Chapter 3: Political framework and legal status[52]

The Main Issues

Choices regarding the political framework and legal status of central banks present the following main issues:

- What powers should the central bank be given to make policy and discharge other functions, and how independent of the government should the bank be when using those powers?
- What ownership structure and legal form best support the preferred delegation of powers and responsibilities to the central bank?
- When placing the objectives of the central bank in law to protect them from short-term political considerations, how detailed and specific should the objectives be, and how deeply should they be embedded (how difficult to change)?
- What other devices are available to protect central bank officials from pressures while still providing for appropriate accountability and the right of governments to govern?
- How can employment contracts of key officers be constructed so that dismissal and threats of non-renewal cannot be used to exert improper influence?

1. Introduction

Legal mechanisms establish the central bank and endow it with rights and responsibilities – its mandate. Although economic considerations are involved, the choice of a precise mandate for the central bank is fundamentally a political decision. Thus, international variations in the legal framework for central banks reflect differences in social preferences and different political environments.

More specifically, the central bank's legal framework expresses society's preferences for how independent of government the central bank should be in discharging its assigned responsibilities. The choice of framework will also affect the flexibility with which the central bank's mandate can be adapted as circumstances change. This chapter addresses these issues as well as the choices regarding the form and ownership of the central bank; the specification, limitation and protection of its powers; the legal procedures for appointing and dismissing officials; and protections and immunities for the bank and its officers.

The chapter will offer examples of particular central banks when appropriate and will note important instances in which actual practice differs from what is specified by law.

2. Creating a legal framework for autonomy

Despite the differences in legal foundations across countries, there are well known advantages to providing the central bank with some - perhaps considerable - autonomy or independence from the state. The legal assignment of authority from the government (executive or legislature or both) insulates monetary policy and reduces the possibility

[52] This chapter was prepared mainly by Ellen Meade.

that the government could use it for political gain. Without legal and, ultimately, actual autonomy, it is possible that a change in the response of the current government due to short-term political pressures or a change in the political party in power could erode the capacity of the central bank to achieve its basic objectives. At the same time, the delegation of authority centralises professional and technical expertise for monetary and financial matters in the central bank, raising the likelihood of appropriate policy decisions.

The degree of a central bank's autonomy is generally determined by four elements of its legal underpinnings:

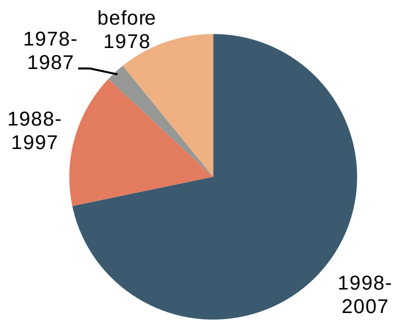
1. Mandate: a mandate that is precise, clear and not contradictory is a hallmark of central bank autonomy (Chapter 2 provided a detailed discussion of objective specification).
2. Relationship to the state: a central bank's autonomy is high when the activities it is required to perform for the government are clearly specified and exclude the obligatory financing of government activities.
3. Power to make policy decisions: autonomy is also high when the state has no say in, and cannot overturn, decisions made by the central bank.
4. Appointment process and term limits for its officers: it is desirable to involve the state in the appointments process, but once appointed, officials can be insulated from political influence through various means.

This chapter provides details on the range of law and practices across countries, particularly as it relates to the latter three elements of central bank autonomy.

Figure 15

Timing of major changes in central bank law

Per cent of 47 countries



Source: BIS (2008b) and BIS analysis of central bank laws.

Since the late 1990s, major changes to central bank laws have been implemented in a large number of industrialised and emerging market economies (Figure 15).[53] For example, the EU Treaty provided for the establishment of monetary union in 1999. The Treaty required changes in the national central bank laws of European Union countries to prepare for the required transfer of authority for monetary policy to the ESCB and the ECB.[54] In general, the changes in law over the past decade have resulted in greater clarity about the position of the central bank within government and with that has come a greater degree of de jure autonomy.

[53] Unless otherwise noted, the figures and tables in this chapter are based upon information for 47 central banks, including 11 national central banks of the Eurosystem.

[54] The Governing Council of the ECB formulates monetary policy and national central banks carry out the monetary operations. The relevant portions of the Treaty are Articles 108 and 109. The latter requires amendment of national laws in order to bring about compatibility with the EU pillar of the Treaty and the Statute of the ESCB and of the ECB.

3. Legal frameworks

Most central banks exist predominantly within their own country's legal framework. Legal frameworks differ in their form and type. This affects arrangements for central banks, although more so in form than in practice. Indeed, multijurisdictional central banks exist, in some cases crossing different types of legal framework – the ECB being the most prominent example.

National legal systems fall broadly into three types: those rooted in a civil law tradition, those rooted in a common law tradition and those with a mixed tradition. Civil law dates from ancient Rome;[55] it is the predominant legal tradition used in most of Africa, Asia, Europe and Latin America. Common law derives from English law that was "common" to the realm and is the legal tradition found in the United Kingdom, the United States and in countries that were formerly part of the British Empire.

Table 3

Constitutional provisions and legal tradition

Per cent of 46 countries

	Number of countries	**Number with civil law tradition**	**Number with common law tradition**	**Number with mixed legal tradition**
With constitutional provisions relating to the central bank law	35	30	0	4
and covered by an international treaty	*17*	*17*	*0*	*0*
No constitutional provisions	65	26	13	26
but covered by an international treaty	*22*	*17*	*4*	*0*
Total	100	57	13	30
of which covered by an international treaty	*39*	*35*	*4*	*0*

Note: The countries covered are those whose central banks are in the Central Bank Governance Network.

Source: BIS (2008b).

Civil law relies much more than common law on written codes and constitutions. This might suggest that countries with a civil law tradition are more likely to rely upon constitutional provisions for establishing the central bank. Table 3 provides a breakdown of countries that have provisions pertaining to the central bank in their constitutions and those that do not, based on a sample of 46 countries.[56] Of the

[55] For additional details, see La Porta et al (1998).

