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"A REVISIT TO CENTRAL BANK INDEPENDENCE: HOW TO RESOLVE THE EMERGING ISSUES?"

Oration

by

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A Revisit to Central Bank Independence: How to Resolve the Emerging Issues?

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Central Bank of Sri Lanka

A Revisit to Central Bank Independence: How to Resolve the Emerging Issues?

'Once a central banker is always a central banker'

It is good to be back after 9 years, if I use a slightly amended phrase borrowed from Madonna, the pop singer. When she visited Argentina 13 years after she had played the main role 'Eva' in Evita to sing to an ecstatically driven live audience 'Don't Cry for me Argentina; the truth is I never left you', it was an overwhelming reception she received from Argentineans[1]. In my case too, I never left the Central Bank. For that matter, no central banker could leave it behind to live a new life that has no part with the Bank. Though they are physically away from the grandiose atmosphere here, they live day and night in the central bank. They cannot forget that institution which had bred them, which had nurtured them, which had educated them, which had raised them to who and what they are today. As Madonna has sung in her song, they continue to live in the central bank 'all through their wild days and all through their mad existence' even after they leave it. To an ex-central banker, the bank is inseparable from his life. Thus, once a central banker is always a central banker. This is true for me too. Hence, it is good to be back and it is good to return home.

A society of intellectuals

The Bank is viewed in high esteem in Sri Lanka's contemporary society. When I ask my students at the university what they want to do in the future, the answer is always a single chorus. Without exception, all of them want to join the central bank. The reason? In their view, the Bank is the leader of the financial system, the leader of the economy, the leader of economic thought and the leader of many more. They want to jump on the bandwagon of that exclusive leadership and be the 'master of Sri Lanka's economy' in the future. This ambition of the young generation today is not unusual. Even in my generation which lived some half a century ago, joining the central bank was one of the two career ambitions which a passing out graduate could afford to have. One was joining the academia. The other was joining the Central Bank. All other career ambitions were looked at if you could not make it to either one of them. I joined the Central Bank leaving a high paying career at the university as a lecturer for a lower salary in the Bank.

1 Available at: https://www.youtube.com/watch?v=qdX33CqIRTI (accessed on 16.8.2018)

In hindsight, I may say that it was a prudent decision. I got the opportunity of working under seven governors and many more worthy intellectuals of the days gone by. When I mentioned it to the late Governor A S Jayawardena, he immediately corrected me. ‘Don’t say that you have worked under them’ he said. ‘Say that you have worked with them’. His point was that the Governor and other senior officers are not kings, but co-workers enjoying equal status in the exclusive intellectual society which the Central Bank has created. In that world of intellectuals, there are no hierarchies. There, a person is rated only by his wisdom and nothing else.

Unbiased, impartial and objective advice

Thus, central bankers should demonstrate this wisdom in all their dealings, both within and outside the Bank. The wisdom to be demonstrated should be unbiased, impartial and objective without being coloured by different political hues, as advised by one time Minister of Finance, Dr N M Perera to senior central bankers when he met them in 1971. It is reported that Dr N M Perera had said that the bank ‘should make independent reports on economic subjects to the government and not report merely to suit the political complexion of the government in power’ and that ‘he would value reports (of the bank) made dispassionately and objectively’[2]. Such dispassionateness and objectivity come only from independent minds. Independent minds are created by an independent culture and environment. Independent culture and environment are nurtured by recognition and appreciation of independence by all. Hence, the central bank’s independence is a product of both external recognition and internal cultivation. The former is an attribute which a central bank has to earn by being an exemplary institution. The latter is a quality which a central bank has to grow within itself through careful planning.

