# Comment on Marc Flandreau , “ Pillars of Globalization: A History of Monetary Policy Targets, 1797-1997 “

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# Introduction

- Marc Flandreau compares monetary targeting under gold standard convertibility 100 years ago with that under inflation targeting today

- The evolution between the two targets is based on changing institutions (especially their incentives) and the constraints facing central banks , and changes in information technology

- Many **similarities** between regimes: rules vs discretion, CB independence, the choice of nominal anchor.

- Key **differences**: today's CB not private profit maximizing entities and we no longer adhere to gold convertibility rules

# Introduction

- Flandreau’s main thesis is that CBs role, as private monopoly banks of issue with public responsibilities, was the object of public concern over their governance
- This explains the advent of the gold convertibility rule, the advent of LLR and CB independence in the nineteenth century
- Gold convertibility targets backfired in the interwar leading to Golden Fetters because gold convertibility was divorced from private incentives
  - Monetary management was a product of the Keynesian/Monetarist debate
  - This was followed by the work on time inconsistency
- The development of good price indexes and advances in monetary theory made the case for a superior target inflation (price level)

# Introduction

- Flandreau contrasts his view on the evolution of modern central banking with that of Charles Goodhart's (1988)
- Goodhart's  thesis is that central banks evolved in the mid-nineteenth century because of financial stability concerns
- Flandreau argues that true central banking  emerged earlier, during the Suspension period 1797-1821, with the Bullionist debate
- He argues that the paper pound regime represented a clear alternative to the gold standard as a regime to deliver price stability
- It was not so chosen because of issues of governance and monitoring

# General Issues/The Origins of Central Banks

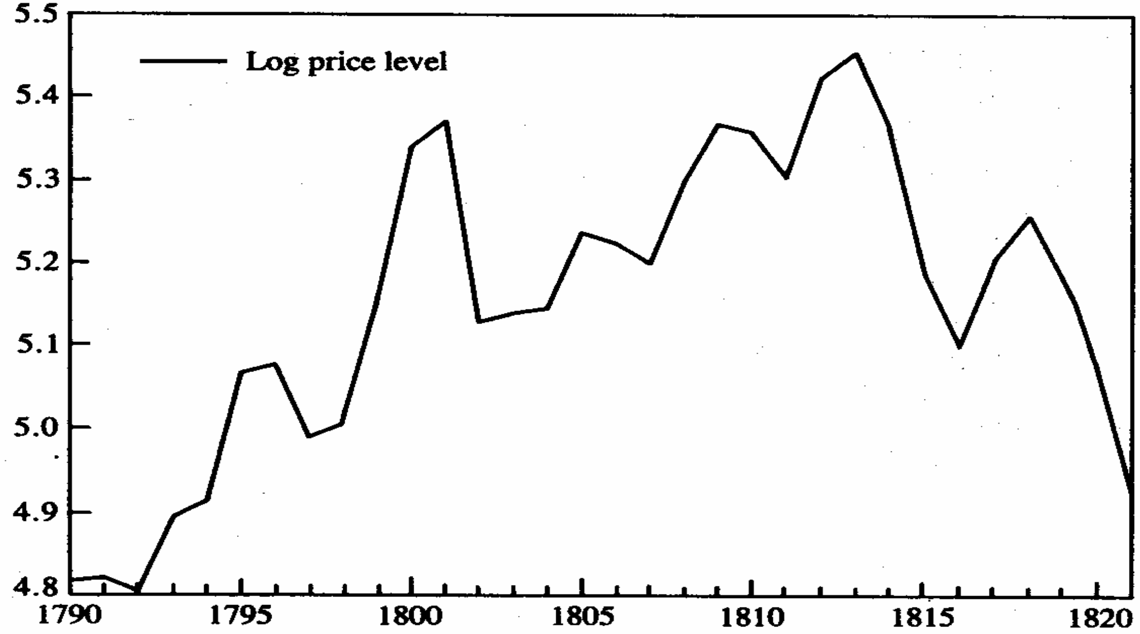
- **The view that the true origins of monetary policy can be traced back to the Suspension is not new. It was the view of Ashton, Clapham, Viner and Schumpeter.**
- **According to them, monetary developments proceeded on two tracks:**
  - innovations in the creation of money made monetary expansion possible
  - need to devise ways to restrain overissue that produced inflation
- **The key objective of CBs was to provide stable PP of national currency. It could be achieved by linking the currency to a fixed weight of metal.**
- **Monetary management didn't begin with the Monetarist/Keynesian debate. It was well worked out by Hume, Thornton ,Ricardo, Marshall, Fisher and Hawtrey.**

# The Suspension Period and the Bullionist Controversy

- Flandreau sees the Suspension period as the crucible of modern monetary policy.
- His story is that the Bank of England, was forced to suspend convertibility in February 1797 “ as a preemptive measure and not as a result of a speculative attack reflecting the lack of credibility”.
- The Paper Pound lasted 24 years and was associated with significant  inflation. See Figure 1.

