The Fed: Solution or Problem?

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Should we abolish the Fed? The Federal Reserve Bank or "The Fed" as it is commonly known, is the central bank of the United States. It was created by Congress in 1913 as the direct result of the Panic of 1907 (recessions or depressions were previously ca e panics, as they tended to be short lived and self-correcting).

The United States had been without a central bank since the closure of the Second Bank of the United States in 1836 by Andrew Jackson. A major goal of the Fed was to stop bank panics which had occurred with some regularity from the Founding of the American Republic. The Fed also was charged with maintaining a stable price level and full employment.

When considering whether the Fed should be kept, or at least kept in its present form, it is always useful to look at the data. Specifically, what happened in the 94 years prior to 1914 (when the Fed became operational), and what happened in the 94 years since 1914?

Before and After the Fed		
	1820-1914	**1914-2008**
Change in the wholesale price level	-0.06%	+1300.00%
Change in the number of banks	+27,000	-1$,500
Maximum number of bank failures in one year	496	4,400

The United States. was on the gold standard in most of the years prior to the Fed, and there was no systemic inflation over the century before the Fed. There were some periods of inflation (during the Civil War) and a sustained period of deflation in the 1890s, but wholesale prices were nearly the same in 1914 as 100 years earlier. (Note: There are reasonably reliable wholesale and/or producer price numbers from the late 1700s, but the consumer price index [CPI] did not exist in the 19th century. The CPI has grown by more than 2,000 percent since 1913, meaning the typical item that cost $20 back then would now cost more than $400.)

It is unambiguously clear that the Fed has failed in its charge to maintain a stable price level.

The total number of banks grew rapidly in the century before the creation of the Fed, but the number declined rapidly during the Depression of the 1930s, both because of bank failures and mergers. The merger trend has continued in recent decades, and the total number of banks continues to fall - not necessarily a bad thing except when they are "too big to fail."

The Fed was supposed to regulate banks (in conjunction with state bank regulators, the Office of Thrift Supervision, and the Comptroller of the Currency) to avoid large numbers of bank failures that occurred in the Panics of 1878, 1893, 1896 and 1907. However, these episodes only resulted in the closure of a few hundred banks, which turned out to be minor compared to the Great Depression where thousands of banks failed, or even the S&L crisis of the late 1980s and early 1990s where a total of approximately 1,600 banks failed.

There is also no evidence unemployment rates have been lower on average since the Fed's creation. The unemployment statistics only go back to 1890, and there were a few years in the early 1890s where unemployment was in the double digits, but this episode was neither as long nor as severe as the one in the 1930s.

If those members of Congress who voted for the creation of the Fed in 1913 had been able to know what the results of their handiwork would be for the next 94 years, given the empirical data, it is unlikely the closely contested bill would have passed.

The "Panic of 2008" appears to have the same origins as the previous panics or recessions/depressions. What typically occurs is a monetary expansion (too much money and/or credit) where interest rates are too low, resulting in a rapid rise in the price of assets, which leads to what Austrian economist and Nobel prize winner F.A. Hayek called not too much investment but "mal-investment," which, in turn, leads to a rise in consumer prices. Under a gold or commodity standard, the loss of reserves finally brings the inflation to a halt.

Under a fiat monetary system, which the Fed and almost all other central banks now use, the end of the inflation only comes when the central bank finally decides to end it by restricting money and credit.

Gerald O'Driscoll, a former senior Fed official and very able economist, recently said it best: “The central bank is like an arsonist watching a fire he set, expressing amazement at how such an event could have happened. The Fed created a moral hazard by first implicitly, then explicitly promising to bail investors out of risky commitments. [Former Fed Chairman Alan] Greenspan promised to 'mitigate the fallout' from asset deflation. How does a central bank do that? By reflating asset prices, or, as Greenspan euphemistically put it in his 1999 testimony, 'ease the transition to the next expansion.'”

Before the Fed and big government, previous bank panics usually ended quickly without "bailouts" or "economic stimulus” programs. Given that the Fed, the Treasury and the Congress are obviously confused about what to do in the current situation, history indicates that perhaps the least harmful course of action is for them to do nothing.

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