

## “Could the United States have had a Better Central Bank? A Historical Counterfactual Speculation” by Michael Bordo

- 1) What if the Second Bank of the United States had seen its charter extended in 1832 rather than destroyed by the Jackson veto?
  - 2) What if the Fed envisaged by Warburg in 1910 had become a reality rather than the system of compromises of Glass and Willis in the Federal Reserve Act?
- Paper argues for better financial and price stability and possibly better macro performance in the 20<sup>th</sup> century in either case.
  - CF 2 raises key issues about the early Fed and how some problems could have been avoided, but is less provocative than CF 1.

In favor of CF 1:

- Had Jackson signed the re-charter of the Second BUS, there would likely have been no pet banks, no removal of federal deposits, more moderate expansion of money stock, and possibly no 1837 panic.
- President Tyler could not have vetoed a “Third Bank,” and Millard Fillmore, the final Whig president, or perhaps Zachary Taylor, would likely have signed the next bill to re-charter if one had made it to his desk.
- The Second BUS might have evolved to assume the characteristics of a more European-style central bank, obviating the need for free banking, National Banking, and the Federal Reserve Act.

But we must recall....

- The Second BUS (capital \$35 mil.) and the first BUS before it (capital \$10 mil.) were mostly private institutions with a public charge to act as fiscal agent of the Federal Government. The branches were created to facilitate receipts and disbursements.
- Before that, the colonies had showed that government provision of currency backed by tax anticipations could work, and could have worked better with elasticity cut free from the crown.
- But the “Continental” issued during the War showed the potential problems of fiat money. They failed because 1) the federal government had no authority to tax and 2) the “faith and credit of the United States” at the time did not mean what it does today.

So the heroics often attributed to Alexander Hamilton in forming the First BUS are not entirely misplaced. Nonetheless, Hamilton:

- 1) Started the “Federalist financial revolution” with a default, dishonoring domestic liabilities (i.e, the continentals) in favor of foreign obligations.
- 2) Privatized the money creation process. At least one economist has called this “usurpation of state sovereignty for personal gain.”
- 3) Acted as “central banker” and “lender of last resort” in the first Wall Street panic of 1792 and may have saved some wealthy investors from losses, but the impact did not reach much beyond them or New York.
- 4) Indeed, the view that the nation as a whole was inadequately serviced and power concentrated among its directors led to its failed re-charter, and these same sentiments led to the demise of the Second BUS.

So what if the Second BUS had survived?

- Consistent with paying robust dividends, it would have continued to extend commercial loans and to protect its own notes by curtailing those of other banks when excessive.
- A lot of silver still would have entered from Mexico and points South in the 1830s. Temin argues that the inflationary pressures would have been present without the pet banks.
- Good public land would have remained in demand and inflation could still have spiked its price in the secondary market.
- The federal debt would still be paid off in 1834, leaving the question of what to do with the surplus by 1836.

- So maybe a panic in 1837 anyway. And though I agree that perhaps not, bad state bonds to finance unsound internal improvements would still have defaulted, foreign capital inflows would still have slowed, and the downturn from 1839 to 1843 would still have occurred.
- Veto or not, Biddle might still have engaged in the same cotton speculations and bad investments that brought down the state-chartered Second BUS by 1841.
- If the Second BUS had survived, other banks would still be needed. Free banking re-instated government control of the money creation process at the state level through the availability of collateral bonds for note issue. The National Banking Acts replaced state regulation with federal control where the money supply was now constrained by the availability of Federal bonds for collateral.

- Yes, money was “perversely” elastic, and there were seasonal strains and financial panics. But credit did make inroads outside the major population centers. Reserves also tended to pyramid in New York, but at the same time the clearinghouses learned how to supply liquidity in a crisis, though never enough.
- The Federal Reserve was designed to bring the best of both worlds: a central bank in the public service, with decentralized control over the money creation process residing in both the banking system at the regional level and a centralized authority.
- The Fed avoided a financial panic for 15 years, quite a feat in retrospect, but the role as lender of last resort was inadequately specified, leading to internal conflicts within the Harrison Fed and pivotal inaction during the Depression.

- But the nation and the Fed learned from its mistakes, improved, made new mistakes, and improved again. It is this organic process that continues in today's Fed.
- Could the US have had and still have a better central bank? Unless we have nothing more to learn, yes! Would prices and the financial sector have been more stable under Warburg's original plan? Bordo provides a persuasive counterfactual that the answer is yes. Would the Second BUS have evolved into a modern central bank with a well-understood role as a systemwide lender of last resort? Maybe.
- But for CF 1, it is also easy to argue that a federal Second Bank could have been riddled by mismanagement in the late 1830s and early 1840s, and that President Fillmore may not have seen a next bill to re-charter it.