CENTRAL BANK INDEPENDENCY ON THE DEVELOPMENT OF THE FINANCIAL SECTOR. A CASE OF RESERVE BANK OF ZIMBABWE (1998-2008)

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ABSTRACT: The study looks deeper in the relationship between central bank independence and Gross Domestic product growth and other economic variables which are indicative of improved performance with specific reference to a developing economy. It seeks to find out how the central bank policies affected the state of development of the financial sector and the extent to which the banking sector influenced economic development in the economy. The research also aims to find out how the government affected or influenced the state of development of the financial sector in the country. It was found that the government was sorely dependent on central bank financing as a matter of survival due to limited sources of finance as GDP decline meant a reduction tax revenue base. Rising inflation and contracting real incomes put pressure on the fiscal budget. Questionnaires, interviews and document review were used to obtain information for the study. It was concluded that the cohesion between fiscal and monetary policy is of paramount importance; and there was need for a high degree of formal instrument independence.

KEY WORDS: Central Bank Independence; Reserve Bank of Zimbabwe

1. INTRODUCTION

The issue of central bank independence has generated considerable debate all over the world in recent years. Since attaining independence in 1980, the Reserve bank of Zimbabwe (RBZ) ‘s policies were designed, approved and implemented with government control as evidenced by the appointment of the central bank Governor by the state President. It was also evidenced by the existence of the laws and statutes which explain the operations of the central bank in the Zimbabwean constitution. Varying degrees of successes and failures of these policies under government control and influence have been realized. At the helm of its economic woes, the Zimbabwean economy had inflation at more than 300 000% as at 31 March 2008, interest rates...
above 350%, unemployment estimated at more than 85% and fiscal deficits being the order of the day in the economy (CSO, 2008).

In line with these challenges besetting the economy, the RBZ made frantic efforts to come up with policies that not only aimed at reducing these unbearable levels of these variables, but to stabilize them with considerable increases in output. However, given that failure has been witnessed with central bank policies under government control and empirical evidence shows that elsewhere, economic recovery and improved performance has been attained through the granting of independence to central banks.

The general objective of each and every central banker across the globe, according to Summers (1991) is to minimize a weighted sum of inflation and output variability. In recent years, many countries, especially those in the European Union Trading Bloc, have made progress towards removing their central banks from government control. Considerable economic recoveries and improvements have been witnessed in various countries as a result of central bank independence. Given that the post World War II star economic performers, German and Switzerland, have independent central banks and the legendary Argentinean economic recovery of 1989-1995 (Welch and William, 1999) being attributed to central bank independence questions can be raised as to the state of affairs in Zimbabwe economy.

When a new Governor of the RBZ was appointed in 2003 some considerable improvements in economic performance were realized, notably reduction in the inflation rate, currency stabilization coupled with improved foreign exchange inflows as well as increased output. The inflation rate recorded a decline of a magnitude of more than 300%, from 613.9% in December 2003 to 265% in October 2004 (Zimbabwe Independent, 2005). This trend did not however persist for long as an upward surge of the variable resumed by 2004 year end due to lack of harmony between the monetary (RBZ) policies and fiscal (government) objectives. The increase in money supply by printing of money to finance public sector wage bill which promoted liquidity conditions in the economy (Financial Gazette, 2004) pushed prices (inflation) upwards. Dykes and Michael (1989) argued that sound economic policies need to be separated from politically biased policies. Government interference or interjection may have caused the RBZ to fail to turn the fortunes of the country and bring back the economic days of glory. The central bank has to come up with policies that promote sound economic performance in Zimbabwe hence the need for an independent central bank for improved economic performance in the country. This research aims at evaluating the effectiveness of central bank independence on sound policy formulation and implementation for sustained economic performance in Zimbabwe.

In line with these developments, many questions have been asked in regard to the essence of an independent central bank and for the purpose of this study, the following research questions seek answers:

a) How has the central bank policies affected the state of development of the financial sector?

b) To what extent did the role of RBZ or developments in the banking sector influence economic development?
c) How did the government affect or influence the state of development of the financial sector in the country?

