Iikka Korhonen

Head of Research, Bank of Finland

Central Bank Independence in CEE: Attempts to Limit or Reverse

Motivation

- Higher central bank independence was one part the *acquis* that new member countries accepted when they joined the European Union in 2004 and 2007
- Some countries that joined the European Union in 2004 have also joined the euro system, while others have not
- In some countries that joined the European Union in 2004 there have been actions both in legislation and otherwise that can be interpreted as a threat to central bank indepence
- Why?

Traditional arguments for central bank independence

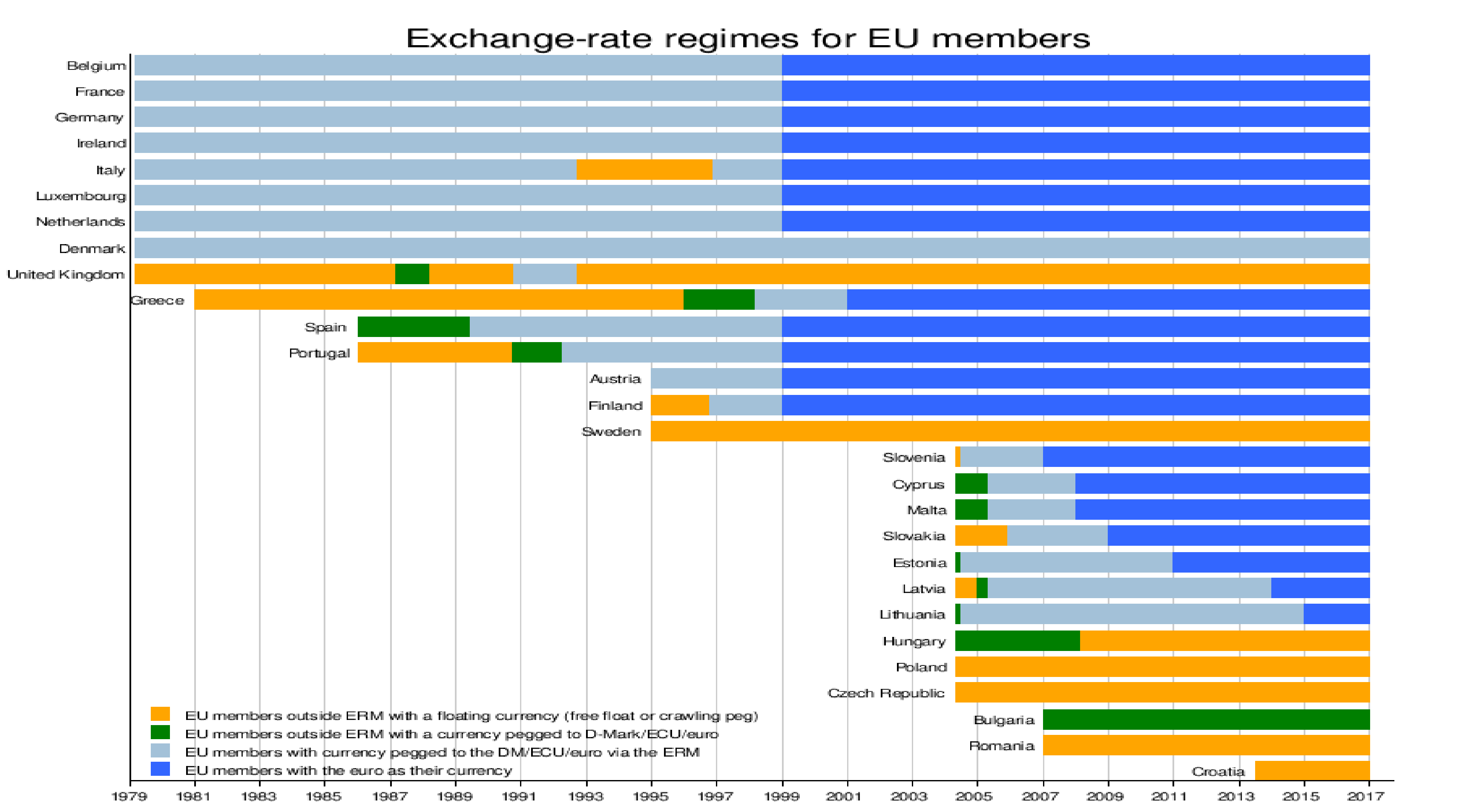
- Independent (and inflation-averse) central bank as a solution to time inconsistency problem of optimal policies (Rogoff, 1985; Kydland and Prescott, 1979)
- Empirically, it was found that higher central bank independence was associated with lower inflation (Alesina, 1988; Alesina and Summers, 1993, for example), but apparently without adverse effect on GDP growth or employment
- Hence, movement towards greater central bank independence from New Zealand (1989) onwards
- In the European Union Germany often cited as an example

