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ABSTRACT

This essay looks at the foundation and development of the US Federal Reserve and the Bank of England, through the perspective of the recent debate over central bank independence in the design of optimal monetary policy. It shows that the creators of the Federal Reserve were acutely aware that they were establishing a central bank (based to some degree on the Bank of England as it had then evolved). Thus they were troubled by the potential power that such an institution might wield and so the question of control and influence was paramount. Interestingly, the founding fathers eventually opted for independence from the money interests of Wall Street rather than independence of the state. The Fed's reputation for policy competence and independence owes much more to the role of strong Chairmen in recent years than to any statutory design.

By contrast, the Bank of England was founded as a private bank. Concerns about independence played no part in its early history and only came to the fore after it had acquired, step by step, the responsibilities of a central bank. The first serious concerns about independence were voiced in the inter-war period when it was thought that the Bank was too keen to support London's role as the centre of international finance, against the interests of the domestic economy. Partly for this reason it was nationalised in 1946. When it was granted operational independence in 1997 it was stripped of two of its oldest responsibilities in order to avoid conflicts of interest.

What the history of the two banks shows is firstly, that it is not independence of government that is essential for optimal policy, but a freedom to pursue one, single priority and secondly, that the effectiveness with which this is carried out has little or nothing to do with laws, charters and statutes.

Keywords: Central bank independence; optimal monetary policy; inflation targeting

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1. Introduction

In the course of the last twenty years or so a substantial consensus has built up regarding the optimal design of a monetary policy framework. This includes the view that policy should be focused primarily upon price stability (usually defined by a numerical target), that the most appropriate policy instrument is the rate of interest charged on central bank lending to the banking system, that the policymaker should conduct its operations in the most transparent manner possible and, above all, that the policymaker should be 'independent', where independence means primarily free of political pressures. The importance of independence lies in its apparent association with low rates of inflation, achieved at little or no apparent cost – the nearest that economics has ever come to providing the elusive 'free lunch'. By 1996, Otmar Issing (at the ECB) was describing these benefits as 'two of the established findings of our discipline'. The speed with which the merits of independence came to be accepted is astonishing, as James Forder (2005) pointed out in a comparison with the much longer time that it took for other, bigger, ideas to become orthodox. Furthermore, the idea that inflation could be overcome by Act of Parliament must also have come as a revelation to those economists whose arguments in favour of prices and incomes policies in the '60s and '70s had met with widespread derision. Nonetheless, although based on weak theory and even weaker evidence, the view that freedom from political pressures is beneficial in monetary policymaking has stuck.

In the course of this chapter we shall look at the foundation and evolution of the Fed and the Bank of England against this background. We shall see that the two banks had very different origins, structure and mandates (in sections 2 and 3) and that this places them at very different points on the independence spectrum as conventionally understood.

In section 4, we shall show how these historical and structural differences further undermine the idea that the conventional meaning of independence - statutory independence of government - is largely irrelevant to the quality of monetary policy outcomes. Section 5 is a very brief conclusion.

2. The US Federal Reserve: foundations, ownership and control

Amazing as it may seem, especially to those familiar with the history of the Bank of England, the US banking system managed without a central bank until December 1913. This was not without costs. The nineteenth century saw a succession of increasingly severe bank runs culminating, in 1907, in a major financial crisis. A widely-accepted explanation for the problem was the 'inelasticity' of money (more strictly the monetary base). In an economy that was still marked by a large agricultural sector, the demand for liquidity contained a seasonal element to which supply was unable to respond. Without a central bank or interbank market, the situation was exacerbated by the fact that surplus liquidity in one part of the system could not be recycled to areas of shortage. Out of this came the Aldrich-Vreeland Act which provided for groups of banks to form local clearing-house associations as a temporary solution. More significantly it established a Monetary Commission which reported in 1912 in favour of the creation of a National Reserve Association to provide emergency reserves as required. This plan was also known as the Aldrich Plan, and provided for the Association to be controlled by the banks. The fate of this plan tells us a great deal about the failure to establish a successful central bank before 1913.

The Aldrich plan provided for one central institution, to be called the National Reserve Association, with branches all over the country and with the power to issue currency, and to rediscount the commercial paper of member banks. Since these two functions (note issue and the lender of last resort) are core, virtually defining, functions of a central bank, it is clear that Aldrich and his colleagues can have had no doubt that they were designing a central banking institution.[1] Control of the institution would reside in a board of directors, the overwhelming majority of whom would be bankers. It was this last feature that caused the controversy. At one level, it was a rather principled discussion about democracy and the ownership of a potentially powerful institution. This can be seen in debates in the academic literature. For example, Laughlin (1912) was broadly in favour of the proposal while Kemmerer (1913) argued that its success depended upon popular support (and therefore could not be left to management by bankers).

