Governing the Governors:

A Clinical Study of Central Banks

by

Lars Frisell, Financial Stability Department, Sveriges Riksbank, and ECB

Kasper Roszbach, Research Division, Sveriges Riksbank

Giancarlo Spagnolo, Stockholm School of Economics, Consip and CEPR

The Governance of Central Banks

August 31 – September 1, 2006, Sveriges Riksbank

Motivation

• Recent alleged corporate governance problems in CBs. Intense public debate in several European countries.

• Central Banks are complex organizations. At the same time:
  - a bank and an insurance company
  - a public or publicly controlled firm
  - a regulated monopolist producing a public good
  - regulator or supervisor of the banking industry
  - sometimes: competition authority

• Main *corporate* governance mechanisms absent (competition, takeovers, etc.)

• Literature on independence/accountability mostly restricts focus to monetary policy issues

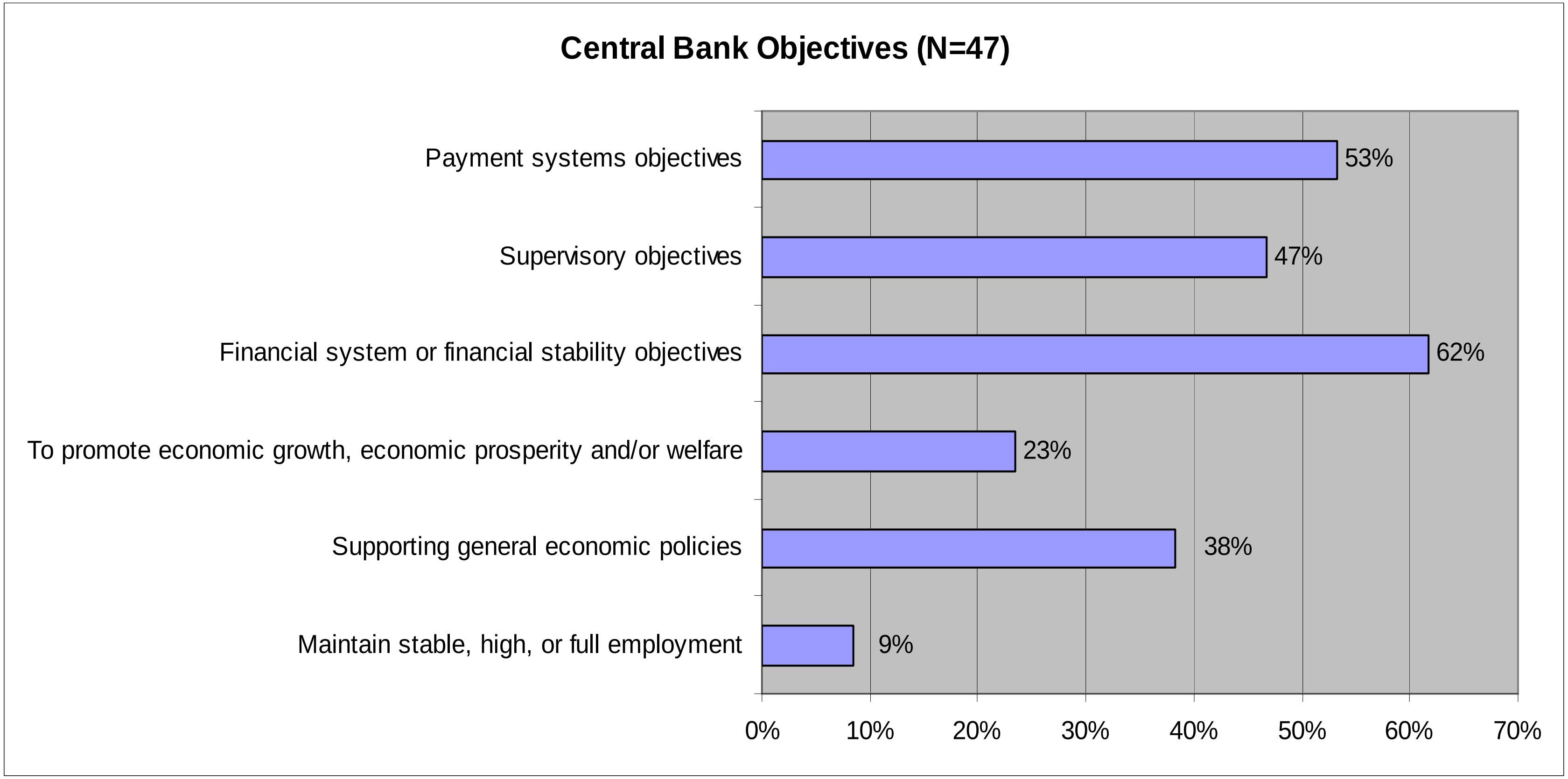
Purpose of our paper

- Create a benchmark of the current governance, standards and institutional organization of CBs;

- Compare this benchmark with “standards” provided by the existing economic literature, if any;

- Make an inventory list of specific governance issues not yet satisfactorily addressed.

