

Caesar, Rolf

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## MONETARY POLICY

### Central Banks in the Political Arena

by Rolf Caesar, Cologne\*

**The central banks of the Federal Republic of Germany and the USA have recently drawn renewed fire because of their independent stance.<sup>1</sup> Such attacks often hinge upon the legal position of the central bank, which is regarded as the crucial factor in determining its effective independence or lack of it. But to what extent is such a correlation valid? A comparison of six central banks shows that the gulf between legal provisions and political realities is occasionally very wide.**

Ever since the establishment of state banks of issue, their position and scope for action have been controversial issues in political and academic debate. The academic disciplines that have traditionally concerned themselves with the subject are principally jurisprudence and political economy, to some extent business management and in recent years occasionally political science as well. Each has its own viewpoint and purview. Legal commentaries focus on the question of the legal independence or autonomy of central banks and its compatibility with the parliamentary principle.<sup>2</sup> Political science examines primarily the political legitimacy of central banks and their power,<sup>3</sup> while economics and business management concentrate on the appropriateness of monetary policy as an instrument of stabilisation policy and deal with the problems of strategy and implementation that arise in this context. These two disciplines have also tackled the "traditional" problem of central bank independence, but generally in descriptive institutional terms<sup>4</sup> or from the normative point of view.<sup>5</sup>

#### **The Central Bank's Room for Manoeuvre**

These diverse aspects can be integrated by the use of the term "room for manoeuvre", which – in its German version as "Handlungsspielraum" – was introduced by Hansmeyer<sup>6</sup> in connection with central bank policy. Paraphrasing Hansmeyer, the effective room for

manoeuvre of the central bank can thus be defined as the full range of options open to the central bank to perform its tasks as commonly understood without hindrance from legal provisions, political opposition or economic constraints. The breadth of the range is determined by the alternatives that may be chosen freely and the extent to which the desired course of action can be implemented.<sup>7</sup>

Expressed in negative terms, the central bank's room for manoeuvre is circumscribed by all regulations or influences that either restrict the range of activities and aims that may be pursued by the central bank and the scale and use of the instruments available for this purpose or impede or even block the economic effects sought by the central bank. This encompasses not only all factors that force the central bank to act in ways contrary to its own conception of aims and means or prevent it from acting as it intended but also constraints on the economic effects of monetary policy.

The central bank's room for manoeuvre is therefore an amalgam of political latitude and economic options. Although the legal provisions form an important basis for this, the effective room for manoeuvre is determined ultimately by the extent to which the political and economic reality of the central bank permits the independent realisation of its aims. The real room for manoeuvre thus comprises two elements: the political element consists in the scope for the central bank to take independent decisions or actions without

\* Cologne University.

provoking conflicts that it would be politically incapable of withstanding, while the economic element describes the scope for the central bank to translate its economic intentions into effective action.<sup>8</sup>

The central bank's room for manoeuvre in this sense is determined by a multitude of legal, political and economic constraints. This is not the place, however, for a thorough discussion of such constraints on central bank action.<sup>9</sup> The remarks that follow are confined to an analysis of the political element of the effective room for manoeuvre of a few selected central banks. In other words, the object is to ascertain the de facto independence of the central banks of various countries.

### Independent and Dependent Central Banks

A limit must be set on the number of institutions examined in any empirical attempt to ascertain and

compare the many factors determining the effective political latitude enjoyed by central banks. For this reason just six central banks have been chosen, three of which are commonly considered to be independent of state institutions de jure and the other three to be dependent. The first group is represented by the Deutsche Bundesbank, the Swiss National Bank and the Federal Reserve System of the USA. On the other hand, the Bank of France, the Bank of England and the Bank of Italy are generally regarded as central banks with a large degree of legal dependence, although differing from one to another in detail. The decisive criterion is whether state institutions – primarily the government – have the right to give the central bank directives or to make its actions subject to approval, veto or supervision (the functional aspect). As a rule, it is also significant who appoints the board, whether and in what circumstances the central bank governor, as the dominant figure on the board, and perhaps his fellow directors can be dismissed (the personnel aspect). Nevertheless, the primary characteristics for the

