The End of Central Banking, Part I

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This year marks the centenary of the law establishing the U.S. central bank, the Federal Reserve (Fed), so it's an appropriate time to assess the role of central banking and the Fed's long-term performance. Another reason to focus on central banking is its recent vast expansions in both paper-money creation and government debt monetization.

Although retrospectives on the Fed's centenary may proliferate, few will address truly fundamental issues, such as: What is the *purpose* of central banking? Why did proponents of central banks seek to establish them, and what defects (if any) marred the systems they displaced? How have central banks performed historically? Have they fostered sound money, safe banking, and economic prosperity? If not, should central banks still exist? Such questions are rarely asked. Most people who write about the Fed presume central banking is a legitimate or necessary aspect of the economy and focus on how central banks now behave or might better behave in the future.

The broadest fact that few people grasp about central banking is that it is essentially central planning applied to the realm of money and banking. Central banks, in their essential features and functions, operate as branches of government to facilitate government spending and growth of the state. As government grows and spends more, politicians seek to avoid the electoral consequences of raising taxes and try to rely more on borrowing and printing money, policies that central banks uniquely facilitate. Although proponents and practitioners of central banking may deny this thesis and insist that central banks exist to cure "market failures"—and although most economists today resist the idea that the *primary* aim

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of central banking is to enable government spending—an examination of historic and economic facts reveals the truth.

The title of this two-part essay, "The End of Central Banking," has a double meaning: The first pertains to the "end" in the sense of its *purpose*, the second to its "end" in the sense of its *termination*. Part I will elaborate the theme that central banking is a form of central planning—specifically, a means of funding fiscally profligate states—by explaining the essential features and functions of central banking, considering some candid claims from its practitioners, and examining its origin and evolution. Part II will examine the theory and practice of free banking based on gold; how it is consonant with the principles of constitutionally limited government; and how central banking, despite its current power, can be safely and swiftly dismantled and replaced with a free, economically sound monetary system.

The Essential Features and Functions of Central Banking

Central banking is a system in which a legally privileged bank, a "central bank," has a government-granted monopoly on the creation of base money (i.e., currency and bank reserves) and the power to dictate the ratio of reserves that other banks must hold to back deposits. Under a central banking regime, this base money is accorded an exclusive legal tender status. No institution or person other than the central bank is legally permitted to create such money (to do so would be to engage in counterfeiting), and no one is permitted to use anything other than the central bank-authorized money to pay for goods or services or to settle debts.[1]

Other important features of a central bank merely derive from this monopoly on base money. For example, a central bank serves as a "lender of last resort" to private banks (especially those deemed "too big to fail") because it alone issues base money. At root, a central bank is not even defensible on the grounds that some agency must conduct "monetary policy," for such policy flows from the money monopoly; were a state to insist on monopolizing shoe output, it would also need a "shoe policy."

A central bank also typically promotes minimal deposit reserves so as to maximize money creation by private banks. These banks, in turn, through lending, create checking deposits, which constitute the bulk of the money supply and are convertible into base money. This, in turn, heightens the risk of bank runs and invites government deposit insurance (e.g., the Federal Deposit Insurance Corporation, or FDIC). And, to the extent that a central banking system provides bailouts and insures deposits regardless of a bank's practices or performance, the system generates "moral hazard," whereby banks operate recklessly (e.g., lending to borrowers who are not creditworthy, operating with insufficient capital and liquidity) because they know that if they sink they'll be bailed out. This moral hazard, in turn, stokes demand for an extensive regulatory apparatus to control every aspect of "private" bank management (e.g., the Federal Financial Institutions Examination Council).

A central bank can either tie the currency it produces to gold or issue purely fiat paper money—money without any tie to gold and hence prone to volatility and depreciation (as central banks globally have been doing since 1971). This latter practice enables a central bank to produce a limitless supply of base money, which historically has been done to help deficit-spending governments borrow as much as possible from central banks and private banks alike.

