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Janet Ilieva
Manchester Metropolitan University Business School
Barry Harrison
Department of Economics and Politics
Nottingham Trent University
Nigel M. Healey
Manchester Metropolitan University Business School

The Changing Role of Central Banks in Market Economies

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The Director, Graduate Business School, Manchester Metropolitan University, Aytoun Building, Aytoun Street, Manchester M1 3GH

Telephone No: 0161 247-6798. Fax No 0161 247 6854

Janet Ilieva

Manchester Metropolitan University Business School
The Graduate School of Business
Aytoun Building
Aytoun Street
Manchester M1 3GH
Tel: ++44 (0) 161 247 6793
E-mail: j.ilieva@mmu.ac.uk

Barry Harrison
Department of Economics and Politics
Nottingham Trent University
Burton Street
Nottingham NG1 4BU
Tel: ++44 (0) 115 848 5504
E-mail: barry.harrisson@ntu.ac.uk

Nigel M. Healey
Manchester Metropolitan University Business School
Aytoun Building
Aytoun Street
Manchester M1 3GH
Tel.: ++44 (0) 161 247 3703
E-mail: n.healey@mmu.ac.uk

Biography:

Janet Ilieva is a research student at the Manchester Metropolitan University Business School. Her current research interest is in economic transition of Central and Eastern European economies.

Barry Harrison is senior lecturer in Economics at the Nottingham Trent University. His research interests focus particularly on transition economies. He has thought courses in the economics of transition and is currently visiting professor at the European University in St. Petersburg, Russia.

Nigel Healey is Professor and Dean of the Manchester Metropolitan University Business School. His research interests are in macroeconomic developments in Central and Eastern Europe and the Commonwealth of Independent States, and company strategy and economic integration in the European Union. He has served as policy advisor to the governments of Russian and Belarus.

Abstract

Among the main reasons for the emergence of central banks in Europe were the wars that ravaged the continent from the 17th century onwards and the consequent pressure this exerted on government finance. In brief, governments granted monopoly power over the note issue to a commercial bank and in return were given privileged borrowing facilities. This marked the beginning of the 'special relationship' between governments and their central bank. However, in most cases, recent years have witnessed enormous changes in the nature of this relationship. In particular, since the beginning of the 1990s, many governments have become convinced that the way to ensure price stability is to sever the institutional links between government and the central bank, leaving the latter to manage monetary policy free from political interference. The focus of this paper is on the historical developments, which have underpinned this new monetary orthodoxy.

Key words: central banks, central bank independence, history of central banks.

Introduction

Among the main reasons for the emergence of central banks in Europe were the wars that ravaged the continent from the 17th century onwards and the consequent pressure this exerted on government finance. In brief, governments granted monopoly power over the note issue to a commercial bank and in return were given privileged borrowing facilities. This marked the beginning of the 'special relationship' between governments and their central bank. However, in most cases, recent years have witnessed enormous changes in the nature of this relationship. In particular, since the beginning of the 1990s, many governments have become convinced that the way to ensure price stability is to sever the institutional links between government and the central bank, leaving the latter to manage monetary policy free from political interference. The focus of this paper is on the historical developments, which have underpinned this new monetary orthodoxy.

Following this introduction, section two of this paper examines the evolution of central banks. The development of central bank-government relations is traced with reference to the political and economic independence of the central bank from the government of the day. In this context, 'political independence' refers to the autonomy of the central bank to set its own objectives, as well as the independent appointment of governor and board. 'Economic independence' (sometimes referred to as 'operational independence') refers to the central bank's freedom to choose the policy instruments to achieve its objectives.

Section three discusses the changing nature of the objectives of central banks. It identifies common trends in the evolution of central bank independence and studies their development in three major periods: the nineteenth and twentieth centuries up to the mid-1940's, the mid-1940's to the mid 1970's and the mid-1970's to the present day.

Section four provides a study of four central banks: the Bank of England, the Bank of France, the Bundesbank and the Federal Reserve System. The political index of central bank independence constructed by Grilli, Masciandro and Tabellini (1991) is used to demonstrate how the level of independence granted to some central banks changed at different stages of their development.

Section six concludes this paper and draws some common trends in the development of central bank independence. One important finding that we demonstrate is that in countries where the central bank was founded in the nineteenth century or earlier as a private institution, it possessed almost absolute independence. This state of affairs was reversed after 1945 when most central banks were effectively turned into institutions of government responsible for implementing the government's monetary policy decisions. More recently there has been a tendency to reverse earlier post-war trends and many central banks have regained some of the independence that characterised earlier years of their existence.

