The main government-controlled bank in a country, which controls that country's financial affairs by fixing main interest rates, issuing currency, supervising the commercial banks and trying to control the foreign exchange rate

Modern central banks are public, nonprofit, economic, and political institutions, with special functions derived from their command over monetary resources. They shape monetary policy, have a strong influence on exchange rates, and are the guardians of financial stability. Their decisions influence economic variables determining growth, output, and national development policies and have a bearing on the conditions of international financial and monetary cooperation. As a general rule, central banks are regulated by a mandate from government(s) specifying their goals and the conditions under which control over monetary resources is exercised.

After situating the topic in its theoretical context, this entry discusses the rules and social institutions on which central banks' command over monetary resources ultimately rest; stresses the establishment of central banks as a trustworthy system of monetary authority, at the domestic and international levels; and examines the way in which the institution's power has been recast and strengthened in the financial globalization era, in connection with the widespread trend toward central bank independence from elected governments in old and new democracies.

Central Banks as Substate Actors: Theory

An updated review of existing central banks shows a greater variance than is assumed in the dominant rational expectations theories framing the universalistic prescriptions and the role models recommended over the past 30 years. Influence is noticeable, however, in two global trends: (1) in terms of goals, the convergence toward the primacy of price stability, and (2) in terms of the mandated use of monetary resources, the dramatic increase in the number of institutions that acquired statutory independence vis-à-vis governments. Yet the actual variance in the practices and mandates of those institutions across countries and regions limits the scope for generalization. Moreover, central bank functions and powers have been recast over time since the establishment of the first institutions of this breed in the mid-19th century.

A central bank's status as a public, nonprofit institution is the outcome of an evolutionary process, based on the rules and social institutions that underpin its three core functions: (1) as banker to the government, (2) its monopoly of note issuance, and (3) as banker to the banking system—including that of last-resort lender. These functions refer to the unique relationships between the institution and its principal clients: the government and the profit-maximizing financial institutions, mainly commercial banks.

The Relationship Between the Central Banks and the Government

As a public national institution, the central bank derives its functions from a state-backed power as the
sole issuer of a unique currency circulating in a geographical territory—to which it has been granted the status of legal tender (cours forcé).

Parallel to the processes of political delegation, a contractual, economic relationship with the government involves mutual economic interest and economic calculation. Lending to the government, at an agreed fixed interest rate, generates profits alongside those drawn from currency issuance. For the government, having "its own bank" ensures cheaper deficit financing; its power as principal borrower is used to press for a minimum rate of interest. On the other hand, central banks typically stand out as major holders of a government's debt, insofar as they invest their capital in government long-term debt instruments, mainly bonds. Where a domestic public debt market exists or is being established, voluntary loans from private savers provide an additional source of deficit financing. It is a market monitored by the central banks—adding the function of debt management to their other functions.

While the government's preference for cheap finance is an intrinsic component of its relationship to their central banks, deficit financing through monetary expansion—that is, through the monetization of the government’s debt—was exceptional in industrialized countries. Long-term reviews of past practices supplied by Charles Goodhart's team and by Barry Eichengreen indicate economic as well as political reasons for central banks to be congenitally inflation and risk averse. Because they are major holders of the government's debt and because they already profit from lending to the government, they have an overriding interest in keeping the real value of its loans stable. There is also a reputation dimension to its practice, in that the strength of the currency issued is closely related to the creditworthiness of the issuer and to the commitment of the issuing institution to price stability. Prior to the 1970s, the commitment of central banks to convertibility and/or price stability was overridden in only one circumstance: when the survival of the state was threatened by wars. Thus, the "inflationary bias" of economic policy and the temptations of monetary financing of government spending in industrialized countries are late developments that call for a more contextualized analysis of the unstable monetary "regime" in the financial globalization era.

Prompted by two "structural" factors, some developing countries, mainly in Latin America, resorted to an "inflation tax." The first factor was a weak tax system, reflecting the limited capacity of the state to establish itself as a widely accepted fiscal authority. The second was that the inflation tax operated as a conflict-minimizing device to socialize the costs of "catching-up" industrialization. This was typically, as in the case of Brazil, where the state's commitment to a proactive strategy of rewarding the winners was based on the reiterated distribution of skewed fiscal and monetary incentives to selected economic agents.

