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## WORKING PAPER

### **CENTRAL BANKS: REFORM OR ABOLISH?**

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## Central Banks: Reform or Abolish?

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Advocates of central bank reform must examine why central banks emerged and what forces sustain them. They did not arise in an institutional vacuum, and will not be reformed in an institutional vacuum. The historical origins of central banks explain how they came into existence. The forces sustaining and feeding their growth may differ from those explaining their origin.

Plans to abolish central banks constitute an extreme reform. It is doubtful that such plans can succeed without broader institutional change, occurring either first or simultaneously. That is likely true regardless of the strength of evidence on central bank performance. I examine these issues in what follows.

### Why Central Banks?

...The superiority of central banking over the alternative became a dogma which never again came up for discussion and was accepted without question or comment in all the later foundations of central banks.

(Smith, 1990: 167-68)

Vera Smith wrote her dissertation on central banking under Hayek in the 1930s at the University of London.<sup>1</sup> In book form, she titled it *The Rationale of Central Banking*. The reader soon discovers that case for central banking was less a reasoned exposition of principles, and

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<sup>1</sup> In his Preface to *The Rationale of Central Banking*, Leland Yeager provides some useful biographical details. I will add one provided me by Professor Hayek. Though a distinguished economist in her own right, Vera Lutz (her married name) could never attend the seminars at Princeton because she was a woman.

more myths. In Smith's words, it had become dogma. In this paper, I will re-examine the dogma and see if a rationale can be teased out of central banking myths.

I begin by making a basic point. Central banking is suspect because it violates the general economic principle that presumptively favors competitive markets for producing goods and services. In general economic theory, monopoly is bad and an affirmative case must be made for it. When it comes to central banking, mostly economists no longer make the case for central banking. If they do, their reasoning would not pass muster in other areas. Dogma rules more so than even in Smith's time.<sup>2</sup>

To his credit, Milton Friedman argued that the case for monopoly in banking could not go unexamined. Friedman (1960: 4) noted that "control over monetary and banking arrangements is a particularly dangerous power to entrust to government because of its far reaching effects on economic activity at large – as numerous episodes from ancient times to the present and over the whole of the globe tragically demonstrate." He acknowledged that a pure commodity money system is viable. He argued that bankers and their customers would have incentives to find substitutes for the commodity. These have historically been currency and later bank deposits: "fiduciary elements" in Friedman's terminology (Friedman 1960: 5-6).

Friedman (1960: 6-7) further argued that fiduciary elements would dominate because they are cheaper to produce than the commodity money. Banks would over-issue currency and be unable to honor their obligations to pay out units of the commodity money on demand in

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<sup>2</sup> Canada's banking system survived the Great Depression intact without a central bank. But in 1935, Canada joined the countries of the world having central banks. Surely that was despite the experience of its neighbor to the South.

exchange for their currency and deposits. Friedman made the case for the inherent instability of a competitive monetary system.

Since the enforcement of contracts is a basic function of government in a classical liberal order, Friedman (1960: 6-7) noted that one liberal principal (enforcement of contracts) comes into conflict with another (freedom to compete). Competition would not provide an effective limit to the issuance of money and, hence, its value could not be preserved. Friedman (1960: 7) concluded that the production of “fiduciary currency” is “a technical monopoly” and “there is no such presumption in favor of the private market as there is when competition is feasible.” In short, we need a central bank to provide a nominal anchor.<sup>3</sup>

Friedman’s argument is the classic case against free banking. I reference it because, in his telling of it, the argument is particularly clear. And he attended to liberal presumptions favoring liberty over coercion in all matters. I also invoke Friedman on this point because he linked the question of banking reform to that of monetary reform. That linkage is a theme of this paper.

As Friedman was well-aware, his argument did not *ipso facto* make the case for central banking. In one version of his plan for a monetary rule, a functionary in the Treasury Department could make the daily calculation of how much base money to create. Friedman’s 1960 argument was long accepted, however, as a rationale for central banking. Call it the classical liberal rationale for the Fed.

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<sup>3</sup> In much of the rest of monetary work, Friedman documented the proclivity of central banks to over-issue. Including in Friedman (1960).

The problem is that Friedman's argument against competitive banking is fallacious. As one of his students, Benjamin Klein, later pointed out, Friedman had a model of competition without competitors (Klein 1974). More precisely, the money in Friedman's model is not branded. When firms produce superior products, they enhance the value of the firm (brand name capital). Markets provide incentives to improve products, not produce shoddy output. In a competitive monetary system, banks would compete to produce superior money that held its value.<sup>4</sup> There would be a virtuous cycle toward high-quality money, not the race to the bottom that Friedman predicted.<sup>5</sup>

Klein (1974) modeled a competitive system of money under a fiat standard. That aspect was unpersuasive to Friedman and many others. But Klein was surely correct that competition results in better products and services. Friedman offered a lemon model for competitive money (and, not as he suggested, a natural monopoly).