2. METHODOLOGY

In order to make a detailed and effective research the study focused on commercial banks registered in Zimbabwe under the Banking Act Chapter 24:02 and the Reserve Bank of Zimbabwe as the regulatory authority responsible for banking licensing, supervision and surveillance as enshrined in the Reserve Bank Act. Since the study is aiming at evaluating the effectiveness of central bank independence on economic performance, the researcher targeted those individuals who were well-acquainted with the operations of the central bank, monetary policy and economic variables’ movements. A total of fifteen (15) officials were chosen to complete questionnaires. Using judgmental sampling method 3 officials from the Bank Surveillance and 3 from the Economic Research of RBZ completed questionnaires. Nine (9) economists from different commercial banks also completed questionnaires. A total of four personal interviews with independent financial analysts were also carried. In gathering secondary data, the researcher had to go through already existing records, statistics and other publications.

3. LITERATURE REVIEW

Central bank independence leads to improved economic performance, firstly by ensuring a low inflation environment which is attractive to investment and then by increasing output through increased production as a result of improved investments (Dunne, 1985). The Reserve Bank Act Chapter 20:20 Section 1 gives the Reserve Bank Board the power to determine the bank’s and country’s monetary policy and take the necessary action to implement policy changes. Dunne postulated that monetary policy needs to be conducted in an open and forward looking way because policy adjustments affect economic activity and inflation. With clearly defined inflation objectives, it is important that the central bank report on how it sees the developments in the economy, currently and in prospect, affecting expected inflation outcomes and the real economy (Hoskins, 1991).

The consideration point to the need for effective central bank independence coupled with transparency and accountability arrangements for sound economic policy formulation and implementation which aids overall economic performance in the country. Literature shows that most of the arguments of central bank independence as an economic activity stimulus revolves around ability to maintain low inflation levels in the country followed by a cumulative causation effect on other economic variables which will then have a direct positive impact on economic performance. This therefore gives us the direction as to where central bank independence must derive the economy towards but the issue is how effective is it as an economic stimulus strategy in third world countries.
3.1. Central Bank Independence and Monetary Policy

The Oxford Advanced Learners Dictionary defines independence as being free from the influence, guidance or control of another or others. As applied to central banks, this translates into being free from the influence, guidance or control of the rest of the government, meaning both the executive and legislative branches of the central government in the formulation and implementation of monetary policy.

A study by Grilli et al (1991) revealed that central bank independence exist in the following two forms.

i) Goal independence: Where the central bank is free to set the final objectives for monetary policy.

ii) Instrument independence: Where the central bank is free to choose the settings for its instruments in order to pursue its ultimate objectives.

Independence to central banks, according to Pauls (1990), gives them flexibility in the formulation and implementation of monetary policy for the attainment of the said economic variables without crossing lines with government political objectives, thereby enhancing the economic performance of the country. This means if independent central banks formulate and implement policies with the sole aim of long term economic development of the country, regardless of short term costs, whereas if they are under the control of the government, they may end up implementing policies for short term political gains of the government regardless of long term cost associated with these policies. McNees (1993) defined monetary policy as the central banks’ process of managing money supply to achieve specific goals such as constraining inflation, maintaining an exchange rate and achieving full employment of economic growth.

Feinman (1993) argues that with central bank goal and instrument independence; these objectives allow the central bank to focus on price stability while taking into account the implications of monetary policy on economic activity and therefore, employment in the short term. Price stability is a crucial pre-condition for sustained growth in economic activity and employment, which is a desirable condition for all economies across the globe. Johnson (1990) concur with these arguments by revealing that the general objectives of all central banks are best attained in a situation where goal and instrument independence prevails than under any other condition. This will be a source of economic growth as independence is an ingredient of sound economic policy implementation by the central bank for improved economic performance. The granting of independence to the central bank enables the government to make suggestions, rather than giving directives on the operations and objectives of the central bank and this gives the central bank flexibility in policy formulation and implementation for the betterment of the economy instead of government’s political benefits (Meulendyke, 1992).

