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Apolitical Money – An Illusion?

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Abstract: Monetary history is a history of inflation. The Statute of the ECB, as a copy of the Bundesbank Act, can be viewed as an attempt to establish the euro as apolitical money. Experience with the short history of the euro shows the limits of this attempt. Fundamentally, the state remains the final authority in monetary matters. The article begins with a very brief outline of monetary history and the efforts undertaken to achieve a stable currency. The second chapter analyses the Statute of the ECB as an attempt to shield monetary policy from political influence. This is followed by a review of the experience gained in the short history of the euro. The last chapter draws conclusions about the possibilities of apolitical money.

Keywords: currency, central banks, ECB

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1 Lessons from History

Monetary history is in no small measure a history of inflation, with a long list of currencies that have succumbed to hyperinflation and been replaced by new currencies. Metaphorically speaking, these extreme cases invariably come down to the states, the governments, abusing the money press. One could therefore speak of politicised money creation, of "political money". This observation leads one to wonder how the negative influence of politics on the value of money might be eliminated. Can the call for "apolitical money" be truly answered, and if so, what would this require?

Goods such as shells, cattle or even stones once functioned as the most primitive forms of money. The supply of money was thus limited by the scarcity of the goods in question. This also fundamentally applies to all kinds of metal currencies, most clearly to a pure gold coin standard, in which all money consists of gold coins. (The use of less rare metals to mint small value coins can be neglected in this context). With the gold bullion standard, the tie to the available amount of gold loosens. This applies more strongly to the gold exchange standard, though the natural restriction

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on the amount of money in circulation remains fundamentally intact. The monetary system post 1945 was no longer subject to this restriction. Therefore, the common use of the term “gold exchange standard” for this period is misleading and essentially incorrect (Issing 2021).

Besides, in the late eras of the gold standard, the value of money was only secured over extended periods of time. The annual inflation rates were subject to great fluctuations (Richter 1987).

This is not the place to delve into the merits and pitfalls of the gold standard. In today’s world, only paper currencies exist. Although there are always some champions of a return to the gold standard – in whatever form – it is fair to assume this will not happen, for a variety of reasons.

With the paper standard, any element of natural scarcity in money creation, as represented by the “golden brake”, disappears. This opens up the prospect of freely shaping monetary policy along the lines of economic welfare. Therefore, one could say that paper currency is the logical culmination of the development of money (Helfferich 1923; Issing and Wieland 2013). On the other hand, there is then essentially no limit to the amount of money that can be created, practically for free, with the aforementioned risk of inflation and, in many cases, the total destruction of that currency’s value. The fact that even the very first known paper currency ended in disaster is indicative of this immanent weakness of the paper standard (Kuhn 2009).

Recognition of the inherent danger of inflation in the paper standard has led numerous scholars to propose limits to money creation under this regime. For example, commodity reserve currency and index currency have at times found prominent advocates. Milton Friedman’s proposal to perpetuate and limit money supply growth by enshrining his *k*-percent rule by legislation was ultimately withdrawn by Friedman himself. In short, none of the concepts developed to date have been theoretically convincing, let alone had a serious chance of being implemented in practice (Issing 2019).

In the aftermath of the 1970s inflation in the USA, the question as to what caused this “Great Inflation” became a pressing concern. A flood of empirical studies eventually found a clear correlation between central bank independence and inflation for many countries: the higher the degree of independence, the lower the inflation. Not least as a result of this finding, more and more countries granted their central bank the status of independence (Masciandaro and Romelli 2015). The low levels of inflation worldwide during the years of the “Great Moderation” are widely seen as confirming the importance of independence for a policy of price stability.

This matter draws attention to the statute of the central bank. Here, the question of independence plays a crucial role. How must a central bank statute be crafted in order to limit the inherent weakness of a paper currency or, best of all, to avoid it altogether? What is the optimal constitution of a central bank?

This question will be discussed with reference to the Statute of the European Central Bank (ECB). Aside from the special features of the European Monetary Union – one central bank, many states – the observations can be applied generally.