Now I pause to point out a conundrum. Friedman would not have made his argument as he did had he known of *The Rationale of Central Banking*. He would certainly have had to take note of the argument and historical evidence in that book and perhaps even rethought his position. And he certainly knew Vera (Smith) Lutz. She and her husband were longtime members of the Mont Pelerin Society, of which Friedman was also a member. Friedrich Lutz was president of the society from 1964-67 (Yeager 1990: xv). Additionally, Hayek and Friedman regularly attended meetings and Vera Lutz's work had influenced Hayek. Anyone attending

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<sup>4</sup> Kevin Dowd (1990: 101) argued in similar fashion in his review essay of Charles Goodhart's *The Evolution of Central Banks*.

<sup>5</sup> Daniel Klein (1997) generalized the argument to all manner of social interaction. Individuals value their reputation and so do not cheat.

those meetings knows that monetary topics frequently came up. So I am puzzled by Friedman's apparent ignorance of her contribution. I am only more so because he was later to write a blurb for the jacket of the Liberty Fund edition of her book.<sup>6</sup>

I will not repeat the arguments of more recent contributions to the free-banking literature, well known to the readers of this paper, some of whom authored the works in question. Building on the earlier work of others, White (1984) marked the renaissance of free banking theory. The earlier work included Rockoff (1974) and Rolnick and Weber (1982). White was followed by numerous other works. Selgin (1988), Dowd (1989), White (1989), Horwitz (1990) and Dowd and Timberlake (1998) are just a sampling. The kind of argument made by Friedman (1960) can no longer be taken seriously by students of monetary history. Indeed, Friedman recanted in the face of the work of White and others (Friedman and Schwartz 1986).<sup>7</sup>

Ralph Hawtrey and others have viewed the lender-of-last-resort role of central banks as their primary function (Smith 1990: 141). Walter Bagehot coined the phrase and first explicated how a central bank should act in a liquidity crisis. Economists who justify central banks by their ability to act as lender of last resort get Bagehot's argument exactly backwards. Bagehot thought that it was unfortunate that the banking system had evolved as it had. Bagehot (2011: 130) described "the natural system" as the one "which would have sprung up if Government had let banking alone." There would be "many banks of equal or not altogether unequal size."

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<sup>6</sup> Larry White reminded me that Gary Becker had provided an argument for limited free banking, to which Friedman (1960: 108n10) alluded. Still, Friedman held to his instability thesis.

<sup>7</sup> There is a separate literature on laissez-faire banking based on equity payments systems. It is sometime called the BFH (Black/Fama/Hall) system and was presented by Greenfield and Yeager (1983). White (1984) and O'Driscoll (1985 and 1986) criticized it. Woolsey (1992) updated BFH and Cronin (2011) has recently revived what is now called Monetary Separation on empirical grounds. I do not deal with the literature in this paper.

In a decentralized banking system, each bank would hold its own reserves and provide for its own liquidity. Reserves would not be concentrated in one place, a practice he thought unwise. Bagehot (2001: 134) described it as “the many reserve system.” In times of illiquidity, the scramble by all banks for the common pool of reserves leads to the multiple contraction of the money supply (White 1998:389).

Serving as lender of last resort is *not* then an argument in favor of central banking. Rather, the LOLR role is a necessity, given that a country has a central bank. When there is a central bank, reserves concentrate on its balance sheet. In time of crisis, it alone has the wherewithal to lend. Hence the contradiction he noted. In Bagehot’s view, better the system of central banking with its concentration of reserves had never arisen. Given that Britain had a central bank, however, it was critical that it follow the policies presented in *Lombard Street*. It is a second-best policy.

It is important to note that, in fact, central banks today do not follow Bagehot’s strictures for a lender of last resort (Humphrey 2010). In times of liquidity crisis, the central bank should lend freely on good collateral at penalty rates. Instead, they now typically lend freely at subsidized rates for periods well beyond any liquidity crisis.

In the United States, this practice has been in place since the 1984 failure of Continental Illinois National Bank (Gelinas 2009: 5, 43-51 and 156-57).<sup>8</sup> It has very much been the practice during the current financial crisis, already evident by 2008 and continuing today. “Central banks ... did not sufficiently heed Bagehot’s admonition to provide liquidity only at a penalty rate. Not

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<sup>8</sup> The failure of Franklin National Bank in 1974 was a precursor. The Fed kept it open while uninsured deposits ran off.



designing the financial incentives faced by their counterparties in these new facilities to minimize moral hazard has turned out to be the central banks' Achilles heel in the current crisis. It will come back to haunt us in the next crisis" (Buiter 2008: 27)

Bagehot wanted to ensure that central banks lent only to solvent institutions experiencing liquidity problems. If institutions have good, unpledged collateral, it indicates they are solvent. The penalty rate motivates banks to pay off emergency borrowings as soon as financial markets return to normal.

If central banks relax collateral requirements and lend at subsidized interest rates, they risk lending to insolvent institutions. Keeping insolvent institutions open and operating by lending directly to them at subsidized rates misallocates resources. Resources are taken from solvent banks, which could lend productively, and instead provided to insolvent banks, which are not in a position to lend. Credit is constrained, and normal economic activity stifled.