2. The nature of central bank independence

The extent of central bank independence is assessed against two criteria: political independence and economic independence. Political independence, as defined by Grilli, Masciandro and Tabellini (1991, p366), embraces three aspects of monetary policy:

> '(i) the procedure for appointing members of central bank governing bodies; (ii) the relationship between these bodies and government; and (iii) the formal responsibilities of the central bank. … This is why we identify independence with autonomy to pursue the goal of low inflation.'

Defined in this way, political independence was greater in the earlier history of central banks than in the present day. The fact that most of the central banks were established as private institutions gave them autonomy to make their own appointments, set their own regulations and pursue their own objectives.

Economic independence, on the other hand, is defined by Grilli *et al.* (1991 p.368) as the freedom of a central bank to choose the instruments of monetary policy with regard to:

> '(i) the influence of the government in detemining how much to borrow from the central bank; and (ii) the nature of the monetary instruments under the control of the central bank'.

Central banks were established mainly to provide finance for governments to prosecute wars. Consequently, despite the high degree of political independence accorded central banks, until recently they were granted far less economic independence. The major problem confronting central banks throughout the early years of their existence was that their obligations conflicted. On the one hand they were required to finance government wartime expenditures, and on the other they were required to maintain the full convertibility of gold at the fixed rate. In reality, this conflict of objectives was more apparent than real and the over-riding objective of central banks was to maintain the Gold Standard. Furthermore, in times of peace no conflict arose since the prevailing orthodoxy was one of *laissez faire*.

3. Independence and the changing objectives of central banks

No consensus has emerged in the literature over the historical development of central banks. Toniolo (1988) has referred to their development as '… the free offspring of parents who were not born free'. Despite the lack of any consensus, this section identifies three distinct phases in the historical development of central banks: the nineteenth and twentieth centuries up to the mid-1940's, the mid-1940's to the mid-1970's and the mid-1970's to the present day.

3.1 Period up to the mid-1940's

Goodhart, Cappie and Schandt (1994, p51) have argued that in the nineteenth and early twentieth centuries, central banks had considerably more independence than they currently possess. Elgie and Thompson (1998) offer three reasons for this. First, the *laissez-faire* economies of the nineteenth century provided no role for the state and left the problem of resource allocation to the market. Correspondingly, no active role existed for central banks in influencing the performance of the macroeconomy which was regarded as self-regulating. Second, the operation of the Gold Standard implied central bank independence since their major objective was to maintain a stable economic environment consistent with ensuring convertibility with the national currency within the limits set by the 'gold points'. Third, the equity of central banks was privately owned and this gave them considerable *a priori* independence.

Goodhart (1988) has also stressed the role of Gold Standard and has argued that the objective of the early central banks was to 'unify what had become in cases, e.g., in

Germany, Switzerland, and Italy, a somewhat chaotic system of note issue, to centralise, manage, and protect the metallic reserve of the country, and to facilitate and improve the payments system'. The operation of the Gold Standard provided a means of achieving at least some of these objectives and during the late nineteenth and early twentieth centuries, central banks were charged with responsibility for maintaining the convertibility of national currencies. Central banks also provided finance for governments in times of war when tax revenues were insufficient to meet government expenditures. An obvious conflict exists between these objectives, but until the mid-1940s it was generally accepted that central banks would have no obligation to finance government expenditures in times of peace.

3.2 Mid-1940's – mid-1970's

A second period stretching from the 1940s until the mid 1970s can be identified. During this period governments became increasingly active in managing the economy and Goodhart (1995, p112) has noted that following the end of the Gold Standard 'the links between central banks and governments in the conduct of the macro-policy became much closer'. The economy was no longer thought to be self-regulating and mmong other things, central banks were now charged with responsibility for ensuring that the central government's budget deficit was financed in accordance with planned changes in aggregate demand governments felt would deliver their economic objectives. The multiple and inconsistent goals of central government (inflation, employment, growth and the balance of payments) were a source of conflict with their central bank because these goals had no clearly defined hierarchy and their importance often changed in response to economic mismanagement, or as governments moved through the political cycle.

