

The Three Pillars of Central Bank Governance - Towards a Model Central Bank Law or a Code of Good Governance?¹

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I. Introduction

In recent years the role which central banks play in the economy and their position within or outside government structures has been the focal point of numerous contributions mainly by economists and lawyers, but also by political scientists. This may not only be the case due to the fact that the tasks which central banks fulfill have changed dramatically, but rather as a consequence of increased attention which is paid to the approach to economic policy understood in a broad sense and the role which central banks fulfill in this regard. Central bank systems have been scrutinized more or less systematically with regard to their institutional structure in search of the ideal setting both from an economic and legal point of view. Adding to this has been the more recent discussion on *good governance* as a means to provide macroeconomic stability, orderly economic growth and a stable regulatory environment. Given the role commonly assigned to them, central banks are thought to play a vital role in achieving these goals to the extent that the legal framework in which they operate reflects good governance.³ As *Lybek* has pointed out: ‘Good central bank governance means that the objectives and tasks delegated to an institution are performed effectively and efficiently, thus avoiding misuse of resources, which is crucial for establishing a good track record.’⁴

This contribution identifies a number of principles that arguably should form the basis for the good governance of central banks and what their impact is on the institutional structure of a central bank. If it is accepted that the legal framework of a central bank

¹ This contribution is based on presentations during an IMF LEG Workshop on Central Banking in March 2004 and the IMF LEG and IMF Institute Seminar on Current Developments in Monetary and Financial Law in May 2004, both in Washington D.C.

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³ IMF (2003).

⁴ Lybek (2004).

should be based on these principles, the question arises whether and to what extent they can and should form the basis for a model central bank law.

Throughout this paper emphasize is put on institutional rather than operational and legal rather than economic considerations. While the importance of the economic dimension of central bank governance is presently acknowledged, considering the limited amount of space available this dimension cannot be included here. Given the broad institutional approach to central bank governance presently chosen, issues closer related to what may be summarized under the term corporate governance are outside the scope of this paper.⁵ Finally, while many observations made hereafter have implications for all areas of operations of a central bank, in principle this contribution focuses on the arrangements surrounding the primary task of central banks that is the conduct of monetary policy.

II. The three pillars of central bank governance

Central bank governance is arguably defined by a number of key-concepts or pillars, which *together* should form the basis of the legal framework governing a central bank and on which central bank governance should rest, that is independence, democratic accountability and transparency. While these concepts are in the first instance introduced separately this is not to say that they should be considered in isolation. In fact, as will be highlighted in section III, the three pillars are intertwined and in some instances positively or negatively correlated.

1. Central bank independence

While central bank independence is still one of the most discussed institutional features of a central bank in economic and legal literature, it may be conclude that there is a large consensus basically accepting the need for central bank independence. Indeed, in recent years an increasing number of countries have released their central banks into independence or strengthened the existing degree of independence. In the European context this has been promoted by the establishing of an Economic and Monetary Union

⁵ This includes among others issues such as strategic and risk management, human resource management and the role of ethics.

and the legal requirements that Member States of the European Union have to meet with regard to the institutional structure of their respective central banks in order to qualify for participation in the Euro zone.⁶ Numerous economic studies have set out to establish the economic benefits of central bank independence and in particular its impact on inflation and inflation variability as well as growth and growth variability.⁷

The basis argument is that elected politicians face monetary temptations conflicting with an inflation-averse monetary policy. The very nature of their position, being based on the mandate of the electorate, makes it impossible for politicians to be impartial to the short-term benefits of an expansive monetary policy. Politicians may also lack the qualifications of experts in the field. By leaving it to the discretion of an independent central bank to conduct monetary policy, the focus can be on long-term stability rather than short-term monetary temptations.⁸ Some promoters of central bank independence even go so far as to argue that a central bank should in fact be a separate, sort of fourth branch of government that can check potentially damaging policies of other government branches.⁹ And indeed in some instances central banks may have taken on this role voluntarily, such as is the case with regard to the European Central Bank.¹⁰

Despite the overall convincing economic case for independence it is nevertheless important to always keep in mind that a universal legal theory, according to which a central bank charged with the conduct of monetary policy has to be independent, does not exist. Rather, central bank independence may be required to this feature of the institutional structure of a central bank serves the purpose of ensuring the effective conduct of monetary policy.

⁶ According to Article 108 EC Treaty Member States are obliged to ensure that national legislation including the status of its national central bank is compatible with the EC Treaty. According to Article 109 EC neither the European Central Bank nor the national central banks participating in the European System of Central Banks are allowed to seek or take any instructions from Community institutions or Member State institutions.

⁷ For an overview and assessment of studies on these issues see Berger, De Haan and Eijffinger (2000), with further references. Interestingly, findings of empirical evidence still seem vary quite considerably.

⁸ Amtenbrink (1999), 11 et seq., with further references.

⁹ O. Issing, as quoted in Howarth and Loedel (2003), at 119.

¹⁰ Zilioli and Selmayr (2000); critical Torrent (2000) and Amtenbrink and De Haan (2002).

Both legal and economic studies on central bank independence focus - *primarily* - on the evaluation of the institutional settings of the central banks and its relationship with the executive and legislative branch of government. Different aspects of independence are classified under heading such as institutional, functional, organizational and financial independence.¹¹

2. Central bank accountability

The second pillar of central bank governance is democratic accountability. As has been set out elsewhere, the need for mechanisms of democratic accountability derives both from the legal nature of a central bank and its position within a democratic system, as well as the task that a central bank usually fulfills with regard to monetary policy.¹²

It may be considered a common feature of all central banks, which do not form an integral part of the executive branch of government that they fall outside the classical three-branch system of government, or *trias politicas*, and its system of checks and balances. The latter forms an important element in the legitimation of and the accountability for the power delegated to these branches. From a normative point of view the need for mechanisms of democratic accountability derives from the special position which the central bank has vis-à-vis the democratically elected legislative and the executive. To the extent that central banks are independent, mechanisms of democratic accountability are required in order to legitimize the position of the central bank within a given constitutional system. Central banks do not operate in a constitutional vacuum nor should they.