Playing the game according to prudent rules

Ever since central banks have been created to produce money through a centralised mechanism, their independence had been a subject of issue coming up again and again. This is because a central bank today produces money out of nothing as if a magician produces a rabbit by waving a magic wand. This money has no intrinsic value of its own. The value comes from its ability to facilitate the owner to acquire a real basket of goods and services. They are called real because they enable the owner to consume them directly or use as an input for

2 Reproduced from Ceylon Daily News in the Central Bank of Sri Lanka 60th Anniversary Publication.

producing a further output. Because of this promise, people agree to exchange the real assets they own for the paper money which a central bank produces on behalf of a government. Though the government is the institution behind the creation of a central bank, it is supposed to allow a central bank to produce money in accordance with the mandate which Parliament has given it.

That mandate requires a central bank to supply money in sufficient quantities at the correct time to facilitate the exchange of the output produced by the economy without disruption. Hence, money printing by a central bank is not evil at all times as popularly believed by many. The problem arises if a central bank produces more money than necessary. In that case, the excess money will lead to creating an excess demand for goods and services with two interrelated outcomes. One is the tendency for prices to go up causing a decline in the value of the real basket of goods and services which people can command by using money. The other is the leakage of that excess money out of the country through increases in the demand for imported goods and services. If the country does not earn enough foreign exchange to meet that demand, it leads to creating balance of payments difficulties, exerting pressure for the exchange rate to depreciate. Hence, both inflation and exchange rate depreciation are the result of a central bank producing more money than necessary.

Accordingly, a central bank is required to play the game of money printing according to a set of prudent rules. If it does so, it can earn the trust of the people. If it does not, it loses their trust as well as its ability to get people to accept the money it produces[3]. As such, a central bank should have freedom to decide how much money it should produce without the interference of outside parties. This freedom, in laymen's language, is paraphrased as the right of a central bank to say no, when there is pressure from the government or any other party to produce money in excessive amounts.

Central bank independence has a long history

The world's oldest existing central bank, Sweden's Sveriges Riksbank, established in 1668, ran into problems when it refused to finance King Gustav III's military expeditions against Russia in 1788. The King reacted to the independence demonstrated by the Riksbank by issuing his own currency through The Swedish National Debt Office. It pushed the Riksbank to the

3 For a discussion of this issue, see Wijewardena, W A (2017), Central Banking: Challenges and Prospects, A BMS Publication, Colombo, Chapter 3.

backwater till 1802[4]. That was surely a too high a price which a central bank had to pay for refusing to accede to the demands of a recalcitrant political leader.

Keynes on central bank independence

Since then, the independence of central banks was valued by academia who wrote on central banking. For instance, John Maynard Keynes who was a part of the Chamberlain Commission of 1913 on India's Financial System submitted a memorandum on the invitation of other commission members on the establishment of a shareholder owned central bank. This new bank, proposed to be called the Imperial Bank of India, was to be established by amalgamating the three Presidency Banks that had existed in Calcutta, Bombay and Madras. Keynes advised that the Secretary of the State, though he was the official behind, has only the final word about the work of the bank. Thus, he was the adjudicator of last resort. Its day to day operations, as recommended by Keynes, should be free from the interference of both the government and the shareholders, since it might run counter to the general interest[5]. In today's context where central banks are owned by governments, what this means is that they should be free from the interference of political authorities. However, with the onset of the World War I, Keynes' wisdom could not be carried forward. It was in 1935 that the Reserve Bank of India was setup as a shareholder owning bank with independence and once it was nationalised in 1949, it got relegated to an institution that "traditionally functioned as an arm of the government" prompting Governor C Rangarajan to call for greater autonomy for the bank in a public lecture in 1993[6].

Recently, it was the former Governor of the Reserve Bank of India, Dr Y V Reddy, who succinctly related the exact status of the independence of that central bank. Addressing a forum in Chennai in December 2017, Reddy is reported to have said that a central bank being the creation of the government can never be

4 Fregert, Klas (2018), "Sveriges Riksbank: 350 Years of Making" in Edvinsson, R et al (eds) Sveriges Riksbank and the History of Central Banking, Cambridge University Press, Cambridge.