<sup>1</sup> In the Federal Republic of Germany it was the Bundesbank's high interest rate policy that caused the SPD spokesman on economic affairs, Wolfgang Roth, for example, to criticise the Bundesbank in 1981 as the "economic problem number one" and as a "first-class crisis maker" and to question its independence in relation to the government, as had frequently happened in earlier years; trade union representatives have made similar utterances. In the USA a Treasury study published in June 1982 makes numerous (but by no means new) proposals for reducing the independence of the Federal Reserve Board. These include making the Fed a department of the Treasury or appointing the Secretary of the Treasury to the Federal Reserve Board and synchronising the term of office of the Chairman of the Board with that of the President of the United States. Cf. Angriff auf Autonomie der US-Notenbank (Attack on the autonomy of the Fed), in: Handelsblatt, No. 116, 22. 6. 1982, p. 1. For earlier material see the comprehensive bibliography in: R. Caesar: Der Handlungsspielraum von Notenbanken. Theoretische Analyse und internationaler Vergleich (Central banks' room for manoeuvre. A theoretical analysis and an international comparison), Baden-Baden 1981, pp. 297 ff.

<sup>2</sup> The most important recent works include C. S a m m: Die Stellung der Deutschen Bundesbank im Verfassungsgefüge (The constitutional position of the Deutsche Bundesbank), Berlin 1967; D. Uhlenbruck: Die verfassungsmäßige Unabhängigkeit der Deutschen Bundesbank und ihre Grenzen (The constitutional independence of the Deutsche Bundesbank and its limits), Munich 1968; H. F a b e r: Wirtschaftsplanung und Bundesbankautonomie (Economic planning and Bundesbank autonomy), Baden-Baden 1969; O. L a m p e: Die Unabhängigkeit der Deutschen Bundesbank. Eine verfassungsrechtliche und verwaltungsrechtliche Untersuchung (The independence of the Deutsche Bundesbank. An examination of constitutional and administrative law), Munich 1971; R. S c h m i d t: Grundlagen und Grenzen der Unabhängigkeit der Deutschen Bundesbank (The foundations and limits of the independence of the Deutsche Bundesbank), in: Xenion, Festschrift für P. J. Zepos, edited by E. von C a e m m e r e r et al., vol. II, Athens, Freiburg im Breisgau, Cologne 1973, pp. 655 ff.; K. v o n B o n i n: Zentralbanken zwischen funktionaler Unabhängigkeit und politischer Autonomie, dargestellt an der Bank von England, der Bank von Frankreich und der Deutschen Bundesbank (Central banks between functional independence and political autonomy, as portrayed by the Bank of England, the Bank of France and the Deutsche Bundesbank), Baden-Baden 1979; H.-H. P a p i e r: Die Zentralbank im Verfassungsgefüge. Generalbericht (The central bank within the framework of the constitution. General survey), in: Instrumente der sozialen Sicherung und der Währungssicherung in der Bundesrepublik Deutschland und in Italien (Instruments of social security and monetary protection in the Federal Republic of Germany and Italy), Supplement No. 5 to "Der Staat", Berlin 1981, pp. 109 ff.; R. S c h m i d t: Die Zentralbank im Verfassungsgefüge der Bundesrepublik Deutschland (The central bank under the constitution of the Federal Republic of Germany), *ibid.*, pp. 61 ff.

<sup>3</sup> With reference to German-speaking countries cf. G. v o n E y n e r n: Die Unabhängigkeit der Notenbank (The independence of the central bank), Berlin 1957; H.-J. A r n d t: Politik und Sachverstand im Kreditwährungswesen. Die verfassungsrechtlichen Gewalten und die Funktion von Zentralbanken (Policy and competence in the monetary credit sector. The constitutional powers and the function of central banks), Berlin 1963; R. W i l d e n m a n n: Die Rolle des Bundesverfassungsgerichts und der Deutschen Bundesbank in der politischen Willensbildung. Ein Beitrag zur Demokratietheorie (The role of the Federal Constitutional Court and the Deutsche Bundesbank in the formation of political will. A contribution to the theory of democracy), Stuttgart 1969; G. v o n E y n e r n: Grundriß der Politischen Wirtschaftslehre (Outline of political economy), vol. I, 2nd edition, Opladen 1972, pp. 215 ff.; R. R o b e r t: Die Unabhängigkeit der Bundesbank. Analyse und Materialien (The independence of the Bundesbank. Analysis and documentation), Kronberg/Taunus 1978.

