

# CENTRAL BANK INDEPENDENCE UNDER EUROPEAN UNION AND OTHER INTERNATIONAL STANDARDS

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## ABSTRACT

*Il contributo fornisce un breve resoconto del contesto in cui si è svolto il lavoro sulla legislazione relativa alle banche centrali condotto dall'Istituto Monetario Europeo (IME) e delinea i requisiti indicati dall'IME e, successivamente, dalla Banca Centrale Europea (BCE). Lo studio ne esamina anche l'influenza in alcuni paesi esterni all'Unione Europea (UE).*

*Il Gruppo di lavoro di esperti legali (Working Group of Legal Experts – WGLE) dell'IME fu istituito nel 1995 per svolgere attività di ricerca ed elaborare proposte su questioni giuridiche connesse con l'istituzione della BCE e con l'introduzione della moneta unica, l'euro. Uno dei suoi compiti principali è stato quello di elaborare proposte per garantire che gli statuti delle Banche Centrali Nazionali (BCN) fossero compatibili con il Trattato e garantissero l'indipendenza di ciascuna BCN, requisito, quest'ultimo, da applicare anche alle banche centrali dei paesi che non avevano ancora adottato l'euro. Il WGLE ha esaminato l'ammissibilità delle cosiddette "peculiarità nazionali", valutandone il grado e concludendo che erano ammissibili in misura limitata. I requisiti che l'IME, come precursore della BCE, avrebbe stabilito dovevano essere, in linea di principio, rigidamente applicati.*

*In retrospettiva, la BCE e i requisiti di indipendenza stabiliti dal WGLE hanno avuto una influenza significativa sulla legislazione relativa alla banca centrale in molti paesi. Gli standard UE sono considerati lo "stato dell'arte" e rappresentano a livello internazionale la migliore prassi in materia di legislazione per la banca centrale. L'adozione di questi standard da parte della UE ha anche chiaramente dimostrato agli altri paesi che la politica monetaria può e dovrebbe essere delegata a banche centrali indipendenti.*

## I INTRODUCTION

This paper provides a brief account of the background behind the work on central bank legislation conducted by the European Monetary Institute (EMI), and outlines the requirements set out by the EMI and, later on, by the European Central Bank (ECB). The paper also examines their influence on some countries outside the European Union (EU).

As several studies have demonstrated, for example those by Finn Kydland and Edward Prescott<sup>1</sup>, governments in democratic countries may have a *time consistency problem*. If economic policymakers lack the ability to commit in advance to a specific decision rule, they will often not implement the most desirable policy later on. What Kydland and Prescott offer is a common explanation for events that, until then, had been interpreted as separate policy failures. Their award-winning work on how economies become trapped in high inflation even though price stability is the stated objective of monetary policy established the foundations for an extensive research programme on the credibility and political feasibility of economic policy. This research shifted the practical discussion of economic policy away from isolated policy measures and towards the institutions of policymaking, a shift that has largely influenced the reforms undertaken by central banks and the design of monetary policy in many countries.

The importance of adequate institutional arrangements for conducting monetary policy had been periodically highlighted by some economists from the 1940s onwards, but it was not until the end of the 1970s that this topic came to the fore and was more broadly studied and discussed. The reaction to the oil crisis was an expansionary fiscal policy, partially financed by the printing press, which ultimately resulted in inflation and stagnation – dubbed “stagflation” – because fiscal policies were solely focused on creating demand instead of addressing the underlying structural deficiencies caused by the new relative prices that OPEC had imposed on the industrialised economies. The immediate effect of this was the introduction in many countries during the 1980s of an explicit statutory price stability objective for the monetary policy, and the limiting of direct central bank credit to the government. However, such provisions rarely qualified the concept of price stability, and central bank laws seldom contained statutory provisions stating the independence of the central bank to define and execute its monetary policy to attain this objective. In some small open economies, the political authorities chose to peg the national currency to a foreign currency, which implied the need to adjust the economic policy, in particular the inflation rate, to that other currency. By contrast, the political authorities in some other countries were hesitant or unwilling to delegate such powers to the central bank. This may partly be attributed to an unwillingness to relinquish important

1 The 2004 laureates of the Bank of Sweden Prize in Economic Sciences in Memory of Alfred Nobel. F. E. Kydland and E. C. Prescott (1977), “Rules Rather than Discretion: The Inconsistency of Optimal Plans”, *Journal of Political Economy* 85, pp. 473-90.

economic powers to technocrats, and additionally by the fact that under Keynesianism, which emerged during the depression of the 1930s, the cost of inflation was not fully appreciated. However, in all fairness, it must be recognised that politicians in control of government are understandably reluctant to relinquish monetary policy, since they would still be perceived by the electorate as being responsible for the economic policy of the country as a whole.