5 See, RBI, Genesis of Central Banking in India, (available at: https://rbidocs.rbi.org.in/rdocs/content/PDFs/89634.pdf), p 22-23 (accessed on 18.8.2018)

6 Barua, Shamir K and Varma, Jayanath R (1993) "RBI Autonomy and Indian Financial Sector", (available at: http://journals.sagepub.com/doi/pdf/10.1177/0256090919930402) (accessed on 18.8.2018)

independent of the creator[7]. Addressing another forum earlier in Hyderabad, Reddy had recalled how he answered the question raised by a journalist in 2008 when he was holding the office whether the Governor of the Reserve Bank of India was independent. He had told the journalist: "The RBI Governor is very independent; I took the permission of my Finance Minister to say this"[8].

Central banks are more independent today than earlier

Central banks today enjoy a degree of independence ranging from full autonomy to partial autonomy. The global trend has been to go for greater independence in central banks within the last two to three decades. This trend has been supported by the realisation that greater autonomy in central banks helps countries to fight inflation more successfully. But this has not been the consensus among the mainstream economists. Some have given pre-qualifications such as the presence of strong institutions for an independent central bank to operate successfully[9]. Others have raised the issue of independent central banks failing to avert the financial crisis of 2007-8[10]. Thus, according to these groups, independence is irrelevant and unnecessary to tackle today's problems. However, a study conducted by Marco Arnone et al in 2007 has revealed that, while all central banks have improved their political and economic autonomy over the years, some central banks in the developed world, namely, Australia, Denmark, Iceland, Sweden, Norway, Switzerland and UK, enjoy full autonomy[11]. According to this study, Sri Lanka's central bank which has scored 0.5 out of 1.0 is categorised as a bank enjoying partial autonomy.

Finance Secretary sitting on the Monetary Board as a vote-carrying member

The issues relating to the independence of the Central Bank have been discussed by me elsewhere[12]. The main contention has been the placement of the Secretary

7 https://www.business-standard.com/article/current-affairs/central-bank-is-not-independent-from-govt-ex-rbi-governor-y-v-reddy-117120700073_1.html (accessed on 19.8.2018)

8 https://www.thehindubusinessline.com/money-and-banking/how-independent-is-the-reserve-bank-governor/article7503967.ece (accessed on 19.8.2018)

9 Acemoglu, Daron, et al (2008). "When Does Policy Reform Work? The Case of Central Bank Independence", National Bureau of Economic Research, Working Paper No. 14003

10 See, Joseph E Stiglitz, C D Deshmukh Memorial Lecture at RBI in 2013 (available at: https://rbi.org.in/Scripts/BS_SpeechesView.aspx?Id=765) (accessed on 18.8.2018)

11 Arnone, Marco et al (2007), Central Bank Autonomy: Lessons from Global Trends, IMF Working Paper No 88 (available at: http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.367.6837&rep=rep1&type=pdf) (accessed on 18.8.2018)

12 Wijewardena (2017) op cit, Chapter 2

to the Ministry of Finance as a vote carrying member on the Monetary Board in terms of the Monetary Law Act as proposed by John Exter, the architect of the Bank. The criticism has been that the Finance Secretary acting in self-interest would get the Bank to fund the budget through accommodative monetary policy, thereby causing fiscal policy to override monetary policy. The past experience of the Central Bank shows that this criticism has some validity. But Exter's wisdom was to create an environment for both the government and the central bank to have a peaceful and amicable cohabitation. Exter argued in his report that "….there are, however, many important problems of monetary policy, especially those relating to fiscal policy, on which a central bank should work in close harmony with the government"[13].

