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The Political Economy of Central Banking: Historical Perspectives

The question of central bank independence as we discuss it nowadays has been mainly shaped by the theoretical debate on rational expectations which emerged around 40 years ago, during the age of the Great Stagflation. In a famous series of articles published in the 1970s, Thomas Sargent and Neil Wallace argued that changes in the public's expectations are bound to frustrate *any* attempt of impacting the real economy through variations in the money supply.[1] If Sargent and Wallace were right, just the suspicion that monetary authorities might be pursuing some kind of nonmonetary target was, *per se,* sufficient to make monetary policy a useless macroeconomic tool. The conclusion which was generally drawn from these theoretical findings was that monetary policymaking could only be credible when monetary and fiscal authorities were clearly separate institutions, pursuing clearly different targets. This provided the basis for the doctrine of central bank independence, which gained widespread popularity in the following decades.

The question of the relationship between monetary and fiscal authorities is, however, far older than that. More than to pure macroeconomics, it essentially relates to the domain of *political economy*. Political economy is the branch of economics which analyzes how the interplay among different interest groups determines economic policymaking as well as its distributional effects. The adoption of a political economy approach to the study of monetary policymaking is legitimate: As a matter of fact, central banks are – as any other institution – the outcome of some form of collective bargaining among different interest groups. Therefore, trying to relate the evolution of monetary institutions to the evolution of the *social contract* appears to be a particularly insightful endeavor today, at a time when some major changes in the role of central banks are suspected to be underway.

In order to shed some light on the political economy of central banking, it is convenient to take a very-long-term view on the subject. This means going back to a time when central banks as we know them today had not appeared yet. Although modern central banks did not exist before the late 19th century, central banking *did* exist to a certain extent. Over the centuries, a variety of different organizations have happened to perform the same main functions central banks do perform nowadays – i.e., to ensure a stable value of money as well as stability in the financial system. Some of these institutions (e.g. early banks of issue) somewhat resembled modern central banks, but some others did not. As a matter of fact, plenty of alternative arrangements have been engineered over time in order to ensure monetary and financial

[1] *For a summary of this influential research strand, see Sargent and Wallace (1976).*

stability within domestic banking systems. Sometimes, such functions were provided directly by the government; sometimes, they were provided by some private intermediary which enjoyed a predominant market power in the domestic payments system; sometimes, they were provided by a special corporation which was granted a particular privilege by government.[2] Looking at the way monetary institutions gradually crystallized into their current form is instructive; In fact, it helps us understand to what extent modern central banks are the outcome of complex historical processes, rather than the only viable solution to the demand of monetary and financial stability.

How did political economy issues actually shape the evolution of monetary institutions, then? To try to answer this question, let us first take a microeconomic view and focus on the

provision of *financial stability*. The basic microeconomic function of central banks consists in the management of the payments system. The *payments system* is the infrastructure established in order to implement transfers of value discharging mutual obligations between parties. As soon as economies start to become sufficiently advanced to entail the execution of large payments on a regular basis, the demand for the establishment of such an infrastructure naturally arises. To work properly, a consistent payments system implies the existence of a central place where all transactions are effectively cleared. In the early stages, intermediaries will typically agree to create a clearinghouse: At the end of each day, all intermediaries adhering to the clearinghouse will discharge mutual obligations without having resort to reserve assets. However, this kind of solution has historically tended to be unstable. As most network businesses, the payments business actually appears to be strongly subjected to economies of scale: The higher the turnover, the lower the costs. As a result, what has occurred in many different contexts is that a few intermediaries – most often, a single one – have gradually ended up dominating the whole payments system.[3] The concentration of market power with a single intermediary in the clearing process is a particularly serious concern. Claims on the institution sitting at the center of the payments system enjoy a high degree of liquidity: As a result, they naturally tend to assume the status of money even though such status is *not* sanctioned by law. The possible dangers relating to a situation of this kind have constantly called for government intervention in this very sensitive sector of the economy.

