determine the volume of note issue. Although there are some proposals that seigniorage should be shared between central banks and commercial banks, it seems that in practice that is unachievable and that is attributed to the fact that the practice of injecting new currency is considered (by governments) as a precious source of revenue.<sup>19</sup> However, if the central bank is dependent on the government, note-issue is

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<sup>17</sup> Supra note 13 at p. 2

<sup>18</sup> This is the margin between the normal value of the notes issued and the costs of their production. These are revenues which are amounts of real sources bought by the government by means of new base money injections. It is the creation of money.

<sup>19</sup> Lastra R M. Central Banking and Banking Regulation (Financial Markets Group . London . 1996 ) p. 253



clearly under political control. This duty remains a matter of controversy, as we will see later below in the detailed study of CBI.

## **II. Monetary Policy**

The task of monetary policy is to ensure that the expansion in domestic liquidity is consistent with the authorities' objective for growth, inflation and balance of payments. This objective focuses on the fact that countries, especially those implementing adjustment programs, usually suffer from high inflation, sluggish growth and external disequilibrium. To an extreme extent these problems are likely to reflect inappropriate developments in monetary aggregates.

From the view of stabilization policy, the primary role of monetary policy is to prevent excessive spending. However, in a broader sense financial policy plays a key role in affecting the efficiency of resource use in the economy by influencing the mobilization and employment of financial resources.<sup>20</sup> In the strict sense of the term, monetary policy is carried out by monetary means – the traditional instruments of policy, namely bank rate and open-market operations.<sup>21</sup>

Monetary policy is nowadays generally accepted as the main function of a central bank. In the case of purely dependent central banks, the government via its Treasury or Ministry of Finance, is responsible for the determination of the goals of monetary policy whereas the central bank would be responsible for its implementation. It is, however, often argued that effective implementation of monetary policy requires the subordination of individual or sectional or whatever group interest to macroeconomic interests and this

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<sup>20</sup> Davis J. M. , *Macroeconomic Adjustment: Policy Instruments and Issues*. (International Monetary Fund, August 1992) p. 7

demand cannot be fulfilled by a profit – making body; Thus the need for a central bank to be a non-profit maximizing institution.

Though there are dissenting views, the majority of the economists today accept monetary policy as an important part of the economic policy of the state. The effectiveness of monetary policy is demonstrated at the operational level of the banking system. Certain instruments, for example, such as open market operations (OMOs), are necessary for the conduct of a market oriented monetary policy. In developing countries the conduct of monetary policy presents additional challenges as the shift from direct instruments to indirect instruments need to be accompanied by the parallel emergence and development of money market. In examining these operations it is worth realising the scope of powers entrusted to the monetary authorities. Such scope of powers will vary depending on a number of factors such as the exchange regime, the degree of independence of the central bank and the openness of the economy.

### **III. Bankers' Bank**

Historically, the central bank's role as banker of other banks originates from the traditional tendency in which commercial banks used to centralise their reserves in one or more well – established commercial bank/s <sup>22</sup>, or in a clearing association. The bank/s at the centre would pool the reserves and provided services and facilities to other commercial banks. The bank/s at the centre maintained inter-bank deposits.

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<sup>21</sup> Hanson. J. L., A dictionary of Economics and Commerce

<sup>22</sup> Goodhart, C., The Evolution of Central Banks, (MIT Press, Cambridge, MA, 1988) p. 37

However, other writers hold the view that ordinary commercial banks could not effectively perform functions of central banking because of their inclination to competition and profit making. As Goodhart notes:

*“the function rests upon the metamorphosis from a competitive, profit maximizing institution to a non-profit maximizing central bank, because in so far as the central commercial bank is a competitor, other banks will be unhappy about placing deposits with it that increase the size of its book.”*<sup>23</sup>

A crucial point to note on the advent of central banking is the dual role i.e. (being the banker for commercial banks and at the same time for the government) which central banks play. This makes transactions between the latter and the former easier. The crediting and debiting of their respective accounts is easily facilitated that way unlike where accounts are held at separate banks. The only and, perhaps, major drawback over this dual role arises when a central bank is politicised as it would tend to favour the interests of the government above those of the banking sector. Therefore, as Goodhart notes<sup>24</sup> “an independent non-competitive central bank is likely to be welcomed by other banks”. This is how old central banks like the Bank of England evolved up to the fuller role of central banking which they have attained today.

In its role as banker to commercial banks, *inter-alia* a central bank may undertake the following functions:

The acceptance of deposits which act as prudential reserves for these banks.

The provision of central clearance facilities for inter-bank transactions and the operation of the payment system. Sustainable economic growth requires a well

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<sup>23</sup> *Ibid* p. 38

<sup>24</sup> *Ibid* p. 73

functioning, efficient and reliable clearing and payment system. In today's world, payments are increasingly made by electronic means. It is therefore, a key function of a central bank to ensure that the national clearing and payment system meets all the needs of the business community in order to effectively support both national and international business transactions by providing liquidity in the financial system. The day-to-day liquidity support to the commercial banks through its rediscount or advance facilities.

The commitment to act as lender of last resort for commercial banks, providing extraordinary credit or emergency lending – This lending can be taken either to support a single banking suffering from liquidity crisis or to preserve the stability of the banking system as a whole by extending reserves to all banks suffering from large cash withdrawals. The second measure is intended to preserve the entire banking system from collapsing. This is held in favour of the view that an individual bank problem can quickly convert into a system problem. Sudden decline of confidence in one bank may spread by contagion to other banks.

#### **IV. Bank supervision**

Although different definitions to the terms “supervision” and “regulation” may be provided, the two terms can be used interchangeably with reference to central bank functions. Bank supervision in a broad sense is a process with four stages – licensing, supervision *stricto sensu* sanctioning and crisis. Governments often delegate the banking supervisory functions to central banks though some banks are assigned with some of the

responsibilities only for some of the stages, for example, licensing. The government may also delegate some or all the stages of supervision to any institution than the central bank though often working in close connection with it. In the US, for instance, the Federal Deposit Insurance Corporation (FDIC) is a separate agency from the Federal Reserve System.

## **V. Government's bank**

Historically in exchange for some monopolistic advantage in note-issue, or in corporate status, the central bank, for example the Bank of England, was expected to carry out certain functions for the government. It became the standard practice for the central bank to act as the bank to the government and acting as its fiscal agent and its advisor in general economic and financial matters, and so on.

Certainly, the position of banker to the government is very crucial to central banking as it involves the following functions:

The provision of lending facilities to the government. Most central banks, especially if dependent upon the government, are required to help finance the fiscal deficits, either by granting direct credit facilities to the government or by purchasing government securities directly from the issuer.

The central bank by running the government bank accounts acts as its fiscal agent.

The central bank provides technical advice to the government on monetary policy and financial affairs nationally and internationally. The importance the government gives to this advice will vary according to the degree of independence accorded to the central bank in the fulfillment of its tasks.

Management of Gold and Foreign Exchange Reserves. Historically, the monopoly of note-issue by central bank entailed that the bank also assumed the responsibility as guardian of the country's monetary reserves. The conduct of foreign exchange policy also involves determination of the exchange rate and exchange regime, and the management of monetary reserves (both gold reserves and foreign reserves). A favourable over-all-balance of payments usually increases the reserves, just as an adverse balance of payments reduces them. Consequently, an adverse balance of payment is treated as a serious situation, and has tended to cause governments sometimes to adopt policies to rectify it which have also tended to check the economic growth of a country.

It is worth noting that the general practice in many countries is that foreign exchange and gold reserves are owned by the government and central banks hold and manage monetary reserves.

## **VI. Development and Promotional Tasks.**

Central banks in developing countries often fulfill development tasks as well. In these countries the research department(sometimes called economic department) of the central bank is in most cases the best and sometimes the only economic policy research group in the country. The function of the economics department is to advise on the formulation of monetary policy. This entails collecting and processing large amounts of financial and economic data to assess the likely future trends in the rate of inflation and providing advice on an ongoing basis on what course of action to be taken next so to ensure price stability. The department's other but related responsibilities include the publication of various types of economic reports and statistical bulletins. The department

is also the point of contact for the IMF on the formation and implementation of the structural adjustment programme. The economics department is also instrumental in carrying out academic research which helps the Bank's understanding of monetary policy issues.<sup>25</sup>

## VII. Debt management

Debt management is not necessarily the function of a central bank. It is the function linked to the finance of government. In most countries the ministry of finance or the Treasury undertakes debt management. Nevertheless, in the countries like the UK, historical circumstances dictate that the central bank serves as debt manager. In this country debt management has been used not only to fund fiscal deficits, but also for monetary policy purposes. As Goodhart stated,

*“One result of the British approach is a closer interrelationship between interest rate and debt management policies.”*<sup>26</sup>

However, the popular view is that central banks should not be involved with debt management. Stressing this point Acheson and Chant wrote:

*“One method of directing the central bank's efforts toward major goals such as price stability and full employment would be through limiting its responsibility for debt management, either through the delegation to another bureau or through establishing a set of rules for debt management”.*<sup>27</sup>

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<sup>25</sup> See 1964 – 1965 The History of the Central Bank, “The Changing Roles of the Bank of Zambia.”

<sup>26</sup> C. Goodhart, “The Operational Role of the Bank of England,” Economic Review, London, 1985, p. 20

<sup>27</sup> K. Acheson and J. Chant, “Bureaucratic Theory and the Choice of Central Bank Goals,” Journal of Money, Credit and Banking, Vol. 5, 2, May 1973. P. 653

Along the same premises, Fisher maintains that the Treasury or another agency should manage the national debt, so as to avoid creating a conflict between the government's desire to keep debt service low and the goals of monetary policy.<sup>28</sup>

### VIII. Exchange controls

Exchange controls are an artificial barrier, extended to protect national credit markets. Once the controls are abolished and individuals are free to transfer their funds abroad, domestic direct controls are likely to be less effective as a lever of monetary policy. In the words of Goodhart:

*“without exchange controls, inter-mediation that is blocked ... will simply be re-routed offshore to the detriment of the domestic sector.”*<sup>29</sup>

Broadly, there are two main types of exchange controls, though these can sometimes be combined. These are :- (a) exchange restriction, and (b) Exchange intervention. The former is an instance where inhabitants of a country are permitted to obtain foreign currency only after application to the central bank. The latter control is where the monetary authority intervenes in the foreign exchange market in order to influence the rate of exchange by buying or selling their own or foreign currencies.

