ONE

Understanding Central Bankers and Monetary Policy

Our monetary system is unprecedented. After decades of instability, central bankers, governments, and economists have reached a consensus that the appropriate role of a central bank in the prevailing fiat-money regime includes: (1) the clear assignment of the responsibility for inflation to the central bank; (2) agreement that inflation should be low and stable; (3) rejection of price controls as a means of controlling inflation; and (4) acceptance of whatever degree of fluctuation is required in interest rates to achieve the inflation objective. This is at once more ambitious and more modest (realistic) than earlier systems. The gold standard was a way to price stability in the long run, and Keynesian monetary and fiscal policies aspired to multiple (if inconsistent) price and quantity goals.

The system is not accidental. This book traces its development through successive interactions of central bankers, economic ideas, and governments, all affected in greater or lesser degrees by the experiences of earlier systems. There are several excellent histories of central banking for particular periods.[1] However, this is the first attempt to tie the threads across

[1] Standouts include the authorized histories of the Bank of England by John Clapham (for 1797–1914), Ralph Sayers (1890–1944), and John Fforde (1941–58) and, for the United States, Richard Timberlake's history of monetary policy from Alexander Hamilton to Alan Greenspan and Milton Friedman and Anna Schwartz's *Monetary History of the United States from 1867 to 1960*. Further useful studies of British experiences are those of T. Fortune, *A Concise and Authentic History of the Bank of England*, Thorold Rogers, *The First Nine Years of the Bank of England*, A. Andreades, *History of the Bank of England*, A. E. Feavearyear, *The Pound Sterling*, Marston Acres, *The Bank of England from Within*, P. G. M. Dickson, *The Financial Revolution in England: A Study in the Development of Public Credit, 1688–1756*, R. G. Hawtrey, *A Century of Bank Rate*, and Richard Roberts and David Kynaston, *The Bank of England: Money, Power and Influence, 1694–1994*. An

three centuries within a unified framework that is made up not only of monetary theory but of the situations of central bankers in the financial markets. The story is told from the standpoints of central bankers in two countries, from the establishments of the Bank of England in 1694 and the Bank of the United States in 1791, although similar policy regimes in Europe and elsewhere suggest that it has wider applicability (which will be examined in the last chapter).

The focus on central bankers has several advantages for understanding the monetary system. Their position at the center provides a unique perspective on the progress of events, and their responsibility for day-to-day policy gives their exchanges with governments insight into policy in practice. The views of policymakers as revealed in the statements of Governors Whitmore, Harman, and Palmer before parliamentary inquiries in 1810, 1832, and 1848 are not found elsewhere; nor are Governor Hankey's quarrel with the *Economist's* Walter Bagehot, Governor Lidderdale's reactions to the Crisis of 1890, Governor Norman's defenses of resumption in the 1920s, the resistance of Governors Cobbold and Cromer to government pressures in the 1950s and 1960s, or Governor George's exposition of the new consensus in 1998.[2] The institutions of American monetary policy have been more changeable, but Nicholas Biddle's defense against Andrew Jackson's war on the Second Bank of the United States and the explanations of Treasury monetary policies by Secretaries Guthrie, Sherman, and Shaw and of Federal Reserve policies by Governors Strong, Harrison, Eccles, Martin, Maisel, Burns, Volcker, and Greenspan are equally valuable. Heads of Federal Reserve Banks were called governors before the Banking Act of 1935 (for example, New York's Benjamin Strong and George Harrison); they were called presidents thereafter.

Finally, their common situation in the financial markets provides a strong element of continuity to the development of central banks. We

American sample is provided by Parker Willis, *The Federal Reserve System*, Paul Warburg, *The Federal Reserve System: Its Origin and Growth*, Randolph Burgess, *The Reserve Banks and the Money Market*, Seymour Harris, *Twenty Years of Federal Reserve Policy*, E. A. Goldenweiser, *Federal Reserve System in Operation*, Lester Chandler, *Benjamin Strong, Central Banker* and *American Monetary Policy, 1928–41*, Elmus Wicker, *Federal Reserve Monetary Policy, 1917–33*, and David Wheelock, *The Strategy and Consistency of Federal Reserve Monetary Policy, 1924–33*. Although Alan Meltzer's history of the Federal Reserve from 1913 to 1951 did not appear until 2003, many of its previously published components are used.