At a more colourful level, the debate was closely involved with the politics of the time. Although the Monetary Commission was established by a Republican administration, its proposals were inherited by Democrats who had won not only the Presidency, in the person of Woodrow Wilson, but both Houses of Congress. Wilson was a Southern Democrat and a member of what was referred to as the 'progressive' movement. (Aldrich was a conservative Republican). In the course of his 1912 election campaign, Wilson is quoted (by Hofstadter, 1948, p. 250) as saying:

> The great monopoly in this country is the money monopoly. So long as that exists our old variety and freedom and individual energy of development are out of the question . . . The growth of the nation, therefore, and all our activities are in the hands of a few men . . . who necessarily, by very reason of their own limitations, chill and check and destroy genuine economic freedom.

Similar sentiments had been repeatedly expressed by William Jennings Bryan, a Nebraska populist who had himself run three times for President and was to become Secretary of State in Wilson's administration. He had based his 1896 campaign on a denunciation of bankers and the deflationary impact of the gold standard[2] and is quoted as asserting in 1912 that, if the Aldrich plan were implemented, the big bankers would, 'then be in complete control of everything through the control of our national finances.' (Johnson, 2010, p. 18). It is hardly surprising, therefore, that Wilson and his colleagues would find the Aldrich plan unacceptable, at least so far as it placed control in the hands of banking interests.

Even without the change of administration, however, we can be certain that the Plan would have faced an uphill struggle. Between 1870 and 1914 the US economy had grown rapidly, overtaking the UK and Germany in output per capita and taking the technological lead in major industries. In many cases these industries also benefited from economies of scale which led to high levels of concentration and quasi-monopoly positions and rents. This was the period in which immense fortunes were made in railroads, shipping, oil, iron and steel by families like the Vanderbilts, Carnegies, Rockefellers and Astors (amongst others) who became known, justly or otherwise as the 'robber barons' (see Josephson, 1934; Nevins, 1940). Such concentration of wealth and industrial power created much resentment and criticism and eventually a widespread 'anti-trust' sentiment and legislation to back it.[3] The one industry conspicuously missing from our list is money and finance. But this was the industry above all where resentment was greatest because of its ability to exploit all others. Names like Morgan, Cooke, Mellon, Seligman, Drew and others (often referred to collectively as the 'money trust') were regarded with deep suspicion

[1] We shall see later that the origins of the Bank of England were very different. Meltzer (2003) p.65 argues that Aldrich and his supporters had the Bank of England clearly in mind as a model. But by 1913 the Bank of England had been in existence for more than 200 years and had had time to evolve into a recognisably modern central bank. See also Dunbar (1929 p.87)

[2] Arguing on one occasion that the country was in danger of being 'crucified on a cross of gold'.

[3] The Sherman Anti-Trust Act was passed in 1896. The Wilson administration would later (1914) set up the Federal Trade Commission to prevent monopolistic practices.

throughout the country but especially in mid-western and southern states.[4] Unfortunately for the Aldrich plan, the House Banking and Currency Committee chose 1912 to conduct what became known as the Pujo hearings into the extent of monopolisation in US banking and finance.[5] Its Report, published in 1913, contained the damning conclusion that:

> If by a 'money trust' is meant an established and well defined identity and community of interest between a few leaders of finance… which has resulted in a vast and growing concentration of control of money and credit in the hands of a comparatively few men… the condition thus described exists in this country today. (Quoted in Johnson, 2010, p.19)

In these circumstances, there was no prospect of establishing a central bank answerable primarily to bankers.

The solution came from Wilson himself and two specialist advisers on whom he had come to rely after his election.[6] Carter Glass served many years in Congress as the Representative of Virginia and became well-known after 1933 as co-sponsor of the Glass-Steagall Act that separated investment from deposit banking. H Parker Willis was a Professor of Economics and associate editor of the New York *Journal of Commerce*. Together they put together a plan for twenty or more privately controlled regional reserve banks, which would hold a portion of member banks' reserves, perform other central banking functions, and issue currency against commercial assets and gold. The reserve banks would be financed by subscription from commercial banks within their area of jurisdiction. This would be compulsory for nationally chartered banks; state chartered banks would have the option to join. This was put to Wilson in December 1912 who received it with some enthusiasm but insisted on one, major, modification. This was the appointment of a central board to control and co-ordinate the work of the regional banks but this time the centralisation was to be vested in a public agency, answerable to congress, and not a committee of bankers. Once this became known, the battle began.

