Central Bank Independence, Accountability and Transparency: The Case of Ukraine

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Abstract

This paper discusses different dimensions and measurements of central bank independence, the arguments and possible drawbacks of granting more autonomy to central banks, factors influencing the degree of central bank independence, the experience of different countries, as well as objectives and procedures for strengthening central bank accountability and transparency. The paper makes an attempt to measure formal and actual degree of independence of the National Bank of Ukraine, to highlight the main problems undermining an effective independence, accountability and transparency of the Bank and, on the basis of conducted analysis, provides recommendations aimed at enhancing policy in this direction.

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"Economists and practitioners in the area of monetary policy generally believe that the degree of independence of the central bank from other parts of government affects the rates of expansion of money and credit and, through them, important macroeconomic variables, such as inflation and the size of the budget deficit."
(Cukierman, 1992).

INTRODUCTION

In recent years substantial changes have taken place in the operating structures of central banks world-wide**. Firstly**, their independence in making decisions on monetary policy has been increased. In particular, over the past decade, 34 industrial and developing countries legislated increases in the operational independence of their central banks, as opposed to only three such changes during the 1980s (Maxfield, 1997). This trend has been driven by a) the founding of the European Central Bank in 1999, b) the attempts of emerging market countries to secure the gains of their stabilization programs, and c) the move by former communist countries to build market economies. Comprehensive reforms have also been made by other countries in very recent years (see Table 1). **Secondly**, more emphasis has been put on increase in transparency of monetary policy and accountability of central bank. These reforms reflect an attempt to incorporate price stability into monetary policy as a formal principle, and to make it easier for the public and elected representatives to monitor their central banks.

Table 1: Changes in existing central bank legislation

OECD & EMU members	*OECD Ex-EMU*	*Non-OECD*
Austria 1998	Greece 1997	Argentina 1992
Belgium 1993 / 98	Hungary 1991	Chile 1989
France 1993 / 98	Japan 1998	Colombia 1992
Finland 1998	Korea 1998	Ecuador 1992
Germany 1993 /94 /98	Mexico 1994	Egypt 1992
Ireland 1998	New Zealand 1989	Honduras 1995
Italy 1992 /93 /97	Poland 1991 /97	Indonesia 1998
Luxembourg 1998	Sweden 1998	Pakistan 1994
Netherlands 1994 /95 /98	Turkey 1989	Peru 1992
Portugal 1990 /95-98	UK 1998	Philippines 1993
Spain 1994 / 97	South Africa 1989	Venezuela 1992
		Ukraine 1999

Source: King (2001)

Theoretical arguments and international experience suggest that countries with relatively independent central banks generally achieve better economic policy outcomes than those with relatively dependent central banks: lower inflation is achieved without incurring the costs of lower growth or employment levels. On the other hand, to preserve a democratic monetary policy decision - making central bank independence must be accompanied by strong *accountability* mechanism and procedures. Efficient monitoring and evaluation of central banks pre-supposes that definition of their goals and policies must be clearly stated and their actions must be *transparent* to the public.

This paper discusses different dimensions and measurements of central bank independence, the arguments and possible drawbacks of granting more autonomy to central banks, factors influencing the degree of central bank independence, the experience of different countries, as well as objectives and procedures for strengthening central bank accountability and transparency. The paper makes an attempt to measure formal and actual degree of independence of the National Bank of Ukraine, to highlight the main problems undermining an effective independence, accountability and transparency of the Bank and on the basis of conducted analysis provides recommendations aimed at enhancing policy in this direction.

I. Why an independent central bank is an advantage

Central bank independence (CBI) is associated with benefits that are described by Grilli, Masciandro and Tabellinini (1991) in the following way: "*Having an independent central bank is almost like having a free lunch; there are benefits but no apparent costs in terms of macroeconomic performance*".

CBI is an institutional instrument for optimising the contribution of monetary policy to attaining the overall goal of steering the economy along a path of high (long-run) growth of real GDP, high employment rates, and low volatility of these variables (i.e. stabilisation against adverse supply and demand shocks). *The basic theoretical argument for CBI is that high long-run economic growth requires price-level stability , and that independent central bank has less incentives to inflate than the government and enhances fiscal responsibility of the latter.*

In the short run monetary policy (including exchange rate policy) is effective in influencing employment and real GDP, which is potentially useful for stabilisation purposes. This effect occurs due to "inflation surprises" (or, resp., unexpected changes in the foreign exchange rate). In the medium and long run (when inflation expectations have adapted, i.e. inflation rates are more or less foreseen by the economic agents), however, monetary policy has no significant effect on employment and real growth rates of GDP, at least as long as longer run average inflation rates are below 10 %. There is empirical evidence that high (double-digit) inflation, and hyper-inflation, is detrimental to growth, which is due to the fact that with an increase in the medium and long-run average inflation rate its volatility also increases, which in turn increases the uncertainty about future relative prices providing a disincentive to investment. Moreover, high (and volatile) inflation has unpalatable distributional consequences (for creditors, in particular small savers, workers whose income is based on nominal contract wages, pensioners, etc.).

For these reasons, a welfare-maximizing macroeconomic policy should aim at preserving price-level stability over the medium and long run or, at least, at low average inflation rates, while not foregoing the short-run stabilization potential of monetary policy. However, even if the government were a "benevolent planner" putting the "socially correct" weights on price-level stability and, respectively, on output and employment stabilization, its interaction with the private economic agents, who understand the government's policy goals and predict its behaviour, results in higher long-run average inflation rates (without long-run effect on output and employment) than are optimal. The reason is that the "long run" is made up of many "short runs" in which the government would be tempted to engineer "inflation surprises" – there is an equilibrium inflationary bias. In reality, the situation is of course even worse since governments are not apolitical, social-welfare maximizing planners but have a lot of political motives (increasing budgetary revenues, reducing the real value of government debt, generating a short-lived upswing before elections, etc.) for exploiting the short-run possibilities of "money creation". But the point is that even for an "ideal" government representing the "true" societal preferences it would be advisable to bind its own hand by delegating monetary policy to an "independent" central bank which has less incentive to inflate (but still pays some attention to stabilisation policy!).

The relationship between *monetary policy and the government budget deficit and debt deserves special mentioning*. Government solvency implies that the stock of government debt (in real terms or as a share of GDP) must not exceed the present value of the expected future primary surpluses (i. e. net budget surpluses plus interest payments). The higher the stock of government debt, the more difficult it becomes to increase the long-run primary surplus by a sustained increase in regular taxes or reduction in expenditure. In this case, the government will become more inclined to put pressure on the central bank to allow a higher long-run rate of inflation which acts like a tax on money balances ("inflation tax"). In such a scenario of "*fiscal dominance of monetary policy*" there may even be an optimal positive inflation (tax) rate. However, the government will have a strong incentive to exceed the optimal long-run inflation rate if government debt is denominated in domestic currency and is not inflation-indexed. In the short run, an actual inflation rate above the expected rate of inflation reduces the real government debt – at the cost of rising inflation expectations and nominal interest rates which require another "surprise inflation" in order to keep real government debt down.

The logic of this scenario is similar to the one in which excessive inflation is triggered by the short-run stabilisation or employment motive. In an open economy for which part of government debt is external and denominated in foreign currency an excessive inflation will lead to a depreciation of the currency, possibly resulting in external default. Again, the independence of a central bank charged with maintaining a low inflation rate works as a beneficial commitment mechanism of the government. From what has been said it is obvious, however, that fiscal policy matters for monetary policy even if the central bank is formally independent. The higher expected future inflation rates, and therefore nominal interest rates, the higher are the costs of disinflation (in terms of the real interest burden on the government budget) and the more the central bank will hesitate to reduce inflation. As empirical research shows, inflation expectations are positively related to the size of government budget deficits and debt. Nevertheless, central bank independence enhances the chance of breaking the fiscal dominance of monetary policy and to strengthen government fiscal responsibility.

Empirical support of CBI idea comes from the studies on the relationship between central bank independence and economic performance. They offer three main conclusions. ***Firstly***, there is a negative correlation between central bank independence and long-term inflation. A low inflation rate is therefore more likely to be found in countries with independent central banks than in countries where the central bank is subject to government control. ***Secondly***, there is a negative correlation between central bank independence and the long-term budget deficit expressed as a percentage of a country's gross national product. Countries with independent central banks tend to have smaller budget deficits than those with government-controlled central banks. ***Thirdly***, there is no evidence of a correlation between the independent status of a central bank and production growth. Other words, production or employment cannot suffer from the independent status of the central banks over the medium to long term.

The main criticism against making central banks autonomous entities is based rather on political than economic arguments. The political argument is that it is undemocratic to turn over the decisions about interest rates, exchange rates, the efficiency of the financial system and other monetary issues to a body of unelected officials. However, one should distinguish between independence and accountability. Even the most autonomous central bank has to report in some or another form to the legislature, which has an ultimate power to change the laws governing the central bank.

Another argument against the autonomy of central banks is that CBI prevents effective coordination of fiscal and monetary policy as well as other economic policies. However, this argument is based on interpreting policy coordination as a potential for fiscal dominance of monetary policy. In reality, independent central bank, whose primary responsibility is control over inflation, contributes to a long term fiscal sustainability and economic growth.

II. What kind of central bank independence is needed?

In general, CBI could be defined as an institutional capacity of the central bank —typically derived from an institutional mandate—to conduct monetary policy free from directives, instructions and other forms of interferences from the side of government, industry and other interest groups.

Institutional freedoms of the central bank might include (1) goal and (2) instrumental independence.

Goal independence provides the central bank with the power to determine its own goal(s) independently. A single or, at least, clearly defined primary goal of the central bank provides more weighty grounds for holding the latter accountable. It is argued that multiple objectives, in contrast, can impede central bank effectiveness, reduce accountability, and complicate the coordination of economic policies with the government (Lybek, 2004).

Instrument independence refers to the central bank's ability to use the full range of monetary policy instruments without restrictions from the core executive (Alesina & Summers, 1993). A central bank should have sufficient authority to determine the adjustment of its monetary policy instruments within the constraints stipulated by its objectives and the autonomy delegated to it.

