The Changing Face of Central Banking

Central banks have emerged as the key player in national and international financial policy making. This book explores their evolution since World War II in 20 industrial countries. The study considers the mix of economic, political, and institutional forces that have affected central bank behavior and its relationship with government. The analysis reconciles vastly different views about the role of central banks in the making of economic policies. One finding is that monetary policy is an evolutionary process. The emphasis on clarity of objectives, transparency of the decision-making process, and a clear understanding of the accountability of the central bank cannot be understood in isolation from the previous 50 years of policy making. The changing face of central banking, born out of the turbulence of the first half of the last century, nurtured by evolution and revolution in policies, defines the history of key financial events in the second half of the twentieth century.

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The Changing Face of Central Banking

Evolutionary Trends Since World War II

PIERRE L. SIKLOS

Wilfrid Laurier University, Canada
To Nancy, the “big” guy and the “little” guy
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Throughout much of my professional career I have investigated eco-
nomic issues that affect central banks directly or indirectly. My earliest
involvement in this area dealt with conditions that lead to a hyperinfla-
tion and their termination, an extreme illustration of total subjugation
of a central bank to government demands. By the early 1990s I became
interested in the relationship between central banks and governments
and the monetary policy choices made by these same authorities. Paral-
lel literatures, with important contributions by Canadians, had emerged
wherein a central bank either was an optimizing agent that could fine-
tune the economy or behaved as a bureaucratic institution determined
to maintain its special role via obfuscation and secrecy. At the same time
political economists, and political science, claimed that central banks
were constantly pressured by the political authorities to change their
policies to facilitate reelection prospects or support partisan economic
programs. Throughout, these various strands of the literature continued
to grow, though some floundered by the late 1980s due to a lack of
empirical support or an inability to address the issues that were the
concern of the day.

Little did I know that, in 1993, a topic that lay largely dormant in
economists’ minds (but not in the minds of political scientists) would
get its second wind so to speak. The catalyst was, of course, the publica-
tion of John Taylor’s article on the Fed and its interest rate setting behav-
ior. This led to an explosion of research into the “new” economics of
central bank reaction functions. It was also when I undertook (initially
with a colleague at Wilfrid Laurier University) a research program
to investigate how central banks react to both the economic and politi-
cal pressures they face. In a very real sense then, this study began in
1993.
Yet, despite the increased scrutiny faced by central banks, there is little emphasis in the literature on the connection between the economic and political pressures on them. Moreover, there is relatively little known about how and why central bank policies have evolved over time, how the institutions themselves have changed, or the proximate causes for these changes. It is with this in mind that the present study mixes economic history with a quantitative analysis of central banks and their policies, roughly since the end of World War II. The aim is to try and isolate how monetary policies have been shaped by economic, political, and institutional forces. As will become clear, bits and pieces of the main arguments in this study can be found elsewhere. I hope, however, that I have not reinvented too much.

I have tried to make the study as accessible as possible. While technical details cannot be avoided entirely, they are kept to a minimum. It will also become apparent from a reading of the text that central banks, as institutions, are best understood as having evolved over time. Hence, the notion of “game playing” between the monetary and fiscal authorities, while a useful tool under specific circumstances, is seen as a profoundly unsatisfactory way of explaining the changing face of central banking since World War II.

There are too many people to thank for their help, directly and indirectly, in the preparation of this study. They are, in any event, acknowledged in the various articles I have written over the years on the topics of greatest concern for this study. Nevertheless, I do wish to add a special thanks to Professor Michael Bordo and his referees for their valuable assistance in ensuring that the coverage of topics would appeal to economists and to a broader audience of individuals interested in central banking issues. I am also grateful to Elsie Grogan for assisting me with the manuscript and making endless corrections to many drafts. I also owe a debt of gratitude to the many officials of central banks who assisted me by providing valuable historical and other information, and for the many discussions I had with various officials over the years. Finally, I am grateful to the Social Science and Humanities Research Council of Canada, the German-American Academic Council Foundation, and Wilfrid Laurier University for financial support. I am particularly grateful to Wilfrid Laurier University for providing me with the time to complete this manuscript as recipient of the 2000–1 University Research Professor award. I was able to indulge in a year of research free of teaching and administrative responsibilities for which I am very thankful. Indeed, I was able to put the finishing touches to the manuscript in
Preface

Sydney, Australia, as a visiting professor at the University of Technology, Sydney. The vistas of Sydney provided, I believe, some wonderful inspiration about central banks and central banking. Finally, I appreciate the opportunity to publish this research with Cambridge University Press, and the help of Scott Parris in shepherding the manuscript to completion.

Pierre L. Siklos
Waterloo, Ontario, CANADA
June 2002