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KEY ISSUES IN THE REFORM OF CENTRAL BANK LEGISLATION

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Key Issues in the Reform of Central Bank Legislation

Introduction--Achieving Stable Money

Stable money is one of the comer stones in the foundation of successful and healthy economies. Yet historically, it has been difficult for countries to maintain the value of their money. Central banks have had an especially poor record in this regard, despite the fact that price stability is the one objective that they are technically most capable of achieving. The frequent failure of central banks to achieve price stability has most often been the result of demands by governments that central banks help finance fiscal deficits and/or that they pursue other objectives such as the reduction of unemployment, promotion of investment, or indirect subsidization of the commercial banking sector. These other objectives may be important, but the attempt to achieve them directly with monetary policy tends to result in inflation, lower investment, less efficient investment, and, as a result, lower incomes in the long-run. In fact, experience has confirmed what economic theory states--that monetary policy cannot directly reduce unemployment or promote investment in the long-run. What it can do is determine the value of money and if it is used to maintain price stability it will enhance employment, investment, and income indirectly.

In order to improve the performance of central banks, monetary arrangements should be designed to anchor monetary policy to long-run considerations and to establish specific accountability for its implementation. In order to strengthen the long-run view needed for monetary stability against the short-run problem solving perspective more typical of governments and parliaments, there has been a growing movement in recent years in all regions of the world toward increasing central banks' independence from governments and parliaments. In all countries, the responsibility for the monetary system is ultimately the state’s. This responsibility is often explicit in a country's constitution. Central bank relative independence, which can take several forms, is quite consistent with the state’s ultimate responsibility for monetary policy.

In order to anchor monetary policy to long-run considerations while maintaining the state's ultimate responsibility for monetary policy, the central bank law should establish well focused and feasible objectives for the central bank (price stability), instruments and powers sufficient for the central bank to achieve these limited objectives, and the means to monitor how well it fulfills them (accountability). In this way the government delegates its monetary responsibilities while remaining ultimately responsible for them. Extraneous powers and duties for the central bank should be avoided and the central bank should be protected from outside interference in its operations (e.g., the law should set clear limits on the central bank’s lending to the government and it should prohibit any other credit with the exception of temporary credits to banks on transparent, objective terms).

A well designed central bank law and a public that appreciates and wants stable money can make it less likely that government will give in to the short-run temptations to misuse its central bank. In countries in which the central bank has had recent success in the reduction of high inflation, the public should be especially appreciative of the return to relatively stable money. In fact, such a public should have a government that champions stable money and a central bank with the requisite degree of autonomy to maintain price stability.

Because of the far-reaching economic and social consequences of the conduct of monetary policy, a sound and lasting reform of central banking legislation should be the outcome of a careful consideration of the substance of such legislation and result in drafting of comprehensive and internally consistent provisions. The burden of achieving successful central banking falls as much on the law as on the practical arrangements and relations between the policy makers and the public that develop under the law. No matter how much independence is given to the central bank by law, in practice the central bank can only successfully pursue monetary policies that are understood and accepted by the government and the public. Consultation and cooperation are essential.

In light of the experience that has been gained during the years of transition, often with a changed policy environment and recognized need for a more coherent legislative framework suitable to the requirements of a transitional economy financial sector, many countries with economies in transition are amend their banking laws. Unnecessary powers are being eliminated, independence and new mechanisms of accountability strengthened, and necessary instruments and powers modernized.

In light of the preceding observations about the desirability of increasing the independence of monetary policy from the government, a new central bank law needs to address three issues of substance and organization: the nature of policy formulation and implementation; the scope of the central bank's activities; and central bank accountability and oversight.

The **degree and nature of policy independence** should not be so absolute that it seriously reduces the sustainability of independence arrangements. There is a need to ensure that there are sufficient formal mechanisms through which the government and parliament can have, and be seen to have, influence over the central bank. Their formal oversight helps keep the central bank accountable for its behavior. The desired distancing of monetary policy from political pressures and from short-term considerations that might jeopardize price stability, while maintaining oversight by the state, is achieved by delegating clearly defined objectives and powers to the central bank so that its performance can be meaningfully monitored and evaluated. The government and parliament have determinative roles in appointing central bank chief executives and board members. Once appointed, board members of the central bank need to have their tenure protected, typically by having them subject to removal only for misconduct, not for policy disagreements. There should also be provisions that prohibit them from receiving or seeking influence from outside to maintain the integrity and accountability of the central bank administration.