The question whether the central bank should be given "comprehensive independence" (i.e., both goal and instrument independence) is related to the issues of accountability and transparency. It is obvious that accountability is harder to implement when the central bank chooses (and changes) its goals and justifies the missing of one goal (e.g., price stability) with the necessity of attaining other goals (foreign exchange rate, balance of payments, employment, financial sector stability, etc.). The emerging consensus in academic literature is that the **central bank should not be allowed to determine its own policy goals**. However, an externally defined goal should be supported by the instrumental independence of central bank.
It is important to make a clear choice of the goal. It might be either (i) an unequivocal formal mandate for price stability (including the price index to be used), or (ii) an inflation target for average inflation rates over one or two years (with a corridor of +/- 1 %, again with a specification of the price index to be used) supported by full instrument independence (including exchange rate policy). The central bank should be held fully accountable for reaching the goal. Alternatively, a foreign exchange rate target may be imposed on the central bank, in which case the inflation rate or price level must not be targeted.

III. Central bank's goal: direct inflation rate targeting

A central bank endowed with instrument independence should be given a clear formal mandate for maintaining *price stability* specifying also the price index to be used. "Price stability" my be defined as *price-level stability* or as *low (including zero) inflation*. A monetary policy aiming at price-level stability has to offset past temporary inflationary shocks by a period of below-average inflation in order to return to the targeted path. This is not only more ambitious than the targeting of an inflation rate; it would put central bank independence under counterproductive political strain and thereby undermine the creditability of central bank independence. Moreover, since the inflation rate would fluctuate in the short run more under price-level targeting than under

inflation rate targeting and most nominal contracts are of short-term nature, inflation rate targeting seems preferable.
Inflation targets may be specified in two ways. In the one version the central bank formulates a long-run target inflation rate, but not a path for this rate (this was done, in fact, by the Deutsche Bundesbank and is presently done by the ECB). In the narrower sense, inflation rate targeting specifies a range for the inflation rate over the next few years (e. g., the Bank of England, the Reserve Bank of New Zealand, the Swedish Riksbank). Inflation rate targeting in this sense is inflation-forecast targeting. The central bank has to forecast the inflation rate for the target horizon and, if the forecast deviates from the target, to adjust its policy instruments accordingly. Inflation-forecast targeting has several advantages:

- Making the forecasts public gives the best opportunity to outside observers to monitor and evaluate the central bank's policy.
- This helps build credibility and anchor inflation expectations more rapidly and durably.
- Inflation targeting gives more flexibility; supply shock effects can be taken into account.
- Inflation targeting involves lower economic costs in case of monetary policy failure (compared e. g. to exchange rate pegging).
- Any criticism of monetary policy has to become more specific (e. g., is it the target or the forecast or the choice of instrument that is wrong?)
- Above all, central bank independence is shielded from fundamentalist attacks by the government's sharing of responsibility for the choice of the target path.

Presently, as reported by the IMF (World Economic Outlook, September 2005), some 21 countries (8 industrial and 13 emerging market) are inflation rate targeters. In most countries targets are announced either by the government or jointly by the government and the central bank. This contributes to strengthening the target's credibility by indirectly committing the government to pursue a fiscal policy that is compatible with the inflation target. Typically, only in countries in which central bank laws designate price stability as the unequivocal goal of monetary policy (e. g., Poland, Spain, and Sweden) the central banks announce inflation targets on their own. In some countries, however, whose central bank laws charge monetary policy more vaguely with maintaining the stability of the currency (e. g., Chile and Finland), the central banks nevertheless announce inflation targets, which indicates their ability to interpret their legal mandate as domestic price stability.

Clearly, exchange rate targeting or interpreting a legal mandate for maintaining the stability of currency as pegging the exchange rate to one particular foreign currency or a basket of currencies precludes independent inflation rate targeting. If the nominal exchange rate is pegged, the path of the inflation rate is determined by the requirement to keep the real exchange rate in line with the longer-run development of the terms of trade (if balance-of-payments problems are to be avoided). Conversely, targeting the inflation rate implies a path of the nominal exchange rate, though does not preclude smoothing operations to avoid excessive fluctuations in the exchange rate. It is important for the central bank to make it clear to the public whether its primary target is a path of the inflation rate or a path of the exchange rate. Any confusion in this respect is damaging for the credibility of the central bank and, as a consequence, its effective independence.

For inflation rate targeting the choice of price index is important. Most countries which target the inflation rate use the consumer price index (CPI). The advantage of the CPI is that it is the best and most up-to-date price index available and that is is known to the general public. Its disadvantage is that it contains items not under the control of the central bank (administrative prices, terms-of-trade and indirect tax effects). This disadvantage can be mitigated either by focusing on a “core” inflation rate (measured by a CPI from which certain highly volatile elements are removed) or by openly adjusting the inflation rate target-temporarily in order to take once-and-for-all price level effects (e. g. of a rise in the value-added tax) into account.

IV. Formal and effective independence

Formal (or statutory) CBI is the one stipulated and guaranteed by legislation. In general terms, formal CBI could be divided into three levels (by formal status): independence established by international treaty (European Central Bank); constitutional independence (Switzerland), independence established by national legislation acts.

In order to safeguard goal and/or instrument independence, it is essential that issues of personnel and financial autonomy of central bank are to be secured in the legislation. In particular, to ensure *personnel autonomy*, the following elements, among others, should be considered (Lybek, 2004):

- The bank’s CEO and board’s members should comply with certain qualification requirements (citizenship, good reputation, relevant experience etc). Boards with oversight functions should have external members, preferably the majority, in order to avoid the management of the central bank from overseeing itself.
- The nomination and appointment of the bank’s CEO and board’s members should be carried out by separate arms of the government to ensure a balance of authority.
- The term of board’s members should be longer than the election cycle of the body with the principal role in selecting the member. Terms should be staggered to ensure continuity and facilitate accountability.
- The bank’s CEO and ideally board’s members should only be dismissed for breaches of qualification requirements or gross misconduct, and preferably with the approval of the legislative body.

Financial autonomy assumes permanent definition of the procedures for accumulating and distributing the bank's resources that excludes any possibility of financial pressure being exerted. A central bank should have an initial authorized capital and accumulate general reserves until the equity capital is sufficient to cover its risks. It is important that the central bank first makes prudent provisions and allocations to general reserves, and only afterwards transfers *realized profits* net of unrealized losses to the owner(s) of the central bank, usually the government.

Optimal profit distribution mechanisms should exhibit at least two properties:

(1) Either a rule or the central bank should decide on the distribution of the excess profits over capital coverage requirements. Ensuring greater degree of CB's accountability and transparency argues in favor of the former option.
(2) There is a need to decouple profits distribution from current profit generation. In other words, distributed profits should average current and past earnings.

To ensure that losses do not deplete the initial capital and make the central bank economically dependent on the government, the central bank law should include provisions that obligate the government to recapitalize the central bank.

For best practices of ensuring legal independence also see *annex 2*.

Formal independence is measured with indexes based on legal criteria of political (goal) and economic (instrument) independence. Pioneering work was done by *Bade and Parkin* (1980), who constructed an index of political independence of Central Banks, for twelve countries (BP index). However, the most comprehensive index of CBI was designed by *Cukierman, Webb and Neyapti (1992)*, LVAW. It provides a quantitative illustration of central bank independence giving numerical weights to each question. Selected Indices of legal Central Bank Independence are provided in *annex 3*.

Nevertheless, it is obvious that *legal framework* is only one element of overall central bank independence. **Actual (or effective),** contrary to formal, central bank independence depends not only on the law, but also on many other less-structured factors -such as informal arrangements between the bank and other parts of government, the quality of the bank's research department, and the personality of key individuals in the bank and the rest of the government (Cukierman, 1992).

In general, CBI based on the law has at least two weaknesses. First, the laws are incomplete in that they cannot specify explicitly the limits of authority between the central bank and the political authorities under all contingencies. These voids are filled by tradition at best and by power politics at worst. Second, even when the law is quite explicit, practice may deviate from it.

In response to this problem, several indices of central bank independence that do not depend on central bank legislation were developed: (1)*turnover rate of central bank* governors *(TOR)*, with greater turnover interpreted as implying a more dependent central bank; (2) *questionnaires* sent to a nonrandom sample of specialists on monetary policy in various central banks.

Political economy offers several concepts explaining the variation of effective CBI. Firstly it is argued that a *high natural rate of unemployment* and *high government debt* (as well as unsustainable budget deficits) *increase* the pressure on the central bank to tolerate high inflation rates. Thus, these factors are as such actually detrimental to effective central bank independence. As Cukierman (1994) points out, if governments understand this and wish to avoid long - run costs of high inflation they will eventually grant more independence to the central bank. The need for central bank independence is the higher the stronger is the inflationary bias to government policy. And therefore, in the longer run we should observe stronger independence of central banks in countries with structurally higher inflation bias.

In line with Eijffinger (1998) and other studies, potential economic and political determinants of central bank actual independence could be categorized into the following groups:

1. *openness of the economy*

An *open economy*, dependent on international trade and foreign capital, requires an independent central bank. An independent central bank can help prevent inflation from eroding the competitive position of the economy, especially in countries which do not have floating exchange rates. An independent central bank also helps attract foreign capital and investment by demonstrating the host government's commitment to price stability (Maxfield, 1997).

2. *political system arrangements*

– Highly polarized political systems or systems with highly antagonistic parties are likely to have more independent central banks. Systems with moderate, centrist parties are likely to have more dependent banks as politicians can trust the opposition to pursue similar policies. However, this rule applies rather to democratic political systems with a strong constitutional consensus among the parties that alternate frequently in government.

– Right parties are traditionally more concerned with controlling inflation, while left parties place more emphasis on employment and wealth redistribution (Havrilesky, 1987). Consequently, *right parties* will likely institute an independent central bank to counter inflationary pressures in the economy. *Left parties* will likely prefer a dependent bank, which allows them to manipulate monetary policy to enhance growth and employment.

3. *supervision of financial institutions*

A central bank, responsible for supervision of the financial system and, thus, also for failures of financial institutions, could be tempted to admit lower (money market) interest rates or higher money growth than would be desirable from the perspective of price stability, in order to avoid such failures. A separation of responsibilities could, thereby, increase the autonomy of the central bank. However, this statement is not straightforward and coexists with opposed arguments in favor of combined responsibility, such as the goal of a smooth operation of the payments system and the role of lender of last resort of the CB.

4. *financial opposition to inflation (FOI)*

Posen (1995) advocates that central bank independence is determined by the degree of financial opposition to inflation, and the effectiveness of the financial sector to mobilize - through the political system - its opposition to inflation. Thus the monetary policy is driven by a coalition of political interests in society, because central banks will be prepared to take strong anti-inflationary actions only when there is a coalition of interests politically capable of protecting their anti-inflationary policy.

