1 The Institutional Make-up and Evolution of Central Bank–Government Relations: An Introduction

INTRODUCTION

As the twenty-first century begins, central banking would appear to be at a crossroads. From lender of last resort, to active participant in stabilizing economic fluctuations, and now as the guardian of price stability, much is expected from the monetary authority. Indeed, where once fiscal policy was considered the main instrument of economic policy, the ascendancy of monetary policy became especially noticeable by the late 1980s in much of the industrialized world with profound implications for the role of the central bank. Yet, as this is written, financial innovations seemingly threaten once again the position of central banks as the dominant force responsible for ensuring financial stability and in influencing economic outcomes.[1]

There is an important sense in which, over the past several decades, central banking has been at the mercy of whim or fashion. "At a time when the price level is rising and employment is relatively full, price stability takes precedence over full employment as a policy objective. At a time when prices are stable and unemployment is rising, on the other hand, employment becomes the prime objective. A better measure of central bank conservatism might be the length of time it takes for him to accept a change in conditions and adjust his thinking accordingly" (Whittlesey 1970: p. 225).

The above quote highlights the fact that the practice of central banking involves a considerable amount of learning and adaptation to a

[1] Since the present study is not about the future of central banking I shall, for the most part, avoid the question of whether central banks are indeed even necessary. See, however, Chapter 2, Friedman (1999) and Goodhart (1999).

changing environment, a theme now gaining wider acceptance, both in terms of formal models (as in Sargent 1999) as well as in historical descriptions of central bank policies throughout this century (see Howitt 2000; Siklos 1999a). Yet, an understanding of such developments requires more evidence than has heretofore been brought to bear on the issues.

This study examines, using both qualitative and quantitative evidence, the evolution of central banks and their policies since the end of World War II. The degree to which central banks have tended to be cast as separate, if not at times autonomous, institutions from the rest of government has changed considerably over the past fifty years. This separation has been the cause of considerable tension, particularly when the preferences of elected officials seem to conflict with those who manage monetary policy. Among the questions considered in this study is how seriously one ought to take institutional elements in central bank–government relations as the crucial ingredient in gaining an appreciation for the evolution of the monetary authority's influence vis-à-vis government. The conclusions, as we shall see, are very much in the mold of the proposition that institutions matter and that it is of inherent interest to explore how central banks have evolved the way they have over the past fifty years or so.

Nevertheless, central bank behavior cannot simply be about what banks are legislated to do. No statutory relationship can define either day-to-day central banking operations, nor can it ultimately dictate the influence of the personalities who set the direction of monetary policy. Therefore, politics and the preferences of the central bank may intrude on the institution's evolution and performance. Louis Rasminsky, a former governor of the Bank of Canada, put it best in his Per Jacobsson Lecture (1966: p. 116): "The formal status of the central bank varies a great deal from country to country. In any case this is a field in which the real situation is not likely to be revealed by the terms of the statute. Much depends on history and tradition and a fair amount even on the personalities involved."

Despite the appeal of institutional economics there are some limitations to the approach as will become apparent. We simply do not yet know enough about why certain central banking and monetary policy frameworks work better in some countries than in others. In part for this reason the present study resorts at times to the case method approach to illustrate the significance of institutional or economic factors which are relevant to an understanding of central bank behavior. We have, however, learned a great deal over the decades about key aspects of

monetary policy implementation and central bank–government relations that work and these do highlight the central role of the institutional structure in place.

This study is also prompted by the need for more comparative evidence on the activities of central banks and their place in government. While economists have, very recently, embarked on such a task, the available comparative evidence is relatively thin. Moreover, a significant portion of recent research tends to be cast in terms of an approach introduced by economists in the 1990s to characterize the conduct of monetary policy, primarily in the United States. Perhaps more importantly, there has been a gulf between various strands of literature dealing with central banks. Some view central bank operations solely through the lens of statutory and other legal aspects of central bank behavior. Other literature presumes complete freedom of action by the monetary authority to set interest rates and the question then becomes what weight the central bankers place on controlling inflation versus some real objective such as output growth or unemployment. Finally, an altogether separate literature interprets central bank behavior as being significantly affected by political forces.

Discussions of the myriad of pressures on monetary policy in one place is not available and this study hopes to at least make a start at looking at the relative importance and influence of each across countries and over time. Existing theories in each strand of the literature are now fairly well developed and, though some modest points about the relevance of existing theories will be made, the study is mainly about building and sifting through the available evidence about what central banks have done, and why, over the last half century.