<sup>4</sup> Cf. inter alia H. R i t t e r s h a u s e n: Die Zentralnotenbank. Ein Handbuch ihrer Instrumente, ihrer Politik und ihrer Theorie (The central bank of issue. A guide to its instruments, policy and theory), Frankfurt/Main 1962; E. S c h u p p l e r: Die Unabhängigkeit der Notenbank (The independence of the central bank), Vienna 1962; O. H a h n: Die Währungsbanken der Welt (The banks of issue of the world), vol. I: Institutionen und Organe (Institutions and organs) and vol. II: Die Abhängigkeiten der Zentralbankleitung (Constraints on the independence of the central bank's board), Stuttgart 1968; O. V e i t: Grundriß der Währungspolitik (An outline of monetary policy), 3rd edition, Frankfurt/Main 1969.

<sup>5</sup> The normative question, which arguments can be raised for and against the hypothesis of a central bank independent from the state, will not be discussed further in this article. A host of essays on the subject can be found in both German and American literature. Cf. in particular R. C a e s a r: Die Unabhängigkeit der Notenbank im demokratischen Staat. Argumente und Gegenargumente (The independence of the central bank in the democratic state. Arguments and counterarguments), in: Zeitschrift für Politik, new series, vol. 27 (1980), pp. 347 ff.

<sup>6</sup> See K.-H. H a n s m e y e r: Wandlungen im Handlungsspielraum der Notenbank? (Changes in the central bank's room for manoeuvre?), in: C. A. A n d r e a e et al. (eds.): Geldtheorie und Geldpolitik, G. S c h m ö l d e r s zum 65. Geburtstag, Berlin 1968, pp. 155 ff.

<sup>7</sup> R. C a e s a r: Der Handlungsspielraum von Notenbanken, *op. cit.*, p. 69.

<sup>8</sup> *Ibid.*, p. 70.

<sup>9</sup> For further details see *ibid.*, pp. 125 ff.

classification of central banks as dependent or independent institutions are usually the functional arrangements.

Textbooks on the subject have dealt repeatedly and in detail with the relevant legislation;<sup>10</sup> we shall therefore not examine it closely here. It should merely be noted that the three central banks that are dependent *de jure* are all subject to directives from their governments; the Bank of England and the Bank of Italy are directly dependent on the Treasury and the Interministerial Committee for Credit and Saving, respectively, whereas in France there is an intermediate body with competence to establish guidelines (the National Credit Council) on which representatives of private business also sit but which is completely dominated by the government through the membership and voting arrangements. By contrast, the three central banks described as independent *de jure* (the Deutsche Bundesbank, the Swiss National Bank and the Federal Reserve System) maintain a considerable distance between themselves and their governments. In particular, absolutely no right to issue directives exists, although there are individual rights of approval or supervision. Furthermore, in the Federal Republic of Germany the government has a suspensive right of veto with respect to Bundesbank decisions. Viewed as a whole, however, the position of the Deutsche Bundesbank, Swiss National Bank and the Federal Reserve System cannot be compared with that of the central banks of the United Kingdom, France and Italy. The fact that in some cases the differences in the personnel aspect<sup>11</sup> are less acute is of no fundamental consequence; the differences in the functional area remain decisive.

#### Relative Nature of the Legal Constraints

A glance at the reality of the last three decades shows, however, that actual relationships differ, in some cases quite widely, from the picture formed by the legal framework. For example, the formal rights of direction, approval, veto or supervision in France, the United Kingdom and Italy have proved to be almost meaningless in practice; not once in more than thirty years has the British Treasury made use of its right to

issue directives. The power of the Interministerial Committee to issue directives to the Bank of Italy has been used *de jure*, with varying intensity, but *de facto* it represented a mere formality over long periods of time; in any case, there is no known instance in which such directives have forced the central bank to take action against its will. In the case of the Bank of France it has also become clear that the National Credit Council, the body with formal directive rights, has faded into insignificance; consequently, the apparent strong representation of private groups within this forum has also lost all practical meaning.

Similar curtailment of the legal restrictions applies to the right of state institutions to withhold approval or to veto decisions that are to be found not only in countries with legally dependent central banks but also where the central banks are independent *de jure*, as in the case of the Deutsche Bundesbank and the Swiss National Bank. Even where the first group of central banks are concerned such powers have been exercised only in part, and then generally more to uphold the official decision-making process than to effect a conscious change in central bank policy, as with various monetary

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<sup>10</sup> Cf. in particular H. Aufricht: *Comparative Survey of Central Bank Law*, London 1965, and O. Hahn, *op. cit.*, vol. II.

