Merits and Challenges of Central Bank Independence: Case of Banque du Liban

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Table of Contents

I. Introduction

Ladies and Gentlemen,

It is a pleasure to address such a distinguished audience with a topic that has been glazing for the past three decades under the ashes of financial crises and economic turbulences, i.e: central bank independence (CBI).

"Monetary policy might be the football of political manipulation". Those were the words uttered by Milton Friedman back in 1962, as one of the very first signals pointing to the significance of the notion of CBI vis-à-vis the intervention of the political establishment.

The trend towards a more independent, transparent, and accountable central bank is empirically observed and largely supported by modern monetary policy, in the aftermath of the global financial crisis. Different approaches imply that central banks, being independent from the government, are not compelled to implement inflexible rules in order to reduce the inflation bias. However, monetary theory does not conclude that the mere establishment of an independent central bank prompts an improvement in social welfare.[i] The recent financial crisis, accompanied with the financial manifestations of the fourth industrial revolution, has inflicted certain challenges pertaining to financial stability regarding systemic risks that have to be dealt with in order to actualize the merits of CBI.

In my talk today, I will start by introducing general notions about the purpose of regulatory independence in general. Then I will highlight some facts about the evolution and assessment of CBI. I will also outline some of the merits embedded in the CBI in addition to challenges confronted, on the global and regional levels. Finally, I will shed a light on significant practices that involve governance and independence at Banque du Liban (BDL).

II. Purpose of Regulatory Independence

In order to fully understand the significance of CBI, it is crucial to comprehend the fundamental purpose of regulatory independence in general. The 4th meeting of the OECD Network of Economic Regulators (NER) held a round table in 2015, where NER members discussed the rationale, practical implications, and impact of independence on regulated sectors. In summary, the discussion highlighted the following significant implications:[ii]

- "*Rationale*: There is value in separating some of the regulatory functions, especially those related to administering regulation, from the policy-setting and fiscal policy functions that are exercised by government. Regulation is expected to mitigate market failures at minimum cost. Independence of regulatory agencies can enhance the role of regulation in minimizing market failures, by enabling regulatory agencies to address the following downsides:
    - Lack of commitment, time inconsistency[1] and political uncertainty;

[1] A situation in which a decision-maker's preferences vary over time in such a way that they become inconsistent at another point in time is known as time inconsistency. In terms of economics, inflationary bias can be caused by the time inconsistency of monetary policy

- Lack of competitive neutrality ensuring a level-playing field for all operators… without undue preferential treatment linked to state ownership of certain market actors;
- Information and expertise asymmetries" through promoting meritocracy, professionalism, and expertise in taking decisions. Moreover, "an independent regulator might be more inclined to consult a broader spectrum of the population to get a diversity of opinions before making any regulatory decisions."

- *"Long-term regulatory stability*: regulators can help align the interests of users and, more broadly, citizens and society with the interests of investors in key sectors. Independence from the executive government can shield regulators from short-term party politics and assist in the creation of a stable and reliable regulatory environment that encourages long-term investment. Protecting regulators from "undue" executive influence can boost investor confidence, but it's also critical that regulators do not succumb to "undue" influence from the regulated industry or be swayed by narrow interests articulated by consumer groups, especially when consulting on regulatory decisions."

- *"Role clarity and accountability*: independence does not mean that regulators will work in a vacuum, without appropriate checks on their work or disconnected from executive government's decisions. Independence is hard to realize if the roles and respective responsibilities of the executive government and regulators are unclear and ill-defined… Setting clear and transparent boundaries on who does what and which institution can be held accountable is essential to guarantee independence of regulatory agencies and make them accountable for what they do."

- *"Changes*: independence is not a static given. In such a dynamic institutional and economic environment, a deeper understanding of the practical implications of independence and how to realize it is paramount, not only for regulators but also for executive governments and other stakeholders", including regulated sectors.

- *"Determinants*: Academics have developed a number of indices to measure and assess the drivers of independence:
  - Budget independence;
  - Conditions for dismissal of the head of the regulatory agency;
  - Appointment of members/head of the regulatory agency by parliament or the legislature;
  - Accountability and reporting to executive, legislature, or representatives from regulated industry;
  - Power to set tariffs or price-setting; and
  - Power to examine or approve contract terms between regulated bodies or market participants.

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making. This is due to the fact that policymakers lack credibility, i.e. they have an incentive to break their vow made today to keep inflation low. As people are more aware of this temptation, their inflation expectations are higher, resulting in higher inflation with no increase in employment or productivity. (Haan, J. and Eijffinger, S., 2017. *Central Bank Independence under Threat?* Center for Economic Policy Research)

- *"Outcomes*: Independence is a tool towards more effective outcomes – and not an end in itself. Some econometric studies have used independence as an explanatory variable to investigate the determinants of, among others: efficiency and performance in the regulated sector; infrastructure quality and coverage in the sector; or consumer prices. At the micro-economic level, revenue stability and investor certainty (rather than predictability) are viewed as important elements which regulators can bring to markets."

