Central Banks: Between Internationalization and Domestic Political Control

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This paper attempts to examine a number of phenomena that relate to the exercise, the efficiency, and the legitimacy of monetary policy-making:

1. Before the twentieth century, central banks had been more concerned with the management of government debt and with financial stability.

2. Central bank autonomy is in recent times the outcome of a demand for price stability.

3. The demand for central bank autonomy is often a consequence of the fragmentation of national decision making, in federal systems but also in regional and international monetary arrangements.

3. Economic crises promote redistributional thinking, both within and between countries.

4. In economic crises, the combination of disenchantment or disillusionment with the operation and a demand for government action challenges the foundations of international cooperation.

5. A greater discussion of policy failure occurs in the aftermath of crisis.

6. European developments have offered a particularly striking illustration both of the mechanisms involved in the building of a cooperative framework, and also of their problems and weaknesses.

7. There is an oscillation between seeing the central bank as producing a general or universalizable good (price stability) and interpreting it as fundamentally a tool for redistributive or factional policies. The former can clearly occur in an international and trans-national setting, while the latter will only work in the framework of national policy.

8. A concern with redistribution, which also arises out of central bank involvement with issues of credit distribution, leads to greater demands for accountability and political control.

The Problem Today

Bursting bubbles inevitably turn the conventional wisdom of the boom periods on its head. Central bankers used to be heroes (of the Great Moderation story). Now they have become villains (of the Financial Crisis story). In the Great Moderation, central banks were primarily concerned with price stability and with monetary policy. The Financial Crisis has however brought an involvement with financial sector stability issues and with issues of credit allocation and credit policy. But monetary policy and credit policy raise quite different questions of political economy.

In consequence of the shift in emphasis from monetary policy to credit policy, central banks are subject to strong, and sometimes quite conflicting, political pressures. But even when they conflict, the complaints and the demands are actually similar: the complaint, that central banks are too internationally oriented, and the demand, that the central bank should act as a national carapace. In the course of his presidential campaign, Nicholas Sarkozy called for a weaker Euro in order to resist U.S. and Asian "dumping"; after the outbreak of the financial crisis, as President of the French Republic, he complained that the ECB did not lower interest rates: "They have facilitated things for speculators, while complicating them for entrepreneurs." [1] Chancellor Angela Merkel from a different angle criticized quite directly the ECB's purchases of covered bonds, which she described as "bowing to international pressure."[2]

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[1] *Financial Times*, April 3, 2007, p. 9; *Times*, September 17, 2007, p. 40.
[2] *Financial Times*, June 3, 2009, p.9

Probably the most elaborately articulated response to central banking activity has been in the United States, where it feeds on a populist tradition that goes back to Andrew Jackson's campaign against the Second Bank of the United States. Jackson is now cited as a model for effective political action in dealing with the financial sector, even by distinguished economists.[3] At the end of July 2009, Federal Reserve Chairman was grilled on the financial crisis before Congress, and the result was a series of viral you.tube videos that bounced around the world's electronic highways. From one side of the political spectrum, the Republican Ron Paul accused Ben Bernanke of making inflation by buying Treasury bills. From the other side, more spectacularly and more aggressively, the Florida Democrat Alan Grayson focused an attack on the previously rather obscure topic of central bank swaps. Exchanges of reserves on a short term basis between central banks historically constituted one of the smoothing elements in forex markets. After the Lehman crisis their volume expanded as part of the global effort to provide liquidity, with repurchase arrangements that avoided foreign exchange risk. On July 21, 2009, Grayson asked Ben Bernanke why the swaps on the Fed's balance sheet had increased from $24 bn. at the end of 2007 to $553 bn. in 2008, and which foreign institutions were benefiting from such loans. Then he picked one foreign central bank that had done a swap, taking New Zealand, which is tiny and at the other side of the world. Why was the Fed giving $9 bn. (or $3,000 to each inhabitant) to New Zealand, when the money could have been better spent on Americans suffering from the credit crunch? People think not about central banks as facilitators of payments systems but as the producers of wealth which is available for spending.

Original Purposes of Central Banking

Central banks were historically created first to manage the state's credit: this is the story of the oldest central banks, the Swedish Riksbank, the Bank of England, as

[3] Simon Johnson and James Kwak, *Thirteen Bankers: The Wall Street Takever and the Next Financial Meltdown*, New York: Pantheon, 2010.

well as of a newer wave of central banks that followed the example of the Banque de France. It was suspicion of the politics behind a designated state-oriented central bank that led to the non-renewal of the charters, and the demise, of the First and Second Bank of the United States. Resistance to the process of political capture led in some countries such as Switzerland at the end of the nineteenth century to opposition to any central bank at all.

A second historical motivation for the creation of central banks involved the safeguarding of a financial system, and the maintenance of an adequate supply of credit. In the mid-nineteenth century, a new generation of central banks was established essentially to manage payments systems, and stabilize fragile banking systems: this was the motivation behind the German Reichsbank (1875) or the Federal Reserve System of the United States (1914).

It was only after the end of metallic monetary standards and the advent of paper based money that central banks began to be concerned with the problem of price stability.

Cycles in history

The idea that central bank independence and international central bank cooperation were conspiracies to divert money away from a national community was a commonplace argument seventy years ago, in the aftermath of the Great Depression. Figures such as the long-lasting Governor of the Bank of England, Montagu Norman, were first venerated (before the Depression), and then ridiculed and reviled. According to the retrospective diagnosis, Norman had pushed the over-valuation of sterling in order to restore Britain's position as an international financial center, but had in consequence starved British industry of funds.