[56] The constitution of a country may contain various sorts of provisions relating to the central bank, including the following: granting the central bank its right to exist, setting its structure, noting its independence, establishing its purpose or providing the objective for monetary policy, prohibiting credit

26 countries in the sample that have a legal system rooted in civil law, about one half have provisions relating to the central bank in their constitutions. None of the countries with a common law tradition have constitutional provisions relating to the central bank.

Despite the importance of written codes in countries ruled by civil law, not all such countries have codified every attribute of the central bank into law. Brazil is a good example of this point: although the Central Bank of Brazil is given powers in the Brazilian constitution, it does not possess legal autonomy from the Government. However, the Presidential Decree that established inflation targeting in 1999 gave the central bank wide de facto autonomy.

In some cases, a constitution may limit the degree of legal autonomy that the central bank can possess, with respect to the discharge of certain functions. This possibility had to be considered when the Bank of Japan law was amended in 1997. The Constitution of Japan (Article 65) reserves sovereign executive power to the Cabinet, with the question being the extent to which decision-making on monetary policy was covered by that provision.[57]

Several central banks have legal responsibility for policy in more than one country; national authority is ceded to them for this purpose. While the multistate ESCB/ECB system is the most recently created and perhaps best-known example, three other multistate central banks have been in existence for much longer. The Central Bank of West African States and the Bank of Central African States have existed since 1959 and are responsible for the two monetary unions in Africa that are known collectively as the CFA franc zone.[58] A monetary union among countries in the eastern Caribbean was founded in 1950 and is operated by the East Caribbean Central Bank.[59] Monetary unions are currently being considered by countries in southern Africa, western Africa and the Middle East.[60]

A multistate central bank may possess some, but not necessarily all, of a central bank's powers. Some powers, such as the responsibility for banking supervision, may be retained domestically by the constituent national central banks – which is the case in the Eurosystem, where the authority for monetary policy is held by the Eurosystem as a whole, including the supranational ECB. (In contrast, the central bank of the East Caribbean Currency Union regulates banks on behalf of and in collaboration with the governments of member states.) Thus, the laws that govern the central bank may be

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to the government, and laying out procedures for the appointment or dismissal of officials. See Table 4 and the associated discussion for further details.

57 For further discussion, see Oritani (forthcoming).

58 The CFA franc zone was established in 1945. The West African Economic and Monetary Union (WAEMU) currently unites eight countries in western Africa (Benin, Burkina Faso, Côte d'Ivoire, Guinea Bissau, Mali, Niger, Senegal and Togo), while the Central African Economic and Monetary Community currently unites six countries in central Africa (Cameroon, Central African Republic, Chad, Republic of Congo, Gabon and Equatorial Guinea). Each union (and its respective central bank) operates separately but identically.

59 The East Caribbean Currency Union currently consists of Antigua and Barbuda; Dominica; Grenada; St. Kitts and Nevis; St. Lucia; St. Vincent and The Grenadines; and two British territories (Anguilla and Montserrat).

60 The Southern African Development Community (SADC) consists of Angola, Botswana, Democratic Republic of Congo, Lesotho, Malawi, Mauritius, Mozambique, Namibia, Seychelles, South Africa, Swaziland, Tanzania, Zambia, and Zimbabwe. The Economic Community of West African States (ECOWAS) combines the WAEMU countries with Cape Verde, The Gambia, Ghana, Guinea, Liberia, Nigeria and Sierra Leone; the Gulf Cooperation Council (GCC) comprises Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates.

both international and domestic, where the former cedes domestic authority for monetary policy to the supranational central bank, and the latter specifies the tasks to be carried out by the national central bank.

Central banks in a single country may be established as a single institution or as multiple institutions that are joined together in a federated system. Here, the issue of multiple jurisdictions does not arise, although careful attention is often given to the balance between the powers of the federation and those of the constituent parts. The Federal Reserve System, for example, is composed of the Board of Governors in Washington, DC, and 12 Federal Reserve Banks that are located throughout the United States. The Federal Reserve Act gives a legal form and responsibilities to the Board of Governors that differ from those it gives to the twelve Reserve Banks. Other federal countries – Brazil, Canada, Germany and India, for example – also have regional offices of the central bank that are established in the law (although the regional offices in some of those countries cannot be compared to the US Federal Reserve Banks because they do not have a separate legal personality and responsibilities).

4. Embedding and the management of legislative change

The choice of which body of law or administrative procedure is used to delegate national authority to the central bank affects the permanence of that delegation. A government instruction or decree can be readily changed; a constitutional provision cannot. Central bank authority is more readily defended against improper influence if it is provided in a law whose amendment requires a super majority – for example, the constitution or some international treaties may require a two thirds majority or even unanimity. The relatively high hurdle for proposed changes to such bodies of law weakens threats of withdrawal of authority or modification of the objective. The same goes for threats to change the specification of objectives.

If flexibility is valuable, however, it may not be sensible to deeply embed details of delegated authorities by placing them in higher levels of law (such as the constitution). Because our understanding of economics changes over time, the specification of objectives, and especially of any numerical targets selected as the best practical representation of those objectives, may need to change. As an example, it might not be sensible to embed the inflation target for an inflation targeting regime even in ordinary statute law, let alone in the constitution. Likewise, embedding a specific exchange rate target in law may reduce exposure to speculative attack but reduce flexibility to adjust to a structural shift in competitiveness. In both cases, the choice depends on the gains from flexibility compared with gains from better anchored expectations.

To constrain the use of flexibility, the law can set out the factors to be taken into account and the process to be followed when targets are being selected. The central bank, the minister of finance, or both acting together can be required to make and publish a decision for a defined duration, for example. Another example is a requirement for an agreement between the central bank and minister of finance. Such extra-statutory statements that clarify the objectives of policy have become increasingly commonplace.[61]

Local circumstances and problems affect the choice of what to embed in the law and how deeply. Countries with written constitutions have additional options in this regard,

[61] Table 1 in Chapter 2 provides information on the use of extra-statutory statements in relation to setting monetary policy objectives.

