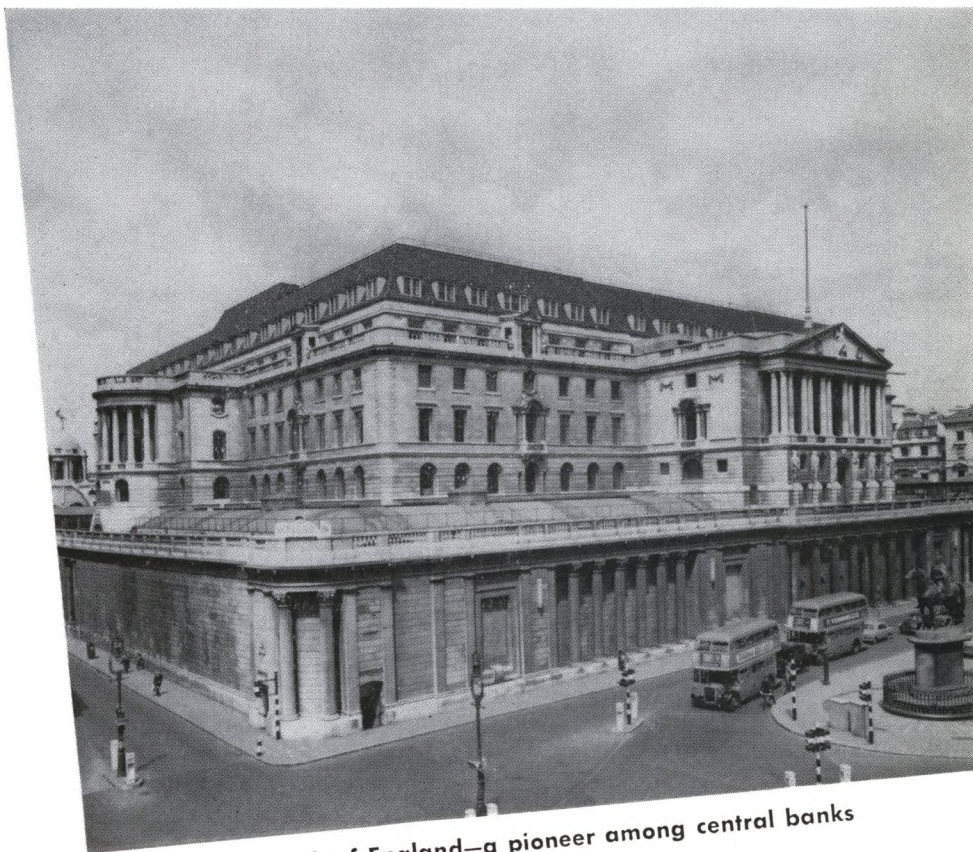


# MONTHLY REVIEW



*The Bank of England—a pioneer among central banks*

**FEDERAL RESERVE BANK OF RICHMOND**

**APRIL 1962**

## *Nature and Characteristics of . . .*

# CENTRAL BANKS

In every major country of the world the central bank is the central arch of the monetary and financial system. Its activities are essential to the proper functioning of the private economy and indispensable to the fiscal operations of the national government. Yet the central bank is usually taken for granted. Even among those who frequently come into contact with its operations, only a very small minority has a full understanding of what a central bank is, what it does, and why. Often there are illusions and misunderstandings as to the purposes and functions of central banks and confusion or imperfect understanding of the differences between a central bank and a commercial bank.

This article is the first of a series planned for this *Review*, the purpose of which is to explain in simple terms the nature, characteristics, and functions of central banks and the rationale behind them. Attention will be centered on broad, general characteristics and functions. Any given statement may not be true of a particular bank since no two central banks are exactly alike. From time to time special attention will be directed to the Federal Reserve System as the central banking organization of the United States.

### **A GLANCE AT HISTORY**

It is reported that on one occasion Will Rogers said: "There have been three great inventions since the beginning of time: fire, the wheel, and central banking." He may have been kidding when he said this, for it is doubtful if central banking belongs in such exalted company. But it is true that the central bank is one of the most useful institutions modern man has developed to help him manage his collective financial affairs.

Although the roots of some central banks go back

200 years or more, central banking as we know it today is mostly a recent development. Some would contend that it is almost entirely a product of the twentieth century. In 1900 not a single central bank existed in the Western Hemisphere. The Federal Reserve System was not created until 1913 and the Bank of Canada did not appear on the scene until 1934. Now every independent nation in the hemisphere except one has its own central bank. According to available information, there are now 88 central banks in the world. Of those, 47, or slightly more than half, have been established since 1940.