<sup>11</sup> For example, in all six countries the appointment of the central bank's senior officials is in the gift of the government. Dismissals are possible *de jure* in France and Italy at any time, in Switzerland upon statement of the reasons, in the United Kingdom and Germany in the event of civil or criminal offences, gross dereliction of duty or incapacity to conduct business normally, and in the USA in specific circumstances (themselves controversial).

policy instruments used by the Bank of Italy. In the case of the legally independent central banks the latter holds true of the various rights of approval that apply to the Deutsche Bundesbank and the Swiss National Bank. In particular, the weighty suspensive right of veto that the Federal government may exercise over Bundesbank decisions has not been used to this day; the parallel with the equally unused right to issue directives in the case of the legally dependent central banks is obvious.

Besides these possibilities for exerting direct influence on central bank decisions, the laws governing the central bank's operations – and in particular the legal provisions regarding direct or indirect central bank lending to the government<sup>12</sup> – may play an important role in deciding the question as to the central banks' legal and actual independence from the functional point of view. Here the range among the six central banks under consideration stretches from the lack of any obligation on the part of the central bank to finance public expenditure in this way (Switzerland,<sup>13</sup> USA) to more or less generous credit ceilings for direct central bank lending to the state.<sup>14</sup> On the other hand, in none of the countries except the USA are there limits on indirect government financing by the central bank through the purchase of government securities on the open market or the rediscounting of government paper. The formal provisions on credit relations between the central bank and the state are always observed *de jure*, but more to the point is the fact that they are often circumvented in practice by means of indirect financing of the kind mentioned above or by repeated amendment of the legislation, as with the continual raising of the legal borrowing limits in the USA. Hence the degree to which the central banks actually contribute towards financing

the government is incomparably more important than the provisions for direct credit relations between the government and the central bank in the laws governing the latter. This will be discussed in greater detail later.

### Politicisation of Central Bank Offices

The regulations in the personnel field carry much greater weight than the legal constraints of a functional nature. In this field the potentially most important means of influence open to political bodies is the legal right they possess in several countries to dismiss the board of directors of the central bank (France, Italy and, subject to certain restrictions, Switzerland and the USA); this instrument has been used only in France – and there with regularity – whereas in the case of the other countries it should be classified more as a theoretical sanction that is not usually contemplated.

However, the other important possibility of influencing the central bank, namely the right to appoint its most senior officials, has been used in almost all countries as a tool in the attempt to exert political pressure. It is hardly surprising that this affects the central banks classed as independent *de jure* more strongly than those that are legally dependent. Whereas a clear trend towards politicisation of the senior positions in the central bank can be discerned to almost equal degrees but at different levels<sup>15</sup> in the Deutsche Bundesbank, the Swiss National Bank and the Federal Reserve System, the same cannot be said of the Bank of Italy or the Bank of England. Once again the Bank of France is an exception among the legally dependent central banks; politically inspired appointments and dismissals are regarded as perfectly normal.

### Effective Room For Manoeuvre

Hence in the personnel field the framework of laws clearly does play some part in the effective influence the state can bring to bear on central bank action; in other respects, however, the law's provisions concerning the relationship between the central bank and the state are of comparatively minor importance for the *de facto* independence of a central bank. In order to ascertain the bank's effective political room for manoeuvre more accurately, additional criteria must therefore be adopted as secondary indicators. The chief yardsticks of this kind are the frequency of serious conflict between the central bank and the government, the outcome of such conflicts

<sup>12</sup> In addition, the legal formulae concerning the duties and objectives of the central bank might be important for a central bank's room for manoeuvre. However, in most countries (Switzerland, the USA, France, the United Kingdom, Italy) such clauses contain only a very vague description of the central bank's functions as generally understood. Only in the case of the Deutsche Bundesbank does the law seem to formulate the bank's objectives relatively precisely and comprehensively. Even then it leaves considerable areas unclear and is open to various interpretations, but it has nonetheless frequently been of great significance in political wrangles about the priorities of central bank policy, though more by way of a (political) prop to the Bundesbank than as a restrictive factor.

<sup>13</sup> The Swiss National Bank is even expressly forbidden to grant advances to the government.

<sup>14</sup> Section 20 of the Bundesbank Law sets an upper limit of about DM 10 billion for Bundesbank advances to the Federal government, its separate entities and the Länder. In France comparatively strict limits for direct central bank lending to the state are laid down in "conventions" between the Minister of Finance and the Governor of the Bank of France. In the United Kingdom the direct financing of government expenditure by the Bank of England is traditionally restricted to short-term bridging loans ("overnight ways and means advances"), the upper limit and duration of which are laid down annually in an Appropriation Act for the implementation of the Budget. In Italy a current account advance equal to 14 % of the proposed budget expenditure is placed at the disposal of the Treasury by the Bank of Italy.

