Comments on Harold James's paper "Central banks: between internationalisation and domestic political control"

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1. The paper

Harold James's paper can be summarised as follows: (i) there are historical cycles in central bank independence (and popularity); (ii) there are inherent limitations in the various indicators of independence used in empirical work by economists; the analysis must therefore be integrated with the "examination of the political and social setting within which CBs work" (p 8); (iii) in general, central banks are likely to be more independent in decentralised-federal than in centralised unitary states (pp 9–12), a point previously made, with caveats, by Capie, Goodhart and Schnadt (1994, pp 61–2) and extended by James to international integration. The latter, James argues, shapes an idiosyncratic central bank culture of independence, also by providing insulation from domestic policy. Finally, (iv) European integration provides a case study proving the latter contention.

2. On central bank independence

Capie, Goodhart and Schnadt (1994, p 50), offer a straightforward definition of central bank independence, namely "the right to change the key operational instrument without consultation or challenge from the government". The same authors add that the use of this simple categorisation "requires a fairly intimate knowledge of the structure, organisation, and working practices of the institution, to say nothing of the personalities in both central bank and government".

The trouble with this definition however is that it sets independence as a 0,1 variable while there are obviously many degrees of independence. Napoleon famously said: "I want the Bank to be just enough but not too much under government control" (quoted by Crouzet (1993, p 544)). In France, things were not always as bad as when, upon becoming President, Giscard d'Estaing immediately removed from office the Governor who, during the electoral campaign, insisted in public that interest rates should be raised without delay (Bouvier (1988, p 102)). Forty-eight years before, for instance, Moreau stood firm against Poincaré's fixation on stabilising the franc at an unreasonably high parity. His prestige was such that the mere threat of resignation brought the Prime Minister to reason. Personalities matter but are hard to quantify.

In the 1920s the main apostles of central bank independence, Norman and Strong, managed to have the principle of independence proclaimed at every economic conference and eventually engraved in the tables of the League of Nations. Yet they disagreed about the nature and limits of independence. Norman argued that the Bank should have the right to rebuke the government in public and to be free to make decisions on several issues regardless of any political consideration. Strong, on the contrary, repeatedly told his friend

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that the Fed could never openly act against the government's interest (Giannini (2004, pp 260–1)).

Sixty years later, Alec Cairncross wrote that "The British experience has been that there is no alternative to a close relationship (between the Government and the Bank) with each preserving its independence of judgment but with responsibility for major decisions resting inevitably on the government of the day" (Cairncross A, (1988, pp 71–2)). Margaret Thatcher would agree. The return to a mechanism of price stability, she wrote in 1995, "should not entail giving new autonomy to the Bank of England. Ultimately, it is the politicians who must be accountable for economic policy" (Thatcher (1995, p 570)).

Let me add that misused independence might on occasion be harmful to both the government and the central bank. Schacht's defiant attitude during his first tenure at the Reichsbank helped to destabilise the Weimar Republic. In the 1930s, central banks lost prestige and autonomy precisely because they remained too stubbornly independent in interpreting their role as custodians of gold convertibility. In 2008–09 central bankers did not repeat the mistake.

Moreover, central bank independence is largely seen from an English or, at best, Anglo Saxon viewpoint, ie in contexts characterised by an early development, sophistication and specialisation of financial markets. This was not, for instance, the condition of continental Europe where universal banking prevailed and the discount business was weak, with the possible exception of France. This meant that: (i) the money supply had to be regulated by tools other than the rediscount of commercial paper, tools that required legal provisions and government authorisation, (ii) in extreme cases, lending of last resort to ailing banks entailed taking responsibility for non-financial companies, (iii) the central bank felt, and was understood to have, broader responsibilities for the overall growth of relatively backward economies. All this meant that relations between the government and the central bank were by no means confined to managing monetary aggregates and that, occasionally, the central bank had to make politically sensitive decisions about resource allocation.

Is central banking in rapidly emerging countries today more similar to the British or the continental paradigm?

Regardless of their legal independence from the government, central banks in developing countries seem to pay close attention to real economy issues, necessarily in contact with government authorities. In a recent public address, Mr Zhou, Governor of the People's Bank of China, said: "In accordance with the overall arrangements of the Chinese Communist Party's Central Committee and the State Council, we will try to strike a balance between maintaining a stable and relatively rapid development of the economy, economic restructuring and managing inflationary expectation." This action will require close cooperation with government agencies, of the kind continental European central banks were expected to have for a good part of the 20th century.

3. International economic integration and central bank cooperation

Harold James argues that the integration in the international economy enhances central bank independence. I tend to agree: as they gathered for their monthly meetings at the BIS, central bankers were acutely aware that their cooperation also made them more independent from their respective governments (Toniolo (2005)).