From a more functional point of view it can be observed that despite its importance, monetary policy in principle forms part economic policy and should thus ultimately treated as other elements of economic policy when it comes to the requirement of democratic accountability.¹³ Indeed, a central bank does not hold a neutral position within the system

¹¹ These or similar classifications are generally in all studies, see Eijffinger and Schaling (1992), 18 et seq.; Eijffinger and De Haan (1996), with further references. Some of these elements are revisited in section III.

¹² Amtenbrink (1999).

¹³ Amtenbrink and De Haan (2002), 65 – 66.

of government. Since the executive delegates these functions, the accountability of executive activity through the legislative is narrowed. While the initial act of delegation of monetary policy to a central bank through an act of parliament arguably legitimizes the position of a central bank in a given constitutional system, this cannot justify the absence of mechanisms of democratic accountability.¹⁴

To be sure, where a central bank operates under executive control this is not only likely to deteriorate the performance of the tasks performed by the central bank for the reasons explained above, but it moreover also does not remove the need for mechanisms of democratic accountability. Rather than to provide for adequate mechanisms in the institutional setup of the central bank, government itself has to be accountable for its control over the central bank.

It has been argued that independent central banks constitute a democratic self-restraint by the democratically legitimized legislative which recognizes its own tendency to (ab)use monetary policy for its own political ends.¹⁵ The logic which runs behind this argument seems to be that central bank independence provides monetary stability which in return is a necessary condition for a stable democracy. The implication of this school of thought is far reaching indeed as monetary stability seems to be viewed as an essential pre-condition of democracy. From this hypothesis it is only a small step to elevate central bank independence into the ranks of a democratic principle.¹⁶ Yet, it is far from self-evident that the absence of a system of checks and balances could actually promote or ‘stabilize’ a democratic system.

It is true that the case for central bank democratic accountability is based on the assumption that central banks operate in a democratic system featuring a basic separation of powers and a system of checks and balances. Where countries lack some or all of these prerequisites, making central bank independence subject to the development of

¹⁴ See III 2 hereafter.

¹⁵ Deane and Pringle (1993), at 320; Lastra (1992), at 479.

¹⁶ In the context of the European Central Bank see Amtenbrink and De Haan (2002).

democratic institutions may actually turn out to be contra-productive.¹⁷ Indeed, it could be argued that the introduction of central bank independence and some (lesser) mechanisms of accountability to non-majoritarian systems will still have the potential of being democracy-enhancing, as it result in a more stable economic environment, arguably creating an atmosphere in which democratic structures are given a chance to develop. However, at the same time it has been suggest that central bank reforms have also been used by conservative authoritarian regimes in the past to insulate the central bank from undesired public scrutiny in the wake of a transition to democratic rule.¹⁸

Mechanisms of accountability can be provided in different way in the legal basis of central banks and different elements have been identified as contributing to it.¹⁹ Interestingly, in many instances they refer to the same institutional features of a central bank, which are examined in the context of central bank independence, such as the way in which the bank conducts monetary policy and the relationship of the central bank with the executive and legislative branch of government.²⁰

3. Central Bank transparency

In the course of the discussion on democratic accountability, transparency has emerged as yet another key feature of the way in which central banks operate.²¹ Indeed, while the traditional view has been that at least some of the tasks assigned to central banks can best be achieved outside the limelight, in more recent times central banks have discovered transparency as an ally both in meeting demands of more openness and accountability and in communicating monetary policy. With the words of *Posen* it may be observed that central bank transparency has gone from highly controversial to motherhood and apple pie.²² Together with central bank independence and accountability, transparency forms the third pillar of central bank governance.

¹⁷ Maxfield (1999), at 291, with further references, which points out that ‘...concern over the threat central bank independence may pose to democratic accountability could also be somewhat misplaced in a developing country context.’

¹⁸ Boylan (2001), at 226.

¹⁹ Gromley and De Haan (1997); Amtenbrink (1999), 36 – 61.

²⁰ See section III.

²¹ See e.g. Eijffinger and Geraats (2002); De Haan, Amtenbrink and Waller (2004), with further references.

²² Posen (2002), at 1.

Despite its common usage it is not always very clear what central bank transparency amounts to. Basically two definitions of transparency can be distinguished in the policy-oriented literature on central bank transparency. Firstly, central bank transparency is referred to as the activities of the central bank in providing information. Thus, for example *Lastra* defines transparency as the degree to which information on policy actions is available.²³ A somewhat broader approach to transparency includes the public's understanding of the decisions taken by the monetary authorities and the reasoning behind it.²⁴

The role of transparency in central banking arguably is twofold. Firstly, transparency functions as a *precondition* for accountability. In the words of *Deane* and *Pringle* in ‘[A]n open democratic society has the right to demand a broad degree of understanding of what central banks do and how they do it.’²⁵ Through institutional arrangements ensuring the transparent conduct of the central bank activities those institutions charged with judging the performance of the central bank gain the necessary information to do be enabled to do so on a reliable basis. As *Day* and *Klein* have observed sharply: “[E]ffective scrutiny implies effective access to information”.²⁶

It is with regard to transparency that the IMF has already made an important contribution in to defining central bank governance. In the *1999 IMF Code of Good Practices on Transparency in Monetary and Financial Policies* a broad approach is taken to the notion of central bank transparency, referring to ‘[...] an environment in which the objectives of policy, its legal, institutional and economic framework, policy decisions and their rationale, data and information related to monetary [...] policies, and the terms of agencies accountability, are provided to the public on an understandable, accessible and timely basis [...]’.²⁷

²³ *Lastra* (2001), 69-75.

²⁴ *Winkler* (2000); *Eijffinger* and *Geraats* (2002); *De Haan*, *Amtenbrink* and *Waller* (2004).

²⁵ *Deane* and *Pringle* (1993), at 313.

²⁶ *Day* and *Klein* (1987), at 22.

²⁷ IMF (1999), *supra*, at 2; brackets added.