<sup>15</sup> In the case of the Deutsche Bundesbank more at the level of the Land central banks, less at that of the Directorate; in the case of the Swiss National Bank at the level of the Board of General Managers; in the case of the Federal Reserve System at the level of the Chairman of the Board of Governors.

and a comparison of the priorities of central bank policy with those of general government policy. Other factors are the central bank's actual involvement in government financing, its role in the determination of exchange rate policy, the degree of co-ordination among central bank, government and private economic agents and finally the public's assessment of the central bank's position.

In order to reduce these various indicators to a common denominator, a five-point scale which extends from very extensive political room for manoeuvre (++) via progressively weaker positions (+, -, -) to very restricted political scope (---) is adopted. Using the facts described in detail elsewhere,<sup>16</sup> we thus obtain the picture represented in the chart for the last two decades. Two separate periods have been considered (up to 1970 and since 1970) in view of the significant differences between the sixties and seventies.

One or two criticisms may be raised concerning the meaningfulness of the indicators used. Evaluating the indicators individually poses problems, but especial difficulties arise in formulating an overall assessment of the political room for manoeuvre. The classification could be open to debate, depending on the weight attached to whichever criterion is regarded as the prime determinant. Take the Federal Reserve System, for example. On the one hand the Fed has shown itself quite prepared to enter into conflict with the executive

and in at least some cases has come out "victorious", and yet on the other hand it has frequently adapted its priorities to those of the government, has played a prominent role in the provision of state finance and has shown some tendency towards the politicisation of senior offices. The overall assessment of the Swiss National Bank is equally difficult; on the one hand some tendency towards the politicisation of offices, a high degree of official and informal co-ordination and a lack of conflicts could be observed, while on the other hand the central bank continued to set monetary policy priorities with singleness of mind and to maintain its distance on the question of government financing. A third problematic example is the Bank of Italy, whose generally "victorious" conduct of an admittedly small number of conflicts with the government is to be set against the clear adaptation of its priorities to those of the government and the almost complete subordination of monetary policy to the needs of government financing, especially since the mid seventies.

### An International Comparison

If an attempt is made to place the six central banks in some kind of order in spite of such undeniable problems of classification, then the Deutsche Bundesbank takes the lead by a clear margin notwithstanding the slight constriction of its freedom in the seventies. The Swiss National Bank and the Federal Reserve System display a narrower, though still considerable, political room for manoeuvre.

### A Comparison of the Political Room for Manoeuvre of the Central Banks under Examination

Criteria	Central banks <sup>a</sup>		de jure independent central banks						de jure dependent central banks					
			DBB		SNB		Fed		BoF		BoE		BoI	
	up to 1970	since 1970	up to 1970	since 1970	up to 1970	since 1970	up to 1970	since 1970	up to 1970	since 1970	up to 1970	since 1970	up to 1970	since 1970
1. Significance of legal provisions	·	-	-	-	-	-	-	-	-	-	·	·	+	·
2. Conflicts														
a) Actual disputes	++	+	·	·	+	+	·	·	·	·	-	-	·	·
b) Over priorities	+	+	+	+	-	-	-	-	--	--	--	--	+	-
3. Involvement in government financing	+	·	++	++	-	-	·	-	·	-	--	--	+	--
4. Role in determination of external monetary policy	++	++	++	++	+	·	-	-	-	-	++	+	++	+
5. Degree of institutional co-ordination with state institutions	·	-	·	-	+	+	-	-	·	·	·	-	+	+
6. Attitudes towards the central bank:														
a) of academic circles and public	++	+	+	+	·	-	·	·	·	·	--	--	+	+
b) of politicians (incl. attempts to reform the central bank law)	++	+	·	·	-	--	-	-	-	-	--	--	·	-
7. Relationship with private groups	+	·	-	--	+	+	++	++	++	++	-	-	++	++
Overall assessment	++	+	+	+	+	+	--	--	--	--	--	--	+	·

<sup>a</sup> The abbreviations used in the column headings have the following meanings: DBB Deutsche Bundesbank, SNB Swiss National Bank, Fed Federal Reserve System, BoF Bank of France, BoE Bank of England, BoI Bank of Italy.

