Chapter 1
Introduction

Although Central Banks would appear to be firmly established in all major countries, academic economists have been far from convinced that these institutions are necessary, or even desirable in an optimal state of affairs. It is notable that two of the main authors on the role and functions of central banking in the United Kingdom, Walter Bagehot in *Lombard Street* and Vera Smith in *The Rationale of Central Banking*, both preferred free banking in theory[1] even though they both recognized that the abolition of the Bank of England in practice would appear an impractical and farfetched proposal. Yet, despite this, many of the recent group of economists who have been examining the option of free, or competitive, banking, and questioning the need for, and functions of, a Central Bank (in a critical spirit) have emphasized their view that this issue has been foreclosed and ignored by other economists.[2] Thus Klein (1974) begins his paper with the claim that "few areas of economic activity can claim as long and unanimous a record of agreement on the appropriateness of government intervention as the supply of money" (p. 423).

Discussions on free banking (i.e., banking freed from the presence of a Central Bank), and the role, if any, for a Central Bank, were particularly lively during the early and mid-nineteenth century; indeed, Vera Smith's excellent book largely consists of a historical restatement of the course of these controversies and discussions during the nineteenth century in the United Kingdom and Europe. Subsequently the subject fell dormant, and issues appeared largely settled. More recently, however, there has been a revival of discussion and interest on these issues. This has had several sources. Both Friedman and Hayek have queried whether the exercise of discretionary monetary policy by a Central Bank is desirable. If such discretionary policy was to be abandoned, however, and replaced by a policy rule, or by laissez-faire, what role, if any, would be left for a Central Bank? Although both Friedman and Hayek independently criticize the exercise of discretionary monetary policy, they have markedly different views on the preferred alternatives. Thus Hayek (1978) doubts whether a rule for monetary growth could be established within the context of the existing structure of the banking system (see p. 77 especially); instead, he argues for free competition in the provision of notes and deposits by competitive banks within a laissez-faire system, in which there would be no need for any Central Bank (see pp. 101–102 especially). Friedman, on the other hand, advocates the adoption of a rule to determine the rate of growth of high-powered money, but continues to see a necessary role for the Central Bank within the system, in order to maintain the sanctity of contract, the prevention of fraud, and the effective working of the monetary system, in a world in which information is costly and scarce [see (1959), especially pp. 6–7].[3]

There has subsequently been a more general revival of interest in examining, questioning, and analyzing the structural necessity for, and functions of, a Central Bank. This is one aspect of a general reconsideration of the need, if any, for outside (governmental) bodies to intervene and regulate market forces. This also accords well with current trends in economic analysis, particularly among the rational expectations school, which advocates greater attention to the effect that different institutional structures, or regimes, particularly policy regimes set up by governments, may have on behavioral patterns in the various parts of the economy, and the functioning of the economy more broadly.[4] Prime examples of such studies are Klein (1974), Kareken and Wallace (1978), and King (1983), (1984b).[5] This theoretical literature has also been buttressed by a growing number of historical studies, which, inter alia, seek to reevaluate earlier historical experiences of free banking, especially in the United States and the circumstances surrounding the introduction of Central Banks. Such studies include Rockoff (1975), Timberlake (1978), Vaubel (1984a), White (1984b), and Rolnick and

Weber (1983). Also see the bibliography provided by White in the appendix to chapter 3 and the supplement to that appendix in Salin (1984b), King (1983), and Timberlake (1984). The main conclusion of several of these exercises has been to suggest, upon such re-examination, that a free banking system, or at least a monetary system without a Central Bank, was not so bad after all.

In this approach, therefore, a comparison is drawn between a laissez-faire, free-banking regime and a regime in which a Central Bank is constituted, under one, or another, operating regime, such as the Gold Standard, a fixed monetary growth rule, or discretionary monetary policy. By implication, Central Banks have been introduced as a policy step, an intervention from outside, and could, by some such similar step, be changed, or even removed entirely in future. Anyhow, the appropriate role and functions, if any, of a Central Bank has now become an issue in the literature, alongside the appropriate design of monetary regimes.