On the one hand, bankers and conservatives argued that the Wilson plan allowed too much government intrusion into private commerce. A poll showed that over 25 per cent of nationally chartered banks would consider resigning their charters if the plan went through (Dunne, 1966, p.51). In the event only 18 out of 7,493 did so (Dunne, p. 54). Interestingly, in the light of arguments 80 years later about the benefits of central bank independence, those in favour of bankers' control pointed to the dangers of political pressures that might intrude into policymaking if control were vested in a public agency. Gerald T Dunne, General Counsel for the Federal Reserve Bank of St Louis, writing some fifty years later, referred to Paul M Warburg's '…early prophecies that a central bank accountable to the political branches of government would provide, both in appointment and function, political boodle beyond the wildest dreams of Tammany Hall.' (Dunne, 1966, p.59)

On the other side were the agrarians and progressives. Bryan argued that the proposal did not go far enough to ensure government control. In particular he argued for a minimum of fifty

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[4] The strength of this anti-banking sentiment (and the reasons for it) can be read in chapter 5 of John Steinbeck's *Grapes of Wrath* (1939) while its legacy can be seen in the activities of Occupy Wall St and other protest groups after the 2008 crisis.

[5] It may not have helped Aldrich's case, with the general public at least, that his only daughter was married to John D Rockefeller Jr.

[6] This account, crediting Glass and Willis, is based upon Johnson (2010) pp.21-2 and Meltzer (2003) ch.2. Dunne (1966), however, says that many people claimed to have played some part in framing the proposals. These included Colonel House, Paul Warburg and Prof J Lawrence Laughlin. Dunne also says that '…assertions of paternity flew so thick and fast that Elihu Root's biographer found it a virtual mark of distinction that his man was one member of the Sixty-Third Congress who "never claimed to have credit for framing the Federal Reserve System"' (p.50). Given the protracted nature of the debate over the foundation of a US central bank, it seems likely that many people would have contributed ideas that were finally reflected in the Federal Reserve Act. It fell to Glass and Willis to put the proposals to the President in a coherent way. Willis himself wrote a very detailed account of the Act's development and final provisions for the *American Economic Review* (1914).

regional reserve banks (the number finally decided upon was 12)[7] and for the issue of currency to be an obligation of the Federal Government. After taking advice from Louis D Brandeis, a well-respected legal authority at the time, Wilson announced in June 1913, that he would insist upon exclusive government control of the Federal Reserve Board and make Federal Reserve notes an obligation of the United States.

Since we shall later wish to make comparisons with the foundation and structure of the Bank of England, it may be helpful to summarise the main features of the Federal Reserve System, including material amendments since 1913.

The 1913 Federal Reserve Act provided for:

- A presidentially appointed seven person Board of Governors, including the Secretary of the Treasury, and the Comptroller of the Currency (*ex officio*)
- 12 regional Reserve Banks with nine person directorates. Three of the directors were to be appointed by the central Board of Governors; the remaining six to be elected by the member commercial banks to represent both lender and borrower interests
- Membership of the system to be compulsory for nationally chartered commercial banks and voluntary for state-chartered banks
- Nationally chartered commercial banks to hold stock in the regional Reserve Banks, this stock to pay a fixed dividend of 6 per cent p.a.
- Nationally chartered commercial banks to hold reserves with the Regional Reserve banks, in the light of their deposits.
- Annual profits from Federal Reserve operations (about $80bn in 2012) to be paid to the US Treasury.

The principal amendment to this structure was the creation of the Federal Open Markets Committee (FOMC) under an Act of 1933 (and further amendments in 1935[8] and 1942). This is the body responsible for key decisions about the setting of interest rates and the open market operations in securities required to impose them. The FOMC consists of the central Board of Governors, the President of the New York Federal Reserve and the Presidents of four other regional Reserve Banks on a one year rotating basis. The FOMC is required by law to meet four times a year but generally meets eight times at five to six week intervals.

The original functions of the Federal Reserve were distinctly limited. They reflected the specific anxieties of the time and these, as we said earlier, were issues for a central bank – essentially lender of last resort and note issue. The one notable omission, for modern students of central banking, is any reference to inflation and protecting the value of the currency. But, as Meltzer (2003, p.5) points out, these were not issues of the day. The USA (and the UK and most other countries engaged in significant international trade) were on the gold standard and this mechanism was regarded as an automatic guarantor of price stability. According to Willis himself (1914, p.4) the responsibilities with which the newly-founded Fed was charged were:

- Creation of a joint mechanism for the extension of credit to banks which possess sound assets and which desire to liquidate them for the purpose of meeting legitimate commercial, agricultural, and industrial demands on the part of their clientele.
- Ultimate retirement of the present bond-secured currency, with suitable provision for the fulfillment (sic) of Government obligations to bondholders, coupled with the creation of a satisfactory flexible currency to take its place.

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[7] See Dunne (1966) pp.51-54 for an interesting discussion of the process by which their locations were chosen.

[8] The 1935 Act introduced a number of other changes including the removal of the Secretary of the Treasury, and the Comptroller of the Currency as *ex officio* members and reductions in the autonomy of the regional reserve banks. See Meltzer 2003 p. 5.

