



Curzio Giannini

THE AGE OF CENTRAL BANKS



The Age of Central Banks

Curzio Giannini

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Foreword

Curzio Giannini, 1957–2003, was a brilliant economist. He was a passionately dedicated scholar of central banking, having worked most of his life, since 1983, at the Banca d'Italia. In the last months of his life he fought against his illness, supported by Vera, his wife, while working on this book in which he collected his published and unpublished works on the evolution and functioning of central banking. He was able to finish it only a few weeks before his death; entitled *L'età delle banche centrali*, 'The Age of Central Banks', it was first published in Italian by Il Mulino in 2004.

Besides this book, a selection of his published works include: 'Credibility without rules? Monetary frameworks in the post-Bretton Woods era' (IMF Occasional Paper, 1997); *Enemy of None but a Common Friend of All?* (Princeton Essays in International Finance, 1999); 'Moneta e Istituzioni Monetarie' (Hoepli, 2001); 'Pitfalls in international crisis lending' (in Charles Goodhart and Gerhard Illing (eds), *Financial Crises, Contagion and the Lender of Last Resort*, Oxford University Press, 2002); 'Lender of last resort', (ibid.); 'Promoting financial stability in emerging-market countries: the soft law approach and beyond', (*Comparative Economic Studies*, 2002); and 'Bedfellows, hostages or perfect strangers? Global capital markets and the catalytic effect of IMF crisis lending', (IMF Working Paper, WP/02/193, 2002, co-authored with Carlo Cottarelli).

Curzio was born in Chieti in 1957, and studied at LUISS Guido Carli in Italy, at the London School of Economics (LSE) and Oxford University in the UK, and at the University of California, Berkeley in the USA. In 1983 he joined the Research and International Relations Department of the Banca d'Italia and in 1999 was appointed Deputy Head of the Bank's newly created International Relations Office. He died of cancer in 2003.

Curzio had one of the most fertile and original minds ever to be deployed on questions relating, first, to the interactions between the central bank, private sector financial intermediaries and the government, and second to the working of the international monetary system in general, and to the role of the International Monetary Fund (IMF) specifically within that.

Until a couple of years ago, the concept had taken hold that the central bank could, and should, largely separate itself from the hurly-burly of the financial system, setting official interest rates in Olympian macroeconomic

solitude, leaving market developments to the beneficent workings of efficient markets on one side, while maintaining complete independence from government on the other. As that concept has become discredited, so we need to return to the much more nuanced and subtle institutional analysis that Giannini presents here. As Giannini states: ‘The mistake that neo-classical theories make is to consider money as a commodity. Instead, it is really an institution that is held up by trust: trust in its future purchasing power and trust in the continued convention that payment is complete when money changes hands.’ What Giannini outlines here is the essential institutional role that central banks should play in each country in maintaining that trust, a role that gives the financial stability objective at least equal billing to their price stability purpose.

Whereas the role of central banks within each country had seemed, mistakenly, to be settled and clarified a few years ago, the international monetary system, if it can be properly so called, has remained defective. International imbalances remain and fester. The IMF has no capacity to exert much influence, if any, on the most important countries whose policies really drive global developments. Curzio was a clear-sighted observer of all this, even if he had no blueprint for overcoming such intractable problems.

His approach has been to apply a ‘theory of history’, which provides a beautifully written and illuminating book, much easier and nicer to read and more rounded than the limited mathematical models that have so monopolized academia in recent decades.

Overall it is a privilege to present and to recommend this book to, I hope, a host of new readers.

Charles A.E. Goodhart
Emeritus Professor, London School of Economics

Foreword to the Italian edition

What role do central banks play and how has it evolved over the two centuries since they came into existence? How and why, in the course of time and in different places, have central banks acquired distinct but complementary functions that continue to be a topic of debate: issuing bank, lender of last resort, monetary policy-maker, banking supervisor, payment system operator? What mutations, from Bretton Woods to the European System of Central Banks and perhaps beyond, have given central banking its international dimension? How do these questions tie in with the history of money and its progressive dematerialization from commodity money to fiat money and to the advancing forms of electronic money? None of the paradigms of economic analysis – classical, Marxian or neoclassical – can fully explain the *raison d'être*, the development or the effects of economic institutions; monetary institutions are no exception.

