This article can be cited as: David Howden and Joseph T. Salerno. 2014. “A Stocktaking and Plan for a Fed-less Future”, in *The Fed at One Hundred: A Critical Review of the Federal Reserve System*, (*ed.*) David Howden and Joseph T. Salerno, pp. 163 – 69. London and New York: Springer.

It can be found at: http://link.springer.com/book/10.1007%2F978-3-319-06215-0

A Stocktaking and Plan for a Fed-less Future

David Howden and Joseph T. Salerno

The essays contained in this volume have portrayed the Federal Reserve in a less than favorable light. In particular, they have pointed to both deficiencies in the theory guiding the Fed’s operations and the venerated institution’s historical record.

These are not criticisms to be taken lightly. Granted a legal monopoly over the United States’ money supply, the Fed is an institution with far reaching powers that is secured in its position by an act of Congress. This legal privilege bestowed by Congress has expansive effects. Money is the common denominator of all monetary transactions. When something goes wrong with money, the error is not restricted to its area of initial impact. It reverberates throughout the whole monetary economy, and in this way a single error may propagate a general cluster of errors.

That errors happen in the market economy, is not in dispute. In normal market processes, errors are exposed through losses at firms. These losses should not be shunned or swept under the table, but embraced as important signals that tell entrepreneurs when an action has been either unwanted by consumers or unsuccessfully implemented. These losses also open the doors to competitors to enter the market and better satisfy consumers. In this way, the trial and error method of the market, guided by the signals of profit and loss, continually weeds out unsuccessful or unwanted activities that impede the increase in consumer satisfaction.

Protected from competition and assured that its product will be accepted due to legal tender laws, the Federal Reserve stands outside of any system of checks and balances. This fact must already strike the reader as strange, as goods which share a similar monopoly status, such as public utilities and national defense, are subject to political checks and balances. The Fed operates as more or less an independent entity, at least de jure, and most economists vehemently argue that this is necessary to assure an unbiased and proper production and control of the nation's money supply.

What this volume has demonstrated is that there is a myth of independence, but that even if the Fed were subject to some of the more typical political checks and balances, the results would not be much better. In fact, the problem is not the institutional structure of the Fed or its exact relationship to the government. The problem is in the institution itself, and broadly applies to all central banks.

Take a step back and review the specifics of how the Fed is supposed to operate. Its mandate gives it two roles. On the one hand it must maintain price stability, which incidentally is now de facto defined as mild price inflation of around 2 percent per year. On the other hand it is entrusted to enact monetary policy so as to engender full employment in the economy, or at least soften the landings of any business cycles. By creating an artificially low interest rate environment to fulfil this latter goal, the Fed not only promotes inflation but also hinders employment opportunities as it engenders destabilizing business cycles.

There is another important conflict and this is inherent in the method through which the Fed was granted its monopoly powers. These were bestowed by an act of Congress, and because misusing the Fed's tools for its own purposes is tempting to elected officials, political independence is staunchly guarded. Yet, what Congress giveth it can taketh away. As this book has made clear, however, the independence of the Fed is a mere myth, and there is substantial overlap between its operations ostensibly aimed at aiding an ailing economy and those pursued to covertly aid the federal government's finances.

Furthermore, one would think that the institution entrusted to control the nation's money supply would be staffed by employees who actually have dealt with money, or know something about the banking business. While this was indeed true in the Fed's early years, over time a shift has occurred which has increased the number of academics and politically-connected individuals in important positions within the organization. This is perhaps not problematic in itself (except for possible political conflicts of interest) but has created a lasting and negative effect on the economics profession.

The Federal Reserve System is today a major sponsor of monetary economics research undertaken by American economists. While the involvement of Federal Reserve economists in monetary research could be attributed to self-selection, it could also be that the Fed biases monetary research by sponsoring its own researchers at the expense of competitors. In a recent assessment of the accepted papers in the *Journal of Monetary Economics*, over 80 percent of authors had either a current or past affiliation with the Federal Reserve System, and nine of its eleven editorial board members had a Fed affiliation (White 2005). This over-representation is troubling.

Perhaps the most troubling aspect of the current state of monetary economics, and this is readily apparent in almost all Fed-sponsored research, is an implicit belief that economic cycles are a natural occurrence. Whether they are caused by investors losing their nerve, or consumers not generating sufficient aggregate demand, as in the variety of Keynesian-oriented business cycle theories, the result of technology shocks in real business cycle models or the aftermath of debt-fueled binges in many Post-Keynesian depictions, one stylized fact is clear: the crisis' origin is inherent in the market process and the Fed's proper job is to clean up the aftermath of these instabilities.