At the same time it may somewhat overstretching the potential of transparency as a pillar of central bank governance if these information requirements are summarized as ‘[...] broad modalities for accountability for the conduct of monetary policy [...]’.²⁸ Transparency by itself cannot provide for a sufficient degree of democratic accountability and thus, cannot substituting for other mechanisms of accountability. Transparency as a constraining mechanism is overestimated by those observers, which assume that once provided with sufficient information; the financial markets provide an adequate mechanism of accountability in the form of a loss of credibility of the central bank in case of poor performance.²⁹ Indeed, it may be observed with *Posen* that the claim that central bank transparency provides sufficient accountability for central banks in democratic societies is misleading.³⁰ The mere fact that a central bank has to conduct monetary policy in a transparent manner at best results in the availability of the information necessary in order to judge the bank’s performance.

Addresses of this information are not only government but also the public at large. The latter’s perception of what the central bank does and how it is done may have an impact on the performance of the central bank. Put differently, insulating the central bank from outside influence and providing it with a clear set of (monetary policy) objectives may not be by itself sufficient to ensure the success of the bank in performing the tasks assigned to it, as transparency may form a vital component of an effective monetary policy.³¹

In identifying features describing a transparent central bank the main focus lies with the conduct of monetary policy, an area that has already been identified in the context of central bank independence and accountability where it plays a similarly important role.³²

²⁸ IMF (1999); brackets added.

²⁹ *E.g.* Mayes, (1997).

³⁰ *Posen* (2003), at 168.

³¹ See III 1 hereafter.

³² The 1999 IMF Code differentiates between the clarity of rules, responsibilities and objectives for

III. Good governance in the conduct of monetary policy

Each of the three pillars of central bank governance deserves to be observed in their own right for the reasons stated above. Arguably, the key to good governance in this regard lies in the combined application of these principles in designing the legal framework of a central bank. As it has become clear that the same central bank features are consulted in order to implement the respective element, observing all three pillars becomes a balancing act. The conduct of monetary policy forms the primary task of a central bank. Hence, institutional arrangements ensuring good governance must first and foremost relate to this function. Moreover, the three pillars take central stage in the relationship between the central bank and the executive and legislative branch of government.

1. Monetary policy formulation and communication

It is monetary policy that central bank independence is primarily geared towards. Institutional independence first of all refers to the central banks power to formulate monetary policy independently from political institutions. Moreover, it may also refer to a central bank's freedom to set the final goals of monetary policy. This is also sometimes referred to as *political* or *goal* independence.

From the point of view of accountability a yardstick is needed for the body charged with holding the bank accountable in order to determine whether the central bank has satisfactorily discharged its duties. Indeed, without a yardstick, an assessment of the central bank performance is either impossible or can only be based on variables most likely in the form of political considerations which will not serve accountability. Both the monetary policy objective of a central bank, as well as its projections on monetary policy and quantified intermediary targets can form the basis for such a yardstick.

The existence of an explicit and clear legal mandate in the central bank status has to be considered an important feature of all three pillars of central bank governance. A clear monetary policy objective reduces the risk of political pressure and open conflicts between government and the central bank³³ while at the same time ensuring that the

³³ Siklos (2002). See also section III 2.

central bank does in fact follow an inflation adverse monetary policy.³⁴ Central banks charged with multiple objectives face policy choices that may require putting aside the objective of price stability.³⁵ A single objective may be politically difficult to defend. However, in case of multiply objectives there should be a clear hierarchy between objectives stated in the central bank law. Where this is left to the central bank to decide, the real objectives of monetary policy may be opaque and moreover subject to unsolicited influence.

The classic example for a central bank featuring multiply objectives is the Federal Reserve System (Fed). Here the actual objective of monetary policy can only be construed from central bank announcements. The European Central Bank (ECB) is an example of a system, which includes a clear prioritization, as the bank is only allowed to support the general economic policies in the European Communities if and to the extent that this does not interfere with the primary objective of the ECB, i.e. price stability.³⁶ However, the value of a secondary objective may be limited. The central bank may interpret the primary objective, e.g. price stability, in such a way that it effectively excludes steering monetary policy towards a secondary objective, in particular if the secondary objective is broad and largely undefined, such as is the case when the legal basis refers to the supporting of the general economic policy. In such an arrangement the central bank may very well effectively ignore the secondary objective, by arguing that this objective can best be achieved by pursuing the primary objective.

Whether the monetary policy objective is directed towards price stability or another economic aggregate is secondary from the point of view of central bank governance, as long as it is quantifiable in a way that allows for the formulation of a point target or target range. Monetary policy objectives can range from broadly defined to quantified objectives. Broadly defined objectives may be considered the least useful in terms of providing a yardstick for the evaluation of the performance of the central bank. In such a

³⁴ E.g. Grilli, Masciandaro and Tabellini (1991); Cuckierman, Webb and Neyapti (1992), at 357; Alesina and Summer (1993), 152 *et seq.*.

³⁵ De Beaufort Wijnholds and Hoogduin (1994), 82 *et seq.*

³⁶ Art. 105(1) EC Treaty.

setting the central bank not only has to decide whether and when to apply the monetary policy instruments, but also has to define the monetary objective and decide on the approach it takes in achieving this objective. In economic terms the central bank has both instrument and goal independence. This has for example been established for the ECB.³⁷ This is also the case, albeit to a lesser extent, where the legal basis fails to quantify the monetary objective leaving it to the central bank to do so.³⁸ Taken to the extreme this may be reflected a legal basis which leaves it to the central bank develop and define monetary policy objectives.

Where a central bank has both instrument *and* goal independence the body charged with holding the central bank accountable is not provided with an effective statutory yardstick to evaluate the performance of the bank.³⁹ While a quantification of the monetary policy by the central bank itself could theoretically also function as a yardstick for the evaluation of its performance, it is questionable whether these self-announced quantifications amount to concrete legal rules, in particular in the light of potential deviations.

Given the fact that economic circumstances change, it does not seem practical to provide for a quantification of the monetary policy objective in the legal basis itself. One possible arrangement, to be found at the Bank of England, is to provide for the executive government to define a monetary policy target, which the bank thereafter has to reach in conducting monetary policy independent from government. Another arrangement, which gives the central bank a greater influence in defining the monetary policy objective is to be found in the so-called contract approach. Here the monetary policy objective is quantified in an agreement between the government and the central bank. Since it is the central bank, which in the end has to meet the quantified monetary objective in implementing monetary policy, it will be in its vital interest to reach an agreement with the executive government that will include a realistic target. At the same time the

³⁷ Amtenbrink (2002), 149 – 150.