The **scope of the central bank's activities** should be limited to those that are necessary to achieve its objectives. Extraneous or unachievable objectives and associated activities can dilute public confidence in the central bank's ability to achieve its primary objective of price stability. In particular, public confidence in the value of the currency will be undermined if monetary policy targets potentially conflicting objectives (e.g., price stability and full employment) in the short-run. Public confidence in price stability reduces the risk premium required when entering into long-term contracts and thus tends to lower the real rate of interest and increase the amount and efficiency of investment. The public also will be rightly concerned about the considerable power and influence of the central bank, which should not extend beyond what is required to fulfil the bank's limited objectives.

For the central bank to be delegated the authority to formulate and implement monetary policy, it should be **accountable** for its performance. Although accountability does not strictly require one objective, it is most effective when there is a single primary objective against which performance can be assessed. The law should provide the central bank with incentives to achieve its objects.

Public willingness to grant the central bank considerable independence from the state will also depend on the central bank having appropriate internal accountability, incentives, and sanctions. Such mechanisms are required to provide reasonable certainty that central bank officers will indeed pursue the objectives delegated to them and be immune from undue external pressures. In this area, it is not sufficient to rely on individual personalities; the details of the legislative framework must contribute by specifying, for instance, the role and composition of central bank's board and the arrangements for oversight, as discussed in greater detail below. To allow the state to monitor the central bank's fulfillment of its responsibilities, the central bank should be required to submit a semi-annual report to the government, the parliament and the public, and to submit to an external audit of its financial operations.

What sorts of mechanisms would be "sufficient" or "appropriate" for sustainable independence in any particular country is difficult for outsiders to judge and indeed, arrangements vary widely among countries. It will depend on a number of factors, including the extent to which there has been a tradition of financial discipline by the authorities and public support for anti-inflationary policies.

In preparation for adopting a new central bank law, this paper sets out the key policy issues that should be dealt with in a draft law.

I. General Provisions

Objectives

The objectives of the central bank stated in the law are the criteria upon which the performance of the central bank will be judged. In this regard, some laws are more specific than others. The law should state explicitly that the central bank's primary objective is to maintain price stability .In addition, the central bank could have subsidiary objectives such as fostering a sound banking system and financial markets.

The choice of a primary objective of achieving domestic price stability would follow recent central banking practice as increasingly reflected in legislation, which has been focusing on a sole principal objective. It is included in the Protocol on the Statute of the European System of Central Banks and of the European Central Bank set forth in the Protocol attached to the Maastricht Treaty of December 1991.

Functions

In order to achieve the objectives given to the central bank by the central bank law, it must have the authority to do what is necessary to achieve them. As price stability involves the control of monetary conditions, the soundness of the banking sector, the payment system, and other aspects of the government's macroeconomic policies are relevant to the central bank. Central banks generally provide advice to the government on monetary matters. The functions of a central bank should normally include:

a. Design, printing and issuance of notes and coins;
b. Regulating the supply of money;
c. Preventing disorderly fluctuations in the exchange rate;
d. Providing temporary credit to banks;
e. Being a depository for government and banks;
f. Providing temporary credit to government;
g. Being fiscal agent for the government
    -debt issuance and registry
    -debt clearing and settlement
    -foreign exchange operations;
h. Holding and management of foreign exchange reserves;
i. Bank supervision and licensing;
j. Payment system oversight.

While these functions and the powers to perform them provide the main substance of a central bank law, many laws provide a succinct summary of functions near the beginning for he convenience of readers.

Communication and Cooperation

Within the sphere of responsibilities given to the central bank, consultation with other bodies (e.g. the Finance Ministry, parliament, banking community) over specific policies is generally desirable and should be specified in the law. Such consultation needs to be in both directions. The draft law provides explicitly for cooperation among the government, parliament, and the central bank and for an annual policy statement in which the central bank is required to describe its current policies and assess its performance over the past year.

II. Monetary and Foreign Exchange Policy

Determination of Policy

The law should specify the role of the central bank and of the government in formulating, adopting, and implementing monetary and foreign exchange policy, i.e., who decides on the country's exchange regime, who determines the exchange rate, who decides how rapidly to increase the quantity of money and credit. The authority given to the central bank on this matter and the actual manner in which the central bank carries out its mandate defines the degree of a central bank's independence. The logic of delegating the responsibility of achieving price stability to the central bank is that the central bank has the tools needed to determine the domestic value of money in a market economy. The government and parliament should not interfere in the central bank's formulation and execution of the monetary and foreign exchange policies the central bank judges necessary to achieve price stability if the government and parliament expect to hold the central bank accountable for achieving that objective.