Several reasons account for this rapid growth in recent decades. Perhaps the most important is that there are a great many more independent nations in the world, each with its own monetary and banking system to be managed and supervised. Second, the nations of the world have almost entirely abandoned the international gold standard which provided some degree of automatic control over a country's monetary system. In the absence of that automatic control, a central bank is necessary to provide some conscious and discretionary control over monetary affairs. Third, monetary and banking systems are larger, more complex, and more technical than they were a century ago and for that reason they require closer and more effective controls. Finally, international financial relations are more important in the world today, and central banks are needed both to conduct or supervise those relations and to deal with any domestic disturbances they may create.

### **WHAT IS A CENTRAL BANK?**

It is not possible to give any brief definition of a central bank which will be both comprehensive and accurate. To a considerable extent the nature of a



### Board of Governors of the Federal Reserve System

central bank depends on its functions and those functions vary from country to country and from time to time. Many central banks, especially the earlier ones, accumulated their functions as they went along; like Topsy, they “just grew.” Nevertheless, it is proper to say that today any full-fledged central bank must perform at least three broad functions: it must be a bankers’ bank, it must act as fiscal agent for the national government, and it must manage the nation’s monetary system. These functions will be discussed in some detail in later articles, but they will be briefly described here.

**A Bank for Bankers** Under the first two groups of activities, a central bank performs for the commercial banking system and for the national government the basic functions which the commercial banking system performs for individuals and business firms. As a bankers’ bank it holds the reserves of commercial banks, clears and collects checks, distributes currency and coins to the banks, makes short-term advances to banks under certain conditions, and acts as “the lender of last resort” (see this *Review*, February 1961). Further, the central bank may, and usually does, exercise some degree of supervision and regulation over the activities of commercial banks, although this is not essential to the central banking function.

**Banker for the Government** In its capacity as fiscal agent the central bank receives, holds, transfers, and pays out the funds of the national government. In addition, it receives and allots subscriptions to new security issues, makes exchanges of securities, redeems interest coupons and maturing securities, and, under certain conditions, makes short-term advances to the government. In almost all

countries the central bank is the principal financial adviser or consultant to the government and in some cases it actually manages the public debt.

**Manager of the Monetary System** Perhaps the most distinguishing function of a central bank is control of the nation’s money and banking system. One authority opens a treatise on central banking with these words: “The essence of central banking is discretionary control of the monetary system.” In performing this function, central banks exercise one of the prerogatives and powers of the sovereign government. This means that the power must be exercised primarily for the achievement of national economic goals, and that a central bank is a public service organization, placing the national interest above any consideration of its own profit or welfare.

In acting as a bankers’ bank and as manager of the country’s monetary system, a central bank frequently creates money. It does this when it makes an advance to a bank or buys securities in the open market. The money thus created is “high-powered” money—money which the commercial banks count as reserves and on the basis of which they expand their deposits to an amount several times the amount created by the central bank.

**No Commercial Banking** To round out this brief definition, it is well to note one thing which a central bank does *not* do. Although there are exceptions, central banks ordinarily do not conduct a commercial banking business for the general public. In fact, individuals and private business firms (except commercial banks and a few security dealers) seldom if ever deal directly with central banks. This probably is a major reason why the public generally is not well acquainted with central bank activities. It is custom-

arily regarded as inappropriate to mix central and commercial banking functions. The objectives and the methods of the two are quite different, and it might be difficult to keep the two activities properly separated. As noted below, the central bank places primary emphasis on the attainment of national economic goals while commercial banks necessarily put the major emphasis on running a profitable business. Further, if a central bank did engage in commercial banking, it would have an unfair advantage. For example, the central bank might have to examine and supervise its competitors. Naturally, this would tend to antagonize the commercial banks and would threaten their free cooperation, which is vitally necessary for successful central bank operations.

In summary, then, a central bank may be broadly defined as a public service organization which does not engage in commercial banking, but which functions rather as a bankers' bank, acts as fiscal agent and adviser for the national government, and manages the country's money and credit system.

#### CHARACTERISTICS OF CENTRAL BANKS

Although the characteristics of central banks vary widely, there are a few essential ones which are present in almost every important bank. These will be discussed under two broad headings: first, the place of the profit motive and, second, relationships with the national government.

