Six centuries of central bank independence

A historical rehabilitation

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The economic and financial crises of the last 12 years have led to large-scale unconventional central bank measures and renewed discussions on central bank independence, culminating in the 2018 publication of Paul Tucker's *Unelected Power*. The same year, the Economist noted that, 'Operational independence for central banks is relatively new. The principle grew out of work in the late 1970s and early 1980s by prominent economists working in the "rational expectations" school of economic thought, among them Finn Kydland and Edward Prescott, who were eventually awarded the Nobel prize.'

The true story of central bank independence is much older and less academic than what the Economist and others assume.

1. Forms of central bank exploitation by governments

Inappropriate access to the central bank has taken different forms across history. First, precious metal reserves could be confiscated by an invading army, such as the silver reserves of the Hamburger Bank by the Napoleonic occupation forces in 1813.

Second, a domestic sovereign could confiscate precious metal reserves, as in the case of the recourse of Charles I in 1640 to the London Goldsmiths reserves deposited in the Tower of London. Another example is the King of Naples' flight to Sicily in 1798, taking with him the Naples public banking system's precious metal reserves.

Third, a government of weak credit quality could force a central bank to provide loans and suspend convertibility. In the best-case scenario, the government would repay the loan, and the only damage would be to the bank's reputation (examples include the Nürnberg Banco of 1619 and the Caisse d'escompte of 1776). Fourth, the government may later repudiate its debt to the central bank, at least in terms of the initial precious metal equivalence. This materialised for the Banque Royale in 1720, and during the Napoleonic age for the Russian, Danish and Austrian/Habsburg central banks.

2. Why central bank independence?

Central banking from the 15th century until the end of the Bretton Woods era in 1973 meant in essence issuing fully convertible monetary liabilities, i.e. liabilities with overnight maturity that would be redeemable into precious metal. Monetary stability therefore required unconditional trust in central banks' ability to remain liquid and solvent. Any substantial recourse of a financially stressed government to central bank resources could undermine this, jeopardising the central bank's ability to deliver on its convertibility promise. The rational anticipation of this problem – when unsolved – prevented the establishment of successful central banks in various countries until the late 19th century, despite many attempts. Frederic the Great of Prussia, who took a personal interest in the establishment of a Prussian central bank, failed no less than four times to establish one. All attempts in the Kingdoms of Spain and France failed for centuries because none of the imagined schemes could establish ex ante credibility. Credibility required a sufficient combination of central bank independence and the rule of law.

3. Tools to achieve central bank independence

Three tools have been applied to achieve central bank independence since the 15th century.

First, explicit limitations, or prohibitions of central bank credit to the public sector. Limitations to the Taula de Canvi's lending to the city of Barcelona were introduced as early as 1412, and again in 1438, when it was decided to limit the size of such loans. By 1468, any lending of the Taula to the city was forbidden. Similarly, the Senate of Venice committed to never borrow from the Banco di Rialto when it was established in 1587. The Bank of Amsterdam was in principle, according to its statutes, not supposed to lend to the city of Amsterdam, although in reality it did. The Riksens Ständers Bank's charter of 1668 precluded the government from accessing the bank's financial resources. The ban was respected for just a few years. Some loans to the government were provided as early as 1675. Large-scale lending threatening convertibility started in 1703. The issue was discussed in various bank plans which did not materialise, such as in Peter van Oudegherste's 1576 national bank project for Spain, which foresaw strong lending prohibitions: 'To allay the widespread fear that banks could not survive in a monarchy, the king would swear never to lay hands upon their assets; and upon coronation each successive monarch would repeat the oath. Since the banks would extirpate the deadly sin of usury, the pope would be asked to excommunicate anyone who despoiled them. For directors who authorized irregular advances to the king, the penalty would be death.'

The 1791 Bank of the United States bill prevented direct financing of the government, and required a law to be enacted for each loan surpassing $100,000, raising high hurdles and preventing covert state financing. Those who infringed this rule faced hefty financial penalties.

Second, relative independence within the public sector. Public central banks typically enjoyed institutional separation. Their administrators were assigned clear objectives defined by law. They had clear mandates to pursue the bank's interests through careful management, with regular reporting to the municipal council regarding the bank's books. For example, the 1619 charter of the Hamburger Bank specified the bank's objectives (to develop commerce and trade by providing a means of payment, and lend to stressed debtors to prevent abuse by usurers) and the composition of its board, including a rotation mechanism, presumably to prevent its administration being monopolised by a few citizens who over the years could collude with the government.

The effectiveness of the governance of the Bank of Amsterdam has often been praised, emphasising the bank's successful 170 years of operation. However, in 1801 Büsch provided a more critical analysis, arguing that a major weakness of the bank, compared with the Hamburger Bank, was that it had few members and little turnover in its governing bodies. This made it easy to provide covert loans to the city and state-sponsored firms like the Dutch East India company.

Riksens Ständers Bank reported to the Swedish parliament, giving it distance and independence from the crown. The success and stability of the charity-based public giro banking system in the Kingdom of Naples was also based on a strong separation from the crown, achieved by putting the system into the hands of charitable institutions. These banks' religious and charitable origins, and deep roots in the catholic hierarchy and the population's religious beliefs, gave them the power to withstand even the pressures of an absolutist king.