Nevertheless, the administration of exchange controls are often subject to different legislation and regulation in many countries.<sup>30</sup>

In concluding this chapter it should be reasserted that monetary policy is the main function of a central bank. The other functions of central banking can be said to be

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<sup>28</sup> S. Fischer, Modern Central Banking, paper presented at the Bank of England's Tercentenary Celebration, London, June 1994

<sup>29</sup> C. Goodhart, Money Information and Uncertainty (2<sup>nd</sup> Edition), MacMillan, London, 1989. P. 374

<sup>30</sup> See F. Mann, The Legal Aspect of Money, 4<sup>th</sup> ed., Clarendon Press, Oxford, 1982.



ancillary branches in support of monetary policy. In addition, monetary policy is considered as an important part of the economic policy of a state, as being one of the tools used to combat inflation.

We now turn to examine inflation and how the United States and Germany central banks endeavoured to remove the scourge.

## CHAPTER TWO

### INFLATION AND THE EXPERIENCES OF THE UNITED STATES AND GERMANY

#### A. INFLATION

The analysis of the term inflation, on this paper has been based on the understanding that central banks are mostly tasked with the goal of maintaining price stability. In one way, price stability can be defined as the maintenance of absolute purchasing power. In such a case the central bank would have to ensure that the price level did not deviate lastingly from a constant target value. Alternatively, price stability can be defined in terms of avoiding inflation. This means that a central bank has to orient the growth of money stock towards the medium-term growth of potential output. This would remove the most important reason for persistent losses of purchasing power in the past. Such losses would still occur, however, owing to shifts in price level for non-monetary policies.<sup>31</sup>

In view of those other causes, the study below has outlined the sources of inflation and the their remedies.

Monetary histories of many countries, even the most cautious ones, have shown that these countries have had their own episodes of rapid inflation. And some of these countries have had pretty desperate deflation as well, all or most of that inflation being consequent upon avoidable human decisions.<sup>32</sup> The quantity theory of money views

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<sup>31</sup> See Supra note 53 at p. 272

<sup>32</sup> R.S. Sayers, "Central Banking After Bagehott" (The Clarendon Press. Oxford. 1967) pp. 2-3

inflation as being solely the result of prior increases in the quantity of money in circulation: an X percent increase in the quantity of money would ultimately produce an X percent increase in the price level.<sup>33</sup> Inflation is said to be a political disease. Its characteristic symptoms are excessive claims on current income and significant, often rapid increases in price for many goods and services.<sup>34</sup>

Inflation is generally costly and distorts economic activity. Serious inflation, over the long run tends to lower real savings and investment, reduce productivity, and aggravate distributional inequities, and weaken social cohesion. Once inflation gets out of hand, eliminating it becomes very painful for politicians even if they regularly campaign against the failures of their predecessors.<sup>35</sup>

The sources of inflation comprise, from various perspectives, excess government deficits and/or money creation, wage price in less competitive sectors, expectational momentum, and world market scarcities or trends. Most sources have political origins within countries or among international community.<sup>36</sup> We are now turning to examine the sources of inflation in details.

## **I. Excess money spending**

The most obvious factor, generally speaking, that caused inflation was an excessive growth of spending, purchasing power, and money supplies. However, in

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<sup>33</sup> P. Folley, "Lloyds Bank Annual Review: Why Inflation" (Printer Publishers. London. New York. 1992) p. 163

<sup>34</sup> See A.L. William, "Inflation and Politics" – Fiscal, Monetary, and Wage –Price Discipline. (Heath and Company. Massachusetts. Toronto. 1982) p.xi

<sup>35</sup> Ibid

<sup>36</sup> Ibid

relation to excessive spending, government deficits are primarily the cause of sustained inflation or the more extreme (usually war related) hyperinflation.<sup>37</sup>

What is the right treatment for excess spending inflation? The remedy is simply to eliminate the excessive deficits and reduce the rate of monetary expansion. An awkward ambiguity may arise. Thus, where governments may be tempted to continue some deficit spending and merely reduce the growth of monetary balances, this will increase interest rates but allows government leaders to distribute the purchasing power associated with deficits. However the combination of substantial deficits with tight money is unsound; it leads to steady inflationary momentum, entrenched expectations and distorted capital market and an unhealthy bias toward quick appreciation of existing assets.

Unfortunately, the political temptation leaning on loose fiscal policy with deficit finance and tight monetary policy to limit inflation has been strong. Politicians can distribute more to constituencies in spending programs, tax incentives, or tax reductions and appease banking and financial interests with higher interest rates. But this trend tends to entrench inflation, aggravate deficits, and enlarge the government share of borrowing in capital markets.

The only real way to stop excess spending inflation is to eliminate budget deficits. This may be painful for politicians, but it is essential to stop this underlying inflationary

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<sup>37</sup> Ibid. p. 96, footnote No. 4. Hyperinflation occurs when a persistent inflation gets out of control and the value of money declines rapidly to a tiny fraction of its former value and eventually to almost nothing so that a new currency unit has to be adopted. Also see J.L. Hanson, "A Dictionary of Economics" (MacDonald and Evans Ltd. London. 1969)

pressure. Unfortunately, this treatment by itself may not prevent the other forms of inflation, especially if a strong inflationary momentum has been established.<sup>38</sup>

## **II. Wage-price “Push”**

This type of inflation is as a result of increased market power for many concentrated industries and powerful labour unions. It should be emphasised that such “wage-price” or cost push inflation will be more serious and widespread as a contributory cause of inflation than as an independent, initiating factor. The reason is that, with little inflation, industries and unions find it difficult to press excessive claims on the economy. Therefore, wage-price inflation, led by industries and labour markets that are insufficiently competitive will be much more serious whenever an inflationary spiral has been launched by excessive monetary growth , deficit spending and significant scarcities. As such, with less competitive industries and more powerful unions are likely to suffer the worst wage-inflation.

The treatment for this type of inflation is difficult. It requires regulatory reforms to reduce part of the market power, though it takes great courage to deal with certain powerful vested interests in industry and labour. Nevertheless, selective price and wage restraints may be helpful where reforms cannot be achieved. In this regard, special monitoring agencies may be empowered to rescind or reduce excessive price and wage increases. But selective controls policy must never be

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<sup>38</sup> See supra note 36 at p.97

confused with the comprehensive control of prices and wages that is typical for total war mobilisation and rationing. Obviously, prices and wages must be reasonable and consistent with the needs for investment and development. This limited intervention should be infrequent. It is most effective during those “exceptional periods” when excessive monetary growth or government spending may have recently launched a wage-price spiral and inflationary momentum.

### **III. Scarcities**

Scarcity inflation is a situation where there is shortage of a commodity or commodities. The trend may be caused by an artificial shortage, resulting to the increase of demand, hence sending prices up. However, scarcity inflation that comes from world markets or is imposed by external events, such as crop failures, resource limitations, or foreign cartels is another source. Under-pricing these imported commodities such as oil or metals only aggravates the dependence on these imports and worsens the nation's trade balance.

The treatment for scarcity inflation is not easily available. In the short run there is no alternative, but to accept these harsh facts of life. The only viable solution is a sustained effort to find substitutes or produce more commodities. When such pressures are significant in world-market, pricing countries suffering them must learn to adjust their fiscal, monetary, and wage-price policies accordingly. Further, they have

to undertake normal budgeting without extra deficits in nominal incomes and the related monetary aggregates, and accept the price increases resulting, even if domestic living standards decline slightly.<sup>39</sup>

#### **IV. Expectational Momentum**

This form of inflation involves “inflationary expectations.”<sup>40</sup> This also contributes towards inflation in sense that it occurs when monetary, fiscal, or scarcity inflation must have already launched the initial price movements. This type of inflation derives its name from the fact that, once significant inflation is underway, the forces of expectations that it will continue becomes a very strong, independent factor in sustaining the momentum of spiraling prices and wages.

The momentum of inflation expectations can be broken. But the means selected must be adapted to the circumstances. When an economy is overheated, for example, and its industrial and labour markets are fully employed, it will be very difficult and costly to break this momentum. Controls on prices and wages are burdensome in these circumstances and would probably lead to significant distortions in resource allocations. Such a situation requires that overspending excessive money supplies are eliminated by conventional monetary and fiscal discipline. But if inflationary momentum is allowed to move with great impetus, the

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<sup>39</sup> Ibid p. 98

<sup>40</sup> See W. Fellner, ed., “Contemporary Economic Problems” (Washington D.C. ; AEL. 1978)

deflationary recession, slack and increased unemployment may generate another round of excess spending and related monetary growth.

It is worth to note that during the control period of this type of inflation, there must be no excessive monetary growth or significant budget deficits. The presence of those factors could refuel the original inflation or destroy the public and business confidence in the ability to halt its momentum.

In conclusion, it is submitted that an effective anti-inflation policy should blend fiscal, monetary and wage-price policy. Countries that have combined these policies intelligently – like Japan, West Germany, and Switzerland – have achieved significantly better results. Nations that try to deal with inflation in a more limited way, particularly those neglecting wage-price discipline, will suffer more severe and long-lasting inflationary pressure. One lesson seems clear, a nation that relies only on monetary restraint, while continuing large budget deficits and a strong wage spiral, condemns itself to further inflationary momentum and underachievement. Thus, it calls for central bankers to ascertain the actual source of inflation at a particular time. Central banks mainly come in with monetary policies when the cause of inflation is clearly that of “excess money spending.” Monetary policy, as noted above, is primarily the responsibility of central banks. This fact is crucial to a study of central bank independence like the current one.



## **B. HISTORY OF THE FEDERAL RESERVE SYSTEM**

On 16<sup>th</sup> November, 1914, Reserve banks in the United States of America opened for business.<sup>41</sup> The Federal Reserve System devoted the period from November, 1914 to April, 1917 to the important tasks of completing its organisational structure, initiating fiscal services, establishing the basis for its credit policies, drafting regulations interpreting the Federal Reserve Act, and initiating research activities.<sup>42</sup>

The concentration of defence expenditures in certain periods and its effects on the Federal deficit and public debt have often prevented the Reserve System from instituting and following those policies that it favoured. Obviously, in wartime a central bank must try to do what it can to further the efforts of the government. The financial methods used by government to achieve these aims, however, may not only impede the war effort but may also increase the difficulties in transition to a peaceful economy.