2 The Statute of the ECB

At the Maastricht Summit on 9/10 December 1991, the heads of state and government resolved to create an economic and monetary union. They agreed on a statute for the future European Central Bank with the following core elements (Issing 2008):
- Price stability as the primary objective.
- Independence.
- Prohibition on monetary financing.

Price stability clearly defines the most important task of the central bank.

Independence from political pressure should ensure the central bank's freedom in its decisions over how to fulfil its task, according to purely factual considerations.

The prohibition on lending to the public sector and on buying public debt instruments on the primary market is intended to block a source of money creation that has repeatedly proven to cause inflation throughout the ages.

It is fair to say that this statute reflects both the empirical and theoretical understanding of an optimal central bank constitution. It is intended to take money creation out of political reach. In other words: the euro is, conceptually, "apolitical money".

While the Bundesbank Act, for example, could have been amended at any time by means of a majority vote in the Bundestag, the independence of the ECB is anchored in an international treaty that can only be amended unanimously. Thus, the Statute of the ECB, and not least its independence, is subject to the greatest conceivable legal protection.

Has the Statute of the ECB passed the test of real-world conditions in its over 20 years of existence? Can the euro really be described as apolitical money in the light of actual experience? Where are any weaknesses to be found?

3 The Statute Put to the Test

3.1 Independence

At the time when the heads of state and government agreed in Maastricht on the statute of the future European central bank and on its independence, only the

Bundesbank was completely independent. All other national central banks were, to a greater or lesser degree, dependent on decisions made by their governments.

As previously mentioned, lessons learned from the historical development of inflation supported the case for independence. To what extent the governments were convinced by the scientific evidence remains an open question. There is one crucial factor for the quick agreement on this issue. For the German side, this point was non-negotiable. Given the high esteem in which the German public held the Bundesbank and its currency, the D-Mark, and the great scepticism on the flip side towards a future common European currency, it seems unlikely that any German government could have signed a treaty without the present statute and the central bank independence enshrined therein.

In general, it is difficult to gauge what status central bank independence enjoyed in the other countries at the time. The range most likely extended from full support to considerable reservations, if not rejection.

Looking at the sceptical side, one statement stands out from then French President François Mitterrand after (!) the signing of the Maastricht Treaty and shortly before the French referendum on its adoption.

"La Banque Centrale, la future Banque Centrale … elle ne décide pas … Les techniciens de la Banque Centrale sont chargès d'appliquer dans la domaine monetaire les décisions du Conseil Européen, prises par les douze Chefs d'Etat et de Gouvernement, c'est-à-dire par les politiques qui représentent leurs peuples … Or, j'entends dire partout … que cette Banque Centrale Européenne sera maîtresse des décisions! Ce n'est pas vrai! La politique monétaire appartient au Conseil Européen et l'application de la politique monétaire appartient à la Banque Centrale, dans le cadre des decisions du Conseil Européen" (Debate on French TV on September 3 1992).

Institutional economics has developed criteria for the acceptance of formal institutions and their stability (Richter and Furobotn 2003). According to these criteria, attempts to impose a constructed institutional framework on a society cannot be expected to succeed in the long term. Institutions continually rest on experience. This results in a certain path dependency for political decisions.

Depending on how the Maastricht Act was received in those countries that later became members of the monetary union, a lack of implicit consent on the independence of the future European central bank in the societies of the member countries places a heavy burden, in certain cases, on the ECB.

The ECB therefore faced a difficult challenge from the very beginning. On the one hand, it had to maintain and strengthen confidence in its independence. On the other hand, it had to win people over with its policy in countries where this trust had not yet been sufficiently developed. This task is rendered all the more difficult by the diversity of the states in the euro area along multiple dimensions. Last but not least,

the numerous languages of the member states pose a great challenge in communication.

This heterogeneity in the euro area extends far into society and goes way beyond attitudes to the central bank and its independence. The differences deeply rooted in national cultures have long impeded, if not blocked, the path to monetary union. The Maastricht process led to a rapprochement, but old differences resurfaced during the financial crisis (Brunnermeier et al. 2016). Developments since then do not suggest that the problem has substantially subsided in the meantime. This scepticism is not least evident in the national origin of attacks on the ECB and its decisions.