Conspiracy theories about central banks abounded. In Britain, the left of the Labour Party blamed the Bank of England for orchestrating a "Banker's Ramp" which had used financial blackmail to force the government to cut unemployment benefits. In France, the left saw the Banque de France as controlled by its two hundred shareholders which represented the "two hundred families," a sinister and powerful money elite. Central banks were blamed (rightly) for failing to provide currency stability; and blamed (mostly rightly) for having used their independence or autonomy in a political sense. The solution was popular control.

In the United States, Benjamin Strong, Norman's close friend and Governor of the Federal Reserve Bank of New York – at that time the institution that managed the Fed's international business – was believed to have fueled the New York stock market bubble by holding interest rates down in 1927 and 1928 to comply with the demands of European central bankers. In an extreme version, the critique held that the major cause of bubbles, speculation and fraud was financial internationalism.

Norman's leading critic was the Cambridge economist John Maynard Keynes. When it came to designing an international monetary system at the end of the Second World War, Keynes wanted to limit the power of central banks. The major new institution for coordinating international action, the International Monetary Fund, was to be run by Finance Ministries and Treasuries, not central bankers. In other words, it would be firmly anchored in the structure of domestic political arrangements. The U.S. administration wanted to close down the central bankers' bank, the Basel-based Bank for International Settlements. The IMF would ensure that capital markets were tightly controlled, and that monetary policy could be made in a national setting.

One country went a different way, but that was because the rest of the world, for good reasons, did not trust the political process of that country. The German central bank, the Reichsbank, was recreated as an independent institution under the terms of the 1924 Dawes Plan and the London Conference. It had a new administrative council,

half of whose members were foreigners, as a guarantee of its independence. But after 1933 under the Nazi dictatorship it became subject to political control. In reconstructing the German economy in the wake of the Second World War, the U.S. military authorities insisted on central bank independence, strengthening the position of the central bank at the expense of government. By the 1970s, the Bundesbank was widely admired by other central bankers.

The discussions of central bank independence in Germany, both in 1924 and in the post-World War II era, emphasized independence from the government and political institutions, which had been in the eyes of Allied experts responsible for the pressures that led to hyper-inflation in the early 1920s. But it was not only independence from the government that mattered. Part of the pathology had lain in the subservience of the central bank to the interests of the financial and business community. It had not only discounted government paper, but had also offered credit facilities to banks and large and well connected businesses at low nominal and negative real interest rates. In consequence the central bank had to be doubly insulated, and taken away from pressures to yield both to politics and to finance.

By the 1970s, when the fixed exchange rate system invented at the Bretton Woods conference collapsed, central bank independence began to be fashionable again. In particular the German Bundesbank, with a firm legal guarantee of its independence, looked like an impressive model that yielded a better macro-economic environment and greater growth. Academics and politicians followed the general public into thinking that inflation was damaging. Many central banks consequently wanted to be more like the German model. European monetary integration was founded on the idea that an institution created by international treaty and consequently endowed with a cast iron autonomy would give a better framework for making a strong European economy. Center-Left parties in Britain and France and elsewhere became enthusiastic converts to the idea of central bank independence. The process was best described as "tying

hands" in order to prevent sub-optimal outcomes resulting from short-term political pressures.[4]

The Arguments for Independence

In the course of the 1980s, a substantial academic literature developed concerning the benefits in terms of inflation performance, and in regard to macro-economic stability and growth, which suggested that in industrial countries, but also more generally, central bank independence was closely correlated with better economic performance. It was already well known that monetary authorities were subject to political pressures that produced higher levels of monetary growth.[5] The newer literature initially developed on the basis of an appreciation that establishing firm commitment mechanisms was an essential element in the establishment of policy credibility.[6] The approach emphasized the contractual element of the position of central banks, and consequently focused on the explicitly defined terms of contracts or laws establishing central banks.

The literature became so vast because of the problems of defining precisely what is meant by central bank independence. One deceptively simple approach takes the statutes of the central banks as a guide, and then measures legal independence. It tries to quantify variables concerning the appointment, dismissal and term of office of the governor or chief executive; variables about how conflicts between the executive branch and the central bank and the degree of participation of the central bank in the formulation of monetary policy and in the budgetary process; the objectives as stated in the charter of the central bank; and legal restrictions on the ability of the public sector to

[4] F. Giavazzi and M. Pagano, "The advantage of tying one's hands: EMS discipline and central bank credibility," *European Economic Review*, 32, 1985, pp. 1055-1082.

[5] James Buchanan and Robert Wagner, *Democracy in deficit*, Amsterdam: Academic Press, 1977.

[6] Especially Finn E. Kydland and Edward C. Prescott, "Rules rather than discretion: the inconsistency of optimal plans," *Journal of Political Economy*, 85/3, 1977, pp. 473-491; Robert J. Barro and David B. Gordon, "Rules, Discretion and reputation in a Model of Monetary Policy," *Journal of Monetary Economics*, 12, 1983, pp. 101-121.

borrow from the central bank. But laws do not cover every eventuality, and there is often a quite large room available in which power politics can intrude.

Secondly, it is possible to look simply at the rate of turnover of governors/chief executives. A high turnover and brief tenures are characteristics of many unstable political and monetary regimes, in the second half of the twentieth century especially outside Europe (though France in the 1930s had a very rapid rotation of central bank governors).

Thirdly, the use of questionnaires may give some sense of perceptions of central bank independence in practice. [7] This approach rests on the notion that central bank independence is actually not easily measured by formal legal criteria, and that the actual practice of central bank operations is what is decisive.