**Place of the Profit Motive** One of the most important characteristics of a central bank, and the one which distinguishes it most sharply from a commercial bank, is that it must subordinate considerations of profit to its responsibility for public service. If a central bank were operated primarily for profit it would try to stay "loaned up," to make approximately all the loans, discounts, and investments its reserve position would permit. In many cases this would be inappropriate for two reasons. First, it would not allow the bank to give primary attention, as it should, to managing the country's money system in accordance with the changing needs of the nation's economy. It would always be exerting pressure to keep the money supply expanded as far as the legal provisions would allow. Such a policy would almost certainly create serious financial complications both domestically and internationally. Second, if the central bank is to function as a lender of last resort it must have some reserve lending power—some cushion—to meet extraordinary situations. This it could not do if it ordinarily stayed loaned up as far as its reserves permitted.

The fact that central banks do not place primary emphasis on making profits does not mean that they do not make profits. Quite the contrary: the power they have to acquire earning assets by creating money is a most lucrative source of profits.

**Disposition of Profits** If a central bank is entirely owned and controlled by the national government, as is frequently the case, there is no problem in curbing the profit motive, since governments do not conduct their operations for the purpose of making profits. But if some or all of the central bank stock is owned by private stockholders, it is usually considered necessary to place some limit on the return they can realize from the stock so as to discourage them from putting too much emphasis on earnings. This usually takes the form of placing a rigid limit on the dividends which can be paid on the stock of the bank. Any excess earnings are usually placed in a reserve fund or paid to the government as a tax or a franchise fee. This may be strengthened further by a provision that in case the bank should be liquidated, the stockholders would be paid the par value of their stock and any amount remaining would belong to the government. This prevents any possibility of stockholders benefiting from placing large amounts in reserves.

**Profits of the Federal Reserve System** The provisions governing the profits of the Federal Reserve System are perhaps typical of the above arrangements. The stock of the Federal Reserve Banks is owned by the member banks. The return on that stock is limited to an annual 6% cumulative dividend. After that dividend is paid, each Reserve Bank adds to its surplus any amount needed to bring its surplus up to twice the par value of its outstanding stock. All earnings remaining after this operation are paid to the Federal Government. This last payment is made not under the provisions of any law but under a regulation of the Board of Governors.

In 1961 the gross earnings of the 12 Reserve Banks were \$945 million (\$938 million from interest on U. S. Government securities, \$4 million from profit on sales of securities, and \$3 million from earnings on discounts and advances). Current expenses amounted to \$161 million, leaving net earnings of \$784 million. Of this amount, \$26 million was paid as dividends on the stock of the Reserve Banks, \$71 million was added to their surplus, and \$687 million was paid to the U. S. Government. Thus, the Federal Government received 73% of the gross earnings and 88% of the net earnings of the System. Over

the five years 1957-61, Federal Reserve payments to the Federal Treasury averaged \$712 million per year.

**Relationships with National Government** The relationships of central banks with their national governments vary widely but usually are broad, close, unique, and complex. They vary because in many cases they grew or evolved rather than being fashioned according to one common pattern. Thus, they were influenced by each country's conditions and developments. Many of the early banks which performed some central banking functions began as privately owned institutions, operated for private profit. With the passage of time they assumed more and more central bank functions, and the governments then insisted upon an increasing amount of government control. In a number of cases the government assumed complete ownership and control. Again, it must be remembered that these close relations developed because central banks exercise, as one of their most essential functions, one of the most important powers of a sovereign government—the power to create money.

In all cases the central bank operates under a special grant of power, usually embodied in a charter with various amendments and supplements. This legislation, of course, is enacted by the national parliament or congress and thus can be modified at any time. On some points this legislation is likely to be in fairly broad and general terms, allowing some room for interpretation. Further, as time passes new situations arise which were not contemplated in the original legislation, and some of these may not be covered by specific amendments to the law. As a result the relationships set forth in the original legislation are likely to be modified and supplemented somewhat by interpretation, precedent, and practice, so that actual operating relationships may vary from those originally established.

**Ownership and Control** As noted above, most of the early institutions which performed some central banking functions were privately owned. In contrast, nearly all of the banks created in recent years are owned entirely by the government, and governments have assumed ownership of some of the early ones. In addition, as related above, governments usually insist upon a large share of the profits, including the residual share. Also, the government is usually the residual claimant in case the bank should be liquidated.

