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## The Capitalist Perspective

### Do we really need a central bank?

The financial crisis of not long ago has not surprisingly generated a great deal of anguish within the electorate. Americans were and continue to be a skeptical lot when it comes to the competence of the various federal bureaucracies which dot the Washington, DC landscape. But they were still disappointed when the regulators overseeing our financial system were seemingly caught unware by a banking collapse.

Rightly or wrongly, the US Federal Reserve has become one of the biggest targets within the financial bureaucracy for public distrust, and as a result, its ongoing purpose is increasingly being questioned. Some in the political class seek greater congressional oversight of our central bank, while others, including Rep. Ron Paul, would like the Fed to be abolished altogether.

The Fed's greatly reduced reputation naturally raises questions about why we have a central bank to begin with. Although the Fed presently engages in a wide array of activities, its adherents generally support its continued existence on three grounds. They expect it to manage inflation through manipulation of short-term interest rates; to issue a currency which facilitates exchange; and, most important, they see an essential role as "lender of last resort" to banks during periods of tight credit.

These Fed functions seem compelling at first glance, but given a careful rethink, it becomes apparent that much

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of what it does is either ineffective or superfluous, and could be handled much more skillfully outside this government-chartered monopoly. Contrary to the broadly held view that we need the Federal Reserve, logic says we'd be much better off absent a central bank that economist George Selgin terms "fundamentally destabilizing."<sup>1</sup>

**How the Federal Reserve came into existence.** As the Fed was created in 1913, the vast majority of us have never known a world without it. It's important to recall that there was a time when banks issued their own currency, and there was no government-sponsored entity waiting in the wings when banks ran short of cash.<sup>2</sup>

The United States did experience a number of financial crises—1873, 1884, 1893, and 1907—prior to the Fed's charter. But Selgin writes that "by almost any measure, the major financial crises of the Federal Reserve era—those of 1920-21, 1929-33, 1937-38, 1980-82, and 2007-2009 most recently—have been more rather than less severe than

those experienced between the Civil War and World War I."<sup>3</sup> If greater financial stability had been the main purpose of creating the Fed, then it has failed on that score.

Of course it's arguable that stability wasn't the sole reason the Fed came into existence as is often assumed. As writer G. Edward Griffin observed in *The Creature from Jekyll Island*, its unannounced purpose was initially to drive out competition that was increasingly crimping the profits of money-center banks.

According to Griffin, by 1910 the number of banks in the US was increasing at a very high rate, and the majority "were springing up in the South and West, causing the New York banks to suffer a steady decline of market share." In 1913, when the Federal Reserve Act was passed, non-national banks accounted for 71% of all banks, and they could claim 57% of total deposits. From 1900 to 1910 70% of the funding of corporations was generated internally, which meant that financial innovation inside and outside traditional money center banks threatened to make them irrelevant.<sup>4</sup>

The Federal Reserve Act of 1913 would serve to halt the market share decline of the traditional banks, because those banks, according to *Secrets of the Temple* author William Greider, would have "dominance over the new central bank," and in the bargain they would "enjoy new insulation against instability and their own decline."<sup>5</sup> To put it

1. George Selgin, "Central Banks as Sources of Financial Instability," *The Independent Review*, v. 14, n. 4, Spring 2010, p. 485.

2. G. Edward Griffin, *The Creature From Jekyll Island*, 2002, American Media, p. 12.

3. Selgin, *op. cit.*, p. 493.

4. Griffin, *op. cit.*

5. William Greider, *Secrets of the Temple*, Simon and Schuster, 1987, p. 275.

more simply, as large banks all, they would have access to cash during shortfalls thanks to the creation of an entity that would restore and perpetuate their dominance.

### **If not banking stability, then what?**

If it's agreed then that the Fed's initial purpose wasn't as elegant or innocent as is often assumed, it can then be asked whether it's doing a good job in other areas where it's deemed essential.

