Forrest Capie
Professor
CASS Business School, City University, London

# Can Central Bank Independence Survive a Crisis?

## Introduction

Central bank independence does not survive crises essentially because it is impossible to create an independent central bank suitable for all occasions. This short paper illustrates this by reference to the Bank of England's history and more briefly to the Federal Reserve's much shorter history.

Taking independence to mean operational independence to achieve a goal set by government the argument is that specification of the goal is part of the problem. Starting from the position that government is responsible for money, it should not be able to abuse that responsibility by debasing the currency. So the central bank is given the job of maintaining the value of the currency or price stability. It might do that by managing a metallic standard or by following a policy rule or by being given the freedom to do whatever it deems necessary to deliver the desired end.

While there was no explicit statement about much of this when the first institutions that became central banks were founded, there was much that was implicit. So it should be useful to consider the history of one of these government banks, the Bank of England, that later became a central bank, before looking briefly at an institution, the Federal Reserve, which was founded explicitly as an independent central bank. These two banks provided the models for many others around the world. They were, however, and always will be creatures of the state.

## The Bank of England

The Bank of England was founded in 1694 out of the needs of the state to finance war. In return, the Bank was given a charter from the state that gave it a privileged position in banking in the country. The renewal of the charter clearly rested on the Bank's satisfying the state's requirements. And so began a relationship of dependency. The state needed the Bank and the Bank relied on the state for its privileges. When the Bank's charter was renegotiated in 1697, for ten years, it was given protection from competition from rivals; and its position was strengthened further in the renewal of 1708 when a fresh loan was required from the Bank. On that occasion other banks were restricted to six partners or fewer, and the Bank was given a monopoly of note issue in joint stock banking, in effect a joint stock banking monopoly. At the renewal of 1715 its privileged position was further enhanced when it was given the job of managing the government's debt. The Bank's position de-

pended on its fiscal usefulness to the state. In these early years, "the close relationship between the Bank and the state … was deemed to be unhealthy and corrupt". (Bowen, p. 7.)

As Britain was at war for more than half of the years between 1694 and 1815 the relationship between Bank and government grew ever closer and stronger. The state needed finance for war and the Bank either provided it or organised it, so that by the end of the 18th century the government saw the Bank as an essential component of its war finance programme. By the late 18th century, "North had depicted the state and the bank as enjoying a relationship that was closely akin to matrimony …" (Bowen, p. 8.) In the wars with France at the end of the 18th century the government would take bills in large volumes to the Bank for discounting. The Bank would huff and puff a great deal but there was no question of it not complying with the state's wishes. In 1797 sterling's link with gold was suspended and greater monetary expansion was made possible. That was when the dramatist Sheridan referred to the Bank as, "an elderly lady in the City of great credit and standing who had unfortunately fallen into bad company". (i.e. with Pitt the Prime Minister) If at any stage the Bank showed any inclination to support a resumption of cash payments, government quickly slapped it down. It supported the Bank through the heavy criticism the Bank suffered in these years and then rewarded it by giving the Bank's notes de facto legal tender status in 1811 (de jure in 1816). In the world after the Napoleonic Wars the Bank's fiscal usefulness was in decline and so the case for the monopoly in joint stock banking was eroded, and it was soon abandoned.

In the 19th century, even in the age of laissez faire when there was free trade, sound money, and small government the Bank's independence was still limited. In the first place the Bank's essential function was the management of the gold standard and so it was heavily constrained by the rules of the gold standard and particularly so after these were redefined in the legislation of 1844. The main objective was to maintain convertibility of the currency into gold and the main control instrument was the short-term interest rate. The interest rate was made effective by discounting bills and, increasingly as time passed, by open market operations. These were all things the Bank became expert in and it was left to get on with the job without political interference.

However, a financial crisis that involved a scramble for cash presented a serious problem. In the first great financial crisis of capitalism in 1825 the government instructed the Bank to pay out to the last penny (Feaveryear, 1963). Instruction was thought to be needed as it was feared the still privately owned bank might otherwise have looked after its immediate profits due either to insufficient heed to the long term or to caution over its own survival. But then the 1844 legislation made it difficult for the Bank to perform its key role in a crisis, that of lender of last resort. The act needed to be suspended and that required a letter from the Governor to the Chancellor seeking the necessary exemption. That happened in the crisis of 1847 and again in the crisis of 1857. Then again at the height of the Victorian boom in 1866 crisis struck again in the famous case of Overend Gurney. The Chancellor agreed that it was, "requisite to extend their discounts and advances upon approved securities, so as to require issues of notes beyond the limit allowed by law". But he continued: "No such discounts or advance, however, should be granted at a rate of interest less than 10 per cent, and Her Majesty's Government reserve it to themselves to recommend if they should see fit, the imposition of a higher rate." (Quoted in Fetter. See also Gregory.)