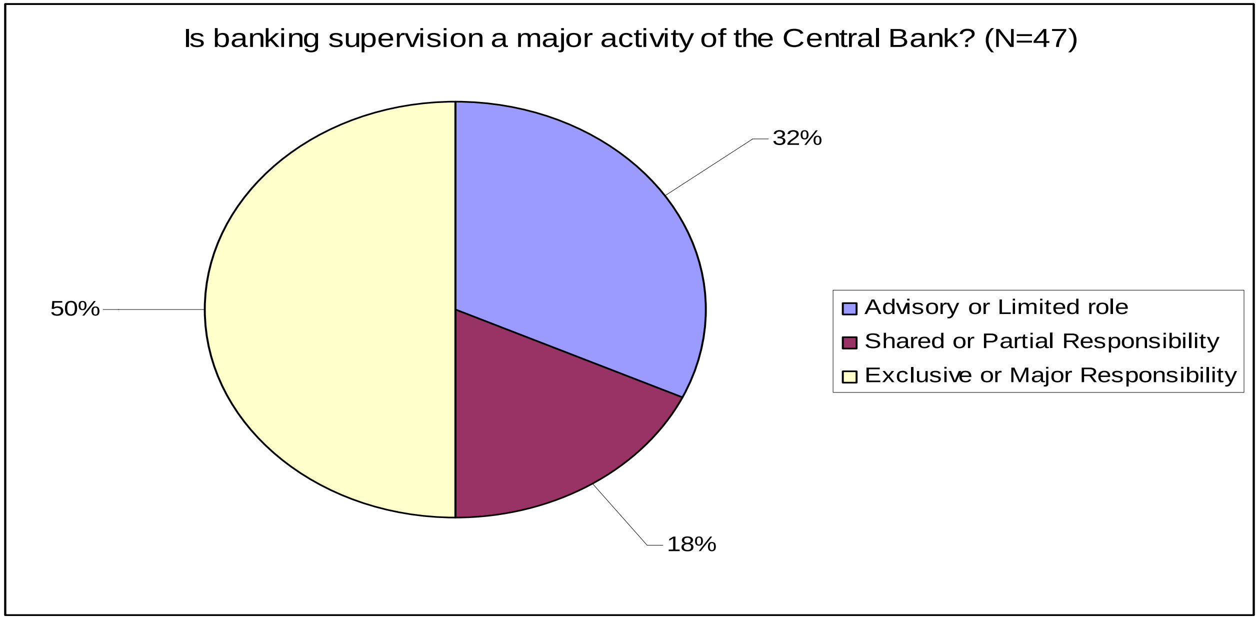
Overall objectives



The multiplicity of tasks

- Multiple tasks makes governance difficult:
  - Incentives may be detrimental if not all tasks measurable (M-H ‘91)
  - Career concerns weak if multiple tasks (Dewatripont et al. ’99)
- Typically, lexicographic priority to inflation control, as in the literature. Now that inflation is down:
  - Is the such a strong emphasis on price stability justified?
  - Which are the correct weights to be attached to other objectives?
  - If conflicts appear between objectives, how should they be traded off?
- Performance measures for other tasks?

Separation of powers

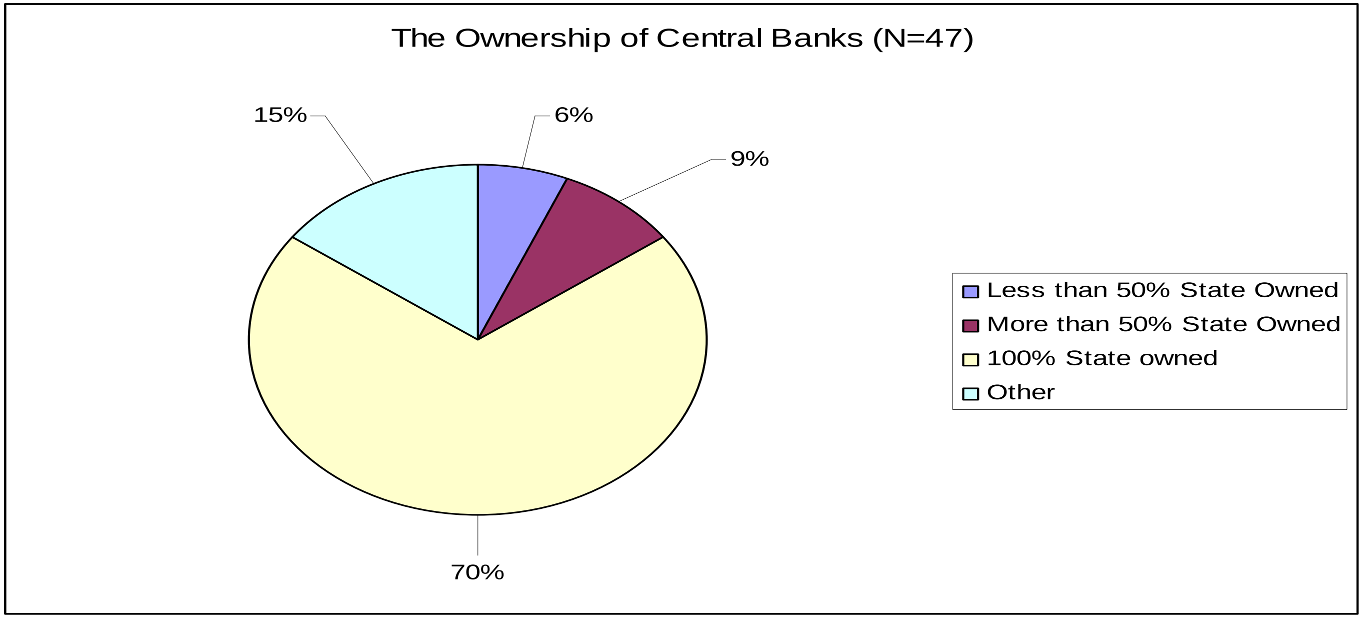


- Debate: conflicts of interests vs. informational synergies

  e.g. Schoenmaker (1992), Boot and Thakor (1993), Di Noia – Di Giorgio (2000), Kahn and Santos (2004)

- Why so much variety? What performs better?

