

# **The winds of change for central banks: the impact of economic crises on the central banking world**

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I need not remind you that ultimate authority regarding credit and currency must rest with Governments and that a Central Bank in any country is obliged to frame its own policies within limits set by Government decisions.

Sir Ernest Harvey, Deputy Governor, Bank of England to Leslie Lefeaux, Governor, Reserve Bank of New Zealand, 1936.

There have been many dramatic changes in the world of central banking since the classic days of the Gold Standard before 1914. Some – though not all – of these shifts have occurred in response to financial and economic (and political) crises. New disasters, such as the one now in progress, could result in further remodelling of central banking institutions and functions. While the job of the historian is not to look into the future, the example of the 1930s and 1940s suggests that the next round of central banking reforms might not be palatable to the current generation of central bankers. Even so, central banks have demonstrated a remarkable capacity to adapt to changes in the environment. This paper examines how crises – especially the depression of the 1930s and the inflation of the 1970s and 1980s – led to the remoulding of central banks.

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In the Richard T. Ely lecture to the AEA in January 2004, Mervyn King pointed out that central banks would continue to evolve:

[T]he core of the monetary-policy problem is uncertainty about future social decisions resulting from the impossibility and the undesirability of committing our successors to any given monetary-policy strategy. The impossibility stems from the observation that collective decisions cannot be enforced, so that it is impossible to commit to future collective decisions; the undesirability reflects the fact that we cannot articulate all possible future states of the world (King 2004: 1).

This comment is equally applicable to other possible central bank responsibilities such as the prudential supervision of banks and other financial institutions. The central banking consensus at the start of the new millennium, which owed so much to the RBNZ, Roger Douglas, and Don Brash, will not be the last word. That this is so is also implied by the most recently published (as of April 2009) central bank history, Gunnar Wetterberg's account of 350 years of the Stockholms Banco / Sveriges Riksbank:

The winds of change have left their mark on the Riksbank's history. Time and again, the directors and officials have had to tackle questions that were entirely new to them or have found that well-tried solutions no longer worked. ...the story of the Riskbank is one of those innumerable tales of learning and adjustment. The bank has sometimes managed by relying on experience, while on other occasions it has had to reject experience and produce new responses (Wetterberg 2009: 11-12).

It is only in the most extreme circumstances that central banks are closed down, and even then they are reconstructed, one way or another, after a few years. The Austro-Hungarian central bank ceased operations in 1919, but the 1920s saw the establishment of new central banks in the successor states of central Europe. After World War Two the Reichsbank was polished off, but many of its senior staff members were recycled and rehired, first by the Bank deutscher Länder, and then by the Bundesbank (Marsh 1993). The Central Bank of China fled to Taiwan in 1949,

went into hibernation, and then returned to central banking in the early 1960s. Most spectacularly, the Khmer Rouge celebrated the Cambodian revolution in 1975 by blowing up the central bank in Phnom Penh (Clark 2006: 15). However, the Khmer Rouge did not stay in power for ever, and Cambodia now has a central bank again.

Though the bulk of my paper concerns the impact of crisis on existing central banks, it must be borne in mind that some central banks owe their establishment to such episodes. Most notably, the Federal Reserve System was set up in response to the 1907 crisis in the US financial system (Wood 2005). The original purpose of the Fed was to avert future crises – during the late 1920s and early 1930s it failed in this task in the most extravagant style imaginable. The Bank of Canada, formed in 1935, was a belated response to depression (Bordo and Redish 1987). Of course many central banks did not owe their establishment to financial crises. The implementation of plans to set up a central bank in New Zealand was delayed by several years because the government was preoccupied with the depression; the RBNZ did not come into being until 1934 (Wright 2006). In the developing world central banks owed their foundation principally to nation building, while the ECB is part of a much broader federalist project.

### **Revolutions in central banking**

Historians of central banks identify several ‘stages’ in the development of central banking. These stages do not form a natural progression. They are separated by crises, in the midst of which it was difficult for anyone to imagine (and impossible to know) what would happen next.

