BANK OF ALBANIA

“CENTRAL BANK OF ALBANIA IS IT REALLY INDEPENDENT?”

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Abstract

Enhancing central bank independence is a recent worldwide trend, greatly supported by academics and researchers.

Does Bank of Albania fit into this trend? Can Bank of Albania be defined as an independent central bank? How does it stand *vis-à-vis* other central banks? What measures can be taken to enhance Bank of Albania independence?

This paper is aimed at providing answers to these questions.

CONTENT

1. INTRODUCTION

It is not the intention of this paper to argue whether a central bank should or should not be an independent institution. "Why do we need a central bank?", "Is it wise to establish an independent central bank?" and other suchlike questions have already been addressed by many researchers and academics.

The principle that **central bank of a country should be independent** is taken for granted. No additional arguments are presented in the paper in relation to this.

A large literature dealing with central bank independence already exists. Different authors have developed various indices to measure central bank independence. They have also tried to compare central banks from different countries and provided central bank rankings in terms of the degree of independence. On the other hand, different countries show different experiences in this regard, sometimes proving that the relevant theories are true and sometimes false.

There is, however, one well-known outcome: ***Typically, developed countries have established independent central banks. These countries proved to be successful in achieving price stability.*** Based on this, developing countries as well as Eastern and Central European Countries in their transition period have attempted to establish independent central banks. At least, the new central banking laws have been based on the charters of Western central banks. In other words, **the first step was taken through granting a substantial legal independence.**

The same happened in Albania. By creating a two-tier banking system, a central bank was first established in 1992. The Law "On the Bank of Albania", passed by Parliament in April 1992 and subsequent amendments were formulated in line with the respective laws in Western countries and recommendations of international organizations (particularly IMF). Is the central bank of Albania, Bank of Albania, legally independent? How has legal independence evolved over the years? Is Bank of Albania really an independent central bank? These issues are examined in this paper.

To be able to answer these questions, we examine the provisions of the central bank law; compare central bank of Albania with central banks in other countries; and measure Bank of Albania independence based on indices developed for this purpose. Although we did our best to be objective in interpreting the legal provisions, we found it difficult to ignore actual experience in enforcing those provisions.

Measuring central bank independence is not an easy task due to differences in central bank laws of different countries and changes that have occurred in the central bank law of our country during the last seven years, which has led to a change in the behavior of the central bank. Considering that Bank of Albania is a newly created central bank (with only 7 years of operations), the probability that casual phenomena will affect its behavior is higher, thereby making it difficult to predict the future of the bank.

2. THEORY IN BRIEF

2.1 Why an independent central bank?

Different arguments are presented in favor of an “independent central bank”. The main and widespread reason is that “more independent central banks are associated with lower levels of inflation”[1]. That very statement is confirmed by many researchers who also tried to find out the correlation between central bank independence and the lower level of inflation[2]. In supporting this idea, several authors mention the well-known practical example of the central bank of Germany. “*Monetary policy during the last one hundred years in Germany gives an excellent example to evaluate the empirical evidences in using rules and central bank independence to formulate monetary policy*[3]”. The majority of the authors concluded that central bank of Germany is the most independent central bank.

The authority over monetary policy, which, in turn, affects the level of inflation, must be delegated to an agent (institution), which weighs price stability higher than social interests and long-term solutions higher than short-term benefits. It means that politicians agree to delegate to other, nonpolitical individuals (technocrats) the authority to formulate monetary policy. By doing so, the former voluntarily limit their room to maneuver in the area of monetary policy. A central bank, as an institution, seems to be more conservative and far-sighted than the politicians. As such, the incentive “to delegate” the authority over monetary policy to central bank is to ensure price stability. By doing so, the circumstances under which this primary objective is sacrificed in favor of other, potentially conflicting, objectives (such as economic growth, higher employment) in the short-term are reduced.

[1] Alberto Alessina, Lawrence H. Summers, “Money, Credit and Banking” Journal, vol. 25, no. 2, May 1993, page 151.

[2] Some authors find the correlation between central bank independence and inflation performance not so very significant. As we mentioned earlier, however, our intention is not to prove whether a central bank has to be independent or not.

[3] “Rules, discretion and central bank independence: The German experience 1880 - 1989” Bernhard Eschweiler, Michael D. Bordo, WP No. 4547, National Bureau of Economic Research.

Box 1. Alan S. Blinder (former vice-president of the Federal Reserve Bank – 1994), says :

"... the politicians in democratic and not democratic countries are not known to be patient and long time horizons. Neither media nor the public. If the politicians would deal with the daily monetary policy, the temptation to achieve short-term benefits at the expense of the future would be very difficult to resist. Knowing this, many governments were wise enough to try to depolitise the monetary policy through putting it, for example, in the hands of unelected technocrats with a longer term in office and insulation form the hurly-burly of politics".

It is generally accepted that nominating a central banker, who appears to be more conservative than the average of the population, is a good strategy. This contributes to long-time horizons and continuity in an unstable political environment where governments can change often and their objectives may differ from each other.

An independent monetary policy may force or impose stronger fiscal discipline on government. It may even contribute to long-term growth.

2.2 How is central bank independence defined?

What is the definition of an independent central bank? There is no unique (sole) definition of the term "central bank independence".

An operational paper from the Monetary and Exchange Affairs Department of the IMF lists three necessary preconditions for effective central bank autonomy[4].

[4] The authors of this paper preferred to use the term "autonomy" instead of "independence". They say "autonomy entails operational freedom, while independence indicates a lack of institutional constraints". However, the frequently used term "independence" in the literature refers to the meaning of "autonomy". In this paper we will also use the term "independence".

First, an autonomous central bank should have a clearly defined objective, namely price stability. Second, the central bank should have both sufficient authority (*de jure* and *de facto*) and adequate instruments to manage liquidity in the banking system to meet its primary responsibility. Finally, a central bank's operations should be transparent, and information should be disclosed on a regular basis so that the central bank can be held accountable for its monetary policy and inflation performance"[5]. Obviously, as it is explained in the above paragraph, a central bank can be considered as independent if it meets these three conditions.

Friedman suggests an "underlying meaning" for central bank independence: "A central bank should be an independent government branch, and should coordinate with legislative, executive and legal branches. Thus, it is empowered the same as the legal power.[6] It will comply with laws approved by the government and its operations can be changed by the government only if the law (or its charter) changes".

Alan S. Blinder says: "In my opinion, central bank independence means two things: first, a central bank is free to decide how it will pursue its objectives and, second, it is very difficult for any government branches to reverse the decisions of central bank"[7]. The definition consists of two components of central bank independence. Rather than focusing on what or who a central bank is independent from, the author defines the level (the ground) from which the independence is to be considered.

A central bank does not have latitude to choose the objectives on its own. But it has the latitude on how it will pursue these objectives. In other words, central bank independence entails instrumental and political independence. According to Blinder, this is consistent with the democratic organization of a country. Politicians or the elected individuals must define the objectives while the institutions have the freedom to determine available instruments to achieve monetary policy objectives.

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[5] MAE Operational Paper (MAE OP/98/1) "Elements of central bank autonomy and accountability", February 1998, FMN, page 2.

[6] "Central Bank Independence : What is it and what it will do for us ?" Geoffrey E. Wood, Terence C. Mills, Forrest H. Capie, no. 4, January 1993, page 11.

[7] "Central Banking in Theory and Practice", Alan S. Blinder, 1998, page 54.

The decisions of the central bank are irreversible. This is the other component of the central bank independence. It means that to be independent, a central bank has to be empowered with adequate authority to implement the monetary policy decisions it has taken to achieve the objective.

Other authors, who have dealt with government-central bank relationship, say that the meaning of the term "central bank independence" is obvious. It simply means that the government poses no formal means to affect the central bank decisions on monetary policy.[8]

[8] "Central Bank Independence : What is it and what it will do for us ?" Geoffrey E. Wood, Terence C. Mills, Forrest H. Capie, no. 4, January 1993.

3. MEASURING CENTRAL BANK INDEPENDENCE

Central bank independence depends on various factors ranging from legal independence to the integrity and reputation of the central bank administrators and the tradition and mentality of a given country. Due to these factors, measuring central bank independence through quantitative measures is relatively difficult and even impossible for a number of factors. Nevertheless, several indices have been developed to measure quantitatively central bank independence, by initially determining some independence types.

Legal independence implies the degree of central bank independence provided by its law or charter. Legal independence consists of two components: ***political independence*** and ***economic independence***. The former is defined as the capacity of the monetary authority to choose policy goal(s), i.e., it indicates whether the law provides clauses which allow central bank to pursue its objective(s) without being under political pressure. The second indicates the independence from government interference. The economic aspect of central bank independence depends on legal limitation over credit facilities offered by the central bank to the government.

Legal independence breaks down into other aspects such as ***policy formulation independence***, ***instrument independence*** and ***staff independence.*** The first aspect indicates whether the central bank is independent in formulating policies on its own; the second aspect deals with independence in implementing policies formulated by the central bank itself or other institutions. In other words, it indicates whether the central bank can freely choose those instruments that it deems appropriate to implement a given policy. The third aspect means independence in staff recruiting process.

Can a central bank decide freely in employment procedures? Does the government interfere with the issue? Obviously, the staff independence deals with the top level of bank employees. These aspects, that are relatively easy to be measured, cover the overall independence of a central bank only partially.

Box 2. Staff independence

Neumann[9] (1991): "The office and contract terms and conditions are to be determined in such a way that the appointed individual will find himself free from the previous political relations or dependence and does accept the central bank objective to preserve the currency value as his professional leitmotif"

Waller[10] (1992) developed a model with regard to nomination in central bank in the context of a bipolar political system, where the party who won the recent elections is entitled to appoint the nominees. The party who lost, has the right to confirm the appointments. An interesting conclusion drawn from the model is that if the society is willing to minimize the risk of a partisan monetary policy, it should extend the term in office of the central bank policy making staff and make it longer than the election cycle"

Measuring ***de facto central bank independence*** is also an important aspect. The term "de facto central bank independence" indicates ***whether a central bank is really independent, despite what the legal clauses provide.***

In developed Western countries legal independence is considered as a good proxy for total central bank independence. The same does not hold true for other countries. The independence of central banks in the latter group of countries depends to a great extent on effective independence. Different countries inherited different traditions and culture in complying with laws. *There is no doubt that Albania can not be included among those countries, which have respect for the law and strictly comply with it.*

[9] C.W.Eijffinger dhe Jakob de Haan "The Political Economy of Central Bank Independence", page 5.

[10] Same as footnote no. 9.

According to Cukierman,[11] the efforts to develop central bank indices focusing more on legal aspect and on developed countries merely reflect the fact that this is what can be done. To complement the legal aspects other factors can be considered.

First, central bank laws usually are not complete in terms of clearly separating the powers between central bank and political authorities. So called “gaps” are bridged by informal practices or agreements, tradition, etc.

Second, even if the law is explicit, actual experience may deviate. Indeed, assuming no deviation in enforcing the law or no changes in its interpretations, the law itself cannot predict in detail all circumstances.

Legal independence, in fact, indicates only the degree of independence granted by legislators to central banks. As such, it is only one aspect, although an important one, of central bank independence and one cannot explicitly say that a legal independent bank is *de facto* independent.

3.1 Measuring legal independence.

3.1.1 Cukierman Index

Cukierman classified the elements affecting legal independence in four major variables, namely:

* **Management (ceo).** This variable covers the procedures for appointment or dismissal of bank administrators as well as the length of their term in office. Typically, focus is placed on the Governor of the central bank.

[11] “Central Bank Strategy, Credibility and Independence: Theory and Evidence”, Alex Cukierman, 1992, Chapter 19.

* **Policy formulation (pf)**. This variable covers the issue of conflict resolution between the central bank and government as well as the extent of central bank participation in formulating monetary policy and budgetary process.

* **Final objectives (obj)**. The variable covers the final objective (s) provided by the central bank law.

* **Limitations on lending (ll)**. The variable covers the limitations on lending by a central bank to government. Limitations are expressed in terms of credit amount, maturity period, interest rate applicable, collateral, etc.

Each of these variables is given a numerical value from 0 (lowest level of independence) to 1 (highest level of independence). The numerical code assigned to each of the variables depends on the numerical value given to the respective group of elements[12]. Applying the same index to Bank of Albania, we find:

MANAGEMENT (ceo)

The evaluation criteria for the variable: Banks with a higher length of governor's term in office and where the executive is less powerful in appointing or dismissing the governor, are assumed to be more independent.

[12] For further details see Annex I.

Definition of variable	Numerical coding (the years represents the year on which the law was passed or amended)			
	Variable	1992	1996	1997
Term of office of CEO in years	Too	0.75	0.75	0.75
Who appoints the CEO?	App	0.5	0.5	0.5
Provisions for dismissal of CEO	Diss	0.5	0.5	0.5
Is CEO allowed to hold another office?	Off	NA	1	1
Group : Chief Executive Officer	**Ceo**	**0.4375**	**0.6875**	**0.6875**

Comments on evaluations for each element:

too – legal Governor's term in office is six years under the 1992 law and 7 years under the 1996 and 1997 laws.

app – the three laws entitle the President to appoint the Governor. This is changed in the 1998 Constitution where the president only nominates the governor and the parliament confirms it. This change in appointing procedures does not change the numerical value given to this element.

As we see, the two legal documents, for the time being, contradict each-other (The two legal documents contradict in other aspects as well. To give the proper numerical value, the Constitution clause is considered). According to the law in effect, the Council of Ministers nominates the Governor, while the President confirms him/her.

In this case, however, the numerical values do not change when measuring the variable.

diss – the governor can be dismissed only for nonpolitical reasons, such as: disability to perform properly; conviction by a court order, unjustified absence from several consecutive board meetings, violations of standards of ethics and central bank interest, etc. Typically, where a governor may be dismissed only for nonpolitical reasons, the Bank is assumed as independent. On the other hand, considering that the Parliament is the body in charge of dismissing the governor, the degree of central bank independence is reduced. Because of this, in assigning the numerical code for the element, we took into consideration the institution in charge of dismissing the Governor. Indeed, the experience proved that dismissing a governor is not difficult. They were changed very easily.

off – the 1992 law does not provide explicitly whether the governor can or cannot hold other offices at the same time[13]. The 1996 law prohibits the Governor from holding a ministerial portfolio or having a seat in the Parliament simultaneously. In addition to this, the 1997 law does not allow the governor to perform the duties of the president of the republic.

POLICY FORMULATION (pf)

The evaluation criteria for this variable are: Banks with a higher authority over monetary policy formulation and more resistant in a case of conflict with the government are assumed to be more independent.

[13] Indeed, one of the governors held two "chairs" at the same time. He was governor of the Bank of Albania and a president of a second-tier bank.

Definition of variable	Numerical coding (the years represent the year on which the law was passed or amended)			
	Variable	1992	1996	1997
Who formulates monetary policy?	Monpol	0.66	1	0.66
Government directives and resolution of conflict	Conf	NA	NA	NA
Is central bank given an active role in the formulation of government's budget?	Adv	0	0	0
Group : Policy Formulation	**Pf**	**0.33**	**0.5**	**0.33**

Comments on evaluations for each element:

monpol – we found it rather difficult to assign a value for this element in case of Albania. The relevant article in the constitution provides: "Bank of Albania consent the exclusive right to.... independently implement the monetary policy...."[14]. As we see, the article deals only with **independent implementation***, which* implies instrument independence. It indicates only the capacity to choose instrument(s) to implement a given monetary policy. **The article does not indicate independence in policy formulation.** According to the Constitution, Bank of Albania is not given explicitly (nor denied) the exclusive authority over monetary policy.

The Bank of Albania Law, passed in 1997, provides: "Bank of Albania is responsible for **formulating, adopting** and **implementing** the monetary policy of Albania"[15]. Further, the law indicates "**Bank of Albania**, within the limits of its authority established by this Law, **shall be entirely independent from any other authority** in

[14] Article 161, paragraph 1.
[15] Law no. 8269, dated 23.12.1997, "On the Bank of Albania", article 3, paragraph 4, item a.

the pursuit of its objectives and performance of its tasks. Any person should respect the independence of the Bank of Albania, and no person shall seek improperly to influence any member of a decision making body of the Bank of Albania in the discharge of his duties towards the Bank of Albania or interfere with the activities of the Bank of Albania”[16]. Considering the law, we found that the independence conferred to the central bank is higher than provided for in the constitution. The latter grants only independence in implementing monetary policy thus leaving room for other institutions to step in and assume the responsibility for formulating and approving it, for example the government may formulate it and the parliament approve it. As a consequence, the contradiction between the constitution and the law, de facto, exposes the central bank to the risk of restrictions in its independence.