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Table 4

Constitutional and international treaty provisions relating to the central bank

	Constitutional provisions; see also last column for provisions relevant to central banks of countries that have adopted the euro or plan to adopt it.																						
	AR	**BG**	**BR**	**CH**	**CL**	**CZ**	**DE***	**FI***	**HR**	**HU**	**ID**	**IN**	**MX**	**MY**	**PH**	**PL**	**PT***	**RU**	**SG**	**SE**	**SK***	**ZA**	**EU Treaty/ESCB***
There shall be a central bank	✓				✓	✓	✓		✓	✓			✓			✓	✓	✓		✓	✓	✓	✓
CB structure															✓	✓				✓	✓		✓
Independence is noted				✓	✓				✓				✓					✓		✓	✓	✓	✓
Other acts to have limited effect					✓											✓			✓				✓
A specific statute is required					✓	✓			✓	✓	✓					✓	✓			✓	✓	✓	✓
CB's purpose is stated							✓						✓					✓		✓		✓	✓
Monetary policy objective is stated				o		✓							✓			✓		✓				✓	✓
Credit to govt prohibited			✓		✓											✓							✓
CB has regulation power										✓			✓								✓		✓
The state has final jurisdiction				✓								✓								✓			
Supreme Court has jurisdiction			o																				
Who appoints		✓	✓			✓		✓		✓			✓			✓		✓		✓			✓
Who fires		✓	✓							✓			o					✓		✓			✓
Firing restricted													✓							✓			✓
To whom CB is responsible				✓				✓	✓	✓						✓							
CB must consult with				✓																		✓	✓
Other specific provisions				✓			✓							✓			✓						

Notes: Country abbreviations are translated in the Annex. (1) No constitution or no specific constitutional provisions are to be found in the following countries: AT, AU, BE, CA, CN, DK, ES, FR, GR, HK, IE, IL, IS, IT, JP, KR, NL, NO, NZ, RO, SA, TH, TW, TR, UK and US. (2) In the case of countries belonging to the euro area (including those marked with an asterisk in the table), relevant EU Treaty/ESCB provisions have a quasi-constitutional status. Such provisions are taken into account under the column heading for the EU Treaty/ESCB, and should be read as applying to AT, BE, CY, DE, ES, FI, FR, GR, IE, IT, LX, MT, NE, PT, SK and SL, in addition to the separate constitutional provisions listed in the table. EU Treaty/ESCB provisions relevant to central banks may also be implemented in countries planning to join the euro area. (3) "o" indicates that the constitutional provision is inferred rather than explicit. (4) Shading indicates constitutional provisions that provide a direct safeguard of the central bank's independence from unwarranted interference. (5) Country abbreviations can be found in the Annex.

and a wide range of constitutional provisions related to the central bank are used, as Table 4 shows. The countries of the European Union have chosen to place the statutes of the ESCB in a Treaty that requires unanimity and ratification in the Member States to change, which gives the Treaty quasi-constitutional status. For this reason, the Eurosystem column in Table 4 is the most complete. More generally, deeper embedding in law might be used where the political process has historically delivered unstable policy. Going in the other direction, it might be desirable to be less specific in the law and make greater use of extra-statutory devices in situations where the entire statute is open for review should any one part be amended. Similarly, situations in which the process of law-making is particularly cumbersome would also push the choice in the direction of reduced embedding.

When relevant legislation is being amended, an important aspect of the process is the role of the central bank – whether it is permitted to initiate or propose such a change, whether it is able to participate in the discussion and debate during the development of a proposal, and whether it is asked to comment on a legislative proposal before it is voted upon. The central bank's participation in any and all of these stages of the amendment process can help to ensure that inappropriate changes to the law do not occur. Amendments to higher order law, such as a country's constitution, will likely require greater legislative consensus, but the procedure for amendment may be similar to that of lower order laws. Article 105(4) of the Treaty on the EU provides a good example of a legal requirement that the central bank be consulted on relevant changes to legislation. It provides that the ECB shall be consulted on any proposed EU act that falls within its field of competence, and also on certain legislative proposals developed at a national level.

Recent amendments to central bank laws in several countries also provide instructive examples of legislative processes that allow for central bank consultation. In Australia, Iceland, Sweden and Switzerland, a working group or consultative committee was appointed to consider changes and develop a proposal; in all four countries, the central bank participated in the process either as a member of the committee or as a consultant to it. The committee was appointed by the prime minister, minister of finance, or parliament. In the United Kingdom, however, the reform of the Bank of England, which involved, inter alia, the transfer of responsibility for banking supervision to a new regulator for the financial services industry as a whole, was initiated by the Government (George (1998)). Ultimately, the Bank of England and the Treasury agreed to an MoU implementing the reform. There are fewer recent examples of fundamental amendments to the central bank law in countries with presidential systems.

5. Legal status and ownership of the central bank

Different countries have different approaches to the legal status of the central bank. There appears to be no single best form – instead history seems to be an important determinant of both legal form and ownership. A number of recently created central banks are part of the state and owned by it; some older central banks were originally created as privately owned institutions and continue to have features related to that status (see Figure 16).

Almost all central banks are established under special legislation. The mandates and powers of the central bank, any restrictions (for instance, on the provision of credit to the government) and the procedures for governance are generally specified in that legislation. As Figure 17 shows, slightly more than two fifths of respondents can be grouped under the broad heading of state-owned corporations, and slightly less than two fifths describe themselves as independent, autonomous or self-administered government institutions.[62] Another 16% of central banks have been established as private entities under some version of company law. In this latter case, the monetary authority is not explicitly part of the state, and the law establishing it must specify its relationship with the government. Furthermore, central banks established as private companies must be empowered to implement policy and may need to be provided with certain immunities or special powers.

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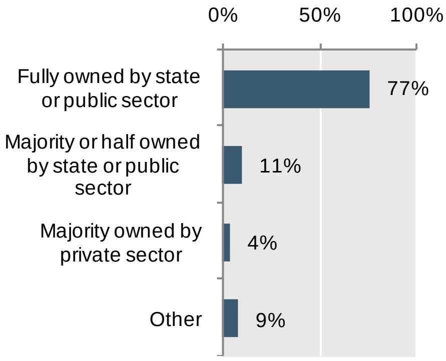
Figure 16

Legal ownership of central banks

Per cent of 47 countries



Source: BIS (2008b) and BIS analysis of central bank laws.

