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Introduction

Rodney Edvinsson, Tor Jacobson and Daniel Waldenström

In 2018 Sveriges Riksbank celebrates its 350-year anniversary. This volume outlines the Riksbank's historical development, along with the histories of some of the more important and dominating central banks worldwide.

The Riksbank was established in 1668, after the collapse of Stockholms Banco. It is thereby the world's oldest central bank, at least among the currently existing central banks.[1] Even if Sweden is a small country, and the Riksbank a small central bank, its unique historical continuity offers an international point of reference for studying the evolution of central banking in the international monetary system.

One ambition with this book is to place the history of the Riksbank in an international context of the development of central banking. For this reason, it assembles historical presentations of major central banks in the world, and presents comparisons between these. Each chapter on central banks in various countries – one chapter per bank – has a common theme, centred on their history of central banking practice and the various functions of money and central banking in different periods.

By attempting comparative historical analyses, this collective volume aims to clarify our understanding regarding some of the main lessons to be learned from the evolution of central bank institutions around the world. The tasks of central banks have evolved over a long period and are therefore, to a considerable extent, historically contingent. As shown in this book, many of the functions performed – or potentially performed – by central banks could well be undertaken by other organisations or institutions in society; for example, the private financial system, or other

[1] Which bank was the first acting central bank is, however, another, and still debated matter. For example, Quinn and Roberds (2006) claim that the early Bank of Amsterdam acted as central bank in the early sixteenth century.

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governmental authorities. A recent example is the responsibility for micro-prudential bank supervision now re-allocated to the Bank of England. The question remains, what features characterise a central bank? Many of today's central banks were established after episodes of financial panic. Economic crises as stimuli for financial innovation are a fascinating phenomenon, still far from fully understood. In some countries, most notably in the USA and in Brazil, central banks were not called for until the twentieth century. Whereas in other countries they have been in place for centuries. Through a better understanding of regularities and irregularities in the past of central banks, we may be in a better position to foresee their future development.

1.1 Overview of the Book

The book contains 13 chapters – excluding this Introduction – written by some of the world's more prominent and renowned scholars on central bank history. The next chapter is intended to provide the readership with an international overview for the evolution of monetary policy regimes and central banking throughout four centuries, and is written by Michael Bordo and Pierre Siklos. They argue that the shifts from one monetary regime to another, for example from the Classical Gold standard to the gold exchange standard, have not always been smooth. Financial crises and the desire to maintain price stability contributed considerably in the transformation towards modern central banking. The chapter combines a narrative and econometric approach and investigates how the timing of the establishment of a central bank impacted on various economic variables, and poses the important counterfactual question of how aggregate economic activity would have developed had not a centralised monetary institution been in place. The authors show that the gold standard delivers the lowest inflation rate, while the Bretton Woods system the higher economic growth. The role models for central banking were the Bank of England in the eighteenth and nineteenth centuries, and the Federal Reserve in the twentieth century. However, in the late twentieth century, it was small open economies that were more prone to adopt new policy regimes, when the old ones no longer served their purpose.

Chapter 3, written by Klas Fregert, presents a history of the Riksbank – or Sveriges Riksbank – from an international perspective. One of the central questions raised is how the Riksbank has performed relative to its mandates, and the chapter finds a great deal of continuity in this respect. During the first 260 years, the convertibility of the

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Riksbank deposits and notes into metal, and into foreign currencies until 1992, have been its overriding mandate. Already in the charter from 1668 it is stated that one purpose of the bank is to uphold the value of domestic coins. However, on several occasions the bank had to suspend convertibility, many times due to a crisis, such as warfare. Another mandate has been to take a responsibility for the financial system, which in its first century entailed that the Riksbank was the only financial intermediary. Although Stockholms Banco in 1661 was the first bank to issue paper notes in Europe, its subsequent failure delayed a further expansion of paper notes to the eighteenth century. While the King's attempt to use the Riksbank to finance the war with Russia in 1788 failed, the King nonetheless established a parallel currency issued by Riksgäldskontoret – The Swedish National Debt Office – which made the Riksbank irrelevant up to 1803. During the course of the nineteenth century, the Riksbank transformed from *the* (only) bank to *a* bank (among other banks), as a consequence of the expansion of private banking, and finally took the role of a central bank in the early twentieth century. In 1895 all interest-bearing deposits were closed, and the Riksbank obtained monopoly of issue in 1904. The Riksbank suspended convertibility in 1914 and 1931, and Sweden joined the Bretton Woods system in 1951. The banking sector was deregulated in the 1980s, which was followed by two major financial crises: 1991–1994, which was largely domestic, and 2008–2009, which was arguably mostly internationally caused. Inflation targeting was declared in 1993, after the abandonment of the fixed exchange rate in 1992.