As mentioned earlier, in assigning value to the elements, the constitution provision is considered, for two reasons: first, the constitution is a superior legal document compared to other laws, and second, a more conservative perspective is taken into consideration to make the necessary evaluations. This holds true only when we deal with the 1997 law.

While for the years 1992 and 1996, only the laws are considered as no constitution existed during this period. The country was governed pursuant to a package of constitutional clauses which had no provisions for the central bank.

In compliance with the 1992 law, Bank of Albania had the right and was accountable for **adopting** and **implementing** monetary policy[17]. Bank of Albania still lacked the right to formulate it.

In compliance with the 1996 law, Bank of Albania had the right and was accountable for **formulating** and **implementing** monetary policy [18].

[16] Law no. 8269, dated 23.12.1997, “On the Bank of Albania”, article 1, paragraph 3.
[17] Law no. 7559, dated 22.04.1992, “On the Bank of Albania”, article 13, item a.

[18] Law no. 8076, dated 22.2.1996, “On the Bank of Albania”, article 13, item a.

However, we also found that the option “central bank participates in formulation of monetary policy together with the government” is the relevant option to be considered in giving the numerical value.

An additional aspect should be considered, namely “***IMF authority***”, which has a significant bearing on central bank independence, especially on the legal one. This factor is very important in the case of Albania and we assume the same for other developing countries or countries in transition, particularly at the very beginning of transition. The IMF presence, in many cases, “forces” the authorities of a given country to make certain choices. Usually, countries like Albania have concluded agreements with the IMF[19], committing themselves to meet certain conditions. The IMF presence serves as a mechanism to smooth institutional conflicts, which may arise, especially between central bank and the Ministry of Finance. Signing an agreement with the IMF automatically harmonizes the policies of different institutions merely by the fact that all elements included in the agreement are consistent with each other.

In the case of Albania, the IMF has always emphasized the need to establish a de juro and de facto independent central bank. Bank of Albania’s law(s) has been drafted with considerable IMF management. In this regard, monetary policy is actually formulated by the central bank in cooperation with the government (mainly Ministry of Finance) and IMF.

Box 3. Recommendations of IMF mission in September 1997

“... the recent institutional problems have resulted in a weakening of the Bank of Albania’s independence. In order for the Bank of Albania to be able to effectively accomplish the responsibilities that it has been assigned in the current process of rebuilding economic conditions in Albania, there is a need to restore and maintain both effective and formal independence of the Bank of Albania. In this regard, the mission has reviewed the current Bank of Albania law and has identified several articles that would need to be amended in order to strengthen formal independence.

[19] In May 1998, Albania concluded the ESAF-2 Agreement with IMF.

The current conditions as well as the macroeconomic conditions envisaged for the remainder of 1997 and 1998 would not make it possible to implement the legal amendments being proposed immediately. In other words, the effective independence of the Bank of Albania would not be restored in the short-term and the mission is proposing some transitional provisions to accommodate this situation. However, for de facto independence to be restored and maintained the authorities would need to take steps to reduce the fiscal deficit (and particularly to avoid excessive recourse to financing from the Bank of Albania), and to promote the development of Treasury bills market.

For the autonomy to be effective, the amendments must include provisions beyond the formal aspects of its decision making process. Little would be gained in terms of effective independence if the Governor and other members of the Board (Supervisory Council) served at the pleasure of the appointing authority **and could be removed without legal clause. Similarly, the Bank of Albania should have a clear understanding of its basic objective, which is to maintain price stability. The Bank of Albania should not be required to undertake more ambitious objectives, such as economic development, which may be inconsistent with price stability. In fact, by pursuing price stability, the Bank of Albania would be effectively contributing to longer-term economic growth.**

Financing of the Government is at the heart of the central bank independence. If the Bank of Albania has unlimited legal authority to finance the public deficit, as under the present law, the political pressure to which it might be subjected could be overwhelming. In this respect, large amounts of government financing would be inconsistent with sound monetary policy and price stability.

Monetary and exchange rate policies are also at the heart of the Bank's activities. These policies affect the overall macroeconomic balance of the country and the objective of price stability. At present, Bank of Albania has the obligation to consult these policies with other government officials. Thus, the pressure to adopt – or not to adopt – certain policies to attain internal and external stability is always present.

The draft amendments proposed by the mission are designed to strengthen the independence of the Bank of Albania. But this enhanced independence should be exercised with responsibility.

A. Independence

The present Law on the Bank of Albania states in a laconic way that the Bank of Albania is an independent legal entity. It does not elaborate further on this concept, nor does it prevent any person from improperly influencing any member of its decision making body.

B. Organization and management

The present Law was amended recently [it refers to the amendment made on July 1997] to increase the number of directors of the Supervisory Council to nine. And, unfortunately, the provision designed to ensure that the Governor of the Bank of Albania could not be removed without legal cause was deleted.

Under the newly enacted provisions the Governor of the Bank of Albania, who is also the Chairman of the Supervisory Council and principal officer, can be appointed and removed by the President of the Republic without legal cause. This affects significantly the independence of the Bank. Moreover, the recent amendment provides for an unusual and inconvenient system for the nomination of candidates for the Supervisory Council.

Each candidate must be elected by a different institutional group or a particular government official, thus giving the impression that each candidate represents the interest of that particular person or institutional group, instead of the more general interest of the country as a whole. This may create unnecessary factions and frictions at the Council and may affect the conduct of its policies.

Under the legislation presently in force, three candidates are proposed by the People's Assembly; one by the President of the Republic; two are nominated by the Council of Ministers; the Minister of Finance nominates one candidate; the Governor himself can nominate his own candidate; and the Supervisory Council nominates another person. The governor and deputy governor are nominated by the Supervisory Council and are appointed and replaced by the President. The General Secretary of BoA, who is a member of Supervisory Council is proposed by the Governor and is appointed by the Government according to the latest amendments.

The draft proposed by the mission simplifies significantly the nomination procedures, but retains the existing provision under which the appointment of each member corresponds to the People's Assembly. Under the new procedures, all members of the Supervisory Council would be appointed by the People's Assembly upon the nomination by the Council of Ministers. The Council would select the Governor and Deputy Governors.

To ensure that no member of the Supervisory Council would be subject to political or other pressure, the draft amendment would prohibit their dismissal for reasons other than legal cause. Such protection would extend to the Governor and Deputy Governors as well. The draft amendment would modify the provisions for dismissal of all members of the Supervisory Council and their corresponding disqualification.

The functions of the Supervisory Council have been redrafted to make clear that the Council is charged with the supreme direction and supervision of the policies. ... consistent with the above, the powers of the Supervisory Council have been redrafted along the lines of the existing provision, to insure that it would have full powers to adopt its own monetary and foreign exchange policies without having to consult with any other government official.

Other modifications proposed in this chapter include the elimination of the existing Management Committee, the introduction of a provision to permit the Minister of Finance to attend the Supervisory Council meetings without being entitled to vote, and the appointment of the Inspector General of the Bank of Albania, which in the proposed amendment would be made by the People's Assembly and not by the Bank of Albania.

C. Objectives

The objectives of the Bank of Albania are redrafted and expanded in accordance with modern central banking legislation. The principal objective is to achieve and maintain price stability; to which the other objectives mentioned in the law would be subordinated.

D. Credit to the Government

The present law gives the Bank authority "to lend money to the State". Even though direct lending to the Government is limited, indirect lending is not prohibited and has no limitation. In practice, the Bank of Albania has financed the fiscal deficit indirectly by purchasing Treasury bills from the state-owned banks.

The draft amendments suggested by the mission are designed to correct this situation. At no time the aggregate principal amount disbursed and outstanding may exceed the equivalent of (five percent) of the annual average ordinary revenue of the Government. Any government securities acquired by the Bank of Albania in open market or other operations would have to be included in the total amount of government securities outstanding, except if the acquisition responds to the Bank of Albania's own initiative and is consistent with the monetary policy designed to maintain price stability.

E. Exchange Arrangements and Exchange Rate Policy

The Law on the Bank of Albania, adopted on February 22, 1996 vested it with authority to determine the exchange rate policy. In addition, it gave power to the Bank of Albania to "establish the method for determining the value of the Lek in relation to other currencies", which means, presumably, power to determine the exchange system.

The draft amendments…. make the distinction between the exchange arrangements (the legal framework for determining the value of the Lek in terms of other currencies) and exchange rate policy. The Bank of Albania would have authority to determine the exchange arrangements in consultation with the Government, but would be solely entitled to adopt and execute its own exchange rate policy.

conf – the three central bank laws mention nothing on the government-central bank conflict(s), conflict(s) resolution and do not explicitly indicate which institution has the final word. For the time being, such a provision may not seem relevant as no severe conflict has occurred yet due to, as explained earlier, the "IMF presence". On the other hand, the contradiction between the Constitution and the existing law, and the possibility that one day, the IMF will "leave" the country, makes it necessary to review this aspect in terms of making the necessary adjustments in the legislation.

adv – the laws provide that Bank of Albania gives its advice on papers dealing with economic and financial issues which are to be approved by the government or the parliament. In practice, it is not actively participating in an advisory process.

FINAL OBJECTIVES (obj)

The evaluation criteria for the variable: Banks complying with laws which explicitly state that the **sole** and **primary** policy objective is price stability, are assumed to be more independent than banks which pursue also another set of additional objectives. These ones are assumed to be more independent than banks that pursue a great number of objectives or those whose law does not state at all the price stability as an objective.

Actually, this criterion deals with the legal mandate of a central bank and indicates whether it is enough powerful to rank "price stability as a superior objective among other goals"[20].

Definition of variable	Numerical coding (the years represents the year on which the law was passed or amended)			
	Variable	1992	1996	1997
Group : Central Bank Objective	**obj**	**0**	**0.6**	**0.6**

Comments on evaluations for the element:

obj – with regard to the Bank of Albania principal objective, a significant evolution from 1992 to 1996 occurred aiming at enhancing its independence.

"***Preserving internal and external value of national currency***" [21] is the primary objective provided in the 1992 Law. While "***price stability***" is the **primary** though **not the only** objective provided in 1996 and 1997 laws. Any other objective or task assigned to Bank of Albania is subordinated to achieving the main objective[22],[23].

[20] The mandate given to Federal Reserve Bank of New Zealand is very clear in this regard – it is instructed by the law to rescue inflation rate at 0 – 2 per cent as of the end of 1993. This appeared to be the sole monetary policy goal and the Bank was solely responsible for it.

[21] Law no. 7559, dated 22.4.1992, "On the Bank of Albania", article 3, paragraph 1.

[22] Law no. 8076, dated 22.2.1996, "On the Bank of Albania", article 3.

[23] Law no. 8269, dated 23.12.1997, "On the Bank of Albania", article 3.

As mentioned above, price stability is not the only objective stated in the 1996 and 1997 laws. The other objectives, however, do not conflict with it, for example, to promote and support the development of the payment system, to foster the liquidity, solvency and proper functioning of a stable market-based banking system, etc.

LENDING LIMITATIONS (II)

The evaluation criteria for the variable: Banks imposing stricter limits on lending to government are assumed to be more independent. Limitations are considered to be stricter, the closer the interest rate charged on credit to government is with market interest rate and the shorter the maturity period. Central banks that are prohibited by the respective laws to acquire government securities in primary market are also assumed to be more independent.

Definition of variable	Numerical coding (the years represents the year on which the law was passed or amended)			
	Variable	1992	1996	1997
Limitations on advances	Ila	0.00	0.00	0.33 (0.66)
Limitations on collateral lending	Ils	0.00	0.00	0.33 (0.66)
Who decides control of terms of lending?	Idec	0.66	0.66	0.66
How wide is the circle of potential borrowers from central bank?	Lwidth	1	1	1
Type of limit when such limit exists	Ltype	0.33	0.33	0.33
Maturity of loans	Lmat	1	0.66	1
Restrictions on interest rates	Lint	1	1	1
Prohibition on lending in primary market	Lprm	0	0	0
Group : Limitations on Lending – Miscellaneous	**Lm**	**0.5825**	**0.4975**	**0.5825**

Comments on evaluations for each element:

IIa – the amount of credit to government is not unlimited. The three laws state a maximum amount of credit not more 15 per cent of budget revenues. The 1997 law also provides an exception to the rule that applies for 1998 and 1999. The limit for these two years is set at 30 per cent. We mention this fact to explain the numerical value assigned to this element; otherwise, a numerical value of 0.66 would be given.

On the other hand, according to the 1996 law, the numerical code given to the element is zero, ignoring the limitations on lending to government. The 1996 Law includes a clause which practically provides that the central bank lending to government is unlimited. According to the respective article, the credit to government can take the form of securities directly acquired from the ministry of finance; Treasury bills acquired auctions and government securities acquired in the secondary market. The total outstanding amount of securities for years 1996, 1997 and 1998 must not exceed 10, 6 and 2 per cent of annual budget revenues and 4 per cent for the securities acquired in auctions. With regard to the amount of securities acquired in the secondary market, the Law applies no limitations. Based on the above-mentioned article, Bank of Albania increased significantly the total outstanding portfolio securities during 1997. The same applies for the 1992 Law.

IIs – the three laws state that credit to government is to be collateralized with government securities. Even the acquirements by central bank in the secondary market should comply to the same limitations. Because of this, the numerical values given to the element are the same with those given to lla.

Idec – although there are some differences, the three laws state that the credit to government is short-term. The 1996 law provides a longer maturity period with a maximum to 12 months, while in the other two laws, the maximum maturity period is 6 months. The other terms and conditions are to be set according to a bilateral agreement.

Iwidth – Albania is a unified state. As such, the central and local government are not separate (only the central government rules the country). However, the 1996 Law is the only one providing explicitly that the credit is extended to the state represented by ministry of finance. The other two laws are vague in this regard. In practice credit is granted only to the ministry of finance (representative of central government).

ltype – maximum allowed amount of credit to government, according to the three laws, is calculated as a percentage of budget revenues.

lmat – see the explanation for *ldec* element.

lint – the interest rate to be paid for credit to government is based on market interest rates.

lprm – none of the laws prohibits Bank of Albania from acquiring securities in the primary market. Indeed, the central bank did participate in this market. Pursuant to the internal policy adopted recently, Bank of Albania does not acquire new securities in primary market (it only reinvests). The Law, however, is not strict in this issue.

LEGAL INDEPENDENCE INDICES (LVAU, LVAW)

To give a numerical value for the legal independence indices the numerical values of the four variables are aggregated, as follows:

Definition of variable	Numerical coding (the years represents the year on which the law was passed or amended)		
	1992	1996	1997
LVAU	**0.376**	**0.493**	**0.528***
LVAW	**0.357**	**0.510**	**0.563***

Note: If we consider the exception for the ***lla* element for year** 1997, the aggregate values of indices would show higher values, 0.565 and 0.629 respectively. While according to the notes for the monpol variable, the indices hold values of 0.669 and 0.665 respectively.

Based on the numerical value given to the Cukierman legal independence indices, Bank of Albania is ranked among the most independent central banks (see Annex I, Table 6). According to LVAU Index and the Cukierman ranking of 68 countries, Bank of Albania is listed after the central bank of Luxembourg, if we take into consideration the 1992 Law (among the 30 most independent central banks); after the Federal Reserve Bank of USA, if we take into consideration the 1996 Law (among the 7 most independent central banks); after the central bank of Egypt, if we take into consideration the 1997 Law (among the 5 most independent central banks).

It should be mentioned that Cukierman ranking is based on the central bank legislation of '80s, while the Bank of Albania legislation belongs to the '90s. There is a time lag during which many things have changed in the central bank legal framework and several central banking concepts are further developed. It means that comparing Bank of Albania with Cukierman rankings, although not so very relevant, gives us a clue on the position held by Bank of Albania in terms of its legal independence.

On the other hand, in addition to the substantial legal independence granted to Bank of Albania, we found that it was enhanced over the years. The 1996 Law provided a considerable "jump".

3.2 Measuring legal central bank independence in transition countries.

Examining central bank independence became crucial in a third group of countries that emerged in the late '80s and early of '90s, namely countries in transition (Eastern and Central European Countries, including Albania as well).

These countries have adopted central bank laws based on the laws (charters) in force developed in Western countries. Cukierman pointed out that establishing independent central banks in many former socialist countries is part of a general effort in these countries to create the necessary institutional framework which will bring a normal functioning of the market economy[24]. But, the reality differs from the rules stated by the law.

