Forbes

100 Years Later, Was The Federal Reserve A Good Idea?

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November 13, 2013

With the Fed in its centennial year, Janet Yellen facing confirmation hearings in the Senate, and questions swirling over whether the Fed will enact "tapering," many monetary scholars are asking: Was the Fed a good idea?

Not since the Great Inflation of the early 1980s has the Fed been so controversial. Its causal role in the housing boom and bust remains contentious. Other factors aside, the Fed was a poor overseer of the safety and soundness of the financial system. At best, the central bank was a passive bystander during the boom and early stages of the housing bust; it couldn't even accept that we were in the midst of nationwide housing downturn.

Certainly, the Fed has made many mistakes, but the current era of big government precludes any near-term possibility of abolishing it, as some would hope. However, it can be improved. At a minimum, the Fed needs to be much more rule-bound. Targeting nominal GDP (the dollar value of all goods and services produced in the United States, not adjusted for inflation) would be one such rule. That policy would have the advantage of moving the Fed away from targeting a real variable, like employment.

Monetary policy cannot over the medium- to long-term systematically influence real variables, like the number of jobs created. Even in the short run, monetary policy's track record is mixed at best. Witness the Fed's inability to generate a normal economic recovery – especially in employment – despite unconventional monetary policy. In contrast, nominal GDP targeting lets the market determine the composition of output and price changes for a given rate of growth of nominal output. In many versions, nominal GDP growth is targeted at five percent annually, with the expectation that over the long run, real output will grow at a trend rate of three percent and prices at two percent on average.

Other scholars support free banking, or banking without a central bank trying to steer the economy, or a return to a gold or alternative commodity standard. These positions overlap, and taken together are perhaps the most viable alternative to central banking.

It’s not just monetary scholars looking for change in the Fed. Representative Kevin Brady (R-TX) has offered legislation for a national monetary commission to consider reforms to the Fed. This legislation offers an important first step toward needed reform.

There are those who likely don’t see the need for reform, but a look a the Fed’s unenviable performance over the past one hundred years shows how clearly its needed. On its watch, America endured the Great Depression, the Great Inflation and the Great Recession. Even excluding the Great Depression, real output has been no more stable than in the pre-Fed era.

In fact, the years of monetary stability under the Fed have been comparatively few. There was a period of notable prosperity in the 1920s, where the Fed was constrained by the post-war, modified gold standard and benefitted by the sound economic and fiscal policies of the Harding and Coolidge administrations. Then, inflation remained low after the end of the Korean War. While some attribute that to the Fed’s acquiring independence from the Treasury, it was more due more to President Eisenhower’s aversion to deficit spending that anything else.

Finally, there has been what is called the Great Moderation, from approximately the late-1980s through the first part of the 2000s. There were some exciting events during those roughly two decades, such as the 1987 stock-market crash and recessions, but it certainly looks good in retrospect. Some argue the Great Moderation came about because the Fed was also rule-bound, by the Taylor rule.

Looking at history to help today’s policy making shows that when the Fed had conservative fiscal administrations and were bound by rules, America’s economy did better. The big question is whether the Fed has outlived its purpose and competitive banking and a commodity standard should take its place. There are no near-term prospects for ending the Fed. Longer term, it would a formidable but not impossible. Whether that particular goal is achievable, fundamental monetary reform is a necessity.