WHY CENTRAL BANKING?

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While there is continuous debate about the optimal policies of central banks, there is rarely a debate about the structure, and indeed the existence, of central banks. In this essay, David Lally boldly questions the necessity of central banks. He continues to ask: if we need them, do they need to be government controlled. His probing questions lead to an interesting rethinking of our monetary systems.

> "The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else".
>
> (John Maynard Keynes)

Introduction

What are central banks, why do they exist and how do they affect economic activity? In attempting to understand the quagmire of policy debate which currently exists as to what central banks should actually 'do', one must examine the origins of this institution and the motives behind its creation. The inherent assumption is that this powerful institution is a natural and necessary development in any economy. Where such an organization, capable of huge influence over the wellbeing of an economy is concerned, there should naturally be extensive debate. This debate must question not only on the current roles and functions, but also to the necessity of its existence. This essay will attempt to challenge this logical conclusion, highlighting the need to question central banking at a deeper level, examining whether this pillar of modern economics is plausibly a natural free market development. Political motivations for central banking will be examined, alongside a general introduction to the debate on institutional centralization to emphasize the need for re-examination of our current monetary framework. The objective of this essay is to catalyze the debate on central banking, allowing for a more critical analysis of this powerful institution and its place in a modern economy.

The Contemporary Debate on Central Banking

> "Over the past decade, central banks have emerged from relative obscurity to global recognition as one of the most powerful institutions in the world—powerful not only economically, but also politically, socially, and as forces for cultural and historical change".
>
> (Geoffrey P.Miller)

Coming out of 'the great recession' of recent years, central banking has not been left unscathed by the public and academic scrutiny of the economic institutional framework and its role in ensuring future stability. Three major questions remain as to the functions of central banking. Firstly, there is debate as to the policy objectives of central banking. Here, contention exists whether a central bank should seek to achieve both monetary and financial stability, and whether this is indeed even possible. Proponents of financial stability standards, seen to be supportive of a "leaning against the wind" strategy, advocate measures to introduce countercyclical interest rate policy and means to burst asset bubbles prematurely (Goodhart, 2000; Bordo and Jeanne, 2002; Borio and White, 2003) One major, and convincing argument against this ability of central banks to integrate such an orientation as a financial stabilizer is the Tinbergen rule. Jan Tinbergen highlighted the inability of a single monetary tool (control of interest rates) to simultaneously achieve different policy objectives (Stark, 2010; Miller, 1996).

Secondly, the question of central banking independence has come to the fore in recent years. Across the spectrum of economic commentary, there reverberates the viewpoint that central banks need to become more independent. One conclusion reached is that the logical next step in central banking is an expansion of powers to cover a three part mandate of price, output and financial stability. The influential report of the Committee on International Economic Policy and reform, has, in this context, proposed greater independence; "Central banks already require substantial operational independence… they will require even greater independence" (Eichengreen et al, 2011). Central Bankers reiterate the necessity of strong, independent central banks (Miller, 2002; Bernanke 2010), while political theorists are, of late, highlighting the inevitability of a central bank coming under political influence, or, if 'independent', becoming subject to regulatory capture by commercial banks (Boyer and Ponce, 2010) .

The role of central banks in crisis management can be deemed the third major question surrounding central banking in contemporary debate. Following from the perceived dichotomy existent between monetary and financial stability policy (Mishkin, 2011; Issing, 2003), the resulting framework which has been applied until recently has been that of the Greenspan Doctrine. Here, under the influence of Alan Greenspan, central banks were seen to avoid attempting to burst asset bubbles, but instead focus on damage limitation thereafter. Juxtaposed against those who argue in favor of a more comprehensive stability initiative, this has been dubbed the "lean versus clean" debate (White, 2009). Conversely there is a push for central banks to act to reduce accommodative monetary policy in times of higher growth (Wagner, 2010), or more specifically to adopt a stricter alignment to the Taylor rule (Lee, 2011).

Free Market Development?

> "If you want to understand the nature of a modern central bank, you have to study its history and relationship to commerce and government".
>
> (Federal Reserve Bank of Minneapolis)

Central banking is by its nature, a government empowered institution. It is given powers beyond those achievable in the free market. According to Michael Rozeff, central banking can only exist once four conditions are satisfied (Rozeff, 2009). These four necessary prerequisite steps are, he asserts, all unnatural designs imposed against a free market. Below I will explore these preconditions, using them as a framework by which to analyze central banking from a free market and political perspective. To assess the historical truth in the implementation of such steps, reference will be taken from some early developments in central banking, both in France and the United States. These are primarily drawn from the work of Vera Smith (1936):

