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D. Rohde, Central Bank Independence & Commercial Bank Independence: Are We Asking the Right Questions?

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Discussions of central bank independence often have an historical bent, even when not specifically addressing historical issues. The question, as it is generally put, is whether and when elected officials should be warranted in delegating their legal authority over currency to agencies administered by unelected technocrats. To what extent is this delegation running around the electoral system and/or subverting, in some way, the democratic order? Even in the abstract, this framing carries a certain historical presumption —that, before the establishment of a central bank, sovereign authority over money was kept closer to the chest. The implication of this, of course, is that reducing the powers delegated to the central bank would lead the money power to devolve back, in some way, to core, more democratic government institutions, such as congress or parliament.[1]

Attention to the legal history of money and finance, however, undermines this presumption. Understanding money as a legal institution requires that we not only consider central banks as delegates of monetary authority, but commercial banks as well. Immediately before the widespread adoption of central banks, the money power was often delegated largely to precisely these entities, who were generally not at all subject to a public mandate or democratic accountability. While it is very much alive in contemporary discussions about digital currencies, the question of delegation to commercial banks is oddly absent in debates around central bank

independence.

Why am I talking about historiography in a forum about central bank independence? Because our assumptions about which institutions “come first” frame our discussions about which ones call for justification. Here, treating central banks as state delegates while simply assuming the fact of commercial banking leads us to ask that central banks justify their role in a democratic society while leaving the authority of private banking largely untouched. However, if we understand commercial banks themselves as creatures of law, as fundamental government instrumentalities, then our concerns over democratic legitimacy cannot begin and end with central banks alone, but with the monetary order more generally. The question, in other words, should not simply be how to keep our central banks accountable to the electorate, but how democratic we want the money power to be.

This short piece will offer a very condensed version of my own research into Canada’s monetary order immediately before the creation of its central bank in 1935. Canada is used here simply as a representative example, indeed as one sometimes regarded as a paragon of less-regulated, private money issuance. While in some ways unique, Canada’s example here is meant to offer a narrative generally comparable to other states where Central Banks were put in place. After that, I will reflect briefly on the implications of this historiography to the key questions of this Roundtable.

A Brief Summary of Canadian Monies Before the Bank of Canada[2]

As in many countries, the creation of Canada’s central bank in 1935 is often cast as the advance of the state over an unregulated and volatile private sector. It is described as a key part of the end of “laissez-faire”, when “Canadians began to realize that government must interfere in the private

affairs of the nation."[3] On the plain version of this view, which is hardly unique to either Canada or central banks, the administrative state seems to emerge suddenly from the interwar period out of the primordial soup of common-law governance and market self-ordering. Banks are understood as somehow self-actualizing, and central banks as an advance of state authority over their domain. Attention to the legal foundations of finance and markets, however, belies these assumptions, and reveals that the monetary and financial system before the Bank was just as much made by laws and anchored by the state as the system established after.

The Canadian money supply in the interwar years primarily consisted of four components, each established by federal law. (1) First, coinage included not only Canadian, but also British and American coins, all of which were made legal tender in Canada and assigned a value in Canadian dollars by the *Currency Act*.[4] (2) In addition, the federal government directly issued a paper legal-tender currency in the form of Dominion Notes.[5] While originally redeemable for specie, Canada had been (more or less) off the gold standard since 1914, and these notes acted, essentially, as a domestic fiat currency. By far the majority of the circulating medium of exchange in Canada at the time took the form not of those two official, government-accepted monies, but of (3) notes and (4) deposits issued by Canada's chartered banks.

Canada's banks have always been small in number, yet large in size and influence. Indeed, this may be the single most defining feature of Canada's financial system. And it was one settled remarkably early on in the country's history. Confederation in 1867 placed power over "Banking, Incorporation of Banks, and the Issue of Paper Money" exclusively with the Federal Government, and the country's first comprehensive *Bank Act* in 1871 established that all Canadian banks would be chartered federally, and would be able

to establish branches throughout the country.[6] In direct contrast to the American, unit-banking model, this approach specifically privileged size, concentration and brand-recognition. While the number of banks in Canada has shifted a bit over time, the general trend has been toward consolidation.[7] In 1933, Canada had only ten major commercial banks. The three largest alone accounted for roughly 70% of the banking sector as a whole, issued 67% percent of the chartered banknotes in circulation and 74% of the available on-call deposits. In the year 1931, their deposit accounts alone totaled around 91% of the total circulating money supply. Circulating credit issued by the chartered banks was then, and remains today, by far the majority of Canada’s medium of exchange.