The issuance of fiat money helps finance government spending in three main ways. First, it reduces the purchasing power of the money already in circulation and thus inflicts an "inflation tax" on money holders. Second, it melts large portions of the debts owed by governments (if the value of currency decreases by x percent, then so does any debt denominated in that currency). Finally, under a graduated income tax, inflation automatically moves people into higher-rate brackets, forcing them to pay higher tax revenues. Governments today, which are far larger in size, scope, taxing power, and spending capacity than ever before, obtain material advantages from the issuance of fiat money by central banks. This is one of the major means by which governments can spend recklessly.

Despite the alleged widespread embrace of free market principles since the breakdown of socialist regimes in the early 1990s, few economists today challenge the propriety of central banking—which is to say, few challenge the propriety of the fifth plank of Marx and Engels's *Communist Manifesto* (1848), which calls for "Centralization of credit in the hands of the state, by means of a national bank with state capital and an exclusive monopoly." This *is* the essence of central banking, which is anti-capitalist and pro-statist, but most economists today endorse it either openly or by silent default.

Of course, today's advocates of central banking don't say they embrace the *Communist Manifesto* or even mention the central role of central banking in any statist regime. To their credit, some economists have candidly examined the truth of this phenomenon, and some have even criticized its insidiousness; in academia, it goes by the name "inflationary finance." Yet most economists still insist that central banking is an essential feature of a free market, and that its purpose is to fight inflation, smooth business cycles, foster jobs, preempt "bubbles," and prevent financial crises.

Certain former central bankers, however, have been more candid.

Candid Confessions from Central Bankers

In a 1995 speech on "The Role of Central Banks," Paul Volcker, Fed chairman from 1979 to 1987, noted that historically central banks "were not at the cutting edge of a market economy," that "central banking is almost entirely a phenomenon of the 20th century," and "to some extent, central banks were looked upon and created as a means of financing the government."[2]

A similarly candid admission came in 1946, in the wake of vast wartime borrowing by the United States. Beardsley Ruml, then head of the Federal Reserve Bank of New York, declared taxation an "obsolete" revenue source because central banks could simply print money: "Final freedom from the domestic money market exists for every sovereign national state when there exists an institution which functions in the manner of a modern central bank, and whose currency is not convertible into gold or into some other commodity."[3]

Perhaps the most brazen description of the Fed's government funding prowess comes from the current Fed chairman, Ben Bernanke. In a 2002 speech, Bernanke explained that even after driving short-term interest rates to zero, the Fed could still foster inflation: "U.S. dollars have value only to the extent that they are strictly limited in supply," he explained, "but the U.S. government has a technology, called a printing press (or, today, its electronic equivalent), that allows it to produce as many U.S. dollars as it wishes at essentially no cost"; and "by increasing the number of U.S. dollars in circulation, or even by credibly threatening to do so, the U.S. government can also reduce the value of a dollar in terms of goods and services," thus "raising the prices in dollars." The bottom line, Bernanke said, is that "under a paper-money system, a determined government can always generate higher spending and hence positive inflation." However, he reassuringly added, "The U.S. government is not going to print money and distribute it willy-nilly."[4]

Bernanke's predecessor, Fed chairman Alan Greenspan, has gone further, noting that Fed money-printing can simply melt away government debts: "The United States can pay any debt it has," he argued in 2011, "because we can always print money to do that. So there is no probability of a default."[5] Of course, such a method entails, if not an explicit debt default, at least an *implicit* one—which fiat money alone permits.

Yet governments have not always been so cavalier about money and debt.

