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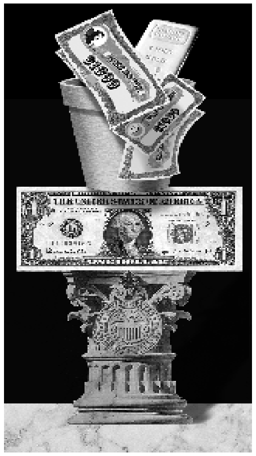

Fixing the Federal Reserve

by Richard W. Rahn

FED'S SOLE MISSION SHOULD BE MAINTAINING VALUE OF CURRENCY

There is a growing consensus that the Federal Reserve is broken - because it is. The Fed was established to provide price stability and prevent periodic banking crises. It has accomplished neither.

The wholesale price level in the United States was at almost the same level when the Fed was established in 1913 as it was in 1793, 120 years earlier. Now it takes about 22 dollars to equal the 1913 dollar. There have been far more bank failures post-Fed than pre-Fed, and we seem to be in an almost permanent state of banking crises with "too big to fail."

The Fed's near-zero interest policy is a growing disaster. With inflation near 4 percent and interest on various types of savings accounts less than 1 percent, those who have been prudent and saved are being punished - forced to accept what is, in effect, a negative rate of interest. Credit is no longer being allocated by the market but to classes of borrowers as determined by politicians. Homeowners are being given money at a near-zero rate (the interest rate they are being charged is about equal to inflation) and the interest expense is tax-deductible. Many small-business people are not able to get loans because they are "risky," and the banks can borrow from the Fed at lower rates than they can get on government bonds, so there is no incentive for them to take on the risk. Unless the banks become more willing to lend to businesses that create real jobs and innovations, the economy will continue to stagnate.

All of the Republican presidential candidates have called for getting rid of Fed Chairman Ben S. Bernanke, but only Rep. Ron Paul has advocated abolishing the Fed. Mr. Paul wants to return to a gold standard. There are pros and cons of going back to gold, but, short of that, there are a number of constructive things that can be done.

One reason Fed policy is so confused and conflicted is that the Fed has been given multiple targets and tasks, some of which, at times, conflict with one another. The Fed is supposed to maintain not only price stability but also full employment. In addition, it is supposed to make sure the banking system is sound. The Dodd-Frank bill gave it the additional task of consumer financial protection. To understand the problem, assume you decide to participate in the Olympics because you are a fast runner and want to compete in the 100-meter dash. But then the government says, "By the way, you must also compete in weight lifting." A bit later, the government comes back to you and says, "You must also add diving to your Olympic sports." How would you train?

Fed officials often say - and some seem to believe - that their job is to "lean against the wind." Do they know which way the wind is blowing better than anyone else? Remember, they managed to miss the financial meltdown in 2008 even though some in the private sector got it right.

Lesson 1: The Fed should have only one target and one responsibility, and that is price stability. (Other government agencies can do the other things.)

Lesson 2: Even with only one target, the Fed still will have trouble getting it right.

Therefore, the government should let citizens experiment, as the great economist F.A. Hayek advocated, with developing their own monies, whether it be gold, silver, a commodity basket or whatever. Americans now do have the legal right to make contracts in gold, as long as both buyer and seller agree.

There are two reasons why private monies have not been successful. The first is that the Treasury Department has taken the position that only the government can produce money. The Constitution says the Congress shall have the power "To coin Money, and regulate the Value thereof." Clearly, the government has the right to specify what legal tender is for the collection of taxes, for government payments and for payment of debts when an alternative to government money is not specified. However, the Constitution does not say that nongovernment entities are prohibited from producing money - provided they do not claim it is legal tender - and that both buyer and seller agree to the alternative money.

The second reason gold or other commodities cannot be practically used as money is the U.S. Treasury takes the economically destructive position that there must be capital gains taxes paid on commodity transactions. This, in a practical sense, means that to use gold for payment, every transaction, no matter how small, would require a calculation and report of the capital gain or loss. Commodities trading is a zero-sum gain, so the capital losses and gains offset each other over time. Thus, the Treasury receives no net revenue from such trades, making payment of capital gains a truly stupid tax.

In sum, the monetary situation could be greatly improved if: (1) The Fed were charged only with maintaining the value of the currency and nothing else; (2) others were given the right to compete with the Fed in creating money (again, provided they do not claim it is legal tender); and finally, (3) the capital gains tax were removed from commodity transactions.

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