



Could the United States have had a better central bank? An historical counterfactual speculation

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ABSTRACT

This article argues that two alternative hypothetical central bank scenarios could have improved upon the Federal Reserve's track record with respect to financial stability and possibly overall macroeconomic performance in its first century. The first scenario is to assume that the charter of the Second Bank of the United States had not been revoked by Andrew Jackson in 1836 and the Second Bank survived. The second scenario takes as given that the Second bank did not survive and history evolved as it did, but considers the situation in which the Federal Reserve Act of 1913 was closer to the original plan for a central bank proposed by Paul Warburg in 1910.

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1. Introduction

The Federal Reserve's Centenary will be in 2014. It is time to reflect on how the institution has done in its first 100 years—on its successes and failures. Much has been written on the history of the Federal Reserve. The key books are by Milton Friedman and Anna Schwartz in the *A Monetary History of the United States (1867–1960)* and Allan Meltzer, *A History of the Federal Reserve (2003)* and (2009) and two recent books are also important: John Wood, *A History of Central Banking in Great Britain and the United States (2005)* and Robert Hetzel, *The Monetary Policy of the Federal Reserve: A History (2008)*.

The general thrust of the evaluation of the Fed's performance is that it did well in the 1920s, the 1950s, and from the mid 1980s to 2006 (the Great Moderation) but that it performed badly in the Great Depression of the 1930s and the Great Inflation from 1965 to 1980. Many also have criticized the Fed for its performance during the recent financial crisis and Great Recession (e.g. Meltzer, 2009; Taylor, 2009; Hetzel, 2012) but it will take more time to conclude that this experience should be ranked as badly as the Great Depression and Great Inflation.

This literature is critical of the Fed for following flawed doctrine, for its lack of independence from political pressure and for flaws in its structure. However despite its serious failures the consensus would argue that the Fed during its 100 years has exhibited the ability to learn from its past errors.

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Selgin et al. (2010) go farther than the main stream view. They argue that the Fed has never done better with respect to price stability, real economic stability and financial stability compared to the regime which preceded it – the classical gold standard, national banking, US Treasury and Clearing House regime.

This paper does not directly engage into the debate over how well or badly the Fed did in its first 100 years. Rather I focus on whether the track record of economic performance could have been improved if the development of a US central bank had followed two quite different historical paths which were presented at key conjunctures in the past. The first scenario is to assume that the charter of the Second Bank of the United States had not been revoked by Andrew Jackson in 1836 and the Second Bank had survived. This is not a totally unrealistic scenario since absent Jackson's veto the Bank would have survived and the Congress came reasonably close to overriding the veto. The second scenario takes as given that the Second Bank did not survive and history had evolved as it did, but considers the situation in which the Federal Reserve Act of 1913 was closer to the original plan for a central bank for the United States proposed by Warburg (1910a). Both of these scenarios would have led to greater financial stability than we had in the 20th century and possibly better overall macro-performance and price stability.

Section two develops the Second Bank counterfactual. Section three considers the Warburg scenario. Section four speculates on whether these alternative arrangements would have given us better overall financial, macroeconomic and price stability performance throughout the 20th century than we had. Section five concludes with some policy relevant lessons from history.

2. Had the Second Bank of the United States survived

In 1790 Alexander Hamilton proposed a financial reform package for the US to overcome the economic paralysis of the Confederacy. It would serve as the basis for US financial development and lead to a financial revolution which underpinned long run economic growth (Rousseau and Sylla, 2003). A key plank of Hamilton's plan was the creation of a national bank, the First Bank of the United States. This bank modeled after the Bank of England, would have both public and private ownership and would provide loans to both sectors. It would be sufficiently well capitalized to be able to provide the government with medium term bridge loans to finance shortfalls in government tax receipts. It was also hoped that its loans to the private sector would spur economic development but it was deemed imperative that it also hold sufficient specie reserves to always maintain convertibility of the notes. The First Bank of the United States was chartered in 1791 with a capital of \$10 million (it was the largest business enterprise in the country) (Bordo and Vegh, 2002).

There was strong opposition to the First Bank from Hamilton's initial proposal. The opposition was on both constitutional issues and populist distrust of the concentration of economic power. The Constitution had merely said that the Federal government could coin money and regulate its value; it said nothing about setting up banks. The constitutional debate that has followed since then reflected the fundamental political question of how power was to be divided between the Federal government and the States. The second source of opposition was a deep seated populist distrust of the concentration of economic power in a national bank located in Philadelphia with branches in every state. As a consequence of this opposition the First Bank had its charter revoked after 20 years in 1811.

A Second Bank of the United States with terms similar to the First Bank was chartered in 1816, in the face of financial disarray following the War of 1812, with a capital of \$50 million. Once again opposition to the Second Bank arose from politicians, especially in the South, who wished to preserve as much power in the states as possible, and from citizens concerned about the concentration of power. This pressure was taken up by Andrew Jackson who made it a centerpiece of his agenda to close the Second Bank under Nicholas Biddle.

As a result of this opposition the charter of the Second Bank was not renewed and the chartering of banks became the sole prerogative of the States. The succeeding 80 years was characterized by considerable financial instability – the Free Banking era from 1836 to 1863 – with a flawed payments system, numerous bank failures and several notable banking panics, followed by the National Banking era which did create a uniform currency but was punctuated by four serious banking panics and several minor ones. The system did not solve the problem of “the inelasticity of high powered money” (Friedman and Schwartz, 1963). The outcry following the Panic of 1907 led to the reforms leading to the Federal Reserve.

My counterfactual, which is close to that of Hammond (1957), is that had the Second Bank not been destroyed by Andrew Jackson in 1836 that US monetary history would have been very different. Monetary and financial instability would have been considerably less.

The Second Bank of the United States under Nicholas Biddle in the decade before the Bank War had developed into a first rate central bank. According to Redlich (1951) Biddle had read Thornton's (1802) and understood the principle tenets of monetary theory. Biddle had a remarkably clear understanding of the role of the Bank in stabilizing exchange rates and maintaining adherence to the gold standard, smoothing seasonal and cyclical shocks and acting as a lender of last resort to the banking system. In many respects he was ahead of his contemporaries at the Bank of England.

Had the Second Bank survived, the US may have adopted nationwide branch banking as Canada did. The state banks were already competing with the Second Bank in the 1830s and it is likely that the Second Bank would have expanded and extended its branching network. It is unlikely that the federal government would have blocked chartering competitors for the Second Bank as happened in France in this period. Moreover the states would likely have moved to promote interregional branching because their banks would have found it difficult to compete with the Second Bank without cross state branching.

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