Stanley Fischer (1994) identifies four stages:

- 1) In the first, special banks (banks of issue) were established in some European countries, primarily to raise loans for the government. Such banks typically became involved in regulating the note issue.
- 2) The second stage, beginning in the nineteenth century, marked the onset of central banking proper. Banks of issue, such as the Bank of England, started to place more emphasis on their role as bankers to other banks, and began to

accept some responsibility for systemic banking stability by acting as the lender of last resort. By 1900, most central banks were required to maintain the convertibility of their notes and deposits into gold at a fixed rate (the Gold Standard). As a result they were responsible for maintaining fixed exchange rates between national currencies. Central banking involved managing the Gold Standard, while keeping an eye on financial stability. This model came unstuck in the 1920s and early 1930s.

- 3) In the 1930s and 1940s, central banking entered its third stage. National economic policies changed in the aftermath of the depression of the early 1930s and the collapse of the Gold Standard. Many privately-owned central banks were taken into state ownership. All governments began to take a closer interest in the activities of their central banks. During and after the 1940s, central banks played a subsidiary role in the implementation of general macroeconomic policy. They also took on large new responsibilities, particularly in the administration of exchange controls. Governments now had multiple macroeconomic goals: full employment, rapid economic growth, price stability, and stable exchange rates. Outcomes were not necessarily bad, as Romer and Romer (2002) stress in their account of US monetary policy in the 1950s.
- 4) The fourth stage was reached in the late twentieth century. By the 1970s, a reaction was setting in to the Keynesian approach to macroeconomic policy, which was said to have caused rising inflation and exchange rate instability, without generating a sustained improvement in economic growth. Many central banks started to win back some of their former autonomy. They also began to focus more single-mindedly on the macroeconomic objective of price stability. By the early 1990s, most developed countries had succeeded in reducing inflation to much lower levels. Some functions were shed, including the onerous task of operating exchange controls, while others, such as prudential supervision, were added, albeit temporarily in some cases.

Fischer's summary is fleshed out by Goodhart, Capie and Schnadt (1994). Marcussen (2006) adds a fifth stage of 'scientization', beginning around 2000, in which central

banking becomes a highly intellectualized and technical activity divorced from politics. The fifth stage might not last long, for the global financial crisis has already brought politics back into central banking.

Stages 2 and 3 were separated by the great depression, while stages 3 and 4 were separated by the great inflation. Central banks were remodelled after each of these episodes. War also had a significant impact. World War One brought governments and central banks closer together and undermined the Gold Standard, paving the way for the transition from stage 2 to stage 3. World War Two strengthened governments' belief in their ability to manage economic activity using fiscal policy and direct controls. The Vietnam War helped to spark off the great inflation, which in turn set in train a further transformation in the central banking world.

How did central banks survive these upheavals?

- (1) By assimilating new doctrines
- (2) Through the appointment of a new generation of leaders
- (3) Through the implementation of new legislation or the reinterpretation of existing legislation

It was not possible for central banks to resist making adjustments. While governments imposed some changes, for example by passing legislation or by appointing new Governors and Chairmen, it would be too simplistic to attribute everything to government manipulation. The internal thinking of central banks was influenced by developments in the intellectual climate, not least because staff professing 'old' ideas retired and were succeeded by staff professing 'new' ideas. Some central bankers were ideologues for one intellectual position or another, but many others were just doing their job or trying to defend their institutional 'turf' (Havrilesky 1995). They could not protect their turf by going to war with an enemy as powerful as the government. Central bankers who did declare war on their governments, including James Coyne at the Bank of Canada in the early 1960s, did not last long, and did not

do their colleagues any favours. According to Bruce Muirhead (1999: 167), the Coyne affair 'came close to devastating the Bank of Canada'.

### **Revolution No. 1: The 1930s and 1940s**

Appalled by recent policy disasters, and influenced by Keynesian, corporatist, and/or socialist doctrines, politicians in many countries rewrote their central banking laws in the late 1930s and 1940s. Even in countries such as the US where legal changes were less dramatic, governments became much more involved in the management of monetary and exchange rate policy. In many cases central banks were allocated new functions including the administration of exchange controls and banking regulations. As well as contributing to monetary policy, banking regulation substituted for prudential supervision.