Accordingly, a degree of independence has been afforded to the Central Bank of Sri Lanka unlike other governmental bodies. This independence extends to the budget of the bank, job security of key central bank officials and power to make monetary policy without consulting the government. The wisdom of Exter was that the Central Bank should as far as possible work in consultation with the government, rather than in isolation. He believed that the true independence of the Central Bank could be preserved only through that consultative process. In the words of Exter, "the ideal is….one in which there will be continuous and constructive co-operation between the monetary board and the government. The principal instrument for achieving this co-operation should be the permanent secretary to the Ministry of Finance whose membership on the board will ensure at all times that his Minister's views will be known to the other members of the board"[14]. However, Exter did not expect this arrangement to be effective at all times. Hence, he made the proviso that "it would depend on the men occupying the key positions"[15] and not on any legal formula. He argued quite correctly that such complex and delicate relationships cannot be established full-blown by a piece of legislation. It must be the result of years of experience and the slow growth of political conventions.

Permanent secretaries are no longer permanent

Exter report testifies to the fact that the independence of the central bank should be attained and maintained by people in both the central bank and the Ministry of Finance. They should work with a 'moral consciousness' regarding the

13 Sessional Paper No XIV of 1949 hereinafter referred to as Exter Report, p 15
14 Ibid. p 16
15 Ibid.

well-being of the whole society. Any attempt at seeking narrow self-interests will be contrary to this moral consciousness. Exter had a noble objective that the permanent secretary of the Ministry of Finance will guide his Minister appropriately and independently. But that objective was defeated by the 1972 Republican Constitution which abolished the post of permanent secretary in the public service. Instead, the constitution created a post of secretary which was under the control of the Cabinet of Ministers. Hence, in today's context, the secretary to the Ministry of Finance sitting on the monetary board is not an independent member. He is a public official who will seek to lead the monetary board in accordance with the wishes of the Minister of Finance. Hence, a serious question has arisen today with respect to the independence of the Central Bank.

Maturity of central bankers

Exter's point was that the maturity of people and growth of guiding conventions were needed for the success of the Central Bank. This is in accord with the role of institutions in making a central bank a successful outfit as presented by Acemoglu and others[16]. According to them, the presence of a supporting institutional structure was a sine qua non for economic policy to work in an economy. Institutions in institutional economics are not just organisations. They refer to "rules, enforcement characteristics of rules and norms of behaviour that structure repeated human interactions"[17]. Accordingly, a society with strong institutions has members with high values and ethos that are built into a self-governing governance system. When the central bank as well as the Ministry of Finance is run by such people, as envisaged by Exter, the question of Bank's independence does not arise. The presence of such a perfect situation not only leads to the development of a cohesive policy infrastructure but also helps both the government and the central bank to achieve their respective objectives without running into conflicts and battling with each other.

Central banks' challenge to remain relevant

It is, therefore, clear that the independence of a central bank cannot be ensured just by a legal arrangement. It is dependent on how those in the central bank view independence as a necessary safeguard, on the one hand, and the appreciation of that stand of the bank by all others, on the other. At the core

16 Acemoglu et al (2008) op cit

17 North, D C., 1989, 'Institutions and economic growth: an historical introduction', World Development, 17 (9), 1319–32

of this independence, therefore, lies the bank's freedom to decide on the appropriate level of money which it has to produce and supply to the economy. The experience throughout the globe has shown that the central banks which have produced more money than necessary have got into trouble by causing inflation to destroy their economies and having to go through painful currency reforms. In the past, it was just writing off a few digits from the face value of currency notes or introducing a new series of currency notes at new values. But today, with the proliferation of crypto-currencies competing with central bank produced money, the challenge has been for central banks to remain relevant in their respective economies[18].

The latest case in point is that of Venezuela which had to write-off not only five digits from its currency but also to introduce its own crypto-currency named Petro to fight hyperinflation in the country[19]. Thus, the management of a central bank – Governor and the board – should be careful about those who have an interest in getting it to compromise its independence. There are three groups falling into this category, the political authorities, pressure groups in the market place and its own employees. Political authorities may need the bank to print more money to keep the electorate satisfied so that they could win elections. Pressure groups seek to earn a rent by getting a central bank to offer a favourable credit policy, a situation known as 'regulatory capture'. Employees may agitate for enhanced compensation packages over and above the increase in labour productivity in a central bank. Since the only power enjoyed by a central bank is to print money, acceding to the demand of any of these groups will be disastrous for fulfilling its mandate.