In the light of what precedes, government intervention in the payments system can conveniently be seen as regulation of a natural monopoly – i.e., as a question of political economy properly-speaking, permeated by major distributional issues. Were rulers sup-

[2] *For a detailed survey, see Ugolini (2011).*

[3] *A clear exposition of this problem can be found in Goodhart (1988).*

posed to fight such a monopoly power? Were they to keep it for themselves? Or rather, were they do leave it to a private corporation subject to some special constraint? All three approaches have been adopted by governments in different historical circumstances. In some cases, regulators have preferred the *free-market* solution and defended the clearinghouse system. Yet, the choice of breaking down the natural monopoly has been the exception rather than the rule; It only has prevailed in some particular contexts in which centralized solutions were politically unviable. This was the case in decentralized countries like the 19th century United States of America – where local elites long fought the emergence of a national banking system.[4] Much more often, however, governments have kept the natural monopoly untouched, and sought to take advantage from it. One solution has consisted in *nationalizing* the clearing process and confining it to a state-owned organization. This was the case in city-states like early-modern Venice, Amsterdam or Hamburg. In Amsterdam, for instance, the municipal government founded a public institution known as "giro bank" and decreed that international payments would be legally enforceable only if cleared via the bank's books. This strict regulatory constraint automatically made the Wisselbank the seat of interbank clearing in Amsterdam.[5] The alternative solution has consisted in *subcontracting* the management of the natural monopoly to a private company. This was the case in monarchical states like early-modern Sweden, England or Austria. In England, for instance, the government provided the shareholders of a bank of issue with the monopoly of banknote issuance and joint-stock banking in London (the country's only international financial center). The "privilege" was only granted for a limited period of time and the deal had to be renegotiated at expiration, but the solution was effective in establishing the Bank of England as the seat of interbank clearing for the whole country.[6]

Therefore, the structural features of domestic political systems have been crucial in determining the way payments systems have been organized in different times and places. Changes in the organization of payments systems have coincided with major changes in the balance of power – e.g. the rise of the federal government in the United States; the fall of the municipal government in Amsterdam; or the gradual democratization of English society.

Let us now abandon a microeconomic viewpoint and look at the very same facts from a macroeconomic perspective. This means focusing on the provision of *monetary stability*. The basic macroeconomic function of central banks is *money creation*. Central bank money consists of sight liabilities of the organization standing at the center of the payments system: To make a parallel with sovereign debt, we can say that these sight liabilities – which actually correspond to central bank "debts" – can be either "inscribed" (it is the case with deposits) or "securitized" (it is the case with banknotes). Strictly speaking, central bank money is issued only when the bank's liabilities exceed its reserves of gold or foreign currency – i.e., when the central bank engages into "fractional reserve banking" in order to buy

[4] *Timberlake (1993).*

[5] *Gillard (2004).*

[6] *Broz and Grossman (2004).*

some non-reserve asset. Here, the crucial question is to know why money is issued – or, to put it differently, what is the counterpart to money creation. Once more, it is a political economy question with non-negligible distributional consequences. If the counterpart to money creation is dubious, holders of money – who are, in fact, creditors to the central bank – are exposed to the risk of being confiscated a considerable portion of their purchasing power.

American humorist Will Rogers is credited to have once jokingly said: "There have been three great inventions since the beginning of time: fire, the wheel, and central banking." No doubt, this joke has a lot of truth in it. Indeed, money creation is an extremely powerful instrument: It is, potentially, one of the most efficient means to perform wealth redistribution. This is why it is easily prone to abuses. The problem, then, is to find a way to convince potential "creditors" that the instrument will not be abused, so that they will "stay" the market and hold central bank money instead of other assets. Historically, different kinds of equilibria have been found between those sitting on the liabilities side of the central bank's balance sheet (the holders of money) and those sitting on its assets side (the recipients of central bank credit). To illustrate this, let us just focus on the two early types of money-issuing organizations that we have already mentioned: giro banks and banks of issue.[7]

As we have previously said, giro banks (e.g. Amsterdam's Wisselbank) were state-owned institutions bearing the monopoly of legal interbank payments. Besides enjoying this valuable privilege, they had no capital endowment and were not subject to any strict limit in their money creation. How were institutions with such an enormous discretionary power able to attract the confidence of potential money-holders? The fact is that the model of giro banks was adopted in city states like early-modern Venice, Amsterdam, or Hamburg. In these international financial centers, the government was in the hands of an oligarchy of bankers and tradesmen who also were the main users of the payments infrastructure. This means that the main creditors to the giro bank basically coincided with its main debtor – which was, of course, the State.[8] As a result, there was no risk that the State would, one day, indulge into money creation to fund enterprises whose aims conflicted with their own interests. This worked as a guarantee that money creation would not be systematically used to confiscate money-holders' purchasing power: as such, it played a role in widening the popularity of central bank money to agents that did not have a stake into the oligarchic government.

