CENTRAL BANK GOVERNANCE, ACCOUNTABILITY AND INDEPENDENCE: THE CASE OF RESERVE BANK OF MALAWI

by Lukes Kalilombe

Submitted in partial fulfillment of the requirements for the degree of Masters of Development Studies, Faculty of Humanities, Development and Social Sciences, University of KwaZulu-Natal

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Abstract

This dissertation measured using appropriate methodology the degree of independence of the Reserve Bank of Malawi based on the Reserve Bank of Malawi Act of 1989. Furthermore the dissertation assessed the vulnerability of this independence in the context of good governance and a variety of internal and external threats on the independence. This comes from the understanding that even though central banks are accorded independence, there are situations where practice deviates from what the charters state. Therefore the dissertation provides recommendations on how to strengthen the Reserve Bank Act to support its legal independence.

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DECLARATION

Submitted in fulfillment / partial fulfillment of the requirements for the degree of Masters in Development Studies, in the Graduate Programme in Faculty of Humanities, Development and Social Sciences, University of KwaZulu-Natal, Durban, South Africa.

I declare that this dissertation is my own unaided work. All citations, references and borrowed ideas have been duly acknowledged. It is being submitted for the degree of Masters in Development Studies in the Faculty of Humanities, Development and Social Science, University of KwaZulu-Natal, Durban, South Africa. None of the present work has been submitted previously for any degree or examination in any other University.

Student signature

23/02/2009

Date

Acronyms and Abbreviations

BIS	Bank for International Settlements
CBI	Central Bank Independence
GDP	Gross Domestic Product
HIPC	Heavily Indebted Poor Countries
IMF	International Monetary Fund
MPC	Monetary Policy Committee
PRGF	Poverty Reduction and Growth Facility
SMP	Structured Monitored Programme
RBM	Reserve Bank of Malawi
WB	World Bank
UNDP	United Nations Development Programme

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Chapter 1: Introduction

Independence of Central Banks has generated considerable debate since the 1990s for several reasons. The most cited reason by economists is that in a highly globalised world economy and with intensified competition for capital and finance, politicians tend to use Central Bank's independence to signal their country's credit worthiness (Maxfield, 1997:11; Padayachee, 2001:745). Both Padayachee and Maxfield point out that this derives from the belief among agents in financial markets that the government on its own cannot be trusted with effective and non-partisan implementation of monetary policy. In many instances, it is argued that the independent pursuit of monetary policy tends to be compromised by political interests and populist pressures. Therefore autonomy and independence of the Central Bank is vital for monetary policy effectiveness and credibility (Maxfield, 1997:4, 11; Maliszewski, 2000:1; Padayachee, 2001:747; Lybek, 2004:2).

Even though much of the debate has been directed towards independence, inflation rates and recently inflation targeting, issues of governance and accountability have started to take centre stage (Padayachee, 2001:747; Lybek, 2004:8). In the 1990s Central Banks began to compare their internal governance arrangements amongst themselves through groups such as the Bank for International Settlements (BIS) or bilaterally (Koch, 2007:1). According to Koch, external pressures emanating from other public sector agencies, private sector firms, international institutions such as the International Monetary Fund (IMF) and the public at large have all played a part in pushing Central Banks towards better governance, improved accountability and transparency. Most economists believe that issues of independence, accountability and governance far from being opposed to one another are rather complementary. The better the governance and accountability, the more likely it will be that the Central Bank's goals, policies and independence will be understood and defended (Eijffinger & Hoeberichts, 2000:1-2; Lybek 2004:2-3; Quintyn, 2007:n.p.). Research in Malawi has been directed towards Central Bank independence and inflation rates, and regimes (Sinoya, 2001;Simwaka 2004); very little has been done on transparency and accountability. While some researchers (Eijffinger and Hoeberichts, 2000; Lybek 2004) have studied issues of good governance, accountability and transparency in developed countries, there are no such studies on Malawi.

This research attempts to fill that gap by looking at the issues of governance in the Reserve Bank of Malawi in relation to the independence accorded to it by the Reserve Bank of Malawi Act of 1989. The study will also advise the revision process of the Reserve Bank of Malawi Act which is in the pipeline.

1.1. Objectives and Methodology

The project had two main objectives:

i. To measure, using appropriate methodology, the degree of independence of the Reserve Bank of Malawi based on the Reserve Bank of Malawi Act of 1989.

ii. To assess the vulnerability of this independence in the context of good governance and the variety of threats on the independence.

To achieve the objectives, the project used measures of Central Bank independence developed by Cukierman, A., Web, S., and Neyapti, B. (1994) (see annex 1 page 59). This measure is based on the coding of the Central Bank charter and may be termed the Legal Independence Measure since it is based on the degree of independence conferred on the Central Bank by law. The criteria assigns weighted values to four main themes namely: (a) The chief executive of the Central Bank, that mainly looks at the conditions of appointment and dismissal of the chief executive of the Central Bank (b) the policy formulation cluster, which looks at the freedom of the Central Bank in monetary policy formulation and the resolution of conflict between the government and the Bank. It also looks at the participation of the Central Bank in the budget process, (c) the objectives of the Central Bank, that address the issue of whether or not the Central Bank's main objective as stipulated by its charter is to achieve price stability, (d) lending to the government, that is how the Central Bank limits lending to government. This legal index has its own limitations as there is a lot of divergence between what the law states and what is practiced more especially in the less developed countries.

To address this limitation, the informal indicator which looks at the turnover of the governors which was also developed by Cukierman et al (1994) was also used. This indicator was used on the presumption that at least above some threshold more rapid turnover of governors indicates a lower level of independence. More rapid turnover creates dependence because when politicians frequently take the opportunity to choose a new governor, they will usually choose those who will obey their wishes. Frequent turnover may reflect the firing of those who choose to challenge the government. However, a low turnover rate does not necessarily imply high Central Bank independence as a subservient governor may stay in office for a long time.

Another informal instrument, a questionnaire, which basically requires the Central Bankers themselves to rate their independence, was used to strengthen the research further. The questionnaire was also developed by Cukierman et al (1994) (see annex 2 page 63).

On good governance the study used the criteria developed by Eijffinger and Hoeberichts (2000) (See Annex III page 65) that deals with accountability and transparency. The criterion has thirteen components which are given a score of one each. The thirteen components are divided into three main themes to do with accountability and transparency.

1.2. Main Challenges Faced by the Research

The project was faced by two main challenges. The first challenge is that the methodology used is highly quantitative, which makes it likely to lose useful information which is qualitative in nature. To mitigate this problem the research, apart from doing the calculations and administering the questionnaire encouraged discussions that dealt with recent trends in Central Banking currently toping debates.

The other weakness is the difficulty in comparing the results from the researcher's calculations and those by Cukierman et al. (1994). The time periods in question are different making it difficult to compare because Central Banking is dynamic. The analysis done by Cukierman et al. (1994) was based on data collected in the period between 1980 and 1989 but Central Bank independence generated considerable debate in the 1990's (Maxfield, 1997:11; Padayachee, 2001:745). The researcher's analysis has been done using data in the period 1989 to 2006. The incomparability of the time periods should be borne in mind when interpreting the results.

1.3. Summary of Findings

The aggregate score for the Reserve Bank of Malawi's independence under Legal Independence Measure as calculated by the researcher was found to be 0.50. This is a very high score if we compare with the results found by Cukierman et al. (1994). Despite having a high score the Reserve Bank of Malawi act of 1989 still has some weaknesses in four areas namely: (a) Terms of employment of the Governor of the Reserve Bank of Malawi (b) Limited independence in monetary policy formulation and implementation (c) Absence of ranking in the objectives of the central bank (d) Weak rules pertaining to lending to the government.

On the informal indicator of turnover of Central Bank governors, even though the results are higher than the African average when we compare with Cukierman et al. (1994) results, there are some weaknesses. It was found that there is some overlap between the political cycle and the turnover of Central Bank governors which compromises Central Bank independence. Since the inception of the multiparty system in Malawi a new governor is appointed a year after general elections.

Under accountability and transparency the Reserve Bank of Malawi Act 1989 gets an aggregate score of 5 out of 13 points which translates to 38.4%. The reason behind the poor score is that the debate about accountability and transparency started to take shape later than 1989, after the Reserve Bank of Malawi Act was formulated. During the 1980's, debates mainly concentrated on Central Bank's independence and its impact on macroeconomic variables. Even though there are some mechanisms in place to deal with accountability and transparency, the act does not mention this since it was updated at a time when notions of accountability and transparency were still new.

1.4. Organization of the Dissertation

The dissertation has five chapters. Chapter Two, "Literature review, theory and methodology", discusses theories and studies that have been conducted in this field both at international level and in Malawi. The section also explains the methods used in data collection and analysis. Chapter Three gives a brief description of the Malawi economy and a brief history of the Reserve Bank of

Malawi and its monetary policies. Chapter Four discusses the results/findings and their implications. The last chapter provides some recommendations and conclusion.

Chapter 2: Literature, Theory and Methodology

2.1. Introduction

This chapter will review the debates on Central Bank independence. Some economists prefer central bank independence while some oppose it. The chapter will also look at case studies which try to link Central Bank independence and other macroeconomic variables such as inflation and economic growth. The link between Central Bank independence on one side and accountability and transparency on the other will be established by looking at how monetary policy should be implemented and how the Central Bank should be organized to achieve this end for example, the composition and size of the monetary policy committee. The chapter will conclude by outlining theories and methodology that were used to collect and analyze the data.

The main argument of the chapter is that most research on Central Bank independence and governance has tended to concentrate on developed countries (Maxifield, 1997:9; Padayachee, 2001:747; Lybek, 2004:8; Johnston, 2006:91). A few cases carried out in Malawi, such as those by Sinoya (2001) and Simwaka (2004) have concentrated on the relationship between Central Bank independence, inflation rates and economic growth rates and none has concentrated on good governance.

2.2. Central Bank Independence

Some economists have looked at why governments opt for Central Bank independence both in developing and developed democracies and how Central Bank independence affects other macroeconomic variables (Cukierman, 1993; Maxfield, 1997; Johnson, 2007). For example, Maxfield (2005:35) argues that one of the major reasons for Central Bank independence in developing countries is to attract foreign investment. Maxfield points out that most explanations of why governments cede authority to Central Banks focus on internal political causes while neglecting external pressures. This closed-economy approach, she suggests, is particularly inadequate when it comes to understanding why governments prefer Central Bank independence in developing countries. She notes that there are several reasons for Central Bank independence in developing countries. However the single most important factor that is overlooked in closed economy models is the need for international credit and investment faced by developing countries' governments. In her view, independent Central Banks promote lower inflation by curbing politicians' ability to manipulate money supply in order to create short-term growth. Politicians may stimulate the economy at the expense of longer-term macroeconomic stability (Maxfield, 2005:35) thereby chasing away foreign investment. She proposes a model where the government gives authority to Central Banks in order to signal their country's creditworthiness to international investors. She notes that politicians are more likely to use Central Bank independence to attract foreign investment, the larger the need for balance of payment support, the fewer the countries restrictions on international financial transactions (Maxfield, 1997:35). Movement of foreign investment is encouraged further by the reduction of barriers to international movement of currency and other financial assets.

Still on the relationship between Central Bank Independence and credit worthiness, Johnston also provides reasons why developed and developing countries moved towards Central Bank independence (Johnston, 2006:91). She notes that in industrialised countries where democracy reached maturity, the granting of Central Bank independence was a domestic democratic decision. The decision was made primarily for domestic economic reasons, resulting from a domestic political debate, for example United Kingdom after 1997. As such, the Central Bank, though independent, has a firm domestic political mandate for its mission. In developing countries Central Bank independence is mainly targeted at signalling monetary policy credibility to international financial actors and the transnational donor community played a key role in transforming the old command institutions (Johnston, 2006:91). There is need therefore to build democratic support for Central Bank independence for it to work in developing countries.

Apart from signalling creditworthiness supporters of Central Bank independence propose other reasons for the move towards independence. They believe that leaving monetary policy to the state has several disadvantages and it is imperative to shield monetary policy from government and politicians. For example, Alesina (1989:57) argues that macroeconomics and politics are deeply interconnected and that elections are either won or lost because of economic conditions. In trying to establish the relationship between political cycles, inflation, economic growth and unemployment, Alesina argues that there are several issues that motivate politicians to behave this way. He notes that politicians are selfish in nature and they try to remain in office as long as possible. Secondly politicians are usually partisan and they like to please their constituencies. These motivations are usually at their peak during the times of elections. They try to create the most favourable economic conditions just before elections even though these policies may have adverse effects. This tendency according to Alesina is unnecessary and suboptimal since the timing of macroeconomic policy is artificially affected by the elections.

Alesina, contributing to the unemployment and inflation trade-off debate, notes that political parties have different preferences on this trade-off as the outcomes have different redistributive consequences (Alesina, 1989:58). Looking at the low-unemployment/high-inflation scenario, lower middle class people benefit from this while the opposite scenario favours the upper middle class. Left wing parties therefore choose situations of high inflation and low unemployment. He goes on to note that socialist parties usually understate the cost of inflation and over stimulate the economy whereas conservative parties do not mind unemployment at all when they fight inflation. Therefore it is better to leave decisions of the unemployment and inflation trade off to the neutral central bankers than politicians.

Proponents of Central Bank Independence also argue that it reduces political conflicts over monetary policy because political leaders cannot be blamed for unpopular decisions. Independent Central Banks can be blamed for implementing unpopular but beneficial monetary policies without taking into account the change in the political landscape more especially during election years (Johnson, 2006:91). In this case Johnson argues that Central Bank independence is a public good for democracies. The public prefers a lower rate of inflation than would obtain if politicians controlled the Central Bank, and Central Bank independence ensures that this public preference is respected.