In this elegant work, Curzio Giannini offers a compelling, overarching interpretation of the manifold responsibilities that have gradually fallen to central banks, which he views as complex institutions and not only as makers of monetary policy. The nature of central banks has been examined from different perspectives over the years: they are a natural response to the crises that accompanied the growth of bank money during a period of incomplete contracts and information problems in the credit and financial markets; they are entities whose purpose is to use the currency as a hidden tool of taxation for the state; they are agents whose task is to ensure the achievement of the final objectives of monetary policy – objectives that the increasing abstraction of money and growing complexity of intervention have reduced to the core requirement of price stability, to be pursued autonomously. Analysis, guided by history, has explored each of these dimensions, producing important theoretical and practical contributions. Yet these contributions all share a perplexing feature: none offers a comprehensive interpretation that can account for the enormous differences in the structure and functioning of economic systems, in public intervention in the economy, and in international trade and cooperation.

It is just such a comprehensive interpretation that *The Age of Central Banks* seeks to offer. The basic thesis is that central banks are neither a historical accident, the fruit of changing political interests, nor the inevitable

product of the instability and incompleteness of credit contracts, nor even a means of guaranteeing the price stability of money as a 'good' (not, in this instance, a standard good with a market of its own, but an institution that is necessary for the operation of all markets). The 'central bank' is the outcome of a gradual institutional evolution, the rationale of which resides in money's distinctive features compared with the other goods and services produced in the economic circuit. This evolution is not deterministic but path-dependent, correlated with the historical evolution of our political, social and economic systems. It depends largely on the fact that if money is to survive and perform its functions in economic transactions effectively in space and time it must instil and maintain a sufficient degree of confidence in its acceptability and future value. The role and the powers of central banks – indeed their very existence – derive from the ultimate purpose of sustaining that confidence.

This book provides an all-round view of the phenomenon of central banking, proposing an original and complex interpretation of the evolution of central banks at every level. Methodologically, it adopts a 'neo-institutionalist' approach. Social institutions such as firms, political parties, trade unions or, in this case, money are essential to allow individual decisions to be coordinated given high transaction costs, crucial information shortcomings and incomplete contracts. In the case of money, the analysis turns on the concept of 'payment technology' as the set of conventions, objects and procedures that make it possible to extinguish obligations arising from economic exchange. Here the fundamental problem is the incompleteness of the monetary contract, which must be remedied. The means of doing so are unavoidably flawed and determined by history, consisting in investment in the 'brand name' of a currency, upheld by rules and institutions designed to bolster confidence among those who use it.

In terms of instruments, Giannini's approach draws on the authoritative precedent of the 'theory of history' proposed by John Hicks, although without aiming for historiographical completeness. Through the examination of secondary sources, the analysis of the evolution of payment technologies in the pre-industrial age and the subsequent emergence of convertible currency, the study of banking crises and of the establishment of the first central bank, with the rise and fall of the various monetary regimes that preceded the fiat standard, the book marshals extensive and convincing evidence in support of the basic thesis. The debate on the independence of central banks, the credibility of their action and the recent proposals for a more or less flexible form of inflation targeting are also examined, with close attention for the occurrence and recurrence of general phenomena in different situations in time and space.

As to results, there is clear evidence that payment technologies have been designed, although not by intention or determinism, to increase the flexibility of money supply and its prompt adjustment to the needs of economic growth and to cyclical friction. Money supply thus becomes increasingly abstract, entailing a growing degree of risk, although it is also better able to respond to the 'deflationary drift' that is the true common denominator of the various payment technologies, all of which tend to be based on a rigid money supply, at least in the short to medium term. Clearly, this is a very different approach to that normally used to study the 'money market' and consequent formation of monetary policy. Nowadays, monetary issues are considered in the light of a token money that is easy to manipulate, not one that is relatively inflexible and impedes growth. From a 'theory of history' standpoint, however, although this view is useful for immediate operational purposes, it is not adequate for a fully satisfactory study of the institutions of money and central banks and their evolution over time, especially – and here lies the innovative force of Giannini's work – their future prospects.

These prospects encompass the evolution of the international monetary system itself. Globalization tends to alter the relationships between nation-states and central banks. The series of solutions proposed since the collapse of the Bretton Woods system show that the evolutionary process is in full swing, with new equilibria being sought in the institutional field as well. One strand of this search is the essentially supranational consortium model of central banking embodied by the European System of Central Banks as part of the monetary internationalism that has prevailed throughout history, regardless of the developments of the last century based on 'regional currencies'. Although profoundly different, the regimes of monetary union and of hegemony (the present dollarization of the economy) have a key feature in common: the renunciation of national monetary sovereignty. The result, however, is a highly unstable equilibrium; an 'imperfect bipolarism' that only a cooperative solution can overcome. Given the failure of the cooperative arrangements of Bretton Woods, the only possible solution is closer institutional integration. In the author's opinion one advisable direction would be that of cooperation within a soft-law system, a natural evolution of cooperation among central banks that is exemplified by the Basel capital accords and non-binding recommendations and best practices designed to promote financial stability. This is the method of cooperation adopted by the Financial Stability Forum, set up by governments, central banks and other market regulators in response to the financial crises of the late 1990s.