Maastricht Treaty (1992)

Article 107

When exercising the powers and carrying out the tasks and duties conferred upon them by this Treaty and the Statute of the ESCB, neither the ECB, nor a national central bank, nor any member of their decision-making bodies shall seek or take instructions from Community institutions or bodies, from any government of a Member State or from any other body. The Community institutions and bodies and the governments of the Member States undertake to respect this principle and not to seek to influence the members of the decision-making bodies of the ECB or of the national central banks in the performance of their tasks.

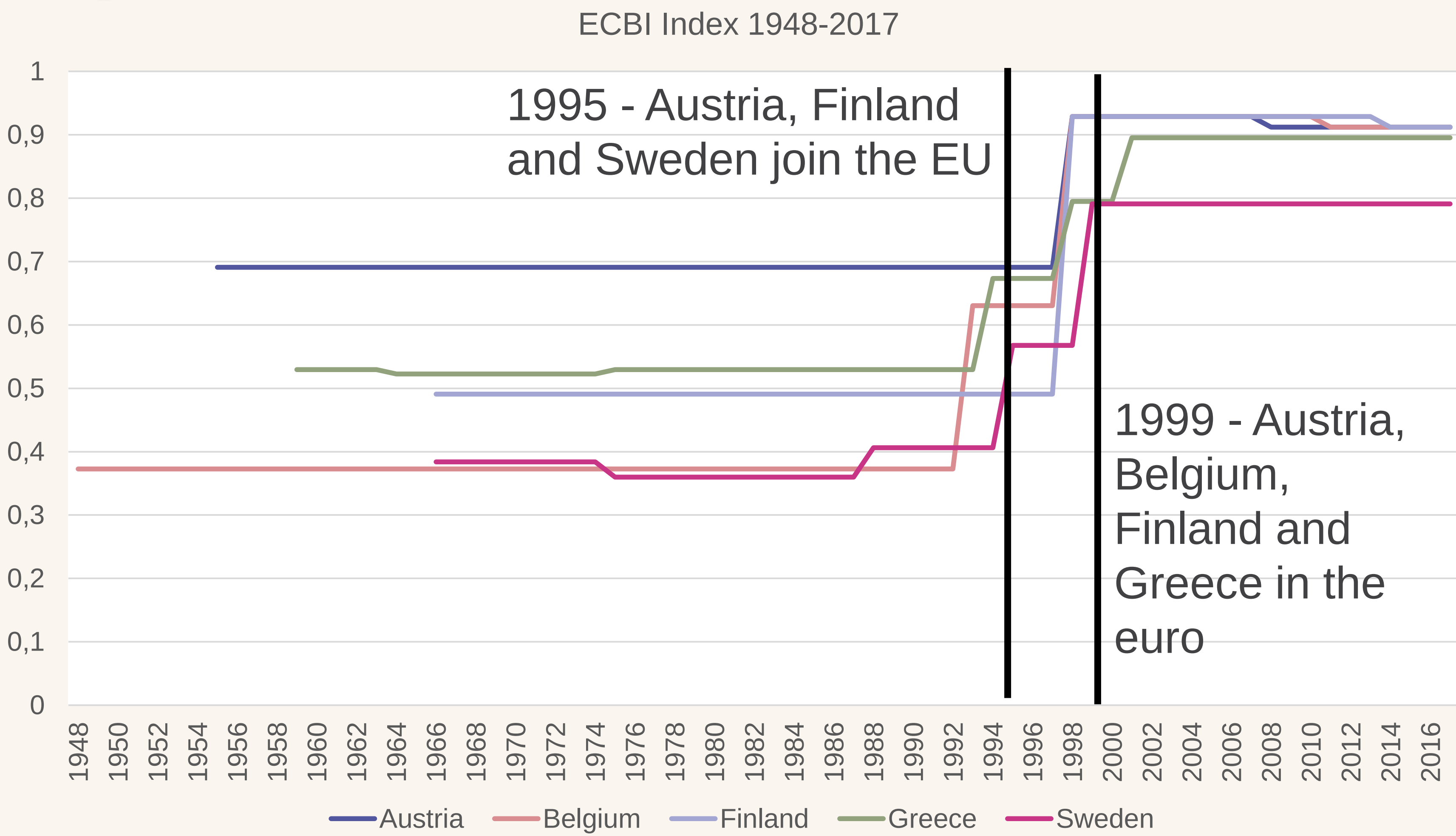
How did members of the European Union progress (or not) towards the euro area?



