Central Bank Independence: History

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The Problem

- Money is a sort of **call option**:
  - Counterparties swap a present real flow for a future real flow that can be called at any moment
  - Money is easily negotiable, is senior to all other liabilities, and can generally be used to pay taxes
  - Real price depends on expectations about the real value of the call (i.e. *inflation* – but also, more generally, the issuer's ***solvency***)

➢ A powerful mechanism… but prone to abuses!

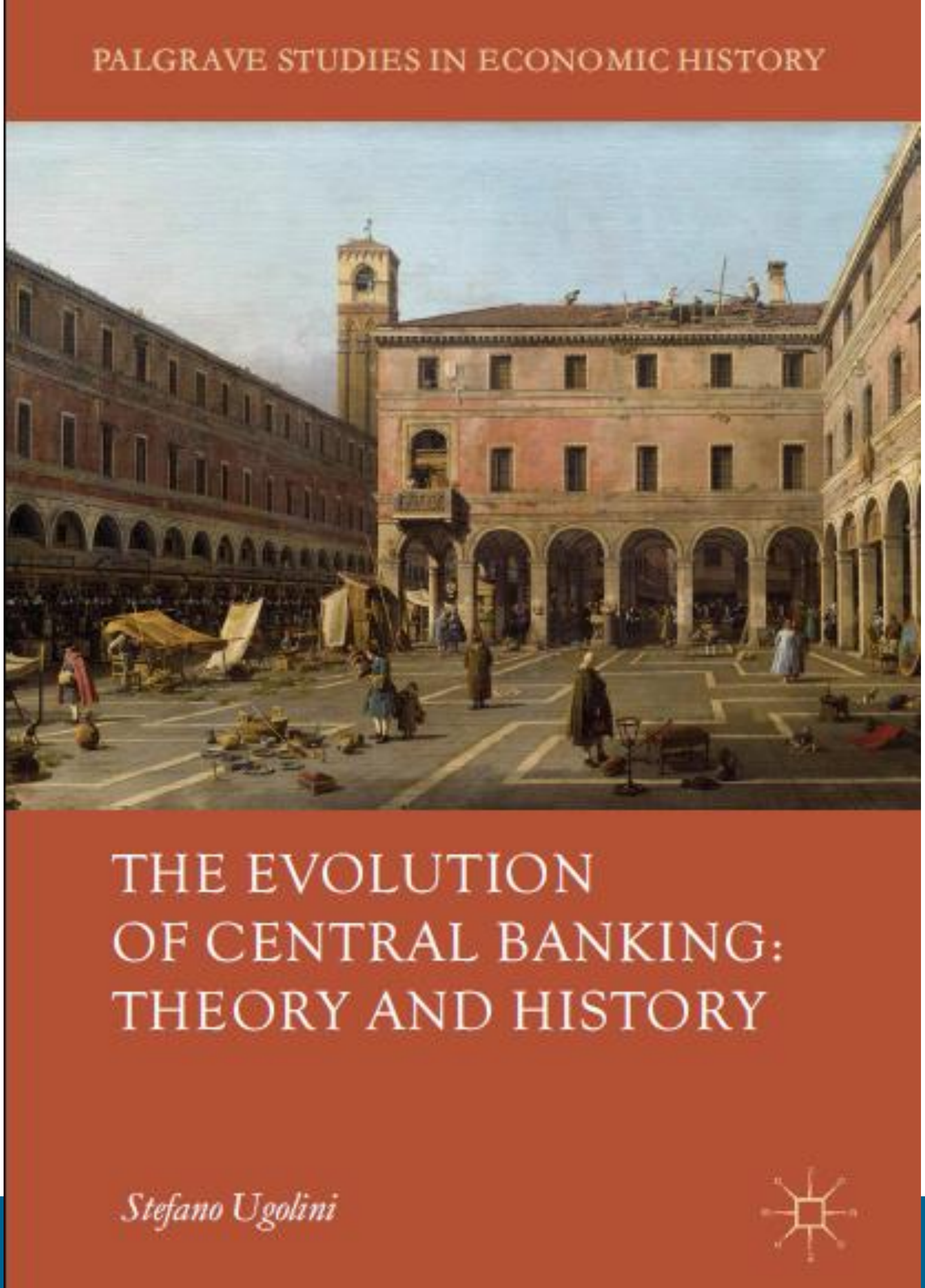
The Solution

- **Central bank independence** is a solution to this problem. According to the mainstream view (e.g. Rogoff 1985):
  - Time-consistent money creation can only occur if issuer narrowly focuses on inflation
  - Hence, the money-issuing organization must be designed as public but fully independent agency
    - ✓Alternative solutions are clearly suboptimal…

…The Definitive One?