All of these approaches raise conceptual problems. The codings that are applied to establish legal independence are sometimes rather arbitrary, and scholars have disagreed on such topics as whether a given central bank has a government representative on its board. Surprisingly often, they discover that in the country that they know best, the laws do not full describe the realities of central bank appointments and discussions, while for more remote" countries, they are prepared to accept the letter of the banking laws. Thus Malinvaud found that Grilli, Masciandaro and Tabellini overstated the degree of French independence; Alesina criticized the approach of Bade and Barkin to the position of the Italian bank; and Eijffinger and de Haan thought that the Nederlandsche Bank was more independent than was represented in Cukierman's survey. [8] An apparently rigorous scientific exercise becomes very quickly and

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[7] See Alex Cukierman, *Central Bank Strategy, Credibility, and Independence: Theory and Evidence*, Cambridge Mass.: MIT Press, 1992. Also Alex Cukierman, Steven B. Webb and Bilin Neyapti, "Measuring the Independence on Central Banks and its Effect on Policy Outcomes," *World Bank Economic Review*, 6/3, 1992, pp. 353-398.

[8] See R. Bade, and M. Parkin, Central bank laws and monetary policy, Department of Economics, University of Western Ontario, mimeo 1988; Alberto Alesina, "Macroeconomics and Politics," in Stanley Fischer (ed.), *NBER Macroeconomics Annual*, Cambridge, Mass.: MIT Press, 1988, pp. 17-52. Alberto Alesina, "Politics and Business Cycles in Industrial Democracies," *Economic Policy* 8 (Spring 1989), pp. 58-98; Alberto Alesina and Vittorio Grilli. "The European Central Bank: Reshaping Monetary Policy in

evidently random and arbitrary. The eminent Italian central banker Carlo Ciampi, in a letter to the *Financial Times* protesting against a league table produced by the journalist David Marsh which showed the Italian institution as the least independent European central bank, wrote that "a meaningful appraisal of central bank independence requires a thorough evaluation of the institutional setting and of the bank's modus operandi as developed over time and consolidated in practice."[9]

Turnover of central bankers need not necessarily be a measure of political interference; it could indeed be (as it was in the case of the nineteenth century Bank of England, whose governorship rotated every two years) a way of combating influence and clientilism. Finally, the survey approach is also problematical, in that the perception of independence often follows from observing the demonstrated effects of independence (such as low inflation), and the approach thus generates a circularity when used to determine the nature of the link between central bank independence or autonomy and particular outcomes such as price stability or economic growth.

In the light of these problems, different analyses may be required that are not so simply quantifiable. A more subtle approach involves examining the political and social setting within which the central banks work. They reflect a particular culture. Thus it is often persuasively argued that the German outcome in terms of the policy of the Bundesbank is not only originally the outcome of externally imposed discipline but also and primarily a response to a high preference of German people, voters, and politicians for monetary stability. That preference was the result of the experience of two severe inflations associated with the world wars which led to the practical expropriation of middle class Germans. Another approach to the problem thinks of

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Europe." in (eds.) Matthew Canzoneri, Vittorio Grilli, and Paul Masson, *Establishing a Central Bank: Issues in Europe and Lessons from the United States*, Cambridge: Cambridge University Press and CEPR, 1992, pp. 49-77; Vittorio Grilli, Donato Masciandaro, and Guido Tabellini, "Political and Monetary Institutions and Public Finance Policies in the industrial Countries," *Economic Policy* 13 October 1991), pp. 341-92; Sylvester C.W. Eijffinger and Jakob de Haan, "The Political Economy of Central-Bank Independence," Princeton Studies in International Economics 19, International Economics Section, Departement of Economics Princeton University, 1996.

[9] *Financial Times*, March 13, 1992.

central banks also as exposed to interests, but sees the existence of a powerful financial community as pressing for a stability-oriented policy. This account seems to offer some insights into the behavior of the Bank of England before 1945, when the central bank was often regarded as nothing more than a transmission mechanism for the interests of the City of London, and perhaps it applies also to the case of the modern history of the Bundesbank. [10]

The "culture" of central banks may also be thought of as being cemented or embedded in an international system, in which repeated interaction – or "cooperation" – creates an insulation for domestic politics.[11]

Central bank independence and fragmented politics

In September 1992, the then French Directeur du Trésor, Christian Noyer, stated that central bank independence was incompatible with France's republican traditions, in that the Republic was "one and indivisible." Centralized states such as France or Japan (which as he pointed out had an excellent record in fighting inflation) exercised a political control of central banks, while independent central banks were fundamentally suited to federal states such as Germany, Switzerland or the United States (and hence also, presumably, although he did not point this out at the time, the European Union). [12]

This position has an inherent plausibility and even attraction. Central bank autonomy becomes more important the more emphasis is given to policy coordination

