A Century of Central Banking: Was the Fed a Good Idea?

The Great Depression left a black mark on the nation's central bank, and the Great Recession has vastly expanded the bank's powers. In 1913 the dollar was defined in terms of gold. Today we have a pure fiat money, and the Federal Reserve is the largest buyer of U.S. public debt, enabling the government to live beyond its means. Would we have been better off adhering to the rules of a gold standard? At the 31st Annual Monetary Conference, experts considered the record of the Federal Reserve since its establishment in December 1913. Speakers included Charles I. Plosser, president of the Federal Reserve Bank of Philadelphia; Leszek Balcerowicz, former chairman of the National Bank of Poland; Lewis E. Lehrman, chairman of the Lehrman Institute; and John A. Allison, president and CEO of the Cato Institute.

CHARLES I. PLOSSER: As the Fed approaches its 100th anniversary, it is entirely appropriate to reflect on its history and its future. Today, I plan to discuss what I believe is the Federal Reserve's essential role and consider how it might be improved as an institution to better fulfill that role.

Central banks have been around for a long time, but they have clearly evolved as economies and governments have changed. They are usually given the responsibility to protect and preserve the value or purchasing power of the currency. In the United States, the Fed does so by buying or selling assets in order to manage the growth of money and credit. The ability to buy and sell assets gives the Fed considerable power to intervene in financial markets, not only through the quantity of its transactions but also through the types of assets it can buy and sell. Thus, it is entirely appropriate that governments establish their central banks with constraints.

Yet, in recent years, we have seen many of these limits stretched. The Fed and many other central banks have taken extraordinary steps to address a global financial crisis and the ensuing recession. These steps have challenged the accepted boundaries of central banking and have been both applauded and denounced. As we contemplate what the Fed of the future should look like, I will discuss those constraints that might help limit the range of objectives it could use to justify its actions.

Many discussions about the Fed's mandate seem to forget the emphasis on the long run. The public, and perhaps even some within the Fed, have come to accept as an axiom that monetary policy can and should attempt to manage fluctuations in employment. I have concluded that it would be appropriate to redefine the Fed's monetary policy goals to focus solely, or at least primarily, on price stability. I base this on two facts: Monetary policy has very limited ability to influence real variables, such as employment. And, in a regime with fiat currency, only the central bank can ensure price stability. Indeed, it is the one goal that the central bank can achieve over the longer run.

The Fed has also ventured into the realm of fiscal policy by its purchase programs of assets that target specific industries and individual firms. One way to circumscribe the range of activities a central bank can undertake is to limit the assets it can buy and hold. My preference would be to limit Fed purchases to Treasury securities and return the Fed's balance sheet to an all-Treasury portfolio. This would limit the ability of the Fed to engage in credit policies that target specific industries.

A third way to constrain central bank actions is to direct the monetary authority to conduct policy in a systematic, rule-like manner. It is often difficult for policymakers to choose a systematic rule-like approach that would tie their hands. Yet, research has discussed the benefits of rule-like behavior for some time. Rules are transparent and therefore allow for simpler and more effective communication of policy decisions. While choosing an appropriate rule is important, research shows that in a wide variety of models simple, robust monetary policy rules can produce outcomes close to those delivered by each model's optimal policy rule.

Finally, the Fed plays an important role as the lender of last resort, offering liquidity to solvent firms in times of extreme financial stress to forestall contagion and mitigate systemic risk. This is not intended to prop up insolvent institutions. However, in some cases during the crisis, the Fed played a role in the resolution of particular insolvent firms that were deemed systemically important financial firms. Nonetheless, by taking these actions, the Fed has created expectations—perhaps unrealistic ones—about what the Fed can and should do to combat financial instability.

The central bank should therefore set boundaries and guidelines for its lending policy that it can credibly commit to following. If the Fed is asked by the fiscal authorities to intervene by allocating credit to particular firms or sectors of the economy, then the Treasury should take these assets off of the Fed's balance sheet in exchange for Treasury securities. In 2009 I advocated that we establish a new accord between the Treasury and the Federal Reserve that protects the Fed in just such a way.

LESZEK BALCEROWICZ: My focus will be on the problems currently playing out in Europe, but I will of course touch on monetary issues. The Eurozone is, after all, a monetary arrangement. But let me start with some facts.

There has been much talk recently about Europe as a whole, which unfortunately masks the enormous amount of variation you see within the continent. The problem with aggregates is that you often lose information. If you look, for instance, at gross data for the European Union from 2008 to 2013, you see huge differences in economic growth.

Nine countries have been growing faster, in per capita terms, than the United States. These countries include those with a flexible rate of exchange—like Poland and Sweden—but it also includes countries with hard pegs—like Germany, a member of the Eurozone. A very interesting group of countries—which I call BELL for Bulgaria, Estonia, Lithuania, and Latvia—have Euro-based currency boards, which means they cannot engage in outright devaluation. They suffered a huge currency boom and, as a result, a bust. But then they recovered, and the accumulated growth in these countries has been faster than in the United States.