It is argued further that guiding macroeconomic policy is a complicated and delicate task beyond the comprehension of most non-economists and politicians. Highly educated Central Bank professionals are best suited to make policy decisions (Stiglitz, 1997:np; Padayachee, 2001:748; Johnson, 2006:95). Delegating authority over monetary policy to such technocrats requires a government that is ready to surrender its influence on macroeconomic variables to unelected officials for the greater good of the country.

Critics of Central Bank independence counter these claims based on four major arguments. The first argument is that independent Central Banks do not necessarily improve the overall economic wellbeing of their countries (Stiglitz, 1997:np; Padayachee, 2001:747; Johnson, 2006:94,9 5). Economists widely concur that Central Bank Independence has no measurable impact on economic growth. Studies demonstrate that steadily moderate levels of inflation do not retard economic growth, and may actually be beneficial in maintaining higher employment levels.

The second argument is that granting Central Bank independence violates the most important tenets of democratic governance (Stiglitz, 1997:np; Johnson, 2006:95). First, they insist that it violates the fundamental principles of democratic governance by concentrating immense power in the hands of one unelected individual, the Central Bank governor. Stiglitz notes that the manner in which the decision makers are chosen does not conform to democratic principles. He points out that monetary policy is no more complicated and technical than many other fields such as health care, taxation, or foreign policy and has no special qualities requiring its insulation from democratic control and debate. In fact the field of monetary policy involves the trade off between inflation rate and unemployment which affects the society as a whole. However the decisions about the trade-off are made by a group of individuals who do not represent the society as a whole due to their banking background (Stiglitz, 1997:np).

Critics further note that supporters of Central Bank independence assume that independent Central Banks can reduce inflation at less cost than can more politically dependent ones and that once inflation is left to rise it has a tendency to spiral out of control (Stiglitz, 1997:np; Padayachee, 2001:745; Johnson, 2006:95). Central Bank advocates have long believed that independent Central Banks can reduce inflation at a lower societal cost specifically with fewer negative effects on employment and output than can dependent ones, because people trust independent Central Banks to do what they say they will do. Therefore people adjust quickly their expectations and wage demands in response to the policies of independent Central Banks. According to Stiglitz, evidence does not support this view because Central Bank Independence either has no effect or actually raises the societal costs of disinflationary policies. This likely occurs because independent Central Banks are so concerned with lowering inflation rates and preserving their reputations as credible inflation fighters that they tend to adopt tight monetary policies. Moreover evidence does not suggest that such moderate rates of inflation exhibit a tendency to develop into unquestionably damaging hyperinflations.

Fundamentally Central Bank independence exists on a continuum. According to Cukierman (1993), Lybek (2004) and Johnson (2006), a Central Bank has the highest independence when the governor enjoys a term of at least eight years, its board members hold lengthy terms not synchronized with the electoral cycle, the appointment process is clear and relatively apolitical, and the governor and board members must possess particular professional qualifications and may not simultaneously hold other posts or represent the government. A Central Bank is at its most economically independent if it has a clear legal mandate to protect price stability, if it may not finance the government, and if it alone determines monetary policy, controls its own budget and sets its own salaries and fees, and possesses a range of monetary-policy instruments. The underlying presumption is that the more independence, the better. While no Central Banks unambiguously meet all these criteria, many exhibit high levels of *de jure* independence. According to Lybek there are several levels of Central Bank independence in relation to the Central Bank charters or acts (Lybek, 2004:3-5). A distinction can be made between the following kinds of autonomy: (i) goal autonomy, (ii) target autonomy, (iii) instrument autonomy and (iv) limited autonomy.

Lybek (2004:3-5) considers goal autonomy as the highest level of independence a bank can be accorded. Goal autonomy is the broadest since in principle it gives the Central Bank authority to determine its primary objective among several competing objectives included in the Central Bank charter/act. This requires the government to choose the exchange rate regime and monetary policy and in the case of floating exchange rate, the bank is just expected to choose the monetary policy. The bank basically chooses some goals among several goals or determines a goal in the absence of goals. Lybek gives an example of the Federal Reserve System in the United States which includes both full employment and price stability among several potentially competing objectives even though price stability is given priority.

Target autonomy is the second highest level of independence based on the ranking by Lybek (2004:3-5). The Central Bank is also expected to determine monetary policy and the exchange rate regime, or simply monetary policy where the exchange rate is floating. The only difference with goal autonomy is that target autonomy means the bank is given one clearly defined objective by law. Target autonomy allows the Central Bank to decide a specific target for achieving the primary objective, which is stipulated in the law, such as price stability. Goal and target autonomy are perceived as strong degrees of autonomy, but they also raise the question why Central Bankers, who are not elected by the general public, should be given that much power and autonomy to decide the short-term trade-off between the rate of inflation and employment (Stiglitz1997:np) .

Instrument autonomy according to Lybek signifies less independence in that the government or the legislature decides the target, in agreement with the Central Bank and the exchange rate regime, but the Central Bank retains sufficient authority to implement the monetary policy target using the instruments it sees fit. One example is the Reserve Bank Act of New Zealand. There may also be a contract or an agreement between the government and the Central Bank that is not explicitly stipulated in the Central Bank law, as for example in Canada and Norway. Instrument autonomy implies that the cabinet or the legislature actually decides the target, in agreement with the Central Bank, but the Central Bank retains sufficient authority to implement the target using the instruments it sees fit.

Lastly, limited or no autonomy means that the Central Bank is almost a government agency. The government determines the policies (objectives and targets) as well as influences the implementation. The latter is the case mainly in centrally planned economies and in some developing countries.

Despite different people having different views on the desirability of central bank independence and its impact on macroeconomic variables, there is consensus that central bank independence is good for development (**Arnone, Laurens, and Segalotto**, 2006, Arnone, Laurens, Segalotto, and Martin, 2007). For example there is belief that central bank independence will CBA may help countries achieve lower average inflation, cushion the impact of political cycles on economic cycles, enhance financial system stability, and boost fiscal discipline (Arnone et al.: 2006). Arnone et al. noted that there has been an increase in number of countries who are pursuing central bank independence. Arnone notes that a vast majority of central banks have been mandated to set price stability as one of the objectives of monetary policy. In addition, most central banks have autonomy with respect to setting the policy rate and are not required to extend direct credit to the government. These are indicators of greater central bank independence.

Arnone et al. also notes that in a number of emerging markets and developing countries, CB autonomy has gained momentum in the course of the last decade. This has been accomplished through a consistent political will and a strong interest in central bank reform, leading to rapid progress in terms of both policy and instrument autonomy. These developments were underpinned by the growing consensus among developed and developing countries about the benefits for overall economic performance to be expected from assigning price stability as the primary objective of the central bank, and limiting the scope for the monetization of public deficits. As a consequence, today we can see an approximately equal distribution of autonomy among countries, irrespective of the level of economic development.

2.3. Good Governance (Transparency and Accountability)

International financial Institutions such as the International Monetary Fund and World Bank have made Central Bank accountability and transparency part of their development agenda. They argue that when the state delegates authority to a Central Bank and gives it autonomy, there is need to make the Central Bank accountable to ensure appropriate checks and balances to minimize abuse of powers (Lybek, 2004:10; Koch, 2007:1). The accountability provisions should thus ensure that an autonomous Central Bank uses its delegated authority effectively to achieve its primary objectives, and manages its resources well. The independent Central Bank is ultimately though indirectly accountable to the general public, but directly accountable to the executive branch or the legislature (Fraser, 1994:7; Eijffinger & Hoeberichts, 2000:1-2; Quintyn, 2007:n.p.).

Even though most banks are in essence not directly accountable to the general public, the bank needs to take the needs of the general public seriously (Mendonça, Ferreira, Filho, and Simão, 2007). Most of the times according to Mendonça et al. (2007), decisions made by the central bank affect inflation, unemployment and interest rates. For example, Central Banks define the interest rate taking into consideration the departure of the expected inflation from its target value, and a disinflation process in the economy is thus associated with an increase in the interest rate and this in turn affects the general public and poverty. Central bank transparency plays an important role in the reduction of poverty because it increases the information set available to the public and reduces the asymmetries of information, and in the end reduces the gap between the projected value of a variable and the realized value of the variable. For example increasing central bank transparency contributes to the convergence of inflation expectation and inflation target creating credibility and enhancing inflation control.

Accountability and transparency can be expressed in many ways since it is guided by varying charters. For example, in New Zealand the governor reports progress to government in achieving the governments specified target periodically while in the United States of America the chairman of the Federal Reserve is obliged by the Humphrey – Hawkins Act to report to congress several times a year. In Australia the Reserve Bank produces quarterly articles, annual and parliamentary reports and the governor makes several speeches. This serves to increase the transparency of the monetary policy and to avoid confusion in the market (Fraser, 1994:7). In South Africa the Central Bank is not directly accountable to Parliament, However South African Reserve Bank submits its Annual and Financial reports to the Portfolio Committee on Finance which submits to parliament (Reserve Bank of South Africa, 2008:np). In Malawi the Governor reports to parliament about monetary policy at irregular intervals but he is not compelled by the law to do that (Sato, 2001:7). Just like the South African case the Governor submits annual reports o the Minister of Finance who forwards it to the Business Committee of Parliament.

Central Bank governance is also looked at in different ways depending on the approaches taken. For example Koch looks at governance as having two branches, external and internal governance (Koch, 2007:2-4). According to Koch, external governance is related to factors associated with the political environment in which the Central Bank operates and over which the Central Bank has limited control. It mainly deals with the role and function of the Central Bank within society, and it varies from country to country. External governance is also associated with how parameters are set for monetary policy, currency issuance payment and settlement system oversight and/or delivery, and acting as the lender of last resort. The extent to which this affects Central Bank is dependent upon the level of independence accorded to the bank. Lastly, external governance is usually dependent upon whether the Central Bank is independent of the government or legislature on choosing targets and on how to achieve these targets. Internal governance deals with how the Central Bank conducts its business within the context of external governance. Internal governance is mainly to deal with oversight, management and organization of the Bank. Examples of issues that fall under internal governance are the size and composition of the board, powers conferred to the members of the board and their independence, how sub-committee work is handled, the presence of the monetary policy committee, its composition and its skills endowment.

The last approach to good governance the research followed is that proposed by Amtenbrink (2004:2). Amtenbrink looks at good governance as a combination of three pillars namely: Central Bank independence, accountability and transparency. Even though he discusses the three concepts as three different issues he is quick to point out that in practice they are very difficult to separate. He notes that the key to good governance lies in the combined application of these principles in designing the legal framework of a Central Bank. Monetary policy in his understanding is taken as being at the heart of good governance and hence institutional arrangements of the Central Bank should first of all deal with this aspect (Amtenbrink, 2004:9). The three pillars should therefore be used to steer two important relationships which are very central to the conduct of monetary policy. The relationships are monetary policy formulation and communication and relationship between the Central Bank and the government.

The first point Amtenbrink makes is the importance of having an accountability yardstick to measure the performance of the Central Bank in achieving its monetary policy objectives (2004:2). The monetary policy objective of a Central Bank, as well as its projections on monetary policy can form the basis of such a yardstick. A clear monetary policy objective reduces the risk of political pressure and avoids opening conflicts between government and the Central Bank while at the same time ensuring that the Central Bank does in fact follow a low inflation monetary policy. When there is a case of multiple objectives the Central Bank Charter should clearly rank the objectives in terms of importance, even though it becomes quite difficult when the Central Bank is given the mandate to choose the objectives. The classic example for a Central Bank featuring multiple objectives according to Amtenbrink is the United States Federal Reserve System. The ideal way of achieving accountability is making inflation the only objective of the Central Bank (Amtenbrink, 2004:2).

Apart from having explicitly defined goals the other aspect of monetary policy should be transparency. Amtenbrink (2004:12) notes that a clear understanding by the market participants of the underlying framework on which Central Bank decisions are based will lead to a better understanding of the decisions taken. Market participants should know what the Central Bank has in mind when it sets interest rates and be able to clearly distinguish between the instruments of monetary policy and the operational target that is affected by the Central Bank's action. To this end, the Central Bank should announce the monetary policy strategy and explain its monetary policy decisions. This has the advantage that it reduces the ability of politicians to influence monetary policy.

The other main point made by Amtenbrink is the institutional set-up of a Central Bank when it comes to communication with the public. The effect of monetary policy on inflation and output growth (outcome) is determined not only by monetary policy decisions, but also by the expectations and the behaviour of the public, based on their understanding of the bank's strategy (Amtenbrink, 2004:12). Therefore the bank is charged with the responsibility of facilitating the general understanding by the general public of what the Central Bank is doing by publications and public statements just to name a few. This includes public access to the economic data underlying monetary policy decisions, such as money supply, inflation, output and unemployment rates, as well as the announcement of the economic models applied by the Central Bank.

Amtenbrink (2004:15-17) argues further that while the transparent conduct of monetary policy supports both parliament and the executive in its decision-making process about the performance of the Central Bank, its connection with the government is also important more especially when one considers the link between monetary policy and fiscal policy. One way to enhance the communication between the Central Bank and government is to allow the participation of government officials in Central Bank organs more especially the monetary policy committee of the Central Bank in non-voting capacity. He notes that this is a difficult arrangement as the governor of the Central Bank is considered by law to be responsible for monetary policy and hence charged with taking the relevant decisions. Representation on the monetary policy board creates a forum for government to promote its views on the general economic situation. At the same time those charged with deciding on monetary policy can explain the approach to monetary policy to the state/government.