Direct public support of chartered banking was increased to meet the exigencies of World War 1. Under the *Finance Acts* of 1913 and 1923, the government created a rediscounting facility through which banks could pledge securities in order to receive advances of Dominion Notes under a published interest rate (called the Advance Rate). This regime has been described as a “lender of last resort”, and certainly it played that role, though it might better be described as a general standing liquidity facility. Loans were not limited to struggling institutions and banks seemed to feel no substantial stigma by taking them; the interest rates offered were not punitive, and there was little actual evaluation of the quality of the securities underwriting those advances. The officials administering the regime regarded their own roles as largely passive, and the banks typically dictated the terms of their borrowing.[8] In spite of its public base and statutory framework, control over Canadian money issuance was then (and remains today) largely a private affair.

The *Finance Act* both propped up Canada’s monetary system and instituted a fundamentally procyclical monetary policy regime.

In good times, any investment or loan that promised a higher rate of return than the Advance Rate was worth borrowing for, and the banks made full use of the resources available to them. At its peak in 1929, banks borrowed a total of $2.4 billion under the Act.[9]

In hard times, the opposite happened: rates went up, loans went down, and borrowing under the *Finance Act* decreased. In the hardest of hard times, not only did banks stop borrowing under the *Finance Act*, but many felt a distinct pressure to go so far as to *repay* their outstanding loans, reducing them in the year 1931 to zero, and further contracting credit across the country as a whole. In the words of the first Governor of the Bank of Canada (then an executive at the Royal Bank of Canada), this was a “catastrophic” experience that played a fundamental role in turning Canadians towards the idea of instituting a central bank:

> *Then came the crash and there was some criticism, I think, that the banks were so much indebted to the Government at that time… One or more of the banks set off to try to repay those loans. By doing so they reduced the cash reserves of the banks in the process, thereby making it more and more difficult for the banks to lend, in fact it caused them to contract. As we weren’t on the gold standard, in spite of anything that Mr Bennet may have said, there was absolutely no way of getting additional cash unless you borrowed from the Finance Act. Whereas… paying off caused continuing contraction in the banks’ ability to lend or buy securities. It intensified very greatly the deflationary aspects of the time, the troubles of borrowers, and the difficulty companies had of getting any accommodation just to carry them on until things got a little better. It was a catastrophic experience really, and a very sad and unnecessary one. That, I think, is what caused the belief in many people’s minds, including myself and some of my colleagues in the Royal, that this situation was absolutely, fantastically inefficient and that*

> *there must be a central bank.*[10]

Famously, no Canadian banks failed in the Great Depression.[11] Nonetheless, by at least one estimate, the Canadian money supply actually decreased at a higher rate than in the US, where 7,000 banks failed. The reason for this was nothing natural or inherent in Canada's economic situation: its statutory architecture was designed in a way that specifically privileged bank concentration, stability and liquidity over stimulus or access to credit. In other words, the architecture of the state specifically entrenched a procyclical monetary order.

The creation of the Bank of Canada, of course, fundamentally changed this picture. The creation of a central bank limited, in some ways, what Canadian banks could do, eliminating their note issuance powers and subjecting their authority over credit issuance to a degree of centralized control. In that sense, the Bank did (and does) "regulate" the banking sector. The Bank of Canada is also, of course, a government entity in a way that Canada's chartered banks plainly are not. In that sense, the creation of the Bank of Canada does mark an increase in government *administration* over markets; however, my argument is that it does not mark an increase in government *power* over markets, and this distinction is fundamental. From this perspective, the creation of a central banks appears less as a regulatory "intervention" into the market than a "taking back" of powers previously delegated elsewhere: where monetary policy was previously delegated to Canada's network for-profit chartered banks to act out under a specific statutory architecture, the Bank of Canada would consolidate those powers under a centralized agency with an explicitly public directive. This change is, of course, fundamental, but it is simply not a mere expansion or delegation of state authority, and to label it as that blinds us to the role the state plays in establishing not only the public, but also the private

monetary order.

What Does This Tell Us About Central Bank Independence?

Renewed attention to the independence and political accountability of central banks is helping to pull aside their technocratic mask to reveal the inherently distributive nature of their work and its inextricable ties with state governance. This is a vital discussion, particularly now after the world has experienced two financial crises in the past decade.