To sum up, regulatory independence serves to mitigate market failures while ensuring stability and consistency between the interests of citizens and investors. This role should be implemented with diligent accountability and based on clear determinants in order to face the changing environment effectively and efficiently.

III. Evolution and Assessment of Central Bank Independence

Evolution

Although the first central banks were government-owned institutions, they gradually integrated functions that transformed them into the bank of the banks of the 20th century.[iii] Inflation rates in the 1970s and early 1980s were historically high and volatile, prompting a rethinking of monetary policy and central bank practices, of which the Volker disinflation was a landmark. Two global trends have evolved since then: the adoption of improved monetary policy techniques and the abolition of high inflation rates. A comprehensive strengthening of CBI, increased transparency, and the confirmation of price stability as a statutory goal for monetary policy are among the improved policy practices.[iv] Hence, starting from 1990s, CBI became crucial to policy making and central banking practices due to the emerging economic, political, institutional, and budgetary autonomy[2] of the central bank.[v]

The 1990s and the beginning of the new millennium were characterized by intensive collective global endeavors aiming at enhancing corporate and central bank governance, which encloses the principle of independence. Prominently, these included the IMF Code of Good Practices on Transparency in Monetary and Financial Policies in 1999; the BCBS Principles for Enhancing Corporate Governance for Banking Institutions (1999, 2006, 2010), followed by similar guidelines for insurance and deposit insurers IAIS (2003, 2011, 2012); the introduction of the IMF Safeguard Assessment for central banks in 2000; the Central Bank Governance Forum established by the Bank of International Settlement (BIS) in 2005; the OECD's Guidelines on Corporate Governance of State-Owned Enterprises (2005) and the G20/OECD Principles of Corporate Governance that were updated in 2015; the International Association of Deposit Insurers in 2009.[vi] [vii]

Even before the financial crisis has altered the balance sheets of central banks and augmented the types of risks they need to mitigate, some have been

[2] According to IMF literature, *autonomy* is sometimes preferred to the frequently used term *independence*, as autonomy entails operational freedom, while independence indicates a lack of institutional constraints.

initially keen on moving towards a new governance structure where "objectives, tasks, and functions delegated to the central bank are achieved effectively and efficiently. It is now generally accepted that central banks should have clearly defined and prioritized objectives; be given sufficient authority and autonomy to achieve their objectives, tasks, and functions; and be held accountable to ensure checks and balances".[viii] Such a formulation embodies the trinity of central bank governance enclosing transparency, independence, and accountability. Making a central bank independent limits the government's ability to intervene in monetary policy; while this independence requires counter-factors to enhance and retain the central bank's credibility which are transparency and accountability. Thus, making the central bank accountable and transparent imposes a constraint on how it exercises this independence and requires disclosure practices.[ix] The temporary trend of literature that discusses central banking is the delegation of the monetary policy tasks to a bureaucracy that is independent of both politicians and the industry sector, and thus accountable to parliament, the media, and the general public for the performance of its functions.[x]

The number of central banks with a high degree of independence has progressively expanded in recent years, and the experience of a few big central banks confirms the relevance of that independence (Bank of England, European Central Bank, Bank of Japan, Federal Reserve).[xi] The most thorough increase in all dimensions of independence has been seen in developing and emerging market economies, each according to its initial conditions.[3] In particular, more democratic countries, countries with higher starting inflation, countries with initially less independent central banks, and countries with initially less flexible exchange rate arrangements have all seen the most reform.[xii] On the other hand, the independence of these central banks has not been unambiguously accepted, but rather came at the price of increased transparency and accountability. Cases are the European Central Bank's transparency and accountability practices relating to its Quantitative Easing policy[4] [xiii], the ongoing discussion on increasing oversight of the Bank of England[xiv], and the campaigns rallying for more transparency of the Federal Reserve under the bipartisan slogan "Audit the Fed"[xv].

Assessment

The first CBI indices were basically constructed for evaluating the degree of de jure[5] CBI. Overall, the ratings for each central bank in the world are based on 27 distinct metrics that use both quantitative and qualitative criteria.[xvi]

Cukierman (1992) and Cukierman et al. (1992) created the most complex central bank de jure independence indices – LVAU and LVAW[6] – which viewed

[3] Prominent cases include Malaysia, Armenia, Azerbaijan, Turkey, Yemen, Hungary, Romania, and Estonia. (N., Dincer and Eichengreen, B., 2014. *Central Bank Transparency and Independence: Updates and New Measures*. International Journal of Central Banking, March, 2014.)

[4] Review Transparency International EU report, titled *Two Sides of the Same Coin: Independence and Accountability of the European Central Bank*, dated 2017.

