Independent Central Banks: New and Old

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In the 1990s, several governments gave their central banks operational independence to pursue low inflation, and steps were taken to make the new monetary policy more credible by making it more transparent (Bernanke et al. 1999). The governor of the Reserve Bank of New Zealand is subject to dismissal if inflation is outside the assigned range. In the United Kingdom, if inflation misses the target by more than 1 percentage point, the governor must explain publicly why the divergence occurred and what steps the Bank of England is taking to deal with it. The new transparency "facilitates public understanding of monetary policy and increases the incentives for the central bank to pursue the announced goals of monetary policy" (Svensson 1999: 631–32). Accountability is increased, indeed made possible, by the choice of a unique objective, which implies "a stronger commitment to a systematic and rational optimizing monetary policy than other monetary policy regimes" (p. 608).

These institutional changes are consistent with the literature on time inconsistency that shows the impossibility of employment-promoting monetary policy under rational expectations (Kydland and Prescott 1977, Fischer 1977). But they are not without precedents. The Bank of England Act of 1998 was like the Bank Charter Act of 1833 in its antecedents, design, and purposes. The latter also increased the Bank of England's independence, and provided the transparency and accountability needed to make the step credible. Furthermore, it also came on the heels of developments that had rendered the Bank less useful to governments—namely, the end of war finance, which served the same purpose as the end of belief in the Phillips Curve.

The main purpose of this article is to elucidate, by comparing the

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Acts of 1833 and 1998, the unsurprising necessary and possibly sufficient condition for the independence of central banks from governments—namely, the independence of governments from central banks. The first section sets the stage by examining the relation between the British government and the Bank of England from its founding in 1694 until 1815, during which England was constantly at war or preparing for war. In the next two sections, I discuss the Bank Charter Act of 1833 and the Bank of England Act of 1998. The final two sections examine two American examples of the principles of those acts: (1) Andrew Jackson's veto of the renewal of the charter of the Bank of the United States, which had originated in the War of 1812, and (2) a brief comparison with the Federal Reserve during the Greenspan era.

The First 121 Years of the Bank of England (1694–1815)

In his classic *Lombard Street*, Walter Bagehot ([1873] 1931: 90) described the Bank of England as "probably the most remote from party politics and from financing" in the world. Yet, "in its origin it was not only a finance company, but a Whig finance company. It was founded by a Whig Government because it was in desperate want of money, and supported by the 'City' because the 'City' was Whig." Under Charles II, England's credit rating had sunk "to the lowest possible point, and the Government created by the Revolution of 1688 could hardly expect to be trusted with money more than its predecessor."

During the war with France under Louis IV, the British had raised taxes "as far as they dared" and borrowed from "every one who would lend. . . . And almost as a last resource, they founded the Bank of England" (Feavearyear 1931: 114–15). In 1694, a corporate charter was offered to "the Governor and Company of the Bank of England" on the condition that they raised capital of £1,200,000 to be lent to the government at 8 percent. The charter was to expire on repayment of the principal, with a year's notice, but not before 1706. Although 8 percent was below the market rate, the Bank's stockholders were attracted by the expectation of profit from privileged banking activities (Wood 2005: 37).

Earlier proposals had failed for various reasons, not the least of which was the fear of a powerful government able to circumvent the financial discipline of Parliament by access to a client bank. That uncertainty was addressed in the Bank of England's charter by the prohibition of loans to the government or purchases of Crown property except by an Act of Parliament.

The charter did not wait 12 years for renewal. In the summer of 1696, William III wrote to his ministers from the Continent: "In the name of God determine quickly to find some credit for the troops here" (Ogg 1955: 433). After "hard and close bargaining," the Bank of England extended another loan for an extension of its charter and Parliament's promise to recognize no other "Corporation, Society, Fellowship, Company or Constitution in the nature of a Bank" during the life of the Bank of England (Clapham 1944: 47). Such exchanges were repeated several times over the next century: as in 1708, during the War of the Spanish Succession; 1781, when the charter was extended to 1812 and the Bank lent the government £3 million at 3 percent; and in 1800, when the charter was continued to 1833 "on condition of three Millions being advanced for the Public Service, without Interest, for six years" (McCulloch 1858: 42; House of Commons 1832: app. 1; and Wood 2005: 39–40).