Central banks established under company law may be subject to the rights, privileges and governance mechanisms of the private sector. This may provide the central bank with well-developed techniques for the control of resources and give it a supervisory board, which can foster sound management and reduce the risk that the central bank's autonomy will be challenged by government intervention. However, central banks established under company law may be subject to challenges by "rogue" shareholders. (In Belgium, South Africa and Turkey, for example, part or all of the shares of the central bank's capital are publicly listed and available for purchase by private individuals.) Addressing such challenges can consume a significant amount of the central bank's time and resources. Another drawback may be an inconsistency between stock exchange reporting requirements and restrictions on disclosure that are designed to buttress the effectiveness of policy. An example is emergency liquidity support that is of a scale or form sufficient to fall within stock exchange requirements to report material changes in exposures. Yet immediate disclosure may render emergency lending ineffective in seeing an institution through a temporary liquidity problem.

If established under company law, the central bank may be subject to both company law and particular laws written precisely for the central bank. For example, the Swiss National Bank, a company, is subject to the law governing joint stock companies, but its officials are subject to legislation that governs the behaviour of federal authorities.

Of the quarter of central banks that are not fully owned by the state, only in a small number does the private sector have majority ownership. One of these, the South African Reserve Bank, lists its shares on the Johannesburg Stock Exchange, and the shares are held by more than 600 shareholders composed of companies, institutions and private citizens. The remaining central banks are not majority publicly or privately owned for one reason or another. Korea's central bank, for instance, has no capital. The Federal Reserve System and the Swiss National Bank have a mixed public/private ownership structure that is specified by law. In the Federal Reserve System, the Board of Governors is a public institution owned by the state, while the regional Federal Reserve Banks are private institutions whose stock is held by commercial banks. The capital of the ECB itself is owned by the national central banks of European Union countries according to shares based upon population and GDP. (The ownership of these national central banks varies: while most are owned by the state, a number,

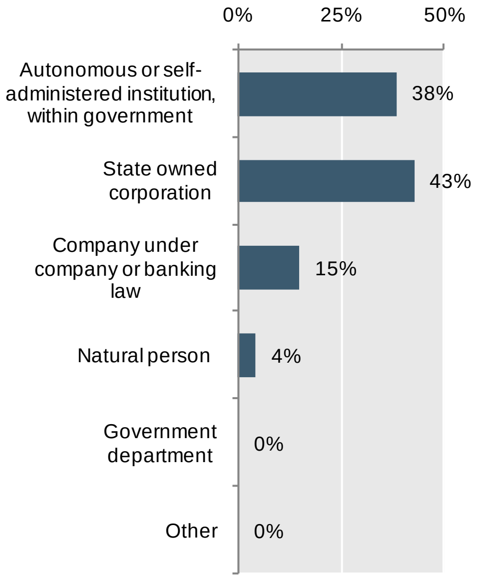
[62] Although the latter grouping could also include some state-owned corporations.

including in Belgium, Greece, and Italy, are owned partly or wholly by private sector shareholders.)

Figure 17

Legal status of central banks

Per cent of 47 countries



Source: BIS (2008b) and BIS analysis of central bank laws.

All in all, these different ownership models do not appear to affect the performance of the main tasks of the central bank and are instead mostly arrangements designed to satisfy local constitutional or practical needs. As discussed next, additional powers may need to be provided so that the central bank can perform its public policy tasks; or powers may need to be constrained to ensure that the institution serves the public interest.

6. Specifying the type and breadth of powers

As discussed in Chapter 2, the range of functions assigned to and discharged by today's central banks covers a wide spectrum. The decision to extend a narrow, intermediate or broad range of powers to the central bank must balance a number of factors, including the compatibility of the associated functions and the government's desire for control or retention of decision-making. The decision will thus be closely related to the measures that require the central bank to account for its actions.[63]

In addition to the question of what powers are provided to the central bank, there is the question of how they are assigned. Legal tradition determines whether powers, responsibilities, functions and duties must be expressly stated or, instead, can be inferred or adopted if not expressly prohibited. Functions and powers can be stated explicitly in the law or, as has become more common in recently written or revised central bank statutes, the functions can arise from the need to satisfy particular objectives that are stated in the law. Different sorts of legislation will be necessary to support different functions and to provide the central bank with the legal means to accomplish its duties.

Where central bank laws provide explicit authority to transact with a specified range of counterparties, the range is normally expressed in fairly open terms allowing the central bank to widen or narrow it as a matter of policy choice.[64] If a central bank is established under ordinary company law, or law specific to financial companies, it may not require express permission to carry out monetary policy operations because it is already bestowed with powers to borrow and lend. Finally, the law may give the central bank the right to formulate regulations or make quasi-legal judgments (including the

[63] Chapter 7 discusses central bank accountability.

[64] For example, the Monetary Authority of Singapore may lend to "such financial institutions or class of financial institutions as the Authority may from time to time determine" for the purposes of money market operations (Section 23) or safeguarding the stability of the financial system or confidence in it (Section 26).

issuance of fines or sanctions). These sorts of powers may be required to operate or oversee the payment and securities settlement systems or participate in banking supervision or for the enforcement of monetary reserves or statistical requirements.

Legislation may be constraining as well as empowering. Later in this chapter are examples of constraints that serve to buttress the desired autonomy of the central bank from the government. Other constraints may inhibit improper private influence by, for example, ensuring that private shareholders (where relevant) have no influence over the public policy tasks of the central bank or over the bank's finances, or restricting the ability of key officers to work for financial institutions or run for political office.

7. Provisions concerning the interaction between the central bank and the government

The relationship between the central bank and the government is one of the prime determinants of central bank autonomy, and the provisions in a given country's law for the several aspects of the relationship should be clear. Insufficient clarity about roles and responsibilities creates the potential for dispute between the central bank and the government. A few countries have explicit mechanisms for resolving such disputes so that the intended relationship is not disturbed by ad hoc agreements made in the heat of the moment.

