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Introduction

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1 Trust and the Central Bank

A widespread view among economic historians is that a well-functioning and stable monetary and financial system is a necessary condition for a thriving economy and rising living standards. Traditional students of European economic history have long noted the association between the expansion of the banking system and economic development. At a time when economists still grappled with the notion of the neutrality of monetary institutions, Cameron (1967) posited the existence of a link between banking and development. The US experience in the nineteenth century has for a while stood as a possible counter-example to this view, in that its banking system was crisis prone and yet the economy did thrive. However, more recent work has shown that the output losses of the recurrent crises that occurred in America during the nineteenth century were limited (Rousseau and Sylla, 2006). Modern research is moving toward a better understanding of the underpinning of this long underestimated financial success.

Both fiat money and commercial bank finance are underpinned by trust but the mechanisms whereby trust is produced are still incompletely understood. The role of the rise of the modern state as a producer of trust has been emphasized. It has been traced back to Italian city states (Fratianni and Spinelli, 2006) and the British "Glorious Revolution" of 1689 (North and Weingast, 1989), which is seen as having paved the way for Britain's Financial Revolution in the eighteenth century (Dickson, 1967). The Industrial Revolution in the second half of the nineteenth century can be seen as having completed the process.

Both history and theory suggest that the construction of trust have led to the emergence and development of systems of monitoring. It is not surprising perhaps that where the consolidation of trust took place in Western Europe in the eighteenth and nineteenth century, a form of institutional proliferation occurred whereby state and privileged banks controlled one another: This makes the early history of central banking a narrative of how rents and privileges were granted by the state to private institutions (banks of issue) and how the banks of issue reciprocated by improving the credit and liquidity of state debt (Broz and Grossman, 2004). The result was an evolutionary process whereby compromises had to be found between the needs of public finance and the conduct of monetary policy. It did not go without failures or controversies. The temptation of cash-strapped governments to extract more seigniorage from the bank led to episodes of monetary exploitation, which usually resulted in a reduction of credit for both the state and the central bank. The famous episode of the "bullion controversy" during the French wars, whereby economists and policy makers debated whether the depreciation of sterling in terms of gold ("the high price of bullion") was due to the monetization of British debt facilitated by the inconvertibility of the banknotes of the Bank of England or to other factors, provides illustration. In the instance, the depreciation was moderated by the roaring expansion of the British economy, which fuelled an increase in the demand for banknotes and enabled the Bank of England to lend support to the economy. Toward the later part of the nineteenth century, the wisdom accumulated from these experiences was encapsulated in a new theory that enshrined the independence of the bank of issue, and anticipated on the modern theory of central bank independence (Flandreau, Le Cacheux, and Zumer, 1998).

In parallel, the belief had spread that leaving the establishment of trust solely to market forces was unlikely to produce satisfying results, and in Europe it was felt that the adequate solution was to be found in the replacement of free banking by central banking. Historically, many examples were invoked to underpin this view, which led contemporaries, long before the idea was emphasized by Bank of Japan Governor Masaaki Shirakawa, to think of financial stability as a public good whose provision invited the creation of a government supervised monopoly (Goodhart, 1988). The idea of a special role for the central bank to play in the midst of financial stress coagulated in the aftermath of financial crises, with the crisis of 1866 playing a distinct role through the introduction of the so-called Bagehot doctrine. Bagehot was the editor of British weekly Liberal magazine *The Economist* and, following a series of articles that went back to 1866, he eventually published in 1873 a book called *Lombard Street: A Description of the Money Market*. There he argued, on the basis of the behavior of the Bank of England during the panic of 1866, that a central bank could, and should, intervene during crises. The three pillars of Bagehot's guidelines for central bank intervention now known as "Lending of Last Resort" or LOLR (generous liquidity, against good collateral, at high rates) have been often commented upon (Bignon, Flandreau, and Ugolini (2011) and Bordo (2014)). More important for our purpose here is the question of understanding why the Bank of England rather than another institution came to be the vehicle in charge of intervening in the aftermath of the failure of Overend Gurney and Co, a leading non-bank financial institution (in the language and categories of the time the Bank of England referred to such money market funds as "bill brokers" and "Overends" was the most aggressive of them all). The answer could be that, because of the Bank of England's vast knowledge of how the market operated in normal times, it was in a unique position to determine what constituted "good collateral". This interpretation is consistent with the evidence in Flandreau and Ugolini (2013) who show the stability of the composition of the discounting portfolio of the Bank of England before and during the crisis of 1866. Based on the British experience, a crisis was an episode that called for monetary authorities to do "more of the same."