Current central bank practice creates "zombie" banks. Think of the S&L crisis in the United States in the 1980s, the Japanese banking crisis of the 1990s, or the European banking crisis of today.<sup>9</sup>

As this is being written, the Fed has renewed currency swap lines with the European Central Bank and four others (Canada, the United Kingdom, Switzerland and Japan). It lends at 50 basis points above the overnight index swap rate. The ECB (and others drawing on the lines) then lends dollars to its banks. European banks engage in dollar lending in global markets. Funding dollar assets with dollar liabilities is least costly. As Buiter (2008: 34) observed,

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<sup>9</sup> Kane (1987) originated the concept of "zombie" financial institutions.

however, “expensive is not illiquid.” European banks could issue debt instruments denominated in euros, and purchase dollars in the forex markets. If the banks are unable to raise euro funds, it suggests they are not perceived to be solvent. The swaps arrangement has put the Fed in a position of funding a cross-border bailout of foreign banks. It is an escalation of bad central bank practice.

Notably, in the recent round of swaps, the Fed cut its interest rate from 100 basis points to 50 basis points. Even in an earlier round of swaps, Buiters (2008: 34) concluded the swap arrangement provided “unwarranted subsidies to euro area- and Switzerland-based banks needing US dollar liquidity.” That is even truer today.

What I have been describing is credit allocation. Subsidized lending to favored financial institutions is inherently so. The Fed did this also by targeting certain securities, such as mortgage-backed securities, for open-market purchases. In the process, the Fed accepted dubious assets likely at inflated valuations. The ECB is reportedly doing the same. Richmond Fed president Lacker (2011) criticized the practice: “Credit allocation can redirect revenues from taxpayers to financial market investors, and over time can expand moral hazard and distort the allocation of credit.” It transfers resources from solvent banks, which would fund profitable investment, to unsound or even insolvent banks. The latter are constrained in lending. It is a recipe for creating a Japan-style “lost decade” of economic stagnation.

Central banks are not following Bagehot’s rule for the lender of last resort. But they do continue to conduct monetary policy in part by using the discount window (“rediscounting” in the older terminology). As long-ago noted by Friedman (1960: 38), “rediscounting is a

technically defective tool” for conducting monetary policy. Better just to use open market operations, which were infeasible in Bagehot’s time. Using the discount window makes the central bank a passive agent dependent on banks coming to it. By engaging in open market operations, the central bank can take an active approach in a financial panic and provide liquidity to the entire banking and financial system. To conclude, central banks are no longer adhering to Bagehot’s sound rule, but they are wedded to an archaic policy procedure.

I now focus on the origins of the first central bank.

### **The Bank of England**

We need to understand the fiscal history of Europe, England and the Continent. In *The Wealth of Nations*, Adam Smith (1981: 907 and 908) distinguished between two eras: that “rude state of society which precedes the extension of commerce and the improvement of manufactures, when those expensive luxuries which commerce and manufactures can alone introduce, are altogether unknown...”; and “a commercial country with every sort of expensive luxury.” In the modern commercial society, “the sovereign, in the same manner as almost all the great proprietors in his dominions, naturally spends a great part of his revenue in purchasing those luxuries.” The lure of luxuries leads to overindulgence in them, “His [the sovereign’s] ordinary expenses become equal to his ordinary revenue, and it is well if it does not frequently exceed it” (Smith 1981: 909).

This dynamic leads the sovereign into a chronic statement of impecuniousness. It is aggravated by the proclivity of kings to go to war. “The want of parsimony in time of peace, imposes the necessity of contracting debt in time of war” (Smith 1981: 909). Much of the

remainder of the chapter, "Of publick Debts," details the sad fiscal record in England, France and Italy. It is an early Public Choice accounting of the costs of war, empire and royal luxuries.

Kings used a variety of expedients to raise revenues, especially to fund wars. They sold monopolies; made arrangements with guilds; seized Church lands and revenues; seized the property of Jews and expelled them; and clipped coins. These were often temporary expedients. In England, the king eventually created Parliament to collect taxes (Liggio 1999). The rise of the Estates-General was product of the same fiscal dynamic (Aftalion 1990).

The Bank of England was created as another fiscal expedient and with no thought to anything we would call monetary policy. Charles II spent and borrowed heavily and eventually defaulted on his loans to bankers. The King's credit was left in ruin. As Vera Smith (1990: 12) phrased it, William III "fell in with a scheme" to raise 1,200,000 pounds. The government did so in a clause of the Tunnage Act of 1694 by creating the Governor and Company of the Bank of England. That sum was raised as capital and immediately lent to the government. In turn, the bank was permitted to issue notes in that amount. As Smith (1990: 12) summarizes it, "the early history of the Bank was a series of exchanges of favours between a needy Government and an accommodating corporation."

Kings had heretofore entered in many arrangements in which money was lent to the government in return for favors. It was their stock in trade, and there was nothing notable in that accommodation. In 1697, however, the government renewed and extended the privileges of the Bank. The Bank was allowed to increase its capital so as to lend more to the government and issue more notes. That model would be followed a total of seven times between 1694 and

the beginning of the 19<sup>th</sup> century: a renewal of charter, more loans to the government and more notes outstanding (Smith 1990: 13).