So when crisis struck the rules were such that government again dictated how the Bank should behave. Fetter concluded for the 19th century, "the Bank and the Government ... continued the fiction of official independence" (Fetter, p. 280).

That was true again in 1914. At the outbreak of war in August 1914 there was a major crisis. The Governor was invited to a meeting in Downing Street and told to sign a statement and to promise: that during the war "the Bank must in all things act on the direction of the Chancellor of the Exchequer whenever in the opinion of the Chancellor the national interests are concerned and must not take any action likely to affect credit without previous consultation with the Chancellor". (Sayers 1976, pp. 99–107)

Cunliffe, the Governor, initially refused to sign and had the support of the Bank, where they believed, "it was impossible for the Bank thus to renounce its functions". But some face saving was allowed and Cunliffe agreed to comply.

For the interwar years the Bank of England was of the view that it should be operationally and institutionally distinct from government regarding this as independence, but it should accept Treasury control of policy – which was an implicit target regime on the exchange rate. The Governor throughout the interwar years, Montagu Norman, made it clear that ultimate authority rested with the Treasury. "I assure Ministers that if they will make known through the appropriate channels what they wish to do in furtherance of their policies they will at all times find us willing with good will and loyalty to do what they direct, as though we were under legal compulsion". (Collins, p. 294.) Norman went further than that when he told a meeting of Commonwealth bankers, "I am an instrument of the Treasury". Following the Great Depression that affected much of the world and for which the blame fell on bankers, both central and commercial, central bank room for manoeuvre became further circumscribed.

It is often assumed (or asserted) that after the Bank was nationalised by the Labour Government in 1946 everything changed and the Bank henceforth became a subsidiary of the Treasury. But in fact very little changed. While there were complex drafting requirements to specify the functions, powers, and purposes of the new public corporations being formed after the war, in the case of the Bank this was unnecessary because there was "never any question that it should not continue doing what it had been doing for a very long time". (Chester, p. 196.)

The fact that little had changed following nationalisation so irritated the Labour Party when in opposition in the 1950s that it was instrumental in getting the Radcliffe Committee established to enquire into the nature of the monetary system. It was particularly concerned to bring the Bank to heel and have the Treasury clearly dictate the terms.

The question of Bank Rate setting was at the centre of the discussion. It was partly one of principle and partly symbolic. The Bank took a strong line from which it never deviated: this was an operating rate and only the Bank knew which way it should be moving. This was largely accepted by government. The Bank delegated its power to set Bank Rate to the Governors, with the Chancellor giving formal approval to any change. And that was essentially what happened. The Bank would, primarily for external reasons, decide that a change in the rate was required. It would notify the Treasury of their view and expect to have the decision rubber-stamped. There are some isolated examples of disagreement for political reasons or for timing but generally these simply took the form of the Treasury suggesting a delay of a week or some such trivial alteration.

Across the period from the 1950s to the 1970s the Bank operated with considerable freedom, what it liked to think of as independence (Capie, 2010). Its principal function of defending the exchange rate was restored. Things were as they had been in the golden age before the First World War. Many actions were taken but most important was the use of its oldest instrument – Bank Rate. And Bank Rate was regarded as primarily of use for external purposes, and as noted movements in Bank Rate were not merely executed but determined by the Bank. Whenever there was a developing threat to sterling the Governor would tell the Chancellor that a rate change was proposed on a particular date. The Chancellor's reply was simply a one line memo of approval. (Capie, chapters 4, 5, 6.) The relative freedom began to come under serious pressure in the 1970s following the loss of the explicit exchange-rate target. When monetary targets were introduced monetary policy became increasingly politicised as politicians and civil servants had a simple number on which to focus. They wanted to see what action was being taken to meet the target and if it was not met to be shown why it was not.

Something else that contributed to the relative freedom the Bank enjoyed was the method of its financing. How central banks are financed matters for independence. There are essentially three ways in which a central bank can be financed: first, it could be done straightforwardly out of taxation; secondly, it could be allowed to retain seignorage; or thirdly, it could be achieved by placing a levy on the financial institutions. The first two means present problems in terms of independence. The third raises fewer objections in this respect since the Bank is being financed privately. It was, as a consequence of its history, the last of these that was used to finance the Bank of England (and it continues to be the means of financing the Bank).

