

I. THE ROLE OF A CENTRAL BANK IN THE SOCIETY

80 years passed from the beginning of activities of Eesti Pank on 3 May 1999. The Bank dedicated to the anniversary an international conference “The Role of a Central Bank in Economic Policy Management” with the European Central Bank, Bank for International Settlements, European Bank for Reconstruction and Development, Nordic Investment Bank and most of national central banks from Europe represented. Although the first of the two panel discussions was dedicated to **central banks in transition economies**, discussions often deviated to the other topic – **central banks and politics**. This is understandable as the position of the central bank in the society, its competency, functions, responsibility and accountability have been debated about in some countries for centuries already. The keynote speeches on the topic were held by Sir Peter Petrie, Advisor to Governor of the Bank of England and Bengt Dennis, former Governor of *Sveriges Riksbank*.

As the extent of independence of central banks is topical for banks operating already for hundreds of years, it is not surprising that in transit economies the role, functions and various aspects of responsibility of local central banks are again and again brought into the limelight. The bank’s independence, transparency and accountability are topics to be discussed in the context of the youngest but one of the most influential financial institutions in the world in the upcoming years – the European Central Bank (ECB) – as well, represented in the person of Christian Noyer, Vice-President, at the conference in Tallinn.

Nowadays it would be rational to specify the institutional role of the national central bank on the basis of the Treaty establishing the European Community and Statute of the European System of Central Banks (ESCB) and of the European Central Bank. The above applies also to Eesti Pank, marking its tenth anniversary of the re-establishment on 1 January 2000. The Republic of Estonia is one of the EU applicant countries, planning to join the Economic and Monetary Union as well.

What Is the Independence of the Central Bank and Why Is it Necessary?

The Constitution of the Republic of Estonia provides in Articles 111 and 112 the functions, rights and obligations of Eesti Pank. The activities of the Bank are regulated by the Central Bank Act. Pursuant to the Act the central bank is independent of other state institutions and is subjected neither to the Government of the Republic nor to any other executive state authority. Eesti Pank is not liable for the proprietary obligations of the state and the state is not liable for those of the Bank. Members of the government cannot be members of the highest body of the Bank – the Board. The Minister of Finance attends the Board meetings without the right to participate in decision-making.

Eesti Pank is the only constitutional institution pursuing national monetary policy and directing the banking sector supervision¹. The Bank has the sole right to issue Estonian currency, obligation to regulate currency circulation and to uphold the stability of the national currency. Eesti Pank

¹ On the performance of the above and the following functions see Consistent Monetary Policy, pp 39 to 44; Supervision under New Law, pp 58 to 64; Payment Instruments, pp 67 to 68; Cash Demand, pp 68 to 71; Foreign Currency Reserves Management, pp 76 to 78; International Cooperation, pp 47 to 54; Statistical Activity, pp 73 to 75; and Appendices, pp 119 to 122.

regulates also the use of national precious metal and foreign currency reserves and draws up the national balance of payments. The Bank performs supervision of all the credit institutions operating on the territory of Estonia, cooperates with international financial institutions and national banks of other countries. Summarising the above Eesti Pank has formulated the following mission statement – **to implement all the measures at its disposal in order to increase confidence in the Estonian kroon and the stability and integrity of the Estonian monetary system both at home and abroad.**

The Republic of Estonia has learned its lesson of wrong performance in the years 1919–1928. One of the main reasons for the devaluation of the national currency was the performance of Eesti Pank as the financier of the executive power and it was not possible to keep the exchange rate of the Estonian mark stable while financing the government. Having learned the lesson, the 1928–1929 monetary and banking reform oriented Eesti Pank to independence and non-dependence of the government.

After the restoration of the Republic of Estonia the *Riigikogu* passed unanimously the Central Bank Act in May 1993. This very fact reflects the societal understanding that **only an independent central bank, with not only an obligation but also a right and possibility to perform adequate monetary policy and provide sufficient banking supervision, can uphold the stability of the national currency.** The latter gives confidence to economic agents to be involved in long-term planning of saving, consumption and investment performance. Thus, the stability of the currency is the basis of long-term economic and social development in the society.

The reason why the implementation of monetary policy, ie the securing of currency and financial stability is vested with the central bank and not with the government in most of the countries all over the world, lies in the fact that solving short-term economic tasks the executive power might sacrifice long-term national economic interests on political considerations. By shielding monetary policy decisions from political interference, the central bank can help to maintain lower inflation without having to give up economic growth. Short-term political considerations can lead to non-sustainable accelerations in economic activity, at the expense of lasting increases in inflation rate and also at long term the curbing of economic output and increases in unemployment.

In order to uphold the national financial stability, Eesti Pank will develop the operational framework of the monetary policy in such a way as to guarantee continuously reliable implementation of the currency board arrangement in the small and open economy of Estonia and reduce market deviations in the financial sector. The supervisory activity of the central bank arising from the control of the execution of laws and normative acts function, is based on international standards and practice whereas the prudential ratios and provisions of regulatory acts are for transition economies stricter than for stable economies because of larger underlying micro and macro risks. Therefore the implication of the South-East Asian financial crisis on Estonia's financial sector has been below anticipation, the monetary system has survived all speculative attacks and after the price downfall in the stock market, merger of banks and a number of bankruptcies the financial sector is stronger than ever.

