Could the United States Have Had a Better Central Bank : An Historical Counterfactual Speculation

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Introduction

- In honor of the Fed's Centenary it is time to reflect on its performance
- Evaluation by Friedman and Schwartz (1963), Meltzer (2003, 2010), Hetzel (2008) is that the Fed did well in the 1920s, 1950s and the Great Moderation.
- But it performed badly in the Great Depression and the Great Inflation.
- It has also been criticized for its actions in the recent financial crisis and recession.

Introduction

- I ask whether the track record of the Fed could have been improved if the US central bank had followed two quite different historical paths.
- First. If the charter of the Second Bank of the United States had not been revoked in 1836 and it had survived.

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- Second. Had the Second Bank not survived but a US central bank was established in 1913 based on the Warburg Plan of 1913.

- Both of these scenarios would have led to greater financial stability than observed in the twentieth century as well as better price level and real macroeconomic performance.

Had the Second Bank survived

- Both the First and Second Banks of the United States were set up as prototypical central banks to create a uniform currency, to foster economic development and to provide intermediate run finance for the government.
- Both banks were well capitalized and had branches in every state.
- The First Bank of the United States was set up by Alexander Hamilton in 1791 modeled after the Bank of England

Had the Second Bank survived

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- From the beginning there was strong opposition to the First Bank on both constitutional issues and popular distrust of the concentration of economic power.
- Its charter was not renewed in 1811.
- The Second Bank was chartered in 1816 in the face of the financial disarray after the War of 1812.

Had the Second Bank survived

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- It soon faced the same opposition as the First bank and its charter was revoked by Andrew Jackson in 1836.
- The succeeding 80 years was characterized by financial instability.
- The free banking era 1836-1863 with a flawed payments system, numerous bank failures and several panics.
- Followed by the national banking era which did create a uniform currency but had four serious banking panics.

Had the Second Bank survived

- It didn't solve the problem of the inelasticity of high powered money.
- The outcry following the Panic of 1907 led to the reforms leading to the Federal Reserve.
- I argue that had the Second Bank survived that much of the financial instability in the US in the remainder of the nineteenth century would have been avoided.
- The Second Bank under its President Nicholas Biddle had developed into a best practice central bank.

Had the Second Bank survived

Had the Second Bank survived

- The Second Bank developed the tools of monetary policy to stabilize internal and external exchange rates, smooth seasonal and cyclical shocks and serve as a lender of last resort
- The Second Bank would have learned to act as a LLR just as the Bank of England did.
- Biddle had been developing and strengthening the market for two name bills of exchange which in Europe became the deep and liquid bankers acceptance market.

Had the Second Bank Survived

- This would have enabled the Bank to backstop the market and provide liquidity when needed.
- It would also have learned to follow Bagehot's Rule as the Bank of England did.
- This would have obviated the need to found the Federal Reserve.
- The US central bank would not have made the mistakes that the Fed made in 1929-33.

Had the Second Bank Survived

- The key legacy of the survived Second Bank is that it would not have allowed the Great Depression to happen because it would not have been hobbled by the orthodoxy of the real bills doctrine embedded in the Federal Reserve Act.

- It would not have followed the tight monetary policies the Fed did in 1928-29 to stem the stock market boom.

Had the Second Bank Survived

- And it would have learned to follow orthodox LLR policy-open market operations to provide liquidity to the money market or else discount freely to all commercial banks on the basis of sound collateral—to prevent the type of banking panics that occurred in the 1930s.
- Had the Great Depression not happened then monetary history would have been very different indeed and we might not have had WWII, Keynesian economics and the Great Inflation.

Had Paul Warburg's Plan for a U.S. Central bank been adopted

- In the second counterfactual I assume that the Second Bank was destroyed and the financial history of the nineteenth century played out as it did.

- The major problems of the national banking era – the inelasticity of high powered money; the inverted pyramid of credit ;and the seasonal stringency of the money market; would have led to the call for reform following the Panic of 1907 that led to the founding of the Fed.

Had Paul Warburg's plan for a U.S. central bank been adopted

- Paul Warburg, a prominent German banker who emigrated to the U.S. was a member of the National Monetary Commission which was mandated by the Aldrich Vreeland Act of 1908.

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- Warburg proposed a plan for reform of the U.S. financial system along the lines of the European financial systems.
- He made the case for a European style central bank to provide the liquidity to back up the market for bankers acceptances as in Europe.

Had Paul Warburg's plan for a U.S. central bank been adopted

- And to serve as lender of last resort in times of stringency.
- Warburg succeeded in convincing Nelson Aldrich, the Chairman of the Senate banking committee of the efficacy of his plan at a secret meeting of prominent bankers held at Jekyll Island Georgia.

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- He proposed the creation of a central bank with 20 regional branches controlled by bankers but regulated by government officials.

