8 CONCLUSION: THE CASE FOR A 'BROAD' CENTRAL BANK

The analysis in this study may disappoint strong believers in the freedom of the individual and limited government interference in the economy. One of its conclusions is to reject Hayek's call for the denationalisation of money and the repeal of the legal-tender laws. Instead the study endorses the issue of legal-tender notes by a unique kind of institution, a central bank, which relies on statutory backing. Other arguments here may upset those critics of central banking who, from a free-market perspective, would like all banks to be on the same footing. This study asserts that, on the contrary, economic efficiency is served by a clear differentiation between commercial banks that maximise profits and the central bank charged with public policy objectives. It accepts – in line with the prevailing political consensus – that these objectives are twofold, monetary stability (to keep the value of its liabilities stable in real terms) and financial stability (to maintain the convertibility of bank deposits into its own note liabilities). Further, it acknowledges that the central bank must be accountable to the legislature, and must even from time to time cooperate with the executive (specifically the finance ministry) over such matters of mutual concern as the management of the public debt. So, this very special and unusual institution awkwardly straddles the public and private sectors. Its operations lie in the sphere of profit-making business and finance, while its

status and performance are part of the political debate. It can have none of the purity, simplicity and supposed automaticity of central banking, as this activity is sometimes envisaged by free-market economists.[1]

Why 100 per cent systems don't work

Moreover, the present study has questioned the attractions of 100 per cent reserve banking and its contemporary version of 'narrow banking', both of which may be seen as expressions of Currency School thinking. To recall the quotation from Phillips' classic on *Bank Credit*, the essence of banking is to expand earning assets as much as possible relative to both cash and capital.[2] Banks are driven in this direction by their attempts to maximise the rate of return on capital. The lessons of history are clear cut, that profit maximisation is all powerful and 100-per-cent-backed systems in their various forms always break down. Sooner or later free markets develop a money substitute for the 100-per-cent-backed 'money' asset, the quantities of this substitute become enormous relative to the 100-per-cent-backed money, and sudden large-scale conversions of the money substitute into the 100-per-cent-backed money overwhelm the system, usually in crisis conditions. One hundred per cent systems are sometimes advertised as foolproof and unsinkable. In practice, they hit an iceberg in the form of mass exchanges of the money substitute back into the supposedly 100 per cent safe 'money'

1 For a recent critique of central banking, from the standpoint of an advocate of 100-per-cent-reserve-backed money, see Jesus Huerta de Soto, *Money, Bank Credit, and Economic Cycles*, Ludwig von Mises Institute, Auburn, AL, 2006 (originally published in Spanish in 1998).

2 See p. 42 above.

asset. The imposition of a 100 per cent reserve requirement on all notes, on all sight deposits or on all deposits nowhere guarantees monetary and financial stability.

If a 100 per cent bullion reserve requirement is imposed on notes (as under England's 1844 Bank Charter Act), the central bank and its customers remain free to expand the central bank's deposit liabilities, and the convertibility of these deposit liabilities into notes may lead to a run on the notes which exhausts the gold, as it did more or less in 1847, 1857 and 1866. If a 100 per cent reserve requirement is set on sight deposits (as recommended by Irving Fisher and the 'narrow bankers'), the commercial banks and their customers remain free to expand their time deposits, and the convertibility of the time deposits into sight deposits and so ultimately into cash may lead to a total withdrawal of banks' cash holdings. If a nation establishes a currency board and orders its central bank to match its note liabilities entirely by dollars, the nation's commercial banks remain free to expand their deposit liabilities without any dollar backing, and the convertibility of deposits into notes and so into dollars may result in the total depletion of the central bank's dollar assets, as happened to Chile's currency board in 1982 and Argentina's in 2002.[3]

Attempts to ensure financial stability by 100 per cent systems are often attempts to prohibit 'banking', in that credit creation is meant to occur outside institutions that call themselves 'banks'. They may work for a time, but in the long run they disintegrate. Surprising though it may seem, banking has one characteristic

3 For Chile's woes, in which the privatisation of the banking system had to be reversed by wholesale renationalisation after a wild boom-bust cycle, see Tim Congdon, *Economic Liberalism in the Cone of Latin America*, Trade Policy Research Centre, London, 1985, pp. 90–98.