Whereas New Zealand was in the forefront of central bank design in the late twentieth century, Australia was in many respects the pioneer in the 1940s. Boris Schedvin (1992: 63-4), the historian of the Australian central bank,<sup>2</sup> describes the Commonwealth Bank Act 1945 as a landmark, which set the tone for central banking in the postwar decades. The 1945 Act outlined ambitious new goals for the central bank. As well as ensuring the stability of the currency, the CBA was instructed to promote full employment and prosperity, and to advance the welfare of the Australian people. The Governor was required to work closely with the Secretary to the Treasury. If they could not agree, policy would be set by the government (Schedvin 1992: 149-55).

The appointment of a new CBA Governor, sympathetic to the emerging postwar consensus, was crucial for the bedding in of the new arrangements. Nugget Coombs, who led the Australian central bank between 1949 and 1968, was an economist with a doctorate from the LSE. Coombs had been critical of the CBA's conservatism in the 1930s, and accepted that monetary policy was ultimately a government responsibility. The central bank could (and should) offer expert advice, but it had a duty to accept and implement the decisions of the government. Coombs recalled his intentions at the time of his appointment.

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<sup>2</sup> The Commonwealth Bank of Australia performed commercial and central banking functions until 1960 when the latter were spun off and allocated to the new Reserve Bank of Australia.

The first of these was to establish the “Keynesian” conceptual framework as the language of communication between myself and my colleagues, between the Bank and the Government/Treasury complex, and between the Bank and its commercial bank clients (Coombs 1981: 147-8).

Coombs was the epitome of the central banker as civil servant. He never did anything to embarrass ministers or the Treasury, even under provocation. Whenever he felt compelled to criticize government policy, he did so behind closed doors. As Coombs explained in a newspaper article in 1968, the year of his retirement:

I don't think it makes good sense for a Central Bank to want to have both the role of a private confidential adviser to government and an outspoken public critic at the same time. These roles are incompatible (quoted in Rowse 2002: 289).

From the perspective of the 1920s or indeed of today, central banks appeared to lose much of their independence in the mid twentieth century. From the perspective of the 1950s or the 1960s, however, the costs of this loss of independence were not so obvious. Central banks continued to assert themselves from time to time, as the Fed did in 1951 when it negotiated an accord with the US Treasury that restored control over interest rate policy to the central bank (Meltzer 2003: 699-712). The Bank of England continued to enjoy considerable autonomy in many areas including banking policy. With the advent of a new generation of central bankers, moreover, the heresy of the 1930s became the orthodoxy of the 1950s.

Post-war central bankers saw their relationship with government as one of partnership. Commenting in 1964 on the Treasury-Fed Accord of 1951, Allan Sproul (formerly a key figure at the Federal Reserve Bank of New York), said that it was based on ‘the recognition that Treasury and the Federal Reserve are coequals in the area of their overlapping responsibilities.’ Treasury and the Fed had ‘a common purpose’ and a duty to work together for the national interest. Sproul denied that the Accord was a declaration of independence.

The Federal Reserve does not have, never has had, and never has claimed to have an independence in monetary affairs which divorces it from the general economic policies of the Government (Sproul 1980: 73).

Of course some central bankers were inclined to feistiness. Leslie Lefeaux, the first Governor of the RBNZ, was an Englishman and a former Deputy Chief Cashier and Assistant to the Governors at the Bank of England. Not long after he took office in Wellington, an apparently radical Labour government was elected with plans to nationalize the central bank and engage in unorthodox financial practices. Lefeaux became agitated and cabled his former boss, Montagu Norman, Governor of the Bank of England.

For your information events appear to be moving towards crisis for the Reserve Bank of New Zealand. Main point at issue is the control of credit and currency. My view is that the transfer of our responsibility to the Government thus opening up way for unlimited inflation would render Reserve Bank of New Zealand a menace instead of useful part of financial machine. ... If Reserve Bank of New Zealand were to be made a Government Department without any discretionary powers I should regard terms of my appointment violated and should have no option but to reconsider my position here (Bank of England Archives, G1/339, Cable: Lefeaux to Norman, 10 Jan 1936).