Government demands endangered the Bank's reserves on several occasions, and in 1782 it registered a formal complaint with Lord North (Clapham 1944: 252). The pressures increased with another French war, however, and in 1797 rumors of invasion led to a run on the Bank of England and the government's order to suspend payment. Those events inspired Richard Brinsley Sheridan's reference in the House of Commons to "an elderly lady in the City of great credit and long standing who had . . . unfortunately fallen into bad company," and James Gillray's cartoon of the Chancellor of the Exchequer and Prime Minister William Pitt attempting to possess the Bank's gold represented by the "Old Lady of Threadneedle Street" crying "rape, ravishment, ruin" (Acres 1931: i, 283). The suspension of convertibility continued until 1819. The "paper pound" traded on international exchanges at significant discounts from its prewar coin value (Cannan 1919).

Criticisms of the Bank of England, which denied responsibility for the depreciation of the currency, were hampered by its secrecy. Pitt told a committee of inquiry that he had "received from the Bank confidentially the particulars . . . of their precise situation, and must beg to decline stating those particulars unless I receive their permission," which was not forthcoming and which he did not want (House of Lords 1797: 7). On March 9, 1797, he successfully resisted a motion in the House of Commons for information on "outstanding advances made from the Directors of the Bank to the Government" on the ground that "it would tend to divulge the private transactions of the Bank, and thereby prove injurious to public credit" (*Hansard* [*Parliamentary Register*] I: 786–87; Fetter 1965: 61).

David Ricardo (1809) argued that the depreciation of the currency must have been due to an excess supplied by the Bank, which defended itself by pointing out that its loan terms—interest rates and collateral—had been unaffected by suspension. Henry Thornton (1802: chap. 10) had explained that discounts of real bills of exchange (secured by goods) could not limit money and credit. An excess demand for credit could be eliminated only by more stringent terms, such as had been used in peacetime. "Whilst the Bank is willing to lend," Ricardo ([1809] 1951: 17) pointed out, "borrowers will always exist, so that there can be no limit to their overissues."

In 1810, the Bank's critics in Parliament formed the *Select Committee on the High Price of Bullion*, made famous by the testimony of the Bank's witnesses. In "answers that have become almost classical by their nonsense," they denied that their lending could have affected prices or exchange rates (Bagehot 1873: 167).[1] However, the House of Commons overwhelmingly rejected the Committee's proposal that the Bank be brought under control by a time limit for the Restriction. The government's counterresolutions, which carried the House, stated that the suspension should terminate when "the political and commercial relations of the country" rendered it "compatible with the public interest," but it "was highly inexpedient and dangerous now to fix a definite period for the removal of the Restriction earlier than the existing limit of six months after the conclusion of peace" (Cannan 1919: xxvi). Lord Castlereagh, a former secretary of war, identified "winning the war" with rejection of the Committee's *Report*, and issued a plea to "preserve that system of currency" that has so far enabled "us to confine [Napoleon's] violence to the continent." Prime Minister Spencer Perceval warned that its adoption would amount to a declaration that the country should not "continue those foreign exertions which they had hitherto considered indispensable to the security of the country [and that] the House, in adopting it would disgrace themselves forever, by becoming the voluntary instruments of their country's ruin" (*Hansard* [*Parliamentary Register*], May 7–8, 1811; discussed in Fetter 1965: 53–54).

Only after Waterloo did the Bank and Parliament revise their monetary theory. When asked by another parliamentary committee in 1832 if he believed the Bank was responsible for the value of the

[1]See House of Commons (1810), especially the testimony of the governor and deputy-governor on March 13; summarized in *The Bullion Report*, reprinted in Cannan (1919: especially 32–36, 46–48).

currency, specifically if it "should conduct itself, in its issues, with reference to the state of the foreign Exchanges and the bullion market," William Ward, a director since 1817, replied: "Certainly; I do not think there is one person in the Bank of England that denies it, or is disposed to act in opposition to it." Other witnesses, including a director who had denied the principle in 1810, agreed (House of Commons 1832: Questions 2073, 2279); Fetter 1965: 151–52).

The chairman, Lord Althorp, asked Ward:

> From what period is it that the Bank Directors have conducted themselves generally upon the principles you mention, of regulating their issues by the state of foreign Exchanges?—It may be recollected that in the year 1819 [the Bank] distinctly denied the principle that the Exchanges were to be regarded in regulating the issue. Subsequently to that period, opinions became changed, and of course, in the working of the machinery, they found the merits of the case such as they really were; and a growing disposition manifested itself to heed in a greater degree than they hitherto had done the principle of exchange and bullion. . . . I always believed, in Mr. Horner's time [Francis Horner was chairman of the Bullion Committee], that his principle was completely right [House of Commons 1832: Question 2074].