Ownership

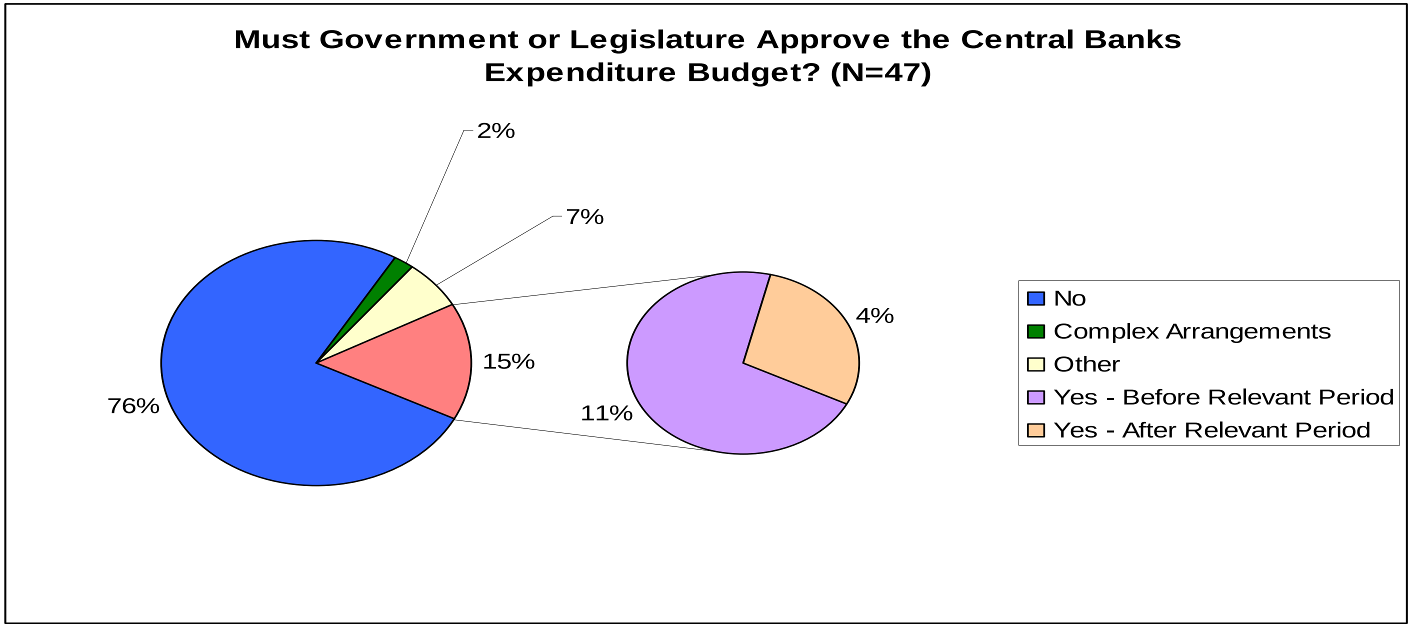


- Generally, public ownership is costly: poor incentives, political distortions

- Good when (i) non-contractible quality important, (ii) innovation not crucial, (iii) competition weak, and (iv) reputation ineffective (Marshall; Hart et al. '97; Shleifer '98)