It may come as no surprise that Norman and his colleagues had little time for socialism in the colonies. Yet they repeatedly urged Lefeaux to calm down and find a way of working with the Labour government. Deputy Governor Harvey responded immediately:

I need not remind you that ultimate authority regarding credit and currency must rest with Governments and that a Central Bank in any country is obliged to frame its own policies within limits set by Government decisions. But when this is appreciated both by the Central Bank and by the Treasury the Central Bank has unrivalled opportunities for pressing its views on the Treasury thus gradually provoking recognition of them. Even if state-owned the Bank does not necessarily lose its power of independent initiative as instanced by the

Commonwealth Bank, Riksbank and others. In the case of New Zealand the presence of a trained Central Banker at the head of the new Reserve Bank is a vital interest of the Dominion and a vital imperial interest as well. If action on your part were to force issue result might be to place Reserve Bank destinies in hands of someone less capable and experienced than yourself and whose opinion would not command the same attention. Under these circumstances and with full realisation of your present difficulties I counsel you to do nothing precipitate (Bank of England Archives, G1/339, Cable: Harvey to Lefeaux, 10 Jan 1936).

We can set aside the imperial overtones. Norman, who was of a similar mind to Harvey, wrote to Lefeaux:

You know that I share your view that anything that tends to reduce the true independence of a Central Bank is unwelcome. But let me repeat my conviction, which I am sure is yours also, that fears aroused by apparently sweeping legislative changes may be proved groundless by the willing collaboration and prudent administration of the people concerned with putting them into effect (Bank of England, OV59/10, Letter: Norman to Lefeaux, 30 April 1936).

The RBNZ was nationalized in 1936. Lefeaux was not a success as Governor by the standards of either the Bank of England or the New Zealand Labour Party. Some of Labour's policies were unorthodox, but life went on. The RBNZ and the New Zealand government enjoyed a harmonious relationship between the 1940s and the early 1980s (Singleton *et al* 2006).

The personal factor was important in effecting adjustment in the US in the 1930s, where a total outsider of unorthodox economic views became Chairman of the Board of Governors of the Federal Reserve System in December 1934. Marriner Eccles was an obscure Utah banker who had been talent spotted by the Roosevelt administration, which was eager to appoint men with new ideas and enthusiasm to important positions in public life after the policy disasters of the previous few years. According

to Vernengo (2006: 8), Eccles held notions that were ‘peculiar for a banker’. Meltzer (2003: 477) elaborates:

Eccles held a Keynesian view long before that view became dominant among academics and central bankers. Mixed with that view were vestiges of older ideas about underconsumption, overinvestment, borrowing, speculation, and income distribution. Eccles repeated many times ... that the depression was due in part to inequality in income distribution.

Chairman Eccles even agreed with Congressman Goldsborough that, in the context of depression, monetary policy was as ineffective as ‘pushing on a string’. Evidently the Congressman had discovered the liquidity trap. Eccles believed that the solution to depression and mass unemployment was increased government spending, financed by borrowing, and the redistribution of income. This emphasis on income distribution is reminiscent of Kalecki. Such ideas were radical indeed for a central banker. On fiscal policy, Eccles was much more avant-garde than the Roosevelt administration, including the Treasury, which continued to believe in balanced budgets. Milton Friedman suggested that Eccles ‘played a far greater role in the development of what came later to be called Keynesian policies than did Keynes’ himself (quoted in Israelsen 1985: 362).

Following the depression, there was a changing of the guard in the central banking world, and a revolution in the intellectual, and sometimes in the legal, framework within which central banks operated. Central banks were no longer as independent as they had been in the 1920s. At the same time, it would be misleading to suggest that they became enslaved to governments. Rather the relationship that emerged was one of partnership. This was possible because central banks and most central bankers (though not Lefaux) were able to adapt to the new situation. Have we any reason to believe that this would be any less the case in the future?