2 Jeremiah Harman, Horsley Palmer, and Thomson Hankey were past governors on these occasions (Richard Roberts and David Kynaston, eds., *The Bank of England, 1694–1994*, app. 2)

will see how central bankers' concern for financial stability has become reconciled with monetary policy. Technology has developed, but the fundamental characters of money and the credit markets, as well as of reputation and speculation, persist. Central bankers' earliest and longest experiences were within the framework of the gold standard, but their intellectual positions have been similar under paper standards.

Instead of treating monetary episodes as distinct, I examine policy as a sequence of actions by durable groups with shared experiences and environments. In the 18th century, the Bank of England – the model central bank (although its directors had to be told at the end of the century that this is what they had become) – focused on profits and survival, the latter requiring the payment of gold on demand for its notes. The long 19th century – until 1914 – saw the progress of the Bank's acceptance of a wider responsibility for financial stability, although convertibility remained in ascendance. The United States had no institution that could be called a central bank – except two short-lived Banks of the United States between 1791 and 1836 – before the establishment of the Federal Reserve in 1913. Nevertheless, the federal Treasury Department, central money markets, and clearinghouses performed central banking functions that were governed by the same ideas that prevailed across the Atlantic, that is, profits for private institutions and seigniorage for the government, subject to currency convertibility and with attention to financial stability.

Central bankers failed to cope with the disruptions of World War I and the Great Depression of the 1930s and tended to make matters worse as the old system collapsed. Monetary theory and practice since that time have to a large extent been quests for an adequate replacement of the pre-1914 system. The dollar-exchange system that was agreed at Bretton Woods in 1944 to achieve the solidity of the gold standard without its rigidity proved inconsistent with concurrent monetary stimulations, and its breakdown in the 1970s presaged an agonizing period of accelerating inflation and unemployment.

The anti-inflationary monetarist policies associated with Federal Reserve Chairman Paul Volcker and Prime Minister Margaret Thatcher may be understood as reactions to inflations that had failed to bring the promised benefits, and monetary debates since 1979 have led to the consensus just described. Commitments to the new policy were legalized in the Bank of England Act of 1998 and, less formally in the United States, by the statement of Chairmen Volcker that "price stability . . . is to be treasured and enshrined as the prime policy priority; that objective is inextricably part of a broader concern about the basic stability of the financial and economic system" and that of Chairman Greenspan, who stipulates, "Monetary policy basically is a single tool and you can only implement one goal consistently."[3]

Nonetheless, we must pay attention to Greenspan's warnings of "irrational exuberance in the stock market," as well as his worries of a shift in bankers' attitudes toward risk during the 1998 Asian financial crisis: "If there was a dime to turn on," they did, he said. A "fear-induced psychological response is provoking a sudden rush to liquidity that poses a threat to world economic growth. . . . When human beings are confronted with uncertainty . . . they disengage." Comparing investors to a pedestrian crossing the street, he observed, "When . . . you're uncertain as to whether a car is coming, you stop."[4]

Economists have been critical of central bankers' attention to the financial markets at the expense of their macroeconomic responsibilities. Allan Meltzer was in the tradition of David Ricardo when he told a congressional committee in 1964 that the Federal Reserve's "knowledge of the monetary process is woefully inadequate, . . . dominated by extremely short-run week-to-week, day-to-day, or hour-to-hour events in the money and credit markets. [T]heir viewpoint is frequently that of a banker rather than that of a regulating authority for the monetary system and the economy."[5]

Notwithstanding these criticisms, we will learn how central bankers' understanding of their role in monetary policy has grown. The stage for the intellectual gap between the two groups is set in Chapter 2, which examines the Bank of England's denial of the Bullion Committee's charge of economy-wide effects of what the Bank saw as normal lending practices. Its rejection of the risks and responsibilities of managing the currency was the occasion of Ricardo's censure that opens the book. We will encounter more instances of this difference in viewpoint, but jumping ahead to 1998, we see that the conflict between the career central bankers and economists on the Bank's Monetary Policy Committee (MPC) was similar to that between the Bank and the economists on the 1810 Bullion Committee.