This potted history shows that ever since the founding of the Bank of England a dependent relationship with government was accepted. Since the country was at war more often than it was not between the Bank's founding and 1815 and the state needed funds, it needed the Bank and the Bank depended on the state for preservation of its privileges. In the 19th century whenever crises flared, under the gold standard the Bank needed government approval to act in the necessary way and that came with conditions. In the first half of the 20th century war dictated much of what happened; again the Bank responded to the needs of the state. There was a brief period after the Second World War when another exchange-rate target was in place and the Bank enjoyed a similar freedom of action that it had in the past but that all came to an end in the debacle of the 1970s. The next attempt at restoring some independence in 1997 has lasted only so long as there was no crisis.

## United States

When the Federal Reserve was founded in 1914 financial stability was its chief focus and it was intended that the bank be independent of political influence. It was founded after a long period of peace, but war broke out soon after and the Fed was almost immediately involved as the Treasury's banker. (Further, indicating another level of independence, the twelve district banks were free to operate independently of each other.) The Federal Reserve Act was quickly amended so that banks could borrow from the Fed using government securities as collateral. Inflation followed but the Fed could not raise its discount rate without Treasury approval. So it did not get off to a good start in terms of either independence or inflation control and it took some years after the war before it returned to its intended path of being an independent institution. In the years after the War and particularly following the recession of 1920–21 the Fed discovered open market operations and the Open Market Investment Committee was established. The New York Fed became the dominant bank under the leadership of Benjamin Strong.

Hardly had the post-war adjustment taken place before new problems confronted the Fed, at the end of the 1920s, and its actions and its failures to act resulted in the Great Depression. (Friedman and Schwartz, 1963) Following the Great Depression and the criticisms, subsequent and sometimes consequent, that were made of banks and central banks the Federal Reserve Act was again amended, by the Emergency Banking Act of 1933. That Act, amongst other things, gave the President powers to regulate credit, whatever that may mean. But calls for greater reform were strong and a new Banking Act was designed, for implementation in 1935. Initially, the principal aim had been to provide a small but flexible monetary authority with its independence restored. The vague mandate that the Fed had been given in 1913 was, however, preserved in the 1935 Act. Further, in the 1930s if the Fed did not stay in line with the Treasury's wishes it was readily brought back into line by the Treasury acting through the new Exchange Stabilisation Fund or other Treasury accounts. Meltzer (2009) is critical of the chairman of the time, Marriner Eccles, who, he said, failed to defend the Fed's independence under Roosevelt.

In any case within a matter of a few years there was war again and in war the Fed was obliged to support the prices of government securities. It was an instruction in time of crisis. Tensions

arose immediately between the Treasury and the Fed, with the Treasury seeking low rates to support the sales of bonds for war finance. In 1942, Federal Reserve banks were authorized by government to buy government securities directly from the Treasury. The dangers that gave rise to remained in place for years after the war. Throughout the period of low interest rates commercial bank reserves grew hugely and the inflationary dangers rose with them.

Tensions between the Fed and the Treasury over interest rates came to a head in 1950 and there broke out what has been called the "greatest battle in the history of central banking" (Davis, 2012). Sproul of the New York Fed was sufficiently worried after the outbreak of the Korean War in 1950 to force the

issue. In what he saw as a dangerously inflationary situation he thought it was time to exercise some independence. So the Board of Governors announced rate increases and indicated they would take further action if required to restrict credit.

The turning point came in January 1951. There was a special meeting between the FOMC and the President. That meeting was a direct consequence of an instruction by the Treasury to the Fed to buy government bonds at a specified price. The Treasury released a public statement after the meeting that suggested that the Fed would do as it was told. This so enraged Eccles, still a board member though a former Chairman, that he broke confidentiality rules and gave the press the Fed's record of the meeting. The Fed's record had suggested no such thing. Discussions then began in earnest between the parties and these led to the Accord of March 1951. The Chairman (McCabe) resigned soon after and his replacement was William McChesney Martin Jnr., the Treasury assistant undersecretary who had conducted the meetings on the Accord. This might have looked like a cynical Treasury move but subsequent events indicate otherwise. Some see the Accord as the turning point in the Fed's history, the point at which it became a truly independent central bank. How true that is will continue to be debated. What it does for our purposes is remind us of how fragile independence can be. When any kind of emergency appears the dangers are that the response to these circumstances will be actions and sometimes legislation that seem at the time entirely appropriate to the problem. But it then weakens the central bank's position when "normality" is restored. Although Martin went on to become the longest serving Chairman of the Fed, and is generally credited with maintaining the Fed's independent position, he still held a slightly ambiguous view of independence. He liked to repeat the words of Sproul that the institution should be, "independent within government not independent of government". Does that match Friedman's favoured definition of independence? It might, but then it might not.