"An important problem, - as stressed by Radzymer and Riesinger (1997) – is a political pressure on banks and the practice of overruling the banks' law by the Parliament[25]. However, conclude the authors, there is a tendency towards strengthening central bank independence in countries under investigation" (Poland, Hungary, Czech and Slovak Republics).

Wojciech Maliszewski sampled 14 countries[26] which seem to be relevant to be compared with Bank of Albania. The author has developed two indices: political independence index and economic independence index. Based on the information aggregated into two indices, they are used to measure the legal independence of a central bank. The sum of the two indices is the overall independence index[27].

3.2.1 Political independence index

The political independence index consists of 9 variables and the maximum numerical value that may be assigned to it is 10. Based on this index we found the position of Bank of Albania as follows:

[24] "The Political Economy of Central Bank Independence", Sylvester C.W. Eijffinger and Jakob de Haan.

[25] "Central Bank Independence in Transition Economies", Warsaw, December 1997, Wojciech Maliszewski, page 20.

[26] The sample includes the following countries: Six former Soviet republics (Belarus, Georgia, Kyrgyzstan, Latvia, Russia and Ukrahine) and eight Central Europena countries (Bulgaria, Croatia, Czech Republic, Hungary, Poland, Romania, Slovak Republicand Slovenia).

[27] See Annex 2 for further details.

Definition of variable	Numerical coding (the years represents the year on which the law was passed or amended)		
	1992	1996	1997
G1 : Governor appointing	**	**	** (*)
G2 : Governor term of office	*	*	*
B3 : Board appointing			*
B4 : Board term of office	*	*	*
B5 : Governor dismissal	*	*	*
R6 : Government representative in the Board	*	*	*
R7 : Monetary policy approval	*	*	*
C8 : Legal objective		*	*
C9 : Conflict resolution			
Political Index (IP)	**7**	**8**	**9 (8)**

Comments on evaluations of components of political index for Bank of Albania.

G1: The three laws state that the governor is appointed by the President of the Republic. According to Constitution the governor is appointed by Parliament (the numerical value in parenthesis is assigned taking into consideration the Constitution).

G2: The three laws provide that the governor is appointed for more than five years.

B3: Pursuant to the current Law, the members of the Supervisory Council are appointed by the Parliament. Under the 1996 Law, one member was to be appointed by the Council of Ministers. That member assumed the functions of the General Secretary. The 1992 Law stated that both deputy governors were to be appointed by the Council of Ministers and the Ministry of Finance consented the right to appoint one member.

B4: The three laws provide that the members of the Supervisory Council are appointed for more than five years.

B5: As we explained earlier, the governor dismissal clauses are of nonpolitical nature.

R6: No compulsory government representative in the Supervisory Council is provided in any of the three laws.

R7: Evaluating properly this element is rather difficult. The three laws do not provide that monetary policy has to be approved in Parliament or by the Government, thus one point is added for this element. On the other hand, as we have already explained, there is a contradiction in the legislation (between central bank law and the constitution) with regard to monetary policy. In this case, no value would have been assigned for this variable, lowering the aggregate value of political index by one point (6, 7 and 8 respectively). In turn, the reduced value of political index causes no significant change in the interpretation of political independence of central bank.

C8: The 1992 Law only, does not state “price stability” as the primary objective for Bank of Albania.

C9: No explicit provisions on conflict resolution between the government and the central bank exist in any of the three laws.

Obviously, the political independence of Bank of Albania is relatively considerable (the numerical values assigned to political index is high). In other words, Bank of Albania has been granted the necessary legal space to operate as an independent bank. It should be reminded that the same conclusion is reached after getting the results of the Cukierman Index. It means that in establishing the central bank of Albania and in approving the respective legislation, the experience of transitional countries was followed: the legislation was based on the laws (charters) of the developed countries.

Maliszewski concludes that in most cases the law on central banks was formulated according to the international standards and contains at least the most important provisions for political independence:

* the Governor is appointed for more than five years;
* usually there is no formal influence of the Government on the Bank policy, although none of the statutes provides a legal provision supporting the Bank in case of conflict with the Government;
* the goal of maintaining the price stability is enumerated in almost all statutes.

The same elements are included in the central bank laws in Albania. Considering the values assigned to political index, we found that political independence has increased over the years indicating that the adopted laws are approaching more and more the international standards. However, the Albanian laws do not provide clauses on conflict resolution with the executive.

3.2.2 Economic independence index

The economic independence index consists of 7 variables and the maximum numerical value that may be assigned to it is 8. Based on this index we found the position of Bank of Albania as follows:

Definition of variable	Numerical coding (the years represents the year on which the law was passed or amended)		
	1992	1996	1997
D1: Direct credit facility to government	*	*	*
D2: Direct credit facility interest rate	*	*	*
D3: Direct credit facility maturity	*	*	*
D4: Direct credit facility amount	*	*	*
D5: Participation in primary market for governmental securities			
M6: Setting discount rate			
M7: Bank supervision			
Economic Index (IE)	**4**	**4**	**4**

Comments on evaluations of components of economic index for Bank of Albania.

D1: Central bank direct credit facility to government is not automatic. The total amount of credit facility is determined in the State Budget Law and the credit is extended upon request submitted to Bank of Albania by the Government, after the former reviews other sources that are at Government disposal.

D2: In any case, the government is charged with market interest rate comparable with market rate.

D3: In any case the central bank credit to the government is temporary (short-term).

D4: The maximum amount of credit that can be granted to government is limited to a certain percentage of state revenues.

D5: Bank of Albania does participate in the primary market and this is not prohibited by any of the laws.

M6: The discount rate is based on the average market interest rate prevailing in the last three T-Bills auctions. It is not determined from Bank of Albania. No asterisk is given to this variable based on the criteria evaluations developed by the author with regard to Economic Index. In our opinion, fixing the discount rate based on an average market interest rate, enhances Bank of Albania independence, given the tradition and the degree of interference and influence from the ministry of finance.

M7: According to the author, the central banks that assume the functions of bank supervision are assumed to be less independent. The three Albanian central bank laws acknowledge the bank supervision function to Bank of Albania. There is no, however, consensus whether bank supervision function enhances or reduces the central bank independence.

In the case of Albania, the Bank of Albania is carrying out the supervising function of the banks. It is not in our attention to discuss about this problem, if the supervising function should be or not the function of BoA. Upon our opinion (point of view) the actual solution is and will be adequate for a medium term period.

First: there is not a unique experience regarding the location of bank supervising function. There are a lot of cases when this task is carried out by the central bank, in developed as well in the developing countries. From this point of view the BoA it is not a special case.

Second if the Minister of Finance would carry out the bank supervising function, then this will put this function under higher political pressure and interest of the moment.

Also if this function would be given to a separated institution, this will make it difficult to function as an independent one. If the gain of real Independence is difficult for the central bank,than it will be much more difficult for every other institution. “Under the shadow” of the central bank actually the bank supervision has more powerful support to be away of the politic pressure.

Third: Bank supervising function inside the BOA has provided to this last one a better and more precise knowledge of the situation in the banking system and his problems. As a consequence, this has affected it to take realistic decision for the monetary policies, to use more efficiently the direct instruments of the monetary policies and to ensure the implement of her decisions related to the monetary policies under the conditions, when the transmission mechanism of these decesions does not work efficiently in the economy.

In a strict meaning, through bank supervising system BOA has provided the necessary information on the financial situation and of each bank separately.

This information is needed to analyze and to take decisions. Taking into account the low level of the statistic development in our country, the lack of the transparence related to financial information, as well as the lack of a good tradition between the institution to exchange information, the BOA must be affronted with serious difficulties.

At last creating an independent supervising institute will burden albanian state finances, because of the cost of training and qualifying the supervisor staff of the institute.

Box 4 : Bank supervision

The major argument in favor of carving out the bank supervision function from that of monetary policymaking is based on the fact that central bank's anti-inflation position will be jeopardized by injections of high liquidity in order to maintain one or more important financial institutions. Yet, even when the supervision function is carried out by another agency, central bank should intervene if one of the biggest banks goes down. According to De Haan and Sturm (1994), whether the central bank has also the Supervisory function or not has little effect on its independence. The arguments for and against separating the supervision role from central bank are:

In favor of separation	Against separation
* Possibility that conflicts of interests arise within an institution which controls both monetary policy and supervision process. Central bank, being responsible for supervision and consequently for banking system's bankruptcy, might try to avoid such events by lowering the interest rate or increasing money supply more than a level where price stability objective would be satisfied. Division of responsibilities might increase bank autonomy.	* Central bank plays an important role in the smooth functioning of a payment system and management of its financial risks. In order to minimize risks, central bank would prefer to supervise and regulate the system and its members. * The role of central bank as a last resort which offers the adequate liquidity to solve structural solvency problem or even to save banks.

* Bad publicity which associates bankruptcy or intervention operations. It might hurt central bank reputation as a supervisory agency and also its credibility in implementing monetary policy.	

Cukierman (1996) argues that giving the supervisory role to central banks makes them more vulnerable to political pressures. In case of bankruptcy, the risk can be measured in terms of money. Transferring supervision function outside central bank will make cost of intervention more transparent. On the other hand, if this function is associated with central bank, this one might use precise information on banking system to regulate monetary policy behavior. Besides, it seems that the personnel needed for supervision and that for managing monetary policy are complementary, and this is considered as an argument for giving central bank the function of supervisory authority.

According to Maliszewskit (1997), only two of the central banks considered in his model (banks in Eastern and Central Europe countries) do not have the supervision function. Thus, supervision is thought of as a traditional function of central bank. However, the reason this author argues that banks, which do not act as Supervisory authority, are more independent is related to the possibility that political pressure on central bank to engage in saving operations of a large scale is higher if the bank acts as a supervisor as well. This can jeopardize achievement of political objectives.

As it might be noticed, economic independence index ranks central bank of Albania in a less favorable position than the political independence index and the evolution of laws has not led to any development in this index. Maybe this shows that in the process of formulating the laws, more attention was given to changing and adjusting those clauses, which avoid political pressures. The risk for such interference was more present.

Box 5

"The Economist" (February 10, 1990) said: "The only good central bank is the one that says NO to politicians".

The overall index, however, is relatively high, at 11, 12 and 12 respectively confirming a high legal independence for Bank of Albania.

3.3 Bank of Albania's position compared to main recommendations on central bank independence.

Main recommendations on central bank independence[28] are reviewed and compared with the case of Bank of Albania:

[28] Tonny Lybek, "Central Bank Autonomy, and Inflation and Output Performance in the Baltic States, Russia and Other Countries of the Former Soviet Union, 1995-97", WP/99/4, IMF, January 1999.

Element	Bank of Albania		
	1992	1996	1997
I. Objectives and targets.	**0.17**	**0.5**	**0.5**
a. "price stability" is the preferable formulation for the primary objective.	Primary objective “preserving the currency value” 0	Primary objective "price stability" 1	Primary objective "price stability" 1
b. specific targets should be established and published	Specific targets for monetary aggregates are established but not published. 0.5	Specific targets for monetary aggregates are established but not published. 0.5	Specific targets for monetary aggregates are established but not published. 0.5
c. the target should be easy to monitor. Consideration should be given to explicit, but limited "escape clauses" in the face of significant exogenous shocks.	No "escape clauses" are provided 0	No "escape clauses" are provided 0	No "escape clauses" are provided 0
II. Monetary policy.	**1**	**1**	**1**

a. the bank should have the authority to determine quantities and interest rates on its own transactions without interference from the government.	The bank has the authority 1	The bank has the authority 1	The bank has the authority 1
III. Conflict resolution.	**0**	**0**	**0**
a. a clear and open process should be established to resolve any policy conflict between the central bank and the government.	No clauses are provided in this regard 0	No clauses are provided in this regard 0	No clauses are provided in this regard 0
IV. Governor.	**1**	**1**	**1**
a. nomination and appointment/confirmation of the governor should be by separate bodies to provide some measure of balance.	Law is in compliance with this recommendation 1	Law is in compliance with this recommendation 1	Law is in compliance with this recommendation 1
b. the term should be longer than the election cycle.	It is 1	It is 1	It is 1

c. dismissal should be only for breaches of qualification requirements, or misconduct, lack of performance if that is accurately determined by primary objectives and specific goals.	It is (according to the law) 1	It is (according to the law) 1	It is (according to the law) 1
V. Board.	**0.9**	**0.9**	**0.9**
a. composition of the board should ensure a reasonably well informed and balanced view, but avoid conflict of interest. The board should include a majority of non-executive, non-government directors.	Not entirely 0.5	Not entirely 0.5	Not entirely 0.5
b. direct government representatives should be eliminated or, at least, should be without the right to vote.	Government representatives are eliminated 1	Government representatives are eliminated 1	Government representatives have no right to vote 1
c. nomination and appointment/confirmation is not carried out from the same institution.	It is done by different institutions. 1	It is done by different institutions 1	It is done by different institutions 1

d. the term should be longer than election cycle and scaled.	It is longer than the election cycle but scaling is not provided. 1	It is longer than the election cycle but scaling is not provided. 1	It is longer than the election cycle but scaling is not provided. 1
e. members are dismissed only on grounds mentioned with respect to the governor	Yes 1	Yes 1	Yes 1
VI. Lending to Government	**0.63**	**0.63**	**0.63**
a. in case direct credit is allowed, it should be limited. It should be clearly determined as a small percentage of average revenues during the preceding five years.	It is limited to a percentage of budget revenues but based on a period of one year ago and at a rate of more than 5% 0.5	It is limited to a percentage of budget revenues but based on a period of one year ago and at a rate of more than 5% 0.5	It is limited to a percentage of budget revenues but based on a period of three years ago and at a rate of more than 5% 0.5
b. applicable market rate	Yes 1	Yes 1	Yes 1

c. collaterized by negotiable securities.	Yes 1	Yes 1	Yes 1
d. central bank should not participate and behave as a buyer in primary market for government's securities, except for noncompetitive bids and within the overall limit allowed for government's borrowings form CB.	Not entirely 0	Not entirely 0	Not entirely 0
VII. Exchange rate policy	**1**	**1**	**1**
	Floating regime	Floating regime	Floating regime
VIII. Financial Statements	**1**	**1**	**1**
a. budget should not be subject to annual adjustment normal procedures	Yes 1	Yes 1	Yes 1
b. the government should be returned only net income generated after accounting for provisions and overall reserve allocations.	Yes 1	Yes 1	Yes 1
c. government should provide liquidity for central bank by transferring negotiable interest bearing securities if the authorized capital is spent.	Yes 1	Yes 1	Yes 1

d. the authority to which central bank is accountable to should be allowed to ask internal or external auditors to audit central bank accounts and procedures.	Yes 1	Yes 1	Yes 1
IX. Publication and reporting	**1**	**1**	**1**
a. central bank should prepare official statements on monetary policy outcome every, let's say, six months despite government's initial approval	Yes 1	Yes 1	Yes 1
b. these statements should be made available to legislative and executive branches as well as to the public.	Yes 1	Yes 1	Yes 1
c. financial statements audited by external auditors should be handed to the legislative and executive branches and then should be published.	Yes, but audited by internal auditors 0.5	Yes, but audited by internal auditors 0.5	Yes, but audited by internal auditors 0.5
d. balance sheet should be published more frequently, (for instance, every month or every week.)	Yes, it is published every month 1	Yes, it is published every month 1	Yes, it is published every month 1
Compliance rate with the recommendations	**0.74**	**0.78**	**0.78**

Note: To measure the rate of compliance with recommendations quantitatively, the value of 1 is assigned to every answer "Yes" and the value of 0 is assigned to every *answer “No”. The answers, which show partial compliance with recommendations, are assigned value of 0.5. Each criterion is the average of its components.*

It is estimated that the majority of the recommendations in this material are addressed by the Albanian legislation. Thus, the idea that Bank of Albania enjoys a considerable legal independence is once again affirmed.

4. MEASURING REAL (EFFECTIVE) INDEPENDENCE

In light of the results of legal independence indices, Bank of Albania is considered an independent central bank and is listed right after the most independent banks in the world. However, it should be noted that comparison with Cukierman ranking is not accurate as the laws on Bank of Albania examined and used here have been approved during the last ten years, while Cukierman's ranking was designed in the 1980s. Many things have changed and new concepts are developed during this time. Yet, Bank of Albania holds a favorable place in the ranking of fourteen central banks of transition countries, compared on bases of relevant current laws.