³⁸ This is for example the case for the European Central Bank, since Article 105 (1) EC Treaty does not define the term ‘price stability’ in any way.

³⁹ To be sure, this does not necessarily have to result in an intransparent conduct of monetary policy, if and to the extent that the bank makes its preferences public.

executive government also commits itself to certain goals, making it more difficult for it to criticize the central bank for its conduct of monetary policy in accordance with what has been agreed. The contract approach has been implemented in the central bank systems of New Zealand and Canada which require government-central bank agreements on monetary policy targets.⁴⁰

The strategy of the central bank to reach the ultimate objective(s) should be transparent. A clear understanding by the market participants of the underlying framework on which central bank decisions are based will lead to a better understanding of the decisions taken. Market participants should know what the central bank has in mind when it sets interest rates and be able to clearly distinguish between the instruments of monetary policy and the operational target that is affected by the central bank's action, but which is ultimately determined by market forces. To this end, the bank should announce the monetary policy strategy and explain its monetary policy decisions.

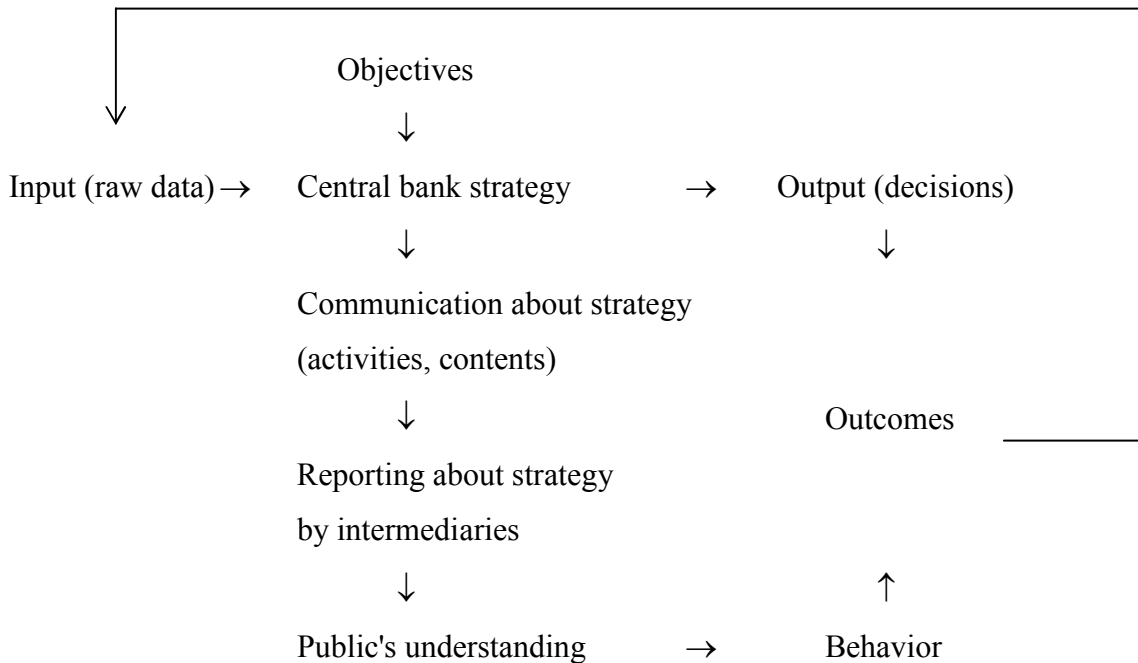
An explicit mandate does not only enhance accountability but arguably also the credibility of the monetary policy framework of the central bank and helps to avoid the perception or reality that the central bank conducts an overly conservative monetary policy.⁴¹ The institutional set-up of a central bank must ensure adequate communication of monetary policy to the outside world. The key to the understanding of this function of transparency is the interrelationship between central bank transparency and the public. As has been argued elsewhere, the effect of monetary policy on inflation and output growth (outcome) is determined not only by monetary policy decisions, but also by the expectations and the behavior of the public, based on their understanding of the bank's strategy. The outcome arguably influences the input used by the central bank, i.e. economic raw data, which in turn influence the bank's decisions. The media, as intermediaries between the central bank and the general public play a vital role in communicating the monetary policy strategy of the central bank to the general public and

⁴⁰ In Canada government and central bank agree on an Inflation Control Target (ITC). In the case of New Zealand this takes place in a Policy Target Agreement (PTA).

⁴¹ Freedman (2003), at 103.

have a considerable influence on how public understands the monetary policy pursued by the central bank as is shown in figure 1.

Figure 1. Monetary policy strategy and communication⁴²



In facilitating the general understanding of the general public of what the central bank does and does not do, publications and public statements can play a vital role. Press conferences and the publication of press releases can function as substitute for press conferences and, can communicate the motivation for a certain policy decision. This also includes public access to the economic data underlying monetary policy decisions, such as money supply, inflation, GDP and unemployment rates, as well as the announcement of the economic model(s) applied by the central bank. The 1999 IMF Code has moreover identified the public availability of the schedule of meetings of the policy-making body as a further element of transparency, as it becomes clear when policy decisions will be taken.⁴³

Openness in the decision-making process of the central bank can further add to the understanding of what the central bank does. This can be reached mainly through the

⁴² See De Haan, Amtenbrink and Waller (2004).

⁴³ IMF (1999).

publication of the minutes of the meetings of the monetary policy board. Revealing potential differences in opinions on the monetary policy board in retrospective does not only assist in judging the performance of the bank, and even individual central bank officials, with regard to the adequacy of their assessments, but also educates a larger audience in understanding monetary policy as a consequence of judgments based on more or less reliable economic data, rather than an exact science.⁴⁴ Such an arrangement is of course far from undisputed, as it is often argued that the publication of such information could not only hamper free and open discussions on the monetary policy board of the bank, but also offset monetary policy decisions by the central bank. With regard to the latter argument the arrangement in the Bank of England Act provides a good example of how market sensitive information can be excluded from immediate publication. The first argument may be one that is primarily directed at the ESCB and ECB and its particular structure, which includes the governors of the central banks participating in the Euro zone on the Governing Council, the monetary policy board of the ECB. Here it is feared that an open process of deliberations could result in undesired pressure on the national central bank governors.