INFLATION THEN AND NOW

A few words are in order about the choice of the post-World War II era for analysis. First, as will be seen in the next chapter, the economic environment and mission governing almost all central banks being studied here altered substantially following the decade of the 1940s. It is fair to say that while central banks have always been viewed as lenders of last resort, their role in stabilization policy was far more passive in the pre-World War II era than thereafter. Moreover, cataclysmic events such as wars and revolutions were relatively more prevalent prior to the 1950s. Finally, the behavior of inflation is sufficiently different in the years before World War II which suggests that other forces were at play rather

than the ones that are the prime concern of this study. To illustrate, Figure 1.1 plots inflation in Germany and the United Kingdom since the middle of the nineteenth century. In the case of Germany the plot omits the years of hyperinflation, another feature of the pre-1950s history of inflation (also see Siklos 2000a). Two important distinguishing features of the pre-World War II era include the more-or-less regular appearance of periods of deflation, and the relatively greater volatility of inflation. While there are no doubt several proximate causes for these distinctive characteristics in the inflation process, the Gold Standard and the Great Depression clearly come to mind as the main explanations for this outcome. In contrast, as we shall see, the post-World War II era is dominated by persistently positive inflation rates and changes in policy regimes that shall be the focus of the discussion in the remainder of this study. To illustrate, Figure 1.1c shows inflation in New Zealand since 1930. There is a consistent upward trend in inflation until the middle 1980s when major reforms, not just ones affecting the position of the central bank, produced a sharp decline in inflation that has been maintained ever since (see Chapters 2 and 7).

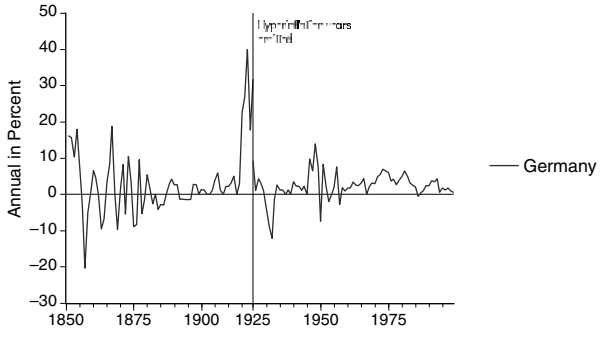
There are additional reasons to treat the years since the 1940s somewhat differently from the monetary policy experience of preceding decades. Consider a simple description of the relationship between the amount of slack in economic activity, referred to as the output gap (see Chapter 2)[2] and inflation. The resulting trade-off, usually referred to as the Phillips curve, can be written in simplified form as

$$\pi_t = \pi_t^e + a\tilde{y}_t + e_t \tag{1.1}$$

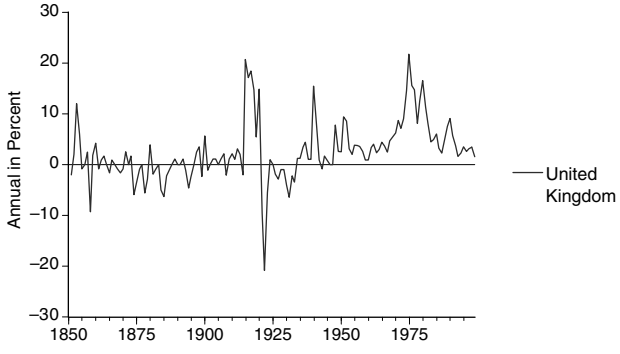
where π is the actual inflation rate at time t, π^e are inflation expectations also at time t (though possibly conditioned on information available only up to time $t-1$), $\tilde{y}$ is the output gap and e_t are random "shocks" to inflation. The latter can be thought of as having a zero mean and a constant variance. The coefficient a is positive suggestive of the notion that inflation is lower when there is excess capacity in the economy ($\tilde{y} < 0$) than when the economy produces more than its potential (that is, $\tilde{y} > 0$). Versions of Equation 1.1 are part and parcel of most standard macroeconomic models. There is, of course, continuing controversy over the existence of the Phillips curve trade-off, whether linearity is an appropriate characterization, as well as the extent to which the trade-off is "exploitable" by governments and central banks. We shall return to some

[2] The output gap is simply the (percent) spread between actual and some measure of potential aggregate output.

