

# Why do societies need independent central banks?

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This paper provides background and historical context for the Riksbank's timely conference on "Rethinking the Central Bank's Mandate." While most of the discussion at the conference will focus on the complex issues we face today and those we will likely face in the future, it is generally a good idea to keep an eye on the rearview mirror as you move forward, and that's the role of this paper.

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## 1 Introduction

History makes clear that central banks exist because modern financial economies are prone to catastrophic pathologies: unsustainable fiscal policies that give rise to sovereign debt and/or inflation crises, private sector financial crises, and crises emanating from external imbalances. This paper will review the essential role that central banks have historically played in society's quest to find remedies for these pathologies.

We have especially good reason to review this history as we reconsider central bank mandates. The early 21st century will, I suspect, stand out as a tragic aberration in the long history of thinking about central banking. It was a period when many experts, pundits, and policymakers either forgot most of financial history or declared its lessons passé. In the bold new view, the central bank's overriding objective was to "provide a nominal anchor"; the myriad other issues that consumed most of monetary history came a distant second. History has a way of reminding those who forget, and in this case it did so with breathtaking speed and ferocity in the form of a classic financial crisis, the economic and political ramifications of which reverberate to this day.

The argument will be critical of the bold new view, but this in no way implies that this view should be rejected wholesale or that some prior version of conventional wisdom should be embraced without alteration. The bold new view incorporated some important advances in thinking, and no one ever argued that prior conventional wisdom was without flaw.

Instead, I will argue it is a good time for academics, policymakers, and the public at large to engage in a thorough re-think of all the key issues surrounding central banking. The papers at the rest of the conference take up many aspects of this re-think and, I hope, will be part of a productive ongoing discussion.

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## 2 The main question and a summary of the answer

The conference organizers asked me to consider the following:

(Why) Are central banks necessary? Which functions can central banks fulfill that other government authorities or market mechanisms cannot? Is the central bank's role affected by increasingly sophisticated financial markets and payment technologies? Is the central bank's role broader than providing a nominal anchor?

The traditional answer to these questions begins with the fact that central banks around the world play many roles in the financial sector. The two core functions of central banks are monetary policymaking and acting as lender of last resort to the banking system. Many central banks also have a long laundry list of other functions, including facilitating operation of the payments system, bank supervision and/or regulation, providing banking services to the government, managing foreign exchange reserves, and issuing and maintaining the physical currency (notes and coins).

Monetary policymaking and providing a lender of last resort function are essential tasks in the economy, and they are naturally conducted by a body we would call a central bank. Conventional wisdom also adds the proviso that monetary policy should be conducted by an independent central bank—that is, a central bank that is insulated to a high degree from political interference from the rest of the government.

The central bank should generally use monetary policy to promote low and stable inflation.<sup>1</sup> This is often referred to as providing a nominal anchor. Contrary to some conventional thinking, I will argue that regardless of their mandates, many central banks do not unambiguously have the definitive power to provide a nominal anchor. Further, it is not at all clear that they should have that power. Finally, there is no strong consensus that any of the various other roles central banks often play need necessarily be the responsibility of the central bank. As I will argue in what follows, which of these other roles any given central bank should play may differ depending on other aspects of the system in which the bank operates.

The remainder of the paper explains and provides historical foundations for these views.

## 3 Ubiquitous financial sector pathologies and the role of central banks

The earliest English-language use of the term central bank that is reported in the Oxford English dictionary conveys a key notion:

To enjoy the full benefit of the banking system, you must combine with them [local banks] a *central bank*...

[Hunt's Merchants' Mag., Apr. 1841, quoted in Oxford English Dictionary, 2016]

Without a central bank, the country's banking system would be deficient or defective in some way, and a central bank can help remedy the defects.

In this section, I explore this wisdom, and broaden the claim to include the need for myriad private and public sector institutions that form a patchwork of remedies for the ubiquitous pathologies that seem inherent to financial systems.

Financial markets, history makes clear, work very badly. Indeed, without an elaborate set of public and private sector institutions and practices, markets for financing barely work

<sup>1</sup> How low and how stable is a matter of some debate, I will not discuss these issues.

at all. For most of history, most people, firms, and governments that had productive ideas simply could not bring those ideas to fruition if they required any substantial capital. This is underscored by the fact that in this century, Muhammad Yunus and Grameen Bank earned a Nobel Prize for figuring out a way to get tiny amounts of credit to folks who would then repay the loans almost without fail (Yunus, 2006).

