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Central Banks in European Emerging Market Economies in the 1990s

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WORKING PAPER 40

**Central Banks in European Emerging Market
Economies in the 1990s**

Eduard Hochreiter and Tadeusz Kowalski

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Editorial

In this Working Paper, Eduard Hochreiter, Oesterreichische Nationalbank, and Tadeusz Kowalski from the University of Poznan, analyze the institutional framework of central banks in ten Central and East European countries in the 1990s using the ECB as benchmark. The paper looks at the legislated objectives of these central banks, assesses the degree of political and functional independence and the status of their democratic legitimization and accountability.

We find that while much progress has been made in making the statutes “Maastricht compatible”, all of them will have to be adapted once again before EMU entry. The legislation provides for democratic accountability comparable to that of the ESCB. Moreover, in recent years the enacted limitations of fiscal financing have become more binding. Yet, rescue operations in the financial sector that occurred in some of the studied countries might be seen as encroaching the independence of the respective central bank.

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Central Banks in European Emerging Market Economies in the 1990sⁱ

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and
Tadeusz Kowalskiⁱⁱⁱ

April 3, 2000

Abstract

This paper analyzes the institutional framework of central banks in ten Central and East European countries using the ECB as benchmark. It looks at the legislated objectives of these central banks, assesses the degree of political and functional independence and the status of their democratic legitimization and accountability.

We find that while much progress has been made in making the statutes “Maastricht compatible”, all of them will have to be adapted once again before EMU entry. The legislation provides for democratic accountability comparable to that of the ESCB. In recent years the enacted limitations of fiscal financing have become more binding. Rescue operations in the financial sector might be seen as encroaching the independence of the central bank.

JEL Codes: E52, E58

Keywords: central bank independence, central bank accountability, emerging market economies

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1. Introduction

With economic and political transition now well advanced in a number of European Emerging Market Economies (EEME) these countries are now setting their sights to become members of the European Union and to join Economic and Monetary Union (EMU). One important aspect of the latter is the requirement of independence of central banks as laid down in the Treaty of Maastricht. Intimately related to the issue of independence are accountability and transparency of independent central banks.

This paper is concerned with institution building in the central banking sphere in ten EEMEs, i.e., Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia, as it evolved in the 1990s. Section 2 reviews and analyzes the legal status of these central banks as of 1997/1998 and discusses the question of political and functional independence of central banks in these countries. The focus is on issues and facts which, it is hoped, will be of longer-term interest. Section 3 looks at their democratic legitimacy and accountability. In section 4 some conclusions are drawn.

2. Institutional Issues

A functioning market economy requires institutions that lay down foundations and enforce the "rules of the game". Properly designed institutions may also speed up the transition by reducing friction and uncertainty. They are also prerequisites for successful stabilization and sustainable growth. In the financial sphere the establishment of a two-tier banking system with an independent central bank whose main tasks are clearly specified was of paramount importance initially. The design and the implementation of monetary policy needs appropriate instruments and money markets. Politically and functionally independent central banks must be placed in the institutional context of democratic societies¹.

The overriding importance of rapid financial reform for the transition process had not been seen at the outset. Therefore, the typical sequencing order did not give top priority to financial market reform. With hindsight this has been identified as the single most important sequencing error and is still causing sizeable problems in some of these countries². Nonetheless, it has to be stressed that much has been accomplished in the last ten years. The two-tier banking system was established and due to liberalized entrance rules competing commercial banks have emerged³. This has been particularly so in Hungary, Poland and Estonia where the share of foreign banks in the commercial

banking sector is much bigger than in other EEMEs⁴. New central bank legislation of a Western type was adopted and financial markets have been developing gradually.

2.1 The New Central Banks

There is widespread agreement that the stabilization of the macro economy is a necessary but not sufficient condition for successful systemic change. The experience of Western European countries after the Second World War (e.g., Austria) also points in this direction⁵. There is also agreement that monetary policy has an important role to play. Since it had no economic relevance in the old system, the necessary institutions, policy instruments, payment systems and financial markets have had to be developed from scratch⁶. Moreover, there is no way around earning the credibility of monetary policy⁷ (although it can be borrowed initially). Finally, the reputation of central banks has to be established.

The design of a credible monetary policy also depends on the institutional set-up of the central bank⁸. By now (beginning of 2000) new central bank laws have been adopted in all countries covered⁹ with Poland (January 1998¹⁰) and Romania (May 1998) coming last. The acts of the latecomers are modeled along the lines of the new acts of other reforming countries. Note, however, while price stability is codified as the prime objective of monetary policy in both acts, it is only the NBP, but not the RNB Act, which also establish formal political and functional independence and explicitly prohibits fiscal financing¹¹.

The widely held view that the Bundesbank Act served as a blueprint for the new central bank legislation in EEMEs has been contested, e.g., by Siklos (1993). Indeed, a case can be made for the assertion that, e.g., in terms of the prime goal of the central bank - price stability - and its independence, certain provisions of the central bank laws of these countries resemble the (pre-ESCB) Austrian National Bank Act rather than the Bundesbank Act¹².

Be that as it may, central bank legislation in these EEMEs who seek EU membership will have to be compatible with the Treaty of Maastricht, which, in Protocol No 3, contains the statute of the European System of Central Banks (ESCB) and that of the European Central Bank (ECB)¹³. Thus, the statutes of the ESCB already served as the benchmark for those EEMEs, whose central bank legislation was implemented towards the end of the 1990s. This is particularly evident in the case of new central bank legislation in Hungary and in Poland. The relevant provisions of the Maastricht Treaty require full political and functional independence of member banks (Art. 7 of the Statute of the ESCB and of the ECB) and completely prohibit direct fiscal financing (Art. 104 of the Treaty). It is noteworthy that all EU states including Germany had to amend

their central bank legislation prior to EMU to meet the provisions of the Maastricht Treaty¹⁴.