- Regulatory function appears to fit (i-iv), but analysis is needed

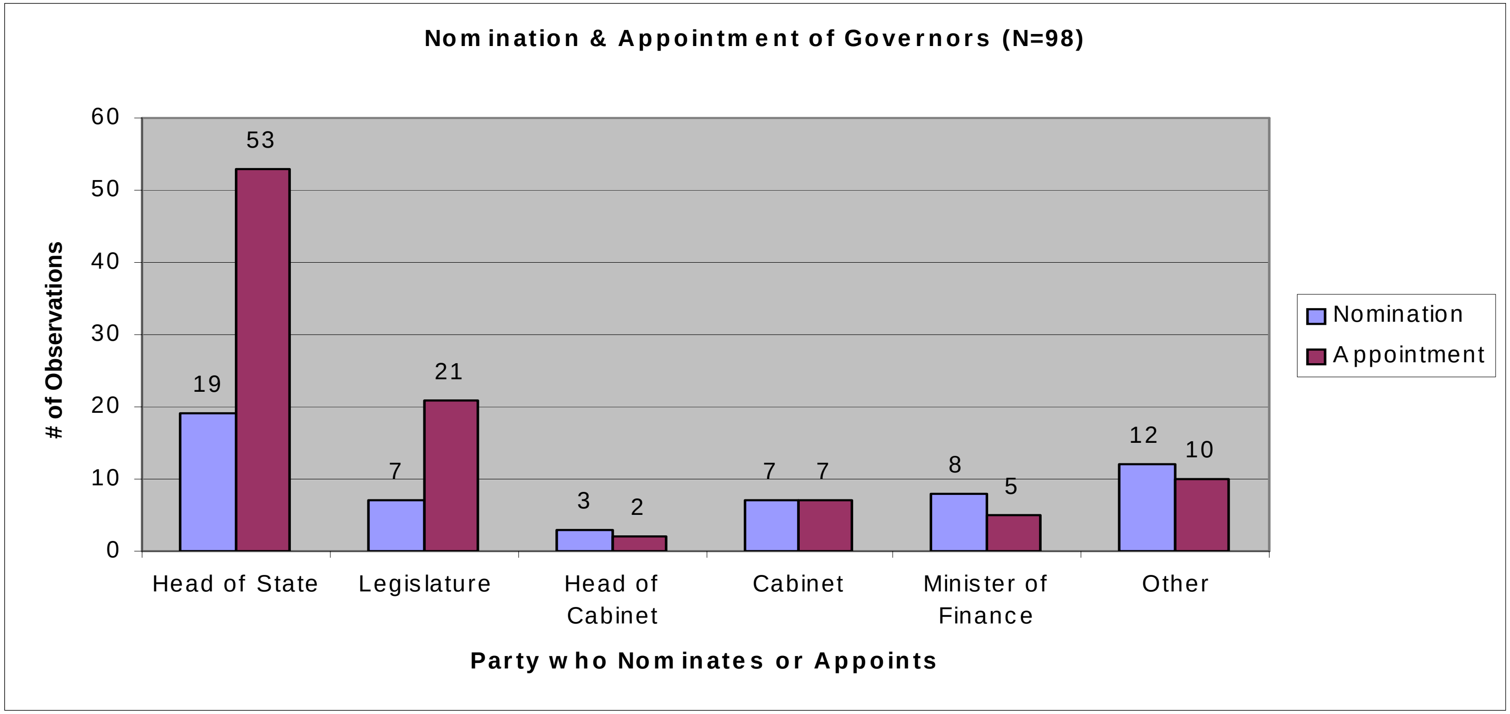
Budgetary independence



- Financial independence and accountability may conflict in reality (Von Ungern-Sternberg, 2003)
- Unlike other government bodies, few CBs subject to ex-ante budget approval

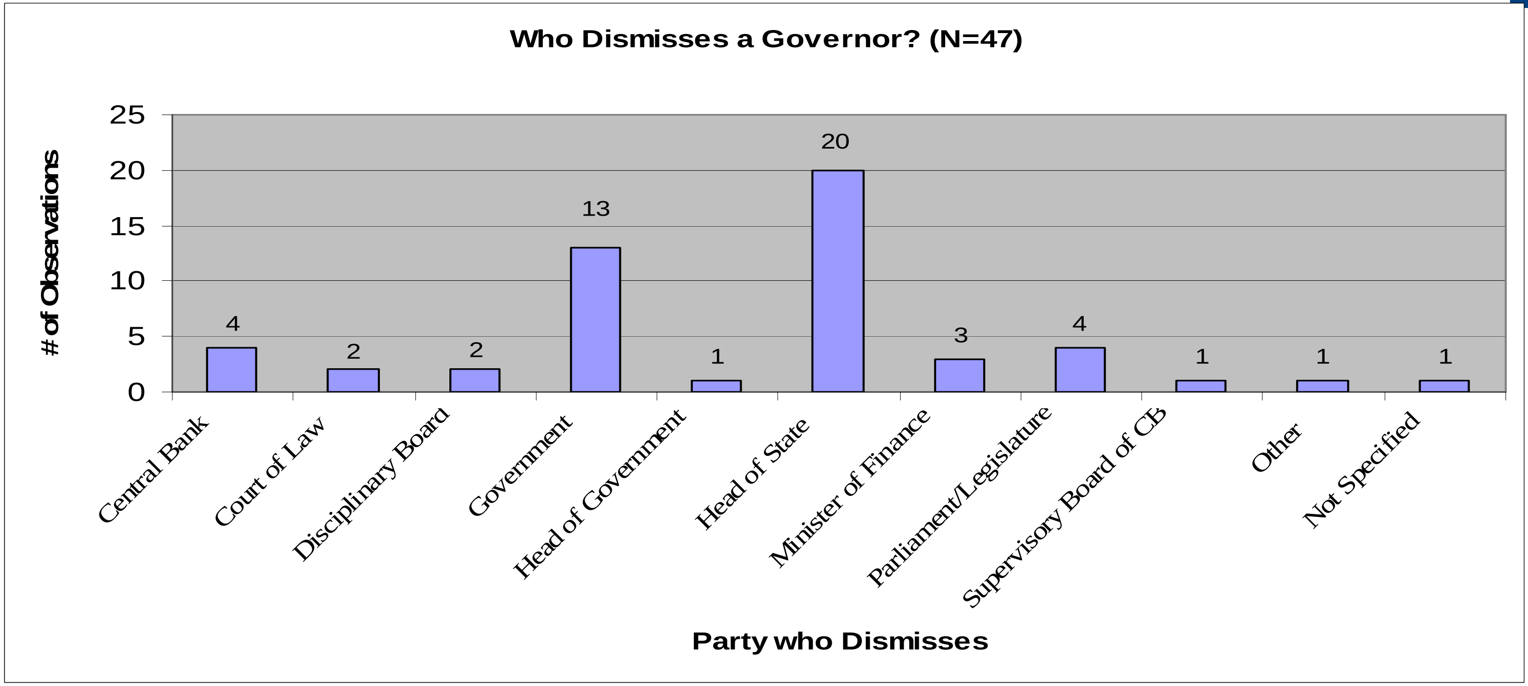
- What is reason? Special tasks? Necessary for political independence?