- Provision for better extension of American banking facilities in foreign countries to the end that our trade abroad may be enlarged and that American business men in foreign countries may obtain the accommodations they require in the conduct of their operations.

Since its foundation the Fed's responsibilities have evolved (and generally increased). They now embrace four areas of activity:

- conducting the nation's monetary policy by influencing the monetary and credit conditions in the economy in pursuit of maximum employment, stable prices, and moderate long-term interest rates.
- supervising and regulating banking institutions to ensure the safety and soundness of the nation's banking and financial system and to protect the credit rights of consumers .
- maintaining the stability of the financial system and containing systemic risk that may arise in financial markets.
- providing financial services to depository institutions, the U.S. government, and foreign official institutions, including playing a major role in operating the nation's payments system.[9]

The first of these later hardened into the Fed's so-called 'dual mandate', following an amendment of the Federal Reserve Act by Congress in 1977.[10]

The Aldrich Plan and subsequently the Glass-Willis proposals were not the first attempts to establish a US central bank and the issues of ownership and control that we have just discussed were the same issues that undermined the earlier initiatives. The first US central bank was established in 1791 under the leadership of Alexander Hamilton and in the face of opposition from Thomas Jefferson and others who argued that it was unconstitutional (Johnson, 2010, pp.7-8). It was essentially a private bank although the Federal government subscribed one-fifth of its capital and appointed one-fifth of its directors. The combination of its size and its private nature caused a great deal of anxiety to many non-bank and especially agricultural interests and when its twenty year charter expired in 1811 it was not renewed.

In 1816, a bill to create a Second Bank of the United States was presented to Congress and once again the divisions between those who saw the economic necessity and those who doubted its constitutional legitimacy re-emerged. However, it narrowly passed both Houses and the result looked much like its predecessor except for its larger size. (Its capital was $35m against $10m). Like its predecessor it was regarded as a major threat by the much smaller state-chartered banks but also by business and farming interests. The President, Andrew Jackson, was a leading opponent and, once again, when the charter expired in 1836 it was not renewed.

For the next generation or so, banking in the USA was the responsibility of state-chartered banks. These banks could issue their own notes (whose quality varied widely) as well as carrying on the normal business of commercial banks with no Federal oversight. Inadequate capital and reserves, and poor quality loans were commonplace and bank failures, especially in the midwest, were regular events.

In 1863, Congress passed the National Banking Act. This did not attempt to create another central bank but it did lay down conditions to make the need for a central bank less pressing. It established nationally-chartered banks and gave them (eventually) a monopoly over the note issue. It also required nationally-chartered banks to hold minimum capital and reserves. Nonetheless, many problems persisted. There was still no lender of last resort and no effective way of redistributing reserves between deficit and surplus banks. Many private arrangements emerged

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[9] http://www.federalreserve.gov/aboutthefed/mission.htm (accessed 5.6.13)

[10] 'The Board of Governors of the Federal Reserve System and the Federal Open Market Committee shall maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices and moderate long-term interest rates.'

but these lacked any official status or oversight. The result, at the turn of the century, was the picture that we described at the opening of this section.

What this brief history shows is that the arguments over ownership and control, large finance against small business, that dogged the founding of the Federal Reserve went back almost to the founding of the State itself. They also foreshadowed the late 20th century debates over independence and the optimal design of monetary policy. Part of that debate, as we shall see in section 4, has crystallised around the idea that a central bank that is under appropriate democratic control (as the founders of the Fed were determined to ensure) would be wide open to political pressure which would create an 'inflation bias', a problem that could be overcome by 'independence'. We shall show that this anxiety is based on some misconceptions but more relevant here is the fact that the founders of the Federal Reserve felt strongly that democratic control provided the central bank with protection. They also had 'independence' in mind but in this case it was independence of the 'money trust' that they sought. Independence, in this case, was underwritten and not threatened by close relations with the political power. That said, recent Boards of Governors have been unable to ignore the modern interpretation and, sensitive to the spirit of the age, have stressed that the Fed is also independent of government in so far as its monetary policy decisions do not have to be approved by the President or anyone else in the executive or legislative branches of government, it does not receive funding appropriated by the Congress, and the terms of the members of the Board of Governors span multiple presidential and congressional terms.[11] It might also be added that while the Board members are appointed by the President, their appointment is subject to Senate confirmation.

3. The Bank of England

The early history of the Bank of England could not have been more different. Founded in 1694 it was, says Davies (2002, p.257) '…born out of a marriage of convenience between the business community of the City [of London], ambitiously confident that it could run such a bank profitably, and the government of the day, desperately short of the very large amount of cash urgently needed to carry on the long war against Louis XIV…' In other words, it was conceived initially as a commercial banking operation; the accretion of central banking responsibilities would take more than a century.[12]

The Bank of England was created by the Ways and Means Act of June 1694. The same act was sometimes referred to as the 'Tonnage Act' since (as an early example of 'hypothecation') it granted to King William and Queen Mary the tax revenue from ships and wines to be used '…for securing certain Recompenses and Advantages…to such persons as shall voluntarily advance the sum of fifteen hundred thousand Pounds toward carrying on the war against France' (Clapham, 1944, I, p.17)). The intention of the Act was confirmed by a Royal Charter of Incorporation in July of the same year. The Charter was to be renewed (or annulled) in 1706.