The legal status of the central bank, while not sufficient by itself to guarantee a stability-oriented monetary policy, is especially important for countries in transition for the following reasons: First, it has been argued that there is a significant negative relationship between the legal status of the central bank and the rate of inflation¹⁵. Second, empirical research also points to a statistically significant negative relationship between the rate of inflation and the rate of real growth¹⁶. Thus, it is clear that it is advantageous to have an independent central bank. Independence facilitates the building of credibility as an inflation fighter (Blinder, 1998). Third, legislated independence may, in part, substitute the lack of a track record of stability-oriented monetary policy.

Yet, even so a formally independent central bank may encounter very high costs of a disinflation policy¹⁷, if it lacks political support. Thus, governments of EEMEs should give institutional guarantees for the central bank's independence.

In addition to a broad consensus that a central bank should be politically and functionally independent and that it should not directly finance public authorities, there is almost universal agreement among central bankers and academia that the maintenance of price stability is the key task of the central bank.

The central bank laws in Central and Eastern Europe, which have been enacted during the last 10 years have come a long way to meet these requirements and, indeed, those of the Maastricht Treaty, although each one of them will still need to be amended. In particular, current statutes contain the following features¹⁸:

1. The top representatives are appointed by parliament, the governor usually by the president of the Republic. Their term of office is at least five years. Thus, the central banks formally can no longer be seen as being "servants" of the political process. In fact, today they are equipped with a rather high degree of independence.
2. Price/currency stability has been identified as the prime objective. The somewhat more ambiguous term "currency stability" is codified in eight countries, the term "price stability" proper only in Latvia and Poland.
3. Within this constraint the central bank should support the economic policy of the government¹⁹.
4. Fiscal financing, in general, is limited or not allowed. There are, however, significant differences from country to country.

Prima facie evidence suggests that - especially in the early stages of transformation - the limitations to fiscal financing were circumvented in a number of countries. This weakness, in large part, was specifically related to legacies of the past. Since then much progress in tightening the budget constraint was made and today this particular (fiscal) weakness is much reduced. Still, direct fiscal financing will have to be eliminated altogether to conform to the Maastricht Treaty and the provisions of the Stability and Growth Pact will have to be adhered to²⁰.

2.2. Prime Objective of Monetary Policy: Price/Currency Stability

Eight central bank laws of the countries considered stipulate currency stability as the prime objective of the central bank. In Hungary the central bank is called upon to safeguard both the domestic and external purchasing power of the national currency. The Czech National Bank (CzNB) has to ensure the stability of the Czech national currency (Art. 2 CzNB Act). Similar wording, i.e., maintenance of currency stability, is used in other central banking laws in the region except for Poland and Latvia (see the annex). The principal goal of the National Bank of Poland (NBP) (Art. 3.1 NBP-Act) is ... to maintain price stability while supporting the government's economic policy insofar as it does not conflict with the NBP's principal goal²¹. In the case of Latvia the main objective of the Bank of Latvia (BOL) is (...) to maintain price stability in the State (Art. 3 Law on the BOL). The Latvian bank is also called to "facilitate free competition, effective allocation and circulation of assets, and the stability, coordination and supervision of the financial system" (Art. 3 Law on the BOL).

2.3. Prohibition of Fiscal Financing

Similar to the quantitative financing restrictions contained in (pre-ESCB) central banking laws in market economies, direct credit to the government is severely restricted or not allowed in the EEMEs under consideration. Nonetheless, in the early stages of transformation, despite being stipulated by law, the fiscal financing restrictions were in most of the countries in question definitely the weak spot. In the Czech Republic, Slovakia and Romania current laws limit central bank's credit to the government to 5% and 7 % respectively of budget revenues of the previous or current year²².

In Bulgaria the central bank may not extend credit in any form to the state or to any state agency, except against purchases of special drawings rights (SDR) from the

International Monetary Fund. Furthermore, the time limit for the utilization of the credit by the state is set at 90 days after the date of actual purchase of the SDR from the IMF (Art. 45(2), Law on the Bulgarian National Bank (BNB)). In Slovenia a cap is put on by restricting fiscal financing to one fifth of the total expected budget deficit.

The Bank of Estonia is explicitly prohibited from directly or indirectly granting credit to the state budget and local budgets, and from buying securities issued by government executive bodies (Art. 16, Law of the Central Bank of Estonia). Poland's new Constitution prohibits drawing up budgets on the assumption that the possible resulting deficit will be financed by the NBP. This rule has been included in Art. 220.2 of the Constitution: "The Budget Act may not provide for the budget deficit to be covered by assuming liabilities to the state's central bank". The NBP may indirectly provide financing of the budget deficit by open market operations in treasury securities. The Act does not explicitly specify rules for NBP's participation in the securities market. However, Art. 220 of the Constitution and Art. 48 of the NBP Act indicate that the NBP may not participate in the primary public debt market²³. The amended law on the Bank of Latvia now also prohibits direct fiscal financing. Article 36 states that "the Bank of Latvia shall not have the right to issue credits to the government and to buy government securities on the primary market.

In the early stages of transformation, due to the difficult and in some cases deteriorating public deficit position and underdeveloped financial markets, there was substantial pressure on the central bank to increase its direct financing of the public authorities²⁴. In addition to the difficulties to secure sound fiscal policies that are also apparent in industrialized countries, there were serious problems specific to EEMEs inherited from the past. As, e.g., Siklos and Abel (1993) point out, central banks were forced to continue lending to loss making state enterprises in the EEMEs which constituted a form of fiscal financing. Such continued lending occurred because of insufficient progress in the development of the financial system, implying that the central bank - through the monetization of public deficits - acted as a shock absorber. At the beginning of the transformation, both factors (the fiscal deficit and continued extension of credit to loss making enterprises) led to the overruling of legislated restrictions on fiscal financing by parliament (e.g., Bulgaria or Hungary) or in that the negotiated amount of fiscal financing turned out to be higher than stipulated (as was the case Poland²⁵). In that way central bank independence was seriously undermined.

2.4 A High Degree of Political and Functional Independence

2.4.1 Political Independence

Political independence facilitates the task of the central bank to pursue a monetary policy strategy consistent with price stability²⁶. In particular, political independence usually is linked to such features as term of office, lack of government interference in the appointment procedures of the board members of the bank and to the absence of government representatives (having voting rights) on the central bank's board and the Monetary Policy Committee (MPC).

