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Banks can succeed without the Fed

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The recent wave of interest in cryptocurrencies testifies to there being support for alternatives to government fiat money. In addition to the relatively high-profile bitcoin and ethereum networks, there are now hundreds of lesser-known cryptocurrencies. However, notwithstanding the tsunami of interest, cryptocurrencies as money still operate in kind of a never-never land.

One reason cryptocurrencies are still somewhat obscure: the persistent dominance of central banks such as the Federal Reserve.

In the 21st century, most Americans — including most bankers — don't give a second thought to the monopoly central banks enjoy in creating and controlling the flow of money, or the implications of their dominance. In most walks of life, it is taken for granted that competition produces superior results and adapts better to changing circumstances. In credit cards, cellphones and retail banking, to name some examples, a monopoly would not be tolerated.

And yet, despite evidence of superior economic results from private-sector management of money, Americans hold few if any public institutions in higher regard than the Fed.

As the Cato Institute's George Selgin argues convincingly in his book "Money Free and Unfree," this reverence is misplaced. Selgin presents a case for private monetary arrangements and market discipline rather than entrusting central banks with a money monopoly. In his introduction, the author argues that economists have bought into the notion, without real evidence, that "since World War II at least, the price level has become more predictable, output much more stable, and business contractions much less frequent and protracted, than was the case before 1913." (The year the Fed was created.)

Selgin writes:

"In fact, none of these claims is true. Although the Fed was established in response to a series of severe economic crises, in most respects its performance has been even worse than that of the admittedly flawed system it replaced."

Selgin cites the banking success of other countries — namely Scotland and Canada — that favored private-sector management of money over central banks.

From the tail end of the 17th century through the early 19th century, Scotland experienced the most innovative epoch in banking history, without the influence of a central bank. Scottish banks

invented branch banking, interest-bearing savings accounts, overdrafts, lines of credit, and two-sided and multicolor banknotes. They issued banknotes and vigorously regulated each other. Moreover, Scottish history shows that innovative banking, which today may sound like an oxymoron, doesn't have to be high risk. On the contrary, from 1809 to 1830 Scotland's bank failure rate was only 20% that of English banks.

In Canada, up until the establishment of the central bank in 1935, several dozen risk-diversified national banks issued currency. With no central bank, Canada experienced no significant financial crises. Private banknote issuance was banned in 1944.

The author also discusses the success of similar private monetary arrangements in the U.S. In the 19th century, private state and later primarily federally chartered banks issued notes while banks and bank-owned clearinghouses policed each other.

Selgin says, objectively speaking, the Fed's performance has been inferior to prior structures. During the central bank's reign, America experienced the "Forgotten Depression" immediately after World War I, the Great Depression, the Great Recession and 16 additional recessions. The value of the dollar plummeted whereas for more than a century prior to the Fed's control, the dollar held its value. A $100 basket of goods in 1790 cost $108 in 1913. In 2008, it cost a jaw-dropping $2,422.

Competition produces better performance. Markets reward good performance and ruthlessly punish bad performance. Monopolies, however, have no natural self-corrective mechanism. That is true with monopoly monetary systems as well.

But the growing value of cryptocurrencies suggests that alternatives to central banking dominance have economic appeal. For example, startup funders would not be turning to "initial coin offerings" as an increasingly popular way to raise money for new ventures if they did not see investor demand.

Taking a page from prior successful alternative monetary systems, banks could be permitted to issue money backed by a range of assets. Cyptocurrencies could also compete, serving as legal tender and competing with digital and paper banknotes and greenbacks. Banks could take deposits and extend credit in cryptocurrencies.

Currencies backed by financial and other assets — gold or perhaps nothing more than the computing resources required to calculate validating algorithms — could vie for primacy of place in consumers' digital and leather wallets.

Selgin's preferred world of free banking and private monetary systems — in which parties compete but also cooperate out of shared self-interest — would seem radical to most Americans and Congress. The public's view of the Fed, as well as of the role of banks and other private actors prospectively managing America's monetary arrangements, would have to undergo a sea change.

Selgin, however, is an incrementalist in terms of his approach to getting there. Initially he proposes removing some of the Fed's policy tools and subjecting it to additional market discipline. An important benefit of such reform is that it would communicate to Congress and the

public that the central bank’s vast, largely unchecked power can be curtailed — and that good could come of that.

Monetary arrangements matter, enormously. Selgin encourages us to think about them and consider alternatives to the status quo that may serve us better.