

## ***The Policies of Central Banks in Historical Perspective: An International Comparison***

Governor Antonio Fazio of the Bank of Italy has time and again emphasized the vast array and complexity of the problems facing us. These are amplified at a time when delicate structural questions are still unresolved and the world economy is wavering between uncertainty and hope; that is, between the crisis that has struck important countries and the forecasts for the economy of today's great power, the United States, whose indexes of growth are tracked with ill-concealed apprehension by analysts in every part of the globe, who are poised to exult at the barest hint of an improvement and to despair if the sign is negative.

This essay will not address the climate of pessimism or optimism that pervades the present. Rather, I will look at the questions that governments and institutions had to face yesterday and the day before yesterday, in the conviction that present-day issues can only be understood if past experience is fully taken into account. Questions of the past are indeed the focus of the inquiry promoted by *The Journal of European Economic History*, as they are of the reflections by the Chairman of Banca di Roma, Cesare Geronzi, in his introduction to this volume.

In promoting this investigation it was the *Journal's* aim to offer an appropriate contribution of its own to the process of European monetary unification now under way, a process prepared and stimulated by the central banks including, not least, the Bank of Italy. The *Journal* intended to make available to the makers of European monetary policy the experience accumulated in the monetary field in the century just ended. And if that experience, unhappily, was disturbed by catastrophic world wars, it was rich nonetheless and offers a wealth of suggestions and perspectives. The inquiry covers a span of 80 particularly significant years, from the period immediately after the First World War to the present, and focuses on eight of the most important European countries: Belgium, France, Germany, Italy, the Netherlands, Portugal, Spain and the United Kingdom. Several of the approaches that these eight countries adopted in order to resolve the conflicts between stability and growth on the one hand and stability and efficiency on the other strike us as especially interesting and stimulating.

These conflicts took different forms in the various countries. Each had established its own bank of issue, but banking systems differed substantially and the issuers were subject to disparate legislation regulating their relationships with their respective governments and with private banks. Some of the

banks of issue had no autonomy whatsoever. They had to bow to the directives of the government, which in not infrequent cases also appointed their directors. They were obligated at times to carry out bank rescues, but they lacked adequate procedures and instruments to prevent disasters.

None of the banks of issue could be called a true and proper central bank before the second half of the 1930s, except for the Bank of England. In other words, none of them had the exclusive tasks of lender of last resort, conductor of open-market operations, supervisor of the banking system and manager of the volume of the credit and financial market, and not just that of unlimited supplier of monetary means to the state. However, in 1928, the Bank of Italy was charged with the crucial task of the effective protection of savings, so that its functions began to approach those of the Bank of England.

The eight countries in question had come out of the First World War with the fervent aspiration of a prompt return to the monetary stability that had ruled the world from the Napoleonic wars onwards and had led to progress beyond all imagination, even inspiring Bergsonian belief in infinite progress, in a 'golden' age not in the past but to come.

But how to achieve this aspiration? The war had utterly deranged international financial relations, and if some countries seemed condemned to pay war reparations for years, all the countries were basically debtors in varying degree (after taking offsets into account). All, that is, except the United States, which far from being burdened by debts held a wealth of credits. But most of the European countries failed to comprehend that the war had catalysed the explosive growth of America's economic might and the power of the dollar. Monetary parities were finally decided, but not until seven years after the end of the war – seven years fraught with problems and marked by the end of the brief postwar boom in March 1920, by the crisis of 1920–21 and by economic and social strife that in some countries led to radical changes of regime.

In the early postwar years most of the countries in question opted for growth over stability. Growth interested the masses of unemployed and the business world. And it also attracted governments that not only had to tackle the job of reconstruction but also faced having to pay a huge volume of pensions and subsidies and servicing an enormous public debt, which inflation steadily eroded. This was the course taken in Belgium, Italy, Portugal, Spain, Germany and France. Only the Netherlands and Britain did not follow suit.

Once the immediate postwar period drew to a close, some of the countries that had preferred growth began to shift towards a more restrictive policy. The outstanding example is Germany, which, after its bout of hyperinflation in 1923, introduced the Rentenmark and inaugurated a policy of control of the note issue that it did not abandon until 1932. Other countries reduced public spending, increased the tax burden and resorted to loans from America and Britain. In the case of Italy, instead of stabilizing the lira at the value around which it had been fluctuating, the government opted in 1926 and into

1927 for a politically motivated deflation that threw the whole Italian economy into crisis. An analogous course was followed by Britain, with the restoration of the prewar parity.

In 1926, the same year as the Italian and British deflations, Belgium, Portugal and France succeeded in stabilizing their currencies after carrying out strenuous fiscal adjustment with an increase in interest rates and a sizeable loan in dollars from British and American banks. The situation of Spain was more difficult. Between 1927 and 1929 the country attempted to return to the gold standard, but it was unable to defend an unduly high parity against speculation of the kind that had earlier been directed against the currencies of other countries (for instance, Germany in 1919-20, France in 1924, Italy in 1925-26).

