

Central Bank Independence: A Thai Perspective*

1. Introduction

In the wake of the 1997-98 Asian economic crisis, the issue of central bank independence (CBI) has gained in importance, although the view that lack of independence of the central bank may have been one of the causing factors of the crisis lacks sufficient empirical evidence to support it.

The experience of economic management in many advanced countries seems to show that independence or degree of autonomy tends to help support the achievement of the duties of the central bank, both in the short run and the long run. In particular, a high degree of independence has been seen as one of the major components in successful conduct of monetary policy to achieve the aims of stable economic condition and sound banking and payment systems. Many countries have recently adopted new legislation providing for more CBI, including the United Kingdom, the Philippines, Korea and Indonesia. Reflecting such a move towards a more independent central bank, the Bank of Thailand (BOT) has put forward a new draft law, the Bank of Thailand Act, which is expected to be ratified some time in early 2000. It is hoped that the new act will facilitate the adoption of a more flexible policy framework for the conduct and implementation of monetary policy.

This short note will first provide a brief overview of the main features of CBI in the context of Thailand. Particular emphasis is given to the salient elements related to the proposed draft the Bank of Thailand Act. Then, it will provide some discussion regarding the conduct and implementation of monetary policy in the period ahead when the proposed new Bank of Thailand Act enters into force.

2. Central Bank Independence: Salient Features and Implications for Thailand

2.1 Necessary Conditions for the Independence of a Central Bank

Experience from many countries suggests that legal arrangements surrounding the Central Bank play a critical role. As has been widely accepted, the independence of the Bundesbank from direct political interference, for example, is the main reason why the deutchemark has consistently been a stable currency. In broad terms, independence of the central bank can be said to depend on:

- Governor of Central Bank appointed for a fixed term;
- Board of Directors appointed for a fixed term;
- Statutory requirement that the Cen-

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tral Bank should pursue the aim of monetary stability;

- Absence of automatic financing of budget deficits;
- Deficit financing at market-related interest rates;
- No Government (or Parliament) approval of monetary policy;
- No mandatory participation of government representative in the Board.

On the whole, the term “independence of central bank” can be broadly defined as the degree of freedom of the central bank to pursue monetary policy without direct interference from political considerations. In the literature, meanwhile, discussion on independence of the central bank appears to have concentrated on four main aspects: (i) decision-making process in the central bank with respect to the issues of making monetary policy and monitoring the financial system; (ii) relationship with the Government; (iii) budgetary independence; (iv) accountability.

It is difficult, if not impossible, however, to identify the name of any central bank which is completely independent. Consider the case of the Bundesbank which was the most independent central bank in the world before the establishment of the European Central Bank. Nonetheless, the Bundesbank's advice on the issue of the appropriate exchange rate for unification was ignored by the German government and severe inflationary pressure ensued.

Experience has also shown that a large number of central banks have been given “instrument independence”, but only a few of them have been given “goal independence”.

For example, the Bank of England is given full independence in the setting of monetary policy, but its inflation target is set by the government.

2.2 Some Salient Elements of Proposed Draft Bank of Thailand Act

The proposed draft Bank of Thailand Act lays down some important elements of CBI in the important areas of (1) functional autonomy, (2) institutional status, (3) accountability and transparency. The proposed new law also identifies clearly the **objectives** of the BOT in carrying on such tasks as pertain to central banking to be:

- (1) maintain price stability; and
- (2) maintain the stability of the financial institutions system.

Regarding **functional autonomy**, in line with the aforementioned objectives, the **tasks** of the BOT are explicitly stated in the new law to include: (1) issue of notes; (2) formation and implementation of monetary policy; (3) implementation of exchange rate policy under the exchange system prescribed in accordance with the Currency Act; (4) exchange control as prescribed in the law on Foreign Exchange Control; (5) management and administration of international reserves; (6) acting as a banker to financial institutions; (7) supervision and examination of financial institutions; (8) supervision and administration of settlement system and payment system; and (9) acting as a banker to the government, as well as a registrar for securities of the government, financial institutions established by specific law and public enterprises.