There is a radically different way of looking at the problem of the bust, and it can be distilled into a simple epigram. One of Friedrich Hayek's tips for aspiring economists was that "before we can explain why people commit mistakes, we must first explain why they should ever be right" (Hayek 1937: 33). In this way, instead of accepting that a mistake has been made and rectifying it, the economist should first understand under what conditions that mistake would never have been made in the first place.

Although difficult to conceptualize, a world without money is simple to model and draw conclusions from. Individuals produce and consume, and the only way to consume more is to produce more. There is a catch, however. The only way to produce more is to work more productively. Any gain in labor productivity involves capital investment. In the moneyless world, investment is straightforward – it involves stockpiling some savings, and since there is no money to save it must be made in the fruits of our labor: produced goods.

As the worker stops consuming some of his produce and saves it for later consumption, he is freed somewhat from his hand-to-mouth existence. Instead of dedicating all his time to producing for sustenance, he can now devote his efforts to searching for productivity enhancing methods and tools. His prior savings will sustain him while he shifts his labor away from producing goods to sustain him and replenish his energy, to these other efforts that will not pay off until some later date.

Thus, in the moneyless economy, the primitive economic system is tightly controlled by savings. Workers produce goods, a part of which must be stockpiled to consume later if one wants to pursue investment-type activities. Investment will only occur if there is a prior supply of savings, and the length of investment projects (i.e., the amount of time the individual will devote to searching for new production processes or goods), will be determined by the availability of these prior savings.

Enter the money economy. Provided that money is a good like any other, nothing much changes. The key is in defining what “a good like any other” is. Scarcity should be an attribute that springs to mind, as would costliness to produce. Commodity money, or money substitutes that are fully-backed by a commodity, fit the bill. They are scarce in the sense that they cannot be reproduced at will, and even if they could be reproduced at will they would not be because of the cost of doing so (e.g., mining, minting or distribution costs). The moneyed world featuring a strict commodity money (or a perfect substitute for it) is not very dissimilar from the moneyless world. (It should be clear that it would be a much more developed world, due to the increased exchange possibilities and accompanying division of labor and specialization that the generally accepted medium of exchange provides.)

Today's world is not like either of the aforementioned ones. It survives with fiat money – one created by act of government or its central bank. It is not scarce, or at least its scarcity is not determined by its cost of production. Unhinged from any commodity, money today mostly exists as a series of ones and zeros in a computer, and its supply can be seamlessly controlled by the central bank at almost no marginal cost.

While control over a commodity and the ability to create it at will may be seen in a positive light, it is anything but. Hayek described the result of fiat money as a "loose joint" in the economy (1941: 408). Money serves as a joint in the connection between savings and investment activities.

When a commodity serves as money, or when a perfect money substitute is backed fully by a commodity, there is no "looseness" to it. Savings and investment are coordinated as any dollar of savings will result in a dollar of investment—no more and no less.

The Federal Reserve was not created to oversee and control a commodity-backed money, but rather to provide an elastic currency. This elasticity is provided in two ways. First, by raising or lowering the discount rate the Fed is able to decrease or increase the money supply. Alternatively, the Fed controls the supply of bank created money through its setting of the reserve ratio. By reducing the reserve ratio the Fed allows banks to issue money substitutes in the form of deposits in excess of the amount of currency deposited. The Federal Reserve since its inception has been instrumental in permitting the banking establishment to operate with fractional reserves.

The original impetus for the Fed's control over this flexible money supply was, besides pursuing its operating mandate, to more generally cushion the pain of economic recessions. As this volume should make clear, the Fed itself is the instigator of these cycles, and the "elastic money supply" it now controls was also responsible for recessions and panics before its creation.

One way to understand how the Fed is responsible for business cycles over the last 100 years is through the Austrian theory of the business cycle. This theory holds that the fundamental cause of economic instability is the central bank's expansion of money and credit, which severs the link between real savings and monetary savings (Hayek's loose joint).

The problem stems from diverting money from what consumers actually want. Consider why money exists, and why it is held. Money emerges and evolves as a commonly accepted medium of exchange. The reason money is held, however, is ultimately attributable to uncertainty (Mises 1949: 249). Unsure of exactly where, when or to what extent future expenses will arise and incomes accrue, individuals hold on to a sum of money as a type of insurance hedge. Any money held by the individual serves not as an investment, but rather as an immediately available and perfectly "liquid" asset to protect against these unknown future events.