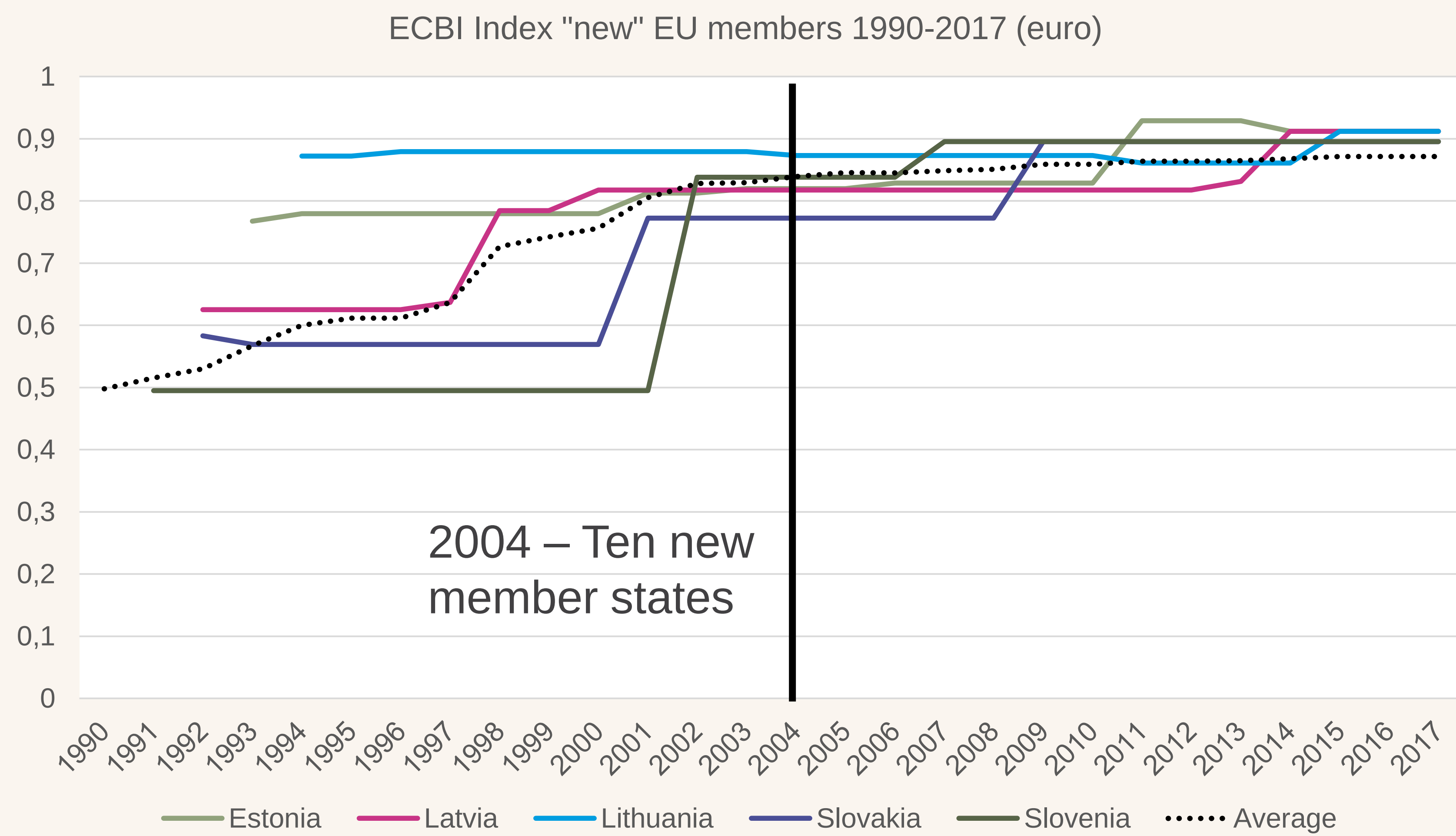
Brief detour on measuring central bank indepedence