The inability to write complete contingent contracts ensures that independence is compromised in a crisis. One route by which that compromising occurs is when emergency legislation is passed whose scope after the crisis turns out to be greater than had been realised at the time.

Reactions to the recent crisis may turn out to be an example of that; but whether they are or not, they certainly exemplify how a crisis can thrust a central bank into the arms of its government.

## Conclusion

It might be tempting to conclude by constructing a counterfactual, so as to consider how a "truly independent" central bank might have acted in financial and other crises. But that temptation is resisted, as the argument of the paper is that such a creature can not exist. There is, however, another and more fruitful way of getting close to the question. What might a central bank guided by and adhering to the principles set out by Henry Thornton, Walter Bagehot, and R. G. Hawtrey have done in these circumstances? I believe the answer is clear. They would have provided liquidity until the liquidity aspect of the crisis was over. They would have had nothing to do with the provision of capital to support individual banks. That was not their responsibility quite apart from it being beyond their balance sheet capacity. Most importantly it was a contradiction of the principles guiding lender of last resort action.

In Great Britain the recent crisis revealed inadequacies in the set of instructions provided by government. But in addition the Bank of England went far beyond the quantitative easing for liquidity purposes and got involved in buying up a big proportion of debt issued by government. It certainly appeared to compromise its independence over inflation by consistently failing to achieve its target, a failure always accepted by the Chancellor, and carried out a policy of financing the Government's budget deficit. Meanwhile, the problem of how to get capital into a failing bank to prevent contagion was dodged by seeking to put in place measures to make retail banks failure-proof.

Much of Alan Meltzer's history of the Federal Reserve is concerned with its independence. But independence was not defined in law but rather left to the interpretation of its chairmen. Nowhere did it set out its lender of last resort policy leading to increased uncertainty. And nowhere was this more evident than in the recent crisis. The Federal Reserve worked erratically and unpredictably along with the Treasury, in ways not consistent with its mandate, and also, as Meltzer put it, changed from protecting the value of the US-dollar to being the "financing arm of the Treasury".

If ever a central bank was designed to be independent it was the ECB using the Bundesbank as a template. But in the recent crisis the ECB's behaviour can only be described as political. The ECB has been politicised under the pressure of numerous heads of government. It switched from control of inflation by monetary policy to a policy of buying government debt to keep the euro area together at least long enough for further political changes to be implemented in the EU. That this has not threatened inflation so far is an accidental by-product of the severe recessions in a substantial part of the euro area. Despite that it represents a complete change in the objective of the ECB.

So long as there have been central banks governments have used them at times of crisis, and have not hesitated to override whatever set of rules supposedly constrained the central bank. This is a consequence of several factors. First there is the inescapable fact that uncertainty makes it impossible to write complete contingent contracts for central banks. Second, even if it were possible to write such contracts, there are few countries where a constitution could prevent them being overridden, were doing so to be temporarily convenient. Rules constrain only so long as belief holds that the rules cannot be broken.

## References

**Bowen, H. V. 1995.** The Bank of England during the long eighteenth century 1694–1820. In: Roberts, R. and D. Kynaston (eds.). The Bank of England; Money power and influence 1694–1994. Oxford.

**Capie, F. 2010.** The Bank of England; the 1950s to 1979. Cambridge University Press.

**Capie, F. and G. Wood. 1991.** Central Banks and Inflation: an Historical Perspective. Published in two parts. In: Central Banking. Autumn 1991 and Winter 1990 and reprinted in: Money over Two Centuries by Capie F. and G. Wood. Cambridge University Press. 2012.

**Chester, N. 1975.** The nationalisation of British industry 1945–51. London HMSO.

**Collins, M. 2012 reissue.** Money and Banking in the UK: a history (Croom Helm).

**Davis, G. 2012.** Financial Times.

**Feaveryear, Sir A. 1963.** The Pound Sterling; a History of English Money. Oxford: Clarendon Press.

**Fetter, F. W. 1965, 1978.** Development of British Monetary Orthodoxy. Harvard University Press. Reprinted Augustus Kelley.

**Friedman, M. and A. J. Schwartz. 1963.** A Monetary History of the United States. Princeton UP for NBER.

**Gregory, T. E. 1929. 1964.** Statutes documents and Reports relating to British banking, 1832–1928. Volume 2 (Frank Cass). Knight. 1991.

**Lastra, R. and G. Wood. 2010.** The Crisis of 2007–2009: Nature, Causes, and Reactions. In: Journal of International Economic Law. Volume 13. Number 3. 531–550.

**Meltzer, A. 2009.** A history of the Federal Reserve, 1970–1986. Volume 2. Book 2. Chicago University Press.

**Sayers, R. 1976.** The Bank of England, 1891–1944. Cambridge University Press.