(a) Germany



(b) UK



(c) New Zealand

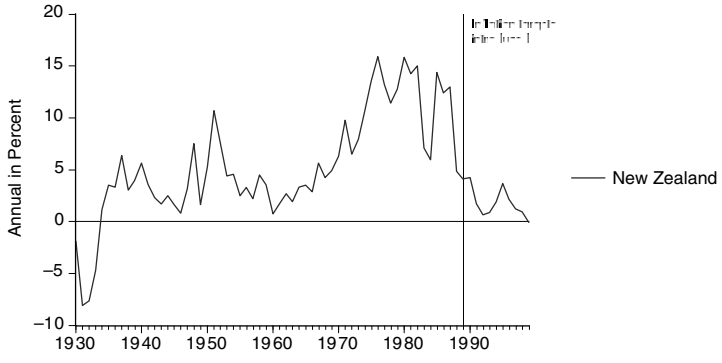


Figure 1.1 Inflation in Germany, the United Kingdom, and New Zealand over the Last Century (*Sources*: Mitchell (1992), updated from sources described in Chapter 2, and at http://www.wlu.ca/~wwwsbe/faculty/psiklos/centralbanks.htm.)

of these questions throughout this study.[3] Nevertheless, what is germane for the moment is the role played by central banks and the policy regime in place. One reason is that, as we shall see, some policies or institutions are better able to anchor expectations than others. This has the effect of minimizing deviations between π_t and π_t^e with implications for the behavior of $\tilde{y}_t$, other things being equal. Indeed, it is apparent from the foregoing discussion that, since policies aimed at influencing inflation and the output gap also lead to more variability in both variables,[4] delivering the best possible monetary policy should aim at minimizing variability in both. Recognition of this idea has led to the formulation of a "new" policy trade-off, namely one between inflation and output variability.[5] Nevertheless, these developments also suggest the necessity of a fairly good understanding of what drives expectations, the ability to model economic relationships that recognize forward looking behavior, as well as identifying economic shocks, among other requirements.

Figure 1.2a makes clear that, in terms of the "new" trade-off, the performance of monetary policy was, for the most part, substantially different after World War II than in earlier decades, at least if we take the U.S. experience as representative. Figure 1.2b makes the same point but via comparisons across policy regimes, again for U.S. data. Hence, we find that inflation and output volatility are considerably smaller during the period of pegged exchange rates, known as the Bretton Woods era, and still better under inflation targeting. The respective roles played by central banks and institutions during these regimes will also figure prominently in the present study.

The remainder of this chapter gives a taste of what is to follow as well as briefly highlighting the need to bring together the separate elements of the literature on central banks.

GOVERNING STRUCTURES

In most industrialized countries, the legislation governing central banks has the same status as that of any other government body. Hence, the structure of government, electoral, and partisan activity, as well as inter-

[3] A recent, and highly readable, view of the current state of key aspects of the debate may be found in, for example, Akerlof, Dickens, and Perry (2000).

[4] Recognition of some facets of the debate owes a considerable debt to, for example, Friedman's Nobel Lecture (1977).

[5] Taylor's (1993) work probably originated this line of debate. Also see, however, the 1996 and 1999 Symposia held by the Federal Reserve Bank of Kansas City (most notably Fischer 1996, and Taylor 1996), Svensson (2001), Taylor (2000), and Walsh (2000a) for highly readable accounts of the principles behind the "new" trade-off.