Hawks, doves, swingers and pigeons in central banks

What this means is that central bankers should be people of stature – or as Exter had pointed out, people of maturity – to withstand the pressure coming from any of these groups. But going by the experience in the past, writers on central banking have taken liberty to identify the central bankers by the behaviour of a selected set of birds. The list is not exhaustive and it is expanding with the

18 Wijewardena, W A (2016), "Thriving in Digital Age: Digital Currencies Pose the Biggest Challenge for Banks" (available at: https://www.academia.edu/29632037/Thriving_in_Digital_Age_Digital_Currencies_pose_the_biggest_challenge_for_banks) (accessed on 19.8.2018)

19 https://www.forbes.com/sites/stevehanke/2018/08/18/venezuelas-great-bolivar-scam-nothing-but-a-face-lift/#1f10f7ba4c23 (accessed on 19.8.2018)

emergence of new evidence regarding the behaviour of central bankers. It first started with doves – those who believe in accommodative monetary policy – and hawks – those who are conservative and in the opposite[20]. But then, hawks and doves did not remain being hawkish and dovish forever; there was a change in attitude moving from one end to another. It led to name vacillating central bankers as ‘swingers’ who would at one point be in one end of the swing and at another, in the other end[21]. They have now been joined by pigeons who are peace makers and would choose a hawkish or dovish policy depending on which way the pendulum would move[22]. This inconsistency in approach by central bankers has a direct bearing on the independence of a central bank. When outsiders feel that the position taken by central bankers can be changed, they too have an incentive to penetrate the walls of the hard fortresses which central bankers have built around them and spoil their independent standing permanently.

New developments affecting central bank independence

There are two developments in the recent past which have made the independence of the central bank somewhat a blurred phenomenon. One is the inability of a central bank to raise a groundswell of public opinion to support it whenever there are attempts by political authorities to compromise its independence. Second is the wider role which central banks have assumed in addition to their main mandate of establishing price stability in the respective economies.

Scandals and loss of trust and reputation

Political authorities acting in self-interest have a natural inclination to abuse the power of a central bank to print money just by making book entries. If the managements of central banks, guided by prudential monetary policy considerations, make objections to such demands, politicians resort to levelling charges against central banks and their senior officers in public[23]. The objective has been to intimidate central bank officers and convert them from conservative

20 Eiffinger, Sylvester and Masciandaro, Donato (eds) (2018), Hawks and Doves: Deeds and Words-Economics and Politics of Monetary Policy Making, CEPR Press, London, p 4

21 Masciandaro, Donato, (2018), “Doves, Hawks and Pigeons: Monetary Policy Making and Behavioural Biases” in Eiffinger, Sylvester and Masciandaro, Donato (eds) (2018) op cit, p 83

22 Ibid.

23 An example in the recent past has been the public outburst of the former Minister of Finance that the current economic malaise has been the handiwork of a few senior officers of the central bank. This charge prompted the incumbent Governor to issue a statement of clarification. Visit: https://www.cbsl.gov.lk/en/node/3616 (accessed on 19.8.2018).

hawks to accommodative pigeons. The way to check such behaviour of politicians is to get the civil society to raise its voice against attempts at undermining central banks' independence.

However, central banks are unable to do so due to two reasons. One is the apathy of civil society on matters that do not have an immediate impact on its members. Even though inflation might hit them destroying the value of the financial assets they hold, its cost has to be borne in the future and not immediately. As such, the civil society makes the inter-temporal choice in favour of the current period's illusive prosperity.