5. *public opposition to inflation (POI)*

Public opposition to inflation is more general phenomenon than FOI and should not be analyzed apart from it. The experience of the public with extremely high inflation or even hyperinflation in the past is, generally, seen as the cause of such public opposition to inflation. Issing (1993) notes that ".... it is no coincidence that it is the Germans, with their experience of two hyperinflations in the 20th century, who have opted for an independent central bank which is committed to price stability".

V. Accountability, transparency, and communication

In a democratic society, accountability is a natural complement to central bank independence. "Accountability" means that the central bank is held responsible for fulfilling its objectives. This includes, first, *accountability to the general public*, and, secondly, *accountability to democratically legitimated institutions*, usually the parliament, under special circumstances (e. g. when specific policy goals are fixed) also the government. The accountability to the general public is of a moral nature but nevertheless psychologically of utmost importance. A central bank which is able to convince the public of its taking its democratic accountability seriously acquires the political strength it needs in conflicts with the government. There is no true accountability without personal responsibility of the central bank's governor and the other members of the monetary policy committee. For this reason, a monetary policy committee (decision making board of the central bank) with too many members is counterproductive. The "*golden rule of committee size*" – not less than 3 but not more than 9 – should be adhered to. Greater numbers of members lead to an attenuation of responsibility and inefficiency of the decision making process.

Basically central bank accountability can be enhanced in two ways: *de jure* and *de facto*. Increasing *de jure* accountability requires imposing legal requirements on central bank in terms of reporting to parliament, as well as empowering parliament with instruments to monitor the policy decisions. Nevertheless, it could be easier to improve the picture without changing the law, which could be done by increasing *de facto* accountability through increasing *de facto* transparency (Sousa, 2002).

Transparency for central banks refers to an environment in which the objectives of monetary policy, its legal, institutional, and policy framework, monetary policy decisions and their rationale, data and information related to monetary policies, and the terms of central bank accountability are provided to the public on an understandable, accessible and timely basis (IMF, 2000).

Ensuring transparency means laying open the central bank's *internal decision making process*, it involves explaining how the various instruments of monetary policy are used to achieve the central bank's mandate. Greater transparency increases the credibility and effectiveness of monetary policy. Transparency requires an explicitly formulated *monetary policy strategy* and the timely publication of all the statistical data and forecasts on which the central bank bases its decisions.

Nowadays, we find a wide academic and political audience favoring transparency in monetary policy, which bases their arguments on its presumable favorable effects. The IMF *"Code of good practices on transparency in monetary and financial policies" (the Code)* is one of such examples. There are four broad categories for transparency on which the Code is structured. They are: (i) clarity of roles, responsibilities and objectives; (ii) open process for formulating and reporting policy decisions; (iii) public availability of information of policies; and (iv) accountability and assurances of integrity.

A transparent operation of the central bank is of particular importance in the case of direct inflation rate targeting. This is due to the considerable time lag between monetary policy action, e. g. a change in the central bank's main financing rate, and the response of the inflation rate. Empirical research shows that this time lag is between 6 and 8 quarters. The time lag between policy action and inflation response makes it difficult for the public to monitor and judge the central bank's actual commitment to its inflation rate target. Monitoring the central bank's adherence to its announced target – and therefore central bank credibility building – is obviously much easier for exchange rate and monetary aggregate targets.

Inflation rate targeting banks have to disclose regularly their views on inflation performance, the motivations behind monetary policy actions, and their outlook for inflation for the next 12 to 24 months. Respective published reports are supplemented by public appearances of senior central bank officials before parliamentary committees and the press. In case of the European Central Bank, for instance, though it does not technically target a forecast inflation rate but just is committed to keep the inflation rate below 2 per cent, its president and vice-president hold a press conference immediately after the first governing council meeting of each month. In his introductory statement the president presents the view of the governing council (which is the ECB's monetary policy board) of the economic situation and its assessment of the risks to price stability relevant for its monetary policy decisions, and provides information on other issues discussed and decisions taken by the governing council. This is followed by an extended question and answer session with the journalists attending the press conference. Transcripts of this press conference are made available on the same day.

Transparency and an effective communication strategy are crucial for shaping the financial community's expectations of the central bank's course of policy actions and the public's inflation expectations. Only by successfully influencing expectations and acting accordingly a central bank can build up credibility and maintain its effective independence. Bringing down high inflation rates to lower target rates turns out to be very costly in terms of employment and ex-post real interest burden if the target is not credible and inflation expectations are not reduced. Such high social costs of disinflation make the implementation of a disinflationary policy politically very difficult and undermine the (instrument) independence of the central bank.

Giving the benefits accountability and transparency could produce it is therefore no coincidence that the countries which have increased their central banks' independence in recent years have correspondingly increased transparency and accountability of the monetary policy decision-making process. *Appendix 10* describes in more detail how the Bank of England's transparency and accountability have been secured with a widely applauded framework which is generally regarded as the most open and accountable monetary policy in the world.

VI. Is the National Bank of Ukraine independent?

In 2002 A. Cukierman calculated his legal – independence index (LVAW) for some 25 transition countries based on central bank laws enacted at the beginning of the **1990's**. He found significant negative correlation between the countries' inflation rate (for the period after adjustment effect of price liberalization), and their central banks' legal independence. For Ukraine, the index value for this period totaled 0.42 (according to our estimations the index is even lower as 0.31) which is below the cross – country average of 0.51 (see *annex 4*)[4]. Our own recalculation of the legal independence index for Ukraine based on its current central bank law yields an index value of 0.73 which is a clear improvement but still puts the legal independence of the NBU below that of the central bank of, e.g., Poland (0.89), Estonia (0.78), and Lithuania (0.78).

[4] Cukierman LVAW index for Ukraine (1991) misses some important data for legal provisions concerning lending to central government and central bank CEO.

Table 2: NBU index of legal independence (LVAW), 1991-2005

	1991-1999 *	1999-2005 **
Criteria	(weighted)	(weighted)
Central bank CEO	**0.05**	**0.11**
1. Term of office of CEO	0.06	0.13
2. Who appoints the CEO	0.13	0.13
3. Provisions for dismissal of CEO	0.04	0.04
4. CEO allowed to hold another office in government	0	0.25
Central Bank objectives	**0**	**0.06**
5. Central Bank objectives	0	0.4
Policy formulation	**0.1**	**0.11**
6. Who formulates monetary policy	0.25	0.25
7. Government directives and resolution of conflicts	0.4	0.5
8. Central Bank given active role in formulation of government's budget	0	0
Central Bank lending	**0.16**	**0.45**
9. Limitations on advances	0	0.3
10. Limitations on securitized lending	0	0.2
11. *Who decides control of terms of lending to government*	0.13	0.2
12. Beneficiaries of Central Bank lending	0.1	0.07
13. Type of limits when they exist	0.05	0.05
14. Maturity of loans	0.02	0.02
15. Restrictions on interest rates	0.02	0.02
16. Prohibition on Central Bank lending in primary market to Government	0	0.05
Total	**0.31**	**0.73**

* - the index is based on legislation effective by adoption of the Law on National Bank of Ukraine (#679 – XIV, 20 May 1999), i.e. the Resolution of Presidium of Verchovna Rada on Statute of National bank of Ukraine (#1605-XII, 7 October 1991), the Law on Banks and Banking Activity (#872 – XII, 20 March 1991), constitutional provisions regulating NBU (#254k/96, 28 June 1996) etc.
** - the index is based on the Law on National Bank of Ukraine.
The index value doesn't exclude from some degree of subjectivism, as (1) 1991-1999 index is built on different legislation acts that to some extent don't correspond with each other; (2) the descriptive criteria used in some variables don't always exactly correspond to statute provisions. For calculation's methodology see Annex 5.

As could be seen from Table 2 the progress occurred in all four aggregated clusters measuring the legal degree of CBI: central bank CEO, central bank objectives, policy formulation and central bank lending. Nevertheless, the most of advance in NBU legal independence index is mainly due to the now much stricter provision against lending to the government. As the result, weighted central bank lending sub - index improved from 0.16 in the mid of 1990's to 0.45 after the new law on NBU was passed.

Beginning with 1999 direct lending to Central government was prohibited by article 54 of the Law on NBU. Nevertheless up to 1997 direct credits to state budget were granted regularly and in large volumes. In particular, in 1995

Bank's direct credits (advances, overdrafts, credits with fixed rate etc) accounted for about 70% of state budget deficit financing, and by the end of the year state debt in front of NBU reached 7.7 milliard hryvna. Following the introduction of state treasury bills in March 1995 the volume of direct lending decreased sufficiently. But direct lending per se hasn't ceased, as NBU being a general agent of MFU and holding T-bills tenders, bought government securities on primary market. In the mid of 1998- 1999 NBU was almost the only buyer of state securities, holding 2/3 of issued T-bills (see *annex 6*).

Another aggregated variable that improved notably since mid of 1990's is the one ensuring Governor's legal status. In particular, the Governor's term of office increased from 4 to 5 years, and also the law on NBU (article 65) prohibited the Governor, as well as other NBU officials, to hold another office in government and/or in private sector. All together, it made up for increase from 0.05 to 0.11of relative sub-index.

The sub-index measuring central bank's main policy objectives remains rather low (0.06 if weighted, or 0.4 if non-weighted) in comparison with most of transitional countries reviewed by Cukierman (2002) (see *annex 7*), thus reflecting the presence of objectives potentially conflicting with price stability function. The progress in score value is due to previous legislation base (namely the Statute of National bank of Ukraine, 1991) which was silent about price stability as one of NBU objectives and therefore scoring a zero for relative sub-index.

Out of legal criteria the less progress is registered in "policy formulation" cluster, though the value of relative sub-index remains high compared with other transitional countries. One should be aware that resolution of conflicts is not clearly stipulated neither in the Statute of National bank of Ukraine (1991), nor in the Law on NBU (1999). Nevertheless, we gave a lower score (0.4) to 1991-1999 index as compared with one of 1999-2005 partially because of legal practice of writing off state debt in front of NBU that was used in 1990-s. Thus the score for "policy formulation" sub – index slightly increased by 0.01 to 0.11.

