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Hundred years of the US central bank

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Just two days before Christmas, there was a commemoration of an event, which went largely unnoticed.

December 23, 2013 marked the centennial of the US Federal Reserve.

One hundred years ago, when President Woodrow Wilson signed the bill for creating the Federal Reserve (the Fed), none would have ever imagined how actions of one central bank would affect in the next 100 years, the economies of other countries, big or small, including Pacific island countries.

Evolution of banking in the US was influenced deeply by "the rugged individualism", which typifies every aspect of human behavior in America, including the "right to bear arms", coming in the way of gun control.

Prior to creation of the Fed, there were individually owned banks issuing currency. When they got into trouble, bigger bankers including J.P. Morgan, the Rockefellers and others had to come to rescue them.

As assistance was not coming in full measure, there were many instances of bank failures.

The 1907 bank panic was the severest of the lot.

The US Federal Reserve Act was enacted for setting up the Fed for provision of liquidity to banks, a function known as the lender of last resort.

Soon the testing time for the US Fed arrived. It was the Great Depression of the 1920s which presented big challenges. In fact, the Fed had limited experience, which exposed some of its weaknesses.

Instead of protecting banks by providing liquidity, the Fed allowed them to die. Those banks were considered to be inefficient and were left to collapse.

Quantitative easing

The outgoing Fed chairman Ben Bernanke, who wrote his doctoral dissertation on business cycles, implemented the lessons learnt: bank failures do not always represent inefficiency. They are due to business expectations and market conditions. Pumping in money and lowering interest rates in a sustained manner over a long time should stop bank failures and revive confidence.

Marking the 90th birth day of the monetarist Milton Friedman, Bernanke said:

"Let me end my talk by abusing slightly my status as an official representative of the Federal Reserve. I would like to say to Milton and Anna Schwartz, [Friedman's coauthor]: Regarding the Great Depression. You're right, we did it. We're very sorry. But thanks to you, we won't do it again".

Additions to money supply each month at the rate of US$85 billion since 2010 through bond purchases earned Bernanke the epithet "Helicopter Ben". With conditions improving since November 2013, the Fed announced last month it would start tapering money supply to US$75 billion a month.

Fed's growing influence

Over time since 1913, the Fed with more responsibilities has been controlling credit.

The US since 1913 has grown to become the largest economy of the world, consuming more than two thirds of the world's resources and exporting more than half of the capital of manufactured goods. By becoming the engine of the world's economic growth, every phase of its business cycle, waxing and waning is impacting the world economy.

Quantitative easing has cheapened the US dollar. It pushed down the interest rate in the US. Its funds, seeking higher return, flooded the emerging economies. A tentative hint in May 2013 on likely phasing out of bond purchases rattled the Asian economies, especially India and Indonesia. The reverse flow of funds to the US depreciated their currencies. Only a subsequent announcement by Fed to the contrary assuaged the concerns.

It now looks certain that tapering would eventuate soon.

“End the Fed”

Detractors of the Fed are many. They represent the right wing’s conservatism.

According to Congressman Ron Paul, author of the New York Times 2009 list of best sellers, *End the Fed*, the Fed acts as a cartel. The name of the game is bailout -- or otherwise known as privatized profits but socialized losses. By inflating currency, the Fed has debased the dollar and has put America into a stagflation.

His reaction to the centenary of the Fed is typical:

“One hundred years is long enough. We know that the Fed’s inflationary monetary policy continues to reap profits for Wall Street while impoverishing Main Street."