The other is the hostility already built among civil society members against well-publicised scandalous occurrences that have happened in certain central banks. Some noted occurrences in the recent past have been worthy of mention here. The Governor of the Bank of Latvia has been arrested by Police for alleged bribe taking[24]. The Governor of the Bank Negara Malaysia was forced to resign from the post for his alleged involvement in a land sale during the previous administration of the country[25]. The Governor of the Central Bank of Afghanistan is reported to have fled the country after his alleged involvement in a scandal in a major commercial bank[26]. The Governor of the Bangladesh Bank had to resign from the post after hackers had siphoned off US $ 81 million out of the Bank's foreign reserves[27]. The former Governor of the Central Bank of Sri Lanka is reported to have defied an order by the Magistrate Court for him to appear before the Police to give a statement in a case involving alleged insider dealing in the government securities market[28].

Need for caution

When this type of news hits the headlines, the public en masse revise their opinion on the central bank from respectful trust to angry hostility. Then it

24 https://news.sky.com/story/central-bank-chief-suspended-in-latvia-corruption-scandal-11259247 (accessed on 19.8.2018)

25 https://www.ft.com/content/57cebf76-694b-11e8-8cf3-0c230fa67aec (accessed on 19.8.2018)

26 https://www.telegraph.co.uk/news/worldnews/asia/afghanistan/8602260/Afghan-central-bank-governor-flees-country-over-Kabul-Bank-scandal.html (accessed on 19.8.2018)

27 https://www.theguardian.com/world/2016/mar/15/bangladesh-central-bank-governor-resigns-over-81m-dollar-cyber-heist (accessed on 19.8.2018)

28 https://www.centralbanking.com/central-banks/governance/3365861/court-orders-former-sri-lankan-governor-to-report-to-police (accessed on 19.8.2018)

becomes a tedious task for those who remain behind a central bank to implement quick damage control measures. But, human tendency has been, according to those who have studied human behaviour, to blow up errors and downplay good work[29]. Hence, even when a central bank has done hundred good things, it is not those good things which are fresh on the minds of the public. One mistake it may have done is sufficient to tarnish its good image and erode its reputation permanently. This is why it is necessary for boards managing central banks to take extra care to prevent the occurrence of scandalous incidents ex-ante.

But, some of the scandals are difficult to be detected before they occur. In such instances, quick ex-post action to bring order back to a central bank would save it from a lot of embarrassment and public hostility. It then boils down to quality and stature of people who manage central banks. John Exter made this qualification about the Governor when he said that Governor should be a "man of recognised and outstanding competence in and understanding economic and financial problems and of unquestioned integrity and responsibility"[30]. Though Exter had not qualified the competence and ability of board members, corporate governance requires them to be "suitably qualified, effective and exercise their 'duty of care' and 'duty of loyalty'[31] to the stakeholders of the institution.

The main stakeholder of a central bank is the public who holds on to the entirety of money it has created prudently or otherwise. Hence, the obligation of the Governor and the board members is to the public and not the political masters who have appointed them to their respective posts. They hold those positions as trustees and not as owners of central banks, as I have discussed elsewhere[32]. Hence, their failure on both counts will result in disaster for a central bank, especially in relation to maintaining its independence in the eyes of the public.

Central banks' wider role: government oversight needed

Historically, central banks have assumed a wider role in their respective economies than their main mandate of ensuring price stability. Thus, whenever a government had faced the problem of finding a suitable institution to handle a specific issue, the central bank had been the obvious government saviour. They have ranged from handling financial system stability to managing superannuation

29 See: Kahneman, Daniel (2011), Thinking Fast and Slow, Penguin, London
30 Exter Report, op cit, p 20
31 BIS, (2012) Core Principles of Effective Banking Supervision, p 39
32 Wijewardena, (2017) Chapter 5

funds. In the case of the Central Bank of Sri Lanka, two co-objectives and many other ancillary functions had been assigned to it from time to time. The co-objectives added to it in an amendment effected to Monetary Law Act in 2002 requires it to attain 'economic and price stability' and 'financial system stability'. The scope of this latter function has been widened considerably after the global financial crisis of 2007-8. Accordingly, when the financial sector is in distress, the Central Bank as its regulator is required to work in close collaboration and consultation with the government to preserve its stability. Today, a central bank like the Central Bank of Sri Lanka cannot just be content with addressing only macroprudential issues relating to a financial system. It is required to pay equal attention to microprudential regulatory aspects as well.