Most central banks have specific legislative mandates and therefore do not have goal independence (Baer and Sue, 1986). Thus the ‘independence’ of ‘independent’ central banks is instrument independence under which the central bank has authority to choose settings for its instruments in order to pursue the objectives mandated by the legislature, without seeking permission from, or being over turned by
Central bank independence on the development of the financial sector... 255

either the executive or the legislature. Countries vary considerably in the specificity of the mandated goals and hence in the degree of discretion of central banks in the conduct of monetary policy.

3.2. Sources of Central Bank Independence

Central bank independence is in part the result of formal institutional features typically incorporated in the legislation creating and defining the central bank. According to Cukierman (1992), the legislation creating an “independent” central bank or in many cases revisions to such legislation, often entirely takes away goal independence by mandating objectives for monetary policy, but otherwise sets up a structure that confers and protects instrument independence. The most important requirement for instrument independence is that the central bank be the final authority on monetary policy. The freedom of instrument choice therefore gives the central bank the discretion to choose a monetary policy tool which is best suited to the achievement of the target objective, regardless of the short run costs, without being interfered by government intended benefits which tend to be generally myopic and short term. This therefore is likely to result in the central bank choosing policies which aid and support economic performance and the long term welfare of the society. In the Zimbabwean case the Reserve Bank Act clearly states the objectives of the central bank, meaning that if independence of the RBZ exists, then it is only in as far as instrument independence is concerned, for goal independence is taken away by the mere existence of a legislation which stipulates the operations and objectives of the RBZ. An intangible source of central bank independence according to Cukierman (2006) is the appointment of a capable, respected, politically astute and ‘independent’ minded governor or president of the central bank.

The freeing of the central bank from the appropriation process is another source of independence (Blinder, 1998). They noted that many central banks around the world are being granted the seignorage function, which is printing and issuing currency for the government. This will be to cover costs of their operations from the earnings on their portfolio of government securities acquired in the process, returning the excess to the government, which is highly inflationary and counterproductive to the economy. Biault et al therefore points to the fact that if independent, no central bank will be given the seignorage function and hence their price stabilization objective will be made easier and therefore stimulation of economic performance in the country will come easier than in a monetized economy. It is critically important to ensure that the central bank will not be required to directly underwrite government debt for it to be accorded the level of independence prescribed by the Maastricht Treaty (Mishkin, 2004). The country’s Finance Ministry will have an incentive to keep rates low to reduce government’s debt servicing costs.

3.3. Central Bank Independence and Monetary Policy

Independence of the central bank is a prerequisite for achieving the goals that traditionally have been assigned to central banks specifically for achieving price
stability (Levin et al, 2004). Grilli et al (1991) noted that independence does not literally mean independence from government, because central banks everywhere are almost always a part of the government. There is always a link between the economics of the central bank and the politics of the central government but if the two are given boundaries, the policies thereof are more effective than if their interests are given room to overlap and conflict. According to Drazen (2002), the motivation for granting independence to central banks is to insulate the conduct of monetary policy from political interference especially that perpetrated and motivated by the pressures of elections to deliver short term gains irrespective of longer term costs. The intent of this insulation is not to free the central to pursue whatever policy it prefers, indeed every country, as Stiglitz (1998) revealed, specifies the goals of monetary policy to some degree, but to provide a credible commitment of the government, through its central bank to achieve economic performance without political interference. This argument therefore shows that granting independence to central banks fosters them towards sound economic policy implementation free of political bias, for improved economic performance in the country.

According to Stiglitz (1998) even a limited degree of independence, taken literally could be viewed as inconsistent with democratic ideals and in addition might leave the central bank without appropriate incentives to carry out its responsibilities. They argued that for central banks to be accountable to their policy outcomes, these policies must have been self formulated and implemented without government interference. Independent central banks are therefore more likely to come up with better policies for improved economic performance as they will be accountable to whatever their policy outcomes. Their argument is in line with that of Barro and Gordon (1983) which points to the fact that independent central banks are indeed an ingredient of improved economic performance in any country.