- Government legislated fiat/forced money
    - In France, the infamous monetary expansion of John Law under his Banque Générale served as an example of a hyperinflated fiat currency.
    - The Caisse d'Escornpte in France 1776. This bank, having lent heavily to the (see Politics Perspective below) state had to use government powers to give forced currency to its notes.
    - Following the Caisse, the Assignat Regime of short dated interest bearing Government bonds were made legal tender, which resulted in the collapse of the state backed bank due to over issuance.
- Homogenous bank note
    - By 1865, the federal government in America had created banking laws to penalise banks not depositing centrally their reserves, and maintaining proportional holdings of greenback' federal notes. Here we see the beginning of a move towards a fully homogenous note issuance. This step would finally be taken with the creation of the Federal Reserve in 1913.
    - The so-called 'Free' banking period in 18371863 was characterized not by the competitive equilibrium of different currency issuance, but instead the misaligned competition of perfect substitutes (one type of currency), which thus fell subject to Gresham's law. The incentives to over expand, the subjectivity to

industry-wide bank runs and constrictive regulations on branch banking and free market developments led to recurring financial crashes and cash suspensions.

- Monopoly of issuance
  - The Banque Générale in France, 1716, which ended in failure after 5 years, had been granted a monetary monopoly by the state of France, with the intention to eliminate public debt.
  - After gaining control of issuance rights through the power to grant charter to banks, the Bank of France, in 1840 ceased granting new charter.
- Arbitrary control of money supply
  - The Bank of France in the mid 18th century imposed issuance limitations on all departmental banks, thus subjecting them to a centralized control over the money supply.
  - The origins of the Lender of Last Resort function to central banks, enabling mass credit expansion by commercial banks, dates back to the Second Bank of the United States. This concept shows the huge powers, especially in times of crisis for a central bank to expand arbitrarily the level of the money supply. This has been reflected in recent years with programs such as the Fed's Quantitative easing and the ECB's Long Term Refinancing Operations.

Politics Perspective

To understand the current form of central banking is to understand the accompanying history of how it came about. Unnatural and undesirable outcomes can development under the interaction of economics with politics. A key feature of this evolution is the link to state funding. The timing of the first developments are of importance, with the theories of sovereignty by Jean Bodin providing as a basis for the claim of a government money mandate (Hayek, 1977). Gerard P. O'Driscoll of the Cato institute furthers this viewpoint, highlighting the inseparable link to the spread of centralized government; "the rise of the central bank coincides with the rise of nation states, whose spending commitments exceed their capacity to finance those commitments" (O'Driscoll, 2012).

We see, looking to historical examples, that the need of these governments to cover expansive spending projects, notably war, was a primary justification for the creation of state currencies and central banks.

The history of how central banking came to be in the US is one of factitious debate and political rivalry. The first venture of the federal government towards creating the functions of central banking was under the Continental Congress. Motivated by the need to find funding sources for the war of independence, notes dubbed 'continentals' were printed and used to cover military expenditure. Operating as a fiat currency, the return on the notes was to be based on future taxation income. Demand on the currency saw it detied to specie, to be followed by its collapse after rapid inflation resulting from over issuance. This voluntary means of exchange, based entirely upon trust in the issuing institution paved the way for more intrusive explorations of central banking in years to come.

Under Alexander Hamilton, the First Bank of the United States gained a charter from 17911811 to issue (under monopoly) a federal currency. Authoritative sources, including a history of central banking from the Federal Reserve Bank of Minneapolis, describe the motivations for such a bank as predominantly political rather than economic. Thomas Jefferson, writer of the declaration of independence and former president of the United States vehemently opposed the bank, citing it as a subversive tool for a return to mercantilist ideals and imperialism. Recognizing the manipulation of financial engineering to eliminate accumulated state war debt, and thereafter to allow profiteering through arbitrage arrangements, Jefferson wrote "Hamilton's financial system had two objects. 1st as a puzzle, to exclude popular understanding & inquiry. 2ndly, as a machine for the corruption of the legislature" (Jefferson, 1818).

Looking to the development in France coming into the 19th century, the push for centralization was far from a free market development. It was instead due to the desires of Napoleon to fund military expansion and concentrate monetary powers (Smith, 1936). Here, as elsewhere, the failing of a partially regulated monetary system gave weight to those who proposed further government control. Looking to France, under Napoleon the loi de 24 Germinal an XI had withdrawn issuance rights to private banks except under charter. As would later be seen in arguments for central banking in the USA, this push for government regulation was justified in response to an earlier financial crisis. Comparison can easily be drawn between these laws being initiated in response to the slight 1802 financial crisis, and recent developments seeing the ECB's bestowed broad new supervisory powers in response to the recent crisis. From historical extrapolation, we can thus conclude that a breakdown of the inherently unstable hybrid system of government regulation, has served as a basis for further centralization.