The book also examines the prospective relationships between central banks and the financial industry and between central banks and

governments. The first of these relationships is becoming increasingly complex, partly as a result of financial innovation. This has led, on the one hand, to the coexistence of payment technologies based on legal tender with exchanges based on bank money, which is likely to become predominantly electronic in the future; and on the other hand to the emergence of huge cross-border intermediaries. Thus the payment system has acquired a pre-eminent role and become a focus of attention, emphasizing the need to take account of the cash and securities settlement services now offered by private sector non-bank intermediaries but that were once the preserve of central banks. The result, in the author's description, is a 'pyramid under attack', which could have serious implications for monetary policy as well. Since providers of private payment services are likely to face major conflicts of interest and will be unable, on their own, to preserve the necessary confidence in money – the *raison d'être* of central banks – the latter are unlikely to disappear with the switch to electronic money or the development of elaborate financial superstructures.

What is happening to the role of central banks in assuring continued supervision of credit systems (broadly defined as financial systems) and acting as lender of last resort? Changes are taking place in this field as well, although their direction is less clear. In some countries the solution for the time being has been to strengthen the central bank's role and expand its functions; in others, the central bank has been stripped of its supervisory powers. In the field of monetary policy, with price stability now the key objective and the central bank entrusted with an institutional role at the highest level while remaining independent from the executive in the performance of its functions, how is it possible not to take account of movements of assets and liabilities in the stock and property markets, be it only in the interests of price stability? No answer has yet been found to these questions and the book addresses them only briefly, although from a very interesting angle. Although the most important developments will probably occur in the fields of supervision and regulation, that intangible but essential factor, confidence, will still have to be safeguarded. If the central bank as an institution rests on this principle, it will certainly not need to seek new lines of business. On the contrary, according to the arguments and evidence put forward in this book, it will become necessary to turn to it (how, is not yet clear) when evolutionary crises inevitably strike the capitalist system.

In July 2003 Curzio Giannini died at the end of a brief but relentless illness. Although aware that the battle was lost, he fought on to the end with fierce determination. His place in the hearts of his family, his friends and his fellow economists can never be filled. Apart from the courage with

which he faced the last months of his life, many will also remember his contribution in the professional field. Formal and casual exchanges alike benefited from his quick and lively intelligence, his erudition and his wide knowledge of culture beyond the bounds of economics. To his work he brought a rigorous analytical and methodological approach and broad historical and political perspective. Alongside these recollections and the many papers he wrote in 20 years of his career we now have the contribution of this ‘unfinished’ book, as he described it. Nonetheless, it remains an extremely valuable contribution and one that is certainly complete in its overall design, in the construction of its arguments, in the historical evidence it presents and in the conclusions drawn.

Curzio Giannini did not have time for the final discussions that an author normally seeks before turning a work such as this over to a wider readership, although the work does take account of many of the points raised in frequent discussions over the years. The book is a general theory of central banking based on money as an institution, although it is not unmindful of the fact that money itself is an evolutionary phenomenon. As far as the implications of his analysis go, it would be true to say that in the trade-off between a flexible and a rigorous conduct of monetary policy the second receives less attention than the first. It is a deliberate choice, and the author certainly does not consider the objective of price stability to be of secondary importance. It is partly a reaction to a sometimes overly deterministic view of economic relationships and the ‘methods’ of economic policy. I believe this book not only provides a firm and reliable guide to newcomers wishing to explore the difficult issues surrounding the role and evolution of central banking, but also raises new questions, generates useful doubts, offers some unexpected answers and opens up new vistas for those already familiar with this field. It remains for the reader to pass judgement on the finished product.