Among potential sources of conflicts between NBU and government, as it is also admitted by NBU authorities, remain legal provisions regulating distribution of NBU profits and repayment of state debt in front of NBU:

– Current legislation doesn't set any formal mechanism (formula) for profit distribution. Authority for allocation of NBU profit for the financial year is assigned to NBU Council. NBU Council annually approves Report on execution of NBU budget and allocation of profit in accordance with submission of NBU Board. Meanwhile, a permanent conflict exists between annual Law on State Budget and article 5 of Law on NBU concerning the volumes and procedure of payment of difference between estimated revenues and expenses of NBU to State Budget. Non-transparent and non- foreseeable manner of profit allocation leaves a possibility for government to overestimate Bank's profit quota to be redirected to State budget (or vice-versa). In particular, in the process of passing draft budget the sum of NBU profit to be paid to the state is usually changed several times upon demands of parliamentarians or by discretionary decision of

MFU. Resulting conflicts between the political authorities and NBU are threatening the bank's financial independence.

– At the beginning of 1997 the government has written off its debt over the credits granted by NBU in 1994-1996. In 2000, MFU has recognized the debt in the amount of 10.6 milliard hryvna. However, the original schedule of repaying the debt is kept rather badly. In particular, the first payment in the amount of USD133 million was carried out only in 2004 and was transformed to State budget. Also NBU portfolio contains restructured T-bills issued in 1998-1999 (POVDP). Their use as financial instrument for regulating money and credit market in 2002-2005 was limited due to: (1)fixing zero annual interest rate in 2003; (2) re- direction of interest revenue paid by Ministry of finance to holders of POVDP to state budget in 2004 – 2005 (according to laws on state budget for 2004, 2005). Such legislative norm excludes the possibility of selling these T-bills by the Bank.

To measure an effective level of NBU independence we have chosen the questionnaire developed by Cukierman (QVAW). It takes into account not only legal variables but also the actual practice and when it differs from the stipulation of the law, monetary policy instruments, intermediate targets and indicators, and final objectives of monetary policy and their relative importance. At the beginning of 1990's, German Bundesbank attained 1.0 on this index, Finland - 0.78, Australia – 0.76, Italy – 0.73, France – 0.65, Belgium – 0.47, to mention only a few (see *annex 8*). An estimation of actual independence performed by internal NBU experts gave us an index value of 0.71 (see Table 3). At the same time, an evaluation of the NBU independence by external experts using this questionnaire puts it with an index value of 0.57 which is in the lower middle range of the countries listed in *annex 8*. According to Cukierman (1992), the divergence in values in such cases might be explained by the fact that "to some extent the questionnaire is based on subjective judgment of qualified but different individuals".

Table 3: NBU index of actual independence (QVAW), 2005

	internal*	**external****
Variable description	(weighted)	(weighted)
Tenure of central bank CEO overlap with political authorities	0.04	0
Limitations on lending in practice	0.15	0.07
Resolution of conflict	0.05	0.05
Financial independence	0.09	0.08
Intermediate policy targets	0.1	0.08
Actual priority given to price stability	0.11	0.1
Function as a development bank, granting credit at subsidy rates?	0.17	0.2
Total (weighted)	**0.71**	**0.57**

*- the index is calculated on the basis of conducting anonymous questionnaire among NBU internal experts (BRAAC, October, 2005).
** - the index calculated on the basis of conducting anonymous questionnaire among external experts
For calculation's methodology see *Annex 9*.

Nevertheless, with some degree or another, weak points, undermining effective independence of national bank, are: a substantial tenure overlap of the governor, members of the NBU board and council with political authorities, absence of operational monetary targets; no clear evidence of resolution of policy conflict with government in favor of the central bank, less tight limitations on lending to government in practice than in the law, and an assignment of first priority to a fixed exchange rate instead of price stability.

Summary:

From the point of view of ensuring a measure of independence that would enable the NBU to keep the inflation rate down, the Ukrainian central bank law has several flaws:

– Price stability is not unambiguously the NBU primary goal. According to article 6, the main function of the NBU "is to ensure the stability of Ukraine's monetary unit". And fostering price stability is named (besides fostering the stability of the banking system) only as means to this goal. In article 36 the NBU is mandated for establishing (besides publishing) the official exchange rate of the hryvna and in pursuance of this goal required to use all kinds of instruments (among them the purchase and sale of securities and the setting of the refinancing rate) to control the supply of money. Though these stipulations give first priority clearly to pegging the exchange rate, which is incompatible with an independent inflation target, Article 15, cipher1, charges the NBU Board with ensuring the stability and purchasing power of the national currency. Thus the obligations of the NBU as far as monetary policy is concerned are not stipulated in completely consistent way. This makes it difficult for the NBU to defend a policy aiming at price stability but, on the other hand, offers some room for interpretation which might be used in favor of an inflation target in line with the inflation rate for some hard currencies like the dollar or the euro.

– The position of Governor of the NBU is not as secure as it is ought to be to make it immune against political pressure. First, the Governor's five year tenure is shorter than that of the other Council members, and not longer than that of the President. Second, the Governor may be dismissed by the President at any time (though a supporting resolution of the Parliament is required too). Third, again according to article 18, resignation for political reasons is explicitly named as a ground for terminating the Governor's tenure in office, which seems to be an invitation to put political pressure on the Governor in case of serious policy conflict. These stipulations, together with article 19, cipher 8, making the governor personally responsible toward the Parliament and the President for the operations of the NBU, let the Governor's position appear rather precarious. The frequent change of Governor since the enactment of the present central bank law may be an indicator for this precariousness.

– The Board of the NBU acts, according to Article 15, as the NBU's monetary policy committee. Nevertheless, the role of the Board is not satisfactorily regulated by NBU law. Article 15 stipulates that "The Board of the National Bank shall take decisions" on all the instruments implementing the Council's General Principles of Monetary Policy. It doesn't, however, say how the decisions are taken. Neither does the NBU law determine the number of members of the Board. Presently the Board comprises 16 members which seem (too) high from the point of view of efficiency of deliberations and concentration of responsibility. The members of the Board are appointed by the Council upon the proposal of the Governor; the law remains silent, however, about their tenure or dismissal (except for the deputy governors according to Article 20). Though the board is formally in charge of monetary policy decisions, it remains strangely in the shadow of the Governor. It is unclear what happens to the Board when the Governor resigns or is dismissed, or not reappointed. Probably it ceases to be effectively in charge in such cases, though this is not explicitly regulated. The weak position of the board puts all the burden of central bank independence on the governor who may not be able to carry it in case of serious conflict over monetary policy, e.g. when the inflation rate forecasts of the NBU are significantly above the target and the refinancing conditions have to be tightened but the government is against a rise in interest rates. If the NBU cannot win such conflict, it can never build up the reputation and credibility necessary for effective independence.

– Article 65 lists positions incompatible with the office of Governor, Deputy Governor, member of the NBU Board etc. It does, however, not rule out other forms of active political engagement that might compromise the personal independence of the respective office holder and, as consequence, that of the NBU. For the member of the Council the law doesn't contain provisions analogous to those in Article 65. Given the competencies of the Council, in particular with respect to formulating the general principles of monetary policy, the approval of the NBU's annual budget and profit allocation, casting a suspensive veto on specific policy measures of the Board, this is a serious restriction of the financial and operational independence of the NBU.

– Financial independence of the NBU is also compromised by the unsatisfactory wording of Article 5 regulating the allocation of central bank profit. In particular, there are no provisions for mandatory formation of reserves and against distribution of revaluation gains to the government budget. Article 5 in connection with Article 9, which puts determination and allocation of NBU profit into the hands of a Council which can be stacked with government and other political functionaries, open the door wide towards financing of the state budget by the NBU.

– The current division of labor between the Council and the Board of the NBU as regards economic research are not favorable to the (instrument) independence and the credibility of the central bank. According to Article 9, the methodology of forecasting of monetary and other macroeconomic indicators and, as it seems, the regular generation of such forecasts fall within the competency of the Council. This puts the Board in its function as the NBU's monetary policy committee in a dilemma. Either it has to base its decisions and its communications to the public on the forecasts provided by the Council (or respectively, its research division), or it does its own forecasting. In the former case, the Board loses a good deal of its actual independence. In the latter case, conflicts between the Council and the Board will arise. Transparency implies that the public besides the government and parliament learn about these conflicting views, which damages the credibility of the NBU's monetary policy. Especially if the NBU employs direct inflation targeting, the deviation of its forecasts from the declared target is crucial for setting the refinancing rate and justifying such policy decisions. Two or more voices from the central bank regarding forecasts destroys the bank's credibility and invites political interference with monetary policy decisions.

<u>Other drawbacks</u> are due less to the law than to the actual practice and conditions of monetary policy:

– So far there doesn't seem to exist a proven record of policy conflicts of the NBU with government of which the public became aware and which were won by the bank. Reputation, can, however, be built up only through such experience. A prime example is the recent warning of the European Central Bank by the European ministers of finance not to increase the bank rate, which did not at all hinder the ECB's President to announce a couple of days later that the ECB is prepared to increase its main lending rate at its next meeting on December 1,2005. The decision making procedures of the central bank and their communication to the public need careful staging. It is not optimal with respect to strengthening the profile of the NBU with the public that the Board doesn't hold its meetings, at which the main refinancing rate is changed or not, on a regular schedule known to the public, and afterwards announces and explains its decision with utmost publicity.

– The failure of building up a significant reputation of effective independence may be also due to the circumstance that the NBU in the past didn't succeed in devising a consistent operational strategy of monetary policy, e.g. targeting some monetary aggregate or targeting directly the inflation rate, which would have allowed the public – when appropriately enlightened by central bank – to judge whether the actual decisions of the NBU had been in line with the bank's announced policy targets.

– Another factor impacting on effective independence is whether there is actually the possibility of conducting monetary policy by regular open market operations. The precondition for employing this channel, without which a medium term control of inflation rate is unthinkable, is a wide and deep market in government papers. This precondition is presently, when the real interest rate on government securities is negative and private economic agents for this reason do not hold them, not fulfilled. As long as financial intermediaries and non-banking public do not find it attractive to hold government securities in their portfolios, government securities will end up in the portfolio of central bank which willy-nilly will them finance the government deficit even if it is formally to buy government securities on the primary market or to grant any credit to the government. The non – existence of markets for government securities over a wide range of maturities, which are deep enough so that regular open market transactions do not affect security prices, severely limits the actual independence of the central bank in choosing the appropriate instruments, e.g. for sterilizing the effect of foreign exchange interventions undertaken to dampen exchange rate volatility.