Considering the ever-deepening integration of Estonia's financial markets with external markets, Eesti Pank is continuously strengthening cooperation with the supervisory institutions and central banks in other countries. Several external advisors, *inter alia*, from the International Monetary Fund, have advised the Banking Supervision Department of Eesti Pank in recent years.

International Experience in Central Bank's Independence

All the EU member states have defined the legal status of the central bank by a relevant law. Some countries have provided for the role of the central bank in the constitution. More and more central banks are independent not only *de jure* but also *de facto*. Together with becoming independent *de facto*, the accountability and public disclosure rules have been specified.

The European Central Bank (ECB) is one of the most independent central banks in the world; its independence is enshrined in the Maastricht Treaty. The ECB is a financially and politically independent institution with the primary objective to implement the EU monetary policy, maintaining price stability in the ESCB countries. Without prejudice to this objective, the ECB supports the general economic policies in the European Union, with objectives such as economic growth and high employment. The stance of fiscal policy is only one of the factors the central bank takes into account in setting interest rates to maintain price stability. The ECB can neither make any commitments itself in relation to an announced fiscal policy nor react mechanically to a given budgetary decision.

The members of the Executive Board of the European Central Bank are appointed by heads of state or heads of government. They are financial specialists independent in their decision-making. Members of the 17-member Governing Council, with a term of office of at least five years, cannot take or seek instructions from politicians. Nevertheless, this does not exclude communication with politicians. The president of the ECB attends the meetings of the Economic and Financial Affairs Council (ECOFIN) whenever issues relevant to the tasks of the central bank are discussed. The ECB top officials participate also in the informal meetings of the ministers of finance of the 11 Member States, which have introduced the euro (Euro-11). The president of the ECOFIN Council and a member of the European Commission have the right to attend meetings of the Governing Council of the ECB, without the right to vote.

The Bank of England founded in 1694 became independent de jure only in the year when the ECB was established. Among Europe's central banks it was one of the last to gain independence. Before the Bank of England Act entered into force on 1 June 1998, the international task force was involved, drawing the following conclusions:

- The central bank must be independent from the government because the government may be tempted to create cash, but excessive money feeds inflation;
- The monetary policy can be independent of short-term considerations if the central bank is not the government bank;
- A successful monetary policy has three components – main goals, implementation mechanisms and a possibility to create a necessary set of instruments for achieving the goals;
- The independence of the central bank can never be absolute: legislation must provide the bank's objectives that determine its operational framework and responsibilities.

The message delivered by the operational principles of the ECB and the Bank of England is clear – **political interest and monetary policy decisions have to be kept apart insofar as it is possible in the modern integrated society.**

The real, not only de jure independence of the central bank is beneficial for the society as it helps to restrain inflation without undermining economic growth.

The coincidence of many provisions in our Central Bank Act with the legal definitions of the ECB and other central banks in Europe proves that adopting the law, the *Riigikogu* has taken into account principles prevailing in Europe and the status of Eesti Pank as a legal person is in full compliance with current European practice. Nevertheless the Central Bank Act needs amending and alignment with the EU *acquis*. Conflicts between some provisions of Eesti Pank's legislation, other laws and the constitution remain to be eliminated.

The independence of the central bank is not and cannot be absolute. The independence is accompanied by accountability and the commitment to inform the public of its activities². Eesti Pank reports to the *Riigikogu*, the latter appoints to office, on the proposal of the President

² See Openness and Transparency, pp 55 to 57.

of the Republic, the Chairman of the Board of Eesti Pank and, on the proposal of the Chairman of the Board, members of the Board of Eesti Pank. Thus, the Board, focusing mostly on the control of central bank's daily activities, is comprised of representatives accepted by the society. The Board representing political power has the sole competence to develop monetary policy and determine its implementation measures, inter alia, credit institutions' prudential ratios. The Board submits to the *Riigikogu* the annual report of Eesti Pank and the candidate auditors, proposes to the President of the Republic to appoint to office the Governor of Eesti Pank, appoints the Executive Management of the Bank and staff of the Internal Control Department, approves the Statutes and the budget of the Bank.

The Strategic Development Plan of Eesti Pank³

Eesti Pank has drawn up its Strategic Development Plan since 1995. The Board of Eesti Pank has approved it as an operational guideline since 1997. This is an annually updated and improved document, setting up on the basis of the mission and main goals of the central bank, where the priorities for the next three years have been formulated.

The activity guidelines for the years 2000–2002 have been thoroughly amended both in substance and structure. All objectives and activities are grouped by priority areas. The tasks arising from Estonia's accession to the European Union and Economic and Monetary Union are formulated in greater detail and more concretely than before. Issues related to the financial sector supervision as well as principles for organisational development of Eesti Pank are explained in a more detailed way. This Annual Report handles the performance of Eesti Pank also in the setting of the Strategic Development Plan.



International conference "The Role of a Central Bank in the Economic Policy Management", on 3 May 1999.

³ See Appendices, pp 119 to 122.