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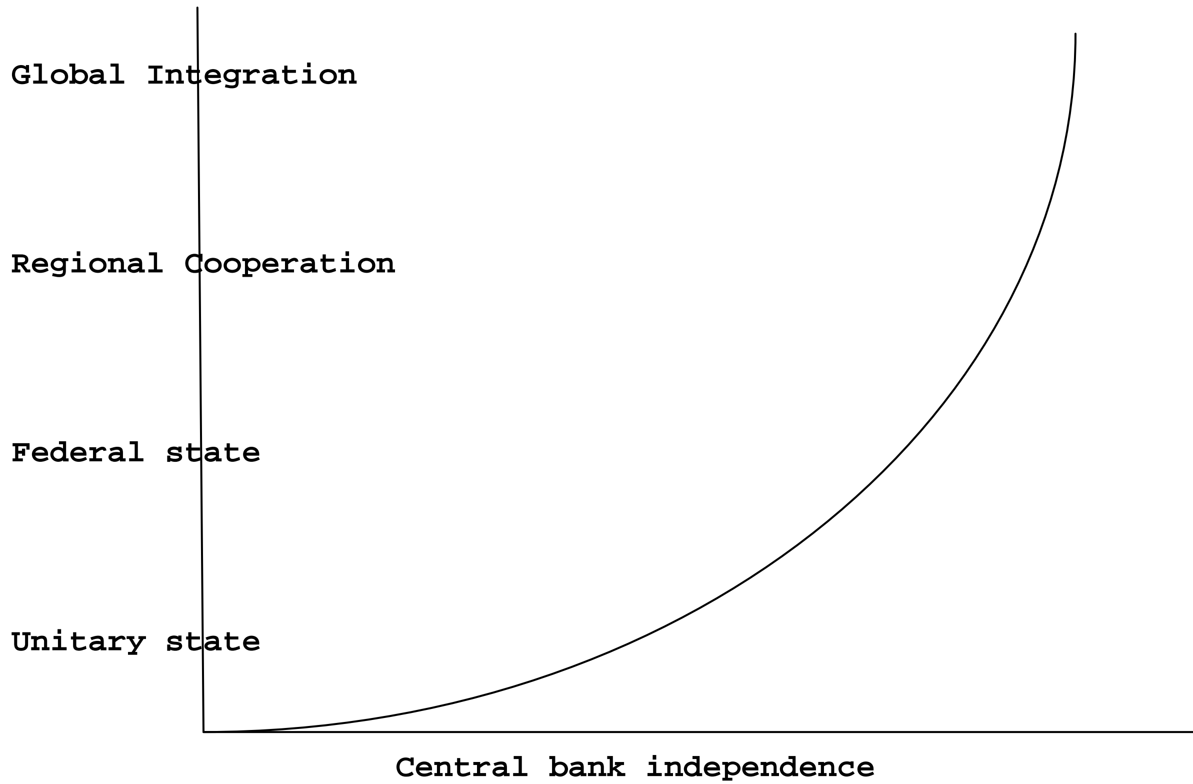
[10] Adam S. Posen, Declarations Are Not Enough: Financial Sector Sources of Central Bank Independence, in: *NBER Macroeconomics Annual* Volume 10, 1995; Geoffrey P. Miller, "An Interest Group Theory of Central Bank Independence," *Journal of Legal Studies*, Vol. 27, No. 2, 1998.

[11] John Gerard Ruggie, "International Regimes, Transactions, and Change: Embedded Liberalism in the Postwar Economic Order," *International Organization* 36(2), 1982.

[12] Christian Noyer, "A propos du statut et de l'indépendance des banques centrales," *Revue d'économie financière*, September 1992, pp. 13-18. David Howarth, *The French Road to Monetary Union*, London: Palgrave,2001, p. 131.

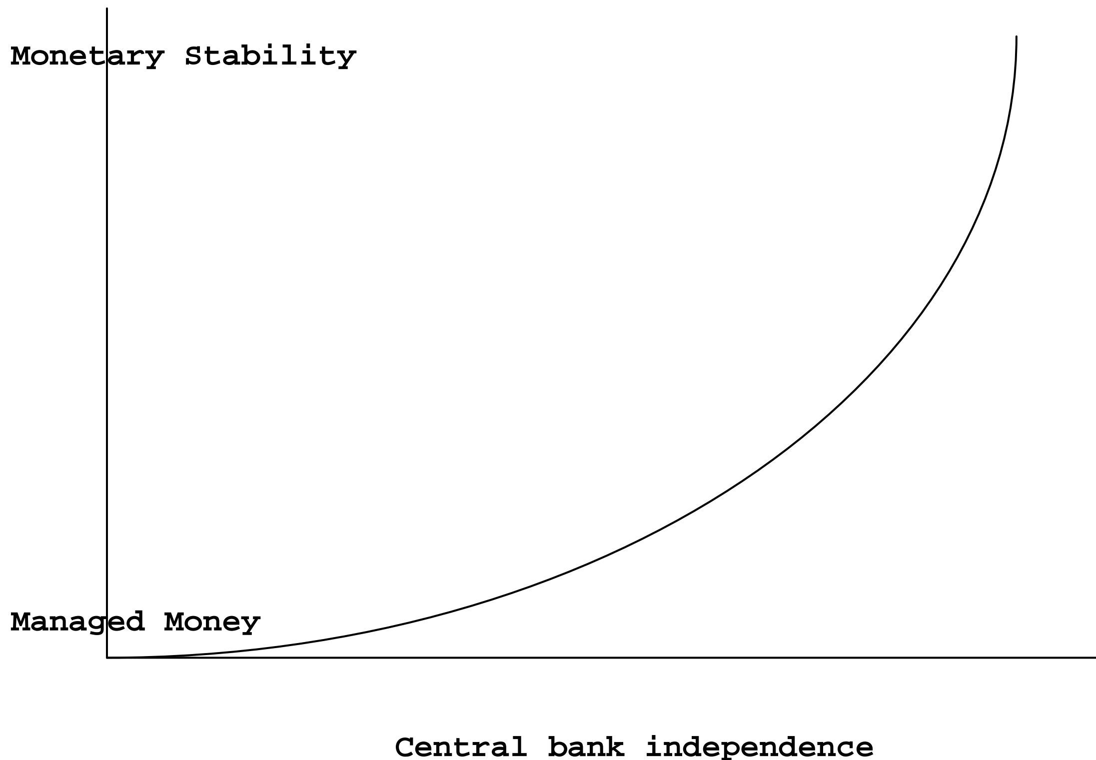
between different tiers of political authority. This may be in one country, in a federal system; but the same principles apply to regional integration and international cooperation and coordination. Without central bank autonomy, monetary policy can rapidly become a cause of disintegration and political fragmentation. To give some striking historical examples, hyper-inflation in Germany in the early 1920s promoted separatism in the Rhineland, Bavaria, and Saxony, as these states believed that the central monetary authorities in Berlin were unfairly giving credits and injecting liquidity to the corporations and public authorities that were near at hand. In 1980s Yugoslavia and in the Soviet Union in the early 1990s, inflation and hyper-inflation lead to a distrust of Belgrade and Moscow, and a demand for regional independence and autonomy.