The requirements of political independence of the ECB (ESCB), being a benchmark for other central banks, are contained in Art. 7 of the ESCB statutes. They stipulate that neither the ECB, nor a national central bank, nor any member of their decision-making bodies shall seek or take instructions from other institutions and bodies. This article also prohibits any attempt by national and supranational institutions to influence the members of the ECB (ESCB) decision making bodies.

The notion of political independence is closely connected with the issue of central bank accountability²⁷. In the EEMEs the following solutions have been adopted:

2.4.4.1. The relationship between the central bank and the government

All central bank laws under consideration (with the exception of that of the CzNB²⁸ and the Bank of Slovenia (BOS)) contain provisions regarding the relationship between the central bank and the government. Generally, a central bank has to support government's economic policy in one way or another. While such a clause is also contained in Article 2 of the statutes of the ESCB, the material meaning of such provisions in Central and Eastern Europe remains somewhat ambiguous. The available evidence is heterogeneous, but points to the conclusion that actual independence in some cases might be less than the statutes would suggest.

2.4.4.2. The term of service of the central bank's top management

The term of service of the top management in general ranges from 5 to 8 years and is, therefore, longer than the electoral cycle. In Hungary the term of the governor and the deputy governors is 6 years; other Central Bank Council members' term is 3 years (Art. 57, Act on the National Bank of Hungary (NBH)). Board members cannot be removed from office unless they are sentenced for committing a crime, they become unable to perform their duties (e.g., extended illness) and, in most cases, if they resign. In the NBH Act a rather vague clause - unworthiness of office - has been preserved, possibly encroaching on the factual independence of the top management. The political independence of the NBP is guaranteed in the Constitution (Art. 277.1): "The role of the central bank in Poland is performed by the National Bank of Poland. The bank has the exclusive right to issue the nation's currency and to formulate and implement its monetary policy". The governor of the NBP is appointed by the Sejm (Art. 9.1 of the NBP Act) on the recommendation of the president of the Republic of Poland for a six-year term of office. Art. 10.2 of the NBP Act states: "The NBP vice-governor and members of the Board of Directors are appointed and dismissed by the president of the Republic of Poland on recommendation of the NBP governor". Sections 4 and 5 of the Art. 9 contain the causes that may lead to the termination of the NBP governor's term. Accordingly, the NBP governor may be dismissed if found "failing to perform his duties due to an extended illness", "guilty of a criminal act by a lawful verdict of a court of law", or if "the State Tribunal bars him from holding high-ranking positions of special responsibility in governmental bodies".

2.4.2 Functional independence

Functional independence empowers the central bank to freely choose the instruments and techniques of monetary control and exchange rate policy which ultimately lead to price stability²⁹. Generally, functional independence gives the central bank the means to control, at discretion, either the quantity or the price of money.

In Western countries as in the ESCB the decision concerning the setting of (formal) exchange rate regimes rests with the government and the (ECOFIN) Council (Art. 109 of the Maastricht Treaty) respectively, although the central bank has, to varying degrees, a role in the decision-making process. The situation appears to be different in the EEMEs under consideration. In the Czech Republic the CzNB

"proclaims" the exchange rate of the Czech currency vis-à-vis foreign currencies (Art. 35 lit. a) and sets monetary policy (Art. 2 lit. a). Similarly, the National Bank of Slovakia "establishes" the exchange rate in relation to foreign currencies (Art. 28 lit. a) and "defines" monetary policy (Art. 2 lit. a). In Bulgaria, under the new law on the Bulgarian National Bank (BNB) the official exchange rate of BGL to the DEM was set at one BGL per one DEM (Art. 29). Furthermore, the aggregate amount of monetary liabilities of the BNP should not exceed the BGL equivalent of gross international foreign exchange reserves (Art. 29(1), and spot exchange rates within Bulgaria, should not deviate from the official exchange rate by more than 0.5 percent (Art. 30)³⁰.

In the case of Estonia, the central bank is responsible for executing the foreign currency regulations (Art. 15, Law on the Central Bank of Estonia (Eesti Pank)). In particular, the Eesti Pank (technically) determines the exchange rate for the Estonian kroon (ESK) against foreign currencies (Art. 15(5)). This stipulation notwithstanding, it has to be noted that the fixed exchange rate between the ESK and the DEM may only be changed by the Estonian Parliament, and that the Eesti Pank has no right to devalue the ESK³¹. Similarly, the Bank of Latvia, has the sole responsibility of setting the official exchange rate of the national currency (Art. 4, Law on the Central Bank of Latvia). In Latvia, the central bank law, as in the Estonian case, does not envisage explicitly any co-ordination of the central bank's exchange policy with the government. The Bank's sole responsibility for the foreign exchange policy is strengthened by Art. 8 of the law on the Bank of Latvia³². In Romania foreign exchange policy is drawn up and implemented by the central bank. Moreover, the NBR sets and supervises the implementation of the foreign exchange rate regime (Art. 9(1), Law on the National Bank of Romania).

In Poland the relevant regulation (Art. 24.1,2,3) reads as follows: "The NBP shall carry out the foreign exchange policy established by the Council of Ministers in consultation with the Monetary Policy Council (MPC), the procedure for setting the exchange rate of the PLZ against foreign currencies shall be laid down by the Council of Ministers in consultation with the MPC, the NBP shall publish current exchange rates for foreign currencies and rates for other types of foreign exchange".

In Hungary the setting of the exchange rate has to be approved by the government in agreement with the NBH (Art. 13(2) of the Act of the NBH). No other limits and/or guidelines are established in the current act on the NBH for the execution of exchange rate policy of the Bank. In Slovenia the central bank has the right to set the

exchange rate. Art. 20 of the BOS-Act stipulates that "in materializing its competence the Bank of Slovenia shall determine the monetary policy and take measures for its implementation". In all countries the central bank has control over the use of policy instruments in day-to-day business.