in common with alcohol consumption, drug taking and prostitution. No matter the strictness with which officialdom tries to restrict and control it, banking – the operation of a deposit-taking and lending system with a reserve of well under 100 per cent – is irrepressible. It always resurfaces in another place or reappears in much the same form, if with a different label. Chapters 4 and 5 of this study documented bankers' persistent and successful efforts, over periods of decades and even centuries, to lower their cash and capital ratios. The two chapters also explained why low-ratio banking was good for economic welfare, in that it lowered the cost of banking services to non-banks. Further, the analysis there identified the origin of banks' demand for a central banking function. It is because banks want to economise on their cash and capital, and yet still of course be able to repay deposits over the counter, that they have a demand for central bank services.

The historical record cannot be gainsaid.[4] A nation with a privately owned, profit-oriented banking system but without a central bank will evolve, as a matter of free choice, in the direction of central banking. People in one nation do not like having to buy and sell in a multiplicity of monies, but favour one monetary standard, a single currency taking the form of a legal-tender note issue emanating from a state-sponsored bank. As far as possible they make this money work for them, either reducing their transactions costs or paying a rate of interest, by leaving a fraction of it deposited with a commercial bank. The benefits of the uniqueness

4 The development of central banking has varied between countries, being conditioned by the interaction with other institutions. But the persistence of the process, and the tendency to arrive at a similar eventual outcome, is difficult to escape. See Forrest Capie et al., *The Future of Central Banking*, Cambridge University Press, Cambridge, pp. 123–231, 1994, for potted histories of central bank development in over thirty countries.

of a 'money' are similar to those of the uniqueness of a system of weights and measures, as Hayek noted in his *Constitution of Liberty*.[5] Once banks exist, a seemingly remorseless pattern of specialisation then develops, in which a variety of interest groups want the bank of issue to be split off from the commercial banks and to be transformed into a central bank.

The central bank as a dominant protective association

Are the resulting arrangements a spontaneous or an imposed order? The order is spontaneous, at least in one sense. In those countries – particularly the UK – which led in the development of central banking, no one had foreseen the eventual outcome when the Bank of England was set up in 1694. Admittedly, the order can be regarded as imposed in a different sense, since its growth and change have been conditioned by legislation, and hence by politics and lobbying. The issue depends on how words are used and so is at least partly semantic. But surely the free banking school must accept that the rule of law, and so the passage of legislation, is an inevitable feature of all societies, no matter how uncompromising their commitment to personal liberty. Central banking is no more inconsistent with a free society than the rule of law. Further, the process by which the central bank becomes the dominant and eventually the sole issuer of legal-tender banknotes is related to the process by which commercial banks select the central bank, the bank of issue, as their banker, the bankers' bank. In due course this bank assumes a responsibility to act as their

5 Friedrich Hayek, *The Constitution of Liberty*, University of Chicago Press, Chicago, 1960, pp. 324–9.

lender of last resort.[6] Arguably, these patterns resemble those which, according to Nozick in his classic libertarian statement *Anarchy, State and Utopia*, result in a single 'dominant protective agency' emerging from a chaos of semi-permanent civil warfare and strife, and establishing peace under the law.[7] A central bank is an integral part of a modern market economy, just as law courts are needed to enforce the law and protect property rights.

Alternative central banking structures

But the case for the existence of a central bank does not close down discussion about its possible structure, constitutional position and ownership. Two extremes – two ideal types – might be distinguished, a 'narrow central bank' and a 'broad central bank'. Before developing the distinction, however, it must be understood that the free banking school is right on one point. A modern economy could function without a central bank. It would function badly, with a less efficient banking system and a more expensive payments mechanism, but life would go on.

6 The author first made this argument in a paper published in 1981 (Tim Congdon, 'Is the provision of a sound currency a necessary function of the state?', *National Westminster Quarterly Review*, August 1981). One of the fundamental questions raised by the UK banking crisis of 2007 and 2008 is whether the lender-of-last-resort function will increasingly be shared between the Bank of England and the UK government, because the Bank does not have the capital resources to carry out a last-resort role autonomously. More pithily, what will banks do if the central bank refuses to act as lender of last resort?

