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Ron Paul and the Fed: how we got to this point

By Louis D. Johnston | 06/06/12

REUTERS/Jonathan Ernst

Rep. Ron Paul held up a silver coin as he questioned Federal Reserve Chairman Ben Bernanke about monetary policy in February.

In his book "End the Fed," Ron Paul asserts that "ending the Fed would address the most vexing problems of politics of our time," including "an end to dollar depreciation" and "ending the business cycle."

Further, he says, "The Federal Reserve should be abolished because it is immoral, unconstitutional, impractical, promotes bad economics, and undermines liberty."

Paul's ideas are at the heart of Kurt Bills's U.S. Senate campaign as well. Though Bills recently backed away from abolishing the Fed immediately (see Eric Black's recent piece) his campaign manager told The Weekly Standard, "We're all Ron Paul fans on economics."

Hamilton vs. Jefferson

Paul's ideas are the latest chapter in an age-old American argument between a more centralized and nationalistic economic policy, identified with Alexander Hamilton, and a decentralized, individualistic policy connected with Thomas Jefferson. In a sense, American monetary history is the result of these contrasting points of view fighting it out over time.

So, here's a quick look at how we got to today's system.

Hamilton and, more generally, the Federalists argued that a strong national government, including a central bank modeled on the Bank of England, was a critical element in economic development. Jefferson and the Democratic-Republicans disagreed with that view, arguing that a decentralized system without a central bank was superior.

The U.S. swung back and forth between these two systems from 1789 to 1913.

Congress gave a 20-year charter to the (first) Bank of the United States in 1791 and then let it die in 1810. Six years later, it created a (second) Bank of the United States with a 20-year charter but then once again killed it.

A period of "Free Banking" lasted from 1837 to 1863. During this time, the federal government issued only coins; paper money consisted of banknotes issued by private banks. These banknotes were backed by the gold, silver and other assets held by the banks. (Art Rolnick and Warren Weber of the Minneapolis Fed did yeomen's work in researching this area.)

The Civil War brought centralization back to the fore.

Congress passed the National Banking Act in 1863 in order to raise funds for the war; specifically, anyone who wanted to set up a national bank had to purchase U.S. bonds, which then allowed the bank to issue banknotes. The banks were required to hold a fraction of their deposits as a reserve but could then lend the rest. Borrowers received their funds through a bank account, from which they could withdraw funds as banknotes. At that point, however, the banknotes of all national banks were identical, except for the inclusion of the issuing bank's name on the note.

Further, a 10 percent tax was levied on privately issued — i.e., non-national-bank — banknotes. The result was that private bank notes disappeared, and for the first time, America had a standardized currency.

But that wasn't the end of the story.

State governments did not want to get cut out of the banking business, so between 1865 and 1913, they offered banks a deal similar to that of the federal government: Buy bonds and you, too, can set up a bank. But, there were two important differences.

First, most states allowed their state-chartered banks to hold lower levels of reserves than national banks. This meant that state banks could lend more money per dollar of deposits than national banks and thus make larger profits per dollar.

Second, since the 10 percent banknote tax made it expensive for state banks to issue their own banknotes, states started experimenting with alternative ways for banks to allow their customers access to their funds.

This is when checking accounts were born. Banks didn't have to issue banknotes, they could simply supply documents that allowed someone to draw on the funds a depositor held in a bank.

Enter the Fed

There was a big problem with this system: Every few years, there was a wave of bank failures across the land. These failures had real economic costs in terms of lost deposits, disrupted loans and, ultimately, deep recessions.

The Federal Reserve was set up to deal with these problems, but the Hamiltonian/Jeffersonian disputes had to be dealt with once again. For instance, should there be a single central bank located in, say, New York? This would make sense, given that New York was the financial center, but didn't this give too much clout to already powerful bankers?

That issue led to a compromise — a system of 12 regional banks, all equal in stature and each with its own board of directors. A Federal Reserve Board, consisting of seven members appointed by the president, was supposed to supervise the regional banks, but the board was not given any powers to carry out this mandate. Thus, instead of a single central bank, we created 12 mini-central banks.

Paul tells a different story about the creation of the Fed.

First, he states that "bank failures are no more to be regretted than any other business failures. They are a normal feature of the free enterprise system." In particular, the possibility of banks collapsing will encourage depositors to be more vigilant about monitoring the banks to which they entrust their money.

Paul then argues that the real reason the Fed was created was to create a central bank that could bail out banks whenever they got into trouble. This short-circuited the natural stabilizing effect of competitive banking and gave the larger banks even more power than before.

What next?

Fear of centralized financial power is at the center of Ron Paul's concerns about the Federal Reserve. Observers on the left side of the political spectrum voice similar fears about banks that wield enormous financial and political influence.

The big questions concern how to deal with these problems: Should we end the Fed? If so, what (if anything) should we put in its place? Should we reform the Fed? If so, what should its goals (or goal) be?

I'll address those questions next week.

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