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Central banks: between internationalisation and domestic political control

by Harold James

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Foreword

On 24–25 June 2010, the BIS held its Ninth Annual Conference, on "The future of central banking under post-crisis mandates" in Lucerne, Switzerland. The event brought together senior representatives of central banks and academic institutions who exchanged views on this topic. The papers presented at the conference and the discussants' comments are released as BIS Working Papers 326 to 331. A forthcoming BIS Paper will contain the opening address of Stephen Cecchetti (Economic Adviser, BIS), a keynote address from Baron Alexandre Lamfalussy, and the contributions of the policy panel on "Do central bank governance arrangements need to be altered?". The participants in the policy panel discussion, chaired by Jaime Caruana (General Manager, BIS), were Mark Carney (Bank of Canada), Andrew Crockett (JP Morgan Chase International), Stefan Ingves (Sveriges Riksbank), Lucas Papademos (Former Vice President, European Central Bank), and Duvvuri Subbarao (Reserve Bank of India).

Conference Programme

Thursday 24 June

Opening remarks	**Stephen Cecchetti (BIS)**
Session 1:	**The future role and mandate of central banks**
Paper title:	The changing roles of Central Banks
Chair:	Armando M Tetangco, Jr. (Bangko Sentral ng Pilipinas)
Author:	Charles Goodhart (London School of Economics)
Discussants:	Stanley Fischer (Bank of Israel) Randall Kroszner (University of Chicago)
Session 2:	**International governance**
Paper title:	Central banks: between internationalisation and domestic political control
Chair:	Henrique de Campos Meirelles (Central Bank of Brazil)
Author:	Harold James (Princeton University) Paper: Central Banks: Between Internationalization and Domestic Political Control
Discussants:	Gianni Toniolo (Duke University) Már Gudmundsson (Central Bank of Iceland)
Keynote lecture	
Speaker:	Alexandre Lamfalussy

Friday 25 June

Session 3:	**Lessons from history for future central bank design**
Paper title:	The Federal Reserve, the Bank of England, and the Rise of the Dollar as an International Currency, 1914-1939
Chair:	Ms Zeti Aziz (Central Bank of Malaysia)
Author:	Barry Eichengreen (University of California) (joint work with Marc Flandreau)
Discussant:	Robert Keohane (Princeton University) Leszek Balcerowicz (Warsaw School of Economics)
Session 4:	**Lessons from political economy for future central bank design**
Paper title:	The Governance of Financial Regulation: Reform Lessons from the Recent Crisis
Chair:	Christine Cumming (Federal Reserve Bank of New York)
Author:	Ross Levine (Brown University)
Discussants:	Gill Marcus (South African Reserve Bank) Howard Davies (London School of Economics)

Session 5:	**Central bank finances: Policy relevant? Politically relevant?**
Paper title:	Minimizing Monetary Policy
Chair:	Zdenek Tuma (Czech National Bank)
Presenting author:	Peter Stella (Consultant)
Discussants:	Marc Flandreau (Graduate Institute of international and Developmant Studies) José De Gregorio (Central Bank of Chile)
Session 6:	**Are central banks special?**
Paper title:	Central banks and competition authorities: institutional comparisons and new concerns
Chair:	Masaaki Shirakawa (Bank of Japan)
Presenting author:	John Vickers (All Souls College, Oxford)
Discussants:	Allan Bollard (Reserve Bank of New Zealand) Mario Monti (Universita Commerciale Luigi Bocconi)
Session 7:	**Panel discussion: "Do central bank governance arrangements need to be altered?"**
Chair:	Jaime Caruana (BIS)
Panellists:	Mark Carney (Bank of Canada) Andrew Crockett (JP Morgan Chase International) Stefan Ingves (Sveriges Riksbank) Lucas Papademos (Ex Vice President, European Central Bank) Duvvuri Subbarao (Reserve Bank of India)

Central banks: between internationalisation and domestic political control

Harold James

Abstract

The paper examines the exercise, the efficiency, and the legitimacy of the monetary policy-making process. The goal of central bank autonomy in recent times is the outcome of a demand for price stability. The realisation of autonomy is also a consequence of the fragmentation of national decision making, in federal systems but also in regional and international monetary arrangements. Economic and financial crisis changes the political economy, and produces a transition from seeing the central bank as producing a general or universalisable good (price stability) to interpreting monetary policy as fundamentally a tool for redistributive or factional policies. The latter will only work in the framework of national policy.

