Why Do We Need Central Banks?

By

Gerald P. O'Driscoll, Jr.

October 17, 2012

Paper prepared for the 35th annual Economic Conference of the Progress Foundation on the "Denationalization of Money," October 29, 2012 in Zurich. I thank Maralene Martin for her comments.

The question posed in the title of my paper will startle many. Central banks are institutions largely taken for granted even by monetary economists. In the 1930s, Vera Smith, a graduate student writing a Ph.D dissertation under Professor Hayek, examined the question. She concluded that "the superiority of central banking over the alternative became a dogma which never again came up for discussion was accepted without question or comment in all the later foundations of central banks" (Smith 1990: 167-68).

In my talk, I will re-examine the dogma in light of theory and history. A re-examination is timely for two principal reasons. First, the Federal Reserve and the European Central Bank have taken on extraordinary new responsibilities. Monetary policy is being transformed into fiscal policy in the form of credit allocation to key sectors and even countries. The Federal Reserve has been accused of industrial planning (Hummel 2011).

Second, controversies have emerged over the historical record and the independence of the Federal Reserve and other important central banks. Reviewing the historical literature, Selgin et al. (2012) find that the Fed's performance in terms of standard measures is not what its supporters have claimed. This is true both in absolute terms (e.g., with respect to price stability) and in comparison to the pre-Fed era (post U.S. Civil War up to the eve of World War One). It is far from clear that the U.S. central bank has brought greater macroeconomic stability to the U.S. economy.

Cargill (2012) and others have questioned the economic literature on central bank independence. That literature suggests that more independent central banks do better in promoting price stability than do less independent central banks. Cargill argues that the literature misstates the nature of independence; misidentifies which central banks are independent; and does not correctly measure independence. A session at the January 2013 meetings of the American Economic Association will examine these and other questions relating to central bank independence.

Taken together, these recent studies and others greatly undermine the received wisdom regarding central banks. My talk builds on the new literature on central banking.

Central Banks: A Brief History

The Bank of England was created in 1694. Despite, or because of its history in the 18th century, political battles were fought in a variety of European countries in in the 19th century over whether to create central banks in them. It was a contentious issue. The United States did not create its central bank until 1913 and Canada not until 1935. It is instructive to ask why the Bank of England was created so early, and it took so long for many other central banks to be instituted.

The Bank of England was created in response to a long line of fiscal embarrassments experienced by the English kings, who found it difficult to fun their extravagances in times of peace and even more so in times of war. King William III needed to raise revenue, but his predecessor, Charles II, had defaulted on loans from his bankers. William hit on a scheme to raise 1,200,000 Pound Sterling. The Bank was created; capital was raised in that sum; the Bank was authorized to issue notes in the same amount, which were then lent to the king. The king repeatedly offered favors and privileges in return for additional revenue. The model was repeated seven times from 1694 into the beginning of the 19th century (Smith 1990: 13).

The creation of the Bank of England and extension of its privileges followed a familiar pattern of a sovereign creating a monopoly and selling it for revenue. Over time, the Bank acquired limited liability long before any other bank possessed it. Very importantly, in 1812 its notes acquired legal tender status.

If such a concept even existed at the time, the creation of the Bank of England had no monetary policy goal in mind. It was a crude exercise in fiscal policy. The Bank acquired a

monetary policy role only gradually, over time, and solely because of the monopoly powers and privileges it was granted.

Financing the Napoleonic Wars threatened the Bank's survival. Parliament passed an Act to suspend cash payments. Smith (1990: 15) observed that this "created a precedent which led the public in the future always to expect the Government to come to the aid of the Bank in difficult circumstances." We observe the symbiotic relationship between king and government on the one hand, and the Bank on the other hand. The Bank supported the king's (later Parliament's) fiscal needs, and the government bailed out the Bank if needed with new privileges or powers; or by waiving its contractual obligations to note holders (to pay in specie if demanded). It was the marriage of finance and government.

