CENTRAL BANK AUTONOMY WITHOUT MONETARY POLICY

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ABSTRACT

Central bank autonomy from political authorities has been advocated both as a remedy against the inflationary bias that would otherwise be present in the conduct of the government's monetary policy, and, more recently, on the basis of empirical evidence. However, both theoretical arguments and empirical findings have associated central bank autonomy with the conduct of monetary policy, while often failing to pay attention to those institutional cases where a central bank is in place, but is not responsible for the conduct of monetary policy. These cases are particularly relevant for those countries which do not possess their own currency, or where extreme" monetary regimes such as dollarization, currency boards or monetary unions are present. These institutional settings, where a central bank exits, but there is no monetary policy to be conducted, raise the issue of central bank autonomy in a framework where the inflation bias is no longer pertinent. In other words: Is central bank autonomy still a relevant objective when a country does not run its own monetary policy? The present paper addresses this question, discusses dimensions of autonomy and accountability and maintains that central bank autonomy still does matter, particularly if the central bank is responsible for bank supervision and financial regulation.

I. INTRODUCTION

In the recent economic literature the notion of central bank autonomy and independence[1] from political authorities is mainly advocated as a remedy against the inflationary bias that would otherwise be present in the government's monetary policy conduct. This bias is usually explained by two motives: the so-called "revenue motive" related to the inflation tax, and the "unemployment motive" linked to the dynamic inconsistency of monetary policy over time.

The revenue motive focuses on the risk of government exploitation of the central bank's capacity to create purchasing power (seignorage) in order to finance the public expenditure that fiscal authorities are unwilling to finance out of explicit taxation. The unemployment motive relies on the short-run trade off between price stability and economic expansion, assuming that politicians aim at maximising their own welfare linked to short-term re-election, rather than achieving the public good of price stability. It also assumes that voters appreciate the immediate, although transitory, benefit of government attempts to stimulate the economy, but underestimate the medium-term inflationary effect of an expansionary monetary policy. In this context, the political forces in democratic societies will have a strong incentive to prefer even short-term expansion to price stability. Consequently, any announcement by the government of its intention to pursue price stability will not be credible, because at some future time implementing the policies announced might no longer be politically optimal. This time-inconsistency problem is well known by rational economic agents who, to compensate for the inflation bias, will require a risk premium in the form of higher interest rates. Unfortunately, the latter hamper sustainable economic growth. In summary, conducting monetary policy is a prerogative of the State, but its effects on the economy might not be optimal if the management of monetary policy is in the hands of the government[2].

A possible solution to the inflationary bias created by the two above-mentioned motives has been identified in delegating the authority to conduct monetary policy to an independent institution - typically a central bank - with a clear mandate to achieve price

stability. Moreover, to be effective and democratically acceptable, the central bank's autonomy must be complemented by its being clearly accountable for the outcome of its policies.

The institutional solution involving delegated authority has also been advocated on empirical grounds. The relationship between central bank autonomy and the inflation rate has been extensively investigated by the empirical economic literature. The results of these studies have generally shown that those countries that accorded greater autonomy to their central banks also experienced lower average inflation, without harming average real growth (see, among others, Grilli, Masciandaro and Tabellini 1991, Cukierman 1992, Alesina and Summers, 1993, IMF 1996, Cukierman,Miller and Neyapti 2001)

However, both theoretical arguments and empirical findings have associated central bank autonomy with the conduct of monetary policy, without paying too much attention to those institutional cases where a central bank exists, but is not responsible for the conduction of monetary policy. These cases are particularly relevant for those countries which do not have their own currency, typically some small countries[3]; these cases also apply to those countries which -despite having the opportunity to emit their own currency - have chosen to adopt another country's currency as the predominant or exclusive legal tender (official dollarization). A further example consists in countries which are experiencing a de facto dollarization process in which the local currency remains the legal tender, but financial and payment transactions are allowed to be denominated in a foreign currency. The regimes of currency boards and monetary unions are also two other cases in point[4].