According to the Monetary Policy Committee's minutes, although the staff's economic model recommended a rise in the Bank's interest rate, Bank careerists favored "delaying any rise in interest rates, even if a rise

[3] Forrest Capie et al., eds., *The Future of Central Banking*, pp. 258, 343.
[4] *Wall Street Journal*, Dec. 9, 1996, p. C1, and Oct. 8, 1998, p. A2.
[5] *The Federal Reserve System after Fifty Years*, Hearings before the Subcommittee on Domestic Finance of the Committee on Banking and Currency, 88th Cong., 2nd sess., Feb. 11, 1964, pp. 927, 932.

were necessary."[6] They referred to "unusually large" near-term uncertainties and did not "feel very confident about the outlook and it would not necessarily be right to draw policy conclusions mechanically from the [staff's] projection. In these circumstances there was a case for delay so as to allow judgment to be made later in the light of more information." If the downturn proved sharper than expected, an increase in interest rates might have a severe negative effect on output, "and would have to be quickly reversed. Such a reversal could impair confidence in the economy" and create "confusion about monetary policy. . . . There was thus a strong case for waiting to get a clearer impression of the extent of the slowdown in the economy before taking policy action."[7]

This thinking was like that of the Bank directors in 1819, who protested Ricardo's money rule as "fraught with very great uncertainty and risk" in which "discretionary power is to be taken away from the Bank," and might, because of the impossibility of deciding "beforehand what shall be the course of events," impose "an unrelenting continuance of pecuniary pressures upon the commercial world of which it is impossible for them either to foresee or estimate the consequences."

The 1998 Committee's academic economists opposed this position by arguing that "policy should reflect the latest news and that uncertainty in itself was no reason for delay." They believed that to delay decisions to reduce the risks of reversal was "irrational." "So long as any policy reversals could be properly explained by new developments or improved analysis of the outlook, they need not create confusion about policy. . . . [T]he desire to minimise the risk of policy reversals was likely to mean that interest rate changes would, on average, be made too late." The tie vote was broken by Governor George in favor of waiting.

Economists have found it "difficult to rationalize" central bankers' concern for smooth interest rates and short-term stability in the financial markets.[8] Nonetheless, they must take it into account. Central bankers cannot help behaving like bankers at least part of the time. Rules are incomplete, and if economists hope to explain and influence the conduct

[6] Those with histories as primarily academic economists on the Monetary Policy Committee were Sir Alan Budd, Professors Willem Buiter and Charles Goodhart, and Deputy Governor Mervyn King; those with careers at the Bank or in industry were Governor Edward George, Deputy Governor Ian Plenderleith, David Clementi, and DeAnne Julius.

[7] This and the next paragraph are from MPC minutes for February and May 1998, Bank of England, *Inflation Report*, May and August 1998.

[8] Lars Svensson, "What Is Wrong with Taylor Rules? Using Judgment in Monetary Policy through Targeting Rules."

of monetary policy, they need to try to understand central bankers on their own ground. Central bankers are informed parties to the new consensus, but monetary policy results from the interplay of central bankers' pragmatism with economists' ideas and the wishes of governments.