In its task of protecting the stability of the currency, a central bank has the responsibility of opposing government policies that it deems detrimental to the national interest and of suggesting alternative measures. Reserve officials have occasionally done so but unfortunately have had little influence on the treasury policies. During both world wars, the Reserve System confronted Secretaries of the Treasury who were adamant in finding ways to easy money and were little inclined to share their decision-making powers with Reserve officials.<sup>43</sup>

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<sup>41</sup> See the brochure entitled: 1914 – 1964 ( New York : Federal Reserve Bank. 1964)

<sup>42</sup> See B.H. Beckhart, "Federal Reserve System" (American Institute of Banking. 1972) pp. 141 - 142

<sup>43</sup> See supra note 44 at p. 146

The system did not have the means to influence economic developments or to contain the forces of inflation. It had no open-market portfolio to use as counter-weapon. It lacked power to raise member bank reserve requirements. It took care however, not to intensify inflationary pressures and it followed a commendably conservative policy in discount and open-market operations.<sup>44</sup>

By early 1917, when it appeared that the U.S. would enter the war, the Reserve Banks entered into methods aimed at maintaining the liquidity of their assets and to discourage any unnecessary expansion of bank credit. Through much of its life, the Federal Reserve policies have been influenced by the two World Wars, regional wars<sup>45</sup> and the preparations for wars. The result of fiscal and monetary policies in that period was to force sharp increases in the money supply. From the Federal Reserve's point of view, the increase in conventional money supply could have increased less had personal income tax rates (particularly on lower incomes) been raised and if they were placed on levels that would have raised additional revenues.<sup>46</sup> In addition, many Reserve System officials felt that inflationary trends could have been less if Reserve Banks had been able to raise their discount rates as early as 1919. By doing so, both the increase in private debt and the decline in quality could have been retarded. The low rate at which government obligations were issued during the World War I inhibited increases in discount rates. A more realistic rate schedule would have eased the transition to normal functioning in the money market and capital markets. Gustav Cassel, a distinguished Swedish economist of that period, declared that weak American discount policy had

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<sup>44</sup> *Ibi.* P. 142

<sup>45</sup> In 1950–1953 the U.S. participated in a conflict with Korea; and in 1965 the U.S. again went to war with Vietnam.

postponed the adoption of sound monetary policies in Europe as well. "A deflationary policy in the U.S.", he remarked, "would have caused earlier adoption of corrective action."<sup>47</sup>

The increase in discount rates in November 1919 marked the beginning of the Federal Reserve independence. Thus, it was stated:

*"The disappearance of the Treasury from the long-term loan market and the rapid reduction of its requirements for short term accommodation foreshadows the approach of the time when financial operations of the Government will cease to be the important factor in shaping the Reserve Bank policies which they have been, and Federal Reserve Bank rates once more will be fixed solely with a view of aiding commerce and business."*<sup>48</sup>

Certainly, the Treasury withdrew its position to an increase in discount rates.

Another important incident in the history of the Federal Reserve System was the 1951 Accord which was meant to correct the relationship between the Treasury and the Banks. Important matters agreed in that Accord include the following:

The Federal Reserve agreed to conduct its open market operations in a manner that would assure satisfactory refunding of maturing Treasury issues. It was agreed that the Reserve Bank would immediately reduce or discontinue purchases of short-term securities and would permit the short-term market to adjust their own reserves. This policy assumed a level of short-term interest rates that would fluctuate in response to market forces around the Federal Reserve discount rate.

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<sup>46</sup> See R.A. Musgrave, "The Wartime Effort in the U.S., the U.K. , and Canada". Proceedings of the Thirty-sixth Annual Conference on Taxation under the Auspices of the National Tax Association (Washington D.C. ; National Tax Association. 1994) pp. 301 - 302

<sup>47</sup> G. Cassel, "Money and Foreign Exchange after 1914" (MacMillan Company. New York. 1923) p. 199

It was also agreed that more frequent conferences between the Treasury and Federal officials and staff would be held so that closer collaboration government financing might be achieved.

Two years after the Accord, the Federal Reserve was free of the Treasury domination. In its quest for independence, the Accord had been the indispensable step.

The independence of the Federal Reserve System was to some extent enhanced by individual personalities. For instance, William MacChesney Martin sounded to be a person of that nature when he took office in 1951 as Chairman of the Board of the Reserve. While taking his oath he said that he believed in a "Strong, vigorous independent and responsible Federal Reserve System."<sup>49</sup>

### C. HISTORY OF THE BUNDESBANK

The German hyperinflation is one of the most notorious and most studied monetary catastrophes. The fundamental cause of the German inflation was the First World War in 1914, and the methods with which the military conflict and its aftermath were financed.

The Reichsbank (the central bank of Germany then) was to meet the financing of the War which was expected to be a short war. Among other things, the limitation on discounting of treasury bills was suspended. In addition, there was established the Loan Bureaux which together with the Reichsbank issued notes. The result of that dual note-issue was monetary expansion so much so that by the end of 1918 there was five times much cash in circulation as there had been at the end of 1913. The note cover arrangement remained throughout the war until it was lifted in 1922.

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<sup>49</sup> Federal Reserve Bulletin. October, 1919 at p. 910

The German government, like other governments in Europe, rejected the responsibility of financing military costs through increased taxation. Furthermore, the public debt had to be financed increasingly by the banking system, and this meant in practice through the Reichsbank discounts.

The end of the War brought new expenditures. The German government faced a large bill for the social costs of the War which included payments to the crippled of the War, and to widows and orphans. The nation also became involved in paying large amounts to keep the social peace in a political situation that hovered perilously on the brink of social revolution. Food supplies were subsidised and in 1920, 12 percent of the government expenditure went to finance deficits in the post and railroad systems where employment was judged as a social necessity. The government in effect adopted a full employment programme for social policy reasons. There was also increasing militant opposition from business interests to the idea of paying tax.<sup>50</sup>

The German budget also focussed on payments (Reparations) which were imposed by the Versailles Treaty of May, 1921 rather than on domestic payments. Reparations therefore posed a substantial potential burden on the budget. The payments required under the Treaty now came to represent a major part of government expenditure. In consequence, the government budget remained unbalanced. It was financed increasingly through short-term (or floating) debt.

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<sup>50</sup> Federal Reserve Bulletin. Also note that W.C. Martin (Jr) held office as Chairman of the Board from April 2, 1951 to January 31, 1970.

<sup>51</sup> See N. Ferguson, (1995): *Paper and Iron: Hamburg Business and German Politics in the Era of Inflation 1897 – 1927*, Cambridge. p. 369

The Reichsbank accommodated this public sector deficit by discounting government bills. By then the Germany currency (Mark) had fallen drastically on the foreign exchange market.

During this period, the Reichsbank also continued to discount private bills at the negative real interest rates (i.e., rates well below the inflation level. It should be noted that negative real interest rates are very harmful to the economic growth if followed for a long period of time.<sup>51</sup>

The Reichsbank's discount policy was said not to be the prime cause of inflation. The Bank viewed the origins of inflation as lying in the balance of payments as well as in the budget deficit. This position could not help the Reichsbank pursue an appropriate monetary policy as it merely involved balancing the process outside the Bank for the course of monetary development. The most striking feature of the Reichsbank's public pronouncements is that it was simply responding to an increased demand for money. Especially in the earlier stages of inflation, it even argued that its activities were required because of the falling velocities of circulation. In 1918, new printing works were taken for emergency money. The law of 1922 regularised the status of these special issues.<sup>52</sup>

The ineffectiveness on part of the Reichsbank was due to its continued adherence to the real bills doctrine which resulted in an inability to guide monetary policy.

According to diagnosis of Germany malaise, Germany needed to produce more in order to export more, and in this way help to tackle the 'balance of payments' problem.

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See World Bank Report, 1993, p. 237

See D. Bundesbank, "Fifty Years of the Deutsche Mark" (University Press. Oxford. 1948) p. 20

On November, 1923, the Reichsbank stopped discounting treasury bills. The immediate cause of inflation was removed, but the credibility of the Reichsbank both internationally and domestically required rebuilding.

However, soon later, the new Reichsbank law limited loans to the government through discounting of treasury paper. The central bank now became more independent. Article 1 of the new Banking Act stated emphatically, the autonomy of the central bank: "The Reichsbank is a bank independent of the Reich Government." This autonomy was constitutionally anchored.

An essential component of the practice of central banking cooperation in 1920 was not only the legal autonomy of central banks, but also their practical independence from national pressures, both political and commercial.<sup>53</sup>

The period from 1930 to 1931 saw the withdrawal of foreign capital from Germany. As a result the Reichsbank reserves shrank drastically. And German banks, generally, became weak and with very low asset values. These and other factors worsened the German depression. Banks blamed the Reichsbank for standing by and letting the banking crises unfold.

Nevertheless, after the debt and banking crises, the German government imposed exchange controls. Further measures, too, helped the Reichsbank control the money market. From October 1933, open market operations (the buying and selling of treasury bills the purpose of supplying or absorbing excess liquidity) were permitted.

By now, how far had Germany gone in the fight against inflation? The answer is that, although Germany instituted cashless transactions as a way of showing that apparent monetary growth were in place during peacetime years, a new inflation had already

began. The government now already obsessed by the damage that inflation might do to popular confidence, tried to use price controls as an anti-inflationary instrument. In support of this situation, the German leader that time, Adolf Hitler commented that: "I had to show Schacht that the cause of stability was of our currency is the concentration camp: the currency stays stable when anyone who asks higher prices is arrested!"<sup>54</sup> Certainly Hitler stood firmly on price controls and any opposition to that would result to suppressive penalties. For instance, because of opposing his economic policies he dismissed Schacht who was in charge of the Reichsbank that time.

In practice the price controls brought unintended consequence, notably a steady deterioration of quality.

However, most of the Reichsbank officials who were trained in the doctrine of orthodox economic liberalism said that the system of exchange control and indeed the whole system of control over Germany's economic life was quite unworkable in a long run.<sup>55</sup> The Reichsbank, deprived of its role as "guardian of the currency" in practice simply became one part of the mechanism for running the war.

Like the First World War, Hitler's war was fiscally ruinous. There were tax rises beginning from 1939. Military expenditure was not covered by tax revenue as it was not sufficient. Therefore, war was managed through the 'silent financing' of private savings channeled by the banks into state paper as they had been through the 1930s.<sup>56</sup> Some part of the war was paid through impositions on occupied countries. But these sources were inadequate and as the war progressed, its cost was increasingly met through the use of the

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<sup>53</sup> Ibid at p. 26

<sup>54</sup> W. Jochmann (1980) *Adolf Hitler Monologe im Fuhrehauptquartier 1941 – 1944* p. 88

<sup>55</sup> Knoke and Depress, *Notes on European Trip, June 16 – August 19, 1938* (FRBNY)

<sup>56</sup> See supra note 53 at p. 42



printing press. As a consequence, the currency in circulation rose tremendously by the time when German was defeated in the War.