Nevertheless, *de jure* independence does not imply *de facto* independence, especially for countries like Albania, where, to put it mildly, feelings for law and order are not very strong.

As mentioned above, measuring real independence is much more difficult than measuring legal independence because of the type of factors that affect real independence. They can be hardly measured in quantitative terms and furthermore, it is difficult to compare them across countries. Different countries apply different practices and though it is possible to standardize their laws, it is nearly impossible to standardize their behavior.

Yet, researchers have developed specific indicators to measure real independence in quantitative terms.

4.1 Governors turnover rate as a proxy for actual independence.

Cukierman suggests the "governors turnover rate" as a measurement for actual independence. The evaluation criteria for this variable are: the longer the governor's appointment terms, the more independent the central bank is. The minimum requirement is that governor's appointment term be longer than election cycle. In this way, it is less probable that central government influences governor's decisions. Many countries design laws which specify that members of the council be elected at different periods so that their appointment is not affected by changes in government.

The governor or members of the Council might not end their appointment term for different reasons. They can be dismissed, can resign, or become incapable of performing. In the worst case they might even leave this world. The term in office can be shorter than the initial appointment term[29].

Despite what law stipulates, the traditions and practices in the relations between central bank and executive government may have been developed in a certain way that in reality things are done differently from the law, although apparently they seem to comply with it. A classic example is Argentina. There, the legal term in office for the governor is four years. But the tradition is different. Anytime that the government and/or even the Minister of finance changes, it is taken for granted that the governor will resign. So, during '80s the effective term in office for the governor was only ten months. Moreover, the governors did respect the tradition. Yet, the procedure seems to be in compliance with the law.

Cukierman developed two indicators to measure *de facto* independence:

i. the effective average term in office for the governor. The main assumption used is that after a certain period of time, the turnover rate is higher which means a lower level of central bank independence;

ii. the indicator developed based on questionnaires delivered to bankers of different central banks in the world. The information received is supposed to be submitted by professionals who lay down their real experience as well;

Cukierman and others consider the governor turnover rate as a very good approach for the actual central bank independence in the developing countries.

[29] In 1998, a member of SC of BoA resigned. He was appointed in year 1997.

The benchmark which divides the high and low turnover rate is considered to be the indicator falling in the 0.2-0.5 interval. The extreme values correspond to a period of 4-5 years. This is based on the assumption that electoral cycle is generally four years and it is relatively difficult to implement long-term policies during short-term periods.

The case of Albania

It should be remembered that banks receive the highest recognition as independent banks if: (1) the legal term in office for the governor is at least eight years. In Albania, the legal term in office is six years based on the 1992 law and seven years based on the 1996 and 1997 laws, very close to the maximum level. Because of this, this element is assigned a relatively high value.

What is the effective term in office for the Albanian governors?

Since end of April 1992[30], when the central bank law was approved up to now[31], BoA was headed by five governors, serving with a different term in the office. The average term in office per governor is 17 months, out of 84 months which is the legal mandate. (i.e. five governors have served the legal term in office of one governor)

It is noted that the difference between the legal and effective term in office is high. The index is appointed with 0.7 far from the benchmark. Comparing the index with the listing of Cukierman, BoA stands almost at the bottom of developing countries. Only central bank of Argentina is behind BoA. (see Annex 1, table 8).

However, a low turnover rate does not always imply a high degree of independence. The governor can serve in his office for longer periods because he exhibits a subservient behavior towards executive government. This element is not worthy to be reviewed in the case of Albania due to the very large turnover rate of the

[30] BoA's first governor was appointed in May 1992.
[31] It corresponds to end of September 1999.

governors, which implies that subservient behaviors that may have been observed served to nothing.

The actual independence index measured by the turnover rate of governors was further developed. It is important to observe whether the change of governors takes place within six months from elections. If yes, it confirms a relatively low level of central bank independence. Cukierman and Webb (1995) developed the second indicator based on the fact that the temptation to change the governor is significantly higher after the political transitions than in other periods. The time period of six months, during which the political instability of the governor is higher, is called “political period”.

Do governor changes occur during the “political period” in Albania?

The first governor was appointed in May 1992, two months after the elections of March 1992. The above mentioned assumption does not apply in this case as the central bank of Albania was established in April 1992 and obviously a governor had to be appointed. In addition to that, the person who assumed the functions of the governor used to serve as the general director of the State Bank of Albania from which BoA originated.

The next elections were held in May 1996[32]. However, the same person held the position of the governor. That person was removed almost one year later, in April 1997.

Other elections were held at the end of June 1997[33] and at the end of August 1997 the governor was again removed[34]. Prior to this, an amendment of the law on BoA was passed in July 1997.

[32] The regular election cycle in Republic of Albania is four years.

[33] The general elections were held in June 29, 1997. They were precocious elections held in the process of finding political solutions to overcome the Albanian crises of the end of 1996 and first half of 1997.

[34] Date of appointment is August 30, 1997.

The amendment affected the governing bodies of BoA in two directions: the number of members in the Supervisory Council was increased from seven to nine. On the other hand, the bodies involved with the nomination and confirmation of the Supervisory Council changed as follows:

Member of the Supervisory Council	Existing Law		Amendment	
	Nominated	**Appointed**	**Nominated**	**Appointment**
1. Member	Minister of Finance	Parliament	Minister of Finance	Parliament
2. Member	Governor	Parliament	Governor	Parliament
3. Member	The President	Parliament	The president	Parliament
4. Member	Government	Parliament	Government	Parliament
5. Member	Government		Parliament	Parliament
6. Member	Deputy Governor		Parliament	Parliament
7. Member	Deputy Governor		Parliament	Parliament
5. Additional member			Government	Parliament
6. Additional member			Supervisory Council	Parliament

Directors	Existing Law		Amendment	
	Nominated	**Appointed**	**Nominated**	**Appointed**
Governor	Supervisory Council	The president	Supervisory Council	The president
First Deputy Governor	Governor	The president	Supervisory Council	The president
Deputy Governor	Governor	Council of Ministers	Governor	Council of Ministers

Another important amendment of article 49 of the existing law deals with the suspension or dismissal of members of Supervisory Council. The amendment of article 2 adds that: "Members of Supervisory Council will be suspended as such till further notice from Parliament, if they are suspended or have resigned from their current office and other members of Supervisory Council are nominated by respective authorities and in accordance with article 42 of the law on Bank of Albania. Supervisory Council of Bank of Albania, or at least a part of it, was elected in accordance with the 1996 law and it violated the amendments of August 1997. Therefore, the structure of the council had to be revised. August 1997 marks the replacement of governor, deputy governor and of all members of Supervisory Council.

The changes took place within the six-month period. So, during two elections, only one was followed by the replacement of governor (Supervisory Council). These two cases, though they are the only ones that can be analyzed, are insufficient to establish a pattern of changes of Bank of Albania directors after elections. It is difficult to determine which of the two cases will become a tradition, however the case of 1997 has a higher probability. The case of 1996, when the governor was not replaced, cannot be totally considered as an expression of "indifference" from government or as an attitude supporting the central bank independence. The results of 1996 elections gave the power to the existing forces in power and ensured their "continuity" in office. The high officials were appointed before this election and since there was no change in political power there was no obvious reason to replace those who did not represent this political force.

Elections held in June 1997 shifted the political power to the other end of the spectrum. That is the reason that the case of 1997 has higher probability of turning into a pattern. Other factors supporting this are:

* the past mentality which presumes that everything should be kept under strict control

* "a high degree of militantism" which often turns the parliament, being continuously dominated by one political force, into a fictional mechanism[35];

* lack of cooperation among political forces in the country to reach a "political agreement" and play by rules of the game.

According to Cukierman and Webb, the rate of changing governors during "political period" is three times higher in developing countries than in developed ones (index scores 0.1 for industrialized countries and 0.34 for developing countries, while the average index for 195-1989 scores 0.24). As pointed out above, in Albania, the change of governors during this period occurs in 50% of the cases.

It is considered positive the fact that the Constitution and the amendments of the 1997 law on Bank of Albania in July 1998 emphasize the office term of government and explicitly state that the members of Supervisory Council appointed in 1997 will serve the office till their term expires. This amendment excluded the option of replacing members of Supervisory Council when the respective law was approved in December 1997.

4.2 Other factors affecting central bank independence.

As aforementioned, it is difficult to measure central bank independence in quantitative terms due to a number of factors, which cannot be measured. Following are listed some of these factors and their effect on Bank of Albania's independence:

i. Political Instability

It is believed that political instability affects central bank independence. Though it is not clear whether there is a strong correlation between the two, i.e. whether a

[35] During the last decade, in Albania, the majority of Parliament (as composed after elections of 1991, 1992, 1996 and 1997) was in the hands of only one political force.

higher instability means higher or lower degree of central bank independence, it is known that there is a correlation.

It is argued that the more politically unstable a country is (more frequent elections and changes in government) the less independent is its central bank since each groups that comes to power tries to appoint its representatives at key positions in administration. This is more obvious in highly polarized countries.

On the other hand, it is argued that when political forces in power notice that they will lose grounds, they try to strengthen the independence of state institutions, especially that of central bank so that it limits the influence of opposition if that one comes to power.

Disrespect for the rules of the political game and frequent changes in powers will lead to political instability, which strongly affects the central bank independence.

Albania has experienced both of the aforementioned scenarios that have had an impact on central bank independence. More or less, the situation has been politically unstable considering four elections and two referendums on Constitution held in a period of eight years (regular period for two elections to take place). Likewise, when the political group in power felt that it would soon lose, the main recurrent theme of the day was "rights of institutions and technocrats", including Bank of Albania. Generally, the political instability has reduced Albanian central bank independence.

ii. Financial market development

It is widely accepted that deep financial markets and a considerable level of financial intermediation leads to a higher central bank independence. The supervision of financial institutions is related to the central bank authority. The more developed the financial market, the more comprehensive central bank's authority and the higher its prestige. It is understood that independent central banks are more likely to exist in countries with developed financial markets than in those with underdeveloped markets.

In the case of Albania, independence of central bank is harmed by the lack of capital market and low level of intermediate transactions. Thus, financial sectors have a small role in economy and the central bank decisions do not give optimal solutions. Accordingly, central bank appears inferior compared to government.

iii. Internal Debt

Political groups are not interested in increasing central bank independence if the internal debt is large. First, there is a tendency not to pay debts owed by public through inflation, and this tendency strengthens the larger the internal debt is. Second, the greater the role of government as a debtor in financial markets, the lower is central bank independence.

Albania has a large internal debt, which limits its central bank independence (see Annex II, Table 12.)

iv. Operations in open market.

Central bank enjoys a higher independence if it is granted the ability and conditions to intervene sufficiently in the open market when need arises. If government securities are tradable, this ability of central bank is limited and also its independence.

In Albania, treasury bills issued by government (Ministry of Finance) turned into non-tradable instruments soon. Foreign banks were not interested to participate in the primary market, let alone in the secondary market, and thus only one bank is dominating the market accompanied by a restricted number of individuals. Furthermore, government asked banks to invest portfolios that were due. Consequently, banks were faced with non-liquid investments and lack of liquidity in the market. In order to avoid liquidity problems in banking system, Bank of Albania intervened by offering REPO-s or by purchasing securities from second-tier banks. The most extreme case has been that of four government obligations issued to cover the debts of agricultural cooperatives. Following the instructions of administration, these obligations were transferred to another state bank, which enjoyed a favorable liquid position. Soon, the bank had to offer these obligations in the secondary market and after unsuccessful attempts to sell them, the obligations were finally recorded in Bank of Albania balance sheet.

v. Advisory function.

In some countries, the duties of governor include that of government advisor for the economy. This allows the governor to address various issues related to employment or fiscal policies to government, regularly.

In Albania, Bank of Albania does not participate actively in formulating or suggesting policies not related to monetary issues. Although law acknowledges it as an active advisor for these issues, practically, Bank of Albania does not behave aggressively. A step forward was taken to improve its position and now the governor participates in the Economic Policies Committee, which is headed by Prime Minister.

vi. Public opposition to inflation.

Another important factor in determining central bank independence is public support to achieve price stability. It is believed that if public tends to oppose inflation, then central bank authority increases and its decisions find greater support. Consequently, central bank independence is higher. The conclusion is that central bank independence is related to public support in achieving price stability. Typical case in point is the behavior of German people. According to Issing (1993)[36] "It is not accidental that it is the Germans, who having experienced twice hyperinflation during the 20th century, have chosen the model of an independent bank engaged in maintaining price stability" Collective memory on past inflation affects the independence level that will be given to central bank in the future.

[36] Qt. in Guy, Debelle. *"Central Bank Independence: A Free Lunch?"* pg. 12.

Thus, it is noticed that after financial crises or high inflation periods the tendency to increase central bank independence is stronger. A similar pattern was noticed in Albania, as the revision of central bank law, among other things, in the end of 1997 was partly a reaction to high inflation and economic crisis that characterized Albania during the first half of 1997.

Is opposition to inflation present in Albania? Absolutely no. Neither by public opinion nor by financial institutions. Also, the mentality of Albanians, who economically exhausted are not willing to "sacrifice" welfare for future economic development of the country, plays a negative role. It is obvious that the attempts of Albanian authorities to maintain macroeconomic stability and low inflation in the past and now, are driven by the need to obtain agreements with international institutions, specially IMF, and obtain necessary financial support.

vii. Reputation and personality of central bank and government's officials

An effective independent central bank is a product of daily policies, institutional and personal interaction between officials of central bank and government, or more specifically with Ministry of Finance. Governor's personality and habits can affect central bank's behavior.

BoA's experience hints that personal characteristics of its governors and those of Ministers of Finance have affected the relations between the two institutions. Whether central bank has honored the independence level granted to it, can be seen at the language used in the correspondence with other institutions. If governor's character was stronger than that of Minister of Finance (or of any other member of government) the language used in the documents was more concise, clear and reserved. Otherwise, the language used was more submissive and overly polite. Personally, I think it should be considered a success the fact that BoA's governor could sign letters which say "According to the law "On Bank of Albania", it is Bank of Albania and not Ministry of ... the legitimate authority to determine the policies related to....

Such instructions interfere with Bank of Albania independence and competencies to fulfill its duties and objectives."[37]

Another factor, which points out the personality of BoA's governor, is the support that the party in power gives to officials. If the party in power supports the Minister of Finance, then the governor is more "docile" and vice-versa.

The issue of governor's personality and character gains a special importance in the case of Albania as the government tries to put pressure on central bank independence, though this independence is granted by law. The latest example is a decision from Council of Ministers, which disregards laws that regulate Bank of Albania activity and interferes in its wage policy. This is an obvious case of infringement of Bank of Albania's economic independence. Considering the lack of factors that could prohibit government to disturb central bank independence, the only thing that could face such situations is the governor – his/her character.

viii. Research Department at central bank

The research department provides central bank with the possibility to maintain a position independent from other economic research institutions in the public sector. Furthermore, it increases central bank importance as compared to Ministry of Finance and government in general. The Research Department at Bank of Albania was established in 1998. Unfortunately, we can not say that this department has been fully matured. From this point of view, Bank of Albania lacks an important element to increase its independence.

[37] The quote is extracted from a letter of correspondence. Based of principle of confidentiality, any reference to real names and issues has been excluded to avoid identification of this letter.

Other factors characterizing developing countries.

Considering the variety of differences among transition countries, the list of factors that affect central bank independence includes also:

* *Applied exchange rate regime.* If exchange rate regime is other than floating rate regime, central bank activity is conditioned by respective requirements and thus it is limited.

This limitation is not present in Albania as the latter applies floating exchange rate regime. Moreover, the law specifies that Bank of Albania is entitled to determine the exchange rate policy.

* *Bad loans.* Central banks were faced with a high volume of bad loans in their attempts to destroy planned economies and build new structures for market economy. Also, the lack of experience in business crediting added to the amount of bad loans. They reduce central bank independence. On one hand, it demands that banks comply with international standards and be efficient and business wise, and on the other hand, it has to indulge in "salvage" attempts to avoid the effects that banks which go bankrupt might have in the economy.

Same thing happened in Albania. The banking system has always been characterized by monopolistic banking activities; banks which have monopoly present the biggest problems with regards to bad loans, lack of capital, financial losses, etc. If central bank would have strictly followed the rules, it had to close down these banks and that would leave the country without a banking system, at least till two years ago. Faced with this possibility, Bank of Albania has implemented a program for reforming the banking system, allowing for some irregularities, and has provided problem banks with enough time to consolidate. On the other hand, government, aware of the problem has not reacted to the requirements of BoA for the solution of the problem thus, reducing the independent behavior of the central bank. (refer to Annex 2, table 12).

