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Central bank independence in a historical perspective. Myth, lessons and a new model

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ABSTRACT

This article puts the independence of central banks into historical perspective. In doing so, it underlines the highly versatile nature of the balance of forces between central banks and governments. From this viewpoint, the situation of public finances emerges as a key explanatory factor, and an analysis of the sequence of central banking models is proposed from the late 19th century to the present day. The article upholds the thesis of the emergence, since the subprime crisis, of a new model qualified as "tacit low-degree independence": central banks have, of their own volition, given up some of their de facto independence, helping governments to contain the rise in national debt. But while keeping a step ahead of pressure from governments, they have lost the control of money supply.

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1. Introduction

Even though there has been no change in the legislation governing the independence of central banks, a new era has indeed dawned since the financial crisis of the late 2000s. Financial upheavals and growth in sovereign debt have prompted central banks to help governments to liquidate debt even if it has meant losing control over the money supply (Goodfriend, 2012; Issing, 2012; Taylor, 2013). What will be the future of central bank independence? According to Capie and Wood "central bank independence never has survived a crisis and never can" (2013, 379).

Beneath the dross of tales about the degradation of sovereign ratings, tectonic movements have affected central banking and outlined the definition of a new model that could be qualified as "tacit low-degree independence". Central banks (Fed, ECB, Bank of England…) have digested the fact that they must help governments if they wish to avoid legal restructuring (Blinder, 2013). This capacity of major banks to keep a step ahead of governments' wants and needs may appear to be the fruit of progress in terms of transparency, a new development in the capacity to listen to political representation and to opinion (Eijffinger and Geraats, 2006, Crowe and Meade 2007, Dincer and Eichengreen, 2014), and also to assimilate the lessons of history in central banking.

Placing the question of the independence of central banking in a historical perspective sheds light on the way that it has changed in line with changes affecting monetary systems, economic structures and also the personalities of the highest-ranking officers. History reminds us of the extent to which relations between a government and a central bank can change quickly (Blancheton, 2012; Singleton, 2011). From a legal standpoint, statutes are never set in stone. When it comes to facts, the balance of power may evolve at any time, geared to a number of factors and transformations that lead to the adjustment of monetary policy, as shown by R. Hawtrey in "The Art of Central Banking" (1932) or more recently and in a different register, by A. Greenspan in "The Age of Turbulence" (2007).

The common thread of this article is the analysis of theoretical and historical interactions between sovereign debt and the independence of central banks. The goal of the paper is to show why and how public debt impacts on central bank independence and central banking. It is the scope of this debt today that has prompted central banks to reduce independence of their own accord.

Our approach is two-phased. The first section puts the question of the varying degree of independence into a historical perspective and proposes an original narrative analysis of the continuity of models of central banking since the late 19th century. The second section proposes empirical approaches to interactions between central bank independence and public debt. A final section concludes with the outline of a new model of central banking developed from lessons learnt from the history of independence.

2. The continuity of central banking models since the late 19th century

This section proposes a novel analysis of the continuity of models of central banking since the late 19th century. As is frequently the case in economic history, these models are narrative models without mathematical specification.

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2.1. Bank of issue model

Under a gold standard regime, the important issues related to a central bank are singularly complex. Over and above national differences, we can locate a bank of issue model. Most issuing institutions are private banks looking for profit (Bank of England, Banque de France, Reichsbank, Banca d'Italia, Banque Nationale de Suisse…). These institutions have a monopoly of issuance and also assume the functions of a Treasury bank and a bank of banks. As they turn into true central banks, they increasingly play the role of a lender of last resort and as a result are seen to be under government supervision. At an operational level, they are unable to arbitrarily modify the compensation of the monetary base. Consequently, the ante at stake with issuance policy is low and is more concentrated on slight variations in discounting practice. Before WWI, central banks did not attach great weight to the goal of maintaining the stability of the domestic economy (see Fig. 1 for a positioning of this model).

The proclamation in 1914 of the flat regime and the gradual shift to currency holding systems upped the ante associated with the management of monetary affairs. Monetary policy and central banking entered an era of "modernity", which consisted primarily of greater instability, discretionary options, monetary illusion and democratic aspirations. In the aftermath of war, faced with the difficulties of governments in re-establishing earlier monetary and financial structures, central bankers appeared to be tempted by greater independence.

