An evaluation of the legal Autonomy of the State bank of Pakistan.

BY

Khadija Firdous
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1. Introduction

Central bank independence refers to the freedom of monetary policymakers from direct political or governmental influence in the conduct of policy. In a developing country like Pakistan, where there is a pervasive market failure, which necessitates frequent government intervention, this freedom or independence is often reduced considerably and therefore deserves attention.

Central bank independence has become one of the vital concepts in monetary theory and policy. It is widely believed that a high level of central bank independence with an explicit mission for the bank to curb inflation is an important institutional device to assure price stability. Although one could suggest alternative mechanisms to reach low rates of inflation, central bank independence is the one most often recommended. The basic message of this argument is that government suffers from an inflationary bias and as a result inflation is sub optimal.

The rationale of central bank independence has received added force from the recent shift to inflation targeting. The government by its very nature is powerless to set such a target because inflation control entails restrictions on the flow of credit and rise in its cost, which in developing countries, in particular is, opposed by the vote-banks of the party in power or out of power

In Pakistan, the issue of autonomy of State Bank of Pakistan was taken up in July 1993; prior to it the central bank had little autonomy as under the State Bank Act, 1956 the ministry of finance retained substantial powers to supervise the affairs of the Bank. The 1956 SBP Act did not explicitly mention the formulation and implementation of monetary policy and regulation and supervision of the banking system, which are commonly deemed to be the two core functions of the central bank.

The State Bank of Pakistan has made major strides in enhancing its supervisory capacity in recent years, bringing it broadly in line with international standards. There is a high degree of compliance with Basel Core Principles for Effective Banking Supervision.

This paper is comprised of three parts. The first part defines the role of the State Bank of Pakistan and provides a theoretical assumption behind central bank independence. The second part forms the basis for the evaluation of the legal autonomy given to the State Bank of Pakistan over the years. The third gives special attention to the legal independence of the State Bank of Pakistan- the assessment of its independence and recommendation for its improvement.

1.1 New Challenges faced by the State Bank of Pakistan

(FASP, 2005) The State Bank of Pakistan has made major strides in enhancing its supervisory capacity in recent years, bringing it broadly in line with international standards. There is a high degree of compliance with Basel Core Principles for Effective Banking Supervision. The State Bank of Pakistan has an array of powers to control the risks assumed by banks, has issued appropriate prudential regulations, has adopted sound methods for on- and off-site supervision, and has the power to require a wide range of remedial measures. In addition, it has adequate resources, and the quality of its staff has been significantly upgraded in recent years. However, the upgrading of the supervisory structure is relatively recent and remains to be tested over a longer period. There also are areas of less than full compliance with supervisory standards that relate to legal provisions regarding the independence of the regulator, arrangements for consolidated supervision, and provisions for country risk.

1.1.2 Legal Issues

As in many developing countries, problems with debt recovery and contract enforcement have undermined creditor rights and contributed to the very high level of non-performing loans in the banking system. The introduction of the Debt Recovery Ordinance in 2002 has improved the debt recovery environment, but further reforms are required. The creation of Banking Courts was a very positive development, but they are limited in number and jurisdiction. Other problems include the lack of capacity of the courts to execute judgment and the lack of commercial knowledge in judges. Improving the standard of legal education and training for judges and judicial and administrative staff would improve the judicial environment.

Though efforts have been undertaken by the government to update and improve the legislative framework for the financial sector, a number of laws lag behind current practice. There is therefore a need to repeal, amend and update old laws to avoid policy reversals and legal challenges. The State Bank of Pakistan Act of 1956 (amended 2003) is antiquated, with provisions that, inter-alia, authorize the government to supersede the central board and allow the federal government to liquidate the bank. In practice, State Bank of Pakistan functions as a modern independent central bank, and there is a clear need to revamp the law to better reflect current practice. The legal provisions governing insolvency and debt restructuring, and the Banking Companies Ordinance 1962 (amended 2001) (BCA) also require modernization to ensure that the legal framework is in line with best international practice.

1.2 Role of the State Bank of Pakistan

Farooq Arby (2004) The State Bank of Pakistan is the central bank of the country. Usually the starting point for a central bank is a banking system that is already in place - the banking system necessitates the presence of a central bank. But the State Bank of Pakistan (SBP) is unique in the sense that it started its function in a newly born country, where it also had to shoulder responsibilities of developing and rehabilitating a banking system and the economy, in addition to the traditional central banking functions.
In order to achieve the goals set before it, the State Bank of Pakistan performed all the traditional and non-traditional functions. The traditional functions, which are generally performed by central banks all over the world, are classified into two groups:

- *The primary functions* including issue of notes, regulation of the financial system, lender of the last resort, and conduct of monetary policy,
- *The secondary functions* including management of public debt, management of foreign exchange, advising the Government on policy matters, anchoring payments system, and maintaining close relationships with international financial institutions.

The non-traditional or promotional functions performed by the State Bank include development of financial framework, provision of training facilities to bankers, and provision of credit to priority sectors. The State Bank has also been playing an active part in the process of Islamization of the banking system. All these functions are shown in a flow chart (**Annex D**).

1.2.1 Primary Functions

1.2.1.1 Sole Authority to Issue Notes

One of the primary responsibilities of the State Bank is the regulation of currency in accordance with the requirements of business and the general public. For this purpose the Bank has been granted the sole right of issuing notes in the country under Section 24 of the State Bank of Pakistan Act, 1956. The overall affairs with respect to the issuing of notes are conducted through two notionally separate departments of SBP, viz., Issue Department, which deals with the issue of notes, and the Banking Department which undertakes general banking business.

1.2.1.2 Conduct of Monetary and Credit Policies

The State Bank of Pakistan is responsible to regulate the monetary and credit system of the country in such a manner that ensures monetary stability in the economy. Section 9A of SBP Act, 1956 entrusts the Central Board of the Bank to formulate and monitor monetary and credit policy by taking into account the Federal Government's targets for growth and inflation, in accordance with the recommendation of the Monetary and Fiscal Policies Co-ordination Board (MFPCB). The State Bank has a number of instruments at its disposal to regulate the volume of credit and to ensure its flow to the priority sectors.

1.2.1.3 Regulations and Supervision of the Financial System

Another principal task of the Bank is to safeguard the soundness of the financial system. To perform this crucial role effectively and efficiently, State Bank of Pakistan has been given vast powers under the State Bank of Pakistan Act, 1956, Banking Companies Ordinance, 1962, Banks Nationalization (Amendment) Act, 1974 and Micro finance Institutions Ordinance 2001 to regulate and supervise the activities of Banks, Development Finance Institutions and Micro finance Banks. These laws have been subject to amendments over time to meet changing circumstances. During the year 1997 some major amendments were made in the banking laws, which gave autonomy to the State Bank in the area of banking supervision. Under Section 40-A of the said ordinance it is the responsibility of State Bank to systematically monitor the performance of every banking company to ensure its compliance with the statutory criteria, and banking rules and regulations.

Off-site & On-site monitoring

The Bank monitors the banking activities through a combination of off-site monitoring and on-site inspection. Off-site surveillance is conducted by the State

Bank through various periodical returns received from banks and DFIs. On the other hand, on-site inspection is undertaken on the premises of the concerned banks. The purpose of inspection is to check the assets and liabilities as they appear on the books, to evaluate the quality of the assets, to determine compliance with laws, regulations, directives and policy guidelines provided by the State Bank, to judge the soundness of operations and the prudence of lending and investment policies, to appraise the quality of the management and to attempt an estimate of the overall position of the bank. The State Bank can give directions to commercial banks pertaining to any matter concerning their business, and can call for any information in respect of their transactions.