[5] De jure means a state of affairs that is in accordance with law.

[6] LVAU: Legal Variables–Unweighted; LVAW: Legal Variables–Weighted.

CBI as a crucial factor that can contribute to a lasting reduction in inflation. These indices compare 68 developed and developing nations on CBI criteria such as personal independence, monetary policy objective, monetary policy decision-making process, and budgetary independence. In order to compensate for the gap between de jure and de facto[7] CBI, Cukierman (1992) and Cukierman & Webb (1995) created indices based on real central bank practices (Turn Over Rate of the Governor and Political Vulnerability of Governor), aiming at acquiring more accurate evaluations for actual CBI practices.[xvii]

As for evaluating the relation between monetary policy and political intervention, Kydland and Prescott (1977) and Barro and Gordon (1983) investigated how time inconsistency issues and political pressures skewed the monetary authority's incentives under various institutional configurations. Moreover, Grilli et al. (1991) created a CBI index that combined the two components of political independence (goal independence) and economic independence (instrument independence).[8] They defined political independence as the freedom to choose policy objectives independently, without any governmental intervention. Economic independence is described as the freedom to deploy monetary policy instruments without restrictions, such as the extent to which a central bank is needed to finance government deficit.

Recently, Ueda and Valencia (2012) studied macro-prudential regulation and monetary policy interactions, finding that a non-independent macro-prudential regulator operating with an independent monetary authority produced better results than a non-independent central bank with a dual mandate of price and financial stability. Other studies broadened the dimension of CBI. In the case of a sample of 69 nations, Hielscher and Markwardt (2012) discovered evidence that more central bank autonomy requires two criteria to generate improved inflation performance: a considerable change in independence and a high quality of political institutions. In a similar vein, Hayat and Farvaque (2012) concluded that inflation performance alone was insufficient to explain people's preference for an independent central bank. Gender, employment status, education level, income quartiles, information extent, and civic issues were discovered to be particularly important. Dincer and Eichengreen (2014) found that many countries have witnessed an increase in CBI. They generated a highly comprehensive measure of CBI, labelled as Central Bank Independence Weighted (CBIW)), which is based on five metrics: political transparency, economic transparency, procedural transparency, policy transparency, and operational transparency.[xviii]

A study based on a large dataset on de jure CBI, which included annual data from 182 countries between 1970 and 2012, found that different samples provide varied perspectives of the worldwide dynamics of CBI and central bank reform. Other aspects, such as regime type or rule of law, must, naturally,

[7] De facto means a state of affairs that is true in reality but not formally sanctioned.

[8] In a democratic society, goal independence – the power of the central bank to define its own goals – is difficult to justify, but instrument independence – the ability of the central bank to determine the optimal monetary policy settings without interference – is critical for economic stability. (Bernanke, B., 2010)

be considered in order to fully comprehend the consequences of CBI in various countries. Thus, CBI is rarely the result of merely monetary logics, and it may also entail other political domestic factors, such as presidential authority, institutional barriers to reform, implementation hurdles, or policy diffusion.[xix]

From the end of the Bretton Woods system until 2010, Bodea and Hicks (2015) have expanded the Cukierman et al. (1992) index of CBI for 78 nations. The outcome includes annual independence codes as well as legislation changes in the last twenty-five years. Accordingly, the average level of legal CBI for numerous groups of nations has not decreased since the commencement of the financial crisis.[xx]

Legal CBI before and after the Global Financial Crisis

IMF-Aggregate	1995-2007	2008-2010
Advanced economies	0.57	0.59
Commonwealth of Independent States	0.6	0.7
Emerging and Developing Asia	0.46	0.59
Emerging and Developing Europe	0.67	0.83
Latin America and the Caribbean	0.63	0.66
Sub-Saharan Africa	0.41	0.42

Source: Haan, J. and Eijffinger, S., 2017

According to Ramlall's ratings methodology, overall, 27 distinct metrics are employed to produce a holistic ratings assessment for each central bank in the world using both quantitative and qualitative criteria. CBI is here within endorsed as one of these metrics.[xxi]

Finally, the impact of the relationship between the rule of law and legal CBI on price stability was explored in an empirical study, employing a panel dataset covering 182 countries over the period from 1970 to 2013. The results show that the impact of legal CBI on price stability is influenced by the strength of the rule of law, with no effect when the rule of law is weak. The findings also demonstrate that whereas 67% of advanced countries have a strong enough rule of law to maintain price stability by raising CBI, only 4.5% of developing countries do.[xxii]

Despite the fact that CBI indicators are all supposed to assess the same phenomenon and are all based on interpretations of active central bank laws, their correlation might be quite low.[xxiii]

Based on the aforementioned, CBI assessment has been subject to evolution itself. In the course of assessing CBI, it is crucial to distinguish between legal-based and factual CBI, the former having more credibility in advanced countries while the latter having more significance in developing countries. Moreover, political independence and economic independence of central banks should be considered distinctively since broad policy-making is mainly determined by the political authorities in democratic countries while central banks are left to regulate economic-monetary practices. Political domestic dynamics and the rule of law are also stressed as prerequisites that determine the span of CBI benefits. Hence, the more democratic and institutionalized the political system is, the greater the CBI benefits reaped.