There are several studies that have tried to look at the sizes of Monetary Policy Committees and what determines the size of the Monetary Policy Committees. One notable study is that done by Berger, H., Nitsch, V. and Lybek, T. (2006). Berger et al. tried to analyse empirically the difference between the size of Central Banks Monetary Policy Committees world wide using a sample of 113 countries and he found that the size and composition of the Monetary Policy Committees varies according to some country specific characteristics. Their results indicate that Monetary Policy Committees size is positively correlated with measures of country size and Central Bank's information-processing requirements and the level of economic development. They also found that Monetary Policy Committees size is related to a country's political institutions, with more democratic countries having, on average, larger boards. Finally, Monetary Policy Committee size is often associated with other Central Bank characteristics. For example, Central Banks that have greater formal autonomy over objectives and targets, a more complex monetary strategy, a longer history, and more staff typically have more board members who serve, on average, shorter terms. Their study concludes by giving several recommendations.

The first recommendation is that the governance structure to be put in place for a Central Bank should acknowledge the type of autonomy delegated to it. It is useful to make a distinction between goal autonomy, target autonomy, instrument autonomy, and limited or no autonomy as noted by Lybek (2004) since it helps define the functions of the respective governing boards and management. In addition, a range of country specific factors, including economic development (preference for price stability), its history, political system (importance of election cycles), and judicial traditions (particularly corporate law and the rule of law) must also be given due consideration. Thus the number of bodies, their size and composition can be determined with a view to ensure an informed, balanced, and professional view without conflicts of interest. In short, it is important to remember that one size does not fit all.

They point out that the policy board must be broad and large enough to guarantee a balanced and an informed view of things in terms of decision making. The members should be well educated since this is a specialised technical field and that the board should include professionals from different sectors and regions and while at the same time ensuring that the size does not impede the effectiveness.

With a view to avoiding conflicts of interest, members may be executives or full-time directors of the Central Bank. However, to ensure a balanced view and to alleviate concerns about Central Banks being too conservative and to a lesser extent to address a perceived democratic deficit, outside members with special expertise should also be considered. If such a board only comprises internal members, whose career depends on the governor, these members will give priority to their fiduciary responsibilities. It may thus be useful to have qualified non executive directors, such as experts from academia or business, provided the autonomy of the Central Bank is not eroded.

2.4. Theory and Methodology

As stated in the introduction, to measure the independence of the Reserve Bank of Malawi the project used the criteria developed by Cukierman et al (1994) (see Annexe 1 page 59). This measure is based on the coding of the Central Bank charter and it is called the legal independence measure since it is based on the degree of independence conferred on the Central Bank by law. This index has its own limitations as there are a lot of differences between what the law states and what is usually practiced more especially in the less developed countries (Cukierman et al., 1994:13). To address this problem the informal indicator looking at the turnover of governors will be used. This indicator is used on the presumption that at least above some threshold more rapid turnover of governors indicates a lower level of independence (Cukierman et al., 1994:13). The project also used a questionnaire developed by Cukierman et al (1994) where the Central Bankers were expected to rank themselves according to what happens during implementation.

On good governance the study will use the criteria developed by Eijffinger & Hoeberichts (2000) (See Annex III page 65) that deals with accountability and transparency. The criterion has thirteen components which are given a score of one each. The twelve components are divided into two main themes to do with accountability and transparency. The criterion is mainly based on the Central Bank charter therefore prone to the weakness of the discrepancy between the act and actual implementation. To balance up Eijffinger & Hoeberichts added more indicators which are not legal in nature such as the count of speeches by the chief executives and publication of minutes of monetary policy meetings.

This set of instruments of data collection were chosen because they have been used widely to measure Central Bank independence and good governance and this makes comparison and interpretation of our findings easier and meaningful. Apart from this set of instruments in depth interviews were conducted that involved senior Central Bank officials and senior ministry of finance officials to capture some issues which are qualitative in nature or not captured by the indicators mentioned above.

2.5. Coding of Legal Independence and Factors Guiding Allocations of Points.

Coding of the Central Bank independence followed two principles developed by Cukierman et al. (1994). Firstly narrow precise legal characteristics of Reserve Bank of Malawi Act will be coded. Secondly only written information from the act will be used. Additional information on how the law is implemented was deliberately left out since it is reflected by informal indicators of Central Bank independence. These principles make it possible to determine the degree of independence on various legal dimensions with relatively small amount of subjective judgment and to focus on concrete details of the law (Cukierman et al. 1994:5). The legal characteristics of the Central Bank independence as stated in its charter/act are grouped into four clusters.

The clusters were built from sixteen different legal variables each coded on a scale of 0 (smallest level of independence) to 1 (highest level of independence). The detailed classification and coding appear in Annexe 2 attached. The codes are set so that a higher number indicates what is expected to be a stronger mandate and greater autonomy for the Central Bank to pursue price stability (Cukierman et al. 1994:5, 9, 10). These clusters are divided as follows:

a) The chief executive of the Central Bank, which mainly looks at the appointment and dismissal of the chief executive of the Central Bank. Those Central Banks which have longer terms of office than those of the executive branch and those Central Banks which are not influenced by the executive branch in appointing or dismissal of the chief executive are regarded as more independent on the chief executive officer dimension (Cukierman et al., 1994:9, 10).

b) the policy formulation cluster, which concerns the resolution of conflict between the executive branch and the Central Bank as well as the participation of the Central Bank in the budget process, those Central Banks with more freedom to formulate monetary policy and to ignore pressures from the government in times of conflict are regarded as more independent in terms of policy formulation (Cukierman et al., 1994:9, 10).

c) The objectives cluster addresses the issue of whether or not the Central Bank's main objective as stipulated by its charter is to achieve price stability. The objective variable is designed to capture the legal mandate of the bank to individually pursue price stability. When the Central Bank charter specifies price stability as the main or only goal, the bank is classified as being more independent on this dimension than a Central Bank with objectives in addition to but not inconsistent with price stability such as full employment. Even though there are six possible ratings that act as guides to coding, this cluster is not very good at showing independence as compared to the Chief Executive Officer and Monetary Policy variables (Cukierman et al., 1994:9, 10).

d) Lending to the government cluster looks at how the Central Bank limits lending to government. Central Banks which have got tight rules for lending to government are regarded as very independent compared to those that have weaker rules. These limitations encompass a number of more detailed variables such as advances and securitised lending and restrictions on maturities and on interest rates. According to Cukierman et al. (1994), the stricter the limitations the higher the independence and the higher the score given to the bank on that dimension. The comparability of various types of limitations is complicated because the limitations are specified in different ways in different countries based on the charter. In a small number of countries limitations on lending are specified in absolute cash amounts and in others, as a percentage of government's revenue from taxes and in a majority of cases as a percentage of government's expenditures (Cukierman et al., 1994:10). However, other things being equal, the absolute cash limits are tougher than limits in terms of Central Bank liabilities which in turn are more binding than limits in terms of government revenues. The most accommodative limits are those that are specified in terms of government's expenditures.

Limitations on lending are also classified as stricter the nearer the rates paid by government to market rates and the shorter the time maturities of the loans from the Central Bank are to public sector. The stricter and narrower the circle of institutions that are allowed to borrow from the Central Bank, the smaller the discretion of the executive branch to decide to whom and how much Central Bank will lend (Cukierman et al., 1994:9,10). In addition, Central Bank laws prohibit the Central Bank from buying government bonds from the primary market are considered stickier than laws that do not contain such a prohibition. These individual clusters are aggregated to come up with one final value which rates the aggregate/overall independence of the Central Banks which will be compared with studies undertaken already in other countries.

2.6. Informal Measures of Central Bank Independence

As noted above legal measures of Central Bank independence do have shortfalls in that they are usually incomplete and can carry different meanings. The other shortfall is that even if the laws were very specific, the situation on the ground may be different as there is a tendency to divert from legal independence more especially in less developed countries (Cukierman et al., 1994:10). To compensate for this weakness Cukierman et al 1994, proposed some informal indicators that are complementary to the legal independence measures. The first indicator looks at the turnover of Central Bank governors. This indicator assumes that rapid turnover of governors beyond some threshold indicates lower levels of independence and creates dependence. It assumes that frequent turnovers accord politicians the opportunity to choose governors who are subservient to the government. Rapid turnover may also indicate that the government is firing the governors who challenge the government. If the tenure of the governor drops to about 0 .2 or 0.25 it means that the independence of the Central Bank is under threat and these levels are taken as the threshold. If converted these threshold figures translate to four or five years (this coincides with the political cycle which is at least 4 yrs). Care should be taken in interpreting these values because low turnover sometimes may mean lower independence of the Central Bank. A subservient governor may stay in the seat for a longer time if he does what the politicians wants him to do.

Apart from using the turnover of Central Bank governors a questionnaire (developed by Cukierman) was sent to the monetary policy specialist of the Reserve Bank of Malawi and Ministry of Finance for completion. The questionnaire captures the same issues that were discussed in the legal independence measure only that the questions focus on the implementation of the law other than the law itself. The questionnaire has additional variables such as credit from the bank to the private sector, limitations on lending to the government and interest rates (refer to Annexe II page 68 for details).

The questionnaire is divided into seven parts each part depicting a certain aspect of Reserve Bank of Malawi. The first part looks at whether the terms of board of directors and the governor's are likely to coincide with that of the government. If the turnover of the governor and the director coincides with that of the government, the less independent the Central Bank and vice versa. The second part deals with the actual limitations on lending in practice. Even though we looked at the same variables as in legal independence this variable looks at what happens during the actual practice of lending and it checks if the laws are followed to the book. Part three looks at how conflicts are resolved between the Central Bank and government whereas section four captures financial independence i.e. the determination of the Central Bank budget and setting salaries of senior bank officials. Section five looks at the targets of the Central Bank being pre-commitments agreed to by the bank and government. Section six of the questionnaire tackles the issues of importance attached to price stability by the bank while section seven looks at the extent to which the Central Bank handles the competing objective of boosting growth through subsidized credit.

2.7. Coding, Accountability and Transparency

Under accountability and transparency the project used the criteria developed by Eijffinger and Hoeberichts (2000) (See Annex III page 65). They pose 13 different questions and the total number of positive answers determines the score for the Central Bank concerned. Each question carries a mark of one if a certain aspect is present in the charter or zero if absent. It should be pointed out that this indicator, like the indicators for Central Bank independence discussed previously, is based on Central Bank laws therefore they have the weakness that they may not be matched by implementation. The indicators have been divided into three sections namely: ultimate objective of the monetary policy (accountability), transparency and final responsibility of monetary policy.

Under the ultimate objective of the monetary policy there is need for a Central Bank to have clear well defined objectives which can be used as a yardstick for measuring the bank's performance in implementing monetary policy. If the bank has one objective it is easier to measure its performance towards achieving the objective. However, where there are several objectives it is advisable to rank the objectives according to their priority. The type of questions that are tackled in the ultimate objectives are whether the Central Bank law stipulates the monetary policy objective, is there prioritisation in the objectives and whether the objectives are quantified.

Transparency is one of the key elements of monetary policy since information dissemination can be used to communicate the targets that need to be achieved and progress towards achieving the objectives (De Haan, J., Amtenbrink, F., and. Eijffinger, S.C.W., 1999; Eijffinger & Hoeberichts, 2000). Even if clear objectives are missing the Central Bank can be judged depending on what targets it sets itself by looking at the information disseminated. Therefore a Central Bank should report at regular intervals on its past performance and future plans for monetary policy in accordance with the monetary policy objective. Ideally laws should clearly prescribe avenues for discussing monetary policy such as reports, minutes and speeches. These laws could even go further to specifically state what should be included in the reports and the presentation. The reports or minutes could provide the reasoning behind a certain decision made. This becomes a topic of debate when it comes to communicating the voting patterns of the monetary policy committee since it could undermine the credibility of a decision taken by only a slight majority (De Haan et al. 1999; Eijffinger & Hoeberichts 2000). Some of the questions that were looked at in the coding of this section are as follows: 1) Must the Central Bank publish an inflation or monetary policy report of some kind in addition to the standard Central Bank bulletins/report? 2) Are minutes of meetings of the governing board of the Central Bank made public within a reasonable time? 3) Must the Central Bank explain publicly to which extent it has been able to reach its objectives?

The last part of the criterion developed by Eijffinger and Hoeberichts (2000) deals with final responsibility. This looks at who bares the final responsibility of monetary policy. There are two competing proposals whether responsibility should be pushed towards government or parliament (Eijffinger & Hoeberichts, 2000:16). Through their studies they were able to prove that credibility is at its highest when the bank searches for transparency through availing information to the public or is answerable to the parliament. If that is not the case then the Government which reports to the parliament should bare the responsibility of monetary policy but on the condition that there should be a clear and transparent process as to how government overrides decisions made by the Central Bank. The questions to be looked at in this section are as follows:

- Is the Central Bank subject to monitoring by Parliament (is there a requirement apart from an annual report to report to Parliament and/or explain policy actions in Parliament)?
- Does the government have the right to give instructions?
- Is past performance a ground for dismissal of a Central Bank governor?
- Is there some kind of review in the procedure to apply the overriding mechanism (when government overrides the decisions by the Central Bank) (Eijffinger & Hoeberichts, 2000:16-17).

2.8. Summary

This chapter has noted that there has been an increasing trend in Central Banks becoming independent since the 1990's. The main reason why states prefer Central Bank Independence as argued by many economist is that they would like to attract foreign investment. This is encouraged further by the reduction of barriers to international movement of currency and other financial assets.

Apart from issues of Central Bank independence and other macroeconomic variables, the other debate that is taking centre stage is Central Bank governance. International financial institutions such as the International Monetary Fund and World Bank have made Central Bank accountability and transparency part of their development agenda. They argue that when the state delegates authority and autonomy to the Central Bank there is a need to make the Central Bank accountable to ensure appropriate checks and balances to minimize abuse of powers. The accountability provisions should thus ensure that an autonomous Central Bank uses its delegated authority effectively to achieve its primary objectives, and manage its resources well.