Obviously, the central bank must formulate its policies in light of the state of the economy, including the condition of the banking sector, and after consulting with members of the government and others. While the manner in which monetary and foreign exchange policy is established differs among market economies, no major industrial country would find it acceptable for the government or parliament to interfere in the central bank's implementation of those policies.

Whereas the role and independence of the central bank in matters of monetary policy has become an established feature of central banking legislation, there is no comparable consensus on the respective role of the central bank and the Government for foreign exchange policy. This is so despite the key influence of exchange rate policy on the central bank's ability to pursue price stability. However, mandating the central bank to pursue price stability, while giving the government power to determine exchange rates, raises the risk of policy inconsistencies. The numerous exchange rate crises and realignments in Western Europe over the past forty years provide examples of such inconsistencies. According to one view, if the government chooses to peg its exchange rate, monetary policy must aim at preserving the exchange rate as its first priority rather than domestic price stability. A central bank that is independent from interference in pursuing price stability should in principle have full control over foreign exchange policy. Pegging exchange rates is one of the intermediate targets of monetary policy available to central banks (an alternative to a money supply target—which requires a floating exchange rate) in the effort to maintain price stability.

According to another view, if governments are kept out of exchange rate determination, it might lead to greater reluctance for them to concede that they should stay out of domestic monetary policy formulation--which is where independence really matters. Although inadvisable regime choices may make the implementation of the policy objective—price stability--more difficult, they do not subvert it completely; a parallel is with fiscal policy where fiscal laxity increases the burden on monetary policy, but does not of itself make monetary policy ineffective. It is worth noting that in the Maastricht Treaty--the high point in Europe of ensuring conditions for central bank independence--foreign exchange policy is to be determined by the council of ministers in consultation with the central bank. None-the-less, modern central bank laws are increasingly assigning the determination of both monetary and exchange rate policies to independent central banks.

Implementation of Policy

The instruments needed to implement monetary and foreign exchange policies should be contained in the draft law in sections dealing with exchange policies, relations with financial institutions, and relations with the Government. In many countries, especially countries in transition, purchases of foreign exchange, loans to banks, and loans to the government are the primary sources of monetary growth and hence, potentially, of monetary control. In the long- run, central bank lending to banks and to the government (if that is to be permitted at all) should be short-term sources of liquidity only rather than sources of long-run monetary growth. The primary instruments of monetary control in the long run should be purchases of domestic securities (generally government) and/or foreign exchange, and reserve requirements.

The instruments of monetary policy for a given country should be consistent with the local legal and social traditions and practices and financial market developments. For instance, it may be impractical to rely solely on indirect monetary instruments such as open market operations for some countries if government securities markets are not yet be sufficiently developed. Thus in such countries the law should provide for the use of open-market type instruments (purchases and sales of foreign exchange and its own securities) and for interim credit instruments such as credit auctions.

Ultimately credit to banks should be temporary and limited, and the law should provide sufficient flexibility to accommodate several lending arrangements that the central bank might wish to establish by regulation. The law should allow the central bank to regulate access to its credit by setting the lending rate (i.e. the central bank's discount rate or Lombard rate) in relation to market rates, and by defining eligible collateral (both type and amount) as well as to undertake auctions of credit and deposits in amounts it determines. The provisions should strike a balance between providing the central bank with sufficient authority to control these instruments while also protecting it from the pressures that may come from banks and the government for lower interest rates and larger amounts of credit.

A chapter on financial relations with the government should provide that if the central bank provides credit to the government, it will be strictly limited and always at market interest rates. Since (net) credit to the government affects the money supply, the central bank ultimately should not lend to the government, as the Maastricht Treaty provides. Thus, more recently most central bank laws prohibit lending to the government all together. The law should not contain the authority for the central bank to directly control the amount and terms of banks' credit and investments. These were generally used as an instrument of non-market governments' credit allocation policies and are being phased out as economies increasingly rely on market allocation. Direct credit controls have also been used for monetary control, but virtually all industrial countries have now replaced direct monetary controls with market based controls. As a part of the strategy to eliminate unnecessary and potentially harmful instruments and powers, the law should not contain direct credit controls for monetary control purposes.

III. Financial Provisions

Capital and allocation of income

The law should provide for adequate capital and reserves for the central bank, the definition and disposition of income and profits, and a mechanism for capital adequacy for the central bank.