Prudential Regulations

In order to safeguard the interest of depositors and to ensure the safety and soundness of the banks/DFIs, the State Bank has issued Prudential Regulations. These Prudential Regulations present a prudent operating framework for the banks/DFIs. The regulations incorporate the spirit and essence of Bank of International Settlement (BIS) regulations and are constantly watched for possible improvement so that their enforcement yields the best possible results to promote the overall objectives of financial sector supervision. The State Bank has devised separate Prudential Regulations for different areas viz. Corporate and Commercial Banking, Small and Medium Enterprise Financing, Consumer Financing and Micro Financing while those for Agriculture Financing are being framed.

1.2.1.4 Bankers' Bank

The Bank also functions as the bankers' bank. Banks are classified as scheduled and non-scheduled. The Bank maintains an updated list of all scheduled banks at its various offices. These banks are entitled to certain facilities from the State Bank and in return they have some obligations to it. State Bank provides the following three important services to the scheduled banks:

1. It keeps the deposits of commercial banks, which primarily constitute the statutory reserves of scheduled banks.

2. The State Bank also provides extensive remittances facilities to banks at a concessional rate under the Remittance Facilities Scheme introduced since 1948. This facility helps the flow of funds smoothly and efficiently between various centers in the country.
3. In order to streamline payments through the financial system, the Bank also manages the operations of clearing houses. In the five major cities, the functions of SBP clearing house has been handed over to a private agency namely National Institutional Facilitation Technologies Private Limited (NIFT) to the extent of sorting of payments instruments and preparing clearing schedules.

1.2.1.5 Lender of the Last Resort

One of the important characteristics of a central bank is its being the lender of the last resort. The State Bank provides loan and re-discount facilities to scheduled banks in times of dire need when they find no other source of funds. These facilities are ordinarily provided by the Bank against government securities, trade bills, agriculture bill, etc. These loans are essentially short-term in nature and are advanced to enable the banks to meet their temporary requirements of funds arising out of seasonal expansion in trade, commerce, agricultural operations, and other economic activities.

1.2.1.6 Banker to Government

The State Bank conducts the banking business of Federal and Provincial Government and some government agencies. These functions performed by the Bank are akin to those ordinarily performed by commercial banks for their customers. The Bank provides the following services to the governments:

1. It accepts the deposits of cash, checks and drafts by the Government and undertakes the collection of checks and drafts drawn on other banks. The Bank transfers government funds from one account to another or from one center to another as advised by them.
2. The Federal and Provincial governments can obtain advances from the Bank subject to mutual agreements in respect of the terms and conditions for such

advances. The Bank makes ways and means advances to the Federal as well as to the Provincial governments without any collateral security. However, sometimes loans are also granted to the Provincial governments against the collateral of Federal Government securities.

3. On behalf of Federal, Provincial or Local governments the Bank also undertakes sale/purchase of gold, silver, approved foreign exchange, securities or shares in any company, collection of return on these shares/securities, transaction of SDR, etc.

1.2.2 Secondary Functions

1.2.2.1 Public Debt Management

The Bank is responsible for the management of government debt under subsection 13(e) of section 17, and section 21 of the SBP Act, 1956. The Public Debt Act 1944 also defines the responsibilities of SBP for public debt management. The following actions are involved in this regard:

1. Subscribing Federal and Provincial governments' securities at the time of their issue;
2. Sale/purchase of such securities in the Money Market (through auction, OMO or discount window);
3. Payments of interest to holders of public debt instruments.

1.2.2.2 Management of Foreign Exchange

Being responsible for maintaining the external value of the currency, the State Bank of Pakistan assumed the charge of management and administration of the exchange system of the country in line with the Foreign Exchange Regulation Act, 1947 which was originally enacted by the British Government and subsequently adopted by Pakistan. As an agent to the Government, the Bank has been authorized to purchase and sell gold, silver or foreign exchange and transactions of special drawing rights with the International Monetary Fund under sub-sections 3(a) and 13(a,f) of section 17, and section 23 of the SBP Act, 1956.

Development of Forex Market

As a part of market based economic policies stance, the process of liberalization of exchange and payments regime has been started since 1991. A number of reforms have been undertaken since then including (a) permission to residents for opening foreign currency deposits, (b) granting license to Pakistani nationals and resident companies/firms to work as authorized money changers on payment of prescribed fee, (c) permission for opening of a 'Special Convertible Rupee Account' by nonresidents for purchase of shares quoted on the Stock Exchange, (d) permission to investment banks to raise foreign currency funds from abroad through issue of certificate of investment, (e) liberalization of rules relating to investment in government securities, including NIT Units, by non-resident Pakistanis on repatriable basis, (f) permission to authorized Dealers for import and export of foreign currency notes and coins, (g) establishment of exchange companies, (h) relaxation in respect of trade-related remittances, and (i) adoption of measures to deepen forex markets/treasury operation etc.

1.2.2.3 Advisor to Government

The State Bank of Pakistan also acts as an advisor to the Government on financial and economic matters particularly with reference to their monetary aspects. The Bank counsels the Government on loan operations and advises it with regard to the timings, terms and conditions and rate of return on these loans. The advice is also tendered on matters like agricultural credit, cooperative credit, industrial finance, exchange regulations, banking and credit control, mobilization of savings, financial aspects of planning and development and similar other economic issues. State Bank of Pakistan also tenders advice to the Government on debt management issues. The advisory role of the Bank has been made mandatory in accordance with the Section 9A(d,e) of the SBP Act 1956.

Monetary and Fiscal Policies Coordination Board

The State Bank also participates in economic policy making as a member of various government agencies and committees. In order to coordinate fiscal, monetary, foreign trade and exchange rate policies, a "Monetary and Fiscal Coordination Board" has been set up under Section 9B of the SBP Act 1956 with the Finance Minister as its Chairman and Federal Minister or secretary for Commerce, Deputy Chairman Planning Commission, Governor State Bank of Pakistan and Secretary of Finance, as its members. The Board is responsible for ensuring consistency among macro targets and to determine, in consultation with the Federal Government, the limits of credit to be extended to the Federal and Provincial governments and review, on a quarterly basis, Government's borrowings in relation to pre-determined or revised targets. The Bank is required to place before the Board its assessment regarding the impact of economic policies on monetary aggregates and recommendations for fixing the safe limits of monetary expansion and Government borrowings.

In carrying out its assigned functions of coordinating fiscal, monetary and exchange rate policies and for ensuring consistency among macroeconomic targets of growth, inflation, fiscal, monetary and external accounts, the Coordination Board shall not take any measure that would adversely affect the autonomy of the State Bank of Pakistan as provided in the SBP Act.

1.2.2.4 Relationships with International Financial Institutions

Pakistan is the member of International Monetary Fund. The State Bank of Pakistan deals with the IMF on behalf of the Government of Pakistan (subsections 13(f) and 15 of Section 17 of the act). As a member of the Fund, the Government accepted the obligations of Article-VIII, Sections 2, 3 and 4 of the IMF Articles of Agreement w.e.f. July 1, 1994. As a result of which Pak-rupee was made convertible on current international transactions. The Governor State Bank accompanies the Minister of Finance in annual general meeting of the IMF and World Bank. The Bank officials also participate in negotiations with IMF missions in Pakistan and at IMF Head Office.

The State Bank of Pakistan also deals with other international financial organizations including Bank for International Settlement, the World Bank, Central Banks of foreign countries, etc. Almost all the agreements of Provincial and Federal Government with International Financial Institutions are executed through the State Bank of Pakistan.