FIGURE 1



Central bankers like to think of another picture, which emerged as a product of substantial empirical research in the 1980s on inflation performance and central bank independence.

FIGURE 2



What is the connection between these two pictures of how central bank independence works? Three inter-connected issues represent rather old chestnuts in the economic history literature: first, monetary order is a critical part of the process of globalization. Complex transactions and relations in a globalized society and economy require an element of certainty that is provided by a simple capacity to make equivalences. The most obvious form of this security is the stability that is provided by a secure monetary standard, and globalization upswings have always had a widely recognized and shared international measure of value. The late nineteenth century was characterized by Charles de Gaulle in retrospect as the *époque du trois pour cent*, the absolute confidence that government and other high quality bonds would produce a stable and predictable return of three percent. The foundational belief is that market prices send an intelligible signal, and it has political implications. Markets limited the

capacity of governments to behave badly. In the late twentieth century, price stability became a major objective of policy. Because the experience of the twentieth century indicated that politicians could not be trusted, this task was delegated to increasingly independent central banks.

Second, there is a political process that moves in cycles between various degrees of acceptance and rejection of the idea of monetary autonomy or, to formulate it in terms of the recent debates, of central bank independence. In the aftermath of the economic crisis, political criticism of central banks increases: whether in the United States, where the debate about the Federal Reserve and its political role seems to pick up a debate that goes back to the nineteenth century and Andrew Jackson's campaign against the Second Bank of the United State; or in Europe, where concerns about the governance and alleged "democratic deficit" of the ECB, which were widely current in the 1990s, are revived with a new force.

In these cycles, there is increased emphasis on redistribution. Monetary policy is believed to be capable of affecting, not so much economic growth, as the distribution of income and wealth. This is largely because different groups in society are holding different levels of debt, whose real value may be reduced or increased by inflationary or deflationary pressure. Before the First World War, and especially in the 1880s and 1890s, the pressure of agrarian interests against the Gold Standard was a feature of many countries. The German economist Karl Helfferich argued that the dependence of a monetary standard on metallic metal produced price fluctuations which in theory might be eliminated by the adoption of fiat money; but that that fiat money would be subject to unbearably intense political pressures. He concluded that "pure paper money represents the logical culmination of the history of the development of money." At the same time he soberly presented the political disadvantages of this quite logical development. The capacity of the state and of public policy to shape value would, he predicted, encourage a mobilization and a polarization of interests, on the one hand of those who might benefit from monetary depreciation, and on the other of recipients of

fixed incomes, whether as wages or interest payments, who wanted an increase in the value of money. The capacity to manipulate value would lead to a new sort of class war, in which groups would form and mobilize in order to seize the levers of power that would give them the capacity of determining value. The conflict had the capacity to lead to a "complete demoralization of economic and social life," he wrote quite prophetically. This was not just a speculation about the future. He was thinking of the example of agrarian populists' campaign at the end of the nineteenth century, both in America and in Europe, to inflate the currency in order to reduce the oppressive load of farm debt. [13]

Third, the two previous discussions are linked. International cooperation by definition requires countries to do something that they do not find to be in their immediate interest. For this reason, some political theorists take the extreme position that international cooperation is impossible. Others make an argument that the degree of potential cooperation may be an inverse function of the degree of parliamentarization. Special interest groups in particular are likely to have a very clear sense of the primacy of their interests. In the 1930s, this became the focus of a famous study, when Schattschneider blamed the Smoot-Hawley tariff on congressional politics; and the political consequence that the Roosevelt administration successfully drew was that trade negotiations needed to be delegated to the President and put out of the reach of the Congress.[14] But the position of central banks is not exactly analogous to the concept of strengthening the executive vis-à-vis the legislature. It is better conceived of as the provision of a framework that anchors long-term policy expectations.

Central banks play a particular role in international cooperation. Why are central banks trusted? They supply a particular function, concerned with monetary and

[13] Karl Helfferich, *Das Geld* (Leipzig : C.L. Hirschfeld, 1903), pp. 528, 530.

[14] E.E. Schattschneider, *Politics, Pressure and the Tariff: A Study of Free Private Enterprise in Pressure Politics, as Shown in the 1929-1930 Revision of the Tariff* (New York: Prentice-Hall), 1935.

financial stability. The degree to which they possess political confidence reflects directly their capacity to supply this demand. An independent central bank can supply this function.

A particular European story of cooperation

The story of the making of a Eurosystem of central banks is in large part the story of the emancipation of central banks from state control. There is the background to the debate about the accountability of central banks. The theme of an absence of accountability in Europe, and of European integration as a project driven by a technocratic elite, has become a rather tired cliché.[15] Some dispute its applicability altogether.[16] In the late 1990s, the political scientists Sheri Berman and Kathleen McNamara, for instance, produced an impassioned plea for public control of central banks because sometimes people would feel "anger" at the bank's decisions; "If the bank's decision-making processes were reasonably transparent and open to democratic oversight, the pain could perhaps be explained and justified." [17] But democratic oversight, if taken strictly, implies the capacity of politics to overthrow, revisers, or alter policies: otherwise the notion of control is simply illusory. A substantial political science literature identifies satisfaction with democracy as a function of economic prosperity: in consequence it is not surprising that complainst about democratic deficits increase in downturns (regardless of the question of whether there is any evidence that greater political control could improve any outcome).

EMU is conventionally treated in a very extensive political science literature as the outcome of political initiatives and policy entrepreneurship from the Commission or as the result of a complex and multi-level intra-governmental bargaining process.

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[15] Ralf Dahrendorf, "Warum Europa? Anmerkungen eines skeptischen Europäers," *Merkur*, 7, 1996.