2. Relationship with government

In discussing central bank governance the conduct of monetary policy arguably cannot be discussed without reference to the relationship with the executive and legislative branch of government.⁴⁵ The three pillars identified above should guide this relationship.

Advocates of central bank independence argue rightly that the status of the central bank as an institution should be separate primarily from the executive, *i.e. government*, but also from the legislative power, *i.e. parliament*.⁴⁶ A central bank, which forms part of the executive branch of government, *e.g.* the Treasury, lacks institutional independence, which may result in a sub optimal monetary policy.

⁴⁴ The Bank of England Act 1998 provides a positive example in this respect.

⁴⁵ The term government is used as a generic term to summarize executive government and parliament.

⁴⁶ Smits (1997), 155 - 156; Roll Report, 21 *et seq.*

The legal basis of the central bank and its position in the overall constitutional system in which it is located play an important role in this regard. The independence of the central bank should be safeguarded by the legal basis of the central bank itself. However, this should not go as far as raising the central bank independence to a quasi-constitutional value. While this may result in a maximum amount of legally secured independence, this can deteriorate the democratic accountability of the central bank. The reason for this is that the legal basis can in principle function as the ultimate instrument of democratic accountability. While the one-time democratic legitimization of the central bank, which stems from the fact that the legislator has passed the respective legislation creating the central bank functions as an *ex ante* mechanism of accountability, this does not amount to mechanism to hold the central bank accountable for its performance. Yet, in as much as parliament can amend the legislation it has once passed, it arguably possesses the most drastic instrument for holding the central bank accountable. It can decide to change the institutional structure of the central bank, thereby restricting its independent position and/or changing its tasks. To be sure this does not result in a mitigation of the independence of the central banks *per se* as political systems will often include two or more veto players that does not make a legislative amendment an easy exercise. Moreover, changing the legal basis of a central bank, which enjoys a high degree of credibility, may meet public resistance. Put in a nutshell, changing the legal basis may be considered the ‘nuclear option’ in holding the central bank accountable.

Insulation of the central bank from undesirable political influence also influences the choice of the composition of the decision-making organs of the central bank and the existence of override mechanisms.⁴⁷ From the point of view of independence, a central bank which features government officials with voting powers on the policy board and and/or features an override mechanism are likely be much more exposed to government influence, than a central bank which excludes government participation entirely.

However, the potential for disputes between the central bank and government may arguably be the highest where the central bank is given a high degree of independence in

⁴⁷ This is referred to as organizational or political independence, e.g. Gros and Thygesen (1992), 420 *et seq.*

the conduct of monetary policy. Where the government is firmly in charge of monetary policy, any potential conflicts with the central bank can easily be decided to its advantage by the former. However, this may have negative effects on transparency and, moreover, arguably drag monetary policy into the political arena. Where monetary policy is conducted by a central bank independent from government, conflicting monetary and general fiscal policy objectives of the central bank and government respectively call for the existence of a conflict resolution mechanism. Adequate communication channels between the executive government and the central bank can help to avoid misunderstandings and false expectations in particular on parts of the government as to what monetary policy can and cannot do.

Mechanisms to resolve potential conflicts are thus closely related to the independence of a central bank. On the one hand it is the independence which gives rise to the need for mechanism to resolve conflicts. On the other hand, it is the existence of adequate conflict resolution mechanisms in the central bank law which functions as a safeguard, as a pressure valve, for central bank independence. Where such mechanisms are missing conflict on the direction that monetary policy should take may spiral out of control, resulting in unsolicited political pressure being exercised on the central bank and/or its officials. Rather than taking place in the open and being subject to the rules laid down in the central bank law, disputes take place behind closed doors and outside public and possibly also parliamentary scrutiny.

While the transparent conduct of monetary policy supports both parliament and the executive in its decision-making process about the performance of the bank, institutionalized contacts support the overall transparency of monetary policy and any existing dialogue between monetary and fiscal policy. One way to enhance the communication between the central bank and government is to allow for the participation of government officials in central bank organs and namely, on the monetary policy board of the bank. To be sure, such an arrangement is difficult to maintain if the governor of the central bank is considered by law to be responsible for monetary policy and hence,

charged with taking the relevant decisions.⁴⁸ Representation on the monetary policy board creates a forum or government to make its views on the general economic situation and the course which monetary policy should take known. At the same time those charged in the central bank with deciding on monetary policy can explain and motivate the approach to monetary policy.

Participation of government officials in decision-making organs of a central bank seems at odds with the model of a central bank, which is independent from government. Yet, whether or not this is actually the case depends on the concrete legal arrangements foreseen in the central bank law. In order to ensure the functional independence of the central bank government officials should be excluded from participating in monetary policy decisions and hence, should not have a voting right. Despite its extensive degree of independence, this arrangement can for example be found at the ECB. The president of the Council and one member of the Commission are entitled to participate on the Governing Council of the ECB without a voting right.⁴⁹ In countries where such a passive role of government in the decision-making procedure of the monetary policy board is considered to be insufficient, an alternative may lie in providing government with the right to ask for a suspension of a monetary policy decision until the next meeting, thereby providing room also for the central bank to explain its approach. Such a possibility was foreseen in the legal basis of the Bundesbank prior to the transfer of monetary authority to the ECB and is still to be found for example in the Bank of Japan Law.⁵⁰ Arrangements whereby government officials have a voting right are to be avoided, but in any event should ensure that government representatives do not form the majority on the monetary policy board, thereby effectively controlling all decisions.

Additional or alternative arrangements providing regular contacts between the central bank and government may include a provision in the central bank law allowing for central bank officials to participate in executive government meetings when issues related to the tasks of the central bank are discussed and/or to give the central bank a right to be

⁴⁸ As is the case at the Bank of England and the Reserve Bank of New Zealand.

⁴⁹ Art. 113 EC Treaty.

