# 24.1: America’s Central Banks

**Learning Objectives**

- What is a central bank?
- Why is central banking important?
- How can a country manage without a central bank?
- What is the history of central banking in the United States?

A **central bank** is a bank under some degree of government control that is generally charged with

- controlling the money supply (to a greater or lesser degree);
- providing price stability (influencing the price level);
- attaining economic output and employment goals;
- regulating commercial banks (and perhaps other depository and nondepository financial institutions);
- stabilizing the macroeconomy (proactively and/or by acting as a lender of last resort during financial crises);
- providing a payments system (check clearing and long-distance payments).

Central banks also often act as the national government’s banker by holding its deposits and making payments on its behalf. *During its 200-plus-year existence, the United States has had three different central banks and two periods, one short and one extremely long, with no central bank.*

Chartered by the federal government in 1791, the Bank of the United States (BUS) worked in conjunction with the U.S. Treasury secretary to act as a lender of last resort and a regulator of commercial banks. Specifically, it helped Alexander Hamilton, America’s first Secretary of the Treasury,www.treasury.gov/about/history/Pages/ahamilton.aspx to stymie the Panic of 1792. *It also returned the notes of commercial banks for redemption into gold and silver (the era’s* **base money***), thereby regulating commercial banks’ reserve ratios and hence the money supply*. Owned by private shareholders, *the BUS was quite independent, a good trait for a central bank to have, as we’ll see*. Its very independence and power to regulate commercial banks, however, made it unpopular in some influential political circles. Its charter was not renewed when it expired in 1811. The government’s difficulties financing the War of 1812 (aka the Second War for Independence) convinced many that the country needed a new central bank. As a result, the government chartered the Bank of the United States (informally called the Second Bank or SBUS) in 1816. Insufficiently independent of the government at first, the SBUS, which like the BUS was headquartered in Philadelphia but had more numerous branches, stumbled by allowing commercial banks to increase their lending too much. It also suffered from internal agency problems, particularly at its branch in Baltimore. When a financial panic struck in late 1818 and early 1819, it failed to prevent a recession and debt deflation. Private stockholders reasserted control over the bank, placing it under the able direction of Nicholas Biddle, who successfully prevented the British economic meltdown of 1825 from spreading to America. Under Biddle, the SBUS also became an effective regulator of the nation’s commercial banks, which by the 1820s numbered in the hundreds. Like the BUS before it, the SBUS paid for its diligence with its life. Aided by many commercial bankers, particularly those in Philadelphia’s financial rival Manhattan, and America’s traditional distaste for powerful institutions, Andrew Jackson vetoed the act rechartering it. (The SBUS continued its corporate life under a Pennsylvania charter, but it no longer had nationwide branches and was no longer the nation’s central bank. It went bankrupt a few years later.)

*From 1837 until late 1914, the United States had no central bank*. Private institutions cropped up to clear checks and transfer funds over long distances. The Treasury kept its funds in commercial banks and in the hands of its tax collectors and left bank regulation to the market (deposit and note holders and stockholders) and state governments. The monetary base (gold and silver) it left largely to the whims of international trade. It could do so because the United States and most of the world’s other major economies were on a gold and/or silver standard, meaning that their respective units of account were fixed in terms of so many grains of the precious stuff and hence fixed against each other. This does not mean that the exchange rate didn’t change, merely that it stayed within a narrow band of transaction costs. The system was self-equilibrating. In other words, discretionary monetary policy was unnecessary because gold and silver flowed into or out of economies automatically, as needed. (The price level could move up or down in the short-term but eventually reverted to the long-term mean because deflation [inflation] created incentives [disincentives] to bring more gold and silver to market.) Nations today that maintain fixed exchange rates also find no need for a central bank, but instead use a simpler institution called a currency board. Countries that use a foreign currency as their own, a process called **dollarization**, need nothing at all because they essentially outsource their monetary policy to the central bank of the nation whose currency they use. (That is often the United States, hence the term *dollarization*.) Other central banking functions, like clearing checks and regulating financial institutions, can be performed by other entities, public and private. The function of lender of last resort typically cannot be fulfilled, however, by anything other than a central bank.

*Indeed, the biggest problem with the U.S. arrangement was that there was no official systemwide lender of last resort, nobody to increase the money supply or lower interest rates in the face of a shock*. As a result, the United States suffered from banking crises and financial panics of increasing ferocity beginning soon after the Second Bank's demise: 1837, 1839, 1857, 1873, 1884, 1893, and 1907. Most of those panics were followed by recessions and debt deflation because there was no institution wealthy enough to stop the death spiral (a shock, increased asymmetric information, decline in economic activity, bank panic, increased asymmetric information, decline in economic activity, unanticipated decline in the price level). In 1907, J. P. Morgan (the man, with help from his bank and web of business associates) mitigated, but did not prevent, a serious recession by acting as a lender of last resort. The episode convinced many Americans that the time had come to create a new central bank lest private financiers come to wield too much power. Anyone with the power to stop a panic, they reasoned, had the power to start one. Americans still feared powerful government institutions too, however, so it took another six years (1913) to agree on the new bank's structure, which was highly decentralized geographically and chock full of checks and balances. It took another year (1914) to get the bank, often called simply the Fed or the Federal Reserve, into operation.

### KEY TAKEAWAYS

- A central bank is a bank under some degree of government control that is responsible for influencing the money supply, interest rates, inflation, and other macroeconomic outcomes like output and employment. A central bank is usually the lender of last resort, the institution that can (and should) add liquidity and confidence to the financial system at the outbreak of panics and crises. On a quotidian basis, central banks also may clear checks, regulate banks and/or other financial institutions, and serve as the national government's bank.
- Early in its history, the United States was home to two privately owned central banks, the Bank of the United States and the Second Bank, that acted as a lender of last resort and regulated commercial banks by returning their notes to them for redemption in base money (then gold and silver). Although economically effective, both were politically unpopular so when their twenty-year charters expired, they were not renewed. From 1837 until the end of 1914, the United States had no central bank, but the Treasury Department fulfilled some of its functions.
- A country can do without a central bank if it is on fixed exchange rates, such as the gold standard, or otherwise gives up discretionary monetary policy, as when countries dollarize or adopt a foreign currency as their own. In such cases, other institutions fulfill central banking functions: government departments regulate financial institutions, commercial banks safeguard the government's deposits, a currency board administers the fixed exchange rate mechanism, clearinghouses established by banks clear checks, and so forth.
- The Treasury Department did not act as a lender of last resort, however, so recurrent banking crises and financial panics plagued the economy. When J. P. Morgan acted as a lender of last resort during the Panic of 1907, political sentiments shifted and the Federal Reserve system emerged out of a series of political compromises six years later.