The Federal Reserve's Place in Central Banking History

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[1] Views expressed are solely those of the author.

Introduction

- Federal Reserve: 100 years old this December
- Central banks go back at least 600 years!
- This talk: use CB history to discuss Fed's role

Central banks: essential roles

Two broad functions

- Maintaining a monetary standard
- Crisis management/ financial regulation

Part I: central banks as monetary authorities

Short history of central bank money

- Central bank money: *a liquid claim backed by government debt*
- How did this come about?
  1. Beginnings: Genoa, 15th century
  2. Development: "Bank of England" model, 18th-20th centuries
  3. Refinement: "Enlightened fiat standard," post-1973

Central bank money: origins

- 1408: Genoa founds a GSE to collect city taxes
  - *Casa di San Giorgio*
- *Casa* pays city creditors who own "shares"
  - Irregular tax revenues makes *Casa* shares equity-like
- Mid-15th century
  - **Casa shares used as payment instruments**

Central bank money: development

- 1694: *Bank of England* founded
- Like *Casa di San Giorgio*, backed by government obligations
- BOE issues claims in more liquid form
  - **bearer notes** rather than equity shares
  - redeemable in gold coin on demand
- BOE side business
  - discounted bills of merchants & private banks

19th century

BOE model becomes widespread

- Dominant institution: Bank of England
  - survives Napoleonic wars intact
- BOE withstands many banking crises
  - 1825, 1839, 1857, 1866, 1890, 1907
- Many "BOE wannabes"
  - France, Germany, Italy, Japan, etc.
- 1913: United States (after two unsuccessful tries)
  - *Federal Reserve System*

20th century

Traditional BOE model collapses under WWI fiscal pressures

Note circulation of select countries, 1913-1921

(local currency units)

	Britain	France	Germany	Italy
1913	717	32,974	4926	15,125
1921	7,634	297,368	82,520	92,856
Annual rate of increase	**34%**	**32%**	**42%**	**15%**

20th century

- Traditional BOE model pressured by
  - WWI & postwar: inflations & deflations
  - 1930s: en masse departure from gold standard
  - WW2: renewed fiscal strains
- 1944: Bretton Woods conference
  - attempt at modernizing traditional model
  - abandoned in 1973

Central bank money: refinement

"Enlightened fiat standard"

- Central bank backed by government debt, as before
- Inflation targeting delivers stable monetary value
- Increased responsibility for countercyclical policy
    - departure from metallic standard provides more policy flexibility
- Best of all possible worlds?

Part II: central banks as crisis managers/ regulators

Federal Reserve as crisis manager

- Fed founded after Panic of 1907
  - Discount window would make financial crises "obselete"
- 1930-1933: Fed fails to counteract bank panics
  - $\Rightarrow$ New-Deal era banking regulation (Glass-Steagall, FDIC)
- 2007-2008 crisis: more aggressive Fed response
  - $\Rightarrow$ Dodd-Frank Act of 2010
  - moves Fed into regulation of "shadow banking"

2007-2008 financial crisis: noteworthy aspects

- A "shadow banking" crisis
  - Instead of depositor runs, loss of market funding for **shadow banks**
    - ABCP conduits, SIVs, investment banks, MMMFs, GSEs, etc.
- Nontraditional policy responses
  - *Emergency facilities:* TAF, TSLF, PDCF, CPFF, AMLF, TALF
    - Conversion of junk collateral to Fed credit/ Treasurys
  - *Special Purpose Vehicles:* Maiden Lane I, II, & III
    - Purchased junk collateral from Bear Stearns/ AIG
  - *Dollar swap lines*
    - Fed lent to ECB, BOJ, BOE, & other CBs
- Are these developments anything new?

What defines a "bank?"

- Traditionally (pre-1800) a *bank*
  - Holds *securities* (bills of exchange) as assets
  - Funded by *issue of securities* (bills)
  - *Unlimited liability*
  - Regulated by *market discipline* ("honor")
- 19th century: worldwide transition to English-style banks
  - *Loans* replace securities as asset
  - *Deposits* replace bills as funding
  - *Limited* liability
  - More explicit *regulation* (charters, examiners, etc.)
- English model dominates U.S. from the start
- Paul Warburg: let's move the U.S. toward the pre-1800 model(!)

2007-2008 crisis: historical precedents

- Shadow banking crises
  - 1763, 1772 (Amsterdam), 1857 (Hamburg), 1866 (London)
- Special Purpose Vehicle
  - 1772 (Amsterdam)
- Liquidity assistance between central banks
  - 1825: Bank of France $\Rightarrow$ Bank of England
  - 1838: Bank of France, Bank of Hamburg $\Rightarrow$ Bank of England
  - 1847: Bank of England $\Rightarrow$ Bank of France
  - 1857: Austrian National Bank $\Rightarrow$ Bank of Hamburg
  - 1890: Bank of France $\Rightarrow$ Bank of England

Part III: lessons learned

Lessons learned

Central banks as monetary authorities

Some big themes from the last 600 years

1. Most vital CB function: provide stable, liquid asset
2. Government finance & countercyclical policy important, but constrained by #1
3. CBs rarely die a natural death, but perish during extreme fiscal events

Lessons learned II

Central banks as crisis managers/ regulators

Recurring themes

1. Financial crises (a) will happen & (b) won't stop at national borders
2. Regulation: necessary, but bankers will outflank the regulators
3. Successful central banks find a way to contain crises

Last but not least

Timeless advice to central bankers

- Motto of the *Casa di San Giorgio*:

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Timeless advice to central bankers

- Motto of the *Casa di San Giorgio*:
- *Ubi ordo deficit, nulla virtus sufficit.*
- "Where (institutional) order is lacking, (human) virtue will not suffice."