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Contents

Central banks: between internationalisation and domestic political control

Harold James[1]

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

1. Before the 20th century, central banks were 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 often proceeds from 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 of 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 universalisable good (price stability) and interpreting it as fundamentally a tool for redistributive or factional policies. The former can clearly occur in an international and transnational 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

[1] Princeton University Woodrow Wilson School, and European University Institute, Florence.

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 US and Asian "dumping"; after the outbreak of the financial crisis, as president of France, he complained that the ECB did not lower interest rates: "They have facilitated things for speculators, while complicating them for entrepreneurs."[2] Chancellor Angela Merkel from a different angle criticised quite directly the ECB's purchases of covered bonds, which she described as "bowing to international pressure".[3]

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.[4] At the end of July 2009, the Federal Reserve Chairman was grilled on the financial crisis before Congress, and the result was a series of viral YouTube 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 21 July 2009, Grayson asked Ben Bernanke why the swaps on the Fed's balance sheet had increased from $24 billion at the end of 2007 to $553 billion 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 billion (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 producers of wealth that 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 well as of a newer wave of central banks that followed the example of the Bank of 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 Banks of the United States. Resistance to the process of political capture led in some countries such as Switzerland at the end of the 19th century to opposition to any central bank at all.

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

[3] *Financial Times*, 3 June 2009, p9.

[4] S Johnson and J Kwak, *Thirteen Bankers: The Wall Street Takeover and the Next Financial Meltdown*, Pantheon, 2010.

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-19th century, a new generation of central banks was established essentially to manage payments systems, and stabilise 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 70 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 overvaluation of sterling in order to restore Britain's position as an international financial centre, 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 Bank of France as controlled by its 200 shareholders, who 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 fuelled 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 US 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, of which half the 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 US 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, emphasised 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 to 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 macroeconomic 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 cast-iron autonomy would give a better framework for making a strong European economy. Centre-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.[5]

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 macroeconomic 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.[6] 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.[7] The approach emphasised 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 are handled 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 borrow from the

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5 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.

6 J Buchanan and R Wagner, *Democracy in deficit,* Academic Press, Amsterdam, 1977.

7 Especially F Kydland and E Prescott, “Rules rather than discretion: the inconsistency of optimal plans”, *Journal of Political Economy*, 85/3, 1977, pp 473–91; R Barro and D Gordon, “Rules, discretion and reputation in a model of monetary policy”, *Journal of Monetary Economics*, 12, 1983, pp 101–121.

central bank. But laws do not cover every eventuality, and there is often ample scope for power politics to intrude.

Secondly, it is possible to look simply at the rate of turnover of governors and chief executives. A high turnover and brief tenures are characteristics of many unstable political and monetary regimes, in the second half of the 20th 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.[8] 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 fully 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 criticised the approach of Bade and Barkin to the position of the Italian bank; and Eijffinger and de Haan thought that the Netherlands Bank was more independent than was represented in Cukierman's survey.[9] An apparently rigorous scientific exercise becomes very quickly and evidently random and arbitrary. 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, the eminent Italian central banker Carlo Ciampi 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."[10]

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 19th 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.

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[8] See A Cukierman, *Central Bank Strategy, Credibility, and Independence: Theory and Evidence*, MIT Press, 1992. Also A Cukierman, S Webb and B Neyapti, "Measuring the independence of central banks and its effect on policy outcomes", *World Bank Economic Review*, 6/3, 1992, pp 353–398.