The latter – the ultimate authority – cannot be ignored. The freedoms that central banks have been given can be taken away. Past government attitudes toward central banks have depended on their need for them. The end of war (and government pressure for cheap finance) brought an increase in the Bank of England's independence in 1833 similar to that given in 1998. President Jackson's veto of the renewal of the charter of the Bank of the United States in 1832 was influenced by the approaching end of the national debt. Senator Thomas Hart Benton declared, "The war made the Bank; peace will unmake it."[9]

The greater independence of the Federal Reserve after the collapse of the Soviet Union might have reflected the government's diminished need for finance as much as the public's revulsion to inflation and disillusionment with the Phillips Curve. By the same token, the deficits arising from the War on Terror will bring pressure for monetization. In any case, monetary policy is at bottom a political decision.

Legislatures have also paid attention to central banks in peacetime, especially during the periods of price instability following wars, during the Great Depression, and in the 1970s. Monetary standards are decided by governments. The creation of the International Monetary Fund in 1944 and its rejection by President Nixon in 1971 were not unusual in the minimal roles played by the central bank. Wartime suspensions, devaluations, gold standard acts, and the creation of the Federal Reserve were political decisions. The task of central bankers even at the height of "independence" is the daily conduct of policy within the framework set by government.

Governments have taken direct control of monetary policy when they lost confidence in central banks. Their institutional shells remained, but monetary control was transferred in the early 1930s to the Treasury in both countries. The Federal Reserve regained control in 1951 when public opinion and Congress determined that the president had abused his monetary powers, a victory that had to be won again in 1979. The Bank of England, although possessing advisory influence, did not approach its former powers until the 1990s.

[9] U.S. Senate, February 2, 1831; Herman Krooss, *Documentary History of Banking and Currency in the United States*, p. 736.

The last chapter surveys the present and speculates about the future of central banking. The current consensus rests on an understanding, developed over many years of hard experience, of what monetary policy can do. Central bankers apparently understand their assignment, although history shows that they also take the financial markets and political pressures seriously. Nevertheless, if we accept the goal of low inflation in free markets, with the understanding that this is the best that monetary policy can do, central bankers will be able to adjust to unusual events in ways that substantially deliver the goal while smoothing the financial markets – such as when the Federal Reserve supplied liquidity after the 1987 stock market crash, during the run-up to the millennium, and after 9/11, and also when it tries to soften the impact of monetary policy on the money markets by improving its transparency.[10]

[10] Such cases include the asymmetric directive and the promise in August 2003 of low interest rates "for a considerable period"; Daniel Thornton and David Wheelock, "A History of the Asymmetric Policy Directive," and Richard Anderson and Daniel Thornton, "The FOMC's 'Considerable Period'."

TWO

An Introduction to Central Bankers

> Do you consider the amount of Bank of England notes during the last year to have borne nearly the same proportion to the occasions of the public as in former times? – The same proportion exactly.
>
> When you represent the quantity of Bank of England notes to be now only proportionate, as heretofore, to the occasions of the public, do you take into consideration the increased price of all articles and the consequent increase of the amount of payments; and do you assume that the quantity of notes ought to be increased in proportion to that increase of the amount of payments? – The Bank never force a note into circulation, and there will not remain a note in circulation more than the immediate wants of the public require; for no banker, I presume, will keep a larger stock of [the Bank's] notes by him than his immediate payments require, as he can at all times procure them . . .
>
> [Question repeated] – I have taken into consideration not only the increased price of all articles, but the increased demands upon us from other causes.
>
> *Minutes of Evidence*, Bullion Committee, testimony of Governor John Whitmore, Bank of England, March 6, 1810

So went the opening exchange between the House of Commons' Select Committee on the High Price of Gold (Bullion Committee), with Francis Horner in the Chair, and the Bank of England, represented by Governor Whitmore. This testimony played an important part in the beginnings of modern monetary theory and the intellectual discovery of central banking. Economists contended that the latter – monetary policy – properly derives from the former, while the central bankers resisted. The events surrounding the inflation that led to Parliament's enquiry are presented in the first section in this chapter, followed by a review of the

Background: People and Events
1793: Beginning of the French Wars; financial panic.
1797: Suspension of convertibility.
1799: Income tax introduced.
1805: Austerlitz and Trafalgar; Napoleon supreme on land, England at sea.
1808: Wellington's Peninsular campaign begins.
1810: Bullion Committee; resolutions voted on, May 1811.
1812: Napoleon invades Russia.
1814: Napoleon abdicates, retires to Elba; Congress of Vienna.
1815: Waterloo.