In the aforesaid countries, despite the lack of monetary policy, central banks can still retain several functions, including bank regulation and supervision. This is especially the case in small and less financially developed countries where giving supervisory powers to a central bank can be particularly advantageous, especially if public institutions and legal systems are weak, coordination among public sector agencies is troublesome and skilled human resources are scarce. In particular, very small countries can achieve significant

economies of scope and scale if they choose to establish a single financial authority (Llewellyn, 1999).

These institutional settings, in which a sole authority exits but there is no domestic currency—and hence no monetary policy to be conducted—raise the issue of autonomy or independence in a framework where the inflation bias looses its meaning. In other words: Is central bank autonomy still a relevant objective when the country does not run its own monetary policy? The present paper attempts to address this question by maintaining that central bank autonomy does indeed matter in contexts in which the central bank carries out other economic functions; this is particularly true if it is responsible for financial regulation and supervision. The organization of the paper is as follows: section II identifies the reasons for which central bank autonomy should matter, even where the central bank has no monetary policy to conduct; section III analyzes the various elements necessary to make central bank political autonomy real and effective;. section IV discusses the need for proper central bank accountability as a necessary complement to its autonomy; section V concludes.

II. CENTRAL BANK FUNCTIONS AND AUTONOMY IN THE ABSENCE OF A NATIONAL CURRENCY

Typically, a central bank can carry out a combination of three main functions. First, it might have a macroeconomic function both through the exercise of a discretionary monetary policy which affects price levels and, in some cases, through its exchange rate policy. Second, it might have a sector-level and microeconomic function of providing support and regulatory and supervisory services oriented towards maintaining the health of the banking sector. Third, the central bank often has a special relationship with the State and can carry out several secondary functions, among which acting as its banker and fiscal agent, or its economic consultant.

Among these functions the first one is strictly linked to the presence of a national currency; without it, the issue of operating discretionary monetary and exchange rate policies disappears. Similarly, in the

absence of a domestic currency even some sector-level functions are no longer relevant; for instance, providing assistance as the 'lender of last resort' is practically untenable if the central bank is not able to create sufficient liquidity to face a banking crisis. However, the remaining functions, and in particular that of regulating and supervising the financial sector, maintain their significance even in scenarios where another country's currency has been adopted. The question of central bank autonomy is kept alive by the existence of these functions, some of which are often neglected by economic scholars while remaining highly relevant in practice. In other words, in such a context we should ask ourselves if the autonomy of the central bank is a necessary prerequisite for establishing the most appropriate institutional framework to perform the remaining functions efficiently from a social and economic perspective.

These notes argue that even if the central bank does not conduct its own monetary policy but performs a set of other functions, a certain degree of autonomy is required for it to act effectively and achieve most of the usual financial regulation objectives. This is above all true if the central bank is also the authority in charge of financial regulation and supervision.

As we know, the economic literature has identified three conditions (or market failures) requiring governmental intervention through some form of regulation. The first condition relates to the existence of possible natural monopolies, and is generally considered to bear scarce relevance for the case of financial service regulation. However, in the case of very small economies—in which the variety of functions that a central bank can carry out is considerable—even the first condition might be of some interest for central bank regulation (e.g. some form of potential monopoly in a small economy could refer to the payment system or to other non-traditional and secondary central bank services such as acting as the government's banker and fiscal agent, or as a provider of statistical information, etc.). The second condition relates to the possible existence of externalities due to financial and banking crises; the potential negative consequences for the whole sector have been advocated to justify regulations in support of the system. Finally, the third condition involves information asymmetries between the seller (who has more information) and the investor.

These three justifications for financial regulation are then used to highlight the main objectives of financial regulation. These can be summarised as: the pursuit of macroeconomic stability, through various kinds of controls (over currencies, interest rates, and assistance as a 'lender of last resort'), financial sector stability, through specific rules for financial intermediaries, investor protection through transparency and information rules, and the promotion of a competitive and efficient financial sector.