Limited Debate

One issue of significance undermining the historical precedent of central banking is the lack of balanced and informed debate that existed during the evolution of this institution. The limited and misaligned argumentation surrounding free banking in the U.S was framed only as a pluralism of homogenous currency issuance, and not one encompassing different types of currency. Much of the debate in America, as in France[1], is centered around the plausibility of free market money issuance and the need for government intervention. Simultaneous issuance of a homogenous currency, but differentiated into different bank

1 Questions of the legitimacy of the Bank of France, notably brought forward by the Pereire brothers, were to be dispelled by the results of a report by the Conseil Supérieur du commerce de l'Agriculture et de l'Industrie 3 Quote attributing to various authors. See (Lietaer et al, 2010)

notes was the system in the mid 19th century in the United States. In Denationalization of Money, Friedrich Hayek dispels the often cited application of Gresham's Law as argument against pluralistic currency issuance. Hayek highlights the misunderstanding evident in this line of debate, which fails to recognize that this law only stands under a fixed exchange rate, where two or more issuers are competing to produce perfect substitute monies (i.e. homogenous gold coins). What one seeks to conclude from this rationale is that while the maxim of 'good money pushes out bad' holds true where multiple issuers seek to compete to create the same money; a system of competing currencies of different denominations, under a floating exchange rate has yet to be truly attempted.

Centralization

> "The urgent message for economics from nature is that the monoculture of national currencies, justified on the basis of market efficiency, generates structural instability in our global financial system".
>
> (Bernard Lietaer)[2]

One important aspect of debate in the need for central banks must be the need for a centralized institution, as opposed to a decentralized system. Historically, central banking has been a transfer of powers from cities or states to national institutions. Current trends are toward an ever wider scope and scale of central banking responsibility. Ireland's economic sovereignty has been now been conceded to a central European central bank in the hope of closer economic integration at European level. The subsidiarity principle, championed by the European Union, and thus by the European Central Bank, states " that a central authority should have a subsidiary function, performing only those tasks which cannot be performed effectively at a more immediate or local level"[3]. By direct implication, this concept implies that functions ranging from currency generation, control of interest rates and inflation, to acting as lender of last resort, are not only necessary, but impossible at any level less centralized that a national or supranational central bank.

Great thinkers of recent history have based their political and economic theories on different interpretations of the idea of freedom, liberty and the nature of the state. On one end of the spectrum would be thinkers such as Hayek, who through his writings such as the Denationalization of Money fervently opposed the central banks, and more generally all monetary policy as unjust and unnecessary. While sharing many views on liberty with Hayek and the Austrian school, Friedman supported central banking in as much as he presupposed their necessity to achieve his suggested inflation targeting policies (Friedman, 1962).

John Maynard Keynes lies on the other end of the spectrum. Commonly under-

2 Quote attributing to various authors. See (Lietaer et al, 2010)

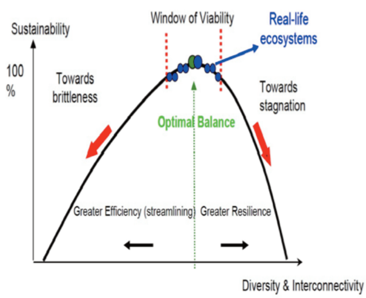
3 As Taken from the Oxford Dictionary, online resource. Available at http://oxforddictionaries.com/

stood to advocate economic management and centralized monetary policy, he too recognized the limitations of state action "But, above all, individualism, if it can be purged of its defects and abuses, is the best safeguard of personal liberty" (Keynes, 1936). What is clear is that, far from consensus, the conclusions of many great economic and political theorists have stumbled upon the question on central banking, not just from an efficiency perspective, but also from a moral one.

One perspective as to the creation of a central bank is the argument of liberty and the mandate for government intrusion into the economic circumstances of individuals. Over a century ago, George Earle made the case against a central bank, recognizing the absence of constitutional mandate allowing for it to be imposed on the American states. Recognizing the inevitable political nature of such a development, Earle condemned this initiative as a step away from freedom "which must inevitably destroy liberty by vesting all discretion in some form of central government".

Emergent economic theories are revolutionizing the centralization debate, drawing on scientific understanding of complex systems. In comparing economics, not to an absolute science, but indeed to a natural ecosystem, a very different perspective on the need for diversity becomes evident. Working on this approach, a direct trade off has been identified between diversity and efficiency, with optimal sustainability accordingly achieved through a balance of the two metrics. As seen in figure 1 below, a window of viability is achieved, not through perfect efficiency (monopoly currency issue), but through significant decentralization of monetary developments (competing currencies). In moving towards an understanding of economic interactions in a given geography as a complex flow system, economics can bring a fresh perspective to the business cycle debate, placing emphasis on the need for decentralized and dynamic economic systems.

Figure. 1. The Sustainability Curve[4]



Conclusion

This essay has covered the major debate points surrounding central banking. Moving from

4 In Is Our Monetary Structure a Systemic Cause for Financial Instability?. (see Lietaer et al, 2010)

the current roadblocks facing policy decision makers, context has been given to the underlying principles of central banking, whilst drawing on historical examples. The major themes of this examination have been those of the free market nature of central banking, the political perspective and the centralization debate. Throughout, the lack of debate on these fundamental tenets of central banking has been highlighted, with a view to encouraging further, more in depth discussion. In concluding, this work seeks to draw attention to the need for a reexamination of the institutional makeup of current monetary policy, with a focus on the role of the central bank, and the potential for a decentralized alternative.

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