1.2.3 Non-traditional Functions

Responsibilities of the State Bank of Pakistan go well beyond the conventional functions that have been discussed above. The scope of Bank's operations has been widened considerably by including the economic growth objective in its statute under the State Bank of Pakistan Act, 1956. They include:

1.2.3.1 Development of the Banking System

The most significant contribution made by the State Bank of Pakistan towards facilitating and fostering economic development in Pakistan was the rehabilitation of the banking system in Pakistan. At the time of independence the commercial banking system in Pakistan had virtually collapsed with the closure of large number of bank offices, which were run and managed by non-Muslims who migrated en-mass to India. Also there was no independent monetary authority, and the Government of Pakistan had to resort to the Reserve Bank of India for its currency and monetary affairs. Thus a tremendous task before the State Bank was to strengthen its own institution as a central bank besides overall development of banking industry in the country.

1.2.3.2 Training Facilities to Bankers

Keeping in view an acute shortage of trained bankers at the time of the independence, the State Bank introduced "Bank Officers Training Scheme" within one month of its establishment. On July 2 1948, the Central Board of Directors of the Bank approved a comprehensive scheme for university graduates especially with mathematics, economics and commerce backgrounds. For clerks, State Bank introduced departmental examinations system in 1950 to enhance the capabilities of the existing staff in the banking industry.

1.2.3.3 Development of Specialized Financial Institutions

The State Bank has actively participated in setting up a number of specialized credit institutions designed to meet the long and medium-term financing needs of various sectors of the economy. These institutions include Pakistan Industrial Credit and Investment Corporation of Pakistan (PICIC), Industrial Development Bank of Pakistan (IDBP), National Development Finance Corporation (NDFC), Agricultural Development Bank of Pakistan (ADBP), Federal Bank for Cooperatives (FBC) and House Building Finance Corporation (HBFC). These institutions were established to provide credit to industrial, agricultural and other sectors. The Bank also subscribed to the share capital of the People's Finance Corporation - renamed subsequently as Small Business Finance Corporation (merged in to the present Small and Medium Enterprise Bank), the Equity Participation Fund and Banker's Equity. These institutions were designed to provide finance to small businesses and the major sectors of the economy.

2. Central Bank Independence: A Theoretical Construct

Numerous literature reviewed describe Central Bank Independence as Vlahovic and Cerovic (2005) in a working paper prepared for the Central Bank of Montenegro have described it as the existence of a great freedom in decision making in conducting monetary policy. Increasing Central Bank Independence is primarily aimed at its protection from short-term and often the shortsighted political pressures associated with election cycles. Central bank independence has two *dimensions*: goal independence and the independence of instruments. Goal independence represents the liberty of a central bank to define the objectives of its monetary policy (price stability, unemployment rate, GDP, and the like). The independence of instruments means that a central bank can freely choose suitable policies – instruments to achieve desired effects on the economy. It is possible for a central bank to have some independence of instruments without goal independence, or vice versa (which is rarer). For example, a country that introduced inflation targeting has the independence of instruments, but this does not imply goal independence because targeted inflation is usually imposed by the government (the example of Great Britain).

There are four aspects of central bank independence:

- *Functional*: freedom in selecting the monetary policy goal,
- *Institutional*: freedom in selecting monetary policy instruments – definition and implementation,
- *Personal*: the role, status, and composition of the highest Central B ank body,
- *Financial*: fiscal independence and the prohibition of monetary financing.

Also, Central Bank Independence can be legal (prescribed by law) and actual (transparent from a central bank's operations). Central Bank Independence is the subject of numerous research and debates. The usual arguments for central bank *independence* are:

- **Inflationary feature of monetary policy:** allowing political pressures on a central bank contributes to the inflationary feature to monetary policy. To wit, the main objective of politicians is to be re-elected, which means that public policies and public goods will be used as the means for achieving this goal. However, politicians cannot or will not focus on long-term objectives, such as price stability. In political business cycles, in a pre-election period, expansive policies are led with the result being lower interest rates and unemployment rate, and soon after the elections the adverse effects of such policies are felt (high inflation and high interest rates), and politicians hope that they will be forgotten by the following elections.
- **Financing fiscal deficit:** allowing a central bank to be under the control of the state president (government, i.e. the Ministry of Finance) represents a danger because the central bank can be used for financing the budgetary deficit, which leads to an increase in inflation.
- Politicians` lack of experience in conducting monetary policy: the control of monetary policy is too important to be handed over to politicians who usually lack experience in making important decisions for the entire economy.
- "The power to spend money should in some way be separated from the power to create money"

The authors of this paper supported the arguments for an independent central bank, without neglecting the opinion of economists who are against overall central bank independence.

The arguments used against *central bank independence:*

- **Non-democratic nature:** In a democracy, citizens entrust politicians with power, which they then transfer to a specialized institution (central bank). In other words, delegating the right to enact decisions on monetary policy to an independent central bank means the transfer of authority from the elected government to another institution. In the case of an already independent central bank, the power to make decisions is taken away from the democratically elected representatives of the people and assigned to an institution that enacts monetary decisions that are not necessarily in accordance with the government's will. Even Milton Friedman asked whether it was ''really tolerable in a democracy to have so much power concentrated in a body free from any kind of direct, effective political control?"
- **A government is responsible for the economic situation in a country:** The public holds the President and the Government responsible for the economic welfare of a country, although they do not control the government agency (central bank) that may be the most important factor in determining the health of the economy.
- **Monetary and fiscal policies must be under the control of one institution:** With a view to promoting economic stability, monetary and fiscal policies have to be interconnected. However, in order for the coordination between these two policies to be successful, monetary policy has to be put under the control of politicians who also control fiscal policy.

2.1 Characteristics of Central Bank Independence

The European Monetary Institute has prepared the list of Central Bank Independence characteristics, distinguishing institutional, personal, and financial independence.

2.1.2 Statutory Objectives — Functional Independence

There is agreement that independent central banks must have a single, rather narrowly defined policy objective, which focuses on the stability of the domestic currency. This postulate is related to the need for the transparency and credibility of monetary policy. However, having a single policy goal does not mean that the central bank can ignore other macroeconomic goals. Therefore, numerous central bank laws contain a secondary objective, namely the support of general economic policies, provided that it does not jeopardize the achievement of the primary objective.

2.1.3 Institutional Independence

The concept of institutional independence is used differently in the literature: The EMI applied a very narrow definition of institutional independence, based on Article 108 of the Treaty and Article 7 of the Statute (EMI, 1996, p. 100). These regulations prohibit the European Central Bank, the National Central Banks and the members of their decision-making bodies to take or seek instructions from Community institutions or bodies, from any government of a Member State or from any other body. Smits (1997, p. 155) presents a somewhat broader concept, which comprises freedom from instructions and the legal personality of the central bank, which must be an institution separate from other government bodies.

2.1.4 Personal Independence

The definition of personal independence is largely undisputed and relates to arrangements on the role, status and composition of the central banks_ highest decision-making bodies. This includes appointment procedures, rules for dismissal, the length of the term of office and the possibility of a renewal of mandate, requirements for professional competence and incompatibility clauses. While the governments typically have a primary role in the appointment of the members of the central banks_ highest decision-making bodies, it is widely agreed that certain limitations on the governments_ appointment powers increase the degree of Central bank independence. Such limitations may include, for example, a proportion of non-government appointments or the right to nominate candidates, e.g. by the state president or by the parliament (Swinburne et al., 1991, p. 31). Another safeguard is to split the responsibility of appointing and that of nominating between, for instance, the government and the state president. These requirements are also reflected in the construction of different models to measure Central bank independence (Cukierman, 1992; Grilli et al., 1991).