* *Financial system development.* Four characteristics of financial system are analyzed.

1. Are there any limitations on foreign banks, if the law treats them differently from domestic banks?

2. Is there a competitive financial system?

3. Is there a stock market, which can provide sufficient liquidity?

4. Is there a variety of financial instruments owned by the public?

The maturity of financial system (i.e. those where public ownership is considerable) means that public affects price stability; this increases central bank role in achieving the objective and also its independence. The reason for this is that public is more sensitive to changes in real interest rate if it owns a considerable share in financial market.

As mentioned above, financial market in Albania is in its first steps and public ownership, as well as financial instruments, are nonexistent. According to the law, all banks, no matter the origin of their capital, are treated equally in Albania. With regard to other three characteristics of financial system, it can be deducted that they reduce central bank independence. There is no competitiveness in the market, stock market is completely undeveloped and there are no financial instruments that public can invest in. For years, the best alternative in terms of finance (excluding Pyramid schemes) is bank deposits.

* *Foreign debt.* Large amounts of foreign debt increase the cost of transition. Consequently, political pressure on central bank in order to increase inflation and reduce restrictions imposed by foreign debt increases. This reduces central bank independence. Despite the large amount of foreign debt, Albania has not faced similar

problems that would reduce central bank independence, as the conditions for repaying foreign debt are very favorable (long-term maturity, low interest rate).

* *Lack of deposit guarantee.* Banking systems of transition countries are very unstable. Moreover, the lack of deposit guarantee schemes exposes central bank to the risks of saving banking system during banking crises. This provides opportunities to reduce central bank independence.

Albania does face such problem as the existence of deposit guarantee schemes is not yet approved, even in circumstances where entry of foreign capital in the market is large.

* *Need for foreign financing.* Transition economies need financial support from international community. This support will be granted if the beneficiary countries will meet certain conditions which serve as a guarantee to prevent misappropriation of funds. Also, it has been stated clearly that the higher the quality of guarantees, the more generous the international community will be. Generally, the conditions are such that they encourage beneficiary countries to build and consolidate institutions, including central bank, according to Western standards.

Being a country in need of foreign financing, Albania has come across such conditions, including the requirement for higher central bank independence. From our point of view, this type of foreign influence has a positive effect.

Other factors which reduce central bank independence

* *Legal initiative.* In accordance with the existing procedures, legal initiatives taken by Bank of Albania are not presented directly in the Parliament. Proposals for laws or amendments are sent to a ministry (depending on the nature of the law), usually to the Ministry of Finance. The ministry gives its suggestions in relation to the proposal and takes it for discussion to government. The same procedure is followed when the proposal is discussed by government, which in the end decides whether to

send the proposal in Parliament or not. Obviously, Bank of Albania lacks the possibility to communicate directly with the Parliament and finalize its legal initiatives. Moreover, it depends on the space the government is willing to provide.

* *Public relations.* Given an exaggerated feeling to keep bank confidentiality and maybe considering also the character of governors, Bank of Albania has behaved very rigidly, sometimes to extreme levels, in relations with public. The lack of communication with public and even with economists has added to reduction of central bank independence. Bank of Albania has not been able to create its lobbies among economists, legislators and politicians, in support of its independence. Consequently, government's attempts to harm central bank independence do not confront any resistance outside bank.

In general, it is believed that legal independence is not in tandem with real independence. Though from the legal point of view Bank of Albania's independence is considerably high, in real terms it scores at low levels. All the factors, which affect real independence as analyzed above, tend to reduce Bank of Albania's independence in general.

4.3. Central bank independence and inflation.

The main conclusion reached through empirical studies is that there is a negative correlation between central bank independence and inflation in developed countries as well as in developing ones. The experience of developed countries, like Germany, is often used as practical example to illustrate the conclusion. Studying developed countries, Cukierman[38] suggests that:

* The lower the central bank independence, the higher is the average level of inflation of a country; and

[38] Cukierman, Alex. Central Bank Strategy, Credibility, and Independence: Theory and Evidence. 1992, Chapter 18.

* The lower the central bank independence is, the bigger are the inflation changes in a country.

However, assuming that independence of central bank affects low inflation, it is not possible to reach a unique conclusion on the above point. Apparently, there are other things that determine the level of inflation, apart from central bank independence. This is more obvious in developing countries. Studies on transition countries point out the same idea, i.e. increase of central bank independence is positively related to low inflation levels. However, it should be noted that such conclusions do not hold true for every case. First of all, the implemented models consider a small number of countries over a short period of time and thus they can not be generalized. Second, transition economies are undergoing different phases of reforms and differences in their inflation rates may be affected by other factors.

Box 6 :

Peter Dittus, Bank for International Settlements, states that: "The belief that the more independent a central bank is the lower the inflation is, at least so far, an acceptable and promising hypotheses. But it needs to be explored in detail. Maybe, independence as well as low inflation can be explained by third factors. The citation, which has become a fashion of the German opposition to inflation due to hyperinflation however, seems very simple. Moreover, also other countries have experienced similar traumatic hyperinflation unable, apparently, to reach similar conclusions.... There are much more elements for understanding inflation in a given country than just knowing the level of its central bank independence.

Different authors argue that low inflation itself can affect the increase of central bank independence. Although the existence of an independent central bank is neither a sufficient nor a necessary condition to maintain price stability, it should be agreed with the theoretical and empirical studies stating that, in general, inflation rate will be lower in countries with an independent central bank rather than in those where the politicians formulate central bank policies. Therefore, it should be considered as positive the trend to give more independence to central banks noticed in some countries.

Latest studies conclude that every society has the central bank it deserves. This means that changing the law on central bank is not enough to guarantee low inflation rates. ***Only if central bank anti-inflation policies find considerable support, the inflation rate can be reduced for real[39].***

Posen[40] (1993) adds a third factor, ***"effective financial opposition to inflation" of a given country*** to explain the inverse relationship between inflation and central bank independence.

According to Posen, central bank will implement anti-inflation policies only if a coalition of political interests capable to protect such policies exists. In industrialized countries, it is the financial sector that represents this coalition. Financial opposition to inflation depends from four factors:

1. In countries with a financial sector involved in universal banking operations, the opposition to inflation is stronger compared with countries that lack such sector;

2. Countries where central bank exerts less control on financial sector are expected to be more against inflation. It is so because banks utilize their political capital to confront or change regulations and thus they find themselves in opposition with central bank;

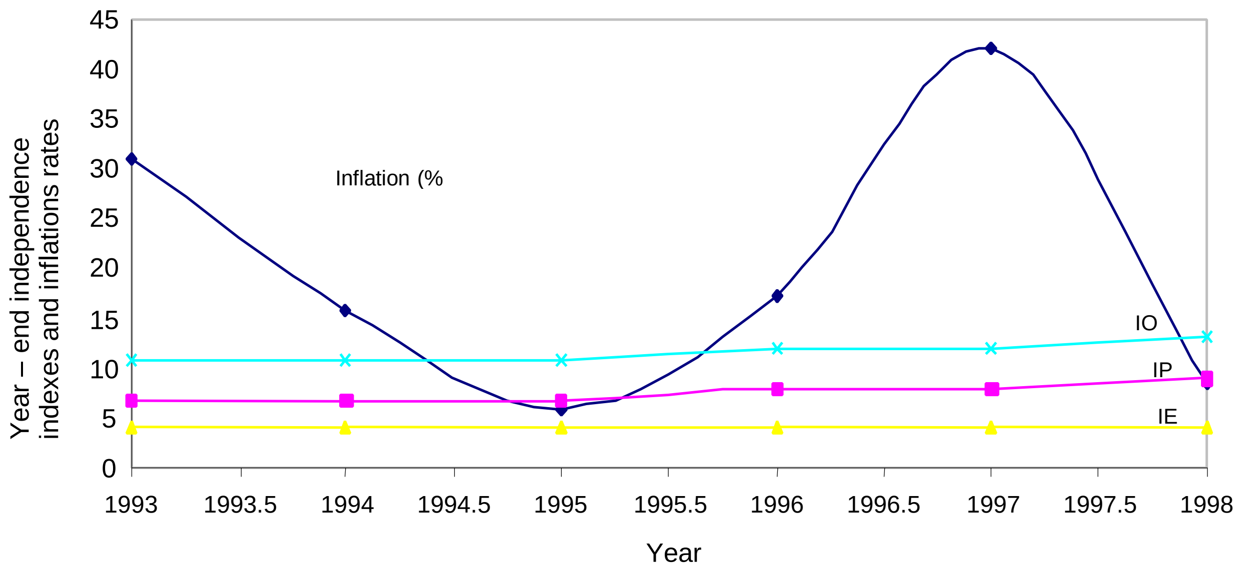
3. Countries ruled by federal government are expected to have a more efficient opposition to inflation;

4. Countries with small political fragmentation are expected to have a more effective opposition to inflation.

[39] Qt. in Eijfinger, Sylvester and Jacob de Haan. *"The political Economy of Central Bank Independence"*
[40] Qt. in Eijfinger, Sylvester and Jacob de Haan. *"The political Economy of Central Bank Independence"*

In addition, Posen[41] states his opinion that ***in less developed countries, financial sector opposition to inflation is weaker and this is a matter of interest clashes rather than institutions. Accordingly, giving more independence to central bank, per se, does not necessarily lead to price stability.*** For this reason, reformers emphasize implementation of policies such as privatization and financial deregulation. This will lead to lower inflation rate and increased central bank independence. In case of Albania, the correlation between central bank and inflation rate is not very strong. Looking at table 12 (Annex 2), it is noticed that 1992 law grants a considerable level independence to Bank of Albania. Inflation progress during 1992-1995 proves that higher central bank independence is followed by lower inflation. Annual inflation rate for this period tends to decline. In 1996, when another law that increases central bank independence was approved (the amendment approved at the beginning of the year) inflation changed in opposite direction. Annual rate increased considerably during 1996 and especially during 1997 as a result of other factors. Thus, statistical results for Albania do not make much sense due to a small number of observations over short time periods and effects of other factors such as crises (1997), local and central elections (1996) which distorted budget structure, pyramid schemes (1995-1996), the beginning of economic reforms, etc.

Bank of Albania independence and inflation



[41] Qt. in Mas. Ignacio. *"Central Bank Independence: A critical view"*, WP/World Bank, no. 1359, September 1994, pg. 10.

In addition, Albanian financial sector does not strongly oppose inflation. Financial system in Albania includes a group of banks, which are considered universal by law. However, this system plays a small role and financial intermediary activity is at low levels; currency outside banks is at high levels; revenues are indexed to inflation (refer to Annex 2, table 12).

Regulations implemented by Bank of Albania to manage banking system have not acted in favor of opposition to inflation. It is assumed that these regulations do not fully comply with international standards. As such, they are expected to increase rather than decrease the “burden”. Implementation of monetary policy is based on direct instruments like credit limitations, which involves banks as well. Bank’s public ownership allows government to interfere in the financial system of the country. The degree to which government interferes can be easily imagined considering the considerable share that state owned banks have in the banking system (banking system is practically defined through state owned banks). As a rule of thumb, in such system banks neglect the traditional crediting and replace it with speculations in exchange rate or tangible assets. In recent years, Albanian banking system has “given up” lending activity, specially the long-term one. State owned banks concentrate on Treasury Bill investments (government securities with maximum maturity of 12 months), while other banks operate in services (exchange, transfer of payments) and deposit their assets in foreign bank accounts.

When decisions are made from centralized structures of government or fragmented political parties or a single fragmented party, it is unlikely that financial sector opposition to inflation will have a lasting effect. Political fragmentation and frequent changes in government diminish banks’ initiatives to “invest in their opposition to inflation”. Also, it is stated that low inflation and independent central banks are present in countries where there is:

* Solid political consequence that objects inflation.
* A more stable and advantageous political system.
* Central bank with higher reputation.

* Conservative fiscal policies and a more responsible government.

All the above mentioned factors act negatively in Albania. Apparently there is no political stability and the existing political system does not seem to assist in keeping inflation at low levels. Attempts to escape engagements with international organizations are made as soon as the occasion rises.

When inflation reaches levels of hyperinflation, giving more independence to central bank without additional concessions is not sufficient to restore price stability. Only the monetary policy can be successful in maintaining price stability over medium-term periods. During short-term periods, the effect of non-monetary related developments is more determinant. Dr. Duisenberg[42], president of European Central Bank, states in a speech held at Central Bank of Poland in May 4, 1999, that monetary policy measures have an impact on prices with long, variable and not entirely predictable time-lags of between 1.5 and 2 years. Furthermore, he emphasizes that monetary policy should be supported by sound budgetary policies and wage developments in line with productivity growth and taking into account price stability objectives. Also, he states that monetary policy cannot be utilized as a tool to solve structural problems, such as the high level of unemployment, etc.

Thus, **central bank independence is more effective as a preventing rather than adjusting instrument**. (Cukierman 1996)[43]. When inflation is in a rapidly changing process, attempts to adjust it should not be left in the hands of central bank only, but they should involve active participation of government and other institutions, as well as willingness to give up some policies in certain areas. As soon as price stability is restored and expectations can be more easily determined, central bank effectiveness as a "guard" will be re-established. It should be remembered that it is easier to prevent rather than cure high inflation. Consequently, the central bank independence as a impeding instrument is always emphasized.

[42] Bank for International Settlements, BIS Review, No. 49, Basle, May 6, 1999, pg.4.

[43] Qt. in Maliszewski, . "Central Bank Independence in Transition Economies". Center for Social and Economic Research, Warsaw, December 1997.

Various scholars have concluded that there is a strong positive correlation between higher bank independence and lower inflation in developed countries. This correlation exists even in developing or transition countries, but it is not that significant. Here, inflation is affected by other factors that have a crucial influence in unstable or changing economies. For this reason, central bank independence does not necessarily lead to low inflation. In order to prove this hypothesis, level of central bank independence should be associated with financial sector opposition to inflation, sound fiscal and wage policies. Monetary policy should not be considered as a tool for structural adjustments. Its effects are felt over medium-term periods. This does not mean that we should give up central bank independence. This element serves as a preventing instrument for high inflation rates.

Albania is one of transition countries where the correlation between central bank independence and inflation is not very strong. Developments in inflation have been affected by other factors different from one year to another. However, the trend to increase central bank independence will show its effects over medium-term periods.

5. CONCLUDING REMARKS

5.1. Conclusions.

This paper tries to examine issues related to central bank independence from the theoretical point of view and to compare those with Bank of Albania's experience and that of other central banks. The conclusions drawn by this analysis are:

1. **From a legal perspective, Bank of Albania enjoys a considerable degree of independence.** It is defined as an independent institution and it is given the respective legal space to act accordingly. The legal independence provided to Bank of Albania is also proved by the relatively high values of indices used to measure it. These values list Albania in a favorable position compared to other central banks. Based on 1997 law, Albania ranks sixth in the Cuikerman's list. However, because of the differences in legislation over different periods of time, it is more meaningful that Albania be compared with central banks of transition economies. Based on 1997 law, Albania is listed after the central bank of Czech Republic.

Legally, Bank of Albania is recognized an independence which is not the maximum one possible considering the traditions and time. However, the goal is to increase central bank independence in the future whenever possible.

2. The 1992 law gave Bank of Albania a favorable legal status. **During this decade, the increase (consolidation) of legal independence was the main trend.** Values of indices based on laws on central bank approved in 1992, 1996 and 1997 have increased.

3. The change in values of indices for 1996 and 1992 is bigger than the difference of 1997 and 1996 values. This means that **the law approved in 1996 reflects qualitative changes with an impact on increasing central bank independence**. It included new elements compared to the law of 1992, one of which is

the main objective. The law approved in 1997 was rather a revision of 1996 law to fix and clarify ambiguous clauses, to avoid the repetition of August 1997 event and to do away with the 1996 law inefficiency to prevent the crisis of mid-1997. Furthermore, the approval of constitutional article for Bank of Albania did not bring the expected development with regard to strengthening central bank independence.

4. Different indices have shown different results. This does not necessarily imply that there is a contradiction of results, but that different indices are used to show different aspects of central bank independence.