Deposits in the fractional-reserve banking system are *not* treated in this manner, contrary to the intent of depositors. Deposits are used as funding for loan activities by the bank. The result is that the fractional-reserve bank lends money which was never meant to be used for any purpose other than as an instantaneously available sum of purchasing power to meet contingent future events. The loose joint of money becomes apparent as a quantity of money finances more investments than would otherwise be the case when deposits are treated, in accord with their owners' intentions, as warehoused cash balances. The result is a source of funding than would otherwise be available, and a corresponding reduction in interest rates below what would otherwise be the case.

According to the Austrian theory the business cycle is propagated through three channels. Overconsumption occurs during the boom because of the falsification and inflation-induced increase of income and financial wealth coupled with the corresponding "wealth effect" on consumption (Mises 1949: 546-47; Salerno 2012: 16-20). Malinvestment occurs as the temporal ordering of investment is altered. Lower interest rates to entice investment into longer-dated investment projects, at the expense of shorter-dated projects (Mises 1912, 1949; Hayek 1935). Finally, as banks are given access to a funding source (demand deposits) that would otherwise not be available in the absence of fractional reserve banking, the financial sector of the economy grows unsustainably and disproportionally to the real productive sector (Howden 2010).

Each of these results is evident in recessions caused by monetary disturbances. Notably, this includes almost all recessions as by definition the initial disruption must be economy-wide for a general downturn to occur. Technology shocks, such as in real business cycles, or the loss of investor nerve in most Keynesian renditions, can only affect specific sectors within the economy. Only a disturbance to money has the ability to systematically disrupt consumption and investment plans and set in motion a general recession. (Wars or famines may also be sufficiently large so as to disturb the broader economy, though these are probably best left to "providence" theories of the business cycle.)

The Fed was originally created with the admirable goal of preventing or mitigating financial panics and resulting recessions. What was largely missed by the drafters of the Federal Reserve Act was that the recessions that plagued the United States over the preceding decades were primarily caused by the banking practice of holding only fractional reserves against deposits. The Free Banking Era from 1837-64 bred generally favorable economic conditions and the private banking system developed innovative methods and products to deal with banking disturbances. Unfortunately, the legal setting of the Free Banking Era fell short of obliging banks to abide by standard contract law, and the result was a system that endogenously bred the very disturbances that bankers and financiers would diligently attempt to combat for decades.

The fact that banks were permitted to fund their operations through fractional reserves left them open to destabilizing panics of their own making. As recessions set in, depositors made periodic runs on banks that would be later known as the widespread panics of the times. Panics led to financial problems throughout 19th century America, principally in 1837, 1857, 1873, 1884 and 1893. By the time the Panic of 1907 occurred, depositors, bankers and legislators were already searching for a solution that would end once and for all the banking disturbances that were becoming more frequent and severe (Bagus and Howden 2012). The result was the creation of the Federal Reserve System in 1914.

The creation of the Federal Reserve, however, is akin to a doctor misdiagnosing an ailment and prescribing a medicine that acts to worsen the original disease. The cause of banking crises in the 19th century was not the lack of a central bank, but rather the ability of banks to finance their lending operations with fractional reserves. The central bank was a short-term solution to paper over the losses created by banking panics, but at the same time increased the extent to which fractional-reserve banking could be practiced while also increasing the associated moral hazard and risk-taking in the economy. In a recent review of the Fed's first 100 years of operations, Selgin, Lastrapes and White (2012: 570) conclude that the Fed's history can be characterized by "more rather than fewer symptoms of monetary and macroeconomic instability." In short, it has been a failure.

If the Fed was the wrong prescription to a misdiagnosed problem, and has been an utter failure at achieving its stated goals, where do we go from here?

There are two potential paths forward, each having its own merits and demerits.

Option one involves abolishing the practice of fractional-reserve banking thus making banks subject to holding full reserves.

The first change needed to get the banking system to a state of 100-percent reserves is to cancel out the government bonds it holds. The government bonds held by the Fed amount to an accounting fiction. The Treasury pays interest to the Fed for these bonds, but the Fed remits this payment back to the Treasury at its year-end (after paying for its operating expenses). Thus, the government bonds held by the Fed can be cancelled without any disturbance to the economy. The Fed´s gold stock can be revalued from its historical price of $42.22/oz. and paid to the banks in exchange for retiring the monetary base. Since the monetary base includes almost all of the Fed´s liabilities, the distribution of its revalued gold will eliminate its balance sheet, and with it, the greater central banking institution.