Governor appointment



- In most cases Governor appointment is complex, involving several institutions

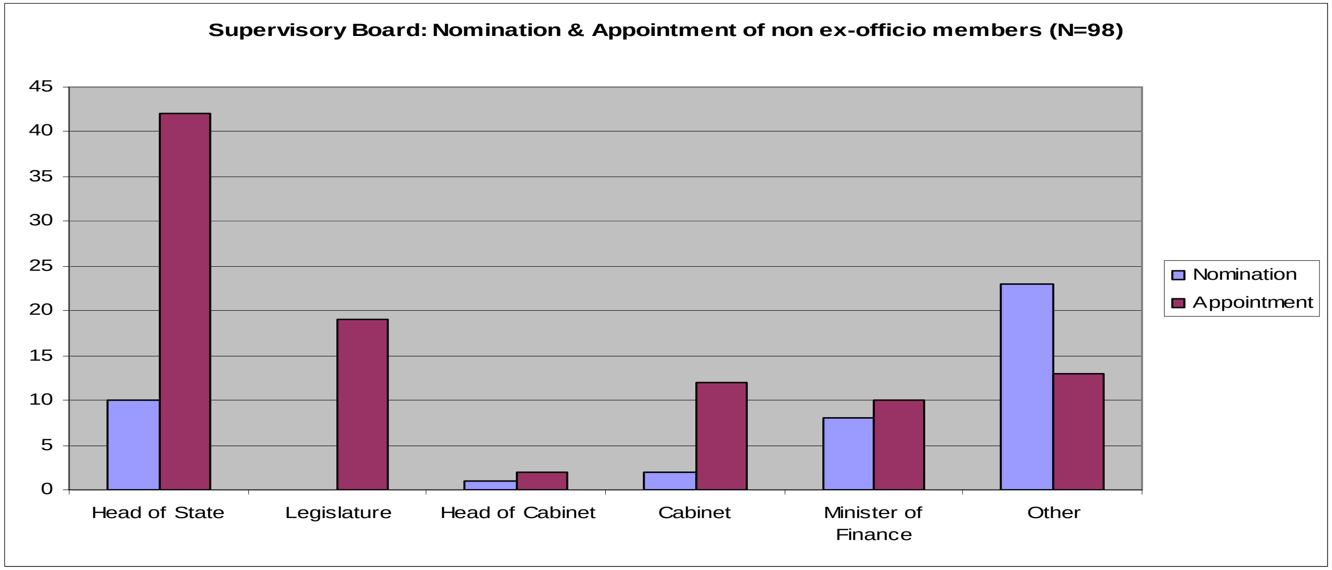
Governor dismissal

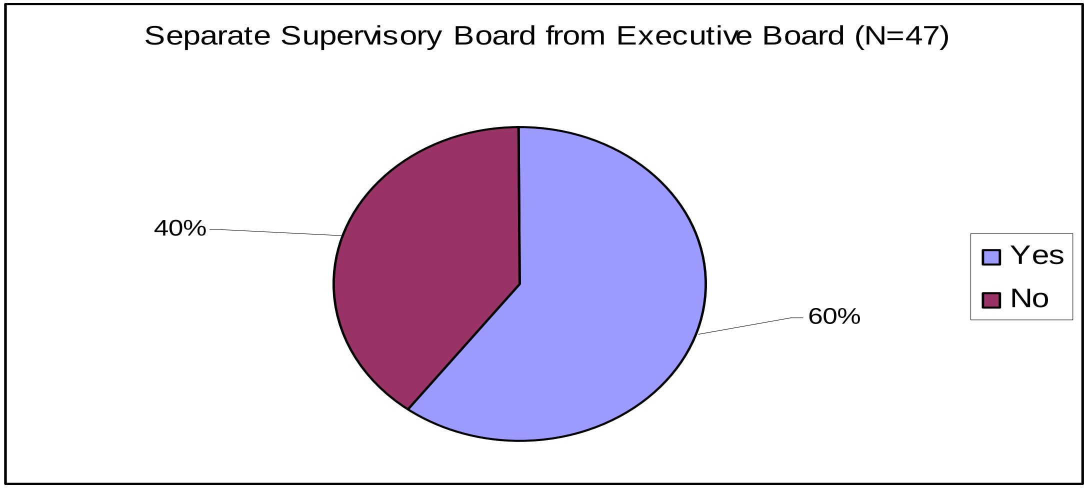


• Grounds for dismissal typically left generic: termination threat is open, but rarely used

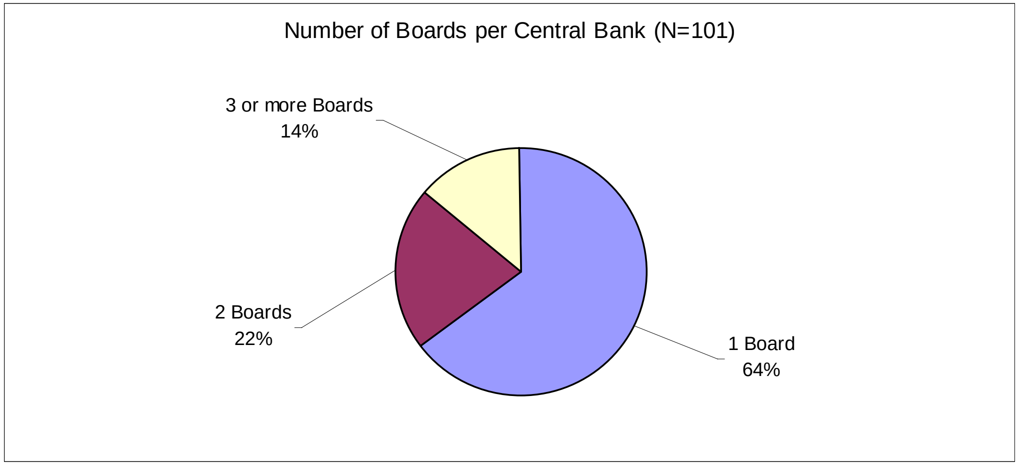
• Implicit tenure appears consistent with Maskin-Tirole (2004) and Alesina-Tabellini (2004/6)