As this happened however, the state remained in a position that enabled it to continue to play a role, either in the forefront or in the background of the formation of trust. In the case of the development of modern LOLR in Britain for instance, a surrounding arrangement that accompanied the implementation of such policies was the suspension of the Act of 1844, an arrangement that effectively freed the Bank from bending the limits of the Act. In other words, the Bank's ability to conduct LOLR policies was itself constrained by the authorization of the State, which enjoyed the right to review such policies afterward (in turn creating some resistance on the part of the Bank to seek the actual suspension of the Act of 1844). Moreover, it was prescribed that, as it performed its role as a LOLR, the Bank would lose the privilege of earning revenues from such crisis lending (Flandreau, 2008). This is important, because the removal of the profit motive and its replacement by a set of rules underscores the notion of a nascent "public good logic" just emphasized (i.e., Bagehot's "Responsibility Doctrine"). This also suggests that the operation of LOLR was only as solid as was its continued societal support materialized in state guarantees. As a result, for prolonged periods of history, in a great number of countries, right up to the dawn of the twentieth century, and even when the supreme monetary authority was on the forefront, the state remained a de facto stakeholder of the management of crises and the ultimate guarantor of monetary and financial stability.

The twentieth century accelerated trends discernible in the past in some "financially advanced" countries. Institutionally entrenched central banks, continued to play a progressively more pivotal role in safeguarding the stability of money and finance. They received this role from governments, in large part, because of the superior information and experience they had accumulated.

2 Central Banks at a Crossroads: "Where Next?"

In the opening paragraph of the *Tale of Two Cities*, Charles Dickens wrote: "in short, the period was so far like the present period, that some of its noisiest authorities insisted on its being received, for good or for evil, in the superlative degree of comparison only." The same phenomenon appears to have characterized the use of adjectives to describe modern financial times. When the global financial crisis of 2008 brought the so-called Great Moderation decisively to an end, it was not long until the outcome was described as the "Great Recession." And indeed after the crisis erupted, central banks quickly made up their minds as to the seriousness and source of the problem and identified the culprits in the shape of a number of pre-crisis blind-spots – extensive credit in the banking system, but also, and more fundamentally, having escaped from their view, the burgeoning of credit by non-banks. Just as had occurred in the crisis of 1866 with bill brokers or in 1907 and 1929 with financial trusts, an enormous credit system had proliferated in the shadow of the banking system, resulting in ballooning debts. In response, central banks have reinvented themselves and although this was certainly not the first time such reinventions occurred in the history of central banks (as the birth of the Bagehot doctrine after the crisis of 1866 reminds us) the magnitude of the modern episode is truly remarkable.

A first aspect of this reinvention relates to monetary policy; it is said that extraordinary times call for extraordinary monetary measures. Global interest rates were lowered to unprecedented levels (making comparison with Bagehot's rules, which called for *raising* interest rates, somewhat irrelevant), accompanied in some major advanced countries by purchases of government securities – the so-called quantitative easing (QE). In some countries, central banks also purchased private sector assets, such as

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mortgage-backed securities and corporate bonds – the so-called credit easing. Others, including the Federal Reserve and the Bank of England, began to rely on announcements known as "forward guidance" to convey their future policy intentions and thereby shape the yield curve.

A second aspect of the reinvention relates to macro-prudential regulation. Inflation targeting was necessary but, by itself, insufficient to curb the financial cycle. The response of governments has been to grant central banks new powers, focused on the needs of the financial system as a whole and the needs of the nonfinancial economy, as much as the financial sector: The approach is no longer narrowly monetary, and it enables central banks to respond to perceived trends in the macro-economy. This is the meaning of 'macro' in macro-prudential.

A third aspect of the reinvention concerns central banking operations. During the crisis, central banks expanded their balance sheets as never before. When crisis lending in the nineteenth century resulted in an expansion of the central bank's balance sheet, it was typically smaller than 30 percent (Bignon, Flandreau, and Ugolini, 2011). The subprime crisis produced a revolution in central banking in that balance-sheet increases have been of an order of magnitude larger. New facilities were introduced that extended liquidity for longer durations and against expanded sets of collateral (public and private) to new counterparties (bank and non-bank). This took last-resort lending to a new level. Some central banks went one step further, becoming effective market-makers of last resort in some assets to secure market liquidity (Mehrling, 2010). These were new and bold steps.

One consequence of this is that the meaning of "normal times" has been transformed. When (if?) we get back to "normal times," will central banks go back to normal activity or will they move further ahead? Haldane (2014) refers to A. A. Milne's (1924) poem, "Halfway Down."[1] Haldane thinks this poem is a fitting description of the position central banks find themselves in today. "During the past twenty-five years or more, central banks' mandates and instruments have moved upward in steps. They have ascended the stairs. But where this leaves central banks today is not entirely comfortable. Halfway up the stairs is neither up nor down, neither nursery nor town. That begs a natural question about where next for central banks over the next quarter-century."