The Working Group of Legal Experts (WGLE)<sup>2</sup> at the EMI was established in 1995 to conduct research and make proposals on legal issues related to the establishment of the ECB and the introduction of the single currency, the euro. One of its main tasks was to make proposals on the criteria according to which the so-called legal convergence requirements<sup>3</sup> should be applied by Member States, with the aim of ensuring that the national central bank (NCB) statutes should be compatible with the Treaty and the Statute of the European System of Central Banks (ESCB)<sup>4</sup> and of the European Central Bank (henceforth “the Statute”), as well as contain provisions securing the independence of each NCB, with the latter requirement also applying to central banks that had not yet adopted the single currency.<sup>5</sup>

At one of the first meetings of the WGLE, at which the extent to which the EMI should accept, if at all, so-called national peculiarities in NCB laws was discussed, some members<sup>6</sup> argued that the EMI should allow for some flexibility. In retrospect, those members were probably all eventually extremely content with the majority decision to stand firm. National peculiarities were accepted to a very limited extent, and the requirements to be set up by the EMI, as the forerunner to the ECB, were, in principle, to be strictly applied.<sup>7</sup>

The ECB and the independence requirements set out by the WGLE have had a remarkable influence on central bank legislation in many countries. In particular, with regard to the target of autonomy, the EU standards are considered to be state of the art and constitute international best practice for central bank legislation. The EU’s adoption of these standards has also clearly demonstrated to other countries that monetary policy can and should be delegated to independent central banks.

2 The WGLE was composed of lawyers of the EMI and of each national central bank of the EU Member States under the chairmanship of Jean Guill, Director of the Institut Monétaire Luxembourgeois (Luxembourg Monetary Institute). Upon the establishment of the ECB, the WGLE was transformed into the Legal Committee of the ECB. Paolo Zamboni was one of the most influential and, it must be said, most charismatic members of the WGLE and the Legal Committee.

3 Article 121 (ex Article 109j) of the Treaty establishing the European Community (“the Treaty”).

4 The European System of Central Banks (ESCB) consists of the ECB and the NCBs of the EU Member States. Most members of the WGLE, including Paolo Zamboni, had been directly involved in the drafting of parts of the Maastricht Treaty, including the drafting of the Statute of the ESCB and of the ECB.

5 These provisions do not apply to the United Kingdom according to the Protocol annexed to the Treaty.

6 Including, among other members, the author of this paper and Paulo Zamboni.

7 While the Treaty required “compatibility” of NCB legislation with the Treaty and the Statute of the ESCB and the ECB, the EMI abstained from requiring harmonisation and still left some room for national peculiarities. See *The EMI Convergence Report 2000*, p. 73.

## **2 THE MAASTRICHT TREATY**

Although important restrictions on German fiscal policy admittedly played a fundamental role in the building up of the strength of the Deutsche Mark, the Deutsche Bundesbank had for many years been internationally admired as one of the best, if not the best, models for central banks and, naturally, had a great impact on the legal framework for the ECB as the Maastricht Treaty was being drafted. Central bankers worldwide had long appreciated the Bundesbank's focus on price stability; its independent status in its relations with the political establishment; and, not least, the remarkable price stability that the Bundesbank had delivered for several decades. To the founding fathers of the Maastricht Treaty, the Bundesbank clearly deserved to serve as the model for the ECB and the NCBs of the ESCB.

Central bank independence had already been on the agenda at several international meetings of central bankers. The Deutsche Bundesbank Act was not the only model that was being studied and discussed; the importance of removing monetary policy issues from the political scene had been discussed in some other countries and, in various forms, implemented in the legal framework of several central banks, for example in New Zealand and Chile. However, when it came to designing the independence of the ESCB, the Bundesbank model was the natural choice on which to build the fundamental legal framework for the future central banking system that would administer the single currency of the European Union.