IV. Central Bank Independence: Merits and Challenges

The rationale behind central bank independence is sometimes misinterpreted, which often leads political authorities, especially in the developing and emerging countries, to miss the full potential of its importance and significance. In order to avoid the pitfalls of such interpretation, political authorities ought to be aware that because central banks are part of the government, especially in emerging and developing countries, central bank independence does not entail, literally, independence from the government. In practice, the relationship between the government and central banks is more complex than the independence word suggests.[xxiv] CBI, more elaborately expressed, is the autonomy of a central bank from the undue intervention of political authorities in the exercise of its policy-making, and the rectification of any subsequent perception of such intervention, on the economic, monetary, instrumental, operational, regulatory/supervisory, and governance levels, in accordance with and in service to the broad national strategies of the political establishment.

It is, hence, crucial to distinguish between CBI on the monetary policy and the financial stability/regulatory levels. On the first level, CBI entails having a wide scope in policy and decision making, implementing measures, and introducing initiatives in the operational framework of monetary policy as for objectives, instruments, and transmission mechanisms, both on the conventional and unconventional perspectives. On the second level, pertaining to financial stability/regulation, CBI covers macroprudential and microprudential supervisory policies and regulations.

On the Global Level

a. Merits

In the context of attaining the optimal paybacks of CBI, certain merits on the global scale can be highlighted:

First, *CBI enables central banks to lead by* example. In order for CBI to realize its strategic objectives, it should be complemented by transparency and accountability in order. This is crucial for the central banks' quest to be leaders, not laggards, who constitute a role model through promoting international best practice recommendations and implementing robust governance principles.[xxv]

Second, *CBI integrates central bank transparency and accountability*. Again, the increased independence should be naturally offset by greater transparency of decision-making and accountability with respect to monetary policy, financial stability, and the resource management, to remain politically acceptable. As a result, the importance of improved financial disclosure, risk management, and financial management processes within central banks has increased. The central bank can demonstrate its stewardship of the resources given to it and the efficiency with which it discharges its functions through transparent reporting of its operations, and hence it can be eventually held accountable for any inefficient management. This can help to strengthen the central bank's credibility while also protecting its independence.[xxvi]

Third, *CBI contributes in enhancing social trust*. CBI, as part of the functions of central bank governance, contributes in establishing what is known as an acceptable operational environment for a central bank. This environment is formulated through a political consensus and a legal framework which involves also the government. Hence, through this environment, CBI, fortified with transparency and accountability, enables the societal entrenchment and credibility of a central bank to be built over time, thus contributing to the enhancement of general social trust. Moreover, proper conflict resolution channels are part of this operational environment, without which disputes between the central bank and government may spiral out of control.[xxvii] In the same context, the link between legitimacy, public support, and CBI is said to promote stability cultures, which are simply defined as cultures that are facilitative to monetary policy functions and conducive to macroeconomic stability.[xxviii]

Fourth, *CBI provides central banking with immunity against short-term political and industrial influence and distortion*. Having a delegated authority to fulfill their legally mandated objectives, in addition to an instrument independence to reach these objectives, central banks are protected from being submissive to fiscal dominance.[xxix] On a parallel level, CBI shields central banks from being captured by undue influence and narrow interests of the industry or other lobby groups.[xxx]

Fifth, *CBI serves to realize optimum levels of inflation and price control*. Only if the central bank is able to decide on monetary policy without political interference, being more inflation-averse than the government, can it credibly strive to control inflation.[xxxi] Consequently, achieving an optimum level of inflation and evading the time inconsistency problem of monetary policy can only be realized by combining central bank independence (CBI) and central bank conservatism. On average, countries that enact de jure CBI assist central banks in adhering to their inflationary objectives, and thus have lower inflation rates than countries where the central bank is under government control.[xxxii]

Sixth, *CBI contributes in achieving optimal growth and economic stability*. In the course of achieving both price stability and maximum sustainable employment, monetary policymakers should strive for guiding the economy toward a growth rate that is consistent with the expansion of its productive capacity over time. In this context, since monetary policy is subject to time lags, achieving this objective requires that monetary policymakers make their decisions according to a longer-term perspective. Hence, independent policymaking in a central bank, with a mandate to achieve optimum long-term economic results, is best suited to take such a standpoint.[xxxiii] Moreover, in order to maintain their popular legitimacy, central banks in general can give up some of their limited political independence without jeopardizing their instrumental independence, which is critical for both their monetary policy and financial stability functions, and subsequently the general economic stability.[xxxiv]

b. Challenges

With the escalating and revolutionary developments underlining the socioeconomic and financial global scenes, CBI has been facing critical challenges that should be emphasized. The most prominent of these challenges are the following:

