1. Governments and their banks

WHOSE MONETARY POLICY?

This book is about the making of monetary policy, especially the people behind those policies, in the United States and the United Kingdom during crises in the last two centuries. Central banks are sometimes called independent, although one might ask “Of what?” No one is independent of everything – of all interests, ideas, and pressures. More precisely, the claim normally (and erroneously) amounts to denials of high-spending governments’ desires or abilities to substitute bank credit for unpopular taxes.

Standard presentations of central banks devoted to financial stability neglect their actual performances as accomplices of government spending and supporters of national debts, which have been the actual primary reasons for their existence. The normal state of government finances has been borderline crisis or worse. The debts of ancient governments and debasements of their coinages are legend. Wartime inflation, then as now, was common. Aristophanes’ *Frogs* in which Charon demands twice his usual price to take Dionysus down to Hades was a comment on inflation during the Peloponnesian War. The Roman Emperor Diocletian’s *Edict on Maximum Prices* in AD 301 was an attempt to curb inflation by price ceilings, which turned out to be no more effective than the many other price controls that have been tried from time to time, down to President Nixon’s attempted controls during the Great Inflation of the 1970s (Jones 1974, p. 190; Southern 2001, p. 160; Blinder 1979).

In the eighteenth century, with the development of commerce including expensive luxuries, Adam Smith ([1776] 1937, p. 861) wrote that sovereigns, like the other great proprietors in their dominions, spent large parts of their revenues on the expanding indulgences:

How can it be supposed that [the sovereign] should be the only rich man in his dominions who is insensitive to pleasures of this kind? … His ordinary expence becomes equal to his ordinary revenue, and it is well if it does not ordinarily exceed it … and when extraordinary exigencies require extraordinary expenses, he must necessarily call upon his subjects for an extraordinary aid.
In fact,

The parsimony which leads to accumulation has become almost as rare in republican as in monarchical governments. The Italian republics, the United Provinces of the Netherlands, are all in debt. The canton of Berne is the single republic in Europe which has amassed any considerable treasure.

“The taste for pageantry prevails as much in the apparently sober senate-house of little republics as in the dissipated court of the greatest king,” Smith continued. For all of them, “the want of parsimony in time of peace imposes the necessity of contracting debt in time of war.”

Much of the difference between government and household spending may be found in the expected future costs and benefits of current behavior. Households can look forward to future rewards from current savings; not so politicians and government officials, whose rewards are concentrated in the present and near future in popularity, power, and re-elections. One might have expected fiscal irresponsibility to be less in small representative governments because of the closer proximity of their overseers/taxpayers, only to be disappointed, Smith observed. Voters of all kinds press for immediate advantages (Buchanan and Wagner 1977, pp. 93–111). Even the smallest government units must borrow for necessary projects such as schools, roads, and overdue maintenance. The occasional/accidental budget surpluses soon disappear into other, more immediately and politically attractive, uses. As I write this, pleas for unemployment benefits during the Covid-19 crisis have been unaccompanied by requests for corresponding finance in the form of increased taxes, perhaps on those less injured by the lockdowns.

Nor are the debts redeemed. “When national debts have once been accumulated to a certain degree, there is scarce, I believe, a single instance of their having been fairly and completely paid,” Smith ([1776] 1937, p. 882) wrote. “The liberation of the public revenue, if it has ever been brought about at all, has always been brought about by a bankruptcy; sometimes by an avowed one, but always by a real one, though frequently by a pretended payment,” meaning inflation. For example, although the U.S. national debt more than tripled between 1950 and 1980, its real value fell 25 percent as prices almost quadrupled, and the debt/GDP ratio fell from 76 percent to 26 percent – before rising to 108 percent in 2010.

The long nineteenth century, 1815–1914, following closely upon Smith, was a partial exception to his pessimistic assessment in its monetary discipline that was enforced by the gold standard. Prices were stable over long periods and national debts were restrained. The U.K.’s debt was about the same in 1914 as in 1815, and American budgets were usually in surplus except during the Civil War. The U.S. debt increased from $64 million in 1860 to $2,755
million in 1866, but was paid down to $961 million by 1893, and was not much larger (despite the Spanish–American War and the Panama Canal) at $1,188 million in 1914.

Banks were less needed for government finance during that century than during the major wars before and after – European powers were almost continuously at war or on war footings in the eighteenth and twentieth centuries – although they were also called on to address financial crises, many of their own making. Banks have often been pushed into the finance of public activities and then bailed out of the consequent financial misfortunes, as we will see in the following chapters. The histories of banks and their governments are stories of alternating mutual support and collapse – in modern times as much as the Middle Ages and before.