3.4. Central Bank Independence and Inflation

Interest in central bank independence was motivated by the belief that, if a central bank is independent of direct political pressure, it achieves lower and more stable inflation (Cukierman et al, 2002). The argument is that, independence enables the central bank to vary its policies and objectives for the attainment of its mandated objectives, chief of which is price stabilisation, without pressure from the government to deliver short term gains regardless of long term costs mainly for political gains of the central government. Price stabilization promotes expenditure in the country, which is attractive to investment in the economy. An increase in investment will therefore mean an improvement in the economic performance of the country hence the attainment of the general central bank objectives.

In a study carried by Bade and Parkin (1988) to find the link between central bank independence and the final effect on the economic performance of the country 12 Organization for economic Cooperation and Development (OECD) countries were used. The degree of policy influence was determined by the government’s ability to appoint the members of the central bank governing board and whether the government or the central bank policy authority. Countries were given a rank of one to four in each
category, with four being the highest level of central bank independence. The research concluded that policy independence is an important determinant of inflation and the resultant GDP growth in the country because the two countries with the highest degree of policy independence, Germany and Switzerland, had inflation rates significantly below those of all other countries in the sample. Their GDP growth rates were considerably higher, indicating a link between their central bank’s independence and economic growth.

Grilli et al (1991) calculated two indexes of central bank independence- one based on economic measures of independence and the other based on political measures of independence. It was found that economic independence was negatively related to inflation. Political independence also had a negative relationship with the GDP growth though the relationship was not statistically significant. It was also noted that the countries with the highest independence, Germany and Switzerland, had the highest GDP growth rates and the lowest inflation rates, indicating a link between better economic performance and central bank independence.

Alesina and Summers (1993) calculated a measure of central bank independence by averaging the indexes created by Bade and Parkin in 1988 and that of Grilli et al in 1991. They found that the more dependent a central bank was, the greater the variability of inflation and GDP growth rates. This, they argued was a result of the link between inflation and the level of investment in the country. From their sample, they found that high degrees of independence were the causes of low inflation, which was attractive to investment hence the increase in the economy’s GDP growth rates.

3.5. Central Bank Independence and Economic Performance

According to Bade and Parkin (1988), central bank independence is designed to insulate the central bank from the short term and often myopic political pressures associated with the electoral cycle. This has been described as the political business cycle in which the pre-election stimulus leads to higher inflation followed by monetary restraint after elections. Guy and Fischer (1995) also argue that the political business cycle gives the government the urge to direct the central bank to indulge into policies that will yield immediate results regardless of their long run effects to the country. In dependent central bank situations, budget priorities and monetary policy objectives can be in conflict (Cukierman, 2006).

The executive branch generally wants to keep the cost of servicing its debt low, and this preference might be at odds with the need for monetary policy to vary interest rates to maintain price stability. Empirical studies generally found an inverse relationship between measures of central bank independence and average inflation or Gross Domestic Product (GDP) growth, for many developed economies. The inverse relationship according to Frankfurt (2004), is reflective of the fact that countries with less aversion to inflation are less likely to have independent central banks but at the expense of improved economic performance.
3.6. Central Bank Independence and the Real Economy

Cukierman et al (1992) found no systematic effect of central bank independence (using either of their two indicators) on the growth rate of real output. Alesina and Summers (1993) likewise found no correlation between average economic growth or the variability of growth and the level of central bank independence. However, they all pointed out to the fact that there is always a transmission mechanism which results from the granting of independence to the central bank in the form of the resultant low inflation rates which are attractive to investment, resulting in employment creation and increases in the output levels in the country, hence improved economic performance.