The most significant part of the deal is that the loan of £1,500,000 was to be initially for twelve years but, given the renewal of the Charter, turned out to be in perpetuity. The Bank was to be paid eight per cent interest and an annual management fee of £4,000. 'Thus for just £100,000 a year, and some vague privileges to a bank, and with no capital repayment burden to worry about, the government received £1,200,000 immediately' (Davies, 2002, p.260). The whole of the £1.5m was in government hands by the end of the year financed by £300,000 in annuities and £1.2m in original capital subscribed. By limiting the maximum ownership of the original shares to £10,000, ownership of the Bank was spread over more than 1,500, private, investors. The bank also had the power to issue notes up to the amount it had lent to the government. The bank discounted British bills at six percent and foreign bills at four and a half percent in order to encourage people to deposit money. There was no mention in the Charter of the newly-founded Bank holding reserve balances for other commercial banks or having control over the note issue (most banks issued

[11] http://www.federalreserve.gov/faqs/about_14986.htm (accessed 5.6.13)

[12] Interestingly, the world's oldest central bank, the Swedish Riksbank, was founded in 1668 also to help the reigning monarch finance a costly war. See Wetterberg, 2009, ch.1.

their own notes at this time) or acting as lender of last resort,. These functions were to come later; in the last case, much later.

With a few exceptions, existing banks ('goldsmith bankers') viewed the Bank of England with hostility, fearing competition and a reduction in the usurious interest rates that they were able to charge (Goodman, 2009, pp.20 and 24; Davies, 2002, p.257). Nonetheless, after several attempts to destabilise the newly-founded bank, many goldsmiths and some private bankers found it expedient to hold accounts at the Bank of England in order to deposit the Bank's notes that had come into their possession and to make withdrawals (Clapham, 1944 pp.30-33).

In 1697, the Bank's stockholders were obliged to make a further advance to the government (this time at six per cent interest), effectively doubling the Bank's capital. The issue of notes 'payable to bearer' was authorised[13] and the monopoly of corporate organisation was granted by providing that no other bank or corporation in the form of a bank (exceeding a partnership of six persons) should be allowed in the UK, for the duration of the Bank's charter. This was renewed in 1707. By 1782 the Bank's capital had increased to about £11.5m, as a result of further lending to the government. Subsequent charter renewals during the eighteenth century enabled the government to reduce the interest it paid to three per cent while negotiating minor changes to the Bank's considerable privileges (Dunbar, 1929, pp.141-2).

The ability to meet requests for payment on demand is one of the critical tests of a bank's soundness. [14] It will be recalled that the periodic inability of private banks in the US to redeem their notes was one cause of agitation for what became the Federal Reserve. A similar situation developed during the eighteenth century in England. Despite the Bank of England's monopoly as a *corporate* organisation there were many small London and country banks that issued their own notes. Furthermore, the number of country banks expanded quickly after 1750, reflecting the needs of trade in the early industrial revolution. Indeed, so pressing did the needs of trade become that country banks greatly increased their issues of private notes, according to Clapham (1944, p.97) by 20-25 per cent between 1822 and 1825. Towards the end of 1825, confidence began to wane and by December panic set in. Although the Bank itself managed to avoid suspending payment (by borrowing gold from the Bank of France), by the end of the year some 50 banks had gone bankrupt, and more were to follow in 1826 (Clapham, 1944, p.102).

The 1826 Banking Act partially relaxed the Bank's monopoly by giving to companies of more than six persons the right of issuing notes provided that they were at least sixty-five miles from London in the hope that notes issued by larger organisations might attract more confidence than those of lesser firms. But more important for the cohesion and stability of English banking was the power it gave to the Bank of England to establish regional branches. In the long-run, this more or less guaranteed that commercial banks would hold balances with Bank of England and also that they would find it expedient to use Bank of England notes. This had already been happening in London since the 1790s. Clapham cites Liverpool-Manchester as an area where this was well-established in the 1830s with Birmingham and Gloucester developing on similar lines (Clapham, 1944, p.120).