The independence of the Bundesbank as it stands today owes much to the Allies, and particularly to the US influence, after the Second World War. Back in 1948, prior to the establishment of the Bundesbank, the Allies stipulated in the military law setting up the central bank that the 'bank is not subject to institutions from any political body public office, with the exception of courts.'<sup>57</sup> Subsequently, that independence was guaranteed under Bundesbank Act of 1957 passed by the German parliament.

Certainly, monetary policy cannot easily be dealt with where a central bank is under the extreme control of the government. We have seen above how central bankers in the US and Germany struggled with their governments in an effort to have their monetary policies adopted by those regimes during the World War periods. Central bank independence of those nations certainly owes much to professionalism of central bankers of that time.

At this juncture, let us focus attention on the methods applicable in measuring CBI.

## **CHAPTER THREE**

### **MEASUREMENTS OF CENTRAL BANK INDEPENDENCE**

This chapter explains the methods which other researchers and scholars have come up in their studies as measurements of central bank independence. These measures have also been called safeguards of independence, thus, under that head I have examined – ‘legal’ and ‘functional’ safeguards of independence. At the end, a measure aimed at checking central bank independence under the term of ‘accountability’ has been analysed. Certainly, most of the references here have been made on the US and Germany where central bank independence has been shown to be in place.

#### **I. THE LEGAL ARTICULATION OF INDEPENDENCE**

Despite the importance of de facto independence, CBI requires the protection of a binding legal institutional framework as a source of legitimacy. Organic safeguards are legal provisions regulating the organisation of the central bank and its institutional relationships with the government. The provisions should legislate both the functions of the central bank and the scope of its powers. That legislation form the central bank’s ‘functional’ or ‘operational’ guarantees. Legal provisions should also refer to the different ways in which central banks can be held accountable for their actions.

The formal declaration of CBI can be contained in a constitution, in a law or in a contract. Chile (1980) and Philippines (1987) are among the few countries to have constitutionalised the independence of their central banks. Most countries choose to grant independence to their central banks through a law, for example, Article 88 of the German

constitution (Grundgesetz) constitutionalises the existence of the German central bank (the Bundesbank) not its independence. Nevertheless, the legal independence of the Bundesbank was to some extent strengthened through the process of Germany reunification. The Treaty of 18 May 1990 between the Federal Republic of Germany and the German Democratic Republic saw the establishment of a monetary economy and social union. Legal independence is preferred for it grants parliament the right to amend or repeal a law at any time. While a constitution can also be amended, it is generally length and complex procedure. A law granting independence to a central bank should take into account the different categories comprising 'organic' and 'functional' guarantees.

Generally speaking, there are substantial differences in the focus, scope, and degree of detail of various central bank laws. Many of the provisions in central bank charters have no direct bearing on the issue of CBI. At times, the spirit of the law and its application in practice are more important than what is actually provided in the bank statute. Ranking of CB charters by their degree of legal independence should be done with extra care as it may involve subjective judgement.

The indices of legal aspects of CBI should therefore be based on a limited number of narrow but relatively precise legal characteristics. In doing that only the written information from the charters should be used.<sup>58</sup> In this connection, Cukierman mentioned a number of elements as means of measuring CBI which we shall now turn to consider below.

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<sup>58</sup>A. Cukierman, Central Bank Strategy and Independence (MIT Press . Cambridge, Massachusetts . London. 1994) p. 378

i. **Legal term of the chief executive's office** – On this dimension reference is made to the period in which governors of central banks are appointed to serve. Crucial to this aspect is the argument that CBI is assured where the executive arm of the government has little legal authority on the appointment of the bank governor. In this regard it can even be considered appropriate that these appointments to certain central bank positions should be conducted in conjunction with parliament. A good example of this is that one of Denmark where eight members of the Board of Directors are appointed by Parliament as provided for under Section of 4 (a) of The National Bank of Denmark Act, 1936. Equally in Sweden the seven members of the Riksbank's Governing Board are appointed by parliament as provided for under Article 28 of The Sveriges Riskbank Act, 1934. This proposal might, however, lead to undesirable results in some cases. That would be the result especially where parliament is dominated by the executive of the political party in power. The danger is that the ruling party might be tempted to make appointments purely on basis of political patronage to the government's economic policy, thereby likely to undermine the purpose of independence.

Germany and the U.S. provide a more subtle illustration on appointments of bank officials in relation to CBI.

In Germany according to the Bundesbank law the President and the Vice-President of the Bank and its Directorate are appointed by the President of the Federal Republic on the proposal prior to consultations with the Central Bank Council.<sup>59</sup>

In the U.S., the seven members of the Federal Reserve Board of Governors are appointed by the President, with the advice and consent of Senate. In selecting the members of the Board, the president "shall have due regard to a fair representation of the

financial , agricultural , industrial and commercial interests and geographic divisions of the country.<sup>60</sup>

ii. **Term of office** – Central banks should have a sufficiently long term of office to safeguard independence and prevent politicisation and short term perspectives. A short term could make central bankers vulnerable to political pressure and electoral cycles.<sup>61</sup> In the Bundesbank, the President, the directorate, and the Presidents of the land central banks are appointed for a term of eight years.<sup>62</sup> With the Federal Reserve System, the members of the Board of Governors are appointed for a four years term. And the nine members of the Board of Directors of the Federal Reserve Banks hold office for three years.<sup>63</sup>

iii. **Dismissal** – CBI is enhanced if the governor and other members of the governing bodies cannot be dismissed by the political authorities in the event of contravening bank's policies. Grounds for dismissals should be clearly defined. This may require specifically drawing a code of conduct as an instrument to deal with all disciplinary matters which may include serious misconduct, permanent incapability, failure to fulfill the required obligations and even committing criminal offences.

For example, the members of the Bundesbank directorate may not be removed from office before the end of their term except for reasons which lie in their person (interpreted as guilty of crime or serious misconduct) or if the initiative comes from themselves or the Central Bank Council.<sup>64</sup> Under the Federal Reserve System a member

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<sup>59</sup> Article 7 (3), Deutsche Bundesbank Law, 1957

<sup>60</sup> 12 USC 241

<sup>61</sup> Supra note 4. P. 30

<sup>62</sup> Bundesbank law, Sections 7(3) and 8(4)

<sup>63</sup> 12 USC 241; 242; and 302

<sup>64</sup> Deutsche Bundesbank Special Series No 7 (1987) pp. 7 - 8

is subject to removal “for cause” by the president.<sup>65</sup> An interesting case is that of New Zealand. In that country the governor of the Reserve Bank is subject to removal for failure to meet his targets.<sup>66</sup>

iv. **Suitability and Salary** – Central bankers should have professional skills that correspond to their functions and should also demonstrate “professional independence”. The “Suitability” of candidates should be proven through fairly conducted tests of their experiences, knowledge, and ability to accomplish central bank functions. Examples of Germany and the U.S. demonstrate this requirement.

In Germany, the Bundesbank requires “special qualifications” for members of the directorate as well as members of the “Land Central Banks”.<sup>67</sup> Similarly, under the Federal Reserve System, the President of each of the Federal Reserve Banks has to be a person “of tested banking experience.”<sup>68</sup> In the same vein, members of the Board of Governors, and particularly the Chairman of the Federal Reserve Board, must have suitable qualifications. Also, the European Community Bank (ECB) requires that the members of the Executive Board shall be selected among “persons of recognised standing and professional experience in monetary or banking matters.”<sup>69</sup>

Monetary incentives in form of salaries can be used as means of attracting suitably qualified candidates to a central bank. This incentive acts both as an “organic” and “functional” guarantee of CBI. Such a mechanism would require high initial salaries, which are subsequently increased or decreased according to individual ability to adequately perform assigned tasks and achieve them. The governor’s success in

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<sup>65</sup> 12 USC 241 and 242

<sup>66</sup> Sect. 49 of Reserve Bank of New Zealand Act

<sup>67</sup> Articles 7(2) and 8(3) ( Bundesbank Law, 1957. Note that the Bundesbank maintains a main office in each Land (which may be called city) and this constitutes Land Central Banks.

controlling inflation, for instance, would be rewarded with a bonus or salary increase. Conversely, if the governor fails to achieve price stability, he/she should accordingly be penalized by denying him/her of the anticipated reward.

v. **Liaison with the Treasury/Ministry of Finance** - there is a trade-off between, on one hand, consistence in the conduct of general economic policy and the need for cooperation between the central bank and the government, and on the other hand, some of the guarantees protecting CBI. In this instance, there is need to prevent government staff from being at the same time members of the central bank governing body so as to promote a higher degree of independence. This restriction on the interchange and liaison of staff is one of the most difficult and controversial issues in discussing the guarantees of CBI. This arises from the fact that no matter how much independent a central bank is, there is need to ensure its accountability. As we shall realize in the subsequent writing, accountability requires that there is a link between the central bank and the inter alia, the executive arm of the state.

In Germany, the liaison between the Bundesbank and the Federal Government is as follows. The members of the Federal government are entitled to attend meetings of the Central Bank Council. They have no right to vote, but are allowed to propose motions. Further, at their request decisions shall be deferred for up to two weeks.<sup>70</sup> The Federal Government should invite the president of the Deutsche Bundesbank to attend its discussions on important monetary policy matters. Although there is no formal liaison or interchange of staff, the Bundesbank and the ministry of finance work closely together in national and international bodies such as the IMF.

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<sup>68</sup> 12 USC 305

<sup>69</sup> Article 11(2) of the Maastricht Treaty

This right to attend meetings, but not to vote,<sup>71</sup> has also been adopted by the new central bank laws in Spain and France, following the Maastricht Treaty of European countries.

In the U.S., there is some exchange of staff between the Federal Reserve System and the treasury. In addition, numerous committees provide formal liaison functions between the two institutions. The Chairman of the Federal Reserve System on occasion meet with the President of the U.S. and regularly confers with the Secretary of the Treasury and the chairman of the Council of Economic Advisors. A luncheon meeting with Treasury officials is generally held weekly, often attended by the Chairman or Vice-Chairman of the Board of governors, by the Deputy Secretary of the Treasury as well as senior officials of both institutions. Members of the Board are in close contact with their counterparts throughout the government, etc.