# The Suspension Period and the Bullionist Controversy

Figure 1




*Source:* as figure 8.8

8.9 Great Britain, log of the price level

Inflation averaged close to 5% and peacked at close to 10% per year

# The Suspension Period and the Bullionist Controversy

- The Bullionist debate arose over the inflation (depreciation of the pound). The Bullionists (Ricardo, Thornton) attributed it to Bank of England note issue. The Anti-Bullionists (including directors of the Bank) attributed it to bad harvests etc. They adhered to real bills.

- The Bullion Report of 1810 according to Flandreau made both a strong case for the Quantity Theory but could also be interpreted as making a case for permanent suspension.

- Moreover a paper standard operated by a private BoE might have been a superior outcome to a return to the gold standard and it had contemporary support.

# The Suspension Period and the Bullionist Controversy

- His argument is that a private, profit maximizing CB will not maximize seignorage revenue à la Bailey ( 1956) and would deliver very low inflation and even Friedman's (1969) OQM.

- The reason why he doesn't get the standard Bailey (1956) result is that the private CB is concerned over the PP of the interest earned on the loans backing its note issue.

- This point was made by Santoni (1984).

- According to Flandreau, the reason why the paper standard was not adopted was because of concern that the Bank Directors would not use their discretion wisely and that adhering to gold convertibility was a transparent way to monitor their performance.

# Problems with this interpretation

1) There was no contemporary support for a permanent suspension. The only supporter of note was Thomas Attwood who represented the interests of the Birmingham manufacturers.

- Suspension was credible, as seen in consol rates below inflation rate, because it was part of the gold standard contingent rule; see Bordo and Kydland (1996).

- People viewed money and specie as synonymous. Convertible money evolved from specie which was anchored in PP by the commodity theory of money.

- The likelihood that the BoE absent convertibility would have been considered as able to provide a credible nominal anchor seems to me to be remote.

# Problems with this interpretation

2) The BoE, in the Suspension period, operated like a *de facto* Bailey (1956) government central bank maximizing inflation tax revenue.

- The Suspension resulted from the pressure on the BoE to discount Exchequer bills which the government could not roll over. It could not satisfy private borrowing, government borrowing and stay on gold.

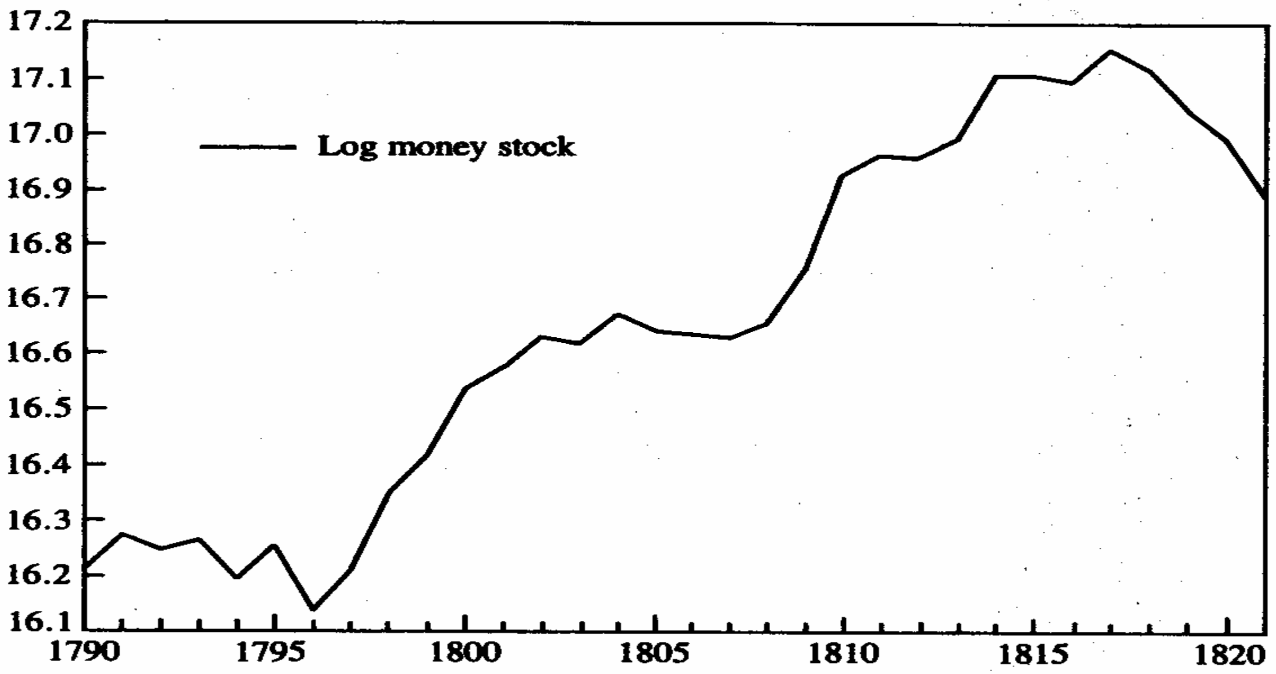
- During the Napoleonic wars, the Bank absorbed government paper and private paper (secured by government bills) at fixed 5% usury ceiling. This rate was below the market rate.