Like other central banks in the developing world, the BOT has in the past been assigned some sort of development role as

part of its overall responsibility. However, under the new law, it is required that the Bank's lending to priority sectors for development purposes will be eventually phased out, as will the Bank's lending to the Financial Institutions Development Fund (FIDF) to help ailing financial institutions encountering severe liquidity shortages, once a Deposit Insurance Agency is set up.

Nonetheless, the question remains whether the role of the central bank as the lender of last resort should still remain at the Bank; or should this sort of role be taken by the newly established institution.

Apart from this, there has been an extensive and lively debate on the issue of whether a central bank should continue to carry on such tasks as the *regulatory and supervisory function over banks*. The separation between the banking supervisory function and the monetary policy function has become a practice in many countries. The list includes in particular the Bank of England, Reserve Bank of Australia, the Bank of Korea, and the Bank of Japan. Major reasons for such a separation include the avoidance of potential conflicts of interest between the maintenance of monetary stability on the one hand and the supporting of ailing banks on the other hand, and the avoidance of damage in the reputation of banking supervision in the event of a bank failure.

However, the view supporting the separation of the two functions needs to be balanced with potential benefits or synergy arising from the integration of these two functions within the central bank. It is often claimed that the formulation and conduct of monetary policy will be more effective, if a central bank can make use of information

gathered from the financial system in its role as supervisor of banks.

With respect to **institutional position (or status)**, it is generally agreed that the Central Bank needs to have an increased degree of autonomy or independence in its formulation and conduct of monetary policy to ensure a more effective conduct of the aforementioned duties. In this connection, the draft Bank of Thailand Act contains a number of articles to ensure a higher degree of CBI. In particular, with respect to personal independence, the proposed law specifies that:

- The Governor and Deputy Governors shall hold office for a term of five years and may be re-appointed, but shall not hold office for more than two consecutive terms;

- Board members should be appointed for fixed staggered periods (term of three years);

- They can only be removed from office, before expiration of their terms, by duly proven cause;

- The BOT will not finance fiscal deficits, except in case of emergency situation.

- In the management of the tasks of the BOT, the new law requires the establishment of the following three management Boards:

- (1) **the Court of Directors.** Its duties and responsibilities involve overseeing, controlling, and superintending the general management of the BOT;

- (2) **the Monetary Policy Board.** It has the primary duty and responsibility of formulating and conducting monetary policy. It also performs as its secondary duties and responsibilities such tasks as are assigned by the Court of Directors; and

(3) **the Financial Institutions Policy Board.** It has the primary duty and responsibility of formulating and executing policies concerning supervising and examining financial institutions. It also performs as its secondary duties and responsibilities such tasks as are assigned by the Court of Directors.

It is also useful to note that, the Monetary Policy Board is expected to be composed of a large number of professionals with six outside appointees having a strong background in macroeconomics, finance or banking. Similar requirements are also applied to the Financial Institutions Policy Board. The Board structure of this kind indicates a move towards a more “expert” model, along the lines of those in the advanced economies.

Concerning **accountability and transparency**, it is proposed that the Bank of Thailand (BOT) is not only accountable to the Government, but also to the public in general via Parliament. Under the new law, for example, the BOT is required, each year, to declare its monetary policy objectives for approval by the Cabinet; every 6 months, to declare monetary policy, operational guidelines and an evaluation of its performance for the past six months to the Parliamentary Committee designated by Parliament and to the Cabinet; and every year, to submit a report by the BOT Board on the operation of the Bank throughout the year to the Minister of Finance, Cabinet and Parliament. The Governor of the BOT is also required to make public the record of proceedings of meetings of the Monetary Policy Board within 3 months.

As the BOT is expected to gain an increased degree of autonomy under the new law in its formulation and conduct of mon-

etary policy, it is natural that such increased independence needs to be matched with more responsibility or accountability. Increased transparency on the part of the central bank is essential, as it will help the public to have a good basis for evaluating the policies adopted by the BOT. This would, in turn, induce the BOT to manage monetary policy in a more efficient and credible manner.