With the exception of the first objective of macroeconomic stability—which, to make the various kind of controls effective, implies full control over the creation of the local currency—all the remaining financial regulation objectives are still equally relevant in a situation in which the central bank has no power to control the amount of money in circulation.

It can be argued that the financial stability objective, above all, requires a sufficient degree of central bank autonomy, even when it has no domestic currency to manage. Leaving aside the complementary relationship between monetary and financial stability (monetary stability reinforces financial stability and vice versa) which is irrelevant in the absence of a national currency, we can still make a strong case for central bank autonomy. This is true on the basis of a common assumption regarding politicians' behaviour. The latter is, in part, reminiscent of the explanation that central bank autonomy is justified by the end goal of achieving monetary stability. It is generally recognised that to ensure the safety and soundness of the financial system, authorities need to establish a stable and transparent set of regulations, including rule-based entry policies for new players and rule-based exit policies for insolvent financial institutions.

However, the achievement of short-term objectives by politicians does not always coincide with the need for a stable and transparent set of rule-based procedures and policies. Politicians can be influenced by short-term factors including personal interest, which might cause pressure, leading them to interfere with regulators. In other words, by delegating power legislators can minimize the inefficiencies of legislative logrolls (Lohmann and O'Halloran 1994)

Pressure from and interference by politicians can affect both the regulatory process and supervisory actions. However, interference also has costs and provokes negative consequences for potential investors and the economy. If regulatory and supervision functions are not perceived to be certain, fair and transparent, the regulatory agency will lose its credibility, damage its own reputation and eventually cause investors to defer or revise their investment decisions. All these effects hamper the development of the financial sector, exacting costs that are even higher in a world like the present one, where international financial integration is developing significantly. In today's globalized world, adherence to best international standards and practices has become a real necessity, particularly for those countries which are trying to become a financial centre for international or regional financial players. If, in any given country, supervisory practices are too weak and/or the financial regulation and the institutional framework diverge too much from international standards, such as those embodied in the Basel Core Principles for Effective Banking Supervision, both domestic and foreign investors might decide to leave the country. Consequently it would be cut off from the benefits that financial integration can provide for the development of the financial sector and the economy more in general.

Furthermore, and in a manner similar to the time inconsistency results regarding the conduct of monetary policy, if the regulatory agency is under the control of the government it might give rise to a credibility problem. In turn, the latter might lead to wrong incentives and thus social costs. For example, some regulatory interventions, like bank liquidations, are often politically unpopular given that they can result in strong hardship for many depositors and investors who are usually voters as well; furthermore, such interventions can also adversely affect the government's budget. Assuming that politicians aim to maximise their own welfare linked to short-term re-election gain, they will be very sensitive about the short-term political costs of a severe supervisory and regulatory intervention (e.g. the closure of banks or businesses) on politically powerful financial institutions. Consequently, politicians will be tempted to put pressure on and interfere with regulators and supervisors, encouraging them to exercise forbearance and grant strategic dispensations from rules and

procedures. To make an analogy using the monetary policy context, politicians face the same incentives in relation to ailing financial institutions as they do with the goal of price stability. The implications of this perverse incentive mechanism is that any pre-announced rule-based policy for financial sector intervention and resolution would not be believed by rational agents including owners and managers of financial institutions. Indeed, the latter will be tempted to undertake riskier activities in the belief that the authority's reaction function will differ in practice from the one already announced. Hence, as outlined above, the perverse mechanisms that generate incentives to making risky and dangerous decisions highlights the need for qualified and independent regulators and supervisors.

Financial sector soundness and stability, and hence autonomy of the financial authority, need to receive more attention in both dollarized economies and economies without a local currency, due to the greater difficulties associated with managing possible bank runs. In fact, these economies not only might be more prone to bank runs, but also runs might be more difficult to manage when they do occur. Two main reasons contribute to this difficulty: first, the impossibility of providing fresh liquidity and recurring to "lender of last resort" facilities; secondly, the existence of more severe funding constraints which might emerge with deposit protection schemes (see Hoelscher and Quintyn 2003).