In Chapter 4, Charles Goodhart offers a novel account of the history of the Bank of England. Given the considerable number of books written about this bank, the chapter is not yet another chronological overview. Instead, it describes the various functional activities and responsibilities of the bank separately – the relationships to the government, the people and other commercial banks – and explores how they have evolved over time. The Bank of England was established in 1694, and is thus the second oldest central bank in the world. It was originally established by the government to finance warfare, and continued to play that role later as well. For the main part of its history, up to the fall of the Bretton Woods system, the objective has been to maintain an external standard. At its inception, the bank received deposits from the general public, but their importance declined over time relative to notes. The bank ceased its activities as a commercial bank in 1914, enabling a focus on its role as a banker's bank. The main connection the bank has had with the general public is

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through its role as note issuer, and from 1844 it became the sole note issuer in England and Wales.

Chapter 5 covers the central bank of Spain, Banca de España, and is written by Pablo Martín-Aceña. Spain's central bank has old roots. Banco Nacional de San Carlos was established in 1782 by Charles III. The chapter argues that this was the same bank as Banca de España, on account of an institutional continuity. It was renamed as the Bank of San Fernando in 1829. The bank began issuing banknotes in the 1840s and in 1856 the bank was again renamed Banca de España. However, from an early stage the bank engaged actively in the government's monetary and fiscal policies, and gained monopoly of issue in the late nineteenth century. During the Spanish Civil War the Bank of Spain was divided, and a national and republican peseta circulated in parallel for three years. During the Franco regime, the Bank of Spain became an appendix to the Treasury, while after 1975 it regained its role as a monetary authority.

Chapter 6 deals with Banque de France, and is written by Vincent Bignon and Marc Flandreau. The French central bank was founded in 1800 by Napoleon Bonaparte and controlled by bankers, gaining monopoly of note issue in 1803. The bank was not formed to refinance sovereign debt, as in the case of the Bank of England and Norges Bank, and, in its ambition to stabilise the system of payment, was closer to the Bank of Amsterdam and the Riksbank. The bank also served the financial system by discounting bills of exchange. While the second half of the nineteenth century was characterised by a resilient financial system, in France accompanied by a low long-term inflation rate, the two world wars were a game changer. France was part of the gold bloc, and missed the recovery after the Great Depression because it was last to devalue. The Bank of France lost its independence in 1936, and was finally nationalised in 1945. After the Second World War the franc was regularly hit by exchange rate crises, and the euro could be seen as an institutional fix to that problem.

Chapter 7 describes the Dutch history of central banking, and is written by Gerarda Westerhuis and Jan Luiten van Zanden. The chapter takes a very long-term perspective and begins with the Amsterdam bank, which was founded in 1609 and functioned as a role model for Stockholm Banco and the Riksbank. For a very long period the bank money of Amsterdam bank was very stable, but confidence in the bank eroded in the late eighteenth century, and it was liquidated in 1821. The current De Nederlandsche Bank was founded in 1814, but served initially both public and private actors with ordinary retail functions. In this way, the activities resembled those of the Riksbank, which at this time had not taken on the

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full role of a central bank, and was essentially also a publicly-owned commercial bank. In the nineteenth century most shares of DNB were in private hands, and could distribute quite high dividends. At the end of the nineteenth century and beginning of the twentieth century the bank developed into a banker's bank. With the Bank Act of 1948, it became focused mostly on public, rather than private functions.