VII. Conclusions and recommendations

Maintaining price stability and then preserving the domestic purchasing power of money is a primary task of government economic policy since the goal is not only not incompatible with economic growth and high employment but in fact, a precondition for attaining these goals over the medium and long run and ensuring a socially sustainable path of economic development. Charging the central bank with this task, giving it full instrumental independence of choosing the proper means of ensuring low inflation rates and inflation expectations, and endowing it with institutional safeguards (in terms of personal and financial independence) against inevitable political pressure is the best strategy known to contain the government's opportunistic instincts due to the powerful short – term incentives to inflate. On the basis of this scientific and practical consensus which has emerged over the last two decades we analyzed the legal framework for and the practice of central bank policy in Ukraine. In both respects, we registered some progress towards a higher degree of independence of the NBU since the enactment of the current central bank law. Nevertheless, the law on the National Bank of Ukraine and the actual arrangement of carrying out monetary policy have been found wanting. There is still a lot of room for improvement as regards independence of the NBU.

Furthermore, ensuring independence of the National Bank acquires special importance in the context of Ukraine's European integration intentions clearly proclaimed by the new authorities. According to the list of activities concerning the fulfillment of Ukraine-EU Action Plan in 2005 (the Cabinet of Ministers' Decree of 22 April 2005), Ukraine undertook to "strengthen independence of the National Bank of Ukraine including, if necessary, through amending the Law of Ukraine on the National Bank of Ukraine in order to bring it into conformity with EU standards" (paragraph 36, Section 2.2 of the List) (see Annex 10).

Our recommendations concern:

a) Changes in the law on the National Bank of Ukraine that would be necessary to ensure effective instrument independence of the NBU,

and

b) Measures, which, though greatly aided by the amendments to the law suggested by us, might be undertaken even on the basis of the present law in order to enhance the NBU's ability to bring inflation rates down in the medium term and preserve price stability in the longer term.

a) <u>Recommendations on amendments of the law on the National Bank of Ukraine:</u>

- Price stability in the sense of preserving in the medium run the domestic purchasing power of the hryvna, as measured by the consumer – price (cost – of – living) index, should be made the primary goal of the NBU. Any other goal, such as the external value of the currency, the stability of the banking system, supporting the economic policy of the government, etc. should be considered by the NBU if and only if their pursuance would not compromise the primary goal.
- Some competencies that are presently lying with the Council shall be transferred to the Board:
  - ✓ the general principles of monetary policy should be formulated by the Board and approved by the Council;
  - ✓ economic research and forecasting ought to be vested in the Board;
  - ✓ the Council should have no right of suspensive veto regarding the monetary policy decisions of the Board.
- The tenure of the Governor should be made considerably longer than the present five years. A non – renewable tenure of 8 to 10 years would be adequate. The tenure of Council members should be likewise non-renewable and sufficiently staggered so that it can never happen that all or a large part of Council members have to be replaced at the same time. One way to achieve a staggering of terms is to specify that the term of office of a certain number of Council members ends each year, or over other year. Another is to stipulate that the term of office of each position is completed in full – if a member leaves the Council before the end of the term, the remainder of the term is served by a new appointee.
- The Board as monetary policy committee of the NBU should be made smaller, 9 members may be its maximum size. The member of the

board ought to have tenure comparable to that of the Governor. As with the Council, the tenures of Board members should be staggered. Decisions of the Board shall be taken by the majority voting.

– Members of the Council and members of the Board may not be actively politically involved, be members of parliament or members of government.

– NBU Governor and other members of the decision-making bodies of the NBU (Council, Board) shall be protected against dismissal on discretionary grounds. Dismissal requirements should be limited to:

- ✓ failure to fulfill the conditions required for the performance of his/her duties;
- ✓ failure to perform his/her duties for a period exceeding six months;
- ✓ judged guilty of serious misconduct (criminality).

– Based on international experience, the following algorithm for allocation of Bank's net profit may be suggested. Profits are to be allocated by Bank's board in the following order of priority:

- ✓ an allocation from net profit shall be made to the capital account of the Central Bank in such amount as shall be required to increase the authorized capital of the Central Bank to a level equivalent to *five* percent of the aggregate amount of monetary liabilities shown in the accounts of the Central Bank for the end of that financial year;
- ✓ an allocation from net profit shall be made to the general Reserve Fund maintained by the Central Bank in such amount as shall be required to increase the amount of the general Reserve Fund to a level equivalent to the amount of the authorized capital of the Central Bank; the general Reserve Fund may only be used to offset losses of the Central Bank;
- ✓ an allocation from net profit shall be made by unanimous decision of the Bank's Board to special reserves fund for specific purposes established by the Central Bank; and
- ✓ any residual net profit remaining after the preceding allocations shall be allocated in accordance with the following: the preceding allocations from net profit shall be deemed to have been made entirely from net operating revenues, except that, if no operating revenues are included in net profit or after the preceding allocations have exhausted net operating revenues included in net profit, such allocations shall be deemed to have been made from net unrealized valuation gains; residual net operating revenues if any shall be distributed to the appropriate fiscal authorities identified by the Parliament within __ months after the end of the financial year, and residual net unrealized valuation gains if any shall be allocated to a Valuation Reserve Account maintained on the balance sheet of the Central Bank.

It is prudent that the law also provide mechanisms for the allocation of net losses and bank recapitalization in the event of extreme crisis.

– Clear formal procedure to resolve conflicts between the government and NBU should be established. These procedures must ensure that the government cannot overrule the central bank, or that the bank is not obliged to accept orders from the government, except during extraordinary circumstances, which should be promptly communicated to the general public. At the minimum, the procedures should allow the Bank to make public when it is forced to adopt decisions contrary to its opinion, so the public knows that the responsibility of the policies adopted at that point lies with the government.

b) <u>Recommendations on measures advisable even without a change in the law:</u>

– Adoption of direct inflation rate targeting in transparent cooperation with the government should imply an explicit and public agreement with the government on the target path of the inflation rate over the next 24 months within a corridor of +/- 1%, which would be regularly reconsidered once a year. In case of extraordinary events (e.g. terms-of-trade shocks, change in indirect taxes, etc.). the target may be changed in between after consultations between the government and the NBU and communication of the target change and the reason for it to the public. The important thing is that the NBU retains full instrument independence while the government shares publicly in the commitment to the inflation target.

– The inflation forecasts of the NBU and their regular revisions have to be made public. The Council and the Board have to make sure that in this respect they speak with one voice. Preferably, the economic research department reports to the Board. Its capacity should be enhanced.

– The monetary policy meetings of the Board should be held regularly and their results communicated with great publicity, preferably in press conferences of the Governor in which the latter explains the NBU’s policy outlook and the reasons for the latest decisions on interest rates.

– The central bank should pressure the government to allow the development of a domestic market in government securities in various maturities to make a genuine open market policy possible. For this purpose the government would have to offer positive real interest rates. The issuance of inflation – indexed government securities would not only contribute to the emergence of a market in hryvna-denominated bonds but at the same time signal the government’s commitment to disinflation and thus strengthen the effective independence of the NBU.

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APPENDIXES:
Some details on International Practice and Experience

Appendix 1. Goal independence: International practices

The level of central bank's involvement in determining its ultimate goal (-s) differs across the countries (also see *annex 1*). In the ECB, the USA and Japan, this decision rests with the central bank (although it is then incorporated into the law passed by the legislature), while in the UK and Norway it is solely in the hands of the government. Many other countries like New Zealand, Australia and Canada fall in between.

The definition of primary objective could have different interpretations. Many countries list several broad objectives in the central bank legislation (such as stability of the currency or prices, or financial stability) without prioritizing them. Recently, some countries declare price stability as the primary objective.

For example, the objective of the Reserve Bank of New Zealand is "to formulate and implement monetary policy directed to the economic objective of achieving and maintaining stability in the general level of prices". In Australia, the *Reserve Bank Act* specifies stability of the currency and maintenance of full employment as the central bank's objectives. In the United States, the *Humphrey-Hawkins Act* requires the Federal Reserve to conduct monetary policy to promote the goals of 'maximum employment, stable prices, and moderate long-term interest rates'.

Appendix 2. Instrumental independence: International practices

Almost all central banks have the authority to use monetary instruments determined in active legislation. In particular, the Law on Bank of Japan states that "the Bank of Japan's autonomy regarding currency and monetary control shall be respected." The Law specifies a wide range of operations that the Bank can conduct in order to achieve its objectives, including buying and selling bonds and bills, making loans, and accepting deposits.

The act on the Czech National bank stipulates that in accordance with its primary objective (price stability), the Czech National Bank shall set monetary policy, issue money, administer payment system, supervise activities of the banks and carry on other activities pursuant with national legislation.

According to Swedish Riksbank Act, the Riksbank is responsible for monetary policy aimed at preserving price stability. The Riksbank may issue regulations within the scope of its responsibility for monetary policy. The Riksbank may also issue regulations that concern activities connected with the Riksbank's payment system or cash-provision mandate.

Appendix 3. Why inflation targeting in CIT?

Explicit governmental inflation targeting plus full instrument independence of the central bank seems the best arrangement, in particular for transition countries without a long-standing "stability culture". The old model of the Deutsche Bundesbank, with rather comprehensive effective CBI (and very vague specification of the goals of monetary policy in the Bundesbank law) is less appropriate, because it relied on "conservative" central bankers supported by a fiercely anti-inflationary public opinion that deterred any government from putting pressure on the central bank – conditions which are not fulfilled in CIT. Having to announce publicly the inflation rate it desires forces the government to shoulder some responsibility and makes it more difficult to put the blame for high inflation on the central bank.

Appendix 4. Qualification requirements: International practices

The law on Central bank of the Republic of Estonia envisages that the President of Eesti Pank must be an Estonian citizen possessing a university degree in economics or law.

Act on the on the Magyar Nemezeti bank stipulates that "Hungarian citizens with outstanding theoretical or practical professional knowledge of issues related to monetary, financial and banking activities may be appointed as members of the Monetary Council".

According to the law on Central bank of Paraguay laws member of the supervisory boards cannot be a shareholder, director, manager, or an officer in banking or financial institutions (Paraguay), while another laws stipulate that a director of the board cannot be a member of a political party (Romania).

Appendix 5. Criteria for removal of board members: the case of the Reserve Bank of Australia

If a member of the Reserve Bank Board: becomes permanently incapable of performing his or her duties; becomes bankrupt, applies to take the benefit of any law for the relief of bankrupt or insolvent debtors, compounds with his or her creditors or makes an assignment of his or her remuneration for their benefit; resigns his or her office by writing under his or her hand addressed to the Governor-General; is absent, except on leave granted by the Reserve Bank Board, from all meetings of the Board held during two consecutive months or during any three months in any period of 12 months; or fails to comply with his or her obligations under the Commonwealth Authorities and Companies Act 1997, the Governor-General shall terminate his appointment.