[9] See R. Bade, and M. Parkin, Central bank laws and monetary policy, Department of Economics, University of Western Ontario, mimeo 1988; A Alesina, "Macroeconomics and Politics", in S Fischer (ed), NBER Macroeconomics Annual, MIT Press, 1988, pp 17–52. A Alesina, "Politics and Business Cycles in Industrial Democracies," Economic Policy 8 (Spring 1989), pp 58–98; A Alesina and V Grilli. "The European Central Bank: reshaping monetary policy in Europe", in (eds) M Canzoneri, V Grilli, and P Masson, Establishing a Central Bank: Issues in Europe and Lessons from the United States, Cambridge University Press and CEPR, 1992, pp 49–77; V Grilli, D Masciandaro and G Tabellini, "Political and monetary institutions and public finance policies in the industrial countries", Economic Policy 13 October 1991, pp 341–92; S Eijffinger and J de Haan, "The political economy of central-bank independence", Princeton Studies in International Economics 19, International Economics Section, Department of Economics Princeton University, 1996.

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

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 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 behaviour 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.[11]

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.[12]

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". Centralised states such as France or Japan (which as he pointed out had an excellent record in fighting inflation) exercised political control over central banks. 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).[13]

This position has an inherent plausibility and even attraction. Central bank autonomy becomes more important as more emphasis is given to policy coordination between different tiers of political authority. This may be in one country, within 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 to and injecting liquidity into the corporations and public authorities that were near at hand. In Yugoslavia in the 1980s and in the Soviet Union in the early 1990s, inflation and hyper-inflation led to a distrust of Belgrade and Moscow, and a demand for regional independence and autonomy.

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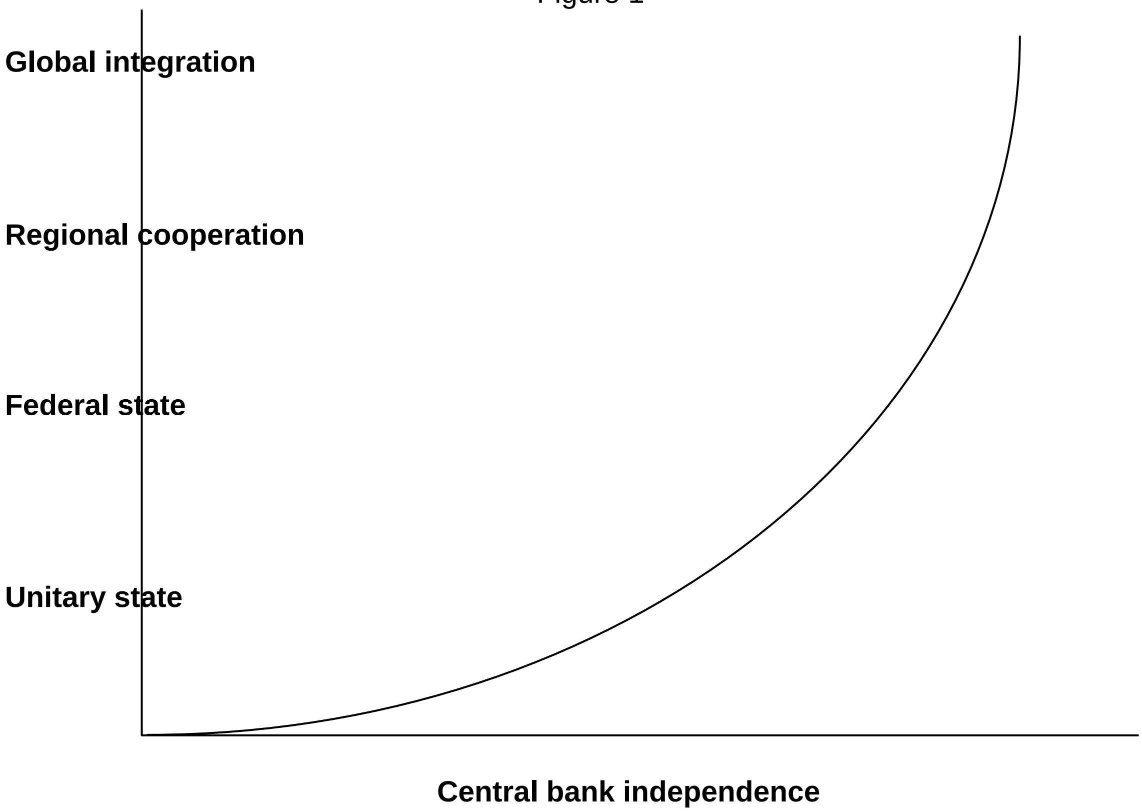
[11] A Posen, "Declarations are not enough: financial sector sources of central bank independence", in NBER Macroeconomics Annual vol 10, 1995; G Miller, "An interest group theory of central bank independence", Journal of Legal Studies, vol 27, no 2, 1998.