The contrasts become plainer if the different weights of the actors exerting an influence are also taken into consideration; whereas in the USA Congress plays a role alongside the government, in Switzerland it is primarily the government and private groups that are to be regarded as actors of significance. Finally, in the case of the Deutsche Bundesbank the only actor of importance to influence decisions is the government, both *de jure* and *de facto*. Moreover, public opinion on the position of the central bank is of considerable importance, although to a smaller extent in the USA than in Germany and Switzerland. Finally, the Bundesbank and to some degree also the Swiss National Bank have had to and still must pay close heed to both economic and political developments abroad in reaching their monetary policy decisions. The Bundesbank's long hesitation about floating exchange rates was due essentially to this factor and Switzerland's voluntary submission to the international currency rules was also based partly on political considerations of this kind.

The political room for manoeuvre of the three central banks classed as dependent is appreciably smaller than that of their legally independent counterparts, although here too there are clear and unmistakable distinctions. In broad terms this statement even holds good for the Bank of Italy, in spite of the fact that at certain times during the sixties and early seventies its political position was extremely strong; as the economic and political environment changed in the course of the seventies, however, the latitude available to the Bank of Italy seems to have narrowed considerably. Nevertheless, the Bank of Italy still ranks above the central banks of France and the United Kingdom on the scale measuring the political room for manoeuvre.

By comparison, the Bank of France and the Bank of England have long possessed only limited room for manoeuvre vis-à-vis the government. Furthermore, in the case of the UK the special relationship between the central bank and the commercial banks gives the Bank of England an advantage from the point of view of the policy aspects of central bank activities but imposes an additional constraint on its freedom of action in the sense of politics.

In the light of the above assessment it is not possible to subscribe to the rather sweeping assertion that the governments of countries with *de jure* dependent central banks have also normally given the latter a "free

hand" to pursue their monetary policy and intervened "with corrective measures only in a crisis"<sup>17</sup>, so that in democracies the formal provisions for intervention are no more than "contingency arrangements".<sup>18</sup> Such a view may have had some validity, at least temporarily, for the part played *de facto* by many central banks in determining external exchange rate policies,<sup>19</sup> but leaving this aside it is true to say only that crisis conditions tend to restrict the central banks' political room for manoeuvre. The claim that government intervention would be limited to such situations is clearly contradicted by the evidence as presented primarily by the cases of France and the United Kingdom.

### Trends Over the Period Under Review

A glance over the entire period under review shows that political restrictions on central bank action have increased almost everywhere and that the political room for manoeuvre has consequently contracted. Viewed as a whole, the influence of the private sector on the central bank has been relatively weak almost everywhere for several decades; to some extent the Swiss National Bank and the Bank of England constitute exceptions to this rule. By contrast, state institutions – i.e. primarily governments but in the USA Congress as well – have sought to strengthen their influence over central bank policy in all countries.<sup>20</sup> Such a development is particularly evident in countries with central banks that have been granted comparatively broad political latitude; the political restrictions on the Deutsche Bundesbank have increased, as well as those on the Swiss National Bank or the Federal Reserve System. In the case of the Bundesbank this was manifest in the Bank's temporary accommodation of growing government deficits (1975) and in far more intensive formal and informal contacts with the government bureaucracy. In Switzerland the central bank has been induced by political pressure to take a number of sectoral measures favouring individual groups; moreover, it too has become more deeply integrated into the political decision-making process in the narrow

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<sup>18</sup> O. Lampe, *op. cit.*, p. 64.

<sup>19</sup> Cf. especially M. J. Brenner: *The Politics of International Monetary Reform – The Exchange Crisis*, Cambridge, Massachusetts 1976, p. 137.

<sup>20</sup> For a similar view cf. K. Holbik: Introduction, in: K. Holbik, (ed.): *Monetary Policy in Twelve Industrial Countries*, Boston 1973, p. XXV, who speaks of a tendency towards the "politicisation of central banks" and in practically all central banks detects an inclination "to compromise that which *ought to be* with that which *is*" (*ibid.*; italics used in the original). Cf. in the same sense M. H. de Kock: *Central Banking*, 4th edition, London 1974, p. 317; L. K. O'Brien, Lord of Lothbury: *The Independence of Central Banks*, Conférence donnée le 14 décembre 1977, Société Royale d'Économie Politique de Belgique, No. 404, Brussels, p. 17.