The chapter also noted that good governance is made of three pillars namely, Central Bank independence, accountability and transparency. Even though these pillars are entities in themselves in practice they are very difficult to separate. He notes that the key to good governance lies in the combined application of these principles in designing the legal framework of a Central Bank. The three pillars should therefore be used to steer two important relationships which are very central to the conduct of monetary policy. The relationships are monetary policy formulation and communication and relationship between the Central Bank and the government.

To measure the independence of the Reserve Bank of Malawi the project the criterion developed by Cukierman et al (1994). This measure is based on the coding of the Central Bank charter and it is called the Legal Independence Measure since it is based on the degree of independence conferred to the Central Bank by law. This measure has its own limitations therefore the project used other informal measures such as turnover of Central Bank governors and questionnaire. On good governance the study used the criterion developed by Eijffinger & Hoeberichts (2000) that deals with accountability and transparency. The criterion has thirteen components which are given a score of one each.

This set of instruments of data collection were chosen because they have been used widely to measure Central Bank independence and good governance and this makes comparison and interpretation of our findings easier and meaningful.

Chapter 3: Background - The Malawi Economy and the History of the Reserve Bank of Malawi

3.1. Introduction

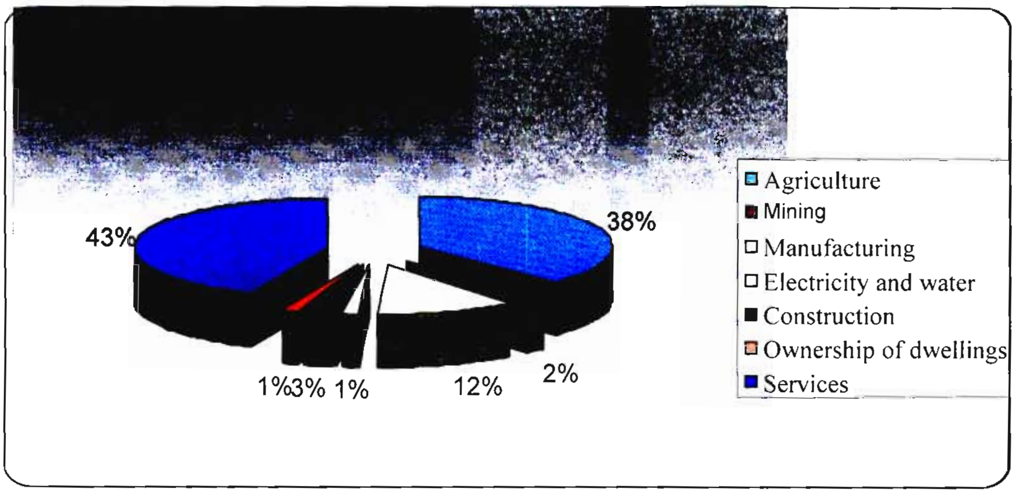
This chapter provides a brief summary of economic conditions in Malawi. It presents trends in major macroeconomic variables namely economic growth and inflation rate. This is supported by reasons behind major changes in the economic variables. The chapter also discusses the history of the Reserve Bank of Malawi more specifically its monetary policies.

3.2. Malawi Economy in Brief

Malawi is a densely populated landlocked country with its economy heavily dependent on agriculture (UNDP, 2000:2-3). Malawi is one of the poorest countries in the world and in Sub-Saharan Africa with over 52% of the population below the poverty line of 1USD (UNDP, 2005:np). With a Gross National Product per capita of US$190 and a Human Development Index of 0.397 in 1999, Malawi ranked eighth and twelfth from the bottom, respectively (UNDP, 2000:np). Its major exports are tobacco and tea. Agriculture on average represents 34.7% of GDP (see figure 1 page 25, contribution to GDP in 2006 by sector). Smallholder farmers produce a variety of crops, including maize, beans, rice, cassava, tobacco, and groundnuts. The agricultural sector contributes about 63.7% of total income for the rural population, 65% of manufacturing sector's raw materials, and approximately 87% of total employment (Government of Malawi, 2007:np).

Malawi's economic reliance on the export of agricultural commodities renders it particularly vulnerable to external and internal shocks such as declining terms of trade, drought and governance. High transport costs, which can comprise over 30% of its total import bill, constitute a serious impediment to economic development and trade (Reserve Bank of Malawi, 2000:np). However, recent government initiatives targeting improvements in the road infrastructure, together with private sector participation in railroad and telecommunications, have begun to render it more attractive to investment (Government of Malawi, 2006:np).

Figure 1. **Contribution to GDP by Sector 2006**



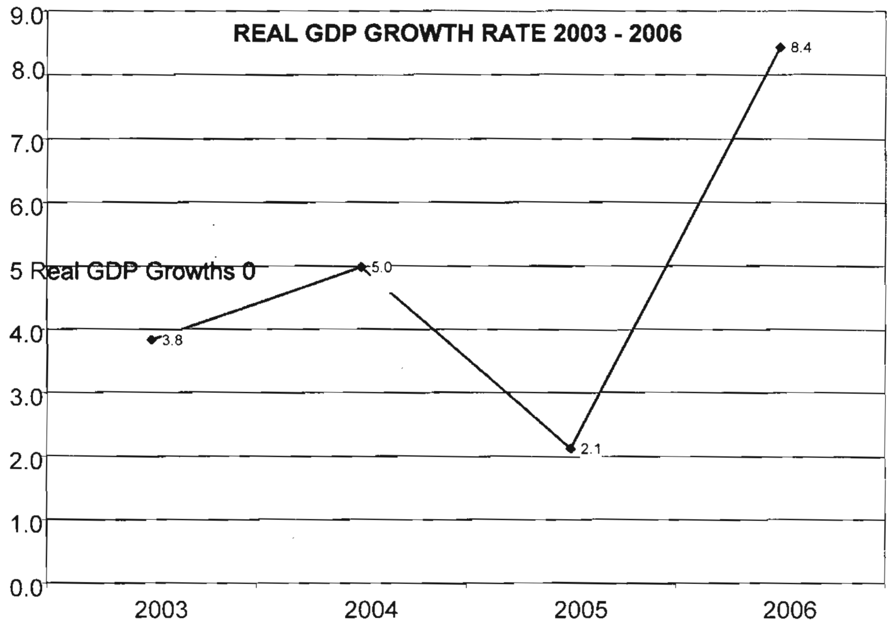
Adapted from Malawi government, 2007

Malawi has also undertaken economic structural adjustment programs supported by the World Bank, the International Monetary Fund (IMF), and other donors since early eighties (Reserve Bank of Malawi, 2000:np). Broad reform objectives include stimulation of private sector activity and participation through the elimination of price controls and industrial licensing, liberalization of trade and foreign exchange, rationalization of taxes, privatization of state-owned enterprises and civil service reform. According to Government of Malawi in May 2002, the IMF program which begun in 2000 was cancelled and a Staff-Monitored Program (SMP) was put in place (Government of Malawi, 2007:np). The main goal of the SMP was to give the Malawi government a chance to establish a track record of fiscal discipline. A new Poverty Reduction and Growth Facility (PRGF) was approved on August 5, 2005 after a successful SMP. In August 2006 Malawi successfully reached the completion point under the Heavily Indebted Poor Countries (HIPC) Initiative, resulting in debt relief from multilateral and bilateral creditors. Over $2 billion in debt has since been cancelled, enabling the government to increase expenditures in development initiatives. A new PRGF has since been undertaken (Government of Malawi, 2007:np).

The picture on real GDP growth has been irregular with the latest figures showing that real GDP grew by 5% in 2004, 2.1% in 2005 and 8.4 in 2006 (see figure 2, page 26 on real GDP from 2003 to 2005) (Government of Malawi, 2007:np). However between 1990 and 2000 macroeconomic stability and growth had been difficult to maintain with years of growth being followed by years of deterioration largely influenced by both political and climatic developments (UNDP, 2000:2).

This period was characterized by episodes of drought, deterioration in the terms of trade and macroeconomic management slippage.

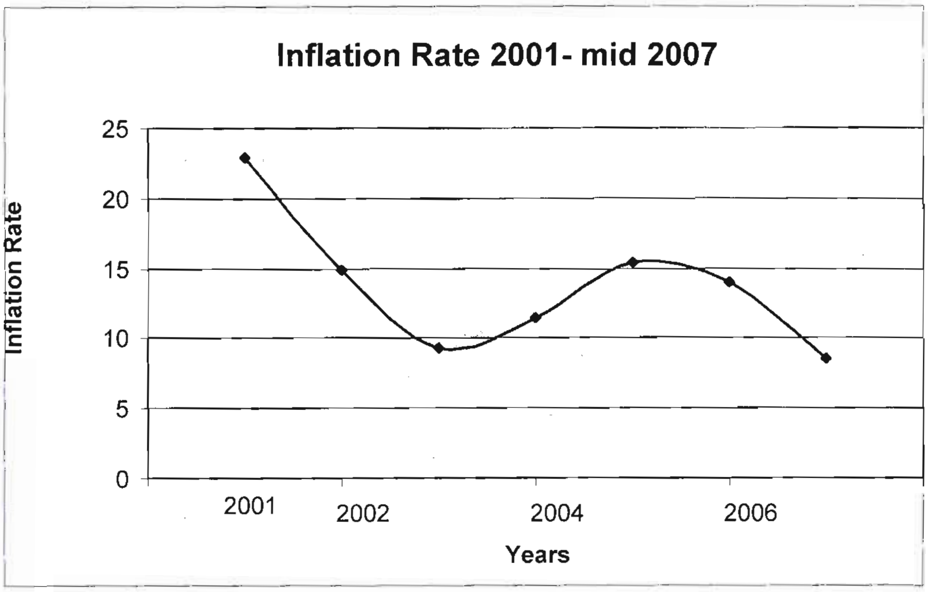
Figure 2.



Adapted from Malawi government, 2007

The figure on inflation has also been mixed even though the current trend shows a reduction. Between 2001 and 2007, inflation reached the highest in 2001 when it reached 24.5% and the lowest at 7.7% mid June, 2007. In Malawi 50% of inflation is determined by food prices which are prone to natural catastrophes such as weather and drought making it difficult to manage(Reserve Bank of Malawi, 2000:np). The lowering of the inflation could be attributed to bumper harvest due to government polices and the reduction of unnecessary expenditures on the fiscal side (Government of Malawi, 2007:np). For example, during the 2004/2005 the government distributed fertilizer and seeds to two million farmers and each farmer received 31Kilograms of fertilizer and seeds in order to enable the farmers to produce more food. This came to a total of 62 million Kilograms of targeted input product that was distributed in one year making it the largest distribution in the history of Malawi. In 2006 the government decided to introduce a universal subsidy on fertilizer and maize and this resulted into the country producing a surplus for the first time since the 1990's.

Figure 3.



Adapted from Malawi government, 2007

On the fiscal side the government established clear performance criteria and benchmarks by which government spending was regularly audited and validated by independent auditors (Government of Malawi, 2007:np). The government went further to design an efficient system of financial management and monitoring the allocation and utilization of all resources so that fraud could be detected as it occurs in the project or programme cycle and prompt measures are taken to address the situation. The government ensured that there is an established system that ensures swift investigation, prosecution and punishment of public officers at all levels of responsibilities that are found guilty of corruption, theft, mismanagement, and abuse of power in all its forms. Lastly, the government strengthened the offices of the Accountant General, Auditor General, Public Accounts Committee and the Anti-Corruption Bureau, to ensure that officials and those entrusted with public funds are fully accountable and act in a transparent manner in the utilization, and reporting of public funds (Government of Malawi, 2006:np).

3.3. History of Monetary Policy in Malawi

The Reserve Bank of Malawi (RBM) was created in 1965 after gaining independence from the British in 1964. This was the period soon after the Second World War when less developed countries were establishing their own Central Banks (Parson, 2005:np). This was more of a political decision than economic as former colonies wanted to signal self government and assert their independence. The Reserve Bank of Malawi has been mainly using exchange rates and interest rates adjustments as major instruments for monetary policy and to influence major macroeconomic variables such as growth and price stability (RBM, 2000:np). This is grounded in the belief that the choice of an exchange rate policy in the country has an important role to play in creating the proper environment for economic growth. The exchange rate policy chosen affects the country's relative price structure between tradable and non-tradable goods and ultimately the overall level of domestic prices (RBM, 2000:np). Thus, a particular exchange rate system chosen does have far-reaching effects on the entire economy. Regarding interest rates, until the late 1970s Malawi experienced a high degree of financial repression, with administered interest rates, credit ceilings, segmented capital markets and excessive intermediation costs (RBM, 2000; Sato, 2000). As part of structural adjustment programs supported by the World Bank and the IMF, Malawi has been implementing structural reforms in the financial system since the 1980s (RBM, 2000). The main objective of these reforms has been more efficient mobilization of resources and optimal resource allocation.

3.3.1. Exchange Rate Developments in Malawi

The Government of Malawi has been using the exchange rate as an instrument of monetary policy since its establishment in 1965 (RBM, 2000). According to RBM, during this time Malawi was using the British pound as its currency but was later dropped to the Malawian Kwacha in 1971. The Malawi Kwacha was pegged to the British pound at the ratio of one to one and any changes in the British Pound meant changes in the Malawi Kwacha. For example, the British Pound was devalued by 14 percent in 1968 and the Kwacha was devalued by the same margin (RBM, 2000:np). During this period, many developed countries including the United Kingdom, maintained a fixed exchange rate system with the gold or the US Dollar.

During the course of 1971, problems arising from limited gold supply began to surface; and by 1973 this system completely collapsed as most major countries renounced the par value system (RBM, 2000:np). This was followed by the generalized floating of exchange rates by several countries which caused large volatilities in currency markets. The Malawian Kwacha, as was expected, depreciated along with the British Pound to which it was pegged. Authorities, thus, began to think of other ways of managing the exchange rate.