### **Revolution No. 2: The 1980s and 1990s**

Central bank reform in the late twentieth century was part of a wider programme of public sector restructuring, though this is often overlooked by economists. The New Public Management (NPM) addressed issues of institutional autonomy,

accountability, and targeting within the context of the public sector as a whole (Hood 1995). The link between central banking and public sector reform was most explicit in New Zealand (Singleton et al 2006: ch 5). Of course central bank reform also addressed specific monetary and financial problems such as the discrediting of Keynesianism (and later of monetarism), perceptions of time inconsistent behaviour among policy makers, deregulation, and the resurrection of the banking crisis.

Central bank independence (CBI) became the new orthodoxy in the 1990s (Siklos 2002; Bibow 2004; Forder 2005). Many countries passed legislation to grant increased autonomy to their central banks; others (including the US and Australia) reinterpreted existing legislation to reinforce or permit enhanced autonomy. This is not the place to discuss the economic rationale for CBI. Central bankers did not agitate for CBI – that would have exposed them to the charge of political partisanship – but they welcomed it nonetheless. The Bank of England was caught unawares by Gordon Brown’s decision to adopt CBI shortly after the 1997. (There are interesting parallels between the stealth shown by New Zealand Labour in 1984 and UK Labour in 1997.) Because the CBI revolution did not threaten the status or power of central bankers, it is in some respects less relevant to the challenges that they may encounter in the future than are the reforms of the 1930s and 1940s.

The critical decisions on reform were made by ministers and legislators. What arguments for CBI might have appealed to politicians (King, Michael 2005: 99-100)? First, in developing and transitional economies, the adoption of CBI sends a signal to international capital markets that prudent, anti-inflationary policies will be followed, hopefully making it easier and cheaper for them to borrow externally (Maxfield 1997). This is the equivalent of the claim that joining the Gold Standard reduced the cost of borrowing for peripheral and semi-peripheral economies in the early twentieth century. Secondly, the domestic financial sector might put pressure on the government to introduce CBI because high and variable inflation create uncertainty for business (Posen 1995). Thirdly, politicians might find it convenient to delegate the formulation and implementation of monetary policy to the central bank (Bernhard, Broz, and Clark 2002). This might be the case if monetary policy has become a source of conflict in cabinet. Unpopular decisions, such as the raising of interest rates, could be delegated to central bankers. Delegation increases the scope for politicians to

engage in the sport of central bank ‘bashing’ (Havrilesky 1995). By granting autonomy to the central bank, the government may constrain the policies of future regimes, an important consideration if opposition parties are perceived to be irresponsible. These motives are not mutually exclusive, nor are they necessarily at odds with the economic rationale for CBI, based as it is on time inconsistency. In what is now Euroland, the legal strengthening of CBI was a treaty obligation during the 1990s. Moreover, CBI (with limited accountability) was enshrined in the constitution of the European Central Bank.

After being ignored by Prime Minister Robert Muldoon, who decided to impose draconian controls over the economy between 1981 and 1984, the RBNZ welcomed the broad thrust of the incoming Labour government’s policy in 1984. Unlike Muldoon, the new Finance Minister, Roger Douglas, was willing to take advice, and he was open to discussing his plans with the central bank. Douglas was anxious to put obstacles in the way of any future leader who might be inclined to behave like Muldoon had done, and in 1986 he asked the RBNZ (in conjunction with the Treasury) to consider whether the law needed amending in order to give the central bank more independence. He later explained in Parliament that his purpose was ‘to make certain that no future politician can interfere with the Bank’s primary objective of ensuring price stability, or manipulate its operations for their own purposes, without facing the full force of public scrutiny (quoted in Singleton *et al* 2006: 138).’ In essence, Douglas wanted to ‘Muldoon-proof’ the RBNZ. He envisaged a price stability mandate for monetary policy, and the overhaul of the central bank’s decision-making mechanisms and accountabilities. The outcome was the 1989 RBNZ Act, which granted operational autonomy to the RBNZ, in the context of a Policy Targets Agreement negotiated with the government, and a new form of accountability based on holding the Governor personally accountable for the central bank’s performance in relation to the monetary policy target (Singleton *et al* 2006: ch 5).