The rate of interest became the main operational tool of monetary policy and, in order to ensure central bank compliance with required changes in the rate of interest, many governments nationalised their central banks. For example, during this period the central banks in Canada, Denmark, the Netherlands, England, France, Norway and New Zealand were all brought into public ownership (Elgie and Thompson 1998, p.17). This removed at a stroke any independence central banks possessed, but the situation was different in

Germany where, after the currency reform of 1948, the Bundesbank was constitutionally authorised to preserve the internal value of the currency. German experience of hyperinflation, in the 1920's significantly increased the country's determination to maintain price stability and this was accorded priority even in times when most countries were targeting maximum employment! .

Being banker to the central government, central banks have gradually increased the degree of centralisation of commercial banks' reserves. Consequently Goodhart (1988) has identified two dimensions of central bank monetary policy: a macro dimension and a micro dimension. The macro dimension involves setting monetary conditions for the macro economy, while the micro dimension involves ensuring the efficient functioning of the individual entities that make up the banking system. The interrelationship between the central bank's macro and micro functions resulted in the evolution of a supervisory function for central banks ultimately involving the provision of lender-of-last-resort facilities. This role was performed in different ways in different countries. In some, like Germany and Switzerland where the central bank was publicly funded, banking supervision was entrusted to a separate body and the central bank was not empowered with lender-of-last resort facilities. In other countries, like England, France and Italy, where the central bank was initially funded by private shareholders, it was charged with responsibility for providing lender-of-last-resort facilities and was also empowered with a supervisory role over the commercial banks.

3.3Post 1970s

The revival of independent central banks marks the third stage of their development as identified by Goodhart (1994). The policy of granting a greater independence to central banks became particularly popular during the 1990's when countries world-wide started providing their central banks with greater autonomy. Cukierman (1995) has argued that there are several reasons behind this tendency. First, the experience with fixed exchanged rates, in particular the Bretton Woods System and later the European Monetary System persuaded countries to design institutions increasing their commitment to price stability. In most countries until about the mid-1970's, economic policy was based on the assumed existence of a stable trade off between inflation and unemployment and decisions by the central bank were motivated by the particular combination of inflation and unemployment that satisfied the government's objectives at each point in time. As the relationship between unemployment and inflation deteriorated during the 1970s a consensus emerged at the International Monetary Fund conference in Kingston, Jamaica in 1976, that the primary objective of central banks should be price stability. Increasingly price stability has become the major objective of the majority of central banks world-wide with other goals, such as promoting stable employment, accorded far less prominence in the hierarchy of central bank objectives. The single policy objective greatly enhanced the independent status of central banks and Goodhart (1994) has argued that central banks with a single objective are more likely to be less subservient to central governments than central banks with a plurality of vague objectives. A single objective for monetary policy also facilitates greater accountability since it is abundantly clear whether an institution has achieved its objectives or not. Goodhart (1994) has further argued that targeting a single objective might reduce any dispute between central bank officials and academic economists over operational techniques since, for most central banks, interest rate adjustment is the only instrument of policy available.

The second reason identified by Cukierman (1994) for the emerging trend towards central bank independence was its establishment as one of the requirements for joining the single currency bloc. As a consequence, the central banks of European Union (EU) countries were granted increasing independence in the 1990's as a prelude to the creation of the single currency. More recently, the EU accession countries have granted independence to their central banks and more generally this is now an established global feature of central bank development.

The third reason for emerging independence among central banks identified by Cukierman (1994) was the performance of the Bundesbank with its proven track record of delivering consistently low inflation in the post-war period. Progress was also made in providing the theoretical explanation for the Bundesbank's success. In particular, Kydland and Prescott (1977) showed that when a central bank is not independent, policy announcements are subject to time inconsistency. Barro and Gordon (1983) extended this work and showed that in the absence of binding rules on central bank behaviour, an inflationary bias existed. Reputational considerations might reduce this inflationary bias, but it was felt that an independent central bank would act as a pre-commitment device, which would enhance credibility by transferring responsibility for monetary policy to a non-political body. This study, as well an earlier study by Rogoff (1979) provided the rationale for what the Germans and the Swiss had known for decades: that price stability would more easily be achieved if central banks were granted greater independence from central government. The theoretical predictions of Rogoff (1979) and Barro and Gordon (1983) were confirmed empirically by Cukierman (1992), Cukierman *et al.* (1992), and Grilli *et al.* (1991) who showed that independent central banks facilitate lower inflation.