Source: Reserve Bank Act (1959)

Appendix 6. Profit distribution mechanism: the case of Norway

In Norway allocations are made from Norges Bank to the so called Adjustment Fund until it contains 40 per cent of the Bank's net foreign exposure and 5 per cent of its Norwegian securities holdings. If the Adjustment Fund ever exceeds that level, the surplus shall be reversed to the profit and loss accounts. If the Adjustment Fund falls below 25 per cent of the Bank's net foreign exposure, a so called Transfer Fund is drawn until the Adjustment Fund is at its full size. The so called Transfer Fund is built up out of any surplus after provisions for or transfers from the Adjustment Fund. Every year a third of the capital in the Transfer Fund is transferred to the Treasury.

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Appendix 7. Actual vs. formal independence: International practices

In Argentina, the legal term of office of the governor is four years. But there is also a tradition that the governor of the central bank offers to resign whenever the government, or even the finance minister, changes. The average actual term of office of the governors in Argentina was about one year from 1950 to 1989. Obviously, the actual independence of the Argentine central bank is substantially lower than the legal indicators imply.

Contrary in Australia, the legislation provides that in the event of a dispute over monetary policy, the government can override the Reserve Bank by tabling its objections before both houses of parliament. While this is the legal position (which scores a negative on the index of independence), such a situation has never arisen in practice.

Appendix 8. Accountability of central bank: the case of Reserve Bank of New Zealand

The Reserve Bank is held accountable in the following ways:

The Governor's personal accountability

Under the Act, the Governor is held personally accountable for achieving the inflation target set in the PTA. If the Treasurer or the Reserve Bank's Board of Directors believe that the Governor's performance in meeting this target has been inadequate, then the Governor can be dismissed**.** The concentration of authority in one person makes for clearer accountability. This gives the framework added credibility, as people know the Governor will be well motivated to deliver price stability.

Regular reporting to the Government and to the people of New Zealand

At least every six months, the Reserve Bank must publish a *Monetary Policy Statement*. Each *Statement* reviews monetary policy over the previous six months and describes how price stability will be delivered in the months ahead. The Governor and other Reserve Bank officials regularly appear before Parliament's Finance and Expenditure Select Committee to answer questions about these *Statement*s, as they do for the *Annual Report*.

Board of Directors

On the Treasurer's behalf, the Reserve Bank's Board of Directors is required to keep the Reserve Bank's and the Governor's performance under constant review. The Board determines whether the Reserve Bank's *Monetary Policy Statements* and actions are consistent with achieving and maintaining price stability, and with the Policy Targets Agreement. However, the Board does not participate in the monetary policy decision-making process and does not receive market-sensitive information prior to the markets.

Funding agreement

The 1989 Act makes the Reserve Bank more accountable for its use of public money. Every five years a funding agreement is drawn up between the Government and the Reserve Bank, which specifies a level of expenditure for the Bank over the upcoming period. So far the Reserve Bank has been able to keep well within agreed limits, year by year. In fact, operating expenses in 1997/98 are budgeted to be 40 percent lower than expenses in 1989/90. Earlier legislation did not restrict the Reserve Bank's expenditure at all.

Source: The Reserve Bank of New Zealand

Appendix 9. IMF "Code of good practices on transparency in monetary and financial policies

The first of the Code's four parts suggests ways to state clearly the role, responsibility and objectives of the central bank. The objectives of the central bank should be clearly defined, publicly disclosed and written into law. Institutional responsibility for foreign exchange policy should be disclosed. While the objectives of the central bank are best decided by society at large, the law should give the central bank the authority to select the instruments best suited to meeting those objectives. The law should specify the manner in which central bankers will be held accountable for their actions, but should also protect them from arbitrary dismissal and over-turning of their decisions. The institutional relationship between monetary and fiscal operations should be clearly defined, as should any agency roles performed by the central bank on behalf of the government.

Second, the decisions of the central bank should be communicated to the public in an open manner. The central bank should explain the framework, instruments and targets, if any, which are used to achieve its objectives. The structure of the central bank's decision-making body should be publicly disclosed and its decisions communicated in a timely manner.

Third, information on monetary policy should be publicly available, and the central bank's data releases should at a minimum conform to the IMF's standards for data dissemination. The central bank should establish and maintain public information services.

Fourth, the Code suggests practices to hold central bankers accountable for their actions. Central bank officials should periodically appear before a designated public authority to explain the conduct and performance of monetary policy and exchange views on the state of the economy and financial system. The central bank should also provide assurances of the integrity of its operations and its officials through release of audited financial statements of its operations, information on expenses and revenues in operating the central bank, and establishment of standards of conduct to avoid conflict of interest. At the same time, the extent to which central bankers are protected from being sued for actions taken in the conduct of their duties should be disclosed.

Source: IMF(2000)

Appendix 10. Transparency and accountability: the case of the Bank of England

Inflation target

The Bank of England has an inflation target of 2½%, a target set by the government. The Bank is allowed a divergence of ±1%, among other things to reflect its incomplete control over inflation (for further discussion on inflation targets.

Monetary Policy Committee

The government has appointed a nine-member Monetary Policy Committee (MPC) which makes decisions on monetary policy. The MPC comprises the Governor, two Deputy Governors, the Chief Economist and the Head of Market Operations, together with four members nominated by the government. These four are selected solely on the basis of academic qualifications in monetary economics and major central bank issues. In practice, most have been well-known professors at British universities. Each is appointed for a term of three years. A Treasury representative attends the MPC's meetings in a non-voting capacity.

Minutes of MPC meetings

The MPC meets monthly according to a pre-announced timetable. Decisions are based on a simple majority. Results of meetings are announced immediately afterwards and the minutes and results of voting are officially published two weeks after each meeting.

Inflation forecasts and accountability towards the public

All decisions by the MPC are based on the Bank's inflation forecast. This forecast, together with an assessment of the forecast uncertainty and forecasts for other key variables which are considered to have an impact on inflation are published in an in-depth quarterly Inflation Report. The aim of publishing the MPC's minutes and record of voting, alongside its regular publication of the

Inflation Report is to make the Bank's policy as transparent as possible and thereby fulfil its accountability towards the public.

Open letter to the government

Each time inflation exceeds the threshold ±1% value, the Bank of England is required to write an open letter to the Chancellor stating the reason for the deviation from target, what actions the Bank plans to take to get inflation back to target, how long it will take and how this is compatible with the Bank's remit. The Bank is required to write another letter three months later if it has still not succeeded in bringing inflation back to target.

The government's response to such a letter will depend on the economic situation at the time. It needs to take into account that a variety of reasons may underlie a failure to hit the inflation target at all times. In some cases, for example if the economy suffers serious supply shocks, hitting the target at all cost may even be undesirable.

Accountability towards parliament

Members of the MPC are required to meet the Treasury Select Committee quarterly, answering questions about the Bank's monetary policy and explaining its actions. Furthermore, the Bank's annual report is debated in parliament every year. The bank is also made accountable towards the Court of the Bank which comprises the Governor and two Deputy Governors, plus 16 non-Executive Members, representing the views of British industry, commerce and finance.

Source: Pétursson (2000).

ANNEX 1

Central bank independence and objectives

	Independence	Legislated objectives	Operational objective
RBNZ	Independent to pursue an inflation target agreed upon by the Governor and the Minister of Finance.	"Formulation and implementation of monetary policy aimed at achieving and maintaining stability in the general level of prices."	Inflation target of 0 to 2% adopted in 1988; 0 to 3% in 1996; 1 to 3% on average over the medium term in 2002.
Reserve Bank of Australia (RBA)	Independent to determine monetary policy, but currently an inflation target has been agreed to with the Treasurer.	To ensure that monetary and banking policy... will best contribute to: (a) the stability of the currency of Australia; (b)the maintenance of full employment in Australia; (c) the economic prosperity and welfare of the people of Australia."	Adopted 1993. Pursues average inflation of 2 to 3% over the business cycle.
US Federal Reserve	"Independent within the government." Its decisions do not have to be ratified by government, but they must work within the government's overall objectives of economic and financial policy.	"Economic growth in line with the economy's potential to expand; a high level of employment; stable prices; moderate long-term interest rates."	The US Federal Reserve has no explicit inflation target but holds the view that price stability is necessary for achieving its legislated goals.
Bank of Canada	Has operational control over monetary policy to pursue a goal agreed to by the Bank and the government.	"To promote the economic and financial wellbeing of Canada."	Initial inflation target adopted in 1991. Price stability is currently defined as inflation of 2%+/-1%.
Bank of England	Has operational independence to pursue price stability. The Chancellor of the Exchequer informs the Bank every year of what price stability is taken to mean, and of the government's economic policy.	"To maintain price stability, and subject to that, to support the economic policy of Her Majesty's Government, including its objectives for growth and employment."	Initial inflation target of 1 to 4% adopted in 1993. Price stability is currently defined as inflation of 2.5% +/- 1 % reporting range.
Bank of Japan	Has autonomy regarding currency and monetary control.	"Currency and monetary control shall be aimed at, through the pursuit of monetary policy, contributing to the sound development of the national economy."	Adopted 1998. To maintain price stability. They have no explicit inflation target.
Sveriges Riksbank	Has operational independence to pursue price stability.	"To maintain price stability."	Adopted 1993. Maintain price stability-a target of 2% inflation +/-1%.
ESCB	Completely independent.	"To maintain price stability."	Adopted 1999. They have an inflation target of less than 2% over the medium term.