After the Napoleonic wars, Britain introduced a series of mutually reinforcing reforms, which had the effect of introducing a new economic order (Coinage Act of 1816; Resumption Act of 1819; and repeal of the Corn Laws in 1846). These acts amounted to the adoption of a gold standard and free trade. Unprecedented prosperity followed in Britain.

Even with the costs of empire, which included maintaining freedom of the seas, Britain experienced strong economic growth. That growth generated tax revenues to fund the government. By adopting sound economic policies, Britain obviated the need for the Bank of England to finance the sovereign. Its fiscal role ended.

But so, too, did any monetary role end. The simple truth is that, under a gold standard, there is no reason for a central bank to exist. It performs no function that could not be conducted by private banks of issue. I examine that point in the next section. Suffice to say, the *historical* reason for central banks is to finance fiscal deficits.[1]

Private Money

Competitive, private note issue is most frequently described as free banking. "Free" refers to free entry and free competition. The Scottish system was the most successful. Professor Lawrence H. White (1984) has chronicled the evolution of the system in Scotland beginning in 1695. The Scottish system reached its apogee in the 19th century. It was only ended by the passage of the Peel Acts of 1844 and 1845, which were designed to provide a monopoly of note issue in England. These acts effectively also ended the free, competitive Scottish system.

Scotland experienced early industrialization and urbanization. Its banking and financial system was highly developed for the era. "During this time Scotland had no monetary policy, no central bank, and virtually no political regulation of the banking industry" (White 1984: 23). White examines the remarkable record of monetary stability in Scotland in the free banking era. He attributes the monetary stability precisely to the free, competitive banking system.

Scottish banks expanded and contracted the supply of notes in response to shifts in the demand for them. They were constrained by the contractual obligation to pay out specie on demand. They were required each to hold sufficient reserves, since there was no concentration of reserves in a central bank. Critically, there was a note exchange system that prevented over-issue of notes by a bank (White 1984: 30-32).

Almost in passing, White notes that "there was no Scottish government with which to become entangled." Consequently, no fiscal demands were placed on Scottish banks. No marriage between banking and government could occur, absent one key partner.

Contrast the Scottish system with another also called free banking: the system that arose in the United States before the U.S. Civil War. It was highly regulated by the states chartering the

[1] Smith (1990) examines the origin of central banks in countries besides Britain and comes to a similar conclusion for them. I examine the U.S. case in the next section.

banks. From inception, there was a marriage between the banks and the states due to requirements to hold state bonds to back note issuance. Branching was limited, if it existed at all, and could only occur within a state.[2] It was "free" in only one sense. Beginning in 1838, general incorporation laws were passed in the various states. State charters were freely issued to all qualified applicants, no longer by special legislative acts. Vera Smith (1990: 42) aptly described the ante-bellum U.S. system as "decentralisation without freedom."

Nonetheless, there was no central bank and notes were privately issued. For all its flaws, the system provided a monetary system that functioned reasonably well despite the criticism that it was characterized by chaos and "wildcat banking" (White 1989: 52-54).

The federal (central) government was not large in antebellum America and did not exert significant demands on the fledgling financial system with the exception of the War of 1812. The Civil War changed that dramatically. Federal government expenditures exploded. The result was passage of the National Banking Acts of 1863 and 1864, which, together, established a system of nationally chartered banks of issue. Their notes were backed by Treasury bonds. Notes issued by state chartered banks were taxed out of existence. The new system was explicitly a marriage of banking and government. The national banks were created to finance the war effort.

The national banking system operated from the 1860s until the creation of the Federal Reserve System in 1913. It was a system of private issuance of notes against the collateral of Treasury debt. There were episodes of financial crises, banking panics and economic downturns. Critics have tended to emphasize these episodes. One observer has argued, however, that 19th century crises were "briefer, milder, and involved acute illiquidity, whereas this [20th] century crises have involved prolonged periods of recession and depression, widespread bank failure, and chronic insolvency" (Salsman (1993: 86).