4. Central Bank Independence Trends: Country Comparisons

This section provides some inter-country comparisons of trends in CBI since their formation until the present day. The central banks included in the comparison are the Bank of England, the Bank of France, the Federal Reserve and the Bundesbank. This paper measures the degree of political independence of these central banks using the index designed by Grilli, Masciandro and Tabellini (1991) from their formation to the present day. Additionally Grilli, Masciandro and Tabellini index (referred to hereafter as GMT index) has become increasingly popular in the economic literature after its introduction in 1991. Table 1 summarises the studies on CBI that have used GMT index:

Table 1: Summary of major studies using GMT index of CBI

Empirical studies	Indices used
Grilli, Masciandro and Tabellini (1991)*	GMT ^
Dvorsky (2000)	Cukierman (1992), GMT
Maliszewki (2000)*	GMT
Alesina and Summers (1993)*	GMT, Bade and Parkin (1988), Alesina (1988)
Alesina and Grilli (1992)*	GMT
De Haan and Sturm (1992)*	GMT, Alesina (1989), Eijffinger and Schaling (1992)
De Haan and Siermann (1994)	Cukierman (1992)
Eijffinger and Schaling (1995)*	Alesina (1988), Eijffinger and Schaling (1993), GMT, Cukierman (1992)

4.1 The Bank of England

From its very earliest days the Bank of England could appoint and nominate its own personnel. The Governor, Deputy Governors and directors were chosen every year between March and April (Elgie and Thompson 1998, p.36). Independence was guaranteed because the Committee of the Treasury was created comprising the Governor, Deputy Governor and the most senior of the directors with responsibility for preparing proposals for the election of Governors and Directors. For 1931, a lower score on the overall index of independence is recorded because the degree of economic independence of the Bank fell as result of its responsibility for selecting the instruments of monetary policy being withdrawn.

An attempt to measure the political independence of Bank of England has been made using the Grilli, Masciandro and Tabellini (1991) index summarised below.

Table 2[a]: Political Independence of Bank of England (1694 – 1998) using Grilli *et al*. index

Question	1694	1931	1946	1992[b]	1998
1. Governor not appointed by the government	*	*	-	-	-
2. Governor appointed for more than 5 years[c]	-	*	*	-	-
3. All the Board not appointed by the government	*	*	-	-	-
4. Board appointed for more than 5 years	*	*	-	-	-
5. No mandatory participation of government representative on the board	*	*	-	*	*
6. No government approval of monetary policy is required	*	-	-	-	*
7. Statutory requirements that central bank pursues monetary stability amongst its goals	*	-	-	-	*
8. Legal provision strengthening the central bank's position in conflict with the government	Na	Na	-	-	Na
Overall index of political independence	6	5	1	1	3

[a] - the authors derive these estimates from reference to the Bank's statute. An asterisk indicates the criterion is satisfied and a dash indicates that the criterion is not satisfied;

[b] - these results are taken from Alesina and Grilli (1992, p.49);

[c] - the results for the period 1694 – 1946 are reported by Elgie and Thompson, according to their index of term of office. During this period the term of office was between five and eight years.

Table 2 shows how the degree of independence of the Bank of England changed over the period since its formation in 1694 until 1998. Both tables confirm that in 1946, when the Bank was nationalised, there was a dramatic fall in the overall level of independence, particularly in the degree of political independence. Prior to this all appointments were made independently of government, but after nationalisation all positions were government appointments and the anchor for monetary stability, the Gold Standard, was replaced by a plurality of competing objectives to be achieved though government intervention. The amendments enshrined in the Banking Act of 1998 granted the Bank greater independence and constituted the main focus of the Act. In line with greater independence, price stability was established the major objective of the Bank and supervision of the banking system was transferred from the Bank to the FSA. As a result, the index score of political independence increased from one to three during 1998.

5.2 The Bank of France

The Bank of France was founded at the very beginning of the nineteenth century with private shareholder capital. It therefore possessed a high degree of political independence since nominations and appointments to the General Council (the governing council) were made independently of government. The General Council consisted of fifteen members who appointed the Central Committee which was charged with responsibility for supervision of the Bank's activities. The Regents (members of the General Council) were elected by the General Assembly of the shareholders. The tenure of the governor and sub-governors was completely free of any outside interference. Monetary policy was conducted by the Bank and decisions of the board were taken independently of any instructions from the government of the day.

Using GMT index, the political independence of the Bank of France is measured and our results using this index are reported in Table 3.