Source: Reserve Bank of New Zealand

ANNEX 2

Summary of Best Practices on Central Bank Independence and Accountability

Criteria	Best Practices
Clarity of objectives	Establish a single or primary objective in terms of preserving price stability. If the are multiple objectives (for example, price stability and financial system stability), and policy conflict that arises should be resolved in favor of price stability.
Political *autonomy*	Central bank's Board of Directors must be nominated and appointed by the government and Congress in a two-step process, without any representation of the government or the private sector. They should be appointed for a term longer than that of the presidential term, and grounds for dismissal should t»e solely of a legal nature and clearly established in law. Although the central bank Board of Directors itself or the government should take initiative for the dismissal of a board member, the Legislature or the Judicial Branch should bear the final decision.
Economic autonomy	Provide central bank with instrument independence, that is, the freedom to use all the means to achieve the inflation target. Interest rate policy should be exclusive responsibility of the central bank, while the selection of the exchange rate regime may be shared with the government, such that it doesn't interfere with the conduct of monetary policy and the achievement of the policy target. Goal *independence,* for example defining unilaterally an inflation target, implies a stronger independence but assigns the central bank the responsibility of driving the short- run trade-off between inflation and unemployment, which is more in the nature of the political authorities decision. Direct credit to the government should be prohibited or carefully limited in line with the policy objective.
Financial autonomy	Define clear rules governing the relationship between the central bank and the government in the treatment of central bank losses and profits. Governments should commit to maintain central bank's capital, such that monetary policy is implemented without financial restrictions and focused on established policy objectives, while central bank profits should be *transferred to the* government after an appropriate accumulation of *central* bank's legal reserves.
Accountability	The central bank should report to the government and the Legislature *on* the conduct of monetary policy and in particular on the achievement of the long-run inflation policy and the implementation of actions and policies *to* that end. Such reports should be given broad public dissemination. Financial statements should be published at least once a *year under* generally accepted accounting principles, and should be certified by *an* independent auditor. Summary balance sheets should be published more frequently under similar accounting standards, supplemented with relevant explanatory notes

Source: Jacome, IMF (1999)

ANNEX 3

Selected Indices of legal Central Bank Independence

Index	Authors of index	Description of index
BP	Bade and Parkin (1980)	BP measures political independence of CB, which is defined as ability of CB to implement its policy without government influence. Index is calculated with (1-4) scale.
GMT	Grili, Mas-ciandaro and Tabellini (1991)	GMT considers both political and economic independence, thus consisting of two sub indices. There are nine indicators of political and seven of economic independence. Usually only two scores of 0 and 1 are allowed for each indicator. Overall score is found by summing all scores.
LVAW	Cukierman (1992)	Index covers 16 characteristics of CBI, including status of the governor, policy formulation, contacts with government etc. Each score is assigned a number from 0 to 1. Then two-round aggregation procedure is used for obtaining overall score, which also lies in interval from 0 to 1.
CBI-DF	Loungani and Sheets (1997)	CBI-DF slightly amends LVAW index. It is calculated on the basis of questionnaire, consisting of 14 questions about legal provisions of CB law.
Lybek	Lybek(1999)	Index covers the issues of CB autonomy and accountability and is based on 21 criteria.
Maliszewski	Maliszewski (2000)	This index is amended variant of GMT index, calculated for 26 CIT countries. The difference incurs from subjective interpretation of CB legislation by author

Source: Sologoub (2002)

ANNEX 4

Index of legal independence (LVAW) for transitional countries, 1990s

Country	Enactment year	LVAW, value
Albania	92	0.51
Armenia	96	0.85
Azerbaijan	96	0.25
Belarus	92	0.73
Bulgaria	91	0.55
Croatia	92	0.44
Czech Republic	91	0.73
Estonia	**93**	**0.78**
Georgia	95	0.73
Hungary	91	0.67
Kazakhstan	95	0.44
Kyrgyz Republic	92	0.52
Latvia	92	0.49
Lithuania	96	0.78
Moldova	95	0.73
Mongolia	96	0.55
Poland	**97**	**0.89**
Romania	91	0.34
Russia	95	0.49
Slovak Republic	92	0.62
Slovenia	91	0.63
Tajikistan	93	0.36
Turkmenistan	92	0.26
Ukraine	**91**	**0.42**
Uzbekistan	95	0.56
Average		**0.52**

Source: Cukierman (2002)

ANNEX 5

Structure of the LVAW index

Criteria	*Values*
I. Central bank CEO (0.20)	
1. Term of office of CEO (0.25)	
- Equal or more than 8 years	1
- 6 years or more but less than 8 years	0.75
- Equal to 5 years	0.50
- Equal to 4 years	0.25
- Less than 4 years	0
2. Who appoints the CEO (0.25)	
- The Central Bank Board	1
- Council composed by executive and legislative branch and Central Bank Board	0.75
- By legislative branch	0.50
- By executive branch	0.25
- By one or two members of executive branch	0
3. Provisions for dismissal of CEO (0.25)	
- No provision	1
- Only for non-policy reasons (e.g., incapability, or violation of law)	0.83
- At a discretion of Central Bank Board	0.67
- For policy reasons at legislative branch's discretion	0.50
- At legislative branch's discretion	0.33
- For policy reasons at executive branch's discretion	0.17
- At executive branch's discretion	0
4. CEO allowed to hold another office in government (0.25)	
- Prohibited by law	1
- Not allowed unless authorized by executive branch	0.5
- No prohibition for holding another office	0
II. Central Bank objectives (0.15)	
5. Central Bank objectives (0.15)	
- Price stability is the only or major goal, and in case of conflict with government, the Central Bank has final authority	1
- Price stability is the only goal that do not seem to conflict with the former	0.8
- Price stability along with other objectives	0.6
- Price stability along with other objectives of potentially conflicting goals (e.g., full employment)	0.4
- Central Bank charter does not contain any objective	0,2
- Some goals appear in the charter but price stability is not one of them	0
III. Policy formulation (0.15)	
6. *Who formulates monetary policy (0.25)*	
- Central Bank has the legal authority	1
- Central Bank participates together with government	0.67
- Central Bank in an advisory capacity	0.33
- Government alone formulates monetary policy	0
7. Government directives and resolution of conflicts (0.50)	

-Central Bank given final authority over issues defined in the law as objectives	1
-Government has final authority over issues not clearly defined as Central Bank goals	0.8
- Final decision up to a council whose members are from the Central Bank, executive branch, and legislative branch	0.6
- Legislative branch has final authority	0.4
- Executive branch has final authority, but subject to due process and possible protest by Central Bank	0.2
- Executive branch has unconditional authority over policy	0
8. Central Bank given active role in formulation of government's budget (0.25)	
-Yes	1
-No	0
IV. Central Bank lending (0.50)	
9. Limitations on advances (0.30)	
- Advances to government prohibited	1
- Permitted but subject to limits in terms of absolute cash amounts or relative limits (government revenues)	0.67
- Permitted subject to relatively accommodative limits (more than 15 percent of government revenues)	0.33
- No legal limitations on advances. Subject to negotiations with government	0
10. Limitations on securitized lending (0.20)	
- The same as in 9	
11. *Who decides control of terms of lending to government (0.20)*	
- Central bank controls terms and conditions	1
- Terms of lending specified in law, or Central Bank given legal authority to set conditions	0.67
- Law leaves decision to negotiations between the Central Bank and government	0.33
- Executive branch alone decides and imposes to the Central Bank	0
12. Beneficiaries of Central Bank lending (0.10)	
- Only central government	1
- Central and state governments, as well as further political subdivisions	0.67
- Also public enterprises can borrow	0.33
- Central Bank can lend to all of the above and to the private sector	0
13. Type of limits when they exist (0.05)	
- As an absolute cash amount	1
- As a percentage of Central Bank capital or other liabilities	0.67
- As a percentage of government revenues	0.33
- As a percentage of government expenditure	0
14. Maturity of loans (0.05)	
- Limited to a maximum of 6 months	1
- Limited to a maximum of 1 year	0.67
- Limited to a maximum of more than one year	0.33
- No legal upper bounds	0
15. Restrictions on interest rates (0.05)	
- Must be at market rate	1
- On loans to government can not be lower than a certain floor	0.75

- Interest rate on Central Bank loans can not exceed a certain ceiling	0.50
- No explicit legal provisions regarding interest rate in Central Bank loans	0.25
- No interest rate charge on government's borrowing from Central Bank	0
16. Prohibition on Central Bank lending in primary market to Government (0.05)	
- Prohibition from buying government securities in primary market	1
- No prohibition	0

Source: Cukierman (1992)

ANNEX 6

The volumes of purchasing of state T-bills by NBU on primary market (as percentage in overall volume of issued state T-bills), as of 1.10.2005

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
the share of state T-bills purchased by NBU in overall volume of issued state T-bills, %	*0*	*21*	*29*	*72*	*58*	*0*	*0*	*0*	*0*	*0*	*0*

Source: NBU

ANNEX 7

Coding of the components of LVAW index of legal central bank independence for CIT

		CEO				Policy formulation			Objec-tives	Limitations on lending							
Country		Term of office	Who appoints	Dismis-sal	Other offices	formu-lates	Final authority	Role in budget		Ad-vances	Securitized lending	Terms of lending	Potential borrowers	Type of limit	Maturity of loans	Interest rates	Primary market
Albania	1992	0.75	0.75	0.83	0.5	0.67	0.2	NA	0.6	0.33	0.67	0.33	NA	0.33	1	0.75	0
Armenia	1996	0.75	0.5	0.83	1	1	1	1	1	1	67	0.67	0.67	0.33	0.67	1	1
Azerbaijan	1996	0.5	0	0.17	1	0.67	NA	0	0.4	0	0	0.33	0.33	NA	0	0.25	0
Belarus	1992	0.75	0.5	1	1	0.67	0.8	1	0.8	1	0.33	0.67	0.33	0	1	0.25	1
Bulgaria	1991	0.5	0.5	0.83	1	0.67	NA	NA	0.6	0.67	0	0.33	NA	0.33	1	0.26	1
Croatia	1992	0.75	0.5	0.33	0	1	0.2	0	0.6	0.67	0	0.67	NA	0.33	0.67	0.25	0
Czech Rep	1991	0.75	0.5	0.83	1	1	1	NA	0.8	0.67	0.67	0.67	NA	0.33	1	0.25	0
Estonia	1993	0.5	0.5	0.83	1	1	1	1	0.8	1	1	NA	NA	NA	NA	NA	0
Georgia	1995	0.75	0.5	0.83	1	1	0.4	1	0.6	1	0.67	0.67	1	0.33	1	0.75	0
Hungary	1991	0.75	0.5	0.83	1	0.67	1	1	0.6	0.67	NA	0.33	1	0.33	0.33	0.75	0
Kazakhstan	1995	0.75	50	0.33	1	1	1	0	0.6	0	0	0.33	0.33	NA	0	0.75	1
Kyrgyz Rep	1992	0.5	50	0.83	1	0.67	0.4	1	0.6	0.33	0	0.67	NA	0	1	0.25	1
Latvia	1992	0.75	0.5	0.33	1	1	1	0	0.8	0	0	0.67	NA	33	1	0.25	0
Lithuania	1996	0.5	0.5	83	1	1	1	1	0.8	1	1	NA	NA	NA	NA	NA	0
Macedonia	1995	0.75	0.5	0.83	0	1	0.4	0	0.6	0	0.33	0.67	0.33	0	0.67	0.75	0
Moldova	1995	0.75	0.5	0.83	1	1	1	1	0.8	1	0	0.33	0.67	NA	1	0.75	1
Mongolia	1996	0.75	0.5	0.5	1	1	1	0	0.6	0.67	0	0.67	0.33	0.33	0.67	0.25	0
Poland	1997	0.75	0.5	0.83	1	1	1	1	0.6	1	1	1	1	1	1	1	1
Romania	1991	0	0.5	0.33	1	0.67	0.4	0	0.4	0.33	0	0.33	NA	0	0	0.25	0
Russia	1995	0.25	0.5	0.83	1	0.67	0.2	1	0.6	1	0	0	0.33	NA	0	0.75	0
Slovak Rep	1992	0.75	0.5	0.67	1	1 00	1	0	0.6	NA	0.67	0.67	0	0.33	1	NA	0
Slovenia	1991	0.75	0.5	1	1	1	0.4	NA	0.8	0.67	0	1	NA	0	0.67	0.25	0
Tajikistan	1993	NA	0.5	0.5	0	0.67	NA	1	0.6	0	0	0.33	0.67	NA	0	0.25	0
Turkmenistan	1992	NA	50	1	0.5	0.33	0	0	0.6	0	0	0	0.33	NA	0	0.25	0
Ukraine	1991	NA	0.5	NA	NA	0.67	NA	1	0.6	0	0	NA	NA	NA	NA	NA	NA
Uzbekistan	1992	0.25	0.5	0.5	1	0.67	NA	0	0.6	0	0.67	0	0.33	0.33	1	0.75	1
Uzbekistan	1995	0.25	0.5	0.83	0	1	1	1	0.6	1	0	0	0	NA	1	0.75	1

