Foreword to the Italian edition

What role do central banks play and how has it evolved over the two centuries since they came into existence? How and why, in the course of time and in different places, have central banks acquired distinct but complementary functions that continue to be a topic of debate: issuing bank, lender of last resort, monetary policy-maker, banking supervisor, payment system operator? What mutations, from Bretton Woods to the European System of Central Banks and perhaps beyond, have given central banking its international dimension? How do these questions tie in with the history of money and its progressive dematerialization from commodity money to fiat money and to the advancing forms of electronic money? None of the paradigms of economic analysis – classical, Marxian or neoclassical – can fully explain the *raison d'être*, the development or the effects of economic institutions; monetary institutions are no exception.

In this elegant work, Curzio Giannini offers a compelling, overarching interpretation of the manifold responsibilities that have gradually fallen to central banks, which he views as complex institutions and not only as makers of monetary policy. The nature of central banks has been examined from different perspectives over the years: they are a natural response to the crises that accompanied the growth of bank money during a period of incomplete contracts and information problems in the credit and financial markets; they are entities whose purpose is to use the currency as a hidden tool of taxation for the state; they are agents whose task is to ensure the achievement of the final objectives of monetary policy – objectives that the increasing abstraction of money and growing complexity of intervention have reduced to the core requirement of price stability, to be pursued autonomously. Analysis, guided by history, has explored each of these dimensions, producing important theoretical and practical contributions. Yet these contributions all share a perplexing feature: none offers a comprehensive interpretation that can account for the enormous differences in the structure and functioning of economic systems, in public intervention in the economy, and in international trade and cooperation.

It is just such a comprehensive interpretation that *The Age of Central Banks* seeks to offer. The basic thesis is that central banks are neither a historical accident, the fruit of changing political interests, nor the inevitable

product of the instability and incompleteness of credit contracts, nor even a means of guaranteeing the price stability of money as a 'good' (not, in this instance, a standard good with a market of its own, but an institution that is necessary for the operation of all markets). The 'central bank' is the outcome of a gradual institutional evolution, the rationale of which resides in money's distinctive features compared with the other goods and services produced in the economic circuit. This evolution is not deterministic but path-dependent, correlated with the historical evolution of our political, social and economic systems. It depends largely on the fact that if money is to survive and perform its functions in economic transactions effectively in space and time it must instil and maintain a sufficient degree of confidence in its acceptability and future value. The role and the powers of central banks – indeed their very existence – derive from the ultimate purpose of sustaining that confidence.

This book provides an all-round view of the phenomenon of central banking, proposing an original and complex interpretation of the evolution of central banks at every level. Methodologically, it adopts a 'neo-institutionalist' approach. Social institutions such as firms, political parties, trade unions or, in this case, money are essential to allow individual decisions to be coordinated given high transaction costs, crucial information shortcomings and incomplete contracts. In the case of money, the analysis turns on the concept of 'payment technology' as the set of conventions, objects and procedures that make it possible to extinguish obligations arising from economic exchange. Here the fundamental problem is the incompleteness of the monetary contract, which must be remedied. The means of doing so are unavoidably flawed and determined by history, consisting in investment in the 'brand name' of a currency, upheld by rules and institutions designed to bolster confidence among those who use it.

In terms of instruments, Giannini's approach draws on the authoritative precedent of the 'theory of history' proposed by John Hicks, although without aiming for historiographical completeness. Through the examination of secondary sources, the analysis of the evolution of payment technologies in the pre-industrial age and the subsequent emergence of convertible currency, the study of banking crises and of the establishment of the first central bank, with the rise and fall of the various monetary regimes that preceded the fiat standard, the book marshals extensive and convincing evidence in support of the basic thesis. The debate on the independence of central banks, the credibility of their action and the recent proposals for a more or less flexible form of inflation targeting are also examined, with close attention for the occurrence and recurrence of general phenomena in different situations in time and space.

As to results, there is clear evidence that payment technologies have been designed, although not by intention or determinism, to increase the flexibility of money supply and its prompt adjustment to the needs of economic growth and to cyclical friction. Money supply thus becomes increasingly abstract, entailing a growing degree of risk, although it is also better able to respond to the 'deflationary drift' that is the true common denominator of the various payment technologies, all of which tend to be based on a rigid money supply, at least in the short to medium term. Clearly, this is a very different approach to that normally used to study the 'money market' and consequent formation of monetary policy. Nowadays, monetary issues are considered in the light of a token money that is easy to manipulate, not one that is relatively inflexible and impedes growth. From a 'theory of history' standpoint, however, although this view is useful for immediate operational purposes, it is not adequate for a fully satisfactory study of the institutions of money and central banks and their evolution over time, especially – and here lies the innovative force of Giannini's work – their future prospects.

