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# Cato Policy Report

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## Has the Fed Been a Failure?

BY GEORGE SELGIN, WILLIAM D. LASTRAPES, AND LAWRENCE H. WHITE

**“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.”**

—MILTON FRIEDMAN (1988)

In the aftermath of the Panic of 1907, Congress appointed a National Monetary Commission. In 1910 the Commission published a shelf-full of studies evaluating the problems of the postbellum 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 one hundredth 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?

We address these questions by surveying relevant research. The broad conclusions we reach based upon that research are that 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; 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 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

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**JOHN ALLISON**, former chairman and CEO of BB&T Corporation, has succeeded founder Edward H. Crane as president and CEO of the Cato Institute. Given his long-standing commitment to free-market ideals, Allison has described his new role as “a natural fit.” **PAGES 2, 13**

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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.

## INFLATION

The Federal Reserve 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." 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, output fluctuations and business recessions, and financial crises.

The Fed has failed conspicuously in one respect: far from achieving long run price stability, it has allowed the purchasing power of the U.S. 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 U.S. 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. 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.

The highest annual rates of inflation since the Civil War also occurred under the Fed's watch. The high rates of 1973–75 and 1978–80 are the most notorious, although authorities disagree concerning the extent to which Fed policy was to blame for them. Yet those inflation rates—in the low teens—were modest compared to annual rates recorded between 1917 and 1920, which varied from just below 15 percent to 18

“Unpredictable changes in the price level have greater costs than predictable changes.”

percent, with annualized rates for some quarters occasionally approaching 40 percent. Significantly, both of the major post-Federal Reserve Act episodes of inflation coincided with relaxations of gold-based constraints on the Fed's money-creating abilities: the temporary gold export embargo from 1917 to 1919 and the permanent closing of the Fed's gold window in 1971.

Although the costs of price level instability are hard to assess, the reduced stability of prices under the Fed's tenure has certainly not been costless. As Ben Bernanke observed several years ago, besides reducing the costs of holding money, stable prices allow people to rely on the dollar as a measure of value when making long-term contracts, engaging in long-term planning, or borrowing or lending for long period. As economist Martin Feldstein has frequently pointed out, price stability also permits tax laws, accounting rules, and the like to be expressed in dollar terms without being subject to distortions arising from fluctuations in the value of money. Feldstein himself has reckoned the recurring welfare cost of a steady inflation rate of just 2 percent—costs stemming solely from the adverse effect of inflation on the real net return to saving—at about 1 percent of gross national product.

As Bernanke's remarks suggest, unpredictable changes in the price level have greater costs than predictable changes. But here again the Fed's record has been unsatisfactory, for while inflation has become more persistent since its establishment, and especially since WWII, the future state of the price level has also become much harder to forecast. Largely for that reason, long-term (e.g., 100-year) corporate securities, which were common before 1914, have now all but disappeared.

## DEFLATION

While it has failed to prevent inflation, the Fed has largely succeeded, since the Great Depression, in eliminating deflation, which was a common occurrence under the pre-Fed, post-Civil War U.S. monetary system. Between 1870 and 1896, for example, U.S. prices fell 37 percent, or at an average annual rate of 1.2 percent.

The postwar eradication of deflation would count among the Fed's achievements were deflation always a bad thing. But is it? Many economists appear to assume so. But a contrasting view, supported by a number of recent studies, holds that deflation may be either harmful or benign depending on its underlying cause. Harmful deflation—the sort that goes hand-in-hand with depression—results from a contraction in overall spending or aggregate demand for goods in a world of sticky prices.

Benign deflation, by contrast, is driven by improvements in aggregate supply—that is, by general reductions in unit production costs—which allow more goods to be produced and are therefore much more likely to be quickly and fully reflected in corresponding adjustments to actual prices. Historically, benign deflation has been the far more common type. Surveying the 20th-century experience of 17 countries, including the United States, Andrew Atkeson and Patrick Kehoe find “many more periods of deflation with reasonable growth than with depression, and many more periods of depression with inflation than with deflation.”

