Functions of a Central Bank

- Sound currency and banking;
- Lender of last resort;
- Monetary policy.

In history the functions developed in this order.

Sound Currency and Banking

Sound currency and banking refers to two goals:

- Stable value for the currency;
- To prevent excessive lending and risk-taking by banks.

Lender of Last Resort

The central bank acts as the *lender of last resort* to prevent a bank crisis. In a crisis banks may contract their lending and the money supply falls, which could push the economy into recession or worse. For the central bank to increase its lending to the banking system may then counteract this contraction.

Monetary Policy

Monetary policy to change the money supply or the interest rate may counteract recession or inflation.

The idea that the government has the ability and the obligation to counteract the business cycle did not take root until after the 1936 publication of Keynes's *General Theory of Employment, Interest, and Money* [2].

Bank of England

The Bank of England—the central bank of the United Kingdom—was established as a profit-making company in 1694. In exchange for making a loan to the new king William of Orange, it received a royal charter for banking. Using the bonds as backing, it issued bank notes, thus receiving both the interest on the bonds and the seigniorage of the bank notes.

The people gradually gained confidence in the bank notes, but overissue was a problem at times. The Bank Charter Act of 1844 regulated the note issue by the Bank of England.

The Bank Rate

The *Bank Rate* is the tool of monetary policy of the Bank of England. It sets the Bank Rate, and the large banks can borrow from it at this interest rate. Consequently the Bank Rate sets the market interest rate in the country.

Federal Reserve

The United States did not have a central bank until the Federal Reserve was created by the federal government in 1913.

First Bank of the United States

The First Bank of the United States was a private bank chartered by the federal government for 1791-1811. The bank was banker for the government, and policed the note issue of other banks by presenting bank notes for payment in specie.

The bank had political opponents, and the charter was not extended. One complaint was the concentration of power in the bank. Another complaint was its actions to keep money sound—some preferred inflation.

Second Bank of the United States

The Second Bank of the United States (1816-1836) was similar.

Money Supply Not Controlled

Because there was no central bank, the money supply was not controlled:

- During the business cycle, the money supply was procyclical, up in the boom and down in recession; the pattern aggravated the cycle.
- The money supply did not vary seasonally. The money supply did not rise at Christmas, even though the demand for money was higher then.

Centralization of Power

When the Federal Reserve was established in 1913, it was anticipated that its power would be decentralized among the twelve regional Federal Reserve Banks. The New York Fed was the most powerful, since New York is the banking and financial center.

During the Great Depression the power was centralized in Washington in the Board of Governors.

Early Failures of the Fed

Many see the Fed as unsuccessful in its monetary policy.

Recession after World War I

After World War I, the economy had a short but sharp recession 1920-1921, and many banks failed.

Stock Bubble of 1929

In 1929 stock prices doubled from January to September, and then crashed in October, falling 50%.

The Fed took no action to counteract the speculation.

Great Depression

The bank panic of the Great Depression caused bank runs and bankruptcies. Half of the nation's banks failed, and bank lending contracted.

The Fed failed to act as lender of last resort and the nominal money supply fell by a third.

Although there is a chicken/egg controversy whether the bank panic caused the Depression or resulted from the Depression, that the Fed acted weakly was a mistake. Many economists believe that the Fed could have kept the recession starting in 1929 from turning into depression.

References

[1] John Kenneth Galbraith. *Money: Whence It Came, Where It Went*. Houghton Mifflin, Boston, 1975. HG231G35.

[2] John Maynard Keynes. *The General Theory of Employment, Interest, and Money*. Macmillan, London, 1936. HB171K45.