⁵⁰ Art. 19 Bank of Japan Law.

consulted when government addresses such issues. Such a setup, which can be found in a number of central banks, may be preferred by the central banks themselves, which often fear that a direct government participation in monetary policy meetings may result in undesired influencing.⁵¹

From the point of view of *democratic* accountability contacts should also exist with parliament. Including both executive government and parliament in holding the central bank accountable results in what *Dutzler* describes as the diversification of accountability, as the various branches of government differ in their obligations to the electorate and have different motives for holding a central bank accountable.⁵² As *Majone* has put it ‘No *one* controls an agency, yet the agency is ‘under control’.⁵³

The role of parliament in holding the central bank accountable is a confirmation of the fact that a central bank in principle exercises monetary policy on behalf of the democratically elected parliament which, at least in the national context, has delegated - but not abrogated - these powers.⁵⁴ Exemplary in this regard is the Fed. Based on an obligation to submit semi-annual monetary policy reports to Congress, the chairman of the Federal Reserve Board appears before the relevant standing committees both of the House of Representatives and the Senate where he is subjected to parliamentary scrutiny with regard to the performance of the Fed.⁵⁵ Interestingly, a similar approach is taken with regard to the ECB, where the president of the Bank appears even on a quarterly basis before the relevant standing committee of the European Parliament in an exercise

⁵¹ The ECB has to be consulted on any proposed Community acts falling within its field of competence and moreover also on amendments of its institutional structure 5 (Art. 105 (4) EC Treaty and Art. 48 EU Treaty) and the president of the ECB has a right to participate in meetings of the Council of the European Union when the latter discusses issues relating to the tasks and objectives of the ECB; in Botswana, the Bank acts as financial adviser to the government (sec. 43 Bank of Botswana Act); in Canada the Minister of Finance and the governor of the Bank are supposed to consult regularly on monetary policy and on its relations to general economic policy (sec. 14(1) Bank of Canada Act); the Bank of Japan Law sets out that the Bank shall always maintain close contact with the government and exchange views sufficiently (Art. 4).

⁵² Dutzler (2003), at 110.

⁵³ As quoted in Dutzler (2003).

⁵⁴ This obligation used to be based on the Full Employment and Balanced Growth Act of 1978. The reporting was also referred to as Humphrey-Hawkins procedure, after the two sponsors of this bill. While the practice continues, the Full Employment and Balanced Growth Act of 1978 has been repealed in 2000.

⁵⁵ For details see Amtenbrink (1999), 287 et seq., with further references.

referred to as monetary dialogue.⁵⁶ Where such fora exist, parliament has the opportunity to review the performance of the central bank with regard to monetary policy on a regular basis, while the central bank at the can explain and justify its conduct.

Alternatively to appearances of central bank officials before parliamentary committees it is in principle also possible to envisage the executive government in-between parliament and the central bank, such as was the case in the Netherlands. Here executive government rather than the central bank was answerable to the government for the conduct of monetary policy. Indeed, where the executive government is ultimately responsible for monetary policy, it takes the place of the central bank in as much as the former should be obliged to give reason for its conduct of monetary policy before parliament in regular intervals. However, this requires that the executive government is given instruments to hold the central bank accountable for its conduct of monetary policy, such as in the form of an override mechanism explained hereafter. Otherwise in practice no one institution would be accountable for monetary policy because the central bank would not be directly accountable to parliament, and the executive government could hardly be held accountable for the performance of monetary policy by a central bank over which it has no real authority.

Contacts between the central bank and government should be foreseen in the legal basis of the central bank in order to form the basis for the regular and ongoing accountability of the central bank vis-à-vis parliament and/or the executive government. *De facto* arrangements remain the second best option given their lack of clarity and the fact that it is essentially left at the discretion of a central bank to uphold the practice.⁵⁷ Informal contacts entail a higher risk of being abused to put political pressure on the central bank to pursue policies other than those determined in the legal basis and the policy target. This not only conflicts with the independent position of a central bank, but also runs contrary to keeping the bank accountable. A clear rule defining the relationship between the

⁵⁶ For a short analysis of these hearings see Amtenbrink (2002), 157 et seq.. Interestingly, Community law does not foresee the appearance of the national central bank governors before the European Parliament. Depending on the legal arrangements in the different countries of origin, governors may be obliged to appear before their respective national parliament.

⁵⁷ Thus, for example, in the case of the ECB, the regular contacts are not prescribed by Community law.

central bank and the executive government is better than central bank systems without an explicit reference to independence, but also without any reference to such rules.

A clear definition of the relationship between the central bank and government arguably also must entail mechanisms to which apply in the case of conflicts between and independent central bank charged with the conduct of monetary policy and the executive government charged with the conduct of fiscal policy. It is presently submitted, that an override-mechanism can function as such a conflict resolution mechanism. The existence of such a directive clause, as it is also sometimes referred to, can also be regarded as an important instrument of democratic accountability. This is the case not only in the sense that the central bank may be overridden in case of a sub-optimal performance, and thus a means of sanctioning, but also in the sense that with the executive government in charge of this instrument the overall responsibility of the latter for the economic policy is recognized, even if the override mechanism is never put to practice.⁵⁸ With an override mechanism it is in principle acknowledged that policy conflicts and disagreements over monetary policy may arise between the central bank and the government. Override mechanisms can channel these conflicts.⁵⁹ With the existence of an override-mechanism the basic premise is recognized that '... in a democratic society the government should in the limit be able to insist on its views.'⁶⁰ In countries where the executive government is thought to be ultimately responsible for monetary policy, the existence of an override mechanism can build the required bridge between the conduct of monetary policy by the central bank and the overall responsibility of the executive government vis-à-vis parliament.

To be sure, override-mechanisms constitute the single most problematic feature in the institutional set-up of a central bank as they are arguably at odds with the notion of central bank independence. However, the impact of such a mechanism on the independence of a central bank is largely determined by the concrete arrangements. Firstly, the application of the override mechanism should not be unconditional. Ideally,

⁵⁸ Amtenbrink (1999), at 52.

⁵⁹ Siklos (2002), at 5.

⁶⁰ Freedman (2003), at 105.

the legal basis of the central bank should lay down in detail the conditions under which an application of the override mechanism is admissible, by defining the exceptional circumstances in which the central bank may be overridden.⁶¹ Rather than to provide the executive government with a card blanche once it has taken the decision to apply the override, the legal basis should oblige the former to define and make public the alternative objectives to be observed by the central bank for the time of the application of the override, thereby committing the executive government to a certain course of action.⁶²

The decision to apply the override should moreover be reviewed thereby excluding political abuse of the mechanism. Either the application of the override by the executive government can be made subject to parliamentary approval and/or the central bank should be given the right to appeal against the application of the override mechanism.⁶³ Moreover, the application of the override mechanism should be limited in time from the outset for the obvious reason that executive government may otherwise permanently take over control over monetary policy. Ideally, the legal basis will stipulate a maximum period for which the override can be applied at any one time.