Some laws explicitly require that the central bank discharge delegated responsibilities independently of the government. Regarding the activities that the central bank might conduct on the government's behalf, it is common for statutes to define those that are permitted (in Argentina, Brazil, Canada and Mexico, for example) and those that are prohibited (in Argentina and Finland, for example). Requirements that the central bank finance government spending or grant large, long-term loans to the state at non-market interest rates undermine the central bank's independence because they compromise its ability to control inflation and achieve price stability. However, the central bank is well placed to perform some other activities – fiscal agency or the management of government assets, for example – so the law needs to be very clear about permissible activities and prohibited ones.

7.1 Restrictions on taking instructions

Many constitutions and central bank statutes state that the central bank is independent or autonomous in exercising its functions.[65] In addition, some laws also contain explicit prohibitions on central bank decision-makers from taking instructions from anyone, outside of the mechanisms and processes that are contained in law. Good examples are the Mexican constitution, which states that "No authority shall order the central bank to grant financing" (Article 28); and the legal texts underpinning the ESCB and the ECB, which state that "neither the ECB, nor a national central bank, nor any member of their decision-making bodies shall seek or take instructions from Community institutions or bodies, from any government of a member state or from any other body."[66] As another example, the law governing the Romanian central bank includes the following: "When carrying out their tasks, the National Bank of Romania and the members of its decision-making bodies shall not seek or take instructions from public authorities or from any other institution or authority" (Article 3(1)). In yet another

[65] For example, the Constitution of Mexico states that "The State shall have a central bank, which shall be autonomous in exercising its functions and management" (Article 28).

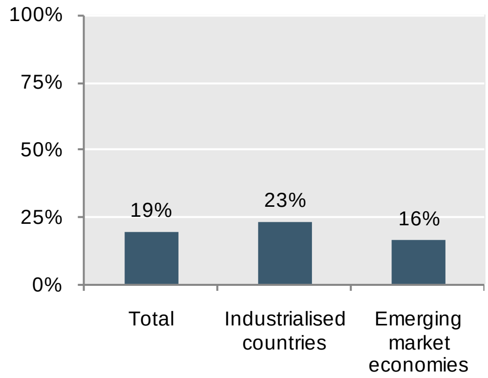
[66] Article 108 of the EU Treaty and Article 7 of the Statute of the ESCB and of the ECB.

example, the charter ruling Argentina's central bank states that "As regards the preparation and implementation of monetary and financial policy, the Central Bank of Argentina shall not be subject to any order, recommendation or instruction given by the National Executive Power" (Article 3). In a number of cases, internal codes of conduct make it clear that central bank officials may not take instructions or expose themselves to partisan influence (see Chapter 1 for details), although such codes of conduct are clearly of less weight than statutory provisions.

Figure 18

Formal directive and override procedures

Per cent of 47 central banks



Source: BIS analysis of central bank laws.

In many cases, however, such prohibitions are implicit: they flow from the various elements of the law whose purpose is to put decision-making at arm's length from political pressures and from the existence of explicit mechanisms that allow the government to convey its view or give directions to the central bank. In several countries, the minister of finance or a representative of the minister may attend policy board meetings and speak (see Chapter 4 for details). In about one fifth of countries, the law provides for the government or parliament to give directives to the central bank and sets rules around the procedure to be followed (Figure 18). The override procedure often stipulates that the decision to override is to be made public, has a time limit and is subject to an appeal process (see Section 3.1.1 in Chapter 5).

7.2 Restrictions on lending to government

An important potential channel for an inflationary monetary expansion is central bank financing of budget deficits. Much of the inflationary risk is removed if central bank loans to the government are made at full market rates, particularly when those rates are influenced by the sterilisation operations used to offset the monetary impact.[67] There are thus two routes to prevent government financing from posing a risk to the achievement of the monetary stability objective:

1. Rules or mechanisms to ensure that all government financing activities affect market rates. Such rules include provisions that all debt raising must be on the open market, at market rates. An early example is the March 1951 Accord between the US Treasury and the Federal Reserve; more recent examples are to be found in New Zealand (contained in fiscal responsibility legislation and reflected in an Agency Agreement between the Treasury and the Reserve Bank) and a number of other countries. Other examples include legal provisions stating that the central bank determines the terms and conditions on which it provides finance (eg Korea); and provisions that allow the central bank to purchase government debt only on the secondary market (eg the Maastricht Treaty and the central bank laws of Brazil, Hungary and the United States).

[67] An important, though rare, exception is where the crowding-out of other financing by government debt issuance drives interest rates to the point that "unpleasant monetarist arithmetic" applies.

2. Prohibitions on central bank lending to government. This route may be preferred in the presence of weak mechanisms to ensure that government debt raising affects market rates (as just covered) together with weak authority on the part of the central bank to determine interest rate levels in pursuit of clear objectives. This route is also used as a "belts and braces" approach – that is, to reinforce the central bank's monetary policy independence.

   Prohibitions on lending to government can take many forms:

   - *Blanket prohibitions*: The requirement that the central bank purchase government debt only on secondary markets already implies a prohibition on primary market purchases. The most common other prohibitions are on direct lending to the government or government agencies (Articles 101 of the EU Treaty and Article 21 of the Statute of the ESCB and of the ECB provide an example); and on automatic or compulsory forms of central bank financing of government activity.[68] A rare example of a complete ban on central bank financing (voluntary or involuntary, direct or indirect) of government activity is provided by Chile. There, liquidity management operations involve trading in the central bank's own securities, as the central bank may not buy government securities.
   - *Quantity limits*: These may be expressed in relation to government expenditure (eg Israel), government revenue (eg Argentina and Canada), the central bank's own liabilities (eg Argentina and South Africa), total government borrowing limits (eg Korea) or a nominal ceiling (eg India).
   - *By purpose*: For example, in Brazil the central bank may buy and sell government bonds only for the purpose of regulating the money supply or interest rates.
   - *By term or maturity of financing* of government activity, usually to restrict financing to coverage of seasonal cash deficiencies (eg Israel, and, with respect to direct financing, the United States). All advances provided by the Central Bank of Argentina must be repaid within the subsequent 12 months. The Central Bank of Malaysia may not purchase government debt instruments exceeding 30 years to maturity, presumably for risk management reasons.

7.3 Explicit mechanisms for conflict resolution

Explicit mechanisms for conflict resolution, especially those that mandate public disclosure of conflict and its resolution, may provide safeguards against the application of pressure in the course of disputes, such as by way of threats of non-renewal of appointment or of a change in the legal status of the central bank.