## **3 THE LEGAL FRAMEWORK TO ENSURE THE INDEPENDENCE OF THE ESCB**

The EU legal framework regulating the ECB is to be found in the Maastricht Treaty and in the Statute of the ESCB and of the ECB (which is part of the consolidated version of the Treaty). On the national level, all NCB laws and, in some countries, the Constitution as well (for example in Germany and Sweden) had to be amended to ensure the independence of the ESCB.

### **A. THE MAASTRICHT TREATY**

The independence of the ESCB is founded on certain provisions in both the Maastricht Treaty and the Statute of the ESCB and of the ECB. Most of the Treaty provisions are copied (or almost copied) and transferred into the Statute. The most interesting provisions in this context are listed below:

#### **NATIONAL LEGAL COMPATIBILITY**

Article 109 (ex Article 108) is crucially important as it prescribes that each Member State shall ensure, no later than at the date of the establishment of the ESCB, that its national legislation, including the statutes of its NCB, is compatible with the Treaty and the Statute. Consequently, limitations on the independence of NCBs would be incompatible, and provisions in national legislation which would prevent the execution of ESCB-related tasks, or

compliance with decisions of the ECB, would be incompatible with the effective operation of the ESCB. With regard to the timing for removing incompatibilities, independence needed to be enforced at the date of the establishment of the ESCB, while provisions relating to the legal integration of NCBs into the ESCB only needed to enter into force when the euro was introduced as the single currency.

### **PROHIBITION AGAINST INSTRUCTIONS**

Article 108 (ex Article 107) is one of the principal Articles of the Treaty on central bank independence and includes the prohibition of instructions. The ECB, each NCB and any member of their decision-making bodies are prohibited from seeking or taking instructions from Community institutions or bodies or from any government of a Member State or from any other body. This principle must be respected by Community institutions and bodies and by the governments of Member States. They must all undertake not to seek to influence the members of the decision-making bodies of the ECB and of the NCBs in the performance of their tasks.

### **OTHER FEATURES**

Although the objectives and functions of each central bank are not, strictly speaking, elements of its independence, the maintenance of price stability is of fundamental importance, and is enshrined as the central bank's primary objective (Article 105 of the Treaty and Articles 2 of the Statute). National legislation should, accordingly, be compatible with these stipulations. Another such issue is the prohibition against the central bank providing credits to the respective governments, which is explicitly regulated in the Treaty (Article 101, ex Article 104) and also reiterated in the Statute (Article 21), which had applied since the start of Stage Two of EMU, i.e. from 1 January 1994.

This had wide implications for the functioning of not only the ECB but also of the NCBs which, up to that point, had operated as government agencies under direct control by the government or by the Ministry of Finance in theory, and by the Minister of Finance in person in practice, in most Member States. European politicians, and politicians in most other countries too, had for a long time tended to consider their respective central banks to be basically the bank of the government. This meant that the central bank should not only support the economic policy of the government and provide additional funds for the government's budget, if required, but also, if necessary, do so whenever this was politically desirable, even if economically unwise or inappropriate at a particular juncture. It may in many cases have been tempting (and perfectly understandable) for any government or Minister of Finance to order the central bank to conduct a lenient monetary policy to boost employment when general elections were approaching, for example. Notwithstanding this fact, this practice had in many countries repeatedly proven to be disastrous to the economy and to its long-run economic growth potential. It was believed that including an explicit price stability objective and a prohibition against providing credit to the government, in conjunction with a statutory prohibition against instructions, would provide an appropriate legal framework that could foster central bank independence in conducting monetary policy in accordance with the central bank's statutory monetary policy objective.

## **B. THE STATUTE OF THE ESCB AND OF THE ECB**

Article 7 of the Statute refers to Article 108 of the Treaty on the prohibition of instructions, and Article 14 of the Statute prescribes specific provisions for the NCBs, in this context in particular on:

- The compatibility of the national legislation of each Member State, including the statutes of its central bank, with the Treaty and the Statute (Article 14.1).
- The statutes of the NCBs shall provide that the term of office of the governor are no less than five years (Article 14.2, first paragraph).
- The governor of each NCB may be relieved of office only if he or she no longer fulfils the conditions required for the performance of his or her duties or if he or she has been guilty of serious misconduct; any decision to this effect may be referred to the Court of Justice of the European Communities (Article 14.2, second paragraph).