[16] Notably Andrew Moravcsik, "In Defense of the Democratic Deficit: Reassessing Legitimacy in the European Union," *Journal of Common Market Studies* **40** (4) (2002) : 603–24.

[17] Sheri Berman and Kathleen R. McNamara, "Bank on democracy" why central banks need public oversight," *Foreign Affairs*, March/April 1999, p. 7.

Again, Berman and McNamara sum up the conventional wisdom when they state that "European integration has thus far been primarily driven by elites." Neither of these perspectives adequately captures the nature of the process, which is about producing at an international level a solution to a problem of how to manage monetary institutions. A more convincing alternative description is that provided by Rawi Abdelal, in which a group of European (and mostly French) officials are portrayed as seeking rules in the late 1980s for the governance of globalization, whether in trade or monetary issues, and whether on a global or a regional level. Looking for rules that are generalizable and universal in their application is the opposite of technocratic arbitrariness.

It is also the story of an increased confidence that independent central banks can play a role in making a better monetary policy that redounds to the benefit of citizens. In that sense the choice is a political one, and does not necessarily reflect a democratic deficit.

A peculiarity of the process of European monetary integration is the way that it represents a marked contrast with almost every other known historical episode of currency unions, monetary integration, or more generally of the institutionalization of monetary arrangements.[18] To take the very striking contrast of a well known nineteenth century precedent, in Germany in the 1870s, Otto von Bismarck first created a political union (1871), then a common currency (1873), then a central bank (1875). In Europe at the turn of the twentieth century, there was a European Monetary Institute (1994) that laid the foundations for a European System of Central Banks, a monetary union (1999), but (as yet) no sign of political unification, despite the renaming of the European Community in the Maastricht Treaty as the European Union. In other monetary unifications, the state and its political processes stand at the beginning and in the center of the process; in Europe, we do not quite know where the state is.

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[18] Michael Bordo and Harold James, "A Long-Term Perspective on the Euro," European Commission, EMU@10, 2008.

For nineteenth century German unification, a long-time favorite school examination question was whether Bismarck had a blueprint for German unification that he used as a strategic guide through the 1860s. Most modern historians are skeptical about the notion of a well-worked out strategy in the case of Bismarck. For EMU and the ECB, there is no doubt about the relevance of blueprints, and two in particular were especially significant: the Werner Report of 1970 and the Delors Committee report of 1989. But even before the Werner report, an institution had been created which can in some ways be regarded as the ugly chrysalis from which the beautiful butterfly of a unified currency emerged: the Committee of Central Bank Governors of the Member States of the European Economic Community.

European Monetary Union is a quite unique process, that has nevertheless a subject of great fascination in other parts of the world: in the Gulf region, where there are periodic discussions of monetary unification, as well as in Asia and Latin America, where movements towards greater monetary integration also have some support but encounter a plethora of difficulties.

A large part of the fascination of the European project lies in two very particular aspects of the process: the non-state character of the integration process, and the relationship of regional changes to debates about reform of the international monetary system.

First, the European monetary union occurred outside the framework of a conventional state. The creation of money is often thought to be the domain of the state: this was the widely prevalent doctrine of the nineteenth century, which reached its apogee in Knapp's *State Theory of Money*. In the New Testament, Christ famously answers a question about obedience to civil authorities by examining a coin and telling the Pharisees, "Render unto Caesar what is Caesar's." Unlike most banknotes and coins, there is no picture of the state or its symbols – no Caesar – on the money managed by the European Central Bank. Especially in the nineteenth century, the

formation of new nation-states was associated with the establishment of national moneys, which gave the new polities a policy area in which they could exercise themselves.[19]

True, there were alternative traditions, which emphasized either a natural law origin of money, or hypothesized on a contractual origin of monetary arrangements. In natural law theory, money represented an intrinsic good or value, and the theory dealt well with the problem of the interrelationship of different monetary standards in varying political structures. [20] Alternately, it is possible to conceive of money arising out of conventional agreements about the exchange of goods, between parties that are not necessarily in the same political unit. Maybe either of these theories is better situated in explaining what happened in the creation of the institutional framework for a European money. In particular, it is striking that in discussions of monetary union, there was a focus not on who was to issue a new currency, but what its characteristics should be: above all, how monetary stability could be achieved. In other words, the fundamental question of monetary sovereignty (and thus also of the possibility for redistribution) was consistently down-played. The supranational character of a new money was often perceived as a valuable instrument in a fight against the scourge of inflation, since national moneys were too easily manipulated in accordance with national political preferences: especially in weaker or more insecure political systems. Supranational money was impossible as long as different countries had very different levels of inflation, in short as long as there was no consensus about the desirability of anti-inflationary policy. The process of monetary integration was thus accompanied by an intense reflection about what money is and what money should do.

By contrast with the historical origins of central banks as agents for the management of government debt, the European Central Bank was not designed as a

[19] Eric Helleiner, *The making of national money : territorial currencies in historical perspective*, Ithaca : Cornell University Press, 2003.
[20] See Benn Steil and Manuel Hinds, *Money, Markets and Sovereignty*, New Haven: Yale University Press, 2009.

fiscal agent of the European Community or its member states, indeed that role was played by a second institution: the European Monetary Cooperation Fund (EMCF, but often referred to by its French initials as FECOM). The EMCF began with very high ambitions, but in practice remained a rather subsidiary and shadowy institution. It was managed by the BIS, although its board was composed of the EEC central bank governors, so that it was in effect a parallel institution to the Committee of Central Bank Governors of the Member States of the European Community (CCBG). But unlike the CCBG, it was an institution of the EEC, and hence the governors regarded its institutional space with suspicion. In the European parliament all the major political groupings endorsed a report of the Committee on Economic and Monetary Affairs that was bitterly critical of the CCBG for its stance over the EMCF. The Committee's rapporteur, the German Social Democrat Erwin Lange, complained that the "representatives of governments in the Council were not prepared to allow the Fund to act as a European organ." [21]