First, *CBI should be founded on ethical and social basics*. The exaggerated liberal course that led to the elimination of many essential monitory and control measures, which comprise basic elements for the principles of transparency and accountability, underlined a major cause for the global financial crisis.[xxxv] Therefore, CBI must be practiced having the background-goal of incorporating a code of ethics into the rationale of governance measures by fully integrating risk management, compliance, good governance, and ethics into the central/commercial banking culture.[xxxvi] Such a code of ethics/conduct would embrace practices and criteria that aim at ratifying the values of financial integrity, sustainable/independent development, impact investment, socioeconomic equity, financial capacity, responsible citizenship, productive economy, and innovative knowledge.

Second, *actualizing independent synergy between financial stability and monetary policy*. Traditionally, financial stability and monetary policy were approached in isolation from one another; however, the current challenge facing CBI is to approach them in a complementary way together[xxxvii] while maintaining the margin of independence necessary to achieve their objectives and the social optimum. This requires maintaining a delicate balance and compromise in their interrelatedness between securing financial stability through regulatory macroprudential policy on one hand, and achieving monetary and price stability through monetary policy on the other.[xxxviii] What complicates the scene further, is that monetary policy is adjusted more frequently than macroprudential regulation because macroprudential regulation is an ex-ante (proactive) tool, whereas monetary policy can be used in ex-ante and ex-post manners (subsequent). Therefore, a central bank should try to diminish this time-inconsistency, aiming at the social optimum.[xxxix]

Third, *CBI should be practiced while maintaining strategic integration with the fiscal authority*. This strategic integration is necessary for the monetary authority to combine its credibility of constitutional de jure commitment with its effectiveness in financial stability, crisis management, systemic risks, and debt management, thus contributing in enhancing the efficiency of real economy.[xl]

Fourth, *mitigating the drawbacks of unconventional monetary policy and rising populism*. The pressures caused by the recent financial crisis, as well as the subsequent European debt crisis, have inflicted changes on the roles of central banks and monetary policy.[xli] These altered roles are evident in the new unconventional monetary policy measures and second-best interventions like quantitative easing or negative interest rate policy, which have the ability to distort financial markets and can have severe distributive implications.[xlii] Accordingly, this has exposed monetary policy in general and CBI in specific to severe criticism from economic elites and observers, populism - and the rise of popular discontent, anti-establishment, anti-expert, and antitechnocratic sentiment, and the political establishment, having conducting quasi-fiscal operations that go well beyond their mandates.[xliii]

Fifth, *coping with the escalation of sovereign debt levels, inflationary central bank balance sheets, and expansion of central banks' operations*. Central bank policies regarding these phenomena represents a critical challenge to CBI since they can undermine central bank credibility and financial independence. Moreover, the expansion of the scope and size of central banks' operations has increased their exposure to risk, most importantly, reputational risk and other market and credit risks. Thus, it is crucial for central banks to head towards sustainable policies and long-term solutions through implementing innovative sustainable governance.[xliv]

Sixth, *sustaining a delicate balance between regulatory/conventional and emergency/unconventional roles*. CBI should maintain a balance between two roles: the first role requires that the monetary authority commits to serving national economic and monetary/financial interests, and abide by its mission assigned by the constitution as a regulatory authority, within applicable laws and regulations. The second role entails the effective contribution of the monetary authority in resolving unforeseen economic crises, when necessary, to preserve economic security, particularly on the monetary and financial levels, as an autonomous authority.[xlv]

On the Regional Level

a. Merits

Most of the merits on the global level are shared on the Arab regional level, taking into consideration the realities of the Arab countries, being developing countries with limited democratic experiences. However, the major merit that I intend to highlight is the potential contribution that the CBI encompasses in aligning between the sustainability of economic growth and development, and the independence of development, being a dire need for developing countries in their quest for reliable independent development. In this context, securing authentic sustainability of economic growth and development requires endorsing the conditions for independent development. Correspondingly, an autonomous monetary policy can contribute in providing these conditions, including: a productive economy that curbs rentier trends, knowledge and technology, human capital, accumulation of national provisions, regional integration, economic diversification, industrialization, and good governance practices that curb corruption and induce participative democracy.[xlvi]

b. Challenges

Relatively, the most comprehensive increase in independence has been witnessed in developing and emerging market economies across all dimensions of independence, including relations between the executive and the monetary authority – specifically in terms of dispute resolution and central bank financing of government – and areas related to governor appointment procedures and the existence of a well-documented policy target.[xlvii] However, important challenges that are specific to developing and emerging countries, to which Arab countries belong, still persist. These challenges mainly are related to the existing vast deviation between central bank de jure and de facto independence due to weak democratization and standardization that causes political and instrumental vulnerability in central bank practices.[xlviii]

V. Governance and Independence at Banque du Liban

Governance at Banque du Liban

Banque du Liban (BDL) governance practices have been internally assessed and reviewed on a continues basis vis-à-vis the existing best governance guidelines and principles and in accord with its independent status. Current BDL governance and practices can be regrouped around five main areas: legal mandate and governance; the role of the Board; strategic planning and budgeting; staff policies and remuneration; and specific management issues relating to risk management, financial reporting transparency, and audit and control procedures.

