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# The failed Fed

*A central bank vulnerable to political pressure was never intended*

By Richard Rahn - November 18, 2013

“I wouldn’t start here if I were you,” is the punch line of an old Irish joke, which monetary scholar Kevin Dowd cites to illustrate the deeper and deeper hole the Federal Reserve is getting us into.

Mr. Dowd, in a paper delivered last week at the Cato Institute’s 31st annual Monetary Conference, concluded: “The modern financial system has not only kicked away most of the constraints against excessive risk-taking, but positively incentivized systemic risk-taking in all manner of highly destructive ways . We have gone from a system that managed itself to one that requires management, but cannot be managed. We have gone from a system that was guarded by market forces operating under the rule of law to one that requires human guardians instead — but we have not solved the underlying problem of how to guard the guardians themselves.” These last two lines could equally be applied to Obamacare, because both are examples of F.A. Hayek’s description of the “fatal conceit” so often exhibited by those who believe in government more than markets.

Speakers at the monetary conference included current and past Fed bank presidents, other former senior Fed officials, members of Congress and noted monetary scholars. All concluded that the Fed has gone well beyond its original mandate and has had a long record of failure, owing not only to its own misjudgments, but also as a result of pressures by various administrations and Congress to do the wrong thing.

The Fed was originally established to be a lender of last resort to stop bank runs, a payments’ processor to clear checks, and an issuer of a uniform national currency (rather than have individual banks issue bank notes). From this limited beginning, it quickly evolved into a full-fledged central bank. The list of failures is long. Once the United States went off the gold standard, the Fed was charged with maintaining the value of the currency — yet the dollar is only worth roughly one-twenty-third of what it was worth when the Fed went into operation a hundred years ago. The Fed is supposed to maintain full employment, which cannot be done by monetary policy alone when excessive government spending, taxing and regulations sap the vitality out of the economy. The Fed has been given powers to regulate banks and, most recently, to “protect consumers,” which is undefined and infinitely elastic.

A former president of the Cleveland Federal Reserve Bank, Jerry Jordan, explained the fundamental dilemma. “The existence, per se, of central banks with discretionary powers in a fiat-currency world creates moral hazard in the financial system. Because of the explicit and implicit ‘safety net’ offered by the existence of central banks, private financial institutions cannot be observed behaving as they would in absence of moral hazard. Because of moral hazard in the financial system — privatization of gains from risky decisions and socialization of the losses — the trend has been toward ever more regulations and calls for closer supervision of financial companies. The resulting 'permission-and-denial' regime opens ever wider the door to crony capitalism in the financial system."

Again, to quote Mr. Jordan, "In the beginning, the U.S. central bank was supposed to be a 'lender of last resort.' But even after almost 100 years, there are no established rules for providing this safety net. No one can say who will and who will not be bailed out in the future."

Other central banks are not immune to the same forces that are pushing the Fed into an ultimate death spiral. Ever-increasing debt as a percentage of gross domestic product by most countries, coupled with ever-increasing global financial regulation, means the global banking and financial system becomes less and less efficient. Central banks have become the enablers of destructive fiscal policies by buying endless quantities of government debt, rather than disciplinarians — because, in the end, they cater to irresponsible politicians. The idea of central bank "independence" is a myth. Former Fed Chairman Arthur Burns is reported to have said, "We dare not exercise our independence for fear of losing it." Even if it were not a myth, there is no reason to think that the decision-makers in central banks can see the future any better or are wiser than markets. The evidence is to the contrary.

The fact is we do not need a central bank. Many eminent monetary and financial scholars both past — such as Friedrich Hayek, Ludwig von Mises and Milton Friedman — and present — such as Richard Timberlake, Lawrence White, George Selgin, Gerald O'Driscoll (all of whom spoke at the conference) and former International Monetary Fund official Warren Coats — have explained better ways of running a monetary system, including a return to the gold standard.

Janet Yellen appeared last week before the Senate for her confirmation hearing as new Fed chairman. The essence of her testimony was that the Fed will continue on course to keep buying government debt as long as there is less-than-full employment, and she is a very smart lady, so trust her. No doubt Ms. Yellen is smart and well-intentioned, but so are many other smart people who see the world very differently. The choice is a system based on a few "smart" people who are subject to political pressure, or one based on free markets — you choose.