What was momentous in 1697 was the inclusion of the privilege of limited liability for the members of the corporation. “This was a favour which was to be denied to all other banking associations for another one and a half centuries” (Smith 1990:12). Even when laws of general incorporation emerged in England and America, they were not automatically extended to banks. Banking was viewed as privilege. Extending limited liability to the Bank of England compounded one privilege with another.

The Bank of England was born in fiscal iniquity, a corporation endowed with privileges – like so many before it --, for the sole purpose of financing the king’s extravagances. It served no other function, no grand public purpose and certainly no monetary role. It acquired a monetary role over time only through the accumulation of more privileges, such as the exclusive right to note issuance in greater London. The granting of legal tender status to Bank of England notes in 1812 was extremely important in cementing the Bank’s monopoly status (Smith 1990: 15-16).

The extension of the Bank’s privileges proceeded more rapidly as the government’s funding needs grew during the Napoleonic Wars. It was more of the exchange of favors between the Bank and the government. Early in the Napoleonic Wars, the governments’ demands on the Bank became so severe that it threatened the Bank’s survival. Parliament passed an Act suspending cash payments. Smith (1990: 15) observed that this amounted to legalizing the Bank’s bankruptcy “and it 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.”

As practice evolved, the Bank underwrote the government's finances and the Government provided the privileges needed to render that a profitable business model. Ultimately, it amounted to the bank's guaranteeing the government and the government's guaranteeing the bank. The eventual monopoly of the production of paper money assured that no default in nominal terms would occur for either partner in the scheme.

The experience of suspension motivated Henry Thornton to write his treatise on *Paper Credit* in 1802. It was a brilliant exposition of central bank practice incorporated within monetary theory. It was a much deeper and more comprehensive analysis than Bagehot provided later in the century. Thornton analyzed such matters as the divergence of money rates of interest from their equilibrium level; the inflationary process that resulted; and price expectations effects on nominal interest rates. It was a prime example of a phenomenon noted by Hayek: the best monetary theory often arises out of the worst monetary practice. That is why Italy has produced so many notable monetary economists.<sup>10</sup>

After the Napoleonic Wars, Britain implemented a series of mutually reinforcing, benign policies. With the Coinage Act of 1816 and the Resumption Act of 1819, it adopted the gold standard (Steil and Hinds 2009: 80-81 and 156). With the repeal of the Corn Laws in 1846, it began the process of adopting free trade. It also adopted fiscal rectitude.

It was after the 1840s that the growth of incomes took off in Britain. Even with an empire weighing it down, and the costs of protecting the seas, Britain experienced enough

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<sup>10</sup> See Hayek's Introduction to the *Paper Credit* for both a brief bibliography and assessment of Thornton's contributions (Hayek 1978). See also Meltzer (2003: 19-64).

economic growth to generate the tax revenues needed to fund its government. And, of course, Britain had established a firm rule of law protecting private property rights.

The Bank of England was not called upon to finance the government. Instead, it managed the gold standard through its adjustments to the Bank Rate. It was born of fiscal necessity, but flourished when released from the demands of the Crown for funds. That was true so long as the mix of other good policies remained intact. It ended with World War I.

Other countries emulated Britain's sound policies in trade, finance and money. Central banking spread but was not adopted uniformly. The rule of law, free trade and sound money was the policy formula for sustained economic growth (Steil and Hinds). History suggests that central banking was adventitious.

### **Other Central Banks**

In the aftermath of the collapse of John Law's scheme, there was revulsion against note issues in France. Eventually private note issuance was allowed to resume. By the 1790s there was limited banking freedom. "The freedom prevailing at this time in banking in France seems to have proved very satisfactory, and no disasters occurred, but the march of political events destined this state of affairs for a short existence" (Smith 1990: 29).

The march of events was the rise of Napoleon Bonaparte and his incessant war-making. With that came the need for finance. It led to the creation of the Bank of France, preference in note issuing and then effective monopoly of note issuance. Added to the familiar dynamic was

“Napoleon’s mania for centralization” (Smith 1990: 29). There were attempts later in the century to introduce competition in banking, but to no avail.

The story of Germany is more complex because of the many separate states. Smith (1990: 58) reported that princes and nobles started banks “motivated by fiscal needs.” In Prussia, Frederick the Great founded the Royal Bank of Berlin as a privileged bank. During the Napoleonic Wars, it lent heavily to the state and suffered losses. The Royal Bank was reconstituted as the Prussian Bank in 1846 (Smith 1990: 61). Finally, in 1875 the Reichsbank was constituted out of the Prussian Bank, and Germany had a central bank (Smith 1990: 68-69). The origins of banking and central banking had their origins in the need of the Prussian state to finance itself. Banks and the state were intertwined.