In that game, in the first place, a central bank cannot allow banks which are 'too big' or 'too important' to fail in the market. In the second place, given the current socio-political situation in the country, it cannot allow even banks which are 'too small' to fail as well. Rescuing such a failed bank requires the infusion of both liquidity and capital. Central banks can provide liquidity through their normal liquidity windows without compromising their price stability objective and entailing long term adverse implications on their role as the regulator of the banking system. However, the provision of capital by a central bank for a failed bank has adverse implications for both these functions. It amounts to the central bank expanding the monetary base permanently, on the one hand, and getting into playing the role of both the 'player and referee' simultaneously, on the other. Hence, that capital should come from the government.

As Charles Goodhart had argued in 2010, "government insurance of the systemically important parts of our financial systems will remain in place for the foreseeable future. As the ultimate provider of such insurance, governments will want, and need, to maintain a close involvement with the conduct of systemic stability"[33]. In addition, the other functions of the central bank, namely, handling the public debt, managing foreign exchange and operating the payment and settlement too should receive close government oversight. Increased government oversight means compromising central bank's independence. But, it is unavoidable given the expanded workload of a central bank.

33 Goodhart, Charles (2010), Changing Role of Central Banks, BIS Working Paper 326, p 13 (available at: https://www.bis.org/publ/work326.pdf) (accessed on 19.8.2018)

Inflation targeting and central bank independence

Today, there is another important development which brings the issue of central bank independence to public debate. That is the adoption of a new monetary policy management system called 'inflation targeting' by central banks. In inflation targeting, as is well known, a central bank will take measures to control inflation directly by announcing publicly a low inflation target for a number of years and stick to it no matter what pressure is brought on it by outside forces[34]. This is a more credible way of conducting monetary policy since a central bank working under the inflation targeting regime has to take full responsibility for its success or failure. Previously, when the actual inflation rate exceeded the central bank's target range of inflation, there was always space for it to pass the blame on to an outside party such as the government.

But for a central bank to take full responsibility, it should have freedom to decide on monetary policy independently of government's fiscal operations. This requires the government budget to be independent of the central bank more than the central bank being independent of the government. For that, the budget should go through a number of reforms. First, it should build a stable and growing revenue source. Second, it should cave in profligate expenditure programmes. Third, it should pursue a more credible deficit management system. Fourth, it should develop its own borrowing power outside the central bank to meet its financing requirements. Fifth, there should be a broad political consensus to continue with this type of budget consolidation policy as a matter of national importance.

The attainment of this last requirement may be difficult, but not impossible. A similar type of budgetary policy was adopted successfully by Singapore's old guard in late 1960s as revealed by Goh Keng Swee, the city state's first Finance Minister, in an article published in 1992. According to Goh, the Singapore's old guard did not believe that central bank credit could bring in prosperity to Singaporeans. Prosperity came through hard work done by them at all levels of society as students, undergraduates or workers[35]. More recent examples of disciplining the budgets have come from Thailand and the UK. According to

34 A layman's explanation of inflation targeting has been presented by Sarwat Jahan in an article contributed to Finance and Development that could be accessed at http://www.imf.org/external/pubs/ft/fandd/basics/target.htm (accessed on 19.8.2018).