The example of New Zealand encouraged a wave of central bank legislation in the 1990s. In Britain the Thatcher and, to a lesser extent, the Major governments were not particularly sympathetic to CBI. In opposition in the mid 1990s, however, the Labour Party held talks with international central bankers and academics about central bank reform. Labour was desperate to shake off its image as the party of high inflation and

trade unionism. If Labour hoped to win more than one term in office it would have to appear competent, prudent, and disciplined. Ed Balls, a financial journalist and Labour adviser, introduced the prospective Chancellor, Gordon Brown, to leading central bankers including Don Brash of the RBNZ. Labour was pledged to restructure the Bank of England, and to enhance its accountability and autonomy, but a final decision on CBI was not made until shortly before the 1997 election. Brown did not reveal his plans for CBI to the Governor of the Bank of England, Eddie George, until *after* the election. According to Michael King (2005: 108), the central bank was astonished by this development. The Bank of England had not lobbied for CBI, as this would have taken it into politics. The new Bank of England Act came into force in June 1998 (Rodgers 1998). However, there was a price to pay, and the central bank was deprived of two functions: banking supervision was transferred to the new Financial Services Agency, and the management of government's debt was taken over by the Treasury. Henceforth the Bank of England would focus to an even greater extent on the functions of price stability and systemic stability.

Despite its legal autonomy, the Fed was perceived to be amenable to political influence during the 1960s and 1970s. This charge became harder to sustain in the 1980s and 1990s when first Paul Volcker and then Alan Greenspan were at the helm (Romer and Romer 2004). Volcker showed some hesitancy at first. However, once Ronald Reagan had won the 1980 presidential election he defied the critics and tightened monetary policy decisively (Goodfriend and King 2005). Volcker and Greenspan were strong leaders with a firm commitment to price stability. While the Federal Reserve Act 1977 and the Humphrey Hawkins Act 1978 required the central bank to promote maximum employment as well as price stability, Volcker and Greenspan were for the most part allowed to place their own interpretations on the dual mandate. According to Blinder and Reis (2005: 75),

[T]he Federal Reserve is a truly independent central bank. As long as it stays within its statutory authority, it has complete control over monetary policy. And it has been years since there was even a veiled threat to that independence, much less an overt one.

Interestingly, the Fed was anxious to avoid further major central bank legislation, fearing that critics in Congress, such as Henry Gonzales, would use the opportunity to undermine rather than confirm its autonomy (Havrilesky 1995).

Transparency was the hardest part of the CBI project for some central bankers to digest. The Federal Reserve in the 1980s was anything but transparent, and this attitude lingered into the 1990s. After October 1982, when the targeting of non-borrowed reserves was discontinued, the Fed stated that it was now targeting *borrowed* bank reserves. In reality, however, it was targeting a short term interest rate, namely the federal funds rate (FFR). Not to put too fine a point on it, the Fed deliberately misled the public, Congress, and the financial markets about its monetary policy framework. Why? For one thing, the Fed was still required by Congress to set monetary targets. In addition, any acknowledgement that the central bank had reverted to a policy based on adjusting interest rates would have been interpreted as an admission of failure. This subterfuge was exposed in 1989. The Fed, however, did not admit that it had a short term interest rate target until 1991, declined to announce the direction of policy changes until 1994, and did not announce a precise target for the FFR until 1999 (Thornton 2006).

Lack of transparency was a point of vulnerability that could be exploited by critics such as Gonzales. Greenspan responded by making gradual concessions, including the reinstatement of the lapsed practice of publishing FOMC minutes in 1993, and the announcement of the direction of policy changes in 1994. A fuller acceptance of transparency as a basic principle required generational change. Chairman Bernanke (2008), himself a former academic economist, placed greater emphasis on transparency. He argued that a transparent central bank was easier for everyone to understand, which made it possible for monetary policy to be implemented more smoothly and effectively.

Canada and Australia responded to changes in central banking philosophy by granting *de facto* autonomy to their own institutions, but not by passing new legislation. The main obstacle to such legislation was party political wrangling. In Canada an attempt to pass new legislation was thwarted (King, Michael 2001). In Australia there was even less support for new legislation (Bell 2004). Both countries, however, had

governments in the 1990s that were prepared to pull back from direct involvement in the affairs of their central banks.