Selgin, et al. (2012) survey the historical literature and also provide a more positive view of the pre-Federal Reserve banking system. They emphasize that the defects of the system can be tied to specific regulations under which it operated (in sharp contrast to the Scottish system). One great weakness was the requirement for Treasury bonds to serve as collateral for note issuance. That requirement reflected the origins of the system in wartime financing requirements. After the Civil War, however, the federal government began retiring debt. The period after the Civil War was a period of rapid economic growth. Demand for notes was rising as incomes rose. Yet artificial constraints imposed by statute constrained the ability of banks to meet the rising demand. The wonder is not that this partially free system of note issuance had problems; the wonder is that it worked as well as it did.

Even at the time, solutions were offered to reform the system. Professors Milton Friedman and Anna J. Schwartz (1963: 117-18n44) noted that, in his 1894 *Annual Report,* Comptroller of the Currency Eckels called for repeal of all laws requiring U.S. bonds as security for national bank notes, and for adoption of an asset-backed currency. Such regulatory reforms would have addressed the defects of the system.

Advocates for a central bank were not interested in reforming the system. They wanted centralization and control over banking. On the theory that no crisis should be wasted, they used the panic of 1907 to push their agenda. Progressives joined with big bankers in support of a central bank. Progressivism was a complex political movement with important representation in both major political parties (e.g., Teddy Roosevelt and later Herbert Hoover in the Republican Party; and Woodrow Wilson in the Democrat Party). Progressives favored more government involvement in the economy. They favored regulation to rationalize the anarchy of markets. Their philosophy was corporatist. The Federal Reserve was the product of the Progressive impulse joined with self-interest of bankers like J. P. Morgan to tame financial markets and control banking (Kolko 1963).

Ending banking panics, like that of 1907, was a frequently cited justification for creating the Fed. The preamble to the 1913 Federal Reserve Act stated its purpose in part was "to furnish an

---

[2] Interstate branching restrictions in the United States were not fully lifted until the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994.

elastic currency, to afford means of rediscounting commercial paper [and] to establish a more effective supervision of banking in the United States." But the Bank was given no monetary policy role as that term is now understood. The classical gold standard was the international monetary system. There is no room for an activist central bank in that system. Bankers like Morgan and his Progressive allies were interested in the "supervision," i.e., regulation of banking.

The creation of the Federal Reserve decisively moved banking away from control by markets and a free banking model. The Federal Reserve was not created as a consequence of a fiscal crisis. But it has evolved into a necessary institutional financer of a government that increasingly cannot fund its expenses through other means.

Denationalization of Money

In the midst of the Great Inflation of the 1970s, Professor Friedrich Hayek (1978: 132) proposed a sweeping and radical reform of national monetary systems. He advocated that *"the countries of the Common Market, preferably with the neutral countries of Europe (and possibly later the countries of North America) mutually bind themselves by formal treaty not to place any obstacles in the way of the free dealing throughout their territories in one another's currencies (including gold coins) or of a similar free exercise of the banking business by any institution legally established in any of their territories."* At the time, it would have represented greater monetary and banking freedom for the citizens of the affected countries. The ability of citizens to transact in the currency of their choice would have limited the ability of national governments to pursue inflationary policies.

Hayek (1978: 133) identified "the source and root of all monetary evil" as "the government monopoly of the issue and control of money." Governments would continue issuing money, but no longer have a monopoly. Much of the proposal deals with the history of the government monopoly and its abuse.

Providing citizens with choice among currencies was an alternative to adoption of the Euro as a means of ensuring sound money. Viewed in that light, one might say that events overtook Hayek's plan. I would suggest, however, that the spirit of the plan has relevance today. If a country like Greece were to abandon the Euro, I suggest that it would be wise of the government to permit its citizens Hayek's choice: transact in the New Drachma or the Euro. Permitting that would signal the possibility of a return to the Euro, which might help maintain the value of the New Drachma.

Hayek also proposed a role for private issuance of what he termed "token money." It is a strange and misleading use of a term best understood in the context of a specie standard (such as gold or silver). Token money was subsidiary coinage of less than full value, e.g., copper coins for small denominations. They were accepted in circulation because the issuer promised to convert them into full bodied coins or notes. I take his discussion of private note issuance as really a second, even more radical proposal for denationalizing money. Perhaps the first was viewed as a way station to the second.