On the other hand, you have a group of countries that have been lagging behind U.S. growth in 2013. You have boom and bust economies like Greece, Portugal, Ireland—although, again, there are divergences there. Ireland, for example, has been doing much better than Greece. But there are also countries that have entered the crisis period with very distorted economies—like France and Italy—and, as a result, they have very slow growth.

I think it's crucial to acknowledge this huge amount of variation. It's important not to just speak about the European Union or the Eurozone as a whole, but to look at differences in the data. When trying to explain those differences, one should mention that the problem countries—including Greece, Portugal, Ireland, and Spain—have developed two kinds of credit booms. I find it useful to distinguish between those problems that begin as fiscal crises and culminate in the financial or banking sector, and those that progress in the opposite direction. In both cases, however, the proximate cause is an excessive growth of credit.


LESZEK BALCEROWICZ

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Of the two, the easier problem to examine and diagnose is the fiscal-to-financial crisis. In Greece, for instance, there was cheap financing, which in turn led to excessive spending and public debt. During this process, financial institutions were buying government debt. But eventually the music stopped, and the fiscal crisis erupted and spilled over into the country's financial institutions. Now, I think it's fairly easy to explain the source of this problem. The root cause, of course, was bad politics. It is therefore up to the citizens to try to advocate better policies and make political competition less destructive. Fiscal constraints, I think, would help.

Now, with financial-to-fiscal crises—as in Spain or Ireland—you've got an excessive growth of credit which can usually be detected. It's not always difficult to figure out when it's expanding too fast. The basic question is what is behind the excessive growth of private credit—and the popular cliché is market failure. It is very fashionable to blame the markets, which are distorted. But if you look at more careful, empirical analyses, you see a lot of policies—from mortgage subsidies to tax regulations to politicized banking in general—which have contributed to the excessive growth of credit. While not the only factor, the monetary policy of the Fed has certainly been a contributor.

Central banks, however, are usually presented as saviors, which means people tend to ask: "What can the central bank do to constrain credit busts?" But the right question is: "What can we do to constrain the central banks?" In short, financial crises do not occur with the same frequency across countries. There are huge differences across time and space. These differences are largely due to differences in politics and, in turn, policies.

LEWIS E. LEHRMAN: As a soldier of France, no one knew better than Professor Jacques Rueff, the famous French central banker, that World War I had brought to an end the preeminence of the classical European states system and its monetary regime, the classical gold standard. World War I had decimated the flower of European youth; it had destroyed the European continent's industrial primacy. No less ominously, the historic monetary standard of commercial civilization collapsed into the ruins occasioned by the Great War. The international gold standard—the gyroscope of the Industrial Revolution, the guarantor of more than one hundred years of price stability and unprecedented economic growth, the common currency of the world trading system—all this was brushed aside by the belligerents. Into the breach marched unrestrained central bank credit expansion—the express government

purpose of which was to finance the colossal budget deficits occasioned by war and its aftermath.

With the benefit of hindsight we can see that quantitative easing was actually inaugurated with World War I. We can see also that the potential of discretionary central banking in the United States coincided with the founding of the Federal Reserve System. Because The Federal Reserve Act had been designed to reinforce the international gold standard, such an outcome would become one of the great ironies of American monetary history.

To interpret the financial events associated with the Great War—and their effect on the ensuing hundred years—my colleague John D. Mueller and I have highlighted two crucial events of 1913. First, of course, the establishment of the Federal Reserve system; and second, the publication by the young John Maynard Keynes of his book, *Indian Currency and Finance*. Either event by itself would probably not have forestalled resumption of monetary stability and economic growth under the pre-war classical gold standard. But the inauguration of the Federal Reserve, and the monetary ideas of Keynes, taken together, gave rise to the perfect financial storm.

Rueff was involved in the successful stabilizations of the French franc after two World Wars. As secretary of the French Treasury and deputy governor of the French central bank—his hands-on experience reinforced his path-breaking views on monetary economics. I recommend his theoretical and policy studies not least for the practical reason that his genius inspired two vital restorations of franc convertibility to gold—in 1926 and in 1959, even as Great Britain failed in 1925, and the United States in 1971. Rueff's success, I believe, was in part due to the fact that he was not only a gifted monetary economist. He was also a successful practitioner—whereby he had shorn himself of the illusions of his academic counterparts.

Rueff's fundamental rule by which to guide a central bank in a reasonably free economy is, first, to understand that no central bank, not even the mighty Federal Reserve System, can determine the quantity of money in circulation—the conceits of John Maynard Keynes and his followers to the contrary notwithstanding. You will remember that Keynes declared in the13th chapter of *The General Theory* that "the quantity of money is not determined by the public." Moreover, Keynes presumed that the authorities can "govern the activity of the economic system by varying the quantity of money."