The Origins and Evolution of Central Banking

In the 19th century, when the world's major governments spent only 5 percent or so of national production (versus 40 to 50 percent today), and systems of central banking were not yet so ubiquitous, base money was comprised mainly of gold and silver coins, supplies of which rose steadily due to market-driven mining and minting. Relatively free banking systems operated efficiently in dozens of nations, competitively issuing widely trusted currencies and checking accounts convertible into fixed weights of coin, under the shared norms of the classical gold standard.[6]

In this freer monetary environment, practically devoid of fiat paper monies, governments could for the most part procure funding only by taxing or borrowing. These two funding sources were generally sufficient, as government spending, in peacetime at least, was relatively modest. Of course, spending increased in wartime—as during the U.S. Civil War, when it peaked at 13 percent of national income—and in such cases governments relied far more on borrowing, and to some extent on printing money (e.g., U.S. "greenbacks"). But extensive borrowing and money-printing persisted only during the war years, not after.

Most of the century, from the end of the Napoleonic Wars (1815) to the start of World War I (1914), was peaceful, and deficit spending was rare. In the century prior to 1913 the United States borrowed only 4 percent of its total spending (in the century since 1913 it has borrowed 16 percent of its total outlays—and, in the past decade alone, an astounding 24 percent of its outlays). After the Civil War ended in 1865, Washington generated budget surpluses for twenty-eight consecutive years, and cut the national debt by two-thirds while reducing it as a share of GDP, from 33 percent to 6 percent (1893), and to just 3 percent on the eve of the Fed's founding (1913) and World War I (1914). The United States also was on the gold standard for most of this interwar period and prospered with no central bank, no deposit insurance, and no national income tax. The result was a stupendous increase in industrial output, population, and living standards. The U.S. government spent an average of only 3 percent of GDP between 1865 and 1913, compared to an average of 16 percent since 1913 (and 21 percent of GDP during the past decade).

Similarly, in the 125 years before 1815, Britain had been embroiled in nearly perpetual war, and due to chronic deficit spending its national debt increased as a share of national income (GDP) from 25 percent to 260 percent. In the subsequent, peaceful century, under limited government, Britain mostly ran budget surpluses and reduced its debt from 260 percent of GDP back down to 25 percent (in 1913).

During that same century Britain was on the gold standard (1821–1914), which preserved the pound's value and fostered prosperity.

In sum, fiscal rectitude, gold money, and prosperity coincided nicely in the 19th century. So how and why did central banking begin? And why does it persist?

The history of the establishment and growth of the major central banks of the Western world lends credence to the government-financing thesis. Central banks originated and expanded in near-lockstep with growth in the size and scope of governments, and with the specific funding pressure that accompanies greater deficit spending. The spread of democracy and voting also played a role: As politicians spent an increasing share of national production, they resisted imposing the full tax burden on voters, for fear of being punished electorally. At the same time, treasury officials in deficit-spending governments realized that if government borrowing were to become excessive relative to available savings, it would raise market interest rates, causing both economic harm and a rise in the government's interest expense. Fiscally strained governments pressured central banks into helping underwrite and distribute government debt securities at artificially low interest rates; central banks would "monetize" these securities—that is, they would create fiat money ex nihilo and use it to purchase debt securities directly from the treasury, or indirectly from private banks that previously bought them.

A number of good histories of central banking have appeared in the past century, written by advocates and skeptics alike, most notably Charles Conant (1927), Vera Smith (1936), M. H. De Kock (1953), and Charles Goodhart (1988).[7] Many more volumes have focused on the two most famous central banks—the Bank of England and the U.S. Federal Reserve.[8] In addition, an array of authoritative, bank-specific volumes were published in 1910 by various scholars under the auspices of the U.S. National Monetary Commission (NMC). The NMC was established by the U.S. Congress in 1908, after the Panic of 1907, to study central banks abroad as a possible model for the United States; in turn, this led to passage of the Federal Reserve Act in December 1913. A careful reading of these histories, including comparisons of evidence and claims, reveals that central banks were not originally established, nor later granted enhanced power, due to any "failure" of free markets in money and banking, nor to any inherent defect in the gold standard. Rather, they were formed to help governments borrow money more easily, or to borrow it at cheaper rates than they otherwise might.