Ignazio Visco
Deputy Director General, Bank of Italy
April 2004

Preface

The idea for this book has been in my mind for most of my professional life. I began working on the history of the creation of the central bank in Italy while studying at Brasenose College in Oxford in 1984–85. However, I soon realized that the time was not ripe for the sort of research I had in mind. At that time, the Bank of Italy was considering setting up a Historical Research Office, primarily in order to give scholars access to documents pertaining to the history of money in Italy; there were enormous gaps in the existing data, but everything suggested they would soon be filled. The experience left me convinced that large tracts of the history of central banking were still very much unexplored, and prompted various observations and considerations that would prove useful in the years to come. During those months I also read Benjamin Klein's 1974 essay on the link between money and trust, which was to become a constant point of reference over the next years. Upon my return to the Bank of Italy I soon found myself involved in a project that helped greatly to forge my ideas about the evolution of central banks. That project was the drafting of the White Paper on the Payment System in Italy, published in April 1987. Nowadays, it may seem unimportant, another technical paper on one of the many aspects of central banking. At the time, though, its publication was a major event. The prevailing opinion in both academic and banking circles was that central banking began and ended with the conduct of monetary policy, and that this had always been more or less the case. According to this approach, the other functions, from management of the payment system to supervision, were merely coincidental, deposits left by history on the main body of the institution of the central bank. In reality it was an anachronistic view, or worse, an opinion without justification even when it was formed. The White Paper shed light on the many complex interactions linking payment system, structure of the banking system, conduct of supervision and monetary policy management. Taking part in drafting it was an exceptional and highly formative experience, with many exciting moments. Traces of analytical contributions remain in two articles already outlining many of the ideas I put forward in this book.¹

I came back to those ideas while attending the University of California at Berkeley in 1992–93. During my stay I was able, through Oliver

Williamson's lessons, to broaden my knowledge of neo-institutionalist theory, which was gaining currency in academe thanks to the contributions of Williamson himself, along with Douglass North, Richard Langlois and other scholars. At the end of that year of study I published two articles in which I expanded the idea that central banks had developed and evolved around the function of ensuring trust in what were beginning to be known as 'payment technologies'.²

During the next years I worked on other topics, ranging from European monetary integration to the reform of monetary institutions in the 1980s and 1990s and to the role of the International Monetary Fund as international lender of last resort. Some of the studies I undertook, often in collaboration with other economists from the Bank of Italy and the International Monetary Fund, form the backbone of the third part of the book.³

Inevitably after such a long gestation, I have accumulated numerous, profound debts of gratitude during the writing of the book. My greatest debt, however, is not to a person but to an institution, the Bank of Italy. It may resemble old-fashioned anthropomorphism to attribute a conscious role to an institution, but anyone who experienced the intellectual atmosphere in the Bank of Italy in the 1980s and 1990s (I cannot speak for the years before) will have no difficulty agreeing with the anthropologist Mary Douglas that 'institutions think'. In my case certainly much of what I am and what I think in the field of economics, as elsewhere, is the fruit of 20 years in the Bank. When I re-read my work I often find it difficult to trace the real source of a particular idea, a particular empirical result or a particular idiosyncrasy.

I also owe much to the people who contributed in various ways to my intellectual development: Cesare Caranza, Guido Carli, Pierluigi Ciocca, Anthony Courakis, Tommaso Padoa-Schioppa, Franco Passacantando, Ezio Tarantelli and Ignazio Visco. Over the years I have also had discussions with numerous friends and colleagues on the issues that were researched in preparation for this volume. Regrettably, I cannot thank them all here, but I would like to mention in particular Carlo Cottarelli, with whom I co-authored a number of papers, Paolo Angelini, Lorenzo Bini Smaghi, Claudio Borio, Marco Committeri, Renato Filosa, Marc Flandreau, Andrea Gerali, Giorgio Gomel, Carlo Monticelli, Fabrizio Palmisani, Giovanni Battista Pittaluga, David Pyle and Fabrizio Saccomanni. Ignazio Visco read the whole manuscript and provided many useful comments. Special thanks also go to Maria Teresa Pandolfi for her unflinching kindness to this often wayward user of the Bank's library, which she manages with knowledgeable and loving care. I also have fond recollections of my dear colleague and friend Stefania Tortiello, without whose

help and encouragement I would never have found the strength to resume a project that professional commitments and family responsibilities had forced me to give up. Maria Rosaria Lazzarini not only showed me constant affection, which never hurts, but also provided diligent editorial assistance over many years. I am also grateful to Chiara Mariani, Angela Di Maria and Giorgio Trebeschi for their help with tables and graphs.

Personal problems have prevented me from revising the text as I would have wished, or indeed as would have been appropriate with a view to publication. In this sense it is unfinished. I have decided to publish nonetheless, in the hope that others will find inspiration and encouragement to formulate a convincing institutionalist theory of central banking.

I dedicate the book to my companion Vera and our two children, Dara and Damjan, in gratitude for the love they have given me and in the hope that they will always remember that in a world without certainty only trust in oneself and one's neighbour can bring serenity.