As economies moved toward a situation in which financing flowed more freely, pathologies inevitably appeared in the form of various types of crisis. This is the main point of Reinhart and Rogoff's (2009) book, *This time is different, Eight Centuries of Financial Folly*. I will follow a slightly modified version of Reinhart and Rogoff's characterization of three types of crisis: government debt crises leading to default or implicit default through inflation, private banking crises, and external imbalance crises arising in the course of international trade in goods, services, and financial claims. These three types of crisis are deeply intertwined and crises may simultaneously have aspects of any or all of these, but the different categories provide a useful way to organize discussion.

### 3.1 Fiscal excesses and default or implicit default through inflation

Throughout history, governments—which until recently mainly meant autocratic rulers such as kings or queens— have used financial markets to borrow. Large borrowing, however, was limited to wealthy sovereigns, and the biggest driver of that borrowing tended to be the need to finance wars. What we now recognize as the first central banks were initially organized or granted special powers in order to facilitate lending to the government (Bordo, 2007).

As Rogoff and Reinhart thoroughly document, for as long as sovereigns have been borrowing, they have faced crises starting with, or ending in, explicit default or implicit default imposed by inflating away the value of the nominal debt. During the debate over governance of the U.S. Federal Reserve, Senator Aldrich (Kettl, 1986) argued,

No government yet has been found strong enough to resist the urge for enlarged note issue in times of real or imagined stress.

It is now widely accepted that ceding power over monetary policy to a central bank with strong insulation from interference from the rest of the government is one useful step to reduce the frequency and severity of these destructive inflationary episodes. While various aspects of conventional wisdom have shifted through the years, this one has consistently gained adherents—at least up until very recent political upheavals.

There may be an important difference, however, between reducing the frequency and severity of inflationary events and definitively providing a nominal anchor. As Leeper (2016) and Sims (e.g., 2016) emphasize, so long as the government can issue sovereign debt in a manner inconsistent with price stability, there is at best an ambiguity over the central bank's ability to provide a nominal anchor. Very few countries have clear legal structures subordinating the fiscal policy to the central bank. Further, the democratic justification for subordinating fiscal policy is questionable. For example, it is perfectly possible to envision a government reaching a point where the only options are explicit default or inflation. Having reached such an unenviable position, the best decision for society may be to accept a period of inflation. It is not clear that independence to maintain a nominal anchor could or should be sustained at such times.

### 3.2 Banks and the associated risk of financial crisis

The ability of wealthy sovereigns to become heavily indebted came long before this privilege was available more generally to firms and individuals. For most of history, most individuals and firms simply could not become heavily indebted. The great sage of central banking, Walter Bagehot (1873), wrote of the stifling effect that this could have on progress and innovation,

A citizen of London in Queen Elizabeth's time ... would have thought that it was of no use inventing railways...for you would not have been able to collect the capital with which to make them.

Bagehot was writing in 1873, during what is known as the second industrial revolution in England, and he argued that by that time England was near the sweet spot at which point every worthy idea could be financed:

A place like Lombard Street [London's Wall Street], where in all but the rarest times money can be always obtained upon good security or upon decent prospects of probable gain, is a luxury which no country has ever enjoyed. (Bagehot, 1873)

The Elizabethan watchwords, "Neither a borrower nor a lender be" had, by Victorian times, become "Every good idea can be financed".

Two points should be emphasized here — in one case Bagehot was clearly wrong, and in the other he was clearly right.

No one would now argue that England had, by the late 1800s, reached the sweet spot of efficient capital allocation. Indeed, from a modern perspective, the claim is absurd. For example, it was not until well after Bagehot's writing that married women were granted clear recognition as economic agents,<sup>2</sup> and it remains arguable whether credit flows as efficiently to this portion of humanity as to the other portion in many economies. But more generally, we can cite a long list of efficiency-enhancing innovations over the last century or so such as credit cards, which allowed a more efficient flow of credit, and mutual funds, which have allowed funds to flow more efficiently into equity financing.

Second, Bagehot correctly emphasized the point that is painstakingly documented by Reinhart and Rogoff: along with freer financial flows comes financial folly in the form of financial crises. Bagehot gives an entertaining description of Overend, Gurney, and Co., one of the largest, most innovative, financial firms of his day. The firm converted from a partnership to a publicly-owned company and promptly bankrupted itself:

The case of Overend, Gurney and Co., the model instance of all evil in business, is a most alarming example of this evil. No cleverer men of business probably (cleverer I mean for the purposes of their particular calling) could well be found than the founders and first managers of that house. But in a very few years the rule in it passed to a generation whose folly surpassed the usual limit of imaginable incapacity. In a short time they substituted ruin for prosperity and changed opulence into insolvency. (Bagehot, 1873)

Such follies are obviously a recurring theme.