[12] J Ruggie, "International regimes, transactions, and change: embedded liberalism in the postwar economic order", *International Organization,* 36(2), 1982.

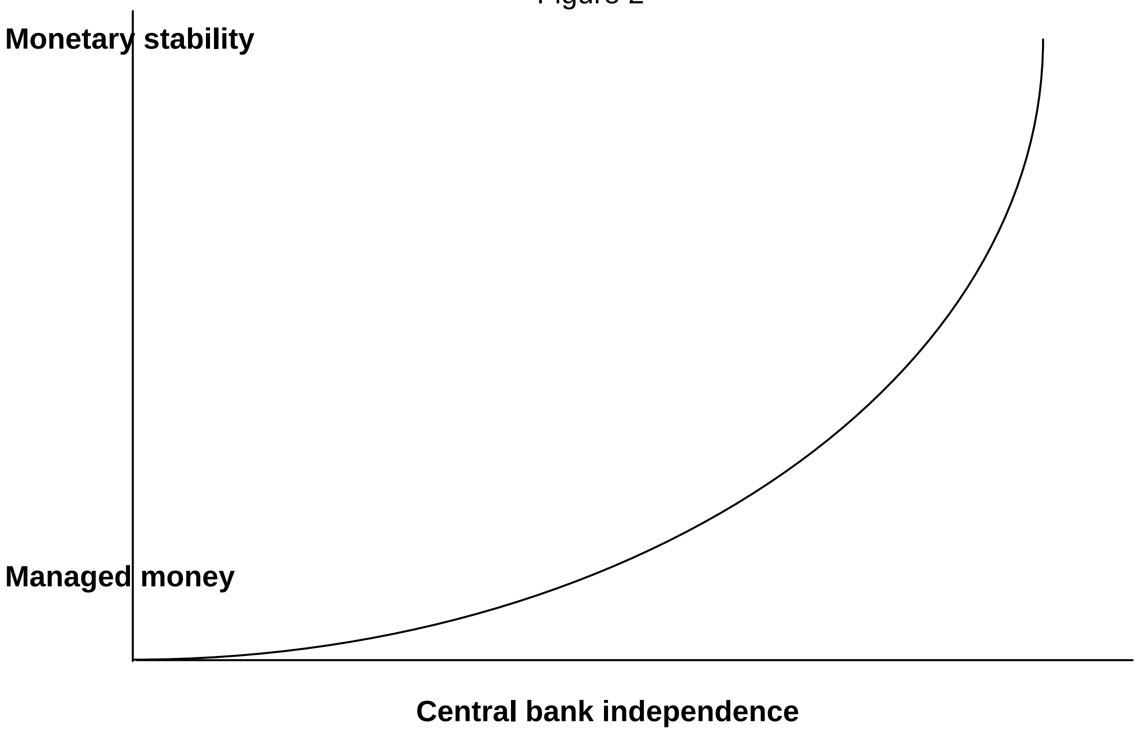
[13] C Noyer, "A propos du statut et de l'indépendance des banques centrales", *Revue d'économie financière*, September 1992, pp 13–18; D Howarth, *The French Road to Monetary Union*, Palgrave, 2001, p 131.

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 globalisation. Complex transactions and relations in a globalised 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 globalisation upswings have always had a widely recognised and shared international measure of value. The late 19th century was characterised 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 20th century, price stability became a major objective of policy. Because the experience of the 20th 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 19th 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 mobilisation and a polarisation 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 mobilise 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 demoralisation 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 19th century, both in America and in Europe, to inflate the currency in order to reduce the oppressive load of farm debt.[14]

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[14] K Helfferich, *Das Geld,* C L Hirschfeld, Leipzig, 1903, pp 528, 530.