The European monetary order also broke with most historical precedents in not being concerned with financial sector stability. The ECB was not primarily designed as a support of an integrated but potentially vulnerable banking system. Though there were debates at the founding era in the late 1980s and early 1990s about whether it should play a central part in banking supervision and regulation, that question was answered negatively. In the wake of the 2007-8 credit crisis, the neglect of financial regulation appears as a fundamental flaw. Cross-national banks are not regulated by a European-level superviser. The most powerful European central bank, with the strongest voice in debates on monetary union, the German Bundesbank, was in general highly skeptical about arguments that the central bank should have a prominent role as a LLR. No, the ECB was designed as a non-state actor whose primary purpose was the issue of money – the kind of institution that had basically only been imagined before the 1990s by Friedrich Hayek and his wilder disciples.

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[21] European Parliament, February 18, 1975 *Proceedings* pp. 93-4, p. 97; and avis of February 18, 1875.

The monetary arrangements for the currency union also evolved in a way that showed a striking distance from the institutions of the European Union or European Community, and have frequently been cited as an example of Europe's "democratic deficit" (while defenders argue in terms of a logic of tying hands). The Committee of Central Bank Governors of the Member Countries of the European Economic Community originated in 1964. But it was not a European Community institution, and its regular meetings were not in a member country, but rather in Basle, Switzerland, because of the location of the Bank for International Settlements. From the beginning this location meant that the institution would play with the geometry of power on the European continent, or engineer what later came to be called variable geometry. All the member countries were represented in the Committee (with the exception of Luxembourg, which was already in a monetary union with Belgium), but as the Committee began to devise monetary arrangements in the 1970s, they excluded some member countries. At the same time, the Committee devised association arrangements to work with non-EC members, notably Norway, Sweden and Switzerland, as well as with countries that were preparing for EC membership. The Treaty of Maastricht, which laid down the timetable to monetary union, did not end this peculiarity of the separation of European monetary institutions from European Community or Union constitutionalization. It only found an end in the provisions of the Lisbon Treaty.

This locational oddity (both physical and constitutional) underscores a further crucial feature of the story. The debate about an institutionalization of European monetary arrangements always took place in a wider context of discussions of the global financial system and its problems. Debates about new institutional mechanisms (such as a basket currency) that took place on the global level were also replicated with respect to European affairs. The Committee was originally created in 1964. But it had little real life until the early 1970s, when it developed into a focal point for coordinating the European response to the breakdown of the par value system. The two crucial successful surges of European monetary institutionalization both followed an acute

crisis in the international system. The creation of the European Monetary System in 1979 was a self-conscious response to the rapid decline of the dollar in 1977-8 and the search for a new mechanism internationally to replace the dollar standard. Secondly, the process that led from the report of the Delors Committee in 1989, through the Treaty of Maastricht to the legal realization of the Euro in 1999 and the establishment of the physical currency had its origins in an attempt to devise mechanisms in the mid-1980s that would generate a more stable global exchange rate regime. The critical policy innovators, in particular the highly activist French Finance Minister Edouard Balladur, took an international answer and started to advocate its realization on the European level.

The Bundesbank consistently interpreted not only the EMS, but its successor, in a particular way. From the perspective of Frankfurt, the EMS rested on an agreement between central banks and not between governments. This meant that it refused to participate in discussions in the EC Monetary Committee about, for example, official reserve diversification, or the extension of the maturity of the swap operations for the creation of ECUs. The attraction of the ECB lay in the fact that it was a central bank whose independence was guaranteed by an international treaty, and not merely by a national law which could be changed if parliamentary politics were to produce such a demand. The story of monetary integration as an extension of the principle of international monetary cooperation is obviously deeply at odds with a received version, which sees the EMS and then EMU as the outcome of political processes. The EMS or the Maastricht Treaty were in this account primarily the products of a high level political negotiation, chiefly on a bilateral basis between France and Germany.

Commission President Jacques Delors repeatedly emphasized that the creation of EMU required a new treaty, and that could clearly not be accomplished without political consent. Article 102 of the 1986 Single European Act stated that further development in the field of economic and monetary policy necessitating institutional changes should be based on article 235 of the Treaty of Rome, which implies the accord

of an intergovernmental conference and ratification by member states.But at the same time, Delors saw the only workable way of getting such an agreement as emanating from the work of central bankers: represented in the committee (the Delors Committee), as well as in the Committee of Central Bank Governors which worked out the provisions of the ECB statute.

Was there a scope for further development prior to a treaty? The reason that the Delors report could generate consensus, and that it could be accepted even by the British government under Margaret Thatcher at the Madrid Council meeting, was that it had a very soft first stage, in which no new treaty was required. The major mechanism of the transitional, pre-Treaty, phase of integration was the CCBG (section 52). As the Delors report put it: "Fourthly, the 1964 Council Decision defining the mandate of the Committee of Central Bank Governors would be replaced by a new Decision. According to this Decision the Committee of Central Bank Governors should: formulate opinions on the overall orientation of monetary and exchange rate policy, as well as on measures taken in these fields by individual countries. In particular, the Committee would normally be consulted in advance of national decisions on the course of monetary policy, such as the setting of annual domestic monetary and credit targets."