Alternatively to a full override mechanism, as has been described above, the central bank law may also give government the right to delay a decision on monetary policy from being taken. While this does not give the executive government a right to ultimately block a decision from being taken, this mechanism arguably provides for a sort of cooling-off period in case of dispute and time for further dialogue.

IV. Towards a model central bank law?

This contribution set out to establish in the short space available the basic elements forming the basis of central bank governance. This inevitably leads to the question whether and to what extent these pillars of central bank governance and the consequences

⁶¹ In the case of the Bank of England, the legal basis (sec. 19) states that the Treasury, after consulting with the governor of the Bank can issue directions only if required in the public interest and by extreme economic circumstances.

⁶² In the case of the Reserve Bank of New Zealand the government has to announce new policy targets (sec. 12 Reserve Bank of New Zealand Act).

⁶³ In the case of the Bank of England, the Treasury order has to be laid before parliament, which thereafter has to approve the order, by a means of a resolution within 28 days. Otherwise the order ceases to have effect.

they have on the institutional structure and tasks of a central bank can form the basis for a model central bank law or, as *Poole* refers to, 'an Optimal Central Bank Law'.⁶⁴ Put differently, should the emphasize lie on the drafting of a blueprint or rather the establishment of legal principles which should be taken into account when designing or reforming a central bank law? Given the noticeable trend towards supranational monetary policy authorities or at least the standardization of the rules on the basis of which national monetary policy authorities operate, this is arguably more than just an academic query.⁶⁵

It could be argued that the introduction of the European System of Central Banks serves as an example of how central banks can be subjected to a particular model with regard to their institutional set-up. In the case of the central banks of the Member States, Community law requires them to be independent.⁶⁶ As a result, all of these central bank laws have been and, in the case of the accession countries, possibly still are in the process of being adjusted.⁶⁷ However, this is not an example for the successful application of a particular central bank model to several central banks. First of all, the model concerned only a particular, albeit important aspect of the institutional structure of a central bank, i.e. independence. Moreover, the reason why the central bank laws were aligned in the first place was that monetary policy authority was transferred from the level of the Member States to the ECB. The fact that the central banks were deprived of their primary function anyway made it relatively easy for the Member States to accept an amendment of their central bank structures in this regard.

From a purely economic point of view it could be maintained that such a model could be established by first of all identifying those objectives which a central bank should pursue and, thereafter, by establishing the *modi operandi* along the lines highlighted above. Translated into concrete legal arrangements this would then form the ideal central bank. However, this approach is problematic given that it rests on the assumption that only one

⁶⁴ Poole (2003).

⁶⁵ Take for example the case of the Banque Centrale des Etats de l'Afrique de l'Ouest and the West African Economic and Monetary Union or the model central bank legislation drafted by the Southern African Development Community (SADC).

⁶⁶ See above, section II 1.

⁶⁷ For examples for the impact of on the structure of the national central banks, see Amtenbrink (1999).

particular set of objectives and set of instruments to achieve them is plausible. However, as has been highlighted throughout this contribution with regard to the conduct of monetary policy and the relationship between the central bank and government different institutional arrangements are feasible. In balancing independence, accountability and transparency there is room for preferences, at least to some extent, in putting more emphasize on one or the other element of governance. This is a choice that should rest with the legislative of the respective country. Indeed, in some instances the constitutional setting in which a particular central bank operates may even require particular legal arrangements related to the governance of the central bank that are different from those necessary for another central bank.⁶⁸

It will be virtually impossible to take the diversity of legal systems in which central banks operate into account in a single model central bank law. This rules out the application of a one-size-fits-all method to different central bank systems.⁶⁹ Central bank laws have to be observed against the background of the political, economic and legal environment in which they are situated. This is not only the case when comparing existing central bank systems with one another, but also when considering a new or when proposing the reform of existing central bank systems. Indeed, this need for diversity has also in some instances been recognized an attempt has been made to establish model central bank legislation.⁷⁰

Preference should therefore go out to the establishment of a code of good governance which could not only function as a benchmark for the assessment of central bank legislation, but also as a blueprint for the institutional structure of future central banks. As a result of the development of such practices an international standard of central banking could emerge. Indeed, some may argue that such a standard has already emerged from practice, as a growing number of central bank systems in one way or another recognize the three pillars of central bank governance.

⁶⁸ Such as is the case when according to the constitution government is answerable to parliament for all of economic policy including monetary policy.

⁶⁹ See also Siklos (2004).

⁷⁰ SADC Draft Model Central Bank Legislation, 3 April 2003. The explanatory note states explicitly that central banks are allowed to modify the model legislation, depending on the need for the particular country.

Moreover, already first steps have been taken towards the establishment of guidelines for good practices, whereby the International Monetary Fund plays an important role in this regard. The latter conducts so-called Safeguard Assessments at borrowing central banks in order to reduce the risk of misuse of Fund resources and misreporting to the IMF. This assessment focuses on a number of areas of a central bank's governance structure,⁷¹ including the legal structure and independence of the central bank. It has to be noted however, that this assessment focuses on areas of the central bank legislation that are considered to contributing to safeguarding Fund resources and as such cannot be simply converted to an institution-building exercise.⁷² At the same time, it may be said that these assessments provide the IMF with valuable experience in analyzing central bank legislation and include elements for the establishment of a code of good practices for central banks, namely with regard to the conduct of monetary policy and the relationship with the executive government and parliament. The same holds true for the *1999 IMF Code of Good Practices on Transparency in Monetary and Financial Policies*, referred to above. The implications of the proposed features arguably already reach beyond transparency and to some extent also touch upon transparency and accountability issues.

While establishing a code of good governance may over time enhance governance of central banks, this will not be a panacea. Indeed, it may be sufficient to provide for a central bank law that is based on the three pillars highlighted above in order to fully ensure that the central bank can fulfill its tasks optimally. Central bank governance has implications beyond the realm of the institutional structure of the central bank; as this requires what is presently referred to as an adequate operational environment.