A qualification is however needed on this point: the international monetary regime matters. The maintenance of the gold standard entailed technicalities that governments could only leave to central banks to manage, thereby enhancing their independence. The Bretton Woods period coincided with a low level of central bank independence. However, keeping the system afloat entailed considerable expertise and international cooperation: central

banks had an absolute advantage in both areas. They therefore enjoyed considerable freedom of manoeuvre on a day to day basis, which slowly increased their independence while at the same time lifting their prestige.

Central banks regained their independence in the 1980s with the international monetary system based on floating rates. International central bank cooperation increasingly focused on the stability of ever more interconnected banking systems and on the regulation thereof (Borio and Toniolo (2008)). The production of soft laws probably enhanced central bank independence in an area other that setting interest rates but whenever soft laws had to be translated into hard laws then interaction with, and eventual subordination to, the political authorities was inevitable. Again, independence is a multi-faceted concept.

4. Lending of last resort and central bank independence

Except for a few lines at the end, there is one missing piece in Harold James's paper, as there was – until recently – in much of the literature on central bank independence. This is the lending of last resort function of central banks. Most economists are uneasy with systemic instability but historians should know better.

A bank of issue graduates into a central bank when it consciously takes responsibility for the stability of the financial system. Needless to say, lending of last resort often entails allocative decisions that in normal times central banks should avoid like mortal sins. And there are only rules of thumb, and little theory, about lending of last resort. At the same time, besides the common good of financial stability, there are enormous private goods at stake.

A discussion of lending of last resort (and supervision) entails considerations about independence from (or relations with) both the government and the financial community, as amply shown by the current crisis. If we accept Harold James's argument that international economic integration enhanced central bank independence from governments (intrinsically domestic institutions), what about independence from the financial community (intrinsically international)?

5. Then and now: the outcome

During the Great Depression of the 1930s, tragic mistakes were made by independent central banks. In most cases governments initially concurred but then grasped the situation earlier and better than central banks did, and took over. Most of the blame fell on central bankers who lost both prestige and independence. Lending of last resort and bank restructuring – which in Germany and Italy entailed colossal operations – were masterminded and engineered by governments with central banks acting only as their agents.

James argues that the "The increasing politicisation of central banks looks like a dramatic repeat of the interwar story": central banks will lose prestige and independence. I don't think this will be the case as the two stories differ in one major respect: the current success of monetary policy and lending of last resort in taming the crisis.

True, the criticism of monetary policy during the Great Moderation closely resembles the accusations made of Benjamin Strong for keeping interest rates too low for too long. And there are two other similarities between the periods leading up to the two most serious crises of the past two centuries. The first is the inadequacy, compounded by hubris, of the intellectual approach to the financial boom. The second relates to regulatory failures.

However, the similarities between the 1920s and the 2000s end at the onset of the crisis. Monetary policy made the difference. Lending of last resort and financial restructuring, messy as they often turned out to be, were swiftly undertaken in 2008 while they remained timid or absent in the early 1930s. The recent success in putting out the fire is particularly remarkable in perspective, as the potential for disruption was greater now than then. The current crisis was potentially more virulent than the panics of 1931–33 because the financial system had become larger compared with GDP, more complex and interconnected. Leverage was now greater and banks had become more vulnerable by heavy reliance on short-term wholesale sources of funding. Moreover, technology now allows massive amounts of money to be moved by the click of a mouse: it is no longer necessary to line up for hours on the sidewalk outside a bank to move money out of it.

For the public, the villain of the piece is the banking and financial system. When people complain about bailing out Wall Street at Main Street's expense, they blame the government rather than the central bank. Nor can governments shift the blame onto central bankers, as they did in the 1930s, because, for all the mythology of independence, central banks moved in tune with governments, with final responsibility firmly sitting with the elected officials.

Criticism of the ECB, alluded to by Harold James, long antedates the crisis, and the fact that recently Frankfurt had both the means and the will to act to stem speculation on sovereign bonds, while governments were slow in finalising the EU support, can do no harm to the ECB's reputation.

I do not see the political, social and economic conditions for the pendulum to fully swing back to the situation of the 40-odd years following the mid-1930s. The swing will be modest: more accountability will be demanded of central banks, in some cases in exchange for more responsibilities in the supervisory and regulatory areas. All in all, the situation will remain that of a separation of responsibilities. Cooperation and mutual support between central banks and governments will continue, as it has in most countries over the last 30 years, during which period the full, unadulterated, central bank autonomy of the kind advocated by Lord Norman has existed more in the textbooks than in reality.

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