REVIEW ESSAY

Central Banking in a Free Society

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Tim Congdon is a thoughtful and experienced British financial-market economist and policy advisor. In this new monograph *Central Banking in a Free Society* (London: Institute of Economic Affairs, 2009), he ponders how central-banking institutions might be reformed to prevent a replay of the recent financial fiascoes that have affected the United Kingdom as much as the United States. On the one hand, as he notes, the Bank of England as presently constituted has made a mess of things. On the other hand, he argues, we should retain a central bank able and ready to act as a lender of last resort because it benefits the public by lowering the commercial banks' costs of intermediation. In pursuit of a less reluctant lender of last resort than the Bank of England has recently been, he proposes provocatively that the bank be privatized—turned into a clearinghouse association owned by the commercial banks it supervises.

Free-market monetary economists will find the reprivatization of central-banking roles entirely reasonable with respect to clearing and settling interbank payments, administering mutually agreed solvency and liquidity requirements for member banks, and organizing interbank loans of reserve money. ("Member" and "mutually agreed" here mean that any bank's joining would be optional.) Such a reform would more or less re-create U.S. arrangements before the Federal Reserve Act. But Congdon also wants the Bank of England to continue its current roles of issuing fiat money at its own discretion and enforcing the legal restrictions on commercial banks mandated by Parliament. If the proposal to privatize such nonmarket

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roles seems like trying to square the circle, its seeming character may derive from Congdon's paradoxical view that living under discretionary monetary policy and regulatory rule making by men called central bankers is consistent with living under the rule of law.

Congdon suggests that the Bank of England's status as a central bank is not only beneficial, but natural. He reviews the debate between what he calls the "imposed order" and "spontaneous order" views of central banking. The Bank of England's history, as he indicates, is complex. Its evolution from a commercial bank into a central bank was not planned from the outset, and hence it was spontaneous in the sense that it was an unintended result. But it would not have happened without its parliamentary grants of privilege, and hence it was imposed. Congdon grudgingly acknowledges that "[Vera] Smith was right" in taking the imposed-order view in her book *The Rationale of Central Banking* (1936), in that "the privileges given to the Bank of England" meant that the institution "could be construed" as having been imposed "from above" (p. 38). Later he nonetheless asserts: "We have shown how a central bank . . . arises, perhaps not surprisingly given its important functions, as a spontaneous product of market forces in banking" (p. 84). In fact, showing that a central bank can arise as the unintended result of legislated privileges is a far cry from showing it to be a product of market forces. As Congdon writes on the very next page, not the market but "the state has granted the central bank the exclusive right to issue legal-tender notes."

The Bank of England's key privileges were its legal monopoly of the London note issue (which dates from the Act of 1708, not from the Act of 1826 that Congdon cites on p. 38), its role as banker to the state, and its government guarantee against being liquidated in the event of failure. To retain its privileges, the bank toed Parliament's line, and in so doing it gradually became a state-directed policymaking institution rather than a firm maximizing profits for shareholders. The Victorian banking writer Walter Bagehot in his classic *Lombard Street*, which Congdon cites repeatedly on other matters, was quite clear that legal privileges were the source of the Bank of England's central-banking status. Bagehot wrote:

> the Bank of England had among companies not only the exclusive privilege of note issue, but that of deposit banking too. It was in every sense the only *banking* company in London. With so many advantages over all competitors, it is quite natural that the Bank of England should have far outstripped them all. Inevitably it became *the* bank in London; all the other bankers grouped themselves round it, and lodged their reserve with it. Thus our *one*-reserve system of banking was not deliberately founded upon definite reasons; it was the gradual consequence of many singular events, and of an accumulation of legal privileges on a single bank . . . which no one would now defend. (New York: Charles Scribner's Sons, [1873] 1897, p. 100)

Once the Bank of England accepted responsibility for managing the nation's gold reserve and stopped competing with other banks for ordinary commercial business, it backed into a position toward other English banks almost (Congdon suggests) like that of a clearinghouse association toward the member banks that voluntarily formed it. It should be noted, however, that a clearinghouse association's "authority" over its member banks did not stem from legislated privileges.

Congdon writes: "Sometimes commercial banks are forced to accept rules and regulations, and their role in negotiations with the central bank is therefore involuntary. But that was not the historical norm in the UK in peacetime" (p. 37 n. 7). If the second sentence were true, then the United Kingdom's history would be exceptional and not representative of central banking history elsewhere. But is it true? It does appear that the Bank of England's relations with U.K. commercial banks were historically cozy rather than hostile, but this situation is not the same thing as the bank's regulatory authority's being based on and limited by the commercial banks' voluntary consent.