- Legal independence, economic independence etc.
- For example: Grilli, Masciandaro and Tabellini (1991) = GMT, still widely used, has sub-index for political independence and seven sub-indices for economic independence
- Cukierman (1992) was influential in shaping discussion
- Cukierman, Webb and Neyapti (1992) = CWN calculated central bank independence measures for large number of countries AND were very transparent in their methodology
- Romelli (2017) presents a new ’extended central bank independence index’ = ECBI by merging GMT and CWN as well as adding more variables (e.g. accountability and financial autonomy)

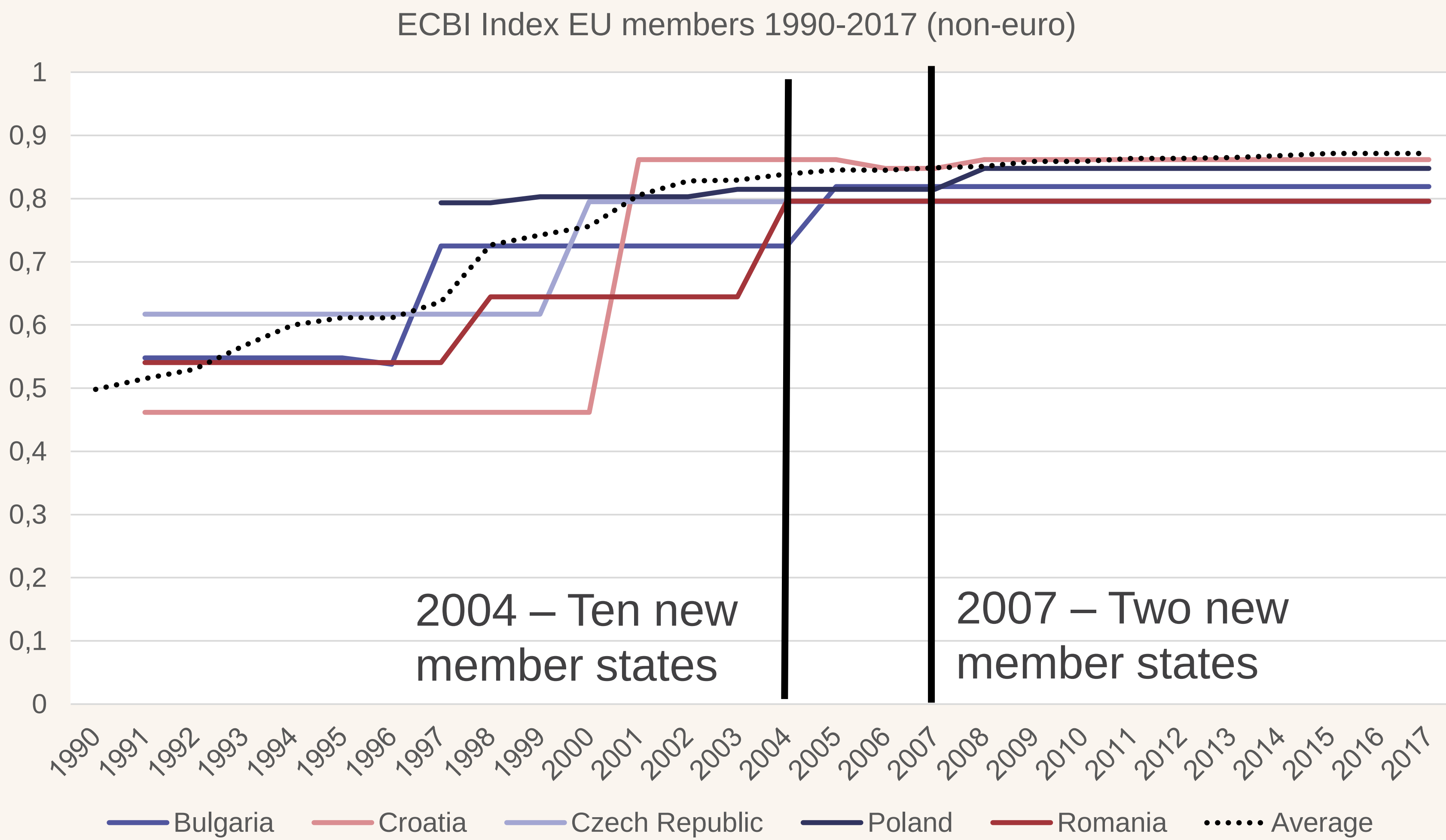
What happened in the European Union? First some examples of EU-15



What happened in the European Union? Member states joining 2004-2007 that now in the euro area



What happened in the European Union? Member states joining 2004-2007 that are not in the euro area



What should we think of all this?

- Prospect of membership in the European Union clearly spurred many countries to increase independence of their central banks, although general trend (’best international practice’) was pointing into that direction anyway
- For countries that joined in 2004 and 2007, the level of central bank independence is higher for those countries that joined the euro area

An attempt to limit actual independence of a central bank

- In 2011 Hungary proposed a new central bank law, which ECB (2011) found highly problematic in many areas including personal indepence of central bank management (but also economic and functional independence)
- In 2013 charter of the central bank was changed by administrative decree
- Changes in the way foreign currency loans had to be repaid etc.
- Funds set up by the central bank – public sector financing? Or something else?

However, membership in the euro area is not an iron-clad guarantee…

- In 2014, 2015 and 2017, there were several proposals in the Slovenian parliament to amend the law on central bank
- Draft laws proposed e.g. changes to the procedure for removing a member of Banka Slovenije's Governing Board and changes into Banka Slovenije's reporting requirements to the parliament, especially regarding banks that have received state aid (also requiring Banka Slovenije to give confidential information on them to the parliament)
- All amendments seemed to stem from 2013 banking crisis, its aftermath and costs

Conclusions and further avenues for research

- Prospect of membership in the European Union spurred legal reforms that fostered central bank independence in practically all incoming members, although starting level of independence varied greatly
- Membership in the euro area seems to have given an extra boost to central bank independence
- There have been attempts to limit central bank independence in the countries that joined the EU in 2004 and 2007; they start with proposed changes in central bank law, but also administrative orders may be used
- Attempts to limit central bank independence may stem from problems in the banking sector or be linked to costs of a banking crisis
- Next step: How does the role of central bank as financial supervisor affect potential reversal?