After the postwar crisis came the Great Depression, which hit bottom in 1932, when the number of people out of work was estimated at 30 million. The crisis afflicted all the countries of Europe and beyond, but it was most severe in the United States and Germany. The crisis had been brewing for some time. Studies of the causes of the Depression have stressed credit inflation, underconsumption, the temporary drying up of investment opportunities, and excessive stock-market speculation. Analysis has concentrated above all on the decline of investment; on the credit tightening following the fall of farm prices and the stock-market; on the excess burden of debt carried by farmers, businesses and consumers; on the policy aimed initially at supporting wages while prices were collapsing and subsequently, after 1930, at allowing them gradually to be reduced, which led businessmen to expect further cuts in wages and thus restrained them from investing.

But perhaps the key factor of crisis was the belief that the modest signs of recovery in the first half of 1930 heralded the end of the recession. Instead, the economic situation foundered in the second half of that year, with the prices of agricultural products and other raw materials collapsing. That mistaken forecast may have convinced businessmen to 'wait and see' and thus delayed the start of recovery. Confidence was further shaken when the international monetary system became unstuck after sterling was devalued by about 40 per cent in September 1931.

Meanwhile, the shift from the gold standard to the gold exchange standard had modified the concept of stability. Stability had come to depend not only on gold but also on the stability of currencies considered equivalent to gold. This was a form of relative stability, set in an 'international context strongly characterized by instability'. Its consequences were seen on the occasion of the devaluation of sterling and the currencies of the sterling area.

Stability was certainly pursued by France, which had accumulated sizable gold reserves, and also by the Netherlands, Italy and Belgium, all of which belonged to the gold bloc, as well as by Germany. This 'stability' conflicted neither with growth nor with efficiency, seeing that prices were spiralling downwards from month to month, if not with each passing day. In Germany,

however, the conflict was of a political nature. The government attempted to balance the budget by cutting public spending by one third starting in 1930 and by raising taxes and social security contributions. The budgets of public bodies were slashed and the Reichsbank maintained a credit squeeze, raising the discount rate also in order to stem the flight of capital. And when the discount rate was reduced in 1931 following the onset of the banking crisis in Austria, Hungary and other countries, the Reichsbank introduced severe exchange controls to head off the danger of inflation.

All this aggravated the Depression, swelled the ranks of the unemployed and made it easier for Hitler to take power in 1933. Even under the Nazis there was no conflict between stability and growth for several years, although the Nazi regime adopted expansionary fiscal and monetary policies, initially not for military purposes but only for full employment. That goal was achieved in 1936, but inflationary pressure mounted. Between 1937 and 1939 the President of the Reichsbank, Dr Schacht, sought in vain to check it until he resigned.

Britain defended stability only up to September 1931. In the spring and summer of that year Spain too fell victim to a grave financial crisis, due partly to a lack of liquidity and partly to a domestic political crisis that came in the passage from monarchy to republic. Notwithstanding its efforts, Spain had to give up defending the peseta directly and fall back on safeguarding the currency's value with exchange controls. In the same year Portugal, adopting the gold exchange standard, also attained stability. However, the crisis spurred the European countries to more effective regulation of the banking system in order to pre-empt the conflict between stability and growth. Almost all of them imposed structural controls, entry barriers and obstacles to competition, without, however, lessening banks' profitability.

No government was under the illusion that stability could be maintained during the Second World War, although all of them devised instruments to prevent it from being weakened excessively: consumer rationing, controls on credit, prices, exchange rates and so on. In any event, they were powerless to avoid the spread of inflation as the war economy expanded.

The end of the war saw Europe with gravely damaged infrastructure, cities and factories, and with scant capacity for the growth of savings. A vast reconstruction effort was launched. The channels of this far-reaching endeavour were the newly-created organizations of international political and social coordination. Its fulcrum was the new, efficient monetary system created at Bretton Woods, which was able to lead the individual countries, by now ready and eager to cooperate, back to the regime of fixed exchange rates and stability. And its engine was the United States, assisting and accelerating the process of economic adjustment first with various types of aid and then with the Marshall Plan.

In many countries where the myth of economic planning prevailed, banking was considered a sector in which the principles of market freedom had to

be ringed by rigorous controls. Hence the central banks were assigned the task of formulating monetary policy, which, as a counterinflationary and countercyclical instrument, assumed a decisive role in the definition of overall economic policy. And so the central banks became policy makers, while price stability and banking stability became essential objectives of financial regulation. In Italy, the Constitution enshrined the protection of savings among its explicit aims and the Bank of Italy was entrusted with these important powers of control.

Elsewhere in continental Europe, the task of ensuring banking stability had been assigned to separate institutions other than the central bank. In Italy, however, where the 1936 Banking Law had, in fact, established the criterion of separation, this function was transferred to the Bank of Italy. This made Italy and Britain the exceptions to the rule of separation. And since Great Britain was not a signatory of the Treaty of Rome in 1957, Italy was the sole exception among the members of the new European Economic Community. On the other side of the Atlantic, the United States adopted a compromise solution.