## II. FUNCTIONAL SAFEGUARDS OF INDEPENDENT

i. **Limitations on lending to the public sector** - The government's access to borrowing from the central bank is governed by central bank laws and their implementing regulations. CBI manifests where there is prohibition or limitation on financing the public sector deficits. This prohibition or limitation refers to direct credit to the government. But if that credit has to be allowed, it should be of a limited amount subject to the discretion of the central bank.<sup>72</sup> In addition, CBI may place prohibitions to purchases of government securities directly from the issuer (in the primary market). The

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<sup>70</sup> Bundesbank Law, Article 13(2) and 13(3)

<sup>71</sup> Article 109b of Maastricht Treaty. Also note that under Article 108 and 109 (e)(5), in the advocacy for CBI, the Treaty requires the member states of the European Union to change their legislation and make their central banks independent from their correspondent national governments.



prohibition does not generally extend to purchases of public sector debt in secondary market. It should, however, be noted that some authors argue that the notion of CBI has practical meaning for institutions in industrialised countries with developed capital markets, as these private sources of financing provide an additional source of government finance. In developing countries, the government must rely on their central banks and foreign markets for debt financing. Therefore for developing countries wishing to grant independence to their central banks, it is important that they develop their government securities markets to generate funds to meet government needs. Germany legislation, for example, forbids the access of the state to central bank credit. Similarly, in the U.S., because the Federal Reserve System enjoys independence from the Treasury Department, it is not compelled to monetise the Government budget deficits. The Chilean case represents one of the strictest prohibitions on central bank financing the government expenditures.<sup>73</sup> Such prohibition has even been “constitutionalised.” Article 97 of the 1980 constitution of Chile provides that, “No public expenditure or loan can be financed with direct or indirect credit from the central bank, unless in the case of war or danger of war.”

- ii. **The Conduct of Monetary Policy** - An independent central bank should be responsible for the formulation and implementation of monetary policy. This requires freedom to use a sufficient array of market instruments whose application is not disturbed by administrative regulations or political interference.<sup>74</sup> For example, the Bundesbank,

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<sup>72</sup> V. Grilli, D. Masciandaro, and G. Tabellini, “Political and Monetary Institutions and Public Financial Policies in Industrial Countries,” *Economic Policy*, Vol.13, October 1991

<sup>73</sup> Article 27 of the 1989 Chilean Central Bank Law

<sup>74</sup> See R.M.Lastra, *supra* note 4, p. 40

according to Article 3 of its law, is responsible for the formulation of the monetary policy. The Bundesbank's independence in the conduct of monetary policy is proclaimed in Article 12 of the Bundesbank Law:

*“The Deutsche Bundesbank shall be obliged, insofar as is consistent with its functions, to support the general economic policy of the Federal Government. In the exercise of the powers conferred on it under this Law it shall not be subject to instructions from the Federal Government.”*

Equally, the U.S. Federal Reserve System is responsible for the determination and implementation of monetary policy to achieve a variety of goals including stable growth and employment.

- iii. **The conduct of Banking Supervision** - Banking supervision is not necessarily the function of a central bank because there are central banks which are not directly entrusted with this task. In some instances the responsibility for supervision can be shared with some agencies. However, according to Goodhart and Schoenmaker there should be no separation between monetary and supervision functions;<sup>75</sup> their main argument against separation being for the reason that a central bank is a lender of last resort. Thus, the monetary policy authority has to be aware of the payment system through bank supervision. Monetary policy, the most important central bank function today, clearly affects the working of the banking system. This occurs when the monetary policy operates through instruments of direct monetary control such as interest rate controls or

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<sup>75</sup> C. Goodhart and D. Schoenmaker., Institutional Separation Between Supervisory and Monetary Agencies, LSE Financial Market Group, April 1993

credit limits. The effect is the same when the monetary policy is conducting open market operation, reserve requirements and discount policies.

Now, the question at hand is whether there is a need to maintain independence on the conduct of bank supervision. It is argued that, as independence is necessary for monetary policy, it is also necessary for the conduct of banking and supervision. Along with this thought it is said that, independence to pursue stable money should be accompanied by independence to pursue sound banking. Krivoy maintains that, if the central bank has no supervisory powers and cannot act directly to prevent a banking crises or deal with it when it arises, its commitment to preserve a functioning payment system may endanger monetary stability. Therefore, according to him, in an environment of weak bank supervision, a strong case can be made in favour of an independent central bank vested with supervisory powers.<sup>76</sup>

It is also interesting to note that at the international level, there is an implicit acceptance of a degree of practical “independence” of central bankers when supervising the activities and operations of international banks. This was demonstrated in 1975 by the setting of the Basle Committee of Bank Supervision which was made by the extended Group of Ten (G-10) countries. This forum was set to upgrade the quality of international banking supervision and also to co-ordinate prudential supervisory matters. This committee is only concerned with prudential issues leaving aside monetary policy which remains the main function of these central bankers in their domestic domains. Indeed, it is interesting to observe the attention paid to supervisory issues – within this committee – by central bankers of countries where prudential supervision is the

responsibility of another agency. For example, with Germany both the Bundesbank and Federal Banking Supervisory Agency of that country are represented on this committee. Equally, the Federal Reserve System of the U.S. is represented at the Basle Committee by other agencies like the office of the Comptroller of Currency and the Federal Deposit Insurance Corporation.

Finally, it can be mentioned that there is need to distance banking from politicians so to preserve both financial and monetary stability. Independence from political instructions is often emphasised on what is called supervision *stricto sensu*, excluding licensing, sanctioning and lender of last resort.<sup>77</sup>

### III. CENTRAL BANK ACCOUNTABILITY

Accountability simply requires that the central bank at the very least explains and justifies its policies and actions and give account for the decisions made in the execution of its responsibilities. An independent central bank needs to be accountable to another authority, in this instance to the three large arms of the government namely, the executive legislature or judiciary. If accountability is spread through all these said branches of the government, it is said to have been “diversified”. The result of that would be that a democratic foundation has been created for an independent central bank.

There are three forms of accountability which economic scholars have settled on in relationship to CBI:

- **Disclosure accountability** – that is transparency in the operation of monetary policy.

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<sup>76</sup> See R. Krivoy, An Agenda for Banking Crises Avoidance in Latin America, paper presented at the Inter-American Development Bank Group of Thirty Conference in Banking Crises in Latin America, Washington D.C., March 1995.

<sup>77</sup> See Lastra, Supra note 4 at pp. 154 - 155

- **Performance accountability** – that is the measurement of performance in relation to the statutory goal or goals to be achieved.
- **Institutional Accountability** – that is where the central bank is accountable to the three major branches of the state – the executive, legislature and judiciary.

Disclosure accountability connotes transparency of the banking system in the operation of monetary policy. With transparency it means that the monetary policy is clearly disclosed to the public by all the possible means available. In the U.S., for example one effective way is when the financial market scenario is brought to the attention of the general public through the publication every after six weeks of the Minutes of the Open Market Committee meetings. In the U.K.(though there is no legal independence here), the Bank of England and the treasury meet monthly to discuss the position of interest rates and the minutes of these monetary meetings are published to the public after every six months. The Bundesbank, though not so transparent on disclosure, since the mid 1970s, publishes a monthly report of its aggregate monetary targets.<sup>78</sup>

With performance accountability, the governing bodies of the central bank, particularly that of the governor, should be held responsible for failing to achieve the stipulated objectives of the central bank. This type of accountability is easier to check when there is a single goal and unambiguously stated goals in the statute of the bank. But most preferable is the existence of a clearly stated and narrowly defined statutory goal. The adverse result, relative to this form of accountability, when the goals are not stated explicitly is that the central bank would be required to account for functions which are not its responsibility. For example the Federal Reserve System's mandate encompasses a variety of objectives with no explicit ranking: "stability and growth of the economy,

maximum employment, stable prices and soundness of the financial and payment systems.”<sup>79</sup> This lack of explicitly defined priorities implies that the Reserve can frequently be challenged on its performance accountability when its decisions do not satisfy certain sectors of the public. However, a central bank that chooses among potentially conflicting targets must be held accountable for choosing the “wrong” target or the “wrong” mix of targets.

It is easier for a central bank to control a narrowly defined target than a broadly defined objective. For example, New Zealand central bank is given a percentage as a target to control inflation. This makes it even easier to monitor the bank. Comparatively, in Germany where the Bundesbank’s mandate is to “secure the value of the currency”, it is not easy to task the bank to account for its performance because that provision is vague.

Now let us turn to examine institutional accountability.

#### **i. Accountability to Executive Bodies.**

The central bank is not a “state within the state”, therefore it is required, upon demand, to provide the government with certain information, reports and advise. In addition, the central bank is also expected to take initiative to provide advice to the government.

In Germany, the Bundesbank Law provides that , “The Deutsche Bundesbank shall advice the Federal Government on matters of primary importance in the field of

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<sup>78</sup> See *ibid*, p. 50

<sup>79</sup> See the Introduction and Section 2(a) of the Federal reserve Act.

monetary policy and shall upon request furnish information to the Federal Government.”<sup>80</sup>

New Zealand offers the strongest example of accountability to the executive. Here, the minister of finance fixes policy targets to be met by the governor and has the power to alter those targets.<sup>81</sup> But this accountability seem to be at the detriment of CBI.

## **ii. Accountability to legislative bodies.**

This is done either by direct control by parliament or reporting to the house both on periodic or extra-ordinar basis. But where parliament is dominated by the executive, this means accountability would be to the political party in government. In essence it would be under the direct control of the executive which makes up the government. Such a result would directly contradict the goal of insulating the central bank from pressures inherent in partisan politics. This problem can be resolved in parliament where the role of minorities is strengthened by affording the opposition group to be chairing the relevant parliamentary committee in charge of reviewing the central bank performance.

Accountability to parliament simply ensures that the central bank justifies its actions before the house and the public. That is not to politicise the central bank. With the Bundesbank, although there is no formal accountability provided in the charter, the bank by practice is required to publish an annual report in parliament. Parliament is empowered to change the bank legislation, remove its independence and even dissolve

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<sup>80</sup> Article 13 of the Bundesbank Law of 1957.

<sup>81</sup> Sect. 9 of the Reserve Bank of New Zealand.

the bank.<sup>82</sup> In the U.S., the Fed is formally accountable to Congress. The Board of Governors is required to submit an annual report of its operations to the Speaker of the House of Representative, “who shall cause the same to be printed for the information of Congress”. Further, the Reserve sends Congress a special report twice a year on the state of the economy and the systems objectives for the growth of money and credit. The Chairman of the Federal Reserve System also testifies in front of the Senate Committee on Banking, Housing and Urban Affairs etc on. The Chairman and other Board members often testify before the Joint Economic Committee of Congress and other Congressional committees.<sup>83</sup>

### **iii. Accountability to Judicial Bodies.**

The judiciary should control the lawfulness of the central banks’ acts and decisions in the fulfillment of its functions. The judicial review of administrative actions to prevent an arbitrary and unreasonable exercise of discretionary authority is an important aspect of the rule of law. Thus, the discretion of central bankers has not to be interfered with but simply be subject to legal control.