7 The emergence of a 'dominant protective association' by a so-called 'invisible hand explanation' was described in Chapter 2 of Robert Nozick, *Anarchy, State and Utopia*, Basil Blackwell, Oxford, 1974. The invocation of Nozick's argument in the author's 1981 article (note 6 above) was intended as a deliberate challenge to the free banking argument, with central banking emerging as the result of 'the invisible hand' that Hayekians so much admire.

Chapter 3 examined the workings of the US economy before 1914, with a large number of private note-issuing banks collaborating in settlement via clearing houses. In the USA of that era numerous note issues – issues by banks, issues by states, issues from the federal government and, as we have seen, even issues by the clearing-house associations – overlapped and competed.[8] But there is a very different possibility. This is for a single legal-tender note issue to be put into circulation by the finance ministry, not the central bank. Although no specific bank of issue exists, deposit-taking, fractional-reserve banking and clearing could all take place. Privately owned banks could meet and reach an agreement that one, two, three or more of their number are particularly strong institutions (which might be called 'money centre banks' or whatever) and that all of them would maintain clearing balances. As the finance ministry would monopolise the note issue, it could set the position of the supply curve of this monetary base asset, just as the central bank does at present. It could therefore control interest rates, even if the context of the transactions differed radically from present-day open-market operations under the central bank's aegis.

This may all seem fanciful, but in World War I the Bank of England and the Treasury quarrelled about their respective roles. The Treasury started to issue notes in its own name (which became known as 'Bradburys', after one of the permanent secretaries of the day who signed the notes) and used them to cover the government's heavy military expenditure. The Bank had to

8 Without a central bank after the dissolution of the Second Bank of the United States in 1833, the US Treasury performed semi-central banking functions. See Richard Timberlake, *Monetary Policy in the United States*, University of Chicago Press, Chicago and London, 1978, pp. 74–82.

tolerate the coexistence of its own and the Treasury's notes, even though by 1918 the Treasury's note issue was much larger than its own and a rampant inflation had developed. After much tension and disagreement, which was aggravated by the mistaken decision to return to the gold standard in 1925, the note issue was again consolidated in the Bank of England's name in 1928.[9] But it would have been feasible – perfectly feasible – for the Bank of England to have been wound up in the 1920s and for the Treasury itself to have become the monopoly issuer of banknotes. Business could continue, even in today's world of sophisticated financial markets, without a central bank at all.

With that point established, the distinction between narrow and broad central banking can be drawn. A 'narrow central bank' is to be understood as one that is little more than an interest-rate-setting, note-issuing branch of the executive; it is in reality a department of the Treasury, even if it pretends to be more than that by name. This kind of central bank – in line with Ricardo's *Plan for a National Bank* – would be the only bank entitled to issue legal-tender notes. Deposit-taking commercial banks might find it convenient to deposit notes with it to facilitate clearing, and in this respect it would be a banker's bank. Again in line with Ricardo's vision, however, the central bank's assets would consist exclusively of government securities. Since the central bank could not lend to the private sector, it could not be a lender of last resort. Of course, repo operations in government securities could take place on first-resort terms and these would be sufficient to set interest rates. Advice on the appropriate level of interest rates could be given by an economic research department, while the

9 Richard Sayers, *The Bank of England 1891–1944*, Cambridge University Press, Cambridge, 1976, vol. 1, pp. 284–96.

actual decision on interest rates could be reached in a committee of the great and the good, which perhaps (as at present) would be called the Monetary Policy Committee. The central bank would have nothing much to do with banking supervision and regulation, it would have no input into decisions on the maturity profile and instrument composition of the public debt, and it would delegate the complex management matters arising when banks get into trouble to quite separate specialist agencies (i.e. the agencies responsible for the resolution of failed banks and deposit insurance).

A justified interpretation, on the basis of his speeches and public statements, is that Mervyn King would like the Bank of England to be run as a narrow central bank along Ricardian lines. The central bank's output would consist of little more than a particularly important and influential body of economic research. According to Brummer in *The Crunch*, relying on the testimony of 'insiders', King was 'cock-a-hoop' in 1997 when the government decided to take away the Bank's responsibilities for banking regulation and debt management.[10] As a narrow central bank organisation would not interact in any meaningful way with the privately owned banking system and have no meaningful commercial risks on its balance sheet, its ownership makes little difference to its behaviour. For simplicity and continuity, it might as well remain in the state's hands.