While a central bank should be independent from government to a certain extent, it would at the same time be mistaken to believe that it could operate in a state of complete isolation from outside influences.⁷³ It is questionable whether a central bank can offset the effects of a government that pursues an irresponsible economic policy. Monetary

⁷¹ IMF (2002).

⁷² Catsambas (2002).

⁷³ This has already been highlighted in section III 1 with regard to the communication policy of the central bank.

policy instruments, as *Asser* puts it, '[...] are designed for the conduct of monetary policy. They are not designed for other macroeconomic policies.' Yet, these other macroeconomic policies, such as fiscal policy or wage policies, can affect monetary policy.⁷⁴

The successful implementation of a monetary policy objective such as price stability therefore also relies on a proper macroeconomic policy framework of which monetary policy forms an important part. This has two implications: Firstly, there must be a political consensus on the need for a sound macroeconomic policy and arguably namely on the need for a sustainable government financial position. Secondly, next to this there must be a legal framework in place which does not only commit the central bank, but also the government to the attainment of the agreed upon macroeconomic policy objectives. The success of rules aimed at providing some form of coordination between economic and monetary policy is less than certain, as arguably the example of the EMU rules on economic coordination highlight.

Institutional arrangements providing for sound governance arrangements can help to achieve, but not single-handedly put in place central bank credibility. For *Issing* '[T]he life of a currency depends on the trust of the population in the stability of the money!' He continues to observe that: '[T]rust in the stability, in the credibility of politics results in lower interest rates, higher investments and more employment.' *Issing* describes this as being '[...] the contribution of monetary policy'.⁷⁵ Independence, accountability and transparency cannot instantly build trust. The societal embeddedness of a central bank is built over time. Where existing, the credibility which a central bank enjoys can to some extent legitimise the policy-making of an independent central bank that is only accountable to a limited extent. The position of the Bundesbank vis-à-vis the German government and the general public in Germany prior to European Economic and Monetary Union may serve as an example in this regard. As the keeper of a *Deutsche*

⁷⁴ *Asser* (2002), at 4.

⁷⁵ Author's translation 'Eine Wahrung lebt vom Vertrauen der Bevolkerung in die Stabilitat des Geldes! Vertrauen in die Stabilitat, in die Glaubwurdigkeit der Politik wirkt sich aus in niedrigen Zinsen, hoheren Investitionen und mehr Beschaftigung. Das ist der Beitrag der Geldpolitik.' EP Hearing during the installation of *Issing*, 1998

Mark the Bundesbank had developed a strong reputation and a high degree of credibility not only in the financial markets, but also with the general public. The Bundesbank was perceived as one of the cornerstones of German post-war economic success. This arguably cemented its independent position vis-à-vis government and made the lack, to some extent, of mechanisms of democratic accountability acceptable.

However, the history of the Bundesbank also highlights the limits of the influence of a central bank on economic policy choices that enjoy public support. In the course of German reunification the monetary system of the German Democratic Republic (GDR) was integrated into that of the Federal Republic of Germany and the Bundesbank extended its activities to the new federal states, thereby replacing the Staatsbank, the central bank of the GDR. The Bundesbank was very skeptical about an early monetary union and opposed the one-to-one conversion rate which had been advocated by the West-German Federal government and thereafter was implemented in the Treaty Establishing a Monetary, Economic and Social Union. The Bundesbank's preference for a two-to-one conversion rate was dismissed.⁷⁶ At the time it was feared that the adoption of the Bundesbank's proposal would have triggered considerable sentiments not only among the East German population. Public pressure resulted in the disregarding of the Bundesbank's advice. This conflict between Federal government, in charge of the exchange rate policy, and the central bank, charged with the conduct of monetary policy, has reportedly been the motive behind a subsequent resignation of the President of the Bundesbank.⁷⁷

IV. Conclusion

This contribution set out to develop what are arguably the three pillars on which central bank governance must rest. What has emerged from this analysis are principles rather than a concrete central bank law model.

⁷⁶ The Bundesbank was concerned about an excessively inflationary exchange rate.

⁷⁷ Tietmeyer (1998).

The complexity of the exercise lies in providing for all of the three elements in one and the same legal basis. In the previous sections it could be seen that contrary to what might still be the sentiment in some quarters this does not necessarily have to result in the (unsuccessful) attempt to square the circle. Concepts like independence, accountability and independence are reconcilable. Yet, certain tensions between these elements of governance cannot be ignored and have to be observed when establishing a code of good governance. Where a central bank that is entirely independent to not only pursue but also define monetary policy it will be very difficult to provide for mechanisms to hold the bank accountable for its performance. Moreover, without proper conflict resolution channels, disputes between the central bank and government may spin out of control. Complete independence is moreover at odds with the general notion that government and thus elected politicians are in principle answerable for economic policy. Indeed, as *Siklos* has emphasized, governments may not be sufficiently accountable if they are not responsible for setting monetary policy.⁷⁸ Ultimately, as *Howarth and Loedel* have observed: 'In a democratic society, transparency and accountability are essential if central bank independence is to remain politically acceptable.'⁷⁹ Providing for a sufficient degree of transparency can help not only to increase the understanding of monetary policy and, as a somewhat cynical observer of events may add, the limited extent to which this is an exact science, but also ensure that conflicts within the central bank and between the central bank and government are carried out in the open. This also functions as a restraint for government and strengthens the position of the central bank independent from government and ultimately its credibility.

It is presently recognized that in some instances suggestions made throughout this contribution may have implications reaching beyond the structure of the central bank and the way in which it is governed. Indeed, the difficulty may not only rest in designing a central bank that is independent, accountable and transparent all at the same time, but in the creation of a constitutional and political environment in which such a central bank can successfully operate.⁸⁰ The impressive volume of documentation provided with the 1999

⁷⁸ Siklos (2002).

⁷⁹ Howarth and Loedel (2003), at 123.

⁸⁰ In some regards, this is what the word *democratic* in democratic accountability stands for.

IMF Code of Good Practices on Transparency in Monetary and Financial Policies offers some indication as to the extent of work involved.

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