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Congressman Ron Paul
Statement for the Record

Although it has taken nearly a century, it seems that the entire spectrum of the American political establishment has finally realized the destructive power of the Federal Reserve System. Whether left, right, or libertarian, politicians are lining up to attack Ben Bernanke and the Fed's destructive monetary policy. Where there is disagreement or lack of understanding, however, is on why the Fed's monetary policy is destructive, how it harms the economy, and what should be done about it. Today's hearing will examine the various proposals that have been put forth both to mend and to end the Fed. It is my hope that this hearing will spur a vigorous and long-lasting discussion about the Fed's problems, a discussion which will lead to concrete actions once and for all to rein in the Fed.

Much confusion exists over what the Federal Reserve System actually is. Some people claim that is a secret cabal of elite bankers, while others claim that it is part of the federal government. In reality it is a bit of both. The Federal Reserve Board is a government agency, while the Federal Reserve Banks are privately-run government-chartered institutions, and monetary policy decisions are made by the Federal Open Market Committee, which has members from both the Board and the Reserve Banks.

The Federal Reserve System is the epitome of crony capitalism. It exemplifies the collusion between big government and big business to profit at the expense of the taxpayers. The Fed's bailout of large banks during the financial crisis propped up poorly-run corporations that should have gone under, giving them an advantage that no other business in the United States would have received. The bailouts continue today, as banks maintain $1.5 trillion worth of excess reserves at the Fed, reserves which were created through the Fed's purchase of worthless securities from banks. The trillions of dollars that the Fed has injected into the system have the goal of forcing down interest rates. But the Fed fails to realize that interest rates are a price, the price of money and credit, and that forcing interest rates down will only create an even bigger bubble and an enormous economic depression when this entire house of cards comes falling down.

The Federal Reserve is statutorily required to focus on three aims when engaged in monetary policy: full employment, stables prices, and moderate long-term interest rates. In practice, only the first two have received any attention, the so-called “dual mandate.” Some reformers have called for the full employment mandate to be repealed, in order to allow the Fed to focus solely on stable prices. But these critics ignore the fact that stable prices are not a desirable goal. After all, with increasing productivity and technological innovation, the natural trend for most goods is for prices to decrease. By calling for the prices of goods to remain stable, the Fed would have to inflate the money supply in order to counteract this trend towards price declines, pumping new money into the system and creating economic distortions. This is exactly what happened during the 1920s, as the Fed's monetary pumping was masked by rising productivity. The result was stable prices, but the malinvestment caused by the Fed's loose monetary policy became evident by 1929. There is no reason to expect that focusing on stable prices today would have a dissimilar outcome.

Other reformers have called for changes to the composition of the Federal Open Market Committee, the body which sets the Fed's monetary policy objectives. On Constitutional grounds, the FOMC is undoubtedly problematic, as government appointees and the heads of the private Federal Reserve Banks work together to set monetary policy objectives that directly impact the strength of the dollar. While all of the members of the FOMC ought to be confirmed by the Senate, debates about the size of the FOMC or whether Reserve Bank Presidents should make up a majority of the members or whether they should even serve at all are largely a sideshow. While the only dissent to monetary policy decisions in recent years has come from Reserve Bank Presidents, there is no reason to think that expanding the FOMC to include more Reserve Bank Presidents would lead to any greater dissent or to any substantive changes to the conduct of monetary policy.

Another proposal for reform is for outright nationalization of the Fed or its functions. No longer would the Fed create money; that function would be taken up by the Treasury, issuing as much money as it sees fit. No longer would the Treasury issue debt to cover fiscal deficits, it would just issue new money to cover budget shortfalls. If what the Fed does now is bad, allowing the Treasury to print and issue money at will would be even worse. These types of proposals hearken back to the days of the first greenbacks, which the U.S. government began issuing in 1863. A pure fiat paper currency, unbacked by silver or gold, the greenbacks were widely reviled. Only once the greenbacks were made redeemable in gold were they accepted by the American people. The current system of Federal Reserve Notes is even worse than the greenback era in that there is no hope that they will ever be redeemable for gold or silver. The only limiting factor is that the Federal Reserve System only creates new money when purchasing assets, normally debt securities. Allowing the federal government to print money without at least a nominal check on the amount issued would inevitably lead to a Weimar-like hyperinflation.

So what then is the solution? The Fed maintains that a paper standard can be adequately managed without causing malinvestment, inflation, or other economic distortions. If the Fed were omniscient and knew the wishes, desires, and future actions of all Americans, this might be possible. But the Fed cannot possibly aggregate or act on the information necessary to engage in monetary policy. The actions of hundreds of millions of individuals, all seeking to better their position in life, acting purposefully towards that aim, cannot possibly be compiled into aggregates or calculated through mathematical equations or econometric models. Neither a single person, nor the members and staff of the FOMC, nor millions of people with millions of computers working in a new Goskomtsen will ever be able to accumulate, analyze, and act upon the information required to create a centrally planned monetary system. Centrally planned fiat paper standards such as the one currently in place in this country are doomed to failure.

This brings us to the question of the gold standard. The era of the classical gold standard was undoubtedly one of the greatest eras in human history. For a period of several decades in the late 19th century, largely uninterrupted by war, the West made enormous advances. Economic productivity increased, art and culture flourished, and living standards rose so that even the poorest citizens lived a life their forebears could have only dreamed of.

But the problem with the gold standard is that it was run by the government, which exercised a monopoly over monetary affairs. The temptation to suspend gold redemption, so often resorted to by governments throughout history, reared its head again with the outbreak of World War I. Once the tie to gold was severed and fiscal restraint thrown to the wind, undoing the damage would have required great fiscal austerity on the part of governments. Emancipated from the shackles of the gold standard, the Western world proceeded to set up a gold-exchange standard which lasted not even a decade before the easy money policies it enabled led to the Great Depression. While returning to the gold standard would certainly be far better than maintaining the current fiat paper system, as long as the government retains the power to go off gold we may end up repeating the same mistakes that occurred from 1934 to 1971 as the government went first off the gold coin standard and finally off the gold bullion exchange standard.

The only viable solution for monetary stability is to get government out of the money business permanently. The way to bring this about is through currency competition: allowing parallel currencies to circulate without any one currency receiving any special recognition or favor from the government. Fiat paper monetary standards throughout history have always collapsed due to their inflationary nature, and our current fiat paper standard will be no different. The Federal Reserve is currently sowing the seeds of its own destruction through its loose and reckless monetary policy. The day of reckoning may still be many years in the future, but given the lack of understanding on the part of the Federal Reserve's decision makers, it is quickly coming upon us.

It is imperative that the American people be educated on the dangers of the Fed and the importance of restoring sound money. Now that nearly 50 years have elapsed since silver was removed from circulation, fewer and fewer Americans have firsthand familiarity with real money. The laying of the groundwork must begin today, so that the American people will be prepared for the day when the mirage the Fed has created evaporates completely.