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"F" as in Fed

The dismal history of a central bank.

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Arr! 12 personnes aime ça.

The Federal Reserve, America's fatally conceited monetary central planner, is not terribly popular these days – which is cause for hope – and now we have a report card on the entire Fed era that strongly supports the view that we'd be better off without it. At the very least, as the authors suggest, the burden of proof is squarely on those who would retain the central bank.

The report card comes in the form of a working paper from the Cato Institute: "Has the Fed Been a Failure?" by George A. Selgin, William D. Lastrapes, and Lawrence H. White. (White, of course, is a *Freeman* contributing editor and regular lecturer at FEE's Advanced Austrian Economics Seminar. Click here for a podcast of an interview on the paper with Selgin.)

The authors state in their abstract:

> As the one-hundredth anniversary of the 1913 Federal Reserve Act approaches, we assess whether the nation's experiment with the Federal Reserve has been a success or a failure. Drawing on a wide range of recent empirical research, we find the following: (1) The Fed's full history (1914 to present) has been characterized by more rather than fewer symptoms of monetary and macroeconomic instability than the decades leading to the Fed's establishment. (2) While the Fed's performance has undoubtedly improved since World War II, even its postwar performance has not clearly surpassed that of its undoubtedly flawed predecessor, the National Banking system, before World War I. (3) Some proposed alternative arrangements might plausibly do better than the Fed as presently constituted. We conclude that the need for a systematic exploration of alternatives to the established monetary system is as pressing today as it was a century ago.

In light of the Fed's defined mission — monetary support for economic growth, stable prices, maximum employment — the authors use the following criteria to assess its record: "the relative extent of pre- and post-Federal Reserve Act price level changes, pre- and post-Federal Reserve Act output fluctuations and business recessions, and pre-and post-Federal Reserve Act financial crises." The Fed has done poorly on every count. No one familiar with the Mises-Hayek critique of central planning will be surprised. Central banking is not equivalent to comprehensive planning of the economy, but money is the most pervasive good and monetary engineers suffer the same insurmountable ignorance as any central planner.

I can only hit the paper's highlights here.

Inflation

Selgin et al. pronounce the Fed a dismal failure in controlling inflation. "[F]ar from achieving long-run price stability, it has allowed the purchasing power of the U.S. dollar, which was hardly different on the eve of the Fed's creation from what it had been at the time of the dollar's establishment as the official U.S. monetary unit, to fall dramatically."

This is truly astounding. The value of the dollar was essentially stable from the late eighteenth century to the second decade of the twentieth century! "A consumer basket selling for $100 in 1790," they write, "cost only slightly more, at $108, than its (admittedly very rough) equivalent in 1913." (Of course that extra $8 bought far better products.)

And since that time? "[T]hereafter the price soared, reaching $2422 in 2008…. [M]ost of the decline in the dollar's purchasing power has taken place since 1970, when the gold standard no longer placed any limits on the Fed's powers of monetary control."

The dollar has lost 95 percent of its value since the Fed came into existence.

Deflation

The authors say that since the Great Depression the Fed has rid the economy of deflation (defined as falling prices), which was a feature of the late nineteenth-century economic landscape. Economists, including Fed chairman Ben Bernanke, generally deem deflation as something to be avoided at almost all costs, so they would give the Fed kudos in this respect. But Selgin et al. point out (as have others, such as Steven Horwitz) that what matters is not deflation per se but the *kind* of deflation.

> Harmful deflation — the sort that goes hand-in-hand with depression — results from a contraction in overall spending or aggregate demand for goods in a world of sticky prices. As people try to rebuild their money balances they spend less of their income on goods. Slack demand gives rise to unsold inventories, discouraging production as it depresses equilibrium prices. Benign deflation, by contrast, is driven by improvements in aggregate supply — that is, by general reductions in unit production costs — which allow more goods to be produced from any given quantity of factor and which are therefore much more likely to be quickly and fully reflected in corresponding adjustments to actual (and not just equilibrium) prices.
>
> Historically, benign deflation has been the far more common type.

During roughly the last quarter of the nineteenth century, prices in the United States *declined* 37 percent – 1.2 percent a year on average. *That's* what the Fed has saved us from, thank you very much.

Frequency and Duration of Recessions

Again, the pre-Fed record is better than the Fed's performance. Drawing on the latest research the authors conclude:

> [A]lthough contractions were indeed somewhat more frequent before the Fed's establishment than after World War II (though not, it bears noting, more frequent than in the full Federal Reserve sample period), they were also almost three months *shorter* on average, and no more severe. Recoveries were also faster, with an average time from trough to previous peak of 7.7 months, as compared to 10.6 months. Allowing for the recent, 18-month-long contraction further strengthens these conclusions.

So the central bank has given us longer recessions and slower recoveries. Nice.

This provocative paper also addresses the Fed's record regarding volatility in output and employment, banking panics, the "Great Moderation" of the Greenspan years, and its role as "lender of last resort." This last topic is especially interesting. Under the classical doctrine, the lender of last resort was to make loans only to *solvent* (though illiquid) banks at higher-than-market interest rates. The Fed has trashed that doctrine by bailing out *insolvent* institutions and accepting toxic "assets" as collateral.

Selgin et al. reject the "too big to fail" doctrine, arguing that the fear-mongering about "systemic risk" is unsubstantiated. Bailing out the creditors of insolvent institutions, as the Fed did during the current financial crisis, has increased the future exposure of the public by reinforcing moral hazard — encouraging excessively risky behavior by creating the expectation of government rescue. In the process the Fed has gone from lender of last resort to allocator of capital – an ominous move toward central planning.

The authors do not endorse the pre-Fed system, which (as discussed last week) was heavily regulated by the national and state governments. Indeed, for most of American history interstate and intrastate branch banking was illegal, producing an industry of uncompetitive and undiversified banks.

Nor do they explore the free-banking alternative, though Selgin and White are well-known advocates of it. Instead they confine their analysis to various rules that would take away the Fed's discretionary power over the money supply. These would be improvements but a far distant second to free banking.

The authors leave no doubt that "the Fed's poor record calls for seriously contemplating a genuine change of regime."

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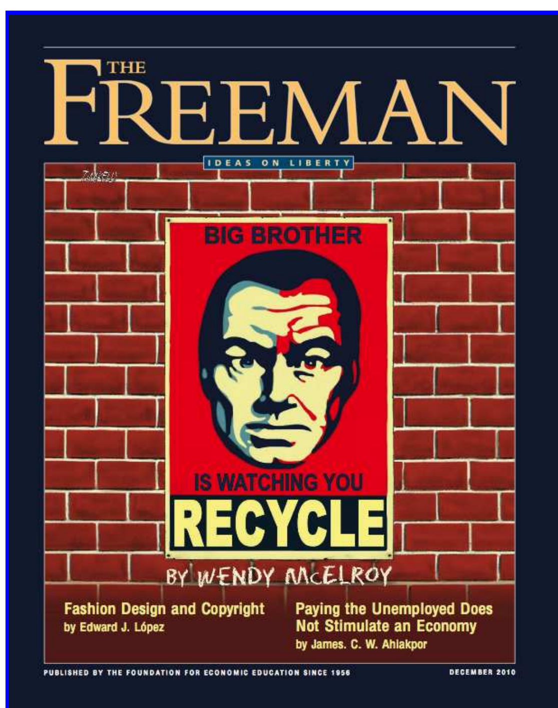

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