[1] In A. A. Milne (1924), *When We Were Very Young* (illustrated by E.H. Shepard), published by Methuen & Co. Ltd.

3 I Told you So: Learning from History

A recent book by Eichengreen (2015) provides important insights on the art and pitfalls of drawing lessons from history for the purpose of policy making. He argues that one source of the dynamics of the current Great Recession can be found in what he calls the progressive narrative of the Great Depression, whereby the disasters of the 1930s were ascribed to a set of correctable flaws in collective decision-making. This reading of the interwar crisis, pioneered by Friedman and Schwartz (1963) in their classic *Monetary History of the United States*, implied that scientific central banking, advances in supervision and regulation, and deposit insurance would ensure that no comparable crisis would occur again in the future. While such beliefs were counter-productive in that they created blind-spots in which financial fragilities accumulated, they also conveyed a sense of policy responsibility that ensured that policy makers reacted in a substantially more pro-active manner in the modern recession than they had in the past.

This sweet and sour conclusion on the uses of history raises important questions about how lessons are constructed. For instance, the conventional reading of the Great Depression led to the impression that bank runs occurred principally in the retail banking sector, and were thus properly addressed by deposit insurance and the supervision of commercial banks, thus creating a loophole in investment banking and the shadow banking system as the 2008 run on Lehman brothers and the repo market revealed. However, the already mentioned crisis of 1866 and the reading that Bagehot had provided of the crisis did emphasize the role of what is known today as the shadow banking system. For what was the failure of Overend, Gurney & Co., that took deposits from the banking system and invested them in short term assets that turned out to be "toxic" if not that of a "shadow bank"? It is tempting to conclude that the whole subject hinges on the selection of a proper precedent.

But if the conclusion is that selecting the right precedent, or reading the right history, is paramount this begs the question of how historical knowledge is organized. Perhaps a heuristic parallel is with the misunderstanding that develops from the parent-children relation. To the frustration of parents who see the elements of repetition in the present, children seem to be more interested in having their own experiences than listening to parents' advice. To the frustration of the children, parents seem more interested in reading the past in the present, rather than taking into account the information that children have about the new world that surrounds them.

The situation is further complicated when the grandparents enter the picture and tell, now to the parents, now to the children, that they are actually not so different from one another and that they both forget earlier lessons.

There is no agreed upon framework whereby knowledge from past experiences in economic policy making is organized and in fact there cannot be. With the tendency of modern economics to be increasingly theoretical and often detached from mundane concerns, the study of past economic successes and failures straddles the borders of economics, economic history, history, political science not to mention anthropology and sociology (Flandreau, 2016). To this scattering of wisdoms, one must add a number of hurdles which Eichengreen recognizes as having obstructed previous inference: he mentions the continuity bias (a psychological phenomenon whereby current trends are simply extrapolated), peer pressure, and the fear of being ostracized, the dominant ideology and the pressure of big financial institutions.

Something should be said also about the fact that, by bringing economic history to the fore as a legitimate source of inspiration for policy making, the current crisis will only add to the political pressures weighing on the work of scholars. This is something to reckon with, especially since the economic history profession forms a relatively tiny group. In summary, the answer to the normative question whether we should learn from history is obviously a clear "yes." As to which lessons and how one gets to pick them, this book attempts to provide some answers and the next section provides indications as to the areas in which writing the history of central banks could become the source of valuable lessons – or perhaps practical imagination. Recent research questions, which this volume reflects, suggest that the history of central banks goes way beyond the remit of the traditional history of monetary policy or the institutional response to financial turmoil. In fact central banks are at the center of social, economic, and political processes and studying them provides rich perspectives on the development of modern capitalism.

4 Lessons Waiting to be Learned

4.1 The Central Bank as an Institution

From the point of view of modern monetary policy making, the history of central banks has been narrated as one of an institution whose predominant concern typically varied between normal times (price or exchange rate stability) and extraordinary times (financial stability). What seems to draw the most interest today, in the light of the recent financial crisis, is indeed this shifting balance between price stability and financial stability raising important questions as to what role a central bank should be playing in the future. Are we actually entering a new epoch? History can provide help in order to illuminate such top of the agenda questions. Modern central banks are the result of past debates, politics and an institutionalization of "experience" and power relations which we call learning. Historically they have been embedded in processes that were part of nation-building. By extending their network of branches across the country, or by being at a center of a system of liquidity provision ultimately tied to the national currency, becoming wholesale provider of this currency, they have defined the meaning of "domestic economy" and made modern macroeconomic policy possible.