Source: Cukierman (2002)

ANNEX 8

Index of actual independence (QVAW), 1989

Country	***QVAW, value***
Germany, Fed. Rep. of	1
Costa Rica	0.81
Finland	0.78
Australia	0.76
Italy	0.73
Denmark	0.73
Bahamas, The	0.71
Luxembourg	0.66
France	0.65
United Kingdom	0.64
South Africa	0.64
Zaire	0.61
Lebanon	0.59
Ireland	0.57
Barbados	0.54
Uganda	0.53
Uruguay	0.49
Belgium	0.47
Turkey	0.44
Tanzania	0.38
Peru	0.22
Yugoslavia	0.17
Ethiopia	0.13

Source: Cukierman (1992)

ANNEX 9

Questionnaire (QVAW) Variables, Weights, and Numerical Coding

CRITERIA	VALUES
1.Tenure of central bank CEO overlap with political authorities (0.1)	
Little overlap	1
Some overlap	0,5
Substantial overlap	0
2. Limitations on lending in practice (0.2)	
Tight	1
Moderately tight	0.66
Moderately loose	0.33
Loose or nonexistent	0
3. Resolution of conflict (0.1)	
Some dear cases of resolution in favor of bank	1
Resolution in favor of government in all cases	0
All other cases	0.5
4. Financial independence (0.1)*	
a. Determination of the central bank's budget	
Mostly central bank	1
Mixture of bank and executive or legislative branches	0.5
Mostly executive or legislative branches	0
b. Determination of the salaries of high bank	
officials and the allocation of bank profits	
Mostly by bank or fixed by law	1
Mixture of bank and executive or legislative branches	0.5
Mostly executive or legislative branches	
5. Intermediate policy targets (0.15)**	
a. Quantitative monetary stock target	
Such targets exist; good adherence	1
Such targets exist; mixed adherence	0.66
Such targets exist; poor adherence	0.33
No stock targets	0
b. Formal or informal interest rate targets	
No	1
Yes	0
6. Actual priority given to price stability (0.15)	
First priority	1
First priority assigned to a fixed exchange rate	0.66
Price or exchange rate stability are among the bank's objectives, but not first priority	0.33
No mention of price or exchange rate objectives	0
7. Function as a development bank, granting credit at subsidy rates? (0.2)	
No	1
To some extent	0.66
Yes	0.33
The central bank heavily involved in granting subsidized credits	0

*- Variable 4 is calculated as a simple average of the variables 4a and 4b.

** - Variable 5 is calculated as a simple average of the variables 5a and 5b.

Source: Cukierman (1992)

ANNEX 10

Enhancing NBU independence as an integral part of EU accession strategy of Ukraine

The EU legislation contains rather distinct criteria of independence of the European Central Bank (ECB) and national banks of the EU Member States, the necessity of providing statutory backup for which was declared as a key precondition for the formation of the European Economic and Monetary Union (EMU). In particular, according to Article 109 (e) of the Treaty establishing the European Community 1992 (hereinafter referred to as the Treaty), the EU Member States undertook to strengthen independence of national banks according to the defined criteria by the commencement of the EMU third stage that took place on 1 January 1999 and was marked with the introduction of euro and transition to implementation of the common monetary policy by the European System of Central Banks (ESCB). Besides, Article 108 of the Treaty established the requirement for adaptation of the laws on national banks of the EU Member States to bring them into conformity with the ESCB Statute (*the Protocol on the Statute of the European System of Central Banks and the European Central Bank 1992*, hereinafter referred to as the Statute).

For the new EU Member States, which acceded on 1 May 2004, meeting the requirements concerning national bank independence became an integral part of fulfilling acquis communautaire, a program document developed for every country and aimed at introduction of the Union's common legal result. In particular, Chapter 11 of *acquis* (Economic and Monetary Union), inter alia, systematizes the results of the national bank independence maintaining policy achieved in the EU that the candidate countries must achieve. It should be noted that the EU legislation does not require full harmonization of statutes of national banks of the candidate countries, which does not rule out possibility of legal differences caused by specific features of national laws. At the same time, national legislation should be compiled in such a way that (1) ensures a sufficient level of integration of national banks into the ESCB; (2) removes any contradiction between national legislation and relevant norms contained in the Treaty and in the Statute. Candidate countries should adapt their national laws, as far as ensuring national bank independence is concerned, according to *acquis* requirements by the date of their official accession to the EU.

The matrix of legislative standards against which national bank independence is evaluated was developed by the European Monetary Institute (EMI), the ECB predecessor. In particular, the EMI offers the following criteria of national central bank independence in its Progress Towards Convergence report (1996) (see Chapter II: Statutory requirements to be fulfilled for NCBs to become an integral part of the ESCB):

1. **Functional independence** (corresponds to the concept of "independence in definition of a main objective").

The EMI's concept concerning national bank independence in choosing the objective is based on Article 105 of the Treaty and Article 2 of the Statute according to which "the core task of the European System of Central Banks should consist of maintaining price stability". In its most recent Convergence Report (2004), the ECB established that statutes of new EU members, which are not EMU members, should contain references to maintaining price stability as the core task of NCB activities. According to EMI (1996), maintaining national currency stability as the core task of NCB activities not quite accurately corresponds to the function of maintaining price stability.

2. **Institutional independence** (that is, independence in choosing monetary policy instruments)
The institutional independence concept is based on Article 107 of the Treaty and Article 7 of the Statute. These Articles prohibit the ECB, the NCBs and members of their decision-making bodies from seeking or taking instructions from EU institutions or bodies, from any government of a Member State or from any other body. The following forms of external influence upon NCB activities as far as shaping and implementing of monetary policy by NCBs is concerned:

- a right of third parties to give instructions to NCBs;
- a right of third parties to approve, suspend, annul or defer NCB decisions;
- a right of third parties to censor NCB decisions;
- participation of political bodies (government or parliament) in decision-making bodies of an NCB with a right to vote;

At the same time, the institutional independence idea should not be interpreted in such a way that it would preclude any form of a dialogue between political authorities and NCBs. Such a dialog, particularly concerning statutory obligations to provide information and exchange views on policy making, is absolutely compatible with provisions of the Treaty and the Statute. However, such a dialog should not:

- result in interference with the independence of the members of decision-making bodies of NCBs;
- result in any loss of accountability and transparency of NCB activities;
- violate confidentiality requirements resulting from the Statute.

3. **Personal independence**
The legislation on a NCB has to respect the following features of personal independence of the bank's top officials:

- in accordance with Article 14.2 of the Statute, a minimal term of office for a Governor should be five years;
- in accordance with Article 14.2 of the Statute, a Governor may be dismissed only if: (1) a court conviction against him for serious misconduct takes effect; (2) criteria determining the Governor's ability of performing his/her duties are no longer met;
- in accordance with Article 107 of the Treaty and Article 7 of the Statute, the same rules for the Governor's minimal tenure of office and possibility of dismissal should be provided for other members of the decision-making bodies of NCBs;
- in accordance with Article 11.1 of the Statute, ECB board members may not combine their functional duties with any other paid or unpaid activities (except for special exceptions decided by the ECB Council). Hence, the key principle ensuing from this point (although it is not binding at the NCB level) reads that the members of decision-making bodies of NCBs must not combine their functional duties with activities potentially able to result in a conflict of interests.

At the same time, the EU legislation sets forward no clear requirement as to a procedure applied to appoint a NCB Governor or other members of NCB decision-making bodies, a procedure of their re-appointment as well as requirements concerning professional qualification of the bank's top officials.

4. **Financial independence**
The financial independence concept is based on the provision that NCBs should be in a position to avail themselves of the appropriate means to ensure that their ESCB-related tasks can be properly fulfilled. This should be accounted for in the statutory provisions regulating the formation of the NCB capital, the distribution of its profits or covering of its losses. Another aspect of NCB financial independence consists of prohibition of budget deficit funding. In this context, the EU legislation provides for:

- prohibition of direct crediting of government by a NCB (according to Article 101(1) of the Treaty and Article 21.1 of the Statute);

- prohibition of privileged access of public authorities to resources of financial institutions (Article 102(1) of the Treaty).

Hence, analysis of the EU legislation as to ensuring NCB independence allows the following **conclusions for Ukraine** to be made:

1. Definition of the NBU's main function (as maintaining stability of the **national currency**) does not meet the criteria of membership in the European Economic and Monetary Unit, according to which "the core task of the European System of Central Banks should consist of maintaining **price stability**".
2. Consolidating the NBU's institutional independence (as far as qualification requirements to the NBU Council members are concerned) is not compatible with the EU statutory requirements that prohibit participation of political bodies (government or parliament) in decision-making bodies of an NCB with a right to vote;
3. Dismissal conditions for the NBU Governor and the NBU Council members fail to meet Article 14.2 of *the Protocol on the Statute of the European System of Central Banks and the European Central Bank* that rules out possibilities for discrete dismissal (that is, on representation and through decision by the Parliament and/or the President).
4. The EU legislation suggests no clear criteria for consolidating NCB financial independence.