2.1.5 Financial Independence

Financial independence as defined by the European Monetary Institute refers to the budgetary independence of the central bank itself, i.e. the question whether it has the appropriate means to fulfill its tasks properly. Budgetary independence comprises such issues as rules on the management of the central bank's budget, ownership issues, the allocation of central bank profits and the coverage of potential losses.

One of the crucial aspects of budgetary independence is the question whether the central bank is entitled to determine its expenses and revenues autonomously or whether the approval of a government body is needed. It is widely acknowledged that financial dependence of the central bank on government institutions may be detrimental to Central Bank Independence.

3. An Evaluation of the legal Autonomy of the State Bank of Pakistan

3.1 History

Aftab Ahmed (2005) describes the efforts made by the Government of Pakistan to give autonomy to the SBP. Pakistan is no exception to have taken steps to grant independence to the central bank, it is part of a worldwide movement and is a pronouncement of present economic wisdom to conduct policies to achieve the targets. During the decade of 1990s, a number of measures have been taken to enable the State Bank of Pakistan to execute its functions independently.

The legal documents governing financial system of Pakistan include:

- State Bank of Pakistan Act 1956
- Banking Companies Ordinance, 1962 and
- Banks Nationalization Act, 1974

They have been subject to a number of changes to give exclusive authority to the State Bank for regulating the banking sector, conducting an independent monetary policy and setting limit on Government borrowings from the Bank.

Box 1: The State Bank of Pakistan Act, 1956 (Highlights)

Section 9

Functions and Responsibilities of the Central Board

9-A. The central board shall, with the view to secure stability of monetary system, -

a) Regulate and supervise monetary and credit system:

Provided that in regulating the monetary and credit system, The Central Board shall keep in view the national policy objectives of the Federal Government, including the target fixed by the Federal Government for growth, inflation and monetary aggregates

Provided further that the Governor may, in any emergency which is in his opinion requires immediate action, take measures under this clause as may be necessary in the circumstances and shall, in the next meeting of the Central Board, report to it for approval of such action;

b) Determine, in consultation with the Federal Government, the limit of credit to be extended to the Federal Government and the Provincial Government;
c) Tender advice to the Federal Government on monetary policy and its interaction with fiscal and exchange rate policy;
d) Analyze and report periodically to the Federal Government on the impact of the policies being followed on the state of the economy; and
e) Discharge such other functions as may be necessary for regulating the monetary system or maybe assigned by the Federal Government.

3.1. 1 First Amendment February 1994

A bill, passed in February 1994, amended the State Bank of Pakistan Act, 1956, in terms of which monetary policy was made the sole responsibility of the State Bank of Pakistan. More specifically, the Central Board of the Bank was given larger responsibility to regulate and supervise monetary and credit system keeping in view the national policy objectives of the Government.

3.1.2 Second Amendment January 21, 1997

The State Bank of Pakistan Act was further amended to strengthen autonomy of the Bank. According to amended **Section 9-A** of the Act, the Central Board would, in order to secure monetary stability and soundness of the financial system, formulate and monitor credit policy. This as we can see in Box 1 was earlier stated as to regulate and supervise the monetary system. In doing so the Bank would take into account the Federal Government's targets for growth, inflation and expected changes in net foreign assets of the banking system and would ensure that monetary and credit policy is conducted in a manner which was consistent with these targets. The Board would also determine and enforce, in addition to the overall expansion of liquidity, the limit of credit to be extended by the State Bank to the Federal Government, Provincial governments and other agencies of the Federal and Provincial governments for all purposes. It would also estimate the credit requirements of the private sector and would intimate the same to the Monetary and Fiscal Policies Co-ordination Board (MFPCB). More importantly, it would submit a quarterly report to the parliament on the state of the economy with special reference to economic growth, money supply and credit, balance of payments and price developments.

In terms of the amended **Section 9-B**, which describes functions of the MFPCB, it would now determine the extent of Government borrowing from commercial banks taking into account the credit requirements of the private sector and liquidity expansion as determined by the Central Board.

3.1.3 Amendments in the Banks Nationalization Act 1974 and the Banking Companies Ordinance, 1962

In terms of these amendments, the Pakistan Banking Council has been abolished, thereby making State Bank the sole agency to supervise and regulate the activities of nationalized commercial banks. The State Bank has also been given powers to institutionalize the management of banks. The chairman of a bank, who would preside over the meetings of the Board, and the president of the bank, who would be its chief executive, would be separate persons. The general direction and superintendence of the affairs and business of a bank and overall policy making in respect of its operations shall vest in its Board. The chief executive will head the operations of the bank and shall act in accordance with the policies, criteria and guidelines determined by the Board. The Government would appoint the chief executive and the members of the Board of Directors of a nationalized bank, which would now be tenured positions, from the list of duly qualified bankers to be provided by the State Bank.

The Government would appoint and remove these professionals in consultation with the State Bank. Section 41-D has been added in the Banking Companies Ordinance, 1962 which states that the State Bank may direct prosecution of a director or chief executive etc. who, in its opinion, has knowingly acted in a manner causing loss of depositors' money or of the income of the bank. It has been explained that for the purpose of this section a director or chief executive etc. would be deemed to have acted knowingly if he has departed from established banking practices or circumvented the regulations/restrictions laid down by the State Bank.

The SBP Act has been given Constitutional protection in 2003 by including it in the Sixth Schedule of the Constitution. The Governor is appointed and removed (under conditions laid down in the Act) by the President of Pakistan.

3.2 Legal Autonomy of the State Bank of Pakistan- Enacted

This paper attempts to evaluate the legal autonomy given to the State Bank of Pakistan in light of the amendments stated earlier. According to Ashraf Janjua, a former deputy governor and chief economic advisor of State Bank of Pakistan and an outstanding economist and financial expert:

> *The State Bank at present has the largest measure of autonomy in the developing world. The effective exercise of this autonomy depends on the leadership qualities, knowledge character and risk taking of the governor and secondly on his team of advisors and analysts who can thoroughly examine all policy options and advise the governor about appropriate action on policy issues.*

In order for a complete understanding of the concept behind Central Bank Independence, this paper further provides an application of the characteristics of central bank independence that are used for the evaluation of autonomy of the State Bank of Pakistan.

The qualitative data that is gathered from defining the characteristics of central bank independence in case of State Bank of Pakistan is then used in the measures as Cukierman, Webb and Neyapti measure, T. Petursson`s criteria for central bank independence and the turnover rate of the governors.

3.3 Data and Methodology

Bank researchers Alex Cukierman, Steve Webb, and Bilin Neyapti (CWN, 1992) developed four measures of central bank independence and explore their relation to inflation. One is an aggregate legal index for four decades in 72 countries. The other three are indicators of independence: the rate of turnover of central bank governors, an index based on a questionnaire answered by specialists in 23 countries, and an aggregation of the legal index and the rate of turnover.

The main findings are as follows: The more independent the central bank, the less the inflation - in industrial but not in developing countries. In the developing countries, the infrequency of change of the chief executive officer of the bank is a better proxy for central bank independence. And an index of overall central bank independence explains much of the cross-country variation in inflation.

This paper uses the measures of central Bank independence as defined by Alex Cukierman, Steve Webb, and Bilin Neyapti, taking in account the State Bank Act 1956 and the amendments made in it there after.