## **4 THE 1998 EMI CONVERGENCE REPORT**

Evidently, the rather fragmented provisions on central bank independence in the Treaty and in the Statute had to be complemented and specified to provide a useful pattern of requirements against which the compatibility of the national legislation of the Member States, including the statutes of the NCBs, could be effectively compared. Some gaps had to be filled in, and the WGLE was entrusted with conducting an investigation into this and working out an appropriate proposal. This resulted in three progress reports in which the assessment methodology was successively developed.<sup>8</sup>

The conclusions of the WGLE were largely adopted by the Council of the EMI and published in the 1998 EMI Convergence Report, in which the EMI established a list of features of central bank independence, distinguishing between features of an institutional, personal, functional and financial nature, and identifying remaining incompatibilities in national legislation. The EMI concluded that neither the supremacy of the Treaty and the Statute over national legislation nor the nature of a specific instance of incompatibility affects the obligation to remove such incompatibilities.<sup>9</sup>

In addition to the statutory provisions in the Treaty and the Statute, the EMI specified the following, related to:

### **INSTITUTIONAL INDEPENDENCE**

- The right of third parties to approve, suspend, annul or defer decisions by the NCBs is incompatible with the Treaty and the Statute as far as ESCB-related issues are concerned.

<sup>8</sup> *Progress towards Convergence*, EMI, November 1995, *Progress towards Convergence*, EMI, November 1996, and *Legal Convergence in the Member States of the European Union*, EMI, October 1997.

<sup>9</sup> *EMI Convergence Report*, March 1998, p. 289. Reference is also made to the ECB Convergence Reports of 2000, 2002 and 2004.

- The right to censor decisions on legal grounds and subsequently submit them to political authorities for final decision would be equivalent to seeking instructions and is considered incompatible with the Treaty and the Statute.
- The right of representatives of external political authorities to participate in the decision-making bodies of an NCB with a right to vote is, even if not decisive, incompatible with the Treaty and the Statute; no voting rights for such representatives at board meetings may be acceptable.
- The right to be consulted (ex ante) on an NCB's decisions is incompatible with the Treaty and the Statute. However, this does not prevent there being a dialogue between NCBs and the respective political authorities to provide information and exchange views, which is not considered incompatible with the Treaty and the Statute, provided that it does not result in interference with the decisions by the decision-making bodies of the NCBs, that the ECB's competences and the special status of the governor as member of the ECB's decision-making bodies are respected, and that any infringement of the confidentiality requirements in the Statute provisions is avoided.

### **PERSONAL INDEPENDENCE**

- The minimum term of office for governors is five years, which does not preclude however a compulsory retirement age that is compatible with the Treaty and the Statute.
- The grounds for dismissal of governors must contain, in addition to the requirements set out in Article 14.2 of the Statute, provisions ensuring that governors are not dismissed for reasons other than those stated in Article 14.2.

### **FINANCIAL INDEPENDENCE**

- The NCBs should be in a position to avail themselves of the appropriate means to ensure that their ESCB-related tasks can be properly fulfilled.
- Safeguards shall be in place to ensure that any ex post reviews by the government or parliament do not infringe upon the independence of the NCBs. In countries where the government or parliament are in a position, directly or indirectly, to influence the determination of the budget or the distribution of profits, the relevant statutory provisions should contain a safeguard clause to ensure that this does not impede the proper performance of the NCBs' ESCB-related tasks.

### **FUNCTIONAL INDEPENDENCE**

As the NCBs shall be integrated into the ESCB, their functional independence is secured if the degree of legal integration into the ESCB is deemed appropriate, in particular in the following areas:

- The statutory objectives (primary and secondary as stipulated in the Treaty).
- The tasks (compatibility with ESCB-related tasks).
- The instruments (any incompatibility with the Treaty and the Statute needs to be removed).
- The organisation (there should be no rule binding the governor in his or her voting at the ECB level or preventing any decision-making body from complying with the rules at the level of the ECB).

## 5 INTERNATIONAL BEST PRACTICE FOR CENTRAL BANK LEGISLATION

The repeated financial disasters during the 1990s, in particular in parts of Europe, Asia and Latin America, made it necessary for the international organisations responsible for fostering international financial stability, such as the International Monetary Fund (IMF) and the World Bank, to study what went wrong and why, and to identify effective means of preventing similar financial disasters from happening in the future. The legal institutional framework was one of the areas identified as being critical to improving financial stability. Monetary policy would be best conducted if policy decisions were removed from the political arena. Governments in democratic countries are naturally and understandably reluctant to take unpopular decisions before general elections, although these decisions may be the most desirable or necessary ones.