In Chapter 8, Øyvind Eitrheim and Jan Tore Klovland write the history of Norges Bank, the central bank of Norway, which was established in 1816, after Norway was separated from Denmark. Although Norway and Sweden formed a political union which lasted over most of the nineteenth century, Norges Bank nevertheless functioned independently, performing central bank services to the Norwegian economy. The chapter compares the developments in Norway and Sweden, and shows some striking similarities, for example in the development of consumer and real estate prices, but also points to important differences. In 1875, Norway, Sweden and Denmark formed the Scandinavian Monetary Union, and the krona was introduced as the common currency, but the union collapsed in 1914. During the Second World War there was a *de jure* Norges Bank in London, and a *de facto* Norges Bank in Oslo. As is the case for Sweden and the UK, Norway has not joined the euro.

Chapter 9 deals with the Italian central bank, Banca d'Italia, and is written by Gianni Toniolo. He discusses the specific circumstances of the evolution of Italian central banking: the political unification, the backwardness of the economy, the bank-oriented financial system and a relatively inefficient public administration. While the Italian financial system had once been the most advanced in Europe, by the time of the political unification in 1861 it was backward. The first decades of the Kingdom of Italy were characterised by the operation of several monetary authorities. The Bank of Italy was formed as a merger of several banks of issue in 1893, after the bankruptcy of the Banca Romana. According to Toniolo, Banca d'Italia graduated as a modern central bank after the crisis of 1907, when it became responsible for both monetary policy and the stability of the financial system. However, it did not gain monopoly of issue until 1926.

In Chapter 10, Masato Shizume deals with the Bank of Japan. After the Meiji Restoration in 1868, the government moved to establish a modern monetary and financial system. However, this turned out to be a process characterised by many trials and many errors. The Bank of Japan was formed in 1882, and was granted the right to issue banknotes alone. The primary objective of the bank was initially to reduce the quantity of

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notes in circulation, but also to consolidate the banking system. The gold standard was adopted in 1897, although suspension of convertibility occurred in 1917. Convertibility was briefly resumed in 1930, and then abandoned in 1931. The bank was reorganised in 1942. After Japan had lost the war, the bank faced ballooning government debt and high inflation. The bank provided liquidity for economic growth up to the 1970s, when a refocus was made towards stabilising the domestic economy.

In Chapter 11, Barry Eichengreen writes about the evolution of central banking in the United States. He divides its history into two eras: one before 1935, characterised by decentralisation due to opposition to the formation of a central bank system; and a second era after 1935, when the Federal Reserve became more centralised. The hostility towards central banking in the US goes back to the tension between the rights of the states and the federal government. There were two earlier, failed, attempts to introduce central banking in the country, the last one ending in 1836. The period 1837–1862 is sometimes described as the free banking period, since in these years only state-chartered banks existed, issuing their own notes which were convertible into specie. In the 1860s the union established federally-chartered banks, and nationwide banks were required to back their notes with federal government bonds. The Federal Reserve was established in 1913 as a consequence of the financial panic in 1907, which had demonstrated that the lender of last resort function could not be fully performed by private agents. The early Fed had a hybrid design, where different reserve banks asserted their independence, which inhibited expansionary open market operations. It was the Great Depression that exposed the weakness of the decentralised approach, when the Fed failed to act as lender of last resort. The chapter also describes the post-war episodes, such as the high levels of inflation during the 1970s and the Subprime crisis in the 2000s, and the unorthodox policies that the Fed developed in its aftermath.

Chapter 12 covers the history of the Bundesbank, and is written by Jakob de Haan. Germany's post-war central bank, the Bundesbank, was Europe's largest central bank at the time of the introduction of the euro. The Bundesbank continued to exercise the central bank functions that had already been performed by its predecessor, the Reichsbank, which existed between 1876 and 1945 and had a very volatile history. The financing of the budget deficit by the Reichstag from 1916 led to the well-known German hyperinflation period. In 1924, the new Reichsmark was set equal to one trillion (old) marks. After the Second World War the monetary system in Germany was in disarray for a second time, and the

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Reichsmark became virtually worthless. In 1948 the allied forces created the Bank Deutcher Länder, and the D-mark replaced the Reichsmark. In 1957 the Bundesbank Act was passed, and the Bundesbank succeeded the Bank Deutcher Länder in 1958. Whereas the Bundesbank Act left it open to prioritise the internal or external value of the D-mark, the bank had to choose exchange rate stability over price stability. After the fall of the Bretton Woods System, the fight against inflation became the main goal of monetary policy. In the 1980s the Bundesbank was the most independent central bank in the world. In the 1990s, the Bundesbank oversaw two monetary unifications. Upon joining the euro, the Bundesbank became the largest central bank in the European System of Central Banks and it is probably fair to say that the monetary policy of the European Central Bank bears some resemblance to that of the Bundesbank.