The final stage in the development of the Bank's responsibility for note issue (and the virtually inevitable holding of bankers' balances that followed) came with the Bank Charter Act of 1844. In English monetary (as opposed to banking) history this Act occupies a prominent position which it almost certainly does not deserve. Its principal motivation was to ensure some control over the pace of monetary and credit expansion. Its focus in modern parlance was macroeconomic stability. One might even stretch a point by saying that it is the first recognition that the central bank should have some responsibility for price stability. But that is not how the Bank saw it and, in any event, as Davies (2002, p.313) points out, it was quite unfitted to the purpose since it focused on limiting the note issue while completely failing to recognise that many transactions were financed (even in 1844) by cheques drawn on deposits. Apparently, for the framers of the Act, deposits were not money. In renewing the Bank's charter again, the Act gave the government of

[13] The earlier notes had been 'payable to order' which limited their circulation (Dunbar, 1929, p.141).

[14] This, and the ability to manage the liquidity risk to which it gives rise, might be regarded as a defining feature of a bank.

Sir Robert Peel the opportunity both to reorganise the Bank (into an 'issue' department and a 'banking' department) and finally to bring an end to the issue of notes by private banks. The formula for the latter (which also imposed a limit on the total issue of banknotes) was as follows. The issue department was enabled to issue £14m in notes backed by UK government securities. Beyond this limit, every note issued must be backed by precious metal.[15] As regards private banks, no bank not then engaged in note issue would be allowed to do so in future, furthermore, should any issuing bank cease to issue for any reason, it would not be allowed to resume but the Bank would be able to increase its 'fiduciary' issue (backed by securities) to an extent of 2/3 of the terminating bank's issue. Eventually, private issues would cease.[16]

As we saw at the beginning of section 2, the lender of last resort function and the need for financial stability was an explicit part of the motivation behind the creation of the Federal Reserve. For this reason, the national banks were required to hold stock in the regional and reserve banks and to deposit with them. In the case of the Bank of England, however, its founders had no such role in view and the Bank's holding of balances of commercial banks developed only with the role of note issue. For this reason, there were numerous crises and panics between 1694 and 1844 in which the powers of the Bank to help were limited, even if it wished to accept that responsibility, by its ability only to discount various securities.

The willingness to help individual banks in moments of transitory illiquidity is one thing however; accepting responsibility for systemic financial stability is something else. The slow and painful evolution of this responsibility is shown by the Bank's reaction to a series of panics in the nineteenth century, culminating in the so-called Baring's crisis of 1890.

Banking is a peculiar business in a number of ways. At the root is the asymmetry of information between borrower and lender that banking is designed to overcome. It is often thought that banks are subject to illiquidity risk and the danger of contagion because of their involvement in the payments system. But Charles Goodhart showed some years ago that this is at best only part of the story and that even if banks could divest themselves of payment responsibilities, they would still be exposed to individual runs and systemic crises. This is inevitable while banks offer a nominal convertible guarantee for deposits while holding non-marketable assets about whose value there is some degree of uncertainty (Goodhart, 1989, pp. 188-93).[17]

We have already referred to the crisis of 1825. There were further crises in 1847 (associated with the 'railway mania') and in 1857 ('…the first really world-wide crisis in history…' (Clapham, 1944, p.226)). The latter began with the failure of US trust companies and banks.[18] In the mid-nineteenth century the UK had been a big exporter of capital to the USA and so the shocks were quickly transmitted eastward. The first UK bank to fail as a result of its US exposure was the Liverpool Borough Bank in October 1857. This was followed by widespread failures of banks and other financial institutions in London, Birmingham and Leeds. On Monday 16th November the Bank received a letter from the UK government advising it that it would be indemnified against the legal consequences of increasing the note issue in order that it could then discount additional bills from banks in distress. By the end of November the monetary phase of the crisis was over but not before many financial firms had gone bankrupt taking with them some large industrial concerns in Wolverhampton and on Tyneside. What is notable is the number of failures that occurred *after* the effective suspension of the Bank Charter Act, as a result of the Bank refusing assistance.[19] It also refused assistance to Overend and Gurney in May 1866, though in this case it is doubtful that the bank was worth saving. Originally two separate partnerships, of long-standing and high reputation in Gurney's case, the firm was floated as a joint stock company in August 1865. Overends had expanded rapidly, however, and had a portfolio 'filled up with all sorts of flimsy paper'. According to Clapham, (1944, pp.260-1) the weakness was widely-rumoured in the City

[15] Effectively gold, since the Bank ceased to hold silver for this purpose after 1855 (Dunbar, 1929, p.146)

[17] The same theme is the subject of the seminal paper by Diamond and Dybvig (1983).

[18] In October 1857 alone, 1415 US banks failed (Clapham, 1944, p.227).

and the Bank may well have felt that it was confronted with a hopeless case.[20] The failure resulted in widespread panic and in the failure of a number of bank and non-bank firms, but this time the rapid publication (on 12 May) of a letter of indemnity from the Chancellor was enough to calm the City (without the Bank having to draw on the indemnity).