Asked whether the Bank had taken the exchanges into account during the Restriction, Ward replied that after "some enquiries" into the Bank's history he thought

> that upon the whole the Bank did not so greatly disregard that principle previously to 1792; but it is necessary to observe that the Bank has not, until latterly, been in a situation exclusively to judge for itself; when it was most in fault, it was most in accordance with the Government and the Parliament and the public at large; I believe the most unpopular tenet that ever was, was the being a bullionist twenty years ago.
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> Must not the Bank, governed as it is by prudent merchants, always proceed upon the principle of reducing their issues, when they find their treasure greatly diminished? – I think the practice of the Bank would make that inevitable; but the difficulty has been that during the period I have been speaking of, the measures of the Bank have been very much in connection with other things than those it exclusively could influence [House of Commons 1832: Questions 2082–83].

Althorp's sermon came easily in 1832. He had not supported the Bullion Committee in wartime, when the Bank's finance was needed.

The Bank Charter Act of 1833

What accounts for the Bank's realization of its powers? Education at the hands of the rising political economists might have played a part, but changed circumstances were the dominant factor. The nation had been engaged in major wars half the time between 1689 and 1815, and in minor wars or preparing for war the rest of the time. However, peace had prevailed since 1815, no war was on the horizon, and government budgets were in surplus. The 1832 committee "to Consider the Expediency of Renewing the Bank's Charter" was the first such occasion on which the government was not short of cash. It was no longer necessary for the Bank to rationalize its support of the government, either for patriotic motives or under duress, by pretensions or self-delusions of innocence of inflationary side effects.

The Bank's good news was also its bad news. The government's need of the Bank had been the foundation of the privileges that were being contested by the new joint-stock banks. The Bank was also vulnerable to charges of destabilizing behavior. Crises formerly laid at the door of government finance had not ended with peace. The Bank's fluctuating credit received much of the blame for the Crisis of 1825. More culpable than the Bank of England, perhaps, were the hundreds of country banks (limited by law to six partners) without the resources to withstand reverses. Parliament addressed these problems in 1826 by opening the door to joint-stock banks. The government had opened negotiations for the Bank's agreement to this step in 1822 in exchange for an extension of its charter and legal tender status for its notes. Although the directors, after some hesitation, had agreed, the government did not follow up, "mainly because of the strong opposition in Parliament to the renewal of the Bank's charter" (Thomas 1934: 49; Acres 1931: ii, 41). Then legal sanction was given to the joint-stock banks without concessions to the Bank.

The Bank's position was precarious. No longer indispensable to government finance, it was in danger of losing its privileges. It had to make a case that it was necessary for monetary stability. The contest between a unique monetary authority and a competitive monetary system to which the joint-stock banks had equal access was not resolved on the side of the former until the Bank Act of 1844 (Smith 1936: chap. 2; White 1984: chap. 3). The Bank was helped by the inclinations of those in power, especially Althorp and Robert Peel, toward a single bank of issue, but it seemed necessary in 1832 to show that the Bank was competent to exercise its special powers. The ignorance (real or studied) of 1810 would no longer do. A solution lay in the rule explained by Governor Horsley Palmer to the 1832 Committee. The Bank had decided that in ordinary times it would stand aside from the private market, investing mainly in government debt, but in "special circumstances" of financial pressure "leave it to the Public to operate upon the Bank"— that is, to borrow from the Bank at a penalty rate of interest. The Bank would avoid its past reinforcements of speculation yet be ready to support the market when crisis threatened. An obstacle, which the Bank now recognized, was the 5 percent legal maximum on interest rates. Director George Warde Norman repeated Henry Thornton's observation of 30 years before when he told the Committee: "If the rate of interest should rise much above 5 percent, the Bank must either over-issue or be obliged to resort to measures to contract its discounts, which might lead to very serious effects, such as rejecting private paper capriciously for no other reason than because enough had been discounted already" (House of Commons 1832: Question 2430). The Bank Charter Act of 1833 revoked the usury laws and extended its charter to 1844.[2]

Markets and critics of the Bank and government needed to be assured of the new arm's-length relationship. The act also required that one-fourth of the Bank's public debt be paid and required a monthly report of its average bullion, securities, notes, and deposits for the previous three months. Since most violations of its charters had been concessions to governments under protest from the Bank, the publication of its accounts may be interpreted as a signal from the government of its own new commitment to financial rectitude. Althorp's committee had managed to pry accounts for the previous 40 years from the Bank. Those accounts and the Act of 1833 were in combination an admission of past sins and a commitment to future good behavior. Althorp thought that the question of "a harmful connexion between the Bank and the Government" was answered by the proposed publication of accounts (Wood 2005: 72).