3.2 Appointment of the Central Bankers

The status of independence opens up a wide scope in the policy of central bank leaders under the paper standard. Liberal economists have always perceived the danger posed here by unsuitable or even incompetent central bankers (Eucken 1955; Simons 1936). The attempt to bind the actions of central bankers by means of a strict rule for monetary policy laid down by law must be considered a failure. The proposal put forward by Rogoff to appoint "conservative persons" (Rogoff 1985) has remained an interesting idea. A number of methods exist for appointing those in charge. The government or the parliament are the first to be considered. The competence resides with the politicians. Clearly, this provides a gateway for the independence of the central bank to be politically undermined. With a long guaranteed term of office and a bar on reappointment, certain precautions exist to strengthen personal independence. Under such a regime, policymakers also cannot be sure that the person selected will prove immune to political influence once appointed. This is more likely to be the case if the decision-making body shows strong consensus on stability orientation and the newly appointed person subscribes to groupthink in a kind of "Beckett effect" (Issing 1993).

In the end, the general attitude towards the independence of the central bank in a country is decisive when it comes to the criteria politicians use to appoint central bankers.

3.3 The Mandate

Shifting responsibility for such an important task as monetary policy to an institution that is independent of the political process, and thus removing it from parliamentary control, contrasts with fundamental principles of democracy. The decisive argument for this decision, an act of "self-disempowerment of parliament" (Schmidt 1973), lies

in the historical and also theoretically justifiable experience with protecting against politically induced inflation. In his statement of 20 May 1997, then British Chancellor of the Exchequer Gordon Brown justified why the government was granting independence to the Bank of England: "The previous arrangements for monetary policy were too short-termist, encouraging short but unsustainable boom and higher inflation, followed inevitably by recession. This is why we promised in our election manifest to … reform the Bank of England to ensure that decision-making on monetary policy is more effective, open, accountable and free from short-term political manipulation" (Statement of May 20 1997). Independence needs to be limited by a clear mandate. Price stability lends itself to this function as the genuine task of monetary policy. A dual mandate, as in the case of the Fed with price stability and maximum employment, charges the central bank with the duty to weigh these goals politically under certain circumstances.[1]

In financial stability, central banks have a task they cannot avoid, regardless of whether or not a legal obligation applies (Issing 2017a). In performing this task, a central bank repeatedly runs the risk of conflicts with its primary objective of price stability. Under these circumstances, discussions about reputation and independence are bound to arise. The situation is similar when the central bank is assigned the task of banking supervision and potentially also macroprudential policy.

This accumulation of tasks must lead to questions about the limits of a central bank's independence. All the more so when a central bank, on its own initiative and/or under public pressure, commits itself to additional goals. The distribution of income and wealth are the primary candidates to consider here. Monetary policy inevitably has distributional effects. It is an entirely different case, however, if the central bank specifically pursues distributional policy goals.

As climate change takes on ever greater significance, on the one hand politicians and the public are pushing for central banks to play their part in tackling this problem. On the other hand, a number of central banks have themselves announced that they will take the problem of climate change into account in their policy decisions or even give it a prominent role.

It is inevitable that the expansion of objectives raises pressing questions about the justification of independence and its limits. It must also be considered that the central bank is placing its credibility at risk if it becomes overburdened by these additional tasks. The associated loss of credibility is bound to damage the public's acceptance of central bank independence (Issing 2022, 2017b).

By extending their measures into areas that, in a democracy, must be reserved for politics, governments and parliaments, central banks themselves provoke concerns about the status of their independence. This also holds true because the

1 The legally prescribed third goal of "moderate long-term interest rates" plays no role in practice.

additional objectives are destined to come into conflict with their primary goal of price stability.

3.4 Danger of Fiscal Dominance

With the massive purchases of government bonds known as quantitative easing, central banks have trodden or even overstepped the boundary of fiscal policy. The more substantial these interventions are, the more difficult it becomes to distinguish the effects – whose macroeconomic successes are disputed – from the monetary financing of public budgets. It is therefore not surprising that so-called Modern Monetary Theory (MMT), which seeks to make a virtue out of this dilemma, notwithstanding its fundamental flaws has found such favour (Issing 2020). The higher the national debt, the greater the impact of interest rate hikes on public budgets. This raises the political pressure on central banks to abandon or at least weaken a monetary policy geared to monetary stability. The Fiscal Theory of the Price Level (Cochrane 2023) provides a theoretical framework that allows to study fiscal dominance. This theory shows that a government with an irresponsible fiscal policy can enforce inflation on the economy irrespective of the independence and interest rate policy of the central bank.