It is useful to mention here that a survey in Chapter IV of the World Economic Outlook, published in October 2005, presents some data in which Pakistan fared very badly in terms of this criterion and, in fact, the score was simply zero. It is surprising that the institutional independence for Pakistan was placed at zero because there is a very high degree of job security for the State Bank Governor, as well as instrument independence, so at least on these two areas State Bank of Pakistan should get some points.

3.3.1 Measures of the legal independence of central banks

Legal independence is an essential component of actual independence, but it is also appealing for other reasons. First, it indicates the degree of independence that legislators meant to confer on the central bank. Second, practically all-existing attempts at systematically characterizing central bank independence rely solely on legal aspects of independence-a difficult task that requires subjective judgment. Three measures as defined by Alex Cukierman, Steve Webb, and Bilin Neyapti are used in this paper as described below:

3.3.2 Coding legal independence

The coding of the central bank independence followed two principles. First, the authors coded only a few narrow but relatively precise legal characteristics. Second, they used only the written information from the charters.

The legal characteristics of the central bank as stated in its charter are grouped into four clusters of issues:

- The appointment, dismissal, and term of office of the chief executive officer of the bank.

- The policy formulation cluster, which concerns the resolution of conflicts between the executive branch and the central bank over monetary policy and the participation of the central bank in the budget process.
- The objectives of the central bank.
- Limitations on the ability of the central bank to lend to the public sector; such restrictions limit the volume, maturity, interest rates, and conditions for direct advances and securitized lending from the central bank to the public sector.

3.3.3 Turnover of central bank governors

This indicator is based on the presumption that, at least above some threshold, more rapid turnover of central bank governors indicates a lower level of independence. Indeed, more rapid turnover presumably creates dependence. If the political authorities frequently take the opportunity to choose a new governor, they will at least have the opportunity to pick those who will do their will. Frequent turnover may reflect the firing of those who choose to challenge the government.

Because average turnover rates for all industrial countries for 1950-89 are less than 0.2, these rates probably do not reveal much about the variations in independence within that group. Because turnover rates vary widely among the developing countries, they seem more likely to reveal variations in the independence of those governors.

3.3.4 Questionnaire on independence

The other group of indicators of central bank independence is based on responses to a questionnaire that was sent to a nonrandom sample of specialists on monetary policy in various central banks. Some questions involve the same issues that underlie the legal variables, but they focus on the practice rather than the law---for example, central bank objectives, their importance in practice, and the strictness of limitations on lending in practice.

Others refer to issues such as subsidized credits from the bank to the private sector, quantitative targets for the money stock, and the determination of the bank budget. Although the responses allow for some subjectivity, they do help to identify divergence between actual and legal independence, particularly when the divergence is large.

The questionnaires clearly indicate that central banks in developing countries are less independent than those in industrial countries. This contrasts with the findings for legal independence, where the two country groups do not differ widely, but it is similar to the finding for turnover.

3.3.5 Relationships between indexes of independence

Because there is no close correlation among the various indexes of central bank independence, they can be usefully combined to obtain a better measure of overall central bank independence. Only the correlation between the legal independence index and the questionnaire-based index of independence for the industrial countries is even marginally significant, which suggests that the law is a more important determinant of actual independence in the industrial countries

Also the criterion of Central Bank Independence by P. Thorarinn is also used in this paper as in **(Annex B)**.

3.4 Formulation and Implementation of Monetary Policy in State Bank of Pakistan

For analyzing current central bank legislation in the State Bank of Pakistan, the four-tier classification introduced by the European Monetary Institute will be applied.

Taking into account the Institutional Independence Under financial sector reforms, the State Bank of Pakistan was granted autonomy in February 1994. On 21st January 1997, this autonomy was further strengthened by issuing three Amendment Ordinances (which were approved by the Parliament in May, 1997) namely, State Bank of Pakistan Act, 1956, Banking Companies Ordinance, 1962 and Banks Nationalization Act, 1974 as mentioned earlier. The changes in the State Bank Act gave full and exclusive authority to the State Bank to regulate the banking sector, to conduct an independent monetary policy and to set limit on government borrowings from the State Bank of Pakistan. The amendments in Banks Nationalizations Act abolished the Pakistan Banking Council (an institution established to look after the affairs of NCBs) and institutionalized the process of appointment of the Chief Executives and Boards of the nationalized commercial banks (NCBs) and development finance institutions (DFIs), with the Sate Bank having a role in their appointment and removal. The amendments also increased the autonomy and accountability of the Chief Executives and the Boards of Directors of banks and DFIs.

From the aspect of personal independence, the State Bank Act 1956 should guarantee the minimum of a 3-year mandate of the State Bank governors, that the governor cannot be relieved of duty for any reason other than those specified in sub section 10 of section 10 of the Act, and that other elected director or member participating in the functioning of the State Bank shall not be removed from his office except upon a resolution passed by the Central Board in that behalf by a majority of not less than six directors.

And lastly, the financial independence implies that State Bank can freely use their funds.

Legal Monetary Objective of the State Bank of Pakistan

…to maintain monetary stability…

3.4.1 Functional Independence

(Akhtar 2006) Monetary policy of Pakistan now for some years has been largely supportive of the dual objective of promoting economic growth and price stability. It achieves this goal by targeting monetary aggregates in accordance with real GDP growth and inflation targets set by the Government.

Qualitatively monetary policy formulation and its implementation have improved substantially, benefiting from the following actions.

1. Legislative changes to the State Bank of Pakistan Act has empowered the SBP and SBP Central Board to formulate, conduct and implement its monetary policy
2. Monetary and Fiscal Board has been set up to ensure formal monetary and fiscal policy coordination and this Board is currently chaired by the Prime Minister in his capacity as Finance Minister with representation from economic ministries.
3. The *Fiscal Responsibility and Debt Limitation Act* 2005 mandates a steady reduction in revenue deficit to zero by 30th June 2008 and maintaining it thereafter, and reducing total public debt to sixty percent of GDP by 2013 and below that limit thereafter
4. State Bank of Pakistan continues to refine the institutional mechanism for monetary policy formulation and its regular review. For instance, SBP has replaced the Open Market Policy and Review Committee by the Monetary and Exchange Rate Policy Committee. This Committee meets bimonthly to establish parameters of broad monetary policy and reviews monetary and economic conditions on a regular basis and recommends changes in monetary policy instruments.
5. The Bank’s Treasury's capacity has been strengthened to manage financial markets and related activities more effectively. Proactive conduct of monetary operations and management of market volatility has helped improve market flows.

6. Additionally, being active in the Swap Market has helped SBP Treasury to mop-up/inject USD/Rupee liquidity in the money market, as and when required, thus complementing the monetary management. This has resulted in managing excessive market volatility, providing effective signals/direction to the market and to set benchmarks for the rupee inter-bank market in line with the monetary policy stance. Consequently, O/N Rates now move within a 100bp – 150bp range compared to previous trends when it fluctuated between zero to 9.0%.

3.4.2 Institutional Independence

Institutional independence implies the autonomous defining of monetary policy instruments by State Bank. The State Bank of Pakistan is responsible to regulate the monetary and credit system of the country in such a manner that ensures monetary stability in the economy. **Section 9-A** of SBP Act, 1956 entrusts the Central Board of the Bank to formulate and monitor monetary and credit policy by taking into account the Federal Government's targets for growth and inflation, in accordance with the recommendation of the Monetary and Fiscal Policies Co-ordination Board (MFPCB). The State Bank has a number of instruments at its disposal to regulate the volume of credit and to ensure its flow to the priority sectors. In terms of the amended **Section 9-B**, which describes functions of the MFPCB, it would now determine the extent of Government borrowing from commercial banks taking into account the credit requirements of the private sector and liquidity expansion as determined by the Central Board. Amended **Section 46-B** prescribes that no governmental or quasi governmental body or agency shall issue any directive, directly or indirectly, to any banking company or any other financial institution regulated by the Bank which is inconsistent with the policies, regulations and directives issued by the Bank pursuant to this Act, the Banking Companies Ordinance, 1962 or any other law in force.