Examples of such a mechanism are to be found in Australia, Canada, New Zealand and Norway. In Australia, the legislation provides that the central bank may disclose differences of opinion between itself and the government on policy matters by tabling a statement in parliament. It has been in place for more than five decades but has never been invoked, possibly because of the political cost it would entail for the two parties.

[68] Arnone et al (2007) indicated that almost all countries have laws preventing automatic central bank financing of government activity.

Although the lack of use might suggest that the power is an extreme option and thus almost unusable, it remains a countervailing threat that the central bank has available in extremis.

In Canada, the Minister of Finance may issue a directive to the central bank in the event of a difference of opinion over the monetary policy to be followed, but only after consulting the Governor and obtaining the approval of the head of state. Any such directive must be made public “forthwith”.

In New Zealand, the Governor might consider a directive from the Minister of Finance on foreign exchange market intervention to be inconsistent with the agreement with the Government regarding monetary policy targets. In that event, the Governor may force the negotiation of a new agreement, thereby making the conflict public. Alternatively, if the directive is considered inconsistent with price stability, the Governor may force the Minister publicly and formally to override the price stability objective itself.

In Norway, Section 2 of the Norges Bank Act (1985) sets out the relationship between the central bank and government authorities, and provides that “before the Bank makes any decision of special importance, the matter shall be submitted to the [Finance] Ministry.” This requirement allows the Government to intervene in exceptional circumstances and direct the central bank before it takes action. As in Australia and New Zealand, specific procedures are triggered in the event that the Government chooses to exercise its directive powers. In this case, directions must be decided by “The King in Council” (ie the King together with the whole Government), with the Bank being given the opportunity to give its opinion before the directing resolution is voted on, and with a requirement that Parliament be notified as soon as possible.

8. Appointments, terms of office, and dismissal

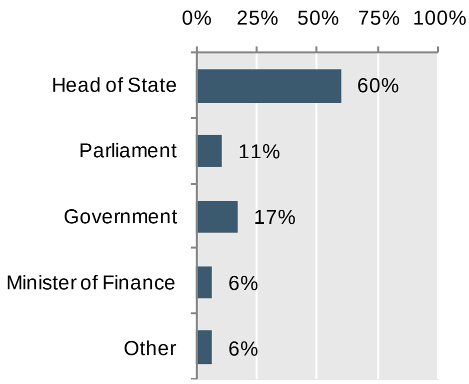
Another critical aspect of the central bank’s autonomy pertains to the appointments process for officials, their terms of office, and the procedures for their dismissal. The central bank’s autonomy is underscored when its officials have secure tenure and cannot be easily removed from their positions. However, as the central bank is ultimately accountable to its government, elected officials should have an important role in choosing high-level central bank personnel as well as a means by which they can remove officials who are found to have acted highly inappropriately or violated the terms of their appointment.

8.1 *Appointment of the central bank governor and senior officers*

Figure 19

Power to appoint the central bank governor

Per cent of 47 countries



Source: BIS analysis of central bank laws.

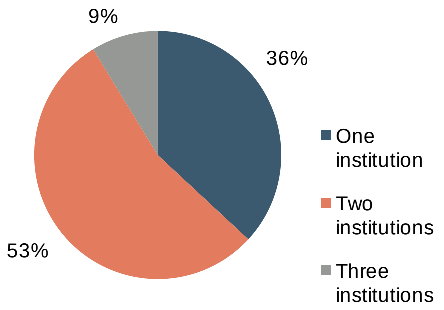
Although the specific legal procedure differs across countries, the governor and other senior officials of the central bank are generally appointed through a governmental process. Appointment of the central bank governor by a high-ranking official or body can help to underscore the stature of the central bank. In 60% of the central banks surveyed by the BIS, the governor is appointed by the head of state or government (see Figure 19). In about one third of the cases, the governor is appointed by the government or the minister of finance. The appointment of the governor by some other body, such as the legislature or supervisory board of the central bank, is thus relatively rare. The President of the supranational ECB (along with the other members of the Executive Board) is appointed by common accord of the heads of state or government of the European Union countries.

Typically, the appointment process involves more than one individual or body (see Figure 20). In about one third of central banks, it is made by one institution based upon the advice, recommendation or proposal of another institution. In New Zealand, for example, the Reserve Bank's Board formally proposes the Governor, who is then appointed by the Minister of Finance. Appointments to the senior executive positions at the ECB involve several institutions. The appointing heads of state or government of the European Union Member States that have adopted the euro are required to act on a recommendation of the Council, and to consult with both the European Parliament and the Governing Council of the ECB. In more than half of the central banks surveyed, the process is more broadly based, with one institution appointing the governor and another institution agreeing to the appointment or two other institutions being consulted.

Figure 20

Number of institutions involved in appointment of governor

Per cent of 47 countries



Source: BIS analysis of central bank laws.

A multifaceted appointment process that involves advice, recommendation or consent by another body may mute the influence of any single political party in the selection of the governor and other senior policymakers. This can generate broad support for the central bank, shield it (to an extent) from changes in the executive or legislature and help to anchor the central bank in the community. However, in practice, a multifaceted appointment process may not ensure full "checks and balances" if the confirmation of an appointment is no more than a formality. That situation tends to reduce the difference between multifaceted and singular appointment processes.

Moreover, the appointments process for the governor and other central bank officials may in fact be more complex than the procedures outlined in the law. For instance, the government may appoint a search committee to interview potential candidates prior to official nomination or appointment.