The Bank of England Act of 1998

The independent central bank vanished with the Great War. Although not nationalized until 1946, the Bank effectively became a government department in 1914. The tenure of governors began to be decided by governments, and they became, with their deputy governors and an increasing proportion of directors, full-time professionals. The Bank was still influential, and Governor Montagu Norman dominated monetary policy in the 1920s. This influence, however, was eroded by the hardships associated with the return to the gold standard in 1925–31, and governments assumed responsibility for monetary policy (Sayers 1976). Although the Bank was consulted, the chancellor determined the bank rate as one of several instruments of macroeconomic policy.

[2]For Palmer's and Norman's evidence and the Act of 1833, see Gregory (1929: 3–27).

The origins of the Bank of England Act of 1998 lay in the 1970s, when in the midst of rising inflation, unemployment, and industrial strife, Prime Minister James Callaghan told a Labour Party Conference: "The cosy world we were told would go on for ever, where full employment would be guaranteed by a stroke of the Chancellor's pen, cutting taxes, deficit spending . . . is gone" (Labour Party 1976: 188). The end of Keynesianism, or however we wish to characterize the collapse of countercyclical macroeconomics as a political force, restored the central bank's independence in the Bank of England Act of 1998 for the same fundamental reason that the end of war had led to its first period of freedom. Independence was initiated in both cases by the government for its own reasons, and came with the end of the central bank's usefulness—as a source of finance and as a means of promoting employment. In neither case was cause followed quickly or smoothly by effect. Mrs. Thatcher came to power in 1979, Ronald Reagan in 1981, and although their anti-inflationary predilections were considered parts of Thatcherism and Reagonomics, the new regimes lacked credibility and real interest rates remained high.

Britain submitted the pound to the European Exchange Rate Mechanism in 1990, but a run forced its departure in September 1992. The next month, in an attempt to salvage some anti-inflation credibility, the government announced an inflation target and invited the Bank of England to publish a quarterly *Inflation Report* to keep track of progress toward the target. The Bank accepted, and defended an explicit inflation target as opposed to targeting money growth, the exchange rate, or the interest rate. Inflation is affected by many variables, and "in such an eclectic framework it is possible for the underlying rationale of policy to be lost in a welter of statistical confusion. That is why we have opted for a policy of openness" (Leigh-Pemberton 1992: 447).

Bank rate decisions were still the chancellor's, but the Bank's disagreements were institutionalized in the *Inflation Report*, and from April 1994, the minutes of their monthly meetings were released after six weeks rather than after 30 years (Mishkin and Posen 1997). Inflation stayed within the target range, but when the Bank saw signs of inflationary pressures in 1995 and 1996, the chancellor, preferring the Treasury's more optimistic forecasts, rejected its advice to raise interest rates.

The Labour Party had committed to inflation targeting, and upon coming to power in 1997, undertook to eliminate these conflicts and enhance the Bank's credibility by giving it operational independence. The Bank of England Act of 1998 (implemented the previous year) created a Monetary Policy Committee (including outside experts appointed by the chancellor) and made it responsible for the inflation target set by the government. "The overriding purpose of these arrangements," the Governor said, "is to improve the credibility of monetary policy, and to demonstrate to the world at large the Government's commitment to achieving and maintaining effective price stability" (George 1998: 174). The "New Lady of Threadneedle Street," as the governor called the Bank, had recovered her virtue, which seems to depend on being unwanted.

The Second Bank of the United States

Alexander Hamilton's proposed national bank was patterned after the Bank of England. Privately owned, with a 20-year charter dating from 1791, its loans to the government were limited except as specifically authorized by Congress (Act to Charter the Bank of the United States, Sec. 7, Art. 11; Krooss 1969: 311).The opposition was led by James Madison who argued, in the House of Representatives on February 2, 1791, that a national bank would expose the public "to all the evils of a run on the bank," its charter "did not make so good a bargain for the public as was due to its interests," and it had not been expressly authorized by the Constitution (Krooss 1969: 262–63).