These sections provide institutional independence to the SBP; it can formulate and monitor the monetary and credit policy, determine the extent of government borrowing and refuse any directives coming from the institutions and the bodies of the governments, quasi-governmental body or agency.

3.4.3 Personal Independence

Personal central bank independence relates to the role, the status, and the composition of the management, i.e. the process of appointment, dismissal, mandate duration, and the possibility of re-electing its members.

Board of Directors

The general superintendence and direction of the affairs and business of the Bank have been entrusted to the Central Board of Directors consisting of the Governor (Chairman), Secretary Finance Division, Government of Pakistan, and seven directors, including one director from each province, to be nominated by the Federal Government ensuring representation to agriculture, banking and industrial sectors. The Board exercises all the powers and does all acts and things that may be exercised or done by the Bank and are not, by the SBP Act, 1956 expressly directed or required to be done by the Bank in general meeting or in annual general meeting. All decisions of the Central Board are taken by majority of members present and voting. In case of equality of votes, the Governor may exercise a casting vote. Deputy Governors of the Bank may also attend the meeting of the Board, if required, but they do not have the right to vote.

Management

The management of the Bank consists of a Governor, one or more Deputy Governors, Executive Directors, Economic Advisor, and Directors of various departments. The Governor is the Chief Executive Officer and directs and controls the whole affairs of the Bank on behalf the Central Board. The President of Pakistan appoints the Governor for a term of three years. A Governor is eligible for re-appointment for another term of three years. The Federal

Government appoints Deputy Governors for such a period (not exceeding five years) and on such salary and such terms and conditions of service as it may determine. Presently the Bank is benefiting from the services of two Deputy Governors (DGs). Deputy Governors are assisted by Executive Directors (ED) and Economic Advisor. Each ED and EA looks after the affairs of one or more department(s). Each department is headed by a Director. A sketch of the Bank management is given in **Annex D**.

Table 1 - Personal Independence of the State Bank of Pakistan

<table>
<tr><th colspan="2">Governor</th></tr>
<tr><th>Mandate term</th><th>Appointment</th></tr>
<tr><td>3 years, eligible for reappointment (Section 10)</td><td>The president of Pakistan appoints the Governor (Section 10)</td></tr>
<tr><th colspan="2">Central Board</th></tr>
<tr><th>Composition and term</th><th>Appointment</th></tr>
<tr><td>The governor, secretary Finance Division GOP, seven directors, one director from each province ensuring representation to agricultural, banking and industrial sectors. (Section 9-1)</td><td>Nomination is done by the Federal Government (Section 9-1)</td></tr>
<tr><th colspan="2">Qualification and disqualification of Directors and Members</th></tr>
<tr><td colspan="2">…Member of central or provincial legislature, salaried government official, credit defaulter, lunatic, officer or employee of a bank, director of a bank other than a bank under Cooperative Societies Act, 1912, absent from three consecutive meetings of the central board…(Section 13-1)</td></tr>
<tr><th colspan="2">Removal from Office</th></tr>
<tr><td colspan="2">Permanently incapable of performing his/her duties, Member of central or provincial legislature, employed in public service of Pakistan, or any province of Pakistan, who is director, officer, and employee of any bank or financial concern. (Section 15)</td></tr>
</table>

3.4.4 Financial Independence

Although a central bank must have complete functional, institutional, and personal independence, their overall independence will be jeopardized if they are not able to create their own financial sources sufficient for the performing of their function. The concept of financial independence should be viewed as whether a third party may, directly or indirectly, influence not only central bank functions, but also their ability to create financial resources sufficient for performing their functions. Therefore, this paper observes the following two aspects in case of SBP:

- **Accounting rules**

The publication of consolidated statement by the SBP will be done as and when directed by the Federal Government **(Section 39)**. Not less then two auditors are elected which may be shareholders but not directors of the bank **(Section 43)**. Also without prejudice to anything containing in section 43, the government may also at any time appoint Auditor- General to examine and report upon the accounts of the bank **(Section 44)**.

- **Allocation of Surplus**

After making provision for bad and doubtful debts, depreciation in assets, contributions to staff and superannuation funds, contingencies, the shareholders will receive a dividend out of the net annual profits at rate fixed by the Federal Government from time to time. Any surplus remaining thereafter shall be paid to the Federal Government **(Section 42)**.

Table 2 - Financial Independence of the State Bank of Pakistan

Who is the owner of the Bank
Not less than 50% is held by the Federal Government and the rest by the public **(Section 4)**
Coverage of Net loss
Not defined in the State Bank Act 1956
Lending to the Government- Direct
MFPCB would determine the extent of Government borrowing from commercial banks taking into account the credit requirements of the private sector and liquidity expansion as determined by the Central Board **(Section 9-B)**.
Lending to the government- Indirect
The purchase and sale of securities of the Federal Government or a Provincial Government of any maturity or such securities of a local authority as maybe specified in this behalf by the Federal Government by notification in the Official Gazette on the recommendation of the Central Board **(Subsection 10 of Section 17)**

4. Turnover Rate of Governors of State Bank of Pakistan

Vlahovic and Cerovic (2005) The turnover rate of central bank governors is used as the indicator of actual central bank independence, and it is defined as the average term of office of a central bank governor (calculated as the relation between in the observed period and the duration of the observed period). For example, if in one country, 4 central bank governors were replaced in the period of 12 years and 9 months, the turnover rate of central bank governors would be 0.31 (4/12,75). Cukierman has defined the upper limit of turnover rate of governors between 0.2 and 0.24, the situation when governors change every 4 to 5 years, which again corresponds to the appointment cycle in many countries. In addition, Cukierman believes that an extremely low turnover rate of governors does not reflect a high level of central bank independence, but may point to the fact that a governor is willing to do whatever the government asks of him.

Calculation for the Turnover Rate of the Governors
Total Period Observed – 1948 to 2005 = 57 years **No of State Bank Governors = 13 SBP Governors** **Turnover Rate of Governors- 13/57 = 0.23**

A frequent turnover of governors points to lower central bank independence since it means that a government replaces a governor that does not fulfill its requests, or if it finds a better governor who can meet its requirements and aims. Also, a shorter term of office may harm central banks by preventing the existence of a longer policy strategy, making them less interested in achieving a good reputation. However, it has not always proved to be correct that a lower turnover rate of governors implies greater central bank independence because if a government finds a governor that fulfils all its requests, it will want to keep him/her in this position as long as possible, which points to central bank dependence.

As stated earlier, in SBP the President of Pakistan appoints the Governor for a term of three years. A Governor is eligible for re-appointment for another term of three years. The turnover rate of Governors is calculated to be 0.23, which is a satisfactory. Most of the governors had been appointed for more than 3 years, this could be seen as a sign of central bank dependence, where the government is complacent with the governors as he/she satisfies all its requests.