The amount of paid-up capital varies widely among central banks, but it should be relatively large. A level comparable to the capital of the country's larger banks, to central banks in the region, or at least five percent of the monetary liabilities of the central bank are sometimes used as criteria.
It is essential for the solvency of the central bank to be beyond question. The central bank must conduct itself in a prudent manner, e.g., lending, when appropriate for monetary policy purposes, only against the highest quality collateral, and investing its foreign exchange reserves only in safe and liquid assets. It should be the duty of the government, however, to take immediate action to preserve the paid-up capital of the central bank from any impairment. Consequently, it should be the responsibility of the government to guarantee the solvency of the central bank.

One way in which the government can ensure the solvency of the central bank is to refrain from requiring it to undertake operations that could cause central bank losses and thus weaken the income position of the central bank as well as its credibility. Many central bank laws also require that all unrealized gains or losses arising from fluctuations in the exchange rate or in domestic security prices not be recorded in the profit and loss account, but in a separate valuation adjustment account, with unrealized losses provisioned by government securities. More recent laws provide that unrealized gains are recorded as income but not distributed, consistent with international accounting standards.

In addition to paid-up capital, a central bank law often provides for a general reserve that is built up over time from profits, unless there is a capital adequacy requirement related to liabilities. Once capital and reserves are adequate, profits should be transferred to the Treasury. The central bank law should give the central bank broad discretion in using income to provide against risks as assessed by the board (i.e., specific loss reserves).

For the determination of the central bank's expenditures there should be a budget that should be transmitted to the government and parliament for information. The Central Bank's board should have the discretion to determine how best to allocate expenditures within the budget.

IV. Organization and Administration

Within the discretion to formulate monetary and exchange rate policy that has been delegated to the central bank, the law should establish the body with the authority to take such decisions. The manner in which the central bank is held accountable for its actions, and in particular for the fulfillment of the responsibilities delegated to it, depends importantly on who within the central bank is held accountable for what. The nature of the central bank and its operations will be greatly influenced by the responsibilities, composition, and tenure of its governing board and the responsibilities and the rules governing the selection and behavior of its management and staff.

As part of the effort to anchor monetary policy to a medium to long-term perspective and to distance it from short-term political considerations, the governing board of an independent central bank generally is given the power to make policy that might otherwise be exercised by the parliament. Its members may be appointed by the head of state, the cabinet or Prime Minister, or the parliament. This sharing of the responsibility promotes the development of consensus on monetary matters and tends to diminish the role of political considerations. Some central banks have separate monetary policy boards or committee's and administrative boards, but most have one board that is responsible for policy in both areas.

As the board adopts policies and oversees their implementation, ideally its members should not also have executive responsibilities. Thus board members should not also head departments of the central bank, but should devote their time fully to the policy and oversight responsibilities of the central bank. However, in a small central bank with limited managerial talent, the combining of board and executive responsibilities is understandable.

Experience has shown that governments often tend to take a short-term perspective in the sense that their choice of policy objectives is dictated by political exigencies. Given this reality, the government is unlikely to pursue price stability single-mindedly. Therefore, members of the government or parliament should generally not be members of a board that makes monetary policy, though the Finance Minister is sometimes a non-voting member. Similarly, independence from outside pressures also includes independence from various economic interest groups that may have a vested interest in expansionary credit policies. If all these competing interests were represented too prominently on the policy making body of the central bank, it may inhibit the central bank from pursuing price stability single-mindedly. In a market economy, the making of monetary policy becomes an increasingly complex exercise requiring up-to-date information and elaborate systems and structures for analyzing such information for policy purposes. Accordingly, members of the board should have superior knowledge and experience in economic and financial matters. In addition to economics, banking experience is a good qualification, but a conflict of interest would result from the appointment of an active banker.

The Governor's and the board members' terms of service should be longer than the term of the person or persons who appointed them. Long terms enhance the independence of the judgment of board members. The terms of board members should be staggered to provide continuity.

The members of the board should be subject to removal only for cause; i.e., physical incapacity, misconduct in office, or personal conduct that impugns their integrity, for instance, conviction of a crime. In this way, board members will not be subject to dismissal because of policy differences with those who appointed them or others with dismissal powers, and their tenure in office will be conducive to long-range planning and to development of the expertise that is required to determine the affairs of a central bank.

V. Financial Relations with the Government

The law should clearly define the role of the central bank as the principal advisor to the government on monetary and financial matters. It will be the duty of the central bank to advise on such matters; to be consulted by the government on economic matters that would affect the financial conditions of the country before decisions are made; to act as the fiscal agent of the government, to manage the Government's banking transactions and to be able to delegate some of these functions to other banks and agents. The objective here is to provide the government with a risk free depository and a mechanism of consultation and coordination in the formulation of a country's macroeconomic policies. In any event, the central bank must have the necessary instruments and mechanisms to minimize undesirable variations in the money supply owing to changes in the amount of government deposit flows in and out of commercial banks.