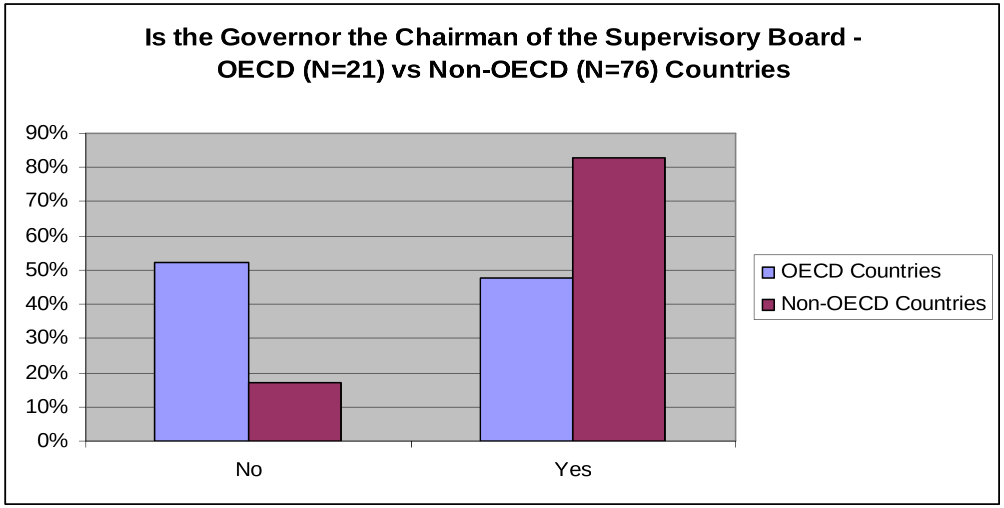
Board independence





OECD vs non-OECD





The board as a supervisor and advisor

- Adams-Ferreira (2004): for corporations, “friendly” sole board first best, dual board if CEO preferences strongly divergent from shareholders’

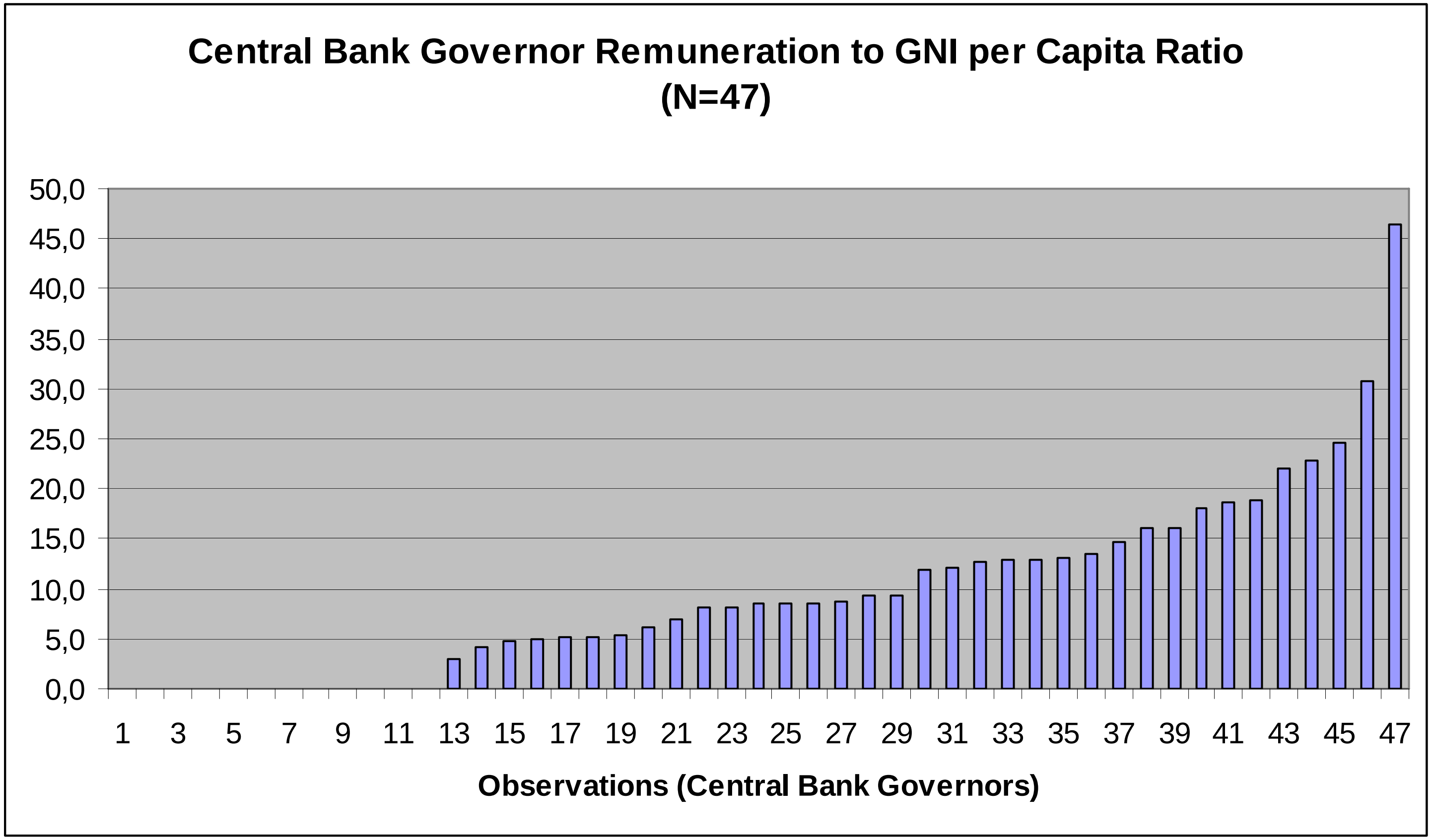
- Nordic countries dual board, have more moral hazard?