From November 19, 1973, Malawi authorities responded to the movements in the international currencies by de-linking the Malawi Kwacha from the British Pound, and pegging it to a trade-weighted basket of the British Pound and the US Dollar (RBM, 2000:np). This system required the RBM to determine the exchange rate by setting daily buying and selling rates for the US Dollar and the British Pound in light of foreign exchange market developments. This phase ended in June 1975 when authorities started pursuing an active exchange rate policy which involved announced devaluations of the Kwacha whenever a need arose. However, the continued instability in the major international currencies forced authorities to look for a permanent peg, preferably to a currency which was considered less liable to violent movements. Authorities thought the Special Drawing Rights DR was suitable for this purpose.

With effect from 9 June, 1975, the Malawi Kwacha was pegged to the IMF's Special Drawing Rights (SDR). For sometime, the peg to the SDR seemed to have worked better for the economy as evidenced by the temporary stability achieved with the new peg at a time when major international currencies were experiencing violent movements (RBM, 2000:np). These benefits, however, proved to be only short-lived as the SDR began to appreciate in chorus with the US dollar in the early 1980s. The Malawi Kwacha responded by appreciating along with the SDR. This did not go well with Malawi authorities as it constrained export development.

It must also be recalled that at the beginning of the 1980s, Malawi's sound economic performance was seriously disrupted by several shocks (RBM, 2000:np). One of the external factors was deterioration in the country's terms of trade which resulted largely from weak external demand for the country's primary products in world markets. As the SDR continued to appreciate, Malawi authorities had to take active exchange rate actions with the view to restraining the terms of trade from further deterioration. Hence on April 24, 1982 the Kwacha was devalued by 15 percent. This was followed by another devaluation of 12 percent on 17 September, 1983. These actions, however, failed to redress the situation as the country was also severely affected by a drought which curtailed agricultural production, thereby adding pressure on the country's balance of payments.

Despite the devaluations carried out in 1982 and 1983, the country's external situation continued to deteriorate, which was worsened by the disruption of the traditional transport routes to the ports of Beira and Nacala due to political conflicts in Mozambique. On 17 January, 1984 authorities delinked the Malawi Kwacha from the SDR and pegged it to a trade weighted-basket of seven currencies representing the geographical composition of Malawi's trade and the currencies used in settling the country's international transactions (Currencies in the basket and their weights were as follows: US dollar (27 %); Pound Sterling (27 %); South Africa rand (18 %); German Deutsche mark (7 %); Japanese yen (7 %); French franc (7 %); and the Netherlands Guilder (7 %)(RBM, 2000:np). During this regime, the rate of the Malawi Kwacha exchange rate as quoted by the Reserve Bank of Malawi was determined on the basis of the daily calculations of the exchange rate of the US dollar in terms of the SDR. Rates of other currencies were quoted by the Reserve Bank on the basis of the appropriate daily cross rates as communicated by the IMF. Frequent adjustments were made with the view to realigning the Kwacha with the basket taking into account inflation differentials.

Although the peg to the trade-weighted basket of currencies managed to improve the current account balance from -11.8 percent of GDP in 1983 to a low of -1.7 percent in 1984, problems on the international trading routes intensified when Beira and Nacala routes were completely closed to Malawi traffic in 1984 (RBM, 2000:np). This forced the country to rely on long overland routes to the ports of Durban in South Africa and Dar-es-Salaam in Tanzania, a change which significantly increased the country's cost of transportation from only 22 percent in the 1970s to over 40 percent since 1984 (RBM, 2000:np). This worsened the country's terms of trade. Authorities had to take active exchange rate changes. Thus on April 2, 1985 the Kwacha was devalued by 15 percent; by 10 percent on August 16, 1986; by 20 percent on February 7, 1987; by 15 percent on 16 January 1988; by 7 percent on 24 March 1990; and twice in 1992, by 15 percent on March 28 and 22 percent July 11.

On February 7, 1994 the foreign exchange market was completely liberalized and the Kwacha was allowed to float freely (RBM, 2000:np). Several factors led to this change the first one being the fundamental disequilibrium as revealed by balance of payments pressures emanating from the 1992/93 drought; the withdrawal of non-humanitarian development assistance by the international community on account of governance issues; and by the fact that several member countries of the then Preferential Trade Area (PTA) now COMESA had already adopted various types of market-determined exchange rates.

The second reason was that, as part of the IMF Structural Adjustment Programmes which started in 1988, the Malawi government embarked on a three-year adjustment program supported by the

World Bank's Industrial and Trade Policy Adjustment Credit (ITPAC) and the Agricultural Sector Adjustment Credit (ASAC). Among other things, this program involved a phased liberalization of imports that is the removal of restrictions on the approval and availability of foreign exchange for private sector imports, as well as a move towards adoption of a more flexible and market determined exchange rate policy. This in the final analysis facilitated the liberalization of the exchange rate.

3.3.2. Interest Rate Developments in Malawi

Prior to July 1987, the basic structure of interest rates was directly administered by the Reserve Bank (RBM) of Malawi (RBM, 2000:np). As a result, interest rates were infrequently adjusted during the period before July 1987. Less attention was paid to underlying macroeconomic conditions, especially inflation as well as the demand and supply of funds. The main preoccupation was to keep interest rates low in order to reduce government expenditures and to promote private investment. During the regime of administered interest rates, deposit rates were set by Reserve Bank of Malawi while lending rates were set by commercial banks, but subject to a ceiling rate. In March 1980, however, interest rates which were in favour of the agricultural sector were introduced for the first time. The sector was given a preferential rate of 1 to 2 percentage points below the prime rate (RBM, 2000:np).

The deregulation or liberalization of interest rates started in earnest in July 1987 when lending rates were freed. The Reserve Bank of Malawi advocated for interest rate liberalization and financial development as growth enhancing economic policies in developing countries based on the arguments on the theoretical works of Mckinnon (1973) and Shaw (1973 in Sato, 2000:np). The policy of low interest rates was considered an important avenue for promoting investment by keeping interest costs low. Mckinnon and Shaw, however, showed that the policy of controlled or administered interest rates was tantamount to "financial repression", which is a general distortion in financial prices like interest rates that reduces the real value of financial assets. Thus, the overall volume of savings decreases and investment is naturally adversely affected. The policy prescription for the financially repressed economy in the Mckinnon Shaw models is then to raise institutional interest rates or reduce inflation.

In line with this thinking and in order to support the adjustment program, it was decided to gradually deregulate interest rates from 1987 to 1990. Refer to table 1 for specific dates of deregulation.

Table 1. Liberalisation of Interest Rates in Malawi

Time	Deregulation
July 1987	Commercial banks were given the freedom to set their own lending interest rates.
April 1988	Deposit rates were deregulated
August, 1988	Preferential interest rates to the agricultural sector were abolished
May 1990	All rates became fully liberalized

Adapted from RBM (2000)

Since complete interest rate liberalization was launched, the Bank rate (the rate at which commercial banks borrow from the Central Bank) has played a more important role in the financial system. The role of the bank rate has been enhanced by the development of the money market and the frequent use of open market operations as a tool of monetary policy. The Reserve Bank of Malawi now uses the Bank Rate as an indicator of the stance of monetary policy. Many times, the adjustment of the Bank Rate has led to adjustment of interest rates in the financial system. The Bank rate is set on the basis of interest rates on the treasury bill market as well as developments in inflation rates.

During the period 1985 to 1990, the bank rate and the savings rate hovered around 10.0 percent with hardly any changes while the minimum lending rate remained at 13.0 percent. As noted earlier, the full liberalization of interest rates in 1990 meant that commercial banks could set their own interest rates. However, in practice during the period 1990 to 1992 the commercial banks moved their own rates only after the Central Bank moved its bank rate. The bank rate was adjusted at least seven times by monetary authorities mainly to reduce excess demand for cash, particularly during the period 1994-1995. This is also the period when Malawi experienced high levels of inflation. To curb inflationary expectations, the bank rate was raised to 50.0 percent by from end 1994 to May 1995. This was also in line with Treasury Bill (TB) yield which soared during this period. From 1996, however, the bank rate has been steadily adjusted downwards and currently stands at 47.0 percent (as of October 1999).

3.4. Summary

This chapter presented statistics that indicate that Malawi is one of the poorest countries in the world and Africa. The chapter also noted that economic growth trend was mixed with some years experiencing high economic growth and some year's negative economic growth. The chapter also discussed the declining trend in inflation due to good agricultural polices coupled with fiscal discipline.

The history of monetary policy was discussed in the chapter and it was noted that Malawi uses the exchange rate and interest rates to achieve monetary targets. In general the Central Bank has moved from interventionist type of policies to those determined by the market. This was done through the liberalization of the interest rates and the exchange rates.

Chapter 4: Analysis of Results

4.1. Introduction

This chapter presents findings of the coding or calculations based on the ranking proposed by Cukierman et al. (1994). These calculations include legal independence and informal measures of the independence such as turnover of Central Bank governors and questionnaire for officials of the Central Bank. The results of the calculations will be compared with values calculated by Cuikerman et al (1994) using data from other countries. The chapter also presents results of calculations from the criterion developed by Eijffinger and Hoeberichts (2000) which focuses on transparency and accountability. Lastly, the chapter presents some qualitative findings not captured by the indices mentioned above and the questionnaire.

4.2. Legal Independence

Chapter 2 (literature review, theory and methodology) discussed the criterion developed by Cukierman et al (1994) and it was noted that it had sixteen different variables which were divided into four clusters namely: (a) The chief executive of the Central Bank, which mainly looks at the appointment and dismissal of the chief executive of the Central Bank (b) the policy formulation cluster which concerns the resolution of conflict between the executive branch and the Central Bank as well as the participation of the Central Bank in the budget formulation process (c) the objectives of the Central Bank, whether price stability is the only objective (d) lending to the government, whether there are limits on lending to government and the type of limits namely absolute cash amounts or based on government revenue.

The aggregate score for the Reserve Bank of Malawi's legal independence was found to be 0.50. This is a very high score compared to those calculated by Cukierman et al. (1994) at both continental level and the world level. For example the country which Malawi is sharing the same level of independence at 0.50 is Denmark (refer to table 2 page 35). This score means that the United States of America, Canada, the Netherlands and United Kingdom have lower levels of independence than Malawi with scores of 0.48, 0.45, 0.42 and 0.27 respectively (Cukierman et al., 1994:14-15). The score also means that Malawi has the strongest level of independence in Africa and the only country which almost has the same level of independence is Egypt with a score of

0.49 (Cukierman et al., 1994:15). This result also means that Malawi has a better score than countries which are regarded as having more Central Bank independence such as Botswana and South Africa with scores of 0.33 and 0.25 respectively(Cukierman et al., 1994:14-15).These results are debatable and there are two possible explanations to Malawi's high score.

Firstly the time periods in question are different and difficult to compare. The analysis done by Cukierman et al. (1994) was based on data collected in the period between 1980 and 1989, but Central Bank independence generated considerable debate in the 1990's (Padayachee, 2001:745; Maxfield, 1997:11). Most of the banks with lower scores in the Cukierman et al. study could fetch higher scores than Malawi such as South Africa (whose independence is enshrined in the constitution) and Botswana if the countries were reanalysed today.

Secondly the Reserve Bank of Malawi Act was being revised at an opportune time i.e. 1989 when debate on Central Bank independence was widespread, therefore they had an opportunity to include some aspects that encourage Central Bank independence. Other countries didn't have this opportunity since their charters were developed earlier than this. For example, South Africa was using South African Reserve Bank Act of 1944 which was later replaced by South African Reserve Bank Act, No 90 of 1989 and the 1996 constitution (Reserve Bank of South Africa, 2007:np). During this period Botswana was using the Bank of Botswana Act, 1975 (Central Bank of Botswana, 2008:np).

Table 2. Indices of Central Bank Independence

Country	**LCBI Index**	**Turnover f Governors**	**Questionnaire**
Denmark	0.50 **(1)**	0.05 **(1)**	0.73 **(1)**
Malawi	0.50 **(2)**	0.21 **(7)**	0.73 **(1)**
United States of America	0.48 **(3)**	0.13**(6)**	-
Canada	0.45 **(4)**	0.10 **(3)**	-
Netherlands	0.42 **(5)**	0.05 **(1)**	-
Botswana	0.33 **(6)**	0.41 **(8)**	-
United Kingdom	0.27 **(7)**	0.10 **(3)**	0.64 **(2)**
South Africa	0.25 **(8)**	0.10 **(3)**	0.64 **(2)**

Adapted from Cukierman et al. (1994) and own calculations

Even though the Reserve Bank of Malawi has got a high score, there are some factors in the Reserve Bank of Malawi Act that need attention. First the Reserve Bank of Malawi Act is weak on the Central Bank objectives cluster. As noted in chapter two, when the Central Bank charter specifies price stability as the main or only goal, the bank is classified as being more independent than a Central Bank with several objectives in addition to and sometimes not consistent with price stability such as full employment (Cukierman et al., 1994:14-15) . The Reserve Bank of Malawi gets a score of 6% under this cluster. The low score is because the Reserve Bank of Malawi Act 1989 does not specifically mention price stability as its main objective. The list of objectives of the Reserve Bank of Malawi according to the Act is stated as follows:

> *...to issue legal tender currency in Malawi; to act as banker and adviser to the Government; to maintain external reserves so as to safeguard the inter- national value of the Malawi currency; to implement measures designed to influence the money supply and the availability of credit, interest rates and exchange rates with the view to promoting economic growth, employment, stability in prices and a sustainable balance of payments position ; to promote a sound financial structure in Malawi, including payment systems, clearing systems and adequate financial services; to promote a money and capital market in Malawi; to act as lender of last resort to the banking system ; to supervise banks and other financial institutions; to collect economic data of the financial and other sectors for research and policy purposes; and to promote development in Malawi. (Reserve Bank of Malawi Act, Part III: Section 4).*

The act does not provide a clear ranking of the objectives and it is becomes difficult to evaluate the Central Banks performance. The situation is even worsened by having two conflicting objectives at least in the short run. There has been some debate as to the compatibility between the objective of price stability and unemployment (Padayachee, 2001:47). Economists predict that through the Philips curve there is a trade off between inflation rate and unemployment i.e. low inflation rates lead to high unemployment and vice versa in the short run. Recently there has been some consensus as to the importance of price stability and that the trade off disappears at least in the long run. In the short run this conflict could be resolved by making price stability the only objective of the Central Bank (Cukierman et al., 1994:10).