The IMF and the World Bank have endorsed internationally-recognised standards and codes in 12 areas as being important for their work and for which Reports on the Observance of Standards and Codes (ROSCs) are prepared. Standards in the areas of data, fiscal transparency and monetary and financial policy transparency have been developed by the IMF, while others have been developed by other standard-setting bodies including the World Bank, the Basel Committee on Banking Supervision, and the Financial Action Task Force (FATF). The work on standards and codes has been termed a “critical pillar” in the effort to strengthen the international financial system. There is now broad acceptance that standards can serve as a framework to focus policy decisions more effectively and to strengthen the functioning of markets not just in emerging market economies, but also in advanced economies.

Member countries have been encouraged by the IMF and the World Bank since the late 1990s to adopt and implement such standards and codes. This is deemed vital to the prevention of financial crises, which have proven to be particularly devastating to the poor and most vulnerable parts of the population in affected countries.

Notwithstanding the fact that no internationally recognised standards or codes exist on the principles of central bank legislation, except on monetary policy transparency (the IMF) and on the independent status of banking supervisors (the Basel Committee on Banking Supervision), the IMF provides guidance to member countries on central bank legislation based on international best practice. The latter is based, in accordance with principles accepted by the vast majority of economists, on the maintenance of domestic price stability as the primary monetary policy objective of a central bank, and its independence<sup>10</sup> in formulating and executing monetary policy. These principles were formulated

10 In the literature, *autonomy* is sometimes preferred to the frequently used term *independence*, as autonomy entails operational freedom while independence indicates a lack of institutional constraints. Even “independent” central banks typically have a strong commitment to pursuing price stability, follow a specific exchange rate policy, or comply with a target explicitly stipulated by the government. Although the term *autonomy* is often preferred by the Fund, the term *independence* is used in this context as it is viewed from the EU perspective, and additionally because it is the term used in the Treaty and the Statute and by the EMI/ECB.

in February 1998 in an Operational Paper of the IMF Monetary and Exchange Affairs Department (MAE) entitled “Elements of Central Bank Autonomy and Accountability”.<sup>11</sup>

When compared the IMF’s Operational Paper with the 1998 EMI Convergence Report, it becomes clear that several items are identical or almost identical. This is particularly the case for items included in the IMF recommendations, such as:

- Price stability is the primary objective. A specific target (e.g. a direct inflation target, the maintenance of a fixed exchange rate, or monetary aggregate targets) should be established and published.
- The central bank should determine and implement monetary policy to achieve its target without interference from the government.
- There should be a statutory prohibition for central bank board members against seeking advice, and for anyone else against giving them instructions.
- The term of office of the governor should be longer than the election cycle of the body which has the main responsibility for selecting the governor.
- A governor should only be dismissed for breaches of qualification requirements or misconduct.
- Direct government representatives should be eliminated from the policy board and probably also from the monitoring board, if either of these exist. If a government representative is a member of a policy board, this should at a minimum exclude the right to vote.
- Basic consistency needs to be ensured between the exchange rate policy and the monetary policy. If the former is not solely the responsibility of the central bank, the bank shall nevertheless have sufficient authority to implement monetary policy within the constraint of exchange rate policy, and should be the principal advisor on exchange rate policy issues.
- The law should ensure that the central bank has sufficient financial autonomy to support policy autonomy, but within matching financial accountability.
- Policy and financial accountability should be clearly published. The central bank should prepare formal statements on monetary policy performance without the prior approval of the government. The statements should be forwarded to both the executive and the legislature and also published. Annual financial statements audited by external auditors should also be disclosed.

It should perhaps also be noted that, notwithstanding the obvious similarities with the EU requirements, some differences do exist. This is particularly the case with respect to certain items, such as:

- A conflict resolution process should be in place to resolve any policy conflicts between the central bank and the government by, for example, allowing the government to overrule the central bank. It should be absolutely clear to the executive, the legislature and the general public that responsibility for the

<sup>11</sup> MAE Operational Paper, MAE OP/98/1. It should be mentioned that the views expressed in this paper are those of the MAE staff and do not necessarily represent the opinions of the Executive Directors of the IMF or other IMF staff.

results lies with the government, not the central bank, if the latter is overruled, its advice ignored or its effectiveness significantly limited by government policies.<sup>12</sup>