On the role of the Board level. BDL Board members are aware of their responsibilities in corporate governance. They supervise the bank's strategic objectives and corporate values that are communicated throughout the organization. In addition to the Governor and the four Vice-Governors, BDL Board includes the Director General of the Ministry of Finance, and the Director General of the Ministry of Economy and Trade. As a feature that endorses BDL's autonomy, the two Director Generals sit on the Board in their ex-officio capacities and not as government proxies, and their action in the bank shall not exceed the power attaching to them as members of the Central Board. Moreover, there is a clear distinction between policymaking and managerial boards.

On the strategic planning and budgeting level. BDL has clearly defined objectives for each function performed. These goals have been specified within a comprehensive strategic plan which was approved by the governing Board. To date, we are still working on linking our budgeting process to this strategic plan.

On the staff policies and remuneration level. The existing employee code is being reviewed to incorporate the best conduct practices in the industry. Additionally, a new structure, grading system, and performance management system are currently being developed.

On risk management level. In January 2009, BDL established an Investment Committee and set formal guidelines for foreign reserve management as they constitute a vital asset in a central bank. Moreover, we should always keep in mind that risks are not avoidable but can be mitigated. BDL followed the IMF guidelines which state that the objectives of foreign exchange reserve management are ensuring that "(i) adequate foreign exchange reserves are available for meeting a defined range of objectives; (ii) liquidity, market, and credit risks are controlled in a prudent manner; and (iii) reasonable earnings are generated over the medium to long term on the funds invested (subject to liquidity and other risk constraints)"[9]. When formulating its investment choices, the Investment Committee takes into consideration a wide range of exposure risks, namely market, credit, counterparty, liquidity and operational

[9] IMF Guidelines for Foreign Exchange Reserve Management, September 2001.

risks. Another important development was the adoption of a "framework" for the investment decisions to effectively manage risk. The framework establishes the acceptable parameters (limits and controls) and asset allocation (benchmark portfolio). Moreover, a formal system to identify, assess, and mitigate the risks at the nine BDL branches has been put in place.

Banque du Liban's Independence

a. BDL's de jure independence

The legal mandate stipulating BDL's independence is clearly highlighted in the Code of Money and Credit under which BDL was established. The code states:[xlix]

"Article 13:
The bank is a juridical person of public law vested with financial autonomy.
It shall not be submitted to the administration and management regulations and supervisions applicable to the organizations of the public sector… Nor shall it be subject to the requirements of the Code of Commerce regarding registration on the Trade Register.

Article 19:
Excluding the case of voluntary resignation, the Governor cannot be relieved of their functions except for physical incapacity duly reported, infringement to the duties of their functions… violation of the provisions of article 20[10], or serious mismanagement.

Vice Governors may not be relieved of their functions except for the very motives designated in the preceding sub-paragraph, on the proposal of the Governor or following his advice.

Article 26:
The Governor has the widest powers in the management and administration of the "Bank". He is entrusted with the enforcement of the present law and of the resolutions of the Board.

Article 70:
The overall duty of the "Bank" shall be the safeguard of currency as a fundamental guarantee for permanent economic and social development, and more specifically:

- Safeguarding a sound Lebanese currency
- Safeguarding economic stability
- Safeguarding the basic structure of the banking system

[10]Article 20:
The Governor and sub-governors must dedicate themselves entirely to the "Bank". Their functions are incompatible with any sort of legislative mandate, public function, activity in any enterprise, or other professional work, irrespective of whether such activity or work be remunerated or not.
During their term of office, they are equally barred from keeping, taking or receiving any interest whatever in a private enterprise.
Shall be considered as interest, within the meaning of the preceding paragraph, any participation or association, in any form whatsoever or by whatever means this may be, even though by simple loan. Shareholding in joint-stock companies shall not be considered an "interest".
No commitment bearing the signature of the Governor or sub-governors may be accepted in the portfolio of the "Bank".

- Developing the monetary and financial market.