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<sup>17</sup> O. Lampe, *op. cit.*, p. 64. In the same vein, though less emphatic, also F. Neumark: *Inflationsprobleme – Alt und Neu* (Inflation problems old and new), Göttingen 1976, p. 21, "that the actual differences (in the independence of central banks; our insertion) are smaller than the legal provisions would suggest".

sense, a development that may certainly have won the central bank greater potential influence over the makers of financial policy but at the same time has undoubtedly placed additional restrictions on its own room for manoeuvre. Finally, in the United States the unmistakable increase in political restrictions can be deduced from the numerous proposals to reduce the legal independence of the Federal Reserve System.<sup>21</sup>

A parallel trend towards further restriction of the political latitude of the central banks is also evident, however, with regard to the central banks that are classed as dependent *de jure*. The case of the Bank of Italy is particularly striking. In the fifties and sixties it undoubtedly had very broad political room for manoeuvre. For a while the Italian central bank was reckoned to be "the only centre for the continuous formation of political will"<sup>22</sup> in the field of economic policy and the Governor in office from 1960 to 1975, Guido Carli, was even described as "his country's most powerful economic policymaker".<sup>23</sup> By comparison with the situation then, the political bounds to independent action by the Bank of Italy were drawn considerably tighter in the seventies, as the complete subordination of monetary policy to the exigencies of budgetary financing emphasises. Similarly, the Bank of England, which was previously considered in some quarters to possess a remarkable degree of independence in the determination of exchange rate policy, has lost much of its influence in this field. In this sense the description of the Bank of England as the creature of the Chancellor<sup>24</sup> is more true today than ever.

### The Causes

The causes of this development are obviously numerous and cannot be documented in detail for all countries. Nevertheless, plausible hypotheses can be advanced to explain the observable trend towards a reduction in the central banks' political latitude.

First, the potential for conflicts that could be triggered by central bank decisions expanded everywhere in the

course of the seventies; the acceleration in the rate of inflation coupled with falling growth rates, rising unemployment and, in some cases, more acute balance of payments problems drew politicians' attention more closely to areas of economic policy that they had been prepared to leave out of purely political discussion in the sixties. Monetary policy is but one example; incomes policy would be another. Moreover, since the introduction of predominantly flexible exchange rates the political sensitivity of central bank decisions has increased in view of the possibility of exchange rate movements, which in turn can have serious repercussions on employment. In the field of budgetary policy in particular, the heightened employment and growth problems mentioned above caused increased efforts to be made to pursue an expansionary expenditure policy, which brought in its wake an unexpected expansion in the public-sector borrowing requirement. As a result, the pressure on central banks to meet this requirement themselves by purchasing government securities or to make it easier to cover by pursuing a more generous monetary policy was much stronger during the seventies than it had been in the preceding decade.

It is also plain that criticism of the central banks in general and their policies in particular has increased everywhere. Equally, doubts have arisen, especially in countries with central banks that are legally independent, about one of the strongest bulwarks of freedom of action in central bank policy, namely advocacy of the principle of an independent monetary institution. Three circumstances lie at the root of this more critical attitude towards the central bank as an institution and its actions. At least some of the blame for the much smaller success in achieving macro-economic objectives in comparison with the fifties and sixties has everywhere been laid on central bank policy. At the same time theoreticians have increasingly expressed the opinion that a more far-reaching institutional coordination of monetary and budgetary policies is required. Finally, the fact that social-democratic or socialist parties have come to power in some countries

<sup>21</sup> Cf. R. Caesar: *Der Handlungsspielraum von Notenbanken*, op. cit., pp. 297 ff., pp. 303 ff. and footnote 1 above.

<sup>22</sup> H. Wirtz: *Geht er oder bleibt er? Rätseleuten um den wohl mächtigsten Mann Italiens, Notenbankgouverneur Guido Carli (Will he go or will he stay? Speculation about probably the most powerful man in Italy, central bank Governor Guido Carli)*, in: *Die Weltwoche* (Zürich) of 14. 8. 1974. See also the famous quotation attributed to Per Jacobsson: "The main problem for all central banks is to make themselves independent of their governments, with the exception of Italy, where it is the government that is striving for independence from the Bank of Italy"; quoted in German in H. Hohenlohe: *Banca d'Italia – Einflußreicher, als auf dem Papier steht* (The Bank of Italy – more influential than it appears on paper), in: *Börsen-Zeitung* of 7. 10. 1972.

<sup>23</sup> M. J. Brenner, op. cit., p. 72.