3. Democratic Legitimacy and Accountability

The central bank derives its democratic legitimacy from an act of parliament. In the case of an independent central bank this means that democratically elected officials chose to limit their power by their free will by delegating some of these powers to the central bank. In addition, parliament also decided upon the central banks's mandate, albeit, in general, in the case of a price stability objective, without numerically specifying it. For these reasons we believe that an independent central bank is sufficiently democratically legitimized. Moreover, delegated power can, as it should, be revoked by law, even if renouncing the central bank act might be extremely difficult and associated with high political cost.

The delegation of power to a body of unelected officials has been criticized, e.g., by Briault et al. (1996) as diluting democracy and giving rise to a democratic deficit. In a democratic society an independent central bank must explain and defend its decisions and the bank must also be sufficiently clear regarding the general strategy it pursues. This is a matter of accountability, which is the natural counterpart to independence. Both go, and have to go, hand-in-hand. As Blinder (1998, 69) notes, public accountability might be interpreted as "a moral corollary of central bank independence. In a democratic society, the central bank's freedom to act implies an obligation to explain itself to the public. Thus independence and accountability are symbiotic, not in conflict. The latter legitimizes the former within a democratic political structure".

The issue of democratic accountability is multifaceted and may be approached both from the angle of the 'democratic deficit' (Levy 1995), and from the 'deflationary bias' (Fischer 1994). In the 'democratic deficit' argument, the call for accountability is based on the need to create a mechanism to oversee an agency that has been entrusted with powerful means of monetary policy. In the deflationary bias argument the main concern is connected with a danger of substituting a partisan inflationary bias with a deflationary one stemming from the independent position enjoyed by central banks in

democratic countries. The call for accountability is also related to the very nature of monetary policy. It is very complicated and hermetic, so both the general public, and the elected politicians have a right to comprehensive justification and explanation of actions and decisions undertaken by the central bank. The information and explanation duties are also a prerequisite for the very judgement of actual efficiency of the central bank's policy.

Thus it is important and useful to distinguish a substantive accountability³³ (To which institutions are central banks legally accountable to?), and a procedural accountability (In which way are central banks accountable to the democratic institutions?). The problem of accountability and political and functional independence of central banks in the EEMEs is a new issue. With a few exceptions (notably the Czech Republic) the EEMEs have had a recent history of high, sometimes extremely high inflation. Although being the result from a diversified and complex set of factors, the cost of further disinflation might be lowered by clearly laying out the monetary policy strategy and by strengthening the central bank's accountability³⁴. In addition, the new democracies need to strengthen their democratic institutions to which the central banks are accountable.

The solutions chosen for the ECB have become a benchmark for other contemporary central banking legislation. The legitimacy of the Executive Board of the ECB derives from appointment by common accord of the governments of the Member States at the level of the Heads of States or of governments, on recommendation from the Council after it has consulted the European Parliament and the Governing Council (Art. 11.2)³⁵.

The ECB's accountability takes a number of forms: It has to publish reports (Art. 15) on its activities at least quarterly, and a consolidated financial statement of the ESCB has to be published weekly. It has to present the annual report on ESCB activities and its monetary policy to the European Parliament, the Council and the European Commission and also to the European Council (Art. 15.3). In addition, the ECB president gives detailed statements regarding the content of the discussion and the reasoning for decisions taken after each meeting of the ECB Council.

Yet, both the ECB's actual levels of accountability and of transparency have been (quite severely) criticized as not being sufficient³⁶. This criticism focuses on the fact that the ECB is not obliged to publish neither its own inflation forecasts nor minutes

of its policy meetings. We feel that this assessment leaves out the significant improvements in transparency undertaken by the ECB upon its establishment. Transparency does not so much depend on the publication of minutes per se but rather on the information content of statements. Comparing the press statement of the ECB president with the minutes of the FOMC meetings we feel that the ECB compares quite favourably.

The central banks covered in this study derive their democratic legitimacy from parliament and are governed by the statutes (laws) passed by parliament. The banks are therefore directly accountable to the law or parliament (e.g., Slovenia). In order to facilitate mutual information and to make the central bank's position with regard to subject matters relevant to central banking clear to the government, the central banks' governors of most of the countries covered in our study have the right to attend the meetings of the government in an advisory capacity. For example, Art. 22 of the NBP Act stipulates that "the governor of the NBP may attend meetings of the Sejm and the Council of Ministers". Moreover, the act specifies the scope of information the NBP is to furnish to the government and the procedure to be followed. The itemized list of information to be submitted by NBP governor on behalf of the MPC (Art. 23.1) includes: "quarterly reports on the balance of payments and annual balances of central government's assets and liabilities". The statutes require that the NBP governor furnishes "draft monetary policy guidelines, opinions on the draft budget, balance of payments projections and the Council's resolutions" to the Ministers' Council and the Minister of Finance³⁷. Finally, Art. 23.2 obliges state authorities, local governments and various other institutions and organizations, on the NBP's request, to produce the information necessary for the formulation of monetary policy and periodic assessments of the state's financial position.

In Hungary, the government is obliged to invite the NBH governor when matters relevant to the tasks of the NBH are on the agenda (Art. 47 of the Act on the NBH states that "the governor of the NBH shall be invited to matters on the agenda of the sessions of government affecting the tasks of the NBH").

In Bulgaria, the BNB is obliged to publish weekly the balance sheet of the issue department and the position of its basic assets and liabilities at the end of each month. The BNB submits to the National Assembly an annual report and annual financial report and also twice a year a report that reviews and assesses the bank's activities during the

previous period (Art. 50 and 51). In the case of Estonia reports to the parliament on the activities of the central bank are the responsibility of the president of the bank's management board. The president is also obliged to answer questions from parliament on the bank's activities (Art. 11(2)). The chairman of the Eesti Pank board answers questions from parliament regarding the activities of the Board (Art. 6(3)) on an ad hoc basis (except for presenting the annual report (Art. 9(8))).

The governor of National Bank of Romania is obliged to submit (until June 30 of the following year) to parliament the annual report (Art. 26(4)). The report should address the economic, financial, and monetary and exchange rate issues. The bank has to report to parliament on banking regulation and prudential supervision as well.