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 parliamentarisation. 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.[15] 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 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.[16] Some dispute its applicability altogether.[17] 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.”[18] But democratic oversight, if taken strictly, implies the capacity of politics to overthrow, revise 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 complaints 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. 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

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[15] 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*, Prentice-Hall, New York, 1935.

[16] R Dahrendorf, “Warum Europa? Anmerkungen eines skeptischen Europäers”, *Merkur*, 7, 1996.

[17] Notably A Moravcsik, “In defense of the democratic deficit: reassessing legitimacy in the European Union“, *Journal of Common Market Studies* 40 (4), 2002, pp 603–24.

[18] S Berman and K McNamara, “Bank on democracy” why central banks need public oversight”, *Foreign Affairs*, March/April 1999, p 7.

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 globalisation, whether in trade or monetary issues, and whether on a global or a regional level. Looking for rules that are generalisable 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 institutionalisation of monetary arrangements.[19] To take the very striking contrast of a well known 19th 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 20th 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 centre of the process; in Europe, we do not quite know where the state is.

For German unification in the 19th century, a long-time favourite 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 sceptical 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 represented 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 19th 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 ECB. Especially in the 19th century, the

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19 M Bordo and H James, "A long-term perspective on the euro", EMU@10, European Commission, 2008.

formation of new nation-states was associated with the establishment of national currencies, which gave the new polities a policy area in which they could exercise themselves.[20]

True, there were alternative traditions, which emphasised either a natural law origin of money, or hypothesised 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.[21] Alternatively, 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 currency. 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 currencies 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 ECB was not designed as a 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."[22]

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 2007–08 credit crisis, the neglect of financial regulation appears as a fundamental flaw. Cross-national banks are not regulated by a European-level supervisor. The most powerful European central bank, with the strongest voice in debates on monetary union, the German Bundesbank, was in general highly sceptical about arguments that the central bank should

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[20] E Helleiner, *The making of national money: territorial currencies in historical perspective*, Cornell University Press, 2003.

[21] See B Steil and M Hinds, *Money, Markets and Sovereignty*, Yale University Press, 2009.

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

have a prominent role as a lender of last resort. 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.

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 constitutionalisation. 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 institutionalisation 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 institutionalisation 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 1977–78 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 realisation 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 realisation 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 emphasised 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 ECB is a story of how a relatively informal institution becomes formalised 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
Globalisation	Weakening of states and diffusion of political authority	Limits to redistribution	Search for stable regime: • Gold standard • CPI targeting
Deglobalisation		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 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 fuelling 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 politicised.

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 politicisation. 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 "advice of experienced bankers, lawyers, businessmen and market watchers."[23]

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 ECB 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 independence, which is emphasised 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 politicisation 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 nationalisation of the central bank: ie the introduction of political accountability. The intellectual shift towards central bank independence, which characterised the late 20th 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

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

discretion in policymaking returned, the case for central bank independence began to look more problematical. The pendulum is swinging back, toward a nationalised 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 US 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 internationalised 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.

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

Már Gudmundsson[24]

It gives me great pleasure to discuss this interesting paper by Professor Harold James. In my comments, I would like to focus on four key points that I took away from Professor James's paper:

1. Autonomous or independent central banks are more likely to exist in federal systems of government.
2. Central banks' status and independence are subject to cycles related to financial and economic crises.
3. There is a tension between international cooperation among central banks and domestic political control that becomes more pronounced in the aftermath of a crisis.
4. As we currently find ourselves in the aftermath of a deep financial crisis, the situation will be more challenging for central banks than it has been in the recent past. They face more critical domestic scrutiny, and there is a larger risk that central bank independence will be undermined and central bank cooperation questioned.

All of the above points are convincingly argued and well illustrated by the case study of European monetary integration, which is interesting in its own right. However, I think that the above statements, although correct in themselves, only sketch a particular picture, making the conclusions perhaps too pessimistic, at least regarding the monetary policy part of central banking. Let me expand on this.