35 Goh Keng Swee, (1992), "Why a Currency Board?", in Prudence at the Helm, Board of Commissioners of Currency, Singapore

the data relating to the annual budget deficits in Thailand, as tracked by the Federal Reserve Bank of St Louis[36], after the financial crisis of 1997-8, there has been an increase in the budget deficit to 9% of GDP in 1999. But since then, the progressive consolidation of the budget has reduced the deficit gradually converting it to a surplus 1% of GDP by 2003. Since then, the budget has vacillated between surpluses and deficits but remained within a corridor of 3% of GDP. In the UK, despite it being a coalition government, the budget deficit which amounted to 10% GDP in 2010 was progressively and gradually reduced through a tight fiscal programme since then. In 2017, it was only 2% of GDP[37].

Sri Lanka's move toward a flexible inflation targeting system

The present management of the Central Bank has resolved itself to adopting a flexible inflation targeting system and is now in the process of converting its policy architecture to facilitate its full implementation shortly[38]. This is a policy measure taken by the Bank in correct direction. It also has received the government's acceptance as announced in its Vision for 2025[39]. Admitting for the first time that loose fiscal, monetary and exchange rate policies in the past aiming at boosting short-term economic growth without introducing the needed structural adjustments have been the cause of the present economic malaise, the vision document has pledged to introduce the necessary legislative and operational changes to facilitate the implementation of the flexible inflation targeting system by the Bank[40]. The necessary legislation requires the enactment of a new Monetary Law Act with restraints for the Bank to monetise the fiscal deficits. In other words, the government, while making the budget independent from the Central Bank through fiscal reforms, should grant more operational autonomy to the Bank.

Independence should be followed by accountability

However, independence without accountability will have the adverse repercussion of creating a monster within the sovereign government of Sri Lanka. That will not be acceptable to either the political authority or to the

36 https://fred.stlouisfed.org/series/CASHBLTHA188A (accessed on 19.8.2018)
37 https://tradingeconomics.com/united-kingdom/government-budget (accessed on 19.8.2018)
38 The details of the system and its modus operandi have been discussed in a box article in Central Bank Annual Report 2016: see Box 01, pp 24-6
39 Government of Sri Lanka, (2017) Vision 2025, Colombo p 19
40 Ibid

public. Hence, greater public scrutiny and oversight should be exercised over the work of the Central Bank once it is granted a greater degree of autonomy. There are a number of ways to introduce greater accountability in the work of the Bank. First, it is necessary to introduce a nomination, screening and selection process for the Governor and the board members as is being done in the case of the Bank of Canada or the Bank of England. The present method, though it is not a reflection on the incumbent office holders, is marred with the possibility of subjugating themselves to the wishes of the political authorities which have appointed them. Second, the administration and financial works of the Central Bank should be transparent and fully disclosed to the public. At present, such a disclosure policy has been adopted by Bank of Canada with respect to foreign travel and entertainment by senior officers and board members of the bank. Third, provisions should be introduced to facilitate the Central Bank management and the board to present and clarify the rationale and objectives of the bank's policy measures to special Parliamentary committees that should be supported by experts in the field. This type of public oversight will serve to check on the behaviour of those who run the Central Bank.

Conclusion

In conclusion, it should be recognised that in a sovereign state there cannot be another sovereign institution. Hence, the independence of the Central Bank should be subject to public oversight. While the Bank should collaborate with the government, the government should also learn to appreciate the important service being performed by the Bank. The political leaders are difficult customers and central bank managements would find it difficult to put the rationale of their policies across to them effectively. The solution suggested by the first Sri Lankan Governor of the Central Bank, the late Mr N U Jayawardena, was that the Bank should keep on nagging the government until it begins to realise and appreciate the Bank's position[41]. It has also been argued that the relationship between the government and the central bank should be that of a husband and wife. A good wife will see to it that what husband does is for the overall welfare of the family. However, in my view, the wife should be a smart wife and not merely a good wife. That is because a good wife, having accommodated the demands of the husband may run the risk of being pregnant every year, whereas a smart wife could at least have a gap between pregnancies.

41 Jayawardena, N U (2008), Remembering a Legacy: Selected Essays in Economic Policy, Ceylon Chamber of Commerce, Colombo, p 123

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