**Bank to the Banking System**

As bankers to the banking system, central banks play a leading role mainly vis-à-vis commercial banks and less effectively vis-à-vis other profit-maximizing financial institutions. Such a role is, first of all, one of guidance and monitoring. Because commercial banks act simultaneously as deposit takers and loan makers, they are credit multipliers. Since credit is money, their individual micro-economic decisions, guided by profit-maximizing considerations, have a direct bearing on the increase or reduction in the stock of money available in the economy. Central banks' overriding concern with financial and economic stability gradually evolved toward a proactive role in averting this source of volatility. Their function as lender of last resort to the banking system—asserted always in the wake of crises—revolves around the bank's systemic responsibility, in exchange for enhanced powers of supervision and regulation of
commercial banks' behavior. While the necessary function of lender of last resort is called for and is reiterated in crises, it is through its open market operations that the leadership of the central bank over profit-maximizing institutions is exercised. To maintain day-to-day control over the short-term nominal interests rates in all market conditions, the central bank purchases or sells financial securities for cash to change the monetary base. Its power to influence the money supply and other economic variables in this case is exercised through the markets. In other words, through a complex system of incentives and penalties—mainly the bank's discount rate—it may induce commercial banks to proceed with their lending strategies (or dissuade them). Because the central bank can impose the ultimate conditions for granting credit, it enjoys the “magical powers” of creating or destroying money. But it does so by relying on market mechanisms—namely, on its monopolistic position in the credit market and on the predictably self-interested response of profit-maximizing institutions to its interest rate policy.

Set against this background, the use of the term central bank is equivalent to and interchangeable with that of monetary authority—a use that is common to economists of all persuasions. This identity relies on three assumptions. One, wherever a market exists, financial firms and investors act independently from one another. Two, the central banks' power over monetary resources is that of a rule maker—an extension of the state's capacity of enforcement. Three, its creditworthiness derives from its governance capacity in terms of price and financial stability, which in turn derives mainly from its technical credentials.

Political scientists assume a political economy approach to the international monetary regimes in which central banks operate as rule based and contingent. They take as a premise that domestic and world markets are embedded in and permeated by social institutions. From this perspective, the history of the international monetary order (or disorder) is thought of as “the history of the construction and demolition of rules, constitutive and regulative, explicit or tacit, substantive and procedural,” in the words of Bruce Hall (2008, p. 10). Central to this cognitive framing are the politico-economic processes underlying the establishment or disruption of a policy consensus around a monetary regime.

The International Political Economy and Central Banking
A major distinctive feature of the current monetary and financial regime is the rising power of central banks vis-à-vis established governments and the redefinition of their authority vis-à-vis cross-border market actors. To situate such processes requires a shift of focus from its role as a predominantly substate institution to one including its capacities as a public transnational actor in a multilevel system of global governance. The bank's command over monetary resources has been recast in tandem with new modes of interaction with government(s) and with market actors. Those shifts were carried out within the cognitive framing of the rational expectations revolution—centered on the notion of central banks' credibility with the financial markets. They are closely linked to a number of developments that distinguish the post-Bretton Woods monetary era, extending from the 1970s to the present, from its predecessors: the classical gold standard (1844-1945), the interwar decades, and the Bretton Woods system (1945-1971). While the previous systems constituted international monetary regimes proper, whose rules and social institutions were designed and enforced by the United Kingdom (UK) and the United States, respectively, the post-Bretton Woods is considered by many, including Barry Eichengreen, as a “nonsystem.” Successive failures at establishing a durable international monetary order and a great deal of technical experimentation underlie the process by which the powers of the central banks were recast.

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The issues around which the practice and theory of central banking came to revolve are explored by the monetary economist Stanley Fisher. On the one hand, the inflationary tendencies are brought about by the conflict between the short-term and the long-run effects of monetary expansion. On the other, it should revolve around the conflict between the need to shield central banks from the political pressures underlying the monetary financing of government spending and the principle of accountability to the public.

Central Banking and Governments

Central banks’ current powers are tied to critical shifts in their relationship with their constituencies and in the cognitive maps adopted by central bankers. A salient aspect of those developments is a shift in the priorities of monetary management toward the primacy of price stability over other policy goals, such as the promotion of full employment and maximum output. The underlying politico-economic framework is shaped by the threat of runaway inflation in the dominant capitalist democracies, in the 1970s and 1980s, mainly in the United States and the UK, which was an unprecedented experience in peacetime. The international political consensus underlying the Bretton Woods regime had already been shaken in 1971 to 1973 by President Nixon’s unilateral decision to detach the dollar (to which all other currencies were pegged) from the gold standard so that dollars could no longer be converted to gold. Because the dollar was the reserve currency, severe losses in the value of foreign reserves held in dollars were inflicted on the other members in the international monetary system. The ensuing legitimacy crisis was compounded by the refusal of Germany and France to import inflation engendered in the United States.