Hayek proposed not free banking, that is, the competitive issuance of a national currency; rather, he proposed competitive or concurrent currencies. The different issuing banks would offer different currencies in the same economic markets. So, UBS might produce the Swiss Ducat; and Credit Suisse might offer an alternative currency, the Hayek. This is a much more radical proposal than classical free banking and raises many more issues.

Hayek (1978: 209) suggested that his plan would be "better even than gold." I found his argument there unconvincing. My own view is that any return to competitive banking and private issuance of currency would necessarily involve a return to a gold or silver standard. On the larger question, however, Hayek clearly favored sound money and monetary freedom. He though the two were linked, and I agree. I put him in the same philosophical camp as free bankers, against central banking and monopoly note issuance.

I now turn briefly to current events.

Europe's Financial Crisis

The European Central Bank is a critical player in the Eurozone's financial crisis. I know of no one claiming that the crisis could be resolved without participation of the central bank. Silence speaks louder than words. The heavily indebted countries are unable to pay their obligations. Some as yet undetermined portion of those debts will be paid by money creation by the ECB. The Eurozone presents a clear, modern example of the essential linkage between central banking and government finances. It also illustrates the stark reality confronting advocates of free banking and denationalization of money.

Advocates of free banking argue that a competitive banking system would constrain government spending. Governments would be limited in their spending by their ability to raise taxes. Competitive banks could not afford to purchase the paper of profligate governments whose credit was dubious. Only the support of a central bank makes that a bankable proposition. If there were free banking, the Eurozone crisis could never have developed – certainly not to the degree and magnitude that now exists. But there can be no thought of abandoning central banks in the midst of such a fiscal crisis.

Monetary reform and fiscal reform are inextricably linked. We have two bad systems: the monetary and the fiscal. They feed on each other and are mutually supportive. They must be reformed, or they will destroy the economic system that sustains them. They have become parasitical on civil society. In such a situation, advocacy of free banking or denationalizing money might seem quixotic. But belief that the current situation can continue is surely delusional.

References

Cargill, Thomas F. (2012) "A Critical Assessment of Measures of Central Bank Independence." *Economic Inquiry.* Online version published January 12, 2012 with print version forthcoming.

Friedman, Milton and Anna Jacobson Schwartz (1963) *A Monetary History of the United States, 1867-1960.* Princeton: Princeton University Press.

Hayek, F. A. (1978) "The Denationalization of Money: An Analysis of the Theory and Practice of Concurrent Currencies." London: Institute of Economic Affairs. Reprinted in Stephen Kresge, ed., *Good Money, Part II: The Standard.* Volume 6 of The Collected Works of F. A. Hayek. Indianapolis: Liberty Fund, 1999, pp. 128-229.

Hummel, Jeffrey Rogers (2011) "Ben Bernanke versus Milton Friedman: The Federal Reserve's Emergence as the U.S. Economy's Central Planner." *The Independent Review* 15 (Spring): 485-518.

Kolko, Gabriel (1963) *The Triumph of Conservatism.* New York: The Free Press of Glencoe.

Salsman, Richard M. (1993) "Bankers as Scapegoats for Government-Created Crises in U.S. History." In Lawrence H. White, ed., *The Crisis in American Banking,* New York and London: New York University Press, pp. 81-118.

Selgin, George, William D. Lastrapes and Lawrence H. White (2012) "Has the Fed Been a Failure?" *Journal of Macroeconomics* 34 (2012): 569-96.

Smith, Vera C. (1990; 1936) *The Rationale of Central Banking and the Free Banking Alternative.* Indianapolis: Liberty Press.

White, Lawrence H. (1984) *Free Banking in Britain: Theory, Experience, and Debate, 1800 -1845.* Cambridge: Cambridge University Press.

White, Lawrence H. (1989) *Competition and Currency: Essays on Free Banking and Money.* New York and London: New York University Press.