For the ECB, the institutional constellation – one central bank, 20 public budgets and sovereign debtors – presents an additional, eminently important problem. With the “whatever it takes” of 2012 by then President Draghi and the announcement of the Outright Monetary Transactions (OMT) programme, the central bank has assumed responsibility for the cohesion of the euro area in its current composition. The ECB has since reinforced this commitment by announcing the Transmission Protection Instrument (TPI) programme (Issing 2022). With the self-imposed obligation to save, if necessary, highly indebted member states from a rise in government bond interest rates that is deemed unacceptable, the central bank is taking on a responsibility that must be reserved for the governments of the member states, for politics. This casts doubt on the status of independence, regardless of how the supreme courts rule.

4 Conclusion

Two different but related conclusions emerge from the previous observations. Central bank independence is the exception rather than the rule in the history of currencies. In the early 1990s, the number of independent central banks reached a

peak. Since then, excessive demands on central banks, but also their own actions, have led to growing doubts about the legitimacy of this status. In *de facto* terms, independence has been undermined to varying degrees in the individual countries. It is impossible to predict whether this trend will continue and whether independence will also be abolished *de jure* through legislative measures. Not least, the development will depend on what legacy the central banks leave behind in the fight against high inflation.

The second insight is of a fundamental nature. Monetary history is marked by a barely interrupted sequence of state interventions in monetary affairs. Even the seemingly safe case of a pure gold coin standard does not protect against the state depreciating the value of the currency. Time and again, governments – the Emperor of Rome, for instance – have gradually reduced the metal value of their coins. "For in every country of the world, I believe, the avarice and injustice of princes and sovereign states, abusing the confidence of their subjects, have by degrees diminished the real quantity of metal, which had been originally contained in their coins" (Smith 1776).

What is true even for pure metal money applies all the more to other monetary systems, particularly paper money. Hayek sums up this insight most succinctly: "Inflation is made by government and its agents. Nobody else can do anything about it." (Hayek 2011).

Logically, Hayek departs from his own earlier proposals, such as the introduction of a commodity reserve currency, and pleads for a de-nationalisation, i.e. depoliticisation, of money. The state loses its monopoly on money and the creation of money is left to competition between private providers. However plausible the basic idea, his proposal is theoretically unconvincing. Moreover, competition between private providers also requires the state to set the framework. So even "denationalised" money needs the state, with all the consequences this may entail (Issing 2019). It is therefore not surprising that calls for the regulation of all forms of "cyber money" are growing louder by the day!

To draw a conclusion from monetary history, one can state: Especially in times of metal currencies, prolonged phases of (largely) apolitical money can be observed. However, in "states of emergency", which were mainly times of war, the gold standard was frequently suspended. To a certain extent, the D-Mark could also be described as apolitical money during its fifty-year existence. On a number of occasions, especially with Chancellor Adenauer's Gürzenich speech, this character stood out with particular clarity as the Bundesbank raised its interest rates to ensure monetary stability against strong objections from the gocernment.

In the end, however, the design of the currency and the monetary constitution remains in the hands of the state. This statement cannot come as a surprise.[2]

Just like public finances, the monetary system is a core element of a state. Politicians cannot be expected to refrain from influencing money, at all times and under all circumstances.

However, it would be wrong to conclude from the above that a country's choice of monetary system is completely irrelevant. Monetary constitutions differ substantially in the extent to which they prevent the state from abusing the money press. The MMT proposal shows how easily experiences with the history of inflation are forgotten. Views on the optimal design of the monetary system can be expected to differ in the future, just as they have in the past. Societies are bound to remain in a constant process of learning and the field of the monetary constitution is no exception. The future will show whether this process will continue to include pathological learning through new periods of inflation.

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