The imperative for central bank independence

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I recently chaired a seminar in Dhaka on the need for an independent central bank.

Not surprisingly there was broad-based support from the participants composed of political and civil society leaders, business representatives, banking community and researchers. Such broad consensus is not easy but speaks to the importance of adopting this policy sooner than later.

Worrisome outlook

The support for this policy is no brainer. Bangladesh has been facing tremendous macroeconomic challenges since 2022. Following a period of messy policy making, the macroeconomic reform process began to take shape starting in May 2024.

While we celebrate the recent hard-earned reforms in exchange rate and interest rate management and the buildup of reserves, the inflation rate remains persistently high and the financial sector stability is fragile. Importantly, the investment climate, the GDP growth and employment outlook are worrisome.

Through my own research I have provided evidence that the source of the present inflationary pressures lies in the excessive liquidity injection in the economy over the periods FY2020-23, compounded by interest rate control and the fragility in the banking sector.

The banking sector portfolio has progressively deteriorated since FY13 but this gained speed between FY17 and FY23. Proper accounting and the downturn in the economy have further intensified the fragility of the banking sector. As of March 2025, banking sector NPL stood at Tk4.2 trillion ($38 billion), which is 24% of the total loan portfolio.

The failure of monetary policy and cumulative deterioration of the banking sector portfolio are two striking outcomes of a weak central bank that functions under political dominance and serves as the financing arm of the Treasury.

This demonstrated weakness of a core macroeconomic policy institution begs the question: can Bangladesh really move forward with the agenda for recovery of economic growth, employment and macroeconomic stability equipped with an inherently weak central bank?

At the global level there is very little debate on the need for a strong and independent central bank. Evidence shows that countries that have an independent central bank on average have performed better in controlling inflation than countries that do not have an independent central bank. Evidence also shows that progressively an increasing number of countries have adopted an independent central bank.

Inflation or growth?

The policy debate is centered around what kind of a mandate an independent central bank should have? In the literature of economics this policy debate has focused on inflation control versus economic growth or unemployment targets. When inflation control and GDP growth targets are reconciled, as would be the case over the longer term, there is no issue.

But in the short term there might be a trade- off between inflation control and growth/unemployment targets, which is nicely summarised in the well-known Phillips Curve Hypothesis.

When this trade-off prevails, the political government and the Treasury usually galvanise in favour of growth and unemployment targets over inflation control. An independent central bank is usually much more focused on inflation control. For example, this is the debate presently ongoing in the USA.

President Trump wants the Federal Reserves to reduce interest rates to boost consumer spending and GDP growth in order to cut unemployment. The independent Federal Reserve is reluctant to oblige because it believes there are inherent risks to inflation owing to the tariff hikes that are already increasing prices.

A further aggressive reduction in interest rates will spike inflation by boosting credit demand and public spending without commensurate supply response.

My own take on the subject is that the trade-off can be reconciled with an independent central bank by setting balanced growth and inflation targets as a part of the central bank mandates and allowing some flexibility for those targets within a narrow band.

Thus, the inflation target could be set at 4-5% rate instead of a rigidly fixed target. Additionally, the government must adopt a broad- based GDP growth strategy that uses a whole host of policy instruments and not just monetary policy to pursue the growth target.

This brings me to another prevailing policy debate: primacy of monetary policy or primacy of fiscal policy. Given our weak tax capacity and expenditure imperatives, some amount of fiscal deficit will always be necessary.

This fiscal deficit will partly be financed through foreign borrowings as guided by an external borrowing strategy based on a well-articulated and sustainable external debt strategy. The rest will be financed through domestic borrowing.

The policy question facing an independent central bank is to what extent, if at all, this deficit should be financed through money creation, which could potentially come in conflict with monetary policy targets for inflation control.

Question of money creation by central banks

Good practice global experience shows that powerful and independent central banks are prohibited by law from financing Treasury deficits through money creation. The list includes the Federal Reserve Bank in the USA, the Bank of England, the central bank of New Zealand, the Deutsche Bundesbank of Germany, and all central banks of the European Union. This is a prudent restriction and highly recommended for Bangladesh as it debates the matter of central bank independence. Money printing to finance fiscal deficit could be addictive and is best avoided by law.

In Bangladesh the central bank mandate gets a bit more complicated because the Bangladesh Bank also serves as the regulator of the banking sector. So, it is also charged with the responsibility of maintaining financial sector stability. In this environment, the primacy of the inflation control mandate gets more challenging when the political economy of saving the failing banks leads to injection of financial support through money printing.

Once the policy of disabling the central bank to finance the treasury deficit through money creation is adopted by law, this problem is also addressed. There are considerable gaps in the prudential management of the banking sector including the absence of a credible deposit insurance scheme.

Banking reform must focus on addressing those gaps, especially the establishment of a meaningful and credible deposit insurance scheme. A good example of this is the Federal Deposit Insurance Scheme (FDIC) of the USA.

In addition to the mandate issues facing an independent central bank, there is the question of the central bank capacity. An independent central bank can only function effectively if it is staffed with high quality professionals who are well trained in the areas of monetary policy, banking sector and macroeconomics and equipped to run this high-level institution as well as engage with their global counterparts.

The staffing challenge permeates throughout the central bank structure from the governor, to the management Board, and the supporting staff. This in turn is closely interlinked with issues of incentives, budget, recruitment, training and promotion policies, accountability and internal control.

There are many strong, effective and well-functioning central banks in the world. Bangladesh can learn and adapt these experiences.

A final set of issues concern the central bank governance. The questions here involve: who appoints the central bank governor and the central bank board? Who can fire these officials and under what circumstances? What is the accountability mechanism for the central bank? These are tough political economy questions and there is no one size fits all answer.

The main principle to guide policy here is that an independent central bank must be truly independent in letter and in practice. This independence requires that the top management of an independent central bank must by law be insulated from political interference.

They also must be held accountable preferably through the parliamentary process or any other mechanism that does not come in conflict with their independence from the executive branch of the government. For specific reforms, once again, there are many good practice international examples available that Bangladesh can draw on.

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