4.2 The Central Bank as Part of the International Monetary System

A national central bank is not alone in the world. Today, there is a central bank in (almost) every country and they cannot operate in isolation. A century ago, in the wake of the crisis of 1907, Italian economist Luigi Luzzatti wrote a much-commented article calling for a conference in support of what he called (in an age fixated by the risks of a European war) "international monetary peace." He emphasized that owing to rampant spill-overs the national economy did not provide a relevant entity when it came to dealing with financial stress. International monetary cooperation was needed and urgent (Luzzatti, 1908). Central banks were to be the intermediaries – in a sense the diplomats – of this international peace. Simultaneously and partly prompted by the crisis, several advanced countries such as the United States and Switzerland indeed created their own central bank. Today, it is widely recognized that, interest-rate setting in a small open economy cannot be done without regard for the interest rate abroad. Recent mentions of the currency wars of the 1930s reflect the persistence and indeed perhaps amplification, of international interdependencies (Eichengreen, 2013). And there are limits to how much banking regulation can vary across countries in a world of free capital movements. So learning from history must also draw on the experiences of the international monetary system: The way in which central banks become part of the international monetary system – influencing it or being influenced by it – is a particularly relevant research direction.

4.3 The Central Bank and the Other National Institutions – Delineations and Limitations

As argued earlier, especially in continental Europe, the nineteenth century saw central banks taking more and more responsibility in the management of crises while the government was less visible. By contrast, after World War II, governments (i.e., the Treasury) played a considerable role in supervising the banking system etc. The division of monetary power between say, central bank, government, and parliament, not to mention the agency problem which central banking raises, is a complex subject that opens many positive and normative questions. It is important to try and understand why central banks evolved the way they did, in order to better understand the underlying issues that underpin the division of monetary power. Conversely, such a better understanding can inform prescription and transformations in legal statuses (e.g. Calomiris, Flandreau, and Laeven, 2015). In other words can we learn from history with regard to the delineation of the contours of central banks and to limitations placed on their reach?

4.4 The Central Bank from a Practitioner's Perspective

It is a conventional aphorism that central banking is an art rather than a science. This captures the essence of an important feature of the evolution of central banks, which have always found themselves at the center of a two-way flow, between economic theory on the one hand and the lessons from the practice on the other. In other words an important aspect of the "learning" of central banks hinges on the practitioners' experience and learning. This experience is kept in the memory of current policy makers. It is held in the publication, archives, and personal papers of former policy makers and their staff. Most central banks have a long history, encompassing past episodes of monetary and financial instability. Memory teaches patience, and both are two crucial virtues for effective public policy. This book's message to practitioners is that they should cultivate both.

5 The Chapters

The chapters in the book are divided into four parts: I) The central bank as an institution – the historical perspective; II) The central bank as part of the international monetary system; III) The central bank and other national institutions – delineation and limitation; IV) The central bank from a practitioner's perspective. We summarize the chapters briefly in the following.

5.1 The Central Bank as an Institution - The historical Perspective

Chapter 2: "The Descent of Central Banks (1400–1815)" by William Roberds and François R. Velde

Whereas the bulk of papers in this volume concern central banks and central banking over the past two centuries from the Napoleonic era onward, this chapter provides a review over their early history from 1400 until the Napoleonic era ends in 1815. A Darwinian model is applied and the key idea is to capture evolutionary aspects and path dependence of these early banks. From this perspective, the structure of today's highly-levered, note-issuing, government-debt-backed central banks preserves a record of the successes and failures of past institutions. The authors argue that this biological metaphor also has some implications for the future of central banks. One implication is that in central banking, as in nature, there are no true steady states. Hence, the present structure of modern banks does not necessarily represent convergence. In fact the history of early public banks confirms nearly the opposite view, i.e., that unorthodox ideas of one generation of central banks may become the orthodoxy of the next. The authors see the evolution of central banking as a sort of alchemy, a continuous search for the right formula, and conclude that the search continues.

Chapter 3: "Central Bank Credibility: An Historical and Quantitative Exploration" by Michael D. Bordo and Pierre L. Siklos

Empirical measures of credibility, based on inflation performance, are supplemented with historical narratives drawing on extensive and detailed analysis of historical evidence of ten 11 central banks over their lifetime, spanning 150 years or more. The results indicate that credibility changes are both frequent and can be of quite significant magnitude. Second, the authors find that institutional factors (i.e., the quality of governance), plays an important role in preventing a loss of credibility. Third, credibility shocks are shown to depend on the type of monetary policy regime in place, such as whether the Gold Standard applies or there is central bank independence. Finally, credibility is most affected by whether the shock can be associated with policy errors.