Chapter 13 is written by Franklin Allen, Xian Gu, and Jun "QJ" Qian and is an historic account of the People's Bank of China, and is to the best of our knowledge the first one, thus quite the opposite of the case of the Bank of England. China had long experimented with paper currency and financial institutions, but it was not until 1897 that the first modern bank was formed – The Imperial Bank of China. The Nanjing-based Republican government established the Central Bank of China in the late 1920s; in the 1940s its excessive note issue led to hyperinflation. The People's Bank was formed in 1948, right before the foundation of the People's Republic of China. Despite being the world's largest central bank, its conduct of monetary policy is still not completely understood. The chapter shows how the People's Bank of China has evolved from initially a mixture of a commercial bank and a central bank, to what can be thought of as a modern central bank. The chapter further discusses the various policy instruments used by the People's Bank and how various financial reforms have promoted the development of the financial system and fostered economic growth.

In the final chapter, Otmar Issing outlines the evolution of the youngest amongst our selection of central banks, namely the European Central Bank, established in 1999. Issing shows that the European Central Bank has historically unique features in that monetary policy pertaining to the euro area has been ceded to a supranational institution. While the convergence criteria all involve nominal variables, real criteria – as given by theories of optimal currency areas, which emphasise real aspects – have been ignored. Its short history is filled with experiences providing various lessons for crisis management. During the recent financial crisis, the European Central Bank

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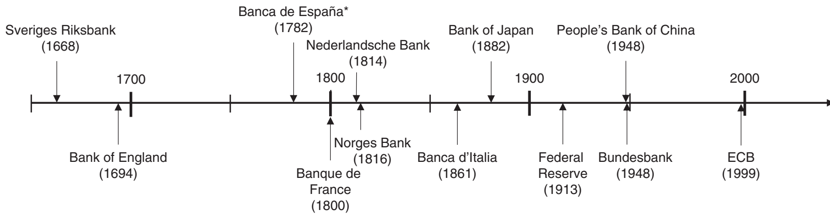

Figure 1.1 Timeline of central banks based on founding years (* denotes predecessor's founding year)

relied on a battery of measures, which contained the downside risks to price stability. Issing also discusses future challenges, for example the problems with the present low interest rate policy, which arguably may increase the risk of a future crisis, and the *de facto* deviations from the non-bailout clause.

The timeline of the central banks covered in this volume, ranked according to their founding years, is shown in Figure 1.1.

1.2 What is a Central Bank?

The evolution of the functions in central banking can be linked to the evolution of three important functions of money: as a medium of exchange, a unit of account, and a store of value. Following Stanley Jevons, one can also add the monetary function of a standard of deferred payment to this list.[2] The most important of these functions is money being a medium of exchange. Historically, establishing a common unit of account and standard of deferred payment has at times been a difficult process, and it was not fully accomplished until the Classical Gold standard of the late nineteenth century. It was during the Classical Gold standard that many central banks adopted functions that today are viewed as the defining features of central banking, although, as Eichengreen argues, a metallic standard itself provided the means to accomplish price and economic stability, without a central bank.

A precondition for a standard of deferred payment is a unit of account whose value is stable over time, i.e., that the debt money fulfils its role as a store of value. If there is great uncertainty concerning the future value of the means of payments that are used to repay debts, transaction costs increase, and may undermine financial intermediation altogether. The role of central banking is to reduce those risks and increase social trust, which

[2] Jevons (1875, p. 13).

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also lowers the interest rate. If the private banking system is at risk of collapsing, central banks must act as lenders of last resort, i.e., as the defenders of convertibility of bank accounts.

