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What to read to understand central banking

Four books and a paper on the most powerful wonks in the world

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FEW WORDS are listened to and scrutinised as closely as those uttered by central bankers. Those bankers control the steering wheel of the macroeconomy by setting interest rates and influencing expectations of their future levels. The first central bank, Sweden's Riksbank, was founded in 1668. The Bank of England was formed in 1694. Some countries only adopted one much later—America's Federal Reserve was created in 1913. The original purpose of central banks was to act as the government's lender, but over time they took on more roles. After several banking panics in the 1800s central banks began to act as lenders of last resort, a function famously described by Henry Thornton, a British banker and member of parliament and Walter Bagehot, an early editor of *The Economist*. Nowadays, most central banks focus on price and financial stability, while many also aim to achieve full employment. But as technology changes the way finance works, central banks' activities will evolve, too. These four books (and one paper) will guide you through the history of central banks, how they work now and where they might be headed.

Money Creation in the Modern Economy. By Michael McLeay, Amar Radia and Ryland Thomas of the Bank's Monetary Analysis Directorate. *Bank of England Quarterly Bulletin.* Q1, 2014.

This often-cited short paper lucidly explains how commercial banks create money and central banks influence that process. It dispels many common misconceptions about money. For instance, most introductory economic textbooks say that commercial banks lend out the money that savers deposit in them. In fact banks can lend money and create corresponding deposits even without savings flowing in–in other words, banks are quite literally creating "new money" when they make a loan and a corresponding deposit. This does not mean banks can lend with abandon. There are other constraints, such as the creditworthiness of borrowers, the interest rate at which banks lend which is influenced by the central bank and regulations on lending. Consider a consumer who buys an item from a vendor using money borrowed from a bank. The bank must settle the transaction with the vendor's bank using reserves held at the central bank. If the borrower never repays the loan, then the bank's reserves will not be replenished, reducing its ability to lend further.

Another common misconception is that the purpose of quantitative easing (QE), in which central banks buy assets from commercial banks in exchange for reserves, is to cause commercial banks to lend those reserves out to consumers. In fact central bank reserves cannot be lent to consumers. Instead, by increasing the level of reserves relative to banks' other assets, QE gives banks the incentive to take on more risk by purchasing other high-yielding assets, such as corporate bonds, which could stimulate economic activity. Read this paper for a precise description of the main concepts in modern central banking. Be warned: though short and well-written, it is dense.

The Man Who Knew: The Life & Times of Alan Greenspan. By Sebastian Mallaby. *Penguin; 800 pages; $22. Bloomsbury; £16.99*

Alan Greenspan, chairman of America's Federal Reserve from 1987 to 2006, is one of the most controversial central bankers of all. His tenure included one of the longest periods of low inflation and solid growth in American history—later called the "Great Moderation". But he also presided over the buildup of risks that led to the financial crisis of 2007-09. Sebastian Mallaby (a former *Economist* correspondent and husband of our editor-in-chief) provides a deeply critical but ultimately sympathetic portrayal of this polarising figure.

The book, published in 2016, goes to lengths to understand Mr Greenspan's psychology, not only his adventures in the halls of power. He was once a jazz musician, loves tennis and counts Ayn Rand as a major intellectual influence—Mr Greenspan introduced her to President Gerald Ford. It assesses what Mr Greenspan's career might tell us about the Fed's response to the mortgage bubble of the 2000s. Contrary to common perception, he was not married to simple economic models and had no fantasies about "efficient markets" or "rational behaviour". Instead he had a keen eye for economic data and stressed the importance of finance to the economy before it became vogue after the crisis. His mistake, then, was in miscalculating how risks in the mortgage market could be systemically harmful. The book offers an explanation for this: over his career he had been able to prevent many bubbles from causing widespread harm, such as in the panic of 1987, so he paid less attention to the buildup of risks in the 2000s. However, he was less than decisive in quelling the risks he *was* aware of. As Mr Mallaby puts it: "Greenspan was the man who knew. He was not the man who acted." Read a longer review by Martin Wolf published in *The Economist*.