The United States is a still more complex story again because of the many states. Before the Civil War, banking was mostly governed by state law and regulation. Texas, to cite one extreme, forbade the business of banking in its state constitution. Then there was the complexity of the First (1791-1811) and Second Banks (1816-36) of the United States, each federally chartered institutions and neither of which saw renewal of their charters. Generally, there was an evolution of how banks were chartered. Banks were at first specially chartered institutions by legislatures with grants of limited liability. Beginning with a New York law in 1838, bank charters were given under a general law of incorporation specifying in advance general rules and regulations of such matters as coverage for note issues and capitalization. The



era of free banking, American-style, began. It was aptly described by Vera Smith as decentralization without freedom.<sup>11</sup>

The system had a number of weaknesses. State-chartered banks were restricted to branching within the boundaries of the states, if at all. This produced a system of small, often financially undiversified institutions. Further, banks might be required to hold state bonds as backing for currency issues. In that sense, we see the linkage of banking and government in the U.S. story, albeit with state governments. The federal government was relatively unimportant in the antebellum era. In some instances, banks could value state bonds at par even if they traded at a discount. That produced an incentive for over-issuance of currency. Nonetheless, Smith (1990: 53) judged that the banking system in the 20 years leading up to the Civil War was “far steadier” than heretofore.

The Civil War required financing. The strains of managing the government’s finances led to the National Banking Acts of 1863 and 1864. It created nationally chartered banks of issue, whose notes were backed by Treasury bonds. The Act attempted to reform the U.S. banking system, but financing the war deficit was the strong motivating factor (Salsman 1993: 89).

Until the creation of the Federal Reserve System, the United States operated with the national banking system. It had a number of flaws and has been much-maligned. It has been portrayed as prone to bank panics and crises in 1873, 1884, 1890, 1893, and 1907. Yet the national bank era was one of the strongest periods of economic growth in the country’s history. Salsman (1993: 86) argued that the 19<sup>th</sup> century crises “were briefer, milder, and involved acute

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<sup>11</sup> The discussion generally follows Smith’s account.

illiquidity, whereas this [20<sup>th</sup>] century crises have involved prolonged periods of recession and depression, widespread bank failure, and chronic insolvency.” The 21<sup>st</sup> century appears to be following suit.

The system proved inflexible in panics when currency demand rose during bank runs. This inflexibility was a product of the law rather than an inherent flaw of competitive note issuance. By imposing legal minimum reserve requirements, the law made reserves unusable when needed. Far from guaranteeing bank liquidity, the requirements rendered banks illiquid (Salsman 1993: 88). The reserve requirement was rendered more stringent by the fact that the Treasury was paying down debt, which constituted the reserves behind national bank notes (Smith 1990: 149).<sup>12</sup> Friedman and 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 adoption of an asset-backed currency. There were also reserve requirements on deposits. “At that time and for at least the next half-century, the U.S. was the only major country in the world that had legal reserve requirements for commercial bank deposits.”

After the Panic of 1907, calls for an alternative increased. Reform was all that was needed, but major banks and Progressives came together in support of some type of central bank. Kolko (1963) cites the creation of the Federal Reserve as an important factor in the triumph of “conservatism,” but I would say it would be more conventional to term it the triumph of corporatism. It was part of the Progressive vision of government management of the

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<sup>12</sup> Horwitz (1990) delved into the constraints on expeditiously increasing the supply of notes in response to higher demand for them. And he detailed market responses in the form of currency substitutes.

economy. It was less about monetary policy and more about control of big finance. As Kolko argued, however, it became a way for big finance to influence government policies. But the Fed did not originally fit the model of banking in the service of government finances. Though it would quickly become so with the outbreak of WWI. Yet, after the war and depression of 1920-21, tax reform and strong economic growth would once again produce budget surpluses. The Fed as financier of large, peacetime budget deficits awaited the New Deal.

I tentatively suggest that the history tells us that chronic government budget deficits are a sufficient, but not a necessary condition for the rise of a central bank in a country. Canada got through the Great Depression without a central bank and experienced no major bank failures. The Bank of Canada was created in 1935 mainly to conform to international practice (Selgin, et al. 2012: 583).

By that logic, ending chronic deficits is a necessary condition for the elimination of a country's central bank. It is scarcely possible to imagine a permanent end to deficits without a downsizing of the modern welfare/warfare state. It is notable that the fiscal surpluses of the Clinton Administration were, at least in part a product of the peace dividend following on the end of the Cold War and welfare reform.

The British experience provides an alternative model to abolition of central banks. The Bank of England was retained in the era of classical liberalism. But it was reduced to managing the operation of the gold standard. The gold standard functioned as a binding monetary rule on the Bank. The gold standard was the effective rule for which monetary economists have been

searching. That case clarifies that it is possible to have free trade, free movement of capital, a gold standard and a central bank.

O’Driscoll (2012) argues that the gold standard worked with a number of banking arrangements. There was the English case with a central bank. For a time, in neighboring Scotland, free banking flourished. The flawed free-banking system in the United States worked, as did the National Bank System. Canada offered yet another model: a small number of banks emerged with national branching and note issuance under the gold standard.<sup>13</sup>

A return to a gold standard would be a return to the monetary system that historically accompanied the classical liberal system. Global fiat money is a discordant element in a system of free trade and free capital movements. Steil and Hinds (2009: 8) observe that “national monies and global markets simply do not mix; together they make a deadly brew of currency crises and geopolitical tensions and create ready pretexts for damaging protectionism.” The current conflict over “currency manipulation” between the United States, on the one hand, and China and now Japan on the other hand illustrates their point.