Finally, the central banks of the Czech Republic and Slovakia have an obligation (at least) twice a year to inform parliament about monetary policy and that of Hungary once a year. In the Czech Republic and Slovakia the general public must also be informed about monetary developments every three months. There are no explicit reporting requirements in Slovenia. In Latvia the law envisages that its central bank should be the consultant of the government and the Saeima on monetary policy and banking operation policy. The Latvian central bank has to publish only monthly and annual balance sheets (Art. 15, Law on the Bank of Latvia). These provisions are designed to guarantee more or less continuous monitoring of central bank policies by the government and society at large.

4. Concluding Remarks

The group of the ten EEMEs covered in this paper is very heterogeneous. None the less some general conclusions may be drawn. All countries have adapted their central bank legislation with a view of making them compatible with the requirements of the Maastricht Treaty.

The current central bank acts of Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovenia and Slovakia closely resemble those of Western central banks, in particular that of the ECB (ESCB).

The law on the National Bank of Romania remains the only one which has no explicit reference to independence. In the other countries the central bank is endowed with a high degree of formal political and functional independence. Price/currency stability has been singled out as the prime task of the central bank. Fiscal financing is

legally restricted or not allowed (Bulgaria, Estonia, Latvia and Poland). Thus, significant progress has been made in making the formal limitation of fiscal financing a binding constraint³⁸. Yet, some weaknesses remain. All analyzed central bank legislation provide for democratic accountability comparable to that of the ESCB.

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NATIONAL BANK LAWS IN CENTRAL AND EASTERN EUROPE^{iv}

INSTITUTIONAL FEATURES^v

Country	Statutory functional independence	Legislated prime objectives
Bulgaria	yes ^{vi}	currency stability
Czech Republic (CzR)	yes ^{vii}	currency stability
Estonia	yes ^{viii}	currency stability
Hungary	yes ^{ix}	internal and external currency stability
Latvia	yes ^x	price stability ^{xi}
Lithuania	yes ^{xii}	currency stability ^{xiii}
Poland	yes ^{xiv}	price stability
Romania	yes ^{xv}	currency stability ^{xvi}
Slovenia	yes ^{xvii}	currency stability
Slovak Republic (SR)	yes ^{xviii}	currency stability

iv) Information based on the following National Bank acts: Poland - August 29, 1997; Lithuania – April 8, 1997; Bulgaria – June 10, 1997; Latvia – May 19, 1992; Romania – May 26, 1998; Slovenia - June 25, 1991; Bulgaria - June 28, 1991; Hungary – June 30, 1991 – version January 1999; Slovakia - November 18, 1992; Czech Republic - December 17, 1992.

v) Positions not explicitly specified in the corresponding laws are indicated with "-".

vi) "In the performance of its functions the Bank shall be independent from any directions of the Council of Ministers and from other state bodies" (Art. 44). "...the BNB and the Council of Ministers shall inform each other of their intentions and actions" (Art. 3).

vii) "In providing for its primary objective the CNB shall be independent of any instructions given by the government" (Art. 9(1)). There is no reference in the CNB-Act concerning the relationship between the National Bank and the government as far as economic policy is concerned.

viii) "Eesti Pank is independent from all government agencies. Eesti Pank reports only to the Riigikogu (Parliament); it is not subordinated to the Government of the Republic of Estonia nor to any other institution of executive state power" Art. 3(1).

ix) The NBH develops its monetary policy "in an autonomous way in the framework of this (National Bank) Act" (Art. 6). "The NBH supports the implementation of the economic policy program of the government with monetary policy means available to it" (Art. 3).

x) "In fulfilling its tasks (...) the Bank of Latvia shall not be subject to the decisions and regulations adopted by the government or its institutions. The Bank of Latvia shall be independent in adoption of its decisions and their practical implementation" (Art. 13).

xi) In the case of Latvia (within the main goal) its central bank should also ..." facilitate free competition, effective allocation and circulation of assets, and the stability, co-ordination and supervision of the financial system" (Art. 3).

xii) "...The Bank of Lithuania shall be governed by the Constitution and Laws of the Republic of Lithuania and shall be independent from the government ... and other institutions of executive authority" (Art. 3).

xiii) "...Implementing the principal objective, the Bank of Lithuania must support the economic policy carried out by the government of the Republic of Lithuania, provided said policy is in compliance with the principal objective of the Bank" (Art. 7(2)).

xiv) "The basic objective of NBP (Art. 3.1 NBP-Act) is ... "to maintain price stability while supporting the government's economic policy insofar as such policy does not conflict with the NBP's basic objective". The position and responsibility of the NBP is also guaranteed in the new Constitution (Art. 277.1): ... "The National Bank of Poland is responsible for the value of the Polish currency".

xv) Conditional. Note that there is no explicit use of the notion of independence contained in the law on the National Bank of Romania.

xvi) "The main objective of the National Bank of Romania (NBR) is to ensure the stability of the national currency, for the overall purpose of price stability" (Art. 2(1)). Article 2(2) stipulates that: "In order to achieve its main objective, the NBR draws up, implements and is responsible for the monetary, foreign exchange, lending and payment policies, as well as for bank licensing and prudential supervision within the general policy of the State, aiming at both the good function of the banking system and the promotion of a market-oriented financial system.

xvii) "The Bank of Slovenia shall be independent in materialising its assignment and empowerments" (Art. 2). As in the Czech case there is no reference concerning the relationship between the Bank and the Government with regard to economic policy.

Country	Management ^{xix}	Appointed by	Term of Service (Years)
Bulgaria	Governor	National Assembly	6
	Managing Board:		
	- Governor		
	- 3 deputy-governors	National Assembly	6
Czech Republic	- 3 members	President	6
	Bank Board:		
	- Governor	President	6
	- 2 vice-governors	President	6
	- 4 senior national bank officers	President	6
Estonia	Board of Eesti Pank		
	- Chairman	Parliament	5
	- eight members ^{xx}	Parliament	5
	Management of the Eesti Pank		
Hungary	- President	President of the Republic	5
	- eight members ^{xxi}		
	Central Bank Council^{xxii}:		
	- Governor	President	6
	- up to 5 vice-governors	President	6
	- up to 5 members plus one ^{xxiii}	President	3

^{xviii}) "In fulfilling the primary objective ... the National Bank of Slovakia shall be independent of instructions given by the government" (Art. 12(2)). "The National Bank of Slovakia within the limits defined by this law supports (the) economic policy of the Slovak Republic" (Art. 12 (1)).