To achieve these ends, the Bank shall exercise the powers vested in it by virtue of the present law."

b. BDL's de facto independence

BDL's de facto independence has been vigorously based on institutionalization that has consistently been reinforced by key enablers, enclosing three elements: (1) strategic direction that defines clear and transparent strategic positioning and sets the direction in which the organization should go through highlighting purpose and vision, mission, targets, objectives, initiatives, plans, and resources; (2) effective communication through enacting a legal framework, processes, systems, knowledge transfer, metrics, and reporting; (3) strong leadership that emphasizes setting the example and motivating people towards modernization, by implementing values, teamwork, empowerment, communication, accountability, and nurturing a culture that promotes constructive behavior.[l]

Despite Lebanon's severe uncertainties of its environment, this de facto independence has been exercised in implementing progressive monetary policy and financial stability in its conventional, unconventional, and regulatory forms.

On the conventional level, BDL's vision has emphasized immunizing the economy and preserving its resilience as aiming at its stimulation. Hence, the Central Bank of Lebanon has been committed to ensure the basis for sustainable economic growth and comprehensive, sustainable, and independent social development through conducting the functions of the conventional transmission mechanisms of monetary policy, pertaining to monetary stability, interest rate relative stability, inflation targeting, financial inclusion, liquidity management, public debt management, financial market development, and payment system securitization.

On the unconventional level, adverse economic conditions have prompted BDL to implement unconventional monetary policy and financial engineering tools that involve monetary transmission mechanisms for stimulating internal demand. These unconventional measures aim at creating the necessary conditions for sustainable growth and reviving the labor market, thus enhancing social and environmental security and promoting economic development. These objectives are pursued through the provision of stimulus packages, launching knowledge economy, and implementing multipurpose and multidimensional financial engineering mechanisms that have quasi-fiscal dimensions.

- *Stimulus packages*: The hard economic conditions have compelled BDL to implement an unconventional monetary policy that encompasses monetary transmission mechanisms which serve to stimulate internal demand through boosting lending activity, aiming at creating the necessary conditions for sustainable growth, revitalizing the labor market, and reviving the middleclass, thus reinforcing social and environmental security and promoting comprehensive development. These packages, extending from 2013 through 2017 and amounting to an average of US $1 billion per year, proved to be successful by contributing around 50% of real GDP growth. These include incentives to support housing, education, renewable energy projects, research and development ventures, entrepreneurship, exporting industries, art-production projects, and other productive sectors of the economy.

- *Knowledge economy*: BDL has dedicated resources for targeting the knowledge industry, acknowledging knowledge economy as a strategic comparative advantage for the Lebanese economy. Based on Lebanon's highly qualified human capital that is distinguished by its innovative capacities, BDL's knowledge economy initiative aimed at boosting employment opportunities, therefore expanding the country's GDP and ensuring sustainable development. In this context, BDL issued Circular 331 in 2013 to encourage Lebanese banks to invest in the equity capital of startups, incubators, accelerators, and other companies working in the knowledge economy. This innovative scheme has provided around $600 million to support creativity and innovation.
- *Financial engineering*: Starting 2016, BDL has further implemented a multipurpose and multidimensional financial engineering aiming at strengthening BDL's foreign-currency assets, consolidating the capital base of banks, increasing liquidity in local currency, improving the government debt profile and Lebanon's credit rating, increasing inflation rate to a 2% target, and improving the balance of payments (BOP) status by turning its cumulative deficit of USD 1.7 billion in May 2016 into a cumulative surplus of USD 1.3 billion at the end of 2016.

On the regulatory level, BDL's regulatory role in preserving financial stability has diligently developed a sound and secure financial sector and model which have stirred confidence in the system. In fact, lessons inferred from the Lebanese model are similar to many of the reforms concluded by international financial regulators in the wake of the global financial crisis, most important of which are: decreasing leverage, regulating derivatives and structured products, strengthening banks capital and liquidity requirements (Basel III and IFRS 9), endorsing corporate governance and transparency of financial institutions, overseeing all players in the financial market, drawing a clear demarcation between commercial banks and investment banks, and prohibiting any defaulting of banks that threatens systemic stability. Furthermore, severe measures have been enacted towards implementing compliance procedures with respect to Anti-Money Laundering and Countering the Financing of Terrorism (AML/CFT), risk management and effective internal control, and global sanctions.

Being the central bank of a country whose GDP has been losing half of its potentials due to the dominating disruptive confessional governance[11] (according to World Bank estimates)[12], BDL's prominent independence seems

[11] A confessional government is a system of government that is a de jure mix of religion and politics. It typically entails distributing political and institutional power proportionally among confessional communities.