Congdon notes that the "impressive" performance of clearinghouse associations in the United States before 1913 "constitutes one of the best arguments that a government-sponsored central bank is not an inevitable feature of a modern economy" (p. 52). But the clearinghouse associations gave way to central banking, he argues, because they could not satisfy swings in the public's demand for currency as a central bank can. Although the problem of "inelastic currency" in the United States here referenced was genuine and was among the motives for the Federal Reserve Act, Congdon fails to note that the problem was entirely owing to arbitrary legislated restrictions on American banks—namely, the requirement that notes of federally chartered banks be backed by (a shrinking stock of) federal bonds and a tax effectively banning the issue of notes by state-chartered banks. Canada had no such restrictions, no such problem of inelastic currency, and consequently no banker demand for a central bank.

In chapters 3 and 4, Congdon argues that a net social benefit arises from having a central bank that is able to issue additional money ad libitum and ready to lend it to illiquid commercial banks. The exposition is important for articulating what may be a widely held position in the financial community, even though the conclusion is ultimately unpersuasive. Congdon begins with the straightforward point that a central bank's readiness to provide commercial banks with additional cash on request (that is, to act as a "lender of last resort" in the fashion recommended by Bagehot in *Lombard Street*) allows the banks to maintain lower cash-reserve ratios and thereby to reduce their operating cost. Under competition in commercial banking, the cost reduction is passed on to bank customers as a lower spread between deposit and loan interest rates. Voilà, Congdon concludes, increased economic efficiency and social welfare.

I fear that a non sequitur lurks in the welfare conclusion. No doubt, if something reduces any bank's cost of holding smaller cash reserves by making it cheaper for the bank to replenish dwindling reserves on short notice, then banks will hold smaller reserves and incur smaller foregone-earnings costs of holding nonearning reserves. For example, the advent of railroads allowed banks to reduce their gold-reserve ratios by reducing their cost of getting gold quickly. The welfare question, however, turns on whether a central-bank lender of last resort is, like the advent of railroads, a cost-saving technological improvement that increases welfare or instead a cost-externalizing subsidy that reduces welfare by distorting behavior. Congdon does not consider the very real second possibility. Do not official last-resort loans potentially shift risks of loss onto the public? Do they not potentially create a moral-hazard problem? Might not a central bank encourage the holding of reserves that are *too* low for the public's well-being?

In addition to the theoretical point, Congdon makes the quantitative claim that the historical trend of banks' reducing their cash reserve ratios "owed much to the innovation of central banking" (p. 72). He provides little evidence for this claim, however. He does *not* show that the Bank of England's adoption of a lender-of-last-resort role (conventionally dated to the 1890 Baring crisis) accelerated the ratio's decline in England. One potentially relevant datum he cites is that U.S. banks held higher reserve ratios than English banks in the late nineteenth century. But there were at least two important reasons for that difference unrelated to central banking—namely, higher legally required reserve ratios and restrictions on branch banking. Congdon mentions neither. A sample larger than two countries at one point in time would be useful to sort out how much, if anything, was owed to central banking. Reserve ratios also trended downward in Scotland and Canada, countries with neither central banks nor peculiar restrictions as in America. Congdon does *not* show that ratios trended downward more among banks able to borrow from an official central bank.

In chapter 5, Congdon discusses the lender-of-last-resort role. Despite his earlier references to the historical era in which gold was the ultimate money of redemption, he presumes without explanation that central-bank notes are "the ultimate 'cash' of business and finance, and the money with which banks settle between themselves" (p. 85).

Congdon distinguishes lender-of-last-resort policy (via loans to specific institutions) from open-market operations (securities sales and purchases). This distinction follows from his Bagehotian view that the lender of last resort should rescue illiquid institutions, as distinct from the modern monetarist view (suggested by Milton Friedman and argued in detail by Marvin Goodfriend and Robert King) that it should instead focus on keeping the broader money stock from shrinking when the public or the banks want to hold more cash. (Congdon also endorses the money-stock stabilization objective.) In the latter view, the central bank's loan facility can be closed in order to avoid favoritism and moral hazard, leaving solvent banks with adequate collateral to borrow liquidity in the market.