The index of economic independence ranks Albania in a less favorable position compared to the index of political independence and in turn, the improvement of laws did not affect any improvement in economic independence. Perhaps, this means that **the purpose of approving new laws on central bank was to change and adjust clauses and avoid political interference in central bank decisions. The central bank was more sensitive to the risk of such interference.**

5. In general, it might be concluded that legal independence is not the same as real independence. This conclusion is reflected in the case of central bank of Albania. **Though from the legal point of view, Bank of Albania enjoys a considerable independence, unfortunately its real independence scores low.**

Governor's turnover rate is high. Five governors have been appointed during one official term. According to Cukierman index, Bank of Albania ranks one before the last, thus losing the favorable position as per legal independence index. Other factors, which affect central bank independence as mentioned above, act negatively in the case of Albania. Leaving aside those objective factors which do not depend on central bank of Albania or other state institutions, such as financial sector development, **the executive has not been willing to honor central bank independence** during the last seven years. Continuously, the executive has tried to interfere in central bank policies through various means, such as through the application of various laws and decrees or through proposing members of Supervisory Council. Likewise, it is noted that **when a**

given political group strengthens its position in power, the pressure to reduce central bank independence increases.

Lack of opposition from public and financial sector as well as politicians' unwillingness to follow the "rules of the game" facilitates interventions in Bank of Albania's policies. **The trinity "legislative-presidential-executive power" in the last decade was represented by the same political party and thus it has been easier to undertake actions that reduce central bank independence.** In order to prove this assumption, it is sufficient to recall how easily banking legislation can be changed by parliament. This implies that **Bank of Albania's legal independence is practically at hazard** and, in an extreme case, it can be reduced to a minimal level if the parliament votes unanimously.

Other factors that erode central bank independence are related to bank's insufficient transparency of its policies, limited relationships with the public, not very good research.

6. **Actual legal independence level of Bank of Albania and the provision of a certain real independence for it are ensured by "IMF factor", among other things.**

7. **Albania is listed among countries where the correlation between inflation and central bank independence is not strong.** Inflation rates are caused by other factors, which from BoA's point of view are considered "external". Almost each year had its own specific nickname like, "election year", "crisis year", "war year", "pyramids year", etc. and the inflation rate was affected by unexpected factors not present in the following periods. Nevertheless, central bank independence will show its effects in the medium-term.

5.2 What we propose.

Two main proposals can be made:

I. **Increase legal independence of Bank of Albania.**

II. **Increase real independence of Bank of Albania in accordance with its legal independence.**

These proposals are presented in detail as follows:

As aforementioned, in general Bank of Albania is given a considerable legal independence. This independence is not at a maximum level but it is still satisfactory considering the tradition of Albanian institutions and “life-span” of Bank of Albania (this bank has been devised and built as a central bank during this decade). So, Bank of Albania should increase its legal independence. The increase should come through approving other amendments that complete the banking legislation with those elements that are not mentioned in Albanian legislation and that take the value of zero or close to zero when used in indices. Likewise, it is necessary to improve some other important factors in legal independence of a bank, but which are not clear or far from the satisfactory level in the case of Albania.

Law adjustments are necessary in view of the contradiction between the constitution and the law “On Bank of Albania” which allows for opportunities to reduce BoA’s independence.

The most appropriate step to take would be to change article 161 of Constitution which speaks of Bank of Albania. This article, should at least have included concepts such as: “Central Bank is a politically independent institution (or an institution which acts independently and the framework within which Bank of Albania would act independently should be defined by law)” and “Bank of Albania is the authority responsible for country’s monetary policy”. Practically, it is hard to change the article, so the other alternative is to define specifically these concepts in the law “On Bank of Albania”. First of all, the revision of this law should increase BoA’s existing level of independence and not defeat it. The amendments should be proposed considering this point of view. However, it should be noted that no matter how accurate and comprehensive the law is, the risk of reducing central bank independence can not be totally avoided. This uncertainty originates from the structure of Constitution and the way it is formulated.

First, the clause which settles conflicts between central bank and executive should be defined. The description in the existing law, article 30[44], is evasive and does not guarantee that the solution to the conflict on Bank of Albania's lending to government will honor bank's independence. Also, the political conflict with the government with regard to monetary policy is not limited in the issues related to crediting the government only.

The new clause should specify that in case of a political contradiction between central bank and government, BoA has the last word. This attitude would imply maximum respect for central bank independence. Another alternative would be that government has the last word but in this case, this approach should be publicly declared and central bank should be released of any responsibility.

The second group of clauses that need adjustment is the one that deals with issues on central bank loans to government. It is clear that the objective of these clauses should be: Central bank should not finance government. However, considering the development of financial sector in Albania, it is unacceptable to prevent this kind of financing. The objective should be that of gradually limiting the space for government's loaning. First, a maximum level of loan set at 5% of average annual budget revenues is acceptable. Second, it should not be aimed at achieving this target or allowing to exceed it. The clause that states that credit could be given only to central government represented by Ministry of Finance should be included again. Also, another step toward increasing central bank independence is to change the method of calculating the maximum level of loan to government.

[44] Paragraphs 5, 6 and 7 state that in outstanding circumstances Bank of Albania can exceed the limits of its loans to government if this action does not contradict with the main objective of monetary policy. However, in no way can this financing exceed the limit of 8% of average annual budget revenue. If Bank of Albania exceeds this limit, then it should report to the Parliament on the causes of its actions and its recommendations. The parliament decides accordingly.

The amendments can specify either a lump sum that can be given as a loan to government in the course of a year, or this amount can be calculated as a ration on central bank's liabilities. Last, but not least, the law should legalize what Bank of Albania is actually doing, preventing government from borrowing in the primary market.

Main attention should be given to increase real independence in accordance with legal independence. It is natural that the first proposal to be made is that **EACH PARTY STRICKLY FOLLOWS THE LAWS.** If the existing laws would be strictly respected despite of their deficiencies, the level of central bank real independence would be higher. This requires the development of a law-friendly feeling and an obedience to the rules of the game giving up the concept of "control on everything". Of course, this requires a higher level of civil education in the Albanian society in general. In this respect, lowering the rate of legislation changes for Bank of Albania would be a good indicator.

Box 7

Goodhart (1994)[45] emphasizes: "The independence given to central bank can be stored and used effectively only through a continuous and fierce political and educational campaign to explain what can and cannot do the monetary policy.

Overall, financial sector development and political stability are other factors, which affect the increase of central bank real independence. But these factors are, to some extend, uncontrollable from Bank of Albania and government. The reduction of internal and external debts increases independence. It is government's responsibility to strengthen fiscal discipline and to reduce the demand for support in financing its deficits as well as building up high debts. Internal debt will be reduced if Bank of Albania applies more severe rules in financing government and if the banking system is restructured. A private banking system, or a system where state ownership is reduced considerably, will limit government intervention in the banking activity and usage of state owned banks as government's pockets.

[45] Qt. in Ignacio Mas. Central Bank Independence: A Critical View, pg. 34.

It is concluded that the small role of banking system in Albanian economy, its problems, and it limited possibilities to operate in the open market reduce central bank independence.

Obviously, Bank of Albania alone can not solve all problems. Government has a major role in carrying out the necessary steps to reform the banking system and that mostly implies reforming state owned banks. Bank of Albania can intervene through strengthening its position as a Supervisory authority, thus being a preventing rather than “curing” or “adjusting” instrument. Another active instrument might be bank-licensing policy followed by Bank of Albania. Now, Albanian banking system accommodates 12 banks, 83% of which have pure foreign capital or are in foreign partnership. Foreign capital accounts for 48% of total capital in the banking system. Another bank financed only with foreign capital is expected to start operating soon (this bank has been granted a license from the Bank of Albania already) and the National Commercial Bank is expected to be privatized. Its owners are identified already as foreigners (banks or companies). These facts are mentioned to illustrate foreign share in Albanian banking system. This share will increase after Savings Bank, the largest bank of the country, is privatized. The period when Albania was “hungry” for foreign banks has long passed. Bank of Albania’s policy should be directed in licensing fewer banks, which promise the vitalization of banking activities and their expansion beyond the capital city as well as the consolidation of banking system. This would encourage the enlargement of financial intermediary means in economy.

Improvements should be made with respect to public relations, which implies written (Bank’s publications) and verbal (press conferences, interviews) communication. A new concept and appropriate structures should be developed inside central bank. Although with regards to publications, Bank of Albania has issued some of them (their quality and appearance needs further improvements) with regards to verbal communication there are still some steps to cross. It would be of interest to establish a unit responsible for media relations (print and electronic media); to increase the number of statements on monetary policy and other issues related to Bank of Albania; to increase transparency by communicating decisions from Bank management (such as the calendar of meetings of Supervisory Council, topics for discussions, decisions and the respective notes, etc. Details on this are not subject of this paper and therefore they will be discussed elsewhere). This would help creating an environment which will first understand what is a central bank and what are its duties and then will be interested in central bank's policies and in supporting them. Thus, Bank of Albania should try to build its own "electorate" which will support bank's policies and will act as factor in ensuring its independence.

It is believed that the increase of central bank independence level will be followed by a higher quality and transparency of its work. Higher independence will be associated with higher bank's responsibility in decision taking and policy making.

ANNEX I

CALCULATING CUKIERMAN LEGAL INDEPENDENCE INDEX

I. METHOD FOR MEASURING THE INDEX

Legal independence index is measured based only on the information provided by the law on central bank (statute, license). According to their legal characteristics, all elements are grouped in four variables:

* The variable which deals with the appointment, dismissal and term of office of central bank top executives (usually this involves only the governor). The definition for this variable is **CEO.**

* The variable which deals with resolution of conflicts between central bank and executive branch and central bank role in formulating monetary policy and government's budget. The definition of the variable is **PF**.

* The variable, which deals with central bank objectives as, defied by the respective law. The definition for this variable is **OBJ**.

* The variable which deals with limitations on lending to government such as restrictions on the volume of loan, maturity period, applied interest rate, specification of segments of government eligible to borrow from central bank. The definition of the variable is **LL**.

There four variables include 16 elements and their respective coding. Each of these elements is assessed quantitatively depending on the level of independence each represents. The higher the level of independence, the higher the numerical value assigned to the element. Each element is assigned a value between 0 and1, where 0 represents the lowest level of independence and 1 the highest.

In case one of the variables is compounded by *n* elements, then coding for each of them is determined by dividing 1 by (*n*-1) as one of the elements will have the value 0. For example, if a variable has four elements, than, the one representing the lowest level of independence gets the value of 0 and the additional value for each of the other elements is 0.33 [calculated as 1/3 (4-1)]. So, the second element will have the value of 0.33; the third will have 0.63; and the element that represents the highest level of independence will get the value of 1.

Following the method described below, the sixteen elements are aggregated into eight elements:

* Variable **CEO** is composed of four elements. The aggregate value of these is calculated as the arithmetic average of their values.

* Variable **PF** is composed of three elements. Their aggregate value is calculated as the weighted average of their values. Weighted coefficients are 0.5 for *conf* and 0.25 for each of the elements *monpol* and *adv*.

* Variable **OBJ** has only one element and its value is equal with the value of the element.

* Variable LL has eight elements. The aggregate value of only four of these elements is calculated as the arithmetic average of their values. The other four elements, *ltype, lmat, lint* and *lprm*, are found as an aggregate value in *lm*.

A variable, which contains one or more elements specified as not available (N/A), is aggregated based on the significant elements. In this case, the weights of those elements for which the coefficient does not make sense is proportionally spread over other elements of the variable.

Legal independence level of central bank is measured after a second aggregation process. The final product is Legal Independence Index of the country subject to consideration during a given period of time.

From the first process derives the aggregated value of eight elements in two indices on legal independence.

The first index is coded as **LVAU** and it is expressed as the average of values of the eight elements.

The second index coded as **LVAW** is expressed as weighted average of its elements. If any of the elements is specified as not-available, its weight is proportionally spread over other elements.

II. VARIABLES, ELEMENTS, NUMERICAL CODINGS AND COEFFICIENTS

Table 1. Legal Variable CEO and its coding.

Definition of Elements	**Element's coding**	**Level of independence and its meaning**
Term of office of governor in years	*Too*	1. *too* $\geq$ 8
		2. 8 > *too* $\geq$ 6
		3. *too* = 5
		4. *too* = 4
		5. *too* < 4
Who appoints the governor?	*App*	1. Governor appointed by CB board
		2. Governor appointed by council composed of members from the executi legislative branches as well as from CB board
		3. Governor appointed by legislative branch (congress, king)
		4. Governor appointed by executive branch (council of ministers)
		5. Governor appointed through decision of one or two members of executi branch (e.g., prime minister or minister of finance)
Provisions for dismissal of governor	*Diss*	1. No provision for dismissal
		2. Dismissal possible only for non-policy reasons (e.g. incapability or viola law)
		3. Dismissal possible and at discretion of central bank board
		4. Dismissal for policy reasons at legislative branch's discretion
		5. Unconditional dismissal possible at legislative branch's discretion
		6. Dismissal for policy reasons at executive branch's discretion
		7. Unconditional dismissal possible at executive branch's discretion
Is governor allowed to hold another office?	*Off*	1. Governor prohibited by law from holding any other office in government
		2. Governor not allowed to hold any other office in government unless aut by executive branch
		3. Law does not prohibit governor from holding another office

Table 2. Legal variable PF and its coding.

Definition of Elements	Element's coding	Level of independence and its meaning
Who formulates monetary policy	*Monpol*	1. Central bank alone has authority to formulate monetary policy
		2. Central bank participates in formulation of monetary policy together witl government
		3. Central bank participates in formulation of monetary policy in an advisoı capacity
		4. Government alone formulates monetary policy
Government directives and resolution of conflict	*Conf*	1. Central bank given final authority over issues clearly defined in the law objectives
		2. Government has final authority only over policy issues that have not be clearly defined as CB goals or in case of conflict within CB
		3. In case of conflict final decision up to a council whose members are froı legislative branch and executive branch
		4. Legislative branch has final authority on policy issues
		5. Executive branch has final authority on policy issues, but it is subject to possible process and disapproval from CB
		6. Executive branch has unconditional authority over policy
Is CB given an active role in the formulation of government's budget?	*Adv*	1. Yes
		2. No

Table 3. Legal variable OBJ and its coding.

Definition of Elements	Element's coding	Level of independence and its meaning
Central bank objectives	*obj*	1. Price stability mentioned as the only or major goal, and in case of confli government CB has final authority to pursue policies aimed at achieving th
		2. Price stability mentioned as the only goal
		3. Price stability mentioned along with other objectives that do not seem t conflict with price stability (e.g., stable banking)
		4. Price stability mentioned with a number of potentially conflicting goals (employment)
		5. CB charter does not contain any objective for CB
		6. Some goals appear in the charter, but price stability not one of them

Table 4. Legal variable LL and its coding.

Definition of Elements	Element's coding	Level of independence and its meaning
Limitations on advances	*lla*	1. Advances to government prohibited
		2. Advances permitted but subject to limits in terms of absolute cash amou to other types of relatively strict limits (e.g., up to 15% of government rever
		3. Advances subject to relatively accommodative limits (e.g., advances ca exceed 15% of government revenues or are specified as fractions of gover expenditures
		4. No legal limits on advances; their quantity subject to periodic negotiatio between government and CB
Limitations on securitized lending	*lls*	Specifications of level identical to those for advances
Who decides control of terms of lending?	*ldec*	1. CB controls terms and conditions of government borrowing from it
		2. Terms of CB lending specified in the law, or CB given legal authority to these terms
		3. Law leaves the decision about the terms of CB lending to government t negotiations between CB and executive branch
		4. Executive branch alone decides the terms of CB lending to government imposes them on CB
How wide is the circle of potential borrowers from CB?	*lwidth*	1. Only central government can borrow from CB
		2. Central and state government and political subdivisions can borrow fror
		3. In addition to the institutions mentioned under 2 public enterprises can l from CB
		4. CB can lend to all of the above as well as to the private sector
Type of limit when such limit exist	*ltype*	1. Limit specified as an absolute amount
		2. Limit specified as percentage of CB capital or other liabilities
		3. Limit specified as a percentage of government revenues
		4. Limit specified as a percentage of government expenditures

Definition of Elements	Element's coding	Level of independence and its meaning
Maturity of loans	*lmat*	1. Maturity of CB loans limited to a maximum of 6 months
		2. Maturity of CB loans limited to a maximum of one year
		3. Maturity of CB loans limited to a maximum of more that one year
		4. No legal upper bounds on the maturity of CB loans
Restrictions on interest rates	*lint*	1. Interest rate on CB loans must be at market rate
		2. Interest rate on CB loans to government cannot be lower than a certain
		3. Interest rate on CB loans cannot exceed a certain ceiling
		4. No explicit legal provisions regarding the interest rate charge on govern borrowing from the CB
		5. Law stipulates no interest rate charge on government's borrowing from
Prohibition on lending in primary market	*lprm*	1. CB prohibited from buying government securities in primary market
		2. CB not prohibited from buying government securities in primary market

Table 5. Weights used in the construction of the index *LVAW* of legal CB independence.