In the last two decades or so, there have been powerful drivers behind the dominant monetary policy framework, which is composed of price stability as the main goal, independence for central banks to apply monetary policy instruments in order to reach that goal, and flexible exchange rates.

First, previous experience of high inflation and the realisation, underpinned by experience and theory, that there is no long-run inverse relationship between inflation and unemployment, gave strong support to the intellectual case that price stability should be the main goal of monetary policy. Additionally, the expansion and development of capital markets strengthened the constituency for price stability.

Second, real and financial globalisation made fixed exchange rate regimes with free capital movements increasingly difficult to operate. An alternative nominal anchor was therefore called for in many countries that had previously used a fixed exchange rate for that purpose.[25]

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[24] Governor, Central Bank of Iceland.

[25] In my former incarnation as Chief Economist of the Central Bank of Iceland from 1994–2004, I was deeply involved with this process in my own country when it moved away from exchange rate targeting to inflation targeting in the late 1990s and the early 2000s. See, for instance, Gudmundsson et al (2001). But it later became clearer that financial globalisation makes even the conduct of inflation targeting and floating exchange rates complicated in very small, open and financially integrated economies. See Gudmundsson (2008).

Third, there were improvements in the "science" and "technology" of monetary policy formulation and implementation. In addition, the repeated nature of monetary policy decisions gives scope for learning through trial and error to a much greater degree than is possible in the case of financial stability. After all, we take decisions on interest rates all the time, whereas we fortunately deal with financial crises only once in a while. All of this gives monetary policy the aura of a science to be entrusted to technocrats.

These factors are unrelated to the form of the state, and to a significant degree they are still with us. Furthermore, although I may be wrong, and I might be too strongly influenced by what I experience in my own country, I do not sense any great drive for the abolition of price stability as a goal or for the transfer of monetary policy decision-making to politicians. Yes, we central bankers are all facing more critical scrutiny, and that is not all bad. There are also more critical comments from politicians, but it seems to me that, in general, they have no strong desire to get involved in the decision-making process. After all, that would make them responsible, which is not always convenient. Better to leave it to the central bankers and be free to criticise.

It is another matter that due to the crisis we have moved into territory that is necessarily more politicised, as Professor James describes quite well. In addition, the governance arrangements for systemic or macroprudential policies are in the process of being worked out. Should central banks be allocated key tasks, as now seems likely, then we need to acknowledge that not all of the arguments for central bank independence that apply to monetary policy will necessarily carry over. Financial stability is more multifaceted than monetary policy, and it involves more trade-offs. Additionally, financial stability is necessarily a cooperative activity, involving other institutions, ministries and the government.

Should central banks be allocated additional tasks in the financial stability field, we might need to make a distinction between the independence and autonomy of the institution, on the one hand, and the various functions, on the other. Central bank independence is not a religion. It has to be argued in each case. The governance arrangements for the financial stability functions will be different from those applying to the monetary policy function, as financial stability requires more cooperation with other institutions and may involve more political oversight. The key issue is to preserve the independence of the monetary policy function.

The crisis has put policy coordination more firmly on the agenda, not least in small, open economies where policy conflicts can be very damaging. It is not clear what this will mean in terms of central bank autonomy and stature. I tend to think the case can be made that central bank independence in terms of setting monetary policy can coexist with better policy coordination, but this should be explored further. Here again, the distinction between the independence of the institution and of the functions might be of key importance.

Finally, as I am supposed to give the perspective of the policymaker, let me say the following: yes, there are cycles in history, but the role of groups and even individuals still matters. It is far from a foregone conclusion that we are seeing the end of independent central banks. Central bankers can influence these developments, and so they should. As we enter uncharted waters, and as other functions are introduced, possibly with different governance arrangements, it is up to us to try to preserve the independence of the monetary policy function that has served society so well in the past.

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

Gianni Toniolo[26]

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

[26] Duke, LUISS and CEPR

regardless of any political consideration. Strong, on the contrary, repeatedly told his friend 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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