At the same time as they were developing a model of international central banking (Cottrell, 2012), one Montagu Norman, the emblematic governor of the Bank of England (an institution that at the time was something of a model on a world scale) and Benjamin Strong, Governor of the US Federal Reserve Bank, were claiming greater independence. Conducting monetary policy, in their opinion, was becoming increasingly technical, as testified at this same period by the growing power of the research departments inside issuance institutes and the intensification of feedback of experience between central banks. Norman was expounding radical positions, totally challenging the legitimacy of political intervention in monetary affairs. On a visit to London in October 1926, Pierre Quesnay, the then Secretary General of the Banque de France, noted: "*He feels that the world's economic and financial organization must be the work of the 20th century. Politicians, in whom he recognizes the qualities needed to decide upon political problems, seem to him to be in no state to conduct with any continuity this task of organization that he would like to see undertaken by banks of issue, that are independent of both governments and private financiers (…) They would successfully remove from the political arena the issues that are essential to the development of national prosperity, like monetary security, the intensification of credit and the movement of prices. They would thus prevent political infighting from harming the wealth of nations and their economic progress*".[1] Quesnay did not fail to notice that Norman's megalomania was alarming his contemporaries even in the United Kingdom and unquestionably constituted an obstacle to the promotion of his conceptions regarding the nature of relations between governments and central banks. Milton Friedman (1968, part 2, chapter 2) observed that with Norman we were witnessing an implicit doctrine that was clearly a framework for dictatorship and totalitarianism. According to Friedman, the risk involved in leaving power in the hands of such individuals was a key argument for rejecting the solution of an independent central bank, and for leaning towards legislation. But, as noted by R. Sayers (1976), even if Norman was demanding independence, the institution he directed "should accept Treasury control over policy" (p. 15).

In continental Europe, this aspiration to greater independence clashed with the question of sustainability of the public debt. Faced with the necessity of rebuilding economies, monetary policy was dominated by budgetary policy. Central banks had to conduct monetary policies that were accommodating, resulting in either uncontrolled inflationary sequences, as in central Europe (Germany, Poland, Austria, Hungary) or stabilization/devaluations as seen in France, Belgium and Italy.

2.2. The emergence of a public central bank model

In the 1930s, a movement by governments to control banks of issue was apparent on an international scale and the model of a public central bank began to take shape. Political leaders intended to take greater control over banking and financial systems, the instability of which had led to a collapse in economic activity. In a context of deep depression and major transformation of capitalism, a section of public opinion suspected that central banks were in the hands of private financiers and lacked a sufficiently acute awareness of general public interests. In particular, the finger was being pointed at the inept management of the banking crises in the early 1930s: "*Central banks had also largely failed in dealing with banking crises, and governments stepped into that area as well: this was typically the case of Italy, Austria, Germany, and Hungary*"… (Toniolo and Clement, 2005, 293). Concern for profit was deemed incompatible with operations of public interest; additionally, a nationalized central bank would be better able to assert its authority over banking establishments.

But, up until the early 1930s, were central banks conducting policies that were running counter to the general interest? Nothing could be less certain. For Italy, A. (Gigliobianco, 2006) states that the "Banca d'Italia" was voicing primarily the viewpoint of the State, not that of the financial community. For France, P-C. Hautcoeur is categorical: "*it is impossible to understand the policy of the Banque de France if you believe that the profits of its shareholders play a role in its orientation…*" (1990, p. 302). For several decades, the Banque de France has very often been governed by former senior officers from the Treasury.

Whatever the theory, control over central banks came about rather quickly. In Great Britain, the supremacy of the Treasury was clearly established from 1931 onwards and the slide in sterling (R. Sayers). In 1936, the Danish central bank was nationalized. That same year, the legal transformation of the Banca d'Italia (banking law and reform of statutes) reflected a determination to strengthen the State's influence and focus on public interest that was already pretty much present within the institution. The banking act banned the Banca d'Italia from dealing in commercial activities with clients other than banks. In Belgium, the public nature of the institute of issue was clearly strengthened: the attributions of the government's commissioner were extended and the conditions required to become regent or censor were toughened, a move that reduced the influence of bankers (Danneel et al., 2005). In 1938, in turn, the Bank of Canada was nationalized.

The French case illustrates the suddenness of the turnaround with regard to the independence of the central bank. Since Poincaré's "stabilization" and thanks to budget surpluses, the Government's financial needs were lower. The independence of the Banque de France looked to be strong and the bank seemed to be alone in defining and implementing future directions for issue policy. From 1932 onwards, as the Treasury began looking for funds to cope with emerging budget deficits, the Banque de France was increasingly forced to deal with difficulties that the Treasury was now facing on account of high interest rates (Mouré, 1991). However, up until 1934, the bank retained a relatively high degree of autonomy gained as a result of efforts to stabilize the French franc. The choice of several governments, opting for deflationary policies while belonging to the gold standard block, expressed a national – and dogmatic – attachment to monetary stability achieved with some difficulty during the 1920s (Blancheton and Maveyraud, 2009). The Treasury's monetary demands seem to have played a key role in the replacement of M. Moret (governor of the Banque de France from 1930) by M. Tannery in January 1935 and, a few weeks later, in the resumption of direct advances of money from the central

[1] National Archives, Papiers Pierre Quesnay, 374 AP 6, notes taken during a trip to London between the 11th and 16th of October, 1926.

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