Legal Variable	Weight
Ceo	0.20
Pf	0.15
Obj	0.15
Lla	0.10
Lls	0.10
Ldec	0.05
Lwidth	0.10
Lm	0.15
	1.00

RANKING OF CENTRAL BANKS BY OVERALL LEGAL INDEPENDENCE DURING THE 1980s (Cukierman)

Table 6. Ranking of central banks as measured by *LVAU.*

Country	*LVAU*	Average yearly inflation	Country	*LVAU*	Average yearly inflation
Switzerland	0.68	3	India	0.33	9
West Germany	0.66	3	Indonesia	0.32	10
Austria	0.58	4	Britain	0.31	7
Egypt	0.53	17	Zambia	0.31	28
Greece	0.51	19	Australia	0.31	8
United States	0.51	5	South Africa	0.30	15
Chile	0.49	21	China	0.29	8
Tanzania	0.48	31	Romania	0.29	4
Ethiopia	0.47	4	Ghana	0.28	44
Denmark	0.47	7	France	0.28	7
Canada	0.46	6	Western Samoa	0.28	8
Bahamas	0.45	6	Sweden	0.27	8
Malta	0.45	3	Singapore	0.27	3
Kenya	0.44	11	Finland	0.27	7
Argentina	0.44	319	New Zealand	0.27	12
Turkey	0.44	50	Thailand	0.26	6
Peru	0.43	194	Brazil	0.26	230
Israel	0.42	105	Nepal	0.25	11
Costa Rica	0.42	25	Bolivia	0.25	230
Netherlands	0.42	3	Hungary	0.24	9
Philippines	0.42	14	Zimbabwe	0.23	13
Nicaragua	0.42	258	South Korea	0.23	8
Honduras	0.41	7	Italy	0.22	11
Zaire	0.41	58	Uruguay	0.22	56
Barbados	0.40	7	Spain	0.21	10
Ireland	0.39	9	Pakistan	0.19	7
Venezuela	0.37	21	Belgium	0.19	5
Uganda	0.37	105	Qatar	0.18	4
Luxembourg	0.37	5	Morocco	0.16	8
Botswana	0.36	11	Japan	0.16	3
Iceland	0.36	38	Panama	0.16	3
Mexico	0.36	65	Norway	0.14	8
Malaysia	0.34	4	Yugoslavia	0.13	108
Nigeria	0.33	19	Poland	0.10	43

Note: Inflation is measured as the yearly geometric average during the 1980s and is rounded to nearest full percentage.

Source: “Central bank strategy, credibility and independence: theory and evidence”, Alex Cukierman, pg. 381.

Table 7. Ranking of central banks by average legal independence (as measured by *LVAU*) during the 1980s in developed countries.

Country	*LVAU*	Average yearly inflation
Switzerland	0.68	3
West Germany	0.66	3
Austria	0.58	4
United Sates	0.51	5
Denmark	0.47	7
Canada	0.46	6
Netherlands	0.42	3
Ireland	0.39	9
Luxembourg	0.37	5
Iceland	0.36	38
Britain	0.31	7
Australia	0.31	8
France	0.28	7
Sweden	0.27	8
Finland	0.27	7
New Zealand	0.27	12
Italy	0.22	11
Spain	0.21	10
Belgium	0.19	5
Japan	0.16	3
Norway	0.14	8

Source: “Central bank strategy, credibility and independence: theory and evidence” Alex Cukierman, pg. 382.

Table 8: CB governors' turnover rates 1950-1989 (average number of changes per annum)

Developed countries		Developing countries	
Country	Turnover rate	Country	Turnover rate
Iceland	0.03	Malaysia	0.13
Netherlands	0.05	Honduras	0.13
Denmark	0.05	Zimbabwe	0.15
Luxembourg	0.08	Barbados	0.11
Norway	0.08	Philippines	0.13
Italy	0.08	Tanzania	0.13
Britain	0.10	Israel	0.14
Canada	0.10	Nigeria	0.19
West Germany	0.10	Kenya	0.17
United States	0.13	Greece	0.18
Finland	0.13	South Africa	0.10
Belgium	0.13	Hungary	0.18
Switzerland	0.13	Lebanon	0.19
Sweden	0.15	Bahamas	0.19
Ireland	0.15	Mexico	0.15
France	0.15	Romania	0.20
New Zealand	0.15	Colombia	0.20
Japan	0.20	Thailand	0.20
Spain	0.20	Zaire	0.23
		Yugoslavia	0.23
		Panama	0.24
		Ghana	0.28
		Malta	0.28
		Venezuela	0.30
		Egypt	0.31
		India	0.33
		Peru	0.33
		Uganda	0.34
		Zambia	0.38
		Singapore	0.37
		Ethiopia	0.20
		Chile	0.45
		Botswana	0.41
		China	0.34
		Turkey	0.40
		South Korea	0.43
		Uruguay	0.48
		Costa Rica	0.58
		Argentina	0.93

Source: "Central bank strategy, credibility and independence: theory and evidence" Alex Cukierman, pg. 382.

ANNEX 2

MEASURING INDICATORS OF POLITICAL AND ECONOMIC INDEPENDENCE FOR CENTRAL BANK

I. GMT Index

GMT Index is named after the first letters of the names of its creators. Grill, Masciandaro and Tabellin (1991) are focused on political and economic independence of central bank. Thus, GMT Index is composed of two parts, political independence and economic independence.

According to authors' opinions, political independence is defined as the ability of central bank to select its final monetary policy objectives. Political independence is affected by three main factors:

* relations between central bank and government in formulating monetary policy
* procedures for appointing members of the council and
* central bank's monetary policy objective

These three elements are expressed in eight criteria:

1. Does the executive appoint the governor?
2. Is the governor appointed for a period of more than five years?
3. Are all the members of policy-making council not appointed by government?
4. Are the members of policy-making council appointed for a period of more than five years?

5. Is the government obliged to participate in the policy-making council?
6. Is government's approval on monetary policy necessary?
7. Does central bank have a legal obligation to follow monetary stability as one of its objectives?
8. Is there any legal provision which support central bank in case of conflicts with government?

Political independence is measured as the sum of these eight factors which have the same weight.

Economic independence is defined as the ability of central bank to select instruments of monetary policy. It is assumed that this variable is affected by legal restrictions on lending to government and who has the Supervisory authority. It is assessed that central bank independence is higher if the restrictions on lending are stronger, the loan is temporary, non-automatic and based on market rates. Besides, central bank independence increases if the bank itself defines discount rate, does not participate in primary market and does not engage in supervision of commercial banks.

The criteria to measure economic independence are as following:

1. Direct lending is not automatic
2. Direct lending is based on market rates.
3. Direct lending is temporary
4. Direct lending occurs in limited amounts.
5. Central bank does not participate in primary market for public loan.
6. Discount rate is defined by central bank.

7. Central bank is not the banking Supervisory authority.

8. Central bank is not the only banking Supervisory authority.

The index on political, economic and overall independence of central bank constructed by Wojciech Makiszewski is based on GMT index. He has built a model including 14 ex-socialist countries. Six of these are ex-Soviet republics (Belarus, Georgia, Khyrkistan, Lithuania, Russia and Ukraine) and the other six are countries in Central Europe (Bulgaria, Croatia, Czech Republic, Slovakia, Poland, Hungary, Romania and Slovenia).

The difference with GMT index is that:

First, different criteria apply to evaluate the procedures for governor's appointment. If it is the president who appoints, the variable takes the value of two, if it is the parliament, it takes the value of one and if it is the government it takes no value. The removal is made considering the economic features of transition such as populism and anti-reformation attitude of certain legislators.

Second, it is assumed that central bank is more independent if the clauses defining dismissal of members of council are non-policy related (such as, losing the ability to work or performing any criminal action). This element is added to political index. Political pressure on bank's administration will more probably influence members of council if they can be easily replaced from their offices.

Third, the political index considers the approval of monetary policy from government or parliament as a restriction of central bank independence.

Fourth, economic independence of central bank is higher if the bank applies market rates or base rate when lending to government. (index GMT presumes only the market rate).

Criteria followed to assess independence of economies in transition are as follows:

A. Political independence index

G1: Governor is appointed from government (-); governor is appointed from parliament (*); government is appointed from president (**).

G2: Governor is appointed for more than five years (*).

B3: None of the members of council is appointed from government (*).

B4: Members of council are appointed for more than five years (*).

B5: Clauses which define governor's dismissal are non-policy related (*).

R6: There are no obligatory government members in the council (*).

R7: The approval of monetary policy from government or parliament is not required (*).

C8: There is legal responsibility to attend monetary stability (*).

C9: There are clauses which support central bank in conflict resolutions with government (*).

Political independence index is the sum of values of these nine elements. The maximum value of the index is 10.

B. Economic independence index

D1: Direct lending is not automatic (*).

D2: Direct lending is based on market rates (or base rates of central bank) (*).

D3: Direct lending is temporary (*).

D4: Direct lending is for a limited amount (*).

D5: Central bank does not participate in primary market of debt to public. (*)

M6: Discount rate is determined by central bank (*).

M7: Supervision of commercial banks is not a function of central bank (**); it is a function of central bank and other institution (*); it is a function of central bank only (-).

The economic independence index is the sum of values of these seven elements. The maximum value of the index is 8.

C. Overall independence index

Overall independence index is the sum of political independence and economic independence. Its maximum value is 18.

Table 9. Political independence index for transition economies (1996)

Country	G1	G2	B3	B4	B5	R6	R7	C8	C9	**PI**
Belarus	*	*	*			*				**4**
Bulgaria	*		*			*	*	*		**5**
Croatia	*	*	*	*		*	*	*		**7**
Czech Republic	**	*	*	*	*	*	*	*		**9**
Georgia	**	*	*	*		*		*		**7**
Hungary		*			*		*	*		**4**
Kyrghyzstan	**				*			*		**4**
Lethonia	*	*	*	*	*		*	*		**7**
Poland	**	*	*		*	*		*		**7**
Romania		*		*		*	*	*		**5**
Russia	**		*		*			*	*	**6**
Slovak Republic		*		*	*	*	*	*		**6**
Slovenia	**	*	*	*		*	*	*		**8**
Ukraine	*		*			*				**3**

Source: “Central Bank Independence in Transition Economies”, Wojciech Maliszewski, pg. 22.

Table 10. Economic independence index for transition economies (1996)

Country	D1	D2	D3	D4	D5	M6	M7	**EI**
Belarus	*		*			*		**3**
Bulgaria	*		*	*		*		**4**
Croatia	*		*	*		*		**4**
Czech Republic	*	*	*	*		*		**5**
Georgia	*	*	*	*		*		**5**
Hungary	*	*		*		*	*	**5**
Kyrghyzstan	*		*	*	*	*		**5**
Lethonia	*		*	*		*		**4**
Poland	*	*	*	*		*		**5**
Romania	*		*	*		*		**3**
Russia	*			*		*		**3**
Slovak Republic	*	*	*	*		*		**6**
Slovenia	*		*	*		*		**4**
Ukraine	*					*		**2**

Source: "Central Bank Independence in Transition Economies", Wojciech Maliszewski, pg. 23.

Table 11. Overall legal independence index for transition economies (1996)

Country	**PI**	**EI**	**OI**	Inflation (end of year) 1996
Belarus	4	3	7	39.30
Bulgaria	6	4	10	310.80
Croatia	7	4	11	8.62
Czech Republic	9	5	14	3.73
Georgia	7	5	12	13.81
Hungary	4	5	9	19.81
Kyrghyzstan	4	5	9	35.00
Latvia	7	4	11	13.16
Poland	7	5	12	18.68
Romania	5	3	8	56.90
Russia	5	3	8	21.80
Slovak Republic	6	6	12	5.40
Slovenia	8	4	12	8.82
Ukraine	3	2	5	39.86

Source: "Central Bank Independence in Transition Economies", Wojciech Maliszewski, pg. 28.

Table 12. Albania: Independence index and inflation

Indicator	1992	1993	1994	1995	1996	1997	1998
1. Political independence index	7	7	7	7	8	8	9 (8)
2. Economic independence index	4	4	4	4	4	4	4
3. Overall independence index	11	11	11	11	12	12	13 (12)
4. Inflation as of end of the year (%)	236.6	30.9	15.8	6.0	17.4	42.1	8.7
5. Base inflation (%)		21.3	7.8	4.9	9.7	36.0	8.4
6. COB/M1 (%)	57.7	63.3	71.3	70.7	52.9	79.3	81.6
7. Internal debt / GDP (%)			20.6	23.5	29.5	33.6	32.7
8. Foreign debt / GDP (%)	90.3	41.1	33.1	1.9	5.3	8.0	
9. Doubtful loans / total loans (%)			27.1	29.8	33.8	45.0	41.0
10. Loans / Deposits (%)			20.3	16.3	12.4	13.2	9.6
11. Short term loans / total loans (%)			53.3	49.8	40.2	25.3	43.1
12. Loans / Assets (%)			6.2	13.6	10.3	10.3	7.8
13. Credit / GDP (%)			4.8	4.7	4.7	4.8	3.6
14. Share of state owned banks in banking system (%)			97.8	95.4	93.9	89.9	85.4
15. Expenditures / Revenues of BoA (annual in %)		42.9	30.5	13.7	8.9	6.7	6.2

ANNEX 3

OTHER INDECES WHICH MEASURE LEGAL INDEPENDENCE OF CENTRAL BANK

I. BP INDEX

Bade and Parkin have built their own index, BP. They have developed the following criteria to define the index:

1. Is the central bank the final authority?
2. Is more than half of appointments in council made independently from the government?
3. There is not any member of government in the council (with or without the right to vote)

The quantitative evaluation for each of these criteria is based on the interval [1,4]. The value 1 will be given to less independent banks and 4 will be given to more independent ones. Thus, the maximum value of the index is 12.

Measuring these criteria against Albanian legislation, it is noted that:

Criterion 1: As mentioned already in this paper, there are no clauses which pronounce that central bank has the final word to formulate policies.

Criterion 2: As explained in Annex 4, 1992 law, in the council of seven members, three are appointed directly from government and three are nominated from government. Thus, the influence is on more than half of the members. In 1996 law, one member is appointed directly and two are nominated by government while the total number of members remains seven. In the existing law, there are no direct appointments but nominations of three members while the number of members of council is nine, thus there is a possibility to influence up to one third of the council.

Criterion 3. Neither 1992 law nor 1996 law specify that a member of government, with or without voting right, should be in the council of Bank of Albania. The 1997 law specifies that minister of finance can participate in the meetings but has not right to vote (article 49, paragraph 9).

Criterion	Year 1992	Year 1996	Year 1997
1.	1	1	1
2.	1	2	3
3.	4	4	3
Total	**6**	**7**	**7**

II. ES INDEX

The index is developed by Eijffinger and Schaling (1992, 1993) and is based on three characteristics:

1. Is central bank the only final authority in policy making; i.e. is the authority divided with the government or is it delegated only to government?
2. There is not any member of government in the council (with or without the right to vote)
3. Is more than half of appointments in council made independently from the government?

The evaluation of these elements is based on following:

Criterion 1: If the central bank is the only authority responsible for monetary policy, it is given twice the value, if this responsibility is shared, it is given only one point and if the responsibility falls on government, then the variable is given no value.

Criteria 2 and 3: If the answers are positive, the variables are given one point.

Besides the points given for the above mentioned variables, the total is added another point. Thus, the least independent bank receives one point and the most independent bank receives five. The index values are in the interval of [1,5].

Criterion	Year 1992	Year 1996	Year 1997
1.	1	1	1
2.	1	1	0
3.	0	1	1
Total	**2**	**4**	**3**

ANNEX 4

AMENDMENTS TO THE LAW "ON BANK OF ALBANIA"

The law on "Bank of Albania" has been approved three times by the Assembly, in April 1992, February 1996 and December 1997. In December 1996, August 1997 and July 1998 the law was amended. Some issues related to central bank are mentioned in an article of the Constitution as well.

What are the changes in law from one version to another? Have they been considerable qualitative changes or just "cosmetic" ones? Following, there is a comparison of the three versions of this law.

