The Washington Times
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Folding the Fed

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Published December 7, 2010

Central bank isn't equipped to save the economy

If you are building a fence and you try using a hammer rather than a shovel to dig the postholes, progress will be slow if not nonexistent. The Federal Reserve is supposed to maintain the value of the currency and keep the banking system sound and stable - which it has not done (more on that below). Yet, in 1978, Congress passed the Humphrey-Hawkins Full Employment Act, which, in part, also gave the Fed some explicit responsibility for maintaining full employment but did not provide the tools to do so.

The Fed does have the tools to increase or decrease the money supply, which means it can control the rate of inflation or deflation. However, the Fed has done a poor job of maintaining the value of the currency, as the dollar is now worth only about one-twenty-second of its 1913 value. The Fed also was supposed to maintain a sound and stable banking system; however, since the Fed was created in 1913, bank failures have been at a higher rate than during the pre-Fed period.

Despite its record of failure, the Fed (as noted) was given the additional responsibility to maintain full employment. Washington operates differently from the real world, where failures are punished. In Washington, failure by an official is often accompanied by a promotion, and an agency that fails often receives a larger budget - the Department of Education being exhibit A. At the time the Fed was given the responsibility for maintaining or creating full employment, the conventional but erroneous wisdom was that an expansion of the money supply (which again, the Fed does control) could lead to a permanent, higher level of employment. What we now know is that a big expansion of the money supply is likely to lead to a much higher level of inflation, not a permanent increase in employment. When the monetary brakes are put on - as they must be to stop the inflation - unemployment always soars.

The Fed has been trying to tackle unemployment by reducing short-term interest rates to virtually zero. The idea is that this will encourage banks to borrow from the Fed and lend money to businesses, thus fueling an economic expansion. But the banks are not lending because they are finding a shortage of creditworthy borrowers. Most of the creditworthy borrowers do not need the money because they are barely expanding because of the slow growth of the economy. The banks are also increasing their reserves as demanded both by the regulators and market conditions - thus the Fed is doing nothing more than pushing on a string.

Only Congress and the Obama administration have the right tools to bring down unemployment. Yet, at the moment, they are doing almost everything they can to discourage employers from hiring workers. Employers don't know what tax rates they will be facing as of Jan. 1. They don't know the costs of the new health care regulations, the new financial regulations and all the new environmental regulations that the Environmental Protection Agency is in the midst of promulgating. Given this uncertainty, coupled with a weak economy, it is no surprise that employers are not hiring. It almost appears as if the elected officials are trying to sabotage the economy. A foreign enemy of the United States would have a difficult time doing more damage to the U.S. economy than the folks in Washington, who are supposed to make the lives of their fellow citizens better.

The Fed is in an impossible situation. It has been given multiple targets - i.e., a constant-value dollar, bank stability, consumer protection and full employment - plus being required to outguess the market. At times, these targets are in conflict with each other, and the people at the Fed cannot see the future with greater clarity than anyone else. Before the creation of the Fed, the economy went through a number of recessions, most of which were short-lived, and the economy bounced back on its own without persistent inflation. Students of economic history are aware that a Fed-type central bank is just not necessary and often entails more costs than benefits.

The dollar needs to be defined by the U.S. government, perhaps as a quantity of gold (as in the past), a basket of commodities or something else in order to make payments and collect taxes. Once the dollar is defined, the private sector is perfectly capable of creating the necessary quantity of money - as it did before the advent of central banks.

If you are skeptical about abolishing the Fed, just consider the following question: "Would those who voted for the Fed in 1913 have done so if they had known that:

1. After having a 125-year period of relatively stable money when the dollar was still close to its value in 1790, the dollar would be worth less than 5 cents at the end of the century?

2. The longest and severest depression the country had ever experienced would occur a mere 20 years after the creation of the Fed and that the Fed had a major responsibility for the disaster?

3. And the number of bank failures would increase and not decrease?"

The answer clearly would have been "no." Why are we keeping a failed institution?

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