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DO WE NEED CENTRAL BANKS?

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All of us alive today have lived in the age of central banks – notably the U.S. Federal Reserve, the Bank of England, the Bank of Japan and, more recently, the European Central Bank. At first, it may seem absurd to even contemplate a world without them, but there is a good case to be made that they are unraveling.

At various times in our lives, we realize that we are in the midst of a storm of change but have little idea of where it will lead – the Internet being a classic case. Two decades ago, many of us understood the world was going to change because of it, but few conceived the shape of the change. Now, it is almost impossible to conceive a world without the Internet.

This essay is different than what you may normally expect to see in the Cayman Financial Review. I rarely use personal pronouns in my writings, but members of the CFR editorial board have been in intense debate in recent years with each other and other professional colleagues as to where central banks, banking, monetary policy, and even the concept of money itself are headed. Thus, I thought it might be of interest to CFR readers to provide you with a window into some of these debate issues – as a way of, perhaps, stimulating your own thought stemming from the current monetary storm.

The first central banks were created in Amsterdam and Stockholm in the early 1600s. The early central banks were largely utilized to assist in financing government operations. The Bank of

England was formed as a private company in the late 1700s to help the government raise funds for financing the wars that England was engaged in at the time. By the mid-19th century, the Bank of England (misnamed because it is the central bank of the U.K., not just England) became totally government owned and had the monopoly on the issue of bank notes (currency).

The U.S. did not have a central bank until the Federal Reserve came into existence in 1913. Under the gold standard, which most major nations were using up to the advent of the WWI, there was not a necessity for money policy. Recessions used to be called "panics," which tended to short in duration and self-correcting. There developed a widespread belief that panics could be mitigated if there was a central bank to serve as the lender of last resort for commercial banks, which would prevent a cascading series of bank failures – which could lead to a depression – hence the Fed.

The role of central banks has been changing over the years, and particularly in the last eight years. In addition to being a lender of last resort, most central banks issue the currency and try to maintain its value, which is a continuous problem once a currency is unhinged from something real, such as gold. Most central banks also have bank regulatory functions, such as requiring certain capital and reporting standards. In recent years, these bank regulatory functions have grown – particularly at the Fed as a result of the passage of the Dodd-Frank bill, stemming from the financial crisis of 2008-09.

For a number of decades, the Fed had a dual mandate which was to insure the value of the currency and promote policies that would lead to full employment. The fact that these goals could be contradictory was most often conveniently ignored. During the last half of the 20th century, the conventional wisdom was that the Fed could achieve these goals by controlling the rate of interest and the money supply. As those of you who took a course in macroeconomics or money and banking may recall, the Fed had three primary tools for achieving its goals. The first was what are known as "open market operations" whereby the Fed buys and sells government bonds in the secondary market often on a daily basis. The second was the "discount rate" or the rate of interest the Fed charged banks for short-term loans. The third was the reserve requirements whereby the Fed determined the percent of assets that the bank had to keep in reserve.

The Fed has a very poor record in maintaining price stability, as shown by the fact that the dollar is equal to about 1/24 of what it was back in 1913. The Fed also has a poor record of maintaining a counter-cyclical economic policy to promote full employment. It is unrealistic to assume that the

governors of the Fed are smarter than the collective wisdom in markets, which is why they so often get it wrong.

After 2008, the Fed and the other major central banks began a program, known as quantitative easing (buying and holding government bonds), with one of its goals to make it easier for businesses to obtain low-cost capital, for job growth and expansion. In effect, the bond purchases have enabled governments to fund their ever-increasing debt burdens at artificially low rates of interest. It has also made it possible for big and very creditworthy borrowers to obtain cheap credit. The ones who have lost out are savers, who are now facing very low or even negative rates – which is the same as a massive tax increase on their returns from savings – and small and entrepreneurial businesses. Increasing numbers of observers believe that the Fed bond buying program is contractionary rather than expansive.