- Lack of performance could constitute grounds for dismissal of the governor if required performance is clearly defined in terms of the primary objective and specific targets.<sup>13</sup>
- If credits to the government are not strictly prohibited, they should be carefully limited to what is consistent with monetary policy objectives and targets.
- The statutory requirement for the central bank to obtain approval from the government should be in place in case the central bank needs to act as lender of last resort to insolvent institutions, if sufficient collateral is not available, in order to prevent a financial crisis affecting the financial sector as a whole.
- The central bank law should contain a procedure to be followed to provide, if necessary, additional funds to the central bank out of the government's budget. Quasi-fiscal activities should be explicitly prohibited, although temporary and clearly limited central bank credit to the government is permissible, but with the sole aim of addressing seasonality of revenues and expenditures.

Since most member countries of the IMF that require technical assistance on central bank and banking legislation are at an earlier stage of economic and institutional development than the EU Member States, the IMF needs to recognise that identical requirements cannot be defined for all countries. There is no “one size fits all” approach, and any recommendation to upgrade the central bank law to the state of the art in one single step is clearly unrealistic in some countries. Accordingly, the IMF has not endorsed a model law but has instead formulated a toolbox of provisions designed to reflect the type of autonomy chosen, the functions of the central bank (in most countries that require IMF technical assistance, the central bank is also the supervisor of banks and other financial institutions), and country-specific conditions, including culture, legal traditions and political systems. The IMF recommendations must, in such cases, allow for a degree of leniency and flexibility that is not acceptable for EU Member States.

The 1998 IMF/MAE recommendations have subsequently been fine-tuned in practice and in light of experience gained, including the development of the International Financial Reporting Standards (IFRS). However, while these recommendations have been periodically modified since 1998, their main content is still valid.

12 In most countries, the central bank law is not entrenched in the Constitution to the same extent as in the EU. Accordingly, the legislature can ultimately amend the central bank law and thus make a good central bank law worse. However, as a safety valve in emergencies, it may be preferable if the government temporarily takes over responsibility for monetary policy by overruling the central bank, say in the case of war or natural disasters. Provided this is done in a transparent way, this could result in a smaller loss of credibility in monetary policy. Even some EU countries (such as the Netherlands) formerly had such provisions in their central bank law.

13 Central bank autonomy presumes professional central bankers. However, while central bankers should be protected from discretionary removal, they must also be made clearly accountable. The most clear-cut example of this practice is New Zealand, where the governor can be dismissed.

The EU standards have played a role in this process, not least by providing practical examples of independent central banks in the EU Member States. The recent EU enlargement, which added ten new Member States, many of these in former socialist-ruled countries, has shown that central bank laws ensuring the highest standard of independence are also possible in countries in transition to market economies.

The standards adopted in the Maastricht Treaty and further developed by the EMI and, later, by the ECB and the EU Commission have played, and continue to play, a pivotal role. The amendments that have had to be made in the NCB laws in Member States to make them compatible with the Treaty and the Statute provide useful approaches for independent central banks in other countries.

## **6 SOME EXAMPLES OF NON-EU CENTRAL BANK LAWS**

Central bank laws in some countries outside the EU were studied and compared with international best practices for central banks for the purpose of this survey.<sup>14</sup> This yielded the following key observations:

### **PRICE STABILITY**

The insertion of the maintenance of price stability as an objective in central bank law may now broadly be considered as the internationally-accepted standard monetary policy objective in many, if not in most, countries, including some developing countries and countries in transition to a market economy. In some countries, this objective is even stated in the Constitution of the country<sup>15</sup>, which may further strengthen public confidence that the political authorities are committed to price stability as the principal monetary policy objective of the central bank.

### **INSTITUTIONAL INDEPENDENCE**

Central bank independence also appears, if this is evaluated based only on statutory provisions in the central bank laws, to be internationally a widely accepted standard. It may be found in a number of countries, and not only in industrialised ones.<sup>16</sup> Its significance varies from country to country, however; unless central bank independence from outside pressure (political or non-political) is clearly specified, its autonomy in practice must be individually analysed for each country. The mere insertion of any of the words “independence”, “independently” or “autonomous” into the central bank law does not necessarily mean that the central bank takes its monetary policy decisions independently of political or other bodies. In countries where an

14 The countries in question are Albania, Azerbaijan, Botswana, Egypt, Georgia, Iceland, Indonesia, Jordan, Lesotho, Mexico, Moldova, Mongolia, the Philippines, Russia, Serbia, South Africa, Sri Lanka, Switzerland, Turkey, Ukraine and Venezuela.