This literature has followed other associated paths. One such has been to examine and to criticize the nature of the incentives and the rewards/penalties incorporated in the structure of Central Banks themselves. The motive for such work lies in a perceived contrast between the individual personnel of Central Banks, who are, at present, generally seen to be as able and desirous of the public good as their confreres outside, with (what are taken to be) the end results of their operations, e.g., endemic and accelerating inflation, volatile monetary and financial conditions, etc. The question is, therefore, raised whether, somehow, the risk/reward structure and/or the decision-making process is systematically badly organized. For an example on the poor organization of the decision-making process, see Mayer;[6] on the question of potentially inappropriate risk/reward structures, see the various papers by Acheson and Chant, Buchanan, Friedman (1982), Santoni, and Schughart and Tollinson listed in the bibliography. Thus Buchanan (1984, p. 21) suggests that "for example, if the compensations of all employees of the monetary authority should be indexed so as to insure personal penalty from any departures from monetary stability, perhaps nothing more need be required by way of rules." Once upon a time Central Banks were more used to fulsome encomiums than to such criticism, as evidenced by this splendid purple passage from Patron (1911, p. 37): "In spite of the complications of its task, we shall find the Bank always the leader in matters of credit as well as of money, unremittingly faithful to the great mission which the State intrusts to it, and its mastery of which we all acknowledge."

To return to the main theme, however, there are, perhaps, two main strands in the case for free banking, which case is described in greater detail in chapter 2. The first argument involves a frontal attack on discretionary monetary management. If such management is to be undertaken at all, it needs an institution to carry it out. This institution would be, in effect, a Central Bank. The argument between discretionary management and some kind of "rule" has, however, been discussed endlessly elsewhere, and it is not the purpose of this book to discuss that issue further.

Instead, this book seeks to follow a second strand of argument about the role of a Central Bank. This latter argument concerns the question of whether the introduction of an outside agency to regulate and control the banking system represents an undesirable intervention in the otherwise satisfactory working of a free-market system in the banking industry. The main purpose of this book is to consider this latter issue, examining both the analytical arguments and the historical evidence.

When the first Central Banks were founded in Europe, there was, however, little, or no, consideration, or attention, given to the possibility of these banks playing a supervisory role in relation to other banks. Instead, the initial impetus was much more basic, generally relating to the financial advantages that governments felt that they could obtain from the support of such a bank, whether a state bank, as in the case of the Prussian State Bank, or a private bank, e.g., the Bank of England. This function naturally involved favoritism, often supported by legislation, by the government for this particular bank in return for its financial assistance—see, for example, Cameron (1967).

An associated purpose for which these early Central Banks were founded was to unify what had become in some cases, e.g., in Germany, Switzerland, and Italy, a somewhat chaotic system of note issue, to centralize, manage, and protect the metallic reserve of the country, and to facilitate and improve the payments system. While these latter functions were seen as having beneficial economic consequences, the ability to share in the profits of seignorage and the greater centralized control over the metallic (gold) reserves had obvious political attractions as well. In any case, prior to 1900, most economic analysis of the role of Central Banks concentrated on the issue of whether the note issue should be centralized, and, if and when centralized, how controlled by the Central Bank.

Once such Central Banks had been established, however, their central position within the system, their "political" power as the government's bank, their command (usually) over the bulk of the nation's metallic reserve, and, most important, their ability to provide extra cash, notes, by rediscounting made them become the bankers' bank: commercial banks would not only hold a large proportion of their own (cash) reserves as balances with the Central Bank, but also rely on it to provide extra liquidity when in difficulties. In several early cases, e.g., the Bank of England, this latter role had not been initially intended; in most cases of Central Banks founded in the nineteenth century the full ramifications of their role as bankers' bank were only dimly perceived at the time of their founding; these functions developed naturally from the context of relationships within the system.

Initially, indeed, the role of Central Banks in maintaining the convertibility of their notes, into gold or silver, was no different, nor seen as any different, from that of any other bank. Their privileged legal position, as banker to the government and in note issue, then brought about consequently, and, naturally, a degree of centralization of reserves within the banking system in the Central Bank, so it became a bankers' bank. It was the responsibility that this position was found to entail, in the process of historical experience, that led Central Banks to develop their particular art of monetary management.

Such management has had two (interrelated) aspects, a macro function and responsibility relating to the direction of monetary conditions in the economy at large, and a micro function relating to the health and well-being of the (individual) members of the banking system. Until 1914 such management largely consisted of seeking to reconcile, as best as possible, the need to maintain the chosen metallic standard on the one hand with concern for the stability and well-being of the financial system, and beyond that of the economy more widely, on the other. Then, as the various pressures of the twentieth century disrupted first the Gold Standard, and thereafter the Bretton Woods system of pegged exchange rates, the macroeconomic objectives of monetary management altered and adjusted. Yet at all times concern for the health of the financial system has remained paramount.