Up to the early 1970s there was no problem of financial stability or any case in which the aim of stability came into conflict with either growth or efficiency. Yet these were years of great transformation. Cooperation between European countries intensified in the Organization for Economic Co-operation and Development (OECD) and European Payments Union (EPU), and the financial sector gradually had to adapt to the changes taking place in the economic structure of the West. Foreign exchange controls were eliminated, the fixed-exchange-rate regime solidified, trade barriers were lowered thanks in part to General Agreement on Tariffs and Trade (GATT), and goods and then capital circulated freely in the EEC.

There is no need here to dwell on the extraordinary economic progress that was achieved. But it is worth stressing the increase in capital formation, which gradually allowed households to diversify their portfolio choices, allocating a growing percentage of their savings to securities issued by the private sector; the progressive internationalization of individual economies, of which the creation of the European Economic Community was but one aspect; and the manifest operational and economic inadequacy of state-owned activities, banks included.

In response to the emerging needs – the initiative came from France, but also from the Bank of Italy – a financial market based on provisions notable for their transparency features and conduct-of-business rules and overseen by appropriate regulatory agencies was being formed. The defence of stability was entrusted to specific instruments, without limiting competition and with preference given to prudential controls. And this continued to the Basle Capital Accord, which established the minimum requirements for all intermediaries, thereby determining *ex ante* the degree of risk of portfolios.

The adoption of capital ratios strengthened the market forces promoting efficiency in the financial sector and tightened the link between profitability, growth and capital. Competition and stability were no longer considered antithetical. Things changed with the oil crisis of 1973. The oil shock set off inflationary processes in all the member countries of the Community and for the first time since the war posed the dilemma of stability or growth in manifest and general form.

All the governments showed a preference for growth, given the rise of unemployment provoked by the oil shock and aggravated by the restructuring under way in large-scale industry, which was in the throes of shedding labour and installing the new labour-saving technologies in pursuit of enhanced competitiveness. In Belgium, there was even discussion of the possibility of a devaluation.

Not all the member countries succeeded in blocking inflation. To be sure, in Germany the Bundesbank, having regained autonomy, intervened aggressively and used the discount rate to halt the inflationary trend. The Netherlands also succeeded in not being caught up in inflation. The same can be said of France. But a similar result was not achieved by the National Bank of Belgium, notwithstanding the pressure it brought to bear on the government to adopt an adequate budgetary and fiscal policy; nor by the Bank of Portugal, which, facing the recession and unemployment that gripped the country, preferred to increase the money supply and allow the government to expand public spending. Nor did the Bank of Italy succeed, even though it had preceded others in introducing the principle of 'total domestic credit' as a guide to policy in 1974 and notwithstanding its contribution, alongside the other central banks and in cooperation with the EEC, to the creation of the European Monetary System (EMS) in 1978.

In the EMS currency fluctuations were kept within a narrow band anchored to a low-inflation currency such as the German mark. The entire system was supported by effective coordination of the monetary policies of the member countries' central banks, all of which had the stability of the economy as their objective. Yet it was clear that the EMS alone could not solve the economic and monetary problems of member states in difficulty. It was impossible to consider the monetary system as detached from the banking system. And the banking systems of the member countries were weighed down by tradition and incapable of evolving towards more flexible and profitable forms. The central banks, and the Bank of Italy in particular, were aware of this situation, and since they could not remove all the obstacles by acting on the domestic front, they worked, with the cooperation of Community, for the Community itself to intervene. This led in 1981 to the First Banking Directive, which established the principle of mutual recognition of the validity of the laws, regulations and rules of conduct of each country.

The Second Directive aimed directly at banking coordination, establishing that the banks of any member state could provide a series of 'services' (specified in the annex to the Directive) throughout the Community; the services were to be subject to supervision only by each bank's home-country authorities. The Investment Services Directive conformed with the same principle and incorporated the capital requirements for credit and market risks established by the Basle Committee for Banking Supervision.

The Directives became law in the 12 member states and, backed by the active cooperation of these states' central banks, facilitated the adoption of a universal bank model, helped to harmonize banking and financial regulation in all the member states, and gradually raised the level of competition, the ultimate aim of financial regulation. The consequence of all this, again with the full participation of the individual central banks, was the reduction of inflation and the start of modernization of the various banking systems, a process compounded of ingredients such as deregulation, the denationalization of public-sector banks, liberalization, privatization and transparency.

The third Community intervention in the banking and financial sector was the consequence of the Maastricht treaty of 1992, the year in which the EMS was caught up in the monetary crisis that rocked several member states. The intervention in question anticipated European monetary union, the process that, with the decisive contribution of the national central banks, has led to the creation of the European Central Bank and the birth of the single currency, the euro. The entry into circulation of this new currency will be an extraordinary historic event. It will mark the first time in world history that men will actually hold and exchange a currency that is not the expression of a structurally unified state able to formulate monetary and economic policies independently and to implement them with sovereign authority and directness. We will have, therefore, a currency without a state.

This exceptional situation raises problems whose contours we still cannot clearly discern. A new scenario is opening whose elements and prospects must be discovered. A host of questions that are anything but rhetorical compel our attention and demand clarifying response. It is to be hoped that the answers to these questions, though not yet explicit, have already been found or will not be hard to identify.