One important form of financial folly is a bank run or bank panic. As most people know from *Mary Poppins* or *It's a Wonderful Life*, an otherwise sound bank can be driven to

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<sup>2</sup> The Women's Property Act of 1882 was a significant breakthrough in this area.

bankruptcy by panicked customers withdrawing funds faster than the bank can economically liquidate its assets.

The possibility of folly by either the bank or its customers also elicited a patchwork of institutional fixes. Most notable among these are central banks with a lender of last resort facility, bank supervision and regulation, deposit insurance backed by the national government, modern accounting standards, fraud and bankruptcy laws, and so forth.

The lender of last resort role is the one piece of this patchwork inherently associated with central banking. Bagehot laid out the core of conventional wisdom about the role of a lender of last resort: The central bank should stand ready to lend freely to institutions that were clearly sound, but facing excessive deposit outflows. While the details of how the lender of last resort function should be implemented are subject to considerable debate, the importance of this function is difficult to question.<sup>3</sup>

### 3.3 Crises driven by external imbalances

Finally, as Reinhart and Rogoff note, balance of payments crises, crises caused by rapid shifts in capital flows, and various types of exchange rate crises have also been a prominent feature of financial history.

In this case, the patchwork of remedies has included exchange market intervention and various types of restriction on trade and capital flows. Between the late 1800s and the Great Depression, the classical gold standard was a principal policy response to recurrent external imbalance crises. Under the gold standard the relative value of currencies was fixed in terms of gold and any payments imbalances were settled in gold. Subsequently, a hybrid system known as Bretton Woods's system was in place from the end of WWII through the early 1970s, and after the breakdown of Bretton-Woods various more ad hoc arrangements and notions of best practices, partly administrated by the International Monetary Fund, prevailed. All of these systems saw recurring crises associated with external imbalances.

Overall, this brief survey is meant to convey the fact that pathologies are ubiquitous in financial markets, and that central banks are one part of a vast array of private and public sector institutions and practices intended to minimize the effects of those pathologies.

## 4 A brief period of very different views

For a brief period around the most recent turn of the century, the perspective just given was broadly rejected by some of the most influential thinkers and policymakers in advanced economies. Many advocated the view that financial firms could be relied upon to protect the economy from folly that might threaten the financial system.<sup>4</sup> This widespread view was reflected in an approach called "light touch regulation" in the U.K. and was associated with a loosening of financial regulation in the U.S. and elsewhere.<sup>5</sup>

As Bernanke (2011) notes, financial stability had traditionally been a primary focus of central banks, but during this period, matters were different:

Central banks certainly did not ignore issues of financial stability in the decades before the recent crisis, but financial stability policy was often viewed as the junior partner to monetary policy. One of the most important legacies of the crisis will be the restoration of financial stability policy to co-equal status with monetary policy.

<sup>3</sup> For example, Bagehot suggested that the central bank should lend only against good collateral and at a penalty interest rate. It is almost in the definition of a systemic crisis, however, that what is and is not good collateral may be unclear, and indeed, may turn on whether the central bank extends loans.

<sup>4</sup> Alan Greenspan was a prominent proponent of this view (for example, Greenspan, 2008). Larry Summers made similar arguments while at the U.S. Treasury Dept. (Summers, 2000).

<sup>5</sup> See The Economist, 2012 for a description of light touch regulation.

A similar perspective took hold regarding external imbalances. Traditional concerns about the need to manage external imbalances using various tools to control the exchange rate and capital flows gave way to a brave new view favoring flexible exchange rates and freer capital mobility. The implicit view seemed to be that if countries would just yield freely enough to market forces, then the imbalances of the past would disappear. This philosophy sometimes is pilloried as the Washington Consensus. While John Williamson, the originator of the term, argues convincingly that he had something more nuanced in mind, he admits that the original formulation ignored the role of financial stability and crises and the tools required to avoid them.<sup>6</sup>

With the central banks freed from concerns about both financial stability and the external sector, they could focus exclusively on delivering low and stable inflation. This focus would, in turn, contribute, insofar as an independent central bank can, to minimizing the risk of default through inflation.

It is instructive to think about this brave new view in historical context. From the later part of the 1800s through 1930, monetary policy was more or less dictated by the gold standard and its imperative to maintain the gold parity.<sup>7</sup> Modern thinkers sometimes associate this with a desire for domestic price stability, but that is deeply misguided. The classical gold standard was motivated almost entirely by external factors, and was intended as a framework for enforcing external balance and facilitating trade. It did so by anchoring the value of all the trading partners' currencies relative to gold and providing an unambiguous basis for settling imbalances.