Finally, by delegating power to a regulatory agency legislators can reap some other rewards. Delegation can be beneficial when there are gains to be realized from allowing bureaucrats to specialize in their particular area of policy.

Moreover, legislators can take advantage of technical and policy expertise and keep their workload lower and more manageable. Besides the lack of autonomy could create additional problems like weak agency governance and management. Even potential conflicts of interest, such as preferential treatment to situations related to state-owned enterprises, might emerge in a more severe manner.

The case for qualified and autonomous regulators can also be supported by some empirical evidence which shows how inadequate

arrangements to ensure the autonomy of regulatory bodies have contributed to the emergence of financial crises. For instance, Quintyn and Taylor (2002) discuss the experiences of Korea, Japan, Indonesia and Venezuela, where the lack of independence of financial regulators and supervisors has undermined the integrity of the financial sector and has been cited as one of the contributing factors to the deepening of the financial crises in those countries. Moreover, within an empirical context, autonomy of the regulators and supervisors might also be supported by opposite scenarios, in which proper arrangements have prevented the emergence of financial sector weaknesses.

However, given the confidential nature of the supervisory function, such (certainly numerous) cases are much more difficult to represent and document.

In brief, central bank autonomy—and more specifically regulatory and supervisory autonomy—can be crucial for financial sector stability; this is due to some of the same theoretical and empirical reasons for which central bank independence matters for monetary stability. Of course, in the case of regulatory and supervisory issues autonomy should be defined not only with respect to political interference (political autonomy) but also with respect to the financial industry (industry autonomy). In this case autonomy must take two aspects into consideration: autonomy from the government and autonomy from industry. In the latter case, the risk is that the regulator might identify special industry interests with the public interest, assuming that bureaucrats may better respond to the interests of powerful and organized groups than to political guidelines or to the public interest (Stigler 1971). This is particularly relevant when the awareness of a latent conflict between the government and the central bank might push the latter to develop a closer relationship with the financial industry that so zealously meets its needs.

In the following section we will discuss the different elements of political autonomy which should be established to ensure that central bank autonomy is a real prerequisite; this is necessary in order to assure its effective and efficient operation during the pursuit and achievement of its institutional objectives.

III. ELEMENTS OF CENTRAL BANK POLITICAL AUTONOMY

Political autonomy should refer to the central bank's possibility to operate freely to achieve the objectives delegated by political authorities. These objectives must then be translated into principles, rules, and enforcement procedures to control the financial sector players' behaviour. Determining the allocation of power therefore involves both horizontal aspects (the extent to which power should be allocated to independent institutions other than legislative or executive bodies) and vertical aspects (the degree of control exercised over such institutions). Once the objectives are selected, the focus moves to the most effective institutional arrangement to achieve those objectives. In the case under discussion, financial stability might be one of the main objectives, which in turn requires financial regulation and supervision. Once the need for financial regulation has been established, and once the special nature and features of the financial sector have been recognized (a high and growing complexity of the sector and an asymmetric distribution of information among players), delegation by the legislature to a specialized agency has emerged as the institutional solution chosen by practically every country. Such delegation can either take the form of a government agency (as was the case in centrally planned economies and in some developing countries) or an independent agency, in turn a public or a self-regulatory one.