The important impact of the government's monetary balances with banks and especially with the central bank make it very useful for the central bank to manage the government's securities issues, which directly affect those balances. Very close coordination between the central bank and the government on the government's cash management is essential for monetary control purposes. In addition, the central bank's close involvement in the money market (through its maintenance of banks' reserve accounts and open market operations) gives it important knowledge and expertise in conducting the sales and settlements of government securities. Central banks generally maintain the accounting for government securities as well.

All serious and prolonged inflation has resulted from governments borrowing excessive amounts from their central banks (or mandating the central bank to extend credit to banks or others in pursuit of government objectives). Many central banking laws allow the central bank to provide credit to the government but strictly limit the amount. More recently, as in the EU, credit to government is prohibited. The primary objective of these restrictions is to protect monetary policy from pressures of the fiscal authorities and to limit monetary accommodation of the government deficit to an amount consistent with the objective of achieving price stability. However, the acquisition of government securities in the secondary market is permitted as a normal feature (often the most important instrument) of monetary policy.

VI. Relations with Financial Institutions

The banking system, including an efficient payments and clearing system, is the channel through which the central bank conducts monetary policy. Its soundness, liquidity, and solvency are therefore a prerequisite for the conduct of effective monetary policy. These considerations involve central banks in overseeing the safety and efficiency of the payments system and of banks more generally and in minimizing the disruption and cost to banks of the implementation of its monetary policies.

As the banker to commercial banks, a central bank will open accounts for banks, accept deposits from them (both in the form of required and voluntary reserves), and provide temporary liquidity to them (e.g., by discounting commercial paper and government securities for them). The law must provide for these and the general powers of the central bank to lend to banks.

The law might also address policy based lending. This is lending that would not have been undertaken unless required by a governmental authority. If policy based loans are permitted, the law should stipulate that the central bank undertakes such lending below market- prices only if the government pays the subsidy. The ultimate objective of the central bank would, however, be to abandon all lending to non-banks and all lending at non-market rates as soon as possible. Thus modern market economy central bank laws do not permit such lending by the central bank.

Having the central bank perform bank supervision may create conflicts of interest, however. For example, to camouflage inept bank supervision, the central bank may provide excessive financial support to one or more troubled banks, which action would be inconsistent with its objective to maintain price stability. Some countries have separate agencies that perform bank supervision.

The law on the central bank should state the authority for the central bank to supervise banks in broad terms. Detailed provisions for prudential supervision should be left for the law on licensing and supervision of banks to ensure consistency between the laws.

In addition, central banks are usually entrusted with the objective of overseeing the safe and smooth operation of the payment system. While the market should be left free to introduce new financial instruments, including payment instruments, to organize payment clearing and settlement, and utilize new technology to improve the efficiency and speed of making payments, the central bank should ensure that payment arrangements do not interfere with its control of the money supply or introduce excessive risks.

VII. Foreign Exchange Regulation and Operations

The law should specify the responsibilities of the central bank in such matters as exchange controls, management of official international reserves, and supervision of the foreign exchange operations of financial institutions.

In most countries, the management of the government's international reserves is entrusted to the central bank as part of its responsibility as banker of the government--presumably, the central bank has sufficient expertise and appropriate management systems to discharge this task as effectively as commercial banks. Moreover, for the purpose of exchange market intervention--should the exchange regime call for it--and given the close links between money markets and exchange markets, a central bank can best achieve desired exchange rate effects if it has control over official reserves. This offers the central bank maximum freedom in the timing and volume of intervention in view of developments in the money market or in coordination with supporting actions in the money market.

VIII. Currency

Most central bank laws define the unit of account and legal tender of a country and assign the responsibility of designing and arranging for the printing, maintenance, and supply of the country's cash. There is usually a standard set of provisions for these purposes.

IX. Central Bank Accounts and Statements

Central banking laws provide for the manner in which the central bank's accounts will be kept, audited and finally published. There is usually a requirement that accounts be in accordance with international accounting standards. In many countries, the law also obliges the central bank to publish a weekly or monthly summary balance sheet.

Most modern central bank laws require an external audit of the annual accounts of the bank. This may be useful for the central bank to establish correspondent accounts with certain foreign banks or international financial institutions, is a good generally accepted business practice of substantial banking institutions, and is a further element of central bank accountability.