In countries such as Canada and Australia (and perhaps the US) where no change has taken place in central banking legislation, CBI is not as secure as it is in, say, New Zealand or the UK. It is less costly and less risky for politicians to reinterpret existing legislation than it is to overturn it.

### **Lessons of the 1920s**

The 1920s was a decade in which central bankers set themselves ambitious objectives. It was also a period in which many new central banks were established, not least in central and eastern Europe, while several other central banks, including the German Reichsbank, were redesigned. There was a strong emphasis on CBI in the 1920s, especially in the terms of the acts setting up new central banks, and in the writing of central banking experts such as Kisch and Elkin (1932: 16-41).

Central bank autonomy was reduced during World War One, as all governments engaged in some measure of inflationary finance. After 1918 central bankers were anxious to regain their lost autonomy, and in the 1920s they succeeded to a considerable extent. Their greatest asset on this quest was the prevalence of the Gold Standard mentalité. Eichengreen and Temin (2000) use this phrase to describe the monetary orthodoxy of the early twentieth century, which attached overwhelming importance to the Gold Standard, and by implication to the role of central bankers as its guardians. In so far as governments were committed to the resumption of the Gold Standard, central banks were in strong position to oppose monetary and fiscal policies that they perceived to be incompatible with this objective. The Gold Standard mentalité was shared by most politicians and economists, and by all central bankers. There are similarities here with the success of the CBI doctrine in the late twentieth century. That central bankers welcomed CBI is not surprising, but its popularity among economists has been described as a case of 'groupthink' (Forder 2005: 856).

Interwar central bankers regarded politicians as incompetent, mendacious, opportunistic, and (in modern jargon) prone to time inconsistent behaviour. In 1926

Pierre Quesnay, an adviser to Emile Moreau, the Governor of the Banque de France, summed up the philosophy of Montagu Norman as follows:

The economic and financial organization of the world appears to the Governor of the Bank of England to be the major task of the twentieth century. In his view politicians and political institutions are in no fit state to direct with the necessary competence and continuity this task of organization which he would like to see undertaken by central banks, independent at once of government and of private finance. ... [Central banks] would succeed in taking out of the political realm those problems which are essential for the development and prosperity of the nations: financial security, distribution of credit, movement of prices (quoted in Boyle 1967: 205).

At the same time, Norman did not advocate open defiance of political leaders. The Bank of England's advice to Lefeaux was that central bankers should remain calm and try to persuade errant politicians to renounce unsound policies.

The central banking cause was boosted by the recommendations of the International Financial Conference at Brussels in September to October 1920. Called by the League of Nations, this conference discussed possible solutions to the current financial crisis (omitting the question of German reparations). All countries were urged to balance their budgets, to combat inflation, and to work towards restoration of the Gold Standard. Having ruled out the introduction of an international currency, the delegates concluded that banks of issue (central banks) should be opened in all countries, and granted adequate protection from political interference (Davis 1920; League of Nations 1945: 12, 20).

During the 1920s the League of Nations Financial Committee advanced a number of reconstruction and stabilisation schemes for the new countries of central and eastern Europe (Clavin 2003). The establishment of an autonomous central bank was a standard component of these schemes. Once the budget had been balanced, inflation had been overcome, and the (new) currency had been stabilized and linked to gold, the task of the central bank would be to defend the new policy regime. In the design and implementation of stabilization plans, the League worked closely with Montagu

Norman and other central bankers, who provided advice, personnel, and short-term credit, and helped with the issuing of reconstruction loans.

For Norman and his peers, the extension of central banking into new lands was not a purely technical matter. Independent central banks would link the countries of eastern and central Europe more firmly into the liberal capitalist international economy. By promoting financial stability and facilitating rising prosperity, they would inoculate the successor states of the continental empires against both communism and militarism. In 1923, Norman looked forward to an ‘ultimate solution for Eastern Europe’, based on a liberal capitalist ‘Economic Federation to include half a dozen countries on or near the Danube free of customs barriers (quoted in Péteri 1992: 251)’.