^{xix}) If it is not explicitly stated in the official translations, Presidents of State are hereafter referred to as "President", and National Bank Governors as "Governor".

^{xx}) Including the President of the Management of the Bank and the Minister of Finance. The eight members are nominated by the Chairman of the Board. The President of the Management of the Bank and the Minister of Finance are members of the Board from the moment of their appointment to their positions (Art. 8(1)). According to Art. 7(2) the President of the Eesti Pank and the Minister of Finance cannot be appointed Chairman of the Board.

^{xxi}) The Management of the Bank consists of the President, the head of the Banking Supervision, the Chief Accountant and other members. Neither the number of members nor the term of the Management is specified directly in the Estonian Law on the Central Bank.

^{xxii}) The term of service of the Governor and vice-governors as the Central Bank Council members is not specified directly in Art. 57 of the NBH Act. However, the term of service of the Governor and vice-governors is 6 years (Art. 58(2) and Art. 59(2), respectively). The same concerns the term of service of the Governor and vice-governors in their capacities of Board of Directors members.

Board of Directors:			
- Governor (chairman)	General Assembly	6	
- vice-governors	General Assembly	6	
- members of the board	General Assembly	not specified	
Supervisory Commission			
- chairman	Parliament	term of parliament ^{xxiv)}	
- 3 members	Parliament	term of parliament	
- representative of the MF	Minister of Finance	term of parliament	
- expert invited by the MF	Minister of Finance	term of parliament	
Latvia			
Governor	Parliament	6	
Board of Governors ^{xxv)} :	Parliament	6	
- Governor			
- deputy Governor		6	
- six Board members		6	
Executive Board ^{xxvi)}	Board of Governors	term not specified	
- Chairperson			
- five members			
Lithuania			
Chairperson	Parliament	5	
Board ^{xxvii)} :	President	9	
- Chairperson			
- three deputy Chairpersons			
- ten members of the Board			
Poland			
Governor	Parliament ^{xxviii)}	6	
Managing Board:			
- Governor			
- 2 vice-governors	President ^{xxix)}	term not specified	
- 6-8 members of the board ^{xxx)}	Governor	by law	

^{xxiii)} Art. 57(3c) of the NBH Act: "further members – of a number equals to the number of the deputy Presidents plus one – appointed, on the proposal of the Prime Minister – upon consultation with the President of the NBH – by the President of the Republic for a term of three years".

^{xxiv)} The members of the Supervisory Commission are elected for the term of the parliament, i.e., 4 years.

^{xxv)} The Deputy Governor and the members of the Board are appointed (upon recommendation of the Governor) by the Parliament through secret ballot (Art. 22).

^{xxvi)} "The Chairperson of the Executive Board shall be appointed by the Board of Governors (...) upon the recommendation of the Governor of the Bank. Other members (...) shall be appointed by the Board of Governors upon recommendation of the Chairperson of the Executive Board" (Art. 23).

^{xxvii)} Art. 10: (...) "The Deputy Chairpersons and the members of the Board (...) are shall be appointed for the term of 9 years by the President of the Republic of Lithuania on the recommendation of the Chairperson of the Board (...). The Board (...), except the Chairperson, shall be renewed by one third every three years".

^{xxviii)} Art. 9.1 of the NBP Act: "The Governor of the NBP is appointed by the Sejm on the recommendation of the President of the Republic of Poland for a six-year term of office".

^{xxix)} Art. 10.2 of the NBP Act: "NBP Vice-Governor and the Board members are appointed and dismissed by the President of the Republic of Poland on recommendation of NBP Governor.

^{xxx)} Including the Vice-Governors.

	Monetary Policy Council ^{xxxix} : President, - the NBP Governor and 9 members	Sejm and Senate	6
Romania	Governor Board of Directors ^{xxxii} : - Governor - prime vice-Governor - two vice-Governors ^{xxxiii} - five Members	Parliament Parliament	6 6
Slovenia	Governor Governing Board: - Governor - deputy Governor - 3 vice-Governors - 6 independent experts	Parliament Parliament Parliament Parliament	6 6 6 6
Slovak Republic	Bank Board: - Governor - 2 vice-governors - 2 executive directors - 3 other members Directorate: - vice-governor - executive directors	President President Government Government Governor	6 6 6 4 6

^{xxxix} According to Art. 13.1.2 of the NBP Act the MPC is chaired by NBP Governor and is composed of “nine members appointed in equal numbers by the President of the Republic of Poland, the Sejm and the Senate, these being specialists in the field of finance”.

^{xxxii} “The members of the Board are appointed by Parliament upon recommendation of the specialised permanent commissions of the two chambers of Parliament for six years (Art. 34(3)). The mandate may be repeated (Art. 34(4)). Five members of the Board of Directors should not be the NBR employees and are nominated by the executive management, and are also appointed by the Parliament (Art. 34(2,3)).

^{xxxiii} The law stipulates that the executive management of the NBR is performed by the Governor, Prime vice-Governor and the two vice-governors (Art. 33(2)).

SUSPENSION OF GOVERNOR

Country	
Bulgaria	<ul style="list-style-type: none"> - upon resignation - when the Governor is found engaged in other remunerative activity - non-attendance without due grounds of three or more successive sessions of the Managing Board - serious misconduct in office - action or inaction resulting in failure to fulfil any task of the BNB provided by the Law on the BNB^{xxxiv}
Estonia	<ul style="list-style-type: none"> - upon resignation - if found guilty by a court of law^{xxxv}
Czech Republic	<ul style="list-style-type: none"> - at sentencing for crimes - Board decision stating loss of ability to perform functions - upon own request submitted to Bank Board - simultaneous membership in Parliament, Government or bodies of banks and commercial companies
Hungary	<ul style="list-style-type: none"> - upon resignation - loss of ability to perform functions - at sentencing for crimes - unworthiness of the office held^{xxxvi}
Latvia	<ul style="list-style-type: none"> - upon resignation - if found guilty by the court of deliberate crime - if he is not able to work for a period exceeding six months because of illness or other reasons^{xxxvii}

^{xxxiv}) Art. 14(2). The mandate of the Governor and any member of the Board may be terminated before the set term (of six years) on any of the following grounds (Art. 14(1)): “resignation, practical inability to perform his/her functions for more than six months, enforcement of an imprisonment sentence for a premeditated crime, adjudication in insolvency in a capacity as a sole proprietor or general partner in a commercial company, previous membership of a managing or a controlling body of a company or co-operative which has been dissolved by insolvency”.