In 1811, now president of a country on the verge of war, Madison had a different view. His secretary of the treasury, Andrew Gallatin, valued the Bank's services, and Madison had come to see its "expediency and almost necessity." He had been reconciled to its constitutionality by "the entire acquiescence" over 20 years "of all the local authorities as well as the nation at large."[3] The charter's renewal was narrowly defeated, however, because the financial interests that had supported it in the beginning now resented its competition.[4]

On October 17, 1814, with the debt mounting and the war going badly, Secretary of the Treasury Alexander Dallas proposed a new national bank. Madison vetoed Congress's version in January because of its insufficient "legal obligation to cooperate with the public

[3]For Gallatin's views, see the Treasury Report on the Bank, March 2, 1809 (Krooss 1969: 362–68) and Hammond (1957: 205–9). For Madison's views, see Clarke and Hall (1832: 778–80) and Hammond (1957: 210).

[4]After near unanimity for the Bank in 1791 (20–1 in the House; Senate proceedings were not published), the three large northern financial states—Massachusetts, New York, and Pennsylvania—split evenly for and against the Bank in 1811, with the House voting 22–23 and the Senate 3–3, and with Vice-President George Clinton of New York breaking the Senate tie against the Bank (Clarke and Hall 1832: 85, 446).

measures," particularly the finance of existing debt and "the prosecution of the war. . . . For it must be kept in view that the sole inducement to such a grant on the part of the public would be the prospect of substantial aids to its pecuniary means at the present crisis." A compromise bank was adopted after the war because of its potential usefulness in financing the debt left by the war and because it might enforce resumption on the state banks (Krooss 1969: 396–400).

Andrew Jackson opposed the Second Bank of the United States on every conceivable ground. It was a monopoly that threatened individual liberties and states rights for itself and, as an agent of government, it had not contributed to a sound and uniform currency; there was significant foreign ownership; it was unconstitutional (notwithstanding the Supreme Court's blessing); and it was unnecessary to government operations. "The public debt which existed during the period of the old bank and on the establishment of the new has been nearly paid off, and our revenue will soon be reduced," he noted in vetoing the recharter of the Bank in July 1832 (Krooss 1969: 826). The charter did not expire until 1836, but all sides wanted its future settled.

The establishment of the First and Second Banks of the United States were major party issues. The Federalists and then the Whigs were in favor of the Banks and of broad central government powers in general, and the Jeffersonian Democrats/Republicans usually were in opposition, although Jefferson had been persuaded to a degree of tolerance by his secretary of the treasury. Times had changed, declared Senator Thomas Benton, Jackson's strongest supporter on the national bank issue. According to Benton,

> The whole argument for such an institution rests upon the assumption that it is necessary to the financial operations of the Government. [Some of those] chosen by the people to administer the Government . . . may deem it unnecessary, as did Mr. Jefferson all his life, and as did Mr. Madison before the capitol was burnt. . . . It does not follow that the same bank would be approved now, which was approved then. The public debt, then great, is now nothing; the annual revenue, then immense, must now be reduced more than one-half. The necessity and uses for the bank are greatly diminished, if not entirely removed [Krooss 1969: 813–14].

One might argue that Jackson would have terminated the bank in any circumstances, but this would be separating the inseparable. Rejection of a national bank was an integral part of his opposition to an intrusive federal government and a national debt that resembled his Jeffersonian forebears, who, as Benton noted, had relented under the pressure of war finance.

The Greenspan Fed

The Federal Open Market Committee (FOMC) dropped the "reasonable" qualifier from "price stability" in its Directive of March 1988, and the *Monetary Policy Report* of February 1990 informed Congress that the Fed was "committed to the achievement, over time, of price stability." As Federal Reserve Chairman Alan Greenspan (1994: 258) stated, "Monetary policy basically is a single tool and you can only implement one goal consistently."

That approach is justified as the best way to support economic growth, and the Directives of 1991 and 2001 showed signs of backsliding in times of recession when the FOMC indicated a "balanced" policy that took account of weak economic activity. But it is hard to see the new focus of American monetary policy as anything other than a unilateral repeal, or at least extensive amendment, of the Employment Act of 1946, which did not treat "employment" or "production" as implicit in the goal of "purchasing power."

Thus, the Federal Reserve, without benefit of legislation but apparently with the consent of Congress, has revised its monetary policy along the same lines as New Zealand, the United Kingdom, and other industrial countries—and possibly for the same reason: the end of Keynesianism.But there is another reason that may be at least as important: the end of the Cold War, which was the main reason for the budget surpluses of the 1990s. If history is a guide, the deficits associated with the War on Terrorism will endanger the Fed's independence again.

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