15 As in, for example, South Africa and the Ukraine.

16 For instance, in Albania, Azerbaijan, Georgia, Iceland, Indonesia, Jordan, Mexico, Moldova, the Philippines, Russia, Serbia, Turkey, Ukraine (“economic independence”) and Venezuela.

authoritarian regime has recently been replaced by a democratic one, the desirable and even necessary coordination of monetary policy with the government's financial policy may be perceived as a tool for conducting discussions with the central bank management, which, in practice, is tantamount to unlawful political interference in the decision-making of the central bank.

As is the case with price stability, the independence of the central bank is stipulated in the Constitution in some countries.<sup>17</sup>

## **PROHIBITION AGAINST INSTRUCTIONS**

Explicit statutory prohibition for members of central bank decision-making bodies against seeking or taking instructions from outside parties, and a reciprocal prohibition of outside parties giving such instructions, is widely recommended, as it defines in a clear manner the meaning of independence. If such a provision is not in place, the authorities might make their own definitions that could be misused. What remains to be explained, however, is that the prohibition against instructions should not prevent desired and even necessary discussions among the central bank, the government, the parliament, the financial community, academia, the media and the general public. Coordination with the government is for example needed on public debt policy. Moreover, all EU citizens should be entitled to express their views on monetary policy issues. The central bank should correspondingly make a great effort to explain its decisions publicly. It may also need to explain what types of monetary policy can and cannot be achieved, and should agree not to take any blame for what rightfully belongs to the government, for example.

Statutory prohibitions against instructions in central bank laws can be found in number of countries.<sup>18</sup>

## **PERSONAL INDEPENDENCE**

The EU standards on personal independence of the members of the central bank board (or of any equivalent decision-making body) have been partly implemented in many countries. They often apply, however, only to the governor of the central bank and only partly, or even not at all, to other members of the board.

The minimum term of office of the governor is often prescribed to be several years and sometimes five years or even more<sup>19</sup>, which in most countries is a longer period than the terms for members of parliament.

17 For instance, in South Africa. Among the EU countries, this is so in Sweden's case.

18 For example, Albania, Azerbaijan, Indonesia, Romania, Serbia and Switzerland.

19 This is the case in, for example, Albania (7 years), Azerbaijan (5 years), Georgia (7 years), Iceland (7 years), Indonesia (5 years), Jordan (5 years), Lesotho (5 years), Mexico (5-8 years), Moldova (7 years), Mongolia (6 years), the Philippines (6 years), Serbia (5 years), South Africa (5 years), Sweden (6 years), Switzerland (6 years), Ukraine (7 years) and Venezuela (7 years). For a survey of terms for governors and other non-officio members specified in more than 100 central bank laws, see Lybek and Morris (2004).

On the issue of dismissal of the governor and other board members, provisions fully satisfying international best practice can only be found in a few countries. There are, however, provisions in several central bank laws prohibiting a discretionary dismissal of the governor.<sup>20</sup>

## FINANCIAL INDEPENDENCE

The power to determine the central bank's budget is, in fact, assigned to the board of the central bank in some of the countries studied.<sup>21</sup> However, in most of these countries, the political authorities appear reluctant to give the central bank board the full authority to avail itself of the resources it considers necessary to fulfil its duties in a proper manner. They are particularly reluctant to allow the central bank to offer salaries that differ from those customary in the public sector, even though this is necessary to attract candidates best suited for the positions. The salaries offered may, at best, be above customary salary levels in the public sector, but still substantially below those in the private sector. As the public sector may to some people be more attractive for other reasons, some difference may be justified, but central bank salaries should not be substantially lower than those in the private sector. Monetary policy and financial sector stability are challenging tasks and responsibilities, and should be assigned to professionals capable of and dedicated to carrying out those tasks.

In most countries, this reality is reflected in the somewhat higher level of salaries of employees of the central bank compared with employees in the public sector.<sup>22</sup>

## FUNCTIONAL INDEPENDENCE

Functional independence mainly entails central bank independence with regard to political authorities in determining and executing monetary and banking supervision policies. The central bank board (or the equivalent body) should have sole authority to determine:

- The definition of price stability;
- The definition of financial stability;
- The means by which the central bank's objectives shall be achieved;
- The authority to decide on its own and to issue binding monetary regulations and, provided the central bank is also responsible for banking supervision, banking supervisory regulations; and
- The sole power, within its authority set out in the central bank law, if any, to approve any credit to the government.