The other aspect where the Reserve Bank of Malawi Act is weak is the monetary policy formulation cluster. Cukierman et al. (1994) predict that those Central Banks with greater freedom and latitude in the formulation of monetary policy are more independent than those that do not have the freedom. They also predict that if the Central Bank conducts monetary policy alone without consulting government is more independent than those Central Banks that have no say on monetary policy. The researcher's calculations following the Cukierman et al. (1994) criteria the Reserve Bank of Malawi scored 0.07 out of 0.45 which is just above 15% under this cluster. Even though the Act does not specifically state that the Government should be involved in the formulation of monetary policy, there are many sections of the act which state that the Central Bank should consult government on monetary policy operations. For example, Part VIII Division II Sections 40 and 41 of the Act state that:

> *"If at any time the Bank has any Government loans and advances outstanding, irrespective of maturity, the Bank may require the Government to issue to it treasury bills or promissory notes and other instruments as the Bank may deem fit for open market policy purposes, and the terms and conditions shall be agreed upon between the Bank and the Minister." (Reserve Bank of Malawi Act 1989, Part VIII, Division II section 40).*

> *"The Bank shall be entrusted with the issue and management of Government securities publicly issued in Malawi upon such terms and conditions as may be agreed upon between the Minister and the Bank." (Reserve Bank of Malawi Act 1989,Part VIII, Division II section 41)*

The other important factor under this cluster according to Cukierman et al. (1994) is the provisions made to resolve conflicts about monetary policy between government and the Central Bank. The Reserve Bank of Malawi Act has weakness in that it does not clearly state who has the final authority as far as conflicts on monetary policy are concerned. Cukierman et al.(1994) argue that those Central Banks that have the final authority or the final say on issues that are clearly defined in the laws as its objectives have the greatest level of independence than those where the executive branch has unconditional priority on policy decisions. Therefore the Reserve Bank of Malawi is weak on this aspect.

One of the clusters that also contributes to the overall low score in Central Bank independence is the chief executive cluster. The Reserve Bank of Malawi scored 0.2 out of the possible 0.8 representing a percentage of 25%. This weakness stems from the fact that the executive branch is very influential and not transparent in the appointment or the dismissal of the Central Bank governor. For example, according to the Reserve Bank Act the President is responsible for the appointment of the Reserve Bank of Malawi Governor for a period of 5 years using an instrument of appointment stating conditions of service for the Governor and yet these conditions are not stated in the Act. The Act only stipulates that the conditions in the instrument shall not be changed to the disadvantage of the Governor during his term of office (RBM Act 1989, Part V Section 12 (1-3).

The second weakness is that the Act allows the Governor to hold other positions apart from the one at the Central Bank as long as the executive branch approves (RBM Act 1989 Part V Section 12 (4). Central Banks that are very independent do not allow the chief executive of the Central Bank to hold other offices more especially in government to avoid conflict of interest and to ensure that the governor is devoted fully to the running of the Central Bank. The current Governor of the Reserve Bank of Malawi owns and runs a four star hotel which is also allowed to buy and sell foreign exchange at a small scale. However there is a strong point that he was made to resign from being the Chairman of the Board of Malawi Rural Development Fund (MARDEF) a government organization responsible for disbursing micro loans, soon after his appointment.

The last weakness under this cluster is that the term of office of the Central Bank is short (the term of office is five years). Cukierman et al. (1994) argues that Central Bank independence is at its strongest when the term of office of the chief executive is longer than eight years (Cukierman et al., 1994:9). Care should be taken when interpreting this since governors who are subservient to the government may end up staying on as governor for a longer period of time.

On lending to government there are eight variables that form the cluster. As already noted in chapter two the cluster tries to show how tight the rules are for lending to the public sector. Theoretically according to Cukierman et al. (1994:10-11) Central Banks that have the highest level of independence do not provide advances to the government and the least independent provide advances with no conditions attached. The other assumption is that Central Bank independence is at its strongest when it is not involved in securitized lending, followed by those that lend to government but with stricter rules and lastly those with no rules at all. The overall score after our calculations of the variables under this cluster is 2.57 out of the possible 8 representing 32 percent. There are several reasons for the bad score.

Firstly, even though there are rules that limit government from borrowing from the Central Bank, there are some weaknesses in the Act pertaining to the repayment. The government is not supposed to borrow over 20% of its annual budgeted revenues, and that the government is supposed to repay within the last four months of the end of the government financial year (Reserve Bank of Malawi Act, Part VIII, Division II, section 40(5)). The law is problematic because it gives government leeway, if at the end of the year there are advances outstanding, to issue treasury bills or promissory notes or other instruments the bank may see fit for open market operations. The law gives government an opportunity to delay the payment of the advances in order to rollover the debt through market operations to the other year.

Another weakness under this cluster is securitized lending. The Reserve Bank of Malawi falls in the category of those which allow securitized lending but with limits that could be described as weak since they can be negotiated between the Minister of Finance and the Reserve Bank Governor, the act states that:

> *The Bank may purchase and sell securities of the Government maturing in not more than twenty-five years which have been publicly offered for sale or form part of an issue which is being made to the public at the time of acquisition: Provided that at any particular date the total amount of such securities of a maturity exceeding two years in the ownership of the Bank … shall not together at any time exceed twenty per cent or such lower percentage as the Minister, after consulting the Governor, may from time to time determine by order published in the Gazette, of the total development budget of the Government for the current fiscal year.* (Reserve Bank of Malawi Act, Part VIII, Division II, section 40(5).

The other weakness under the same cluster is on how limits are set for lending, whether they are on currency amounts (nominal), Central Bank demand liabilities or capital, government revenue or government expenditures. Ideally if the Central Bank sets its limitations based on currency amounts the Central Bank is considered highly independent but just lower than those that do not lend to the government at all (Cukierman et al. (1994). Those Central Banks that set their limits on lending to the government based on the government's expenditure are considered very weak while those that set their limits based on absolute cash amounts are considered stronger. On this aspect the Reserve Bank of Malawi Act 1989 is weak because it stipulates that the total amount of advances outstanding at any time made by the bank shall not exceed twenty per cent of the annual budgeted revenues of the government where budgeted revenue means all those revenues derived from sources within Malawi as estimated for the government's financial year in which such advances are made.

4.3 Informal Indicators of Actual Independence

4.3.1 Turnover of Central Bank Governors

The turnover of Central Bank Governors is based on the assumption that at least above some threshold rapid changes of Central Bank governors indicate a lower level of independence (Cukierman et al., 1994:13). It assumes that frequent turnovers accord politicians the opportunity to choose governors who are subservient to the government. Rapid turnover may also indicate that the government is firing the governors who challenge its wishes. If the tenure of the governor drops to about 0.2 or 0.25 per year it means that the independence of the Central Bank is under threat. These threshold figures translate to a term of office of about four to five years (Cukierman et al., 1994:13). Care should be taken in interpreting these results because low turnover sometimes may also mean lower independence of the Central Bank. Relatively subservient governors may stay in the position a longer time if they do what the politicians want them to do.

In the Malawi case, the Reserve Bank of Malawi has had 10 governors since its inception in 1965 but there is no indication that there was a Governor between 1965 and 1967(Reserve Bank of Malawi, 2008: np). The average term of the Central Bank governor since independence is approximately 4.7 (.21 per year) years which is almost equal to the length of the political cycle (5 years). The longest serving governor of the Reserve Bank of Malawi was Mr. John Tembo who served as governor from 1971 to 1984 during the period of one party rule. The shortest serving governor of the Reserve Bank of Malawi is A.G. Perrin who was the first Reserve Bank of Malawi Governor, only served for one year in 1968. An examination of the rate of turnover of Reserve Bank of Malawi Governors after the advent of multiparty democracy (Referendum was in 1993 and general elections were held in 1994) indicates a drop to 4.5 years on average.

The most interesting pattern discovered is that there is a change in the Reserve Bank of Malawi Governor a year after every general election in the multiparty era. For example, Dr. Chikaonda replaced Mr. Perekamoyo as governor in 1995 soon after the 1994 elections. Similarly Dr. Ngalande in 2000 soon after the 1999 elections. The last occurrence is when Mr. Victor Mbewe replaced Dr. Ngalande in 2005 soon after the 2004 elections.

The most interesting change in the Central Bank governor is the latest case where Mr. Victor Mbewe replaced Dr. Ngalande. During the 2004 elections Dr. Bingu wamutharika was hand picked by the outgoing President Dr. Bakili Muluzi from outside the ruling party UDF. The elections were won by the ruling party and Dr. Bingu wa Mutharika became president. But in late 2004 he declared himself independent and formed his own party in 2005. The reason given was that the ruling party was opposing his no-tolerance stance on corruption. Early February, 2005 government announced that the current governor's contract was expired and will be replaced by Mr. Mbewe, no reason was given for the change. The quotation below extracted from the Central Banking Publications Limited website in the UK gives a good picture of what happened.

> *President Bingu wa Mutharika of Malawi has decided against renewing the contract of Elias Ngalande, the Central Bank governor, whose term expires at the end of this month, a government official said on February 1. Reuters reported that no explanation was given for the decision. Ngalande is to be succeeded by Victor Mbewe, a former head of the Malawi operations for South Africa's Standard Bank, the report said. "The president has decided to replace Dr Ngalande with Victor Mbewe and has not given any reason for doing so," Charles Matabwa, the chief secretary for the civil service, told state radio according to Reuters. (Central Banking Publications Limited, 2005)*

Comparing this score (.21 changes in a year) to the scores calculated by Cukierman et al. in his 1994 study, one finds that the score by the Reserve Bank of Malawi is weak if compared to the industrialised countries which have scores less than 0.2 changes in a year (see table 2 page 37 for selected scores from Cukierman et al. 1994). Comparing the score of Reserve Bank of Malawi with other developing countries one sees that the score is stronger because it is below the maximum of .25 turnovers a year when more than half of the developing countries have turnover rates exceeding the maximum. Even though Malawi has got a better score than most of African countries it does not mean that the Central Bank is more independent. The period where one finds the longest serving Central Bank governor was characterised by dictatorship and Central Banks dependence (this was during the J.Z.U. Tembo era from 1971 to 1984). One could conclude that the governor served the longest because he was subservient to the government of the day. Comparing specifically with South Africa we see the score by the Reserve Bank of Malawi of an average period service of 4.7 years, is beaten by a big margin. South Africa had an average of 8 yrs in office during the period between 1921 and 2001 (Parsons, 2005:10). Despite the fact that both South Africa and Malawi have got the same influence of the Bank of England in their histories.

4.3.2. Questionnaire on Central Bank Independence

To compliment the legal indicator for Central Bank independence and informal indicator of turnover of Central Bank governors, a questionnaire was sent to senior officials of the Reserve Bank of Malawi to see how they rate themselves on Central Bank independence. The questionnaire was divided into seven parts each part depicting a certain aspect of Reserve Bank of Malawi. The questionnaire contains the same questions and variables that were dealt with when measuring legal independence. However some parts of the questionnaire focus on the situation on ground other than the law.

Aggregating the scores one finds that the Reserve Bank of Malawi independence increases from 0.5 as indicated by legal independence to 0.73. This is a very high score and once again equal to that of Denmark and still above South Africa with 0.64 and other African countries whose independence is regarded as very high (refer to table 2 page 35for more scores). The major reason once again is the differences in the times under comparison. This research has been conducted at a time when there are many improvements in the area of monetary policy as compared to the 1980's, the time periods used by the study done by Cukierman et al.(1994). If the study was expanded to include other African countries such as South Africa one would possibly get scores far much better than those by Cukierman et al. (1994) and higher than the Malawian score.

The first variable under the questionnaire deals with the extent to which the terms of office of the governor are independent from those of the government. The more the turnover at the Central Bank coincides with the turnover in government, the less independent the Central Bank is likely to be. In line with the findings under the informal indicator of turnover of governors above where the governor is changed almost after elections, the Reserve Bank of Malawi officials indicated that there is some overlap between the two and this undermines the Central Bank's independence.

The second variable deals with limitations on lending and it was coded by applying the same criteria as in legal independence in the literature review theory and methodology and above. In the legal measurement of Central Bank independent it was found out that there are some limitations but they are moderately loose. The monetary specialists through the questionnaire indicated that the rules are loose and at times nonexistent. What this means is that even though there are some rules limiting lending in the Reserve Bank Act, in practice the rules are undermined thereby reducing Central Bank independence.

The next variable focuses on the resolution of conflict between the executive branch and the Central Bank. Where as the Reserve Bank Act 1989 does not really specify the way conflicts should be resolved, the monetary specialists indicated that there are several clear cases where resolution of the conflicts ends in favour of the Central Bank. There is no clear way as to how conflicts are resolved. The Central Bank officials indicated that there are discussions between the bank and government before a policy stance is taken and implemented. To be specific, officials from the Ministry of Finance and representatives from the Ministry of Finance and Ministry of Economic Planning are in attendance at the monetary policy committee meetings where decisions about policy are held.

