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Why Do We Have a Central Bank?

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Why do nations have central banks? Countries have developed without one, and sophisticated financial systems have evolved in their absence. Some countries with a central bank have suffered for having one. Zimbabwe comes to mind.

The Federal Reserve System was created by an act of
Congress only in 1913. It then presided over a great wartime inflation followed by a major depression in 1920-21. The 1920s were an era of prosperity, due as much to Treasury Secretary Andrew Mellon's wise fiscal policies as anything the Fed did. The Fed's performance in the Great Depression was disastrous, a judgment shared by its current chairman, Ben Bernanke.

The Canadian banking system weathered the Great Depression without a central bank. Instead of the thousands of small, undiversified banks that the United States had, Canada had a small number of banks (with many branches across the country) that were able withstand localized downturns. Even in the Great Depression, banking failures in the U.S. were concentrated in specific regions. Canada's central bank, the Bank of Canada, was created in 1935 in part because of pressure from the rest of the world. Canada had survived without it quite well.

In short, central banking has been neither necessary nor sufficient for the development of a modern economy and financial system. A number of reform proposals for the Fed are being crafted, but there is no agreement on why the institution exists.

Policy makers are debating the wisdom of the Fed's dual mandate of providing price stability and full employment. Rep. Mike Pence (R., Ind.) has introduced a bill to amend the Federal Reserve Act to end the dual mandate and give the Fed one goal: maintaining price stability (H.R. 6406). The dual mandate is seen by many as giving the Fed an impossible assignment of simultaneously optimizing two variables with one policy tool. It is also not clear that a central bank is capable of maintaining full employment.

Yet maintaining stable prices was not part of the Fed's original mandate and, aside from some economists, few thought it the Fed's job. The gold standard provided for stable prices over time, and the Fed's job was to maintain that standard (which does not require a central bank).

In the 19th century, the eminent British economist and journalist Walter Bagehot wrote Lombard Street: A Description of the Money Market as a treatise on the best central bank practice. Bagehot observed that the existence of the Bank of England centralized reserves in that institution. He preferred that banks provide

for their own liquidity by holding a buffer of short-term marketable assets.

Bagehot's goal was to devise central bank policy so that commercial banks would behave in ordinary times as if there were no central bank. In a liquidity crisis, commercial banks would turn to the Bank of England for support. That function, known as the lender of last resort, is the one carry-over to the Fed and all other central banks today. It appeared in the Federal Reserve Act as providing for an "elastic" currency, i.e., one whose quantity could grow or shrink at the Fed's discretion.

The Fed's first round of quantitative easing (printing money) was in response to the liquidity crisis of autumn 2008, which occurred in the wake of the Sept. 15 Lehman Brothers bankruptcy. It is not clear if QE was still needed by the time it was implemented at the end of 2008. It was likely too large and went on for too long. The Fed also forgot Bagehot's dictum that a central bank should lend only on good assets at penalty interest rates. The latter principle was to ensure that emergency lending did not become a subsidy program. Economists will debate the episode for many years.

There is no liquidity crisis now, however, and no justification for continued lender-of-last-resort activity. There are quite possibly still large unrecognized losses on banks' balance sheets associated with the housing collapse and other unwise lending. These losses mean such institutions are in reality undercapitalized, not short of liquidity.

The Fed's critics increasingly see it as acting as an unelected fiscal authority. Its lending to select institutions constitutes credit allocation and surreptitious bailouts of large banks. Its policy of low interest rates is part of its bank support program.

Meanwhile, the economy suffers because none of the Fed's policies will fix the banking system. The failure to fix the banks, not a nonexistent deflation threat, is what calls into mind Japan's lost decade of the 1990s. Banks with large, unrecognized losses will not make new loans while losses from the old ones grow.

Regulators should be consistent in calling for banks to write down assets and recapitalize themselves (and not just apply the policy to smaller institutions that are being closed). Now is not the time for banks to raise dividends, as numerous large banks are seeking to do. Now is the time to raise capital. In the meantime, the Fed must stop conducting fiscal policy under the guise of monetary policy. Taxpayer bailouts of weakened banks would be a terrible idea. But, if done by Congress, it would at least be subject to democratic debate and be conducted in the open.

The Fed has been ceded a degree of operational independence by Congress to conduct monetary policy. That independence is viable only so long as the Fed sticks to conventional monetary policy. If it persists in acting also as a fiscal authority, ordinary citizens and their representatives are going to ask: Why do we have a central bank?

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