Indeed, they conclude “that the only episode in which there is evidence of a link between deflation and depression is the Great Depression.”

Taking these findings into account, the Fed's record with respect to deflation does not appear to compensate for its failure to contain inflation. It has, on the one hand, practically extinguished the benign sort of deflation, replacing it with persistent inflation that masks the true progress of productivity. On the other hand, it bears some responsibility for several of the most severe episodes of harmful deflation in U.S. history, including those of 1930–33, 1937–38, and 2008–2009.

## THE “GREAT MODERATION”

The beginning of Paul Volcker’s second term as Fed chairman coincided with a dramatic decline in the volatility of real output that lasted through the Alan Greenspan era. Annual real gross domestic product growth, for example, was less than half as volatile from 1984 to 2007 as it was from 1959 to 1983. The inflation rate, having been reduced to lower single digits, also became considerably less volatile. Many have regarded this “Great Moderation” of inflation and real output as evidence of a substantial improvement in the Fed’s conduct of monetary policy—a turn to what Alan Blinder terms “enlightened discretion.”

The “enlightened discretion” view has, however, been challenged by statistical studies pointing to moderating forces other than improved monetary policy. A study by James Stock and Mark Watson attributes between 75 percent and 90 percent of the Great Moderation in U.S. output volatility to “good luck in the form of smaller economic disturbances” rather than improved monetary policy. Subsequent research has likewise tended to downplay the contribution of improved monetary policy, either by lending support to the “good luck” hypothesis or by attributing the Great Moderation to financial innovations, an enhanced “buffer stock” role for manufacturing inventories, an increase in the importance of the service sector relative to that of manufacturing, a change in the age composition of the U.S. population, and other sorts of structural change.

Recent experience has, of course, made it all too evident that prior reports of the passing of macroeconomic instability were premature. According to Todd Clarke, statistics gathered since the outbreak of the subprime crisis reveal “a partial or complete reversal of the Great Moderation in many sections of the U.S. economy.” Clarke himself, in what amounts to the flip side of the Stock-Watson view, characterizes the reversal as a “period of very bad luck,” asserting that “once the crisis subsides . . . improved monetary policy that occurred in years past should ensure that low volatility is the norm.”

Those who believe, in contrast, that “luck” was no less important a factor in the modera-

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tion as it has been in the recent reversal, or who see the subprime crisis itself as a byproduct of irresponsible Fed policy, are unlikely to share Clarke’s optimism.

## FREQUENCY AND DURATION OF RECESSIONS

The conventional business cycle chronology from the National Bureau of Economic Research suggests that contractions have been both substantially less frequent and shorter on average, while expansions have been substantially longer on average, since World War II, than they were prior to the Fed’s establishment.

But differences in data, Christina Romer notes, result in a systematic overstatement of both the frequency and the duration of early contractions compared to modern ones.

Romer arrives at a new set of reference dates that “radically alter one’s view of changes in the duration of contractions and expansions over time.”

According to this new chronology, although contractions were indeed somewhat more frequent before the Fed’s establishment than after World War II (though not, it bears noting, more frequent than in the full Federal Reserve sample period), they were also almost three months shorter on average, and no more severe. Recoveries were also faster, with an average time from trough to previous peak of 7.7 months, as compared to 10.6 months. Allowing for the recent, 18-month-long contraction further strengthens these conclusions.

In comparing pre- and post-Federal Reserve Act business cycles we have again tended to set aside the interwar period, as if allowing for a long interval during which the Fed had

yet to discover its sea legs. Nevertheless, the Fed’s interwar record, and especially its record during the Great Depression, cannot be overlooked altogether in a study purporting to assess its overall performance. And that record was, by most modern accounts, abysmal.

Some economic historians have blamed the Great Depression in the United States on the gold standard rather than on the Fed’s misuse of its discretion, claiming that the Fed had to refrain from further monetary expansion in order to maintain the gold standard. But the Fed entered the Great Depression with very large holdings of excess gold reserves, and still held excess reserves at the time of the national bank holiday, when gold payments were suspended. What’s more, Romer, in a paper with Chang-Tai Hsieh, draws on both statistical and narrative evidence to examine, and ultimately reject, the hypothesis that the Fed was compelled to refrain from expansionary policies out of fear that expansion would provoke a speculative attack on the dollar. Instead, Romer and Hsieh conclude, “the American Great Depression was largely the result of inept policy, not the inevitable consequence of a flawed international monetary system.”

