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Has the Fed been a failure?

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ABSTRACT

As the 100th anniversary of the 1913 Federal Reserve Act approaches, we assess whether the nation's experiment with the Federal Reserve has been a success or a failure. Drawing on a wide range of recent empirical research, we find the following: (1) The Fed's full history (1914 to present) has been characterized by more rather than fewer symptoms of monetary and macroeconomic instability than the decades leading to the Fed's establishment. (2) While the Fed's performance has undoubtedly improved since World War II, even its postwar performance has not clearly surpassed that of its undoubtedly flawed predecessor, the National Banking system, before World War I. (3) Some proposed alternative arrangements might plausibly do better than the Fed as presently constituted. We conclude that the need for a systematic exploration of alternatives to the established monetary system is as pressing today as it was a century ago.

"*No major institution in the U.S. has so poor a record of performance over so long a period, yet so high a public reputation.*" Friedman (1988).

1. Introduction

In the aftermath of the Panic of 1907 the US Congress appointed a National Monetary Commission. In 1910 the Commission published a shelf-full of studies evaluating the problems of the post-bellum National Banking system and exploring alternative regimes. A few years later Congress passed the Federal Reserve Act.

Today, in the aftermath of the Panic of 2007, and as the 100th birthday of the Federal Reserve System approaches, it seems appropriate to once again take stock of our monetary system. Has our experiment with the Federal Reserve been a success or a failure? Does the Fed's track record during its history merit celebration, or should Congress consider replacing it with something else? Is it time for a new National Monetary Commission?

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The Federal Reserve has, by all accounts, been one of the world's more responsible and successful central banks. But this tells us nothing about its absolute performance. To what extent has the Fed succeeded or failed in accomplishing its official mission? Has it ameliorated to a substantial degree those symptoms of monetary and financial instability that caused it to be established in the first place? Has it at least outperformed the system that it replaced? Has it learned to do better over time?

We address these questions by surveying available research bearing upon them. The broad conclusions we reach based upon that research are that (1) the full Fed period has been characterized by more rather than fewer symptoms of monetary and macroeconomic instability than the decades leading to the Fed's establishment; (2) while the Fed's performance has undoubtedly improved since World War II, even its postwar performance has not clearly surpassed that of its (undoubtedly flawed) predecessor; and (3) alternative arrangements exist that might do better than the presently constituted Fed has done. These findings do not prove that any particular alternative to the Fed would in fact have delivered superior outcomes: to reach such a conclusion would require a counterfactual exercise too ambitious to fall within the scope of what is intended as a preliminary survey. The findings do, however, suggest that the need for a systematic exploration of alternatives to the established monetary system, involving the necessary counterfactual exercises, is no less pressing today than it was a century ago.

As far as we know the present study is the first attempt at an overall assessment of the Fed's record informed by academic research.[1] Our conclusions draw importantly on recent research findings, which have dramatically revised economists' indicators of macroeconomic performance, especially for the pre-Federal Reserve period. We do not, of course, expect the conclusions we draw from this research to be uncontroversial, much less definitive. On the contrary: we merely hope to supply *prima facie* grounds for a more systematic stock-taking.

In evaluating the Federal Reserve System's record in monetary policy, we leave aside its role as a regulator of commercial banks. Adding an evaluation of the latter would double an already large task. It would confront us with the problem of distinguishing areas where the Fed has been responsible for policy-making from those in which it has simply been the policy-enforcing agent of Congress. It would also raise the thorny problem of disentangling the Fed's influence from that of other regulators, because every bank the Fed regulates also answers to the FDIC and a chartering agency. Monetary policy, by contrast, is the Fed's responsibility alone.[2]

2. The Fed's mission

According to the preamble to the original Federal Reserve Act of 1913, the Federal Reserve System was created "to furnish an elastic currency, to afford means of rediscounting commercial paper, to establish a more effective supervision of banking in the United States, and for other purposes." In 1977 the original Act was amended to reflect the abandonment of the gold standard some years before, and the corresponding increase in the Fed's responsibility for achieving macroeconomic stability. The amended Act makes it the Fed's duty to "maintain long-run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates." On its website the Board of Governors adds that the Fed also contributes to "better economic performance by acting to contain financial disruptions and preventing their spread outside the financial sector."

These stated objectives suggest criteria by which to assess the Fed's performance, namely, the relative extent of pre- and post-Federal Reserve Act price level changes, pre- and post-Federal Reserve Act output fluctuations and business recessions, and pre-and post-Federal Reserve Act financial crises. For reasons already given, we do not attempt to address the Fed's success at bank supervision.

3. Inflation

The Fed has failed conspicuously in one respect: far from achieving long-run price stability, it has allowed the purchasing power of the US dollar, which was hardly different on the eve of the Fed's creation from what it had been at the time of the dollar's establishment as the official US monetary unit, to fall dramatically. A consumer basket selling for $100 in 1790 cost only slightly more, at $108, than its (admittedly very rough) equivalent in 1913. But thereafter the price soared, reaching $2422 in 2008 (Officer and Williamson, 2009). As the first panel of Fig. 1 shows, most of the decline in the dollar's purchasing power has taken place since 1970, when the gold standard no longer placed any limits on the Fed's powers of monetary control.

[1] Although Feldstein (2010, p. 134) recognizes that "[t]he recent financial crisis, the widespread losses of personal wealth, and the severe economic downturn have raised questions about the appropriate powers of the Federal Reserve and its ability to exercise those powers effectively," and goes onto ask whether and in what ways the Fed's powers ought to be altered, his conclusion that the Fed "should remain the primary public institution in the financial sector" (Feldstein, 2010, p. 135) rests, not on an actual review of the Fed's overall record, but on his unsubstantiated belief that, although the Fed "has made many mistakes in the near century since its creation in 1913…it has learned from its past mistakes and contributed to the ongoing strength of the American economy."

[2] Blinder (2010) argues that, *given* the premise that the Fed as presently constituted will continue to be responsible for conducting US monetary policy, it ought also to have its role as a supervisor of "systematically important" financial institutions preserved and even strengthened. Goodhart and Schoenmaker (1995) review various arguments for and against divorcing bank regulation from monetary control.