Other factors that influence the level of central bank independence include – political instability, past inflation, the size of the financial sector, and other structural and economic factors.

The degree of legal independence conferred on a central bank ultimately depends on the decisions of political authorities as expressed through the legislative processes.

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<sup>82</sup> Article 44 of the Bundesbank Law of 1957

<sup>83</sup> USC 247



Political instability arises when the incumbent in authority desire to use all the available institutions to hold on to power. This reduces central bank independence.<sup>84</sup>

Past inflation also has an effect on CBI. Once it has been allowed to run its course for a sufficiently long period, inflation tends to erode the independence of a central bank even without any change with legal independence. In particular, higher past inflation reduces the current level of CBI. There is also evidence that for a given level of legal independence, the rate of growth of central bank credit is large with higher inflation. The ability of central banks to resist pressures to increase credit according to the needs of trade diminishes with the rate of inflation even if there is no change in the legal independence.<sup>85</sup>

It seems therefore that, CBI is more effective as preventive than as a remedial device. Once a fast inflationary process is underway, its eradication cannot be left to the central bank alone. It requires the active participation of the central government as well as other institutions and the deployment of policy measures from several areas. But once price stability has been restored and expectations calmed down, the efficiency of CBI as a safeguard is restored.<sup>86</sup>

Countries with broad financial markets are more likely to grant high levels of CBI to their central banks. The reason is that inflation and inflation uncertainty inflicted on savings and investment are proportional to the size of the financial sector. As a result price stability is more valuable in countries with relatively large and well developed capital markets. This conjecture is also consistent with the fact that central banks which

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<sup>84</sup> See Supra note 59 at p.245 - 246

<sup>85</sup> Ibid

<sup>86</sup> Ibid p. 449; The post World War II record of the Bundesbank supports this view.

## CHAPTER FOUR

### THE CASE OF ZAMBIA

#### I. THE HISTORY OF THE BANK OF ZAMBIA

The Bank of Zambia (BoZ) was established on August 7, 1964 then under the name of Northern Rhodesia. With the coming into effect of Zambia's independence on October 24, 1964 its name was changed to the present one. The Banking Act came into force on March 1, 1965 and banks and other financial institutions were required to comply fully with its provisions by April 1, 1965. However, the bank became fully responsible for all matters provided for in the Bank on June 1, 1965.

It can be pointed out here that, generally speaking, the formation of a central bank is the natural concomitant of political independence and a move towards the control of national finances - both internal and external - in accordance with the national requirements. Certainly, this position can be seen as the source of governments' grip on central banks. Perhaps this explains why the picture head of the President of Zambia, *like in other jurisdictions, was for the first time engraved on a 5/- coin in 1965.*

Under its Ordinance, the Bank of Zambia was notably the sole authority to issue legal tender currency in the country. It also had the powers to maintain the internal and external value of the currency.

The Bank was administered by a Board of Directors consisting of a Governor, a Deputy Governor and these were appointed by the president of the Republic for terms not exceeding five years and were eligible for re-appointment. The seven directors were appointed by the Minister of Finance and the Ordinance required that one of them should be a permanent secretary to the Ministry of Finance but did not have voting powers on

the Board. The Minister of Finance had an over-riding power of directing the Bank which he would exercise after consulting the Bank Governor.

The Bank was empowered to transact business and deal in assets of various kinds in accordance with the normal principles applied to central Banks. The Bank acted as financial advisor to the Government and as its Banker issued and managed Government domestic loans. It was also empowered to grant loans and advances to the Government.

To regulate monetary and credit development developments, the Bank of Zambia has given extensive powers in relation to the commercial banks. It would from time to time regulate the minimum amount of liquid assets which each bank must hold and the minimum reserve balances which each bank had to maintain with it as deposits.

The Bank of Zambia started the issue of new currency notes, but in Pounds, in November, 1964. These were done in exchange for notes issued by the Bank of Rhodesia and Nyasaland and the earlier issuing authorities in Southern Rhodesia.

In December, 1964 the BoZ began the issue of Treasury Bills on behalf of the Government on a private placing basis. In the early months of the following year, Bills were first issued by tender.

In this period Zambia implemented its own exchange control legislation which controls were for the first time introduced over inter-territorial payments as well as payments to other countries. The powers of the Minister of Finance under the Exchange Control Regulations were delegated to the Bank.

Then the Zambian pound was at parity with sterling and Zambia had chosen to remain part of the sterling area. The agreed policy was therefore to continue keeping the

bulk of the Zambian reserves in sterling. Certainly, it seems this explains why the Zambian currency was stable in the early days of the country's independence.

It is presumed that sound banking thrives well under health economic conditions. For that purpose, this paper has sought to examine the economic conditions which prevailed soon after the country gained independence.

## **II. THE ECONOMY**

In the decade preceding the end of 1963, the control of the Zambian economy was largely exercised by the Government of the Federation of Rhodesia and Nyasaland. In this period there was a substantial net flow of revenue out of Zambia (then Northern Rhodesia) to subsidise its two federal partners – Southern Rhodesia (now Zimbabwe) and Malawi (then Nyasaland) with the pull of economic and political forces directing the major share of development to Rhodesia. During this time, earnings from copper mining in Zambia, which could have been invested inside the country were spent elsewhere. The key to Zambia's development was the foreign exchange earnings of the copper industry, which in 1964 accounted for some 90 percent of the total export earnings.

However, although free from the financial difficulties which had retarded progress of many developing countries, Zambia was still faced with certain factors limiting the pace of development. The geographical position of the country in the center of the continent meant dependence on extended lines of communication through other countries, while the economy was heavily dependent on the outside world for export markets and for a wide variety of imported goods. At the same time there were serious bottlenecks in the domestic economy which limited the amount of development

*expenditure than could be absorbed. There was a general shortage of skilled manpower* and throughout 1965, the building and construction industry in particular, was unable to meet all the demands made on it. It was believed that until those bottlenecks were relieved the said economic trend would be difficult to reverse in the future. It was further thought that Zambia's mineral wealth should be directed, over the next decade, to the building of alternative and the rapid development of the agricultural potential of the country. That process was initiated and as a result a large number of companies had been registered since 1963. This included several important manufacturing concerns. The inflow of private sector was, however, likely to be slow in 1966 as a result of the Unilateral Declaration of Independence (UDI) in Southern Rhodesia.

In concluding this subject it can be said that, the fiscal years 1964 and 1965 saw a more satisfactory start for Zambia with good prospects for continued progress. However, things started changing soon after the economic reforms i.e., the Mulungushi Reforms and Matero Reforms of 1968 and 1969 respectively. That was as a matter of political strategy as by then the government policy of nationalism was being implemented. The result of these economic reforms was a command economy. Consequently, the Government started experiencing huge deficit in its coffers. Monetary policy, then, became had to implement due to a number of factors: exchange controls were tightened; domestic commodity prices were controlled; and eventually essential commodities were subsidised by the Government. In a nutshell, this demonstrates how political goals can be incompatible with feasible economic requirements and eventually central banking policies. Certainly, subsidies were measured to ensure the stay of the man on the political hem of authority.

Nevertheless, it is beyond the scope of this paper to recount all events to date which characterized the Zambian economy. Our focus still remains that of central banking, particularly its independence. The subsequent writing, therefore, has concentrated on the Bank of Zambia Statute and other related practices actually performed by the Bank.

Presently the Bank is governed by the Bank of Zambia Act No.43 of 1996 which statute came into force on December 13, 1996 after the repeal of the Bank of Zambia Act, 1985. It carries forward most of the traditional central bank function of issuing notes, acting as the bank and fiscal agent to the Government, advising the Government on matters relating to economic, monetary management, etc.

### **III. ADMINISTRATION**

The Bank of Zambia is headed by the Governor as chief executive who is appointed by the President for a period not exceeding five years subject to re-appointment at the expiry of the first term. A person appointed to that position should have professional qualifications and experience in financial and economic matters. This appointment should be ratified by the National Assembly. The powers, the terms and conditions of service for the Governor have to be determined by the Minister of Finance.

Under the Governor are two Deputy Governors who also have to serve a five years term of office. They are also appointed by the President as long as they possess relevant qualifications and experience. These, too, hold office for a period not exceeding five years.

All the powers of the Bank are vested in the Board of Directors and that includes the responsibility to formulate the policy of the Bank. The Board consists of six members who are appointed by the Minister of Finance from amongst individuals who possess professional or academic experience in business or financial matters. The Governor of the Bank is the Board Chairman followed by one of the members who the members elect as Vice-Chairman. The Secretary to the Treasury in the Ministry of Finance is an ex-officio director of the Board entitled to attend Board meetings but has no voting right.

The Minister of Finance is empowered by law to issue instructions to the Governor relating to Government policies and affecting the affairs of the Bank and the Bank is obliged to implement those policies.

It can now be shown that legal central bank independence as it is understood in that context is non-existent in Zambia. The formal declaration of CBI should be contained in a constitution or other law – in this case a statute. This is not provided in any of these sources of law. However there are other provisions in the Bank statute which portray an emergence of CBI in form of operational and functional guarantees. These, as we shall see below, have attracted the attention of the present work.

Meanwhile suffice it to say that the Bank of Zambia independence has been compromised by the administrative set up. The Bank Governor and the two Deputy Governors are appointed by the President of the Republic. The appointment procedure here could be interesting in that the appointment of the Governor has to be ratified by the National Assembly, but the same ratification procedure is not applied on his/her removal.

The Bank of Zambia statute, however, is not clear on the appointment of the two Deputy Governors. It is silent whether their appointments have to be ratified by National

Assembly as well. Nevertheless, if those appointments are conducted outside legislature's concert, it demonstrates the higher level of influence the executive can exert on the two Bank executives at that level.

The German and U.S. governments provide us with a model acceptable on appointments of the chief executives. In German, for example, there is prior consultation with the Bank directorate before the Federal Republican President appoints them to those offices.

The term of the office of the Governor and the two deputies is another concern for central bank independence. A term of five years is too short a period for one tasked with such an important responsibility of formulating and implementing monetary policy. The removal of the chief executive after a period of five years seems to be unrealistic because sometimes he/she would leave long term monetary goals unaccomplished. A short term could make central bankers vulnerable to political pressure. In Zambia it has shone that with change of government, the president also comes up with a new Bank of Zambia Governor of his choice. This was what happened when Zambia went into the Third Republic. Zambia can take a leaf from the German where the President of the Bundesbank serves for eight years.

