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The Expanding Fed Role

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Split-up of functions needed for quality's sake

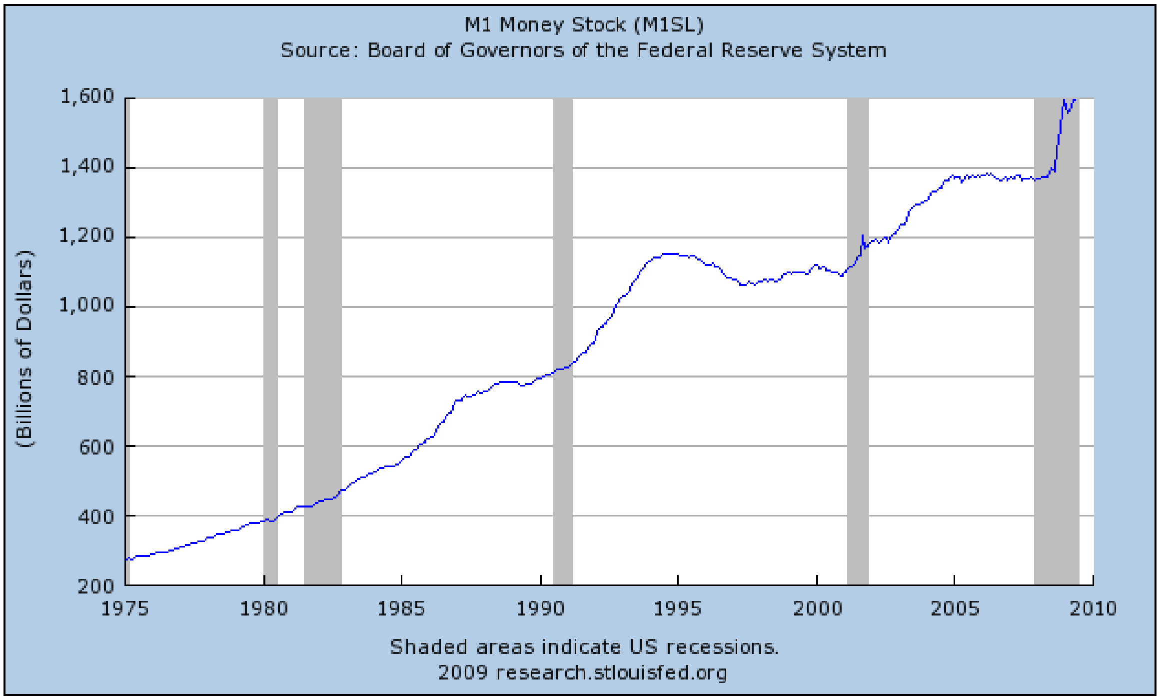
Why is it that those who specialize in individual athletic events hold almost all the records as contrasted with those who compete in the same events as part of a pentathlon? Like the athlete who tries to do everything (or at least five things), the Federal Reserve (the U.S. central bank) is becoming less competent as the number of its functions increases.

The Fed is supposed to provide the United States with stable currency yet it now takes $21.60 to equal the purchasing power of $1 in 1913, the year the Fed was established. (In the 124 years prior to the founding of the Fed, there was almost no permanent change in the purchasing power of the dollar. There was some inflation during the Civil War, which was offset by a slow deflation in the 40 years after the war.)

The Fed is supposed to regulate the banking system to provide financial stability, yet far more banks have failed since the Fed was created, and events of the past year illustrate how the Fed has failed at providing financial stability. The Fed has become like a large fire department that has a fixed percentage of its employees who are arsonists, so as it gets bigger, there are always more fires. Yet the politicians call for an even bigger fire department (or Fed) rather than a smaller one that has rid itself of the arsonists. (The same can be said of most of government.)

The Fed suffers from conflicting responsibilities both within the organization and with other government agencies and actions. It is charged with maintaining full employment, but the long-run level of employment depends far more on government fiscal policy (tax rates, government spending and regulatory burdens) than on monetary policy.

The government tries to protect bank depositors through deposit insurance (administered by the Federal Deposit Insurance Corp.), but this adds systemic risks to the banking system by making bank customers less concerned about the financial health of banks they deal with than they otherwise would be. It also causes a breakdown of market discipline, which adds to the Fed's burden.



The accompanying chart shows the growth in the money supply, as measured by M1 (currency and checking accounts) over the past 35 years. During the great inflation of the late 1970s, M1 grew by almost a record 40 percent in four years, and yet in the past year alone M1, has grown by almost 20 percent.

The reason inflation is stable despite the rapid monetary growth is that velocity -- the number of times a dollar is spent in a year -- has been falling. People have been hoarding cash rather than buying new homes or autos.

Once excess inventories are worked off and global commodity prices begin to rise again, inflation fears will come back quickly and people will rush to get rid of their dollars by buying "stuff." Unless the Fed can quickly extinguish all of the new money it has created, inflation will come roaring back.

Unfortunately, the Fed has become all too politicized -- despite its declared independence -- and thus is unlikely to react quickly and completely enough to extinguish the inflationary fires it has started. Federal Reserve Chairman Ben S. Bernanke appears to have abused his power by forcing Bank of America to buy Merrill Lynch even though the top executives concluded that the purchase was not in the interest of Bank of America's shareholders. This was done to make the Treasury and the political actors in Washington happy.

The Fed needs to be split up. As long as the government insists on maintaining a monopoly on the production of money, it needs to have a board that has the sole responsibility of maintaining price stability (within a relatively specified narrow range, such as plus or minus 2 percent). If the Fed governors fail to do so, they should be dismissed.

The Fed's bank regulatory functions need to be put into a separate agency. If the federal government wishes to bail out companies and serve as a lender of last resort, it needs to put the liabilities on its own balance sheet.

The new central bank should not be required to buy government debt. That would force the politicians (the Congress and the president) to reduce spending or raise taxes to pay for all of the interest on the bonds. (At the current level of federal government spending, raising taxes will not work. Tax rates are already above the long-run maximizing level. Increasing tax rates will only result in even slower economic growth, not more tax revenue.)

The smarter folks in Washington understand that the trillions of dollars of new spending will be "paid for" largely by the "inflation tax," which will fall hardest on those without assets -- i.e. the poor about whom the president and many in Congress claim to care so much.

Given the behavior of the Fed board during this financial crisis, there is no basis to think its members will suddenly have the courage to stand up to their political masters in the White House and Congress and just say "no."

Do not expect an America without pervasive inflation until the money-supply function is separated from the financial-regulatory function at the Fed and governors are appointed who have not only the technical competence but the individual courage and character to do what is necessary.

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