Governments have always been borrowers and regulators. They have encouraged the formation of banks as sources of credit but have been jealous of them as rivals for power. The Bardi family bank lent England’s Edward III (1327–77) 900,000 gold florins during the Hundred Years War with France, which he failed to repay, as well as 600,000 florins borrowed from the Peruzzi’s, leading to the collapse of both families’ banks. Edward’s grandfather, Edward I (1272–1307), had executed or expelled moneylenders whose lending failed to meet his demands. Nevertheless, they and their replacements continued into the next century, financing some of the early voyages of discovery, including Christopher Columbus and John Cabot.

The Welsers were a German banking and merchant family prominent in international finance in the sixteenth century especially as financiers of the Holy Roman Emperor Charles V (1519–56). Along with the Fugger family, the Welsers controlled large sectors of the European economy, and accumulated enormous wealth through trade and finance. They received conquest and settlement rights to the Province of Venezuela from Spain in 1528. There is a Fugger–Welser–Medici trading game with a medieval background.

Venetian bank failures between 1496 and 1533 were not directly due to government defaults, although the consequences were just as grave. They arose from the system of war finance and the erosion of the values of government debt. Although wars were a recurring feature of Venetian life, they were treated as unusual emergencies – much as in the United States in the twenty-first century, as Smith predicted. They were financed by forced loans on the wealthy. In return for payments, citizens received government obligations, which might have been good investments if they had not been issued in excess. Lenders were forced to sell bonds at depreciated prices and withdraw funds from banks to meet the demands of forced loans (Lane 1937).

Although eventually surpassed by corporate enterprises, family merchant and investment banks continued to be important in the finance of large private and public enterprises into the twentieth century. The Duc de Richelieu, prime
A comparative history of central bank behavior

minister of France 1815–18 and 1820–21, who sorted out French finances following Napoleon’s wars, with the help of Baring Brothers, called that banking firm Europe’s “sixth great power,” after Austria, England, France, Prussia, and Russia. They had financed the Louisiana Purchase for the United States, railways in Argentina in the late nineteenth century (which led to the Barings Crisis), and lasted until the speculations of a rogue trader in 1995 (Wechsberg 1966, pp. 90–93; Ziegler 1988; Fay 1997).

At the end of the nineteenth century, J.P. Morgan & Co. rescued the gold standard in the United States by borrowing in Europe, organized U.S. Steel in 1901, the world’s largest firm at the time, and orchestrated the end of the panic of 1907. Kuhn Loeb, Rothschilds, and others affected power politics, for example, by large loans to Japan (partly because of Russia’s treatment of its Jews) that were partially credited with its victory in the Russo-Japanese War of 1904–05 (Best 1972).

There is no better example of the game than banks’ high-risk support of government housing policies and their bailouts during the Great Recession. Commercial banks – short-term lenders to business on the basis of demand deposits – had become the principal financial institutions before the mid-nineteenth century. Their government charters required lending to those governments, such as the purchases of state bonds by state-chartered banks and U.S. bonds by nationally chartered banks (Dewey 1922, pp. 206–11; Rolnick and Weber 1983). Banks have also been used to suppress private in favor of government spending even in peacetime (see Chapter 5). The current international Basel agreement for the regulation of bank risk requires preferences for government debt despite its interest-rate risk. Charles Calomiris et al.’s Fragile by Design: The Political Origins of Banking Crises (2014) is a useful account of this interdependence. Banking systems are always and everywhere political constructs, outcomes of “games of bargains,” the players being governments, bankers, and their clients.

The demand liabilities of banks, essential to exchange and economic activity, are routinely assumed to make the institutions inherently fragile and therefore in need of regulation. There are many official restrictions on bank structures, portfolios, and actions intended to reduce their risk of failure, such as bank size, cash reserve and capital requirements, disclosure, and portfolio allocations. Banks are legally separated from commerce because of fears that some firms might gain financial advantages despite the loss of diversification.

In fact, there is a good deal of evidence raising doubt about commercial banks’ inherent fragility. Even in the United States, the country with the most bank failures, their failure rates were about the same as business failure rates in general between the Civil War and the Great Depression (Benston and Kaufman 1986). Then from the mid-1930s to the 1970s, bank failures were almost non-existent. The previous major cause of the undiversified U.S. bank
Governments and their banks

Failures, volatile farm prices, was displaced by farm prosperity (Cottrell et al., 1995). Increases in bank failures after the 1970s were due to volatile monetary policy and interest rates, government pressures on bank portfolios, such as sub-prime real estate, and increases in financial-asset insurance and bailouts reducing the expected costs of failure to bank owners and increasing moral hazard.