^{xxxv}) Art. 12: “The Chairman of the Board (...), the President (...) and members of the Board (...) shall have their nominations terminated if found guilty by a court of law”.

^{xxxvi}) Art. 58 of the Act on the National Bank of Hungary.

^{xxxvii}) Art. 22 of the Law on the Bank of Latvia.

Lithuania	<ul style="list-style-type: none"> - upon resignation - if it becomes evident that he/she is not able to perform his/her duties properly due to health problems - due to a valid court decision concerning the conviction of a member of the Board for a deliberate crime - when he/she becomes a member of council or board of banks or other credit institutions^{xxxviii}
Poland	<ul style="list-style-type: none"> - upon resignation <p>Governor may be dismissed if found^{xxxix}:</p> <ul style="list-style-type: none"> - failing to perform his duties due to an extended illness, - guilty of a criminal act by lawful verdict a court of law, - if the state Tribunal bars him/her from holding high-ranking positions of special responsibility in state bodies
Romania	<ul style="list-style-type: none"> - upon recall by parliament whenever:^{xl} <ul style="list-style-type: none"> - he/she is no longer eligible, according to the provisions of Art. 36 (Incompatibilities and conflict of interests), - a prison sentence was pronounced and the court ruling is final, - during his/her mandate, he/she engaged in inadequate operations, substantially damaging the NBR's interests
Slovenia	<ul style="list-style-type: none"> - upon recall by parliament
Slovak Republic	<ul style="list-style-type: none"> - upon recall by the President upon a proposal of the govt. - upon resignation - upon sentencing for crimes - Board decision stating loss of ability to perform functions - simultaneous membership in Parliament, Government, or bodies of banks, commercial companies and other entrepreneurial groups

^{xxxviii}) This reason does not encompass international credit agencies or institutions the member whereof is the Republic of Lithuania (Art. 12).

^{xxxix}) Art. 9.1, section 4 and 5 of the NBP Act.

^{xl}) According to the new law (Art. 34(6)) "A member of the Board of Directors may be recalled from the office by the Parliament, at the proposal of the specialised permanent commissions of the two chambers of Parliament". The reasons are listed in the above table.

LENDING TO GOVERNMENT

Country	Limit	Repayment	Days to maturity
Bulgaria	no direct lending to the government ^{xli}	-	maximum 90 days
CzR	5 % of budget revenues in previous year -		maximum 3 months
Estonia	no direct or indirect lending to the government ^{xlii}		
Hungary	2 % of the planned budget revenues ^{xliii})	end of calendar year	up to 15 days in a month
Latvia	no direct lending to the government ^{xliv}		
Lithuania	not specified ^{xl}	-	not specified
Poland	no direct lending to the government ^{xlvi}		
Romania	7% of the annual budget ^{xlvii}		maximum 180 days
Slovenia	5 % of planned budget of current year and shall not exceed 1/5 of expected total budget deficit	end of fiscal year	short-term loans ^{xlviii})
SR	5 % of budget revenues in the previous year	-	maximum 3 months

^{xli}) Under the new law on the BNB the Bank (...) “may not extend credits in any form whatsoever to the State or to any state agency, except credits against purchases of special drawing rights from the International Monetary Fund. (...) the time limit for the utilisation of the credit by the State shall be 90 days (...)” (Art. 45(1),(2)).

^{xlii}) “The Eesti Pank is prohibited from directly or indirectly, granting credits to the state budget and local budgets, and from buying securities issued by government executive bodies” (Art. 16).

^{xliii}) In the current NBH Act (Art. 18(4)) the liquidity loans for bridging the monetary liquidity difficulties of the Single Treasury Account, may exist continuously or separate days up to 15 days in a calendar month; such liquidity debt of the central budget must not exist on the last day of the year.

^{xliv}) Art. 36: “The Bank of Latvia shall not have the right to issue credits to the government and to buy government securities on the primary market”.

^{xl}) Lithuania is the only country under this analysis that does not explicitly address a problem of relationships between the Bank and the budget. The only article where such link is set is Art. 26(1): “In conducting monetary policy the Bank of Lithuania shall buy and sell debt instruments (securities) issued by the Republic of Lithuania”.

^{xlvi}) Poland’s Constitution prohibits drawing up budgets on an assumption that the possible resulting budget deficit will be credited by NBP (Art. 220.2 of the Constitution).

^{xlvii}) Art. 29(4): “The total amount of loans granted during one financial year shall not exceed 7% of the State budget revenues of the previous year, and the standing balance of loans granted and unpaid shall not exceed at any time, twice the amount of the NBR’s own capital and reserves”. The loan has to be repaid within 180 days at a market interest rate (Art. 29(3)).

^{xlviii}) Bridging loans to the budget are allowed.