Steil and Hinds treat the evolution of sound money on a par with the rule of law in making globalization possible. They note that the evolution of contract Merchant Law, *Lex Mercatoria*, was critical for the global extension of commerce. Merchants came together from great distances and different countries to trade.<sup>14</sup> They needed to be governed by common rules of contract and behavior. Those rules became Merchant Law, which only later became

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<sup>13</sup> Dowd and Timberlake (1998:7) point out that “the development of legal tender money and central banking had only a limited impact so long as most countries remained on the gold standard.”

<sup>14</sup> Pirenne (1937) provides a classic account of medieval fairs and merchant trading.

absorbed into national law (Steil and Hinds 2009: 23-26). Just as merchants required a common law, they also required a common money. Commodity money, mainly silver and gold, was the common money.

Mises also portrayed “sound money,” for him a gold standard, as part of a wider liberal program.<sup>15</sup> Mises (1971: 413-14) characterized the chief political problem as “how to prevent the rulers from becoming despots and enslaving the citizenry.” Mises (1971: 414) further stated that “the idea of sound money ... was devised as an instrument for the preservation of civil liberties against despotic inroads on the part of governments.” For Mises, sound money is as much a political institution as an economic one. “Ideologically it belongs in the same class with political institutions and bills of rights. The demand for constitutional guarantees and for bills of rights was a reaction against arbitrary rule and non-observance of old customs by kings” (Mises 1971: 414). Steil and Hinds and Mises provide complementary arguments for why a gold standard is an essential part of a liberal order.

Returning to a gold (or other commodity) standard would be necessary in order to implement a system of competitive banking with note-issuing private banks. O’Driscoll (2012) argues that a restoration of the gold standard is a necessary condition for reform of the monetary *and* banking systems. White (2012) provides a practical path for restoration.

My point can be restated as follows. Commodity money is liberalism’s money. By imposing a rule on central banks, a true gold standard (not a gold-exchange standard) accomplished much of what free-bank advocates desire. It would constitute a major reform and

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<sup>15</sup> O’Driscoll (2010) elucidates the idea of sound money in economics.

end most of the discretion that central banks have acquired under global fiat money.

Additionally, a gold standard provides fiscal discipline. "...A gold standard does help to ensure budget balance in the desirable present-value or long-run, by constraining a government that wants to sell its bonds in the international market to a fiscal path consistent with full repayment in gold" (White 2012: 11).

Adopting a gold standard is a way station for a return to free banking. Many people have lived under at least the vestige of the gold standard. No one alive today has lived in a free-banking system. It will be a more difficult case to make.

Having made this point, however, I turn to recent arguments in favor of free banking. The case is today stronger than it has been for many years.

### Why Free Banking?

Hayek (1937: 13) identified the "fundamental dilemma" of central banking.

The only effective means by which a central bank can control an expansion of the generally used media of circulation is by making it clear in advance that it will not provide the cash (in the narrower sense) which will be required in consequence of such expansion, but at the same time it is recognised the paramount duty of a central bank to provide the cash once the expansion of bank deposits has actually occurred and the public begins to demand that they should be converted into notes or gold.

Hayek has told us that central banks face an inherent time-inconsistency problem (Kydland and Prescott 1977). It must promise today to limit the creation of base money, but the public knows that in the future it will be forced to do so. Hence, its promise is not credible. White (1998: 390) characterized it as “the classic conflict between fighting external and internal drains placed in a dynamic context.” So the goals of a central bank are placed in conflict with the gold standard.

The lender-of-last resort function may also conflict with a gold standard. The practical resolution under a classical gold standard was that liquidity crises were of short duration. And the lending at penalty rates meant that short-term capital inflows would be attracted. The ultimate resolution of the conflict was that one goal was paramount under the classical gold standard: protecting against external drain, i.e., staying on the gold standard.<sup>16</sup> Exception was made for times of war, which came under force majeure. Still, the conflict was always present.

For a fiat money system, the conflict is unresolvable. For the gold-exchange standard of the inter-war years, and the Bretton-Woods system, we know from history that Hayek’s “fundamental dilemma” could not be resolved. Each system was abandoned when imperatives led countries to make domestic considerations paramount.

The best free-banking argument is not that central banking and the gold standard are incompatible. They were not historically. The best argument is that central banks are superfluous under a gold standard. Or, as White (2012: 8) put it, “because the nation’s money

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<sup>16</sup>As Bagehot (2011: 113) put it, “unless you can stop the foreign export [of bullion], you cannot allay the domestic alarm.” Preserving the gold standard was paramount even when a domestic panic was also in progress. It is out of that realization that derived the maxim to lend freely at a penalty rate.

stock becomes endogenous, no monetary policy is needed under a gold standard.” Before moving into powerful government positions, Alan Greenspan (1966) used to make much the same point. “...Under the gold standard, a free banking system stands as the protector of an economy’s stability and balanced growth.”<sup>17</sup>

The free-banking argument is not far from Bagehot’s argument of more than a century ago. Free banking is the natural system. Central banking was an accident of history. The best outcome is to devise policies for a central bank to mimic how a free banking system would work. In essence, White (2012: 8) accepted the first part of Bagehot’s thesis, but doubted the second can be implemented. He presented a three-part argument.