Third, private ownership. This was pioneered by the Casa di San Giorgio and Bank of England. Machiavelli, in his 1521-1524 *Historie Fiorentine*, noted that the foundation of the Casa di San Giorgio allowed it to be a 'state within the state'. He wrote that the Casa represented 'liberty, civil life and justice' in Genoa, while the state stood for 'tyranny' and a 'corrupt life'. He implied that the Casa's independence through its separate private governance would have been used in all citizens' interests. John Law took up the 'state in the state' image of Machiavelli in his own words: 'The bank is independent from the state, and is a sort of separated republic'.

When it was founded in 1694, the Bank of England was privately owned by its stockholders. Over the next 200 years, many central banks copied the BoE model, including the Bank of Scotland (1695), Banque Générale (1716), Caisse d'escompte (1776), Banco Nacional del San Carlos (1782) and Bank of the United States (1791).

However, the 20th century saw an almost complete reversal to public ownership (elements of private ownership still prevail in Belgium, Italy and Switzerland, but shareholders lack material decision-making power). Irish philosopher George Berkeley in 1735 questioned whether a private company could be entrusted with policy decisions as important as those of a central bank. He advocated a public sector solution, painting a positive picture of Amsterdam, Hamburg and Venice, and a negative one of the Bank of England and the Bank of Genoa, which would both suffer from the incentives of private shareholders to act against the common interest. Nevertheless, he conceded that a public national bank was not a universal solution, as it gave too much power to the government, and therefore some independence within the public sector, such as in Hamburg, was preferable.

The Compte de Mirabeau (1785) believed worries about undue state influence on the Caisse d'escompte were overblown. He argued that the bank's equity owners and administrators would pursue their private aims to maximise profitability rather than acting in the public interest. Mirabeau said there were more reasons to worry about private owners' conflicts of interest than a government closely supervising a central bank.

In his 1791 draft veto against the Bank of the United States bill, James Madison explained that the institution's private capital set up was incompatible with the pursuit of public interest. In 1803, Thomas Jefferson, described the bank as a Machiavellian 'state within the state'. Like Berkeley, and in contrast to Machiavelli, he was horrified by excessive independence: 'This institution is one of the most deadly hostility existing against the principles and forms of our constitution… an institution like this, penetrating by its branches every part of the Union, acting by command and phalanx, may, in a critical moment, upset the government... Now, while we are strong, it is the greatest duty we owe to the safety of our constitution, to bring this powerful enemy to a perfect subordination under its authorities.'

Finally, in his 1824 *Plan for the establishment of a National Bank*, David Ricardo called for the Bank of England to be nationalised. This would, he wrote, help lower the cost of national debt interest, by socialising the transformation of public debt into money. In other words, no longer letting a private central bank's shareholders appropriate the seigniorage. On central bank independence, Ricardo questioned whether the Bank of England model was necessary to ensure independence and thereby stability.

4. The rule of law

Regardless of institutional independence, a key factor for successful central banking is whether the rule of the law applies to the government. For a long time, authors debated whether central banks could function in absolutist regimes (previously absolutist monarchies, now dictatorships).

As early as 1576, van Oudegherste's envisaged governance framework for the Spanish national bank reflected the 'widespread fear that banks could not survive in a monarchy'. John Law, in 1715, acknowledged this concern, but argued that even monarchs would not be so short-sighted as to harm their national bank, and thereby their economy and their own finances. Montesquieu disagreed, writing, 'In states that carry on an economical commerce, they have luckily established banks, which by their credit have formed a new species of wealth… The erecting of banks in countries governed by an absolute monarch supposes money on the one side, and on the other power… In a government of this kind, none but the prince ever had, or can have, a treasure; and wherever there is one, it no sooner becomes great than it becomes the treasure of the prince.'

Overall, there is overwhelming evidence that absolutist monarchies were incompatible with banks, with Naples the only exception. Privately owned central banks could function in constitutional monarchies, like Great Britain in 1694 and Sweden in the late 18th century (the Riksens Ständers Bank was unable to maintain convertibility for many decades).

Two privately owned central banks, the Copenhagen Bank and the Banque Royale, were nationalised through the purchase of equity by the crown, with dire consequences in both cases.

5. A fast-forward review of the 19th and 20th century

In the century before 1914, the Bank of England template prevailed and proved a great success, with the gold standard (1875-1914) the ultimate global triumph of this form of central bank governance. The State Bank of Russia, founded in 1860, was the exception. It remained in public hands throughout its existence, abiding by the gold standard as much its private peers. Central bank independence was practically suspended with the beginning of the first world war, with governments largely using monetary financing to pay for military expenditure. Independence and the gold standard were restored gradually after the war.

Central banks' failure to manage the great depression harmed their credibility and support for their independence. What had worked before 1914 no longer worked in the interwar period. In the subsequent decades, most central banks returned to public ownership. Some (including the Bank Deutscher Länder/Deutsche Bundesbank) obtained a high degree of independence and regained credibility in their stability orientation. Others collaborated closely with governments and cumulated significant inflation after the second world war, relieving governments of heavy debt burdens. The fall of the Bretton Woods system in 1973 accelerated global inflation dynamics, reversed only by Federal Reserve Chair Paul Volker in 1983, a masterpiece in communication and handling political pressure.

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