Governing the Governors:
A Clinical Study of Central Banks

by

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The Governance of Central Banks

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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

Central Bank Objectives (N=47)

- Payment systems objectives: 53%
- Supervisory objectives: 47%
- Financial system or financial stability objectives: 62%
- To promote economic growth, economic prosperity and/or welfare: 23%
- Supporting general economic policies: 38%
- Maintain stable, high, or full employment: 9%
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

Is banking supervision a major activity of the Central Bank? (N=47)

- 50% Advisory or Limited role
- 32% Shared or Partial Responsibility
- 18% Exclusive or Major Responsibility

• Debate: conflicts of interests vs. informational synergies

• Why so much variety? What performs better?
Ownership

The Ownership of Central Banks (N=47)

- 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

Must Government or Legislature Approve the Central Banks Expenditure Budget? (N=47)

- No: 76%
- Complex Arrangements: 2%
- Other: 15%
- Yes - Before Relevant Period: 4%
- Yes - After Relevant Period: 11%

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

Supervisory Board: Nomination & Appointment of non ex-officio members (N=98)

Separate Supervisory Board from Executive Board (N=47)
OECD vs non-OECD

Number of Boards per Central Bank (N=101)
- 3 or more Boards: 14%
- 2 Boards: 22%
- 1 Board: 64%

Is the Governor the Chairman of the Supervisory Board - OECD (N=21) vs Non-OECD (N=76) Countries

OECD Countries
- No
- Yes

Non-OECD Countries
- No
- Yes
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

Central Bank Governor Remuneration to GNI per Capita Ratio
(N=47)
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

Corruption vs governor wages

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.

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Term length and term limits

**Term of Governor in Years (N=47)**

- **3 Years**: 1 observation
- **4 Years**: 4 observations
- **5 Years**: 15 observations
- **6 Years**: 15 observations
- **7 Years**: 6 observations
- **8 Years**: 2 observations
- **Not Available**: 4 observations

**Can a Governor be Reappointed? (N=47)**

- **No Limit**: 69%
- **One Reappointment Possible**: 19%
- **No Reappointment Possible**: 4%
- **Two or More Reappointments Possible**: 4%
- **Not Available/Not Specified**: 4%
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)

Cooling off Period (N=47)

- No: 53%
- Yes, Unspecified: 8%
- Yes, 2 Years or more: 16%
- Yes, 1 Year or more: 8%
- Yes, Less than 1 year: 11%
- Other: 5%

Restrictions on Employment
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.