The situation was very different in monarchies like early-modern Sweden, England, or Austria. There, the potential creditors to the money-issuing institution (i.e., bankers and tradesmen) did *not* coincide with its main debtor (i.e., the State). In this context, the problem consisted of finding an equilibrium which would – on the one hand – allow the monarchic government to monetize debt and – on the other hand – guarantee money-holders that they would not be systematically confiscated their purchasing power. Banks of issue were created as a solution to this problem. As we have previously recalled, a bank of issue (e.g. the early Bank of

[7] *More details are available in Ugolini (2011).*

[8] *Gillard (2004).*

England) was a privately-owned company to which the government "subcontracted" the management of a certain monopoly for a given period of time. The shareholders of the bank were free to make use of this monopolistic power to their own advantage for the entire duration of the subcontracting deal, but at a cost. First, they had to pay down immediately a given amount of capital (i.e. the stock capital of the company), which would be mainly lent to the government. Second, they had to face some constraints to money creation – typically embodied by the requirement to assure gold or silver convertibility of banknotes.[9] As a result, the deal between the government and the shareholders was based on a system of mutual limitations to the discretionary power of each party; these guarantees proved effective in widening the popularity of central bank money to agents that did not have a stake into the monarchic government or into the company itself.

Many things have changed substantially since the early-modern era. Old banks of issue (like the Bank of England) have come across major transformations of their corporate structure and their position with respect to fiscal authorities. It is fair to say that these mutations have largely coincided with shifts in the balance of power between different interest groups – shifts which have been mostly connected to big external shocks. The fragile equilibrium between creditors and debtors to central banks has typically been overturned by wartime inflations, often associated with a redrafting of the *social contract* previously in force. Such reshuffles have often implied the termination of earlier monetary arrangements: This was, for instance, the case of giro banks, which disappeared together with the city-states they had been associated to.

Let us try to sum up the implications of this brief historical overview of the political economy of central banking. In the light of our findings, the question of the relationship between monetary and fiscal authorities seems

to be more complex than the recent debate on central bank independence would suggest. In the simple framework inspired by Sargent's and Wallace's theoretical contributions, the recipe for establishing an untarnished confidence in central bank money consisted in severing all links between governments and central bankers. In reality, however, monetary and fiscal authorities can hardly be separated at all: in fact, they are the two sides of the same coin – which is, the modern state. On the one hand, central banks would hardly survive in the absence of a solid political backing: the opportunity to create money depends on the circumstance of being at the center of the payments system, and this is a legal privilege whose fate depends on the one of the political regime which has granted it. On the other hand, advanced fiscal systems would hardly survive in the ab-

[9] *Broz and Grossman (2004).*

sence of a full-fledged payments system and of an efficient mechanism for the absorption of government deficits: These conditions can only be ensured by the existence of a widely-trusted agency capable of monetizing debt in a sustainable way. The idea that monetary and fiscal authorities can live their lives oblivious of each other does not seem to be validated by historical evidence: And in fact, the recent appearance of the very first fiscal troubles in forty years has sufficed to put this concept under severe strain in most developed countries.

Under many respects, the architecture of the Eurosystem was originally conceived as an incarnation of this once-fashionable "principle of separation". The crisis begun in 2007 has seriously questioned the philosophy underlying the whole project. As a matter of fact, it is now generally admitted that at the roots of the euro area crisis lay a number of major distributional problems. In a rather dismissive way, most commentators have depicted such problems as specific to the peculiarities of a monetary union. Sure, the special structure of the Eurosystem has been responsible for making distributional issues emerge in a particularly spectacular fashion. However, history suggests that these are universal features of central banking, inevitably resurfacing in any time and place. If this is true, the belief that monetary and fiscal troubles can be solved separately is a great delusion – and a potentially dangerous one. The legitimacy of monetary and fiscal authorities rests on the very same foundations; should inability to address these troubles imperil the *social contract*, neither authority could reasonably expect to survive the fall of the other one.

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