Book Review: An ECB manager on the long and successful history of monetary financing

May 21, 2020 | In his path-breaking history of central banking in Europe, a high-ranking manager of the European Central Bank shows central banking to be much older than the Anglo-Saxon historiography would admit, and that central banks have historically quite often served the purpose of financing public expenditure.

The Bank of England (BoE) decided in April to give money directly to the government to finance support measures during the corona crisis. The US central bank (Fed), for its part, has started buying up government bonds of states and municipalities in order to help them with financing. And the European Central Bank (ECB) has released all the brakes on the purchase of bonds issued by member states, which until now were supposed to ensure that there was no "monetary government financing through the back door".

Each of these measures seems like a taboo break under the mainstream view on independence of central banks from governments. The Bundesbank has always been very critical of monetary public financing. It is the same with the ECB, whose statutes have been crafted with the Bundesbank as a role model in mind.

However, at the end of last year, a Director General of the ECB, a German even, published a book on the history of central banking in which he describes monetary public financing as the historical norm and considers it to be not be problematic per se, as there are significant examples of central banks which persistently contributed to Government funding without this undermining monetary stability. Director General is the highest career level in the ECB, directly below the politically staffed Executive Board.

The Bank of England was far from first

For the predominant Anglo-Saxon historiography, the history of central banks begins with the founding of the Bank of England in 1694 and the Swedish Riksbank, which was founded somewhat earlier and also still exists.

Ulrich Bindseil contrasts this with a Continental European history of central banking - a history that goes back almost three centuries further. "Central Banks before 1800: A Rehabilitation" is the programmatic title of his book.

Historical figures like Machiavelli, Montesquieu, Mirabeau, Ricardo and Hamilton are lined up with their views on the relationship between governments and central banks: How independent must a central bank be? Does the money creation profit belong to the state or private individuals? Should the central bank give loans to the state? These questions were already being debated in the 15th century.

As examples of early central banks that worked successfully for centuries, Bindseil cites the Hamburg Bank, founded in 1619 with the aim of promoting commerce and trade, the Bank of Amsterdam from 1609, the Bank of Rialto in Venice from 1587, and the Casa di San Giorgio in Genoa, which was in business from 1407 to the end of the 18th century. He gives the title of first central bank to the Taula de Canvi, founded in 1401 in Barcelona to manage the city's finances and reduce its borrowing costs, as well as to manage deposits that served as a means of payment.

Monetary financing was common

The strict prohibition of state financing by the central bank, as included in the Maastricht Treaty on Monetary Union at Germany's insistence, represents an extreme case, even if not unprecedented as a number of central banks had applied such prohibitions for some time at least. Most of the central banks operating before 1800 had statutes that charged them with facilitating the financing of public expenditures, reports Bindseil.

When the Bank of England was founded, this function was also emphasised by its supporters. Similarly, in the early US Alexander Hamilton, who was one of the staunch advocates of a central bank independent of the government, stressed the financial advantages for the government if there were a central bank that could buy its bonds and, in an emergency, help it out beyond.

"The longest-lived central banks appeared to be those that did not deny society the benefit of central bank credit", concludes Bindseil, adding that institutional arrangements that guaranteed independence from government were part of the formula of long-lived central banks. For him, historical evidence suggests that monetization of government debt need not necessarily be considered a bad idea.

For this, he says, has allowed governments to diversify and cheapen their borrowing, to spread expenditure over time and, in critical situations, to rely less on a private capital market, which is very expensive in crises.

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For this very reason, the ECB is currently buying up Italian government bonds en masse. Otherwise the government, which has been particularly hard hit by the corona crisis, could only sell its bonds at very high yields, which could easily lead into a self-fulfilling down-ward spiral of high-financing costs, which bread expectations of insolvency, which raise financing costs further.

The traditional objection to monetary financing is the danger of abuse by short-sighted governments. Bindseil counters that one should not assume abuse from the outset if both constructive and harmful uses of this instrument of financing is possible.

He cites examples of central banks that provided public finance and were successful for a very long time, not least the Bank of England, but also counter-examples where the government used too much credit from the central bank for unproductive purposes. These examples include the Taula de Canvi in Barcelona founded in 1401, whose possibilities of granting credit to the city were drastically restricted for this reason as early as 1412.

The world has changed, the dogmas have not

Bindseil emphasizes two differences between the first 500 years of central bank history and the last 50 to 100 years: Until 50 years ago, a precious metal standard was almost always in effect. That is, the currencies issued by central banks carried the promise that they could be exchanged for gold or silver at a certain rate.

As a result, central banks had to be much more careful than today to remain liquid. If the official gold reserves were not large enough, it was very risky to put additional money into circulation. That limit no longer exists today.

The other big difference is the absolutism that prevailed in the first centuries of central banking. A monarch cannot make a credible commitment to preserve the value of the currency and not to take gold from the central bank when he urgently needs it, for example to wage war.

A state within a state: Machiavelli's ideal central bank

In a democracy with a functioning separation of powers, however, it is much easier to ensure transparency and accountability in the relationship between the central bank and the government. In monarchies, central banks have therefore sometimes been turned into a "state within a state", as Machiavelli admirably put it with reference to the Casa in Genoa.

The trick was to give a group of rich and powerful citizens a state licence to operate a central bank. If the monarch had started a fight with these powerful citizens for the bank's gold, it would have cost him a lot. The Casa in Genoa became a model for the Bank of England.

Even in the days of absolutism, the counter position also had illustrious names to offer. FThe politician and writer Marquis de Mirabeau rejected privately owned central banks. For not only the state, but also private owners of a central bank would have conflicts of interest.

The famous economist David Ricardo strongly advocated that the state and not private central bank owners should receive the profits from the creation of money. He proposed that the operations of the central bank should be placed in the hands of governors who could only be removed from office by a majority in one or both houses of parliament.

The opinion of the banker and politician Alexander Hamilton, on the other hand, who, as first Secretary of the Treasury, pushed forward the Bank of the United States, the Fed's predecessor, was quite different. He strongly advocated that the monopoly on money creation, even in a democracy, was best held by private bankers.

It is true that today the monopoly of banknote issuance is held by public central banks. Nevertheless, the situation is more comparable to that at the time of the founding of the Bank of England in terms of the allocation of the profits from money creation. For at that time there was hardly any private banking in the modern sense. The central bank was "The Bank". That's the popular name of the Bank of England to this day.

The term central bank or Federal Reserve came into being only when it became necessary to separate it from private commercial banks.

Today, in contrast, 90 percent of the money in circulation is created by private commercial banks in the form of bank deposits, which functional as a means of payment almost as good as the legal tender. Banks create that money on their own account, for their own profit, albeit under the supervision of the central bank. The bankers have let central banking go to the state, but only after the bulk of banking and money creation had been privatized.

Ulrich Bindseil: "Central banking before 1800: A rehabilitation." Oxford University Press. 336 pages. 79 Euro.