	Prime Minister	Chancellor of the Exchequer	Political Parties
1783	William Pitt	Pitt	These were Tory
1801	Henry Addington	Addington	governments,
1804	Pitt	Pitt	with the King's support,
1806	Lord Grenville	Lord Henry Petty	between the Whig
1807	Duke of Portland	Spencer Perceval	dominance under the first
1809	Perceval	Perceval	two Georges and its
1812	Earl of Liverpool	Nicholas Vansittart	resurgence in the 1830s.

Note: Short-lived ministries omitted.

Committee's proceedings. Its members stressed in a modern way the effects of an unrestrained central bank on inflation through money creation. In an equally modern way, the Bank's representatives denied responsibility and pointed to other causes.

The third section puts the debate into a longer term perspective by means of the best contemporary analyses of central banks. Henry Thornton explained in Smithian terms that there was much to be gained from a private central bank acting in the enlightened pursuit of its interests. Alexander Hamilton's discussion indicates that similar forces and ideas were at work on the other side of the Atlantic, and prefaces the appearance of American central banking in Chapter 6. The last section reviews the Bank directors' second thoughts about their responsibilities after a change in political circumstances.

War, Inflation, Suspension, and More Inflation, 1793–1810

The Bullion Committee was appointed on a motion by Horner on February 1, 1810, after two years of accelerating inflation, an adverse balance of trade, and a falling exchange rate. Horner, Henry Thornton, and others, although by no means the majority of the House of Commons, attributed these events to an excess of lending by the Bank of England made possible by the suspension in 1797 of its obligation, even its freedom, to redeem its notes for gold. War brought a growing public deficit as the government was slow to find revenue to match its increased spending. The Bank had complained of the government's pressure for funds since 1794. That pressure slackened in 1795 and 1796, but the restoration of gold convertibility in France and uncertainty of British intentions sparked a decline in the Bank's gold reserve from £6 million in February 1795 to £1 million in February 1797. When the drain was turned to panic by rumors of a French invasion and the Bank informed Chancellor of the Exchequer (and Prime Minister) William Pitt that its situation was desperate, he called a Council of State, which declared on February 26

> that it is indispensably necessary for the public service that the Directors of the Bank of England should forbear issuing any cash in payment until the sense of Parliament can be taken on that subject and the proper measures adopted thereupon for maintaining the means of circulation and supporting the public and commercial credit of the kingdom at this important juncture.[1]

The order was confirmed by the Bank Restriction Act, passed on May 3, effective until June 24, and kept in force by continuing acts until 1821. Although the Act referred only to the Bank of England, other banks took the opportunity to refuse redemption of their notes, and before the end of the war the number of country banks had tripled.[2] The public acquiesced, and the country's monetary base was transformed from gold to Bank of England notes.

Later estimates (there were no contemporary price indices) indicated average inflation of about 3 percent per annum between 1797 and 1810.[3] The Bank's note and deposit liabilities grew about 6 percent per annum and the value of its notes at Hamburg, the exchange most often quoted, fell at an average rate of 2 percent.[4]

[1] Edwin Cannan, *The Paper Pound*, p. ix; see pp. xliii–xlvi for the data referred to here.

[2] John Tritton of Barclay & Co. estimated that the number of country banks had increased from 230 in 1797 to 721 at the time of his evidence to the Bullion Committee (April 9, 1810).

[3] W. S. Jevons, *Investigations in Currency and Finance*, p. 144, reported in Cannan's Table I.

[4] The exchange rate data are from an appendix to the fourth edition of Ricardo's *High Price of Bullion, Works*, iii, p. 121.