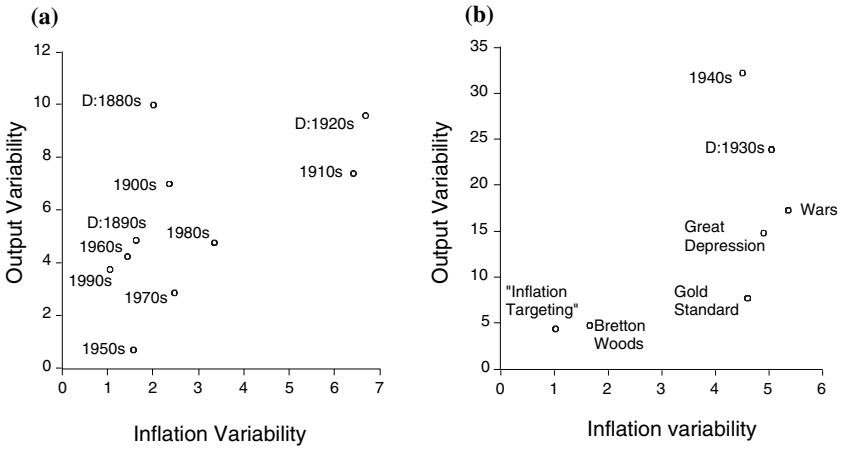


Figure 1.2 Inflation and Output Variability: The U.S. Historical Experience (*Note*: The plots show the variance of real GDP and CPI inflation by decade (part a), and by regime (part b), based on annual data. The Great Slump is the 1928–32 period; wars are 1914–18, 1939–45, and 1950–53; Bretton Woods is 1959–72; the Gold Standard is 1873–1919; "inflation targeting" is 1987–2000. *Sources*: See Figure 1.1.)

national considerations, in large part via the choice of exchange rate regimes, will contribute to explaining central bank performance. In other words, legislation covering the central bank is not typically organic in that it is not protected by some constitutional provision and can, therefore, be amended with relative ease. Hence, a central bank is usually a creature of the central government, to whom it ordinarily pays seigniorage profits, even under a federative structure although the latter can, as we shall also see, have the potential to indirectly influence central bank behavior. In part for this reason the question of appointments and the manner in which central banks govern themselves are potentially important questions though only the former has, until recently, attracted considerable academic interest. While this development is understandable, it will be argued here that such focus on appointments procedures is partly misplaced. First, central bank personalities tend to matter more in times of crises rather than as a rule. Second, central banks, in recognition of changing objectives of governments and society, and due to a growing desire for accountability and openness on the part of public institutions, have formally or informally changed how monetary policy decisions are made and communicated to the public. Issues of governance have thus become paramount, an aspect downplayed in the current literature. Why is governance important? As Williamson (2000:

p. 599) points out ". . . governance is an effort to craft *order*, thereby to mitigate *conflict* and realize *neutral* gains. So conceived, a governance structure obviously reshapes incentives" (italics in original). The foregoing quote clearly suggests that the changing face of central banks since World War II will be marked by such considerations.

Complicating matters is that, if the central bank is not mandated to supervise banks or the financial sector more generally, a separate piece of legislation will govern that authority as well as the degree of coordination between the central bank and the supervisory authority. Table 1.1 provides some general information about central bank governing structures in the countries to be examined in this study.

There are three aspects worth highlighting about governing structures as they exist today. First, central banks are overwhelmingly state-owned. This is not a new development but its roots can largely be traced to the aftermath of the Great Depression and the early post-1940s view that significant government intervention in the economy is warranted. Second, the typical term of office for a central bank governor tends to correspond or exceed the term of office of the political authorities. Nevertheless, terms of office for central bank governors or presidents vary widely, from four years to indefinite terms of office. In this respect, central bank observers have long argued about the desirability of having terms of office long enough to overcome the potential for political or partisan business cycles. Yet, there are also widely held beliefs about the significance of political economy influences on economic activity based on a large body of empirical evidence. The two views come into conflict in part because of difficulties in measuring the impact of political influences on central bank policies because of the role of the term of office in determining the degree of autonomy of the central bank, as well as other factors to be considered throughout this study (see also, Waller and Walsh 1996).

Finally, a more recent development has been the shift away from giving central banks responsibility for supervision of the banking system. Here too the evolution of policies reflects the tension between the need to avoid potential conflicts of interest between the central bank and the banks it supervises versus the need to ensure financial stability. Indeed, it is the growing importance of financial stability as a separate objective of monetary policy that, as we shall see, raises a potentially important drawback with recent reaction, function-based approaches to modeling central bank behavior.

Chapters 2 and 3 use the information in Table 1.1 and explore its implications in greater detail. A final comment is in order. The early