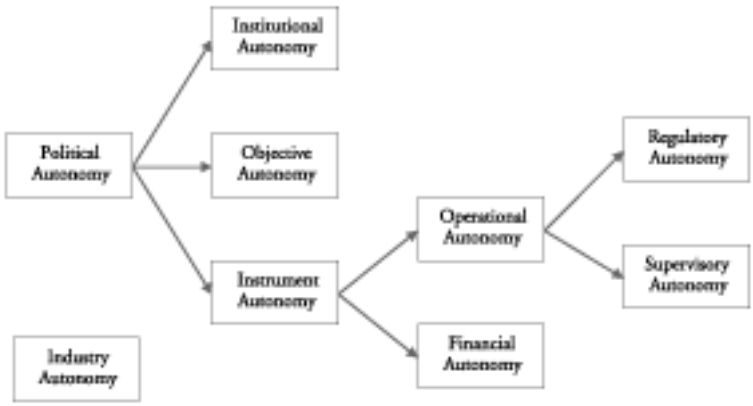
Based on the discussion of the previous section, establishing an independent agency should be the preferred solution, given that it would offer the advantage of shielding the actions of the agency from political interference strengthening its political autonomy. But what do we really mean by the 'political autonomy of the central bank'? We need to discuss the main elements of this political autonomy to be certain that the central bank can exercise its functions effectively and efficiently. The fact that the central bank is a separate institution from the government represents a condition necessary for its good governance, given that it entails the presence of a sort of institutional independence. However, this is not a sufficient condition to ensure satisfactory performance of the central bank in implementing its various functions. The degree to which a central bank can be

considered autonomous can never be established with high precision. However, there are some objective factors that determine the degree to which a central bank is really autonomous. For instance institutional independence must entail a high rank for the legal status of its charter. Independence must also provide for the resolution of conflicts between the central bank and the government, as well as procedures for appointing and dismissing the members of the central bank's governing bodies, and the relative terms of their service.

In addition to institutional independence we need to consider all the other crucial building blocks that together define effective central bank autonomy (see figure 1 for a taxonomy of different notions of political autonomy). Following Fisher (1995), a first distinction can be made between objective autonomy and instrument autonomy.

Objective autonomy[5] gives the central bank the authority to determine its priorities by choosing from the various objectives listed in its charter. Objective autonomy is perceived as the highest level of autonomy, particularly when the central bank is in charge of monetary policy and can conduct it by choosing between such conflicting macroeconomic objectives as the level of economic activity versus price stability. Of course, objective autonomy partially loses its relevance when there is no monetary policy, and in such cases instrument autonomy becomes crucial in evaluating the actual

Figure 1 A taxonomy of central bank autonomy



level of autonomy granted to the central bank. The concept of instrument autonomy is strictly linked to the notion of operational independence, which is also a key precept of the core principles for effective banking supervision issued by the Basle Committee. Within this notion we can distinguish between operational autonomy - which forms the core of instrument autonomy - and financial autonomy, which is fundamental to ensuring operational autonomy. With respect to the role of the financial authority, operational autonomy can in turn be divided in regulatory and supervisory autonomy.

Regulatory autonomy refers to the power of the agency to set rules and procedures for the financial sector within the confines established by the primary legislation. Concerning the financial sector, rules and procedures usually apply to: economic issues (various controls on intermediaries, the licensing process, investor protection, etc), prudential measures (controls over production processes, risk management, capital adequacy, etc.), and information requirements (information sets for the public and supervisors).

The scope of regulatory autonomy differs widely among countries, reflecting their diverse legal traditions and legal systems. However, there are sound reasons to maintain that a desirable model should include general primary legislation in which the basic principles are set out; it should furthermore leave the agency free to devise regulatory initiatives both at the technical and implementation level[6]. In addition to the general considerations justifying regulatory autonomy, there are sector-specific reasons for assigning it to the financial authority. First of all, financial regulation applies to a very complex, technical and fast changing world. In such an environment fast action is key; this obliges regulators to quickly and flexibly adapt prudent rules and procedures, both to prevent fraud and misconduct as well as more general financial crises. At the same time, regulators must also respond to the sector's growing internationalisation. Secondly, there is an ownership argument, namely the rule enforcement and supervisory function can be applied more effectively if supervisors have been directly involved in the rule-setting process.

Supervisory autonomy is a crucial element in safeguarding the soundness and stability of the financial sector. An appropriate

level of autonomy should be extended to all the dimensions of the supervisory function, namely licensing, prudential supervision, sanctioning—including revoking licences—and crisis management. However, despite its importance it is not very easy to evaluate the actual level of supervisory autonomy, due to the high levels of confidentiality and invisibility which are intrinsic aspects of the nature of the supervisory function. This difficulty applies both to assessing the interference coming from the political sphere as well as pressures from the industry sphere.