The control of inflation is a good place to start. But to judge the Fed's inflation fighting skills, it's useful to briefly discuss definitions of the inflation problem. The late Jude Wanniski defined inflation as a "decline in the monetary standard," or more clearly, a decline in the value of the dollar.

This is an important distinction because it can't be stressed enough that today's Fed views inflation in an entirely different way. For evidence, we need only reference a 2008 speech by outgoing Fed vice chairman Donald Kohn: "A model in the Phillips curve tradition remains at the core of how most academic researchers and policymakers—including this one—think about fluctuations in inflation." Kohn went on to note that "bringing overall inflation immediately back to the low rate consistent with price stability could be associated with a much higher rate of unemployment for a short time."<sup>6</sup>

The Fed divines what it supposes to be inflationary pressures through rates of unemployment and capacity utilization within US factories, and it then manipulates the short term interest rate as a way of moderating them. If Kohn *et al* are to be believed, when an economy grows too much such that labor and capacity are in short supply, prices rise and there's an inflationary event.

The obvious problem here is that neither capacity nor labor are finite even within the US. But even if they were, US companies most definitely have access to the world's supply of labor and manufacturing capacity. In short, the Fed's view of inflation misrepresents

what is always a monetary phenomenon. What the Fed presumes to be the cause of rising prices quite simply cannot be that, given both the dynamic and global nature of labor and capacity.

When US central bankers manipulate the short rate of interest, they do not do so to control the value of the dollar. So here too the Fed's interest rate policies have nothing to do with inflation. Worse, the manipulations are in and of themselves economically destabilizing in that their impact on rates across the yield curve drive economic actors to "reschedule" economic growth around the Fed's directional

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control of rates. Contrary to popular belief, the Fed does not manage inflation through the rate mechanism, and it also doesn't stimulate economic growth so much as it just moves it around.

So if we define inflation traditionally as a monetary problem—specifically as a decline in the market value of money—the Fed has failed impressively. When the Federal Reserve Act passed in 1913, a dollar purchased 1/20th of an ounce of gold, while today it purchases 1/1200th.

It should be noted here that the dollar's value is the preserve of the US Treasury as several *Wainwright Economics* publications have made plain.<sup>7</sup> That said, if inflation is one metric by which we should judge our central bank, its role as an inflation fighter would not be

a reason to keep it, as evidenced by the dollar's staggering decline since the Fed came into existence.

### **Without the Fed, where would we get our money?**

Implicit in the above question is the suggestion that we need a government sanctioned issuer of money in order to foster economic growth. This assumption not only defies simple history, but it also mistakes the very purpose of money.

As Griffin and Selgin both make apparent, there were periods in US history in which private banks themselves issued money to their depositors. Left alone, it's fairly easy to conclude that this now archaic form of private money would be ideal today. Indeed, a healthy banking system is certainly one in which poorly run financial institutions are regularly put out of business or swallowed by those well run. If banks were left to issue their own currency, there would exist an automatic incentive to issue sound money.

In a free market for money, it's fair to assume that one or more banks would develop reputations for issuing quality currency acceptable everywhere as a result of their not lending excessively or imprudently. Banks with sterling reputations would also reject the money of poorly run financial institutions, and the bad banks would then have a choice either to be credible in their banking practices or go out of business. Prudence would be forced on the entire banking system thanks to competing currencies. The result would be the opposite of Gresham's Law in that good money would quickly make bad money irrelevant.

More broadly, it's important to remember that money is only a measuring stick meant to facilitate the exchange of goods. Modern economic thinkers often believe that money creation itself is an economic stimulant—thus the alleged need for a central bank. But the greater truth is that an ideal currency, in the classic words of David Ricardo, "should be absolutely invariable in val-

6. John Tamny, "The Phillips Curve Is Dead, Except at the Fed," *RealClearMarkets*, September 16, 2008.

7. See, for example, "Why the Treasury secretary is more important than the Fed chairman," *The Capitalist Perspective*, December 23, 2004.

ue.”<sup>8</sup> For that, we don’t need a central bank, or for that matter, government issued money at all.

