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End The Fed, Or Celebrate Its Existence? Reflections On Our Central Bank's 100th Anniversary

By: James Dorn – January 20th, 2013

This year marks the 100th anniversary of the Federal Reserve System. There will be many events commemorating the signing of the Federal Reserve Act in December 1913. Many of those events will be occasions for celebrations by Fed officials and staff, but should the public celebrate a century of central banking?

At the annual meeting of the American Economic Association in San Diego earlier this month, Harvard economist Kenneth Rogoff told a large audience that the Fed has been a "remarkably successful institution." During Q & A, Mark Skousen, author of *The Making of Modern Economics*, asked why the Fed failed to predict the financial crisis and the Great Recession—but Rogoff failed to answer. Later in that session, Donald Kohn, former vice chairman of the Fed, acknowledged that the Fed had made mistakes and should exercise humility. Yet, he is a firm believer in discretion rather than rules.

In another session, Allan H. Meltzer, the world's leading authority on the Federal Reserve, and a long-time proponent of a rules-based approach to monetary policy, was highly critical of the Fed's expansion of its power since 2007 under Ben Bernanke. "No group," said Meltzer, "should have unrestrained power that the Fed has taken for itself."

The Fed's failure to anticipate or prevent either the Great Recession or the Great Depression, the continuous rise in the price level since President Nixon closed the gold window in 1971, and the Fed's use of financial repression to penalize conservative savers while encouraging risk and creating asset bubbles should give pause to celebrating the Fed's anniversary. Indeed, a growing chorus seems to be following Ron Paul's call for "ending the Fed," and its credibility is increasingly being called into question.

Skepticism toward the Fed's monopoly on money and its growing power is a healthy development in a free society based on limited government, individual freedom, and the rule of law. As Nobel laureate F. A. Hayek noted, "All those who wish to stop the drift toward increasing government control should concentrate their effort on monetary policy." Of course, Hayek favored the denationalization of money, not central banking. He thought free markets and competition among currencies would lead to better money, as opposed to government monopoly power.

In contrast to Rogoff's depiction of the Fed's history as "remarkably successful," Milton Friedman, the most famous free-market economist of the 20th century and co-author

with Anna J. Schwartz of the landmark *A Monetary History of the United States*, concluded, in 1988, that "no major institution in the U.S. has so poor a record of performance over so long a period, yet so high a public reputation."
For much of U.S. history, there was no central bank. In a recent study of pre- and post-Fed performance, economists George Selgin, William Lastrapes, and Lawrence H. White found that since the establishment of the Federal Reserve there have been "more, rather than fewer, symptoms of monetary and macroeconomic instability." (See the summary of their study in *Cato Policy Report*, November/December 2012).

It is also well known that long-run price stability was achieved under commodity standards but never under pure fiat money. In 1900, when the U.S. was still on the gold standard, the wholesale price index was about where it was 150 years earlier, although it varied throughout the period. During peacetime, commodity standards (silver or gold) worked through market forces to achieve price stability, and thus safeguarded the purchasing power of money. That has not been the case under central banking.

Furthermore, under the gold standard, there was a culture of fiscal restraint that helped limit the size and scope of government. As Nobel laureate economist Thomas Sargent has written, "What induced one major Western country after another to run a more-or-less balanced budget in the 19th century and early 20th century before World War I was their decision to adhere to the gold standard."

There is mounting evidence that the Fed is drifting further and further away from a monetary regime consistent with limited government, economic freedom, and sound money. Martin Feldstein, former chairman of the Council of Economic Advisers under President Ronald Reagan and a professor at Harvard, recently wrote in the *Wall Street Journal*, "The Federal Reserve is heading in the wrong direction. What the central bank describes as 'unconventional monetary policy' is creating dangerous bubbles in asset markets that will lead to higher future inflation and is supporting the explosive growth of the national debt. Its new 'communications strategy' will, moreover, only further confuse markets" ("The Fed's Dangerous Direction," January 3).

With the 100th anniversary of the Fed, this year is an appropriate one to reflect on the Fed's performance and, more important, to consider alternatives to discretionary government fiat money. Congress should establish a National Monetary Commission to investigate these issues and think about how to exit the Fed, not just exit current monetary policy. When the next crisis occurs, as it surely will, the U.S. must be ready with alternatives to the current fiat money regime. The public should not let central bankers monopolize that debate.

The late Nobel economist James Buchanan, a pioneer in public choice and constitutional political economy, opposed "unconstrained discretionary monopoly" and urged economists and policymakers to consider "alternative monetary constitutional regimes." This year would be a good time to heed his advice. And a good place to start would be with Richard H. Timberlake's forthcoming book, *Constitutional Money: A Review of the Supreme Court's Monetary Decisions* (Cambridge University Press, co-published with the Cato Institute).