## ALTERNATIVES TO THE FED, PAST AND PRESENT

Our review of the Fed’s performance raises two very distinct questions: Might the United States have done better than to have established the Fed in 1914, and might it do better than to retain it today? While the first question is of interest to economic historians, the second should be of interest to policymakers.

Coming up with alternatives to the Fed today takes some imagination. Assuming that there is no political prospect of restoring a gold standard or other commodity money standard, for the dollar to retain its value some public institution must keep fiat money sufficiently scarce. In this respect at least, our finding that the Fed has failed does not, by itself, indicate that it would be practical to entirely dispense with some sort of public monetary authority. But neither does it indicate that the only avenues for improvement are marginal revisions to Fed operating pro-



cedures or additions to its powers. On the contrary, the Fed's poor record calls for seriously contemplating a genuine change of regime. In particular, it strengthens the case for pre-commitment to a policy rule that would constrain the discretionary powers that the Fed has used so ineffectively. Whether implementing such a new regime should be called "ending the Fed" is an unimportant question about labels.

But the gold standard warrants consideration as an alternative to discretionary central banking. Dismissals of the gold standard as a viable option have often been based on flawed assessments of its past performance. The instability in the U.S. financial system during the pre-Fed period was due to serious flaws in the U.S. bank regulatory system rather than to the gold standard. Indeed, the Federal Reserve Act, which retained the gold standard, was predicated on this view. Canada adhered to a gold standard during the same period, but with a differently regulated banking system it experienced no such instability.

A single nation's return to gold would not, however, reestablish a global currency

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area, and therefore could not be expected to make the relative price of gold as stable as it was under the classical system. To provide considerably greater stability than the present fiat-dollar regime, a revived U.S. gold standard would probably need to be part of a broader international revival.

#### CONCLUSION

Available research does not support the view that the Federal Reserve System has lived up to its original promise. Early in its career, it presided over both the most severe inflation and the most severe (demand-

induced) deflations in post-Civil War U.S. history. Since then, it has tended to err on the side of inflation, allowing the purchasing power of the U.S. dollar to deteriorate considerably. That deterioration has not been compensated for by enhanced stability of real output.

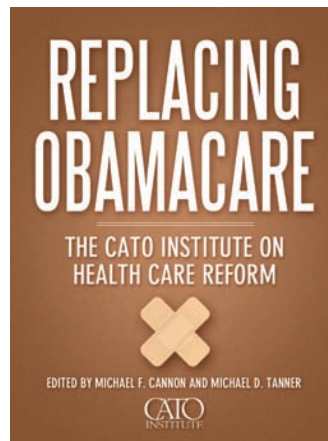
Although some early studies suggested otherwise, recent work suggests that there has been no substantial overall improvement in the volatility of real output since the end of World War II compared to before World War I. While a genuine improvement did occur during the subperiod known as the "Great Moderation," that improvement, besides having been temporary, appears to have been due mainly to factors other than improved monetary policy. Finally, the Fed cannot be credited with having reduced the frequency of banking panics or with having wielded its last-resort lending powers responsibly. In short, the Federal Reserve System, as presently constituted, is no more worthy of being regarded as the last word in monetary management than the National Currency System it replaced almost a century ago. ■

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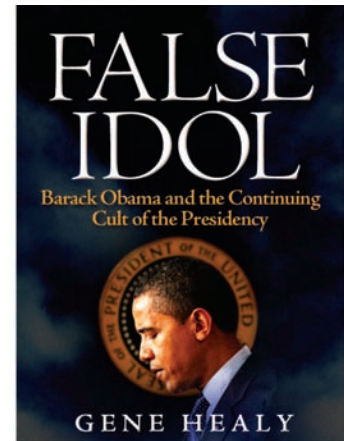
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