Further difficulties may arise in the absence of monetary policy, and in the case of small countries. In a context that lacks the option of creating additional liquidity, financial crises can become more difficult to manage and it is more likely that the financial costs of banking crises will have to be sustained directly by the government. In this case the government may well possess the incentive to more closely control banking supervision, in order to maintain effective responsibility for supervision considering 'who pays the bill' if things go wrong.

In small countries repercussions might also emerge because of the process of granting financial licences. Ideally, granting and revoking licences should be the responsibility of the supervisory agency, licensing being the key first step in the supervision process. However, in small countries, where the relationship between the government and the business sector is generally closer and where the government often has the power to grant licences, supervisors often have to manage a situation with too many banks and more often with too many small banks, with obvious negative potential consequences for the soundness of the sector.

Financial autonomy is especially key for those central banks which have no domestic currency to manage. In fact, the nexus between central bank autonomy and monetary policy is bi-directional, namely autonomy is a precondition to running monetary policy effectively. However, it is also true that the presence of a national currency, and therefore of monetary policy, ensures a stable flow of income towards the central bank; this stems from financial resources coming from seignorage and the management of the country's official reserves.

These sources of income, in turn, represent a necessary condition to guaranteeing financial autonomy to the central bank. Conversely, in contexts lacking a national currency, central bankers can only be funded through a combination of the following channels: government funding; levies or fees on regulated sectors; and the return from its own capital. In these cases legal provisions relating to the central bank's finances should provide sufficient resources to ensure that the central bank does not become subject to indirect influence from the government; insufficient financing would impede it from carrying out its functions. Central bankers who can independently decide about their budgets according to their objectives are better equipped—on one hand—to withstand political pressure and interference, and—on the other—to organise and allocate appropriate resources to fund their activities. Moreover, to ensure that losses do not deplete the central bank's capital and make it financially dependent on the government, the central bank law should contain provisions that obligate the government to recapitalize the central bank in case of need. Finally, it is important that the central bank first make prudent allocations to general reserves, and only afterwards transfer any profits to its owners; this is particularly true where the central bank has limited sources of income, such countries that lack a national currency.

IV. CENTRAL BANK AUTONOMY, RISKS AND ACCOUNTABILITY

The advantages of delegating power to an autonomous regulatory authority must be weighted against the costs of the so-called burocratic drift, namely the ability of an agency to enact outcomes different from the policies preferred by those who originally delegated power and who have been democratically elected. Delegation poses potential risks to the extent it involves handing authority to unelected bureaucrats who may pursue policies that serve narrow and private goals rather than the interests of the public at large. Put another way, even agency autonomy could provide bureaucrats with such a degree of discretion which, in turn, could be used to pursue their own goals rather than to achieve the final objectives and purposes for which the agency was originally established. Paraphrasing Dodd and

Schott central banks and financial regulators might be considered, in many respects, a sort of prodigal child; although born of legislature's intent, they might take a life of their own maturing to a point where their muscles could be turned against their creator (Dodd and Schott 1979).

Moreover, regulatory autonomy could also pose a special risk of over-regulation. When political and external contracts are weak, it is more likely that an autonomous agency will over-regulate the industry by imposing unnecessary costs on the sector. Besides, weaker political checks might increase the risk of being captured both by the industry and powerful financial institutions. In order to reduce the risk of over-regulation and to avoid intervention from the industry it is crucial that a proper degree of transparency be ensured in the rule-making process, and that consultation practices with all interested parties be followed.

In sum, delegation of authority by the legislature to an autonomous central bank gives rise to the problem of controlling and circumsribing agency activities and influence. This can be done by making the agency accountable, making its activities transparent, and limiting its discretion through precise limits on the range of policies it can enact.