Table 1.1. Principal Ingredients of Governing Structures of Central Banks

Country	Ownership[1]	Profits[5]	Governor/President Term of Office[9]	Banking Supervision?[7]
Australia	State[2] (1948)	Finance Minister	7 years (R)	No (1998)
Austria	Public-Private (1965)	State according to formula	5 years (R)	No (see ECB)
Belgium	State-Others[3] (1948)	State in excess of 3%	5 years (R)	No (see ECB)
Canada	State[4] (1938)	State according to formula	7 years (R)	No (1992)
Denmark	State (1936)	Fixed amount to Finance Minister	Indefinite[6]	No
Finland	State (1933)	State according to formula	7 years[8] (R)	No (see ECB)
France	State (1945)	State according to formula	6 years[8] (R)	Combined
Germany	State[4] (1957)	State according to formula	5–8 years (R)	No (see ECB)
Ireland	State (1942)	Central bank with provisions for distribution	7 years (R)	Yes
Italy	State–Public Co. (1948)	Shareholders	Indefinite	Yes
Japan	State[3] (1942)	State according to formula	5 years (R)	Combined
Netherlands	State (1948)	State	7 years (R)	Yes
New Zealand	State (1936)	State subject to central bank budget	5 years (R)	Yes
Norway	State (1949)	State according to formula	6 years[8] (R)	No (1985)
Portugal	State (1931)	State according to formula	5 years (R)	Yes
Spain	State (1946)	Minister of Finance	6 years[8] (NR)	Yes
Sweden	State (1934)	Parliament with provision for central bank share	6 years[8] (R)	Yes
Switzerland	Public-Private	Shareholders	6 years (R)	No
UK	State (1946)	Treasury	5 years (R)	No (1998)
US	Banks	Shareholders	4 years (R)	Combined
ECB	National Central Banks (1999)	Allocation to member CB according to formula	8 years (NR)	No (1999)

[1] In parenthesis the approximate year central banks were nationalized or became state owned.
[2] Commonwealth owned.
[3] Bearer shares or "nongovernmental persons."
[4] Federal government.
[5] In the case of eleven EMU members (Austria, Belgium (Luxembourg), Finland, France, Germany, Ireland, Italy, Netherlands, Portugal, Spain) distribution information is prior to ECB formulation. Formula refers to allocation for expenses or reserve funds.
[6] Subject to maximum age (for example, seventy-five years).
[7] Refers to supervision of the banking and financial system. Central banks ordinarily retain authority over the payments system. Combined signifies a sharing of responsibility with either the finance ministry or other supervisory agencies. Even in the case where the central bank does not formally supervise the banking system there exist vehicles or arrangements that may directly or indirectly involve central bank actions.
[8] Most recent legislation has clarified term of office. Previously, that is, prior to the Maastricht Treaty, term of office was interpreted as indefinite.
[9] R = renewable; NR = nonrenewable.

Sources: Aufricht (1967), Capie, Fischer, Goodhart, and Schnadt (1994), Eijffinger and de Haan (1996), Goodhart and Shoenmaker (1995), Grilli, Masciandaro, and Tabellini (1991), and various publications from national central banks. See www.wlu.ca/~wwwsbe/faculty/psiklos/centralbanks.htm.

history of central banks, and of central banking, involved the establishment of monopoly note issuing authority and lender of last resort functions. Indeed, as shown in Table 1.2, central banks were institutions created to finance wars, manage the public debt, or consolidate note issuing authority, ostensibly to restore confidence and stability in the monetary system. More cynically, they also served the interests of governments via the seigniorage revenues they generated. By the early decades of the twentieth century, the lender of last resort function took on greater importance. The history of central banking since World War II is principally about the establishment and evolution of autonomy and the manner in which monetary policy is conducted. That is the primary interest of the present study. There are several excellent references to the early development of central banking (for example, Eichengreen 1992a; Goodhart 1988, 1995).

CONFLICTS AND CONFLICT RESOLUTION

The potential for conflict between central banks and governments suggests that disagreements about objectives, policies, or both, can emerge with far-reaching consequences. Again, statutory arrangements, politics, and personalities all play a role in the likelihood of such conflicts surfacing. However, economic activity will undoubtedly be the proximate cause for any conflicts since it is to be expected that, particularly at times when the economy is under stress, the preferences of the central bank and the government may deviate most from each other. Nevertheless, once conflict develops, the other factors mentioned above may prove to be decisive in the outcome. Many authors (for example, Capie, Fischer, Goodhart, and Schnadt 1994; Cukierman 1992; and Eijffinger and de Haan 1996 represent a partial list) have pointed out the importance of conflict between the monetary and political authorities. However, it appears that these authors have treated the role of conflicts, and the procedures invoked to resolve them, as no more important than the many other characteristics that define government–central bank relationships. Details about how one can proxy conflicts and conflict resolution processes are discussed in the next chapter. Historical examples from several countries in our study, most notably Canada, New Zealand, Germany, the United Kingdom, and the United States, suggest that while conflicts are comparatively rare events, they can have a lasting impact on the extent of political pressures applied on central banks.