These prospects encompass the evolution of the international monetary system itself. Globalization tends to alter the relationships between nation-states and central banks. The series of solutions proposed since the collapse of the Bretton Woods system show that the evolutionary process is in full swing, with new equilibria being sought in the institutional field as well. One strand of this search is the essentially supranational consortium model of central banking embodied by the European System of Central Banks as part of the monetary internationalism that has prevailed throughout history, regardless of the developments of the last century based on 'regional currencies'. Although profoundly different, the regimes of monetary union and of hegemony (the present dollarization of the economy) have a key feature in common: the renunciation of national monetary sovereignty. The result, however, is a highly unstable equilibrium; an 'imperfect bipolarism' that only a cooperative solution can overcome. Given the failure of the cooperative arrangements of Bretton Woods, the only possible solution is closer institutional integration. In the author's opinion one advisable direction would be that of cooperation within a soft-law system, a natural evolution of cooperation among central banks that is exemplified by the Basel capital accords and non-binding recommendations and best practices designed to promote financial stability. This is the method of cooperation adopted by the Financial Stability Forum, set up by governments, central banks and other market regulators in response to the financial crises of the late 1990s.

The book also examines the prospective relationships between central banks and the financial industry and between central banks and

governments. The first of these relationships is becoming increasingly complex, partly as a result of financial innovation. This has led, on the one hand, to the coexistence of payment technologies based on legal tender with exchanges based on bank money, which is likely to become predominantly electronic in the future; and on the other hand to the emergence of huge cross-border intermediaries. Thus the payment system has acquired a pre-eminent role and become a focus of attention, emphasizing the need to take account of the cash and securities settlement services now offered by private sector non-bank intermediaries but that were once the preserve of central banks. The result, in the author's description, is a 'pyramid under attack', which could have serious implications for monetary policy as well. Since providers of private payment services are likely to face major conflicts of interest and will be unable, on their own, to preserve the necessary confidence in money – the *raison d'être* of central banks – the latter are unlikely to disappear with the switch to electronic money or the development of elaborate financial superstructures.

What is happening to the role of central banks in assuring continued supervision of credit systems (broadly defined as financial systems) and acting as lender of last resort? Changes are taking place in this field as well, although their direction is less clear. In some countries the solution for the time being has been to strengthen the central bank's role and expand its functions; in others, the central bank has been stripped of its supervisory powers. In the field of monetary policy, with price stability now the key objective and the central bank entrusted with an institutional role at the highest level while remaining independent from the executive in the performance of its functions, how is it possible not to take account of movements of assets and liabilities in the stock and property markets, be it only in the interests of price stability? No answer has yet been found to these questions and the book addresses them only briefly, although from a very interesting angle. Although the most important developments will probably occur in the fields of supervision and regulation, that intangible but essential factor, confidence, will still have to be safeguarded. If the central bank as an institution rests on this principle, it will certainly not need to seek new lines of business. On the contrary, according to the arguments and evidence put forward in this book, it will become necessary to turn to it (how, is not yet clear) when evolutionary crises inevitably strike the capitalist system.

In July 2003 Curzio Giannini died at the end of a brief but relentless illness. Although aware that the battle was lost, he fought on to the end with fierce determination. His place in the hearts of his family, his friends and his fellow economists can never be filled. Apart from the courage with

which he faced the last months of his life, many will also remember his contribution in the professional field. Formal and casual exchanges alike benefited from his quick and lively intelligence, his erudition and his wide knowledge of culture beyond the bounds of economics. To his work he brought a rigorous analytical and methodological approach and broad historical and political perspective. Alongside these recollections and the many papers he wrote in 20 years of his career we now have the contribution of this 'unfinished' book, as he described it. Nonetheless, it remains an extremely valuable contribution and one that is certainly complete in its overall design, in the construction of its arguments, in the historical evidence it presents and in the conclusions drawn.

Curzio Giannini did not have time for the final discussions that an author normally seeks before turning a work such as this over to a wider readership, although the work does take account of many of the points raised in frequent discussions over the years. The book is a general theory of central banking based on money as an institution, although it is not unmindful of the fact that money itself is an evolutionary phenomenon. As far as the implications of his analysis go, it would be true to say that in the trade-off between a flexible and a rigorous conduct of monetary policy the second receives less attention than the first. It is a deliberate choice, and the author certainly does not consider the objective of price stability to be of secondary importance. It is partly a reaction to a sometimes overly deterministic view of economic relationships and the 'methods' of economic policy. I believe this book not only provides a firm and reliable guide to newcomers wishing to explore the difficult issues surrounding the role and evolution of central banking, but also raises new questions, generates useful doubts, offers some unexpected answers and opens up new vistas for those already familiar with this field. It remains for the reader to pass judgement on the finished product.

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