Whose central bank?

By J. Bradford DeLong
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Broadly speaking, for at least 115 years (and possibly longer) – that is, at least since the publication of the Swedish economist Knut Wicksell's *Geldzins und Güterpreis* (Interest and Prices) in 1898 – economists have split into two camps with respect to what a central bank is and the purposes it should serve.

One camp, call it the Banking Camp, regards a central bank as a bank for bankers. Its clients are the banks; it is a place where banks can go to borrow money when they really need to; and its functions are to support the banking sector so that banks can make their proper profits as they go about their proper business. Above all, the central bank must ensure that the money supply is large enough that mere illiquidity, rather than insolvency, does not force banks into bankruptcy and liquidation.

The other camp, call it the Macroeconomic Camp, views central banks as stewards of the economy as a whole. A central bank's job is to uphold in practice Say's Law – the principle that output is balanced by demand, with neither too little demand to purchase what is produced (which would cause unemployment) nor too much (which would cause inflation) – because Say's Law certainly does not hold in theory. In other words, a central bank's primary responsibility is not to preserve the health of the firms that make up the banking sector, but rather to maintain the robust functioning of the economy as a whole.

In the United States, from September 15, 2008 – the day that the investment bank Lehman Brothers filed for bankruptcy – until then-US Treasury Secretary Tim Geithner announced in May 2009 that in his judgment the major US banks either had or could quickly raise adequate capital cushions, the two camps' interests and conclusions were identical. For both, reducing the imbalance between aggregate supply and aggregate demand required, first and foremost, preserving the banking system; and preserving the banking system required boosting aggregate demand to bring it closer to aggregate supply. There was a lot of bank rescue in economic stimulus; and there was a lot of economic stimulus in rescuing banks.

Thereafter, the two camps' interests and conclusions diverged sharply. A prolonged and sustained central-bank policy of keeping short-term Treasury nominal interest rates low is essential to keeping the many interest rate-sensitive components of aggregate demand from falling even further below potential aggregate supply. But, for investment banks, shadow banks, and especially commercial banks (with their expensive networks of branches and ATMs), such a policy makes it very difficult to report regular and healthy operating profits on their quarterly income statements and regular and healthy gains in their clients' portfolios.

A prolonged and sustained central bank policy of purchasing ever-increasing quantities of long-term assets is essential to encourage a wary financial sector to use some of its risk-bearing capacity for its proper purpose: reducing the risk burden on entrepreneurship and enterprise. But such a policy diminishes, and may even eliminate, financiers' ability to take the easy route by riding the duration yield curve for profits.

From the standpoint of balancing aggregate demand and potential aggregate supply, the central bank should start by simply issuing a straightforward statement that, five years after the crisis began, a 0-2% target for annual inflation clearly runs unwarranted downside employment risks, and a 2-4% target is called for. But, while such an announcement is an

obvious no-brainer for those in the Macroeconomic Camp, it would make all bankers who hold nominal assets or who think in nominal terms physically ill.

In terms of the US public interest – and that of the world – it is very important that whoever President Barack Obama nominates to succeed Federal Reserve Chairman Ben Bernanke when his term expires at the beginning of 2014 is from the Macroeconomic Camp. The world does not need a bankers' central banker any more today than it did five years ago.

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