As in the case of money, the definition of central banking is multi-faceted and there does not seem to exist any one definition of central banking that is accepted by all. For this reason, it is not trivial to judge which was the first central bank, and, more importantly, exactly when a bank becomes a central bank. The functions performed by central banks have also evolved over time, and sometimes central banks have retaken some of the functions they have previously performed, while abandoning others.

The IMF's (2016, p. 33–34) manual on monetary and financial statistics provides the following definition of a central bank, followed by a list of various functions usually performed:

> The central bank is the domestic financial institution that exercises control over key aspects of the financial system ... The central bank functions generally comprise the following: (1) issuing currency; (2) conducting monetary policy, including by regulating money supply and credit; (3) managing international reserves; (4) transacting with the IMF; (5) providing credit to ODCs [Other Depository Corporations]; and (6) usually acting as banker to government in holding central government deposits and in providing credit in the form of overdrafts, advances, and purchases of debt securities.

Obviously, not all these functions were performed at all times by the banks discussed in this book. The term proto-central banking may be used to describe central banks that do not perform fully all functions of a modern central bank. Eichengreen suggests that since the Bank of United States in its capacity to redeem notes could be seen as a kind of monetary discipline, it assumed a proto-central bank role. The Second Bank assumed further proto-central bank functions, such as acting as a fiscal agent, performing open market operations, and intervening to stabilise the value of the dollar. Similarly, Westerhuis and van Zanden describe the Amsterdam Bank as a proto-central bank. The IMF definition is quite broad, and could be applied on the early proto-central banks established in the seventeenth, eighteenth and nineteenth centuries, including Stockholms Banco, the predecessor to the Riksbank. As mentioned by Bordo and Siklos, some of these banks were termed 'bank of issue', while the term 'central bank' first came into usage in the nineteenth century. Many of the early central banks were in fact the only banks, for example the Riksbank in 1668, or Norges Bank in 1816. As shown by Allen, Gu and Qian, the People's Bank of China was, although under a completely different economic system, initially also such a 'super bank'. Most of the banks discussed in this book assumed

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modern central bank functions in the early twentieth century, although Allen, Gu and Qian argue that the People's Bank of China did not start to function as a central bank until 1984.

The main function of a central bank is to provide and defend the value of the currency. The most important instrument to maintain that function consists in the control of the monetary base, with the backing of a state authority. According to the IMF, a currency 'consists of notes and coins that are of fixed nominal values and are issued or authorized by central banks or governments', while the domestic currency 'is the one that is legal tender in the economy' (IMF, 2016, p. 58). The monetary base 'comprises central bank liabilities that support the expansion of credit and broad money' and 'is defined as currency in circulation, ODCs' deposit holdings at the central bank, and those deposits of money-holding sectors at the central bank that are also included in broad money' (IMF, 2016, p. 197). The last quote also entails that deposits at a central bank from non-financial corporations or households are also included in the monetary base. For example, the bank money of Amsterdam Bank and all the deposits in the early Riksbank could be classified as a monetary base, if the two banks are classified as central banks. As shown by Westerhuis and van Zanden, the Amsterdam Bank enforced the use of its bank money by suppressing alternative uses; furthermore, private banking was not allowed – in this way the Amsterdam Bank functioned as a proto-central bank. If the unit of account of a currency always follows the issued currency that functions as a means of payment in its role as legal tender, the latter cannot lose its fixed nominal value. In contrast, private banknotes – and accounts in private banks – that are not legal tender can lose their nominal value, or even become worthless, and are therefore neither part of the domestic currency, nor the monetary base. Private note issuing banks during the free banking period were unable to perform central bank functions, since they did not control the monetary base. Their ability to perform the role of lender of last resort and government's bank in times of emergency was limited, since they could not issue a theoretically unlimited amount of notes that would be generally accepted, and backed by a state authority. Interestingly, the paper notes of a central bank may, similar to private notes, not be legal tender, as was the case with the banknotes of Bank of France in the nineteenth century. However, that limits the role of the bank as a central bank. As discussed by Bignon and Flandreau, this entailed that any doubts concerning the convertibility of notes could have led to the refusal of those notes in payment, which would have threatened the bank's ability to issue more banknotes to mitigate a liquidity crisis, one of the most important functions of a central bank.

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