Whereas the origins and early histories tell of central banks assisting mostly in war-related deficit spending, central banks in the past century have engaged in both wartime defense spending (especially World War I and II) and ever-expanding welfare and "social insurance" spending. Typically, a central bank's initial powers might be limited, as when it was granted only a partial monopoly on currency, or for credibility's sake was obliged to abide by the gold standard. But powers were later expanded, whether to treat crises that its prior interventions caused, or to better accommodate new government spending, which eventually entailed a displacement of gold-based money with fiat paper money.

That the rise of central banking has led necessarily to the demise of the gold standard is clear from monetary history (and is codified in Gresham's Law: bad money drives out good money). Three broad phases are discernible, with slight differences depending on the nation studied. The first phase is a system of relatively free banking on a pure (classical) gold standard (most of the 18th and 19th centuries); the second phase is central banking based on increasingly diluted and manipulated forms of the gold standard (World War I to 1971); the third phase is a system of full-fledged central banking with pure fiat money issuance having no tie to gold (since 1971). The earlier centuries are characterized by the rule of law, constitutionally limited governments, relatively conservative spending, and rational banking practices. In contrast, the past century, especially the period since 1971, is dominated by the rule of men, unrestrained government, reckless spending, and harebrained banking practices.[9]

Significantly, most of today's central banks were established in a seven-decade period of intensifying global statism, from roughly 1870 to 1940. In the early part of that period, the first "cradle-to-grave" welfare state was being erected in Germany, under Bismarck. This period in America, now known as the "progressive era," involved radical new government interventions in the economy, including antitrust laws (1890, 1914), the federal income tax (1913), and the Fed itself (1913). During World War I most combatant nations forced financial markets off of the classical gold-coin standard; although attempts were made in the postwar period to restore it, they all failed. During the war most treasury departments and central banks transferred gold coin from private banks, melted it into bullion, and thereafter hoarded it in their own vaults. The Fed's first material exercise in money-printing and government debt-buying occurred during World War I, when the U.S. debt increased tenfold; it also encouraged private banks to hold a large share of this new cascade of national debt.

Subsequent political manipulation of currencies contributed to the Great Depression (1930s), but the gold standard was blamed.[10] All remaining U.S. currency links to gold were severed in 1971, when the U.S. government, in the wake of its disastrous inflation policies in the 1960s, utterly eliminated all remaining ties of the U.S. dollar to gold and established the dollar as pure, unmitigated fiat currency. In the century since the Fed was established in 1913, the United States has recorded budget deficits 75 percent of the time; in contrast, in the century before 1913 the United States ran budget deficits only 33 percent of the time.

The inception of the first prominent central bank, the Bank of England, dates to 1694, when King William III exploited a then-private institution to borrow heavily for a war against France; but the banks' monopoly on currency was not granted until 150 years later, in 1844. Other central banks were established in France in 1800 (by Napoleon, also for war-finance purposes); Norway in 1816; Austria in 1817; Denmark in 1818; Belgium in 1850; Russia in 1860; and the Netherlands in 1864. Central banks established by governments in the more statist period of 1870–1940 included the Bank of Spain (1873), the Germany Reichsbank (1875), the Bank of Japan (1882), the Bank of Italy (1893), Sweden's Riksbank (1897), the Bank of Switzerland (1905), the U.S. Federal Reserve (1913), the Bank of China (1928), and the Bank of Canada (1935).

Some of these institutions were launched from the beginning as state-owned or state-sponsored banks, but some were previously private banks that had stopped redeeming currency, or had become insolvent after making forced loans to a defaulting national government—whereupon, instead of closing such banks or adjudicating a bankruptcy, the deadbeat government would excuse them in return for special privileges and pledges to provide still more state loans.