A matter of interest to the social scientist is brought to the fore by this episode. It highlighted the capacity of a powerful state, the hegemon, to deflect the costs of an overdue domestic adjustment to trading partners. It also highlights the critical role of transnational political coordination in counteracting that mode of power. The unique experience of Europe is a case in point: Both that episode and the crisis of the European Exchange Rate System in the early 1990s propelled the gradual crafting of the institutions that underpinned the Maastricht Agreement provisions aimed at establishing a regional monetary order. The powers of national central banks were redefined accordingly, in tandem with the transfer of their command over monetary resources to the European Central Bank. Insofar as it involved a long-term project, multiple acts of sovereign political delegation, and democratic deliberation, the European Central Bank is a unique case of establishing a transnational monetary authority through statecraft, in the sense explored by Lourdes Sola and Laurence Whitehead (2005) in connection with developing countries.

It is within this shifting monetary, financial, and political context that the new powers and functions assigned to central banks vis-à-vis the governments become meaningful. The centrality of the monetary policy and the monetary counterreaction to the dominance of Keynesian thought marked out a paradigmatic shift away from the postwar economic dirigisme structured around demand management and based on exchange rate, price, and interest rate controls. It brought to an end the subordination of central banks to domestic fiscal authorities.

The empowerment of such institutions, in particular the U.S. Federal Reserve System, highlights in what sense the exercise of monetary authority—as a special mode of political authority—can be strengthened and redesigned within the domestic framework of liberal constitutionalism. Three dimensions are of interest: (1) the strengthened role of central banks as rule makers, (2) the political
dimension of their effective capacity for monetary governance, and (3) the relative power of the
hegemon—the United States, as the issuer of the international reserve currency, the dollar—to lead the
international arrangements that deflected the costs of adjustment to developing countries.

The authority of the Federal Reserve as a sub-state actor is constitutionally specified and limited. Its
autonomy vis-à-vis the executive is constrained by the oversight of the U.S. Congress and, in terms of
its goals, by its dual mandate—price stability and full employment. Neither these constraints nor the
prospect of the huge social and political costs inseparable from recession and unemployment barred
the option for a shock therapy to curb runaway inflation—basically a dramatic increase in the U.S.
interest rates by Federal Reserve Chairman Paul Volcker. The political dimensions of the decision-
making processes underlying a sharp turnaround of monetary policy remain understudied—despite the
evidences that it was premised on successive acts of political delegation from both the executive and
the legislative powers.

It is widely agreed that the Federal Reserve's capacity for monetary governance, in terms of its
success in curbing inflationary expectations, is better explained by its political components than by its
technical ones. Monetary economists, practitioners, and political economists agree that as a technical
exercise, it was hardly a success. Volcker's economic objective was achieved thanks to his decision to
emphasize price stability and to de-emphasize (also on theoretical grounds) the possibility that
monetary policy could affect the level of output. This, in turn, relied on the flexible, dual-mandate design
of the Fed and, above all, on Volcker's intellectual authority and moral credentials. To many
practitioners, such as Alan Blinder, this is a critical asset to forge the near unanimity required in the
collegiate decisions within the Fed. Also, insofar as monetary policy works through the markets, the
technical and moral credibility of practitioners in the eyes of market actors are critical. The technical
complexities of monetary management make this mode of personal, contingent authority a powerful
instrument of persuasion and legitimation in the deliberative processes in Congress—and in the eyes
of the relevant constituencies.

The systemic international functions of the Fed and other core central banks—both as rule makers and
in their capacity of governance—relate to one of the most consequential implications of the dramatic
rise in U.S. interest for developing countries, particularly for Latin America: soaring indebtedness,
vulnerability to further external shocks, and the withdrawal of foreign investors for 9 years. Central
banks in core countries were called to lead the coordination of the international arrangements aimed at
deflecting to debtors the costs of the U.S. adjustments. The threat that their rising debts might feed
on the international banking system prompted the emergence of new institutional arrangements, in
concert with the International Monetary Fund (IMF) and the representatives of the private banking
system. The responses to the "debt crisis" in Latin America were designed by the committees
organized to this end and enforced on a country-by-country basis. They were conditioned on the
implementation of structural economic reforms, including deregulation of the domestic financial
systems and, ultimately, central bank independence. Competition for credit and foreign investments
explains the compliance with most of those prescriptions. Sylvia Maxfield explains the move toward
central bank independence in developing countries as driven by the need to obtain credibility in the
eyes of increasingly competitive financial market actors. However, to the extent that this is a global
trend across five continents, the recasting powers of the institution at the global level must be
specified too.