The first League of Nations reconstruction scheme – for Austria – was to a large extent subcontracted to the Bank of England. Austria was cut down to size after 1918. The new Austrian republic was dogged by hyperinflation and political instability, and increasingly cut off by tariffs from its former markets in central Europe. The defunct Austro-Hungarian central bank was liquidated in 1919, leaving Austria, Hungary, and Czechoslovakia without central banks (Schubert 1999). The Austrian reconstruction plan, which formed the basis for the subsequent Hungarian plan, involved a loan guaranteed by European governments, and measures to balance the budget and achieve currency stability. A central bank, the Austrian National Bank (ANB), was established in 1923. According to Sayers (1976, vol. 1: 168), with respect to ‘the constitution of the new National Bank the Austrians ... accepted the British view in its entirety: no government officials, directors elected by shareholders, no lending to governmental bodies, and a note issue with partial gold cover.’ A precedent was created when the League of Nations insisted that the ANB should have foreign advisers, the first of whom was Swiss. These advisers kept in close touch with international organizations and central banks, especially the Bank of England. Hungary’s central bank was set up in 1924 and modelled on its Austrian counterpart (Péteri 1992).

There are parallels with the creation of new central banks (and the transformation of communist central banks) in eastern Europe in the 1990s. The first two Governors of

the Central Bank of Bosnia-Herzegovina, established in 1997, were appointed by the IMF. The first was a Frenchman, the second a New Zealander. The Bosnian central bank was designed by the IMF in conjunction with US negotiators (Coats 1999).

The Reichbank had been subordinated to the German government during World War One, and had been unable to prevent hyperinflation in the early 1920s. After monetary stabilization in 1923-24, a new Banking Act was passed in August 1924. The Reichsbank was reorganized, its independence was reasserted, and the reichsmark was returned to gold. A fourteen person General Council, half of whom were Germans and half foreigners, was set up as a bulwark against domestic political interference in monetary policy. One foreign member of the General Council was empowered to stop further note issues if he considered gold convertibility to be endangered (James 1999: 24-5).

Central bankers from the Federal Reserve Bank of New York and the main European nations collaborated to reconstruct and manage the gold [exchange] standard. Norman and his counterparts shuttled across the Atlantic to central bank summit meetings about gold policy and interest rates. Their exploits are described in a recent popular history entitled *Lords of finance* (Ahamed 2009). Central bankers appeared to be having an impact on the design of the international economy. But any potential for hubris was swept away in the depression. President Roosevelt was particularly dismissive. In a message to the World Economic Conference in 1933, he denounced the ‘old fetishes of so-called international bankers’ (quoted in Kindleberger 1987: 216), or in other words the Gold Standard mentalité. In even more brutal mood in December 1940, he declared that ‘the Federal Reserve system is so unimportant, nobody believes anything that Marriner Eccles says or pays any attention to him (quoted in Meltzer 2003: 556, n. 286). This was something of an exaggeration. Nonetheless it illustrates how far central banks had sunk in status within a few years.

## **Conclusion**

CBI is the modern equivalent of the Gold Standard. Support for CBI, while not ubiquitous, became widespread in the 1990s and early 2000s, so much so that it came to be taken for granted. The experience of the interwar years, however, is that after a major international financial and economic crisis support for established doctrines can

crumble rapidly. Central bankers worked hard in the 1920s to reinforce their prestige and carve out a large measure of autonomy. In the 1930s and 1940s, however, governments lost confidence in the skill of central bankers. This loss of confidence led to sweeping changes in legislation and in personnel. Central banks were not in a position to resist these incursions. In fact they ultimately embraced the Keynesian framework and attitudes and came to regard themselves as partners, albeit junior partners, of the government. Central banks cannot assume that there will always be a political consensus in favour of the principles of the 1990s. In his blog on 5 May 2009 Willem Buiter speculated that the current financial crisis ‘signalled the beginning of the end’ for central bank independence - the prudential and lender of last resort function are very hard to keep separate from politics.<sup>3</sup> As Harvey and Norman realised in the 1930s, the government will always have the final say if it is determined to do so. Central banks must adapt to changes in the political environment because they cannot prevent them, but the same is true of other public institutions.

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