In the immediate aftermath of the Delors Report, before the Maastricht Treaty, the CCBG started transforming itself into a proto-central bank, with a premium placed on its capacity to make monetary policy independent of any political control. The vision that the Delors Report presented was very much of the extension of the principle of monetary cooperation between states, starting from the definition that a "monetary union constitutes a currency area in which policies are managed jointly with a view to attaining common macroeconomic objectives." The evolution of the central institution from a Committee of Central Bank Governors through the European Monetary Institute to the European Central Bank is a story of how a relatively informal institution becomes formalized to such an extent that it becomes a central bank. It holds out the possibility that other institutions (the IMF or the BIS) could follow the same path.

The Return to politics

	Political Order	Redistribution	Monetary Policy
Globalization	Weakening of states and diffusion of political authority	Limits to redistribution	Search for stable regime: – Gold standard – CPI targeting
Deglobalization		Greater redistributional potential	Acceptance of instability

Now independence looks tarnished because the banks are accused of having made bad policy mistakes. Some of the criticisms go further back much further: there has long been a critique that Bundesbank style tight money policies in Europe have led to lower growth rates. But most of the critique arises directly from logic of politics in a financial or economic crisis. It is however necessarily accompanied by a plausible story that has at its heart a rational critique of central bank actions. That critique asserts that central banks, in the thrall of an international and cosmopolitan banking industry, created the crisis by fueling a boom. And then, when the bubble burst, the central banks mismanaged the rescue operation. After the financial crisis we have become wiser. Making monetary policy is more complex. But as a result it is also more politicized.

The Bank of England's Monetary Policy Committee has often been presented as a pioneer of the transparency of the new way of making monetary policy. So it is interesting to see how the MPC process is shaping up in the financial crisis. From a very early stage the transparency that resulted from the early publication of who voted for and against a proposal led to a public identification of members of the Committee as hawks or doves. Doves in particular had a substantial and appreciative audience, as the business community generally thinks that it gets a nice kick out of lower interest rates. The problematic issues confronting monetary policy have led to a new degree of politicization. Ex-MPC member David Blanchflower's denounced the "feeble six" who resisted big injections in liquidity because they were influenced by "group think" and the "tyranny of the consensus," and argued that the Bank of England should have had instead the "edvice of experienced bankers, lawyers, businessmen and market watchers."[22]

If it is clear who will vote for which measure, there will be an increased demand for a public debate about who should be chosen: why not an election of the MPC, since it is in practice a monetary government? In Europe, a similar debate about the political accountability of European central banks has been simmering since long before the ECB was even established. Tensions between the advocates of different policy solutions will lead to a demand for a greater political say.

In Europe, the Lisbon Treaty came into force in the immediate aftermath of the financial crisis. According to Article 1 (14) of the Lisbon Treaty, Article 9 of the Treaty on European Union is amended so as to make the European Central Bank an institution of the European Union, existing in an institutional framework which "shall aim to promote its values, advance its objectives, serve its interests, those of its citizens and those of the Member States, and ensure the consistency, effectiveness and continuity of its policies and actions." It is obliged under this article to practice "mutual sincere cooperation". This provision appears to modify the strict insistence on the ECB's

[22] David Blanchflower, "The story from the inside," *New Statesman*, September 10, 2009.

independence, which is emphasized in its statute, and which was a major source of the argument that its monetary policy independence should not be compromised by requiring it to take over banking supervision and regulation functions (which were also provided for in the ECB Statute). Previous discussions of ECB independence, and demands for more "economic governance" have focused largely on the interest rate policy of the ECB. There is no doubt that the ECB continues to be free of any political control in the setting of monetary policy. But since 2007, another aspect of central bank policy has come to the fore: the extent of quantitative easing, and the kind of collateral on which QE is based. "Mutual sincere cooperation" might be held to include periodically revising the assessment of what kind of collateral could be used for ECB lending, in line with considerations of the financial stability of the EU and of its financial institutions. To this extent, the Lisbon Treaty holds out a way for the ECB to continue to be active in crisis resolution and in support measures.

The increasing politicization of central banks looks like a dramatic repeat of the interwar story. Then too, central banks were blamed when their policy framework (at that time the gold standard) disintegrated. A major platform of the British or French left as a consequence became the nationalization of the central bank: i.e. the introduction of political accountability. The intellectual shift towards central bank independence, which characterized the late twentieth century, was only possible on the assumption that there was a really clear rule or principle that the central bank should follow. When that rule or principle became muddied, and discretion in policy making returned, the case for central bank independence began to look more problematical. The pendulum is swinging back, toward a nationalized Bank of England, a more accountable Federal Reserve, and an ECB that answers to the people of Europe.

The primary lever that is used in the critique of central banks is a new kind of financial nationalism. The Fed's policy of the early 2000s is reinterpreted as having been largely to the advantage of China – in the same way as the accusation of the 1930s was that the Fed had helped Europeans unfairly.

The criticism is even more acute in regard to the handling of the financial crisis. Banks that are under government control – whether in Britain, the U.S. or Europe - are pressed to cut back their foreign lending. Central bank swaps that seem to help foreign banks are a source of embarrassment. What is most painful about the bank bailouts in the September 2008 crisis is that they involved the support of foreign institutions. In particular the rescue of AIG is attacked because the principal beneficiaries apart from Goldman Sachs were the big European investment banks, Credit Lyonnais, Deutsche Bank, or UBS.

The post-crisis assumption – brilliantly captured by Congressman Grayson's sneering laugh at Bernanke – is that something that helps other countries must be bad for one's own country. In short international financial cooperation is unpatriotic and treacherous.

The motives behind such political interventions against the central banks are not difficult to detect. The idea of intensified political control, especially by parliaments, opens up central banks and the financial community in general to political pressure. That strengthens the parliamentarians. They can decide where credit should flow: to their constituents, rather than to the clientele of an internationalized banking community. The parliamentarians in short see a zero-sum distributional game when they think about credit allocation rather than monetary policy goals. They think that they will be the institutional winners as central bankers are discredited and "international finance" once again becomes a term of abuse.