- CBI optimality derived in a restrictive conceptual framework
- In a more general framework (where *solvency* and *inflation* are **separable** dimensions), other institutional solutions than modern CBI may not necessarily be suboptimal
  - Focusing on the ***political economy* of money creation from a *long-term perspective*** allows understanding past (and, maybe, future?) trends

SCIENCES PO TOULOUSE



Central Bank Independence: History

ANCIENT CIVILIZATIONS

Centralized Ancient Civilizations

- Early agrarian civilizations in the Near East did not use coins
- Societies were structured around central organizations (palaces) providing many services (esp. stockage) including **payments**
- No need for independence: Money was issued to the landed aristocracy against deposit of goods (crops) and was mobilized to protect the interests of the landed aristocracy

Decentralized Ancient Civilizations

- Coins invented in a context of political fragmentation (the Aegean world)
- Coins first used essentially to remunerate mercenaries in a context of very dubious solvability of issuers
- Coins spread westwards by the Romans; they remain "legal money" in the Middle Ages thanks to the Roman juridical heritage

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MEDIEVAL CITY-STATES

The "Merchant Republics"

- "Merchant republics" emerged in the Middle Ages as self-governing urban entities ruled by mercantile oligarchies
- Many of them created divisions of government to provide **payments** services
- No need for independence: Money was issued to the oligarchy against sales of goods/services and was mobilized to protect the interests of the oligarchy

The "Merchant Republics"

- Some prominent examples:
  - **Venice** (*Camera del Frumento* 13th-14th centuries, *Banco della Piazza* & *Banco del Giro* 16th-18th centuries)
  - **Barcelona** (*Taula de Camvis* 15th-19th centuries)
  - **Amsterdam** (*Wisselbank* 17th-18th centuries)
  - **Hamburg** (*Hamburger Bank* 17th-19th centuries)
  - ➢ A counterexample: **Genoa** (*Banco di San Giorgio* 15th-18th centuries) – role of partisan politics

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MODERN TERRITORIAL POLITIES

Territorial Monarchies

- Territorial monarchies long struggled to secure stable funding from their subjects
- Potential misalignment of interests between creditors (moneyed elites) and debtors (landed elites)
- To provide **payments** services, need to find an institutional solution credibly guaranteeing the independence of the money-issuing organization from the spending authority

Territorial Monarchies

- Some prominent examples:
  - **Naples** (*Monte di Pietà and 6 other money-issuing charities* 15th-18th centuries)
  - **Sweden** (*Riksbank* 17th-20th centuries)
  - **Austria** (*Wiener Stadtbanco* 18th-19th centuries)
  - **England** (*Bank of England* 17th-20th centuries)
  - ➢ A counterexample: **France** (John Law's *Banque Royale* 18th century) – a big failure indeed!

Territorial Democracies

- English model adopted everywhere since 1800
- But since 2nd half of the 19th century, extension of voting rights and increasing monetization of economies gradually shifted equilibria
  - Debtors no longer limited to landed elites
  - Creditors no longer limited to moneyed elites
- This made private issuing monopolies (as in England) increasingly untenable, esp. since the Great Depression (→CB nationalizations)

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TO CONCLUDE…

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To conclude…

- Optimal institutional design strictly depends on political economy equilibria
- Past solutions do not appear to have been intrinsically inferior, but rather well-suited to the historical context for which they had been designed (and with which they disappeared)
- Changing political equilibria can naturally be expected to lead to new institutional solutions
- *…and history will (again) be written by victors*

From Mario Draghi's last press conference as ECB president, 24 October 2019