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End the Fed? A not-so-crazy idea.

Congressman Ron Paul's bill may never pass, but history suggests the US economy would be better off without the Federal Reserve.

By George Selgin

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Since it was introduced in February, Representative Ron Paul's "Audit the Fed" bill (H.R. 1207) has gained 282 congressional cosponsors. If adopted, the bill would allow the Government Accountability Office to review, not only the Federal Reserve's balance sheet, but its recent monetary policy deliberations and transactions.

Fed Chairman Ben Bernanke opposes the plan, saying it would undermine the Fed's hallowed independence.

But Mr. Paul, a noted libertarian who ran for president last year, also wants to keep the Fed out of Congress's clutches – by scrapping it altogether. That's the goal of his follow-up Federal Reserve Board Abolition Act (H.R. 833). Although that measure has yet to gain a single cosponsor, it has plenty of grass-roots support, and Paul hopes that members of Congress will jump on the bandwagon once their eyes are opened by a no-holds-barred audit.

Wacky stuff? Well, if not having a ghost of a chance is enough to make a bill bonkers, Paul's measure probably qualifies. But that doesn't mean you've got to be crazy to believe that the US economy would be better off without the Fed.

The Fed's apologists suggest otherwise, of course. They note that the US spent nearly half the years between 1854 to 1913 in recession, as opposed to just 21 percent of the time since the Fed's establishment in 1913. Who would want to go back to those bad old days?

But consider: the US economy has actually grown less rapidly since 1914 than it did before. And inflation has been much worse, despite both the Civil War, which featured the nation's worst inflation, and the Great Depression, which featured its severest deflation!

What's more, the frequent downturns before 1914 were due, not to the lack of a central bank, but to foolish government regulations. Topping the list were bans on branch banking, initiated by state governments and then incorporated into federal banking law. The bans propped up thousands of undercapitalized and under-diversified banks – banks unfit to survive major local shocks, let alone macroeconomics ones. They also caused bank notes – competitively supplied counterparts of today's

Federal Reserve notes – to trade at discounts whenever they traveled far from the solitary offices of banks that issued them.

During the Civil War, state bank notes were taxed out of existence to make way for those of new national banks. Because national banks had to accept one another's notes at full value, their currency was uniform. But national bank notes had to be backed by government bonds.

That requirement, designed to bolster the Union's finances while the war raged on, proved disastrous afterward, when government surpluses led to a halving of the federal debt, and to a corresponding shortage of bonds for securing bank notes. The resulting currency panics – in 1873, 1884, 1893, and 1907 – prompted the Fed's establishment.

But they didn't have to. Until 1907, prominent reformers favored simply abolishing Civil War-era restrictions on banks' freedom to issue notes and allowing all banks to branch nationwide to ease the mopping-up of unwanted paper money.

They drew inspiration from Canada, where a similar "asset currency" arrangement had been working smoothly for decades. Between the panic of 1893 and that of 1907, Congress considered more than a dozen "asset currency" measures But none got anywhere, thanks to local bankers' determination to block any proposal for branch banking that would threaten their cozy monopolies.

It was only once these deregulatory efforts failed that reformers fell back on the plan of establishing a "central reserve bank." The resulting Federal Reserve Act was, in essence, merely a plan to allow 12 new banks to do what other banks were prevented from doing themselves, namely, establish branch networks and issue currency backed by commercial assets.

But the Federal Reserve plan proved to be a poor substitute for deregulation. By granting monopoly privileges to the Federal Reserve banks, it allowed them to inflate recklessly: By 1919, the US inflation rate, which had cleaved close to zero ever since the Civil War, was close to 20 percent! Yet the Fed was also capable of failing to supply enough money to avert crises. The first downturn over which it presided – that of 1921 – was among the sharpest in US history. Still it was nothing compared to the unprecedented monetary contraction of 1929-1933.

Would asset currency have been any better? Canada's was: Between 1929 and 1933, for instance, 6,000 US banks failed, and a third of the US money stock was wiped out. In contrast, and despite a fixed Canadian-US dollar exchange rate, Canada's money stock shrank by just 13 percent, and no Canadian bank failed.

Notwithstanding this superior outcome, the Canadian government itself abandoned asset currency in favor of central banking in 1935, to placate a growing Canadian movement for easy money.

So a call to end the Fed would have been anything but crazy in 1934. Three-quarters of a century and a dozen crises later, there are plenty of grounds for insisting that it hasn't gotten any crazier.

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