These interrelationships between the macro and micro functions of Central Banks, with the latter seen as being of primary importance, were well described in the paper "Federal Reserve Position on Restructuring of Financial Regulation Responsibilities" presented to the Bush Commission in December 1983 as follows:

> A basic continuing responsibility of any central bank—and the principal reason for the founding of the Federal Reserve—is to assure stable and smoothly-functioning financial and payments systems. These are prerequisites for, and complementary to, the central bank's responsibility for conducting monetary policy as it is more narrowly conceived. Indeed, conceptions of the appropriate focus for "monetary policy" have changed historically, variously focusing on control of the money supply, "defending" a fixed price of gold, or more passively providing a flow of money and credit responsive to the needs of business. What has not changed, and is not likely to change, is the idea that a central bank must, to the extent possible, head off and deal with financial disturbances and crises.
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> To these ends, the Congress has over the last 70 years authorized the Federal Reserve (a) to be a major participant in the nation's payments mechanism, (b) to lend at the discount window as the ultimate source of liquidity for the economy, and (c) to regulate and supervise key sectors of the financial markets, both domestic and international. These functions are in addition to, and largely predate, the more purely "monetary" functions of engaging in open market and foreign ex-

> change operations and setting reserve requirements; historically, in fact, the "monetary" functions were largely grafted on to the "supervisory" functions, not the reverse.

The above argument, that the monetary (macro) functions of Central Banks were largely grafted onto the supervisory functions, and not the reverse, is of considerable importance. It implies that the central core and rationale for the existence and operation of a Central Bank is *not* necessarily to be found in its macro-economic role in (discretionary) monetary management. Of course, if one believes that such discretionary monetary management is desirable, "a good thing," then one presumably needs a Central Bank to conduct it, and that alone would then be sufficient justification for the existence of a Central Bank. There remains, however, a flourishing debate whether this macro function is best undertaken through the discretionary management of a Central Bank, or whether it would be achieved more successfully through adherence to some "rule." Instead, the main concern of this study is with the need for the micro functions of a Central Bank.

With the Central Bank coming to represent the ultimate source of liquidity and support to the individual commercial banks, this micro function brought with it naturally a degree of "insurance." Such insurance, in turn, involves some risk of moral hazard, i.e., that commercial banks, believing that they will be supported by Central Banks from the consequences of their own follies, adopt too risky and careless strategies. That concern has led Central Banks to become involved—to varying extents—in the regulation and supervision of their banking systems. Revell (1975, p. 127) notes that

> solvency [of commercial banks] must not be set at too low a level if monetary policy is to work at all....
>
> There is one corollary to our line of argument that is worth noting. Prudential regulation and monetary policy are functions that are usually carried out quite separately. Even when a central bank is responsible for both, the interactions between the two are rarely considered. This is not a sensible situation. It would seem highly desirable for both functions to be carried out by the same body (inevitably the central bank) and with a clear realization of the connexions between them.

As lender of last resort, a central bank *has* to be involved in supervisory matters. The choice then rests between centralizing the administration of such functions in the Central Bank, or of having a multiplicity of supervisory agencies. This latter question is addressed again in chapter 5.

The adoption of this regulatory and supervisory role was, at least for those Central Banks founded in the nineteenth century, largely a natural and evolutionary development, and not one that they were programmed to undertake from their foundation. Indeed in England the legislative framework—the 1844 Bank of England Act—was to prove something of a barrier, and antipathetic, to the development of the regulatory functions by the Bank.[7] This act divided the Bank into two departments—the Issue Department, whose note issuing function was to be closely constrained by strict rules (to maintain the Gold Standard), and the Banking Department, which was intended and proposed to behave as an ordinary commercial bank.

As will be argued subsequently in this book, the micro functions of a Central Bank, in providing a central (and therefore economical) source of reserves and liquidity to other banks and hence both a degree of insurance and regulation, cannot be undertaken effectively, basically because of conflicts of interest, by a commercial competitor. The advantages of having some institutions(s) providing such micro Central Banking functions are such that, even in those countries without Central Banks, there was, as will be shown, a natural tendency toward them being provided, after a fashion, from within the private sector, e.g., by clearinghouses in the United States—see Timberlake (1984)—or by large, central *commercial* banks providing quasi-Central Bank functions. Nevertheless, because of conflict of interest, these functions were not, and cannot be, adequately provided by competing institutions. This latter needs to be emphasized because some critics of Central Banks, e.g., Timberlake (1984) and Selgin and White (1987), have suggested that clearinghouses would be capable of taking over several of the micro-structural functions of Central Banks.