- For many countries different than for corporations

- Supervisory board members independent from Governor;
  sole boards mixed

- Board size changes a lot
  (Adams-Mehran 2003: large boards may be good for banks)

Governor compensation



Governor compensation

- Very large variation
- Debated in media, but arguments not well lined up
- What is a Governor's "market value"?

Theory:

- Pay above market to induce performance (Becker and Stigler, 1974; Shapiro and Stiglitz 1984)
- Pay well to select high quality (Weiss 1980; Caselli and Morelli 2004).
- Complex interaction (Besley-McLaren 1993; Besley 2004)
- Vocational doctrine (US): low wage to select "saints"

Efficiency wage theory not rejected

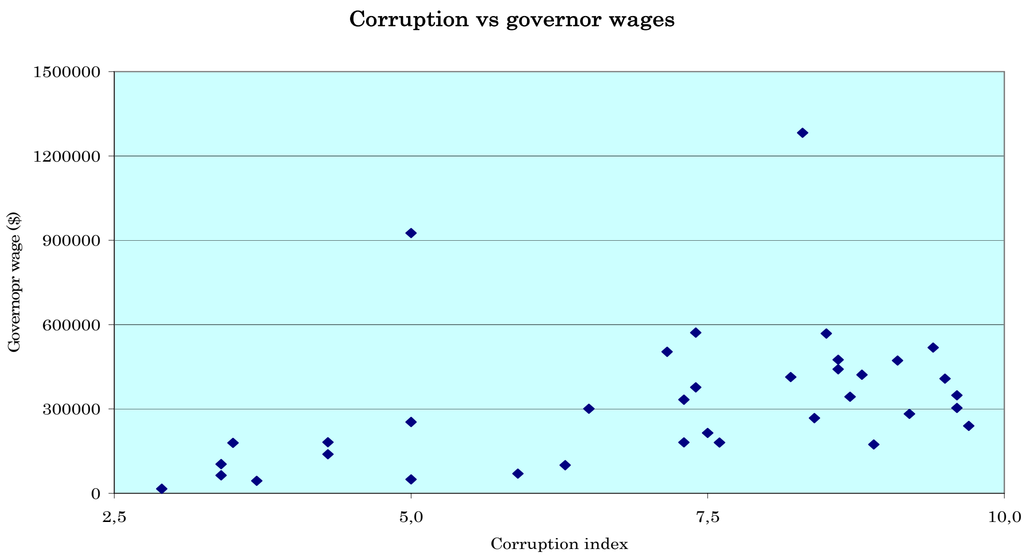
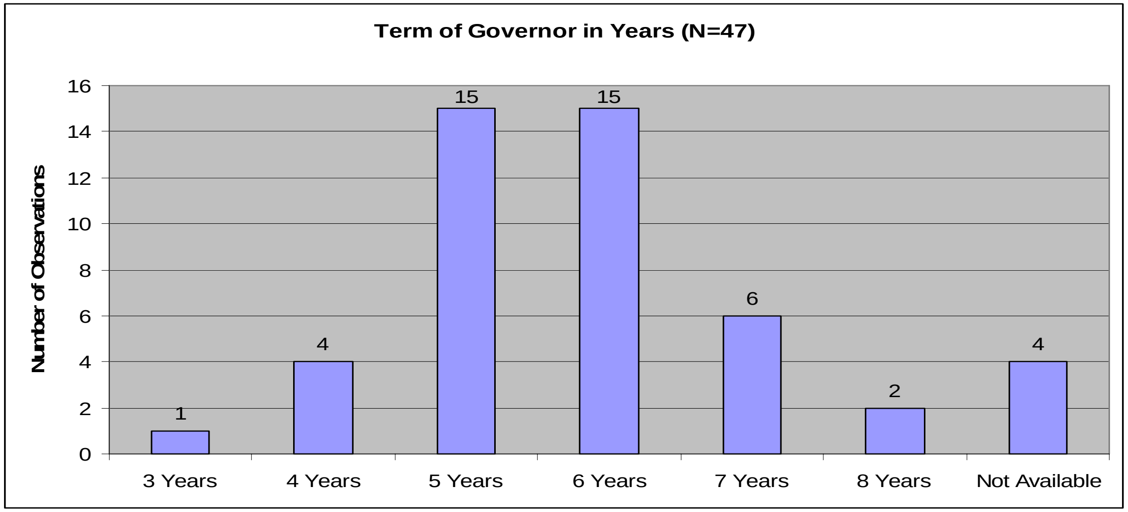
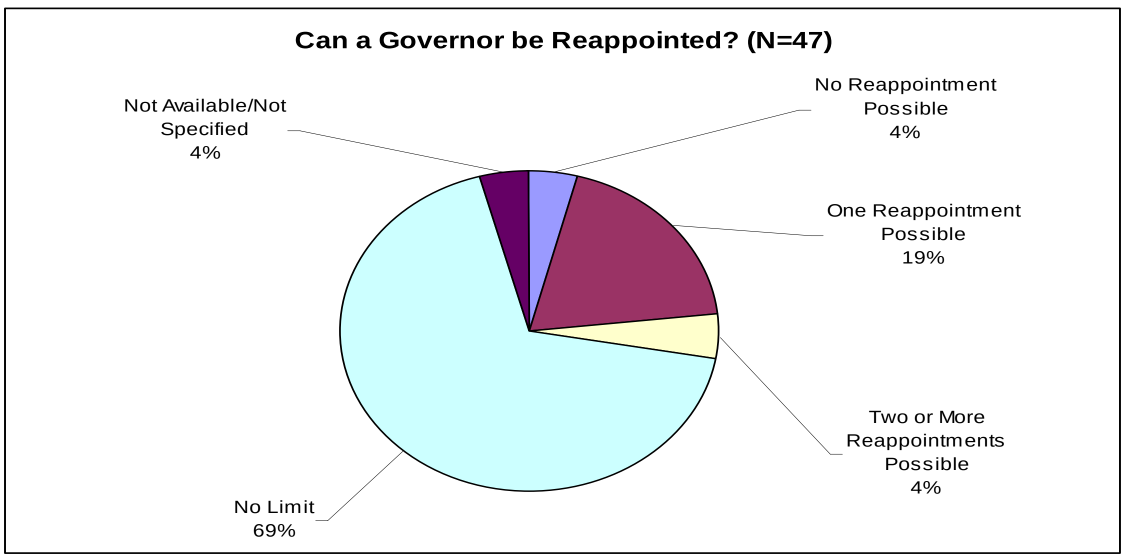