All of this contrasts with the crisis that arose nearly 25 years later when Barings came within hours of failure. Once again, rapid expansion was involved though in the case of Barings it was the wisdom of diversification as well as credit assessment that was put to one side. In the 1800s they (like other UK banks but on a greater scale) had invested heavily in South America and Argentina in particular. Hence, when revolution broke out in August 1890 they were in serious trouble.[21] Rumours of their difficulty were circulating in late-October but the crisis became imminent on 8th November when E C Baring informed the Bank's Governor that they would probably have to cease trading in the next few days. Until these problems emerged, Barings had been a highly-regarded partnership and its paper was widely held by other banks and brokers. A failure would cause large-scale contagion. On Monday 10th the Governor invited the Chancellor of the Exchequer to an urgent meeting. The latter's diary for that day reveals two particularly interesting points. The first is that the Chancellor had time to guess what the problem was. If it was Barings '…1866 would be a trifle to it…' Furthermore, he found the Governor in a state of great alarm and anxious for help from government. The Chancellor's diary records that he made it clear that he could not 'interfere on behalf of an insolvent house…' but that if Barings was solvent he would do all that he could. The allusion to 1866 suggests that the government (and most probably the Bank also) had learned something about the costs of contagion; the reference to solvency is a statement of the fundamental principle of lender of last resort – namely that it should be available only to a solvent bank (and even then on carefully specified terms). Clapham (1944, p.331) records that Barings needed some £8-9m to meet maturing liabilities (at a time when the Bank's own reserves were only £10.8m). Within a frantic week the Governor of the Bank, William Lidderdale, had established the details of Barings' position, sufficient to satisfy the Bank and the government on the subject of solvency. Also, by referring to 1866 and drawing stark pictures of systemic failure in which many innocents would suffer, he had secured promises from all the major City banks (these amounted eventually to £17m) as well as agreement by the government to bear 50 per cent of any loss that the Bank might incur as a result of the rescue.

By 1900, therefore, (and if Meltzer is correct, just in time for the Fed's founders to regard it as a model) the Bank of England looked like a modern central bank. However, as with the Fed in its early years, there was no mandate, nor any expectation, that the Bank should focus on price stability. This was guaranteed by the Bank Charter Act and the linking of changes in the note issue to changes in holdings of gold. And, except for the period of the First World War and its aftermath, when the gold standard was suspended, prices were remarkably stable between 1844 and 1931. It was partly for this reason (but also for reasons of City prestige) that the Governor of the Bank of England fought so strongly to readopt the gold standard, which it did in 1925. Unfortunately, the exchange rate chosen ($4.86 to £1) almost certainly overvalued the pound sterling by about ten per cent and prevented the UK economy from enjoying the growth and prosperity over which the Fed presided from 1925 to 1929 (Moggridge 1972, Kynaston 2001a pp.102-31; Keynes, 1925, Sayers, 1976, I, ch.7) . In 1931, the gold standard was swept away for good and the Bank of England focused its attention on industrial reconstruction. However, the deflationary episode of 1925-31 and the suspicion that the Bank was more concerned with the City's international status than the plight of the domestic economy, left a negative legacy with the left of British politics and

[20] Walter Bagehot, editor of *The Economist* at the time, was scathing about Overend's contribution to the collapse. 'And these losses were made in a manner so reckless and so foolish, that one would think a child who had lent money in the City of London would have lent it better'. (Bagehot, 1873, p.19)

[21] A number of its investments had already turned bad (Davies, 2002, p.349). Clapham hints that standards of probity amongst Argentine statesmen and industrialists left something to be desired. Certainly there were widespread references in the City to an 'enormous mass of discredited South American securities…' (1944, pp.326-27)

the Bank was nationalised by the post-war Labour Government of 1946 (Kynaston, 2001b, pp.9-11). The Treasury became the sole shareholder and the destination for Bank profits.

Until the 1990s, the Bank of England acted effectively as an agent for government. Monetary policy and, to a lesser extent, debt management, were made by the Treasury, though the Governor at the time of nationalisation, Lord Catto, prided himself on having negotiated very little change in the Bank's daily operations. Many decisions that were made by the Treasury continued to be routed through the Bank to the rest of the City (Kynaston 2001b p.12). As regards its policy priorities, therefore, the Bank found itself pursuing a collection of vaguely formulated and partially conflicting objectives such as full employment, price stability, economic growth and a fixed exchange rate. Until 1971, this was done via a variety of direct controls and moral suasion (or 'jawboning' to use a modern expression). 1971 marked the first attempt to adopt ban rate as the principal policy instrument and this became focused on creating and maintaining the conditions for price stability after an explicit inflation target of 2.5 per cent was adopted in 1992. The Bank was granted operational independence (but remained nationalised) in May 1997.