Central banking systems gradually displaced free or freer banking systems anchored by decentralized gold reserves and controlled by private, profit-making institutions and judicious depositors. Yet the displacement was not due to a failure of freedom. Kurt Schuler, an economic historian who has examined sixty such systems, found that "free banking was stable"; "only in a handful of episodes did the banking systems suffer runs or suspend convertibility into gold or silver during peacetime." Moreover, "there was no apparent tendency towards monopoly in any free banking system," "attempts of free banks to form cartels were always unsuccessful," and free banking systems "showed no apparent tendency to develop a lender of last resort—or to need one." In short, he says, "central banking was an imposition, not the outcome of the natural evolution of free banking."[11]

M. H. De Kock, governor of the South African Reserve Bank from 1945 to 1962, writes that "prior to the commencement of the 20th century, there had been no clearly defined concept of central banking." Even though numerous central banks had been established by 1900, no theoretical or conceptual reasoning as to the essence or need of such institutions had been provided. This speaks to the political expediency that generated these systems. Subsequent theories of central banking as being necessary for the correction of free market failures have been nothing more than post hoc and ad hoc rationalizations of an existing, politically dominant system. "A gradual evolution had been taking place in various countries," De Kock contends, "but the process had not always been a conscious one"; yet over time "one bank gradually came to assume more and more the position of a central bank, due mainly to its enjoyment of the sole right of note issue and acting as the government's bank."[12] In other words, central banks were initially formed for purely politically purposes and have remained in existence for the same end.

A contemporary historian of central banks, Charles Goodhart, who is also an avid defender of modern-day central banking systems, nevertheless concurs with proponents of free banking about the purely political and government-supportive origins of central banking. They were not established to fix purported "failures" of free banking, or to regulate private banking practices, or even to improve on the gold basis of the monetary system:

> When the first central banks were founded in Europe there was little or no consideration or attention given to the possibility of these banks playing a supervisory role in relation to other banks. Instead, the initial impetus was much more basic, generally relating to the financial advantages that governments felt that they could obtain from the support of such a bank, whether a state bank, as in the case of the Prussian State Bank, or a private bank, e.g., the Bank of England. This function naturally involved favoritism, often supported by legislation, by the government for this particular bank in return for its financial assistance.[13]

Goodhart's succinct account of the genuine origins of central banking might be taken as an adequate summary of the thesis of this essay: that central banking began, has evolved, and exists today not to fix unstable free banking systems, but rather to satisfy the voracious fiscal appetites of profligate states and to provide governments with "financial advantages."

Goodhart also claims that central banks had "an associated purpose"—to "unify" the "somewhat chaotic system" of private currencies and "to centralize, manage, and protect the metallic reserve of the country." But, in truth, currencies were quite "unified" long before central banks came along. For many decades prior to the establishment of central banks, banks and their clients had converged, rationally and voluntarily, upon a single, global, and objective monetary standard: gold. Free currency markets were not chaotic, because banknotes and checks were redeemable in fixed weights of specie recognized globally (just as checks today may differ in appearance and reputation, but are uniformly convertible into a singular currency). Moreover, central banks were hardly to be trusted to "protect" or manage precious specie reserves. Indeed, Goodhart plainly concedes that governments had an ulterior motive in wishing to "protect" and "manage" what was, until then, a system of privately minted and privately owned gold and silver reserves. Governments wanted, he writes, "the ability to share in the profits of seigniorage [revenue derived from the difference between the face value and the metal value of coins]," so government's "greater centralized control over the metallic (gold) reserves had obvious political attractions as well." Goodhart also concedes that most other widely touted central bank functions (e.g., lender of last resort) arise solely from its monopoly. It was "their privileged legal position, as banker to the government and in note issue" that then "brought about consequently, and naturally, a degree of centralization of reserves within the banking system in the central bank."[14]

Central banking didn't evolve "naturally" or spontaneously, as some device to ensure safe and sound banking; it was invented by fiscally needy states to provide governments with money to spend, and it eroded bank safety and stability.[15] Moreover, central banking didn't displace a "chaotic" system of private currency issuance and reckless banking; rather, it displaced a uniform, gold-centric financial system (sixty nations were on the gold standard in 1913) with what we see today: a bewildering array of free-floating, wildly gyrating national paper monies and banking systems that lurch from crisis to crisis—all amid chronic state deficit spending.