Further, it seems that the powers of the Minister are unlimited upon the Bank of Zambia and his/her decision in relation to the institution is final. This show immense dependence of the Bank to the executive.



#### IV. BANK ADVANCES TO THE GOVERNMENT

The government's access to borrowing from the central bank is one of the controversial issues in relation to central bank independence. CBI is well pronounced where the law puts prohibition or limitation on financing the public sector. The law relating to this is provided under Sections 49 and 50 of the Bank of Zambia Act, 1996. Section 49 reads as follows:

“49. The Bank shall not advance funds to the Government except in special circumstances and on such terms and conditions as may be agreed upon between the Bank and the Minister.”

Certainly, this provision is subject to manipulation. To start with, it is not clear to what can amount to ‘special circumstances’. The Minister since he has overriding powers over the Bank, it would be easier to tell the Governor that a Government loan was needed for a project falling within the provision of the statute even when that is not the case.

Section 50 puts limitations on the Bank's lending to the Government, thus:

“50. (1) Except as provided in section forty-nine and in subsection(4), the Bank shall not directly or indirectly, at any time, give credit to the Government by way of short term advances, purchases or securities in primary issue, or any other form or extension of credit that exceeds fifteen percent of the ordinary revenue of the Government in the previous financial year.”

(2) If in the opinion of the Bank the limitation provided for in Subsection (1), is likely to be exceeded, the Bank shall submit to the Minister a report stating –

- a) the details of the amounts outstanding of the funds advanced and credit facilities extended by the Bank and the Bank's holding of securities referred to in subsection (1);
- b) the causes which are likely to lead to such limitation being exceeded; and
- c) its recommendations to forestall or otherwise remedy the situation”.

It seems these provisions could have applied very well if section 49 was not brought to section 50 as an exemption clause to the limitation on the lending to the Government. This has weakened the provisions to the extent that all what the Bank can do is a matter of formality in view of what could be ‘special circumstances.’ This is what the influence of the Minister can do. A good example of limiting central bank lending to the government is the Chilean case. As we have mentioned above, the prohibition is even constitutionalised that the Bank does not provide credits to the government except in the case of war or danger of war.

## **V. THE CONDUCT OF MONETARY POLICY**

AS we noted above, monetary policy these days is generally accepted as the main function of central banks. With the Bank of Zambia, that is also reflected in the ‘mission statement’ of the Bank. This is provided for under section 4 of the Act and reads as follows:-

“4.(1) The Bank shall formulate and implement monetary and supervisory policies that will ensure the maintenance of price and financial systems stability so to promote balanced macro-economic development.”

It is first of all important to note that the role of the Bank of Zambia is nowadays understood in the liberalised financial environment of the country. The Bank therefore occupies a central place in the economy by striving to achieve and maintain macroeconomic stability through the operation of monetary policy.

The task of the Bank in this area is to strive to reduce inflation to a single figure. However this is managed in conjunction with the Government; the latter using its fiscal policy as a tool. In this instance the Government will come up with an estimated expansion of the real GDP. Relying on this target, the Bank also works out and provides a target for anticipated reduction of inflation in that fiscal year. This is what constitutes the formulation of the monetary policy and in the Bank it is carried out by the Economics Department whereas the implementation is done by the Financial Markets Department. The rationale for the Bank is to control the money supply in order to reduce or remove inflation. But this may not be workable when other factors such as macroeconomic performance and fiscal position have an influence. For instance, in 1999 Zambia's macroeconomic performance was rated poor due to continuing losses of ZCCM and lax fiscal control. As a result, in that year the estimated real GDP expanded by only 2.4 percent, representing a modest decline in per capita terms, compared with the envisaged 4 percent. Notwithstanding weak domestic demand, upward pressures on domestic prices remained during 1999, reflecting the impact of the increase in import prices in 1998, and the expansion of credit to the public sector resulting from an expansionary fiscal stance, and inflationary expectations. Thus, inflation declined by less than programmed, with the twelve-month rate of consumer price inflation falling from 30.6 percent at the end of

1998 to 20 percent at the end of 1999, as compared with 15 percent envisaged under the program.

In the same year monetary developments were characterised by a higher-than targeted expansion in money supply and a rapid expansion of the credit to the public sector.

Further in the same year (1999) fiscal performance was worse than programmed, owing to a shortfall in tax revenue and continued accumulation of domestic payments arrears that resulted from weak expenditure control.

The point of emphasis here is that the Bank can have a better monetary policy, but which does not give anticipated results due to other factors such as microeconomic and fiscal policy. Thus, one of the most important things that can undermine BoZ operations is the Government's fiscal policy when that tends to be contrary to what the Bank has set to reduce inflation.

Government borrowing from BoZ, as we have seen above, brings an inflationary effect. It really defeats the monetary policy since the money which the Bank had siphoned from the financial markets goes back to the market when the Government borrow. This is one of the serious blows which a dependent central bank suffers.

Recently, political interference affected the implementation of direct monetary instrument which the Bank of Zambia thought would be effective in mopping out surplus liquidity which prevailed in the local currency market. In the effort to achieve its objective, the Bank adjusted the statutory reserve ratio on all deposit liabilities by 2.5 percent from 10 to 12 percent as a way of tightening liquidity in the market following an acceleration of the Kwacha's loss of value at successive BoZ auction.

The increase in reserve requirements, however, did not succeed in achieving tightness in the market as the market increased the liquidity from K88.5 billion to K113.2 billion in a week's time. This resulted to the shooting up of lending rates to 58 percent, and this prompted political statements on the need for reduced interest rates. The Bank, as a result slackened on monetary policy as the high lending rates threatened to undo market stability.<sup>90</sup>

In our view, it would seem the rates could have gone down in a long run if the market forces were given sufficient play. On the other hand, however, it prompts us to draw an inference that the financial markets in Zambia are still low. On this point it is important also to realise that central bank independence is unattainable where financial markets are poor. Part of the remedy to this is to encourage an increased security stock and number of banks country-wide.

## **VI. LICENCING, REGULATION AND SUPERVISION OF BANKS AND FINANCIAL INSTITUTIONS**

The Bank of Zambia is vested with these functions primarily to ensure that the banking and financial sector conducts its business prudently. This is also to ensure that the financial sector carries out its business in accordance with the relevant laws and prudential regulations so that the financial system remains sound and stable. The law which enhances this function is the Banking and Financial Services Act of 1994. The current statute was revised with the full view of the liberalised banking and financial services environment.

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See THE POST, Thursday July 12, 2001, at p. 6.

The study of bank supervision and related functions is important here because monetary policy (the most important function of central banking today) correlates well with banking in general. As has been shown above, monetary policy affects the banking system when it operates through its instruments. For example, when it deals with open market operation by enforcing reserve requirements and discount policies, commercial banks get affected. As such, independence from politicians along this function is necessary.

On the main objective of the Bank of Zambia, 'price stability' and 'financial systems stability' are the most important targets of the Bank. This emphasises the correlation which goes along with monetary policy and general banking.

Financial stability simply requires that banks are operating in a sound and prudent manner. Along this function the Bank of Zambia, among others, undertakes licencing and crises management.

Once a bank has been licensed and commences operations, the Bank of Zambia ensures that it does not fall. Inspectors from the central bank monitor the operations of a new bank through reports submitted to the Bank every month. The Bank by encouraging prudential business attempts to remind bankers to avoid risks through such practices as lending to customers who have no proper security.

On crises management, the Bank of Zambia ensures that it supports a bank which is either facing a short-term or long-term liquidity problem. The Bank facilitates that by even allowing overdrafts to affected banks.

Certainly, successful Bank supervision results to financial stability and consequently secures depositors' interests in the banking business. Now, how does the

Bank of Zambia dependence on the executive impairs that function? Interference may arise from politicians where the Bank takes prudential action to avert the downfall of a bank. This would be possible where the government has its own vested interest to serve. In such a situation, it is presumed that the Bank Governor would not be most effective to serve the interest of the banking system other than that of his appointing authorities.

In recuperation, it can be stated that prudential regulation and guidelines for bank supervision at Bank of Zambia are consistent with international standards. But their implementation in Zambia have been weak. A number of banks have fallen. From 1995 through 1999 there were nine bank failures recorded, the largest being Meridian Bank with total assets of K86 billion at closure. Commerce Bank followed and was placed under curatorship after more than two years of poor operations, capital insolvency and failure to repay debt to the BoZ. Of late two other smaller banks - Union Bank and Invest Trust Bank were undercapitalized and the former was technically insolvent.

In early 2000, it came to light that the largest commercial bank ZNCB (state owned) was insolvent. At the end of April, about 70 percent of the bank's loan portfolio were non - performing, with 60 percent of the portfolio concentrated in two borrowers, one of which is a state-owned entity. The bank held about 25 percent of the industry deposits with private sector and the government accounting for 60 percent and 35 percent of its deposit base, respectively.

What has caused banking crises in the aforesaid instances? The present crises is alleged to be inefficient operations, unsound banking practices and indiscriminate government interventions. Surely, it is doubtful for the Bank which is not independent from the Government to act effectively in averting the crises.

## **VII. ACCOUNTABILITY AT BANK OF ZAMBIA**

The need for a central bank to be accountable to the public/executive or any other wing of the government cannot be overemphasised. The essence of that is to check the abuse which the Bank would probably incur were the bank to operate with absolute freedom.

Accountability at the Bank of Zambia is regulated by sections 25 read together with section 26 of the Act which require the Bank to keep books of account and to have the accounts of the Bank audited annually by an auditor appointed by the Board. Those books of account have to be open for inspection by any person authorised by the Minister. In addition, the Board has to submit a report every year to the Minister. The report should reflect the financial affairs at the Bank.

It is clear that this accountability is under the control of the executive branch of the government. Apparently, this set-up is characteristic of a central bank dependent on the Government. The question arising is whether this would be an effective institution to check the Bank's financial affairs.

The Bank of Zambia Reports of Auditors from 1989 to 1992 reveal the ineffectiveness of accounting controlled by the Government per se. We have highlighted few important omissions below.