3.7. Fiscal Deficits

Governments realizing that there maybe some limit on their ability to issue bonds continuously to finance deficits may decide to limit deficit spending (Grilli et al, 1991). Bernanke et al (1999) investigated 12 countries and found that there was evidence of a negative relationship between central bank independence and the long run behavior of government deficits as a percent of GNP. The deficits of Switzerland and Germany, the countries with the highest levels of central bank independence, had long run equilibrium values near zero with little variance. He argued that the independence of central bank in the monetization of these deficits which is inflationary and counterproductive to the economy. The independence of the Deutsche Bank and the Reserve bank of Switzerland were therefore concluded to be the causes of low fiscal deficits and the resultant high GDP growth rates in these two countries.

Bade and Parkin (1988) looked at fiscal deficits as a percent of GDP in Australia, Canada, Japan, New Zealand and the USA for the period 1970-1985. They found that New Zealand, which had the lowest level of central bank independence, had the highest fiscal deficit as a percent of GDP. Therefore it was concluded that there is a negative correlation between the deficit/GNP ration and the degree of central bank independence. They also indicated that central bank independence is an ingredient of improved macro economic performance.

4. RESULTS

Findings were obtained among other methods through interviews and questionnaires as mentioned under Methodology above.

When asked if the RBZ was independent there was a unanimous agreement that it was not independent as it is answerable to the Minister of Finance, who has the power to give general directions on all policy issues and determines the budget of the central bank. They also highlighted that the President appoints the Governor and his three deputies for renewable five year terms as enshrined in the RBZ Act (Chapter 22:15) as such this makes it difficult for the Central Bank to resist government demands as the monetary policy was strongly subordinated to the fiscal policy, to such as extent that the central bank could not bounce government cheques.
All respondents agreed that the level of independency of the RBZ greatly affected the soundness of banks in the financial sector in Zimbabwe between 1997 and 2007 as they pointed that the RBZ employed poor and inconsistent economic policies which were described as perishable. The word “perishability” normally conjures images of food items like milk, fish that go bad when not properly stored. However, because of the circumstances the country finds itself in, a number of policy initiatives exhibited a high degree of perishability. Policy measures would last from a few hours to three months.

On whether the central bank policies influenced the viability of the banking sector, it was mentioned that the monetary policy ceased to be a useful management tool in the maintenance of the internal and external value of the Zimbabwean dollar through price stability. About 60% of the of the respondents noted that as inflation was at 24000% the RBZ would borrow through treasury bills at 340% then on lends to selected sectors at 25%. This sequence of rates was disastrous and increased fragility of the banking sector. It was also found that the removal of zeros would have worked if accompanied by an influx of foreign currency to support the local currency. This would have been in the form of foreign aid, foreign direct investment or increased exports. On interest rates, respondents stated that the negative real returns spurred on by loose monetary policy framework on the money market resulted in depressed interest rates on deposits that scared away savers from investing with banks. Interest rates offered were below the inflation rate which resulted in negative returns; hence, the public had no incentive to keep their funds in banks. It was found that the interest rate regime has failed to address the issue of disintermediation in a hyperinflationary environment. The study found out that it was difficult for savers to leave their funds in low yielding savings accounts with banks, as the negative real interest rates prevailed.

4.1. Foreign Exchange Market

On the foreign exchange regime the study found out that the RBZ erred by pursuing a fixed exchange rate despite the weakening Zimbabwe dollar and this affected the viability of banks.

Between July 1997 and March 1999 a managed float exchange rate regime was used. This resulted in adverse balance of payments developments in 1997, particularly from the last quarter combined with rising domestic inflation exerting immense pressure on the exchange rate. As market confidence declined speculative behavior about probable currency depreciation intensified. This led to prepayment of lines of credit, hoarding of foreign exchange and further attacks on the Zimbabwean dollar. These developments intensified from October 1997, as evidenced by significant build up of foreign exchange balances of companies at banks.