- (1) A central bank undermines the automatic operation of the gold standard and “does more harm than good.”
- (2) A central bank inevitably faces political pressures to pursue policies that undermine the gold standard.
- (3) When there are conflicts between central bank policies and the dictates of the gold standard, “typically the gold standard gives.”

White (2012: 9) proceeded to remind the reader that both Canada and, to a lesser extent, the United States did well under the classical gold standard, 1879-1914. Once again, so, too, did Britain with a central bank. So, we must view White’s three points as contingent facts.

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<sup>17</sup> Since departing the Fed, Greenspan has returned to the same position. White (2012: 8n9) cites a 2007 interview in which the former Fed chairman reiterates that “you didn’t need a central bank” under the 19<sup>th</sup> century gold standard.



They may or may not come into play. The best way to address such contingent facts is to look at history. Fortuitously, we now have more history.

Heretofore, the case for free banking has relied on (1) theoretical arguments and (2) history from the 18<sup>th</sup> and 19<sup>th</sup> centuries. The theoretical arguments are persuasive, but come up against institutional inertia. We have central banking. Even if we thought it would have been better there had never been such an institution, the cost/benefit calculation for abolishing the institution has not been convincingly made.<sup>18</sup>

The historical argument has likely not persuaded many because financial services have changed so much. Banking is an ever declining part of the financial services industry. And the emphasis on note issuance perhaps seems quaint as the payments system moves away from notes.<sup>19</sup> Deposits have long since eclipsed notes for payments, and now electronic payments are eclipsing deposits. The need for Citi or Wells currency does not seem compelling for many in the modern world of the payments system.

Then, too, the Greenspan era and the Great Moderation gained the Fed new respect. Central banks around the world seemed finally to have got it right. One thinks of Milton Friedman's 2006 encomium in the *Wall Street Journal* to the departing Alan Greenspan: "He Has Set a Standard." Well, it turns out that Friedman and much of the rest of the profession may have gotten it all wrong.

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<sup>18</sup> Bagehot thought the cost/benefit calculation argued overwhelmingly against abolishing the Bank of England.

<sup>19</sup> Cronin (2012) documents that central bank reserves are also of declining importance in developed countries. The advent of private, real-time net settlement systems enables financial institutions to increasingly economize on these reserves.

Selgin, et al. (2012) provides an important revisionist history of the Fed's performance. It does not compare the Fed's performance to an ideal free banking system, but to the far-from-ideal national banking system. It surveys the modern historical work on both the Fed and the pre-Fed system. Its criteria are the performance of prices and of output. It examines both averages and standard deviations of variables.

The paper's first observation is perhaps the most telling point. The Fed's performance on long-run price stability has been abysmal. A basket of goods that cost \$100 in 1790 cost only \$108 in 1913. By 2008, a basket cost \$2,422 (Selgin, et al. 2012: 570). What they don't say explicitly, but which is obvious, is that long-run price stability has simply not been a consistent goal of the Fed. Only in times of unusually high inflation, such as the 1980s, when public opinion turns strongly against their policies, will the Fed tighten at the expense of substantially higher unemployment. That was the conclusion of Allan Meltzer after completing his 3-volume history of the Fed.

Most of the decline in the value of the dollar has occurred since 1970. Under Richard Nixon, the United States abandoned the last vestige of the gold standard (exited the Bretton Woods System). That removed the only constraint, admittedly a weak one by then, on the Fed's proclivity to engage in stabilization policies whose by-product is price-level uncertainty. Selgin, et al. (2012: 572) note that the price level has become less rather than more predictable under the Fed. "As the Fed gained greater control over long-run price level movements, those movements became increasingly difficult to forecast."

The Fed has expanded money pro-cyclically in response to positive real shocks (IS shocks), but “was *less* effective than the classical gold standard had been in expanding the money supply in response to unpredictable reduction in money’s velocity” (Selgin, et al. 2012: 578-79).

The Fed’s performance in the interwar years was so poor, and universally criticized, that they make many of their comparisons between the post WWII era and the pre-Fed era. Even then, comparisons are often not favorable to the central bank.

They cite Humphrey (2012: 584) on the Fed’s role as lender of last resort. During the subprime crisis, the Fed “deviated from the classical model in so many ways as to make a mockery of the notion that it is a LLR.” (Humphrey is one of the most knowledgeable historians of lender of last resort.) It accepted toxic assets without giving them a haircut (discounting their price as collateral); lending to firms known to be insolvent; and sterilized lending through the discount window prior to the fall of 2008. The last procedure transferred resources “from solvent firms to potentially insolvent ones – a strategy precisely opposite Bagehot’s” (Selgin, et al. 2012: 585).

In summary, Selgin, et al. found that the performance of the national banking system was better than has been conventionally portrayed. And the performance of the Fed has been worse than been portrayed.

My quick tour through the pages of this important paper does not do it justice. Selgin, Lastrapes and White have provided a systematic analysis of actual, historical monetary and

banking institutions. It is just the kind of comparative institutional analysis needed to challenge the dogma of central banking and to move the debate forward.