The thesis of this study is that a very different type of central bank – a 'broad central bank' – is likely to make a far more positive contribution to economic efficiency. Ricardo and his many Currency School successors saw the debates from a

10 Alex Brummer, *The Crunch*, Random House Business Books, London, 2008, p. 103.

policymaker's perspective. They failed to recognise, first, that a financial system includes thousands of private agents who favour structures that maximise their profits and, second, that these agents' profit-seeking efforts take society closer to a welfare-maximising optimum. The banking industry will invariably favour a bank of issue that has the power, in certain circumstances, to make large loans to solvent banks facing a run; it will always prefer the active vision of central banking expressed in Bagehot's *Lombard Street* to the passivity envisaged in Ricardo's *Plan for a National Bank*. Bankers may believe that, when central banks are able to act as lenders of last resort, that makes possible low-ratio banking, which is good for their profits. As Chapter 4 showed, the true beneficiaries of the lender-of-last-resort role and low-ratio banking are the millions of people and companies who are the banks' customers.

But, while the social cost–benefit arithmetic of central banking is most favourable when it is able to act as a Bagehotian lender of last resort, lender-of-last-resort lending does carry some risks. In return for the collective good of lender-of-last-resort facilities, the central bank is entitled to impose conditions on the businesses that wish to take advantage of those facilities. Fair analogies are with a golf club that has membership rules, and derivatives exchanges and clearing houses that have rule books and by-laws. The central bank must be able to supervise commercial banks, and to some extent to regulate their funding strategies and asset selection. In particular, it is essential that at all times commercial banks have not only a first line of defence against a run in the form of cash, but also a second line of defence in the form of a buffer of liquid assets. Realistically, such assets are most likely to be liquid if they are government securities. The central bank must therefore

be closely involved in public debt management, in order that a sufficient quantity of Treasury bills and short-dated government securities are issued for the banks' purposes. All being well, good management decisions within the commercial banking industry – in association with effective banking supervision and regulation by the central bank, the appropriate supply of liquid securities to the banks by the managers of the public debt and the occasional last-resort facility to ease liquidity strains – ought to prevent any bank 'going bust'. If so, the deposit insurance agency and a special bank resolution regime will be unemployed and irrelevant.[11]

If that seems like a pipe dream in early 2009, it must be emphasised that between 1866 and the early 1990s not one significant British bank went bust in a way that embarrassed the state. At no point in these many decades did UK bank customers require protection, on a large scale, from a specially created deposit insurance fund.[12] The pressures on central bank executives to deliver financial stability are likely to be most powerful if the central bank is privately owned. Specifically, the Bank of England, like the USA's Federal Reserve, should be owned by the banks and be financially accountable to them. The banking industry has a strong interest in the encouragement of a group of long-term career central banking professionals. People who decide to make a career out of central banking must be both familiar with the problems of privately owned commercial banks, and answerable by statute to the legislature to achieve monetary and financial stability.

11 The redundancy of the deposit insurance agency and the special resolution regime would be due, ultimately, to macroeconomic stability and the successful allocation of resources by the banking system.

12 In the early 1990s UK citizens did lose money on deposits held at the Bank of Credit and Commerce International, often at UK-based branches, but BCCI was in fact regulated (if that is the right word) in Luxembourg, not the UK.

The case for the Bank of England to become a broad central bank in private ownership may seem radical and daring, even something of a leap in the dark. But – compared with some of the ideas of the free banking school – the proposal is highly conservative. All that is being advocated is the restoration of the kind of central banking arrangements that existed in the UK until 1946 and which do now exist, although perhaps not to the full ideal extent, in the USA. Bluntly, the division of responsibilities and functions between the Tripartite Authorities, due to misguided legislation in 1998 and 2000, has led to the UK's worst financial catastrophe since the South Sea Bubble. The privatisation of the Bank of England, and its recovery of powers that it exercised successfully for decades, would not be a leap in the dark. Instead it would be the reinstatement of arrangements which were a great practical success and were widely admired across the world.