Table 3: Political Independence of Bank of France (1800 – 1993) using GMT index

Question	1800	1808	1945	1992 [a]	1993
1. Governor not appointed by the government	*	*	-	-	-
2. Governor appointed for more than 5 years[b]	-	*	*	*	*
3. All the Board not appointed by the government	*	-	-	-	-
4. Board appointed for more than 5 years	*	*	*	*	*
5. No mandatory participation of government representative on the board	*	*	-	-	-
6. No government approval of monetary policy is required[b]	*	-[a]	-	-	*
7. Statutory requirements that central bank pursues monetary stability amongst its goals	-	-	-	-	*
8. Legal provision strengthening the central bank's position in conflict with the government	Na	Na	-	-	*
Overall index of political independence	5	4	2	2	5

[a] - these results are taken from Alesina and Grilli (1992, p.49);

[b] - the Board does not accept instructions from the government but there are government representatives with the right of veto and thus we assume that government approval is necessary for policy formulation.

Comparing Table 2 with Table 3 reveals a common trend between the Bank of France and the Bank of England. Their activities were heavily controlled by their respective governments during the period 1945 to 1992, but both were highly independent during the Gold Standard period are again in the 1990s. The governor and sub-governors now have six-year terms of office, secure tenure and are prohibited from accepting any instructions from the central government. Monetary policy was entrusted solely to the Bank. With respect to economic independence, the major change affected lending to government and the Bank was prohibited from:

> '… authorising credit or granting any form of debt facility to the Treasury. The direct acquisition of government debt is also prohibited'. (Elgie and Thompson, 1998, p.133).

5.3 The Federal Reserve

In contrast to most of the European countries, the United States did not have a central bank during the period 1836 - 1914. Instead the US Treasury performed the role of central bank. Sylla (1988, p 20) has described the system thus:

> ‘The entire system was the victim of a kind of irregular and vicious centralisation… The money power of the country passed into the hands of a few financiers and big bankers, and the treasury itself, through politics and manipulation, acted in sympathy with them.’

Clifford (1965, p.50) argues that:

> 'A few years ago, when the US Treasury was burdened with excessive revenues and the money market depended on the whim of the Secretary of the Treasury, practically all public men of whatever shade or political belief, were agreed that the government ought to be taken out of the banking system.’

The corporate elite became the driving force in the process of separating the central bank from the Treasury and creating an independent Federal Reserve. A central banking system, with twelve regional Federal Reserve Banks, instead of a single central bank, was created with the Federal Reserve Act in 1913 that operated. The rationale behind this was to prevent a single bank (New York) from dominating the nation’s administrative and financial centre (Sylla 1988).

The Federal Reserve banks appoint six directors and the Board in Washington appoints three other directors making a total of nine directors in all. The nine-member board appoints officers of the respective regional reserve banks along with regional governors. With regard to these appointments, the Federal Reserve System is completely independent as none of the appointees come from institutions outside the Federal Reserve.

The Federal Reserve Board, consisting of five members, is appointed by the President of the United States for a period of ten years, and additionally two *ex officio* members are appointed. These are the Treasurer and his(her) subordinate who acts as the Comptroller of the Currency. The Federal Reserve Board is thus highly independent from government and its main role is to stand between the latter institution and the reserve banks, to conduct a unified monetary policy and to supervise the reserve banks’ operations. The longer term of office of the Board of Governors makes it difficult for a President to influence the Board’s decisions. Despite this, the President retains power over the Board and is allowed, via the Treasurer, to be involved open market operations with or without the approval of the Federal Reserve. Moreover, in times of emergency theses Offices are also free to intervene in the central bank activities whenever and however they decide appropriate. (Sylla 1989). Table 4 shows the changing nature of Federal Reserve Bank independence between 1912 and 1992.

Table 4: Political Independence of the Fe deral Reserve (1913 – 1992) using GMT index

Question	1913	1935	1992
1. Governor not appointed by the government	-		-
2. Governor appointed for more than 5 years[b]	*	*	-
3. All the Board not appointed by the government	-	-	-
4. Board appointed for more than 5 years	*	*	*
5. No mandatory participation of government representative on the board	-	*	*
6. No government approval of monetary policy is required	-	-	*
7. Statutory requirements that central bank pursues monetary stability amongst its goals	-	-	*
8. Legal provision strengthening the central bank's position in conflict with the government	-	-	*
Overall index of political independence	2	3	5

With respect to the degree of economic independence envisaged in the Banking Act of 1913, the regional reserve banks, acting as lender of last resort and fiscal agents, were partially allowed to issue banknotes. The influence of government became more explicit in 1917 when the United States entered the war. The Federal Reserve objected to the low interest rates set by the government on loans and securities – but these objections had no effect on policy and interest rates remained as set by the government!