Regardless of the extent to which the national government shares in ownership, it invariably participates in control. This usually takes the form of appointing the governing board or several of the top

officials. Where the government owns the bank completely, it, of course, has complete control and the only question that remains is how that control shall be exercised.

**Position in the Governmental Structure** The exact position which the central bank should occupy in the government has long been a delicate and difficult question. Since the bank exercises a major governmental power and since the government always exercises a considerable control over it and often owns it outright, why should the bank not be a regular government bureau, presumably in the treasury or the exchequer? That would seem to be the direct and simple solution, but history provides many warnings against it.

In the financial field the government exercises two major functions. The first is the fiscal function; it must raise the funds to cover the costs of the many activities it carries on. This is usually done by taxation, but taxes are unpleasant and politically unpopular. The second major function is that of providing an adequate and sound money system. The government has the sole power to control the creation of money. The immediate effect of increasing the money supply is likely to be widespread exhilaration and superficial prosperity for nearly everybody, whereas increased taxation is likely to have opposite effects. In the long run, however, inflating the money supply is a method of taxation and historical experience in many countries has shown that ultimately it is both inequitable and disastrous.

If a single authority within the government has control over both the fiscal and money functions there will always be the temptation to cover current expenditures by creating money rather than raising it through taxation. If the government is weak, incompetent, shortsighted, or beset with strong political forces, it is likely to take the easy route of inflation. The result is almost certain to be a steadily rising money supply and an uncontrolled inflation. Financial history affords scores of examples of the dangers of treating the central bank as just another government bureau.

Further, the highly specialized and technical operations which central banks engage in require a special relationship with commercial banks which few, if any, other government agencies have with firms in the private economy. These conditions cannot exist unless the central bank has some degree of individuality and autonomy.

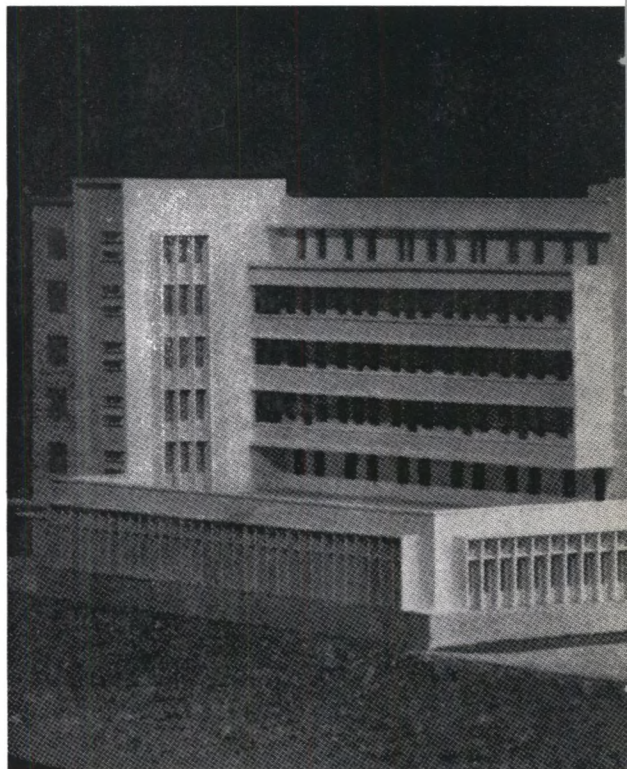
In addition, there is the fact that the government needs expert and politically impartial advice on financial matters. To provide such advice is one of

the major responsibilities of a central bank. Mr. Montagu Norman, regarded as one of the greatest Governors of the Bank of England, stated on one occasion: "I look upon the Bank as having the unique right to offer advice and to press such advice even to the point of nagging; but always of course subject

to the supreme authority of the government."

An astute observer of the American scene arrived at much the same conclusion: "It would not be tolerated to have a central bank . . . in the hands of private persons as distinguished from representatives of the people. The central bank is an instrument of

Top: left, Bank of Canada; center, State Bank of Pakistan; right, Banco Central de Venezuela



government and must always be so. However, it is not an instrument of the fiscal authority. What is needed is that the two authorities be represented by persons of equal rank; equality of rank is essential for effective cooperation. This should be recognized (1) by the fiscal and monetary authorities themselves

and (2) by Congress and the President and the general public.”

The advice, the persistence, and the equality of rank envisioned in these statements would not be available if the central bank were an ordinary government bureau.

Bottom: left, The Central Bank of China (Taiwan); center, Banque de France; right, Banca d'Italia