Endnotes

- ¹⁾ See e.g. Pollard (1993), Banaian et al. (1993), Posen (1993), Masciandaro and Spinelli (1994), Haan de, Amtenbrink and Eijffinger (1998) and Hochreiter (1999a).
- ²⁾ See Nuti and Portes (1993: 16).
- ³⁾ For an analysis and discussion of financial reform in emerging market economies see e.g. Kowalski (1997).
- ⁴⁾ Foreign ownership in the Hungarian banking system reached 48.3% in 1997, see OECD Economic Survey, Hungary 1997. Other sources (eg. Bozsik and Neale 1999) estimate the foreign ownership at a level of over 60%. In Poland, foreign ownership in the banking sector was over 30% in 1997. By the end of 1998 it reached over 40%.
- ⁵⁾ For a discussion of the Austrian experience after the Second World War, see Klier (1990).
- ⁶⁾ See Managing Change in Payment Systems, BIS Policy Papers No. 4, Bank for International Settlements, Monetary and Economic Department, Basle, May 1998.
- ⁷⁾ The essence of central bank credibility is matching actual policy actions by a central bank to its monetary policy pronouncements.
- ⁸⁾ For a discussion of the monetary policy problems in the EEMEs, see The Transmission of Monetary Policy in Emerging Market Economies, BIS Policy Papers No. 3, Bank for International Settlements, Monetary and Economic Department, Basle, January 1998.
- ⁹⁾ Most of the countries covered in this study have amended their central banking laws several times, especially in the second half of the 1990s.
- ¹⁰⁾ The new Act was passed on 29 August 1997 and went into force on January 1, 1998. The new Act replaced a "pre-revolutionary" Act of 1989 that had been partially changed several times in the years 1989-1997.
- ¹¹⁾ See Kowalski (1998) for a discussion of the new act on central bank of Poland.
- ¹²⁾ For a rough comparative analysis of the (pre-ESCB) Austrian National Bank Act see Hochreiter (1990).
- ¹³⁾ The Treaty of the European Union and the Protocol on the Statute of the European System of Central Banks and of the European Central Bank (1992).
- ¹⁴⁾ For an enumeration of inconsistencies of national bank laws prior to amendments see European Monetary Institute (1996: 107 - 148).
- ¹⁵⁾ See, e.g., Cukierman et. al. (1992: 370) or Willett (1993). For a discussion see Swinburne and Castello-Branco (1991: 420) and Spiegel (1998). Note, however, that no such relationship has been found for developing countries. A useful review is Eijffinger and de Haan (1996).
- ¹⁶⁾ A study by Burdekin et. al. (1993) does arrive at such a conclusion. The study also points to the importance of this link for countries in transition.
- ¹⁷⁾ These issues are emphasised e.g. in Posen (1993), Pollard (1993), Mishkin et al. (1997), and Blinder (1998)
- ¹⁸⁾ For details see annex.
- ¹⁹⁾ Except the Czech Republic, Latvia and Slovenia.
- ²⁰⁾ There has been another problem which might have encroached the central banks' independence: the weakness of the financial sector which, in part, was due to the high share of bad loans, threatening the solvency of financial institutions. Central banks in a number of countries covered in this paper undertook costly rescue operations (perhaps after "moral suasion") in order to save banks. Inter alia, they took the form of ad hoc bank rescues and of allowing for differentiated reserve requirements. Hochreiter et. al. (1996) have also argued that subsidies to the financial sector constitute one form of appropriation of seigniorage.

²¹⁾ The NBP's responsibility in this respect is also guaranteed in the new Constitution (Art. 277.1): "The National Bank of Poland is responsible for the value of the Polish currency".

²²⁾ Bod (1994: 55) explicitly makes the point that monetary policy autonomy is being limited by the budget deficit.

²³⁾ According to Art 240 of the new Constitution: "Within one year after the Constitution took effect, the Budget Act may allow for covering of the budget deficit through loans from the state's central bank".

²⁴⁾ Hungary may serve as evidence that such a threat really existed. When deciding on the 1994 budget deficit in December 1993, parliament raised the maximum legally permissible public debt ratio from 4 % of projected revenues (some 50 billion forint) to 80 billion forint. In Bulgaria the Law on Updating the 1991 State Budget (July 18, 1991) provided that up to 50 % of the 1991 budget deficit be financed through a National Bank credit in violation of National Bank Law provisions. The compromise decision of the Bulgarian National Bank was to grant the credit through short-term advances extended every three months. At the end of 1991 the total amount of credit received was transformed into a credit with a 10-year term (BNB News Bulletin No. 3).

²⁵⁾ See Neue Zürcher Zeitung, February 15, 1994, 10.

²⁶⁾ (Masciandaro and Spinelli, 1994: 436).

²⁷⁾ For a discussion of accountability of central banks, see de Haan et al. (1998).

²⁸⁾ Part Three of the central bank Act specifies the relationship of the CzNB to government. The Act envisages that... "the Bank Board may be attended in advisory capacity by a member of the government appointed by the government" (Art. 9.1). Furthermore, according to Art. 10.1; "The CNB shall take a position on proposals presented for consideration to the government, which concern the competencies of the CNB". The CzNB governor is entitled to attend meetings of the government in an advisory capacity (Art. 11).

²⁹⁾ (Masciandaro and Spinelli, 1994: 436).

³⁰⁾ Under the previous law the division of responsibility between the central bank and the government was not clear-cut. Art. 3 of the Bulgarian National Bank Act stated that in defining the general directions of the monetary and credit policy, the BNB and the council of ministers should inform each other of their intentions and actions. In Art. 2 (1) the BNB was called upon to "...formulate and implement the national monetary and credit policy...". Therefore, the setting of the exchange rate regime was also decided or, at least, significantly influenced by the BNB.

³¹⁾ Clause 2 of the Law on the Security of the Estonian Kroon (May 20, 1992).

³²⁾ Art. 8 of the Law on the Bank of Latvia states: "The Bank of Latvia shall perform foreign currency operations at its discretion ...".

³³⁾ In practice there are two general forms of substantive accountability: accountability to elected bodies, and accountability to the electorate (general public).

³⁴⁾ The relationship between accountability and monetary policy uncertainty is analysed, inter alia by Scheling et al. 1998.

³⁵⁾ The French position during the nomination procedure of the first president of the ECB shed some light on the political aspects of the ECB's foundations.

³⁶⁾ Comp. De Grauwe 1997, p. 181-182.

³⁷⁾ In fact, the results of each MPC meeting are presented at the press conference where its members explain the accepted motions and offer their interpretation of monetary and macroeconomic developments.

³⁸⁾ Hochreiter and Rovelli (1999) also arrive at this conclusion. They argue that the substantial decline in seigniorage in the Czech Republic, Hungary and Poland during the 1990s are an indicator that fiscal discipline has increased and the autonomy of the central bank has been strengthened.