An alternative path would be to remove legal tender laws and the monopoly that the Fed currently has on money production within the United States. Such an option would expose the Fed to competitive forces, similar to Hayek's (1974) plan for "choice in currency." In such a way, individuals would be free to use alternative currencies, thus exposing the Federal Reserve to a competitive check.

Viewed individually, each option is a necessary but not sufficient condition for monetary stability. Option one would rectify the business cycles caused by fractional-reserve banking, though at the risk of political instability by a central bank still nominally possessing a government-mandated monopoly of the supply of dollars. The second option returns the U.S. banking system to its Free Banking Era roots, an alternative which we have seen not only bred instability through its use of fractional reserves, but which also created the incentives to install the Federal Reserve System as a market "stabilizing" central bank.

Lasting stability can only be achieved by combining both options. Banks must be allowed to compete against one another in money production, thus providing a competitive check on each other. Simultaneously, these banks must be obliged to follow the laws of other deposit-taking institutions and hold 100 percent reserves to back any deposits created. Anything less than this complete proposal will result in a return, whether sooner or later, to the malaise in monetary affairs we are accustomed to today.

As we reflect on this one-hundredth anniversary of the Federal Reserve System, it is useful and essential to consider its original mission and operating mandates. Price stability has been poorly achieved by the Fed over the past 100 years, with more inflation than at any other period of human history. The business cycle has not been eliminated; indeed, today we find ourselves in the midst of the slowest recovery of the post-War era. In these two regards the Fed has been a failure.

The Fed has been, however, a complete success in some respects. By fostering a demand for government bonds, it has allowed the federal government to spend beyond its means. By serving as a lender of last resort, it has created an attitude of risk-taking among financial institutions never before seen. By stamping out the competitors in the money production business that existed prior to its creation 100 years ago, such as private note-issuing banks, it has come to be seen as the only institution capable of producing money. Finally, in its role of lender of last resort, the Fed has been credited with saving many financial institutions that would otherwise have succumbed to market forces because of their own ill-conceived practices. Never mind that the Fed itself promotes such unsustainable banking activities – it has created an aura among the public that it is the great savior of the financial sector, and in this way has become a venerated institution among even proclaimed defenders of free markets in other walks of life.

Given the dubious nature of these successes, it is high time the Fed stepped aside and let a more suitable institution take control. One of the prime benefits of the market is its ability to integrate and simplify distinct, disparate and dispersed pieces of information. Money prices permeate the market economy, and no other good plays a more central role than money. Far from being unable to efficiently supply money, it is exactly this type of good that the market excels at producing. Let's end the Fed and give the market a chance.

References

Bagus, Philipp, and David Howden. 2012. Still Unanswered Quibbles with Fractional Reserve Free Banking. *Review of Austrian Economics* 25(2): 159-71.

Hayek, Friedrich A. [1935] 1967. *Prices and Production, 2nd ed.* New York: Kelley.

Hayek, Friedrich A. 1937. Economics and Knowledge. *Economica* n.s. 4: 33-54.

Hayek, Friedrich A. 1941. *The Pure Theory of Capital*. Chicago: University of Chicago Press.

Hayek, Friedrich A. 1974. *Choice in Currency: A Way to Stop Inflation*. London: Institute of Economic Affairs.

Howden, David. 2010. Knowledge Shifts and the Business Cycle: When Boom Turns to Bust. *Review of Austrian Economics* 23(2): 165-182

Mises, Ludwig von. [1912] 1953. *The Theory of Money and Credit*. New Haven, Conn.: Yale University Press.

Mises, Ludwig von. [1949] 1998. *Human Action: A Treatise on Economics*. Auburn, AL: Ludwig von Mises Institute.

Salerno: Joseph T. 2012. A Reformulation of Austrian Business Cycle Theory in Light of the Financial Crisis. *Quarterly Journal of Austrian Economics* 15(1): 3-44.

Selgin, George, William D. Lastrapes, and William H. White. 2012. Has the Fed Been a Failure? *Journal of Macroeconomics* 34(3): 569-96.

White, Lawrence H. 2005. The Federal Reserve System's Influence on Research in Monetary Economics. *Econ Journal Watch* 2(2): 325-54.