The observance and practical implementation of functional independence is difficult to measure simply by analysing the central bank law. The law may

20 Among the countries studied in this survey, there are provisions against discretionary removals of the governor and, in some cases, of other members of the board of the central bank in Albania, Botswana, Georgia, Lesotho, Russia, Switzerland and Venezuela.

21 For example, in Egypt, Indonesia and Moldova.

22 However, this is not the case in the Banca d'Italia, where the central bank seeks to recruit, at attractive terms, the most qualified people in the banking and financial sector.

provide what is required but, in some countries, the implementation of adopted laws may not be satisfactory for a number of reasons, such as:

- Corruption in both the private and the public sectors, including within the judiciary;
- Insufficient and/or inadequate resources within the legal system; and
- A lack of tradition in respecting and upholding the rule of law.

This paper does not attempt to evaluate the practical implementation of the adopted central bank laws; this task remains to be carried out at some later stage.

## **7 FINAL REMARKS**

What is next on the agenda? There are still many countries with central bank laws that need to be thoroughly revised to become compatible with international standards, provided the political authorities recognise that this is desirable or even necessary to make their monetary policy as effective as possible in contributing to long-term economic growth. The focus of the international debate has been moving from autonomy to accountability and transparency and, most recently, towards good governance and efficiency.

A major problem in some countries is the misuse of public funds by the central bank. Most central bank buildings are of a considerably higher standard than most other public buildings, and even in some low-income countries, central bank buildings are best described as luxurious. Poor governance is a problem in some countries. If the board does not truly function as an overseer of the central bank, the Minister of Finance has valid reasons for interference. Proper procedures to elect appropriate board members, clear objectives and responsibilities, and proper evaluation and accountability procedures should be in place in order to set up a central bank board that fulfils its duties in as effectively as possible.

Inefficient judicial systems and widespread corruption also cause severe problems in a number of countries and often present a major obstacle to the effective implementation of legal frameworks of standards, even in industrialised countries. Corruption is difficult to combat, particularly in countries where it is also widespread within the political establishment. If lawmakers are reluctant to combat corruption within the legal system and elsewhere in the society, it becomes difficult to set up organisations and other systems which can effectively govern any country to the benefit of the majority of its population. For this reason, governance issues are being increasingly focused upon in international efforts to combat poverty and improve conditions in many countries that are heavily burdened by corruption.

In many newly democratic countries, tradition still plays an important role. Substantial parts of the population are used to politicians not respecting the rule of law; and, in some countries which have recently become democratic on paper, politicians at times tend to act, even though they are lawmakers, as if they were not bound by the rule of law. The legal situation in some countries affected by such traditions is sometimes described as “unpredictable”, to use IMF jargon.

The importance of the rule of law and the importance of respecting and upholding it are concepts that are still unfamiliar in some countries that are currently or were previously ruled by authoritarian governments. In such countries, resources to ensure the rule of law are still scarce. This affects the transparency of the law, so that amendments are rarely if ever incorporated into published laws. Where the court system is under-dimensioned, the outcome of court proceedings may be severely delayed, which is particularly damaging in court proceedings involving banking or financial issues. Evidently, the outcome of court proceedings can be predetermined if even the judges are inclined to accept favours of some sort. In many countries, there is also a clear need to assist judges by informing them about how the banking system functions (including the central bank), how legal and accountancy principles can be applied, and how the market economy functions as a whole. Improvements in such areas would, obviously, represent a great step forward toward making the legal system a useful part of the public sector. This would support democracy and the market economy, which has proven, over the years, to be the most effective economic model for most people in the majority of countries. Simultaneously, it must be recognised that current salaries in the public sector (including the judiciary) are often substantially lower than in the private sector, and that governments in most developing countries have severe budget constraints that do not permit them to raise substantially the salaries of civil servants. Indeed, the low level of current salary levels in some countries even appears to suggest tacitly that some civil servants should raise extra funds on the side.

The effective implementation of legal provisions is a challenging task and an issue that needs to be carefully considered in a number of countries. To a varying degree this is also true for EU Member States: possible legal reforms must be thoroughly evaluated in, for example, upcoming EU assessments of the implementation of the legal convergence criteria in applicant countries.