8.2 Terms of office

While the appointment process for the central bank's governor and other officials can secure public support for the institution if it imparts legitimacy to the incumbents, legal requirements for the length of the term in office can strengthen institutional autonomy. Lengthy terms for the senior policymakers relative to the political cycle, and the staggering of those terms, help to underpin the independence of the central bank as long as the terms are not cut short by, for example, a change of government.[69] Table 5 provides a frequency distribution of the statutory length of term in office for the governor. In about two thirds of the central banks, the governor's term lasts five or six years. While a few central banks have somewhat shorter or longer terms, only six do not have any term length specified in the law. Although both the ECB and the Federal Reserve have limitations on the reappointment of board members, most countries' central bank statutes place no limit on the number of times the president/governor can be reappointed.[70] Notably, only two central banks (the ECB and the Bank of Spain) have explicit prohibitions on the reappointment of the president/governor[71]. It might be argued that such a prohibition removes the incentive for a governor to seek favour from those who decide on his reappointment. Limitations on the number of terms reduce the probability that the political powers that reappoint the incumbent will use the threat of non-renewal to influence central bank policy. At the same time, if the reappointment procedures are based purely on effectiveness, they can be a means to monitor performance and be complementary to the other mechanisms used to scrutinise the operations of the central bank.

Table 5

Length of term and reappointment of central bank governors

Per cent of 47 central banks

	3–4 years	5–6 years	7–8 years	Not specified	Life tenure
Length of term	6	64	17	13	0
Reappointment not limited	0	45	11	0	0

Source: BIS analysis of central bank laws.

The length of term specified in the law may differ substantially from the actual average term of the central bank's officials. Thus, the turnover rate provides an alternative way of measuring the government's influence on the central bank, particularly for

[69] See Cukierman (1992).

[70] Although in some cases age limits may prevent the reappointment of the governor.

[71] Such restrictions on reappointment also apply to the other ECB Executive Board members.

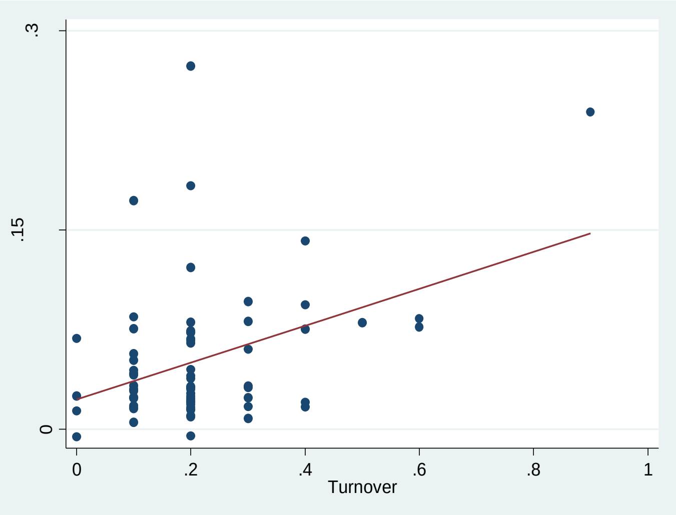
developing countries.[72] Between 1995 and 2004, the average term for central bank heads in advanced economies was 5.2 years, compared with an average term in emerging market and developing countries of 4.8 years.[73] As Figure 21 illustrates, there is a positive association between the turnover of the central bank's governor and the country's average inflation rate. The conventional explanation for this is that a longer tenure of the governor increases the independence of the central bank and allows it to pursue lower inflation. However, there might be other explanations. A lengthy tenure that heightens the governor's expertise and credibility may result in lower inflation. Moreover, if a central bank governor in a country with high inflation is replaced because the government desires to reduce inflation or resigns because of the inflation problem, then the direction of causality could run from high inflation to high turnover.

8.3 Staggering of terms

Figure 21

Inflation and turnover

76 countries



Note: Inflation is transformed to equal π/(1+ π), where π is the average annual increase in consumer prices during 2000–04. The inflation transform reduces the effect of hyperinflationary outliers. Turnover measures the average annual turnover of the central bank's governor between 1995 and 2004.

Source: Crowe and Meade (2007).

The staggering of terms of senior central bank decision-makers helps to foster continuity and renewal. Moreover, and importantly, it can be used to reduce short-term political influence on the central bank yet permit change if there is a prolonged and fundamental difference in views between the central bank and the government. The staggering of terms is widely practiced, including by the Central Bank of Chile, the ECB, the Bank of Japan, the Bank of Mexico, the Bangko Sentral ng Pilipinas, the Sveriges Riksbank, the Bank of England, the Federal Reserve Board and by countries with central bank legislation of recent vintage. There are several ways to provide for staggering of terms in the central bank's statute. First, the law may stipulate that when the central bank is initially established, some officials will serve shortened terms (that is, shorter than the full statutory term) in order to achieve the desired staggering.[74] The first appointments to the Executive Boards of the ECB and the Sveriges Riksbank (following new legislation in 1998) were made in this fashion. If the law further requires that vacancies arising from

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[72] See Cukierman (1992) and Cukierman et al (1992).

[73] See Crowe and Meade (2007). The data source for turnover rates was Morgan Stanley's *Central Bank Directory*. The classification of economies as advanced or emerging market/developing is from the International Monetary Fund.

[74] In general, the term of the governor (and in many cases, that of the deputy governor) is not among the shortened ones.

an official not completing a term are to be filled only for the remainder of that term, then the staggering of terms can be preserved. Alternatively, the law may specify the staggered timing of appointments to the central bank's board. For instance, the law could require that a certain number of terms end each year or every other year. Finally, the law may specify the timing of appointments relative to the electoral cycle. For example, the term of the Governor of the Bank of Mexico starts in January of the fourth year in office of Mexico's president. The terms of the Deputy Governors are similarly staggered so that one starts every other year, commencing in January of the president's first year in office.

In reality, the tenure of senior decision-makers may differ from what is specified in the law. For example, members of the Federal Reserve Board generally do not serve out a full 14-year statutory term. The de facto term is substantially shorter, between five and six years. Because the starting dates of the statutory terms are set by law and officials may be appointed to unfilled terms, there is wide variation in central bank appointments across the political cycle. In other cases, the actual and statutory terms may differ because the central bank's governor is subjected to political pressure and forced to resign before the term is completed.

8.4 Qualification criteria

Where individuals are chosen primarily on the basis of their personal qualities, the law often attempts to provide guidance on the qualities to be valued (Table 6). Perhaps more importantly, such statutory prescriptions can act (imperfectly) to filter out those who might otherwise be selected on the basis of political connections or simply as notable persons but lacking any particular qualifications for the function.