Government regulations may have done as much or more to increase than reduce bank risk-taking. Efforts to reduce runs by limiting deposit withdrawals have been thwarted by the regulators. At the peak of the 1933 bank run, Federal Reserve banks refused assistance to banks not committed to pay deposits in full (Wicker 1996, p. 122). Governments have also encouraged, even forced, maturity mismatching by pushing banks into mortgage lending. Salvaging failed banks is part of the banker–government arrangement in which the former are reimbursed for the risks of financing the latter’s programs. One of the costliest bailouts came during the Great Recession of 2007–09, after banks had financed the packages of subprime mortgages issued by government agencies under the impression that This Time is Different (Reinhart and Rogoff 2010), that the housing bubble would never burst.

We have not improved on ancient practices, and perhaps have made them worse by requiring taxpayers to pick up the pieces – although it’s their (our) own fault because they (we) have not only failed to monitor our political representatives but have erected bureaucratic obstacles which interfere with effective monitoring, based on the assumption that deposit insurance, capital ratios, and regulators take the place of investor oversight (Redish 2001; Wood 2020).

The British pound sterling, worth a pound of silver in Charlemagne’s (768–814) time, had lost 90 percent of its value by the end of Henry VIII’s reign in 1547, most of it to inflationary war finance, after which it maintained its commodity value (except for wartime interruptions) until the 1930s (Feavearyear 1931, 346–7). The gold value of the U.S. dollar was also maintained (except for the Civil War interruption) from 1792 to 1933. The abandonment of the gold standard in favor of fiat money has since resulted in the erosions of both currencies by more than 95 percent.

INTERESTS AND POLICIES

There may be a lesson in the joint rise of stable currencies and representative governments with respect for property in the nineteenth century, and their reversal with the return of executive dominance the next century. The first examples below (Chapter 2) are the monetary policies of the Bank of England during the troubled years following the European Wars ending with Napoleon’s defeat at Waterloo. The structures of government and finance affected monetary policies, and so did the people (interests) involved. The deflationary
resumption policy after 1813 involved a contest between long-term property and short-term economic (especially employment) interests, with the central bank in the middle. In 1847, the Bank responded to threats to short-term stability (Chapter 3), as it did on other occasions before its government takeover during World War I. The reconstituted government Bank was less concerned with economic instability in its determination to restore long-term financial arrangements in the City’s interests after the war (Chapter 4), when the Bank of England’s governor was able to find the domestic costs of tight-money – unemployment – “greatly exaggerated.” So whose monetary policy was it?

These discussions amount to examinations of hypotheses regarding the relations between monetary policies and politics, including choices between rules and discretion under crisis conditions. Their expanded uses for democratically doubtful fiscal purposes during the Great Recession (2007–09) increased doubts regarding the independence of central banks, but the issue is not new. The role of central banks, especially during crises, has always been a significant political issue (Alesina and Stella 2011). “[T]he Bank of England is now … remote from party politics,” Economist editor Walter Bagehot (1873, p. 90) wrote during a quiet period, but it was founded as “a Whig finance company … by a Whig Government because it was in desperate want of money, and supported by the ‘City’ because the ‘City’ was Whig,” willing to finance William III, who had overthrown the Tory-inclined James II.

The Bank was chartered in 1694, during the Nine Years’ War between France and the Grand Alliance that included England. In 1696, King William wrote to his ministers in London from the battlefields of Europe, “… in the name of God determine quickly to find some credit for the troops here, [or] all is lost, and I must go to the Indies.” The Bank’s charter was extended the next year in return for another low-interest loan. “Here was the crisis of the war,” David Ogg (1955, p. 433) wrote, “it was financial.”

U.S. Treasury Secretary Alexander Hamilton persuaded Congress to charter the Bank of the United States in 1791 against the opposition of the mainly rural Jeffersonian/Republicans, who were able to deny its renewal in 1809. John Marshall wrote in his Life of George Washington that Hamilton’s economic program, especially his plan for a national bank, “made a deep impression on many members of the legislature; and contributed, not inconsiderably, to the complete organization of those distinct and visible parties, which, in their long and dubious conflict for power, have since shaken the United States to their centre” (1807, vol. iv, p. 224). The War of 1812 brought the Bank’s renewal, but President Andrew Jackson vetoed the bill that would have extended its life. He, like Jefferson, opposed the banks on the populist grounds that they were used by the elite to exploit the people. Their fiscal conservatism (budget surpluses) also reduced governments’ need for banks (Olsen 2010; Larson 1981; Wood 2005, pp. 123–34).
Bank and public attitudes were affected by the catastrophic Great Depression and the intellectual Keynesian Revolution which followed (Chapter 5), but a lesson of all these discussions is that monetary institutions and policies in the U.S.A. and U.K. have been created and managed in the interests of the politically well-positioned. This was also demonstrated in the U.S.A. in the nineteenth century (Chapter 6), by the Federal Reserve’s behavior during the Great Depression (Chapter 7), and the crisis of 2008, when officials assured the public that the $700 billion of their tax-money that was voted to bail out Wall Street was really for the benefit of Main Street (Chapter 8). An implication of these discussions is that studies of central banking should take structures, governance, and political interests into account at least as much as the more publicized official mandates.