5. Measuring State Bank of Pakistan Independence using the criteria presented in the paper

5.1 State Bank of Pakistan independence according to T. Petursson`s criteria for central bank independence (Annex B)

Table 4 - T. Petursson`s criteria for central bank independence

Criterion	Weight	Scores	Total
The extent to which statutory objectives provide the central bank with a clear focus on price stability	1	0	0
The extent to which the central bank determines the setting of policy targets	1	5	5
The extent to which the central bank determines the adjustment of monetary policy instruments	2	3.3	6.6
The extent to which treasury funding through he central bank is prohibited	2	5	10
The length of the governor's term of office	0.5	5.7	2.85*
TOTAL			**24.45**

* On average the term of office held by the Governors has been 5 years and hence is taken for the calculations.

According to the aforementioned criteria, central bank independence is rated on a scale from 0.7 to 65, so the SBP Independence of 24.45 can be rated as on the low.

5.2 State Bank of Pakistan independence based on responses to the questionnaire on independence

The questionnaire in **Annex A** contains the desired answers to obtaining the maximum score for central bank independence.

For the first part of the questionnaire, it has been observed through the State Bank Act 1956 and later amended Section 9-A that SBP now solely decides on the monetary policy. This is done in accordance to the Federal Government's targets for growth, inflation and expected changes in net foreign assets of the banking system and also ensures that monetary and credit policy is conducted in a manner, which is consistent with these targets. Price stability in nowhere stated separately as an objective but is assumed to be part of the stability of the overall monetary system.

Secondly, the government makes the appointments and to more precisely state it, the appointment of the SBP Governor is made by the President of Pakistan. Legislation does include provisions for the dismissal of the Governor and the legal term of the appointment is three years, which is less than the term of an elected government if the elected government of Pakistan is able completes its tenure.

Thirdly in terms of legislation and tradition, the State Bank Act 1956 as stated earlier was amended to give the central bank more autonomy.

Fourthly, the banking sector of Pakistan is entrusted to the SBP. According to the Amendments in the Banks Nationalization Act 1974 and the Banking Companies Ordinance, 1962**,** the Pakistan Banking Council has been abolished, thereby making State Bank the sole agency to supervise and regulate the activities of nationalized commercial banks. The State Bank has also been given powers to institutionalize the management of banks.

Lastly, in terms of the lending made to the Government, SBP according to amended Section 9-A can set a limit of credit extended to the government.

5.3 State Bank of Pakistan independence according to Cukierman

According to Cukierman coding of CB independence **(Annex C)**, the SBP's independence is moderate, amounting to 0.693 (on the scale from 0 to 1).

6. Conclusion and Recommendations

A central bank is the most significant financial institution in every sovereign independent state and constitutes the apex of its monetary and banking structure. The legal relationship between the State Bank of Pakistan and the government has been discussed extensively in this paper. Without legal independence, central banks cannot ensure an effective defense against the devaluation of the currency. Inflation has always been a monetary phenomena and that inflation cannot for long persist without monetary nourishment. The legal autonomy is only for the purpose of protecting the management of central bank's operations from the political side of the government and to ensure that the central bank can act as impediment to the misuse of monetary instrument.

The State Bank was given a measure of autonomy through legislative acts approved in early 1994.The Central Board of State Bank of Pakistan was then authorized to determine for the first time, government borrowings from the banking system, although it's authority was diluted by the creation of Monetary and Fiscal Coordination Board and by the condition for the Central Board to consult with the Federal Government in the matter. The government's role in the credit policy for the private sector was reduced and the Central Board of State Bank of Pakistan became the final decision-making body in the matter of credit policy.

It is worthwhile to mention that after the promulgation of the three ordinances pertaining to the financial sector reforms, the State Bank's authority and autonomy has been substantially enhanced. The State Bank, no doubt, formulates its monetary and credit policy after taking into account targets set by the federal government for growth, inflation and revenue generation.

Among the measure used in the paper to calculate the legal independence of SBP, the most widely used in Cukierman, Steve Webb, and Bilin Neyapti, this measure in numerous research has reported that among developing countries, the legal Central Bank index of Cukierman, Steve Webb, and Bilin Neyapti is not correlated with inflation, but the Turnover rate is significantly related to inflation. From the findings of this paper, SBP has had moderate Turnover rate but Pakistan has experienced high inflation in this time.

With the financial sectors reforms, although the State Bank of Pakistan has been given considerable autonomy then it had before but still there is room for more improvement in regards to giving State Bank of Pakistan legal independence.

An improvement that can be made in regards to personal independence is that the government should define the qualifications of a governor and propose his/her name to Parliament in the same way that the US president does with regard to the nomination of the Federal Reserve Board chairman. The nominee can then be questioned about how he/she will conduct monetary policy; his/her views on the important monetary matters, and in the end the parliament will then confirm the nominee (or not). The same procedure then should apply to the tenure of the governor. It should be for a fixed term and he/she should not be removed before tenure ends without the vote of Parliament.

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Annex A Central Bank Independence Index and Coding Technique

A) OBJECTIVES AND POLICY FORMULATION

a. Is the price stability the major and/ or only objective of the Central Bank? **X**
b. Has there been any Government interference in formulation of the monetary policy within the last 5 years?
c. Is there any Government or political control of the Central Bank's budget?

B) APPOINTMENTS

a. Is the Central Bank Governor appointed by the Government?
b. Is there legislative provision for dismissal of the Governor?
c. Can the Central Bank Governor hold governmental or political office?
d. Does the Central Bank Governor's term of office exceed the maximum term of the Government? **X**
e. Does the Central Bank's Board office exceed the maximum term of the Government?
f. Are there any appointments to the Central Bank Board made by the Government?
g. Are there any Government representatives attending Central Bank Board meetings with/without voting/veto rights?
h. Does the Government consult (e.g. nominate candidates) the bodies appointing the Governor and the Central Bank Board?
i. Have there been any non-completions of the Central Bank Governor(s) term of office within the last ten years?

C) LEGISLATION AND TRADITION

a. Has the Central Bank legislation been changed within the last 5 years (if yes, which year)
b. Has the Central Bank legislation been breached within the last 5 years?
c. Are there any `other laws` (in the country) that conflict with the Central Bank Constitution (evidence of breaching the Central Bank Charter within the last 5 years)
d. Are there traditions that interfere with the Central Bank Charter (e.g. Central Bank Governor or/ and Board Members resigning with change of Government)?
e. Are there provisions, which strengthen the Central Bank's position in case of conflict with the Government? **X**

D) THE BANKING SECTOR

a. Is the banking supervision entrusted to the Central Bank?
b. Is the banking supervision entrusted to the Central Bank alone? **X**
c. Has there been Government or political interference in fulfilling /not fulfilling the `Lender-of-last-resort` function of the Central Bank for the last 5 years?