Nondepository financial institutions can also become illiquid—for example, an investment house such as Bear Stearns or Lehman Brothers or an insurance company such as AIG. All three of these firms became illiquid when other firms declined to roll over overnight loans because they feared that the borrowers were already insolvent, as indeed all three turned out to be. Walter Bagehot wanted to confine last-resort lending to solvent firms. Congdon, despite enunciating the Bagehotian guideline that "the central bank's function is to extend last-resort loans to solvent but illiquid banks" (p. 106), endorses the Federal Reserve System's rescues of the insolvent Bear Stearns and AIG as "necessary" to the "core objective" of "financial stability, to maintain the convertibility of bank deposits into legal-tender notes" (p. 94). But the convertibility of bank deposits was already guaranteed by federal deposit insurance, so the two bailouts could not have been necessary to achieve that objective. The bailouts were instead all about rescuing the nondepository creditors and counterparties of nonbank financial firms. Congdon later amends his guideline as follows: "the central bank may sometimes be correct to extend a last-resort loan to a bank that, in strict accounting terms, is bust" if that bank has a "reasonable prospect" of recovery (pp. 107, 109). Such a discretionary lending guideline might be fine for a purely private hedge fund, which risks its own funds, but taxpayers would reasonably object that when a present-day central bank is allowed to lend public money to insolvent firms at its discretion, the gate is open to insider deals and below-opportunity-cost returns. They would want a stricter guideline. Congdon's proviso that the central-bank lending committee should include experienced bankers is not very reassuring. The traditional rule of law shields taxpayers by promptly closing and resolving any bank that "in strict accounting terms, is bust."

The problems of taxpayer losses and moral hazard go unmentioned here. Congdon goes so far as to claim: "The extension of a lender-of-last-resort loan by the central bank to a private bank is virtually costless to society" (p. 101). He does note that "[i]f the central bank relaxes its rules on collateral, commercial banks will raise the proportion of illiquid assets to total assets" (p. 98), but he sees this effect not as a threat to taxpayers, a moral hazard problem, or a misallocation of resources, but only as a problem for the loan-appraisal department of a central bank that "has its own capital at risk" (p. 98). We should note that "capital at risk" is not really a concern for present-day central banks that have only irredeemable "liabilities" and therefore effectively cannot become insolvent. It is not clear how capital would constrain the private central bank Congdon proposes, which would also have only irredeemable "liabilities."

In light of the foregoing discussion, it is not surprising that Congdon in chapter 6 argues that the Bank of England should have lent more generously (and more quietly) to Northern Rock Bank when it became illiquid. Here he acknowledges the moral-hazard problem surrounding deposit insurance, but he explicitly denies that such a problem applies to last-resort lending. He takes Bank of England governor Mervyn King to task for worrying that it does apply. In contrast, Congdon lauds U.S. Federal Reserve chairman Ben Bernanke's statement in August 2008 justifying his crisis interventions on the grounds that "it's a long-standing role of the central bank to use its lender-of-last-resort facilities" (p. 137). Sweetening JP Morgan Chase's acquisition of Bear Stearns and rescuing AIG, however, were not lender-of-last-resort actions. They were bailouts.

Congdon makes a fairly persuasive argument that deposit insurance does not need to be prefunded: the deposit insurance agency can borrow as needed from the central bank to make payouts and repay the loan by taxing surviving banks afterward. It is puzzling, then, that he worries about the prefunding of lender-of-last-resort operations, insisting that "the central bank must have strong capital resources." In fact, capital strength is irrelevant for a bank that has no redeemable liabilities and that can create new irredeemable money "from thin air" whenever it wishes to lend it. Although Congdon wants the Bank of England to be privatized, he does not want it to give up the power of issuing money ad libitum. (He does state that all the bank's profits from issuing money would be returned to the Treasury.)

Congdon's call for privatizing the Bank of England rings even hollower when he holds up as a model of a privately funded central bank—mirabile dictu—the Federal Reserve System of the United States. He writes: "the Bank of England, like the USA's Federal Reserve, should be owned by the banks and be financially accountable to them" (p. 188). That the Fed is owned by the banks, however, is a legal fiction. Federally chartered commercial banks were taxed to provide the initial capital for the twelve regional Federal Reserve Banks, for which they received nominal "shares," but these shares do not give the commercial banks control over the Fed's monetary, lending, or regulatory policies. Members of the Fed's Board of Governors are political appointees named by the president, and they call the shots. The board dictates the budgets of the twelve regional Reserve Banks.

In his concluding chapter, Congdon predicts that his arguments will not appeal to "those critics of central banking who, from a free-market perspective, would like all banks to be on the same footing" (p. 178) rather than for a central bank to regulate all the others. True, but it should be recognized that such critics do not object to banks being regulated by a supervisory clearinghouse association that the banks themselves voluntarily form. The banks agree to standards for clearinghouse membership because it is in the interest of each bank to be assured that its clearing partners will make good on their debts at the end of the day. The free bankers' ideal is thus not zero regulation, but regulation by markets and market-based institutions rather than by government authorities. They will indeed find little that is appealing in Congdon's call for quasi-privatization of central banking. He does not propose to constrain the Federal Reserve or the Bank of England on the grounds that they went too far in their panicked operations to rescue insolvent banks and nonbanks, but to move in the opposite direction. (That the seeds of crisis were sown by the central banks' previous monetary expansion is no part of the narrative.) He wants to privatize the Bank of England—sort of—so that it will issue and lend money to banks more freely in the next crisis—with even wilder abandon, a critic might say.