The Report of 1989 revealed that the Bank suffered a breakdown in accounting controls during that year and that led to an absence of systems and controls on which the auditors could rely on. Records and documents, substantiating some transactions could not be located. There were many irreconcilable accounts, and key staff, responsible for



Bank's transactions during the year were not available for interview as they were no longer employed by the Bank. As a result of the breakdown in accounting controls, the auditors at the Bank were unable to explain the imbalance of K1,389,400,000 credit, which was included in the balance sheet under other accounts payable— K13,274,189,000. They were further unable to verify the balance of K2,176,006,000 shown in the balance sheet in respect of currency in circulation or new notes placed in circulation on July 1, 1989. These, and many other discrepancies were the outcome of the Report that year.

The breakdown of accounting at Bank of Zambia persisted and it was still reflected by the Report of the Auditors in 1992. This report revealed that the accounting procedures and controls showed no improvement in the year ended 31 December, 1991 which resulted in the inability of the Bank to prepare the financial statements for that year contrary to section 23 of the Bank of Zambia Act No. 24 of 1985.

It may now be puzzling that for a period of 28 years in operation the Bank of Zambia could not properly keep its record of accounting. There could have been a political reason behind that. Nevertheless, it is beyond the competence of this study to speculate rest it be mentioned that accountability to such a big national institution like BoZ is vital so that public funds are not missused.

The problem of accounting (as at end of March, 2000) at the Bank has been compounded by lack of discipline and accountability at the Government ministries. Financial reporting and information systems within ministries and particularly at the Ministry of Finance are weak, and there has been lack of political will to sanction ministries which make excessive commitments and expenditures. Further, line ministries,

particularly the politically powerful ones, enter into commitments which are inconsistent with budgeted allocations and/or available cash resources. Certainly this borders to fraud and corrupt practices.

With the foregoing in mind, it is hard to imagine how the executive, particularly the Ministry of Finance, could be suitable to carry out the enormous responsibility of monitoring the financial affairs at Bank of Zambia. One can draw an inference that in all the period the Second Republic ruled, accounts at the Bank were in disarray.

## CONCLUSION

Having examined the traditional functions of central banking in general, we can conclude that the controversial task is that of monetary policy. This calls for a central bank to control money supply as a way of ensuring price stability, meaning – reduction of inflation. The difficulties banks face in relation to this task may be compromised by the government's political desire to hold on to power overlooking this function of a central bank.

The paper has deliberately examined the sources of inflation and remedies thereof. On this subject we learnt that effective anti-inflationary policy accommodate fiscal, monetary and wage-price discipline. It has been shown that dealing with inflation in a limited way, such as merely relying on monetary restraint, while tolerating budget deficits and wage spiral simply encourages inflationary momentum. The sense which we derive from that is that whether a central bank is independent or not, it should take note of these factors, otherwise its role merely remains a mockery.

The paper has gone further to examine the histories of the Federal Reserve System of the United States and the Bundesbank of German, which Banks are well pronounced as 'independent'. This was done to draw the circumstances these Banks underwent so as to attain central bank independence. The idea behind the analysis of these banks that way has been to build up an effective comparison between their experiences and that of Bank of Zambia, and finally see whether independence in this country can be attained while adopting more or less similar methods.

From the US we have learnt that much of the Reserve Systems operations were influenced by the Federal Government's involvement in the two World Wars. Quite admirable, however, is that Reserve officials maintained banking policies while adjusting to the Government expenditures in the wars. One of the most important developments in the history of the US was the 1951 Accord which corrected the relationship between the Reserve System the Treasury, and soon after the Banks were independent from the Treasury domination. Cardinal to this outcome was that the independence was fought for and achieved by strong personalities of the Reserve.

*Cetera paribus*, the independence of the German's Bundesbank was as a result of spirited efforts which the Bankers put up in support of Bank policies vis-à-vis those of the Government. That was during the period of the Wars as it were with the US. The thing to remember also with the Germans is that prior to the World War II German was tremendously hit by hyperinflation and that time the head of state – Hitler was a dictator. In fact it has been shown that Hitler was fiscally ruinous. His tax revenue was not sufficient, therefore, military expenditure was financed by private savings channeled through the banks. However, the independence of the Bundesbank in 1957 was the initiative of the allies after the World War II.

The conclusion is that, it would be unrealistic to completely adopt the US and German central bank laws and practices to the situation prevailing in Zambia. Those two nations were already superpowers by the time the world went to the First World War. It means that they were already developed and their central Banks grew under conducive macro-economic environment. For instance the US started applying indirect monetary policies as early as 1951. In the case of Zambia that practice is a recent development

which took effect with the advent of liberalised economy after 1991 when the country moved from a command economy.

The Zambian economy draws its routes from the colonial period. But what could be important to recollect is that this country had started on a sound background economically. That is evident from the fiscal years 1964 and 1965. The economic trend started taking a lower ebb after the economic reforms. Could the bankers at that time manage to put up a spirited fight against the inflationary policies of the government? Perhaps they could manage it as the US and German bankers did.

Nevertheless, Zambia can still draw much benefit from the US and German central banking systems. One important thing we can emulate from their experiences is that to them central bank independence did not easily come. It was as a result of a protracted struggle by the bankers who stood firmly on banking policies during those thorny war conditions. The struggle for Zambia has to be initiated by economists, central bankers and the rest who would like this country to attain sustainable economically prosperity. The struggle is difficult, but, as Maloney and Andrew pointed out, “the stakes are too high”.<sup>91</sup> And Hayo further said that “the critics of advocates of central bank independence must continue to criticise; the rest of us must listen, learn and do not give up.”<sup>92</sup> Certainly, the task is not easy at all.

Notwithstanding the fact that we cannot wholly transplant the US and German Banking systems, certainly it can be prudent to adopt their central bank legal provisions/practices as long as they are compatible to the Zambian environment. This

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<sup>91</sup> John Moloney and Andrew Pickering Central Banking: Quarterly Journal. Volume XI. No. 2. November 2000 pp 86 - 89

<sup>92</sup> Ibid

probability generally incorporates provisions from any other jurisdiction. By saying that, this paper has admitted that the above discussed safeguards for central bank independence will apply in some instances to Zambia.

Starting with the legal articulation, the following are the observations.

The appointment of the Bank Governor by the President and thereafter through ratification by the National Assembly promotes CBI. But the removal of the Governor from office without the consent of Parliament reduces the independence. Equally, the two Deputy Governors are appointed by the President and in this instance without the ratification of the National Assembly. This reduces CBI.

The executive influence at the Bank of Zambia is concentrated in the Minister of Finance. He appoints all the six members of the Board of Directors. The Governor, being an appointee of the President is at the same time the Chairman of the Board. This basically means that the influence of the President is again emphasised on the Board. The Chairman influences the decisions of the Board. The Board is empowered by law to formulate the Bank of Zambia policy. Indirectly, this means the policy is formulated by the Government. Added to this authority is the membership of the Secretary to the Treasury in the Ministry of finance as an ex-officio of the Board. Here, definitely CBI is drastically reduced.

The Bank statute limits the Governor's term of office to five years. This period is too short for the Governor to effectively accomplish his goals. It is not in the interest of CBI.

The Minister of Finance is empowered to issue binding instructions to the Bank of Zambia. By those instructions being final, it means that CBI is compromised.

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From these unlimited powers of the Minister transcends the executive domination that the government can manipulate against the statute and acquire loans easily from the central bank, hence impinging on CBI. Limited access to loans from the Bank is an indicator of CBI.

With functional safeguards of independence we have looked at the conduct of monetary policy and bank supervision.

On monetary policy it has been observed that the executive arm of government stifles the monetary operations because of the fiscal policy which is often inconsistent with the planned targets intended to achieve price stability. In addition, Government deficits are an impediment to the effective implementation of monetary policy. The crucial question surrounding this matter is how the Government of Zambia settles the domestic loans given the scenario that the fiscal policy is poor. Tax revenues are not sufficient to resolve the predicament in which the government is trapped. It is within this economic dilemma that it is feared that the government would print more money in order to settle its loans at the Bank – hence accelerating inflation.

Bank supervision in Zambia has few years ago shown some weakness, hence resulting to liquidation of some banks. Part of the cause of that is attributed to government interference. That is most pronounced with the insolvency of the Zambia National Commercial Bank. Certainly, an independent central bank is likely to implement prudential supervision so to put an end to bank closures in this country.

Functional safeguards of independence are apparently properly in place in the bank charter. The problem could merely be of implementation, as has been shown, partially due to political interference.

We have shown that accountability is essential for central banking. Advocating for central bank independence does not imply the desire to create a state within a state. That independence has to be checked by an effective accounting system. The breakdown of accounting procedures and loss of records at the Bank, as shown by the Audit Reports of 1989 – 1992, is indicative of lack of accountability at the Bank that time. Because of that, what could have happened at the Bank in the whole period of the Second republic is a mist. In those circumstances, how can we know that the Government of that time squandered public funds? Clearly, with that finding, this paper does not rule out the possibility of fraud and corruption at the Bank that time. Certainly, CBI cannot go well without effective accountability.

In the final analysis, it is the view of this paper that legal safeguard of independence is necessary for the Bank of Zambia. Regardless of other contrary economic circumstances prevailing in the country, central bank independence can be entrenched in the Zambian constitution. Such legislation would be an assurance to the people that independence is guaranteed.

With the aforesaid, the Bank statute in its present form would require amendment of some provisions. Apparently, the executive influence upon the Bank has to be reduced. Appointment and removal of the Bank Governor can fairly be handled by both the executive and parliament in an effective manner. The Bank Governor could be appointed after prior advertisement and interviews of the prospective candidates. This could be done in conjunction with the National Assembly so that it could be transparent. The candidate with best qualifications and most suitable for the job could be picked. At the end of it all the best person and who would effectively stand for the interest of the Bank



(not for the appointing authority) would be appointed as Governor. Thus, central bank independence would be assured.

To ensure effective performance, Bank Governor has of course to be motivated with a substantially higher salary. While he can enjoy that incentive, it is also logical that he faces punitive action of reduction of salary or other office emoluments should he/she fail to meet the target pertaining to the operations of the Bank of Zambia.

The overriding powers of the Minister have to be reduced, and his operations at the Bank ought be done in conjunction with the National Assembly.

Finally, it is submitted that the Bank of Zambia should be properly accountable to both the Executive and the National Assembly. A provision to that effect should be specific in the Bank statute.

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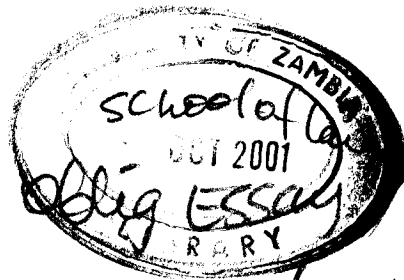
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2000/2001