The Banking Act of 1935 conferred greater independence on the Federal Reserve. The major changes regarding economic independence are:

- the Board of Governors (called hereafter the Board) could alter the legal reserve requirements of member banks;
- the Board could set maximum interest rates on time deposits that banks could pay;
- the Board could set margin requirements on loans to purchase securities;

- the Federal Reserve Open Market Committee was established with responsibility for carrying out open market operations. This marked a departure from the past when the Reserve Banks had the authority to implement their own open market operations.

The amendments above increased the power of the Federal Reserve over the member banks and brought about a more efficient and unified monetary policy across the country. The Federal Reserve is now regarded as one of the most independent central banks in the world. The GMT index a shows relatively high degree of political independence, despite the governor and board being appointed by the President of the US.

5.4 The Bundesbank

The foundation of the German central bank took place on the 22nd January 1870, but the Reichbank *de facto* started to operate in 1876. Most of the founders were private shareholders. The primary objective of the Reichbank was to unify the note issue but its other tasks as central bank were to improve and organise the payment system in the country. Lexis has noted that:

> '… the nature of its (Reichbank's) task is that it shall maintain the value of monetary unit as stable as possible'. (Quoted in Goodhart, 1988, p.108.)

The Reichbank's administrative functions were performed by the Administrative Board and Management. The board was the 'holder of all powers of attorney on the company's behalf'. (Quoted in Gall, 1995, p.13). The management of the Reichbank were required to operate in 'accordance with instructions given by the Administrative Board (subsequently the Supervisory Board)'. The chairman of the board was appointed by election. Instructions to the Reichbank came from its shareholders pursuing their own interest, rather than from government. This is illustrated by the resignation of one of the two members of the board with political affiliations because the:

> 'business activity that has so powerfully imposed itself since. I wished to protect my parliamentary position by on major economic issues against any possibility of attack…(Gall, 1995).

Table 5 below provides the degree of independence of the German central bank using the GMT index of political independence.

Table 5: Political Independence of the German Bank (1870 – 1998) using GMT index

Question	1880	1939	1997
1. Governor not appointed by the government	*	Na	-
2. Governor appointed for more than 5 years[b]	*	Na	-
3. All the Board not appointed by the government	*	Na	-
4. Board appointed for more than 5 years	*	Na	*
5. No mandatory participation of government representative on the board	-	Na	*
6. No government approval of monetary policy is required	*	Na	*
7. Statutory requirements that central bank pursues monetary stability amongst its goals	*	Na	*
8. Legal provision strengthening the central bank's position in conflict with the government	*	Na	*
Overall index of political independence	7	Na	6

The statute of the Reichbank changed drastically at the end of January 1933. The newly appointed State Secretary, Gottfried, concluded that:

> 'Of course the banks need to be directed by the State… One can not accuse the Government of a lack of initiative'. (Quoted in James, 1995, p.284).

This period has been described thus:

> 'The Bank, especially after September 1938, became part of the machine of the German imperialism, and its employees the agents of a brutal political process.' (James 1995, p. 352)

The issues of independence came to the fore in Germany with the creation of the Bundesbank which established a standard of independence against which other central banks were judged. Similarly, its track record of delivering low inflation became the standard against which other policy makers were judged.

6. Conclusions

The cases detailed in this paper draw some common trends in the development of central bank independence. In countries where the central bank was founded in the nineteenth century or earlier as a private institution, the central bank started with almost absolute political independence (according to the modern interpretation of the term 'political independence') along with a comparatively high degree of economic independence that lasted until the beginning of the twentieth century. Later, especially in the 1940s, many central banks lost their independence and in effect became government institutions subservient to the government of the day.

The recent developments in central bank independence show a tendency for central banks to regain the independence they in the possessed nineteenth and early twentieth centuries. The catalyst for this trend was a reaction to the rising levels of inflation that characterised the 1960s and 70s in many countries which focused the attention of policy makers on the anti-inflationary track of Germany and Switzerland during the post-war period. Both countries were well known for having highly independent central banks and these served as models for others to emulate. The increasing emphasis on price stability as the primary objective of policy encouraged interest in central bank independence not simply in the developed world, but also among emerging economies. In Latin American countries with high inflation records like Argentina, Chile, Venezuela and Mexico, central banks are gaining greater independence. With the collapse of the centrally planned system, many countries in Central and Eastern Europe began granting their central banks greater independence with a view to achieving low and stable rates of inflation and, in the case of several East European countries, as a prelude to their application for their accession to the European Union.

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