However, when our attention is exclusively focused on central banks (to the exclusion of the private, but still state-enabled, market of commercial banks that they are intended to coordinate), we run the risk of reifying a certain order of things, placing the private market within the base assumptions of our worldview and state agencies on top of it. Seemingly private institutions, like commercial banks, are accepted as a default; state agencies, like central banks, call for justification.

As histories like the one outlined here reveal, this is a false pretense. Both private and public banking sectors are equally created and enabled by the state through law. Both affect the core of the body politic. If we have genuine concerns over the democratic accountability and legitimacy of our money, they should be addressed to both equally.

To be clear, I’m not at all saying that we should not ask questions about the democratic accountability of our central banks. (Indeed, quite the opposite!) Rather, what I think histories like this make clear is that such inquiries are only ever half of the story, and, when looked at alone, they can overly narrow our perspective. Our concern needs to lie not solely with our unelected central bankers, but also with our unelected private bankers, who, even in the absence of a central bank, would almost certainly continue to carry on

monetary policy, merely from motives not directly linked to a public mandate. Canada's monetary order in the interwar period offers an example of just such a regime.

In other words, the question of central bank independence must always be looked at more broadly. Anglo-American governments have delegated power over money since at least the 1690s, though to varying extents and in various ways. The historically-informed approach to the questions posed in this Roundtable is not whether we should delegate this power, but to whom, with what tools, for what ends, and under which measures of accountability. It reveals that, in every case, these are governance decisions –ones that are central to our constitutional order. In every case, the key question is not only whether government-created central banks should be democratically accountable, but what accountability is required of commercial banks in exchange for the great privileges our state and legal system grants to them –not merely how should they be regulated in the interests of stability, but how they should be made accountable to the democratic order in terms of their *direction*. In sum, rather than ask whether government "intrusion" into monetary policy is democratically acceptable, we should ask which combination(s) of legal architecture, democratic engagements, technocratic administration, and/or private administration is most conducive to democratic realization of the populace more generally. These are not easy questions, but they are essential to truly understanding money's power as a governance mechanism, and they are ones we cannot properly ask when we assume a narrow historiography of central banks.

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[1] Sincerest thanks to Christine Desan, Stefan Eich, Lev Menand, and Hannah Hubbard for comments and edits.

[2] Some of this language in this part is pulled from my own

draft paper provisionally titled “Canadian Monies Before the Bank of Canada”.

[3] Pierre Berton, *The Great Depression, 1929-1939* (Toronto, Ont.: McClelland & Stewart, 1990), at p. 14. See also J. L. Granatstein, *The Ottawa Men: The Civil Service Mandarins, 1935-1957* (Toronto: Oxford University Press, 1982), at p. 3.

[4] *Currency Act*, RSC, 1927, C. 40.

[5] These notes walked the line between traditional bank notes receivable for specie and fiat bills of credit. While they could be redeemed for specie at assigned government offices, they were specifically designed in a way to reduce the likelihood of redemption. Legislation required that the chartered banks not issue notes below five dollars (leaving Dominion Notes with a monopoly over the cash liquidity necessary for everyday exchange), and also required that the banks keep at least 40% of their reserves in Dominion Notes, ensuring that these notes remain largely unredeemed in order to facilitate bank clearings. *Dominion Notes Act*, RSC, 1927, C. 41.

[6] For an excellent account of the design and passing of the *Bank Act 1871*, see Adam Shortt, *Adam Shortt’s History of Canadian Currency and Banking, 1600-1800* (Toronto, Ont.: 1986), Chapter XXI.

[7] There is obviously much more to this story than I can fit here. For more detail, see E. P. Neufeld, *The Financial System of Canada, Its Growth and Development* (New York: St. Martin’s Press, 1972), Chapter 4.

[8] See Robert B. Bryce, *Maturing in Hard Times: Canada’s Department of Finance through the Great Depression*, Canadian Public Administration Series (Kingston: McGill-Queen’s University Press, 1986), at pp. 31-37.

[9] Macmillan Commission Report, at p. 43, Table 13. See also R. Craig McIvor, *Canadian Monetary, Banking, and Fiscal Development* (Toronto: Macmillan Canada, 1958), at p. 129.

[10] Douglas H. Fullerton, *Graham Towers and His Times: A Biography* (Toronto: McClelland and Stewart, 1986), at p. 36-7.

[11] By at least one account, this was directly attributable to the ability of Canada's highly concentrated banking system to contain systemic risk.

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