To believe otherwise is to buy into the naive belief that once individuals enter into government employ, they’re transformed into paragons of virtue, oblivious to the influences that would compromise their integrity in the private sector. More to the point, anecdotal reality tells us that just about anything that governments and monopolies can do, a competitive profit-motivated private sector can do better. It’s fair to suggest that currency is one of those products that might better be left to apolitical private enterprise.

**Lender of last resort.** If the Fed is neither a worthy opponent of inflation nor a necessary monopoly issuer of money, what about its stated role as lender of last resort? No less a personage than Walter Bagehot, the great 19th century monetary eminence, is to this day thought to have been a major advocate of central banks for this reason.

But a cursory read of Bagehot’s classic book *Lombard Street* reveals, that he wasn’t quite so sanguine about central banks. As Selgin reminds us, he believed “central banks were financially destabilizing, and hence undesirable institutions and that it would have been better had England never created one.”<sup>9</sup> Selgin’s read is that Bagehot found central banks to be an “unhealthy arrangement,” and that the ideal scenario was “free banking, with numerous banks issuing their own notes and maintaining their own reserves.”<sup>10</sup>

And contrary to the suggestion that Bagehot felt central banks should “lend freely” during times of distress, financial historian Liaquat Ahamed reminds us that Bagehot actually meant that central banks should only lend to very solvent banks suffering short-term liquidity problems.<sup>11</sup> Insofar as certain financial institutions were seriously in

trouble back in 2008, had he been alive, Bagehot arguably would have opposed their bailout.

Central bank fan he was not. But ultimately Bagehot accepted the existence of the Bank of England with an unhappy countenance. As he put it in *Lombard Street*, “You might as well, or better, try to alter the English monarchy”<sup>12</sup> than abolish England’s central bank. Simply put, he learned to accept the BoE’s role as lender of last resort given resignation that it would always exist.

Absent a Federal Reserve in today’s climate, would the economy or banking

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system suffer for the Fed not fulfilling its most prominent role as lender in distress? Logic tells us that this wouldn’t be terribly problematic.

Indeed, credit is credit, and if the Federal Reserve didn’t exist, it’s not a reach to suggest that other, non-financial institutions would eagerly take on the role of lending to banks during times of trouble at penalty rates much as our Fed does now. To offer up but a few examples, Target is best known for being a retailer, Harley-Davidson for manufacturing motorcycles, and Quicken for its innovative tax software. But despite all three continuing to pursue their core competencies, all have lending arms.

In a world without a Fed, logic says that free markets would create one or many similar funding sources healthy

banks suffering near-term liquidity problems. More important, since private sector lenders of last resort would have their own money on the line, it’s a safe bet that they would prop up only the solvent institutions, while letting poorly run banks fail. This would accrue to, rather than detract from, the banking system’s overall vitality.

**Conclusion.** We’ve been conditioned to believe that the health of the banking system and of the economy more generally are responsibilities of a powerful Federal Reserve. But if its core mission is analyzed even lightly, it becomes apparent that much of what the Fed does is ineffective, destabilizing, superfluous, or all three.

Implicit in the desire for a Federal Reserve is that individuals in government possess magical powers that enable them to do for us what we can’t do on our own. More realistically, the US economy grew quite nicely without a central bank. Given continuous advances in financial alchemy, it’s exciting to imagine what private actors would do for banking if the Fed ceased to exist.

Bagehot observed that magisterial central bank posts are “desired by vain men, by lazy men, by men of rank,”<sup>13</sup> and that such men are dangerous. In that case, the sooner the Fed is demystified, the sooner its role in our economy and banking system can at the very least be reduced; the impact of such a reduction would be a near-certain economic positive.

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8. Griffin, op. cit., p. 180.

9. Selgin, op. cit., p. 492.

10. *Ibid.*

11. Liaquat Ahamed, “*Lords of Finance*,” Penguin Press, 2009, p. 387.

12. Walter Bagehot, “*Lombard Street*,” John Wiley & Sons, 1999, p. 330.

13. *Ibid.*, p. 225.



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