Independence as Global Governance: The Emergence of Private Authority

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Underlying the problématique of central bank independence is a critical shift in the mode of interaction between the “monetary authority” and market actors. The rising influence of cross-border financial transactions is closely linked to the empowerment of foreign exchange markets and disintermediated debt and bond markets in individual nation-states. The intensified competition among banks and between banks and other financial intermediaries in the past 3 decades continues to be central to this process. Competitive pressures explain also the proliferation of “financial innovations”—that is, the recurring creation of new debt/credit instruments intended to make them more attractive to borrowers and to lenders, both corporate and public. Such innovations lie outside the direct control of domestic central banks, are enhanced by information technology, and are driven by the deregulation and the liberalization of domestic financial markets.

In an international system where there is no world government, governance capacity is found in multiple sites of monetary (and fiscal) authority—public and private, national and transnational. Hall hypothesizes that central banks are integrated into an emerging new system of global multilevel monetary governance. Public transnational institutions endowed with supervisory and coordinating monetary powers include the Bank of International Settlements (BIS) and the European Central Bank. The fact that adherence to such rule-based systems is voluntary—and applied domestically by statutory authority—indicates that its implementation depends also on domestic political variables. At the national level, the executive is the main locus of monetary governance; a central bank may share them with fiscal authorities if it has not been granted independence by the government.

In this context, private market actors operating in the foreign exchange and disintermediated bond markets are empowered to adjudicate the credibility of fiscal and monetary policies through the operation of the markets. This function is complemented by private rating agencies that grade the market of sovereign, corporate, and municipal debt instruments. All such shifts reflect the unprecedented emergence of private authority conceptualized by Thomas Biersteker and Bruce Hall.

It is against this shifting context of deregulated, liberalized financial markets—where all money is fiat money—that the global trend toward central bank independence becomes meaningful. Constructing a trustworthy monetary authority is about making credible its long-term commitment to price stability, ensuring private and public wealth holders that their loans will be redeemed at their real value, plus a risk premium. Insofar as central banks can directly control only very short nominal rates of interest, the technical question of how monetary policies will work effectively through the markets is a matter of great concern. Economists and practitioners of all persuasions agree that it has been settled technically along the lines of the rational expectations theory. In other words, monetary policy can work through the markets when central banks properly anticipate and coordinate future expectations of economic agents. For this reason, the case for central bank independence at the global level has been strengthened by the rational expectations school and its analysis of the conditions necessary to attain credibility with financial markets. The central bank’s independence from governments and transparency in communicating its long-term future monetary strategies are the major conditions enabling the institution to achieve credibility with market actors. In this intellectual and economic context, the economic and financial impacts of central bankers’ utterances and communicating strategies can hardly be exaggerated.

While rationalists assume a self-equilibrating free market of actors acting independently and including in their calculations the expected impact of monetary policies, constructivists assume a relational mode of interaction between them and among market actors. It rests on shared understandings of the rules,
norms, and values that underlie what are and what should be considered best practices—underpinned by epistemic communities of monetary economists and central bankers. Hall, a political economist of a constructivist cast, sets the generalized trend toward central bank independence in the context of multilevel global governance: The powers assigned to the institution are related to its ultimate role as the only nominal anchor to achieve international stability. Policy convergence, in this approach, is meant to drive the most critical structures down to the lowest possible national level of governance so that a uniformly effective impetus toward price stability can be provided. Whether or not this desideratum implied in the rational expectations theory is feasible is a quintessentially political problem. It is constrained by the current shifts in the axis of global monetary power, in particular the diversity of monetary strategies of new, “catching-up” countries. China's central bank is the most extreme case of subordination to the unique strategies of the government, aimed at national development and integration into the world market.

There are, however, many points of intersection between the two schools. Most important among them is the unspoken assumption underlying their prescriptions on how to reconcile two desiderata: (1) shielding the monetary authority from political pressures and (2) political legitimacy. Both schools take for granted the political framework within which central bankers operate in core democratic governments—that of liberal constitutionalism. The solution is then settled by means of the distinction between “full operational independence” and “goals independence.” The discretion of central banks, in the first case, would be limited to the choice of monetary tools to achieve the goals ultimately set by elected politicians. Basically, these tools provide free access to periodically publicized reports on the fiscal practices, the economic models, the forecasts and outcomes of monetary policy, and the accountability of elected politicians, in periodic hearings of Congress.

Emerging market democracies, in contrast, confront the task of reconciling integration into global markets, with its ensuing fiscal and monetary disciplines, while building the institutions and policy consensus indispensable to legitimate the construction of a monetary authority. It involves a long-term project, an open-ended process of democratic deliberation, leadership, and the development of constituencies supportive of price and financial stability as priority goals. In this regard, they constitute experiments in statecrafting monetary (and fiscal) democratic authorities.

See also:
Administration, Bureaucracy, Democracy, Theories of, Democracy, Types of, Economic Policy

Further Readings

- Eichengreen, B. 2008 Globalizing capital: A history of the international monetary system (2nd ed.).

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