To date the most informed and best reasoned account of central banking history and theory appears in Vera Smith's book, *The Rationale of Central Banking and the Free Banking Alternative* (1936). Smith synthesizes central bank histories with the theory (really, the rationale) of central banking in a highly clarifying manner. She explains that, for a few decades in the 19th century, a sincere and serious debate occurred among monetary economists comprising a "Currency School," "Banking School," and "Free Banking School." The first two eventually won the day but accepted central banking and only disagreed about what central bankers should do; they differed not about *whether* but about *how* to conduct monetary central planning (much like Monetarists and Keynesians today). And, like De Kock and Goodhart, Smith finds central banking to be a purely political institution:

> A central bank is not a natural product of banking development. It is imposed from the outside or comes into being as a result of government favors. . . . The early [central banks] were founded for political reasons connected with the exigencies of state finance, and no economic reason for allowing or disallowing free entry into the currency-issuing trade was, or could have been given at the time, but once

> established, the monopolies persisted right up to and beyond the time when their economic justification did at last come to be questioned. . . . By 1875, the declared superiority of central banking became nothing less than a dogma without any very clear understanding of the exact nature of the advantage.[16]

Of course, when Smith speaks of no "clear understanding" of the nature of the "advantage" central banking might provide, she means no advantage *economists* could discern for the benefit of the *economy*. Politicians and central planners can conjure all sorts of "advantages" that central banking provides for their own aims. The supposed mystery of the rise and spread of the seemingly superfluous phenomenon of central banking can be solved by the thesis that central banking exists not to fight inflation, or temper business cycles, or ensure a stable financial system, but to finance fiscally profligate governments. And the facts support this thesis.

In a particularly succinct account of this thesis, two economists have explained how "governments have come to supply currency, and to restrict the private supply of currency and deposits, not to remedy market failures, but to provide themselves with seigniorage and loans on favorable terms." Thus "government currency monopolies and bank regulations can be understood as part of the tax system." Moreover, "the move from commodity to fiat money typically occurred in steps corresponding to fiscal emergencies," and governments, with the help of central banks, often exploited private banks "as a source of loans on favorable terms," which were "obtained in exchange for awards of monopoly privileges, especially in note issue." The "harnessing of monopoly banks of issue—central banks—as sources of substantial seigniorage came later, with the discovery that such banks (unlike competing banks of issue) could suspend payments with relative impunity, opening the way to the emergence of fiat money."[17]

Economist Ludwig von Mises makes the point succinctly:

> If the government interferes by freeing the bank from the obligation of redeeming its banknotes and of paying back the depositors in compliance with the terms of the contract, the fiduciary media become either credit money or fiat money. There is no longer any question of fiduciary media, of money certificates, and of money substitutes. The government enters the scene with its government-made legal tender laws. The bank loses its independent existence; it becomes a tool of government policies, a subordinate office of the Treasury.[18]

The founding of the Federal Reserve System in the United States a century ago is a particularly instructive case with regard to the government-finance theory of central banking. At the time, defenders of the proposed central bank argued that it would provide a more "elastic" currency than then existed and prevent the periodic financial "panics" that (allegedly) had plagued the U.S. banking system during the last four decades of the 19th century. Brief panics, which involved not widespread bank failures or even economic recessions but high interest rates, temporary scrambles for liquidity, and limited suspensions of gold convertibility for banknotes and currency, were felt for only a few months in each of the years 1873, 1884, 1893, and 1907. At most a year's worth of "panic" was felt over a forty-year span (1867–1907), which hardly justifies declaring free banking a failure and central banking a necessity. Nevertheless, these panics caused some financial losses and provided an excuse for those seeking more radical (statist) "reforms"—especially the Panic of 1907. Although it wasn't the most severe or even the lengthiest of the four panics, it triggered calls for legislative action, which soon led to passage of the Aldrich-Vreeland Act (1908). Among other things, the Act established a National Monetary Commission to study other central banks and determine whether the United States should have one too. The commissioners were politicians, many of them so-called "progressives," and they invited monetary experts to opine on the benefits of central banking.