Jerry L. Jordan, the former president of the Federal Reserve Bank of Cleveland and a member of President Reagan's Council of Economic Advisors, has been arguing that the Fed's traditional tools have been become impotent. In a new paper for the Cato Journal (volume 26, number 2), Jordan states: "Commercial banks are no longer resource constrained, the historical linkage between the central bank balance sheet (the monetary base) and the outstanding money supply has been broken. […] Without the ability to influence the supply of money, central bank open market operations have no influence on the rate of inflation.

Announced changes in the federal rate therefore have no implications for economic activity or inflation." Jordan and others argue that the above mentioned traditional tools of the Fed are broken and are unlikely to work again. Many traditional Fed advocates argue that the tools can and should be revived. Time will tell.

By way of background, one of our colleagues, Dr. Warren Coats, did his dissertation under Milton Friedman. Coats then spent many years at the IMF, having major responsibility for its SDR program, and setting up many currency boards in the former communist countries of central Asia and Eastern Europe. Coats then retired from the IMF and joined me on the board of the Cayman Islands Monetary Authority. Coats and I were privileged to have known, not only the late Milton Friedman, but also the legendary economist/philosopher, F. A. Hayek and Robert Mundell, all of whom were Nobel Laureates, as well as many other serious thinkers on issues revolving around money.

Back in 1976, Hayek wrote a classic little book, called "Denationalization of Money," in which he argued that there was no reason for the government to have a monopoly on money, and if it were left up to private competition we would have better money. As an example at the time, he thought, perhaps, commodity baskets could serve as a superior store of value and unit of account (money functions). Many of us have come up with proposals over the years as to what such baskets might look like. Again, our colleague Coats has spent some number of years developing a basket-type concept which he calls the "real SDR."

There are many advocates of returning to a gold standard, which is feasible provided that the initial price of gold vs. the dollar is set at a reasonable market value. The government could announce that at a certain point in the future; for instance, noon GMT on April 1, 2017, the government would set the price of the gold in dollars based on the free market price of gold at that moment. Futures markets in gold would have plenty of time to take in global opinion by those willing to put their money, rather than just their opinions, on the line, adjust, and ultimately converge as the date approaches. Under a gold standard, the government would need to be prepared to buy and sell gold at the set dollar-gold price. There is extensive literature on the pros and cons of returning to a gold standard, which I will not repeat here but is available on the Internet – other than to again note it is possible and may or may not be better than the current Fed-created money – but the debate is useful.

A major impediment to the development of private currencies has been the insistence of the U.S. Treasury to treat the change in price of a commodity or any other private money like Bitcoin as a capital gain or loss – which is lunacy, given that the paperwork to record all such changes would be almost impossible and the fact that the Treasury would gain no net tax revenue – because trading in commodities is essentially a zero-sum game where profits and losses cancel each other out over the long run. I wrote an article, published back in 1981 in the Wall Street Journal, making the case to remove the capital gains tax from commodity trading. Despite the fact that no one made a sensible case against my argument, this destructive tax is still with us.

John Tamny, political editor at Forbes, editor of Real Clear Markets, and a senior fellow at the Reason Foundation, has just published a very well-written and entertaining book, "Who Needs the Fed?" Tamny's book is a sharp critique of the performance of the Fed, where he argues by analogy that if any business went from failure to failure as the Fed has done, it would have long ago disappeared. Tamny believes if the Fed was totally abolished, without the government setting up some institution to carry on some of the current responsibilities, the future of the U.S. economy would be no worse. Others, even many "free market" economists, who though also being very critical of the Fed, disagree about how many of its functions can be successfully privatized. The book is a constructive addition to the debate and has the virtue of being far more interesting than the more technical books on the subject.

It is arguable whether or not the major central banks have a coherent plan as to how they will unwind their balance sheets of the trillions of dollars they have added, primarily in government bonds. There is likely to be an increased political outcry against them as the situation worsens. What comes next is worth the debate.

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