Table 3. The legal origin of countries and the remuneration of Governors
The first row displays the absolute remuneration of governors in US$. The second row relates the absolute salary to the average over all countries. The last and most important row presents governor remuneration in relation to a country's GNI per capita.

	N=36 All	N=11 UK	N=10 French	N=5 German
GOVREM	326302	408169	392933	413099
GOVREM Relative	1,00	1,25	1,20	1,27
GOVREM / GNIC	**13,50**	**15,59**	**17,85**	**11,28**

Term length and term limits





Term length and term limits

- Long term lengths to avoid political cycles

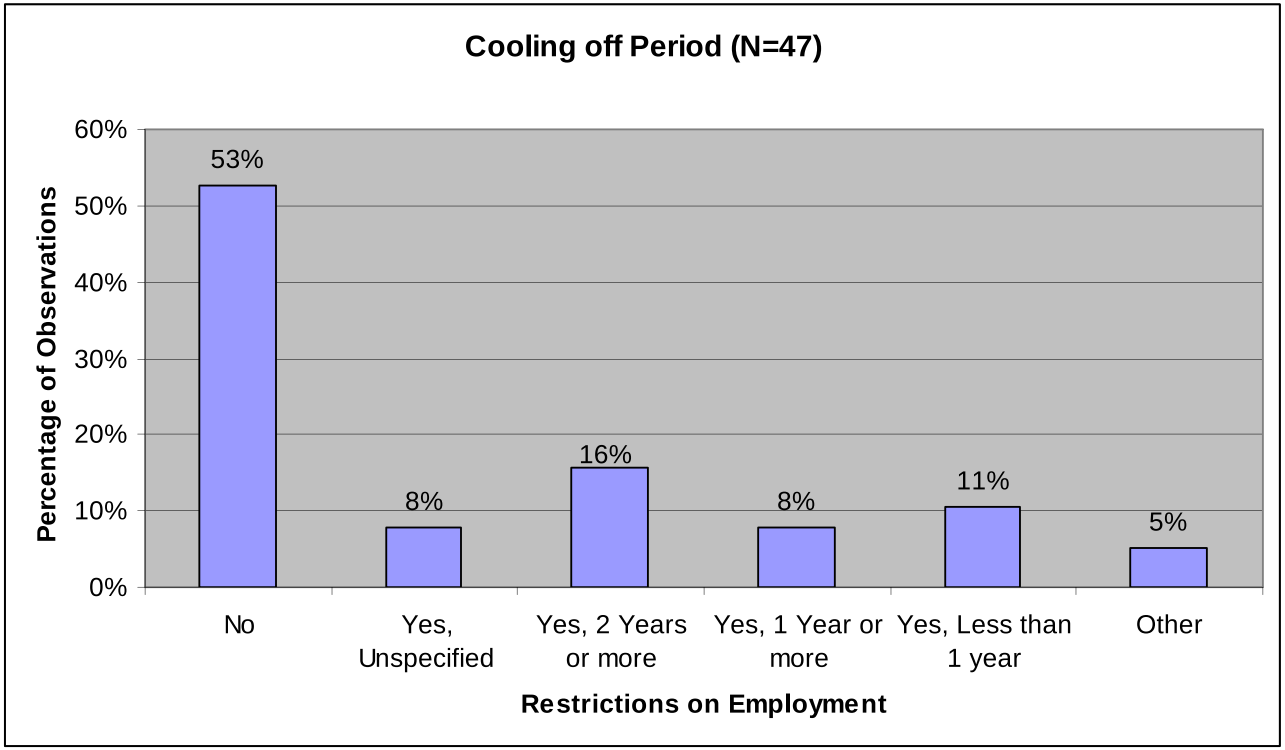
- Term limits in very few CBs; common in US states.

- Pros:
  - incumbents may become too powerful relative to entrants…
  - too long service may induce capture
  - reduced value of office = less rent seeking

- Cons:
  - reduced value of office reduces discipline and selection forces
  - more end-term effects (lame duck), short-termism etc.
  - good people that learned a lot may be forced to leave

  - More research needed to strike the balance!!

Revolving doors, cooling-off and capture 1(2)



Revolving doors, cooling-off and capture 2(2)

- Few CBs limit post-contractual employment

- Are “revolving doors” good or bad? They increase both:
  - risk of regulatory capture (Laffont-Tirole ’91; Leaver ‘01), and
  - regulatory expertise (Che ’96; Salant ’96)

- Are cooling-off periods necessary? Optimal length?

Conclusion

- Aligning central banks' incentives with their (assigned) multiplicity of objectives appears a complex task.

- Large amount of institutional variation between countries, (board structure, governor remuneration, term lengths, appointment rules, etc.) poses a challenge to research.

- Future work:
  - Complete database
  - Study econometrically the determinants and effects of the various governance arrangements found
  - Relate them with legal origin, importance of national conditions, etc.