While many countries in recent years have given their central banks greater autonomy and greater relevance to price stability as their main final objective, there has been considerable variation among countries in the ways autonomy has been combined with provisions to make central banks transparent and accountable to elected bodies.

Typically there are three main reasons why the central bank must be made accountable for the manner in which it exercises its power. First, it must be accountable to ensure the existence of appropriate checks and balances; secondly, accountability measures should contribute to minimizing any abuse of power; and—finally—they should ensure that the central bank manages its financial resources efficiently.

However, proper accountability measures are also crucial to making the central bank autonomy work. Sound business practices and clear

and transparent procedures are important for the credibility and reputation of the central bank and the maintenance of its autonomy. Several recent papers have shown how greater transparency in the operating procedures of central banks contributes positively to build a better reputation (see, among others, Faust and Svensson, 2001). Gerraats (2001) presents a formal argument showing how transparency is beneficial for central banks trough positive effects on their reputation. However the conclusions of economic works discussing the pros and cons of opaqueness and transparency, are fully related to the conduct of monetary policy. When they provide explanations for secrecy or when they advocate openness they always discuss how information disclosure eventually affect monetary policy effectiveness without paying attention to the issue of transparency on the other functions of a central bank. However, transparency is a multifaceted concept and some of its aspects are certainly relevant for a financial regulator as well. For instance, elements like transparency about policy objectives (political transparency), disclosure of economic data (economic transparency), or about internal policy deliberations (procedural transparency), statements about policy decisions and future actions (policy transparency) are concepts fully applicable to all central bank functions. Similarly to the results obtained in the field of monetary control, we might therefore sustain that greater transparency should be beneficial to build central bank reputation which is the main central bank asset in all its activities.

Furthermore, transparency and accountability may also help central bank's management to become more autonomous through two main channels. First, high accountability entails sharing more information with others which in turn can contribute to develop public consensus around the central bank's policies. Second, transparency and accountability should also help in both shielding the institution from external interference making more difficult for outsiders to exercise pressure, and making more complex and costly for insiders to satisfy outsiders' requests. Similarly, the fewer checks and balances there are, the easier and less costly is for the political authorities to undermine central bank autonomy. This is particularly true in and relevant for young central banks and small countries, given the relationship between central bank autonomy on one hand,

and the prevailing political culture and institutional checks and balances on the other. Compared to larger countries, small countries are usually characterized by less transparency in political processes, fewer political checks and balances, a minor role of the media, and a closer government-business nexus. If these features are combined with the results of some recent empirical studies showing the key relevance of broader political and institutional conditions for the actual degree of autonomy, it is easy to argue that greater attention should be dedicated in small countries towards the foundation of the appropriate institutional conditions that will ensure effective and real central bank autonomy. In particular, empirical evidence has been advanced showing that an independent central bank is most effective in the presence of credible and effective political checks and balances (Keefer and Stasavage 2001, Keefer 1999 and Moser 1999).

We may distinguish between three main forms of central bank accountability, in relation to the above-mentioned reasons justifying it. First is the form, which can be called substantive accountability, and which refers to the central bank's main objectives as established in its legislation. In other words, substantive accountability seeks to ensure that the actions and decisions of the central bank are justifiable as regards the public interest goals assigned to the central bank. Secondly, there is procedural accountability, to ensure that central bank actions and procedures are fair and impartial in serving the public interest and resisting undue influence from private interest groups. Within procedural accountability we may distinguish two general categories of administrative control: ex ante controls and ongoing controls. Ex ante controls concern various issues of agency design, like the reporting and consultation requirements which a central bank must follow to make policy, or the standards and criteria have to be followed when it promulgates regulations. Ongoing controls consists of those procedures and initiatives by other institutions that check the central bank's actions on a regular basis. Finally the third form of accountability, financial accountability, should ensure that the central bank satisfies certain standards of financial management.