- It would rediscount bills of exchange for its members, to provide liquidity to the market and establish a LLR.

- The discount rate would be supplemented by open market operations.

Had Paul Warburg's plan for a U.S. central bank been adopted

- As in Europe , adherence to the official gold parity would anchor the price level and the central bank would manage the gold standard.
- The Federal Reserve Act incorporated many of Warburg's ideas but left out or downgraded others.

Had Paul Warburg's plan for a U.S. central bank been adopted

Had Paul Warburg’s plan for a U.S. central bank been adopted

- Of key importance it did not contain explicit instructions for how the Fed should respond in the event of a banking panic.
- Unlike Warburg, it did not state Bagehot’s rule.
- The framers believed that they had created a foolproof mechanism that would prevent panics from occurring in the first place.
- Secondly ,the Act did not address sources of instability from outside the banking system.

Had Paul Warburg's plan for a U.S. central bank been adopted

- Moreover only member banks were given access to the Fed's services which left out nonmember state banks , trust companies and other financial institutions.
- Third the act by following the real bills doctrine only allowed the rediscounting of notes based on commercial transactions (self liquidating real bills).
- It forbade the rediscounting of loans and securities from the financing of financial assets.
- Thus the LLR function envisaged by the Federal Reserve Act fell short of what Warburg had planned.

Had Paul Warburg's plan for a U.S. central bank been adopted

- Federal Reserve policy during the Great Contraction departed radically from what Warburg had in mind.
- The flaws in Fed DWL policy included: the real bills restrictions on eligible paper ; the Fed's discouragement of DWL; the stigma from going to the window; the uncoordinated use of DWL by the Reserve Banks; and the limited success of the Fed's acceptance policy.

Had Paul Warburg’s plan for a U.S. central bank been adopted

- Had Warburg’s original plan been adopted many of the barriers to effective LLR action would have been overcome.
- These institutional changes would very likely have prevented the banking panics of the 1930s.
- Like the Second Bank scenario, had the Great Depression been avoided the rest of the monetary history of the twentieth century would have been worse than it was.

Could the Alternative Scenarios have delivered better inflation and overall macro performance than the Fed did?

- Both hypothetical central banks were based on the gold standard so the answer depends on whether the gold standard would have survived if the Great Depression had been avoided.
- Bordo and Eichengreen (1998) argue that absent the Great Depression the gold exchange standard would have survived at least until the mid 1960s .
- It then would have collapsed because of the Triffin Dilemma.

Could the Alternative Scenarios have delivered better inflation and overall macro performance than the Fed did?

- The world would have shifted to a fiat money regime to overcome the resource costs and vagaries of the gold standard.
- If we had not had the Great Depression then Keynes wouldn't have published his General Theory and Keynesian economics and the Phillips curve tradeoff would never have developed.
- The Fed would have learned to follow a stable nominal anchor with fiat money several decades before they actually did.

Could the Alternative Scenarios have delivered better inflation and overall macro performance than the Fed did?

- The examples of Germany and Switzerland , both of whom had a much better record than the Fed in the postwar suggests that it could have been done.
- Thus a reasonable case could be made that either variant of alternative models for a US central bank could have done a better job in maintaining price stability and overall macro stability to the extent that price instability is an important cause of real instability.

Some Lessons from History

- These hypothetical US central banks had three key features which were crucial to their hypothetical success.
- First was a credible commitment to a nominal anchor, the gold standard and then a fiat money standard operated on lines like the gold standard rule.
- Second following a rule to preserve financial stability—Bagehot's Rule to provide liquidity to the money market in the face of a panic.
- Third, independence from the fiscal authorities which was a key tenet of the classical gold standard.

Some lessons from History

- The Fed achieved price stability in the 1920s, 1950s and between 1985 and the mid 2000s.
- It also learned from its bad behavior in the Great Inflation to follow a credible rule like commitment to maintain low inflation during the Great Moderation.
- It then followed a period of keeping interest rates too low for fear of an illusory deflation between 2002-2005 which added fuel to the subprime crisis fire .
- Since the end of the Great Recession it has kept policy too loose to not avoid future inflation.

Some Lessons from History

- The Fed was granted considerable independence at its inception.
- It abused this independence during the 1930s and then became a virtual branch of the Treasury until 1951.
- It then abused its independence in the late 1960s and 70s.
- It regained its independence under Paul Volcker
- Its experience since 2007 again suggests that its independence has been sacrificed.
- It is too soon to tell how permanent this will be.

Some Lessons from History

- My hypothetical examples suggest that the U.S. could have had a better central bank.
- The actual history of the Fed suggests that with considerable effort that the Fed by the end of the twentieth century had learned from its past mistakes and had moved closer to my history based hypothetical examples.
- It has regressed in the run-up, the management and the aftermath of the recent financial crisis and Great Recession. Whether it will return to this path is an open question.