<sup>24</sup> The famous saying "The Bank is my creature" goes back to the former Chancellor Sir Stafford Cripps: cf. F. Hirsch: *The Pound Sterling: A Polemic*, London 1965, p. 142. For a similar view see also K. Fleet: *Bank of England as servant to the Treasury*, in: *Daily Telegraph* of 9. 12. 1976.

<sup>25</sup> A parallel could be drawn here with events after the Second World War. Then too it was held that the trend towards nationalisation and legal restriction of the freedom of central banks evident in many countries was not least the result of a corresponding shift in the balance of political power. "The advent to power of the socialist parties has ... accelerated the tendencies (towards nationalisation; our insertion) that were inherent in the situation." (M. A. Kriz: *Central Banks and the State Today*, in: *American Economic Review*, vol. XXXVIII (1948), p. 570.)



may have encouraged the view that a greater centralisation of economic responsibilities would be desirable.<sup>25</sup>

### **Increase in the Range of Instruments**

Changes have continued to occur in the status of monetary policy. During the seventies the effectiveness of monetary policy increased almost everywhere, thanks primarily to a broadening of the range of monetary instruments and improved protection of the external flank. In the longer term this could fundamentally enhance the position of the central bank, but in the short term the increase in monetary power has made the activities of the body invested with that power, namely the central bank, politically more "interesting" and allowed the political pressure on it to grow. The worldwide triumph of monetarist thinking within central banks has – even though monetarism lays considerable stress on the value of monetary policy – probably had the same effect; the now general practice of publishing money supply targets has laid central bank policy open to closer scrutiny and hence criticism. The hypothesis that the announcement of such targets also increases the protection against pressure from interested parties on the short-term formulation of monetary policy cannot be rejected out of hand at the theoretical level but is hardly capable of empirical verification.

Finally, the vaunted intellectual superiority of some central banks over their country's ministerial departments in economic policy in general and external monetary affairs in particular seems to have waned in recent years. The increased commitment of budgetary policymakers to stabilisation policy and especially external monetary policy in some countries (Germany, Italy) has been accompanied by greater self-confidence in the subject – and no doubt also greater technical competence – that has diminished the role of the central bank as adviser to the government. Also in the USA and the United Kingdom this function of the central bank clearly does not carry the weight it did in the sixties.

### **Conclusion**

The afore-going considerations have demonstrated that the central bank's effective political room for manoeuvre is determined by a multitude of factors and that their influence can change quite considerably over time. The "independence" of the central bank is no longer primarily a legal problem but is determined chiefly by political restrictions and the weight they carry. In the final analysis it depends on the extent to which there is agreement on the aims of economic policy and, in particular, monetary policy. The question as to the

"best" degree of central bank independence cannot therefore be answered a priori but only after weighing the social and political conditions existing in a particular country and the political priorities to which they give rise. The didactic value of a de jure independent central bank is not contested by such an argument. Indeed, the author shares the view that monetary stability deserves high priority as well as the conviction that a legally independent central bank can defend this objective at least for a while in the face of a different set of government priorities. However, even an independent central bank cannot give permanent pride of place to objectives that clash with other priorities preferred by the forces shaping society. It may be perfectly feasible and, in certain circumstances, desirable to stand up to the government if the central bank receives adequate support from the general public, but if the political authorities *and* public opinion are in agreement about the order of priorities, even a central bank that is independent de jure cannot follow a different path for long.

Viewed from this angle, the frequently claimed link between legal and/or de facto central bank independence on the one hand and comparatively low rates of monetary erosion on the other – a link that is also largely substantiated by empirical evidence – appears in a different light; relative success in combating inflation in countries such as the Federal Republic of Germany, Switzerland and, to a lesser extent, the USA has indeed been attributable to the single-minded policy of the central banks involved, but a substantial part of that success has also been due to the fact that during the period under review economic priorities were generally viewed differently in these countries than in France, the United Kingdom and Italy. Hence the achievement of greater price stability in the first three countries should not be seen simply as the consequence of greater political latitude on the part of the central bank but also as the reflection of a general consensus on economic and social policy that coincided largely, although not always completely, with the objectives of the supposedly independent central bank.

Seen in this light, the fact of legislating for an independent central bank is itself some indication that the country places a fundamentally high value on the objective of price stability. Above all, however, the granting of considerable political latitude can be taken as an expression of society's willingness to accept that the central bank's actions will be oriented towards the maintenance of price stability. The fact that greater price stability is achieved in such countries is therefore hardly surprising.