The RBZ in consultation with the Bankers Association, agreed on an informal arrangement which stabilized the exchange rate at ZWD38/USD in March 1999. The relative stability was also a result of declining import demand due to tariff adjustments, improved operational efficiency of the interbank foreign exchange market and a tight monetary policy. The arrangement to stabilize the exchange rate at ZWD38/USD showed some shortcomings from mid 1999 due to continued poor export performance.
and expected international BOP support which did not materialize. During the first half of 2000, the foreign currency situation deteriorated further and this led to development of a parallel market, accounting for a greater part of foreign exchange transactions. This was also followed by the suspension of BOP support to Zimbabwe and it compounded the foreign currency situation and maintenance of the exchange rate at ZWD38/USD became unsustainable.

The exchange rate which was pegged at ZWD38/USD for twelve months was adjusted to ZWD50 in August 2000. This was under the new fixed exchange policy which linked exchange rate adjustments to changes in inflation differentials between Zimbabwe and its major trading partners. This exchange rate policy was introduced against the background of a breakdown of the informal arrangement between the Reserve Bank and Authorized Dealers to peg the exchange rate at ZWD 38/USD, and the closure of several gold mines, as a result of a combination of rising production costs and declining revenues. Escalating foreign payment arrears and rising domestic inflation also put on pressure on the local currency.

An export Support Rate of ZWD800 per USD was introduced in February 2003 in order to restore exporter viability and increase the capacity of the key sectors of the economy to generate foreign exchange. Government undertook to review the exchange rate on a quarterly basis in line with macroeconomic developments in the country and purchasing power parity with country’s major trading partners. Although after the introduction of the export support scheme, monthly foreign exchange inflows improved, the capacity of exporters to fully benefit from the export support rate was undermined by high inflationary environment coupled with constraints on production.

The Foreign Currency Auction System commenced on the 12th of January 2004 and the system involved the auctioning of foreign exchange through a Currency Exchange- an independent body supervised by the Reserve Bank. The system was abandoned in October 2005 because it failed to achieve the desired results of enhancing export viability.

4.2. Intermediary Role

When asked if banks were effectively playing their pivotal role in the economy, nearly 87.5% of the respondents were of the opinion that banks are not playing their intermediary role effectively and efficiently in the economy. The study found out that the government greatly affected the state of development of the financial sector in the country through the implementation of imprudent, inconsistent and unsustainable policies which played significant role in perpetuating macroeconomic distress in the country. Political turmoil which had been the order of the day for a long time was characterized by civil strife, corruption, and crime destroyed capital and infrastructure increasing cost of doing business and creating uncertainty about property rights. All these were detrimental to financial sector development. There was lack of fiscal discipline as there was a large financing requirement from government crowding out private investment by increasing the required return on government securities and absorbing the bulk of savings mobilized by financial sector.
The study found that during this period there was poor judicial system which caused property rights violation. The weaker property rights forced banks to invest more resources in credit appraisal fees. Banks became reluctant to extend loans because of the inefficient judicial system, corrupt bureaucratic political institutions which hindered loan recovery. State ownership of financial institution has caused low level of financial development as concentrated lending is not directed to the poor but to politically favored and commercially unviable projects this has resulted in lower economic growth, and greater system fragility.

5. DISCUSSION

In Zimbabwe, the framework for the operation of monetary policy is set out in the Reserve Bank Act which requires the board to conduct unbiased monetary policy in a way that, in the board’s opinion, will best contribute to the central banks objectives of: i) Currency ii) Maintenance of full employment in the economy and ii) Economic prosperity and welfare of the majority. Both the central bank and the government agree on the importance of low inflation expectations. These assist business in making sound investment decisions, underpin the creation of new and secure jobs, protect the savings of the public and preserve the value of the economy’s currency, hence improving the country’s overall economic performance. The gaining of independence to the central bank enables the government to make suggestions rather than directives. This argument points to the fact that central bank policies need to be separated from government control and government policies because if the two are given room to overlap the resultant effects are detrimental to economic growth as their overall objectives are usually different. The government always target at political gain, mainly re-election whilst the central bank targets high economic performance through enhancement of low inflation-output variability in the economy. A major reason why policy reform often fails is the absence of a functioning system of accountability and a lack of constraints and checks on politicians.