Variable number four focuses on whether the bank has got financial independence or not by looking at the involvement of the executive in the formulation of the bank's budget and the formulation of salaries of high bank officials. The Central Bankers indicated that the determination of the Reserve Bank of Malawi's budget is mostly done by the Central Bankers, but the determination of salaries of high ranking bank officials is done jointly by the Central Bank and the government. They indicated that they are rarely involved in the formulation of the government budget. The Reserve Bank of Malawi Act is also silent on the involvement of the Central Bank in government budget formulation.

Variable number five reflects the relative importance of monetary targets for the monetary stock or interest rates as pre-commitments with government. The theory behind it is that money stock targets enable the pursuit of price stability because the bank could adhere to them in the face of pressure from the government. A target for the nominal interest generally would work to limit the ability of the bank to react to upsurges of inflation. The Reserve Bank of Malawi, according to the responses from the questionnaire targets quantitative monetary stocks and these targets are usually met but the bank does not target formal or informal interest rates.

The sixth variable tests the commitment of the bank to fighting inflation rate. On this variable the Central Bankers in Malawi indicated that they are committed to controlling inflation rate despite the Reserve Bank of Malawi Act not clearly stating whether the inflation rate is the priority of the bank. The Act lists ten objectives which include price stability and these objectives are not ranked according to priority.

The final variable deals with whether the Central Bank acts as a development bank. Theory predicts that a bank that is very independent is not supposed to involve itself in issues of development such as granting of loans at subsidized rates. The Reserve Bank of Malawi after partial liberalization stopped granting of loans at subsidized credit in 1988 (Reserve Bank of Malawi, 2000: np). Therefore the bank does not act as a development bank even though it has development as one of its main objectives officially.

4.4. Accountability and Transparency

As noted in the theory and methodology chapter under accountability and transparency the project used the criteria developed by Eijffinger and Hoeberichts (2000) to check whether the Reserve Bank of Malawi is accountable to the powers accorded to it. They pose 13 different questions and the total number of positive answers determines the score for the Central Bank concerned (each question carries a mark of 1 if a certain aspect is present and zero if absent, Refer to annex three page 65). The questions are grouped into three different clusters namely objectives of monetary policy, transparency and final responsibility.

Under accountability and transparency, the Reserve Bank of Malawi Act gets an aggregate score of four out of thirteen points which translates to 30.7%. The reason behind the poor score is that the debate about accountability and transparency started to take shape after 1989 when the Reserve Bank of Malawi was revised. The Act therefore does not reflect trends of good governance such as transparency and accountability. Although there are some mechanisms in place to deal with accountability and transparency the act does only mentions the bare minimum compared to the transparency in practice. Comparing with other Central Banks in developed countries, the aggregate score shows that Reserve Bank of Malawi is more transparent than the European Central Bank according to the results by Eijffinger and Hoeberichts (2000). The European Central Bank scored a total of four points out of thirteen (refer to annexe four for more results). According to the same study, the Central Bank that has got the best accountability and transparency mechanisms is the Bank of England with eleven points out of thirteen (Eijffinger & Hoeberichts, 2000:9).

The first section of the questionnaire deals with the objectives of the Central Bank. This is necessary because the objectives are taken as yardsticks to measure performance of the Central Bank for accountability purpose (Eijffinger & Hoeberichts, 2000:1-2). The cluster also looks at whether there are several objectives and if anything there is a ranking of the objectives. The cluster assesses whether the objectives are clearly quantified making it easier to measure performance of the bank. Under this cluster the Reserve Bank of Malawi did not do well because the final score is one point out of four. The Reserve Bank of Malawi Act specifies ten objectives of the bank but these objectives are not clearly defined nor are they clearly ranked. The objectives are broadly defined and not quantified. For example, the Act states that one of the objectives of the Reserve Bank of Malawi is to maintain price stability but does not specify at what levels (Reserve Bank of Malawi Act, Part III: Section 4). This becomes a problem when one wants to evaluate the performance of the Bank because there no benchmarks for assessment.

The second cluster of this criteria focuses on the transparency of monetary policy. This involves finding out whether the Central Bank publishes other reports such as inflation reports or monetary reports apart from the mandated Central Bank reports. This cluster also looks at whether resolutions of the governing board are made public in good time and whether the Central Bank explains how it reached a specific conclusion. The Reserve Bank of Malawi under this cluster gets a score of 2 out of 3 points. Firstly, the bank publishes other reports apart from those mandated by the Act such as annual financial accounts, yearly reports on its operations and a return of its assets and liabilities (RBM Act, Part X Section 52, 1-6). The additional reports include monthly, quarterly, mid-year and yearly economic reviews which are also put on the Central Banks website (RBM, 2008:np).

Another question this cluster poses is whether the governing board releases its results for public consumption in good time. The Reserve Bank of Malawi Act allows the Board, condition to the approval of the Minister, to make by-laws for the administration and management of the Bank and these laws are published in the government gazette. Whether the resolutions are published in the gazette in time is difficult to measure. The last variable in this cluster evaluates whether the Central Bank explains publicly the extent it has been able to reach its objectives. The Reserve Bank of Malawi through its minutes of the Monetary Policy Committee meetings explains the extent the bank has achieved its objectives. The minutes also explain why the bank has taken a certain policy stance but does not include the voting patterns.

The last cluster deals with the issue of who has the last responsibility of monetary policy and whether there are avenues that are used to address disputes between the bank and the government. This cluster also looks at whether the Central Bank is subject to monitoring by Parliament. Under this cluster the Reserve Bank of Malawi has a very poor score of two out of six. The Reserve Bank of Malawi collects a point as it is subject to monitoring by parliament. The Central Bank is supposed to come up with a copy of audited annual accounts and a report of its operations in the year which are submitted to the minister of finance who forwards the reports to parliament for discussion (Reserve Bank of Malawi Act 1989, Part X section 52). The governor however is not obliged to attend parliament to answer questions on monetary policy.

Another set of questions this cluster looks at is whether past performance is a ground for dismissal of a Central Bank governor and how the government and the Central Bank handle conflicts. The act is silent on how conflicts are handled and there is no mention of an override mechanism. It was noted during the interviews that the Reserve Bank of Malawi and the government decide on monetary policy jointly and that in cases of conflict there are clear cases where the Central Bank has won. Using past performance as a determinant in terminating the governor, the Reserve Bank of Malawi Act is silent even though it mentions that the conditions of employment of the governor are stipulated in the instrument of appointment which is not made public.

4.5. Issues not Captured by All Other Indices

Apart from these quantitative indicators the project also looked at some qualitative factors. Firstly the size, composition and duties of the Reserve Bank of Malawi Board of Directors will be discussed. The Reserve Bank of Malawi has a board of directors consisting of seven members who have the responsibility of implementing the administrative and management policy of the bank. The Act stipulates that the Board should consist of the governor, deputy governor and five other directors (appointed by the president for a period of two years) who may include secretary to the treasury, secretary for economic planning and development and the accountant general. Currently, the board is composed of six members namely, the governor, deputy governor, secretary to the treasury, two members from the business community and one member from the academia. The governor acts as the chairman of the board.

The act also requires every director to be a person of recognized standing and experience in business, management, profession or academics. The Reserve Bank of Malawi board, using Parson's terminology (Parson, 2005:17), could be described primarily as an oversight board since the responsibility of monetary policy is delegated to the Monetary Policy Committee and board meetings are not necessarily taken as the main source of effective decisions regarding monetary policy. However this set up, according to some economists, creates a dilemma as the governor being the chairman of the board, tends to oversee himself (Parsons, 2005:17). As one of the solutions and to allow for good corporate governance, economists argue that there is a need to create two posts, one for board chairman and one for Reserve Bank of Malawi Governor who chairs the monetary policy committee.

On subcommittee work the research found out that Reserve Bank of Malawi has fifteen departments some of them are general counsel, human resources, research and statistics, supervision of financial institutions and corporate services. If the board of directors has specific requirements, the job is handed over to a department that specializes in that area for feedback thereby avoiding the task of formulating a subcommittee for that problem. In addition to this, the board always receives reports and position papers monthly from various departments informing the board of the major developments in their departments. However there are some situations when a consultant is contracted to do a certain job which requires certain skills the bank does not have and the findings are communicated to the board of directors in a form of a report. For example the bank employed a consultant to look at how the bank could reform itself and streamline some of its functions between 2005 and 2006.

The research also found out that the Monetary Policy Committee in the Reserve Bank of Malawi consisted of the Governor, Deputy Governor, the General Manager, the Secretary to the Treasury, Principal Secretary in Economic Planning and Development and one member from the academia. During their meetings, which take place once in every two months, the executive directors for economic services, corporate services and supervision of banks are in attendance in non-voting capacity. Just as the board of directors, the Monetary Policy Committee is provided with reports, position papers and research papers from various relevant departments more for its decision making purposes more. The reports are mainly from the research and statistics, supervision of financial institutions and corporate services departments. The Monetary Policy Committee normally decides on its targets for the whole year in January which are reviewed after six months but the targets are monitored quarterly. The Reserve Bank of Malawi mainly targets reserve money and the major instruments are the credit market and foreign assets. Reserve money is targeted because it is easier to use and has immediate impact and control on deposits by commercial banks and price of money, namely interest rates.

The size and characteristics of the Reserve Bank Monetary Policy committee are just in line with other findings from Berger et al. (2006). Berger et al. (2006) discovered that on average Monetary Policy Committees range from five to ten people. The case studies also noted that the size of the committee is decided by the size of the country, the economic development and the political situation. The monetary policy committee of the Reserve Bank is small due to the fact that the economy is underdeveloped, very small, and predominantly agricultural with little heterogeneity. The political system is democratic in nature therefore not requiring a big monetary policy committee to insulate it from political influence.

On the composition of the Monetary Policy Committee there are some issues that could be subject to debate. The first issue is whether the members of the Monetary Policy Committee are sufficiently independent enough given the fact that the government is present at the meetings. The answer is both yes and no depending on the angle you are looking at. For example, Amtenbrink (2004:15-17) argues that there is need for coordination between fiscal policy and monetary policy in an economy and the Monetary Policy Committee provides the perfect platform for this. He proposes the presence of government in the monetary policy committee as it helps the government to communicate the general economic situation to the bank. He argues further that government's representation at the board will work to the advantage of the bank as it provides an opportunity for them to explain and motivate the approach to monetary policy to the government. What is apparent in the Malawian case is that disagreements over policy are rarely noticed and it is difficult to discern where sources of influence in a decision come from since the voting patterns are not shown in the minutes of Monetary Policy Committee meetings.

The other question that might be raised is whether concerns of the employees of the bank that attend the monetary policy committee in non voting capacity are taken into account. Are these members able to influence policy or advise the committee on issues that could potentially contradict the position of the governor as their boss? These issues are also well concealed in the minutes of the Monetary Policy Committee meetings. The other issue that can be raised touches on the question of the qualifications and variety of the members of the Monetary Policy Committee. Most of the members of the Monetary Policy Committee in non-voting capacity are officials of the bank namely directors of various departments. Parson noted that the success of the Bank of England has been attributed to the quality of its policy makers, the knowledge of how the economy works more especially the involvement of outside expertise in the Monetary Policy Committee (Parsons, 2005:19). This is an issue that needs to be considered to widen the range of expertise and knowledge in the committee.

The last issue is deals with the conditions of appointment of the governor and who bares the final responsibility of the monetary policy. Earlier in the chapter we noted that the Reserve Bank of Malawi Act allows the president to appoint the Reserve Bank of Malawi Governor for a period of 5 years using an instrument of appointment stating conditions of service for the governor and that these conditions are not stipulated in the Act. One would argue that the conditions of employment for the governor should be made public for transparency sake more especially when it comes to termination of the contract due to non-performance. This becomes important as government also takes part in monetary policy formulation and one could only speculate as who would bare the final responsibility if the Central Bank fails to meet its targets. These are questions that could be addressed or looked into during the setup of the Reserve Bank of Malawi governance structure, let alone the Act.

4.6. Summary

This chapter has discussed several aspects of the Reserve Bank of Malawi. These included the legal measure of central independence, informal measures of Central Bank independence namely turnover of Central Bank governors, and a questionnaire based index. The Research discovered that even though the score for legal Central Bank independence index was higher than some developed countries and most of the developing countries, the Reserve Bank of Malawi Act 1989 has several weaknesses that need to be looked into. The research also found that it is difficult to compare the results of this research to those calculated by Cukierman et al. (1994) since the time periods are different and that some Central Bank charters used in the Cukierman et al. study were relatively old.

The research also found that the informal indicator that focuses on the turnover of central governors increases the independence of the Reserve Bank of Malawi as compared to the legal index. The research discovered that even though the results were lower than those from developed countries, Malawi did well on the Africa level as the turnover of the governor at the Reserve Bank of Malawi was lower than average. However the research noted that there is some overlap between the political cycle and the turnover of Central Bank governors more especially during the multiparty era therefore threatening the Central Bank independence.

The questionnaire of Central Bank independence came up with a score which was higher than some Industrial countries. The indicator also means that on Africa Level, the Reserve Bank Malawi is one of the most independent Central Banks in Africa. This result just like that of legal independence had the weakness that comparison with other countries was difficult since the times of being compared are different. This research has been conducted at a time when there are many improvements in the area of monetary policy as compared to the 1980s, the time period used by the study done by Cukierman et al. (1994). If the study was expanded now to include other African countries such as South Africa one would surely get scores far much better than those by Cukierman et al. (1994) and higher than the Malawian score.

The chapter also discussed issues that deal with accountability and transparency. The Research noted that the Reserve Bank of Malawi even though with a weak score, performs better than other banks in the developed countries. For example the Reserve Bank of Malawi is more transparent than the European Central Bank according to the results by Eijffinger & Hoeberichts (2000). According to the same study the bank that has got the best accountability and transparency mechanisms is the Bank of England.