The potential adoption of inflation targeting by the BOT will require discipline in the formulation and conduct of monetary policy, and will be supported by greater transparency and accountability, thereby creating a favorable environment for the rebuilding of the BOT’s credibility. Apart from this, the management of monetary policy under the inflation targeting framework calls for a continuous communication with the public through inflation reports, minutes, or frequent speeches by senior officers of the central bank. Practices of this kind are an important channel through which the BOT can gain from the public better understanding and acceptance.

3. Independence of the Central Bank and Monetary Policy in Thailand

Although an increasing number of central banks have gained increased independence in their conduct of monetary policy as characterized by the move toward adoption of inflation targeting in many advanced and emerging market economies, it remains unclear whether such independent monetary policy has resulted in better economic performance. This is an issue which deserves more in-depth study to test empirically the outcome associated with the use of this sort of policy framework. However, a recent IMF survey

shows that the experience of countries that have adopted inflation targeting has been encouraging, since it is seen as providing more transparency and accountability. (But, it does not necessarily imply, however, that the increased degree of transparency and accountability produces better economic performance.)

The adoption of inflation targeting as the principal monetary policy framework is sometimes seen as a way to shield the central bank from political pressure to pursue a looser monetary policy for short-term benefit. However, as has been argued by many central bankers in emerging market economies, there are several constraints against the immediate adoption of inflation targeting in many countries, including in particular the need for a more developed financial system and formal central bank independence.

As had been argued elsewhere, formal independence of the central bank is only a *necessary condition* but not a *sufficient condition* for ensuring credibility of monetary policy. In the actual application of an inflation targeting framework, success must be measured not by the degree of independence of the central bank, but by the results achieved.

Experiences of central banks in many countries have shown that successful implementation of an inflation targeting framework depends very much on the appropriate treatment of a number of essential issues. The list includes (i) whether the target should be “*headline inflation*” or “*core inflation*” or some other measure of underlying inflation; (ii) whether the “*target band*” is appropriate; (iii) whether a central bank has enough instruments at its disposal; (iv) whether the bank needs to take account of other factors, espe-

cially the exchange rate, in achieving its primary target of stable and low inflation; and (v) whether there is difficulty with the accuracy and timeliness of economic statistics, making it difficult to recognize turning points in the economy.

It is important to note that the choice of inflation target cannot be set in a vacuum, but must also take into consideration external competitiveness. More specifically, in the case of Thailand, the targeted level needs to be in line with the weighted average of inflation rates of Thailand’s major trading partners so as to prevent pressure on the currency. At the same time, to help build the reputation of the Central Bank, the targeted inflation must be credible compared with the country’s past inflation record.

Although much progress has been achieved toward increasing the effectiveness of monetary policy implementation in both the institutional and technical fronts, there remain several challenges to monetary management in the short- and medium-term. In the short run, as a consequence of the financial crisis which occurred two years ago, the banking system in Thailand is still faced with a high level of non-performing loans (NPLs) and a high level of liquidity due to the caution of banks to extend new credits. Over the medium-term, the substantial borrowing of the FIDF—which is the BOT’s arm in assisting ailing financial institutions—from the private sector could be an additional constraint on monetary policy. Such unfavorable financial conditions may limit the Bank’s ability to effectively implement monetary policy in the short run.

Moreover, the financial markets are still not significantly developed to fully provide

an efficient financial environment. Thus another area that is being addressed concurrently by the authorities is the development of the bond market, which will pave the way for use of open market operations as a monetary policy instrument, in addition to the present BOT-operated repurchase window and loan window. Under its Bond Market Development Program, authorized dealers have been named by the BOT, a regular schedule for the issue of treasury bills and government bonds has been introduced, and an automated real-time DVP (delivery versus payments) system for government securities is being developed, among other things. Nonetheless, it will be some time before the debt paper

market gains sufficient breadth and depth to make it an efficient monetary policy instrument.

Notwithstanding such difficulties surrounding the Thai financial scene, it would not be too optimistic to take the view that Thailand could enjoy some success in the future official adoption of an inflation targeting framework for monetary policy, given that a number of preconditions with respect to central bank independence have been fulfilled under the proposed new BOT law, and given that the institutional framework that will help monetary policy to deliver low inflation over the medium term are being put in place.