Perversely, the "inelastic" currency, hence the occasional money panics in the late-19th-century American financial system, was caused by a set of regulations that had been designed specifically to assist the U.S. government with its financing requirements during the Civil War (1861–1865). This perversity is explained, in large part, by the government-financing theory of central banking. From 1862 to 1864, amid large wartime outlays and insufficient tax revenues, the United States went off the gold standard; demanded that the banks send their gold reserves to the Treasury; issued massive sums of pure paper money ("greenbacks"); began borrowing by issuing U.S. treasury bonds; and, by means of mandates embedded in a National Currency Act and National Bank Act, compelled banks to purchase the bonds. The ostensible aim of this last provision was to ensure the safety of bank currency in the event of a bank failure (by providing "collateral" in the form of government bonds). But, in truth, the scheme was designed to compel private banks to purchase U.S. treasury bonds and thereby help the government plug its unprecedented fiscal gap.

To its credit, the U.S. government after 1865 repealed most of its Civil War interventions and even returned to the gold standard in 1879. But to its demerit, the government also refused to abandon the wartime bond-collateral provision for bank currency; consequently, over the four subsequent decades, the volume of private bank currency was tethered to the level of U.S. government debt instead of being free to move flexibly in tandem with gold flows, depositors' liquidity preferences, and commercial loan demand. Banking laws also mandated that banks had to hold a minimum level of cash reserves as backing for checking deposits;

by definition that meant the cash was frozen and immobilized, not free to be released to depositors who might demand it. Bank vaults were often stuffed with legally mandated cash piles even as depositors crowded into bank lobbies in all-out scrambles for liquidity. When the U.S. economy expanded in the 1870s, 1880s, and 1890s, demand for currency increased, especially during harvest seasons. But banks could not accommodate the demand, because their currencies had to be tied to the supply of government bonds; and the national debt was plummeting by 60 percent during this time, due to a string of annual budget surpluses. An expanding economy demanded an expanded cash supply, but vestiges of a policy designed to satisfy government fiscal needs made currency both scarce and inflexible. Although key provisions of the Aldrich-Vreeland Act (1908) acknowledged the problem and partially loosened these bond-collateral provisions, effectively precluding further money panics, the juggernaut that that same Act had launched, in favor of a central bank (for which Marxist progressives had long yearned), could not be stopped.

Instead of creating a central bank in 1913, the U.S. Congress should have simply repealed the laws that mandated an inelastic currency.[19] But pro-central bank studies from the National Monetary Commission and mounting political pressure led to legislation that, in late 1913, created the Federal Reserve. Twenty years later, after punitive Fed policies had triggered the stock-price crash of 1929, massive bank runs, a deepening of the depression in the 1930s, and tragic suspension of the gold standard, Fed currency was made the exclusive legal tender. Thereafter no private bank currency circulated in the United States.

In recent decades—and especially since the abandonment of the last form of gold-based national monies, in 1971—major central banks, operating in the context of high-spending, full-fledged welfare states, have seen their government bond holdings and money supplies race upward in near-lockstep with higher rates of government deficit-spending and debt issuance.

Today it should be clearer than ever that central banks are assisting profligate governments in financing their stupendous expenditures while trying to keep interest rates as close to zero as possible (a policy known as "financial repression").[20] Amid such ominous trends, central bank practitioners and the majority of economists who defend them keep insisting that central banking remains superior to any system of free banking based on the gold standard, that present-day central bank policies continue to aim—successfully—at fighting inflation, smoothing the business cycle, maximizing employment, and squelching financial crises. Such claims are straight from the "progressive" playbook. The relevant section of the Federal Reserve Act of 1913 (section 2A), as amended, reads as follows:

> The Board of Governors of the Federal Reserve System and the Federal Open Market Committee shall maintain long-run growth of the monetary and credit aggregates commensurate with the economy's long-run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates.