E) FINANCIANG THE GOVERNMENT

a. Are advances permitted when financing the Government?
b. Are terms of lending controlled by the Central Bank or Bank charter when financing the Government? **X**
c. Does the Central Bank participate on the primary market for public debt?
Overall Central Bank Independence **1.00**

Annex B: Criteria for central bank independence according to Peturson G. Thorarinn

Criterion (weight in total score)	Scores	
The extent to which statutory objectives provide the central bank with a clear focus on price stability (1)	10.0	Only goal is price stability
	7.5	Sole goal together with financial stability and non-conflicting monetary stability objectives
	5.0	Price stability and incompatible goals
	2.5	No formal goals
	0.0	Other goals than price stability
The extent to which the central bank determines the setting of policy targets (1)	10.0	Central bank decides alone or monetary policy has no explicit goals
	5.0	Joint decisions of central bank and government
	0.0	Central bank has no role in decisions
The extent to which the central bank determines the adjustment of monetary policy instruments (2	10.0	Central bank decides alone
	6.7	Central bank decides alone but a government representative attends decision meetings as an observer
	3.3	Central bank and government have a role in decisions
	0.0	Central bank role in decisions is limited
The extent to which treasury funding through the central bank is prohibited (2)	10.0	Prohibited, never used or negligible sums involved
	7.5	Narrow, well enforced limits exist
	5.0	Limits exist that are usually enforced
	2.5	Wide limits exist
	0.0	No limits or little enforcement
The length of the governor's term of office (0.5)	10.0	8 years or above
	8.6	7 years
	7.1	6 years
	5.7	5 years
	4.3	4 years
	2.9	3 years
	1.4	Term of office beyond 3 years not guaranteed

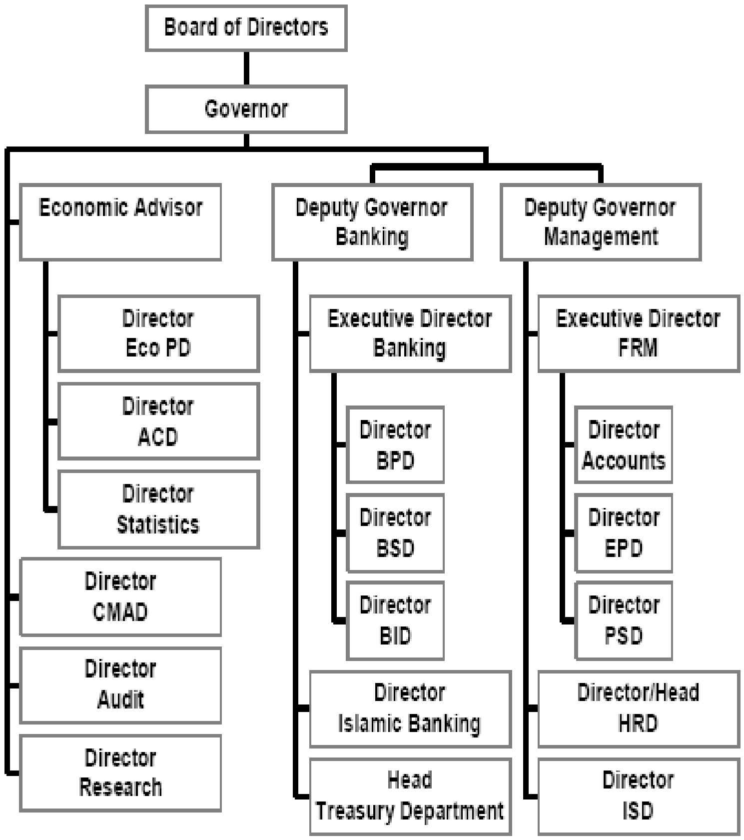
Annex C Central Bank Independence according to Cukierman

Definition of variable	Weight	Numerical coding
1. CEO	**0.20**	
a) Term of office of CEO in years		
Over 8 years		1
6 - 8 years		0.75
5 years		0.50
4 years		0.25
Less than 4 years		0
b) Appointment		
By CB Board		1
By CB Council		0.75
By executive branch (council of ministers)		0.50
By legislative branch (Congress, king)		0.25
Through decision of one or two members of executive branch (e.g. prime minister or minister of finance)		0
c) Dismissal		
No provisions		1
Possible only for non-policy reasons		0.83
Possible and at discretion of CB Board		0.67
For policy reasons at executive branch's discretion		0.17
Unconditional dismissal possible at legislative branch's discretion		0.33
d) Is CEO allowed to hold another office?		
Prohibited by law		1
Prohibited unless authorized by the executive branch 0.50		0.50
Not prohibited		0
2. POLICY FORMULATIONS	**0.15**	
a) Who formulates monetary policy?		
Central Bank alone		1
Central Bank participates together with government		0.66
Central Bank participates in an advisory capacity		0.33
Government alone		0.00
b) Who has the final authority in resolution of conflicts?		

Central Bank, over issues clearly defined in the law as CB goals		1
Government, only over policy issues not clearly defined as CB goals or in case of conflict within the Central Bank		0.80
CB Council whose members are from CB, legislative branch, and executive branch		0.60
Legislative branch on policy issues		0.40
Executive branch on policy issues, but subject to due process and possible protest by CB		0.20
Executive branch has an unconditional authority		0
c) Is CB given an active role in the formulation of government's budget?		
Yes		1
No		0
3. OBJECTIVES	**0.15**	
Price stability is the only/major goal and the CB has the final authority in case of conflict with government		1
Price stability is the only goal		0.80
Price stability mentioned along with other objectives that do not seem to conflict with price stability		0.60
Price stability mentioned with a number of potentially conflicting goals		0.40
CB charter does not contain any objectives from CB		0.20
Some goals appear in the charter, but price stability is not one of them		0
4. LIMITATIONS ON LENDING		
a) Advances	0.15	
Prohibited		1
Permitted, but subject to strict limits (e.g. 15% of government revenues)		0.66
Permitted, subject to relatively accommodative limits (over 15% of government revenues)		0.33
No legal limits on advances		0
b) Securitized lending	0.10	
Prohibited		1
Permitted, but subject to strict limits (e.g. 15% of government revenues)		0.66
Permitted, subject to relatively accommodative limits (over 15% of government revenues)		0.33

No legal limits on lending		0
c) Terms of lending (interest, maturity)	0.10	
CB controls the terms		1.00
Specified in CB charter		0.66
Agreement between CB and government		0.33
Government controls the terms		0
d) Potential borrowers from CB	0.05	
Only central government		1
Central and state governments and all political subdivisions		0.66
All the above and to public enterprises		0.33
All the above and to the private sector		0
e) Type of limits of CB lending specified as	0.025	
An absolute cash amount 1		1
As a percentage of CB capital or other liabilities		0.66
As a percentage of government revenues		0.33
As a percentage of government expenditures		0
f) Maturity of loans	0.025	
Maximum of 6 months		1
Maximum of one year		0.66
Maximum of more than one year		0.33
No legal upper bounds on the maturity		0.00
g) Restrictions on interest rates on CB loans	0.025	
At market rate		1.00
To government – cannot be lower than a certain floor		0.75
Cannot exceed a certain ceiling		0.50
No explicit legal provisions		0.25
No interest charged on government's borrowing		0
h) Prohibition on lending in primary market	0.025	
CB prohibited from buying government securities in primary market		1
CB not prohibited from buying government securities in primary market		0

Annex D Organization Chart of State Bank of Pakistan



Annex E - Governors of State Bank of Pakistan

1. MR. Zahid Hussain	10-06-1948 TO 19-07-1953
2. MR. Abdul Qadir	20-07-1953 TO 19-07-1960
3. MR. S.A. Hasnie,	20-07-1960 TO 19-07-1967
4. MR. Mahburur Rashid	20-07-1967 TO 01-07-1971
5. MR. S.U. Durrani	01-07-1971 TO 22-12-1971
6. MR. Ghulam Ishaq Khan	22-12-1971 TO 30-11-1975
7. MR. S. Osman Ali	01-12-1975 TO 01-07-1978
8. MR. A.G.N. Kazi	15-07-1978 TO 09-07-1986
9. MR. V.A. Jafarey	10-07-1986 TO 16-08-1988
10. MR. I.A. Hanfi	• First Term 17-08-1988 TO 02-09-1989 • Second Term 01-09-1990 TO 30-06-1993
11. MR. Kassim Parekh	05-09-1989 TO 30-08-1990
12. DR. Muhammad Yaqub	25-07-1993 TO 25-11-1999
13. Dr. Ishrat Husain	02-12-1999 TO 01-12-2005
14. Dr. Shamshad Akhtar	02-01-2006 - Present