Table 6

Qualification criteria for policy board members (including boards with mixed functions)

Per cent of policy boards

	Internal members	External members
Educational	9	3
Individual character or integrity	34	3
Professional	51	20
Geographic or sectoral	11	6

Note: Based on the central banks in the Central Bank Governance Network. An entry is recorded for each of the 35 policy boards (including those with mixed functions) in that group. Some central banks do not have policy boards (for example, where the Governor decides, or where decision making is centralised in a multijurisdictional body such as the ECB), while others have more than one. External members are defined as limited-term non-executive members selected from outside the central bank.

Source: BIS analysis of central bank laws and websites.

8.5 Legal provisions for dismissal

Improper behaviour by the central bank's governor, other officials and senior staff can potentially damage the credibility of the institution in the financial markets and harm its reputation among the public. For this reason, most central bank statutes permit the dismissal of the governor and specify the circumstances or conditions for dismissal.

The legal conditions for the dismissal of the governor range from specific, policy related factors (such as poor inflation performance and actions that go against government directives) to more general factors, some of which relate to personal behaviour (such as conviction, dereliction of duties or personal misconduct). New Zealand's central bank law permits dismissal on the basis of policy failures – in the event that the inflation target is not achieved – but such policy related grounds for dismissal are highly unusual. In fact, the great majority of central banks have eschewed the ability to dismiss the governor for policy reasons because of concerns that this could open the door to unwarranted pressure from the government. Many central bank laws carefully specify the grounds for dismissal in order to provide strong protection against such pressure. In the case of the central banks belonging to the ESCB, for example, governors may be dismissed from office only if they no longer fulfil the conditions required for the performance of their duties or if they have been guilty of serious misconduct (with the added safeguard of recourse to judicial review).[75] The central bank law in many countries specifies more than one condition for dismissal. By contrast, a few countries' laws permit dismissal but do not detail the required findings.

In about two thirds of central banks, the governor can be dismissed on the decision of one individual or body: the minister of finance, head of state or government, parliament or legislature, "government" or high court.[76] This feature stands in stark contrast to the most common appointment procedure, which involves two or more bodies. In the remainder of countries, two or more government branches are involved in the dismissal (one has the dismissal authority while the other advises on, recommends or approves the decision). The difference between appointment and dismissal procedures could be related to the more precise specification of dismissal procedures for non-policy related reasons than is the case for policy related reasons. It should be noted, however, that dismissals are rare occurrences.

8.6 Remuneration

Remuneration arrangements usually contain incentive effects. It is relatively rare in central banking for remuneration to be tied directly to performance. For one thing, performance is difficult to measure because of difficulties in specifying clear objectives, lags between action and outcome and the influence of other factors on target variables. For another, meeting policy targets may require actions that have harsh consequences for some people as unemployment rises and income growth falls, even if negative real consequences are temporary for the population as a whole. It would be politically unwise for central bankers to be getting performance related bonuses in the middle of a recession.

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[75] This is stated in Article 14.2 of the Statute of the ESCB and of the ECB. Article 14.2 also states that the laws of the national central banks of the ESCB may not contain grounds for dismissal that would be incompatible with its provisions (ECB (2008)). In the case of the Bank of England, the central bank law contains different wording concerning dismissal, but the substance is similar. There are grounds for dismissal, but they are not policy related.

[76] BIS analysis of central bank laws.

Given the inability to use remuneration as a policy related incentive mechanism, other mechanisms need to be used. Such mechanisms need to be sufficiently independent to protect the governor and board members from potential political pressure. A minister of finance who is prevented by the governance arrangements from influencing decision-making directly may be tempted to exert clandestine pressure through financial arrangements. That is why the salaries of the governor and board members are usually set by an outside body or reference point. The safeguards associated with the resourcing of the central bank and remuneration setting for key officials are taken up in Chapter 6.

9. Provisions relating to legal action against the central bank and its officers

The central bank's statute should provide for protection from arbitrary legal challenges to its policy actions from interest groups. At the same time, however, the law needs to provide for a legal means to check any inappropriate behaviour of the central bank.

In most countries, private parties are permitted to bring legal action against the central bank. The area where the greatest number of cases are brought to court is bank supervision, though there are a few, comparatively rare cases involving monetary policy decisions or the ownership of gold and external reserves (claimed by private shareholders). The manner in which the central bank is established in the law will have a direct bearing on the type of legal action that is permissible. For instance, the Reserve Bank of Australia is established as a body corporate able to sue and be sued, which is the norm for this legal form. The central banks of India and Singapore, also bodies corporate, have explicit provisions that prevent the possibility of a suit against the central bank.

The potential legal liability of a central bank is closely related to the nature and extent of its responsibilities. Central banks with several functions may have immunity with respect to monetary policy but not with respect to other activities such as the operation of the payment system, the issuance of regulations, or the power to issue licences (or the other way round). For monetary policy, repurchase agreements used in open market operations will typically require a contract between the central bank and its counterparty that is governed by the terms and conditions of contract law. But for payment system oversight or regulatory authority, contract law does not apply. In Australia, for example, the legality of central bank regulation of fees on credit cards in the retail payment system has been challenged.

Nearly all countries have laws to protect citizens against negligence, a claim for which can be filed against the central bank unless there is a statutory provision that exempts it from liability due to negligence. A number of central banks (for example, the Bank of Canada, the South African Reserve Bank, the Bank of Thailand, and the US Federal Reserve Board) have immunity provisions that narrow the circumstances of a legal claim against the central bank or its officials to those cases in which bad faith or dishonest conduct can be demonstrated. In some cases in which statutory immunities are not provided, the central bank grants adequate defence to its staff (where needed) and pays the costs associated with defending legal actions where they acted in the execution of their official duties, such as at the Bank of Mexico. The Bangko Sentral ng Pilipinas has purchased personal liability insurance on behalf of staff to cover such risks.

Judicial review is an important means of ensuring the proper behaviour of the central bank, particularly in areas, like supervision, where other accountability mechanisms (such as a clearly specified objective and a reasonable measure of results) cannot be meaningfully applied. At the same time, it is important to limit judicial review to the process by which decisions are made and not permit it to extend to the content of the decisions. Otherwise there is a risk that judicial review could hinder the ability of the central bank to enact policy, perform its functions or fulfil its obligations.