Interestingly, however, the Act includes the following as well:

> Nothing in this Act shall be interpreted to require that the objectives and plans with respect to the ranges of growth or diminution of the monetary and credit aggregates disclosed in the reports submitted under this section be achieved.[21]

As with other central banks, it is true that the Fed has worked to "maintain long run growth of the monetary and credit aggregates," but only because it has been committed, for so long, to aggressively expanding the money supply, mainly to purchase (or "monetize") government debt securities; additionally, by means of inflation, the Fed reduces the real value of debts owed. Thus it is not true that the Fed has increased the money supply "commensurate with the economy's long-run potential to increase production"; indeed, its policies over the long term have debased the dollar's purchasing power, eroded the financial health of the banking system, and undermined the vitality and prosperity of the economy. Fed policies have not delivered "stable prices" or "maximum employment" or even "moderate long-term interest rates." On all important and positive measures of performance, the Fed has failed, as have other central banks.[22]

But this should come as no surprise. The Federal Reserve Act says that "nothing in this Act shall be interpreted to require" that the Fed's objectives regarding money and credit actually "be achieved." Why does the Act say that its stated goals need not be achieved? The goals sound nice, but they are not any central bank's actual goals; or, if some apologists still pretend they are, the goals are simply not those that are achievable—as is the case, we know, of all types of central-planning goals.

Moving beyond the specific acts of particular central banks, a broad theme emerges from ample evidence: Central banks exist to fund profligate governments. This explains both their origin and subsequent evolution. Significantly, one of the most-debated topics among monetary economists in recent decades has been the "independence" (or lack thereof) of central banks, or the extent to which they are beholden to the financing demands of the governments that sponsor them.[23] The more independent a central bank, it is shown, the better is its performance, and vice versa. But why should a central bank be independent if it exists essentially to finance the profligate state? Most economists today presume that central banks and the governments that sponsor them hold sound money, prosperity, and liberty as top priorities; yet each such value has eroded with every passing decade. In one astute account of the fiscal-financing theory of central banking, written the year before the Fed was established in 1913, Ludwig von Mises related the phenomenon to the nature of unlimited government:

> A government always finds itself obliged to resort to inflationary measures when it cannot negotiate loans and dare not levy taxes, because it has reason to fear that it will forfeit approval of the policy it is following if it reveals too soon the financial and general economic consequences of that policy. . . . [Inflationary finance] makes possible the continued existence of a system of government that would have no hope of the consent of the people if the circumstance were clearly laid before them. That is the political function of inflation. . . . When governments do not think it necessary to accommodate their expenditures to their revenue and arrogate to themselves the right of making up the deficit by issuing notes, their ideology is merely a disguised absolutism [by which Von Mises means statism].[24]

Central banking is best conceived as a form of central planning, as extended specifically to the realm money and banking. Central banks, in essence, exist primarily to facilitate growth in unlimited, fiscally profligate governments. Despite the usual rhetoric of central bank officials and their apologists, this statist monetary system does not exist to ensure truly sound money, safe banking, or a smoothly running economy; indeed, central banking undermines these crucial values. Recent, vast expansions in central banking powers, which have coincided with equally vast expansions in the size, scope, and cost of government, have the aim of assisting governments in their reckless deficit spending. By now the true purpose of central banking should be more obvious than ever. If, as I argue, the ultimate purpose of central banking is to help finance the fiscally unrestrained government that sponsors it, then the system cannot be truly restrained or ended unless unlimited government itself is ended. In short, we cannot enjoy gold-based money and banking without a liberty-based politics.[25]

In Part II of this essay, which will be published in the Summer 2013 issue of *The Objective Standard*, I will make the positive case for free banking based on a market-driven gold standard; show how such a system is consonant with the principles of constitutionally limited government; and explain how, with sufficient intellectual support, the Federal Reserve (and, by implication, other central banks) can be safely and swiftly phased out to make way for a free, economically sound monetary system.

Endnotes

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