[12] A World Bank report issued in 2015 indicated that Lebanon has been losing 9% of its GDP annually since 1991, which cumulatively constitutes half of its GDP potential up to the date of the report's issuance.

to be out of scope, not to mention that it is part of a region characterized by slack institutional independent practices. In fact, both perspectives, de jure and de facto, constitute a synergetic momentum for BDL's independence. On one hand, BDL's de jure independence has been rooted in the Code of Money and Credit from the policy-making, operational, and personal perspectives, as for the appointment of the Governor and Vice Governors by the council of ministers, the role of the Governor enjoying full autonomy and authority, and the inability of any governmental body to dismiss the governing Board, except under certain circumstances, namely physical incapacity, infringement to duties, violation of dedication, and serious mismanagement.[li] In addition, BDL's legal independence is embodied in the role of BDL as a commercial entity in its relationship with other stakeholders, the independent appointment of its staff being protected by internal rules and regulations, and the independence of its accounting books. All this would enable the Board and employees to play their role independently and to the interest of the institution without any undue political agenda. On the other hand, BDL's de facto independence and enduring meritocracy lies within the specificities of the Lebanon's political economy. Since savers' deposits represent a major strategic reserve for the banking sector, the government, and the consumers, as a functional financing source for the public debt, consumption and investment, and internal demand stimulation, it would be a collective interest for the majority of stakeholders to maintain BDL's independence in monetary policy transmission mechanisms that tend towards relatively high interest rates and low inflation. This collective interest encompasses the political establishment, the banking sector, and the depositors, while it is offset by BDL's incentive plans towards the economic sectors. However, it is appropriate to conduct a review on the feasibility of maintaining the broad powers granted to BDL to avoid the possibility of a conflict of goals and interests, up to making amendments to the Monetary and Credit Law. For these powers combine maintaining financial stability in terms of regulation, control, and accountability towards the banking sector, setting monetary policies, and raising banking secrecy, not to mention sovereign debt management.

VI. Conclusion

CBI has been proved to be a valuable national asset. However, preserving this asset pauses the question of how to maximize the benefits of initiating new powers within the central bank while minimizing potential frictions with monetary policy, restraining political threats to the legitimacy of central banks' operational independence, and sustaining political accountability and public transparency.

During the past few years, economists have modelled central banks based on: independence from political agendas, accountability to society, transparency in carrying out its responsibilities, and a more efficient and complex communication mechanism. The most critical of these aspects is independence, because accountability, transparency, and communication channels become essential only upon granting independence to the central banks. Attaining these objectives depends on the particularity of national cultures and circumstances, but it certainly endorses a universal and progressive vision.[lii]

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Appendix

INTERNATIONAL MONETARY FUND

IMF Country Report No. 17/21

LEBANON

FINANCIAL SYSTEM STABILITY ASSESSMENT

January 2017

Mandate, independence and cooperation (CP 1–3)

17. A review of primary banking legislation is overdue, with extensive reliance on secondary legislation leading to a complex patchwork of regulation. Acknowledging the difficulty created by the political situation, reforms (and subsequent periodic reviews) should be prepared for when opportunity arises, with the overall objective being to establish a more cohesive body of banking legislation that provides for greater precision and consistency.

18. The BCC has unrestricted access to banks' debtor accounts, but information on the names of individual depositors is beyond its reach due to banking secrecy legislation. While the BCC's senior management is of the view that this does not pose meaningful restrictions on prudential supervision, taking into account the ability to gather information on an aggregate basis (e.g., on deposit amounts by brackets, country of residence, maturity structure, and aggregate inflows and outflows), the lack of full access hinders prudential supervision (e.g., in-depth understanding and monitoring of funding structure) and is not in line with international best practices and, hence, should be reconsidered. It is noted though that this constraint does not apply to the AML/CFT regime, as the SIC is not bound to banking secrecy when discharging its duties.

19. A thorough review of supervisory resources as a first step toward building further capacity appears warranted. Increased complexity of financial services, more demanding international standards for supervisory effectiveness and a broadening of the BCC's responsibilities (now also including nonbank financial institutions and aspects pertaining to consumer protection) have stretched the BCC's capacity.

20. There is no legal protection for BCC staff. While BCC's senior management reports the entire absence of lawsuits against the supervisor and its staff for actions taken and/or omissions made while discharging their duties, it is not acceptable—and not in keeping with international best practice—that a supervisor have exposure to any such eventuality.

21. Coordination and the avoidance of regulatory and supervisory gaps is facilitated through the governor presiding as chairman of the BdL's Central Council and its HBC, and as chairman for each of the SIC and the CMA. In addition, the BCC chairman is a member of both the SIC and the CMA and formally presents the BCC's recommendation to the HBC for supervisory action on a registered bank, when judged necessary. While such a coordination mechanism appears to work in Lebanon, it may be argued that it does so overwhelmingly because the office of the governor is its nodal point.

22. While instruments for cooperation and collaboration, such as MOUs, are in place, Lebanon's Law of 03SEP56 "On Banking Secrecy" reduces their practical effectiveness compared to other jurisdictions. In addition, there have occurred instances where either an MOU (or informal arrangements) has not been set in place for the advantage of BCC/BdL or where an MOU that was already in place has proved inoperative in an important particular.