By fixing the money price of gold, however, the gold standard left the general price level to wander where it might with the supply of gold. And wander it did. Economies experienced long periods of inflation and deflation under the gold standard. Since the recent financial crisis, many analysts have been critical of inflation performance in many countries. But even by the yardstick set in this difficult period, the inflation performance under the gold standard looks very poor.

Thus, under the classical gold standard, the behavior of inflation was entirely secondary, while the main focus was on managing external imbalances. In the recent period, the emphasis is reversed: central banks focus first on domestic inflation and leave external matters to the whims of the market. Neither of these extremes seems to have delivered ideal outcomes.

## 5 Some suggestions for the debate going forward

The main objective of this brief historical review is to posit a perspective that might enlighten the very important re-think of central bank mandates now underway in Sweden and many other countries. The goal is not to present clear solutions for the future, but there are some lessons.

So long as economies run on a government-created currency, it is impossible to avoid having a monetary policy—there is no version of “doing nothing” that does not itself constitute a monetary policy. I have seen no strong reason to question the conventional wisdom behind ceding control of monetary policy to an independent—that is, politically insulated—central bank charged with promoting low and stable inflation in the general course of affairs. The degree to which the central bank should have an explicit mandate for promoting stability of real activity and the best way to codify any financial stability mandate is not a settled matter and is worthy of debate.

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<sup>6</sup> Williamson (1999) discusses the strengths and weaknesses of his original vision and the cruder version of market fundamentalism that has also been prominent.

<sup>7</sup> This discussion of the gold standard is more fully laid out in Faust and Leeper (2015).

So long as banks play a dominant and pivotal role in the financial system, there are very strong reasons for the central bank to stand ready to act as lender of last resort.

As for the long list of other activities central banks are often charged with (bank supervision and regulation, facilitating stability of the payments system, and so forth), I think there is no strong consensus. Almost all of these have some synergies with the core monetary policy responsibilities of the central bank, which provides some reason to house them there.

I think that the main lesson of history, though, is that all questions about these functions should be framed mainly in terms of effectiveness in preventing crises and managing crises when they erupt. And in this light, the central bank's mandate should not be viewed in isolation, but in light of the existing imperfect patchwork of remedies for recurring pathologies. Further, while economists have a good deal to say about these pathologies, one undeniable fact is that these pathologies remain poorly understood. Therefore, the mandate should be considered as much in light of what we don't know as what we do.

For example, many elements of the patchwork of defenses against pathologies are static or not quickly changed: deposit insurance is in place or it isn't, accounting deficiencies cannot be corrected rapidly in response to crises. Central banks often have the resources and the capacity to respond flexibly and quickly in the face of unexpected crises. For better or worse, this often means that when some poorly understood and, hence, poorly prepared for crisis erupts, it first falls to the central bank to deal with the problem. It will probably fall to the central bank largely independent of the bank's official mandate.

Further, it makes little sense to conclude that the central bank should not respond to some problem because ideally some other tool would be used. Donald Rumsfeld famously noted that you go to war with the army you've got. Similarly, the central bank must operate in the context of the imperfect patchwork of remedies in place.

When it comes to crises and their aftermaths, it is also clear that various institutional and political dynamics may dominate purely economic ones. For example, it may be a real management challenge for the central bank to maintain clear focus on inflation, macro stability, and financial stability. This alone might argue for splitting up responsibilities. The central bank should, by conventional wisdom, have independence in its monetary policymaking function. But many aspects of regulation and crisis management inherently involve deep political tradeoffs, and bringing too many politically sensitive topics within the purview of the central bank could make it difficult to justify independence.

I suspect that it is these sorts of issues and not purely economic efficiency arguments that should determine which of the ancillary functions should be lodged at the central bank.

Finally, the fact that the financial market pathologies are not well understood, should remain front and center when drawing lessons from academic research. For example everyone should be wary of predictions from models that are premised on complete understanding of pathologies on the part of private sector and/or public sector actors. Most problems look a bit easier if you start with the premise that folks fully understand them. This injunction covers the vast majority of academic work, at present.

Despite our limited understanding of financial market pathologies, between the Great Depression and the recent financial crisis more than 50 years passed. I believe that lessons learned in the Great Depression contributed to that long period without a widespread financial crisis. Many insights are coming from study of the recent crisis as well, and we have reason to hope that an even longer stable period might be the result. However, history also shows that political instability arising in the wake of crises can lead to erratic and sometimes disastrous policies. Unfortunately, at the current time, it is not so clear how these hopeful and more ominous themes will net out.

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