I. BANK OF ALBANIA AS AN INSTITUTION

The law stipulates Bank of Albania is the central bank of Republic of Albania. The bank is a legal entity located in Tirana, country's capital and acts in accordance with the provisions of the law "On Bank of Albania".

This point in the law has evolved by stating more clearly that central bank is an independent institution. Thus, the 1992 law does not mention the word "independent" while the 1996 law emphasizes that *"Bank of Albania is an independent legal entity".* The 1997 law contains a very clear clause on this issue:

> *"Within the limits of its authority established by this law, the Bank of Albania shall be a legal public entity entirely independent from any other authority in the pursuit of its objectives and the performance of its tasks. The independence of Bank of Albania shall be respected and no person shall seek improperly to influence any member of a decision making body of the Bank of*

Albania in the discharge of his duties towards the Bank of Albania or interfere in the activities of the Bank of Albania."

CONCLUSION I: Clearly, laws have evolved in emphasizing the independence of Bank of Albania as an institution, including special provisions for this.

II. OBJECTIVES AND TASKS OF BANK OF ALBANIA

The structure of objectives and tasks of Bank of Albania is defined the same in all three laws. It is formulated a primary objective for the Bank of Albania but this is not the only one the bank should achieve. The main objective is associated by other objectives and tasks which in general are in line with it.

The 1992 law defines *"maintain the domestic and foreign value of national currency through implementing the monetary policy"* as the main objective of Bank of Albania. While 1996 law and 1997 law define *"achieve and maintain price stability"* as the main objective. Furthermore, the last two express more clearly that this is the main objective and that other objectives or tasks of Bank of Albania are subject to the achievement of *price stability*.

Other objectives and tasks are almost the same. They consist in:

* monetary policy - in this respect, it is noted an evolution in the terms used:

"adopt and execute the monetary policy" in 1992

"formulate and execute the monetary policy" in 1996

"formulate, adopt and execute the monetary policy" in 1997

"independently execute the monetary policy" in the 1998 Constitution.

* supervise and manage banking system in order to provide its development and continuity;

* issue domestic currency and has the exclusive rights;

* exchange rate policy - in this respect, the laws have developed quite obviously, from *“executes government’s policy on exchange rate....”* as defined in 1992 law, to *“formulates and executes the exchange rate policy”* in 1996 law and *“formulates, adopts and executes the exchange regime and the exchange rate policy of Albania”* in the 1997 law. Thus, the existing law gives more clear specifications on exchange policy.

* promote the development of payments systems;

* hold and manage the foreign reserves;

* act as advisor and fiscal agent of the Government of Albania; etc.

Also, Bank of Albania has the task of reporting on specific issues or give statements on regular bases on the assessment of its monetary policy adopted and executed in the previous periods; monetary policy to be followed in the next six months, principles on formulating and executing the monetary policy. The statement is presented to Parliament and Government each six months. It is also available for public use.

The 1992 and 1996 laws specify that this is the only report central bank must deliver. The 1997 law adds other issues subject to reporting:

* assessment on credit and exchange policies. The report will be delivered to Parliament and government every six months and will be open to public.

* state of the Albanian economy. The report will be delivered every three months to Parliament and government as well as to the public.

* possible threats to the stability of financial system, nature and type of threats and the necessary legal provisions to avoid the threats. The statement is delivered every six months to the Parliament, government and public.

CONCLUSION II. The law "On Bank of Albania" has improved qualitatively in 1996 when "price stability" was specified as the main objective of the bank. This is a further step to increasing central bank independence. Also, each new law tends to clarify the clauses related to objectives and tasks of Bank of Albania. The most obvious case is the clarification of types of reports and statements delivered by central bank. Moreover, the trend has been that of increasing central bank's responsibility towards the public and legislative and executive branches. Since the 1996 law, the Parliament is the main institution Bank of Albania reports to. The 1992 law is unclear as it states that the bank reports to the Parliament but in fact the report is submitted to Council of Ministers.

III. CAPITAL AND PROFIT ALLOCATION

With regard to this chapter, all three laws state that net income of Bank of Albania is transferred to state budget. The net income is calculated after deducting from revenues the operating expenditure and after making provisions for:

* bad and doubtful loans;

* other expenses – under the 1992 law, the amount of these expenses was determined by Government, while under the existing law it is the Supervisory Council of Bank of Albania who determines it;

* reserves – all three laws specify the percentage of income that would add to total reserves, but under the 1992 law the government had the right to change this percentage. In 1996, the government was deprived of this right.

Last, all three laws provide that if Bank of Albania generates negative income, the government will transfer tradable securities bearing market rates and in the amount needed to cover the negative balance.

CONCLUSION III. Changes in this chapter tend to increase economic independence of central bank. The government is deprived first of the right to change the percentage of reserves and second of the right to determine the amount of other expenses. Yet, the economic independence is not complete as in practice exists an inflexible (conservative) approach in generating expenses.

IV. THE RELATIONSHIP BETWEEN THE BANK AND THE STATE

The main aspect of this relationship has to do with central bank lending to government. All three laws do not prohibit central bank lending to government. However, this credit is not automatic and is granted based on bilateral agreements. Each agreement should determine the maximum loan amount, interest rate which should be based on market rates, maturity period which should be no longer than one year, and the condition that the loan should be collaterized by tradable securities issued by government. What has changed from one law to another are the maturity period and the total amount of the loans. Only 1996 law determines a one-year maximum maturity period while the other two laws fix a period of six months. The maximum amount of loan is calculated as a percentage of budget revenues in previous periods. Under 1992 law, this percentage was 10 while under 1996 law, the percentage was differentiated such as 14, 10, and 6 for 1996, 1997, and 1998 respectively and 6 percent for the following years. Under 1997 law the percentage changed to 30 for 1998 and 1999 and 5 for the following years. Bank of Albania refers to the Parliament in case of exceeding these limits. Obviously, the most liberal provisions are those of 1996 law. However, the 1997 law contains more specifications of the elements related to bank lending to government. These specifications are not included in the other two laws and thus credit to government was practically unlimited.

The 1997 law specifies that *"purchases by the Bank of Albania of debt securities issued by Government in the secondary market shall be treated as Bank of Albania loans to government."* This definition is missing in the other two laws and in fact, central bank participation in the secondary market has been considerable. Also, the right to restructure the loan is recognized by the law, but in no case will it affect the maturity period set initially. None of the laws prohibits central bank to trade in primary market.

All three laws stipulate that Bank of Albania has the right to act as a fiscal agent of Government and as the budget vault (account). However, under the 1992 law the bank was not to receive any compensation for these services, while under the 1996 law this clause was left out and in 1997 law it was added that these services were to be specified in an agreement with the Minister of Finance, thus giving central bank the possibility, at least theoretically, to sign agreements at its own benefit increasing its independence with regard to this type of relationship.

With regard to government's deposits at central bank, laws have evolved towards reducing government's privileges. Under 1992 law, interest rate on deposits was determined by the respective agreements. Under 1996 law the rate was still determined by agreements but the maximum limit was set at market rate for short-term deposits. In 1997, there is a turn back to the 1992 position, where the interest rate was determined by agreements.

CONCLUSION IV: With respect to relationship between central bank and government, laws have evolved towards increasing central bank independence. Thus, issues related to bank lending to government have been defined more conservatively: clauses are specified more clearly avoiding their misinterpretation and recurrence of old practices. From this point of view, the 1997 law appears the most conservative one. Moreover, considering the terms used in this law, lending to government is considered an exception. So, article 30,

paragraph one states that: ***"Except as otherwise specifically authorized by this law, the Bank of Albania shall not grant any direct or indirect credit or any financial assistance to the Government of Albania or to any of its State agencies."***

V. ORGANIZATION AND MANAGMENT OF BANK OF ALBANIA

This chapter of the law has changed continuously, specially with regard to determining the management of Bank of Albania. In general, one governor managed Bank of Albania and one or two deputy governors as well as the councils appointed for this purpose. The 1992 and 1996 laws mention two councils while the existing one only one council in charge of managing the bank.

Councils

According to 1992 law, the governor and the Council of Directors of Departments were in change of managing the bank. Under the same law, the Supervisory Council of Bank of Albania was also in function. The tasks of this council were specified in the Statute of Bank of Albania and not by law. Also, the council of directors of departments, named Steering Committee, approved the Statute of Bank of Albania. The main task of this Committee is to determine basic principles of monetary and credit policy followed by the bank. The additional amount of compensation for this Committee is settled by the Governor. The Supervisory Council consists of the governor, two deputy governors and four members, one appointed from government and the other three from the president as proposed by government.

Under the 1992 law, the highest council in managing the bank is the Steering Committee. In addition, government's intervention in appointment process of members of Supervisory Council is at a considerable level. Although, none of these members is a member of government, yet this one directly appoints one of them and proposes the other three. However, *in practice all the proposals from government have been approved and there was never a case with two or more candidacies.*

The 1996 law determines the Supervisory Council as the highest body of bank management. This council consists of seven members including the governor, two deputy governors and four members. The four members are appointed by the Parliament but they are proposed by different institutions like the ministry of finance (one), the president (one), the government (one) and the governor who proposes the fourth member. The law adds one year to the term in office for the members (the appointment term changes from six to seven years) and for the first time, the law introduces the concept of distribution, possibly in equal terms, of the appointment term of members over the seven-year period. The reason for this is to avoid that all members finish their term at approximately the same time and that their appointment be influenced by one source. Also, the members can be re-elected. Their compensation remains government's competence. Thus, it is not yet noted a break from government's influence with regard to appointment and finance issues.

It is noted that the tasks performed by the Steering Committee under 1992 law are transferred to Supervisory Council under the 1996 law. The latter is in charge of approving and adopting policies supervising and executing central bank activities. Also, it has the following powers:

* approves the monetary policy of Albania as presented by the governor and gives instructions on the open-market operations by Bank of Albania; approves interest rates for deposits at Bank of Albania and loans by Bank of Albania as well as the levels of reserves that banks are required to maintain with the Bank of Albania;

* approves exchange rate policy of Republic of Albania as presented by the governor and establishes procedures for determining the exchange rates of Albanian currency against other currencies;

The term ‘Steering Council’ is replaced by ‘Steering Committee’. The committee is vested with the functions of a body that manages the daily activities of the bank and whose main task is to execute policies approved by Supervisory Council. The committee consists of the governor, two deputy governors and the directors of departments.

The 1997 law maintains the same structure of management body (the steering committee does not function any longer). The highest body in charge of decision-making, supervision of policies, administration and operations of Bank of Albania is the Supervisory Council. The Council has also the right to approve monetary policy of Albania and to establish the exchange rate policy and regime. As a result, 1997 law grants more power to the Supervisory Council making a further step towards increasing independence. For instance, before 1997, the exchange regime was established by a Council of Ministers.

The number of members in the Supervisory Council increased by two under the 1997 law (from seven to nine). All members are appointed by the Parliament based on the proposals as follows:

* five members are proposed by parliament
* three members are proposed by government
* one member is proposed by Supervisory Council

Another step forward to increase bank independence, is that of determining the compensation of Supervisory Council members. This compensation is determined by the council itself.

Governor and Deputy Governors

The principle applied by all three laws in appointing the governor and deputy governors is that of involving different bodies in the process. Under article 44 of 1992 law, the governor is appointed by the president as proposed by the Steering Council of Bank of Albania. The deputy governors are appointed by the Council of Ministers as proposed by the governor. The appointment term is six years with an option to be re-elected.

With respect to appointing the governor, the 1996 law changes from that of 1992 only in specifying that it is the Supervisory Council and not the Steering Council that proposes the governor. This does not mark any increase in the level of central bank independence. It should be noted that a considerable number of members of Supervisory Council are proposed by government or its agencies. On the other hand, given that the appointment of members of Steering Council was a competence of the governor, the previous law allowed enough room for servile behavior[1].

The law introduces some changes also with regard to the election of deputy governors. First, the concept of hierarchy is introduced, one is first deputy governor and the other is second deputy governor. Second, the first deputy governor is elected by president and not Council of Ministers. The governor proposes both of his/her deputies. The second deputy is elected by the government.

The 1997 law introduces other changes regarding the body, which proposes the governor. The proposal comes from the Prime Minister. The new scheme reduces central bank independence as compared to the other two. It strengthens government's influence in electing the new governor. With regard to the appointment of deputy governors, the move is made in the opposite direction. They are appointed by the Supervisory Council.

[1] In practice, the appointment of governor scheme proposed under the 1992 law has not functioned. The fact that Steering Council members were not elected by high state institutions reduced the council's power. Thus, it was unlikely that its proposals would be taken into consideration. In fact, when this council proposed the governor only in one occasion, the position was assigned to another candidate.

The process of appointing the governor is modified again in the Constitution. As per this document, the president proposes the governor and the parliament elects him/her.

Dismissal of management of Bank of Albania

In general, all three laws do not provide specific cases of removing the governor, deputy governor or members of councils (steering or supervisory council). The governor and the deputies are treated as members of the council and accordingly subject to the same clauses. Also, it is noted that the law provides that the reasons for removing bank management are of non-political nature.

Under article 47 of 1992 law, a member of Steering Council is dismissed when he/she is akin with another member of the council, or with an employee, director, shareholder of a company where another member of the council is an employee, director or has monetary claims of more than ten per cent of the capital of the company; or is an employee, director, shareholder of a bank or financial institution other than Bank of Albania.

Article 48 specifies that the Governor, Deputy governors and any member of Supervisory Council will be removed under the provisions of article 47 and when they are convicted under the provisions of Penal Code, are incapable of performing their duties or they resign.

More or less, the 1996 law establishes the same grounds for the removal of central bank management. These reasons are as follows:

* incapability to serve in the Supervisory Council;
* conviction for penal actions;

* insolvency or bankruptcy and inability to rehabilitate;

* disqualification or suspension by a competent authority from practicing a profession;

* absence in three successive meetings for unjustified reason;

* infirmity of body or mind to carry out assigned duties;

* engagement in serious misconduct in the office, substantially prejudicing the interests of the Bank of Albania.

The law specifically mentions that *"no member shall be removed from the office on other grounds"*. Also, it is added that only the institutions which have appointed the members have the authority to remove the members from the office.

The 1997 law maintains almost the same provisions for dismissal. It only adds two other reasons related to concept of reputation and that of political influence, for which the members of the Supervisory Council could be removed. So, members shall be dismissed if their employment as state official has been suspended or interrupted by court order, or if actively participate in political activities during the period of their tenure.

When one is not eligible to be member of Supervisory Council?

The laws provide cases when the function of members of Supervisory Council is incompatible with other functions. The 1996 law does not allow that a member of Supervisory Council be also a member of government or Parliament. The 1997 law adds also the incompatibility with being the president.

CONCULSION V: There is a tendency to reduce government's influence in the process of appointing central bank management (governor, deputy governors and members

of councils). So, the 1992 scheme provided that the government directly elected three out of seven members in the Supervisory Council and proposed other three; the 1996 scheme provides one direct appointment and two proposals and the 1997 scheme allows government only to propose three members. The office terms are longer than election cycle. Grounds for dismissal are of non-political nature and involve different bodies, which are engaged in the appointment procedures. However, this point of the law does not indicate any qualitative improvement in strengthening central bank independence, or stated more precisely, there is no improvement in increasing real independence. The bank management appointment scheme, as designed by each law, has not worked towards strengthening bank independence as long as the three institutions involved in the scheme, i.e. government-president-parliament, are of the same political force.

VI. EXCHANGE POLICY

According to 1996 law, Bank of Albania establishes the exchange policy and executes it in cooperation with other state institutions. The bank also acts as a non-exclusive agent of government for the administration and control of exchange operations. It has the authority to license and supervise exchange market operators.

The 1997 law stresses that Bank of Albania formulates, adopts and executes the exchange rate policy. It also establishes the exchange regime in accordance with international agreements Bank of Albania is affiliated to. The exchange rate is determined by market forces, unless Bank of Albania sets a target rate or adopts another regime.

CONCLUSION VI: The evolution of laws towards independence is more obvious here. In 1992, issues related to exchange policy are merely mentioned, while in 1996 it is clearly stated that exchange policy is established by Bank of Albania and is executed in cooperation with other state agencies. In 1997, Bank of Albania is empowered with the right to establish the exchange rate regime (this was previously determined by government). Actually, Bank of Albania has adopted the floating rate regime. However, it can switch to another regime if it deems it appropriate. Also, Bank of Albania is in charge of formulating, adopting and executing the exchange rate policy.

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