*C. G.
June 2003*

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This book contains the text left by Curzio Giannini. Apart from checking and completing the references and general editing, at the author's request Chapter 7 on money and the payment system has been updated and the section on informal cooperation and soft law (the only one left unfinished) in Chapter 6 on international money has been completed from an article published in 2002. Special thanks are due to Paolo Angelini, Carlo Cottarelli, Andrea Gerali, Pino Marotta, Maria Teresa Pandolfi, Giovanni Battista Pittaluga and Francesco Spadafora for their assistance in these matters and to Gabriella Bernardi, Maria Rosaria Lazzarini

and Stefania Tortiello for editing of the final text and for bibliographical research.

Special thanks are due to Alba Guidi and Rita Tosi for their dedicated work and precious assistance in bringing all the pieces of the English edition together.

Introduction

*Non aes, sed fides*¹

If the success of an institution can be fairly judged by its diffusion, then the central bank is without doubt a very successful institution. When Will Rogers, the American humorist, said, 'There have been three great inventions since the beginning of time: fire, the wheel, and central banking', it may have been mere journalistic hyperbole, but like all hyperboles it contained an element of truth. In 1900 there were only 18 central banks. By 1950 that number had risen to 59 and by 1999, the last year for which accurate figures are available, it was 172. Today, over 90 per cent of the United Nations member states have a central bank.

More telling than these figures, which reflect the proliferation of nation-states following, first, the break-up of the great European empires and then the demise of colonialism, is the change that took place during that period in the perception of the role and the prerogatives of the central bank and its place in the organization and apparatus of the state. At the turn of the twentieth century, the central bank, still known by the less imposing name of 'issuing bank', was an institution with an uncertain future. Not all of the leading countries had one, notably the United States, which had a long-standing distrust of centralized power. In other countries, such as Italy and France, the central bank continued to lead a precarious existence between balance sheets constricted by large volumes of non-liquid financial assets, trifling legal constraints, and constant debates on the advantages of decentralizing issuance. Nowadays, the central bank has become an essential attribute of the state, if not a symbol of sovereignty.

Given the importance attributed, for better or for worse, to the central bank it may seem surprising that until quite recently it attracted very little theoretical interest. As Fausto Vicarelli remarked some 15 years ago on the question of the central bank's 'independence' from political power:

When the economist begins to tackle such an important and topical subject as central bank autonomy, one question immediately arises: can the autonomy or independence of an economic institution be discussed without taking into consideration a theory which justifies its existence and explains the logic of its evolution? Assuming there are grounds for this question, if the answer to it is a negative one, the economist who begins to explore central bank autonomy will

encounter certain difficulties since, even today, central banking theory has yet to be developed or, more optimistically, is still in the development phase.²

There are many reasons why it has taken so long for a theory of the ‘evolution’ of central banking to emerge. The main reason is probably entirely analytical, that is, that the neo-classical theoretical paradigm’s great heuristic potential in other fields does not reach to institutions – any institution, not just the central bank. In attempting to create a more rigorous discipline, neo-classical scholars have restricted both their method and their field of analysis to the point of reducing their theory of institutions virtually to an oxymoron. Firms, trade unions and even money are thus left out of the neo-classical paradigm.

Without a coherent theoretical framework, it was easy, given the close relationship that had linked central bank and state since the former began to evolve, for the adversaries of central banking to attribute the institution’s existence to the prince’s greed, to the constant attempts of the person in power to entangle the economy in a web of privileges and prohibitions designed to increase the power to raise taxes, whether openly or secretly. We can call this the ‘fiscal’ theory of central banking; Friedrich von Hayek and James Buchanan were its founders, Kevin Dowd, Lawrence White and David Glasner are its present leading exponents.³

The fiscal theory of central banking is backed by an incontrovertible historical fact, that in the early days of many central banks the state’s action was specifically designed to reap advantages from the creation of a large bank endowed with special privileges enabling it to mobilize rapidly substantial amounts of funds with which to finance war. This passage in institutional history was an experience shared, for example, by the Bank of England, the Banque de France, the Bank of Prussia and the Banca Nazionale nel Regno d’Italia. Nonetheless, it is anachronistic, and often blatantly incorrect, to argue on this basis that such a mechanism is the *raison d’être* of central banks as we know them today. Other central banks, for instance, were not created for an immediate return in the form of financing public expenditure but for the advantages to the community of rationalizing the payment system, which was in complete chaos at the time, whether by historical accident or from poor legislation. This was the case of the Reichsbank, the Banca d’Italia, the Schweizerische Nationalbank and numerous other smaller institutions. Moreover, the nature of the financial advantage that would accrue to the state from setting up a privileged bank is unclear. For instance, on closer inspection, the creation of the Bank of England can be attributed to an attempt on the part of Britain’s emerging middle class to exert fiscal control over the sovereign, not to facilitate secret taxation. The state certainly gained in