- The Bank became an engine of inflation using the indirect method; see Thornton (1802).

- The BoE used the same formula in the World War I and World War II.
- The Bank's contribution to the war effort was significant: seignorage was 17% of the fiscal deficit in 1810.
- The real concern that Ricardo and the others had with the Bank was over its role as the inflationary agent of the British government.
- See Figures (2)-(4).

# Monney supply

Figure 2

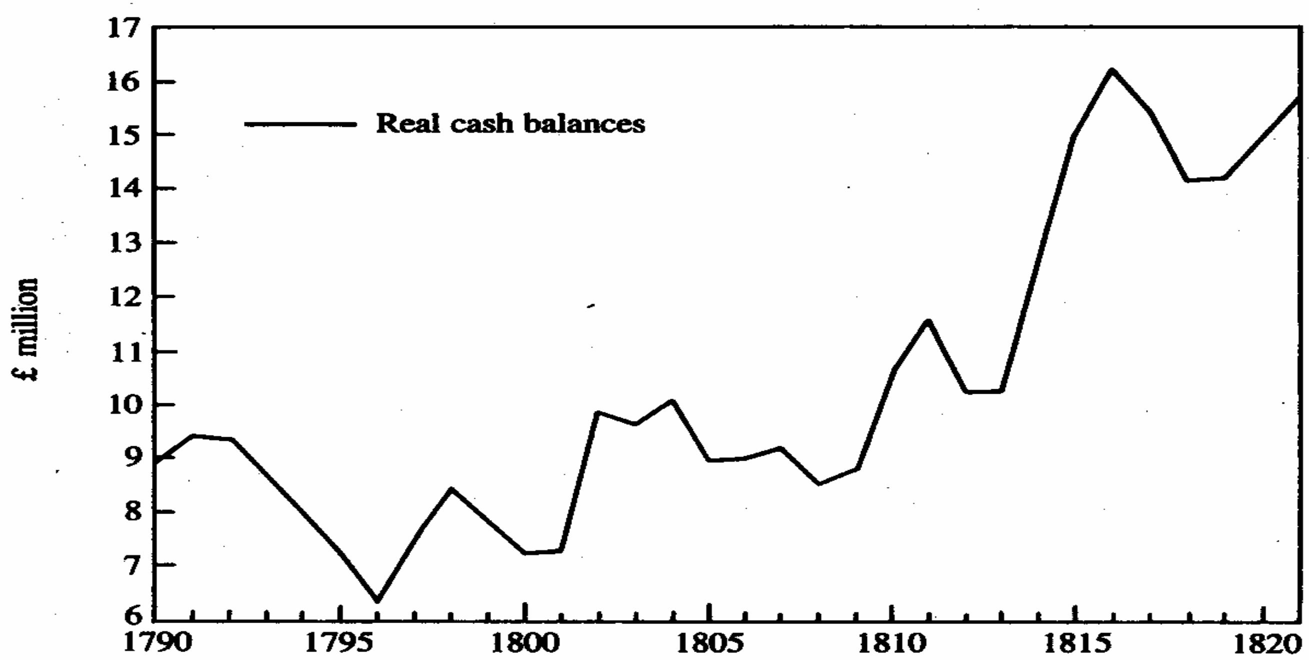



*Source:* Gayer, Rostow and Schwartz (1953)