Later chapters try to show that the self-interested determinants of monetary policies also operate in other areas, such as the famines which have resulted more from government policies than food shortages, and military engagements, including America’s “endless wars” which depend on devices which enable the government’s backdoor finance and lack of accountability (Chapters 9 and 10).

THE ELITE

Government policies – social and economic – are often assumed to be (or ought to be) decisions of the elite, of the best and brightest, as opposed to the passionate and uneducated majority. Political science professor Donald Brand (2016) wrote:

We have entered a new and dangerous age of populism. Populists succeed when they appeal to the passions of voters, rousing them through fear and anger to reject the messy compromises that are intrinsic to a politics of moderation, and to look for scapegoat targets upon which they can vent their frustrations. Populists of the right have embraced nativism and populists of the left have targeted Wall Street and kindled class war. For more than a decade, populism has undermined Congress as an institution, leading to increased partisan polarization and representatives who find it difficult to seek compromises for fear of being challenged in primaries by partisan hardliners.

On the other hand, the record of the elite, when they have had their way, has not been impressive. David Halberstam’s name for their performance during the Vietnam War, The Best and the Brightest, was sarcastic. More recently, New York Times columnist David Brooks (2018) asked “How has such amazing talent [the educated elite, who went to the right schools] produced such poor results … from Vietnam to Watergate to the financial crisis.”
In contrast, Brooks wrote, “The older establishment won World War II and built the American Century.” He ignores the possibilities that it also contributed to the origins of that war, the Great Depression and the Dust Bowl, and destroyed an efficient and stable monetary system. The rebelliousness of the disappointed middle-class or populists, call them what you will, recently and historically, may have been responses to the failures of the elite establishment.

In *Capitalism, Socialism, and Democracy*, Joseph Schumpeter (1942) described democracy as a system of government where elites compete through elections for the right to rule the populace, undertaking to enact their understanding of the will of the people (Elliott 1994). In the course of criticizing the extension of the franchise in his work on *The English Constitution*, Bagehot (1872, p. xxiii) expressed the fear that

> both our political parties will bid for the support of the working man; that both of them will promise to do as he likes if he will only tell them what it is …. I can conceive of nothing more corrupting or worse for a set of poor ignorant people than that two combinations of well-taught and rich men should constantly offer to defer to their decision, and compete for the office of executing it. *Vox populi* will be *vox diaboli*.

We will have “the supremacy of ignorance over instruction and of numbers over knowledge.”

The attitudes of the elite/establishment/office-holders toward the population, their smug presumptions of superiority, are very old, and so have been their failings. The episodes discussed here consider the causes of this situation as stemming from the distributions of information and the costs of failure. The regulators/policymakers are distant from the effects of their policies. There was considerable distress leading to complaints about government policies during the Great Depression that went virtually unnoticed in official circles, and were not altered until emergencies forced them. Adam Smith’s accounts of the benefits of free exchange relied on the distributions of information and consequences, ignored in economics texts, and undervalued by outsiders, including legislatures and regulators. The rejection of a failed model requires the effects of its failings to be palpable. “The uniform, constant, and uninterrupted efforts of” individuals to better their conditions, “[l]ike the unknown principle of animal life, … frequently restores health and vigour to the constitution, in spite, not only to the disease, but of the absurd prescriptions of the doctor” (Smith [1776] 1937, p. 326).

This is a story not of changing central banks, but of their continuities. Their record as stabilizers has been mixed, with little or no improvement over time, as they have vacillated between rules and discretion, with large gaps in their learning, evidenced notably but not exclusively by their policies during the Great Depression and Great Recession. Their subordination to governments’
fiscal conveniences has been unchanging. The so-called Federal Reserve declaration of independence in the 1951 Treasury-Fed Accord, for example, was followed by unprecedented peacetime inflation as governments ran continuous deficits.