Looking at other factors not covered by the indices mentioned above, the research found out that the Reserve Bank of Malawi has a board of directors consisting of seven members who have the responsibility of implementing the administrative and management policy of the bank. The board costs of the governor, deputy governor and five other directors (appointed by the president for a period of two years) who may include secretary to the treasury, secretary for economic planning and development and the accountant general. The research also found out that the Reserve Bank of Malawi has a Monetary Policy Committee which consists of the Governor, deputy Governor, the General Manager, the Secretary to the Treasury, Principal Secretary in Economic Planning and Development and one member from the academia.

There is a need to create a new post of Chairman of the Reserve Bank of Malawi board because the current setup means that the Governor oversees himself. In addition there is a need to include outside members who have experience in different fields.

Chapter 5: Conclusion

The purpose of the dissertation was to measure using appropriate methodology the degree of independence of the Reserve Bank of Malawi based on the Reserve Bank of Malawi Act of 1989. Furthermore the dissertation assessed the vulnerability of this independence in the context of good governance and a variety of internal and external threats on the independence. This was achieved by using formal and informal measures of central bank independence developed by Cukierman et al (1994). The main instrument used in the determination of Reserve Bank of Malawi independence was legal independence which is based on the coding of the central bank charter and is based on the degree of independence conferred to the central bank by law. But this measure has a weakness that most central banks do not adhere to the laws in practice.

To address this limitation, the informal indicator looking at the turnover of governors and a questionnaire were used to make up for the weakness. Turnover of central bank governors is used on the presumption that at least above some threshold more rapid turnover of governors indicates a lower level of independence. On good governance the study used the criteria developed by Eijffinger & Hoeberichts (2000) that deals with accountability and transparency. The criterion has thirteen components which are given a score of one each. The thirteen components are divided into three main themes to do with accountability and transparency.

The main weakness of the study is that it is difficult to compare the results those by Cukierman et al. (1994) since the time periods in question are different and difficult to compare since central banking is dynamic. The analysis done by Cukierman et al. (1994) was based on data collected in the period between 1980 and 1989 but central bank independence generated considerable debate in the 1990's (Padayachee, 2001:745; Maxfield, 1997:11). The analysis has been done using data that is as late as 2006. The incomparability of the time periods should be kept in mind when interpreting the results.

The aggregate score for the Reserve Bank of Malawi's independence under legal independence as calculated by the researcher was found to be 0.50. This is a very high score if we compare with the results found by Cukierman et al. (1994). Despite having a high score the Reserve Bank of Malawi act still has some weaknesses in four areas namely: (a) The chief executive of the central bank cluster, (b) the policy formulation cluster (c) the objectives of the central bank and (d) lending to the government.

On the informal indicator of turnover of central bank governors, even though the results are higher than the average at Africa level, there are some weaknesses which need to be noted. There is some overlap between the political cycle and the turnover of central bank governors which compromises central bank independence. It was also noted that during the multiparty era in Malawi, a new governor is appointed a year after general elections. This in essence indicates that there is a lot of political interference on Reserve Bank of Malawi independence.

Under accountability and transparency the Reserve Bank of Malawi Act 1989 gets an aggregate score of 5 out of 13 points which translates to 38.4%. The reason behind the poor score is that the debate about accountability and transparency started to take shape after 1989 when the Reserve Bank of Malawi act was being formulated. This means that the debate on accountability and transparency was rife after the act was already published. Even though there are some mechanisms in place to deal with accountability and transparency, the act does not mention this even though there is a lot of transparency on the ground.

The Reserve Bank of Malawi board could be described primarily as an oversight board since the responsibility of monetary policy is delegated to the Monetary Policy Committee and board meetings are not necessarily taken as the main source of effective decisions regarding monetary policy. However this set up, according to some economists, creates a dilemma as the governor being the chairman of the board tends to oversee himself and this usually leads to diminished accountability and transparency (Parsons, 2005:17).

The qualifications and variety of the members of the Monetary Policy Committee. Most of the members of the Monetary Policy Committee in non-voting capacity are officials of the bank namely directors of various departments. Parson noted that the success of the Bank of England has been attributed to the quality of its policy makers, the knowledge of how the economy works more especially the involvement of outside expertise in the Monetary Policy Committee (Parsons, 2005:19). This is an issue that needs to be considered to widen the range of expertise and knowledge in the committee.

Finally the conditions of appointment of the governor and who bares the final responsibility of the monetary policy were assessed. Earlier in the chapter we noted that the Reserve Bank of Malawi Act allows the president to appoint the Reserve Bank of Malawi Governor for a period of 5 years using an instrument of appointment stating conditions of service for the governor and that these conditions are not stipulated in the Act. This becomes important as government also takes part in monetary policy formulation and one could only speculate as who would bare the final responsibility (who would shoulder the blame) if the central bank fails to meet its targets.

Recommendations

In view of the findings summarised above the research would like to recommend that the Reserve Bank of Malawi act of 1989 should be revised to include issues of independence accountability and transparency. First of all the act should be clear on the terms and conditions of the Reserve Bank of Malawi Governor since the instrument of appointment of appointment is not made public. This may include whether the contract of the governor could be terminated after he fails to meet a certain given target. Apart from bringing in transparency, this would reduce the firing of Reserve Bank of Malawi governor on political grounds.

Secondly during the review of the Reserve Bank of Malawi Act is to improve the objectives should be taken into account. As noted in the analysis of results, the Reserve Bank of Malawi has ten objectives and there is no clear prioritisation of the objectives. One way of dealing with this is to make price stability their sole target since in practice, as noted by the questionnaire on central bank independence, price stability is taken as priority. If this is not possible, the government should consider prioritising the objectives to make assessment of the central bank's performance easier and transparent.

Furthermore there is need for clear and precise mechanisms that deal with conflict resolution. As noted in the previous chapter the Reserve Bank Act does not spell out the way conflicts should be resolved. Even though Officials of the Reserve Bank of Malawi indicated that there are several clear cases where resolution of the conflicts ended in favor of the central bank, there is no clear indication on how conflicts are resolved. This mechanism is needed to improve the transparency of the central bank.

Lastly when the Reserve Bank of Malawi Act was being revised, there was little debate on issues of governance more especially on accountability and transparency of monetary policy. Even though the Reserve Bank of Malawi has several ways of communicating monetary policy to the government and the public at large there is a need to formalize these avenues to make them a requirement in the act. Formalizing these avenues would ensure accountability and transparency of the bank through the provision of information to the public.

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ANNEXE 1 : CODING OF LEGAL INDEPENDENCE

Variable Number	Description of variable	Weight	Numerical coding
1.	**Chief Executive Officer**	**0.20**	
	a. Term of Office		
	Over 8 years		1.00
	6 to 8 years		0.75
	5 years		0.50
	4 years		0.25
	Under 4 years or at the discretion of appointer		0.00
	b. Who appoints CEO?		
	Board of Central Bank		1.00
	Council of Members from the Central Bank Board, the Legislature and Executive branch		0.75
	Legislature		0.50
	Executive Branch collectively (e.g. Council of ministers)		0.25
	One or two members of the executive branch (e.g. Prime Minister or Minister of Finance)		0.00
	c. Dismissal		
	No provision of Dismissal		1.00
	Only for reasons not related to policy e.g. for incapacity or violation of law		0.83
	At the discretion of central bank board		0.67
	At legislature's discretion		0.50
	Unconditional dismissal possible at Legislature discretion		0.33
	At executives discretion		0.00
	d. May CEO hold other offices in Government?		
	No		1.00
	Only with permission from the Executive branch		0.50
	No Rule against CEO holding another Office		0.20

Variable Number	Description of variable	Weight	Numerical coding
2.	**Policy formulation**	0.15	
	a. Who formulates monetary policy?		
	Bank alone		1.00
	Bank Participates with Government		0.67
	Bank advises Government		0.33
	Bank has no say		0.00
	b. Resolution of Conflict		
	Bank has the final authority on issues that are clearly Defined in the law as its objectives		1.00
	Government has priority or final word only on policy Issues that have not been clearly defined as the bank's Goals or in case of conflict within the bank		0.80
	A council of the central bank, executive branch and Legislative branch makes the final decision in case of conflict		0.60
	Legislature has the final word on policy issues		0.40
	Executive branch has the final word on policy issues Subject to due process and possible protest by the bank		0.20
	Unconditional priority of executive branch in policy Decisions		0.00
	c. Role in Government Budgetary Process		
	Central bank active		1.00
	Central bank has no influence		0.00
3.	**Objectives**		
	Price stability is the major or only goal and the Central has the Final word in favour of price stability in Case of a conflict with other government goals		1.00
	Price stability is the only goal,		0.80
	Price stability is one goal with other Compatible objectives		0.60
	Price stability is one goal with potentially Conflicting goals		0.40
	No objectives stated in the bank charter		0.20
	Stated goals do not include price stability		0.00

Variable Number	Description of variable	Weight	Numerical coding
4.	**Limitations of lending to the government**	0.15	
	A. advances (Limitations on nonsecuritised lending)		
	No advances permitted		1.00
	Advances permitted but with strict limits		0.67
	Advances permitted and the limits are loose		0.33
	No legal limits on lending		0.00
	B. securitised lending	0.10	
	Not permitted		1.00
	Permitted but with strict limits		0.67
	Permitted and the limits are loose		0.33
	No legal limits on lending		0.00
	C. terms of lending	0.10	
	Controlled by the bank		1.00
	Specified by the bank charter		0.67
	Agreed between the central bank and executive branch		0.33
	Decided by the executive branch alone		0.00
	D. potential borrowers from the bank	0.05	
	Only the central government		1.00
	All levels of government (as well as central)		0.67
	Those mentioned above and public enterprises		0.33
	Public and private sector		0.00
	E. the limits on central bank lending are determined by	0.025	
	Currency amounts		1.00
	Central bank demand liabilities or capital		0.67
	Government revenue		0.33
	Expenditures		0.00
	F. Maturity of Loans	0.025	
	Within 6 months		1.00
	Within 1 year		0.67
	More than one year		0.33
	No mention of maturity in the law		0.00

Variable Number coding	Description of variable	Weight	Numerical
G. interest rates on the loans must be		0.025	
	Above minimum rates		1.00
	At market rates		0.75
	Below maximum rates		0.50
	Interest rate is not mentioned		0.25
	No interest on government borrowing from CB		0.00
H. is the central bank prohibited from buying and selling Government securities in the primary market			
	Yes		1.00
	No		0.00

Source: Cuikerman et al., 1994

ANNEXE 2: QUESTIONAIRE BASED INDEX OF CENTRAL BANK INDEPENDENCE (INOFRMAL MEASURE)

Variable Number coding	Description of variable	Weight	Numerical
1.	Tenure overlap with political authorities	0.10	
	Little overlap		1.00
	Some overlap		0.50
	Substantial overlap		0.00
2.	Limitations on lending in practice	0.20	
	Tight		1.00
	Moderately tight		0.66
	Moderately loose		0.33
	Loose or nonexistent		0.00
3.	Resolution of conflict	0.10	
	Some clear cases of resolution of conflict in favour of bank		1.00
	Resolution in favour of government in all cases		0.00
	All other cases		0.50
4.	Financial Independence	0.10	
	A. determination of the central banks budget		
	Mostly central bank		1.00
	Mixture of bank and the executive or legislative branches		0.00
	Mostly executive or legislative branches		0.00
	B. Determination of the Salaries of high bank officials and the Allocation of bank profits		
	Mostly by bank or fixed by law		1.00
	Mixture of bank and the executive or legislative branches		0.50
	Mostly executive or legislative branches		0.00
5.	Intermediate Policy targets	0.15	
	A. quantitative monetary stock target		
	Such targets exist and are usually met		1.00
	Such targets exist: mixed adherence		0.66
	No stock changes		0.00
	B. Formal or informal interest rates targets		
	No		1.00
	Yes		0.00

Variable Number coding	Description of variable	Weight	Numerical
6.	Actual Priority given to price stability	0.15	
	First Priority		1.00
	First Priority assigned to a fixed exchange rate		0.66
	Price or exchange rate stability are among the bank's Objectives but not first priority		0.33
	No mention of price or exchange rate objectives		0.00
7.	Function as a development bank, granting at subsidy rates	0.20	
	No		1.00
	To some extent		0.66
	Yes		0.33
	The central bank is heavily involved in granting Subsidised credits		0.00

Source: Cuikerman et al., 1994

ANNEXE 3: Criteria for Accountability and Transparency
Source: Eijffinger & Hoeberichts (2000)

Objectives of Monetary Policy	RBM
1. Does the central bank law stipulate the objectives of monetary policy?	1
2. Is there a clear prioritization of objectives?	0
3. Are the objectives clearly defined?	0
4. Are the objectives quantified (in the law or based on document based on the law)?	0
Subtotal on ultimate objectives of monetary policy	**1**
5. Must the central bank publish an inflation or monetary policy report of some kind, in addition to standard central bank bulletins/report?	1
6. Are minutes of meetings of the governing board of the central bank made public within a reasonable time?	1
7. Must the central bank explain publicly to which extent it has been able to reach its objectives?	0
Subtotal on transparency	**2**
8. is the central bank subject to monitoring by Parliament (is there a requirement – apart from an annual report - to report to Parliament and/or explain policy actions in Parliament)?	1
9. Has the government the right to give instructions?	0
10. Is there some kind of review in the procedure to apply the override mechanism?	0
11. Has the central bank has possibility for an appeal in case of an instruction?	0
12. Can the central bank law be changed by a simple majority in Parliament?	0
13. is past performance a ground for dismissal of a central bank governor?	0
Subtotal on final responsibility	**1**
Total on accountability	**4**