The Courage to Act: A Memoir of a Crisis and its Aftermath. By Ben Bernanke

The Courage to Act: A Memoir of a Crisis and its Aftermath. By Ben Bernanke. *W.W. Norton; 640 pages; $19.95 and £14.99*

Ben Bernanke succeeded Mr Greenspan at the helm of the Fed just before the financial crisis of 2007-09. His memoir, published in 2015, is a riveting personal account and intellectual exploration of the financial crisis. When Mr Bernanke asked Mr Greenspan for advice on being the Fed chair, the former chairman apparently offered only one suggestion: have a view of a clock in meetings to ensure they end on time. Most of the book is devoted to the crisis. Mr Bernanke describes several big events in detail, including the bailout of Bear Stearns and the bankruptcy of Lehman Brothers. The book is peppered with his characteristic academic and historical analysis. He is quick to admit that (like others) he did not foresee the systemic effects of risks in the mortgage market. Yet he defends his record, saying that he averted "financial and economic collapse."

Perhaps his biggest legacy is bringing academic ideas to the Fed. In board meetings he broke the chairman's convention of speaking first, to encourage more open discussion. His research on transparency in central-bank communication informed his use of "forward guidance"—saying how monetary policy will be set in future, in order to influence market expectations. Most important was his widespread use of unconventional monetary-policy tools, namely quantitative easing, the large-scale purchase of assets like government debt (though Mr Bernanke prefers the term "credit easing"). This tool, which aims to affect long-term interest rates, is now widely used throughout the world. Read our full review of the book.

Lombard Street: A Description of the Money Market. By Walter Bagehot. *White Crane Publishing; 232 pages; $8.99. John Wiley & Sons; £15.99*

Written in 1873 but still relevant, "Lombard Street" is a book that analyses in simple language the Bank of England's role in the British monetary system. It is also where Bagehot provides his famous description of the central bank as lender of last resort. At the time, Britain was on the gold standard: money was redeemable for gold at a fixed rate. This constrained the Bank of England's ability to inject funds into the banking system. Bagehot's solution was a high rate of interest and ensuring good collateral. He lamented the concentrated system that inhibited the competition of many regional banks, though he was pragmatic enough to acknowledge an overhaul was not sensible.

This is not a practical guide for today's central bankers. It was written long before "fiat" money (money not backed by a commodity), computers and the economic frameworks that modern central bankers deploy. Yet it contains nuggets of wisdom that have stood the test of time. Mr Bernanke refers to Bagehot in at least eight chapters of his memoir and kept the book in his office at the Fed. Bagehot's pithy prose helps to emphasise one of its core points: that central banks should be transparent about their guiding principles. Even today this is true. For instance, in 2012 the Fed publicly acknowledged the 2% inflation target it had implicitly pursued for years. Bagehot's classic book should be required reading for students of financial history.

The Future of Money. By Eswar Prasad. *Belknap Press; 496 pages; $35 and £28.95*

This book is a comprehensive look at the future of the financial system, including the impact of new financial-technology firms or that of digital currencies. For a deep dive on what all this means for central banking, focus on chapters six to nine. Eswar Prasad pays particular attention to central bank digital currencies (CBDCs), a form of "digital cash" which consumers hold in accounts at their country's central bank rather than at commercial banks. He surveys the world's CBDCs, from the Bahamian Sand Dollar to China's e-CNY, and even considers newfangled monetary systems organised around, say, a global digital currency. The book is at its best when laying out the pros and cons of different proposals, rigorously yet understandably. It walks through unconventional monetary policies from negative interest rates to "helicopter drops" of cash to consumers. Such drops might have been useful at the start of the pandemic—payments to millions of Americans were heavily delayed or never showed up. Yet Mr Prasad is realistic about the risks of digital currencies. For instance, they are ripe for social engineering: governments could dictate the types of goods and services they might be spent on. Read our review of this fascinating book.

Also try:

"A Monetary History of the United States, 1867-1960" by Milton Friedman and Anna Schwartz. This classic, published in 1963, provided the intellectual foundations for monetarism, a popular school of economic thought.

"The Fed and Lehman Brothers: Setting the Record Straight on a Financial Disaster" by Lawrence Ball. This book, published in 2018, makes a compelling case that the Fed could have bailed out Lehman Brothers in 2008, but that fear of a political backlash and an underestimation of how bad the investment bank's bankruptcy would be prevented it from acting. Mr Bernanke would disagree. ■