The issues of accountability are, in essence, no different from those encountered in the principal-agent literature. However, they

pose greater challenges when accountability refers to a public and institutional setting. In fact, when accountability problems arise in a private context, they involve a homogeneous group of principals and agents, typically between shareholders and company managers. This can be alleviated by both contractual constraints (e.g. the terms and conditions of contracts) and market constraints (e.g. competition for corporate control and the threat of take-overs). Vice versa in a public setting, such as the case of autonomous financial authorities, a diverse set of interests exists, including that of politicians, financial intermediaries, debtors and investors. Furthermore, substantive accountability is more difficult to monitor, especially in a context without monetary policy and therefore without explicit targets for the inflation rate. Whereas performance is easily measurable in a private company's financial statements, this is not so for a central bank. For the latter, performance should be measured by assessing the degree to which it has achieved its various institutional objectives. An additional problem in a public context is the fact that there is no market for central bank functions, and hence no market discipline to alleviate principal-agent problems. Finally, these difficulties are exacerbated by the special need for confidentiality inherent in supervisory work within the financial sector. This last observation reminds us of the possible trade-off which might arise in designing a strategy for substantive accountability. We previously highlighted the importance of rendering institutions autonomous from political power, as well as having experienced and qualified regulators able to maximize institutions' prospects of reaching their public interest objectives. However, these prospects can be significantly reduced if financial regulators' actions and judgements may be over-ridden by other bodies that lack the same degree of political autonomy, expertise and qualifications.

V. CONCLUSIONS

In the recent economic literature the notion of central bank autonomy has mainly been discussed in relation to the conduct of monetary policy on the basis of the inflation bias. However, there are countries which do not have the problem of managing their own monetary policy, but still have a central bank performing a variety

of functions. The number of these countries is on the rise, and not only includes the smallest nations which adopt other countries' currency, but also those with "extreme" monetary regimes such as dollarization, currency boards or monetary unions. These institutional settings raise the question of central bank autonomy in a framework where the inflation bias is no longer relevant . The present paper has argued that even when a central bank does not conduct its own monetary policy but performs a set of other functions, and—above all—is also the financial authority in charge of financial regulation and supervision, a certain degree of autonomy is required for it to act effectively and achieve its final objectives. With particular reference to the role of financial regulator, autonomy is justified to minimize the risk of interference by external factors (both political and industry-level pressures). Such factors could negatively impact the reputation of the regulatory agency, and a damaged reputation will eventually cause investors to defer or revise their investment decisions. The end result of such a scenario would be a hampered financial sector.

This paper has also discussed the different notions of central bank autonomy, and the complementary relationship existing between autonomy and accountability. In particular, an analysis has been carried out focusing on how the relevance of central bank autonomy and accountability changes in a context in which the central bank does not run its monetary policy, but is in charge of regulating and supervising the financial sector. This is typically the case in the smallest countries. The conclusion herein is that in these small countries, despite the presence of more binding constraints, the necessity for central bank autonomy is even more compelling. This is undoubtedly so if financial sector growth is to remain a key final objective of such countries' economic policies.

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ENDNOTES

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[1] The economic literature refers to both the term "independence" and "autonomy" of the central bank; although the distinction in meaning is not so clear, generally the term independence indicates a lack of institutional constraints, whereas autonomy entails operational freedom. In the rest of the paper we prefer to use the term autonomy, but we also discuss the institutional dimension of central bank autonomy.

[2] For a recent critical review of the political economy and determinants of monetary institutions see Bernhard, Broz and Clark (2002).

[3] This is the case of many small economies; for instance, in Europe San Marino has its own central bank and adopts the euro as legal tender.

[4] In a monetary union the concept of central bank independence can be associated with the indirect responsibility of each national central bank at the area level as in the European monetary union experience.

[5] Within objective autonomy a further distinction can be made between goal and target autonomy. The former is a broader concept that may be used if the central bank has no clearly defined primary goal, whereas the latter is used to indicate that the central bank has authority to decide a specific target for achieving the primary goal stipulated in the legislation.

[6] This approach is generally followed by many of the most advanced international financial centres.