4. History and the independence debate

What lessons, if any, do these contrasting histories provide for the recent debate over the merits of central bank independence. The first and most obvious relates to the measurement of independence. Most empirical work on the independence-price stability relationship relies upon cross-section correlations between the average rate of inflation and a measure of central bank independence (see Alesina and Summers, 1983, for a typical and influential example). The index of independence is usually compiled from what Forder (2003 p.309) calls 'statute reading', meaning that the researcher looks at the charter, remit, statute or other official document(s) governing the central bank's operation and ticks those characteristics that, *in the researcher's view*, should conduce to independence from government. Apart from the subjectivity attaching to this exercise (not to mention any attempt to weight the characteristics) there is the obvious objection that what a bank does in practice may not be a close reflection of what the official documents intend (Cukierman *et al*, 1992). One might imagine that this caveat applies primarily to central banks in less developed economies where a free press and the rule of law are in their infancy and where the temptation to personal gain by autocratic and corrupt administrations frequently overrides any constitutional rules. But while that may be, the histories of both the US Fed and the Bank of England also show the dangers of relying on this approach. What we saw in section 2 is that anxieties about the ownership and control of a central bank (what nowadays we would call its 'independence') played a large part in delaying the foundation of the Federal Reserve. Furthermore, when its time finally came, its founders were determined to make it independent, but independent of the money trust. In order to do this, they gave considerable powers to the President and to Congress. As Blinder (1998, pp.21 and 66) and Forder (2003 pp. 298-9) point out, the reputation that the Federal Reserve has as a successful, inflation-fighting, central bank comes from key figures in its history, in particular Volcker and Greenspan.

For most of its like, the Bank of England has been a privately-owned institution, answerable ultimately to its shareholders. At its most independent (of government), under its governor Montagu Norman, it stands accused of being mainly concerned with retaining the City of London's position in the international system (Boyle, Moggridge). For more than forty years, after nationalisation, it acted unambiguously as an agent of the UK Treasury achieving some sort of statutory independence only after 1997. Clearly, therefore, what one learns from 'statute reading' depends upon the timing. That said, however, if one focuses on the post-1997 period, the Bank of England ticks sufficient boxes to be placed somewhere in the middle of the spectrum. But the boxes do not refer to ownership and the significance of this became apparent in November 2012 when the UK Chancellor went to considerable lengths to secure his own choice as Governor of the Bank of England with an understanding that he would pursue a more 'flexible' monetary policy (*Financial Times,* 2012). A rather similar, but more aggressive, version of these events occurred in Japan (*FT* , 2013).

Whether or not reading the statutes tells us much that's useful about the independence of the Fed and the Bank of England, there are other lessons to be learned from their history. This relates to the question of what they are independent of. We have noted that the independence literature is principally concerned with independence of political pressures and we've seen that this was not the independence that concerned the Fed's founders. There are also some interesting lessons from the Bank of England's experience of operational independence. When this was granted in May 1997, the Bank lost two of its traditional functions. The first of these was the one for which it was originally founded, namely the management of the national debt.[22] The second was the supervision of the banking system, a responsibility that we saw it acquire during the later nineteenth century.[23] In both cases the argument was that these responsibilities might pose a conflict of interest when it came to setting interest rates with a view to price stability. 'Independence' in this case was nothing to do with political pressure but simply meant freedom to concentrate on a single objective. Interestingly, a major step in this direction had been taken in November 1992 when the Bank adopted an explicit inflation target and this marked the beginning of what Governor Mervyn King was to call the 'NICE' times.[24] What all this tells us is what most of us know already which is that it is easier to succeed when pursuing just one objective than when trying to achieve several simultaneously; the distractions do not have to come from a political direction.

For the Fed the picture is a little different because of the dual mandate in which it is directed to pay attention to both price stability and unemployment. There is potential for conflict here *if* Congress (or the President) insist on pushing the level of unemployment below the natural rate. But no politicians since the Thatcher-Reagan era have shown any enthusiasm for this. As Blinder (1998 p.42) argues, loss functions (like those posited by Barro and Gordon, 1983) where the optimal level of unemployment is below the natural rate, are a figment of economic theory.

5. Conclusion

For the last twenty years, there has been a widespread view in monetary economics that monetary policy outcomes are better if they are conducted by a central bank which is independent of political pressures. However, there are a number of problems with this argument as Blinder (1998), Forder (2003) and Howells and Biefang-Frisancho Mariscal (2006) have shown. Some, but not all, of those problems can be illustrated by reference to the very different histories of the Federal Reserve and the Bank of England. Those histories raise questions about how we measure independence and whether behaviour can differ from rules. They also raise questions about the meaning of 'independence'. Most of us can get more done (and do it better) if we are not subject to interference. But interference comes in many forms, not just political pressure.

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[22] This was transferred to a newly-established Debt Management Office: www.dmo.gov.uk

[23] This was transferred to the Financial Services Authority: www.fsa.gov.uk

[24] 'non-inflationary, consistently expansionary' (King, 2003)

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