### Conclusion

There are many moving parts in the theory and history of banking and central banking. Banking developed at different periods and evolved differently across countries.<sup>20</sup> That makes generalizations difficult. Particularly in modern times, money and finance have never evolved wholly spontaneously and have occurred within a heavily regulated environment. It is out of the process of banking evolution that a monetary system develops. Reform of money and banking are inextricably intertwined.

Many issues have necessarily been touched upon only lightly, or not at all. The development of central banking in countries other than the United States and the United Kingdom has been only briefly discussed. The development of shadow banking has been entirely ignored, as it has been largely ignored in policy discussions generally.<sup>21</sup> That development complicates most analysis of money, credit and commercial banking.<sup>22</sup>

I have suggested that the rise of the central bank coincides with the rise of nation states, whose spending commitments exceed their capacity to finance those commitments. Historically, wars were the chief source of fiscal embarrassment to monarchs. Early central banks, like the Bank of England, were not conceived as monetary institutions, but banks to the king. Even the Federal Reserve was not conceived as a monetary authority. “The responsibilities

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<sup>20</sup> Cipolla (1976: 182-89) provides a brief and informative overview of aspects of the development in the medieval world.

<sup>21</sup> Gorton (2010) is a notable exception and good starting point.

<sup>22</sup> Within the last year, I asked a senior official at a reserve bank whether anyone in the Federal Reserve had been studying the rise of shadow banking. He responded “no.”

originally assigned to the Fed did not need to include, and in fact did not include that of managing the stock of money or the price level” (Selgin et al., 2010: 36). It did not arise for fiscal reasons, but became indispensable to a growing federal government both in wartime and peacetime. Standard economic justifications do not take adequate account of historical reality. Consequently, they are theoretically naïve.

Wars are still expensive, but most governments no longer fight major wars. The United States is a conspicuous exception. The modern welfare state with its vast array of entitlements drives government finances into deficit (Buchanan and Wagner 1977). Currently, the European Union is suffering an acute financial crisis. Its economies grow too slowly to generate the tax revenues to finance the benefits promised the citizens of those countries. The governments borrow chronically to help pay for ordinary, current expenses. Unforeseen events, like recessions, or housing bubbles bursting, throw the governments deeper into deficit. The modern European sovereign finds himself in much the same situation as his 18<sup>th</sup> century predecessor.

The European Union is an interesting case because its own central bank is limited in its ability to finance government deficits. So the commercial banking system has become a huge holder of sovereign debt. Partly that reflects the favorable treatment given to government securities under the Basel rules (Basel II). Banks do not need to hold reserves against the sovereign debt of OECD members. Since all such debt was preferred by regulators, bankers choose to hold the highest-yielding and riskiest sovereign debt, e.g., that of Greece instead of

Germany.<sup>23</sup> Governments also pressured their own banks to hold sovereign debt to keep funding costs down. That pressure is being very much felt today. So the EU banking system is in crisis along with their governments.

We Americans should not cultivate *schadenfreude* at the plight of Europe. The United States is not far behind Europe on its fiscal trajectory to default, or what amounts to the same thing, high inflation. We benefit temporarily because, relatively speaking, U.S. assets offer a safe haven for investors. If that changes, and global capital repositions elsewhere, borrowing costs for everyone, including the federal government, will rise. That by itself could produce a fiscal crisis here. A U.S. fiscal crisis is being postponed but not avoided.

It is institutionally impossible to end central banking in this environment. I certainly do not mean that it should not be discussed. But, as they have always been in the history of central banking, monetary and fiscal institutions are linked. Monetary reform will need to go hand-in-hand with fiscal reform.

I end with an assessment of modern (“independent”) central banks offered by Milton Friedman (1962: 50) almost 50 years ago. They are most appropriate for these meetings and address the question asked in the title of my paper.

It may be that these mistakes were excusable on the basis  
of the knowledge available to men at the time – though I happen  
to think not. But that is really beside the point. Any system

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<sup>23</sup> In the face of the threat of sovereign debt default (economically, a reality in the case of Greece), banks have now shut down cross-border lending. German bunds are the only exception.

which gives so much power and so much discretion to a few men that mistakes – excusable or not – can have such far-reaching effects is a bad system. It is a bad system to believers in freedom just because it gives a few men such power without an effective check by the body politic – this is the key political argument against an “independent” central bank. But it is a bad system even to those who set security higher than freedom. Mistakes, excusable or not, cannot be avoided in a system which disperses responsibility yet gives a few men great power, and which thereby makes important policy actions highly dependent on accidents of personality. This is the key technical argument against an “independent” bank. To paraphrase Clemenceau, money is much too serious a matter to be left to the Central Bankers.<sup>24</sup>

We have two bad systems: the fiscal and the monetary. They are intertwined now as they were in the 18<sup>th</sup> and 19<sup>th</sup> centuries. They must be reformed, or together they will destroy the economic system that sustains them. They have become parasitical. The unsettled question is whether anything less than radical reform of both will work. Can central banks be constrained to a Bagehot-like role, or must they be abolished? Can a “bad system” be made better, or do we need wholesale replacement? That is the question that monetary economists should be discussing.

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<sup>24</sup> Bagehot (2011) said much the same thing. He described allowing the directors of the Bank of England so much power was “very anomalous [and] very dangerous.”

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