8.8 Great Britain, log of the money stock

# Real money balances

Figure 3

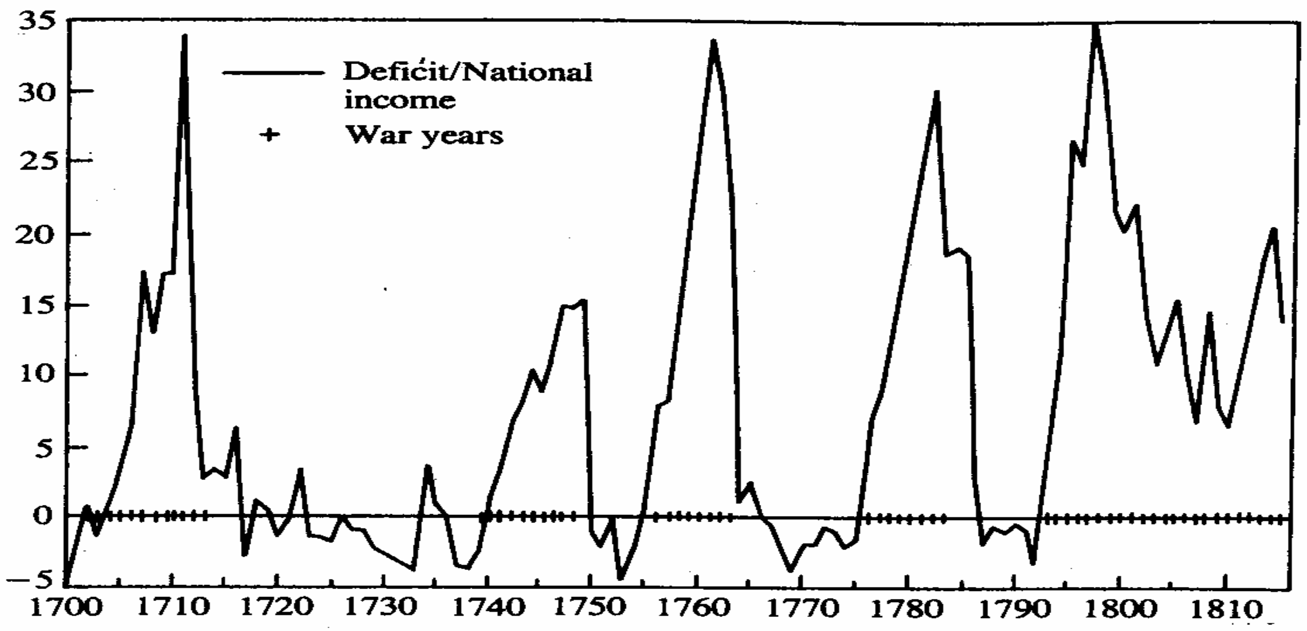



*Source:* as figure 8.8

8.10 Great Britain, real cash balances

# Fiscal deficit

Figure 4




*Sources:* as figure 8.1

8.4 Great Britain, deficit as a percentage of national income

# Other comments

1) **I have problems with Flandreau's interpretation of the gold standard literature:" the rules of the game" and a "good housekeeping seal of approval"**
   - The literature on both issues does not support his assertions.
2) **Flandreau says gold convertibility backfired as a monetary target during the interwar because it was no longer lined up with CB incentives and that it became like a religion**
   - It wasn't the gold standard *per se* that was the problem but the conditions under which it was restored in the 1920s and the way in which CBs operated under it
   - Britain returned to gold at an overvalued parity. France and Germany at undervalued parities. US and France sterilized gold inflows. The adjustment mechanism was not allowed to work the way it did before 1914.

# Other comments

- The “flaws” of the gold exchange standard and the Great Depression were not brought about by CBs constrained from maximizing profits.

- The GB standard largely reflected the post WW I political economy.

- The Great Depression can be attributed to failure of monetary policy by the Fed as a consequence of adhering to the flawed “ real bills” doctrine and a flawed institutional design.

# Other comments

3) Flandreau is correct in stating that it was in the absence of good price indices in 1810 that the Bullion Report had to focus on the price of gold

- Irving Fisher recognized that the price of gold is a less informative target than a general price index
- Fisher, Marshall, Wicksell criticized targeting the price of gold and advocated price level targets

- In sum, the paper by its focus on the relation between the incentives and constraints faced by the central bankers in the past two centuries makes a nice contribution to our understanding of the evolution of monetary policy