However countries vary considerably in the specificity of their mandated goals and hence in the degree of discretion of central banks in the conduct of monetary policy. This means other central banks have legislated objectives which they have to attain using self formulated policies but still the argument is they tend to achieve better overall economic performance than their other counterparts who lack any form of independence (Buchanan and Wagner, 1977). As Grilli at al (1991) argued, central banks have specific legislative mandates and therefore do not have goal independence, therefore the ‘independence’ of ‘independent’ central banks is instrument independence under which the central bank has authority to choose settings for its instruments in order to pursue the objectives mandated by the legislature without seeking permission from, or being overturned by either the executive or the legislature.

If there is interference in the central bank’s policies by the fiscal authorities, there will be pressure on the central bank to keep interest rates low regardless of target objectives and market conditions, for the benefit of the central government. Low interest rates will promote borrowing in the economy, which is highly inflationary as it results in increased liquidity. The resultant inflationary environment in Zimbabwe
during the period under study was not attractive to investment thus resulting in reduced economic activity hence poor macroeconomic performance. For the Zimbabwean case, the RBZ is the sole underwriter of government bills and this again shows that the Zimbabwean central bank does not meet the conditions set out in the Maastricht Treaty for an independent central bank.

The appointment of the central bank governor has a huge effect on the achievement of monetary policy targets. The appointment of a politically astute person as the central bank governor will almost always guarantee the formulation and implementation of policies aimed at purely economic gains. Such a governor will bear the ability to stick to the price stability objective even at the cost of other short term real objectives, thereby enhancing improved economic performance of the country through an array of economic benefits which emanates from price stability in the economy. The RBZ governor is appointed by the President through the Finance Minister, which creates room for the appointment of someone who can be easily manipulated for political benefits at the expense of long term costs to the economy.

Since the existence and objectives of the RBZ are clearly stated in the Reserve Bank Act, its goal independence therefore does not exist and this leaves room for reduced accountability of the RBZ on its policies. This reduces the commitment of the central bank to its policies which it is lowly accountable to hence creating room for poor policies which do not meet the intended objectives as the monetary authority.

As Johnson (2006) argued the need by the government to gain politically has seen central banks getting themselves into expansionary monetary policies which create immediate employment but at the same time resulting in the future inflation prospects in the country which is detrimental to the long run economic performance of the country. Independence therefore insulates central banks against this, thus giving them the platform to formulate and implement policies which are solely aimed at the economic good of the country. There is need to grant central bank’s independence such that there will be no interference on its policies to manipulate them towards the countries budget priorities. Sound economic policies which do not have a bias towards the country’s budget priorities will therefore means that the central bank will come up with unbiased policies which will be implemented for the improved economic performance of the country.

Interest rate ceilings, liquidity ratio requirements, high bank reserve requirements, capital controls, and restrictions on the market entry into the financial sector characterized the banking environment during the period under study. It resulted in banks’ enormous stresses as sudden opportunities to make disproportionately large profits arose.

6. CONCLUSION

In conclusion governments place more weight on meeting its output target than its inflation target whereas the opposite holds for the central bank. If the central bank is independent of government control, then its targets are more likely to be aimed at the long run plan of the economy resulting in improved economic performance than in a situation where the government is in control of the target goal and the instruments to be
employed in policy implementation. The key to effective operation of the central bank within governments is a well-designed policy mandate, a high degree of formal instrument independence, complementary informal relationships to ensure appropriate coordination without undermining instrument independence, a disciplined regular process of legislative oversight, and high degree of transparency and disclosure.

The result is a good balance among government mandated objectives, instrument independence, flexibility and accountability which are aids of improved economic performance and sound financial sector. This balance keeps open opportunities for political interference and requires continuing energy and focus both to the central bank and government on sustaining the independence of the central bank. Otherwise the full benefits of independence in the form of improved economic performance will not be realized. Central bank independence, from the evidence gathered in the empirical studies, must not be taken as an unassailable but rather as a principle that has to be uplifted and defended for the long time good of the nation in the form of improved economic performance.

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