Some Central Banks, mainly those that began their existence under private ownership, e.g., the Bank of England and Banca d'Italia, but also some that were subject to political oversight, e.g., Banque de France and the Commonwealth Bank of Australia, retained for a considerable time a large role in ordinary commercial banking. As will be argued subsequently, it was the metamorphosis from their involvement in commercial banking, as a competitive, profit-maximizing bank among many, to a *noncompetitive non-profit-maximizing* role that marked the true emergence and development of proper Central Banking. Indeed, competition between the other commercial banks and the Bank of England and the Banque de France, respectively, complicated, overshadowed, and tarnished their adoption of a regulatory role. This metamorphosis occurred naturally, but with considerable difficulty, in England, the difficulty arising in part from the existence of property rights in the profits of the Bank, and in part from concern about the moral hazards of consciously adopting a regulatory role (as evidenced in the arguments between Bagehot and Hankey). Conflicts between commercial banks and the Banque de France had been even more marked (than in England) in the first half of the nineteenth century, but, perhaps because it was more subject to "political" direction at the top, it was able to transform itself more easily into a noncompetitive, regulatory institution in the latter half of the nineteenth century (see the appendix).

Other Central Banks, most often those set up later in the twentieth century, such as the Federal Reserve System (1913) or the Swiss National Bank (1905), or set up from the start as a publicly directed institution, e.g., the Reichsbank (1875), were designed from the outset to be non-competitive (with other commercial banks) and non-profit-maximizing (see the appendix). Naturally they found less *structural* difficulty in smoothly adopting a central regulatory role.

It is, however, perhaps surprising that some of those Central Banks that were designed from the outset to be noncompetitive have been relatively *less* involved in the *micro functions* of regulation. Thus the Reichsbank and the Swiss National Bank were intended from the start to regulate overall monetary conditions, but generally left the supervision (auditing, licensing, etc.) of individual commercial banks to separate governmental bodies. It may be that in those countries where conflicts of interest are more generally regulated, and supervision provided, by official bodies set up by legislation, there was a greater tendency to allocate this micro function to a separate body, whereas in countries where (self-) regulation has been provided more informally, this latter function (of micro monetary management) was more naturally adopted, in so far as it was undertaken at all, by the Central Bank. Even so, there seems no clearcut explanation of the varying extent to which Central Banks undertake the micro supervisory functions.

Considering the close interrelationship that generally exists between the macro and the micro regulatory functions of monetary management, and the inherent disadvantages of having a multiplicity of agencies acting in the same field, it is difficult for someone (who has been used to UK institutions) to see what advantages can be obtained from separating these functions, and hiving off certain micro supervisory and insurance functions to other official institutions (separate and distinct from the Central Bank). This subject remains of some practical concern; indeed, the Bush Commission in the United States reconsidered the overlapping boundaries of the various supervisory institutions there. The issue has, heretofore, generated surprisingly little academic and analytical interest, and will only be touched on lightly again in chapter 5. The structural changes in process in many countries, notably in Canada, the United States, and the United Kingdom, are now, however, making the subject of the design, coverage, and powers of the bodies supervising (parts of) the financial system a topical and important issue. I hope to be able to return to this topic in subsequent studies.

Instead, the purpose of the rest of this book is to combine theoretical analysis with historical example to explore the reasons for the development of Central Banks and the rationale for their existence. The following chapter restates the arguments *for* a return to "free banking" without having a Central Bank. Although current analytical discussion on the role of a Central Bank largely revolves around the issues of information availability (and the possibility of insurance), nineteenth-century discussion centered largely around the question of whether the market discipline imposed by a well-functioning clearinghouse would suffice to keep the banking system in order; this is discussed in chapter 3. For various reasons this discipline was not capable of preventing banking cycles and financial crises. In the meantime there were natural forces leading to the centralization of reserves with major banks at the center of the system, particularly, of course, those that had been endowed by legislation or government favoritism with special advantages. The development of such centralization, often through the correspondent system, on the one hand, and the provision of prudential insurance services by the major bank(s) at the center, on the other, was, however, severely restricted by conflicts of interest, so long as the major bank(s) at the center remained competitive, commercial banks. It was the large step to a noncompetitive, non-profit-maximizing role that was crucial for the emergence of true Central Banks; this is described in chapter 4.