JOHN A. ALLISON

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In these academic conceits originates the regime of central bankers as central planners. But the truth of experience and the empirical data show that a central bank may influence indirectly the stock of money and credit; but upon a moment's reflection, it is clear that the central bank cannot determine the quantity of money in circulation. In a non-totalitarian society, only the money users—consumers and producers in the market—determine the cash balances they desire to hold. Sovereign consumers do not consult the authorities when they freely vary their currency and bank deposit holdings. Has any solvent person in this audience been unable on a daily basis to increase or decrease the cash balances he wishes to hold by varying his stock of other assets in exchange for money?

JOHN A. ALLISON: I'm going to talk from a different perspective because I am the only person who actually ran a bank that's been speaking today, and from that context I can tell you with absolute certainty that market discipline beats regulatory discipline. In fact, I will argue that regulatory discipline will always fail to reduce volatility and will slow economic growth. These observations are based on my understanding of public choice theory and particularly on 40 years of concrete experience in the banking business.

One observation in my 40-year career at BB&T: I don't know a single time when federal regulators—primarily the FDIC—actually identified a significant bank failure in advance. Regulators are always the last ones to the party after everybody in the market (the other bankers) know something is going on. Thus, in that context, regulators have a 100 percent failure rate. Indeed, in my experience, whenever they get involved with a bank that is struggling, they always make it worse—because they don't know how to run a bank.

An interesting reflection from public choice theory, reinforced consistently throughout my career, is that regulators regulate for the "regulatory good." They like to talk about the "public good," and sometimes the public good and the regulatory good may align. But they don't manage for the public good; they consistently manage for the regulatory good.

In good times, regulators basically don't regulate banks for safety and soundness. If

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Analyzing the multiplicity of supposed risks from the world

Dangerous World? Threat Perception and U.S. National Security

Last year, Chairman of the Joint Chiefs of Staff Gen. Martin Dempsey contended that "we are living in the most dangerous time in my lifetime, right now." This year, he was more assertive, stating that the world is "more dangerous than it has ever been."

Is this accurate? At "Dangerous World? Threat Perception and U.S. National Security," a Cato Institute Conference held in October, experts on international security assessed the supposed dangers to American security, examining the most frequently referenced threats, including wars between nations and civil wars within nations.

"There's a disconnect between perception and reality that is mostly in the direction of overstating threats," PAUL PILLAR (left), a visiting professor at Georgetown University, said at a Cato Institute Conference on the global risks to U.S. national security. JENNIFER KEISTER, a visiting fellow at the Institute, concluded the panel by commenting on the implications of these inflated threats.

Historically, states have posed the greatest threats to international security. The first two panels discussed whether this is still the case, exploring the dangers not only from traditional nation-states but also from sub-state actors. "The U.S. government has overreacted to terrorism relative to its direct physical costs," Max Abrahms, assistant professor at Northeastern University, said. But the policy community has also inflated the risk that terrorism would spread throughout the world. "Just as the direct costs of terrorism have been overstated, so too has the political value."

With a lack of credible state rivals since the end of the Cold War, fears have arisen in response to less traditional dangers, including cyberwar, climate change, and general instability. Mark G. Stewart, director of the Centre for Infrastructure Performance and Reliability at the University of Newcastle, subjected the worst-case scenarios of global warming to cost-benefit analyses. "My answer is that the impact of climate change on national security is manageable," he concluded. "Change is going to be gradual—not abrupt—and there will be plenty of time to adapt."

Given that many of these threats have been inflated, the question remains whether the global order depends on a single power enforcing the rules. In the final panel, scholars considered whether the United States must prevent general lawlessness in order to maintain our relative prosperity. Eugene Gholz, associate professor of political science at the University of Texas at Austin, challenged this thesis by focusing on how costly it is to fight wars. "The claim that the global economy would become unhinged if the United States was not providing primacy and tamping down conflict around the world is just not true," he concluded.

In the end, many of those scholars that disagreed with the Institute's positions nevertheless praised its scholarship—even on issues as divisive as foreign policy. "Cato scholars are very strong and clear advocates of the view that the U.S. should retrench," said Stephen Brooks, associate professor of government at Dartmouth College. "In my view, this comprehensive version of retrenchment . . . is the one which is most interesting and most compelling as an alternative to the current U.S. grand strategy." ■

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things are going smoothly in the economy, bank examiners might see something that bothers them in a bank. But if they start raising red flags, bankers have plenty of political contacts, and the examiners are going to have a career advancement problem. They can't prove their point because they are guessing what's going to happen in more difficult times. Hence, regulators basically do not regulate from a safety and soundness perspective during good times.

In addition, regulators are politically driven. Those at the top of the regulatory organizations are political appointees. You don't get to be head of the FDIC without having some political contacts. You don't get to be head of the Federal Reserve without having political contacts. Hence, you have people who come from a political perspective, and regulations change a lot depending on who is at the top. Regulators are driven by what's happening in the current political environment; there is no rule of law. ■